EMPLOYES' RETIREMENT SYSTEM

RESEARCH AND ANALYSIS SECTION - LEGISLATIVE REFERENCE BUREAU

EXECUTIVE SUMMARY: 2011 PROPOSED BUDGET HEARING DATE: OCTOBER 19, 2010

1. **2011 Proposed Budget:** The total 2011 Proposed Budget is $28,755,539, an increase of $4,563,955 (18.9%) from $24,191,584 in the 2010 Budget. Increases are primarily due to investment management fees that have increased with the fund balance and increased needs relating to information technology.

2. **Fund Value:** As of September 30, 2010, the Fund's value was estimated to be $4.1 billion. Despite recent economic conditions, the ERS is well-funded. As of January 1, 2010, the actuarial funding had increased to 112.8%, thus requiring no additional City contribution in 2011.

3. **Fund Return:** The Fund's rate of return continues to be volatile. Following record losses in 2008, at year-end 2009, the rate had increased to 23.3%, net of fees compared to a benchmark of 18.89%. Through September 30, 2010, the rate has decreased to 6.45% compared to a benchmark of 5.18%.

4. **Fund Membership:** 2011 is the first year where the ratio of active members to retirees and beneficiaries is expected to reach one-to-one. After this, the number of retirees and beneficiaries will outnumber active members.

5. **Employer's Annuity Contribution:** The 2011 Proposed Budget allocates $24,980,000 to fund the City's share of the employes' annuity contribution.

6. **Employers' Reserve Fund:** The 2011 Proposed Budget allocates a voluntary contribution of $17,350,000 to the Employers' Reserve Fund. This contribution is being made in anticipation of future required contributions. It is estimated that by 2013, the City will be required to contribute $65 million and over $80 million for years thereafter. With the 2011 voluntary contribution, the fund is estimated to have a balance of $29 million by year-end 2011. **The Mayor has committed to vetoing any attempt to decrease the Employers' Reserve Fund contribution.**

7. **Pension Task Force:** On September 21, 2010 the Council adopted a resolution creating a Pension Task Force. The Council recognized the potentially precipitous nature of investment performance, pressures on the long-term liabilities of the pension fund and the need to proactively assess options in the management of City pension benefits. The task force will consist of 7 members and be chaired by the Chair of the Finance and Personnel Committee. It will report its findings to the Council by June 30, 2011.

	2009 Actual	2010 Budget	% Change	2011 Proposed	% Change
Salaries & Wages	$2,203,056	$2,501,084	13.5%	$2,473,539	-1.1%
Fringe Benefits	$1,031,857	$1,041,500	0.9%	$1,187,000	14.0%
Operating	$14,537,239	$20,543,000	41.3%	$24,960,000	21.5%
Equipment	$121,980	$106,000	-13.1%	$135,000	27.4%
Special Funds	$56,101	$0	-100.0%	$0	0.0%
TOTAL	**$17,950,233**	**$24,191,584**	**34.8%**	**$28,755,539**	**18.9%**
Positions	51	52	2.0%	52	0.0%
FTEs	37.3	41.5	11.4%	41.5	0.0%

The Employes' Retirement System (ERS) is responsible for ERS asset management and retirement benefits administration for nearly 27,000 members. ERS also administers the City's participation in federal Social Security, the City's group life insurance program, and health care and COBRA dental benefits for retirees. In addition to City government employees, the ERS includes non-certified MPS employees, and employees of HACM, RACM, MMSD, MATC, and the Wisconsin Center ("city agency" employees).

The ERS is governed by an 8-member Annuity and Pension Board consisting of 3 persons appointed by the Common Council President, 3 persons elected by active system members, one person elected by retired members and the City Comptroller.

2011 Proposed Budget

The total 2011 Proposed Budget is $28,755,539, an increase of $4,563,955 (18.9%) from $24,191,584 in the 2010 Budget.

Personnel Expenditures

Personnel costs increase $117,955, or 3.3%, in the 2011 Proposed Budget. Net salaries and wages decrease slightly by 1.1% while fringe benefits increase by 14%. Personnel costs account for $3,660,539, or 12.7%, of the total Proposed Budget for 2011. The 2011 Proposed Budget includes the same number of positions and FTEs as in the 2010 Budget (52 positions and 41.5 FTEs).

Operating Expenditures

Operating expenditures account for $24,960,000, or 86.8%, of the total Budget for 2011. Operating expenditures in the 2011 Proposed Budget are $24,960,000, up $4,417,000 (21.5%) from the 2010 Budget amount of $20,543,000. Operating expenses are largely driven by professional services totaling $18.9 million in 2011. Investment manager fees of $16.2 million account for the majority of professional services.

There is a $4.1 million increase in investment manager fees in 2011 as compared to 2010. These increases are primarily the result of a growth in performance-based fees. The general growth of fund assets and assets under management are also a factor.

Information technology services are also a significant portion of operating expenditures. The $4.5 million budgeted for information technology in 2011 consists of $4 million for contractor support of the customized MERITS computer system which is required to manage the complicated provisions of chapter 36 of the City Charter. ERS anticipates replacing MERITS in approximately 6 to 10 years.

Equipment Purchases

The 2011 Proposed Budget includes $135,000 for equipment purchases, a $29,000 (27.4%) increase from $106,000 in the 2010 Budget. All $135,000 is for replacement of computer hardware such as workstations and servers.

Special Purpose Accounts

Special Purpose Accounts are not included in the department's budget, but expenditure authority for these accounts is extended to the department by Council resolution after the budget is adopted. The ERS manages 2 tax levy-funded special purpose accounts with proposed funding of approximately $2.9 million.

For 2011, funding for the Group Life Special Purpose Account is increased by $269,000, or 10.7%, to $2,779,000. The increase is the result of an increase in premiums.

The Retiree Benefit Adjustment Fund funds the cost of supplemental pension benefits to certain former City employees who retired prior to 1984. Recipients include members and surviving spouses of the Employes' Retirement System. A decrease of $20,000 to $166,000 is related to deaths in beneficiaries. These supplements are non-contractual, and are subject to continuation or termination by Council action.

Special Funds

There are no Special Funds included in the 2011 Proposed Budget. There was $500,000 in the 2008 Budget for the Fiduciary Liability Deductible. The Fiduciary Liability Policy contains a $500,000 deductible. If there is a claim, the Trust is responsible for the first $500,000 in costs. The deductible fund was reauthorized for this purpose in the 2008 Budget. Since being reauthorized, no funds have been expended and the funds may be carried over for 3 years to 2011. The fund will require reauthorization for the 2012 Budget.

Fund Value and Allocation

As of December 31, 2007, the value of the Fund was approximately $5.2 billion; by December 31st of 2008 it had fallen to $3.4 billion. The Fund's value had grown to $4.0 billion by year's end of 2009, and as of September 30, 2010, was estimated to be $4.1 billion.

Despite recent economic conditions, the ERS is well-funded. As of January 1, 2009, the actuarial funding of the system was 99.1%, requiring a City contribution of over $49 million in 2010. As of January 1, 2010, the actuarial funding had increased to 112.8%, thus requiring no City contribution in 2011. However, a voluntary contribution of $17.4 million is included in the 2011 Proposed Budget. Further discussion of the voluntary contribution is provided on page 5.

Board policy dictates the targets for fund allocation. The targets are as follows.

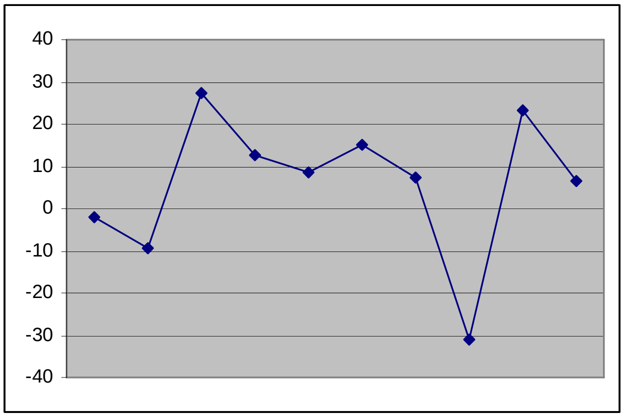
- 31%: Domestic Equity
- 28%: Fixed Income

- 22%: Non-U.S. Equity
- 10%: Global Equity
- 7%: Real Estate
- 2%: Private Equity

Fund Return

Rates of Return (net of fees)

2001 through September 2010

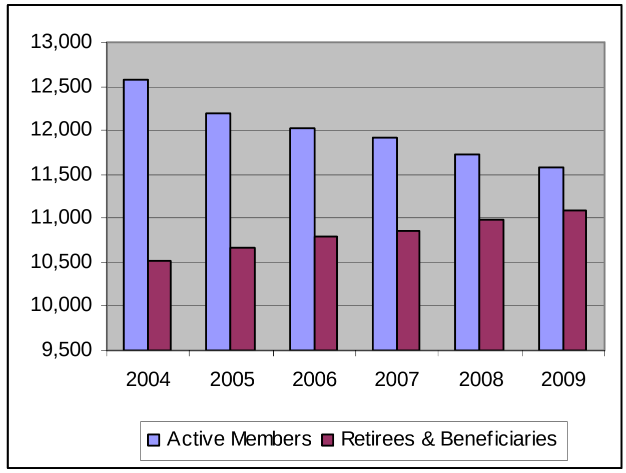


The Fund's rate of return continues to be volatile. As of December 31, 2008, the Fund's 1-year rate of return was -30.84% (Net of Managers Fees) as compared to a blended benchmark passively managed return, or reference index, of -25.64%. At year's end 2009, the rate had increased to 23.3%, compared to a benchmark of 18.89%. Through September 30, 2010, the rate has decreased to 6.45% compared to a benchmark of 5.18%. With the exception of 2007 and 2008, in the past 10 years, the Fund's rate of return after fees paid to investment managers has outperformed the benchmark. ERS estimates that the Fund benefit from the decision to hire active managers over the past ten years is $680.5 million.

For 2008, the Fund placed in the 95th percentile as measured by Mercer's Public Fund Universe. In 2009, it had placed in the 11th percentile. As of June 30, 2010 the Fund was placed in the 85% percentile. (The Mercer's Public Funds Universe is comprised of 59 public funds that have at least $1 billion in assets.)

Fund Membership

Member Composition



2011 is the first year where the ratio of active members to retirees and beneficiaries may reach one-to-one. After this, the number of retirees and beneficiaries will outnumber active members. The ratio for City employees mirrors the membership as a whole. Some City employees contribute varying amounts to the Fund, but the majority of the contribution is made by the City. Given the composition of Fund membership, the burden on the employer will only increase. As a result of an increase in unfunded liabilities, the City will be required to make additional contributions in the future. (This is discussed further on page 5.)

Early Retirements

The City's temporary enhancement of retirement benefits appears to have been successful in encouraging retirements. The number of service retirements though September of 2010 was 382 versus 242 in the same time period in 2009. This is an increase of 140, or 58%. Through September of 2010, there were 529 retirements of all kinds, including disability and deferred, versus 366 in the same time period in 2009. This represents an increase of 163, or 45%.

City Contributions

Employer's Annuity Contribution

The 2011 Proposed Budget allocates $24,980,000 to fund the City's share of the employes' annuity contribution. The contribution consists of 5.5% of pay for general City employees and 7% for Police Officers, Fire Fighters and elected officials. In the 2010 Budget, $23,791,142 was allocated with $16,791,142 from the tax levy and $7 million from the Employers' Reserve Fund. Therefore, the City's share of the contribution has increased $1.2 million from 2010 to 2011.

Employers' Reserve Fund

In the 2010 Budget, $7 million was allocated from the Employers' Reserve Fund to cover the City's share of the employes' annuity contribution. The fund was used to help offset the total contribution of $49.1 million required to be in compliance with the City Charter. The required contribution was the result of the ERS funding ratio of liabilities to assets falling below 100% for the first time in many years. The balance of the Employers' Reserve Fund is estimated to be $9 million at the end of 2010.

The 2011 Proposed Budget allocates a voluntary contribution of $17,350,000 to the Employers' Reserve Fund. This contribution is being made in anticipation of future required contributions. It is estimated that by 2013, the City will be required to contribute $65 million and over $80 million for years thereafter. With the 2011 voluntary contribution, the fund is estimated to have a balance of $29 million by year-end 2011. The Mayor has committed to vetoing any attempt to decrease the Employers' Reserve Fund contribution.

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Issues to Consider

1. The investment market continues to be volatile. More conservative investment performance assumptions should be considered.

2. The funding ratio is not expected to remain at or above 100%, thus requiring additional City contributions. Future contribution needs must be taken into consideration.