Understanding Unfunded Liability

Presented by Sue Feinberg & Marne Carlson

MERS Regional Managers

MERS®

Municipal Employees' Retirement System

Today’s Objectives

- Defined benefit funding concepts
- What is unfunded liability?
- Strategies to reduce unfunded liability

MERS®
Municipal Employees’ Retirement System

About MERS

- MERS is an independent, professional retirement services company that serves municipal members across the state of Michigan
- We are a nonprofit that is governed by an elected board that is committed to accountability and transparency
- These members include:
  - Three officers members
  - Three employee members
  - Two industry experts
  - One retiree member

BY THE NUMBERS

72 Michigan counties represented

800 municipalities enrolled in MERS programs

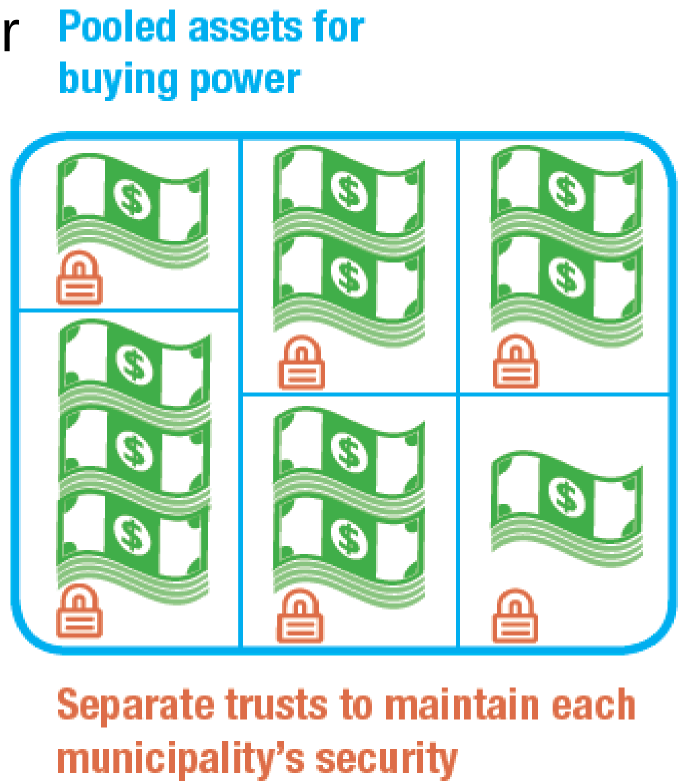
100,000+ participants

$9 Billion+ in combined total assets

MERS®
Municipal Employees' Retirement System

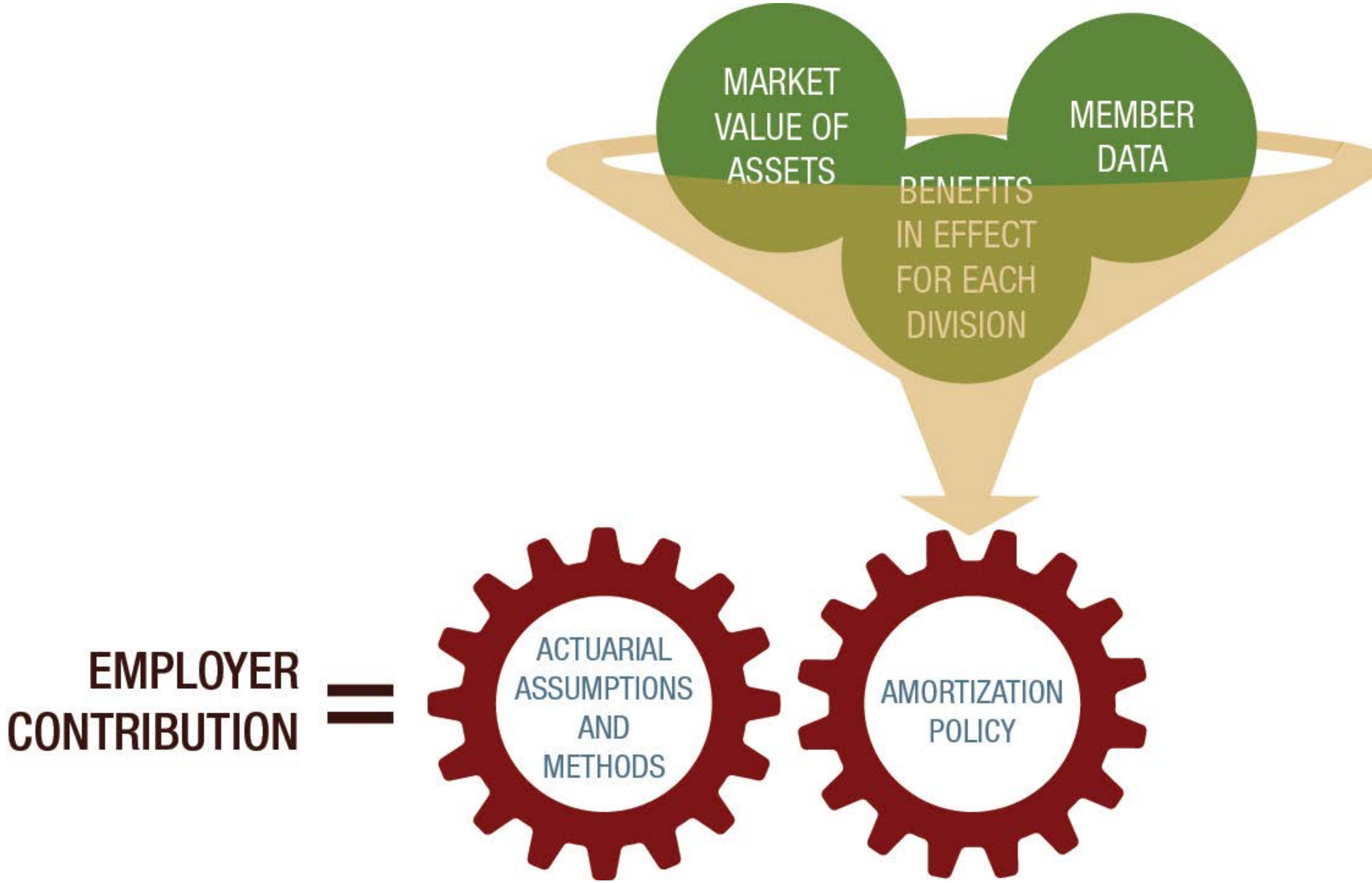
Pooling Powers Financial Security

- MERS administers more than 2,000 different plans
- Each municipality's retirement plan is maintained in a separate trust, which gives our members the benefits of pooling resources for investments
- Pooling municipal assets for investment purposes provides huge benefits to members, including lower administrative costs



MERS
Municipal Employees' Retirement System

How is the Employer Contribution Calculated?



Actuarial Assumptions and Methods established by the Retirement Board

Funding Concepts

- State statute requires that pension plans be pre-funded, meaning regular contributions for each worker are made into the retirement fund during the course of that worker’s career
  - Set aside money now to pay for the benefit payments later
  - Investment income helps pay for the benefits

Basic Funding Equation

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

Employer Contribution

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

What is Unfunded Liability?

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

- The dollar value of the benefits is actuarially determined each year
- Assets are held in a trust and are professionally managed over the years

Why Do Unfunded Liabilities Occur?

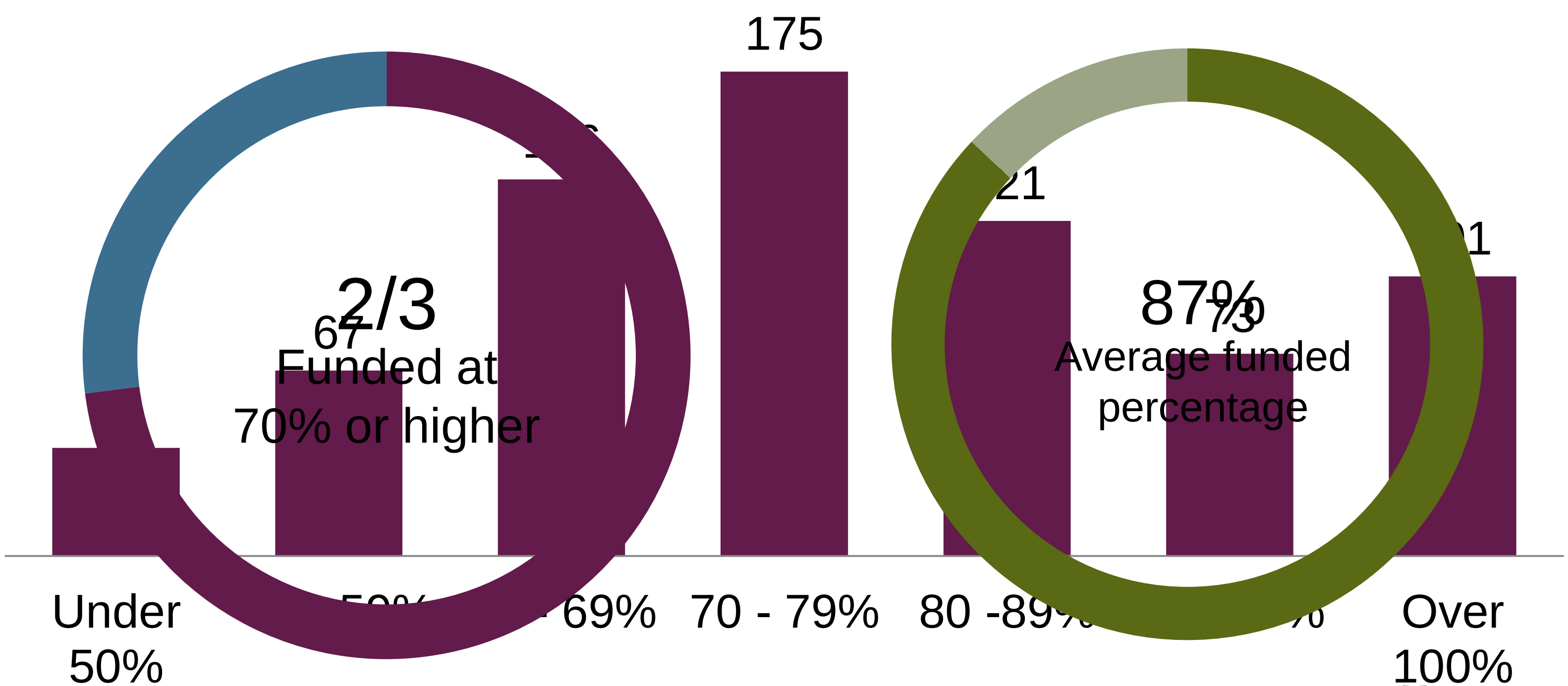
- Benefit improvements
- When municipalities don't meet the minimal required contributions as determined by the actuary
- Experience of the plan (investment experience and demographic experience)
  - This is the difference between what actually happens in the plan compared to the actuarial assumptions

MERS®
Municipal Employees' Retirement System

Distribution of Funded Percentage

Our Defined Benefit Plan is a multiple-employer plan

- Assets 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



MERS
Municipal Employees’ Retirement System

Defined Benefit Case Studies

Underfunded 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

Well Funded Plan

- Joined MERS in 2004
- Transferred from an external DC plan
- Joined at 100% funded
- Made no benefit improvement
- Avg. pension $20,000
- 107% funded today

Strategies to Reduce Liability

Cost-Reducing Strategies - MERS

Strategy	Description	Trend					Impact
		2010	2011	2012	2013	2014	
Cost Sharing for Existing Employees	Employees contribute to help fund the overall cost of the plan	109	176	149	280	143	• Reduces the employer cost, but does **not** affect total cost or the plan’s unfunded liability
Lower Benefit to New Hires	New hires receive a lower tier of Defined Benefit provisions	5	63	49	53	43	• Existing employees are not affected • Reduces the liability for new hires
Bridged Benefits for Existing Employees	Benefits are offered in parts to existing employees Multiplier is then lowered on a going-forward basis	2	14	17	19	29	• Leaves earned benefits unchanged • Reduces the liability for new hires and existing employees
Hybrid for New Hires	New hires receive a Hybrid Plan	6	31	67	31	37	• Existing employees are not affected • Reduces liability for new hires
Defined Contribution for New Hires	New hires receive a defined Contribution Plan	11	21	20	45	30	• Existing employees are not affected • Eliminates liability for new hires
Bonding	Municipalities may bond for all or a portion of their unfunded accrued liabilities—pension or OPEB					4	• Proceeds of the bond are deposited and potentially will fully fund the unfunded accrued liability • No guarantee that future unfunded liabilities may not occur
Voluntary Contributions	Additional payments made into plan toward unfunded liability			180	211	200	• Reduces existing liability • Extra dollars are invested and recognize market returns

Plan Design Strategies to Reduce Liability

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

Lower Defined Benefit to New Hires

- 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** 8/1/2014	Anyone hired **after** 8/1/2014
Tier I • 2.5% Benefit Multiplier • FAC 3 • Vesting of 8 years • Early Retirement Age 55 with 15 years of service • COLA	**Tier II** • 1.70% Benefit Multiplier • FAC 5 • Vesting of 10 years • No Early Retirement provisions • No COLA

MERS®
Municipal Employees' Retirement System

Plan Design Strategies to Reduce Liability

Action	Impact
Defined Contribution Plan for New Hires	**Eliminates future accrual of liabilities** New hires will not accrue liability

MERS
Municipal Employees' Retirement System

Changing Plans– Defined Benefit to Defined Contribution

- New hires, rehires, and transfers are covered by MERS 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

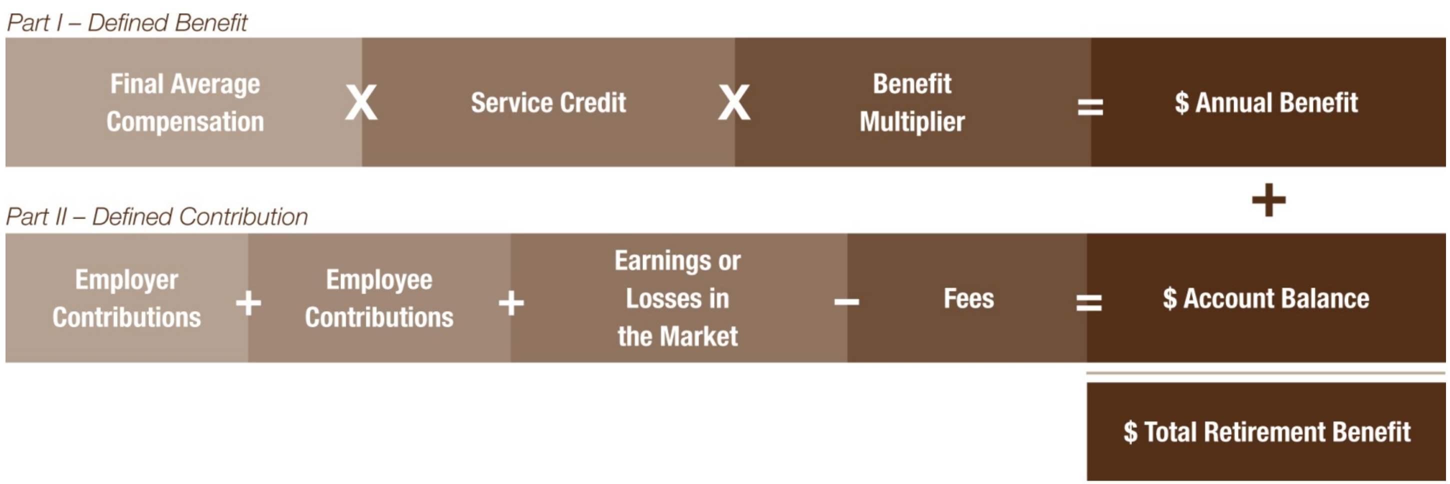
MERS®
Municipal Employees' Retirement System

Plan Design Strategies to Reduce Liability

Action	Impact
Hybrid Plan for New Hires	**Reduces future accrual of liabilities** Future benefits will be lower, and potentially less expensive, than previous benefits

Defined Benefit to Hybrid

- New hires, rehires, and transfers are covered by MERS 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



MERS®
Municipal Employees' Retirement System

Hybrid Plan Impact on Employees

Part I – Defined Benefit

Final Average Compensation $50,000 **X** Service Credit 30 years **X** 1.5% Benefit Multiplier 0.015 **=** $22,500 Annual Benefit

+

Part II – Defined Contribution

7.5 % Total Contributions (Employer + Employee) **+** 6% Earnings in the Market **–** Fees **=** $ 155,777 Account Balance

$ Total Retirement Benefit

MERS®
Municipal Employees' Retirement System

Plan Design Strategies to Reduce Liability

Action	Impact
Bridged Benefit for Active Employees	**Eliminates future accrual of liabilities** Active employees accrue liability at a lower rate and may reduce existing liability. New hires receive the reduced multiplier

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

Original Benefit Multiplier X Final Average Compensation (Termination or Frozen FAC) X Service Credit = $ Original Benefit

\+

New Benefit Multiplier X Final Average Compensation (Termination FAC) X Service Credit = $ New Benefit

$ Total Retirement Benefit

MERS® Municipal Employees' Retirement System

Bridged Benefit Cost Impact

	Current Benefits	*Proposed Benefits*	*Difference*
Benefit Multiplier	2.5%	2.0%	0.5%
Division Funding Level	75.3%	78.8%	3.5%
Employer Contribution Rate	22.68%	17.68%	5.00%

MERS® Municipal Employees' Retirement System

Impact on Employees

Bridging Down – Decreasing Liability

- John's FAC for first 15 years of his career is $30,000
- For the next 10 years his FAC is $50,000
- His termination FAC is $50,000
- Without adopting Bridged Benefits, John's Straight Life benefit would have been $31,250 annually

Final Average Compensation		Service Credit		Benefit Multiplier		Benefit
Final Average Compensation $30,000	X	Service Credit 15 years	X	2.5% Benefit Multiplier 0.025	=	$11,250 Original Benefit
						+
Final Average Compensation $50,000	X	Service Credit 10 years	X	2.0% Benefit Multiplier 0.02	=	$10,000 New Benefit
						$21,250 Total Annual Benefit

MERS Municipal Employees' Retirement System

Funding Strategies to Reduce Liability

Action	Impact
Contribute Annual Required Contribution (ARC)	**Contributes to Unfunded Liability** The actuarial determined contribution is a formula based on Employer Normal Cost and Amortization Payment of Unfunded Accrued Liability
Contribute Above Annual Required Contribution (ARC) • Extra percentage above minimum • Lump sum payment	**Contributes to Unfunded Liability** Extra dollars are invested and have ability to recognize market returns

MERS® Municipal Employees' Retirement System

Conclusion

- Review municipality's funding status through the Annual Actuarial Valuation
- Evaluate options for the future
- Continue to review best practices and implement fiscally responsible policies

MERS®
Municipal Employees' Retirement System

Contacting MERS

MERS of Michigan

1134 Municipal Way

Lansing, MI 48917

Phone: 800.767.6377

Fax: 517.703.9707

www.mersofmich.com

MERS®
Municipal Employees' Retirement System