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CORRESPONDENCE MEMORANDUM

DATE: June 2, 2014

TO: Employee Trust Funds Board
Teachers Retirement Board
Wisconsin Retirement Board

FROM: Steve Hurley, Director, Office of Policy, Privacy and Compliance

SUBJECT: Pension Funding Policy

Staff recommends the Employee Trust Funds Board (Board) direct the Department of Employee Trust Funds (ETF) to draft a WRS funding policy for discussion at a future board meeting.

BACKGROUND

The Wisconsin Retirement System (WRS) continues to be a stable and well-funded plan.[1] Its cost-sharing and risk-sharing features have allowed the WRS to withstand the unprecedented market losses in 2008 without significant increases in contribution rates. Even though the WRS is on sound financial footing, it is good practice to periodically review and to better understand the underpinnings of WRS funding.

As a starting point, the ETF Board may wish to direct ETF staff to work with the Board's consulting actuary to draft a formal WRS funding policy for the Board's discussion and approval at a future meeting. A public pension plan funding policy usually exists partly in statutes and is supplemented by policies maintained by the retirement system governing body.[2] A funding policy summarizes the objectives of the pension plan and the actuarial methods or other mechanisms used to achieve those objectives. For the WRS, a funding policy would provide in a single document the plan's current statutory funding policy as well as the principles, objectives, assumptions, and methods previously adopted by the Boards. Some of this information is expressed in various places in the system's actuarial reports.

[1] Morningstar, an independent global investment research firm, published *The State of State Pension Plans 2013: A Deep Dive into Shortfalls and Surpluses*. For the second consecutive year, Morningstar found that the WRS's funded ratio of 99.9% is the strongest in the nation.
[2] Benefits Magazine: Public Pension Funding - 101 Key Terms and Concepts, Keith Brainard, April 2013.

Reviewed and approved by Robert J. Conlin, Secretary

Electronically Signed 6/9/14

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JM	6.26.14	3B
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The establishment of a formal funding policy has been a frequent topic in publications from actuarial and public pension plan organizations. The American Academy of Actuaries (AAA)[3], the Conference of Consulting Actuaries Public Plans Community (CCA PPC)[4], and the Society of Actuaries (SOA)[5] recently released pension plan funding guidance that recommends public pension plans establish a formal funding policy. In addition, the Government Finance Officers Association (GFOA) recommends that every state and local government plan that offers a defined benefit pension adopt a formal funding policy that provides reasonable assurance that the cost of benefits will be funded in an equitable and sustainable manner.[6] In 2013, the Pension Funding Task Force (a collaborative effort of eleven national public sector organizations) published pension funding guidelines for elected officials that emphasize the importance of documenting and complying with a funding policy.[7]

These recommendations are most likely in response to the decision of the Government Accounting Standards Board (GASB) to "disconnect" pension accounting from pension funding determinations, including the elimination of the annual required contribution (ARC).[8] The elimination of the ARC for accounting purposes is an opportunity to discuss WRS funding policy. However, there are other good reasons to develop a funding policy. These include clarification of objectives, better identification of risks, development of potential responses to contingencies, improved transparency, and stakeholder education.

Other public pension systems with defined benefit plans have created, or are in the process of creating, formal funding policies; attached to this memorandum is one example. (See Attachment A).

GENERAL GOALS OF A FUNDING POLICY

It is commonly stated in the publications that a funding policy should communicate how it will balance, over the long term, three main objectives:

- Benefit Adequacy - Future contributions and current plan assets should be sufficient to provide for all benefits expected to be paid to members and their beneficiaries when due.
- Contribution Stability and Predictability - The funding policy should seek to manage and control future contribution volatility, to the extent reasonably possible, and consistent with other policy goals.
- Inter-Generational Equity – Costs of benefits should be paid for by the generation that receives the services.

[3] AAA Issue Brief: Objectives and Principles for Funding Public Sector Pension Plans, February 2014.
[4] CCA PPC Discussion Draft: Actuarial Funding Policies and Practices for Public Pension and OPEB Plans, February 2014.
[5] SOA: Report of the Blue Ribbon Panel on Public Pension Plan Funding, February 2014.
[6] GFOA: Core Elements of a Pension Funding Policy, 2013.
[7] Pension Funding Task Force: Pension Funding: A Guide for Elected Officials, 2013.
[8] Joint Meeting Agenda Item: Update on Governmental Accounting Standards Board (GASB) Rule 67 and 68, September 26, 2013.

PRINCIPLE ELEMENTS OF A FUNDING POLICY[9]

- Actuarial Cost Method
- Asset Valuation Method
- Amortization Method
- Assumption Changes
- Benefit Changes
- Discount Rate
- Funding Target
- Overfunding Situations
- Responding to Investment Experience
- Risk Management
- Governance

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

Attachment A: Funding Policy of the Illinois Municipal Retirement Fund

[9] GRS Research Report: Developing a Pension Funding Policy for State and Local Governments, January 25, 2012.

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Funding Policy of the Illinois Municipal Retirement Fund

Background

The fundamental financial objective of a public employee defined benefit pension plan is to fund the long-term cost of benefits promised to the plan participants. In order to assure that pension benefits will remain sustainable, the governmental plan sponsor should accumulate adequate resources for future benefit payments in a systematic and disciplined manner during the active service life of the benefitting employees. In pursuit of this objective, the Illinois Municipal Retirement Fund (IMRF) has adopted a funding policy targeting a 100 percent funded ratio.

IMRF believes that its funding policy and its implementation meets the recently released draft "Pension Funding Policy Guidelines" for state and local governments which address the following general policy objectives:

- Ensure pension funding plans are based on actuarially determined contributions
- Build funding discipline into the policy to ensure promised benefits can be paid
- Maintain intergenerational equity so the cost of employee benefits is paid by the generation of taxpayers who receive services
- Make employer costs a consistent percentage of payroll
- Require clear reporting to show how and when pension plans will be adequately funded

Implementation of Funding Policy

In order to actualize the aforementioned funding policy, the IMRF Board will set employer contribution rates required to fully fund promised benefits utilizing the following principles:

1. An actuarially determined annual required contribution expressed as a percentage of payroll will be calculated which will include a factor for normal cost for current service for each eligible plan and tier based upon the benefit provisions in the Illinois Pension Code and a factor to collect or refund any under or over funded amount.
2. Annual employer contributions will be calculated utilizing the annual required contribution rate.

3. In situations where the annual contributions based upon the annual required contribution rate times employer payroll are insufficient to reduce an unfunded liability, a minimum contribution will be calculated which will pay down the unfunded liability over a closed 20 year period.
4. Normal cost will be calculated using the entry age normal level percentage of payroll actuarial cost method utilizing the following:
    a. Economic assumptions based upon the latest applicable triennial experience study. The current economic assumptions are as follows:
        i. Investment rate of return – 7.5%
        ii. Assumed wage inflation rate – 4%
    b. Non-economic assumptions based upon the latest applicable triennial experience study including the following:
        i. Rates of quitting among actives
        ii. Rates of disability among actives
        iii. Patterns of merit and longevity increases among actives
        iv. Rates of retirements
        v. Rates of mortality
5. Amortization of under or over funded status will be determined based upon the following:
    a. Actuarial assets will be determined using a five-year smooth market related basis with a 20% corridor
    b. Amortization will be based on a level percentage of payroll
    c. The amortization period for taxing bodies will be a closed 29 years until it reaches 15 years at which time it will switch to a 15 year open period
    d. The amortization period for non-taxing bodies will be a 10 year open period
6. IMRF will annually furnish employers information on the annual required contributions and the actual contributions received and a schedule of funding progress based on the above actuarial principles and assumptions.

All aspects of the funding policy and the individual factors in the calculation of the employer contribution rate which is the resultant of the above process are subject to the review and approval of the IMRF Board of Trustees and are subject to change if deemed appropriate and in the best interests of IMRF sponsors and participants.

Adopted by the IMRF Board of Trustees on December 21, 2012