A Strategic View of Retirement Plan Governance

Presented by Mike Overley and Sue Feinberg
Agenda

• Who is MERS?
• The Role of a Fiduciary
• Plan Design Strategies and Considerations
• Maximizing Flexibility and Adequacy
• A Modern Approach to Retiree Health Care
Who is MERS of Michigan?

MERS is an independent, professional retirement services company that was created to administer the retirement plans for Michigan municipalities on a not-for-profit basis.

BY THE NUMBERS

- 84% of Michigan’s pension plans participate with MERS
- 100,000+ participants
- $10 Billion in combined total assets
The Role of a Fiduciary
You Might Be a Fiduciary If...

• You are named as a fiduciary by title
  – Trustees and often plan administrators
  – Named fiduciaries have authority over operation and administration of the plan
  – Service providers, such as investment professionals, may assume fiduciary status

• You act like a fiduciary
  – Determined by the actions performed and discretion exercised over plan assets
Fiduciary Responsibility

- With recent high-profile class action suits alleging violation of fiduciary duty, employers need to manage fiduciary risks.

- When fiduciary breaches occur there can be:
  - Personal liability
  - Fines and penalties
  - Legal action
  - Plan disqualification
  - Higher operating expenses
Degrees of Fiduciary Responsibility

When it comes to the fiduciary responsibility for your retirement plan, not all plan providers assume the same degree of responsibility.

**Plan Provider**
In some instances, the plan provider takes fiduciary responsibility, establishes the plan document, determines the investment options available and monitors performance.

MERS provides employers with this level of confidence.

**Co-Fiduciary Responsibility**
Many plan providers act as co-fiduciaries. The provider offers investment information and makes recommendations. The employer is responsible for selecting and monitoring the performance of the funds.

The plan provider and employer share fiduciary responsibility for the plan.

**Employer**
Most plan providers act only as a record keeper and leave decisions regarding the plan document, investment options and performance monitoring to the employer.

The employer has unlimited choices under this scenario, but risks being held liable for fiduciary violations.
Fiduciary Oversight

• A fiduciary is anyone who exercises discretionary authority over:
  – Plan assets
  – The administration of the plan
  – The management of the plan

• Fiduciaries are subject to standards of conduct and must act on behalf of participants

• Responsibilities:
  – Adherence to plan document
  – Investment oversight
  – Ensure reasonable expenses

MERS provides employers with peace of mind because the MERS Retirement Board takes on the sole fiduciary responsibility of their plan.
Investment Menu and Oversight

Responsibilities of the Plan Fiduciary

• Establish clear goals and objectives for the plan investment options with well-defined measures for success

• Maintain a disciplined process for hiring, evaluating and terminating investment managers for the plan

• Choose an appropriate investment default fund

• Document all of the above in a formal Investment Policy Statement
Is a Bigger Investment Menu Better?

Psychologists have concluded that an overload of options can paralyze people or push them into decisions that are against their own best interest.

When Less is Actually More

A study on shopping behavior experimented with jam displays. One table held 24 varieties of gourmet jam; the other held only 6 varieties. The large display attracted more interest, but people were 1/10th as likely to buy from the large display as from the small display.

The same principle of “less is more” was found to apply to participation rates in retirement programs. A large number of fund choices actually discourages participation amongst even well informed participants.¹, ²

¹ Mottola, Gary and Utkus, Stephen. “Can There Be Too Much Choice In a Retirement Savings Plan?” The Vanguard Center for Retirement Research, June 2003
Simplified Investment Options

• Our streamlined investment menu is selected by our experienced investment professionals

• MERS performs the necessary research, due diligence and monitoring to ensure high-quality options are available

• Fully diversified, professionally managed portfolios provide access to funds not otherwise available with other providers

• Outside institutional investment managers are selected and monitored by the MERS Office of Investments and Retirement Board

Investment Categories

1. “Do it for me”
Fully diversified target date funds that automatically adjust over time

2. “Help me do it”
Prebuilt portfolios that are monitored and rebalanced quarterly

3. “I’ll do it myself”
Self-Directed Brokerage Account to access funds outside of MERS
Responsibilities of the Plan Fiduciary

Monitoring Participant Expenses

• Understand all costs paid by the participants, including:
  – Direct investment and administrative charges
  – Third-party and/or indirect fees
  – Reimbursements

• Assess whether plan fees are reasonable

• Ensure that all plan fees charged to participants are clearly disclosed
## Monitoring Plan Expenses

### Provider Comparison Summary

<table>
<thead>
<tr>
<th>Plan Weighted Averages (Appendix III)</th>
<th>Provider A</th>
<th>Provider B</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expense</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weighted Average Expense</td>
<td>1.68%</td>
<td>0.41%</td>
<td>-1.27%</td>
</tr>
<tr>
<td><strong>Performance</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1-Year Weighted Average Performance</td>
<td>16.20%</td>
<td>16.65%</td>
<td>0.45%</td>
</tr>
<tr>
<td>3-Year Weighted Average Performance</td>
<td>6.04%</td>
<td>7.14%</td>
<td>1.10%</td>
</tr>
<tr>
<td>5-Year Weighted Average Performance</td>
<td>10.79%</td>
<td>12.15%</td>
<td>1.36%</td>
</tr>
</tbody>
</table>
Comparing Providers  Effect of Fees on Participants

Meet John

• John is 30 years old
• His current salary is $42,000, with 2% annual salary increases
• He has a balance of $10,000 in his Defined Contribution account
• He will make bi-weekly contributions of 10% into his Defined Contribution account and 5% into his 401k account until retirement
• Assumes a 7.5% gross investment return before retirement
• Retires at age 62
  – John withdraws assets in equal monthly payments for 25 years
  – At the end of 25 years the balance is depleted
• Assumes a 6% gross investment return throughout retirement
In this comparison, lower fund expenses could provide John with **30% more at retirement!**

A comparison report can help an employer gauge the impact of higher costs during the *accumulation phase* of an average employee.

<table>
<thead>
<tr>
<th>Provider</th>
<th>Balance at Retirement</th>
<th>Account Balance Lost to Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Provider A</strong> (1.68%)</td>
<td>$556,419</td>
<td>$241,010</td>
</tr>
<tr>
<td><strong>Provider B</strong> (0.41%)</td>
<td>$727,800</td>
<td>$315,710</td>
</tr>
</tbody>
</table>
The comparison report can also help an employer gauge the impact of higher costs during the **distribution phase** of an average retiree.

Lower fund expenses could provide John with **47% more in monthly income during retirement!**
Plan Design Strategies and Considerations
# Public Sector Retirement Options

<table>
<thead>
<tr>
<th>Defined Benefit</th>
<th>Hybrid</th>
<th>Defined Contribution</th>
</tr>
</thead>
</table>
| • Lifetime benefit that does not fluctuate with investment gains or losses  
• Contributions fluctuate  
• Funded by the employer, employee and investment earnings | • Combines the best of both plans  
• Benefit and contributions vary  
• Funded by the employer, employee and investment earnings | • Benefit based on account balance  
• Fixed contributions  
• Funded by the employer, employee and investment earnings |

## 457 Program
- Supplemental savings account that can be added to any retirement plan
- Voluntary and flexible employee contributions
- Pre-tax and Roth options
Retirement Plan Adequacy

*Potential risks of not providing adequate retirement plan*

Recruit

- Decreased ability to compete with other employers to attract talented employees

Retain

- Benefits keep talented employees engaged in their current position and future opportunities

Retire

*Potential employer costs if employees have inadequate savings to retire:*

- Higher health care costs than younger employees
- Higher absenteeism and lower productivity while at work
- Decreased engagement for other workers unable to advance career
- Large lump sum sick, vacation, PTO bank payouts upon separation
Retirement Plan Considerations

Plan Type
- Is the plan intended solely for retirement income or for health care costs as well?
- Is the purpose to supplement a pension or to be the primary retirement plan?

Participation
- Is the plan mandatory or voluntary?
- Would automatic enrollment enhance the plan?

Contribution Structure
- Are employee contributions voluntary and flexible or fixed?
- What is the employer contribution budget?
- Do the employer contributions incentivize increased participation and/or contributions from the employee?
- Would automatic escalation enhance the plan?

Vesting Schedule
- Vesting schedules help retain employees
- Unvested dollars can return to employer and offset future contribution costs

Loans
- Will participants be allowed to take out loans?
Retirement Plan Trends

Increased life expectancy means retirees need larger retirement savings

Trend of employers no longer offering traditional pensions

Trend of employers no longer offering retiree health insurance
Maximizing Flexibility and Adequacy
What is an Adequate Savings Rate?

• Rather than a one-size-fits-all answer, it’s important to look at how much income a person is likely to need in retirement.

• **80% income replacement rate** is the industry standard.

• The contribution rate needed to achieve that income replacement rate varies from person to person and depends on several factors:
  - Current age
  - Expected age at retirement
  - Life expectancy
  - Health
  - Cost of health insurance
  - Investment risk tolerance
  - Social Security
  - Other income sources
  - Lifestyle in retirement
  - Debt

• Providing the ability to choose a savings rate enables employees to make the best individual choice for their circumstances.
Flexible Retirement Savings

• The IRS prevents an employee from changing their contribution rate in a 401(a) Defined Contribution Plan after initial election

• Pairing a 401(a) Defined Contribution Plan with a 457(b) Supplemental Savings Program provides 401(k)-like flexibility

• An example of this plan design is the MERS Defined Contribution PLUS – two programs essentially function as a single plan
How Does it Work?

Offering an employer match to incentivize employee saving

• Employers establish the contribution structure for the Defined Contribution Plan
  – Any employer contributions are deposited into the employee’s Defined Contribution account
  – Employee contributions may or may not be required

• Employers can encourage even greater employee participation by offering a match on any voluntary contributions the employee makes
  – Voluntary employee contributions are deposited into the employee's 457 account
  – Employer’s matching contributions are deposited into the employee's Defined Contribution account
Simplified Reporting and Oversight

Blending two plans into one seamless design

- Joint reporting of contributions saves employers time
- Combined statements and online account access make it convenient for participants to monitor investment performance
- Using a single investment menu simplifies the decision making process
  - Less oversight for employers
  - Choosing investment options and making allocations is easier for participants
## Benefits of Combining Plans

<table>
<thead>
<tr>
<th>Employer</th>
<th>Employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Minimum level of participation in the Defined Contribution Plan is required</td>
<td>• Employees can contribute up to the annual IRS maximum in each plan (Up to $55,000 in Defined Contribution and $18,500 in 457)*</td>
</tr>
<tr>
<td>• A vesting schedule can be applied to all employer contributions</td>
<td>• Voluntary contributions can start, stop or be changed at any time</td>
</tr>
<tr>
<td>• Loans can be restricted from the Defined Contribution account, while still allowed from the 457 account</td>
<td>• Matching contributions from employer are not taxed as income when received</td>
</tr>
<tr>
<td>• Having both programs administered by a single vendor lowers plan expenses</td>
<td></td>
</tr>
</tbody>
</table>

*IRS limits for 2018*
## Plan Feature Comparison

<table>
<thead>
<tr>
<th>Plan Type</th>
<th>401(a)</th>
<th>457(b)</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Purpose</td>
<td>Qualified Retirement Plan</td>
<td>Supplemental Savings Program</td>
<td>Qualified Plan with Supplemental Savings Program</td>
</tr>
<tr>
<td>Enrollment</td>
<td>Mandatory</td>
<td>Voluntary</td>
<td>Mandatory</td>
</tr>
<tr>
<td>Employee Contribution Flexibility</td>
<td>Choice only at Enrollment</td>
<td>Complete Flexibility</td>
<td>Complete Flexibility Above Required Contributions</td>
</tr>
<tr>
<td>Required Contributions</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Automatic Enrollment (optional)</td>
<td>n/a</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Automatic Contribution Escalation (optional)</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Roth Option Available</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Allows Employer Contribution</td>
<td>Yes</td>
<td>Yes (included as employee earnings)</td>
<td>Yes</td>
</tr>
<tr>
<td>Allows Vesting</td>
<td>Yes</td>
<td>Varies</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Contribution Structure Example

- Employees are required to contribute 2%
- Employer will contribute a minimum of 2%
- Employer will match 100% of voluntary contributions, up to a maximum of 5%
- Voluntary employee contributions above 5% are allowed, but will not be matched by the employer

<table>
<thead>
<tr>
<th>Required Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Contributions - Deposited into DC Account</td>
</tr>
<tr>
<td>Employer Contributions - Deposited into DC Account</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Voluntary Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Voluntary Contributions - Deposited to 457 Account</td>
</tr>
<tr>
<td>Employer Matching Contributions - Deposited into DC Account</td>
</tr>
<tr>
<td>Total Retirement Contributions</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>0%</th>
<th>1%</th>
<th>5%</th>
<th>7.5%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Voluntary</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>0%</td>
<td>1%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Employer Matching</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>0%</td>
<td>1%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Total Retirement</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>4%</td>
<td>6%</td>
<td>14%</td>
<td>16.5%</td>
<td>19%</td>
</tr>
</tbody>
</table>

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Participant Education is Key

Preparing participants for a successful retirement

• Regardless of the plan design, ensuring that participants understand how their benefit works is crucial

• 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
Rising Cost of Retiree Health Care

• Medicare was never designed to cover health care expenses in full
• Most couples would need to have saved $349,000 by age 65 to have a 90% chance of having enough money to pay for retiree health care expenses
• Retiree health care costs is one of the primary reasons people decide to delay their retirement
• Studies show health care costs rank second only to food for retiree expenses
• Fewer employers are offering defined benefit-style retiree health care plans
Retiree Health Care Plan Considerations

• Must include network coverage for pre-65 retirees
• Compliance with stringent Medicare regulations
• Need for retiree-centric customer service model that helps retirees and family members evaluate plan options, with ongoing support
• Must provide timely communication to pre-retirees with easy-to-understand materials
• Seamless integration with other savings vehicles
• Actuarial support for OPEB valuation and consulting
Modernizing Retiree Health Care

• An online marketplace where retirees can purchase benefits from the carrier of their choice

• Provides a variety of plans:
  – Pre-65 coverage
  – Coverage options for Medicare-eligible retirees that include Medicare Advantage, Medicare Supplement (Medigap) and Part D Prescription Drug Plans
  – Dental and vision plans

• MERS will be partnering with Mercer Marketplace 365

• Fully integrates with a health care savings account, such as the MERS Health Care Savings Program
Advantages for Retirees

• Ability to purchase quality, low-cost benefits seamlessly through the exchange without employer adoption

• A Benefits Counselor guides each retiree and eligible dependent through a step-by-step consultative process

• The Benefits Counselor then assists during the enrollment process, which is typically done online

• Premiums can be paid directly to insurer through a health care savings account
OPEB valuation determines liability
Exchange consultants help design the structure
Stipend is deposited into a health care savings account
Benefit Counselors meet with retirees to provide education and assistance to help them choose a plan
Retirees use their health care savings account funds to purchase health plan off the private exchange
Competitive Pricing Reduced Plan Cost

- **Employer Premium**
- **Retiree Premium**
- **Retiree Out-of-Pocket**

<table>
<thead>
<tr>
<th>Health Status</th>
<th>Group Plan</th>
<th>Exchange</th>
<th>Group Plan</th>
<th>Exchange</th>
<th>Group Plan</th>
<th>Exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good Health</td>
<td>$8,772</td>
<td>$2,568</td>
<td>$7,896</td>
<td>$1,164</td>
<td>$876</td>
<td>$1,404</td>
</tr>
<tr>
<td>Fair Health</td>
<td>$9,492</td>
<td>$1,596</td>
<td>$7,896</td>
<td>$1,932</td>
<td>$1,164</td>
<td>$1,404</td>
</tr>
<tr>
<td>Poor Health</td>
<td>$10,212</td>
<td>$2,316</td>
<td>$7,896</td>
<td>$3,336</td>
<td>$6,204</td>
<td>$3,984</td>
</tr>
</tbody>
</table>

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## Benefits of a Private Exchange

<table>
<thead>
<tr>
<th>Employer</th>
<th>Retiree</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Ability to offer quality retiree benefits</td>
<td>• Can select a unique plan that meets their individual needs</td>
</tr>
<tr>
<td>• Reduced costs</td>
<td>• Tax-free deposits are made into a health care savings account</td>
</tr>
<tr>
<td>• No long-term OPEB liability accrues</td>
<td>• Health care savings account balance can be used for other qualified healthcare expenses</td>
</tr>
</tbody>
</table>
Key Takeaways

• The role of fiduciary
  – Must act on behalf of plan participants
  – Not all retirement plan service providers assume the same level of fiduciary responsibility
  – Investment menu and fee oversight and governance

• Maximize your plan design
  – Creative solutions for added flexibility
  – Enable your employees to prepare adequately for retirement

• Retirement adequacy and planning for retirement
  – Knowledge is power
  – Income replacement
  – Healthcare costs and needs in retirement
Contacting MERS of Michigan

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This presentation 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. Where the publication conflicts with the relevant Plan Document, the Plan Document controls.