MERS

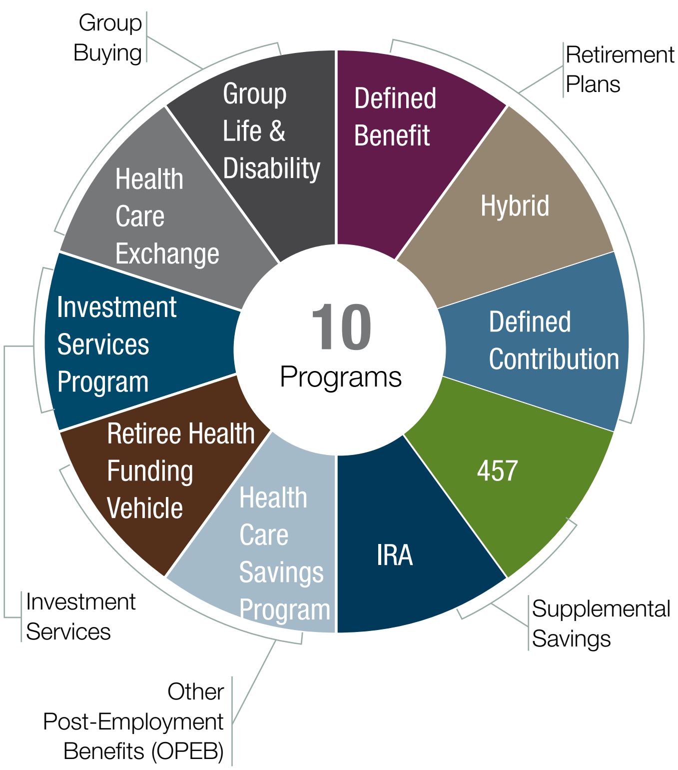
Municipal Employees' Retirement System

Managing OPEB Liabilities

About MERS

The Municipal Employees' Retirement System (MERS) of Michigan is an independent, professional retirement services company that serves local units of government across the state of Michigan on a not-for-profit basis. The team at MERS is made up of top industry experts who use fiscal best practices to give members peace of mind and security in their retirement. MERS listens and works in partnership with our members to deliver a superior value that meets our members' needs. We proudly serve more than 100,000 participants, including local firefighters, nurses, and the men and women who plow our roads and keep our communities safe.

A Program for Every Need



What is OPEB?

Other Post-Employment Benefits (OPEB) are benefits, other than pension benefits, that employers provide to their retirees. They are usually composed of retiree health care benefits, prescription drug coverage, dental and vision coverage, but may also include life insurance, disability, long-term care and other services.

Many municipalities are looking for strategies to manage or reduce liability associated with OPEB. With growing attention and awareness on OPEB liability and the impact on communities, it is important for you to understand your options.

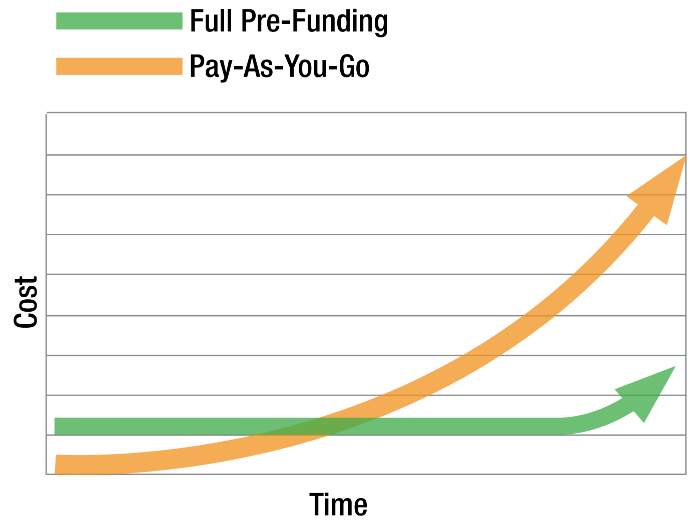
MERS partners with local units of government to help take a proactive approach to OPEB liability, with the MERS Health Care Savings Program and MERS Retiree Health Funding Vehicle, along with access to a private health care exchange. Municipalities can use these programs separately or together to manage OPEB liability. This brochure explains each of these programs, and demonstrates how they have helped other municipalities.

Why Should You Prefund OPEB Liability?

With the passage of Public Act 202, employers are required to prefund the normal cost associated with retiree health care for employees hired after June 30, 2018. Although there is currently no requirement to prefund OPEB for employees hired prior to this date, there are a number of reasons why pre-funding your liability might make sense for your situation.

- OPEB liabilities are likely to be much more volatile, have a longer average duration and can grow much faster than pension liability since expected long-term health care inflation is much higher than the Consumer Price Index (CPI) or average wage increase trends.
- Increasing longevity, coupled with the rising cost of health care, means the traditional pay-as-you-go method will become more expensive each year.
- The financial viability of pay-as-you-go over the next 20 to 30 years is unclear. Long-term costs could rise sharply over time, which could affect your credit ratings and the bottom line of your balance sheet. **Setting aside money now and building assets to address liabilities will help manage these risks.**
- Prefunding OPEB expenses using a qualified medical trust is a best practice established for those local units of government required to file a corrective action plan under Public Act 202.

Not pre-funding any of the liability can be more expensive in the long run. The graph below shows that while the early costs of pre-funding will be slightly higher, the pay-as-you-go costs will increase more quickly over time. Pre-funding over time helps keeps costs predictable.



Based on 10% health care inflation on $1,000

Pre-funding of $3,000 annually

OPEB Financial Reporting Requirements

Who Is GASB?

GASB stands for the Governmental Accounting Standards Board, which is the organization that sets best practices for public sector accounting. GASB regularly issues statements that establish the accounting and financial reporting standards for state and local governments in the U.S.

GASB Statements 74 & 75 deal with the accounting and financial reporting of OPEB. The statements are intended to provide transparency, consistency, and comparability across governments by defining how annual OPEB costs and long-term liability are calculated and reported.

Many of the provisions of GASB 74 & 75 for OPEB are parallel to the provisions of GASB 67 & 68 for pensions.

These statements set forth two important standards:

First, OPEB liabilities must appear on the employer's balance sheet and not just as a footnote, forcing employers to recognize a net OPEB liability in their financial statement. Employers are also required to provide extensive disclosures and supplementary information, including how contributions are calculated and what assumptions and methods are used to calculate the OPEB liability.

The second sets forth how OPEB liabilities are calculated. For plans that have assets projected to cover all future benefit payments, the expected long-term rate of return on plan investments can be used as the discount rate. For other plans, including unfunded plans, a municipal bond rate must be used to discount non-covered payments.

Net OPEB Liability

In a retiree health care plan, the net OPEB liability (also known as the OPEB unfunded accrued liability) is the difference between the total OPEB liability and the plan fiduciary net position (assets that have been set aside to pay for them).

MERS Retiree Health Funding Vehicle

When your municipality adopts the Retiree Health Funding Vehicle, you are joining a Section 115 Governmental Integral Part Trust. This saves you time and money because MERS has an established trust for you. Assets held in trust are legally protected from creditors and may only be used for OPEB. You determine how much to invest and the frequency of contributions. The program can be used alone or in conjunction with the MERS Health Care Savings Program, by depositing directly into individual accounts.

Benefits of joining the funding vehicle:

- You determine the contribution frequency and amount to the trust
- The trust has been approved by a Private Letter Ruling from the IRS
- You benefit from the strength of our substantial membership, with cost-effective investments
- Earnings on assets may reduce your long-term contributions and unfunded liability
- Funding may prevent your net OPEB liability from becoming a significant liability on your balance sheet
- Funding can contribute to a positive credit rating

Investment Options

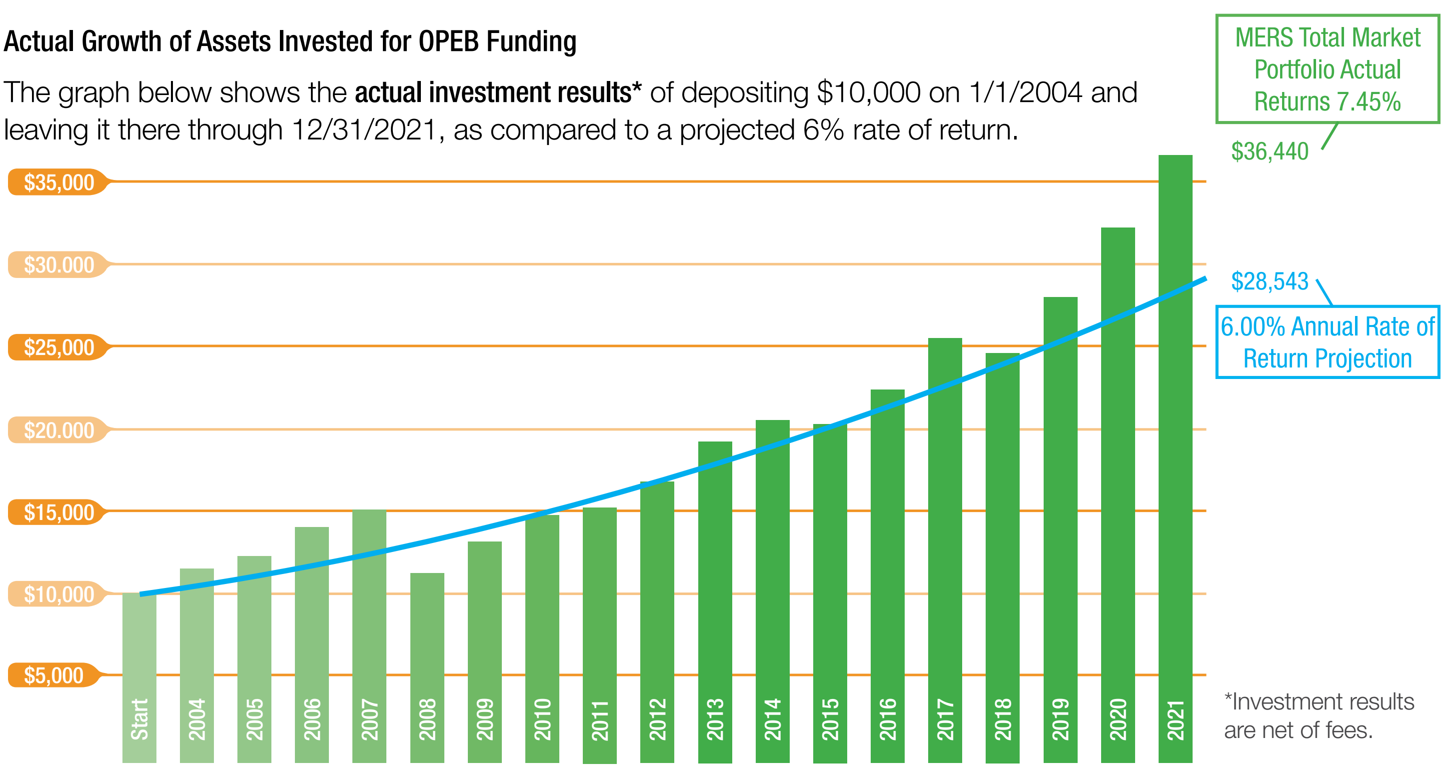
MERS offers two options for investing assets:

For employers who would like the peace of mind that comes with knowing that MERS accepts sole fiduciary responsibility for the investment of your assets, your assets will be invested in the Total Market Portfolio, which uses a prudent, long-term approach designed to provide downside protection and upside market participation.

Employers who wish to have the flexibility to invest assets outside of the Total Market Portfolio have access to quality, cost-effective investment options including risk-adjusted portfolios that are professionally managed by MERS and have a target allocation mix that is rebalanced quarterly. MERS has also made several professionally managed funds available for you to design your own portfolio, including several broad market index funds. Employers who choose their own asset allocation are responsible for the investment of those assets according to guidelines established by the Public Employee Retirement System Investment Act (PERSIA).

Actual Growth of Assets Invested for OPEB Funding

The graph below shows the **actual investment results*** of depositing $10,000 on 1/1/2004 and leaving it there through 12/31/2021, as compared to a projected 6% rate of return.



*Investment results are net of fees.

Employers are continually looking for ways to provide quality benefits for their employees and utilizing health reimbursement plans are a great benefit. Oftentimes, MERS 115 Integral Trust programs can be confused with Voluntary Employees' Beneficiary Association (VEBAs). The accompanying chart will help identify some clear differences about the VEBA's and MERS 115 Trusts.

MERS 115 Governmental Integral Part Trust Compared to VEBA

VEBA

- An IRS 501(c)(9) determination letter is required and must be obtained within 15 months after Trust documents have been executed. VEBA Trusts are typically limited to three contiguous states.
- VEBA board is responsible for compliance.
- Trust earnings accumulate on a tax-exempt basis.
- VEBA Trusts can be expensive to create because plan sponsors must prepare and submit forms, budget, and trust documents to the IRS for approval. The IRS will issue a letter of determination if the plan qualifies.
- Administered by the employer or contracted out to a third-party administrator.
- Employer can manage investment lineup or hire third-party to manage lineup on their behalf.

MERS Section 115 Trust

- MERS has an established trust from the IRS, through a Private Letter Ruling, which allows multiple employers to join. By joining an established trust, municipalities benefit through MERS power of pooling. Pooling provides reduced costs and greater access to institutional investment managers for all MERS customers.
- MERS in-house legal staff monitor IRS changes to maintain the qualification of the Section 115 Trust.
- Trust earnings accumulate on a tax-exempt basis.
- There is no cost to join the MERS 115 Trust.
- Joining the MERS 115 Trust means MERS will administer all benefits.
- Employer can choose investment options from the MERS Investment Menu, benefiting from lower costs and options that might not otherwise be available.
- MERS takes on the fiduciary responsibility of determining investment options and monitoring fund performance.

MERS Health Care Savings Program

The MERS Health Care Savings Program is an employer-sponsored program designed specifically for public sector employees. MERS Health Care Savings Program provides individual medical savings accounts to your employees so they can cover the costs of health care after they leave employment.

The MERS Health Care Savings Program is a tax-favored program, meaning your employees can invest tax-free, while you save on FICA taxes (7.65%). Unique to MERS is the ability for a designated beneficiary to use the balance of the account for qualified health related expenses after the primary account holder passes away.

Strategies for Using Health Care Savings Program

This defined contribution style benefit can be a powerful tool for public sector employers seeking to restructure their OPEB benefits. The program can be used to:

- 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

Combining Strategies

Municipalities can use the MERS Retiree Health Funding Vehicle and MERS Health Care Savings Program together to even further offset OPEB Liability.

Funds in the trust can transfer between the MERS Retiree Health Funding Vehicle and the MERS Health Care Savings Program, providing flexibility.

How It Works

Your municipality works together with employee groups to design the contribution structure, using any combination of the following:

- Tax-free employer contribution
- Tax-free mandatory salary reduction
- Tax-free leave conversion
- Post-tax voluntary employee contributions

The contributions are made into the employee's account, and the employee chooses their investments from the MERS Investment Menu. The contributions grow tax-free, based on performance of the funds.

MERS provides employees with the resources to understand the MERS Investment Menu. Employees can access these resources and their account through myMERS. Here, employees can see all their MERS benefits in one place, including the MERS Health Care Savings Program. Within myMERS, employees can view their balance, make investment changes, and access important resources to help prepare for retirement.

Using the Benefit

After an employee leaves employment, they can access their account to use their savings for tax-free reimbursement of medical expenses, regardless of age.

Some medical expenses that are covered by the MERS Health Care Savings Program are:

- Medical insurance premiums
- Co-pays, deductibles and prescriptions
- Vision and dental services
- Physical therapy
- Long-term care insurance

For a complete list, visit the IRS website, *ww.irs.gov*.

Reimbursements

Take advantage of multiple ways to be reimbursed for eligible expenses:

Debit Card

A MasterCard® card that automatically debits the account when making qualified medical expense purchases.

Online Reimbursements

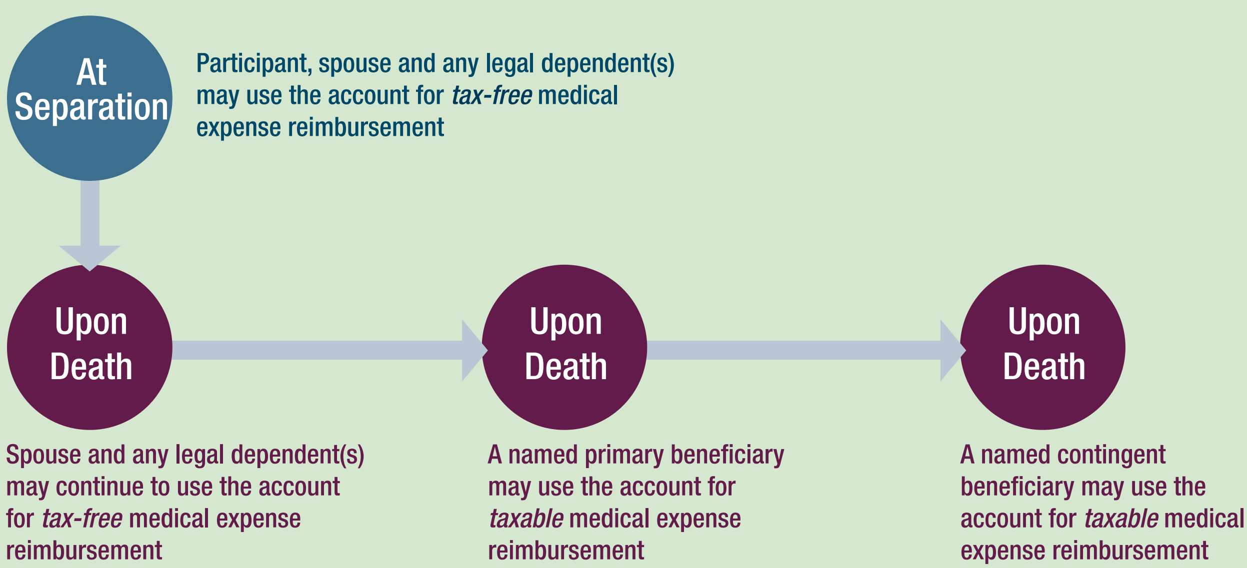
Participants can request reimbursements or pay providers directly online by using the *Claims Management section of myMERS* or the *Alerus Retirement and Benefits* app.

Mail/Fax Reimbursements

Participants may submit their request by mail or fax by using a form and submitting it with copies of receipts.

Beneficiary

A unique feature of the MERS Health Care Savings Program is the ability for the account to be used by someone other than a spouse or eligible dependents, by naming a beneficiary. A participant can name someone as a primary beneficiary and another individual as a contingent beneficiary. The beneficiary may use the account for taxable medical expense reimbursement in the event that a spouse or eligible dependents are no longer living.



A Sustainable Approach to Retiree Health Care Benefits

A private health care exchange is an online marketplace where retirees can purchase individual health insurance plans and other benefits. Using a private health care exchange changes the way employers provide retiree health care benefits, without diminishing their commitment to retirees.

MERS has partnered with Aptia365 Retiree to deliver a complete, individualized solution for your pre-65 and Medicare-eligible retirees.

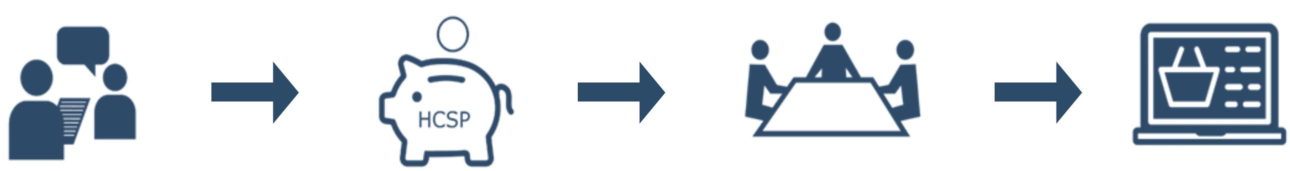
Why a private health care exchange?

- Proven strategy helps employers reduce OPEB liability while maintaining commitment to providing quality benefits
- Reduced administrative costs and challenges as compared to a group plan
- Increased buying power of a private health care exchange enables retirees to enroll in plans that often provide equal or better coverage at a lower cost than typical group plans

Why Aptia365?

- Complete product portfolio with options for pre-65 and Medicare-eligible individuals, as well as short-term medical, dental and vision plans
- An industry-leading customer service model with knowledgeable, licensed benefits counselors dedicated to providing white-glove service to retirees and their dependents
- Proactive outreach to retirees across multiple communication channels to educate each retiree about changes to their health care plan
- Coordination with the MERS Health Care Savings Program – retirees can use funds from their account for retiree health care premiums

How do employer groups use an exchange?



Consultants compare existing group plan to exchange options and help determine an appropriate stipend, which can be amended in the future.

Stipend is deposited into each retiree's health care savings program account.

Benefits counselors work with each retiree to help them select from a wide variety of plans that best meet their individual budget and health care needs.

Retirees use health care savings account funds to purchase an individual plan through the private exchange.

OPEB Case Studies

There are many ways our municipalities have made MERS OPEB solutions work for them. Your Regional Team will be able to discuss with you a strategy that best fits your needs.

Case Study
Municipality 1

Municipality Profile

- City located in southwest Michigan
- 1,800 employees
- OPEB Liability totaled $200 million
- Funds set aside were less than total liability

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Municipal Employees' Retirement System

Situation

The city provided retiree health care to all their employees, which accrued a total OPEB liability of $200 million. The money currently being saved to offset the total liability was much less than what was being accrued.

Process

MERS worked with the city to help reach a solution. The city and their employees negotiated a new program for retiree health care.

Strategy

The city utilized both the MERS Retiree Health Funding Vehicle and the MERS Health Care Savings Program. New hires would be provided the Health Care Savings Program in lieu of retiree health care. The city would provide a contribution of $1,800 per year, with a vesting schedule of 10 years.

Existing employees were given the option to convert to the new program, and were given an actuarially calculated lump sum of the present value of the benefit. All employees would contribute to their program through a mandatory salary reduction moving forward.

Results

By using the Retiree Health Funding Vehicle, the city has been able to set aside money to offset liability and benefit from MERS pooled investment funds. In addition, the city continues to provide the MERS Health Care Savings Program and pre-fund OPEB liability. These combined strategies resulted in a savings to the city of more than $4.5 million in the first year of implementation alone.

Over 40% of active employees are enrolled in the MERS Health Care Savings Program. As of June 2016, the city's OPEB liability had declined to less than $159 million.

Case Study
Municipality 2

Municipality Profile

- Township located in southwest Michigan
- 18 employees
- OPEB Liability totaled $2.2 million
- Funds set aside were less than liability total

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Situation

The township was looking to reduce their liability by considering the MERS Health Care Savings Program.

Process

MERS and the township worked together to provide education to the employees about the program. The township was going to allow employees to vote to replace retiree health care with the MERS Health Care Savings Program.

Strategy

The township employees unanimously decided to replace retiree health care with the MERS Health Care Savings Program. Township employees would receive a “jumpstart” contribution of $2,500 for each full year they were employed with the township between 2001 and 2012. Thereafter, a $2,500 contribution would be made for each full year worked.

New hires at the township would receive $2,500 at the end of each full year they worked.

The Township set aside funds in the MERS Retiree Health Funding Vehicle to benefit from investment performance. The vehicle was originally funded with $500,000. At the end of each year, the township transfers money from the Retiree Health Funding Vehicle to make lump sum payments into the MERS Health Care Savings Program accounts of employees.

Results

Here is a township that had a goal to eliminate OPEB liability completely. In 2009, the total liability was nearly $2.2 million. The township asked their employees to approve the new plan, and adopted both the MERS Retiree Health Funding Vehicle and Health Care Savings Program, which resulted in a reduction of OPEB liabilities by over $2.1 million, more than a 92% reduction!

Municipal Employees' Retirement System

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. If this presentation 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.

Municipal Employees' Retirement System of Michigan

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