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CORRESPONDENCE MEMORANDUM

DATE: September 3, 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 continue developing a Wisconsin Retirement System (WRS) funding policy for discussion and approval at a future board meeting.

BACKGROUND

On June 26, 2014, the Board directed ETF to draft a WRS funding policy for discussion at a future board meeting (Attachment A). Accordingly, ETF has provided a working draft of such a funding policy (Attachment B).

The attached draft funding policy summarizes the financial objectives of the WRS and the actuarial methods, and other mechanisms, used to achieve those objectives. Funding policy for the WRS exists primarily in statutes, but there are areas of policy that may be defined by the Board--the most important of which is the WRS funding target. Other areas for Board consideration and possible inclusion in the final policy relate to special actions to be taken in certain situations, such as if the plan becomes fully funded, or if post-retirement annuity dividends were to be depleted. These items could be presented at a future meeting.

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

Attachment A: Board Memorandum, June 2, 2014, *Pension Funding Policy*
Attachment B: Working Draft, WRS Funding Policy

Reviewed and approved by Pamela Henning, Assistant Deputy Secretary
Pamela L Henning
Electronically Signed: 9/11/14

Board	Mtg Date	Item #
JM	9.25.14	4
ETF	9.25.14	4D

ATTACHMENT A

STATE OF WISCONSIN
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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

Board	Mtg Date	Item #
JM	6.26.14	3B
ETF	6.26.14	4D

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.

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[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.

ATTACHMENT B

September 3, 2014

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:

- **Benefit 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:

1. Actuarial Cost Method **–** [Wis. Stat. § 40.05 (2) (b)]. Normal cost[1] 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 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, set by Board policy. The standard amortization period is currently 20 years and is reconsidered as part of each triennial experience study.

2. Asset Smoothing Method – [Wis. Stat. § 40.04(3)]. Asset smoothing reduces volatility in contribution rates by increasing the period over which gains and losses are recognized. The WRS's Market Recognition Account (MRA) annually distributes 20% of the Core Fund annual gains and losses. 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.

3. Investment Return Assumption **–** [Wis. Stat. § 40.02(7)]. The assumed rate for plan assets is 7.2%. (Recommended by the actuary and approved by the ETF Board on March 10, 2011, effective as of plan year 2012).

4. Assumed Benefit Rate – [Wis. Stat. § 40.02(6)]. The anticipated rate of investment earnings for the Core Fund's annuity reserve is 5%. Post-retirement liabilities are discounted using the assumed benefit rate.

5. Assumed Wage Inflation – [Wis. Stat. § 40.02(7)]. Wage inflation is assumed to be 3.2%. (Recommended by the actuary and approved by the ETF Board on March 10, 2011, effective as of plan year 2012).

6. Funding Target - The funding objective is to reach and maintain 100% funding.

7. Amortization – [Wis. Stat. § 40.05(2)(b)]. For employers who joined the WRS prior to 2009, unfunded actuarial accrued liability (UAAL) is amortized as a level percentage of payroll over 40 years[3]. UAAL for employers who joined the WRS beginning in 2009 is amortized over 30 years.

8. Cost Sharing – Asset losses are shared by active employees (increased contributions), employers (increased contributions), and annuitants (reduced dividends).

9. Surplus – [Wis. Stat. § 40.27(2)]. Surplus in the core annuity reserve shall be distributed by the Board if the distribution will result in at least a 0.5 percent increase in the amount of annuities in force (except as otherwise provided by the Department by rule, on recommendation of the actuary). In regard to active employees and employers, surpluses are used to lower contribution rates.

[3] As of 2013, the remaining amortization period for this frozen initial unfunded liability is 16 years.

10. Deficit – [Wis. Stat. § 40.27(2)(c)]. Annuity reserve surplus distributions may be revoked by the Board in part or in total as to future payments, upon recommendation of the actuary if a deficit occurs in the core annuity reserves and such deficit would result in a 0.5 percent or greater decrease in the amount of annuities in force (except as otherwise provided by the Department by rule).

RISK MANAGEMENT

As with all retirement plans, the WRS is subject to risks. These risks include demographic risk, investment risk, benefit risk, and governance risk. Methods for managing and minimizing these risks are outlined here.

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 pertinent to the administration of the system. 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.

The Board will use the results of the experience studies to determine whether or not the Board will approve modification of the assumptions for future valuations.

Investment Risk *(the risk that market returns will not meet actuarial expectations or that volatility of the returns will create variation in contribution rates and difficulties for participating employers to set budgets).*

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 the ETF Board 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.

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 will recommend to the Joint Survey Committee on Retirement Systems (JSCRS) that an actuarial valuation be conducted, and 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 any law is passed. For the WRS, such risk is addressed by the following:

- <u>Consulting Actuary to the ETF Board</u>: 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* - Annual valuation of liabilities and costs associated with non-retired participants of the Wisconsin Retirement System. (each June).
    - *Annual Gain/Loss Analysis of Experience among Active Members* – (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. The LAB also conducts an annual audit of SWIB to ensure that their financial statements and internal controls are in compliance 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.

Risk Measures

Risk measures allow for the quantification of the risks in this policy. The following risk measures will be annually determined to provide quantifiable measurements of risk as it applies to the retirement system:

1) Funded Ratio
    - (assets / accrued liabilities)
2) Total unfunded actuarial accrued liabilities as a percentage of total payroll
    - Measures the risk associated with contribution decreases relative impact on the ability to fund the UAAL. A decrease in this measure indicates a decrease in contribution risk.
3) Dividend Ratio
    - (dividend liabilities as a % of total retiree (core fund) liabilities)
4) Total assets as a percentage of total payroll
    - Measures the risk associated with the ability to respond to asset experience through adjustments in contributions. A decrease in this measure indicates a decrease in asset risk.
5) Total actuarial accrued liabilities as a percentage of total payroll
    - Measures the risk associated with the ability to respond to liability experience through adjustments in contributions. A decrease in this measure indicates a decrease in experience risk.
6) Portfolio standard deviation of return times Item 4 (Total assets as a percentage of total payroll)
    - Measures asset risk associated with varying investment return
7) Portfolio standard deviation of return times Item 5 (Total actuarial accrued liabilities as a percentage of total payroll)
    - Measures liability risk associated with varying investment return