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BILL ANALYSIS

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Senate Bill 1040 (Substitute S-2 as reported)
Sponsor: Senator Roger Kahn, M.D.
Committee: Appropriations

CONTENT

The bill would amend the Michigan Public School Employees' Retirement System (MPSERS) Act to make several substantial changes, including the following:

-- Beginning July 1, 2012, future compensation would no longer include merit pay, tax sheltered annuities, or longevity pay.
-- For employees hired on or after July 1, 2012, final average compensation, as used in the calculation of a pension, could not exceed $100,000, adjusted annually by inflation. This cap would not affect the pension of employees hired before July 1, 2012.
-- Employees hired before July 1, 2010, would have the following choices: 1) make higher contributions in order to continue receiving a 1.5% multiplier for future years of service; or, 2) either a) continue paying current contributions but have a 1.25% multiplier for future years of service, or b) freeze pension benefits earned to date and move to a defined contribution plan for future years of service. "Hybrid" employees (those hired on or after July 1, 2010) would not be affected by these pension changes.
-- For employees first hired on or after July 1, 2012, retiree health care premium coverage would be eliminated and replaced with matching employer contributions up to 2% of compensation, deposited into a 401k account; new hires would not have to remit the 3% employee contribution for retiree health that is in the law for current employees.
-- The premium coverage paid by the State would decrease to a maximum of 80%, with retirees (both existing retirees and future retirees) paying at least 20% of health care premiums.
-- The Office of Retirement Services would have to determine a fiscal year 2012-13 employer contribution rate not later than July 1, 2012.

The bill also would appropriate $1.0 million to the Office of Retirement Services (ORS) for implementation of the legislation.

The proposed changes would address both pension and health care costs. As of the most recent Comprehensive Annual Financial Report, the unfunded accrued liability (UAL) for MPSERS pensions was $17.6 billion and the UAL for retiree health care was $27.6 billion. The bill would reduce the liabilities under both the pension and health sides, but most of the impact would affect the health care liability.

Definition of Compensation and Final Average Compensation

Senate Bill 1040 (S-2) includes two proposals that would limit future pension payouts. The first would amend the definition of "compensation" to exclude from future compensation, beginning July 1, 2012, merit pay, tax sheltered annuities, and longevity pay. Any merit pay, tax sheltered annuities, or longevity pay earned before July 1, 2012, would be included in compensation earned in previous years, to the extent allowable under current law. However, going forward, those items would be eliminated from the definition of "compensation".

The second proposal would place a cap on final average compensation for employees first hired on or after July 1, 2012. Specifically, the cap for new hires would be $100,000, adjusted annually by inflation. Since a pension is calculated by multiplying an employee's final average compensation by the number of years worked, times a specified multiplier, both proposals would work to limit the final pensions paid out, by limiting compensation used in the calculation of the pension.

Increased Employee Contributions or a Reduced Multiplier or Conversion to DC

The next series of changes under Senate Bill 1040 (S-2) relate to choices offered to employees as follows: 1) increase employee contributions and continue the multiplier (for pension calculation) of 1.5% for future years of service, OR, 2) keep the same level of employee contributions but have a reduced multiplier of 1.25% on future years of service, OR, 3) make no future contributions, but also receive no future years of service for a pension, and instead freeze existing pension benefits and convert to a defined contribution (DC), or 401k, plan.

Employees who wished to continue receiving the existing 1.5% multiplier for future years of service (for use in calculating a pension) would have to pay higher employee contributions than under current law. Specifically, employees hired before January 1, 1990 ("basic" plan members) who chose to remain in the basic plan would have to pay 5% of compensation; these employees currently make no contributions to the MPSERS. All member investment plan (MIP) members hired before July 1, 2010, whether they switched from basic or were first hired into MIP, would have to pay a flat 8% of compensation; these employees currently make graded contributions based on salary, presently ranging from 3% to 6.4%. The bill includes language stating that the contribution rate charged to employees could not exceed the normal cost of their pension; this means that if the normal cost fell below 8%, then the employee contributions would be reduced from 8% to a level not more than the normal cost rate. Employees hired on or after July 1, 2010, are in the "hybrid" system and would not be affected by the proposed changes; they would remain in the hybrid plan at their current contribution levels.

If employees did not choose to make the higher contributions listed above, they would have two choices: 1) pay the existing employee contributions, but receive a 1.25% multiplier for future years of service, OR, 2) freeze the earned benefit to date and convert to a DC plan. The DC plan would require the employer to deposit 4% of compensation into a 401k account, but no future pension benefits would accrue to an employee choosing this option. Regardless of the option chosen, previously accrued service would be calculated at the 1.5% multiplier when determining pension benefits earned to date.

Retiree Health Care

Two changes to retiree health care are proposed under Senate Bill 1040 (S-2). First, beginning July 1, 2012, State premium coverage would be reduced to not more than 80%, with retirees paying at least 20% of retiree health care premium coverage, an increase from the current roughly 10% cost sharing. This change would affect not only future retirees, but also people already retired.

Second, the bill would eliminate retiree health care coverage for employees first hired on or after July 1, 2012. Mirroring changes made for State employees under Public Act 264 of 2011, the bill would require an employer to make up to a 2% matching contribution into an employee's 401k account in lieu of retiree health care coverage. Employees would not be able to take loans out against the employer's contributions, under this proposal, which was also implemented under Public Act 264.

MCL 38.1303a et al.

FISCAL IMPACT

Table 1 is a summary of the sections proposed for amendment and their estimated fiscal impact, if available. If Senate Bill 1040 (S-2) were enacted, the cumulative first-year pension savings would be $260.0 million and cumulative first-year health savings would be $80.0 million, for combined first-year savings of $340.0 million. Long-term pension liability would be reduced by $1.6 billion and long-term health liability would be reduced by $3.3 billion, for an estimated total reduction in unfunded liability of $4.9 billion.

Date Completed: 5-16-12 | Fiscal Analyst: Kathryn Summers

Table 1

Section-by-Section Analysis of MPSERS Reform Legislation (Senate Bill 1040 Substitute S-2)		
Section Number and Purpose	**Proposed Change**	**Estimated Fiscal Impact**
Sec. 3a, Definition of Compensation	Beginning July 1, 2012, future compensation would no longer include merit pay, tax sheltered annuities, or longevity pay.	No estimated fiscal impact available because, until this point, compensation was not broken down into categories. Could slightly reduce payroll; which could increase employer contribution rate.
Sec. 4(12), Definition of Final Average Compensation	For new hires, compensation used to determine Final Average Compensation could not exceed $100,000, adjusted annually by inflation.	Year 1: $1 million savings Year 2: $3 million savings Year 3: $5 million savings …Year 10: $18 million savings Long-term hybrid employer rate reduced by 0.13% of payroll. Unfunded accrued liability (UAL) reduction of $55.0 million.
Sec. 43a Existing Employee Contributions Sec. 43g Proposed Employee Contributions	Employees would be given a choice to either 1) continue to pay existing contributions under Sec. 43a, but receive a reduced pension multiplier of 1.25% (rather than 1.5%) for future years of service, or 2) pay higher contributions under Sec. 43g in order to continue receiving the 1.5% pension multiplier. Basic Employees (hired before 1990) choosing option #2 would pay flat 5% of compensation (up from 0% current contribution) into pension system. Member Investment Plan (MIP) employees (hired between 1990 and 2010) would pay flat 8% of compensation (up from a graded system where contributions range from 3% to 6.4%, based on hire date and salary) into pension system. Hybrid members (hired after July 1, 2010) would remain in the hybrid plan, and continue contributing existing amounts.	5% Across the Board for Basics = $74 million 8% Across the Board for MIP (nonhybrid) = $279 million Total Additional Employee Contributions = $353 million Long-term reduction in employer contribution rate if employee contributions were directed to reduce employer costs is 2.8%. UAL reduction of $1.6 billion.

Section-by-Section Analysis of MPSERS Reform Legislation (Senate Bill 1040 Substitute S-2)		
Section Number and Purpose	**Proposed Change**	**Estimated Fiscal Impact**
Sec. 59 Employee Choices: Higher Contributions/Retain 1.5% multiplier for future years of service Same Contributions/Reduced 1.25% multiplier for future years of service No Contributions/Freeze Pension Earned to Date/Switch to DC for future years	All existing employees hired before July 1, 2010, would be given a choice to either pay higher contributions and retain the 1.5% pension multiplier, or, if choosing not to pay the higher contributions, then either retain the existing contributions with a reduced multiplier (1.25%) OR freeze earned pension and transfer to a Defined Contribution plan. An employee choosing to make the higher contributions to retain the existing 1.5% multiplier for future service would be given a further choice to pay the higher contributions until termination or until reaching "attainment date" (i.e., 30 years of service). Employees choosing to pay the higher contributions until attainment date, after reaching 30 years of service, would return to the lower contribution levels, but at a 1.25% multiplier for years in excess of 30. An employee choosing not to pay the higher contributions who further chose to freeze the earned pension to date and transfer to DC, would make no contributions and would receive an employer contribution of 4% of pay into the employee's 401k account.	This section would implement the employee contribution sections referred to above, and therefore would have no stand-alone fiscal impact.
Sec. 84b Pension Calculations Based on Choices Made in Section 59	People choosing to make the higher contributions under Sec. 43g would retain the 1.5% multiplier for future years of service, in the calculation of their pension. If they chose to make the increased contributions only until attainment date, the 1.5% multiplier would be used for service accrued until they reached the attainment date, and a 1.25% multiplier would be used for years of service after the attainment date was reached.	This section would implement the employee elections section referred to above, and therefore would have no stand-alone fiscal impact.

Section-by-Section Analysis of MPSERS Reform Legislation (Senate Bill 1040 Substitute S-2)		
Section Number and Purpose	**Proposed Change**	**Estimated Fiscal Impact**
	People choosing not to make the higher contributions under Sec. 43g, but choosing to continue making the contributions under Sec. 43a, would receive a 1.25% multiplier for future years of service, when calculating their pension. People choosing not to make any future contributions would be frozen at the pension accrued to date, and switched to DC for future years of service. All previously accrued service would be calculated at a 1.5% multiplier.	
Sec. 91 Retiree Health Care	"80/20" All existing retirees would have State retiree health, dental, vision, and hearing coverage of 80%, rather than the existing 90% coverage. Retiree health care coverage would be eliminated for any employee first hired on or after July 1, 2012.	"80/20" Year 1: $90 million savings Year 2: $100 million savings Year 3: $110 million savings …Year 10: $183 million savings UAL Reduction of $3.3 billion.
Sec. 91a "401k" for Retiree Health	Combined with Sec. 91(15), retiree health care premium coverage would be eliminated for employees first hired on or after July 1, 2012. In place of retiree health care coverage, the employer would pay up to 2% in matching contributions to an employee's 401k account. New hires would not pay the 3% retiree health contribution required under Sec. 43e for all current employees, since they would not receive retiree health care upon retirement.	This would be a new cost in addition to payment of the cash costs of existing retirees, which would grow until a break-even point was reached in roughly 30 years, after which costs would decline, with significant savings achieved in 60 years. Eventually, long-term costs for retiree health care would max out at 2% of payroll. Year 1: $11 million additional cost Year 2: $22 million additional cost Year 3: $31 million additional cost …Year 10: $110 million additional cost

Section-by-Section Analysis of MPSERS Reform Legislation (Senate Bill 1040 Substitute S-2)		
Section Number and Purpose	**Proposed Change**	**Estimated Fiscal Impact**
Appropriation for ORS to Implement	$1.0 million appropriation to the Office of Retirement Services for implementation of the bill.	$1.0 million appropriated from the retirement system's assets.
Total Fiscal Impacts		SFA estimated first-year reduction in MPSERS employer contribution rate, compared to the anticipated rate without any reforms, if all savings were used to reduce employer contributions: 3.5% **Note:** FY 2011-12 MPSERS employer contribution rate is 24.46% of payroll, and, in the absence of any changes, the FY 2012-13 rate will be 27.37% (an increase of 2.91% of payroll over FY 2011-12) and the FY 2013-14 rate will be 31.21% (an increase of 3.84% of payroll over FY 2012-13).

Note: The reforms addressed in Senate Bill 1040 (S-2) would not result in any State savings. Instead, they would produce short- and long-term reductions in costs in the retirement system, and would require additional employee contributions to the retirement system, if that option were chosen by the employees. The savings could be realized either by lowering the anticipated employer contribution rate (resulting in savings to local schools), or by directing those savings toward the unfunded accrued liabilities, or some combination of both. As noted in the Total Fiscal Impacts above, if all of the proposed reforms were enacted and the savings were realized by lowering the otherwise anticipated contribution rate, then the employer contribution rate for FY 2012-13 would remain near the level for FY 2011-12, rather than increasing the anticipated nearly 3% of payroll.