Municipal Employees' Retirement System

# DEFINED BENEFIT FUNDING
## Frequently Asked Questions

### Affordability, Relief Options, and Costs

1. Does MERS consider employers' ability to afford required contributions?
2. Isn't there more MERS could be doing to alleviate contributions given the times we are in and the challenges we are facing?
3. Should my municipality bond for our unfunded accrued liability (UAL)? What are MERS' thoughts on bonding?
4. What are MERS administrative costs?

### Actuarial Assumptions

5. My municipality has been making the required contributions (or more) and has made plan changes. Why does it feel like the goal posts keep moving?
6. Why has the smoothed rate of return been below the actuarial assumed rate of return for so many years?
7. Is MERS considering lowering (or raising) the assumed rate now that the smoothed rate is over 8%?
8. The State of Michigan uses 7% as the assumed rate for PA 202 reporting purposes. Shouldn't MERS also use 7% to align with the State?
9. When conducting the Experience Study, where do you gather data? Is it MERS-specific? Public sector? Private and home rule plans?
10. We would like to get this report earlier in the year, is this a possibility?
11. Did MERS look at subgroups other than just police for distinct assumptions?
12. My payroll is shrinking and we aren't hiring any new people. How does this factor into our required contributions?
13. What numbers are used in the FAC load factor, and what happens when that changes?

### Investments

14. Isn't MERS being overly optimistic trying to achieve 7.35%, when we all know that's unachievable?



PUB 5795 2021-08-03

## Affordability, Relief Options, and Costs

**Does MERS consider employers' ability to afford required contributions?**

As the plan fiduciary, our primary responsibility is to ensure that plans are adequately funded. Plan costs vary by each municipality and depend on the benefit plan design and other plan-specific details. To help you proactively assess the affordability of your plan, we include projections and "what if" scenarios in your annual valuations. We are here to partner with you and can discuss various strategies that may help your specific goals and situation.

**Isn't there more MERS could be doing to alleviate contributions given the times we are in and the challenges we are facing?**

MERS is here to partner with you. We have staff across the state that are available to meet with you to review your plans, to explain your options, and to assist with communication and education to your stakeholders, including your elected officials, the public and your employees.

We carry the fiduciary responsibility of the plan for you – meaning, we have a legal duty to follow both the law and best practice standards, while ensuring there are enough assets to fund the benefits that have been accrued (which are constitutionally protected in Michigan).

We have consistently added options for plan design and funding strategies that can assist you with managing your liabilities and cost to your plans. This includes options to phase in assumption changes, as well as to request an extension to your amortization schedule.

There is no one-size-fits-all solution, and for some, multiple strategies will need to be employed to reduce contributions to a manageable level. We are continuously seeking feedback and are open to suggestions for additional ways we can help.

**Should my municipality bond for our unfunded accrued liability (UAL)? What are MERS' thoughts on bonding?**

Whether your local unit of government should issue a pension obligation bond (POB) is a complex question, and we recommend consulting with a qualified expert before reaching a decision. If you plan to explore bonding as an option, MERS will work closely with you and your consultant to provide the necessary information to assist you with your decision. To ensure an efficient experience for you, we continue to work closely with the Michigan Department of Treasury and others to ensure the information we are providing meets the needs of all stakeholders.

It is important to remember that issuing a POB does not change the underlying liability for your plan. Even if a POB is issued for an amount equal to the current UAL, there is no guarantee against the development of future UAL (whether from adverse experience or assumption changes). Ultimately we consider the issuance of a POB to be an investment decision.

**What are MERS administrative costs?**

At December 31, 2020, the cost of the Defined Benefit Plan was 0.26% (0.18% for administration and 0.08% for investments). It's important to remember these are the costs of administering your plan, not the cost of your benefits. The contribution requirements to your plan are the actuarially determined contributions, based on your plan design and funded status, calculated by Gabriel, Roeder, Smith & Company (GRS) and required by law to prefund.

## Actuarial Assumptions

**My municipality has been making the required contributions (or more) and has made plan changes. Why does it feel like the goal posts keep moving?**

This is a challenge that public plans across the country collectively have faced. Within a defined benefit plan, assumptions are made about future events that may or may not come to be. So, there is always variability between what's estimated and what actually occurs. However, the market volatility of the past decade has added increased pressure to the investment rate of return of plans. Many plans, including MERS, have moved to a more frequent review of their economic assumptions. The past two Experience Studies have resulted in lowering that assumed rate of return twice, consecutively. As the fiduciary, we must use the most reasonable assumptions and have made the tough decisions to lower the rate of return to where it is today, at 7.35%.

When your funded level decreases because of the assumptions being used (regardless of what you have or have not done), it really can seem like the goal posts keep moving. But what's important is that plans are using the most reasonable assumptions to ensure adequate funding of their plan, and are making progress to that funding over time.

**Why has the smoothed rate of return been below the actuarial assumed rate of return for so many years?**

In 2015, the MERS Board moved from a 10-year smoothing to a 5-year smoothing. When we did this, GRS used the actuarial value of assets as of 12/31/15 to begin the new 5-year smoothing period. This resulted in 2008's market loss of almost 25% being smoothed an additional three years. The good news is that with the 12/31/2020 annual actuarial valuations, that smoothed market loss falls off, which is why we are seeing an increase in that smoothed rate of return.

**Is MERS considering lowering (or raising) the assumed rate now that the smoothed rate is over 8%?**

At this time, there is no immediate plan to lower this assumption again. However, part of our fiduciary duty is to check assumptions at least every five years. In addition, and as we've shared in the past, in today's ever-changing world, there is a need and growing trend to review economic assumptions ***more frequently*** and with ***incremental changes***.

With that in mind, we have begun reviewing with GRS our funding policy approach to support a more frequent review of the economic assumptions. This approach should contribute to an iterative process for establishing assumptions that are within a range of reasonableness, while working to mitigate large influxes in required contributions to the plan.

We remain committed to providing you as much advance notice as possible when a decision is made regarding a change to this assumption.

**The State of Michigan uses 7% as the assumed rate for PA 202 reporting purposes. Shouldn't MERS also use 7% to align with the State?**

It's important to note that the uniform assumptions established for PA 202 do not dictate the actuarial investment rate of return that plans should use. Rather the purpose of these guidelines help ensure plans across the state have a standard set of assumptions to use for comparison and reporting purposes only. MERS proactively worked with GRS to provide PA 202 reporting numbers within your valuation to help you fulfill these reporting requirements, and at no additional cost to you.

**When conducting the Experience Study, where do you gather data? Is it MERS-specific? Public sector? Private and home rule plans?**

Data used in the Experience Study is MERS-specific and comes from the census data in the annual actuarial valuations. In some cases, for example when assessing mortality rates, we look to broader data sets such as U.S. public sector employees and Social Security data. But even then, we adjust the national data to MERS' experience.

**We would like to get this report earlier in the year, is this a possibility?**

Our actuaries make every effort to provide your reports as soon as possible. It's important to remember that the reports as of 12/31 of any given year are received in June of the following year, and set forth the contributions that will be required in your next fiscal year. For example, the 12/31/2020 report sent to you this past June is for your fiscal year beginning in 2022.

In addition, each report provides you with five-year projections to allow you the opportunity to proactively review your contribution estimates.

**Did MERS look at subgroups other than just police for distinct assumptions?**

It is common for plans across the country to review experience for general and public safety members separately. When GRS performed the review of public safety groups separately from the general membership, they observed significant differences in retirement and withdrawal behavior that warranted reflecting in the assumptions.

GRS completed additional analysis for some other subsets as well, but observed two things: (1) the experience of other subsets was not that different from MERS as a whole, and (2) many subsets were too small to give full weight to their experience. If we slice and dice the data to isolate one small group, it may be harder to give that group's experience full weight to select a new assumption. This uncertainty increases the smaller the group is.

We haven't given pay raises to our employees for years. Why are you assuming a 3.00% wage inflation?

Wage inflation is an assumption that considers large-scale or general economic factors and is used to project long-term increases of total payroll. Two key factors of this assumption are:

- Price inflation (2.50%)
- Real wage growth (0.50%)

The key to remember is that wage inflation is a long-term assumption, whereas year-to-year pay increases are short-term experience. Short-term experience will always differ from long-term assumptions, and one purpose of annual actuarial valuations is to adjust each year to what has actually occurred.

**My payroll is shrinking and we aren't hiring any new people. How does this factor into our required contributions?**

Shrinking payroll affects required contributions in two ways. First, lower-than-expected payroll translates into lower benefit accruals, and hence lower active actuarial liability. In this way, a shrinking payroll may increase a plan's funded level and decrease employer contribution dollar requirements.

On the other hand, amortization rates generally are set based on expected future payroll, so a lower payroll may require a higher rate. Specifically, open divisions (where new employees become members of the division) are invoiced on a percent-of-payroll basis; however, the employer contribution is remitted to MERS in dollars. So a division with a shrinking payroll may see their contribution increase when measured as a percent-of-payroll, even if the dollar amount paid remains relatively stable.

If payroll is shrinking because the number of covered active employees is decreasing, this means fewer employees are receiving a benefit, resulting in lower costs in the long run. However, if the number of active employees is lower, but actual payroll is higher on average (such as from paying additional overtime or higher pay increases), any long-term cost savings may be offset.

If your plan is experiencing short-term fluctuations in payroll, you can opt to be billed as a flat dollar amount vs. percentage of payroll to ensure your actuarially determined contributions reflect that short-term change.

### What numbers are used in the FAC load factor, and what happens when that changes?

Previous Experience Studies found that the Final Average Compensation (FAC) of new retirees was often higher than expected, compared to the reported annual pays from the years prior to retirement (the most recent Experience Study confirms this as well). Employees retiring with higher-than-expected FAC have higher-than-expected liabilities, leading to actuarial losses at retirement. Loading for the anticipated increase in FAC allows the employer to fund for the anticipated higher liability during the working lifetime of the employee, rather than paying for the liability loss after the employee retires.

For each new retiree in the five-year study period, the actuaries compared the actual FAC at retirement against the projected FAC based on previous year-end valuation data. The recent Experience Study showed that, on average, the actual FACs were 3% higher than expected.

Because FAC increases varied significantly from one group to another, FAC loads were developed separately for each affected municipality. A higher FAC load results in larger active employee liability. However, the FAC load does not determine the ultimate cost of the benefit – the ultimate cost depends on the actual FAC used upon retirement. In other words, if an employee's FAC was understated during their employment, the liability loss generated at retirement would need to be paid during the employee's retirement years, and vice-versa.

Note that the FAC load factors reflect things like lump sum payments at retirement or extra overtime in the final year of employment. However, the load factors do not reflect any overtime increases that occur during the entire 3-5 year FAC period.

## Investments

### Isn't MERS being overly optimistic trying to achieve 7.35%, when we all know that's unachievable?

Public retirement systems, like MERS, 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. We use analysis and forecasts from independent experts and governmental sources to validate the assumptions that we use.

For those local units of government who wish to plan more conservatively, your Annual Actuarial Valuation contains a "what if" scenario showing what your required contributions would be with a lower investment return assumption.