Managing UAL

Closing the Gap in Unfunded Accrued Liability

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What is UAL?

In a defined benefit pension plan or retiree health care plan, ***UAL (unfunded accrued liability)*** is the difference between the estimated cost of future benefits, and the assets that have been set aside to pay for them.

Municipalities can find their pension funded level and UAL in the ***Annual Actuarial Valuation***, a report provided to them each year. To learn more about your valuation or to explore ways to reduce UAL, contact your MERS Regional Manager by visiting *www.mersofmich.com*, or by calling 800.767.MERS (6377).

Reducing UAL

There are several ways a municipality can reduce unfunded liability, including:

+ INCREASE ASSETS

Paying more than the required minimum contributions through additional lump sum payments.

Bonding to fully fund the plan.

− REDUCE LIABILITY

Reduce liability for new hires by offering a lower tier of benefits (either in the Defined Benefit or Hybrid Plans).

Reduce the liability for new hires and existing employees by “bridging” their benefits to a lower tier and freezing final average compensation.

Eliminate future liability by closing the Defined Benefit Plan and offering a Defined Contribution Plan.

4 Things to Consider

1 Purpose:

Why do you offer your employees a retirement plan?

For example: recruitment, retention, union negotiation, portability, or security for your retirees. Compare your purpose for current employees to your purpose for future employees. Has the purpose changed?

2 Benefit:

Be sure to ***understand the benefit*** your retirees receive compared to any change in the proposed benefit for a current or new employee. Then, evaluate if the current benefits or proposed benefits fulfill the purpose.

3 Cost:

When comparing the costs of your current and proposed retirement plans, ensure you're comparing apples to apples. For example, the long term cost of a Defined Benefit Plan that is fully funded is the ***Normal Cost***. The Normal Cost can be found on Table 1 of your Annual Actuarial Valuation.

4 Cash Flow Urgency:

Consider your budget goal for both your current and proposed retirement plans. Do you have an immediate cost savings need or is this change aimed at longer term impact?

Bridged Benefit

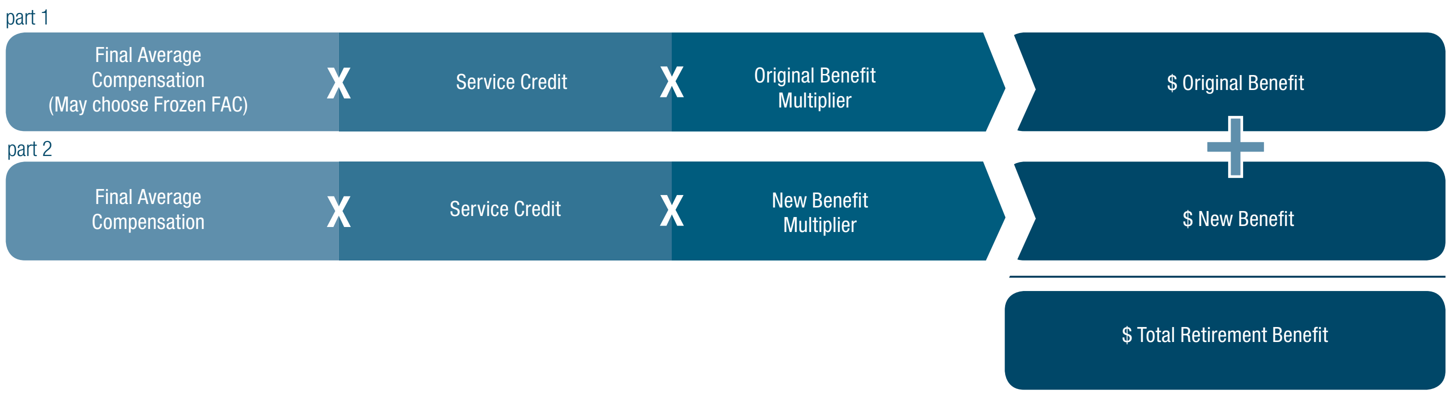
Bridging benefits reduces the benefit multiplier for existing employees on a going-forward basis while leaving earned benefits unchanged.

How Does It Work?

- The first part of the bridge is the current benefit structure already adopted.
- The second part of the bridge allows for the benefit multiplier to be changed on a going-forward basis, impacting only future service.
- At the employee's retirement, the two parts are combined to complete the retirement benefit.

Calculating the Final Average Compensation (FAC):

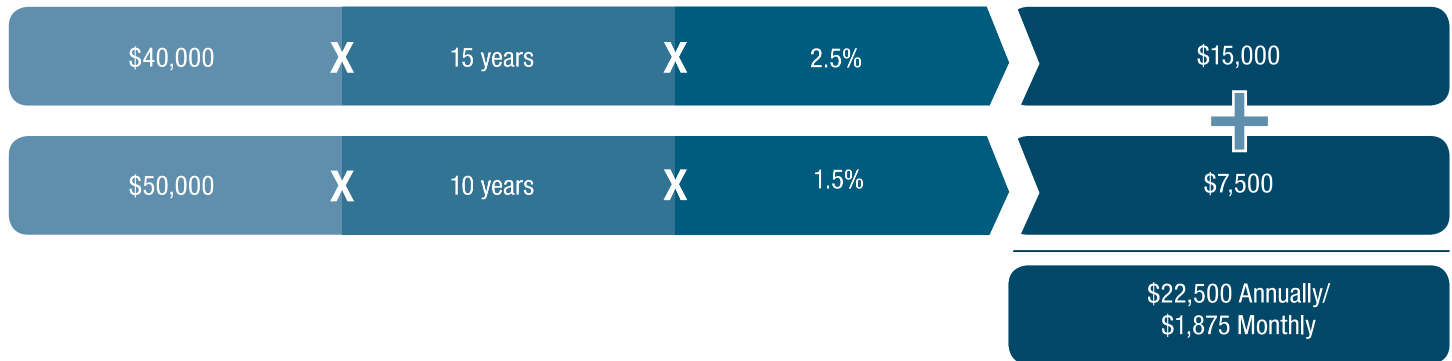
- You have the option to use a Frozen FAC. This "freezes" the FAC in the current (previously accrued) benefit structure and is used to calculate part 1 of the bridge. Choosing this option will provide the greatest cost impact.
- Termination (unfrozen) FAC calculates the FAC throughout the employee's employment. If you do not freeze the FAC, it will be calculated at retirement using the FAC provisions adopted by the plan.



An actuarial report will provide estimated impacts to bridging, and will show both FAC options. See page 5-6 for an example of how a bridged benefit works. As you can see, selecting to freeze FAC provides the greatest impact in most cases.

EMPLOYEE BENEFIT EXAMPLE

Bob worked for 15 years when his employer decides to bridge from a 2.5% benefit multiplier to 1.5%. For the first 15 years, Bob's FAC is calculated at $40,000 with a 2.5% multiplier. Bob works another 10 years at the 1.5% benefit multiplier and when he retires his FAC is calculated at $50,000. Bob's benefit will look like the following:



If frozen FAC is not selected for part 1, Bob's FAC at retirement will be used for both parts of the bridge and his total benefit would be $26,250 annually instead of $22,500. If Bridged Benefits would not have been adopted, Bob would have accrued all 25 years at 2.5% and his benefit at retirement would have been $31,250 annually.

COST EXAMPLE

Bob's municipality has 29 employees, a current annual payroll of $1,532,757, a monthly contribution of $23,867 and a 2.5% benefit multiplier. Below are the results of their bridging from a 2.5% benefit multiplier to a 1.5% benefit multiplier:

Frozen FAC Calculation for Part 1 of the Bridge

Actuarial Accrued Liability	
Current Benefits	$ 9,615,809
Proposed Benefits	8,416,803
Difference	(1,199,006)
Division Percent Funded	
Current Benefits	73.1%
Proposed Benefits	83.5%
Difference	10.4%
Long-Term Employer Contribution (Annual)	
Current Benefits	$286,404
Proposed Benefits	128,604
Difference	(157,800)

Not Frozen FAC Calculation for Part 1 of the Bridge

Actuarial Accrued Liability	
Current Benefits	$9,615,809
Proposed Benefits	9,316,155
Difference	(299,654)
Division Percent Funded	
Current Benefits	73.1%
Proposed Benefits	75.4%
Difference	2.3%
Long-Term Employer Contribution (Annual)	
Current Benefits	$286,404
Proposed Benefits	198,936
Difference	(87,468)

CASH FLOW REQUIREMENT

Implementing Bridged Benefits may provide immediate contribution rate relief by changing the Normal Cost moving forward. The impact will vary depending on each specific plan's details (provisions, demographics, etc.).

Lower Defined Benefit for New Hires

Offering a lower tier of benefits to new hires can help lower future liability while keeping benefits the same for current employees. This option maintains the Defined Benefit Plan, but with lower plan provisions for new hires after a specified date.

How Does It Work?

- New hires, transfers, and rehires are covered by a different tier of Defined Benefit Plan retirement benefits.
- Current division is closed and new hires are enrolled in the new division with lower tier of benefits.
- Accelerated funding is not required with this change.
- The closed division is billed as a flat dollar amount, and you have the option to “blend” the rates of the two divisions.

FOR EXAMPLE:

A municipality is adopting a lower Defined Benefit Plan for new hires after August 1 in the General Division. The municipality currently has a benefit multiplier of 2.25% for active employees. They want to change the benefit multiplier to 1.50% for anyone hired after August 1.

Results

The General Division is closed to new hires and the new lower Defined Benefit Plan Normal Cost is 6.95%*, a savings of 8.27%* of payroll. All new hires, transfers, and rehires will be enrolled in the new lower Defined Benefit Plan (Tier II).

* Assumes average new hire age of 35. Payroll and impacts vary by municipality.

CASH FLOW REQUIREMENT

Implementing a lower Defined Benefit Plan is a long-term cost savings approach because future benefits will be lower and less expensive than what was previously offered. How quickly savings are realized depends on how soon new hires are enrolled in the plan.

Defined Contribution

MERS Defined Contribution Plan is a qualified retirement plan under Section 401(a) of the Internal Revenue Code. Each participant has a plan account to which contributions are made and assets are invested. When an employee retires, their benefits are based on the total amount of money in the account. As a qualified plan, participants are not taxed on employer contributions or earnings until assets are withdrawn.

How Does It Work?

- The Defined Benefit Plan's funded level must meet the minimum requirement before closing to Defined Contribution.
- An actuarial report provides the cost impact of closing the Defined Benefit Plan. This includes a projection of the accelerated funding requirements.
- New hires, transfers, and rehires are covered by the MERS Defined Contribution Plan.
    - Current employees may be given a one-time option to switch plans after reviewing municipality and division funding levels. A minimum funding level is required.
    - Current employees may also have their accrued benefit frozen and then be placed in the DC plan on a going forward basis.
- Once closed, the Defined Benefit Plan will be billed as a flat dollar amount.

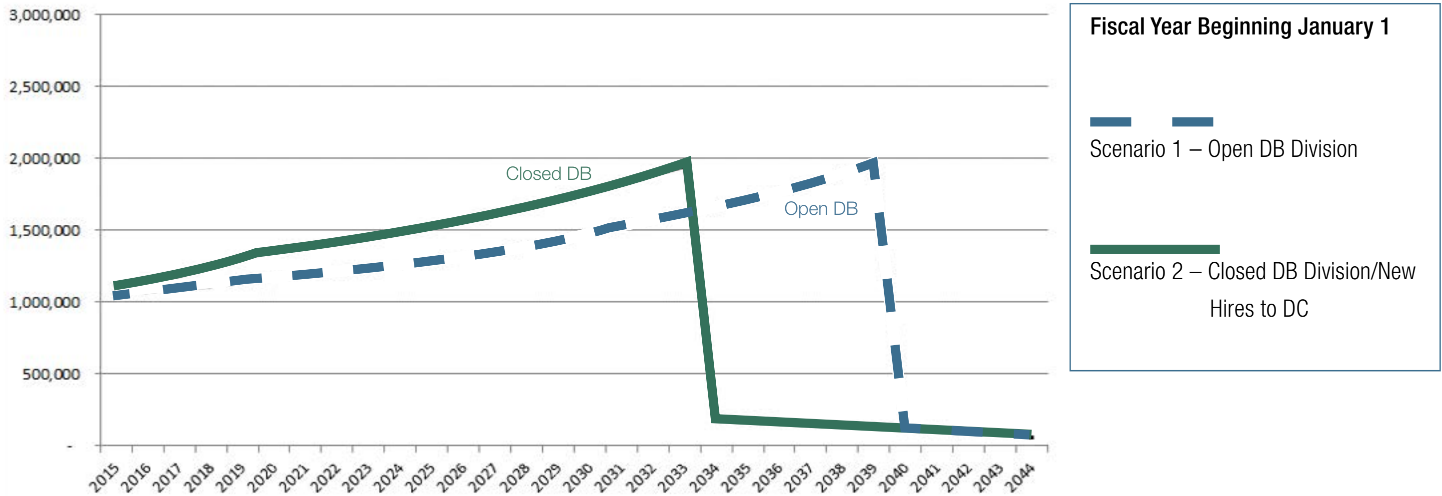
How is a 401(a) different than a 401(k)?

By law, all public sector plans are required to be a 401(a) defined contribution plan, which is different than the private-sector counterpart, the 401(k). The IRS states that 401(a) defined contribution plans require all eligible employees are to be enrolled into the plan, with a set contribution rate for all participants. With the more familiar 401(k) plans, participation is voluntary, and participants may increase, decrease, start or stop contributions at anytime.

For more flexible contribution options, MERS offers the MERS 457 Supplemental Retirement Program, which can enhance any retirement plan.

EXAMPLE: Annual Amortization Payment for Existing MERS Defined Benefit (DB) Plan

An accelerated funding schedule for the closed defined benefit plan is required as a best practice and to ensure adequate funding of the closed plan.



CASH FLOW REQUIREMENT

When closing a Defined Benefit Plan, the accrued benefits of the active participants in that plan remain and will continue to accrue. You will continue to contribute a Normal Cost payment, plus any payment toward any UAL, until the last retiree stops drawing a benefit. The payment toward UAL will not go away by changing plans.

Implementing Defined Contribution for new hires is not an immediate cost savings. To compare your long term cost savings, you compare the ***Normal Cost*** of the Defined Benefit Plan (found on Table 1 of your AAV) to your ***proposed employer contribution*** of the DC plan. This will give you a better idea of the ultimate, long-term costs. Once accrued benefits of the past have been fully funded in the Defined Benefit Plan, you will only contribute the Normal Cost.

Hybrid Plan

MERS Hybrid Plan is two plans in one — offering the security of a defined benefit and the flexibility and investment choice of a defined contribution.

At retirement, employees receive a lifetime benefit and a separate account of their invested assets.

How Does It Work?

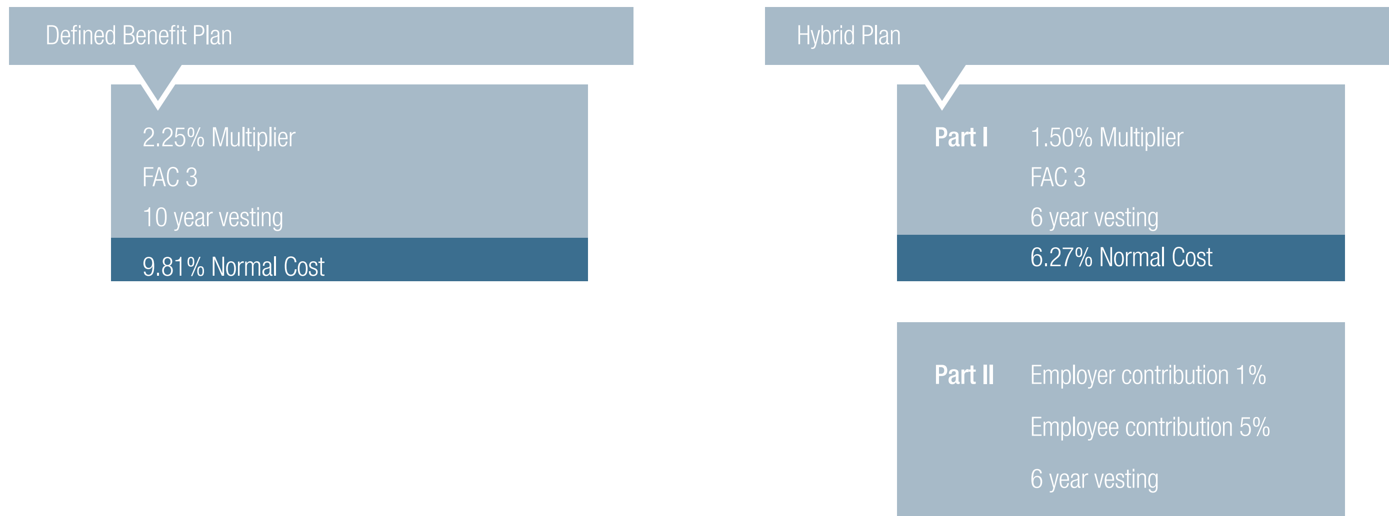
- The current Defined Benefit Plan is closed and new hires, transfers, and rehires are covered by the Hybrid Plan:
  - Current employees may be given a one-time option to switch plans, after reviewing municipality and division funding levels.
  - Current employees may also have their accrued benefit frozen and then be placed in the Hybrid plan on a going forward basis.
- The closed Defined Benefit division is billed as a flat dollar amount, or you may choose to blend the rates of the Defined Benefit divisions.
- The Defined Benefit portion of the Hybrid Plan has a select menu of provision options and requires an actuarial report to calculate the cost.
- The Defined Contribution portion allows both employer and employee contributions as a fixed percentage of pay.

Part I – Defined Benefit

Part II – Defined Contribution

FOR EXAMPLE:

A municipality is adopting a Hybrid Plan for new hires after August 1. The Employer Normal Cost is currently 9.81%. Below is an example of their current plan, and the new Hybrid Plan.



Results

The Defined Benefit Plan is closed and all new hires, transfers, and rehires are enrolled in the Hybrid Plan. The new cost for the municipality is 6.27% (Normal Cost for the Defined Benefit portion) plus the 1% employer contribution to the Defined Contribution portion, totaling 7.27%. This reflects a savings of 2.54% (9.81% minus 7.27%) of payroll.

Additional Contributions

The most direct way of addressing UAL in your Defined Benefit Plan is by making additional payments into the plan. Let's consider four ways your municipality could approach this.

CONTRIBUTE THE ANNUAL REQUIRED CONTRIBUTION (ARC)

The ARC is actuarially determined, and consists of the ***Employer Normal Cost*** plus any ***Ammortization Payment of Unfunded Accrued Liability***. Making this contribution ensures movement to a fully funded position over time, and is required by state statute.

ADDITIONAL VOLUNTARY CONTRIBUTIONS

Additional payments made into the plan, above and beyond the ARC, go toward funding any unfunded liability faster. These contributions may be made as an additional percent above the minimum or in a lump sum payment. In addition, these extra dollars are invested and have the ability to recognize market returns.

For example, a municipality is 78% funded and currently paying an estimated $35,000 monthly.
To accelerate to 100% funding*:

* The above numbers are for example purposes only. Each plan's estimates will vary.

BONDING FOR UNFUNDED ACCRUED LIABILITIES

Public Act 329 allows for a municipality to bond for all or a portion of their UAL. To bond, your Defined Benefit Plan must be closed with a Defined Contribution Plan established for new hires. It's important to remember that bonding to fully fund the plan does not guarantee that UAL will not develop in the future, as plan experience will never match the assumptions used. If bonding funds your plan at 100% or more, the Normal Cost is the required payment into the closed Defined Benefit Plan.

COST-SHARING WITH EMPLOYEES

Over 2/3 of MERS Defined Benefit Plans have employee contributions to the plan. This contribution is deducted (pre-tax) from the employees' paycheck as a percentage of pay. The employee contribution may be used in addition to the employer contributing the ARC (MERS highly encourages the additional payments above the ARC), or may be used to offset the employer contribution.

Other Considerations for Retirement Plans

Whether you offer a Defined Benefit, Defined Contribution, or Hybrid Plan these additional programs can provide benefits to employees without incurring unfunded liabilities. Each can be designed to meet various needs while providing flexible solutions for the challenges facing your municipality.

MERS 457 Supplemental Retirement Program

MERS 457 Program is an easy and low-cost enhancement to any MERS retirement plan, providing employees with flexible contribution options and an invested account they manage. The program is an employer-sponsored deferred compensation program, meaning taxes on the contributions are deferred until they are withdrawn. A post-tax Roth option is also available.

MERS 457 offers individuals a self-directed account in which they choose a portion of their salary to be contributed. They decide the level of contributions and how to invest the assets. After leaving employment, their benefit is based on the total amount of money in the account.

MERS Health Care Savings Program

MERS Health Care Savings Program is an innovative way to help employees prepare for rising health care costs, with a tax-free medical savings account for use after leaving their employer.

Each employee is provided an invested account, to which the employer, employee (or a combination of both) make tax-free contributions. Individual employee accounts are invested in the MERS Investment Menu and grow tax-free. After leaving employment, the vested account balance is available for tax-free reimbursement of eligible medical expenses, for the employee, any eligible dependents, and even a beneficiary on a taxable basis. The program can be used alone, or to complement an existing health care plan.

STRATEGIES FOR USING HCSP

This defined contribution-style benefit can be a powerful tool available to public employers seeking to restructure their OPEB benefits or limit UAL. Here are some different ways the program can be used:

- Supplement existing retiree health care for active employees.
- Buy out vested employees' benefits.
- Offer the program to new hires.
- Provide retirees an account to supplement or replace health care.
- Tax-free for both employer and employee – and an additional option for PTO/longevity payouts so FAC calculations in the Defined Benefit Plan are not inflated, which manages increases in liability without incurring further UAL in your pension program.
- Contact us today to learn more about MERS OPEB strategies, including our 115 OPEB Trust.

This publication 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 (as of the date of publication 10/30/2015). If this publication conflicts with the relevant provisions of the Plan Document, the Plan Document Controls. MERS, as a governmental plan, is exempted by state and federal law from registration with the SEC. However, it employs registered investment advisors to manage the trust fund in compliance with Michigan Public Employee Retirement System Investment Act. Past Performance is not a guarantee of future returns. Please make independent investment decisions carefully and seek the assistance of independent experts when appropriate.

For more information about MERS, contact a member of your Regional Team at 800.767.6377, or visit www.mersofmich.com/myteam to find a representative in your area.

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