



# 2017

## RETIREMENT CONFERENCE

# Pension Funding & Plan Design

## Part 1 – The Fundamentals

*Presented by Sue Feinberg  
and Matt Taylor*



# Agenda

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- Overview of MERS
- How Defined Benefit Plans Work
- Fundamentals of Pension Funding
- Determining Annual Contributions
- How Unfunded Accrued Liability Develops
- Best Practices



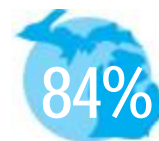
# About MERS of Michigan

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MERS is an independent, professional retirement services company that was **created to administer** the retirement plans for Michigan municipalities on a **not-for-profit basis**

## BY THE NUMBERS

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of Michigan's pension plans participate with MERS



participants

A green rectangular icon with a white border containing the text "\$10 Billion".

\$10 Billion

in combined total assets



# An Independent Elected Board

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- MERS is governed by an elected board that operates without compensation
- Our board is committed to accountability and transparency; holding the line on costs; and watching out for the best interest of our members
- MERS provides customers with peace of mind because the ***MERS Retirement Board takes on the sole fiduciary responsibility of their plan***



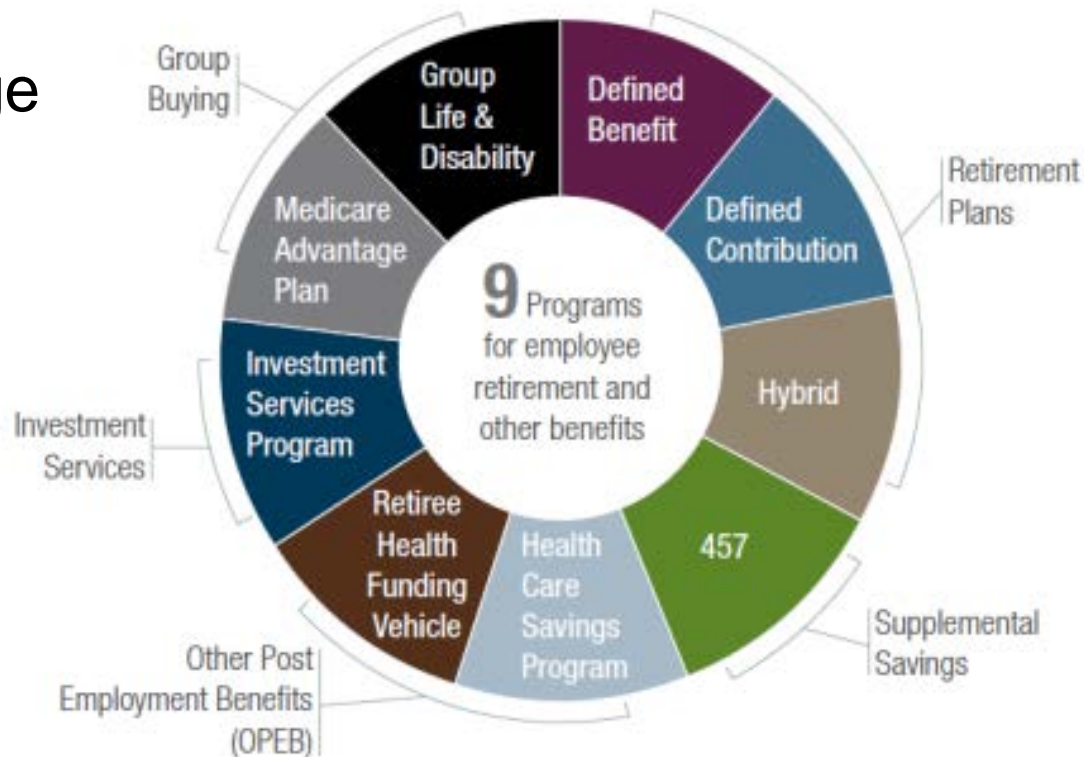
## **MERS Retirement Board**

is responsible for administration of the system with fiduciary responsibility for the investment of assets and oversight.



# One Size Does Not Fit All

- Each municipality has unique needs
- We offer a broad range of customizable plans and services
- We listen to our members and continuously add new products and tools to meet their needs



# Public Sector Retirement Options

## Defined Benefit

- Lifetime benefit that does not fluctuate with investment gains or losses
- Contributions fluctuate
- Funded by the employer, employee and investment earnings

## Hybrid

- Combines the best of both plans
- Benefit and contributions vary
- Funded by the employer, employee and investment earnings

## Defined Contribution

- Benefit based on account balance
- Fixed contributions
- Funded by the employer, employee and investment earnings

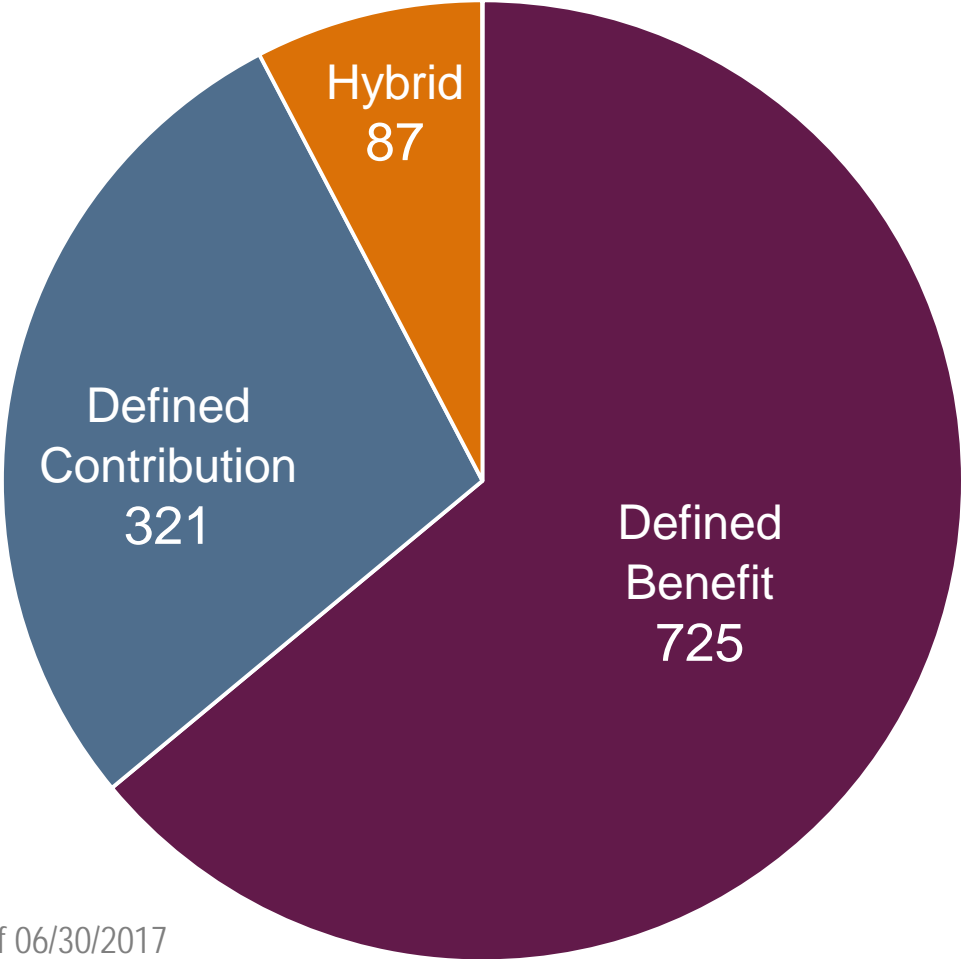
## 457 Program

- Supplemental savings account that can be added to any retirement plan
- Voluntary and flexible employee contributions
- Pre-tax and Roth options



# MERS Retirement Plan Customers

MERS partners with 876 municipalities\*  
*Some municipalities have multiple plans*



\*As of 06/30/2017



# Pooling Powers Financial Security

- MERS administers more than 2,000 different plans
- Each municipality's retirement plan is maintained in a separate trust
- MERS pools assets for investment purposes, which provides huge benefits to members, including lower administrative costs

Pooled assets for buying power



Separate accounts to maintain each municipality's security





# How Defined Benefit Plans Work



# Lifetime Benefit for Career Employees

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# Defined Benefit Formula

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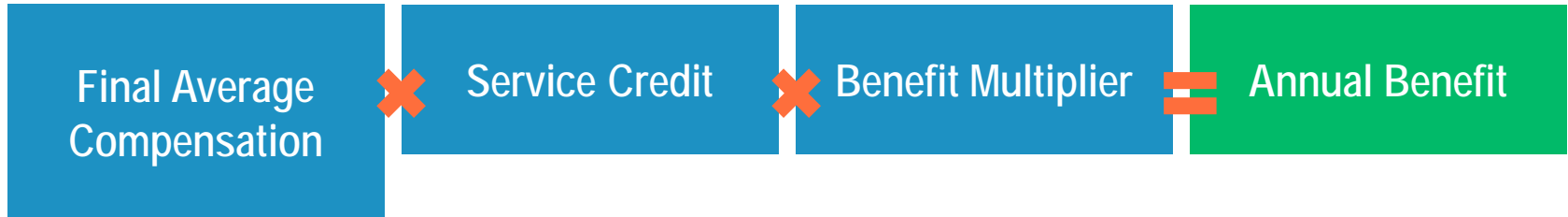
The benefit formula is comprised of three components:

- Final Average Compensation
- Service Credit
- Benefit Multiplier



# Final Average Compensation

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- Average of the highest consecutive wages
- Majority of divisions use a 3-5 year period
  - 3-year period (47%)
  - 5-year period (52%)
- The average compensation is \$51,084



# Service Credit

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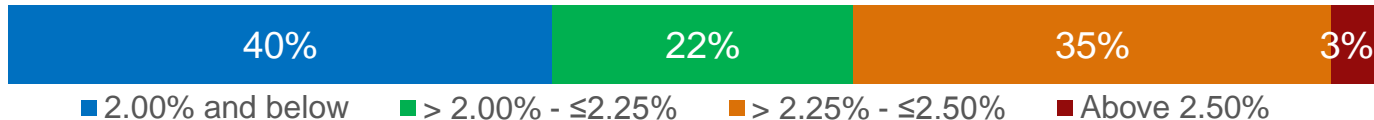
- Earned for each month of work that meets the employer's requirements
- To reach an 80% income replacement rate, a participant would need to work approximately 32 years (with a 2.5% multiplier)



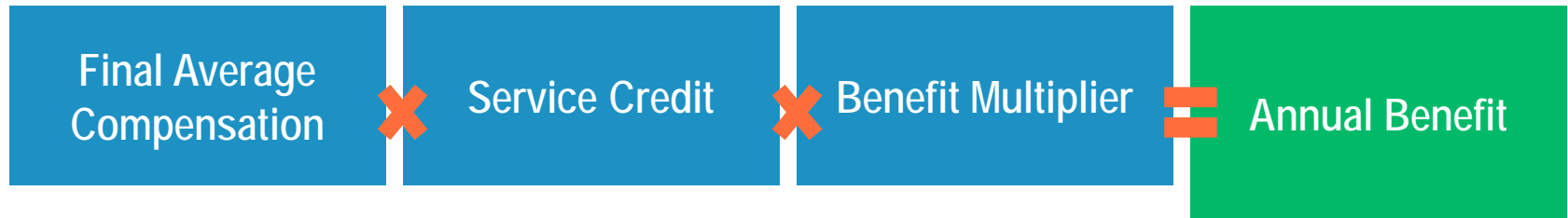
# Benefit Multiplier



- Benefit multiplier is a specific percentage adopted by the employer
- About a third of divisions have a 2.5% multiplier
  - No new divisions are adopting this provision
  - Higher multiplier divisions may have opted out of Social Security
- Experience over the past two years been:
  - 30% increase in divisions with the 1.5% multiplier
  - 53% increase in divisions bridging to lower multipliers



# Annual Benefit

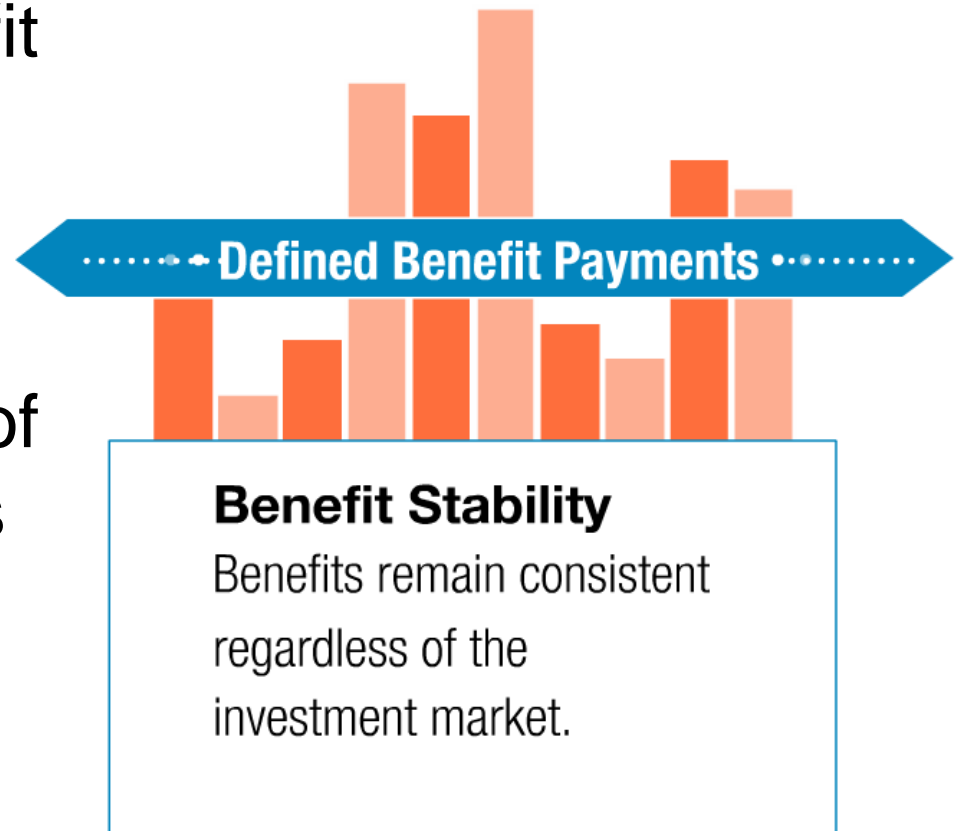


- To be eligible to receive a benefit an employee must meet both age and service requirements (also called vesting)
  - Majority have an eligibility age of 60
  - 2/3 of divisions have a vesting period of 10 years
- Currently there are 38,774 retirees
  - Average age is 69.2
  - Average annual benefit is \$21,216
- Fewer than 1/4 of open divisions have a cost-of-living adjustment (COLA) for future retirees



# Lifetime Benefit Stability

- The calculated benefit will not change with investment market fluctuations
- Retirement benefits of municipal employees are constitutionally protected





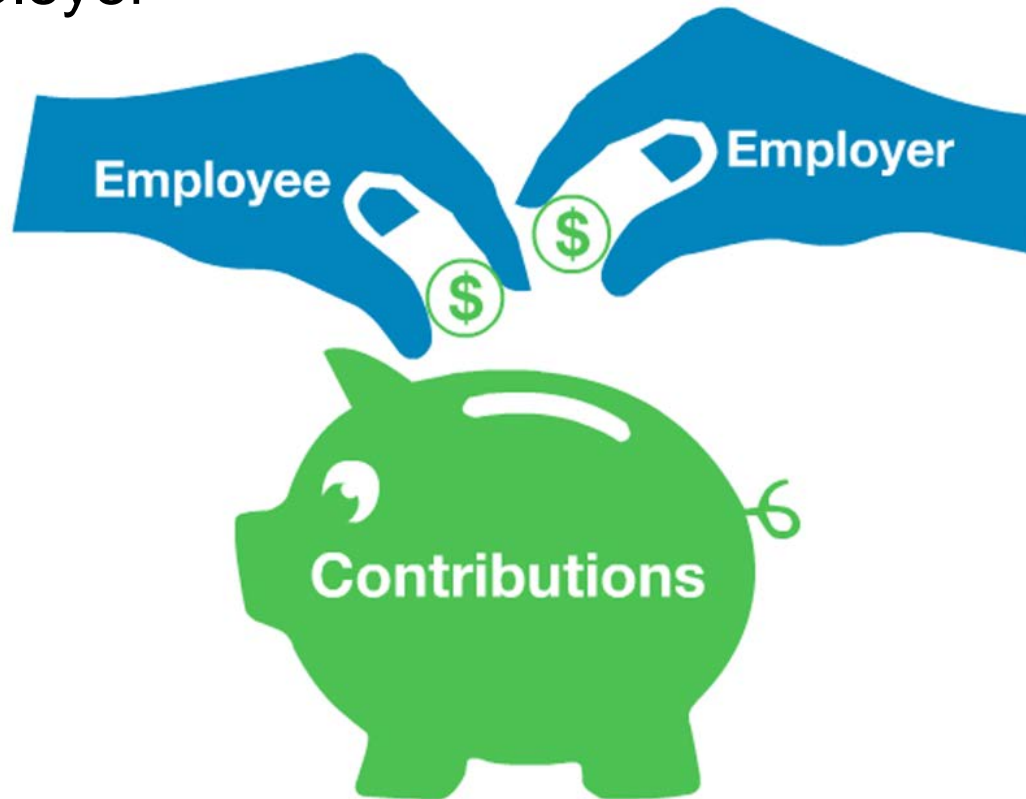
# The Fundamentals of Pension Funding



# Prefunding the Benefit

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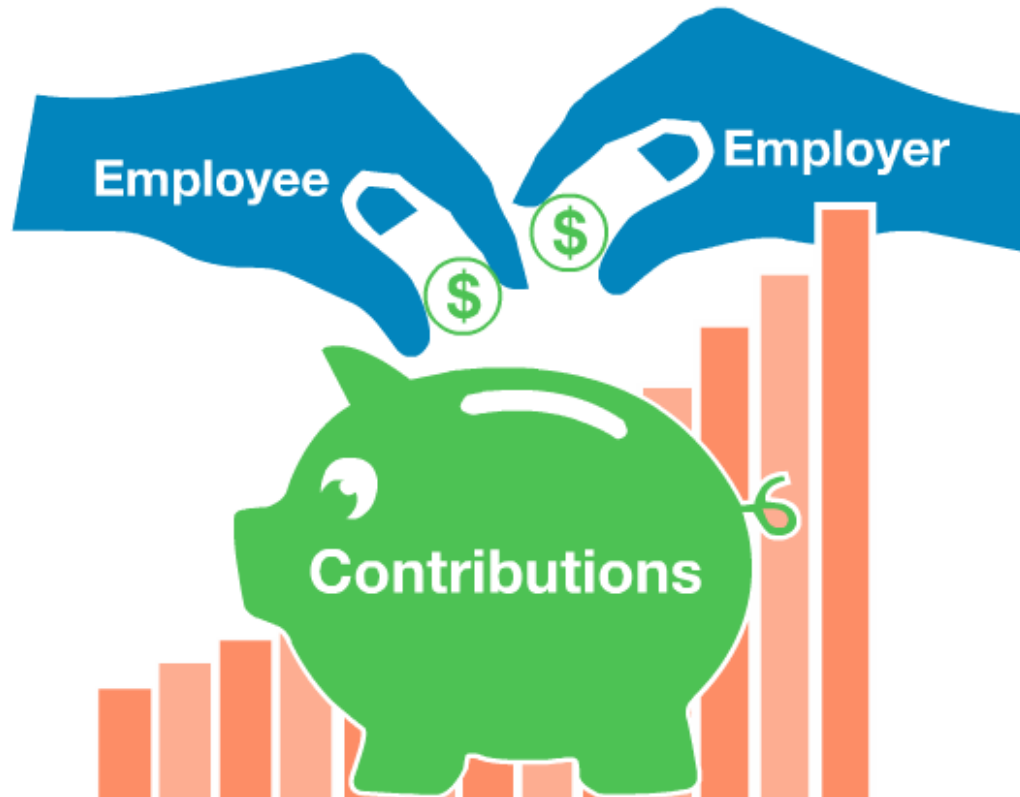
- Defined benefit plans are pre-funded during the employee's career
- Contributions are typically made by both the employee and employer



# Contributions are Invested Long-Term

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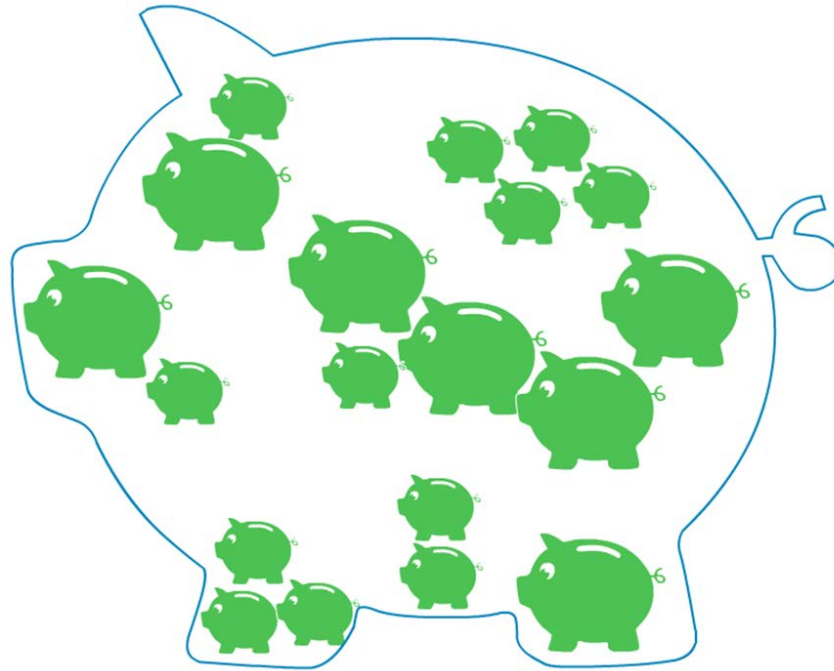
MERS strategically invests the contributions with a prudent long-term approach to provide downside protection with upside participation



# Pooling Assets

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- MERS pools assets for investment purposes, providing our members the benefit of investing with a \$10 billion pool of assets
- Each municipality's assets are maintained in separate accounts



# Investment Earnings

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MERS' investment earnings actually fund **more than half** of the benefits



# Determining Annual Contributions



# Determining Annual Contributions

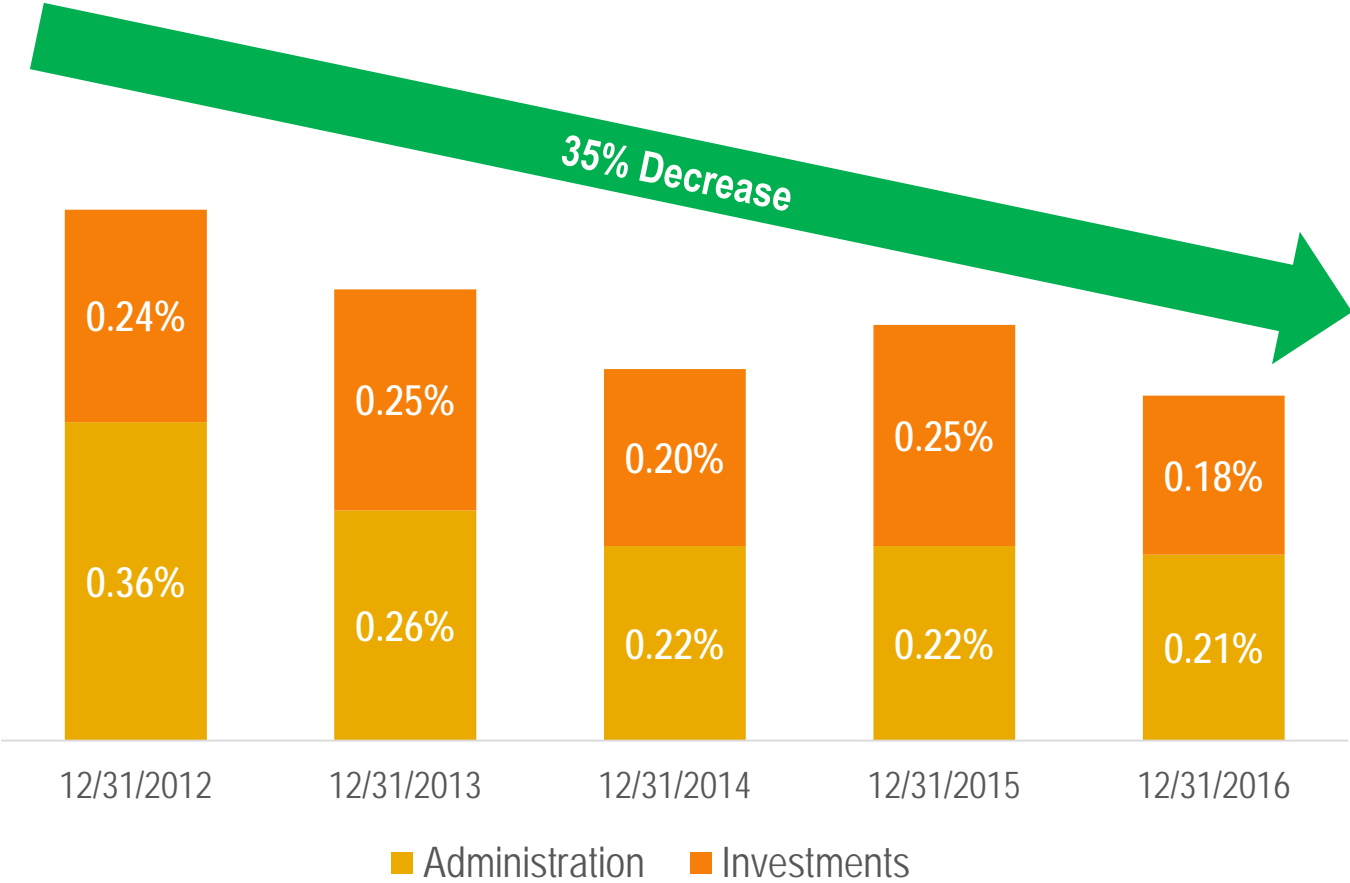
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- The cost of the plan is determined annually and provided in the Annual Actuarial Valuation
  - Defined benefit plan costs vary by municipality and depend on the benefit plan design and other plan-specific details
  - The ultimate cost will not be known until the last retiree/beneficiary stops drawing
- MERS' administrative and investment costs are charged to the plan as basis points and reported in quarterly statements



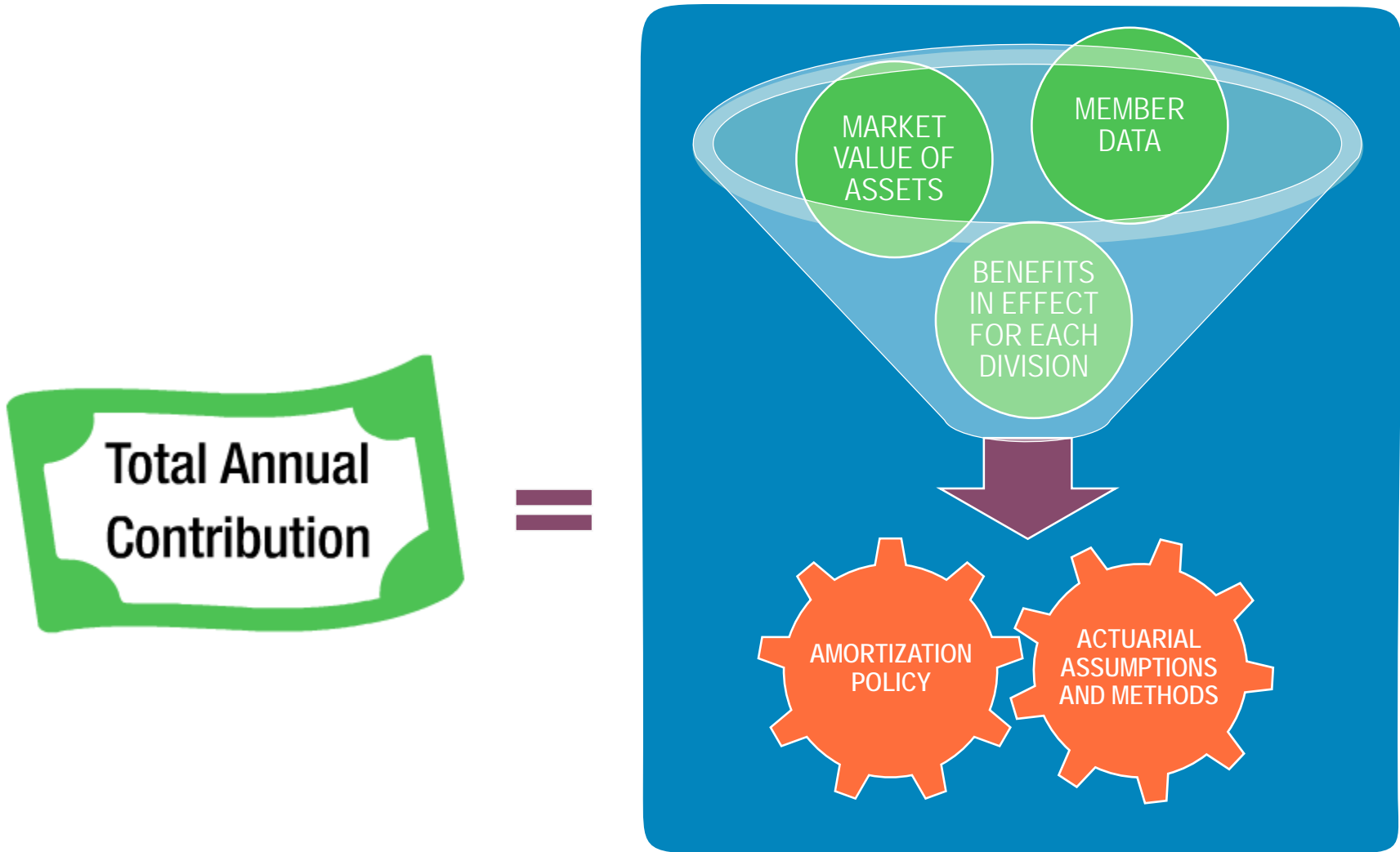
# MERS Defined Benefit Costs

5-Year History





# Calculating the Total Annual Contribution

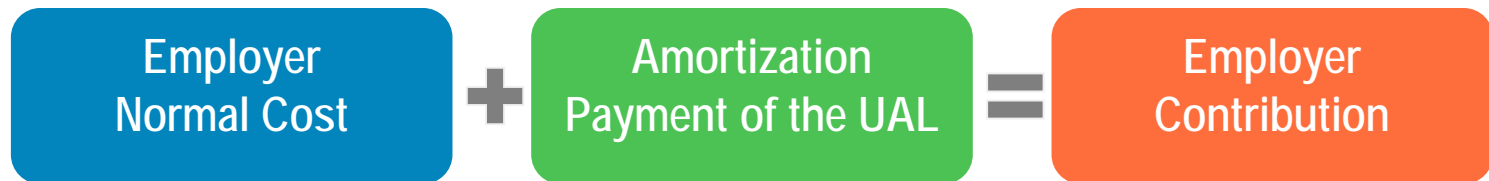


# Employer Contribution

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The employer contribution is made of up two parts:

- **Employer Normal Cost** – Present value of benefits allocated to the current plan year less any employee contribution
- **Amortization Payment of Unfunded Accrued Liability** – Payment to reduce any shortfall between liability for past service and assets



# Employee Contribution

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The employee contribution rate is set by each municipality or division, not by MERS

## **Average Employee Contribution Rate\***

- The average employee contribution rate for MERS municipalities approximately 6%
- Employee contribution rates vary based on the level of benefits offered

*\*As of 12/31/2016*

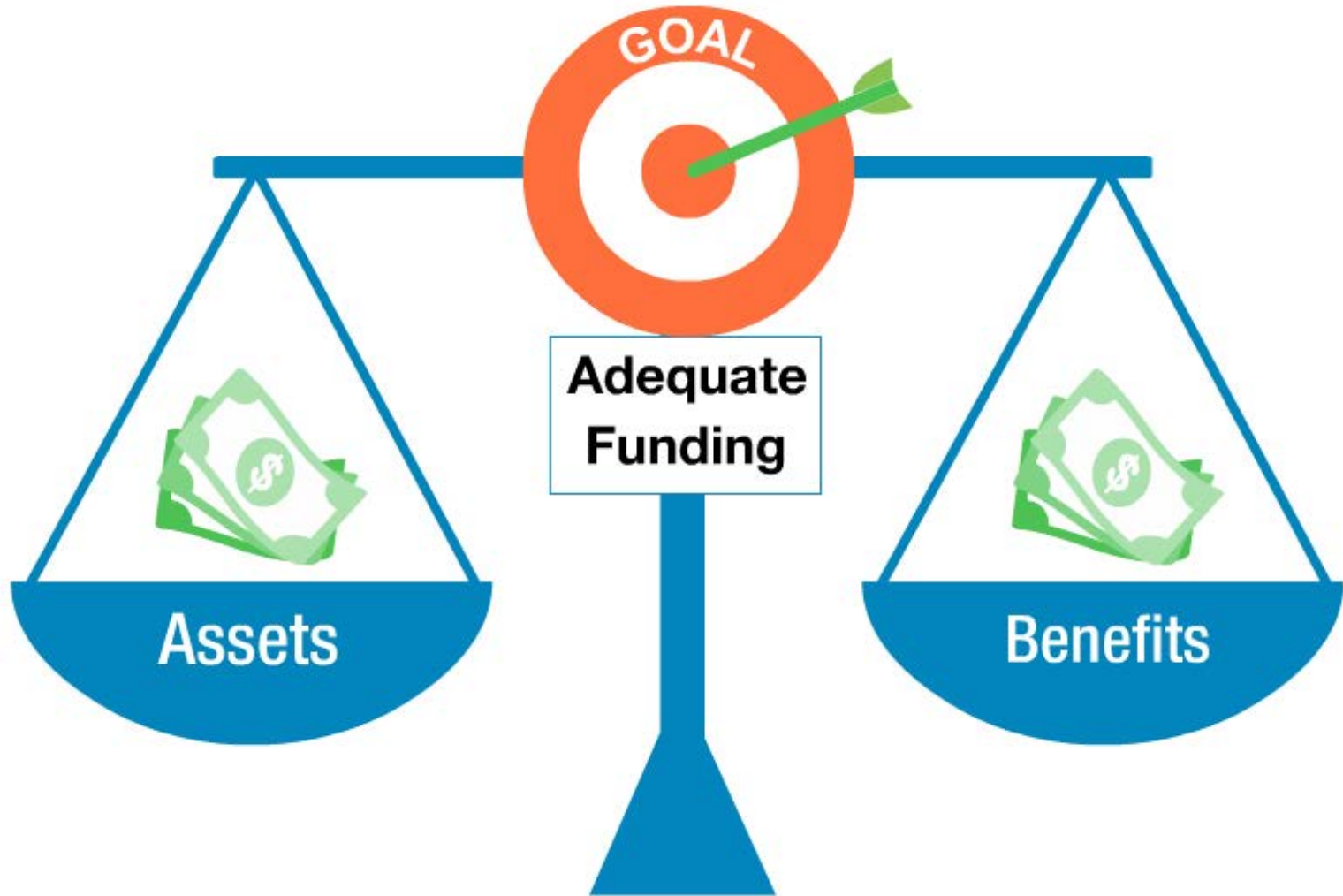


# How Unfunded Accrued Liability Develops

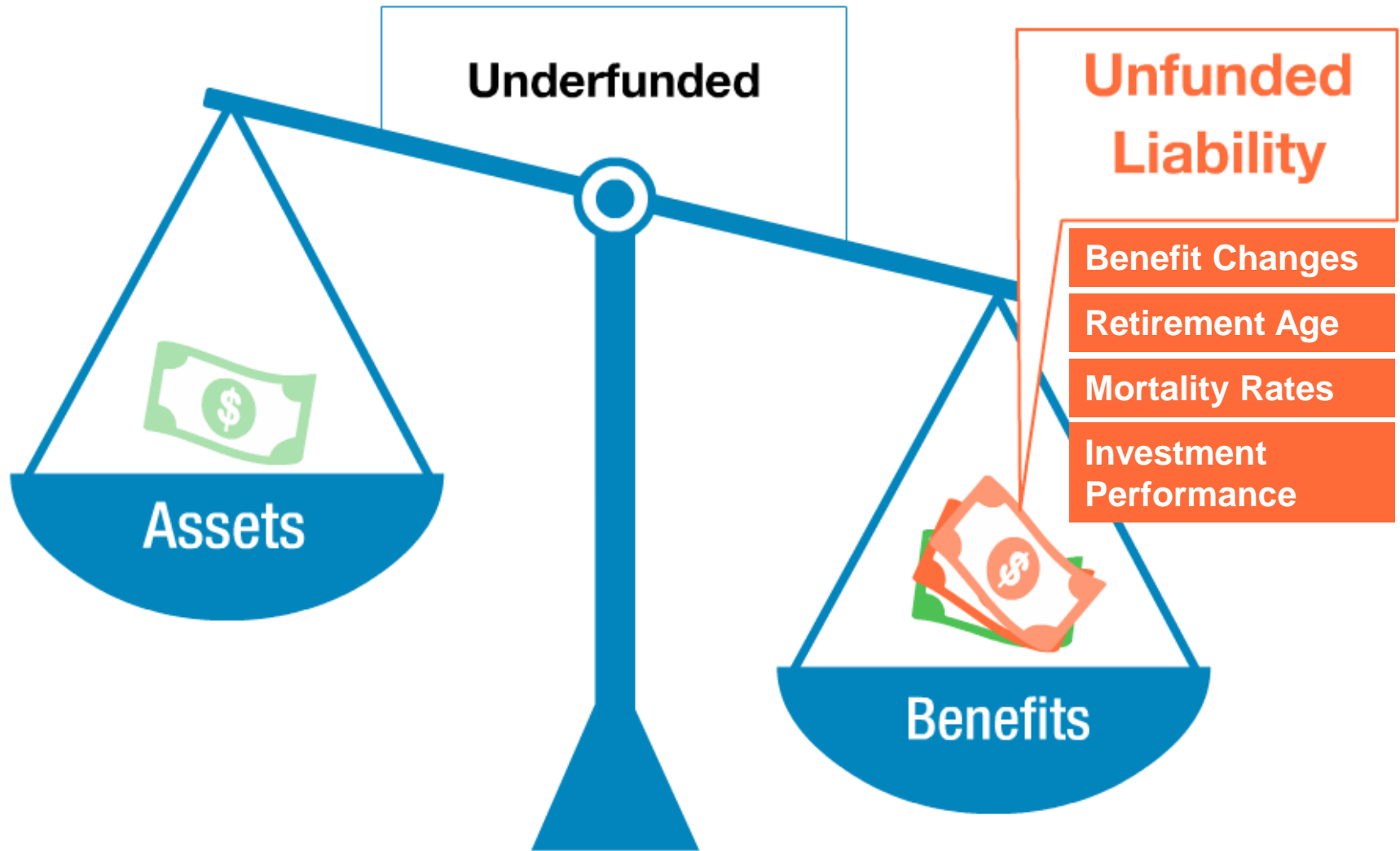


# A Fully Funded Plan

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# Unfunded Accrued Liability

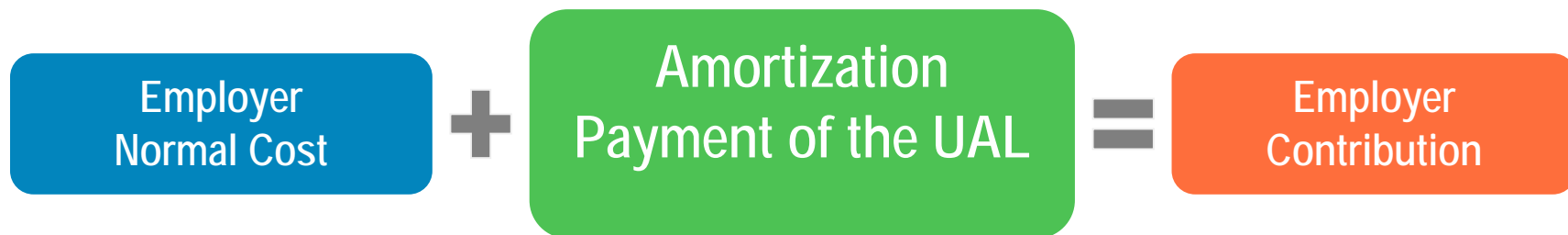


# What is Unfunded Liability?

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Unfunded liability is the difference between a plan's estimated pension benefits and assets that have been set aside to pay for them

- The dollar value of the benefits is actuarially determined each year
- Unfunded liability is paid off over a period of years



# Why Unfunded Liabilities Develop

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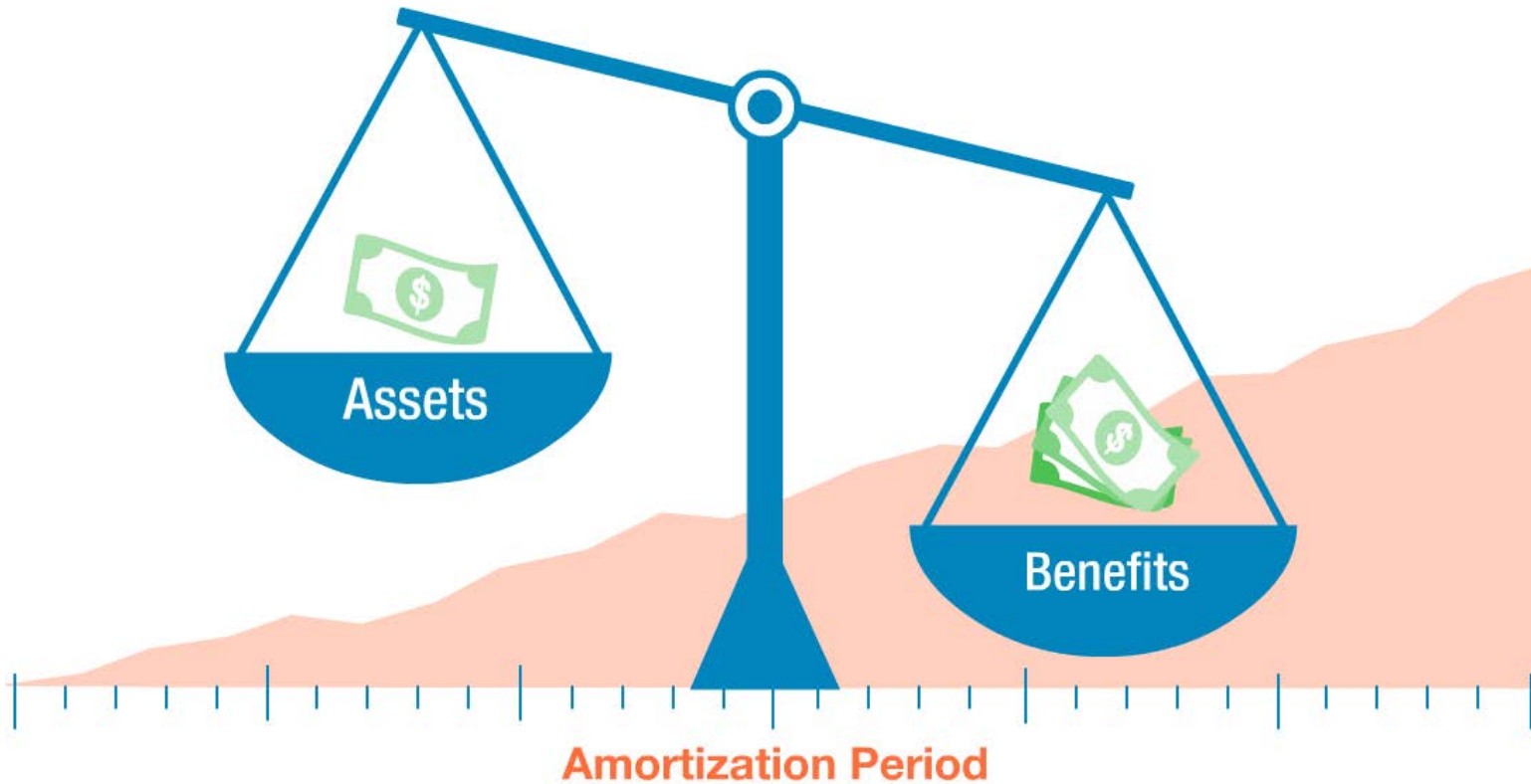
- Actual experience is different than assumed (liabilities and assets)
  - Market performance
  - Demographic experience
  - Rates of retirement
- Benefit enhancements adopted and not entirely funded
  - Early retirement windows
  - Increased benefit multiplier
  - Cost of Living Adjustment (COLA)
- Higher than projected Final Average Compensation
- Granting prior service for benefits without funding





# Paying Down Unfunded Liability

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Unfunded liability is paid off over a fixed period of time known as the amortization period.



# Plan Funding

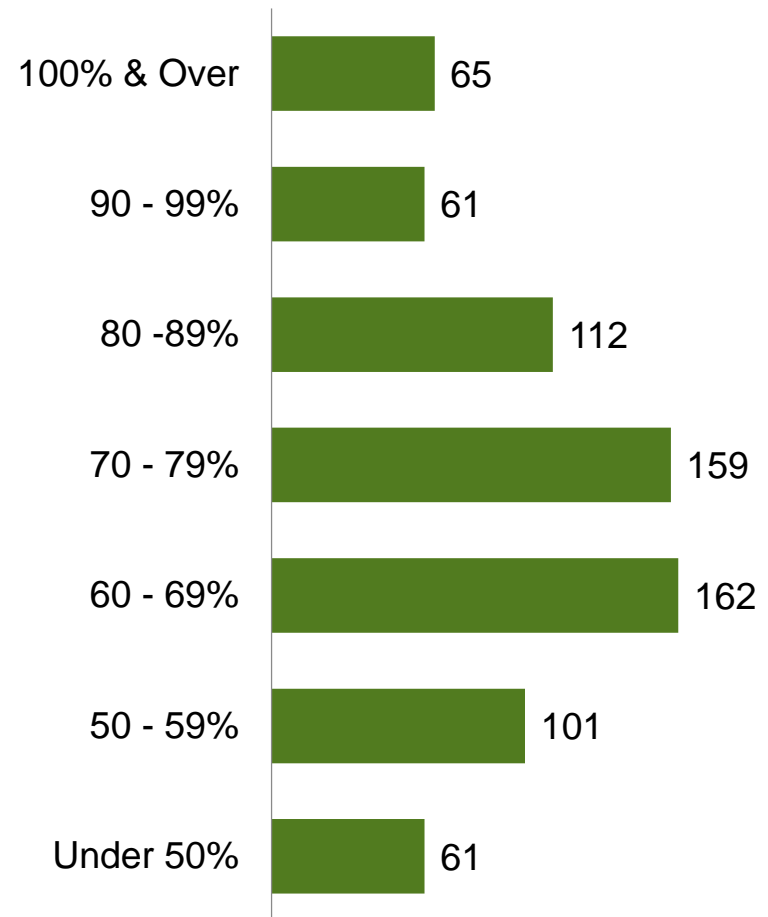
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- While funding ratio may be a useful measure, understanding a pension plan's funding progress should not be reduced to a single point in time
- Pension plans should have a strategy in place to reach or maintain a 100% funded level or greater over a reasonable time frame



# Distribution of Funded Percentage

- Our Defined Benefit Plan is a multiple-employer plan
- Assets are pooled for investment purposes only
- Separate accounts are maintained for each individual employer
- We do not borrow from one municipality's account to cover another municipality's obligation



As of 12/31/2016



# Best Practices



# Experience Study

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- Part of MERS' fiduciary responsibility
- Conducted with our actuarial firm every five years, with the last study covering 2009-2013
- Compares actual experience of the plan with the current assumptions to determine if changes are necessary
- The next study will be conducted in the fall of 2019



# Sound Funding Policies

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- Encourage extra contributions through market volatility scenarios



- Establish a minimum funding threshold that prevents plans from running out of assets



- Implement a fixed amortization policy that gives plans a specific date by which all known obligations will be fully funded



# Benefit Enhancement Modeling

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- For any benefit enhancements, municipal plans must be fully funded



- Actuarial reports illustrate financial impacts of benefit changes by providing cost projections of at least 5 years



# Pension Spiking Mitigation

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- Avoid “pension spiking” by limiting lump sum payouts into final compensation



- Actuarial loads are applied to groups that have demonstrated a history of Final Average Compensation increases





# Ready to Learn More about Unfunded Liability?

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- MERS works in partnership with our members to ensure that each municipality is making reasonable progress to achieve full funding
- We offer many options to help reduce UAL, with a variety of programs and provisions to fit each municipality's unique needs
- Attend Pension Funding & Plan Design Part 2 – A Deeper Dive



# Contacting MERS of Michigan

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## **MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM**

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Lansing, MI 48917

800.767.MERS (6377)

[www.mersofmich.com](http://www.mersofmich.com)



*This presentation contains a summary description of MERS benefits, policies or procedures. MERS has made every effort to ensure that the information provided is accurate and up to date. Where the publication conflicts with the relevant Plan Document, the Plan Document controls.*

