

## **Fiscal Assessment: Milwaukee County Employees Retirement System**

The Milwaukee County Employees Retirement System (ERS) provides retirement benefits to nearly 8,000 retirees, covers 3,600 active County employees, has total liabilities of \$2.3 billion and is currently 77% funded. Milwaukee County is one of two local governments in Wisconsin that administers its own defined benefit pension plan rather than participating in the state system. Prompted by concerns over administrative complexities and fiscal sustainability, County officials have recently taken steps to examine a potential transition to the Wisconsin State Retirement System (WRS). Earlier this year, the County Board adopted a resolution requesting that the Department of Retirement Services convene a workgroup to report on the steps necessary to begin a transition to WRS ("state option"). County Executive Chris Abele, noting that such a transition is "irrevocable", established the Retirement Sustainability Taskforce to study the state option, as well as other policy options to help ensure that retirement benefits are affordable, sustainable and secure.

At the request of the County Executive, Pew is providing technical assistance to the taskforce that will include (1) a fiscal assessment of ERS, (2) research and analysis on a potential transition to WRS, and (3) research and analysis of other policy options. Pew's technical assistance work with state and local jurisdictions is guided by core principles related to fiscal sustainability and retirement security and our approach is outlined in our [analytic framework](#) document. **Our review of ERS found that while the plan is well-funded based on standard measures of fiscal position, the operating cash flow measure - a better indicator of the possibility for fiscal distress- warns of challenges ahead.**

As the starting point for our engagement with the Taskforce, the fiscal assessment is a tool that identifies the level and sources of fiscal distress in a pension plan. We do this by reviewing actuarial valuations and financial reports, concentrating on central data points related to funding, contributions, benefit payments and membership, and using our 30 year projection model to estimate funding and contribution impacts going forward. Analyzing this data over time and in relation to other jurisdictions in our state and city database allows us to make an overall assessment of the plan's health and brings to light areas that require further analysis.

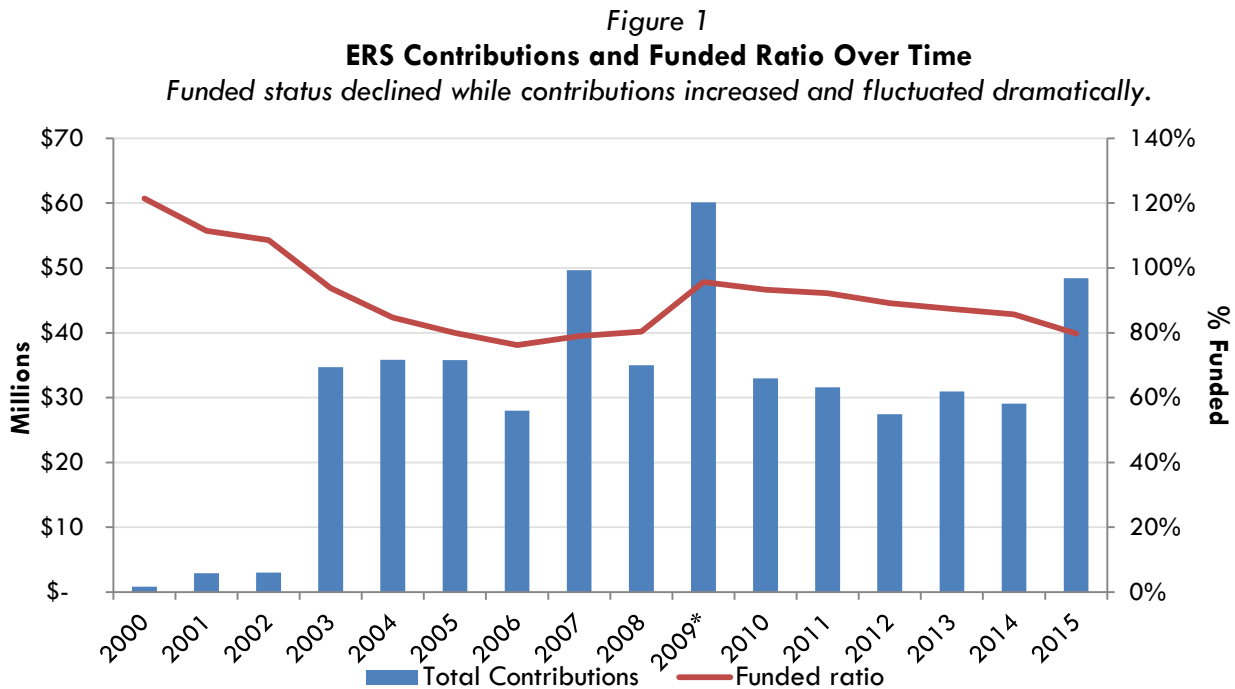
### **Key findings from the assessment include:**

1. The 2015 ERS funded ratio was slightly above the national average for FY 2015 and FY 2014. Fully funded in the early 2000s, the declining funded ratio follows a trend line that is similar to the nation as a whole.
2. While well-funded based on standard measures of fiscal position, the plan's negative 8% ratio of operating cash flow (benefit payments-contributions) to assets warns of challenges ahead. This was lower than all states in FY 2015 and all but two cities- Detroit and Chicago- in FY 2014. Our analysis indicates that a declining County workforce and unusual benefit provisions are the likely cause.
3. At 35%, Milwaukee County ERS has the lowest percentage of active employees as a share of total membership compared to the states, and second lowest compared to cities.
4. The BackDROP and Rule of 75 are two benefit provisions that stand out from the typical plan and likely contribute to the relatively high ERS benefit payments as a share of liabilities.
5. Total contributions are projected to rise over the next two decades, improving plan funding and operating cash flow but placing fiscal pressure on both the County and employees. A low investment return scenario exacerbates the fiscal pressure while limiting improvements to plan funding and operating cash flow.

## Finding #1

The 2015 ERS funded ratio was slightly above the national average for FY 2015 and FY 2014. Fully funded in the early 2000s, the declining funded ratio follows a trend line that is similar to the nation as a whole.

Between 2000 and 2015, the ERS funded ratio declined from over 100% to 80% while total contributions grew from less than one million dollars to \$48 million.



Note: 2009 contribution excludes \$397.8 M pension obligation bond proceeds.

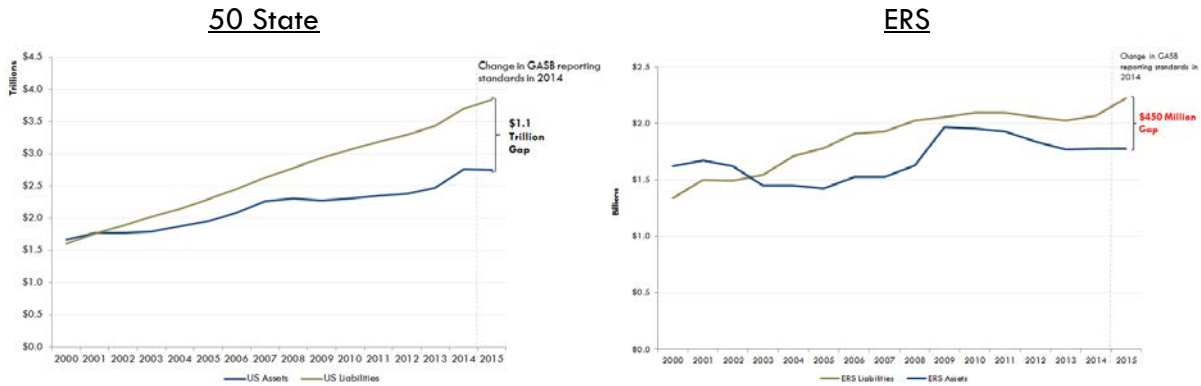
Source: ERS Annual Reports and Actuarial Valuations

At 80%, the ERS funded ratio for 2015 was higher than 33 states and is above the aggregate funded ratio of 72%.<sup>1</sup> Compared to 33 cities the year prior, six had a funded ratio above the ERS ratio.<sup>2</sup> Similar to the aggregate funding of plans across the country, ERS assets exceeded liabilities during the early 2000s but subsequently developed an unfunded liability due to a combination of low investment returns, insufficient contributions, and benefit enhancements. Despite the infusion of nearly \$400 million in 2009 from the pension obligation bond, the ERS unfunded liability was \$449 million in 2015.

<sup>1</sup> Appendix Exhibit 1

<sup>2</sup> Appendix Exhibit 2

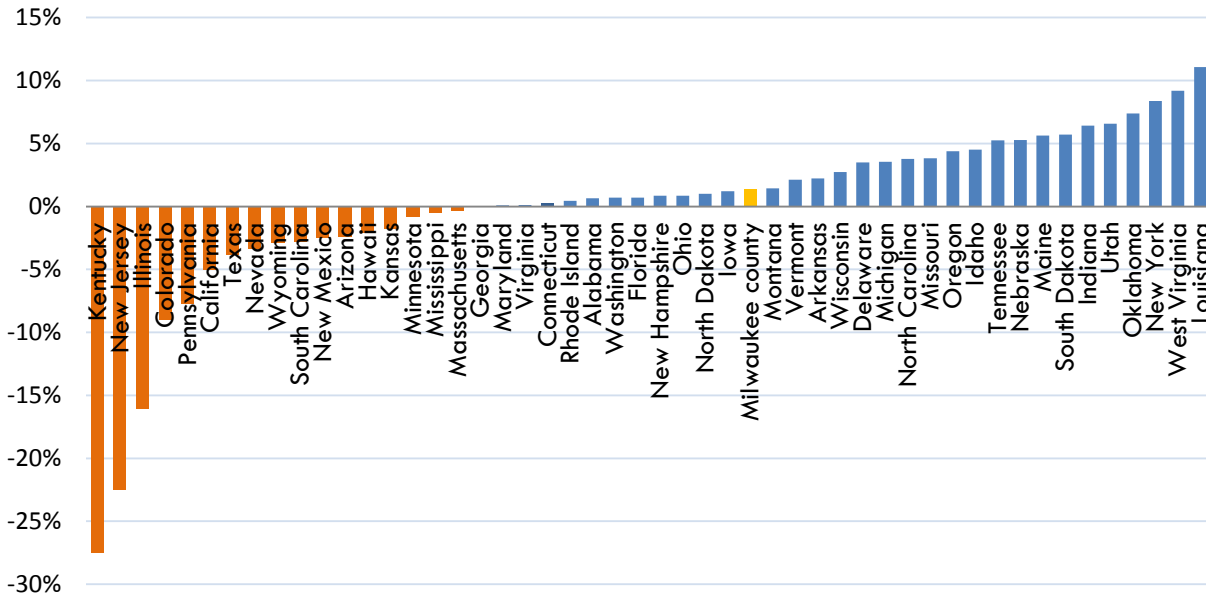
**Figure 2**  
**Milwaukee County ERS vs. State Pension Funding Gap**  
 Assets & Liabilities for ERS compared to 50 State Aggregate for 2000-2015



Sources: Comprehensive Annual Financial Reports (CAFRs), actuarial reports and valuations, or other public documents, or as provided by plan officials.

Using the net amortization metric, which measures whether total contributions to a pension system would have reduced unfunded liabilities if all actuarial assumptions- primarily investment expectations- had been met for that year, Milwaukee County ERS achieved positive amortization in 2015 which was higher than 30 states.

**Figure 3**  
**Net Amortization as Share of Covered Payroll (FY 2015)**  
 Milwaukee County ranked 21<sup>st</sup> among the 50 states



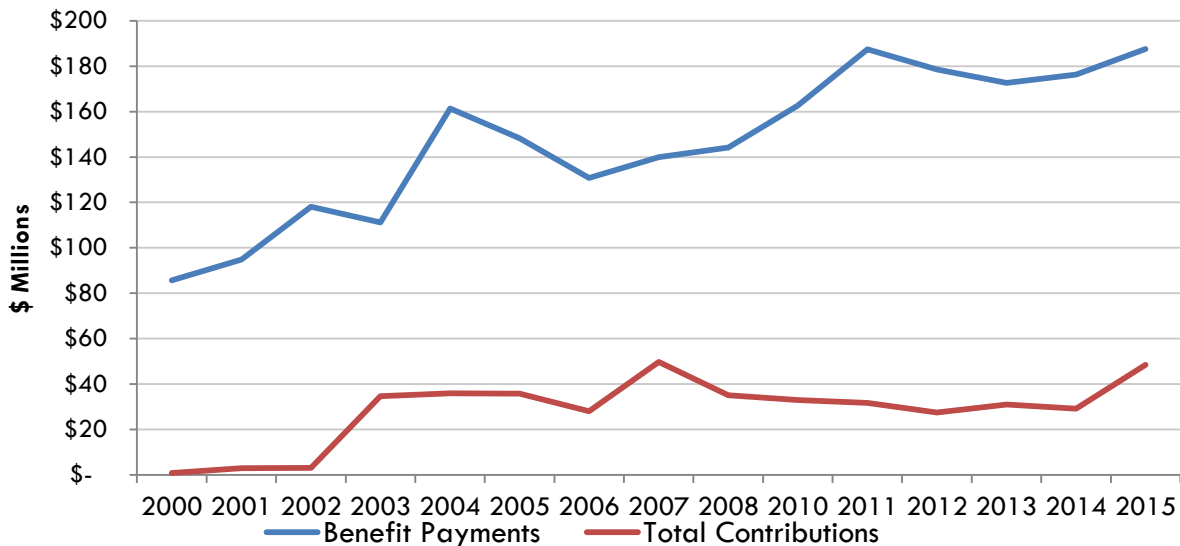
Sources: Comprehensive Annual Financial Reports (CAFRs), actuarial reports and valuations, or other public documents, or as provided by plan officials.

## Finding #2

While well-funded based on standard measures of fiscal position, the plan's negative 8% ratio of operating cash flow (benefit payments-contributions) to assets warns of challenges ahead. This was lower than all states in FY 2015 and all but two cities- Detroit and Chicago- in FY 2014. Our analysis indicates that a declining County workforce and unusual benefit provisions are the likely cause.

Using cash flow as a measure of pension fiscal health is important because it highlights how actuarial funding and the maturity of plan demographics leave pension funds dependent on investment returns to maintain asset levels. Like the vast majority of public pension plans, ERS benefit payment outflows exceed contribution inflows each year. In 2015, contributions were \$48 million and benefit payments were \$188 million.

Figure 4  
ERS Benefit Payments and Contributions 2000-2015



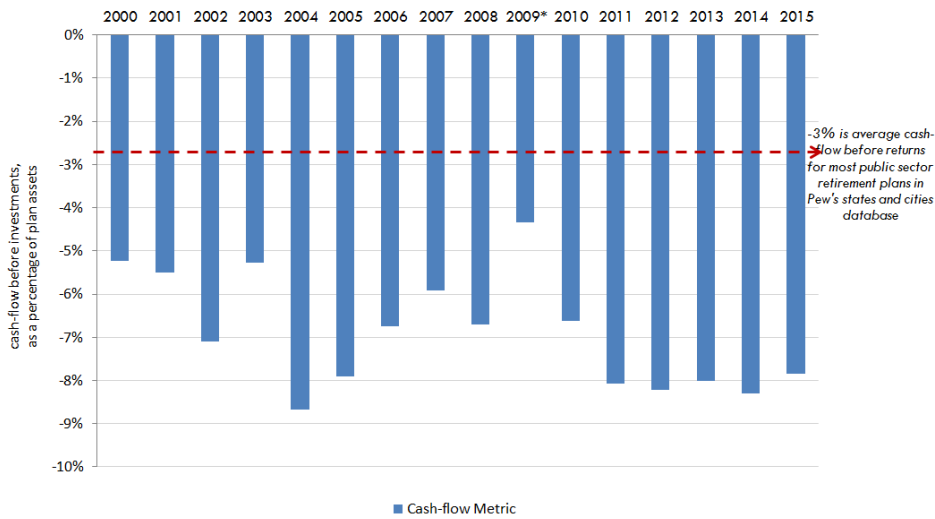
Note: 2009 contribution excludes \$397.8 M pension obligation bond proceeds.

Source: ERS Annual Reports

However, Milwaukee County ERS is an extreme outlier in the size of this gap relative to plan assets, averaging -5.6% per year since 2000 compared to -3% for all plans. At around -8% in both 2014 and 2015, Milwaukee County paced behind all 50 states and all but 2 cities (Detroit and Chicago).<sup>3</sup> Negative operating cash flow matters because it represents the investment return that must be achieved in order to prevent the fund assets from declining. In 2015, -8% operating cash flow meant that ERS plan investments needed to earn at least 8% to break even. By comparison, the average plan only needed to earn 3%.

<sup>3</sup> Appendix Exhibits 3 & 4

Figure 5  
**Milwaukee County ERS Operating Cash Flow 2000-2015**  
 Average annual operating cash flow was negative 5.6%

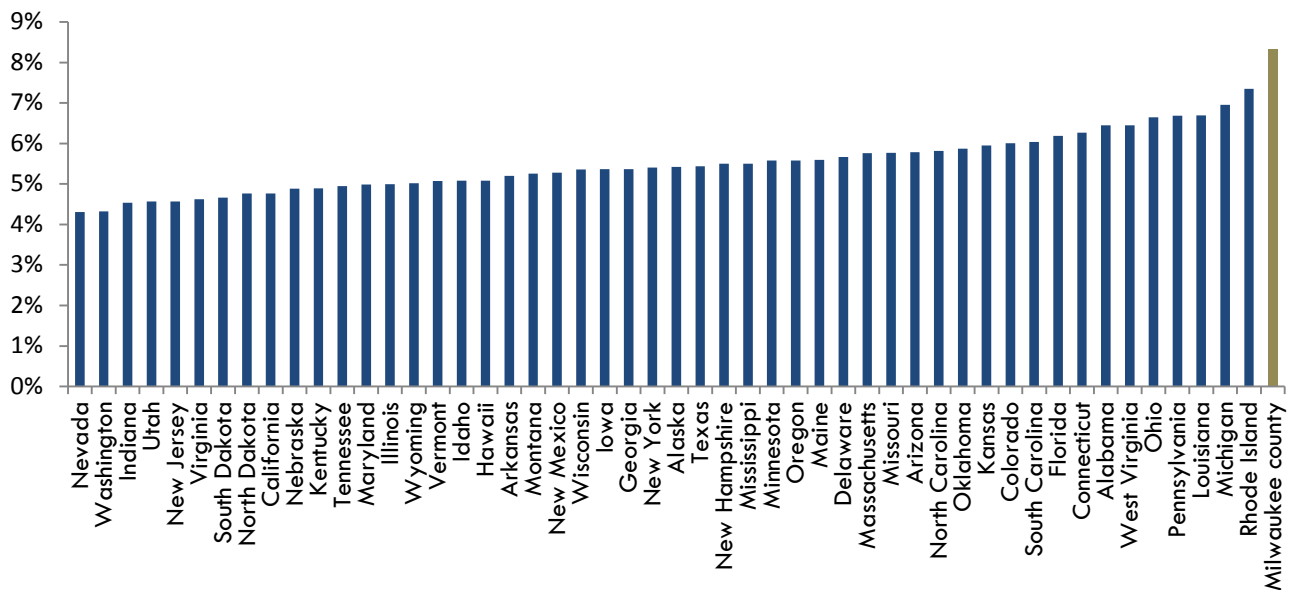


Note: Excludes the proceeds of the 2009 POB for visual purposes but includes the proceeds for the calculation of the 15 year average. If excluded from the calculation, the average falls to negative 6.9%.

That the relative gap between ERS contributions and benefit payments is so much larger than the national average suggests that the plan is experiencing some combination of relatively low contributions or relatively high benefit payments. Looking at the annual benefit payment as a share of total plan liability, Milwaukee County had the highest percentage in our state and city database, prompting us to analyze further two factors that are likely contributing to the relatively high rate of benefit payments: member population (related to the number of benefit payments) and benefit design (related to the size of a given benefit payment).

Figure 6  
**Benefit Payments as a Share of Liabilities (FY 2015)**

Milwaukee County ranked first among the states in terms of benefit payments as a share of liabilities



Sources: Comprehensive Annual Financial Reports (CAFRs), actuarial reports and valuations, or other public documents, or as provided by plan officials.

### Finding #3

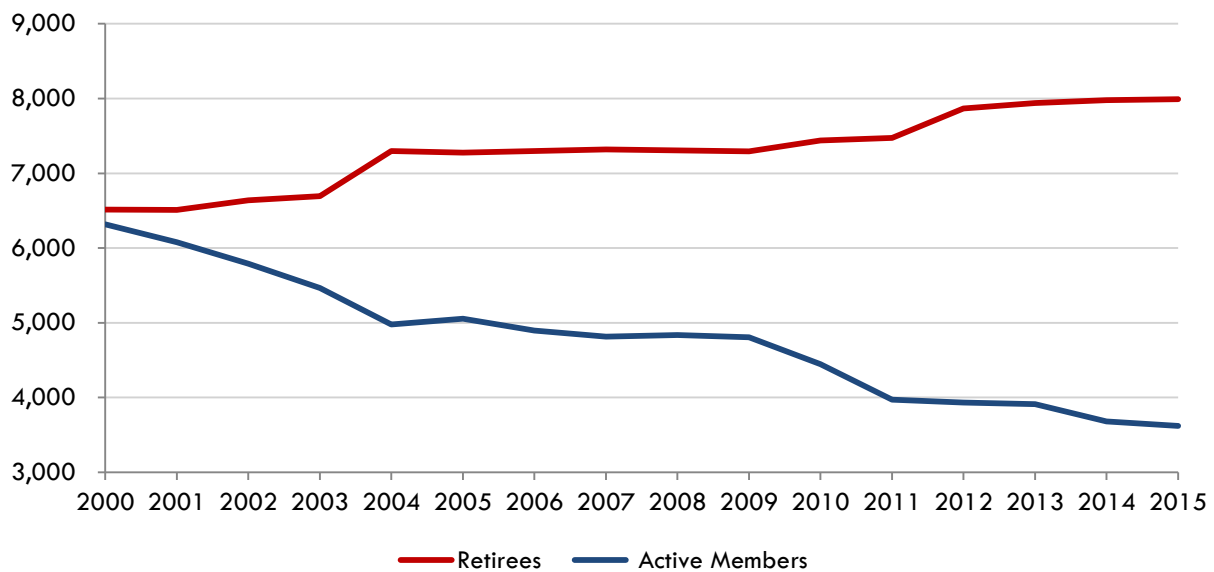
At 35%, Milwaukee County ERS has the lowest percentage of active employees as a share of total membership compared to the states, and second lowest compared to cities.

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As of 2015, the ERS membership consisted of nearly 8,000 retirees and around 3,600 members. Between 2000 and 2015, the number of active employees declined by 43% while the number of retirees grew by 23%.

Figure 7  
ERS Membership over Time

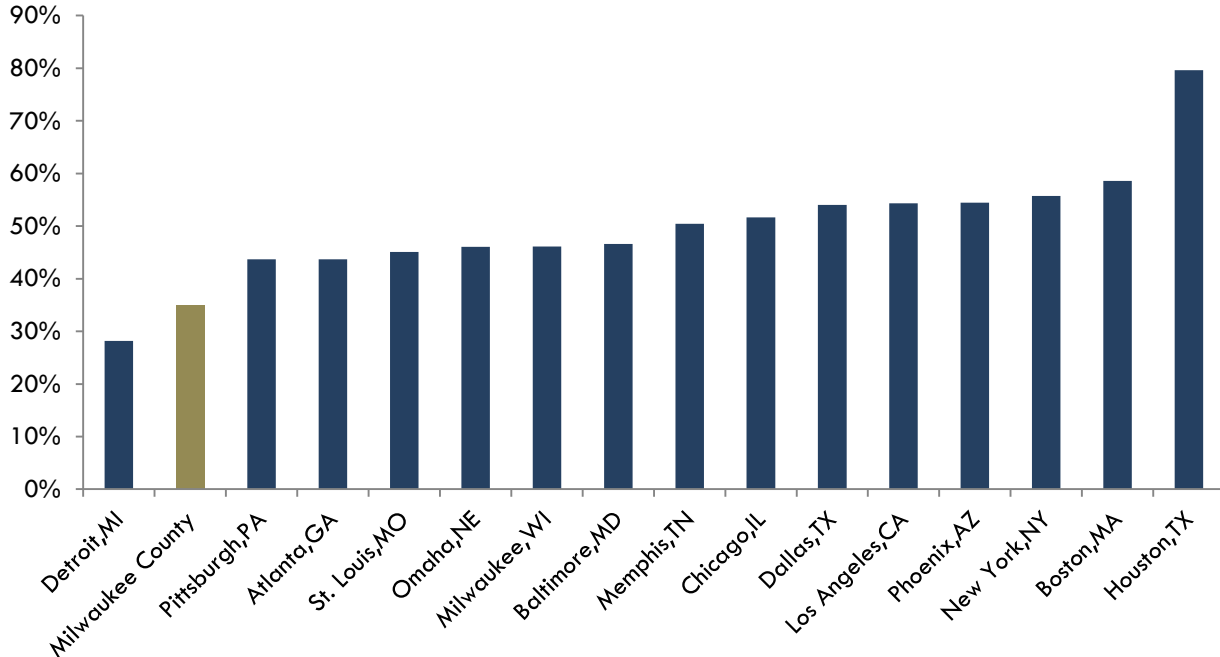
*As retired workers receiving benefits have grown over time, the number of active employees has declined*



Source: ERS Annual Reports and Actuarial Valuations

At 35%, Milwaukee County has the lowest share of active employees compared to the 50 states and second lowest compared to the 15 cities in our database that report this information.<sup>4</sup>

Figure 8  
Active Employees as a Share of Total Plan Membership (2014)

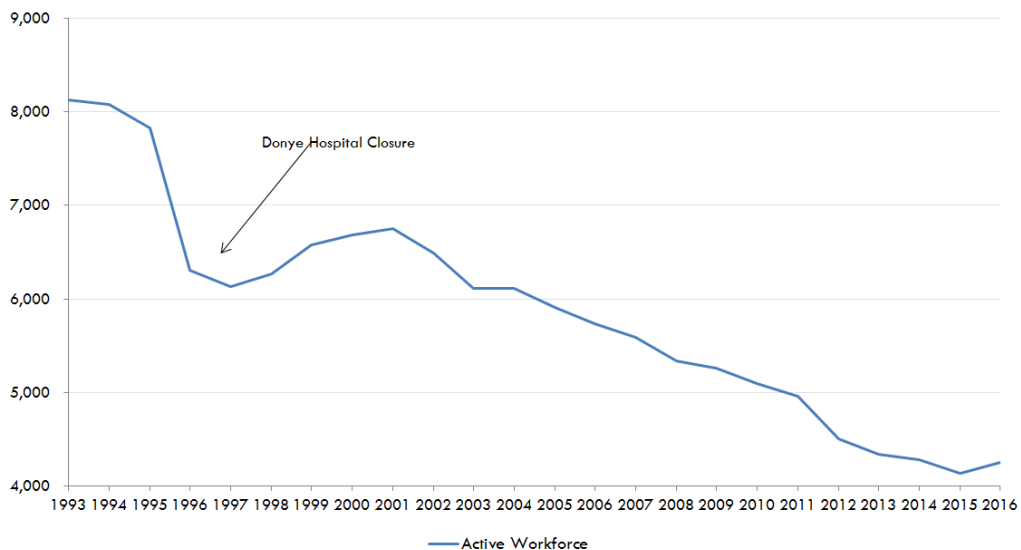


Source: Analysis by The Pew Charitable Trusts using Pew's states and cities database and publicly available comprehensive annual financial reports and valuation reports

The decline in active ERS membership is consistent with the steady decline in County workforce as a whole, as total County employment has fallen by about half over the past 25 years.

Figure 9  
Milwaukee County Active Employee Population Over Time

County has seen significant and steady drop in active employment over the course of 25 years



Source: ERS actuarial reports and valuations, or other public documents, or as provided by plan officials.

<sup>4</sup> See Appendix Exhibit 5

## Finding #4

The BackDROP and Rule of 75 are two benefit provisions that stand out from the typical plan and likely contribute to the relatively high ERS benefit payments as a share of liabilities.

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### *BackDROP*

In 2001, Milwaukee County created a BackDROP benefit that allows employees who work beyond their normal retirement date to collect a lump sum payment at retirement, along with a reduced monthly pension benefit. Similar to a DROP plan, which is the more commonly used approach to providing workers with a lump sum at retirement, the key factors that determine the size of the BackDROP payment are the interest rate and the number of years an employee may continue to work during the BackDROP period.<sup>5</sup> For the ERS BackDROP, the interest rate is equal to the assumed rate of return (currently 8%, dropping to 7.5% by 2020) and the maximum BackDROP period is 10 years.

To put these figures in perspective, Pew earlier this year reviewed 28 DROP plans across the country as part of an analysis of the Dallas Police and Fire Pension System. We found that the Dallas plan was much more generous than any other plan studied, with a guaranteed rate of return of up to 10% and an unlimited participation period. By comparison, the average interest rate guarantee was around 2%, with half the plans offering no guarantee, and the average participation period was 5 years.<sup>6</sup>

As shown in figure 10, there has been significant fluctuation in the size of the ERS BackDROP payment each year. BackDROP eligibility was closed to employees hired after 2007, but active employees hired prior to that date remain eligible. Recent changes to the plan, including a cap on the salary used to calculate the benefit, have further limited the potential size of future lump sum payments. As of 2016, BackDROP benefits represented around 16% of the actuarial liability attributable to active employees and going forward, BackDROP payments are projected to decline.<sup>7</sup>

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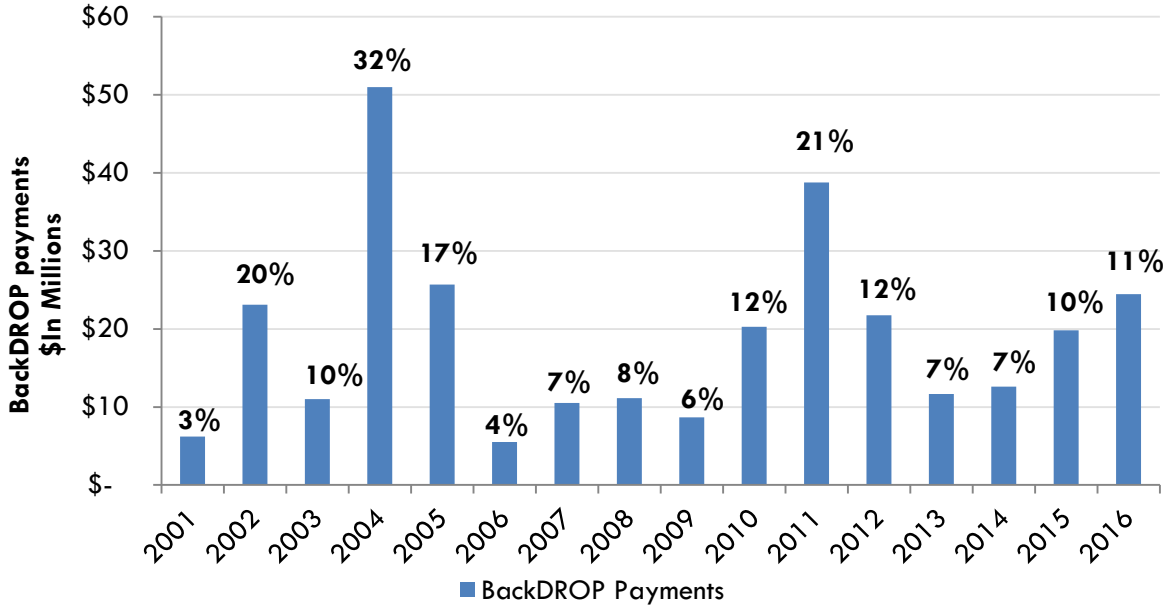
<sup>5</sup> The primary difference between a DROP and BackDROP is the point at which the employee elects to participate. In a traditional DROP, the employee elects to participate in the DROP plan and then continues to work for a period of time. The benefit is calculated based on the time between the election and the date the employee stops working. In a BackDROP, the employee simultaneously ceases employment and elects to participate in the BackDROP, which applies retroactively to a date in the past selected by the employee. The benefit is calculated based on the time between the retroactive date and the date the employee stops working.

<sup>6</sup>Source: Pew Analysis. <http://www.pewtrusts.org/en/research-and-analysis/analysis/2017/08/23/investments-costly-savings-program-drive-shortfall-in-dallas-pension-system>

<sup>7</sup> Appendix Exhibit 6



Figure 10  
**BackDROP Payments: Total and as a Percentage of Overall Benefit Payments**  
*BackDROP payments spiked in 2004 and 2011*



Sources: ERS actuarial reports and valuations, or other public documents, or as provided by plan officials.

**Rule of 75**

There are a range of retirement eligibility rules among the various ERS benefit tiers, including a Rule of 75 for some employees. An employee who is subject to the rule of 75 is eligible to retire when the person’s age and years of service added together equal 75 or more- for example, an individual hired at age 25 who works for 25 years could retire at age 50. The age and years of service rule is a commonly used method of determining retirement eligibility, with around 35% of state employee and teacher plans taking this approach. However, the retirement threshold is typically much higher than in Milwaukee County- 88 on average based on our review of more than 100 state employee and teacher plans, ranging from 80 to 92.<sup>8</sup>

Table 1  
**Retirement Eligibility Comparison: Rule of 75 vs. Rule of 88**

	Rule of 75	Rule of 88
<b>Starting Age</b>	25	25
<b>Years of Service</b>	25	31.5
<b>Retirement Age</b>	50	56.5
<b>Retirement Age + YOS</b>	<b>75</b>	<b>88</b>

Although we were unable to determine the number of current retirees who retired based on the rule of 75, the potential impact on benefit payments is clear. Under the Rule of 75, an example employee hired at age 25 would collect an additional 6.5 years of benefit payments compared to an employee subject to the average Rule of 88. While new employees stopped being eligible for the rule of 75 at various points over the past 15 years depending on the benefit tier and collective bargaining agreement, approximately 25% of the current employees were hired prior to the cutoff dates and remain eligible to retire under this rule.

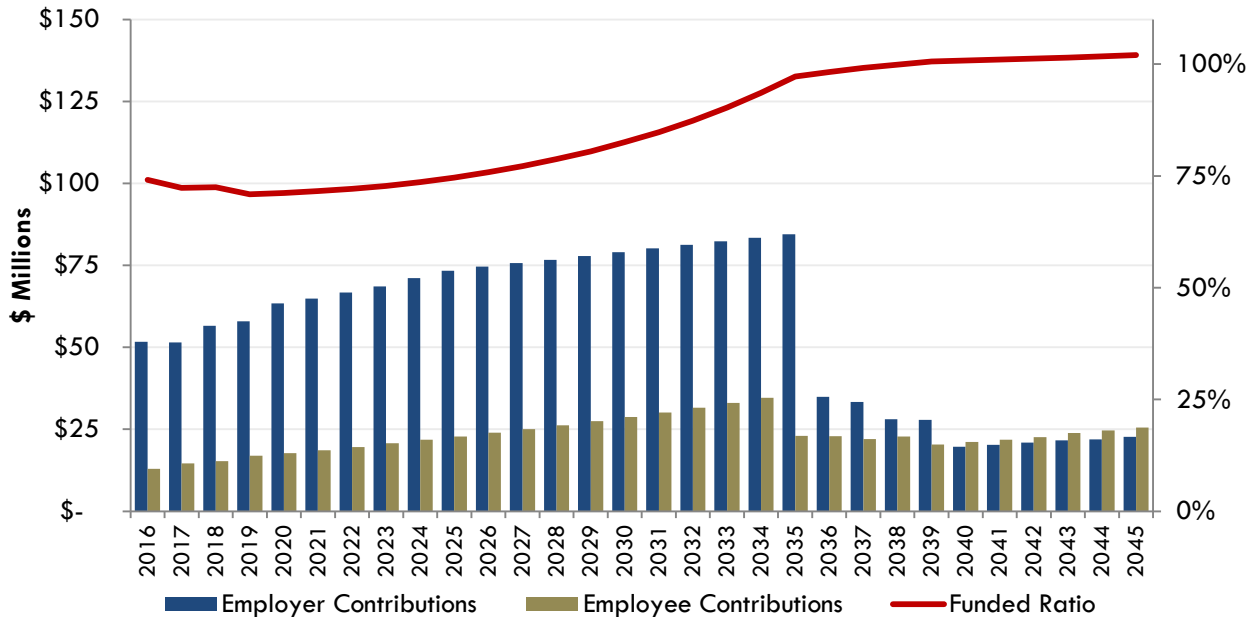
<sup>8</sup> Pew analysis of the most recent tier of state and teacher plans (107 plans) in the Urban Institute database of state and local pension plans.

## Finding #5

Total contributions are projected to rise over the next two decades, improving plan funding and operating cash flow but placing fiscal pressure on both the County and employees. A low investment return scenario exacerbates the fiscal pressure while limiting improvements to plan funding and operating cash flow.

Over the next 18 years, employer contributions are projected to rise from around \$50 million to \$84 million as the plan approaches full funding. At the same time, annual employee contributions will grow from \$13 million to \$35 million.

Figure 11  
**Long-term Projection of Contributions and Funded Status for ERS**  
*(Expected investment returns)*

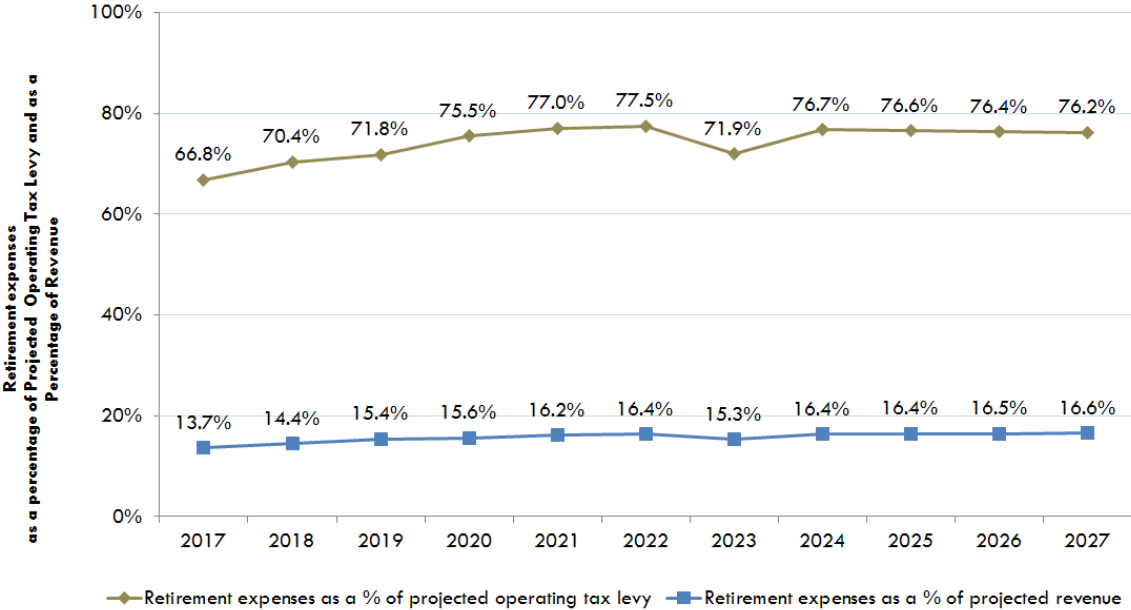


Note: Expected returns follow planned ERS schedule to lower discount rate gradually from 8% to 7.75% on 1/1/2018 and again to 7.50% on 1/1/2020.

Source: Projections by Pew and the Terry Group using a financial simulation model created using data from ERS Annual Reports, Actuarial Valuations and other documents provided by County and plan officials.

For the County, rising pension contributions, combined with the annual \$33 million POB payment and retiree healthcare costs will continue to account for a significant portion of the County’s projected operating tax levy over the next 10 years.

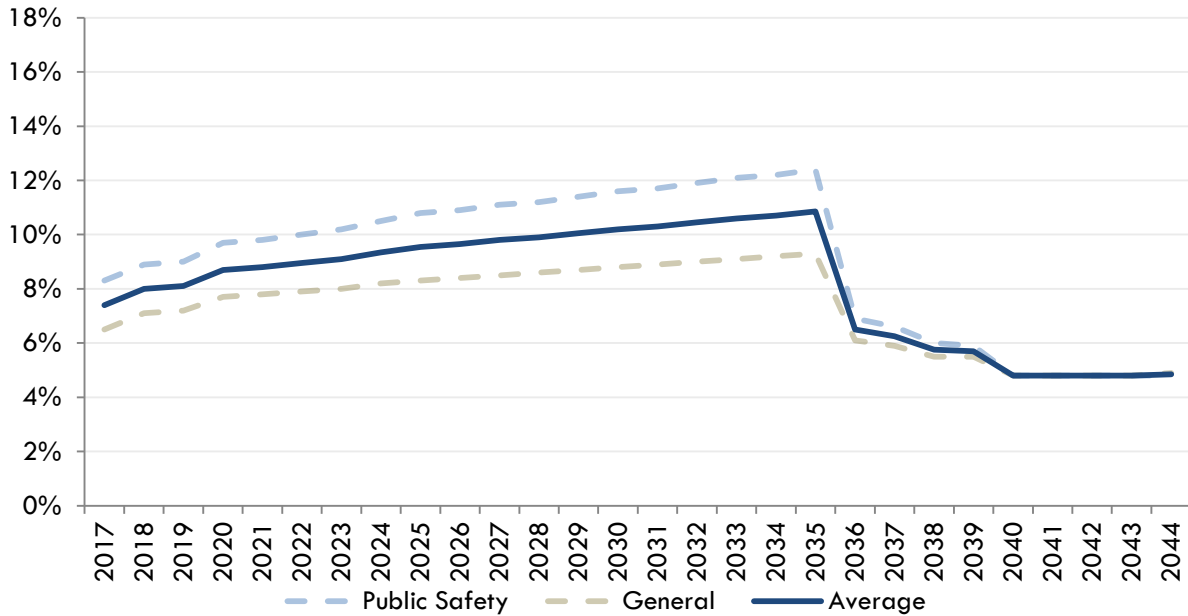
Figure 12  
**Forecast of Milwaukee County Retirement Expense**  
 Percentage of Tax Levy and Percentage of Projected County Revenue



**Note:** “Retirement expenses” include County contributions to ERS, the annual POB payment, and retiree healthcare costs.  
**Source:** ERS projections by Pew and the Terry Group using a financial simulation model created using data from ERS Annual Reports, Actuarial Valuations and other documents provided by County and plan officials. Retiree healthcare, POB costs and projected revenues provided by County.

While employees did not make contributions prior to 2011, employees and the County now split equally the normal cost, expenses and the unfunded liability payments attributable to active employees. The County continues to pay 100% of the unfunded liability attributable to retirees.<sup>9</sup> As a result, employee contributions fluctuate based on the health of the fund and rates are projected to rise to around 11% of compensation on average.

Figure 13  
**Projected Employee Contribution Rates Over Time**  
*All assumptions met.*

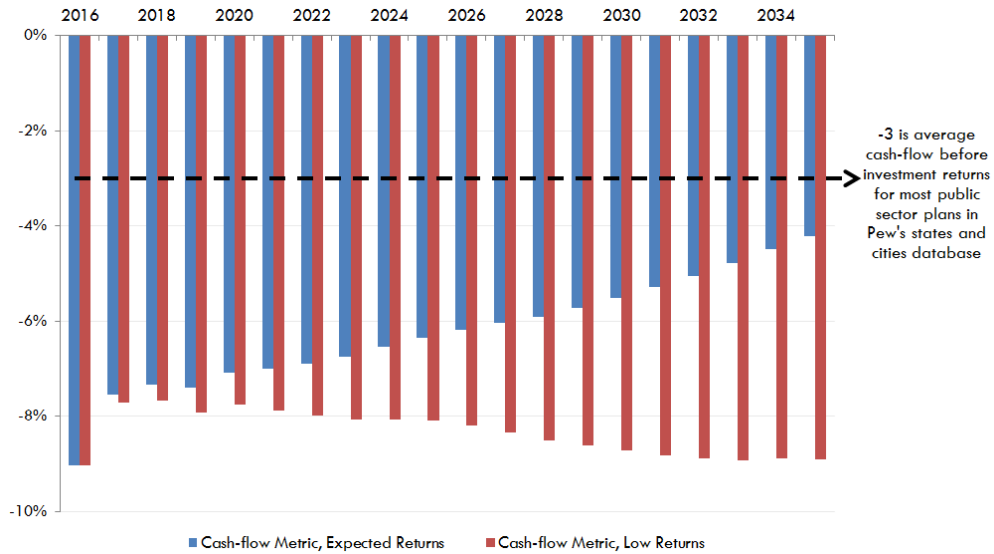


Note: Expected returns follow planned ERS schedule to lower discount rate gradually from 8% to 7.75% on 1/1/2018 and again to 7.50% on 1/1/2020.  
 Source: Projections by Pew and the Terry Group using a financial simulation model created using data from ERS Annual Reports, Actuarial Valuations and other documents provided by County and plan officials.

<sup>9</sup> Page 16, Table 6. 2017 ERS actuarial valuation.

Cash flow improves in a scenario where investments achieve the assumed rate of return, but still falls short of the national average. However, in a scenario where investment returns only achieve 5.5%, cash flow continues to erode even as contributions increase dramatically as shown in Figure 14

Figure 14  
**ERS Twenty Year Cash Flow Projections**  
*Expected and lower-than-expected investment returns*

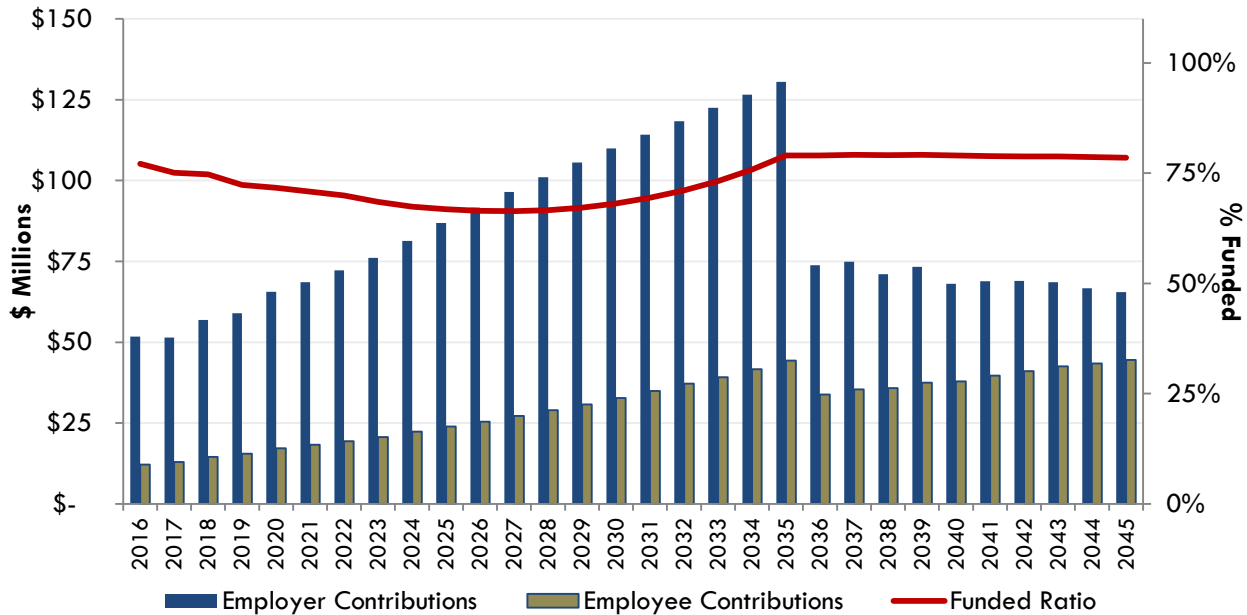


Note: Contributions held constant in scenarios. Expected returns follow planned ERS schedule to lower discount rate gradually from 8% to 7.75% on 1/1/2018 and again to 7.50% on 1/1/2020.

Source: Projections by Pew and the Terry Group using a financial simulation model created using data from ERS Annual Reports, Actuarial Valuations and other documents provided by County and plan officials.

Low investment returns drive required contributions up even further, peaking at \$175 million in 2035 and placing further strain on County resources.

Figure 15  
**Long-term Projection of Contributions and Funded Status for ERS**  
*(Low investment returns)*

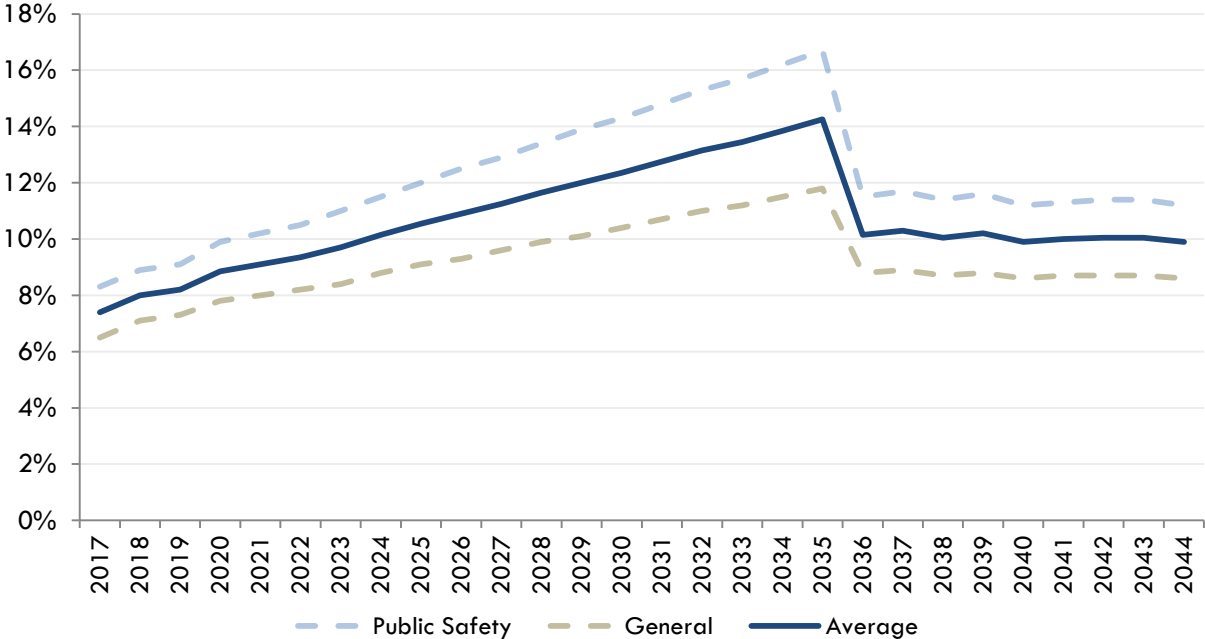


Note: projections assume long-term investment return rate of 5.50%

Source: Projections by Pew and the Terry Group using a financial simulation model created using data from ERS Annual Reports, Actuarial Valuations and other documents provided by County and plan officials.

For employees, the higher contributions translate to peak contribution rates that exceed 14% on average.

Figure 16  
**Projected Employee Contribution Rates Over Time**  
*If investment returns lower than expected, employee contributions can spike*



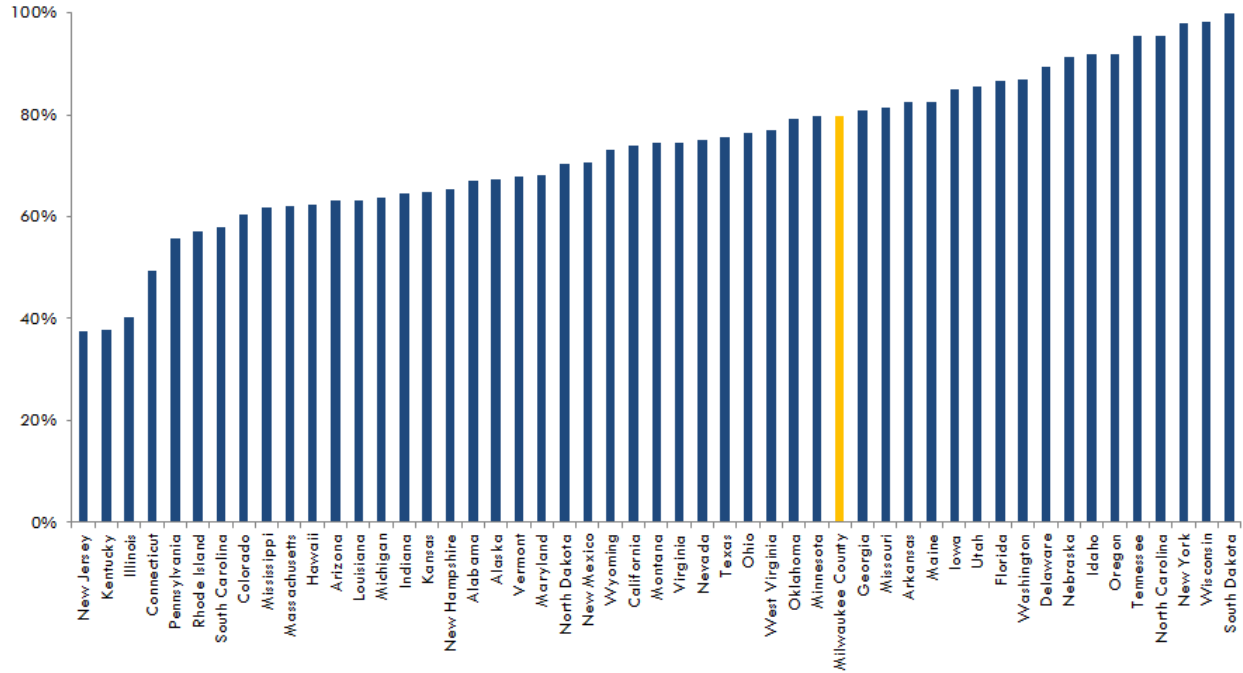
Note: projections assume long-term investment return rate of 5.50%  
Source: Projections by Pew and the Terry Group using a financial simulation model created using data from ERS Annual Reports, Actuarial Valuations and other documents provided by County and plan officials.

## Appendix

### Exhibit 1

# Comparative Analysis: State Funded Ratio (FY 2015)

Milwaukee County ERS funded ratio higher than 33 states.

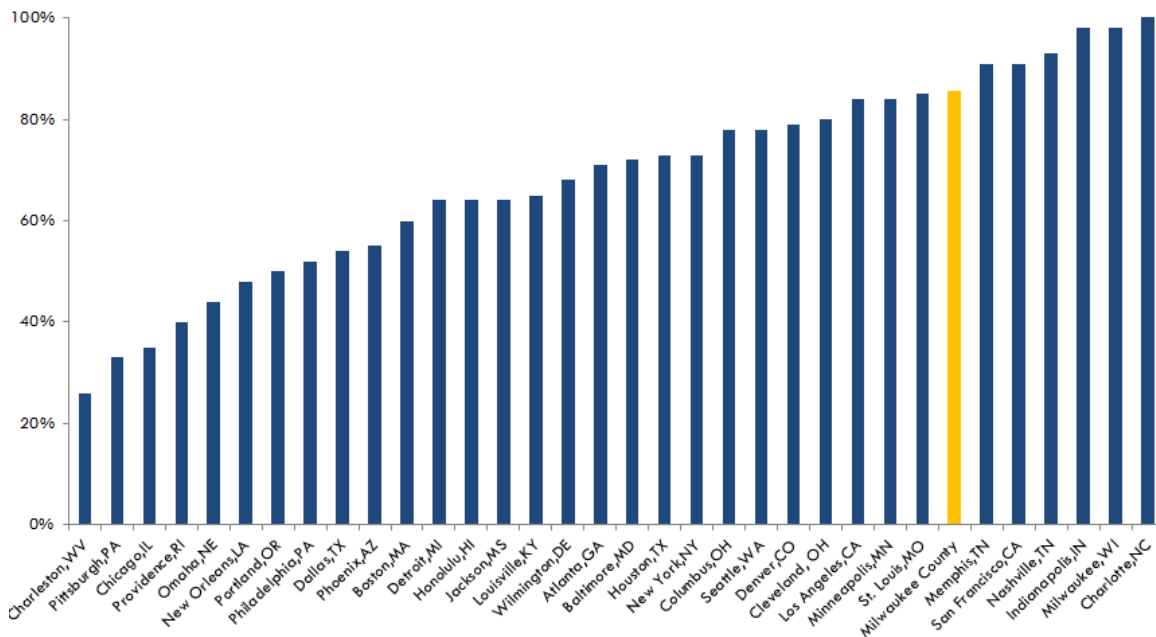


Source: Comprehensive Annual Financial Reports (CAFRs), actuarial reports and valuations, or other public documents, or as provided by plan officials.

### Exhibit 2

# Comparative Analysis: City Funded Ratio (FY 2014)

Milwaukee County ERS funded ratio higher than 27 cities.



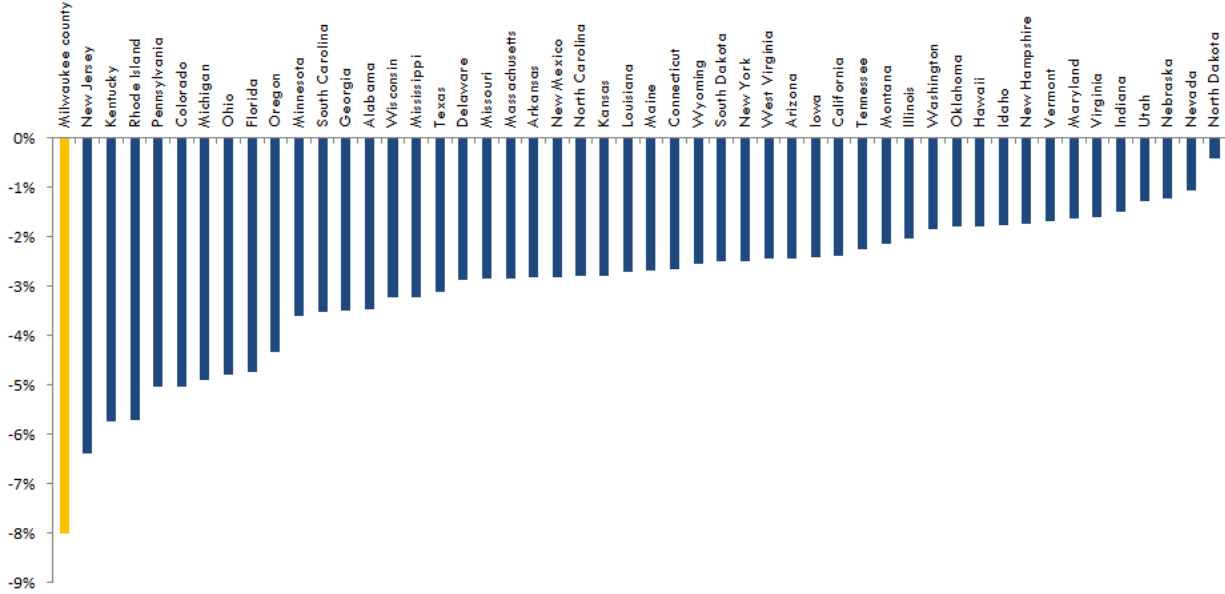
Source: Comprehensive Annual Financial Reports (CAFRs), actuarial reports and valuations, or other public documents, or as provided by plan officials.



Exhibit 3

## Comparative Analysis: State Operating Cash-Flow as a Share of Assets (FY 2015)

*Milwaukee County ERS paced behind all 50 states.*

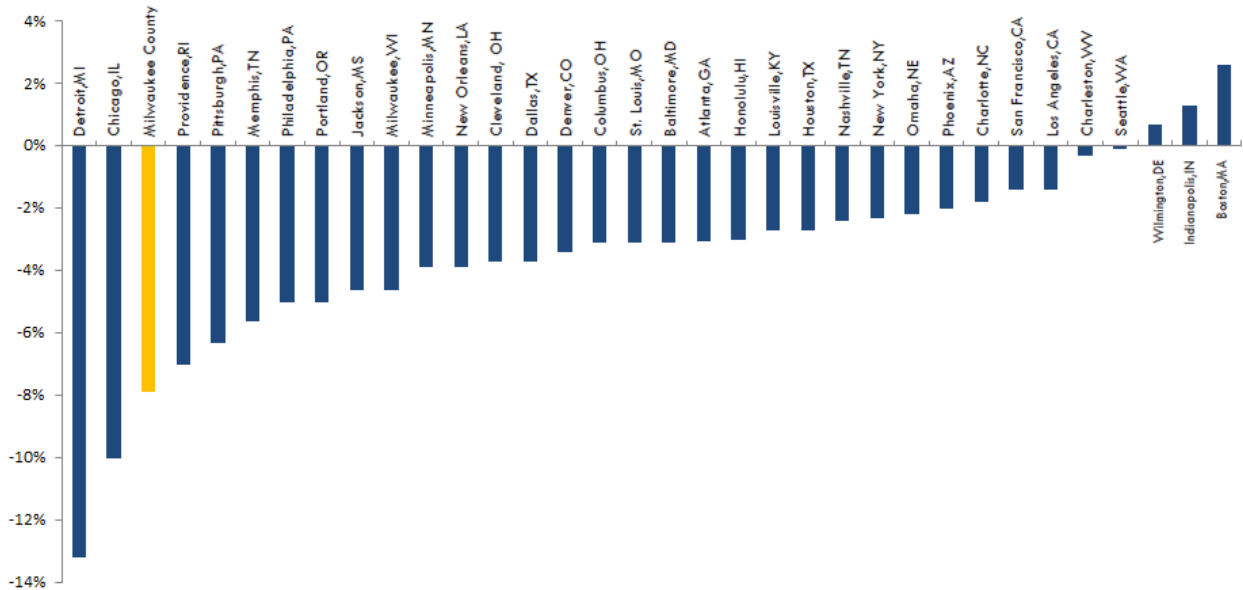


Source: Comprehensive Annual Financial Reports (CAFRs), actuarial reports and valuations, or other public documents, or as provided by plan officials.

Exhibit 4

## Comparative Analysis: City Operating Cash-Flow as a Share of Assets (FY 2014)

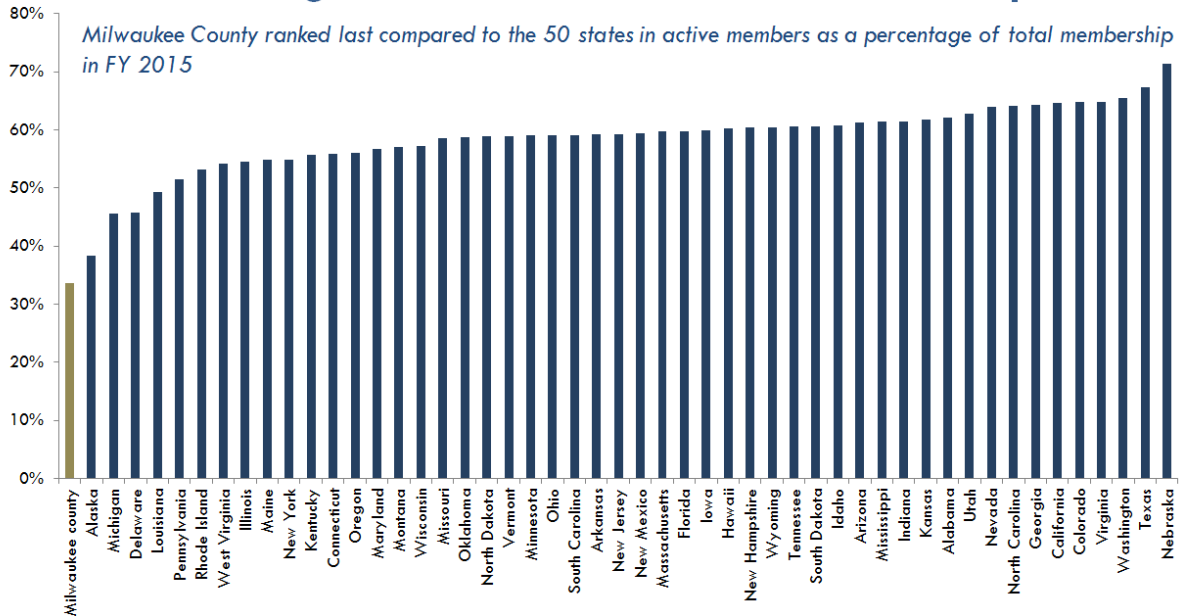
*Only Detroit and Chicago had lower operating cash-flow than ERS.*



Source: Comprehensive Annual Financial Reports (CAFRs), actuarial reports and valuations, or other public documents, or as provided by plan officials.

**Exhibit 5  
Comparative Analysis:**

**Percentage of Actives as a Share of Total Plan Membership**



Note: Milwaukee County ERS compared to 50 States using FY 2015 data

Source: Analysis by The Pew Charitable Trusts using Pew's states and cities database and publicly available comprehensive annual financial reports and valuation reports

**Exhibit 6**

**Milwaukee County ERS  
January 1, 2016 Valuation**

**Liability and Normal Cost Breakout attributable to Backdrop Benefits:**

<u>January 1, 2016</u>	<u>DROP Benefits</u>	<u>All Other Benefits</u>	<u>Total</u>
Active Accrued Liability	81,096,786	409,475,729	490,572,515
Normal Cost	598,627	15,495,697	16,094,324

**Projected Benefit Payments attributable to Backdrop Benefits:**

<u>Year</u>	<u>Total Projected Benefit Payments</u>
2016	13,639,554
2017	12,417,562
2018	11,788,464
2019	11,451,815
2020	10,501,941
2021	9,650,988

Source: Information provided to County by plan actuary.