MERS Basics for Trustees

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MERS
Municipal Employees' Retirement System

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RETIREMENT
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Objectives for Today

- Review of MERS
  - Who we are
  - What we do
  - Products we offer
- Actuarial Basics
  - Methodology
  - Pension Funding
  - Key Terminology
- Managing Unfunded Liabilities
  - What they are
  - How they develop
  - Case studies
  - Changing Plans
  - Bonding

About MERS

- We are a statewide nonprofit organization that has helped provide retirement plans for municipal employees for more than 65 years
  - We began with just 13 municipalities in 1946
  - Today we partner with over 800 Michigan municipalities and nearly 100,000 participants
- We are governed by a Retirement Board that is elected by our membership

38,000 +
Number of MERS participants retired from or working for county governments or road commissions

90% +
Percentage of MERS 26,000+ retirees that remain in the state

23,000 +
Number of MERS participants retired from or working for city governments

$18,000 +
Average pension payment

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How We Help

- We provide one-stop access to shared professional retirement services
  - Plan Governance
  - Administration
  - Portfolio management
  - Investment options
  - Participant education
  - Customer service
  - Legal counsel
  - Actuarial services
  - Plan compliance, including tax qualification
- We offer a range of customizable plans which employers can choose from to fit their budget and manage their ongoing unfunded pension and retiree health care (OPEB) liabilities

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MERS Investments Practices

- MERS follows Michigan state law and prudent standards of diligence
- Our assets are invested in accordance with the Public Employee Retirement System Investment Act (PERSIA)

Investment Fees

- One of the greatest benefits provided to members of MERS is our ability to "pool" assets, for investment purposes only
- Pooling creates tremendous buying power and helps reduce the overall fees for our municipalities

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Our Programs

Retirement Plans

- Defined Benefit
- Defined Contribution
- Hybrid

OPEB Programs

- Health Care Savings Program
- Retiree Health Funding Vehicle

Supplemental Retirement

- 457 Program

MERS Defined Benefit Plan

- Traditional pension plan which provides retirees a lifetime monthly benefit
- Gives employees an important tool to help them reach their retirement goals
- Defined Benefit Formula:

Final Average Compensation X Service Credit X Benefit Multiplier = $ Annual Benefit

MERS Defined Contribution Plan

- Pre-tax contributions are made to an employee's account throughout employment
- Assets are invested and accumulate tax-deferred
- Retirement benefit is account balance

Employer Contributions + Employee Contributions + Earnings or Losses in the Market − Fees = $ Account Balance

Evolution of the MERS Defined Contribution Plan

1997

- MERS Defined Contribution Plan was established
- Outsourced to a third-party administrator

2008

- At the request of our membership MERS pooled investment options added to the investment menu

2011

- MERS brought the plan in-house
  - Saved members $656,000 annually in fees
  - Created a strategic investment menu
  - Created a transparent fee structure
  - Modified loan provisions

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MERS Hybrid Plan

- Combines the security of a modest defined benefit plan with the flexibility and investment choice of a defined contribution plan
- Defined benefit portion is designed to provide stability by **not** allowing for benefit improvements

Part I – Defined Benefit

Final Average Compensation X Service Credit X Benefit Multiplier = $ Annual Benefit

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Part II – Defined Contribution

Employer Contributions + Employee Contributions + Earnings or Losses in the Market – Fees = $ Account Balance

$ Total Retirement Benefit

MERS 457 Supplemental Retirement Program

- Offers employees a self-directed account in which a portion of their salary is deposited into an invested account
- The employee decides level of contributions and how to invest assets to meet their goals and personal risk tolerance
- Benefits are based on the total dollar amount in account when employee leaves

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Retiree Health Funding Vehicle

- A qualified 115 medical trust in which employers can dedicate assets to offset their retiree health care liability
- Allows employers to accumulate funds for post employment health care benefits
- Employer decides how much of their OPEB liability to fund based on budgetary constraints and plans for funding
- Earnings on assets reduce long-term contributions and unfunded liability
- Contributes to a positive credit rating
- Assets are legally protected from creditors and may only be used for OPEB
- Provides economies of scale and pooling

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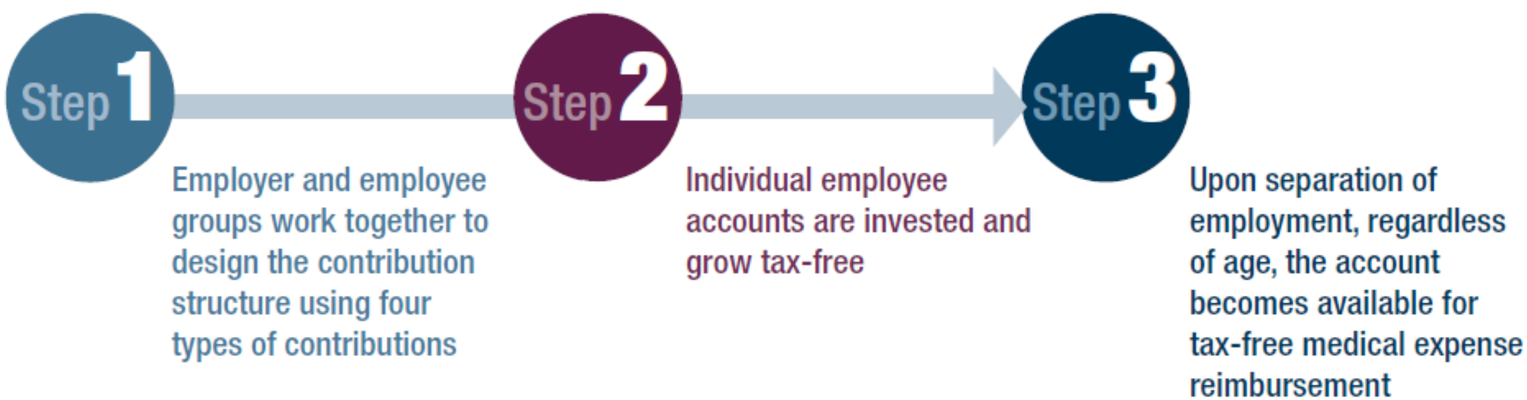
Health Care Savings Program

MERS Health Care Savings Program	

MERS Health Care Savings Program

- Employer-sponsored program providing a tax-free medical savings account
- For covering the costs of post employment medical expenses only
- Tax-exempt Section 115 Governmental Integral Part Trust
  - Ensures the assets are used for future medical expenses only



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Health Care Savings Program Benefits

Employer Benefits	Employee Benefits
• A valuable employee benefit with no administrative cost to the municipality • Does not incur additional unfunded OPEB liability • Tax-free contributions are exempt from FICA taxation, saving the municipality on the amount contributed • MERS administers the entire plan	• Participants receive a savings plan that can help them build health care assets before leaving employment • Program offers tax-free savings • Participants have the ability to name beneficiaries other than a spouse or children • Access to MERS investments • Eligible participants can use the mySourceCard®

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Actuarial Basics

Funding Concepts of Retirement Plans

- Pre-funding
  - Set aside money now to pay for the benefits promised later
  - Investment income helps pay for the benefits promised
  - More level funding method
- Pay-as-you-go
  - Pay the benefits as they come due
  - Forego investment income
  - Increasing funding method

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Funding Concepts of Retirement Plans

Basic Funding Equation

Contributions + **Investment Income** = **Benefit Payments** + **Expenses**

This equation must hold for any financing arrangement to be self-sustaining

Funding Concepts of Retirement Plans

- Defined Benefit Plan
  - An actuarial valuation is necessary to calculate the employer contribution
- Defined Contribution Plan
  - Actuarial valuation is not needed because employer contribution is defined
- Hybrid Plan
  - An actuarial valuation is necessary for the defined benefit portion

Actuarial Valuations

- A mathematical process that estimates plan liabilities and calculates employer contribution requirements for each division with Defined Benefit (or the Defined Benefit portion of the MERS Hybrid Plan)
- Provides employer and employee contribution rates for future fiscal year
- Provides updates to funding levels, history of plan provisions and tracks employee demographics
- Provides Governmental Accounting Standards Board (GASB) information for annual audits
- DOES NOT determine the ultimate cost of benefits, only the pattern of employer contributions

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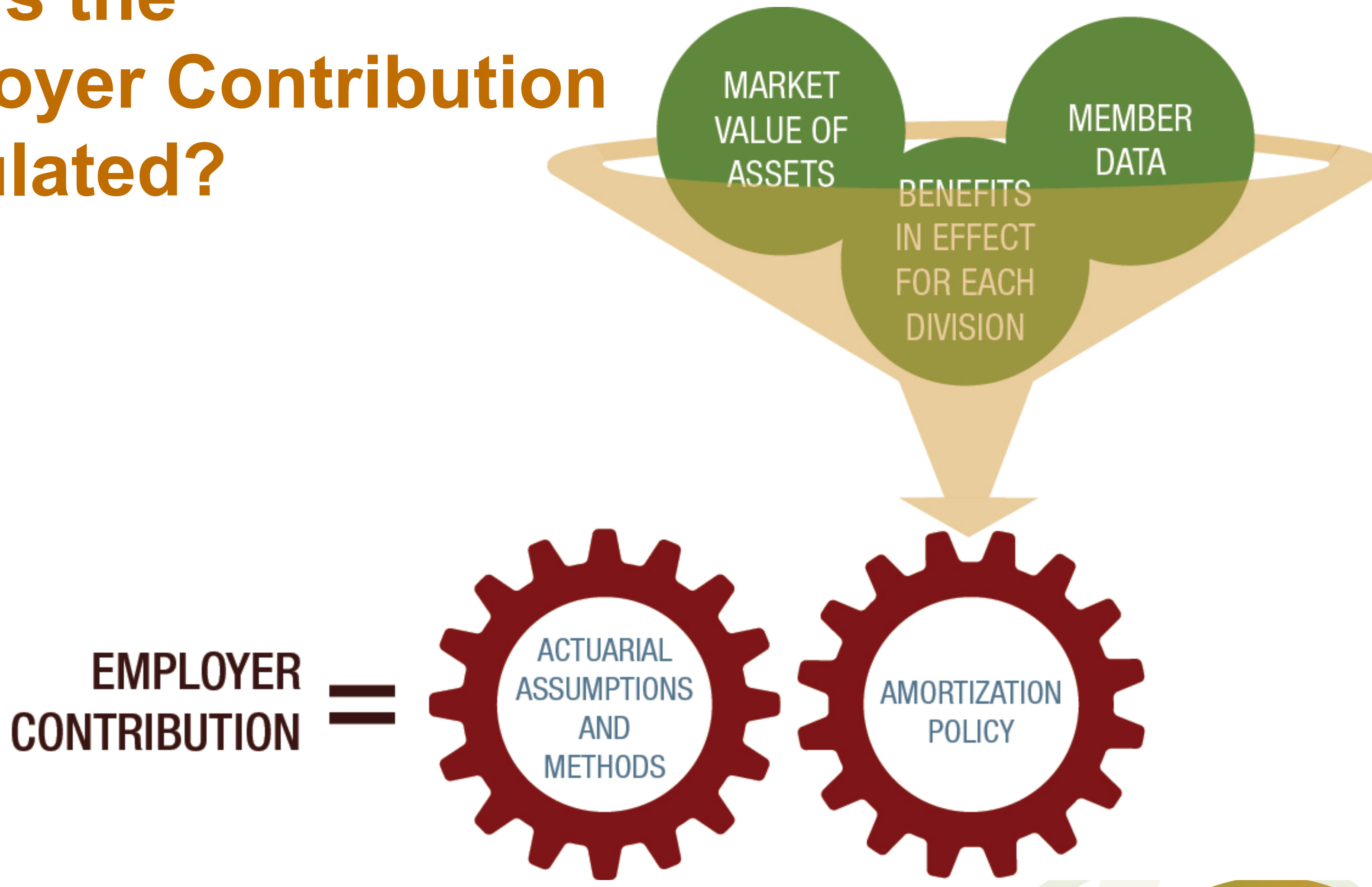
How is the Employer Contribution Calculated?



Actuarial Assumptions and Methods established by the Retirement Board

Key Actuarial Terminology

- **Actuarial Accrued Liability (AAL)**
  - Portion of PVFB allocated to past service
- **Actuarial Value of Assets (AVA)**
  - Reflects market value fluctuations over time
  - AVA is used in the calculation of the employer contribution
  - Intent is to generate a smoother pattern of employer contribution
- **Unfunded Actuarial Accrued Liability (UAAL)**
  - Difference between AAL and AVA
- **Normal Cost (NC)**
  - Portion of PVFB allocated to current year

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Employer Contributions

Employer contribution rate is made of up two parts:

1. **Employer Normal Cost**– Present value of benefits allocated to the current plan year less any employee contribution

2. **Amortization Payment of Unfunded Accrued Liability**– Payment to reduce any shortfall between liability for past service and assets

Employer Normal Cost + Amortization Payment of the Unfunded Actuarial Accrued Liability = Employer Contribution

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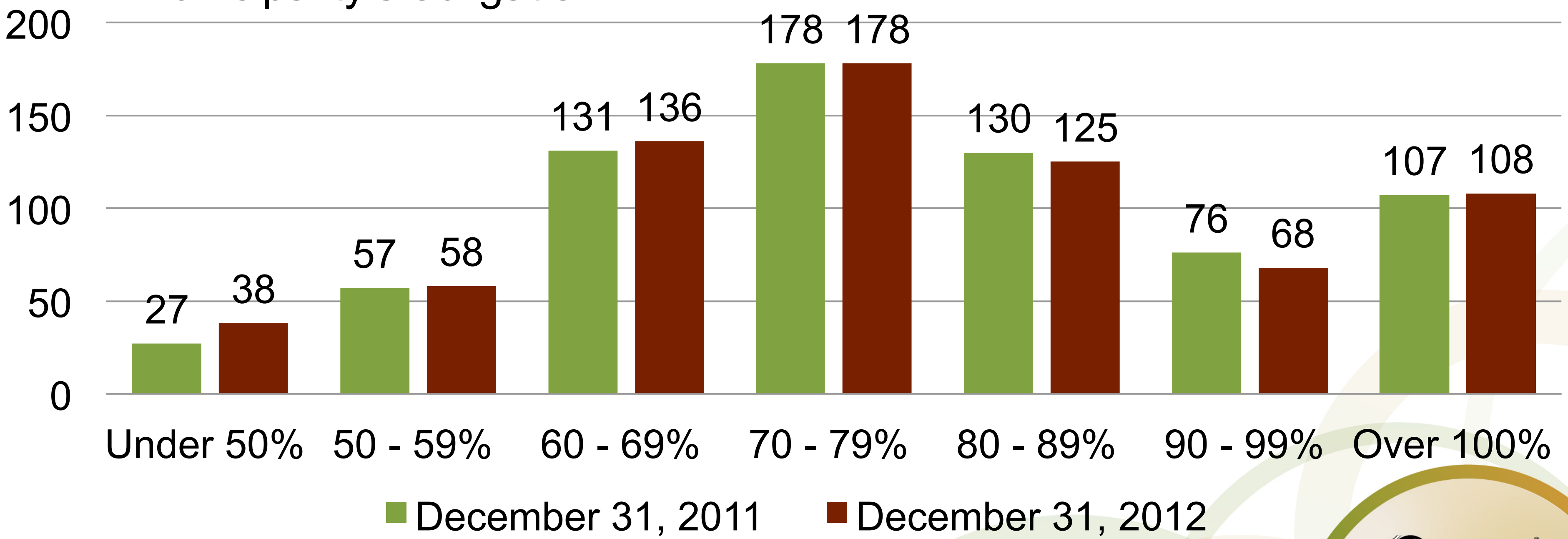
Managing Unfunded Liabilities and Increasing Costs

Distribution of Funded Percentage

MERS is a multiple-employer plan

- Assets of the participating employers are pooled for investment purposes only
- Separate trusts are maintained for each individual employer
- We do not borrow from one municipality's account to cover another municipality's obligation



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Why Do Retirement Plans Have Unfunded Liability?

- Many new defined benefit plans were not fully funded from the beginning
  - Adopting prior service credit for employees and did not require them to roll over assets
- Improved benefits adopted, due to collective bargaining, and financed over-time
- Early retirement windows
- In addition, some municipalities are facing increased employer contributions due to:
  - Actuarial Assumptions are not being met

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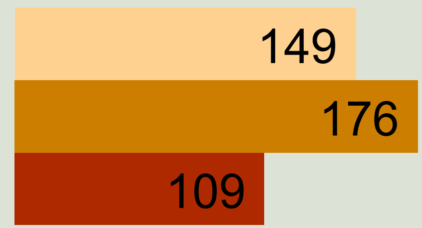
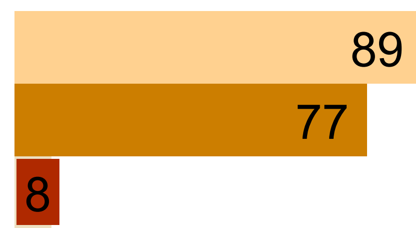
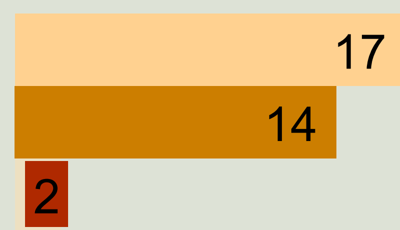
Defined Benefit Case Studies

Underfunded Plan	Well Funded Plan
• Joined MERS in 1992 – Transferred from an external DC plan – Joined at 15% funded • Added benefit improvements such as a cost-of-living adjustments • Avg. pension $34,000 • 41% funded today	• Joined MERS in 2004 – Transferred from an external DC plan – Joined at 100% funded • Made no benefit improvements • Avg. pension $20,000 • 107% funded today

Cost-Reducing Strategies

Strategy	Description	Trend 2012 2011 2010	Impact
Cost Sharing	Employees contribute to help fund the overall cost of the plan		• Reduces the employer cost, but does **not** affect total cost, or the plan's unfunded liability
Lower Benefit to New Hires	New hires are covered by a lower tier of either Defined Benefit or Hybrid benefits		• Existing employees are not effected • Reduces the liability for new hires
Bridged Benefits	Benefits are offered in parts to existing employees Multiplier is lowered on a going-forward basis		• Leaves earned benefits unchanged • Reduces the liability for new hires and existing employees

Changing Plans: Defined Benefit to Hybrid

- New hires, rehires, and transfers are covered by the Hybrid Plan
  - Active employees may be given a one-time option to convert if municipality meets funding requirements

More than 80 divisions have moved from MERS Defined Benefit Plan to MERS Hybrid Plan

- Actuarial report is needed to calculate the contributions for the Defined Benefit portion of the Hybrid Plan
- Defined Benefit Plan division is **not** subject to the closed division policy
  - Assets can be used to finance the benefits for members covered by old Defined Benefit Plan and members covered by the new Hybrid Plan Part I - defined benefit portion
  - No accelerated funding and short term contribution spike

Changing Plans– Defined Benefit to Defined Contribution

- New hires, rehires, and transfers are covered by the Defined Contribution Plan
  - Active employees may be given a one-time option to convert
- Funding level for municipality and division is considered when making this change
- A projection study is required
  - Shows the long-term cost of the current benefit plan compared to the long-term cost of the proposed benefit plan
  - Shows how employer contributions would be affected 20 years into the future
- Defined Benefit division is subject to closed division policy
  - Reduced amortization schedule and accelerated funding requirements
  - Assets in the Defined Contribution Plan cannot be used to pay benefits for members covered by closed Defined Benefit Plan

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Closed Division Amortization Policy

- MERS Board requires accelerated funding of a closed defined benefit division, which ensures it is funded properly
  - Assets are dedicated for future retirees
  - Currently, MERS requires the municipality to become fully funded more rapidly in order to pay promised benefits
- MERS has two options for amortization

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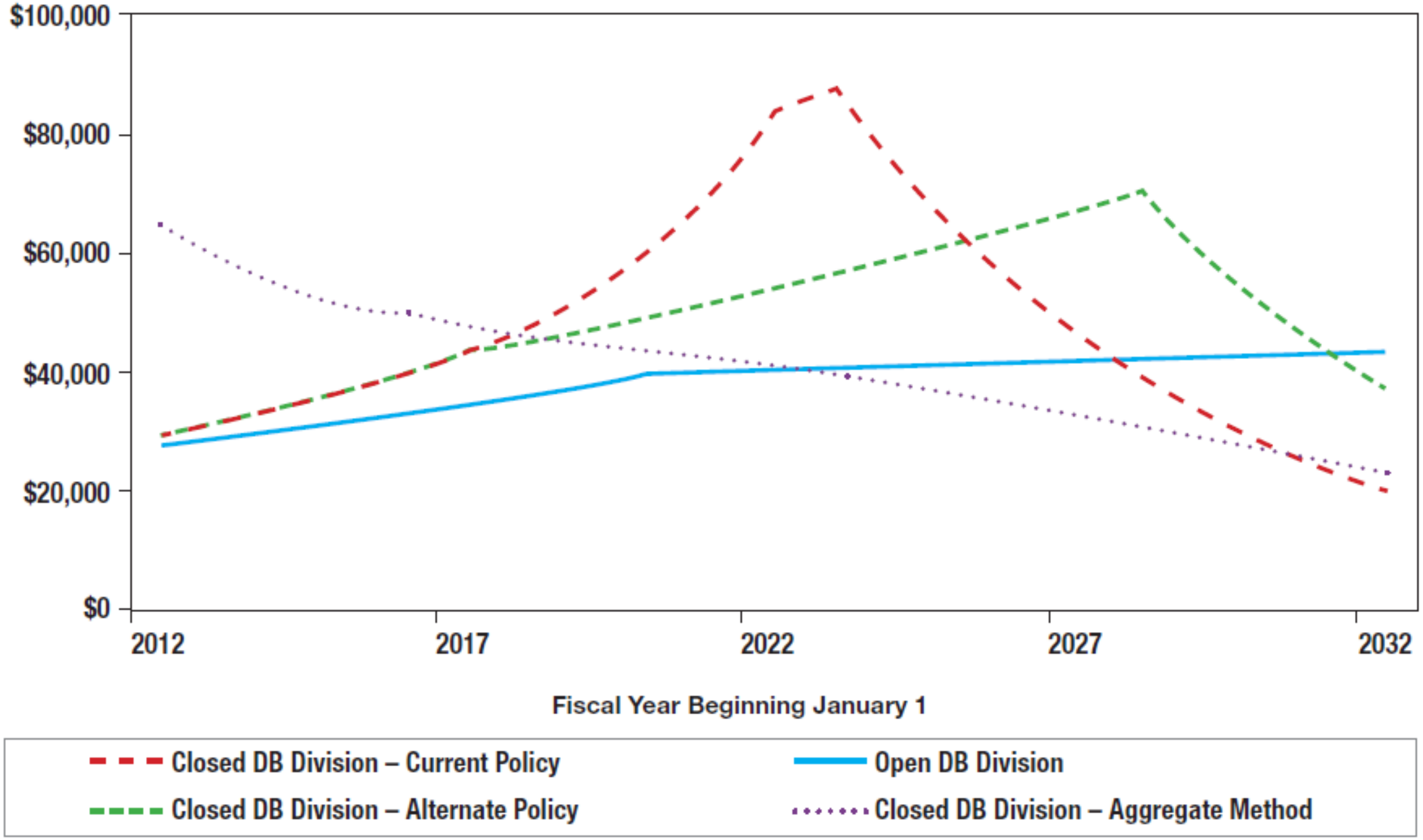
MERS Amortization Options

Option A Current MERS Policy	Option B Alternative MERS Policy
• Amortization period begins two years below current schedule • Schedule decreases by two years each year until five years is reached • Division holds at a five year amortization schedule	• Amortization period begins two years below current schedule • Schedule decreases by two years each year until 15 years is reached • Schedule decreases by one year each year until it reaches five years • Division holds at a five year amortization schedule

MERS Amortization Options



Why Do OPEB Plans Have Unfunded Liability?

- Majority of local governments did not calculate the liabilities until required to do so by accounting standards beginning in 2007
- Many plans have not been prefunded
  - Over time prefunding allows for investment earnings to offset liabilities

Examples of Other Post-Employment Benefits (OPEB)

Other post-employment benefits

- Life Insurance
- Disability
- Long-Term Care
- Group Legal
- Health Care

Health care benefits

- Medical
- Prescription Drugs
- Dental
- Vision

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City Reduces OPEB Liability – Example

Overview	• A City with 1,800 employees offered full retiree health care benefits to vested employees • OPEB liability totaled $200 million • Funds set aside were less than liability total
Decision	• Negotiated new program for retiree health care: – New hires receive health care savings account in lieu of retiree health care – Existing employees allowed option to convert to the new program, which is not a medical plan
Health Care Savings Program	• For new hires: – Employer contribution of $1,800 per year, with a vesting schedule of 10 years – Mandatory Salary Reductions of 5% of salary • For conversions, lump sum actuarially calculated using present value of benefit
Retiree Health Funding Vehicle	• Transferred existing funds to MERS funding vehicle to take advantage of our pooled investment funds • The City continued to pre-fund OPEB liability

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Bonding

- Public Act 329 of 2012 allows a municipality to issue a security, or Pension Obligation Bond (POB), to offset all or a part of a retirement program's unfunded liability, subject to certain conditions
- Municipalities may also bond for OPEB liability
- MERS is available to assist, by providing bonding projections

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Bonding Projection

Important Points:

- The unfunded accrued liability will be calculated as of a December 31st date
  - The amortization period will decline to zero
  - The selected closed amortization policy will be used
- The data will be based off of the most recent actuarial valuation
- There is no guarantee divisions will remain fully funded

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Bonding Projection

Projected Amortization Payments Based on December 31, 2011 Actuarial Valuation
sed Amortization Policy Option A - Modified After Reaching 5-Year Amortization Period

			Based on the Actuarial Value of Assets		Based on the Market Value of Assets	
Fiscal Year Beginning July 1	mortizatio Period	mortizatio Factor	Beginning of Year UAL Balance	Amortization Payment	Beginning of Year UAL Balance	Amortization Payment
2013			11,822,628	878,812	18,017,891	1,333,732
2014			11,854,925	960,867	18,072,926	1,457,721
2015			11,804,510	1,059,313	18,003,478	1,606,291
2016			11,647,729	1,180,883	17,774,038	1,789,451
2017			11,352,035	1,337,201	17,335,849	2,024,411
2018			10,870,195	1,550,724	16,618,369	2,344,224
2019			10,127,853	1,873,130	15,511,048	2,824,305
2020			8,990,987	1,989,951	13,816,103	3,002,246
2021			7,641,737	2,130,209	11,800,596	3,216,625
2022			6,038,752	2,241,198	9,401,004	3,384,838
2023			4,192,156	2,367,815	6,634,590	3,577,112
2024			2,066,216	967,327	3,446,995	1,741,530
2025			1,225,990	560,022	1,912,457	874,380
2026			741,934	585,223	1,156,546	913,727
2027			192,957	200,477	299,262	310,926
2028			0	-	0	-
2029			-	-	-	-
2030			-	-	-	-
2031			-	-	-	-
2032			-	-	-	-
2033			-	-	-	-

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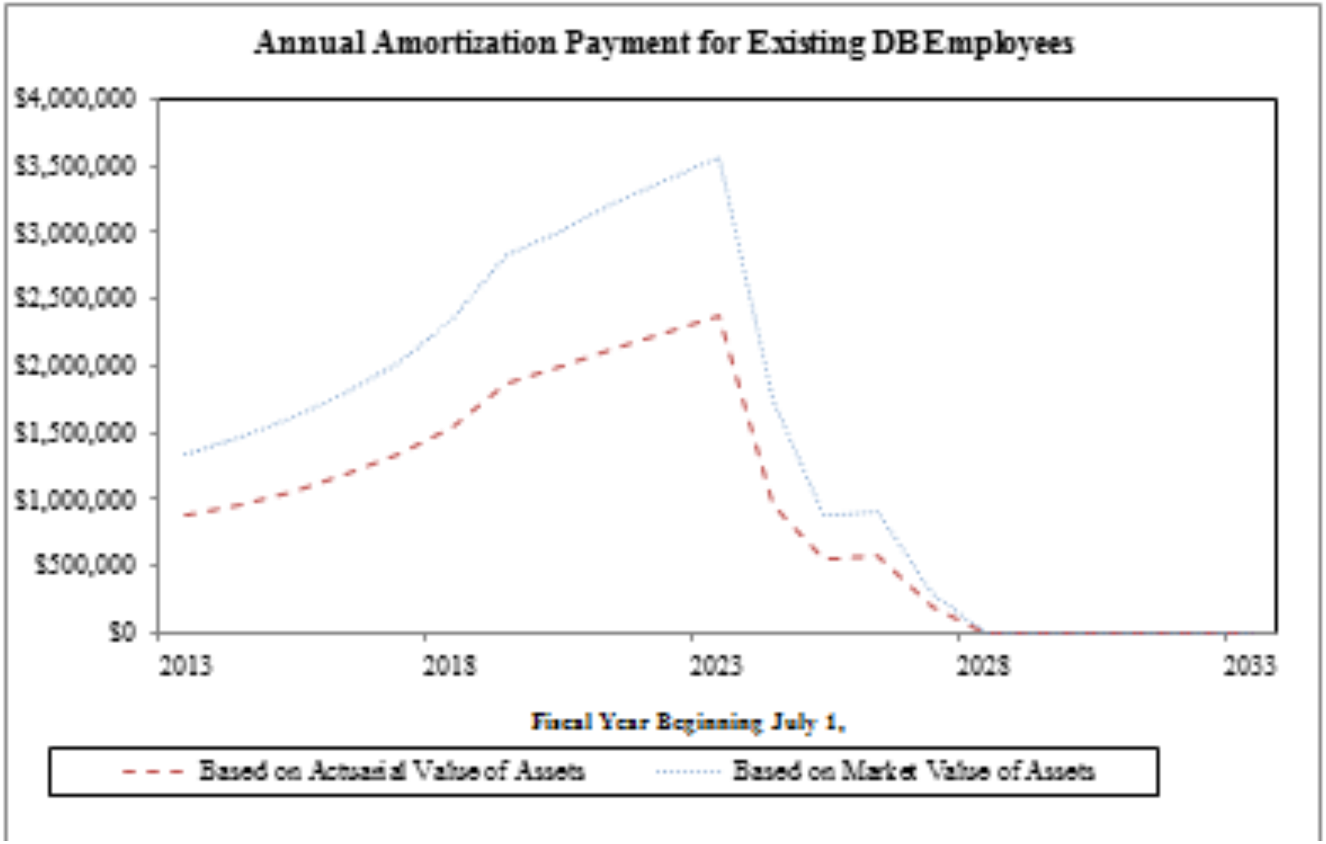
Bonding Projection



MERS Fiscal Best Practices

- Require municipalities to be at least 50% funded when they join MERS
- Require actuarial reports to illustrate the financial impacts of benefit improvements
- Require municipalities be at least 100% funded or pay for the benefit upfront in order to make improvements
- Streamlined our process for defining and reporting compensation
  - Limits lump-sum payouts which avoids unexpected “spiking” of final compensation
  - Built flags into our reporting system that help inform employers on excess amounts of compensation that are being reported
  - Apply actuarial loads to groups that have demonstrated a history of unexpected final average compensation spikes

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Concluding Observations

MERS is in the business of partnering with our local governments by offering:

- A complete range of products
- Cost-effective fees
- Innovative product development to meet emerging needs
- Fiscally responsible governance

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Please take time to fill in your survey

There are session surveys in the back of your book. Please take the time to fill in the survey to assist us in planning future events!

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Contact Us

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