Legislative Analysis

HOUSE FISCAL AGENCY
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MICHIGAN PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM (MPSERS) REVISIONS

Senate Bill 1040 (H-3)
Sponsor: Sen. Roger Kahn

House Committee: Appropriations
Senate Committee: Appropriations
Complete to 6-13-12

A SUMMARY OF SENATE BILL 1040 (H-3) FLOOR SUBSTITUTE:

The bill would amend the Michigan Public School Employees' Retirement System (MPSERS) Act to make the following changes to pension and retiree health care benefits:

- Require all employees (except those in the Hybrid - Pension Plus plan) to choose one of the following options by August 31, 2012 to take effect October 1, 2012:
  - Increase contributions to 4% for the Basic Plan and 7% for the Member Investment Plan (MIP) and maintain a 1.5% pension multiplier.
  - Maintain current contribution rates but freeze existing benefits at a 1.5% multiplier and receive a 1.25% pension multiplier for future years of service.
  - Freeze existing pension benefits and move into a defined contribution (DC), 401(k)-style, plan with a flat 4% employer contribution for future service.

- Offer new employees, hired after July 1, 2012, the option of choosing between the existing Hybrid plan or a defined contribution plan which would provide employees a 50% matching employer contribution for an employee's contribution of up to 6% of his or her salary.

- Requires an independent third-party study of several potential plan changes including:
  - the short-term and long-term costs of closing the defined benefit plan for new employees and replacing it with a new defined contribution plan identical to the one offered to state employees with an automatic employer contribution equal to 4% of compensation and an employer match equal to an employee's contribution of up to 3% of compensation.
  - the cost/benefit of prefunding retiree health care benefits.
  - an analysis of comparable plans for school employees in other states and comparable private plans.

- Increase the retiree health insurance premium contribution of both existing and future retires to at least 20%, capping the MPSERS's premium share at 80% beginning January 1, 2013. For retirees who are receiving a benefit and who are age 65 or older on January 1, 2013, the cap on the maximum employer contribution for medical, dental, and vision benefits would be 90%.

- Eliminate retiree health insurance for employees hired on or after July 1, 2012, and replace it with a 401(k) or 457 plan with an employer match of up to 2% of compensation plus a lump sum deposit of either $1,000 or $2,000 into a Health Reimbursement Account (HRA) upon termination of employment.

- Continue the 3% employee contribution for retiree health but guarantee an employee's individual contributions. Use the 3% contributions toward prefunding future retiree health benefits. Allow existing employees to opt out and choose the 2% matching contribution into a DC plan in lieu of retiree health benefits.

- Shift from paying for retiree health care benefits on a pay-as-you-go method to prefunding with a combination of employee contributions, employer contributions, and state funding.

- Cap the employer rate at the equivalent of 24.46% of payroll (the maximum FY 2011-12 rate) after adjusting for changes in employer contributions for unfunded accrued liabilities (see below), and provide for School Aid Fund contributions to pay the amount of annual required contribution that exceeds the employer maximum rate.

- For local districts only, beginning in FY 2013-14, charge the normal cost of pension and health care (estimated at 3.5%), meaning the amount necessary to prefund the benefit earned by current employees in any given year, on each employer's MPSERS payroll, but shift the cost of paying unfunded accrued liabilities (UAL) (11.9%) to an employer's current operating expenditures (COE). The total rate would be the equivalent of 24.46% on payroll. Community Colleges, District Libraries, ISDs, and Public School Academies would still be charged based on MPSERS payroll.

Pension Changes: Basic and Member Investment Plan (MIP)

Currently, employees hired prior to 1990 who never transferred into the MIP are in a noncontributory plan called the Basic Plan and contribute 0% for their pension benefits. Employees hired since January 1990 but prior to July 2010 (or former Basic members who transferred into the MIP plan) contribute between 3% and 6.4%, depending on their level of compensation and their hire date, in return for an enhanced pension benefit compared to the original Basic Plan.

Senate Bill 1040 (H-3) would require that employees currently in either the Basic or MIP pension plan choose among the following options, which would take effect October 1, 2012:

1. Increase their contribution to 4% for the Basic Plan and 7% for the Member Investment Plan (MIP) and maintain the current 1.5% pension multiplier. Currently MIP contributions are graduated based on income, but Senate Bill 1040 (H-3) would require a flat 7% on all compensation. The bill specifies that the employee contributions could not exceed the normal cost of the pension benefit.

   Employees who chose to pay an increased contribution could choose to contribute either until their retirement or until they reach 30 years of service, at which point

their contributions would decrease to current levels and their pension multiplier for years of service that exceed 30 would decrease to 1.25%.

2. Maintain current contribution rates, freeze existing benefits at the 1.5% multiplier, and receive a 1.25% pension multiplier for future years of service.

3. Freeze existing pension benefits and move into a defined contribution (DC), 401(k)-style, plan with a flat 4% employer contribution for future service.

Pension Changes: New Employees

Senate Bill 1040 (H-3) would offer new employees, hired after July 1, 2012, a choice between either a defined contribution plan or the current hybrid plan, which has been in place for new employees hired since July 2010. Employees would have 75 days after beginning employment to choose which of the two plans they want to participate in. The DC plan would provide employees a 50% matching employer contribution for an employee's contribution of up to 6% of his or her salary. If an employee chose the DC option, he or she would be automatically enrolled at the 6% contribution level, but could opt to contribute something less or nothing at all. The maximum employer contribution would equal 3% of the employee's salary.

Increased Employee Health Care Premium Contributions

Currently, retirees hired prior to July 2008 pay between 0% and 10% of their monthly medical care premiums plus an amount equal to the Medicare Part B plan, depending on whether they are Medicare-eligible and whether they have dependents. They also pay 10% of their monthly dental and vision benefits. The MPSERS system pays for the balance of costs. Employees hired since July 2008 earn a graded health care premium based on the number of years of service they earn: 30% after 10 years and an additional 4% per year capped at 90%.

Senate Bill 1040 (H-3) would cap the maximum employer contribution for medical, dental and vision benefits at 80% and would require that retirees pay at least 20% of their premium for most existing and future retirees. For retirees, who are receiving a benefit and who are older than age 65 on January 1, 2013, the cap on the maximum employer contribution for medical, dental, and vision benefits would be 90%.

Defined Contribution (DC) Health Care Revisions

Senate Bill 1040 (H-3) would eliminate retiree health insurance coverage for employees hired after July 1, 2012 and would replace it with an employer matching contribution of up to 2% of compensation into either a 401(k) or 457 plan.

In addition, these employees would receive a lump sum deposited into a Health Reimbursement Account (HRA) upon termination of employment. The lump sum would equal $1,000 for an employee who terminates employment prior to reaching age 60 with ten years of service or $2,000 for an employee who terminates employment after reaching age 60 with ten years of service.

Employer matching contributions provided in lieu of retiree health care could not be used as a basis for a loan from an employee's tax-deferred account.

Continuation of Mandatory 3% Employee Contribution for Retiree Health Care

Beginning in July 2010, all employees in MPSERS began contributing 3% of their compensation into an irrevocable trust for retiree health care costs. The employee contributions are currently being held in an escrow account pursuant to court order while the legality of the mandatory contributions is litigated. Senate Bill 1040 (H-3) would continue these contributions and use them to begin prefunding retiree health care benefits. If an employee were not eligible for retiree health care upon retirement, he or she would have their contributions returned in equal monthly installments over 5 years after reaching age 60.

Senate Bill 1040 (H-3) would allow existing employees to opt out of the 3% contribution if they agree to forego all retiree health care benefits and take the 2% DC matching contribution in lieu of health care benefits, as described above, for new employees.

Prefunding of Retiree Health Care Obligations

Currently, retiree health care benefits are paid on a cash or pay-as-you-go basis. Senate Bill 1040 (H-3) would instead require that retiree health care benefits be prefunded. Prefunding retiree health care benefits requires a significant increase in current contributions but saves the system in the long term because of the benefit from investment returns on prefunding contributions. The bill would include employee 3% contributions and increased retiree premium share contributions, as well as employer and state contributions, to pay for prefunding. Prefunding triggers a change in the accounting method used to calculate future unfunded liabilities, allowing MPSERS to use an 8% discount rate rather than a 4% discount rate. This will reduce the UAL, currently calculated at $27.6 billion, by $10.8 billion.

University Health Care Study

The bill would require a study of the health care costs for retirees of the seven public universities with employees in MPSERS (all of whom were hired prior to 1996). The MPSERS would have to provide the universities with 5 years of historical data on the cost of providing health care to the universities' retirees and provide a comparison of that data with the aggregate cost of health care for retirees from all reporting units over the last 5 years.

Other Employer Rate Changes

The bill would also include a number of other changes to the employer contribution rates:

First, the bill would reamortize the cost of the early retirement program of 2010 from 5 years to 10 years in order to create short-term savings and allow additional funding in the short term to be redirected to prefunding retiree health care for greater long-term savings.

Second, the bill would revise the employer contribution method for local school districts to apply costs on a combination of payroll and current operating expenditures beginning in FY

2013-14. The normal cost of pension and health care (approximately 3.5%), meaning the amount necessary to prefund the benefit earned by current employees in any given year, would continue to be charged on each employer's MPSERS payroll, but the bill would shift the cost of paying unfunded accrued liabilities (UAL) (11.9%) to an employer's current operating expenditures (COE). The total rate would be the equivalent of 24.46% on payroll. A local school district's COE would include the COE of a public school academy it authorizes after Senate Bill 1040 (H-3) takes effect. Charging UAL costs on COE better ensures that unfunded liabilities related to previously earned benefits remain with the employer that created the cost. Community Colleges, District Libraries, ISDs, and Public School Academies would still be charged based on MPSERS payroll.

Third, the bill would cap the employer rate for the unfunded accrued liability at either 20.96% of payroll or 11.9% of current operating expenditures, with intent to provide School Aid Fund contributions to pay the amount of annual required contribution that exceeds the employer maximum rate.

The bill would also include a requirement that the Office of Retirement Services regarding the degree to which current operating expenditures are a stable, growing, and equitable base for charging unfunded accrued liability costs to public local school districts, as compared to alternate measures of district financial activity. The study shall include an analysis of the degree to which current unfunded accrued liabilities are the result of stranded cost factors.

FISCAL IMPACT:

Senate Bill 1040 (H-3) would create both quantifiable short-term savings and long-term savings that cannot be precisely quantified. The fiscal impacts of the various provisions of the bill are summarized in the table below. For FY 2012-13, the bill would cap employer contributions at the equivalent of the FY 2011-12 rate of 24.46%, which would require an estimated $150 million in School Aid funding to meet the full annual required contribution. The cost to the School Aid Fund would rise as the unfunded liability costs are expected to increase for the next few years, offsetting contributions that would otherwise be made by local employers over that time. The State share is expected to grow to 6.4% of payroll, or roughly $800 million, in FY 2018-19. The bill would decrease the UAL calculation by a total of $15.6 billion, reducing it from $45.2 billion to $29.6 billion.

<u>Office of Retirement Services Appropriation</u>

Senate Bill 1040 (H-3) would also appropriate $4.7 million for FY 2011-12 for the Office of Retirement Services to administer the changes proposed in the bill.

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent

Michigan Public School Employees' Retirement System (MPSERS) Proposed Reforms

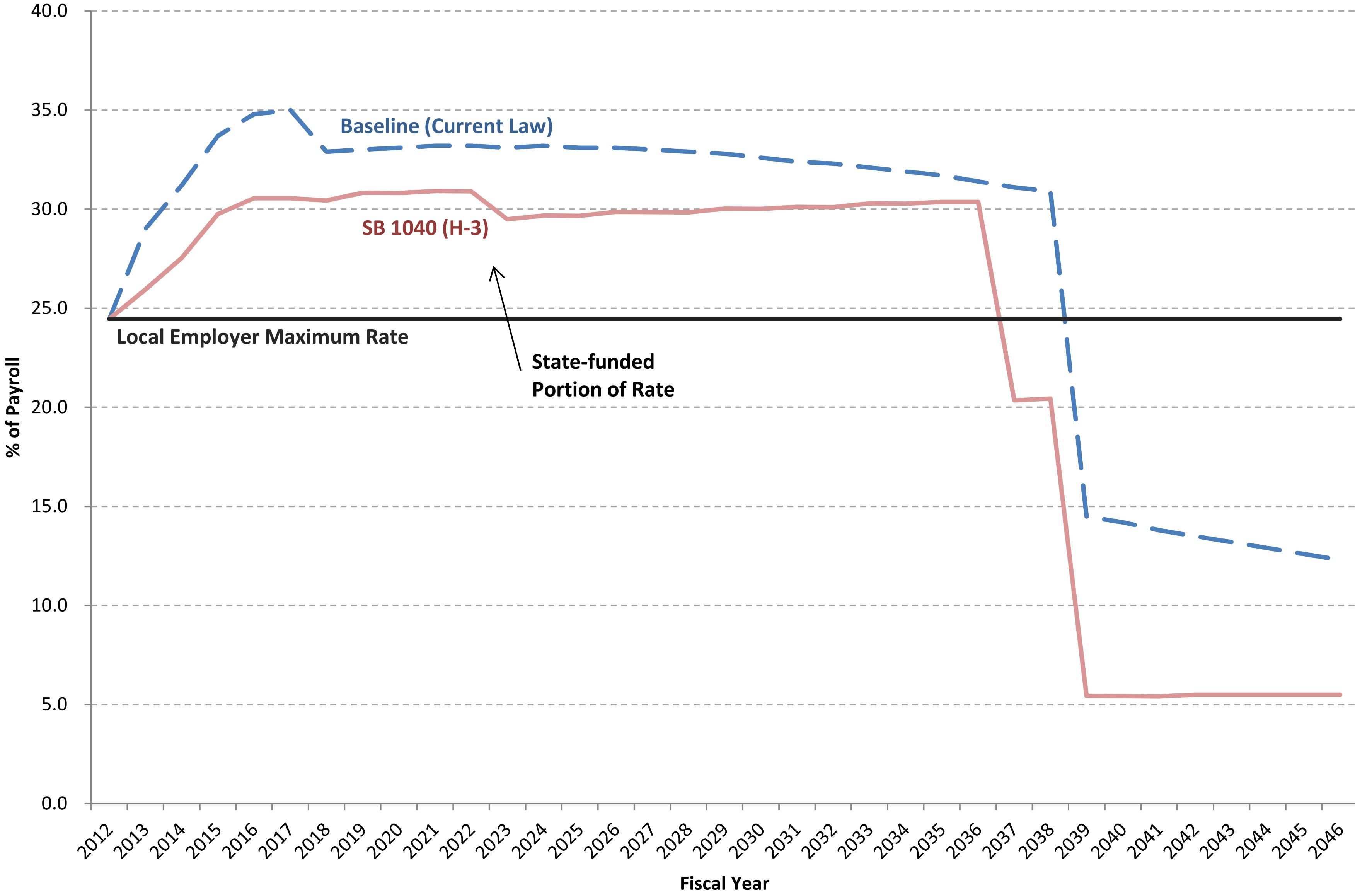
SB 1040 (H-3) Provisions	Current Law Provisions	Year 1 Savings/(Cost)	Impact on Unfunded Accrued Liability (UAL)
1. Basic/MIP Changes - Employees choose among the following options: • Increase employee pension contributions as follows: Basic: 4% MIP: 7% • Continue paying current contribution rates and have a decreased pension multiplier of 1.25%, instead of 1.5%, for future service • Freeze their pension and move into a 4% flat defined contribution (DC) plan for future service.	Currently employees contribute varying rates depending on plan and hire date: Basic: 0% MIP: graduated rate with top rate between 3.9% and 6.4% depending on hire date	Reduces the Employer contribution rate by 2.07% of payroll. Increases Employee contributions by $265 million in Year 1.	Reduces the UAL by $1.56 billion.
2. Offer an Optional DC plan, in addition to the Hybrid plan, with a matching employer contribution equal to 50% of an employee's contribution up to a maximum employee contribution of 6%.	Currently all new hires in a Hybrid plan with both a defined benefit and defined contribution component. Employee pays 6.4% for DB component and receives a matching employer contribution equal to 50% of an employee's contribution up to a maximum employee contribution of 2%.	The short-term costs of the DC plan are slightly less expensive than the normal cost of the Hybrid plan. Any savings would depend on the number of employees who chose the DC option.	Avoids added unfunded liabilities for new employees who choose the DC option.

SB 1040 (H-3) Provisions	Current Law Provisions	Year 1 Savings/(Cost)	Impact on Unfunded Accrued Liability (UAL)
3. Commission an independent study from a nationally recognized firm that specializes in public retirement issues to determine all costs associated with closing the DB system and replacing it with a DC plan. The study shall provide an analysis of retirement benefits provided in the current market for education employees.			
4. Increase retiree share of health care premiums to 20% for existing and future retirees, except that retirees age 65 or over as of January 1, 2013 would experience an increase to 10%.	Retirees currently pay between 0% and 10% of health care premiums depending on age and dependents.	Reduces the Employer contribution rate by 0.75% of payroll. Increases retiree contributions by $47 million in Year 1.	Reduces the UAL by $1.6 billion.
5. 2% Matching DC Plan Contribution in lieu of retirement health care for new hires	Employees receive between 30% and 100% of their retiree health care premiums depending on hire date and number of years of services.	Minimal cost increases due to required match, which will grow over time.	Avoids added unfunded liabilities for new employees.
6. Continue 3% Employee contributions for retirement health and use funds to prefund their future benefits. Guarantees each employees' individual contributions and refund them if the employee does not qualify for retiree health care upon reaching age 60.	Currently employees pay 3% of their compensation for retiree health care, intended for use toward current retiree health care costs.	See item 7.	Reduces the UAL by $5.5 billion.

SB 1040 (H-3) Provisions	Current Law Provisions	Year 1 Savings/(Cost)	Impact on Unfunded Accrued Liability (UAL)
7. Begin prefunding retiree health care using both employee 3% contributions mentioned above as well as employer and state contributions.	Currently retiree health care is paid on a pay-as-you-go, cash basis each year, paying the annual cost of providing health care for current retirees.	Increases employer/state costs equal to 3.55% of payroll (6.13% total with 2.58% from employee 3% contributions) Creates long-term savings as prefunding amounts are invested and used to pay future costs.	Reduces the UAL by $5.3 billion.
8. Cap the Employer contribution rates for UAL at the FY 2011-12 level and shift future increases related to prefunding to the School Aid Fund.	Total retirement costs were shifted to employers in 1995.	Caps employer UAL rate at the equivalent of 20.96% (see below). With normal rate of 3.5%, equates to total of 24.46%. State costs would equal $150 million in first year and grow as cost of prefunding grows.	No change
9. Redistribute "stranded" unfunded liability costs over employer current operating expenditures (COE) rather than payroll.	Currently both the normal costs and unfunded liabilities are charged to employers based on a percent of payroll. However payroll is declining disproportionately across the system, which shifts the cost of unfunded liabilities to those districts with a higher proportion of payroll.	Beginning in FY 2013-14, for local school districts only, maintain costs of approximately 3.5% of payroll for normal costs and convert the UAL rate of 20.96% of payroll to 11.9% of COE.	No change

Total Impact of Proposal

	Under Current Provisions	Under SB 1040 (H-3)
FY 2012-13 Local Employer Contribution Rate	27.37% of payroll	24.46% of payroll
Long-Term Unfunded Liability: Pension	$17.6 billion	$16.0 billion
Long-Term Unfunded Liability: Health Care	$27.6 billion	$13.6 billion
Long-Term Unfunded Liability: Total	$45.2 billion	$29.6 billion
Additional state funding needed for FY 2012-13	$0	$150 million


Projected MPSERS Employer Contribution Rates
Presented on Statewide Payroll-Equivalent Basis
40.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
0.0
% of Payroll
Baseline (Current Law)
SB 1040 (H-3)
Local Employer Maximum Rate
State-funded
Portion of Rate
2012
2013
2014
2015
2016
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Fiscal Year