Headwinds and Oversight:

Managing Pension and Retiree Health Liabilities in an Uncertain Environment

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Agenda

- Michigan Retirement Landscape
- Funding Best Practices
- Economic and Demographic Trends
- Plan Design and Funding Strategies
- Retirement Industry Trends to Watch

MERS of Michigan

MERS is an independent professional retirement services company that was created to administer the retirement plans for Michigan's local units of government on a not-for-profit basis

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84% of local units of government choose MERS

We provide reliable retirement benefits to over 100,000 public employees

$11 Billion+

MERS creates economies of scale by pooling together $11 billion in total assets

Retirement plans are designed at the local level and we offer a range of customizable plans to fit our customers' budgets, needs and goals

An Independent Elected Board

- 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
- The ***MERS Retirement Board takes on the <u>sole fiduciary responsibility</u>***

Michigan Retirement Landscape

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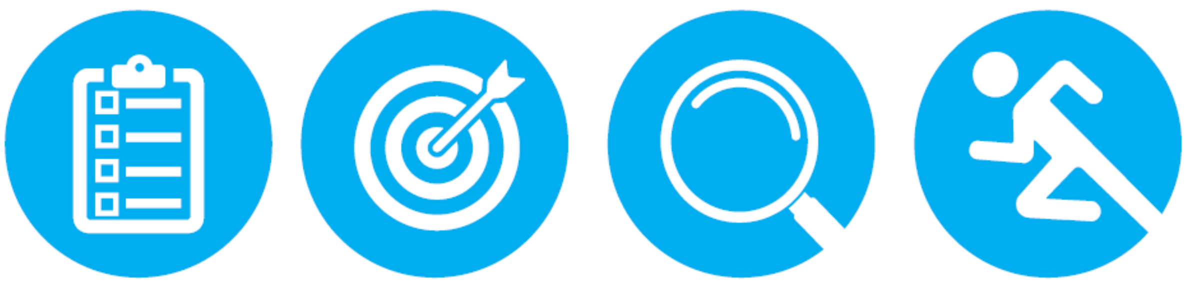
Public Employee Benefits

- Retirement Benefits
  - Protected by the Michigan Constitution
  - Prefunding of pension plans is required

- Retiree Health Care
  - Not considered a protected retirement benefit
  - Collectively bargained benefits are binding

Public Act 202 of 2017

- Protecting Local Government Retirement and Benefits Act
- Affects local units of government with **defined benefit** retirement and retiree health care plans
- Requires prefunding normal cost of retiree health care premiums for new hires
- Addresses existing unfunded liability through four stages:



Transparency through reporting

Identification of potential problems

Review for fiscal health (waiver process)

Develop action plan

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Using Uniform Assumptions

- Please note that the uniform actuarial assumptions are for dashboard reporting purposes only
- MERS customers received this information in the 2018 Annual Actuarial Valuation report
  - Analysis of potential volatility and projected contributions as a result
  - Options for determining contributions above and beyond the minimum required amounts
- Annual PA 202 reporting will still be based on your GASB 68 figures

Pension Funding Levels

How do Michigan's local units of government stack up?

876

SYSTEMS

$38.8 billion in liabilities
$29.5 billion in assets
$9.3 billion in unfunded liabilities

167

<60% FUNDED

19% of plans are less than 60% funded

Source: PA 202 reporting data for FY 2018

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OPEB Funding Levels

How do Michigan's local units of government stack up?

507

SYSTEMS

$13.4 billion in liabilities
$4.8 billion in assets
$8.6 billion in unfunded liabilities

185

NOT FUNDED

36% of systems have operated on a pay-as-you-go basis

345

<40% FUNDED

68% of systems are less than 40% funded

Source: PA 202 reporting data for FY 2018

Funding Best Practices

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Responsible Funding Practices

- Required contributions are calculated by an **accredited actuary** using assumptions about future events
- Assumptions fall into two categories — **economic and demographic**
- **Each year** if actual experience is different from the assumptions, gains or losses are recognized on a fixed amortization period
- As part of our **fiduciary responsibility**, we check assumptions *at least* every five years
- In today's ever-changing world, there is a need to review economic assumptions more frequently so that plans can make **incremental changes**
- MERS has moved up the review of our economic assumptions to help ensure MERS plans are continuing to **adequately fund benefits**

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Economic Trends

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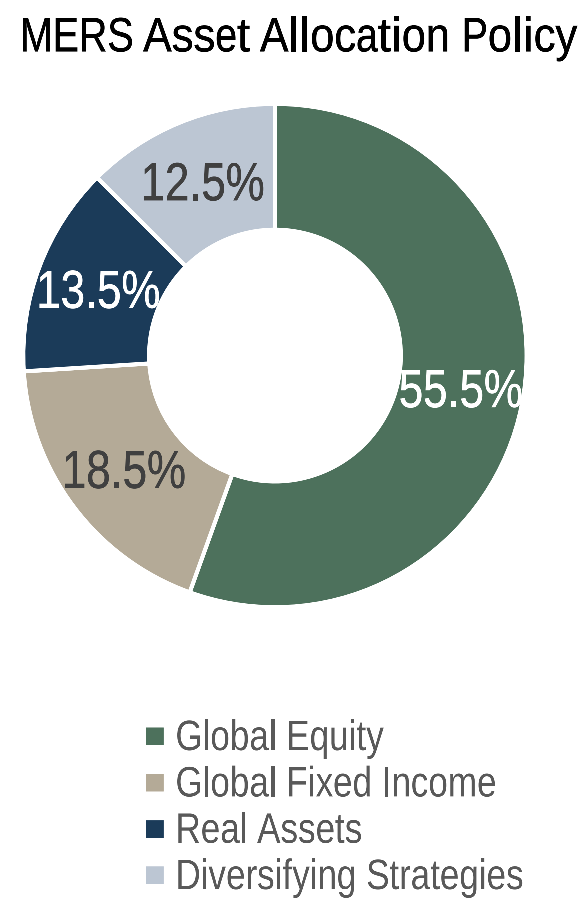
Economic Assumptions

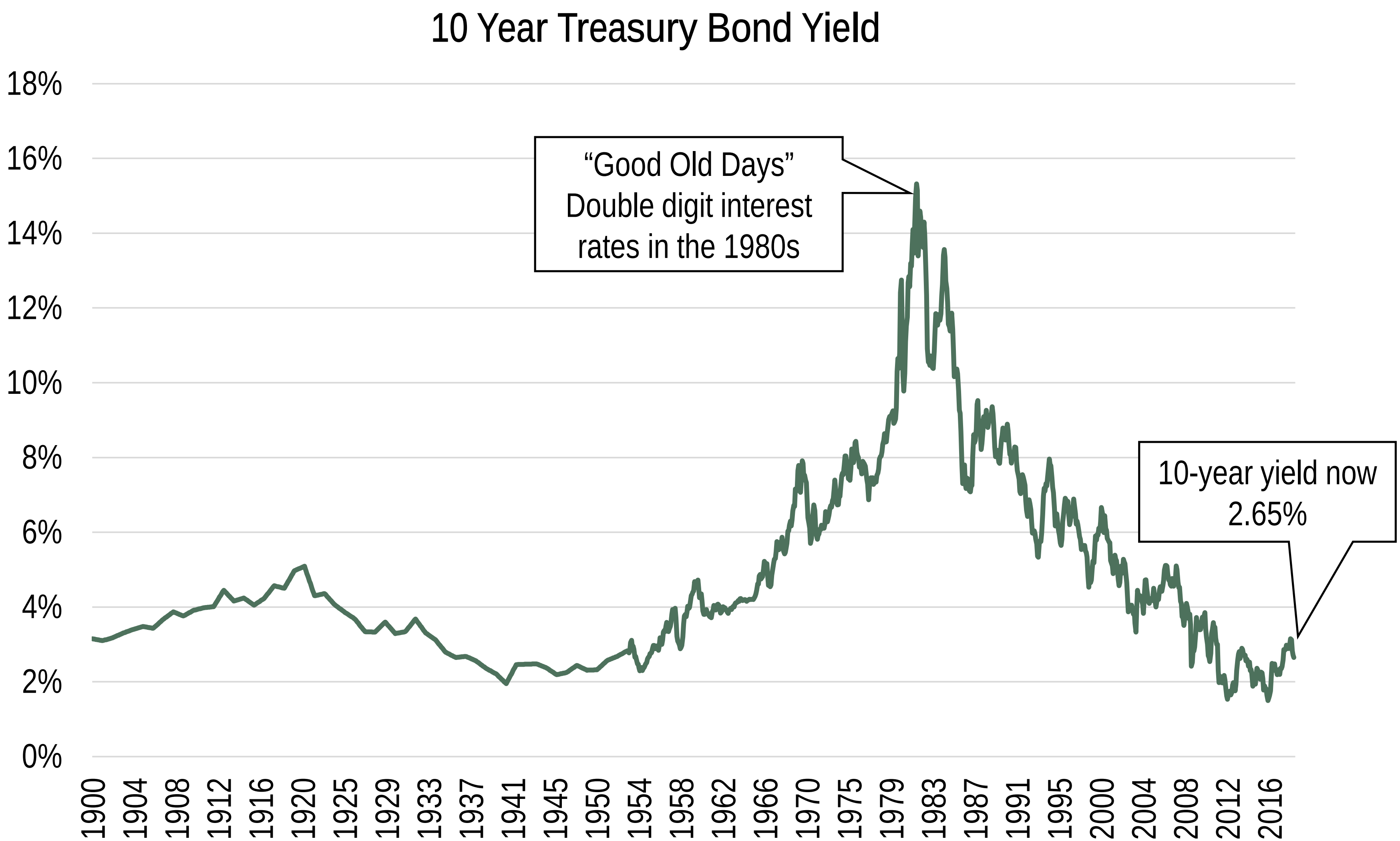
- Economic assumptions are **forward** looking
- The actuary looks to estimates of future economic conditions inherent in current market data, expert opinions, investment consultant expectations, etc.
- Public retirement systems follow a process for establishing the investment return assumption that considers various financial, economic and market factors, and is based on a long-term view

Pension Plan Portfolio

- Mature pension plans must balance growth with stability, providing downside market protection with upside market participation
- Diversification reduces exposure to volatility through a variety of investments that are unlikely to all move in the same direction

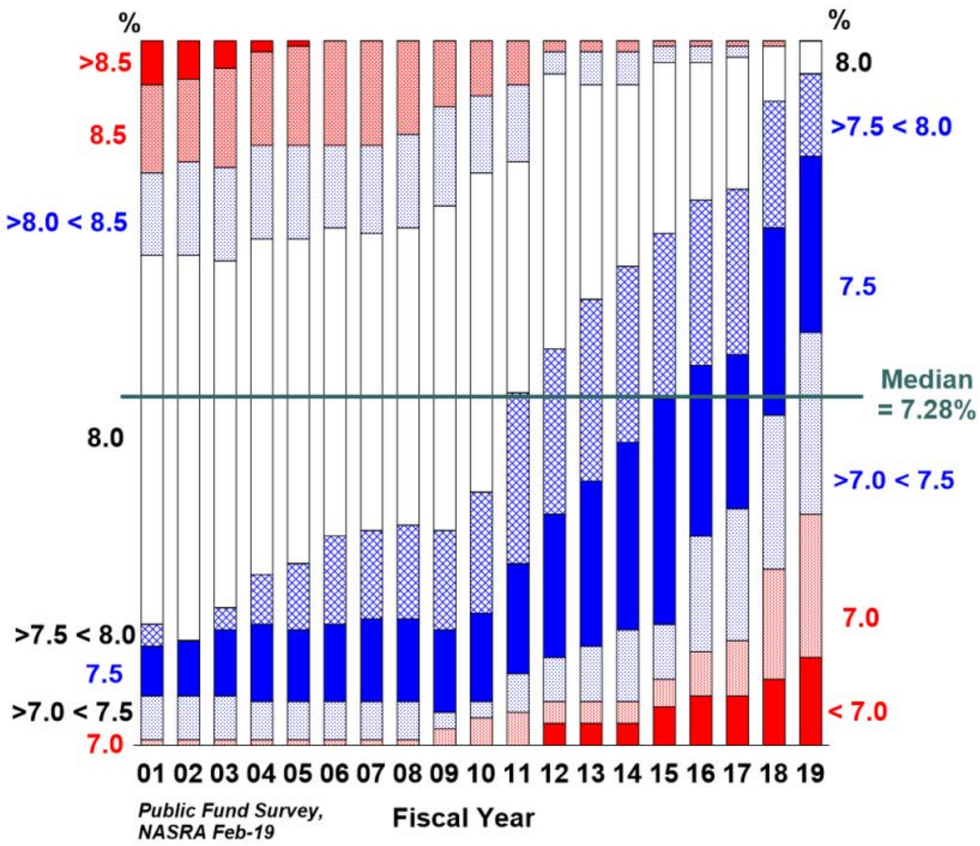


Interest Rates



National Trends in Public Pension Plans

Change in Distribution of Public Pension Investment Return Assumptions, FY 01 to FY 19



- NASRA study of public pension plan investment return assumptions
- Median rate: 7.28%
- Lowest rate: 5.25%
- Highest rate: 8.0%

Source: NASRA Issue Brief: Public Pension Plan Investment Return Assumptions – updated February 2019

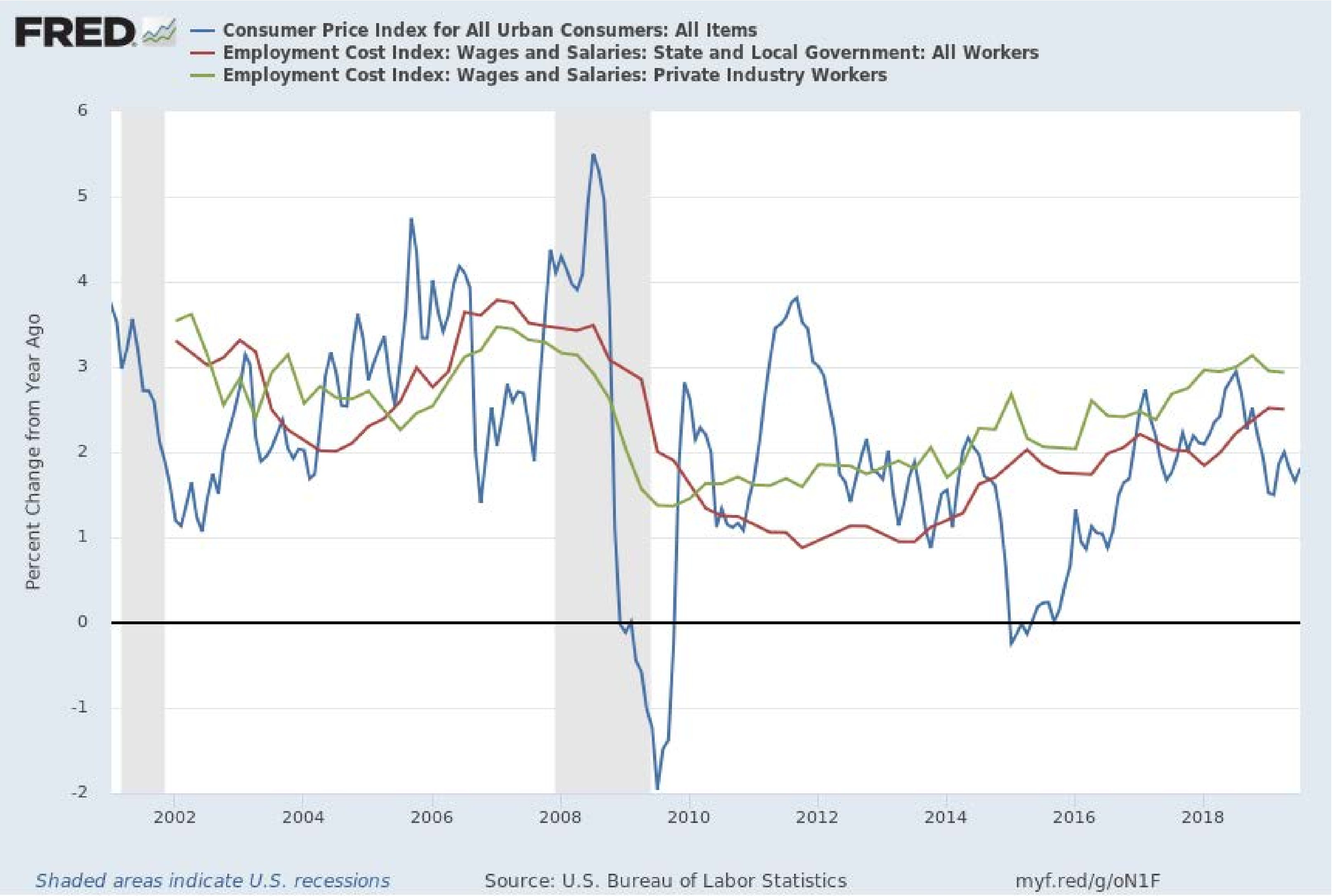
Investment Return Assumption

- Expected investment returns are likely to be materially lower than the past due to historically low interest rates and high equity market valuations
- Plans around the county have made reductions to their investment return assumption
- MERS will be reducing our investment assumption from 7.75% to 7.35%
- Economic assumption changes have been communicated, and are effective with FY 2021 contributions

Wage Inflation Assumption

- Two key factors of this assumption are:
  1) Price inflation (2.5%)
  2) Real wage growth (0.5%)
- MERS will be reducing our wage inflation assumption from 3.75% to 3.00%

Rate of Wage Growth



Demographic Trends

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Demographic Assumptions

- Demographic assumptions not only look back at the plan's actual experience, but also look forward to future expectations
- Based on industry trends, we are **forecasting continued increases** in participant longevity
- MERS is beginning our demographic review now, with any changes impacting FY 2022 contributions

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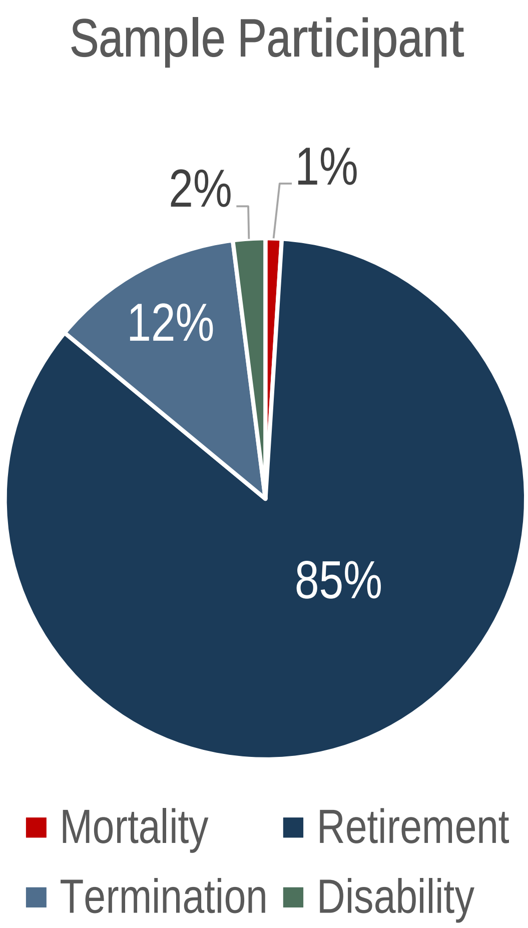
Key Demographic Assumptions

- Mortality rates
  - How long people live determines how long pensions will be paid
  - Includes an assumption for future mortality improvement
- Retirement rates
  - When people retire affects when pensions will be paid
- Termination rates
- Disability rates



Trends in Demographic Assumptions

- Mortality trends
  - People are living longer, but mortality improvement has slowed down in recent years
  - The Society of Actuaries recently published new mortality tables based on public plan experience
    - Generally lower mortality rates
    - Translates into longer life expectancy
    - May result in increased cost for pensions
- The economy may affect demographic experience
  - Turnover may be higher/lower if the job market is good/bad
  - Retirements may be delayed in a bad economy

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Strategies to Manage Pension UAL

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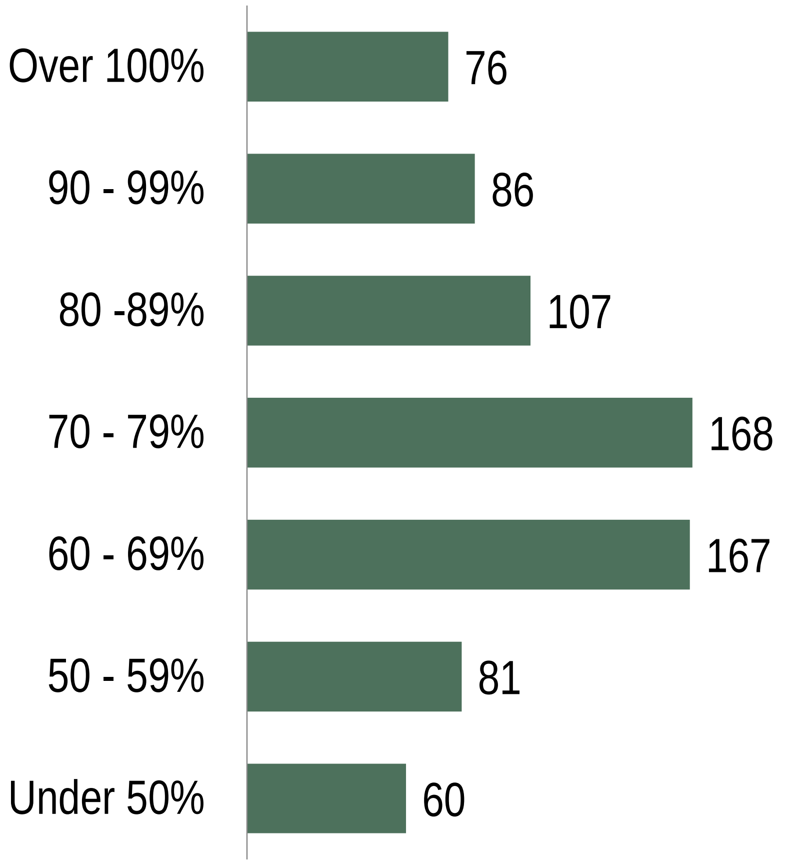
Distribution of Funded Percentage

- 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
- Plans that require additional time to pay off existing unfunded liabilities can request a one-time extension of their amortization period



As of 12/31/2018

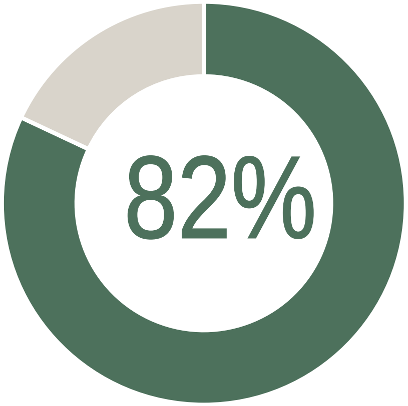
Reducing Pension UAL

There are two ways a municipality can close its unfunded liability gap

Increase assets to close the funding gap
- Funding strategies

Reduce or eliminate liability moving forward
- Plan design strategies

Members taking steps
to reduce UAL
in the past 5 years*



** As of 12/31/2018*

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Plan Design Strategies to Manage UAL

Strategy	Description	Trend 2015	2016	2017	2018	2019	Impact
Lower Benefit to New Hires	New hires receive a lower tier of Defined Benefit provisions	52	34	47	24	16	Existing employees not affected Reduces the liability for new hires
Bridged Benefits for Existing Employees	Benefits are offered in parts to existing employees Multiplier is lower going forward	16	45	27	40	16	Leaves earned benefits unchanged Reduces the liability for new hires and existing employees
Hybrid for New Hires	New hires receive a Hybrid Plan	21	15	12	13	0	Existing employees are not affected Reduces liability for new hires
Defined Contribution for New Hires	New hires receive a Defined Contribution Plan	37	39	73	56	27	Existing employees are not affected Eliminates liability for new hires
Bridged Cost of Living Adjustment (COLA)	Eliminates the COLA on future service credit	n/a	n/a	n/a	8	8	Leaves earned benefits unchanged Reduces the liability for new hires and existing employees
Defined Benefit Plan Freeze	Plan is frozen and all employees move to a new plan	n/a	7	3	2	2	Existing employees do not accrue additional service credit and FAC is frozen

Divisions that have adopted these strategies as of 7/31/2019.

Funding Strategies to Manage UAL

Strategy	Description	Trend					Impact
		2015	2016	2017	2018	2019	
Cost Sharing for Existing Employees[1]	Employees contribute to help fund the overall cost of the plan	97	136	169	130	80	Reduces the employer cost, but does not affect total cost or the plan's unfunded liability
Voluntary Contributions[2]	Additional payments made into plan toward unfunded liability	277	320	421	442	386	Reduces existing liability Extra dollars are invested and recognize market returns
Bonding[3]	Municipalities may bond for all or a portion of their unfunded accrued liabilities — pension or OPEB	1	3	2	6	0	Proceeds of the bond are deposited and potentially will fully fund the UAL No guarantee that future unfunded liabilities may not occur

[1]Divisions that have adopted this strategy as of 7/31/2019.

[2]Municipalities that have adopted this strategy as of 6/30/2019.

[3]Municipalities that have adopted this strategy as of 7/31/2019.

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Alternative Contribution Scenarios

- AAVs contain "what if" projection scenarios, including the recently adopted 7.35% rate of return and 3.0% wage inflation assumptions
- MERS highly encourages additional contributions, if possible

Valuation Year Ending 12/31	Fiscal Year Beginning 1/1	Actuarial Accrued Liability	Valuation Assets[2]	Funded Percentage	Computed Annual Employer Contribution
7.75%[1]/3.75%					
NO 5-YEAR PHASE-IN					
2018	2020	$ 15,478,372	$ 10,380,846	67%	$ 775,680
2019	2021	$ 15,900,000	$ 10,500,000	66%	$ 804,000
2020	2022	$ 16,300,000	$ 10,900,000	67%	$ 837,000
2021	2023	$ 16,600,000	$ 11,200,000	67%	$ 877,000
2022	2024	$ 17,000,000	$ 11,500,000	68%	$ 718,000
2023	2025	$ 17,300,000	$ 12,000,000	69%	$ 745,000
7.35%[1]/3.00%					
NO 5-YEAR PHASE-IN					
2018	2020	$ 15,978,582	$ 10,380,846	65%	$ 828[illegible]
2019	2021	$ 16,400,000	$ 10,400,000	63%	$ 854,000
2020	2022	$ 16,700,000	$ 10,800,000	65%	$ 883,000
2021	2023	$ 17,100,000	$ 11,200,000	65%	$ 919,000
2022	2024	$ 17,400,000	$ 11,500,000	66%	$ 762,000
2023	2025	$ 17,600,000	$ 12,000,000	68%	$ 786,000
5.75%[1]/3.75%					
NO 5-YEAR PHASE-IN					
2018	2020	$ 19,081,517	$ 10,380,846	54%	$ 1,124,028
2019	2021	$ 19,500,000	$ 10,300,000	53%	$ 1,170,000
2020	2022	$ 20,000,000	$ 10,800,000	54%	$ 1,210,000
2021	2023	$ 20,300,000	$ 11,400,000	56%	$ 1,260,000
2022	2024	$ 20,700,000	$ 11,800,000	57%	$ 1,120,000
2023	2025	$ 21,000,000	$ 12,500,000	60%	$ 1,150,000

12/31/2018 Valuation Results	Assumed Future Annual Smoothed Rate of Investment Return		
	Lower Future Annual Returns	Adopted 2019 Assumption	Valuation Assumptions
Investment Return Assumption	**5.75%**	**7.35%**	**7.75%**
Wage Increase Assumption	**3.75%**	**3.00%**	**[illegible].75%**
Accrued Liability	$ 19,081,5[illegible]7	$ 15,978,582	$ 15,478,372
Valuation Assets[1]	$ 10,380,[illegible]6	$ 10,380,846	$ 10,380,846
Unfunded Accrued Liability	$ 8,700,[illegible]1	$ 5,597,736	$ 5,097,526
Funded Ratio	5[illegible]%	65%	67%
Monthly Normal Cost	$ 28,38[illegible]	$ 17,741	$ 17,857
Monthly Amortization Payment	$ 65,280	$ 51,309	$ 46,783
Total Employer Contribution[2]	$ 93,669	[illegible] 69,050	$ 64,640

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Impact Relief and Other Funding Options

- Phase-In of contribution increases from assumption changes (by request)
- Amortization Extension analysis
- Level Dollar contributions approach
- Surplus Divisions

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Defined Benefit Plan Costs

- As a multiple-employer plan, MERS creates economies of scale by pooling together assets for investment purposes, while maintaining separate accounts for each municipality
- In addition, strong cost control measures have helped MERS hold the line on administrative costs
  - In 2018, our administrative costs were equal to our expenses back in 2009
  - Since 2009, MERS has gained 272 members; an increase of more than 42%

Managing OPEB UAL

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OPEB Liability Under Increased Scrutiny

Governmental Accounting Standards Board (GASB) Statements 74 & 75 affect the accounting and financial reporting of OPEB

- OPEB liabilities must appear on the employer’s balance sheet, not just as a footnote
- Unfunded plans must use a municipal bond rate to discount non-covered payments

OPEB Management Programs

- MERS created a Section 115 Governmental Integral Part Trust with an IRS Private Letter Ruling
- From this trust we created two programs that can be used together or independently:

Retiree Health Funding Vehicle

Health Care Savings Program

Strategies to Manage OPEB

Strategy	Description	Trend 2015	2016	2017	2018	2019	Impact
Health Care Savings Program	Individual tax-free invested accounts for qualified health expenses	271	289	321	333	356	Tax-free employer and participant contributions
Retiree Health Funding Vehicle	Invested trust fund for designated OPEB program funding	153	157	171	194	226	Legally protected from creditors Reduces OPEB liability Funds are invested and recognize market returns
Health Care Exchange	In lieu of health care, retirees received stipend to purchase benefits from private health care exchange	n/a	n/a	n/a	2	7	OPEB liability is limited to stipend amount

Total municipalities that have adopted this strategy as of 7/31/2019.

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Private Exchange Overview

AN EXCHANGE IS A MARKETPLACE OF INSURANCE PRODUCTS

Private health care exchanges couple insurance products with support and tools to help people shop, compare and enroll in plans that best meet their needs

Private Medicare exchanges are dedicated to helping seniors access all types of Medicare plans: Medicare Supplement (or MediGap), Medicare Advantage and Medicare prescription drug plans

Medicare exchanges have been around for decades and have helped millions of Medicare beneficiaries find and enroll in the best coverage for them

Why a Private Health Care Exchange?

A private exchange changes the way employers provide retiree health care benefits, without diminishing their commitment to retirees

Increased buying power enables retirees to access plans that provide **equal or better coverage** at a lower cost than typical group plans

Proven strategy helps employers reduce OPEB liability while maintaining their commitment to provide quality benefits

Reduced administrative cost and challenges for employers as compared to supporting a group plan

MERS Employer Analysis

EXCHANGE RESULTS WITH MERS MUNICIPALITIES

10
ADOPTIONS
Out of 48 employers; 15 employers still considering

19
AVERAGE SIZE
Groups range in size from 3 - 45 retirees

$415
PER MONTH
Average cost of Medicare group plan

35%
ANNUAL SAVINGS
Average annual savings of $1,800 per year per participant

40% - 60%
REDUCTION
Estimated reduction in actuarial liabilities

$275
STIPEND
Average recommended stipend amount

Retirement Industry Trends to Watch

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Retirement Industry Trends to Watch

Financial Wellness

Self-Service Tech.

Cyber Security

HSAs

Target Date Funds

Maximizing the Match

What do Employees Want in a Retirement Plan?

Benefit Adequacy (Income Replacement)

Benefit Predictability

Flexibility

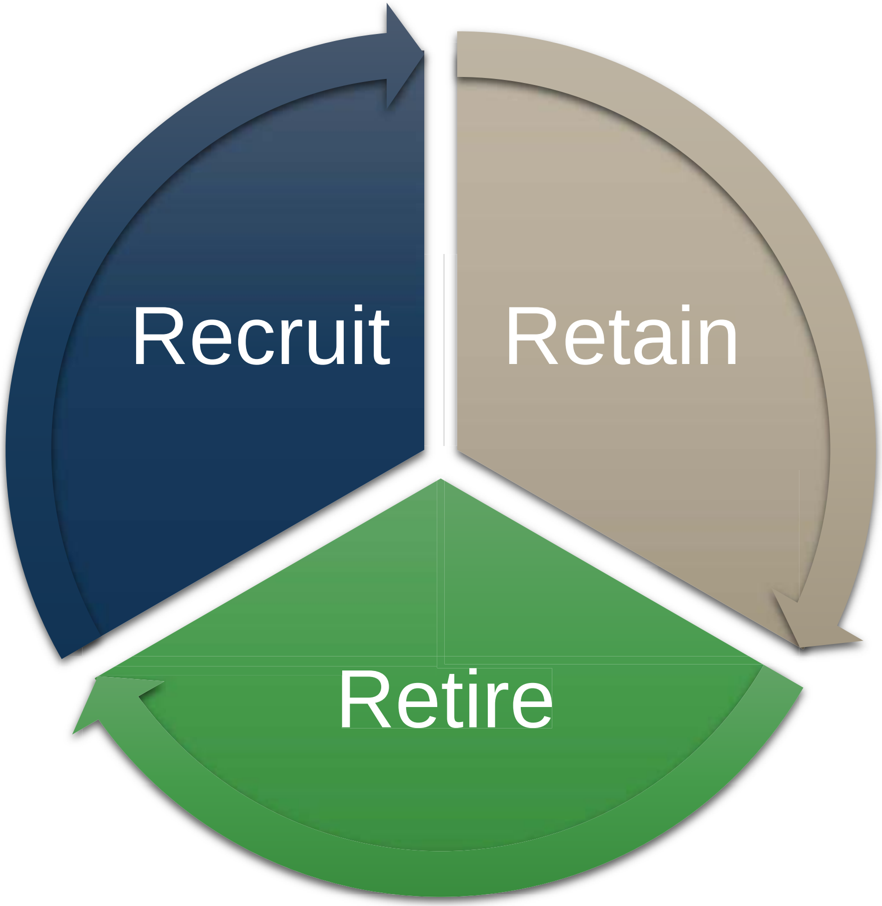
Simple to Understand

Portability

Education Resources and Tools

Retirement Plan Adequacy

An adequate retirement plan can strengthen your workforce



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Employee Education is Key

Preparing Employees for a Successful Retirement

- Ensuring employees understand how their benefit works is a crucial component for building an effective retirement plan
- Higher financial literacy among employees is associated with higher voluntary participation rates or lower quit-rates in automatic enrollment plans
- Financial literacy has a larger effect on saving than a sizable increase in income
- Knowledge of a plan’s specific features — such as the employer matching threshold — is also associated with increased saving

Source: Center for Retirement Research at Boston College

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Employer's Role in Education

- New hire information
  - Quick enrollment forms
  - Videos
  - Welcome Kits
- Retirement planning information
  - Retirement process publications
  - Webinars
  - Free *Pizza & Planning* events
- On-site employee education

40% of MERS participants indicated that they learned about MERS educational events from employers

Contacting MERS of Michigan

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