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The Honorable Senator Robert Cowles
Co-Chairperson Joint Legislative Audit Committee
PO Box 7882
Room 118 South
Madison, WI 53707

The Honorable Representative Samantha Kerkman
Co-Chairperson Joint Legislative Audit Committee
PO Box 8952
Room 315 North
Madison, WI 53709

Dear Chairperson Cowles and Chairperson Kerkman:

The Legislative Audit Bureau's (LAB) Report 20-14: *Wisconsin Retirement System* recommended the Department of Employee Trust Funds (ETF) provide a status to the Legislative Audit Committee by February 26, 2021 on ETF's efforts to work with the ETF Board (Board) to continue to analyze the risk of depleting the core fund dividend reserve[1] and the effect on dividend adjustments on individual retired participants. Additionally, the LAB recommended ETF develop a written plan to address the level of risk identified by the Board. Lastly, the LAB recommended ETF implement the written plan and seek statutory changes as necessary. We appreciate the opportunity to report on ETF's actions regarding these recommendations.

The Wisconsin Retirement System (WRS) is fully funded and often cited as a model governmental defined benefit pension system in large part due to its risk-sharing plan design. According to the National Association of State Retirement Administrators, "Wisconsin's risk-sharing post-retirement benefit feature is credited as a key factor contributing to the plan's solid funding level and relatively low and stable costs over many years. This feature works as a relief valve reducing pressure on plan benefit payments following periods of relatively poor investment performance and rewarding retirees only after periods of strong investment performance."

The risk-sharing plan design has been a part of the WRS since it came into existence in 1982. In 1989, a Wisconsin Retirement Study Committee was formed by Governor

[1] "Dividend Liability" refers to the collective amount of all positive dividends that have been distributed to annuitants. Dividend liability is equivalent to the term "dividend reserve," which ETF has used in the past. However, because it is not a true reserve, ETF uses the more accurate term dividend liability.

Tommy Thompson. After consideration of the dividend process and comparison with other possible methods of post-retirement benefit adjustments, the Committee recommended no change, stating: “While current annuitants are taking all the risk inherent in adjustments based on investment yields and mortality, they also receive the benefits when these factors are better than the actuarial assumptions. The alternatives available do not appear to improve on the current method.” The Wisconsin Retirement System Study Committee, Final Report May 1989, page 41.

The risk-sharing plan design of the WRS continues to work. The 2008 Great Recession, considered the worst economic downturn since the Great Depression, resulted in significant losses in nearly all financial markets. The WRS was not immune. The core fund dividend liability declined from $9.2 billion in 2008 to $3 billion in 2013. Consequently, retirees experienced negative annuity adjustments (2009-2013) for the first time in the history of the WRS. Since that downturn, retirees have received an average annual annuity adjustment increase of two percent. The 2021 annuity adjustment is expected to be approximately five percent. Actuarial estimates project the core fund dividend liability will increase to around $10 billion after the 2021 annuity adjustment, which is higher than the level that existed prior to the 2008 recession. The past decade has shown that the WRS plan design is successful in maintaining stability of the WRS trust fund in good and bad times.

While fluctuations in the core fund dividend liability occur naturally with investment performance and demographic changes, ETF nonetheless continually works with GRS (WRS consulting actuary) and the Board to monitor the impact of investment returns and other assumptions on the core fund dividend liability and on WRS retired participants. The Board has a detailed written funding policy to provide oversight and governance. Key elements of that oversight are described below.

- The Board and the State of Wisconsin Investment Board (SWIB) of Trustees oversee and monitor the WRS trust fund to ensure the WRS is being managed prudently and meets the goals of the WRS funding policy.

- ETF staff, the Board, and SWIB consult with GRS to understand the risks of depleting the dividend liability and the impact this would have on retirees. Due to the risk-sharing nature of the plan, SWIB performs regular stress testing and uses the information about key risk factors to manage risk in the portfolio.

- GRS conducts annual actuarial valuations to recommend contribution rates and annuity adjustments.

- Every March, ETF provides the Board projections of annuity adjustments for WRS retired participants under different investment earnings scenarios.

- Experience studies are conducted every three years to determine if the actuarial assumptions used in the valuations are reasonable compared to actual plan experience. These studies often lead to changes in underlying assumptions.

Furthermore, the WRS undergoes stress testing every two years, as well as additional stress testing as warranted. For example, additional stress testing was performed as a result of the 2008 Great Recession and in 2020 during the COVID-19 pandemic.

In addition to the above studies, ETF has been providing additional written analyses and presentations to the Board regarding the risk of depleting the core fund dividend liability and the effect on individual retiree annuity adjustments.

In 2012, ETF presented and provided a memo to the board outlining these risks and introducing potential statutory changes. At that time, the ETF Board elected to not make changes given the low probability of dividend liability depletion and the risks and disadvantages of proposed changes, including legal and equity concerns and increased costs to taxpayers.

In 2014, the ETF Board adopted a written funding policy/plan, which provides guidelines on the WRS actuarial cost method, the asset smoothing method, the amortization policy and the risk management policies. ETF continues to work with GRS to monitor the status of the core dividend liability and assess opportunities for improvement. Subsequent board monitoring actions are highlighted below.

- March 2015 – The Board received a written report and presentation from GRS on the effectiveness of smoothing mechanisms on Core and Variable dividends, dividend liability remaining, with additional detail on remaining dividend liability by year of retirement.

- April 2015 – The Board discussed annuity adjustments and dividends and how Wisconsin statutes control the Board's flexibility regarding the funding of the WRS.

- June 2015 – The Board reviewed ETF's memo on WRS dividends and annuity liability options and the effect of investment performance. The Board directed ETF to work with SWIB and GRS to develop models to show the effects of various investment return simulations outside the normal expected range of returns.

- September 2015 – The Board reviewed ETF's memo on WRS investment risk and market volatility, along with a presentation on projected effects of specific worst-case scenarios. The memo explained basic funding components of the WRS, existing volatility-controlling mechanisms, and described potential strategies for responding to volatility. The memo outlined several approaches related to core fund dividend liability depletion.

- December 2015 – The Board reviewed ETF's memo on WRS Investment Risk. The Board directed ETF to continue developing measures for mitigating volatility.

- March 2016 – The Board received a written report and presentation from GRS on the effectiveness of smoothing mechanisms on Core and Variable dividends, core fund dividend liability remaining, with additional detail on remaining dividend liability by year of retirement.

- December 2016 – The Board reviewed ETF's memo on core fund dividend liability options. These materials provided analysis based on research by GRS on the probability of core fund dividend liability depletion, comparing status quo to the "Cap and Liability"' approach (limit dividends to annual inflation but no more than 3%), and "Dividend Delay" (dividends for new retirees commence after five years). In addition, ETF presented information on an equity measure called "Dividend Lock," which contemplated allowing annuitants that have reached 80 years to lock in their dividends. The Board commented on the need to continue educating members about the necessity of personal savings beyond the WRS pension. The Board did not take action on the core fund dividend liability options.

- March 2017 – The Board received a written report and presentation from GRS on the effectiveness of smoothing mechanisms on Core and Variable dividends, core fund dividend liability remaining, with additional detail on remaining dividend liability by year of retirement.

- March 2018 – The Board received a written report and presentation from GRS on the effectiveness of smoothing mechanisms on Core and Variable dividends, core fund dividend liability remaining, with additional detail on remaining dividend liability by year of retirement.

- June 2019 – The Board was provided a memo providing a re-cap of the previous dividend liability discussion.

- March 2020 – The Board received a written report and presentation from GRS on the effectiveness of smoothing mechanisms on Core and Variable dividends, core fund dividend liability remaining, with additional detail on remaining core fund dividend liability by year of retirement.

- December 2020 – The Board received a presentation from GRS detailing the results and analysis of recent stress testing scenarios, including a focused analysis of dividends with potential options for changes to mitigate the risk of dividend depletion. The Board instructed ETF to engage GRS to develop language for the WRS Funding Policy to add and clarify references to dividend liability and dividend risk, to document requirements for cyclic monitoring of dividend risk levels through annual reporting of dividend liability levels, and to include a specific risk measure for dividend liability requiring a report to the Board upon reaching specific thresholds. This language is planned for discussion at the March 20, 2021 Board meeting. The Board did not recommend pursuing any other changes.

As noted above, the Board has been monitoring the health of WRS core fund dividend liability for many years. Although the LAB called attention to one aspect of the inherent risk involved in the WRS, the Board believes that efforts to address that risk may, in fact, compound that risk or create other risks. The shared risk plan design has been recognized as a significant reason for WRS's strong funding and stable contribution rates compared to peer public retirement systems. The Board discussions have stressed the system is working as designed and the Board has not proposed seeking plan design changes to the system. Finally, the Board has discussed that if the core fund dividend liability is depleted, and the annuity liability is in deficit, all annuities would be at their guaranteed annuity floor levels. There would be no further positive annuity adjustments until there are sufficient gains from investment returns to remove the deficit.

The continued due diligence of the governing boards and staff administering the program, oversight by policymakers, and sound funding principles contribute to the WRS' ability to pay promised benefits long into the future. ETF will continue to work with the ETF Board to monitor all risk, including dividend liability. Finally, ETF stands ready to assist the Joint Survey Committee on Retirement Systems and its staff if the Legislature is interested in researching this topic further.

As always, if you have any questions, please do not hesitate to contact me.

Sincerely,

Robert J. Conlin Secretary

cc: Joe Chrisman, State Auditor, Legislative Audit Bureau