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CORRESPONDENCE MEMORANDUM

DATE: September 18, 2012

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

FROM: Steve Hurley, Director, Office of Policy, Privacy and Compliance
Bob Willett, Director, Office of Trust Finance & Data Analysis

SUBJECT: Annuity Adjustment Update

This memorandum is for discussion purposes. No Board action is required.

This memorandum is a follow-up to the Board's discussion of the annuity adjustment projections presented by the Department at the Joint Informational meeting in March.

ANNUITY ADJUSTMENTS FOR 2013

Wisconsin Retirement System (WRS) retirees will likely see significant reductions in their Core Fund annuity dividends next year. Core Fund gains and losses are recognized over a five-year period. The anticipated negative adjustments for 2013 would mark the fifth and final year of annuity reductions originating from an unprecedented $21 billion investment decline in 2008. As a result of annuity reductions over the past several years, many annuities have been reduced to their original, guaranteed amounts (their "floor"), as previously distributed dividends have been recovered. Currently, all annuities since approximately 2004 are at their floor. This has left a smaller pool of annuities still above the guaranteed floor from which further reductions may be made in 2013, which unfortunately increases the proportional amount of the reductions for these annuitants. If investment performance meets expectations, annuity adjustments may once again be positive in 2014.

CURRENT LAW REGARDING ANNUITY ADJUSTMENTS

Annuity adjustments are addressed in Wisconsin statutes and Employee Trust Funds (ETF) administrative rules. By law, the WRS is a cost-sharing system and does not provide a cost of living allowance (commonly called a "COLA") to retirees. Annual

Reviewed and approved by Robert Marchant, Deputy Secretary

Signature _______ Date 9-18-12

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investment performance dictates whether there are funds available to provide retirees with annuity dividends over their initial annuities. Therefore, annuity adjustments can be positive or negative.

Positive Adjustments to Annuities

Under Wis. Stat. § 40.27(2)[1], surpluses in the Core Fund annuity reserve *must be distributed by the ETF Board* if there would be at least a 0.5% increase in the amount of annuities in force, except as otherwise provided by the Department by rule, on recommendation of the actuary. Administrative rule ETF 20.25(1)(a) provides that the increase is based on a valuation of the annuity reserve each December 31. If the valuation indicates a surplus, a dividend is payable effective April 1 (which is applied to May 1 annuity payments) following the valuation; it is applicable to all Core Fund annuities that were in force on or prior to the date of the valuation.

Negative Adjustments to Annuities

Under Wis. Stat. § 40.27(2)(c)[2], intended future payments of previously-granted annuity reserve surplus distributions *may be revoked in part or in whole by the ETF Board* on recommendation of the actuary if there is a deficit in the Core Fund annuity reserve and the deficit would result in a 0.5% or greater decrease in the amount of annuities in force, except as otherwise provided by the Department by rule. 40.27(2) differs regarding positive and negative adjustments. It mandates that the Board distribute surpluses that meet the statutory criteria, while the paragraph regarding negative adjustments is permissive. However, the ETF Board's discretion is tied to their role as trustees. The Board's decision to revoke or not revoke previous dividends is made as fiduciaries of the public trust fund and in light of the consequences to all those with a beneficial interest in the fund.

POWERS AND DUTIES

Unlike non-governmental plans, in which plan provisions are set out in a plan document, the plan provisions of the WRS reside in Wisconsin law. Any approach for addressing plan design issues is guided and limited by ETF's and the Board's legally-defined roles. It is well-established law that, like all other administrative agencies, the Board and ETF only have the powers that are expressly conferred upon them by the statutes under

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[1] 40.27(2) CORE ANNUITY RESERVE SURPLUS DISTRIBUTIONS. Surpluses in the core annuity reserve established under s. 40.04 (6) and (7) 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, as follows: ...

[2] 40.27(2)(c) The distributions shall not be offset against any other benefit being received but shall be paid in full, nor shall any other benefit being received be reduced by the distributions. The annuity reserve surplus distributions authorized under this subsection 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.

which they operate, plus any powers necessarily implied from those statutes.[3] Courts generally strictly construe an agency's enabling statute and resolve any reasonable doubt about implied powers against the agency.[4] Note, however, that when it comes to accomplishing the fundamental purposes of the public employee trust fund, the statutes call for a liberal interpretation of any statute relating to the fund.[5]

The ETF Board and ETF are created and governed by Chapters 15 and 40 of the Wisconsin Statutes. The principal duty of ETF is to administer the Chapter 40 benefit plans to ensure that the right person is paid for the correct benefit in a timely manner. The ETF Board's powers and duties are regulatory, advisory, and policy-making. There is no provision stating that the Board or ETF is responsible for creating structural changes to the retirement system.

However, as plan trustees and fiduciaries, the ETF Board and the ETF Secretary must exercise diligence and prudence in relation to the plan. There is significant responsibility for making recommendations, when warranted, to the legislature and to others who are responsible for the laws that create and maintain the WRS. Typically, retirement plan issues have been taken up by Legislative Council staff and the Joint Survey Committee on Retirement Systems. Under Wis. Stat. § 13.91(1)(d):

> **(1)** DUTIES OF THE STAFF. The legislative council staff shall:
>
> ...
>
> **(d)** Provide staff services to assist the legislature in identifying and responding to issues relating to the Wisconsin Retirement System. In the performance of these duties, the legislative council staff shall:
>
> **1.** Provide legal and research staff services to the joint survey committee on retirement systems under s. 13.50.
>
> **2.** Prepare fiscal estimates on bills referred to the joint survey committee on retirement systems.
>
> **3.** Facilitate communication between the legislature and participants in the Wisconsin Retirement System on issues relating to public employee retirement systems.
>
> **4.** Every 2 years, prepare a comparative study of major public employee retirement systems in the United States.
>
> **5.** In consultation with groups representing participants in the Wisconsin Retirement System, suggest to the cochairpersons of the joint legislative council any feasible subjects for study or investigation of public employee retirement issues with respect to which committees may be appointed under s. 13.82.

The legislature has an appropriation under Wis. Stat. § 20.765(3)(ec) for conducting actuarial studies of the WRS:

> **20.765 Legislature.** There is appropriated to the legislature for the following programs:

[3] *Wisconsin Builders Association v. Wisconsin Department of Transportation,* 285 Wis.2d 472, 702 N.W.2d 433, 438 (Ct. App. 2005).
[4] *Wisconsin Citizens Concerned for Cranes and Doves v. Wisconsin Dept. of Natural Resources,* 270 Wis.2d 318, 335, 677 N.W.2d 612, 620 (2004).
[5] Wis. Stat. § 40.01(2) ... All statutes relating to the fund shall be construed liberally in furtherance of the purposes set forth in this section.

...

(3) SERVICE AGENCIES AND NATIONAL ASSOCIATIONS.

...

(ec) *Joint legislative council; contractual studies.* For the joint legislative council, biennially, the amounts in the schedule for actuarial studies contracted and approved by the joint survey committee on retirement systems and for actuarial opinions ordered under s. 13.50 (6) (am).

POST-RETIREMENT ANNUITY ADJUSTMENT OPTIONS

WRS assets experienced unprecedented investment declines in 2008 and never before seen negative annual adjustments in the Core Fund. Post-retirement annuity adjustments have been a major focus of discussion for Department staff since 2008 and the Department has worked vigorously to communicate with members about the current laws governing the annuity adjustment process and the possibility of consecutive years of negative Core Fund adjustments. ETF has recently received ideas from affected retirees for mitigating the expected negative Core Fund annuity adjustment for 2013. Suggestions include: run a deficit in the annuity reserve; use supplemental money from General Purpose Revenue (GPR); increase employer contributions to cover losses; give those retirees with previously reduced annuities the first rounds of any positive adjustments in later years; and eliminate the WRS guaranteed floor for annuities. These options all have significant consequences.

Allow a Deficit in the Annuity Reserve in Lieu of Negative Adjustments

While permitting a deficit in the annuity reserve appears to be discretionary for the ETF Board under 40.27(2)(c), there are potentially serious fiduciary issues related to the exercise of this discretion for the purpose of preventing negative Core Fund annuity adjustments. Intentionally allowing a significant deficit in the annuity reserve would potentially require enacting legislation and promulgating new administrative rules in early 2013. In addition, it is clear that something more refined than a simple deficit is in order because just allowing the annuity reserve to carry a deficit would likely create new inequities by transferring the deficit to future retirees and others. Retirees who have already seen their annuities reduced to their floor would not be helped by action in 2013, yet they would share in repaying the annuity reserve deficit because they would not receive positive dividends until the deficit was eliminated. Depending on market behavior, future dividends for those who have not yet retired could be affected. An intentional deficit in the annuity reserve would result in an overall lower funding ratio in the trust fund. The funding ratio is often cited as a key indication of the strength of the WRS.

Add Money to the System

- Increase Employer Contributions: An increase in employer contributions would not affect the expected negative annuity adjustment for 2013 nor would it address post-retirement adjustments in later years. Employer (and employee) contributions occur during a member's active employment. An increase in contributions now would result in higher initial pension benefits for future annuitants. Current annuitants, whose pensions were funded by contributions while employed, would not be helped. A retiree whose employer provided higher contributions while the member was employed would still be subject to post-retirement annuity adjustments according to investment performance.

- Supplements from GPR: Although there is an appropriation under Wis. Stat. § 20.515 to pay annuity supplements and payments, there are very few cases where amounts have been paid to annuitants from GPR. There is no history of money being used from GPR to deflect the impact of negative annuity adjustments.

Those Whose Annuities Have Been Reduced Receive Positive Dividends First

Some have suggested that those whose annuities have received the greatest reductions have suffered the most financial harm and that, therefore, when positive dividends become available, such gains should be distributed only to those who have received the greatest reductions in the past few years. Such distribution of dividends fundamentally changes the role of post-retirement annuity adjustments in the WRS from a risk-sharing element to an inflation-protection measure.[6] Under such a plan, risk would be shared unequally by different segments of the annuitant population. It would be difficult to implement over periods of multiple negative adjustments. Finally, newer retirees would likely argue that their earned share of gains from their contributions in the annuity reserve is being taken from them to subsidize an unearned benefit for another retiree.

Remove the Guaranteed Floor for Annuities

One suggestion was that it would be more equitable to remove the guaranteed floor provisions for the WRS. Removal of the guaranteed benefit transforms the WRS from a defined benefit plan into a type of defined contribution plan and represents a costly change that would have many undesirable consequences, including possible reductions in overall levels of benefits. Even if it were determined that removal of the guaranteed floor was warranted, it could only be accomplished for new employees and therefore would not change the post retirement annuity adjustments for existing retirees.

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[6] Historically, the WRS has been able to avoid large swings in contribution rates and sustain high funding levels due to its cost and risk-sharing features. WRS members bear approximately 75% of the risk associated with the Core Fund. Taxpayers bear 25% of the risk for the Core Fund. *See Study of the Wisconsin Retirement System, June 2012.*

OTHER CONSIDERATIONS

In the early 2000s, the legislature transitioned the WRS between two smoothing mechanisms. The Transaction Amortization Account (TAA) was phased out and replaced by the Market Recognition Account (MRA). The TAA was a "buffer" account where market gains and losses were recorded to smooth fixed trust earnings. The TAA tended to distribute funds slowly, over about 15 years. The newer MRA provides for 5-year smoothing of all gains and loss, which is a much faster recognition of gains and losses than occurred with the TAA.

One of the reasons given for changing from the TAA to the MRA was that annuitants in the system would reap the benefits of good investment performance more quickly, rather than having the increases spread out over a longer period of time. No one could have predicted the financial markets of 2008 and the volatility of the years following. However, we are now seeing the results of this change to the WRS. The public policy goal underlying the MRA is another good reason for careful consideration of any changes to the structure of the system.

CONCLUSIONS AND NEXT STEPS

The "Great Recession" has taken a toll on the economy and WRS annuitants. However, when we look at the structure and the design of the WRS, it appears to be performing exactly the way it was designed. Issues of plan design are generally the jurisdiction of the legislature. The expected negative adjustments in 2013 present a complex issue. Short-term changes carry unique risks and funding problems. Because of the high potential for reducing funding levels and creating other inequities, any contemplated changes must be studied thoroughly and pursued with legislative support.

Staff will be available at the Joint Informational session and the ETF Board meeting to answer questions you may have.

Core Fund Annuity Adjustment Projections

Joint Informational Meeting

September 20, 2012

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Assumptions

- Based on 2012 projected Core Trust Fund investment returns.
- Includes 2008 - 2011 investment gains and losses carried forward in the Market Recognition Account (MRA).
- Annuities will be increased if annuity reserve surplus provides at least a 0.5% increase.
- Annuities will be reduced if annuity reserve shortfall would require at least a -0.5% adjustment
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Assumptions (cont.)

- 0.4% per year is reserved for mortality improvement and other actuarial adjustments and is not available for annuity adjustments.
- Negative adjustments can only reduce increases granted in prior years. A core annuity cannot be reduced below the original value.

Market Recognition Account

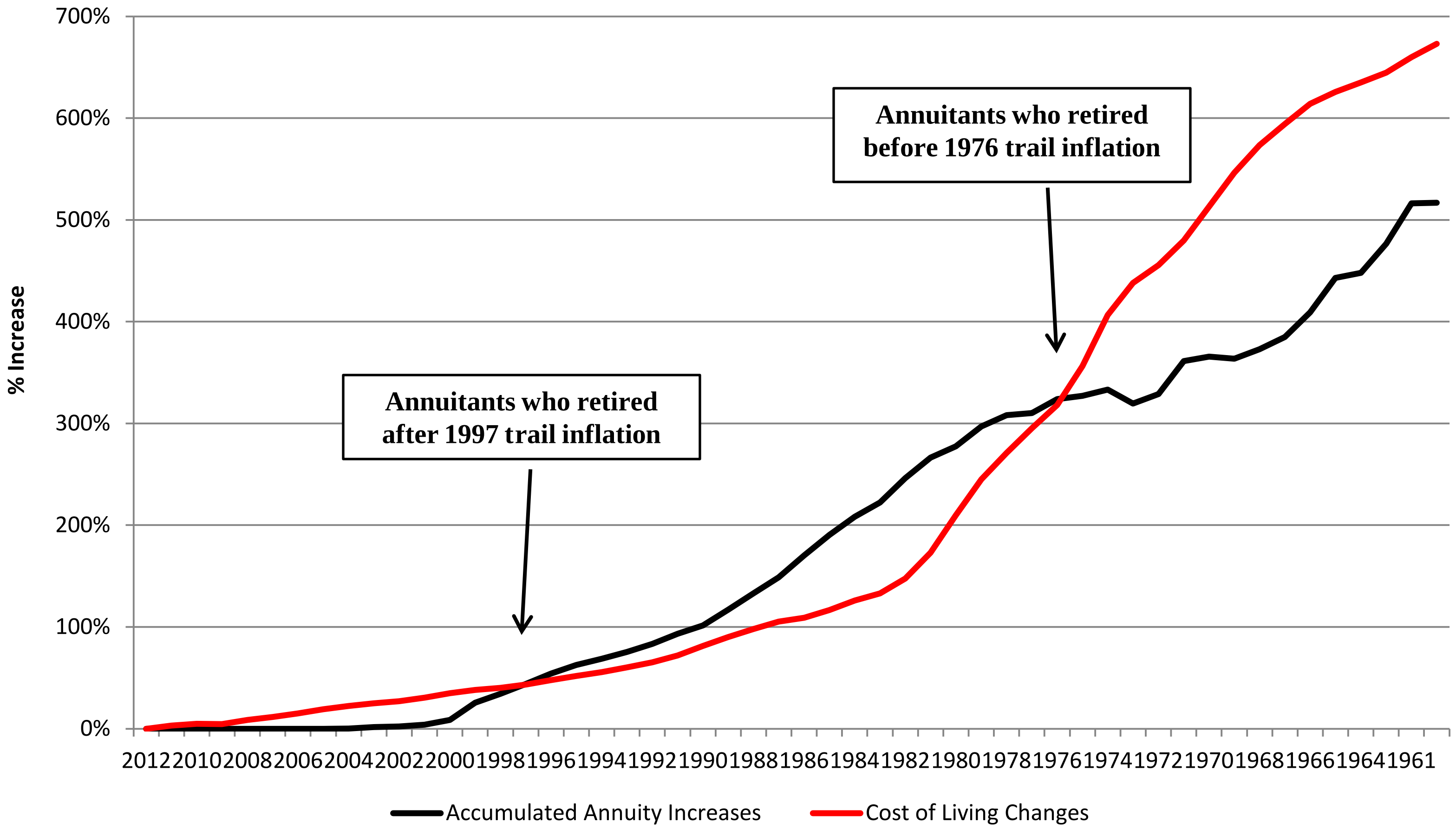
- Investment gains / losses are "smoothed" through the Market Recognition Account (MRA):
  - The MRA is intended to give recognition to long-term changes in asset values while minimizing the impact of short-term fluctuations in the capital markets;
  - Investment gains equal to the assumed rate (7.2%) are recognized;
  - The difference between actual gains or losses and the assumed rate is spread equally over 5 years.

There is a $5.3 billion investment loss to be recognized in future years, $4.6 billion of it in 2012

	Year to Be Recognized (millions $)				
Year Earned	2011	2012	2013	2014	2015
2012		?	?	?	?
2011	(935)	(935)	(935)	(935)	(935)
2010	399	399	399	399	
2009	1,288	1,288	1,288		
2008	(5,370)	(5,370)			
2007	212				
Totals	(4,406)	(4,618)	752	(536)	(935)

The deferred investment losses will be allocated approximately 51% to the annuity reserve, 29% to the employer reserve and 20% to the member reserve.

Annuity Increases versus Cost of Living by Annuity Begin Year

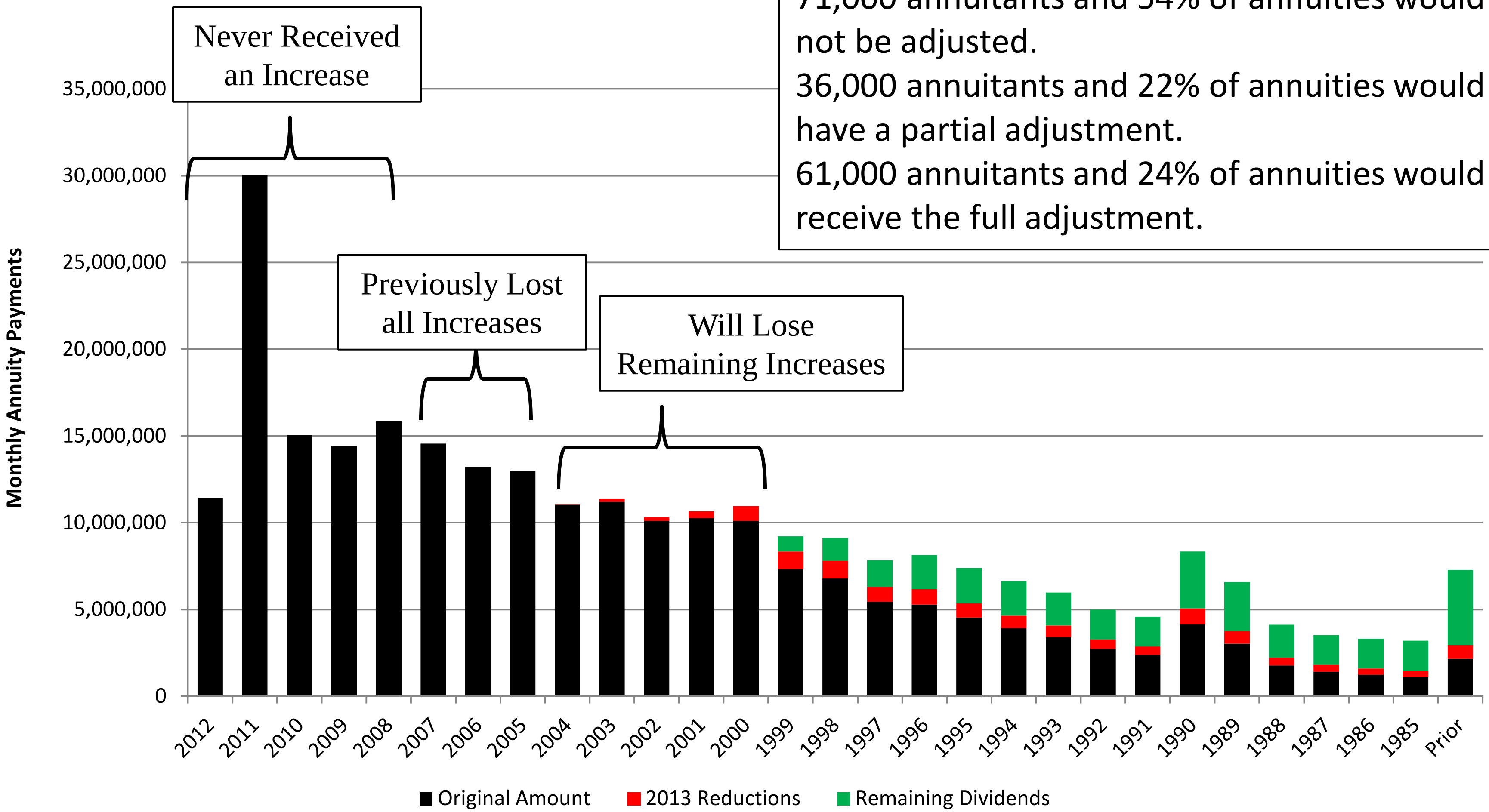


Another Large Negative Annuity Adjustment is Likely in 2013

SWIB Net Investment Return	5%	7.2%	10%	15%
Effective Rate	0.5% to 0.7%	1.0% To 1.2%	1.5% to 1.7%	2.5% to 2.7%
Average Annuity Adjustment	-4.5% to -5.1%	-4.1% to -4.7%	-3.6% to -4.2%	-2.7% to -3.3%
Maximum Annuity Adjustment	-12% to -16%	-11% to -15%	-9% to -13%	-7% to -11%

Annual Annuities by Year of Inception
Assuming -11% Adjustment

71,000 annuitants and 54% of annuities would not be adjusted.
36,000 annuitants and 22% of annuities would have a partial adjustment.
61,000 annuitants and 24% of annuities would receive the full adjustment.



Questions?