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Correspondence Memorandum

Date: March 1, 2021
To: Employee Trust Funds Board
From: Steve Hurley, Director, Office of Policy, Privacy, and Compliance
Subject: Revisions to the WRS Funding Policy and Dividend Liability Risk

The Department of Employee Trust Funds (ETF) recommends the Employee Trust Funds Board (Board) approve the attached revised Wisconsin Retirement System (WRS) Funding Policy.

This is a follow up to the [Stress Testing Policy Discussion](#) (Ref. ETF | 12.10.20 | 4C) at the Board meeting on December 10, 2020, in which the Board directed ETF to work with the actuary to address dividend liability risk in the WRS Funding Policy (Policy). Note that Report 20-14, issued by the Wisconsin Legislative Audit Bureau (LAB) in September 2020, provides that ETF should continue to work with the ETF Board to analyze the risks of dividend liability depletion and to develop ways to address the levels of risk identified. The proposed revisions will assist in addressing the recommendations in the LAB Report. ETF and the Board's actuary reviewed the Policy and recommend the Board approve the amendments in the attached draft.

The proposed revisions to the Funding Policy include an added definition of "dividend liability." As a reminder, dividend liability refers to the collective amount of all positive dividends that have been distributed to annuitants. The revised Policy's risk management section contains a new risk category on dividend liability. Monitoring of dividend liability risk is addressed in the Policy by requirements to review dividend liability status and consult with the Board's actuary in biennial stress testing and annual retired lives valuation discussions.

Finally, the attached draft contains a few edits unrelated to dividend liability, including a definition for "assumed rate," and to correct minor text issues that we became aware of as we conducted the review.

Staff will be available at the Board meeting to answer questions.

Attachment: WRS Funding Policy (Redline Version)

Reviewed and approved by Pamela Henning, Assistant Deputy Secretary

Electronically Signed 3/10/21

Board	Mtg Date	Item #
ETF	3.25.21	5B



Funding Policy of the Wisconsin Retirement System

The Wisconsin Retirement System (WRS) is a public trust established under state law as a governmental tax-qualified retirement plan. The funds of the trust can only be used for pension purposes. The WRS is a defined benefit plan, created to aid public employees in protecting themselves and their beneficiaries against the financial hardships of old age, disability, death, illness, and accident. The WRS provides retirement, disability, and death benefits to employees of the State of Wisconsin and employees of local government employers who elect to participate, and Milwaukee Public School District teachers. Employees of the City of Milwaukee and Milwaukee County do not participate in the WRS.

FINANCIAL OBJECTIVE

The main financial objective of the WRS is to fully fund the long-term cost of benefits provided by statute, through disciplined and timely accumulation of sufficient assets to deliver earned benefits on a continuing basis.

FUNDING GUIDELINES

This funding policy seeks to balance three main objectives:

- **Contribution Adequacy** — Contributions and current plan assets must be sufficient to provide for all benefits expected to be paid to members and their beneficiaries when due.
- **Contribution Stability and Predictability** — Contribution volatility must be controlled to the extent reasonably possible, consistent with other policy goals.
- **Inter-Generational Equity** — Costs of benefits should be paid for by the generation that receives the benefits.

FUNDING METHODS AND PRINCIPLES

The following methods and principles, most of which are stipulated by statute, will be used to implement this policy:

- Actuarial Cost Method – [[Wis. Stat. § 40.05\(2\)\(b\)](#)]. Normal cost¹ for the WRS is calculated using the *frozen initial liability* method, modified to adjust the normal cost by the amortization of the Experience Amortization Reserve (EAR)².

¹ “Normal cost” refers the amount of money that must be set aside for future payment of pension benefits that have accrued this year. Normal cost is calculated differently depending on the cost method chosen.

² The EAR is a reserve created in the mid-1980’s by ETF Secretary, Gary Gates, under authority granted in Wis. Stat. § 40.04(1). The EAR helps reduce volatility in contribution rates. It allows an actuarial loss to be absorbed in what would be the unfunded actuarial liability under the entry age actuarial cost method. The resulting liability can then be amortized over an extended period to mitigate the effects of short-term negative experience.

Under the Frozen Initial Liability method as modified, normal costs are determined in the aggregate. The first component of normal cost is equal to a level percentage of payroll, which is determined in the aggregate as the ratio of the present value of future entry age normal costs for all participants divided by the present value of expected future pay for all participants. The second component of normal cost is equal to an amortization of the EAR over a period of years, which is reconsidered with each triennial experience study.

- Asset Smoothing Method – [[Wis. Stat. § 40.04\(3\)](#)]. Asset smoothing reduces volatility in contribution rates by increasing the period over which asset gains and losses are recognized. The WRS's Market Recognition Account (MRA) annually distributes 20% of each year's Core Fund annual gains and losses over/under the ~~a~~Assumed ~~investment~~investment~~R~~Rate. Therefore, the actual market gain or loss experienced in a given year is fully recognized by the Core Fund in five years. The Variable Fund is not smoothed and recognizes actual gains or losses each year.
- Assumed Rate – [[Wis. Stat. § 40.02\(7\)](#)]. The Assumed Rate is the expected rate of return on Core Fund assets. The anticipated rate of investment earnings for the Core Fund is 7%³.
- Assumed Benefit Rate – [[Wis. Stat. § 40.02\(6\)](#)]. The anticipated rate of investment earnings for the Core Fund's annuity reserve is 5%. The ~~A~~Assumed ~~B~~Benefit ~~R~~Rate is used for calculating reserve ~~benefit~~ transfers at the time of retirement.
- Funding Target – The funding objective is to reach and maintain 100% funding measured against the Entry Age Normal Actuarial Cost Method.
- Amortization – [[Wis. Stat. § 40.05\(2\)\(b\)](#)]. For employers who joined the WRS prior to 2009, the entry age unfunded actuarial accrued liability (UAAL) is amortized as a level percentage of payroll over 40 years. UAAL for employers who joined the WRS beginning in 2009 is amortized over 30 years.
- Discount Rate – Active and inactive member liabilities are discounted at the same rate as the ~~A~~Assumed ~~investment~~investment~~R~~Rate. Post-retirement liabilities are discounted using the ~~A~~Assumed ~~B~~Benefit ~~R~~Rate.
- Dividend Liability – Dividend Liability refers to the present value of all previously-granted post-retirement annuity adjustments.

³ Approved by the ETF Board December 13, 2018.

RISK MANAGEMENT

As with all retirement plans, the WRS is subject to risks. These risks include demographic risk, economic risk, benefit risk, and governance risk. Methods for managing and minimizing these risks are outlined here. The Board will periodically engage the Board's actuary to undertake stress testing and scenario testing or review the results of stress and scenario testing performed by the SWIB in order to gain an understanding of the potential effects of major risks that may affect the System.

Demographic Risk: *the possibility that the plan's experience related to retirement patterns, mortality and other demographic factors will not match actuarial assumptions.*

The Board approves actuarial assumptions based on recommendations of the actuary. Regular review of actuarial assumptions is a best practice in the management of demographic risks. Wisconsin law provides that the actuary must make a general investigation at least once every three years of the experience of the WRS relating to mortality, disability, retirement, separation, interest, employee earnings rates, and of any other factors deemed pertinent to the administration of the system. [[Wis. Stat. § 40.03\(5\)\(b\)](#)]. The Board will use the results of the experience studies to adopt assumptions for future valuations. The demographic portion of the experience study will include these principal areas of risk assumption:

- Rates of mortality among participants, retirees, and beneficiaries.
- Rates of withdrawal of active participants.
- Rates of disability among participants.
- Patterns of salary increases to be experienced by participants.
- Age and service distribution of actual retirements.

As noted in the "Funding Methods and Principles" section above, the triennial experience study also investigates the EAR amortization period. The ETF Secretary may, in consultation with the Board's actuary, adjust the operation of the EAR, including the EAR amortization period. For example, if the EAR is underfunded, the amortization period will be set to minimize the amount of negative amortization that would otherwise occur.

Economic Risk: *investment, price inflation, and wage inflation risk.*

Investment Risk relates to market returns differing from actuarial assumptions. Price inflation and wage inflation risks relate to unexpected movements in underlying inflation that will create variation in contribution rates and potential loss of purchasing power for members.

The financial assets that are accumulated to pay the pensions of WRS participants are invested by an independent state entity: the State of Wisconsin Investment Board (SWIB). SWIB is required to prudently invest the assets in a diversified manner to meet funding needs while minimizing the risk of large losses. SWIB establishes asset allocation policies, investment guidelines, and performance benchmarks. SWIB is subject to these additional requirements:

- Annual review of the WRS asset allocation and report to ETF on the market value of the assets of the Core and Variable Funds.
- For any change in investment policies or guidelines provide a summary report to the Joint Legislative Audit Committee, the Joint Committee on Finance, and the chief clerk of each house of the legislature.
- Annual report to Legislature with a description of the Board's annual investment goals and long-term investment strategies; an assessment of the Board's progress in meeting its annual investment goals; information on the types of investments held by the Board, including the market values and degree of risk associated with the investments.

The ETF Board and its consulting actuary will review economic assumptions (for example, long-term rates of investment income likely to be generated by fund assets and wage assumptions) based on recommendations from SWIB and will consider appropriate adjustments to ensure assumptions comport with the WRS asset allocation and the principles of long-term stability and predictability. The review of economic assumptions, including the Assumed Rate, occurs with each experience study (see description under Demographic Risk section). ~~The experience study includes an investigation of the assumed investment return and assumed wage inflation [Wis. Stat. § 40.02(7)]. The current assumed investment rate is 7.0% and the current assumption for wage inflation is 3.0% (both approved by the ETF Board on December 13, 2018).~~

Benefit Risk: *the risk that benefit changes will result in future contributions that are unaffordable.*

The Board and ETF will review legislative proposals and consult with the actuary as appropriate to determine possible impacts on the WRS. If it is determined that a legislative proposal might materially affect plan funding, the Board may recommend to the Joint Survey Committee on Retirement Systems (JSCRS; see description below) that an actuarial valuation be conducted, and ask that the results of the valuation be reflected in JSCRS' written report of the proposed legislation.

Governance Risk: *the risk that the plan's administrative policies and procedures are not fully appropriate for carrying out the functions of the plan.*

Management of governance risk requires sufficient administrative structures for monitoring compliance with this policy and ensuring that actuarially determined contributions are made. Mitigation of governance risk also requires that structures be in place to determine long-term costs of benefit changes before passage of any law that materially affects plan funding. For the WRS, such risk is addressed by the following:

- Joint Survey Committee on Retirement Systems (JSCRS): serves as the legislative oversight committee for all matters relating to proposed statutory changes to state-operated public employee pension plans. Current law prohibits the Legislature from acting on any bill or amendment which would create, modify, or in any way provide for the retirement or payment of pensions to public employees unless the proposal has first been referred to the JSCRS, and the Committee has provided a written report on the bill or amendment.
- Legislative Council: provides legal and research assistance to the JSCRS and may prepare fiscal estimates on bills referred to the JSCRS. The Legislative Council staff must prepare a comparative study of major public employee retirement systems in the U.S. every two years. The Legislative Council is charged under current law with consulting with groups representing participants in the WRS and suggesting to the Joint Legislative Council subjects for study or investigation of public employee retirement issues. Finally, funds may be appropriated to enable the Legislative Council staff to contract for actuarial studies approved by the JSCRS.
- Consulting Actuary to the ETF Board: serves as the technical advisor for the Board and ETF on any matters of an actuarial nature affecting the soundness or operation of the retirement fund. The actuary is required under contract to provide periodic reports, including:
 - *Retired Lives Valuation* - Annual valuation of core and variable fund annuities being paid from the Wisconsin Retirement System. (each March).
 - *Active Lives Valuation* and Gain/Loss Analysis - Annual valuation of liabilities and costs associated with non-retired participants of the Wisconsin Retirement System and analysis of experience among participants. (each June).
 - *Valuation to meet plan and employer disclosure requirements under Governmental Accounting Standards Board Statements 67 and 68.* - (each June).
 - *Three-Year Experience Study.*
- Legislative Audit Bureau (LAB) Oversight of Actuarial Services to the ETF Board: The Legislative Audit Bureau is required by Wis. Stat. § 13.94(1)(dc) to contract for the performance of an actuarial audit of the WRS at least once every five

years. The purpose of the audit is to review the actuarial methods, assumptions and procedures employed by the WRS. LAB also performs an annual financial audit of ETF to ensure that ETF's financial statements and internal controls are in compliance with applicable statutes, policies, and guidelines. The LAB also conducts an annual audit of SWIB to ensure that their financial statements and internal controls comply with applicable statutes, policies, and guidelines.

- Ensuring contributions are made: WRS contributions are required to be made under Wis. Stat. § 40.05(1) and (2), according to the assumption the actuary recommends and that the Board approves.
- Determination of long-term costs: The consulting actuary periodically produces a 50-year projection study that uses stochastic projections that compares future benefits with future contributions against a range of investment returns. The Board will use the results of this and other such studies to make recommendations to JSCRS when relevant and appropriate to any proposed legislation.
- Funding Policy Review: This WRS Funding Policy will, at a minimum, be formally reviewed by the ETF Board in conjunction with each three-year experience study.

Dividend Liability Risk: *the risk that the Dividend Liability will decrease to a very low level.*

While it is considered normal for the level of Dividend Liability to fluctuate with annual investment return gains and losses, it is of concern if the Dividend Liability level becomes very low. When the Dividend Liability is very low, the effect of future adverse investment experience can potentially have a magnified effect on contribution rates. At zero, all annuities would be at their base "guaranteed floor" levels, and would have no inflation protection. To monitor Dividend Liability risk, the Board and ETF will review Dividend Liability levels and consult with the actuary at a minimum, as a part of the biennial Stress Testing and the annual Retired Lives Valuation discussions.

Risk Measures

Risk measures allow the quantification of the risks in this policy. Risk measures will be included in annual valuation reports in accordance with actuarial standards of practice and also investigated whenever evaluating legislative proposals. Many risk sharing features inherent in the WRS plan design mitigate some of the items below. Examples of risk measures include:

- Funded Ratio (Assets/Accrued Liabilities): The funded ratio is the most widely known measure of a plan's financial strength, but the trend in the funded ratio is much more important than the absolute ratio. The funded ratio should trend to 100%. As it approaches 100%, it is important to re-evaluate the level of

investment risk in the portfolio and potentially to re-evaluate the Assumed Rate of return.

- Total unfunded actuarial accrued liabilities as a percentage of total payroll: Gives an indication of the plan sponsor's ability to pay off the unfunded liability. A ratio above approximately 300% or 400% may indicate difficulty in discharging the unfunded liability within a reasonable time frame.
- Annuitant Liabilities as a Percentage of Total Accrued Liabilities: Gives an indication of the maturity of the system. As the ratio increases, cash flow needs increase, and the investment policy may need to change. A ratio on the order of 50% indicates a maturing system.
- Other Measures: Other measures as deemed appropriate by the Actuary and the Board consistent with Actuarial Standards of Practice are included in the annual valuations of the retirement system.