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CORRESPONDENCE MEMORANDUM

DATE: November 10, 2014

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

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

SUBJECT: Funding Policy for the Wisconsin Retirement System (WRS)

Staff recommends the Employee Trust Funds Board (Board) approve the attached WRS funding policy.

The attached funding policy summarizes the financial objective of the WRS, the actuarial methods or other mechanisms used to achieve that objective and how risks will be managed and measured. At the June meeting, the Board directed the Department of Employee Trust Funds (ETF) to draft a funding policy for discussion at a future board meeting.¹ At the September Board meeting, ETF received feedback on its working draft, and the Board directed ETF to continue working on the document.²

The final policy is substantially similar to the working draft presented in September. The document was reviewed by the Board's actuary. It is presented here in two forms for easier reading: the first is a redline version (Attachment A) that indicates edits made to the working draft the Board reviewed in September; the second is a final, clean version (Attachment B).

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

Attachment A: Funding Policy (Redline version reflects edits to September 3 draft).
Attachment B: WRS Funding Policy (Final draft).

¹ [Board Memorandum, June 2, 2014, Pension Funding Policy](#)

² [Board Memorandum, September 3, 2014, Pension Funding Policy](#)

Reviewed and approved by Pamela Henning, Assistant Deputy Secretary

Electronically Signed 11/25/14

Board	Mtg Date	Item #
JM	12.11.14	5D
ETF	12.11.14	4E

September 2 ~~November 10~~, 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 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 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 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).~~
- ~~4.3. 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).~~
- ~~6.4. Funding Target - The funding objective is to reach and maintain 100% funding.~~
5. 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 years³. UAAL for employers who joined the WRS beginning in 2009 is amortized over 30 years.
- ~~7.6. Discount Rate – Active and inactive member liabilities are discounted at the same rate as the investment return rate. Post-retirement liabilities are discounted using the assumed benefit rate.~~
- ~~8.7. Cost Sharing – Asset losses are shared by active employees (increased contributions), employers (increased contributions), and annuitants (reduced dividends).~~

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

9-8. 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.

10-9. 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~~economic 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.

~~In addition, the experience study explores assumed investment return and assumed wage inflation [[Wis. Stat. § 40.02\(7\)](#)].~~

~~As noted in item 1) in the “Funding Methods and Principles” section above, the triennial experience study also investigates the EAR amortization period, according to the policy set forth below:~~

- ~~• The standard period is set at 20 years.~~
- ~~• The standard period is reconsidered as part of each triennial experience study.~~

- Temporary interim changes in the period are made as part of the annual active lives valuation report, based on recommendation of the actuary, only when there are large, but mostly offsetting market gains and losses known to be flowing through the MRA that would otherwise result in contribution rate volatility. Large changes would be defined as those which, over a 2-year period, were expected to result in contribution rate changes of at least 0.4% of payroll.
- The minimum and maximum EAR amortization periods are 10 years and 30 years respectively.
- The amortization policy will be applied in the same manner to market gains and losses flowing through the MRA.

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 Economic Risk (~~*the investment, price inflation and wage inflation risk*~~) ~~*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).*~~

Investment Risk relates to market returns not meeting actuarial expectations or that volatility of the returns will create variation in contribution rates and difficulties for participating employers to set budgets. 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 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. The review of economic assumptions 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 rate for plan assets (investment return rate) is 7.2% and the current assumption for wage inflation is 3.2% (both approved by the ETF Board on March 10, 2011).

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-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 is passed. 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* - 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. 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 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 the quantification of the risks in this policy. The following measures will be included in annual valuation reports and also investigated whenever evaluating legislative proposals. All liability measurements will reflect the Entry Age Normal Cost method, and asset measurements will reflect both the MRA and the market value of assets.:

- 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



Funding Policy of the Wisconsin Retirement System

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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. Assumed Benefit Rate – [[Wis. Stat. § 40.02\(6\)](#)]. The anticipated rate of investment earnings for the Core Fund's annuity reserve is 5%.
4. Funding Target - The funding objective is to reach and maintain 100% funding.
5. 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 years³. UAAL for employers who joined the WRS beginning in 2009 is amortized over 30 years.
6. Discount Rate – Active and inactive member liabilities are discounted at the same rate as the investment return rate. Post-retirement liabilities are discounted using the assumed benefit rate.
7. Cost Sharing – Asset losses are shared by active employees (increased contributions), employers (increased contributions), and annuitants (reduced dividends).
8. 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.
9. 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).

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

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.

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.

As noted in item 1) in the "Funding Methods and Principles" section above, the triennial experience study also investigates the EAR amortization period, according to the policy set forth below:

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- The amortization policy will be applied in the same manner to market gains and losses flowing through the MRA.

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.

Economic Risk (*investment, price inflation and wage inflation risk*)

Investment Risk relates to market returns not meeting actuarial expectations or that volatility of the returns will create variation in contribution rates and difficulties for participating employers to set budgets. Price inflation and wage inflation risks relate to

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- 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. The review of economic assumptions 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 rate for plan assets (investment return rate) is 7.2% and the current assumption for wage inflation is 3.2% (both approved by the ETF Board on March 10, 2011).

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.

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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 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.

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