Sustainable Defined Benefit Plans

Michael Overley, Lead Regional Manager

2020

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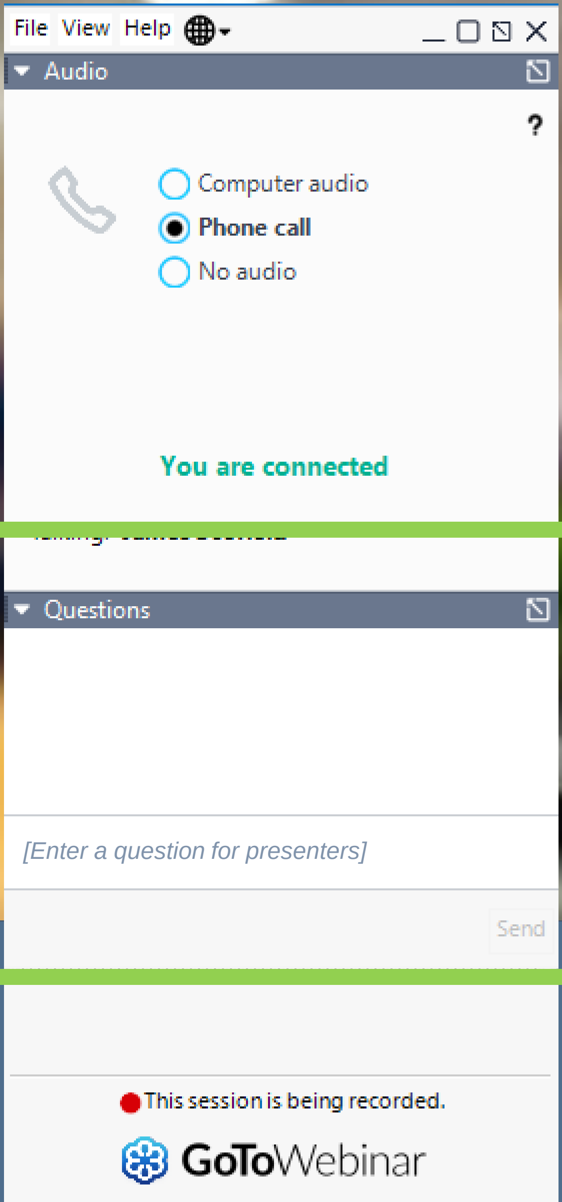
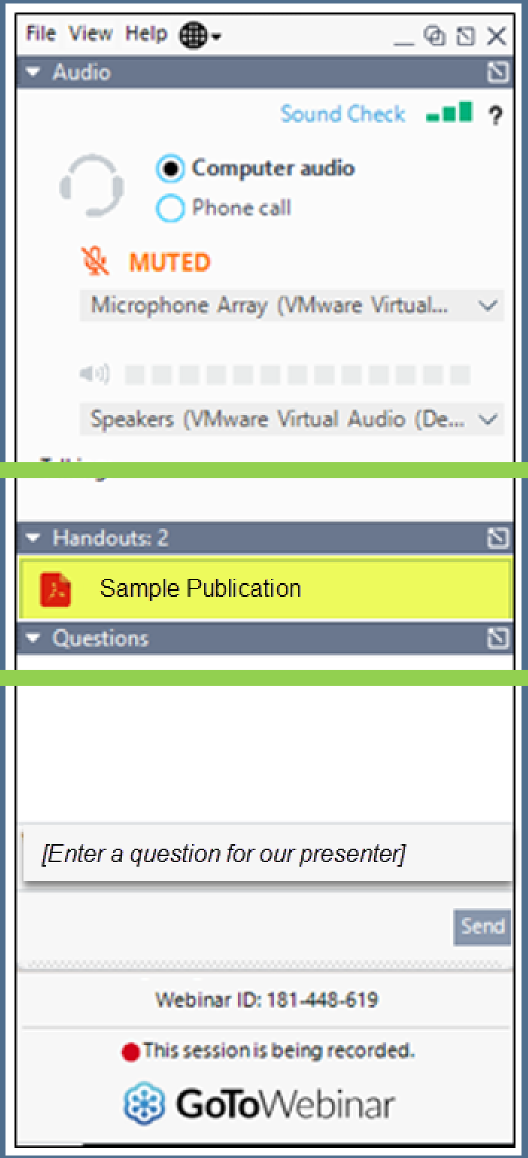
Submit your questions here



Publications

A copy of this presentation and additional publications on this topic are available for you to download

Look here for additional information



Agenda

- Defined Benefit Fundamentals
- How Unfunded Accrued Liability (UAL) Develops
- Amortizing UAL
- Strategies for Addressing UAL

Defined Benefit Fundamentals

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Defined Benefit Fundamentals

- The benefit formula is comprised of three components:

Final Average Compensation × Service Credit × Benefit Multiplier = Annual Benefit

- Plans are pre-funded during the employee's career with contributions typically made by both the employee and employer

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How Unfunded Accrued Liability (UAL) Develops

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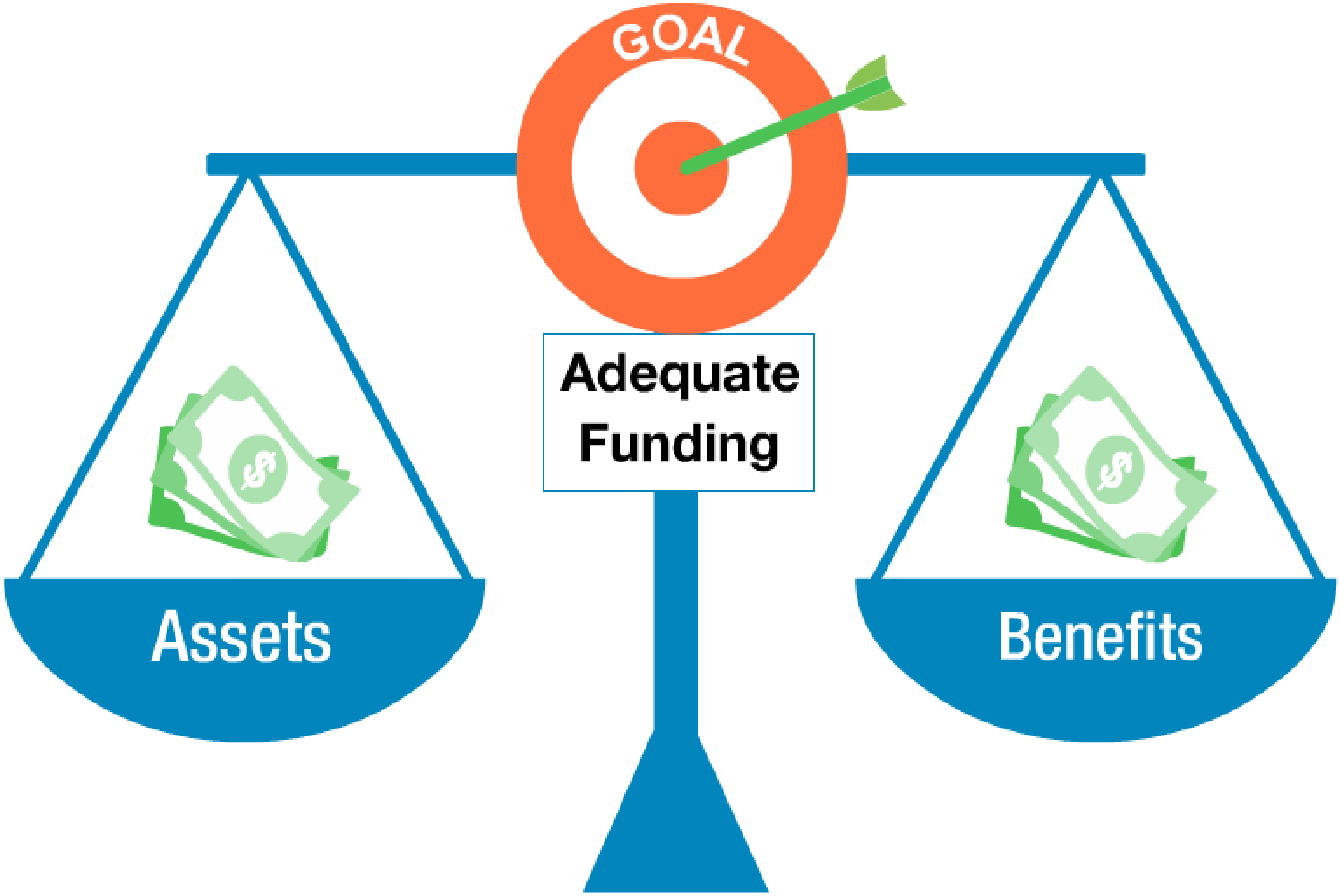
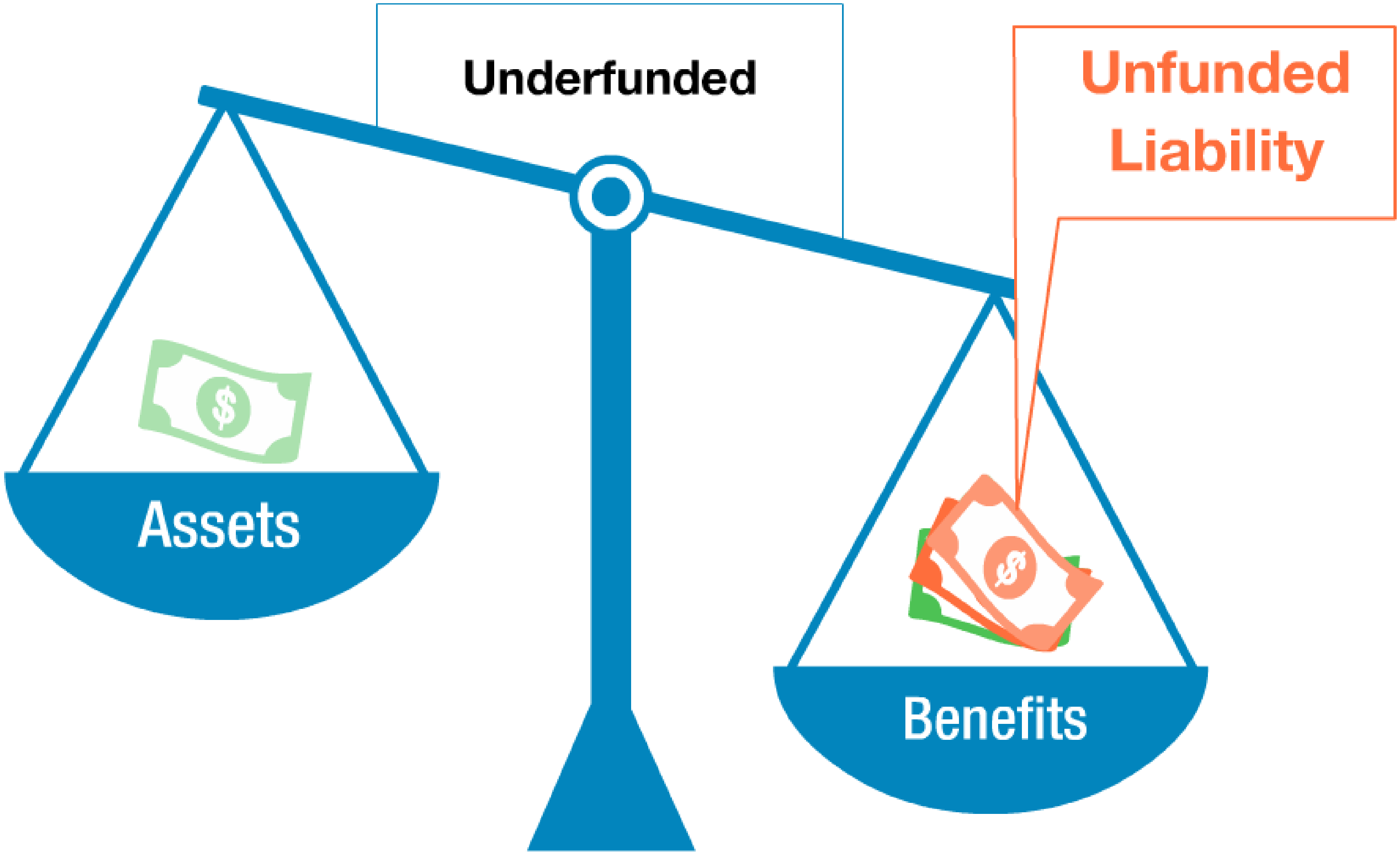
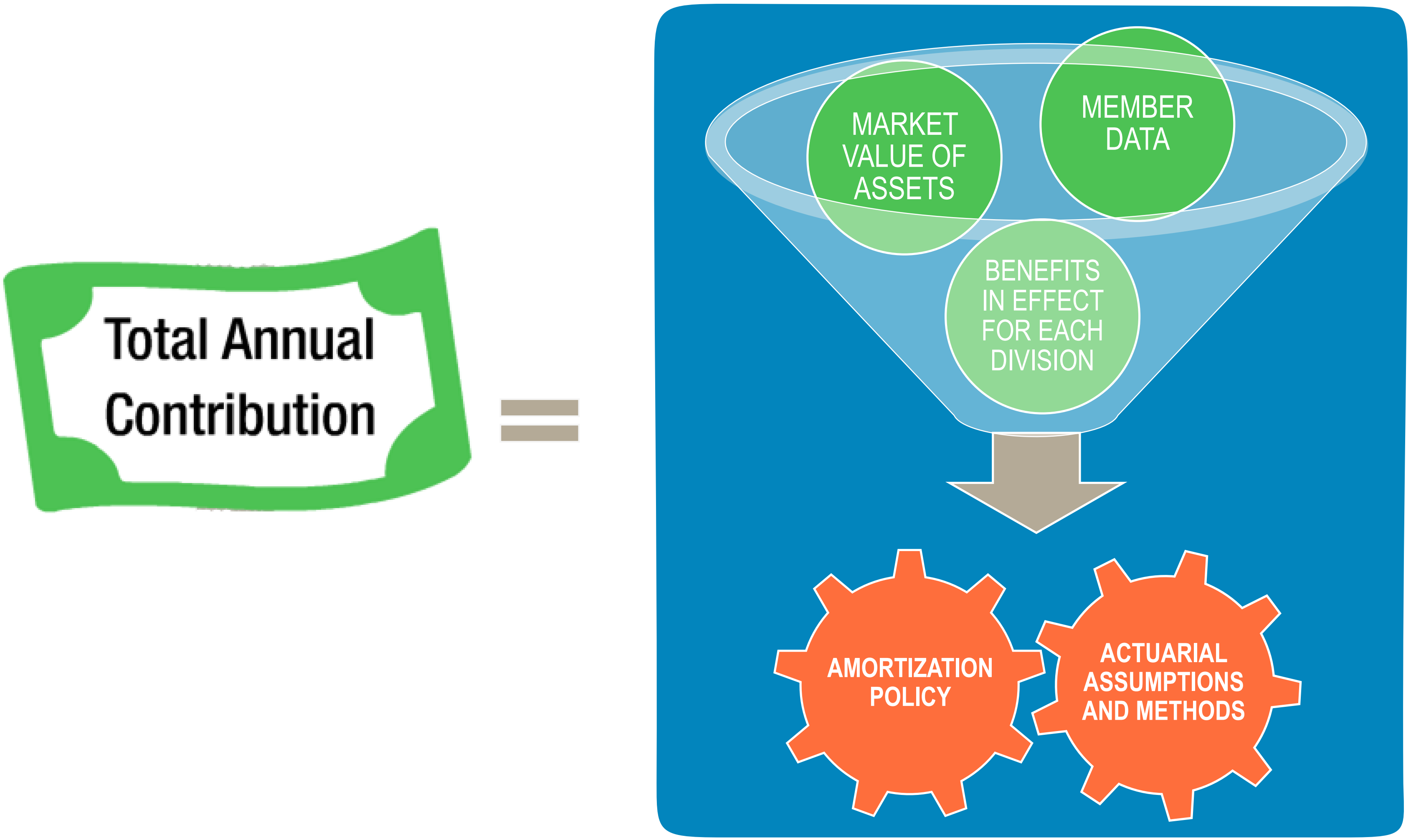
A Fully Funded Plan



Unfunded Accrued Liability



Calculating the Total Annual Contribution



Total Annual Contribution

- The cost of the plan is determined annually and provided in the Annual Actuarial Valuation
- The employer contribution is made of up two parts:

Employer Normal Cost + **Amortization Payment of the UAL** = **Employer Contribution**

What is Unfunded Liability?

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

Employer Normal Cost + **Amortization Payment of the UAL** = **Employer Contribution**

Why Unfunded Liabilities Develop

- 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

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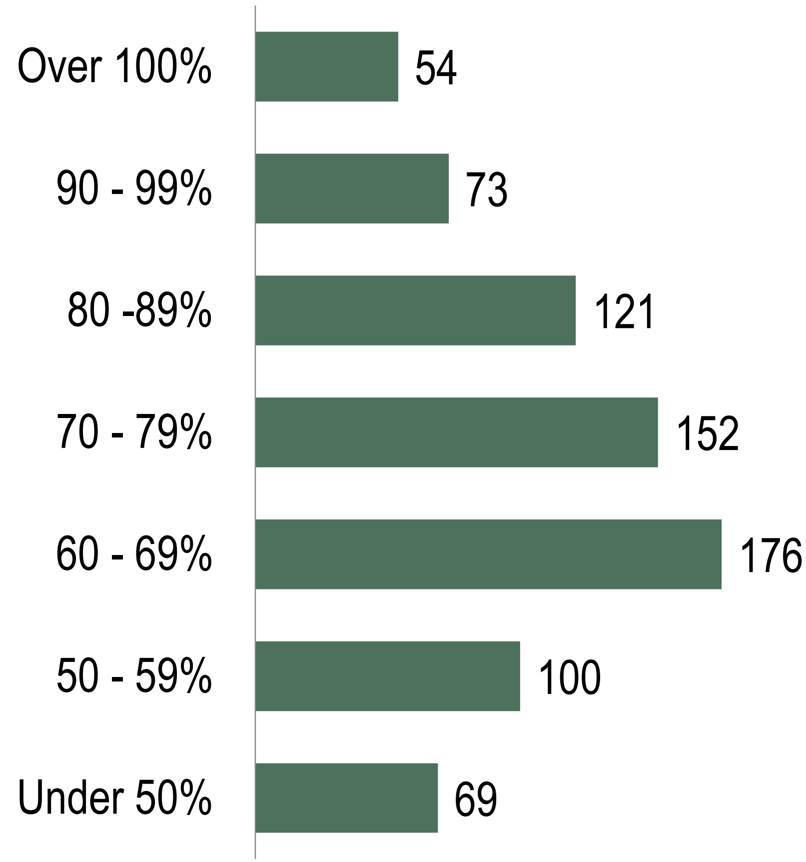
Distribution of Funded Percentage

- Understanding a pension plan's funding progress should not be reduced to a single point in time
- Plans within MERS are on a schedule to eliminate legacy unfunded liabilities within 20 years



As of 12/31/2019



Amortizing UAL

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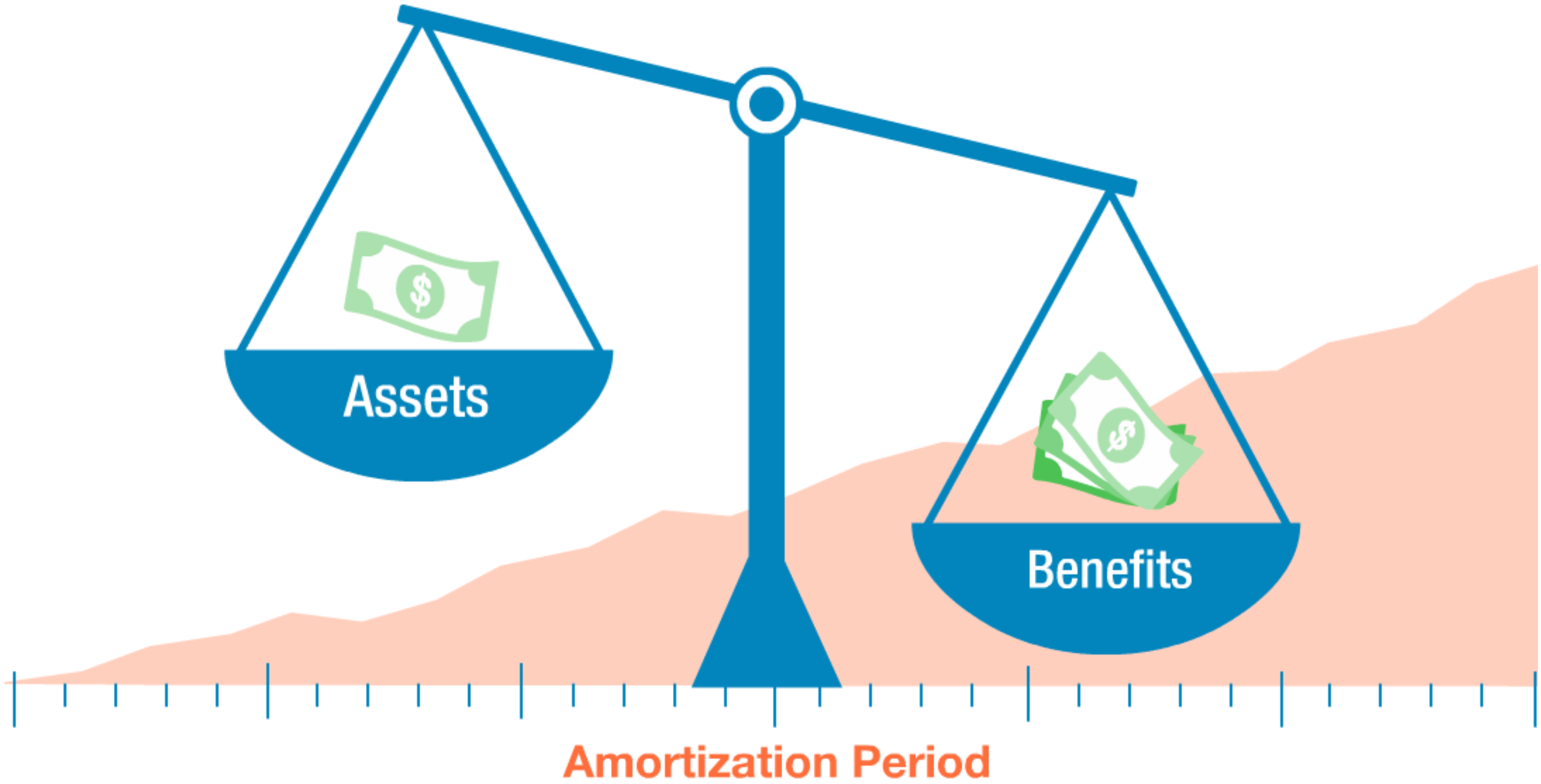
Paying Down Unfunded Liability



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

Fixed Amortization Policy

- The amortization policy sets the process for making payments on a plan's unfunded accrued liability
- Historically, public pension plans like MERS, used a rolling amortization period of 30 years
- Since 2005, MERS has been gradually reducing the amortization period to ensure that pension costs of current employees do not shift onto future generations
- The amortization policy doesn't make the benefits cheaper or more expensive; it simply impacts the pattern of contributions

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Amortization Period Extension

- Based on feedback from our customers, we recognize that some groups may need additional time
- Employers may request a sustainability analysis to determine if an extension of the amortization schedule for UAL is possible
- Extending the amortization period defers costs into the future, resulting in higher long-term costs

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Strategies for Reducing UAL

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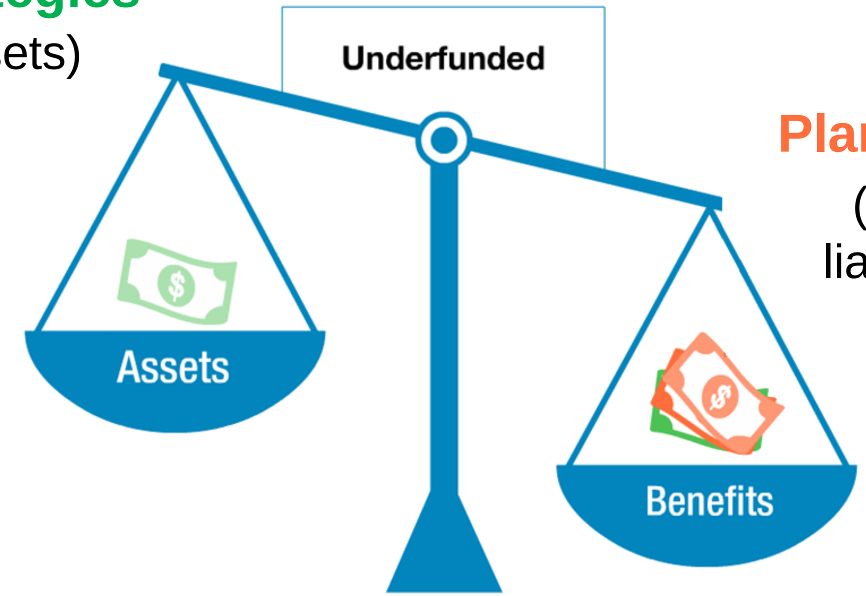
Managing Unfunded Liability

Plans can address unfunded liability two ways:

Funding Strategies

(Increase assets)



Plan Design Strategies

(Reduce or eliminate liability moving forward)

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Plan Design Strategies

Reduce Future Liability for New Hires

- Higher retirement age
- Defined Benefit Plan with lower provisions
- Hybrid Plan
- Defined Contribution Plan

Reduce Future Liability for Existing Employees

- Lower multiplier going forward
- Eliminate COLA on future service

Eliminate Accrual of Future Liability

- Plan freeze

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Reduce Future Liability for New Hires

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Higher Normal Retirement Age

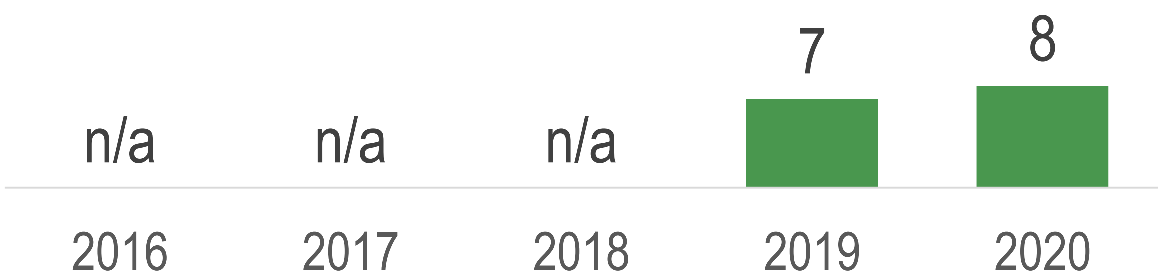
Action

- Higher Normal Retirement Age for participants in newly established divisions

Impact

- Reduces the future liability accrual
- Future benefits will be lower, and therefore less expensive, than the previous benefits offered

Trend



Divisions that have adopted these strategies as of 6/30/2020.

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Lower Benefit for New Hires

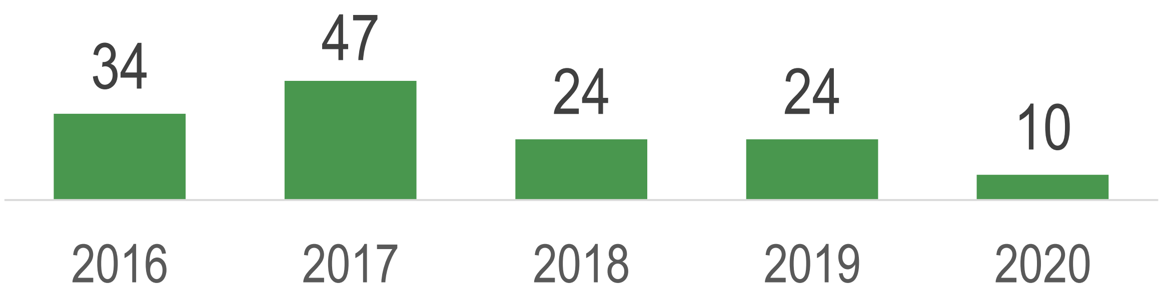
Action

- Lower Tiered Benefits for New Hires
  - Lower multiplier
  - Removed cost of living adjustments
  - Removed early retirement options
  - Increased vesting period
  - Increased retirement age

Impact

- Reduces the future liability accrual
- Future benefits will be lower, and therefore less expensive, than the previous benefits offered

Trend



* As of 6/30/2020.

Lower Benefit for New Hires, Cont.

- New hires are covered by a lower tier of either defined benefit or hybrid benefits
- Existing employees are not affected
- Reduces the liability for new hires

Anyone hired **before** 1/1/2020	Anyone hired **after** 1/1/2020
Tier I	**Tier II**
• 2.5% Benefit Multiplier	• 1.70% Benefit Multiplier
• FAC 3	• FAC 5
• Vesting of 8 years	• Vesting of 10 years
• Early Retirement Age 55 with 15 years of service	• Early Retirement Age 55 with 25 years of service
• COLA	• No COLA

Hybrid Plan for New Hires

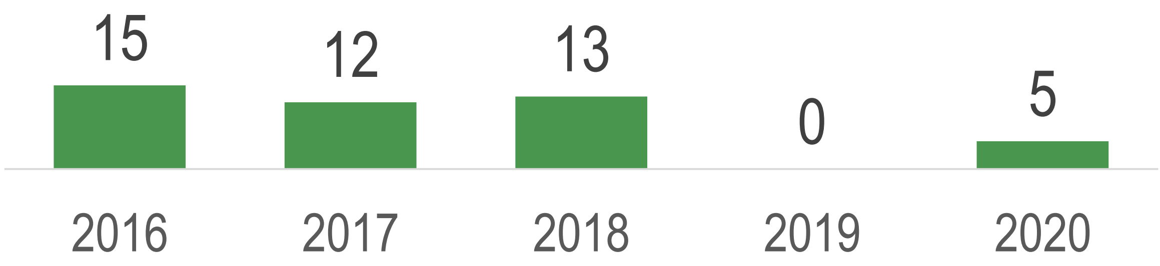
Action

- Hybrid Plan for new hires

Impact

- Reduces future accrual of liabilities
- Future benefits will be lower, and potentially less expensive, than the previous benefits

Trend



Divisions that have adopted these strategies as of 6/30/2020.

Hybrid Plan for New Hires, Cont.

- 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
- Actuarial report is needed to calculate the contributions for the Defined Benefit portion of the Hybrid Plan

Part 1 – Defined Benefit

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

+

Part 2 – Defined Contribution

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

$ Total Retirement Benefit

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Defined Contribution Plan for New Hires

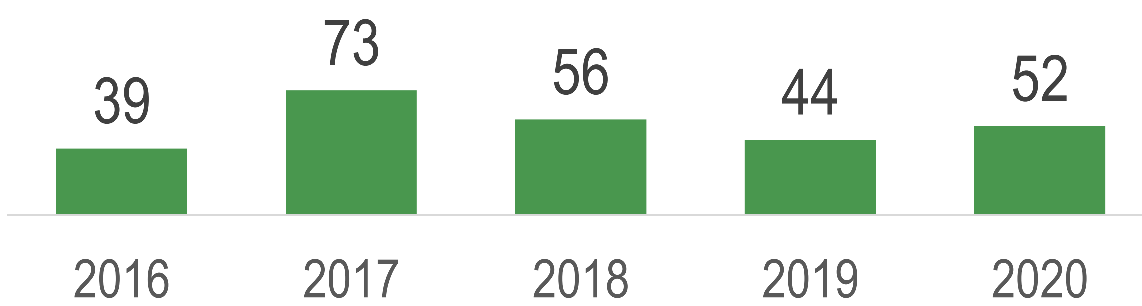
Action

- Defined Contribution Plan for new hires

Impact

- Eliminates future accrual of liabilities for new hires

Trend



Divisions that have adopted these strategies as of 6/30/2020.

Defined Contribution Plan for New Hires, Cont.

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

- New hires, rehires and transfers are covered by the Defined Contribution Plan
  - Active employees may be given a one-time option to convert
- A projection study is required
  - Compares long-term cost of current plan with proposed plan
  - Projects employer contributions for next 20 years
- Sustainability analysis determines the required amortization period to ensure closed Defined Benefit Plan is adequately funded

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Comparing Plan Costs

- When closing a Defined Benefit Plan, the accrued benefits of the active participants in that plan remain and will continue to accrue
  - Normal Cost payment, plus any payment toward UAL, is required until the last retiree/beneficiary stops drawing a benefit
  - The payment toward UAL will not go away by changing plans
- Implementing Defined Contribution Plan for new hires is not an immediate cost savings
- To compare long-term cost savings, you compare the *Normal Cost* of the Defined Benefit Plan (found on Table 1 of your AAV) to the *proposed employer contribution* of the Defined Contribution Plan
- Once accrued benefits of the past have been fully funded, you will only contribute the Normal Cost

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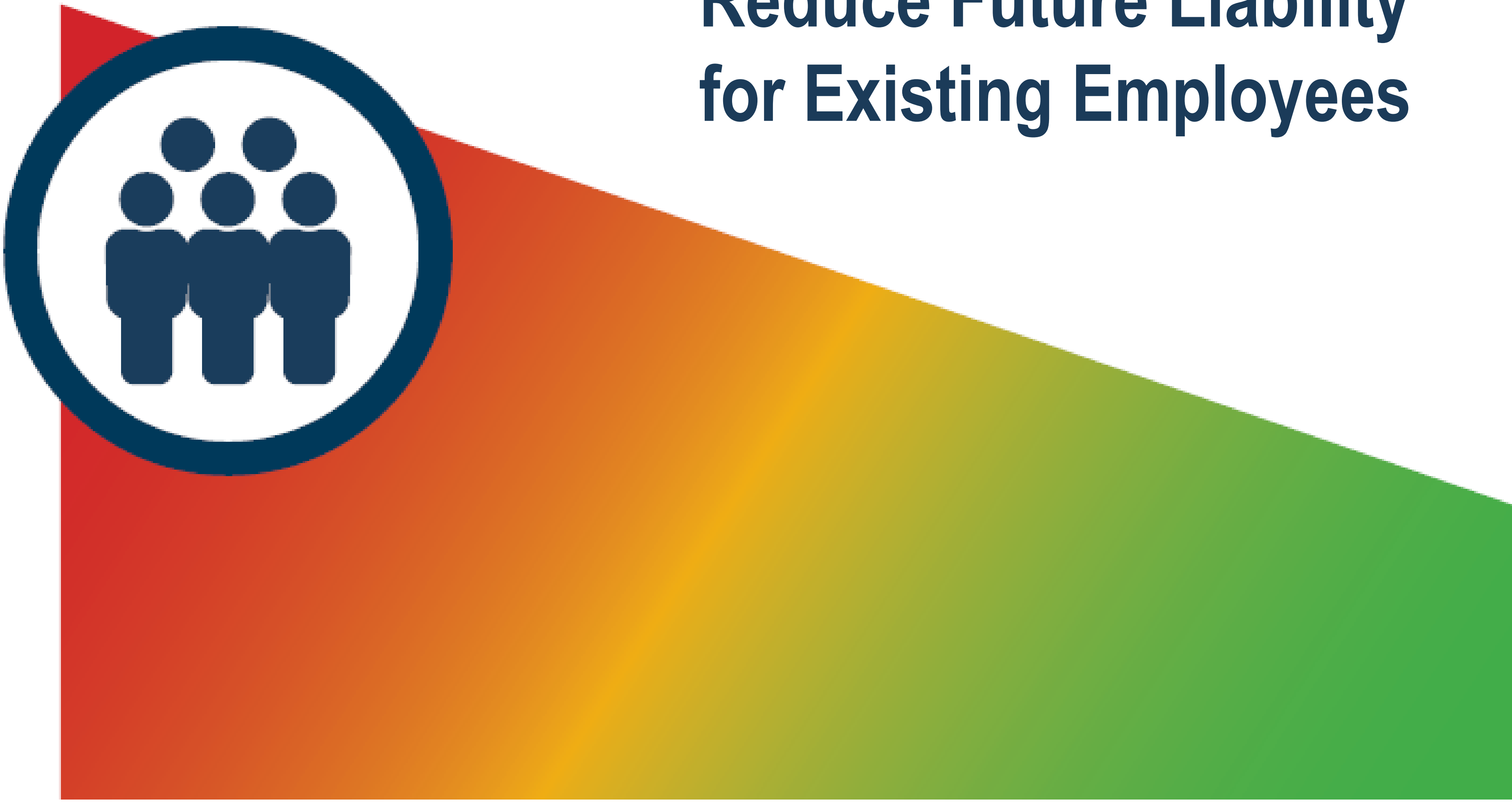
Reduce Future Liability for Existing Employees



Bridged Benefit for Existing Employees

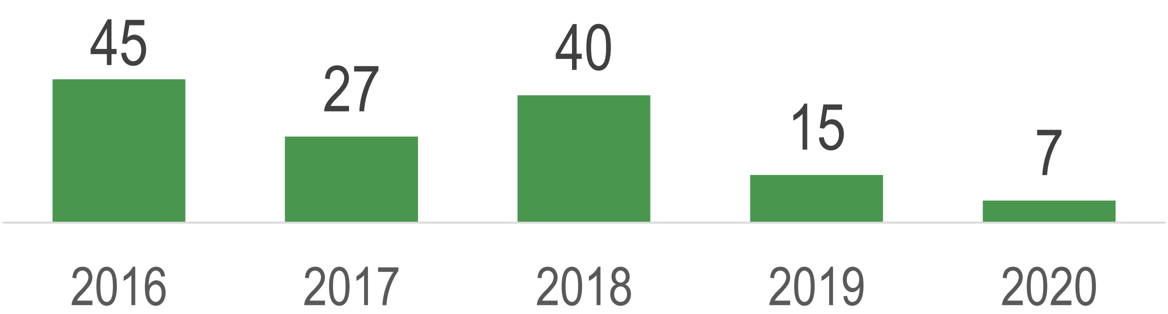
Action

- Bridged benefit for active employees

Impact

- Active employees accrue liability at a lower rate and may reduce existing liability
- New hires receive the reduced multiplier

Trend



Divisions that have adopted these strategies as of 6/30/2020.

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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

Part 1

FAC (may choose frozen FAC) × Service Credit × Original Benefit Multiplier = $ Original Benefit

+

Part 2

Final Average Compensation × Service Credit × New Benefit Multiplier = $ New Benefit

$ Total Retirement Benefit

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Bridged COLA

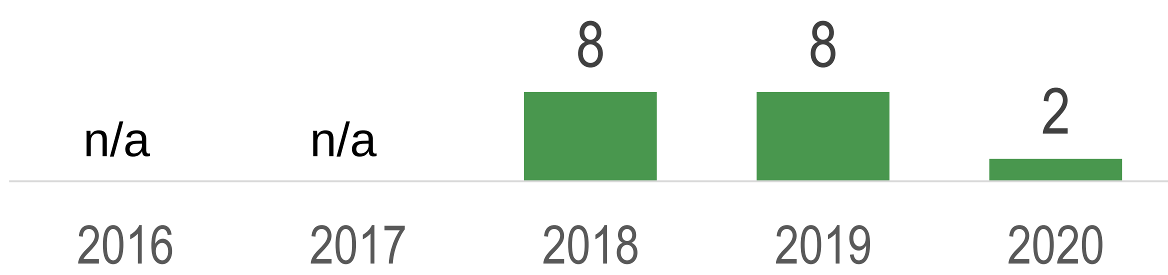
Action

- Eliminates the COLA on future service credit
- COLA is only applied to portion of benefit earned prior to bridge

Impact

- Leaves earned benefits unchanged
- Reduces the liability for new hires and existing employees

Trend



Divisions that have adopted these strategies as of 6/30/2020.

How a Bridged COLA Works

- Eliminates the COLA on future service credit
- COLA is applied to COLA Base only, which is calculated with frozen FAC
- Leaves earned benefits unchanged
- Reduces the liability for new hires and existing employees

COLA Base is Calculated as of the Bridge Date

Frozen FAC × Service Credit × Benefit Multiplier = COLA Base

Calculating the Annual COLA

COLA Base × COLA % = Annual COLA

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Eliminate Accrual of Future Liability

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Defined Benefit Plan Freeze

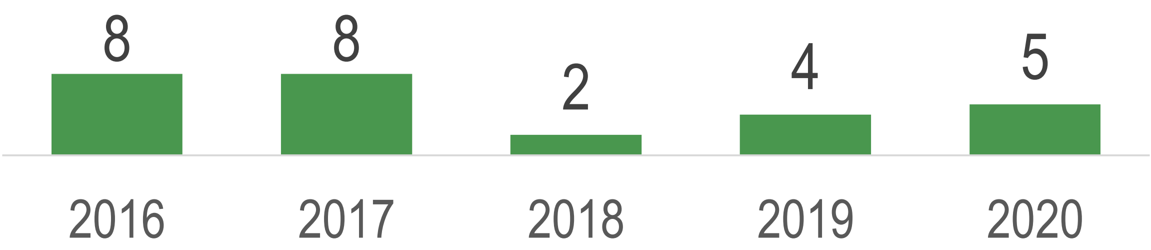
Action

- Defined Benefit Plan freeze

Impact

- ALL employees transition to a new plan type
  - Do not accrue additional service credit
  - FAC is frozen
  - Employees may opt to convert the value of existing service into Defined Contribution Plan
- Eliminates the Normal Cost of the plan
- Does not eliminate UAL – could still increase

Trend



Divisions that have adopted these strategies as of 6/30/2020.

Funding Strategies

Cost Sharing

- Reduces burden on employer

Voluntary Contributions

- Reduces existing liability

Bonding

- Available to ***some*** municipalities

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Cost Sharing with Existing Employees

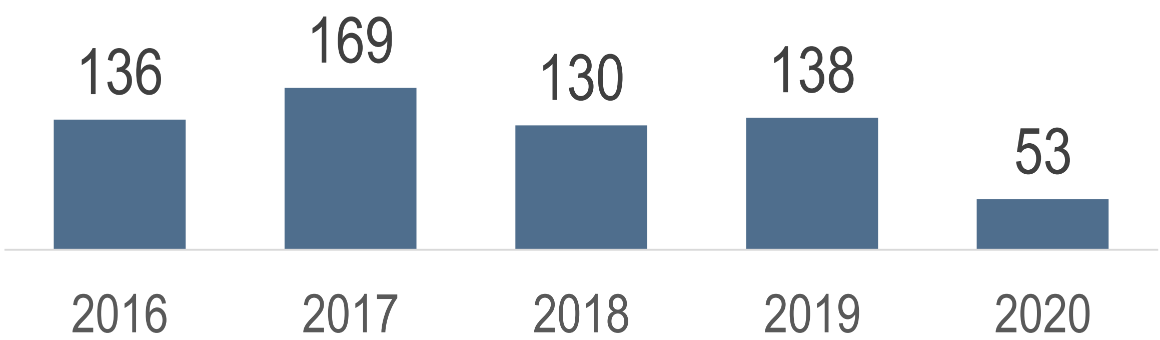
Action

- Employees contribute to help fund the overall cost of the plan

Impact

- Reduces the employer cost, but does *not* affect total cost or the plan's unfunded liability

Trend



Divisions that have adopted these strategies as of 6/30/2020.

Voluntary Contributions

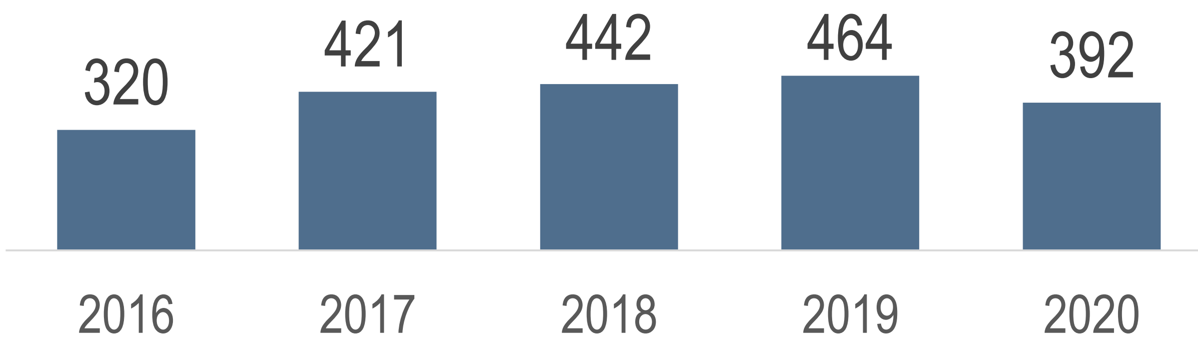
Action

- Contribute above ARC
  - Extra percentage above minimum
  - Lump sum payment

Impact

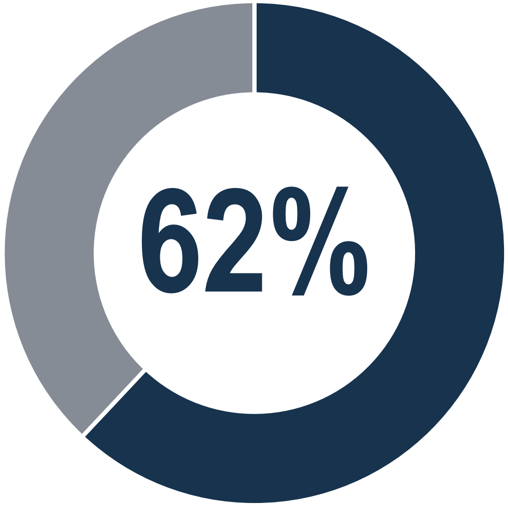
- Reduces unfunded liability
- Extra dollars are invested and have ability to recognize market returns

Trend



Voluntary Contributions, Cont.

- More than half of customers are making additional, voluntary contributions
- We've recently introduced additional flexibility in how voluntary contributions are applied, including:
  - Allocating additional assets to specific divisions or equally distributed
  - Applying the additional assets to pay down UAL, or to reduce future contributions



Customers Making Additional Contributions in 2019

*As of 12/31/2019

Surplus Divisions

Apply assets directly to UAL by establishing a surplus division

Additional Voluntary Contributions to the Plan –
$25,000/year for 15 years increases the funding level while decreasing the ARC

Funded Percentage	ARC	Additional Contributions to Plan	Total Annual Employer Contribution
56%	$114,000	$25,000	$139,000
56%	$119,000	$25,000	$144,000
57%	$124,000	$25,000	$149,000
59%	$130,000	$25,000	$155,000
62%	$133,000	$25,000	$158,000
65%	$136,000	$25,000	$161,000
67%	$139,000	$25,000	$164,000
70%	$141,000	$25,000	$166,000
72%	$144,000	$25,000	$169,000
74%	$147,000	$25,000	$172,000
76%	$150,000	$25,000	$175,000
79%			
81%			
83%			
85%			
87%	$168,000	$0	$168,000
89%	$174,000	$0	$174,000
91%	$180,000	$0	$180,000
93%	$187,000	$0	$187,000
94%	$194,000	$0	$194,000
96%	$201,000	$0	$201,000
98%	$113,000	$0	$113,000
100%	$117,000	$0	$117,000
100%	$122,000	$0	$122,000
100%	$127,000	$0	$127,000

Plan is fully funded in 23 years.

Additional Voluntary Contributions to a Surplus Division –
$25,000/year applied directly to UAL for 15 years increases the funding level ***without*** decreasing the ARC

Funded Percentage	ARC	Additional Contributions to Surplus Division	Total Annual Employer Contribution
56%	$114,000	$25,000	$139,000
56%	$121,000	$25,000	$146,000
57%	$128,000	$25,000	$153,000
59%	$136,000	$25,000	$161,000
62%	$141,000	$25,000	$166,000
65%	$146,000	$25,000	$171,000
68%	$152,000	$25,000	$177,000
71%	$157,000	$25,000	$182,000
74%	$163,000	$25,000	$188,000
76%	$169,000	$25,000	$194,000
79%	$175,000	$25,000	$200,000
95%	$210,000	$0	$210,000
98%	$218,000	$0	$218,000
102%	$226,000	$0	$226,000
105%	$234,000	$0	$234,000
108%	$243,000	$0	$243,000
111%	$252,000	$0	$252,000
115%	$261,000	$0	$261,000
118%	$118,000	$0	$118,000
122%	$122,000	$0	$122,000
123%	$127,000	$0	$127,000

Plan is fully funded in 18 years.

Applying assets directly to UAL increases the funding level ***without*** decreasing the required contributions

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Bonding

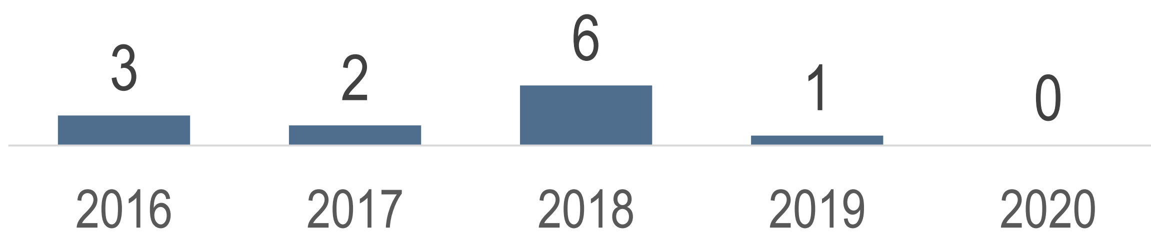
Action

- Municipalities may bond for all or a portion of their unfunded accrued liabilities

Impact

- Bond proceeds are deposited and may fully fund the accrued liability
- No guarantee that future unfunded liabilities won't occur

Trend

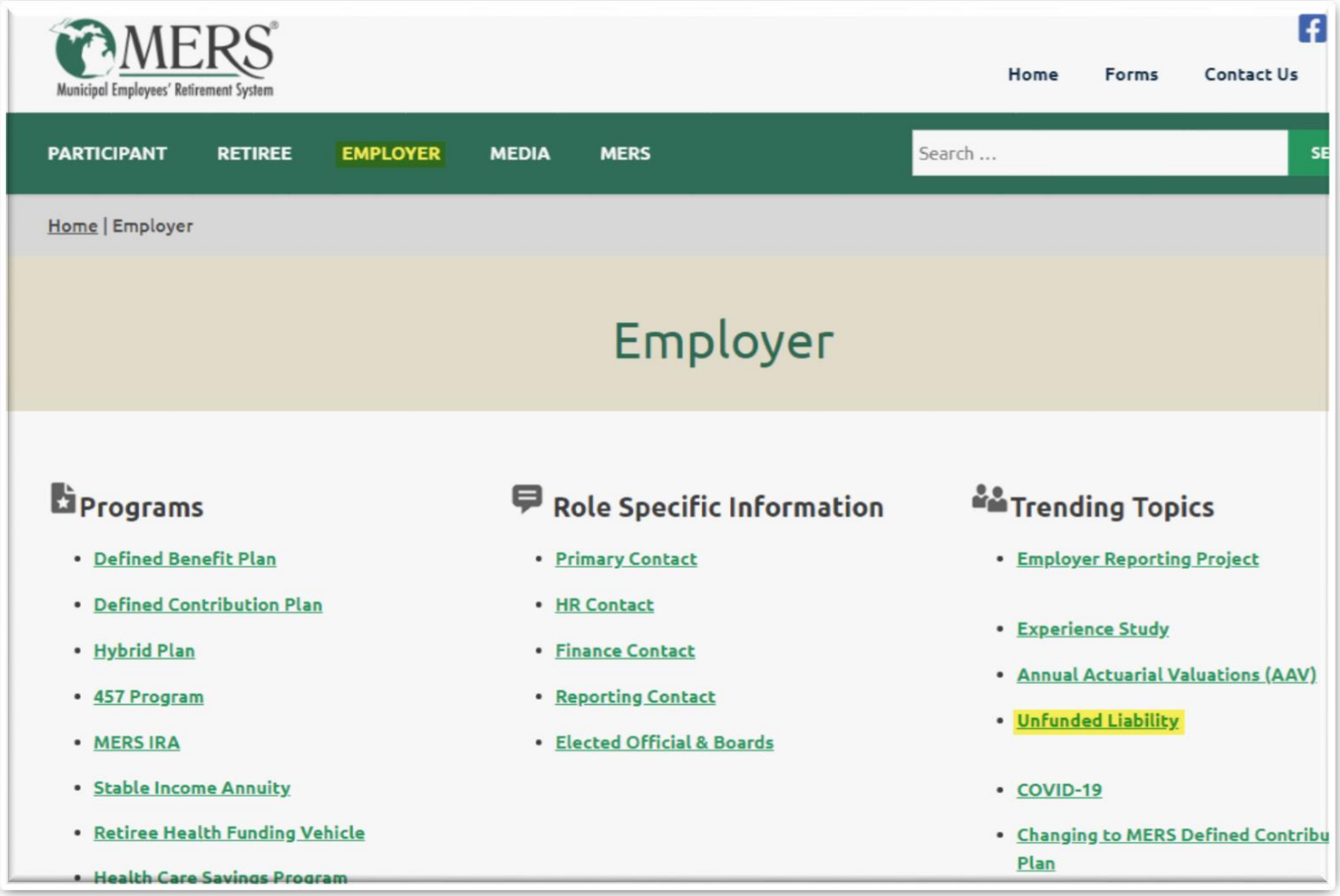


Municipalities that have adopted these strategies as of 6/30/2020.

Bonding Requirements

- Revised Municipal Finance Act was amended in 2018:
  - Extend the eligibility period
  - Allow single-A rated municipalities to issue bonds
  - Additional transparency
- Must close plan to new employees
- Bond amount cannot exceed the difference between 95% of the actuarial value of liabilities and 100% of the actuarial or market value of assets

Resources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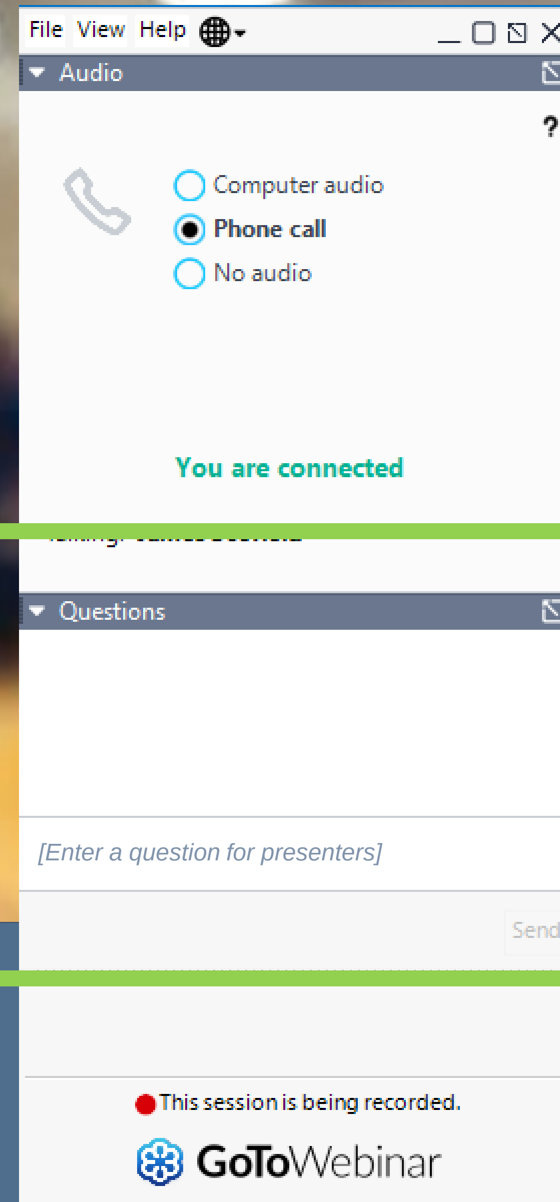
Changing to MERS Defined Contribu
Plan



What questions can we answer?

Contacting MERS of Michigan

MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM

1134 Municipal Way
Lansing, MI 48917

800.767.MERS (6377)

www.mersofmich.com

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