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April 2013 A Legislative Briefing

HOUSE FISCAL AGENCY

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The Michigan Public School Employees' Retirement System

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Executive Summary

- Over the last decade, the unfunded actuarial accrued liability (UAAL) of the Michigan Public School Employees' Retirement System (MPSERS) has increased substantially. This, along with declining payroll in the system, has caused the contribution rate paid by employers in the system to increase from 13% of payroll in fiscal year (FY) 2003-04 to 27% in FY 2012-13 (prior to 2012 statutory changes), with further increases projected for future years.

- Changes to MPSERS employee benefit and contribution levels made by the Legislature in 2007, 2010, and 2012 have reduced projected rate increases while also beginning to prefund retiree health care benefits, thereby substantially reducing the calculated UAAL for those benefits. The net result is that the employer contribution rate is now projected to peak at about 33% of payroll rather than 36%.

- Employees in the traditional MPSERS pension plans now accrue a substantially lower pension benefit for current service or pay a higher portion of the total costs to fund their pension benefits, along with a 3% contribution designated to help begin prefunding future retiree health benefit costs (unless they opt to forego those future benefits in favor of a defined contribution benefit). Setting aside unfunded liability costs tied to benefits accrued by employees and retirees in previous years, employees are now paying the clear majority of costs currently being accrued annually for their pension and health benefits.

- New employees since 2010 are entering a Hybrid retirement plan with a more limited pension benefit and a small defined contribution component. Retiree health benefits have been eliminated for new employees beginning in September 2012 and replaced with a defined contribution cash benefit.

- Beginning in FY 2012-13, the UAAL contribution rate for local employers is now capped, with the state paying any UAAL costs above that cap. This new state contribution keeps local employer contribution rates roughly flat (at around 25% of payroll) while also prefunding retiree health care benefits. Absent legislative action to address the issue of declining payroll, state-level costs will likely be higher than current projections.

NOTE: This report is intended to describe aspects of the retirement system that involve major policy considerations or fiscal impacts. It should not be considered an exhaustive description of all possible benefit scenarios for individual employees or retirees.

Background

The Michigan Public School Employees' Retirement System (MPSERS) was established by Public Act 136 of 1945 to provide a system of uniform retirement benefits for employees of local school districts in the state. Health care benefits were added by the Legislature in 1975.

The provisions governing MPSERS were later recodified as Public Act 300 of 1980, the Public School Employees' Retirement Act. That act, as amended, currently governs the system and includes provisions related to the retirement system's board, benefit vesting, eligibility age and years of service, the calculation of service credit and purchase of credit rules, employee contributions, and the determination of benefit levels. MPSERS is administered by the Office of Retirement Services (ORS) in the Department of Technology, Management, and Budget. The act does not cover retiree health care benefit co-pays and deductibles, which are determined by the MPSERS Board and administered by ORS.

In addition to traditional local public school districts, employees of the following public entities are also members of MPSERS:

- Intermediate school districts (ISDs)
- Public school academies (PSAs, or charter schools): Only employees hired directly by a PSA, as opposed to a management company operating a PSA (direct hires make up a small percentage of total PSA employees)
- District libraries: Only if the employee was hired prior to the library separating from the school district (currently 35 libraries)
- Community colleges (28 total)
- Seven public universities: Only employees hired prior to January 1, 1996[1]

As of September 30, 2012, a total of 711 employers had employees in the system.

Prior to recent statutory changes, MPSERS was purely a defined benefit (DB) retirement system. Employees who are members of the system receive a pension upon retirement. In general, an employee's annual pension benefit under MPSERS is calculated by multiplying three factors:

Final Average Compensation (FAC) x 1.5% x Years of Service

For example, an employee who had an FAC of $60,000 and 30 years of service, would receive an annual pension of $27,000. The average annual pension benefit received by MPSERS retirees in fiscal year (FY) 2010-11 was $20,720.[2]

Certain benefits are also available in the cases of disability or death prior to retirement, as well as for survivors of retirees. Public employers and employees in the system make financial contributions to prefund the future costs of the pension benefits, with the employer share adjusted each year based on actuarial calculations. Those contributions are then held as assets that are invested on a long-term basis and used to pay out pension benefits to retirees each year.

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[1] The seven universities are Central Michigan, Eastern Michigan, Ferris State, Lake Superior State, Michigan Tech, Northern Michigan, and Western Michigan. Beginning in 1996, new employees hired by those universities have no longer received retirement benefits through the system and instead enter retirement systems individually maintained by those universities. Employees of community colleges and the universities in MPSERS have also had the option to enter an Optional Retirement Program, which provides defined contribution (401k-style) benefits. The remainder of this report does not attempt to cover public universities' unique situation relative to MPSERS. For information on that topic, see this HFA memorandum: http://www.house.mi.gov/hfa/PDFs/mpsers%20university%20memo%20apr2012%20w%20charts.pdf.

[2] MPSERS Annual Actuarial Valuation Report: As of September 30, 2011, Gabriel Roeder Smith & Company.

Additionally, employees and their dependents are eligible for certain health care-related benefits—currently including medical, prescription drug, dental, vision, and hearing benefits—as retirees. Until recently, the costs of those benefits have been funded by employers on a "pay-as-you-go" basis, under which contributions are made to the system each year only to fund the cost of providing benefits to retirees expected for that given year.

As of September 30, 2012, MPSERS had 436,597 members:

- 196,661 retirees and beneficiaries (of which 145,874 were also receiving health benefits and 156,765 were also receiving dental or vision benefits)
- 223,769 current employees (of which 113,519 were vested)
- 16,167 inactive employees entitled to benefits but not yet receiving them[3]

As of September 30, 2011, the actuarial value of the system's assets held for pension benefits was $41.0 billion. These assets are managed by the Bureau of Investments in the Department of Treasury.

Article IX, Section 24 of the State Constitution of 1963 has direct bearing on the ability of the Legislature to make changes to retirement plan provisions. That section reads as follows:

> *The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby.*
>
> *Financial benefits arising on account of service rendered in each fiscal year shall be funded during that year and such funding shall not be used for financing unfunded accrued liabilities.*

The term "accrued financial benefits" has been interpreted by some observers to exclude health care-related benefits, although there are additional legal considerations surrounding benefit changes for both current employees and retirees.

Benefit Changes Prior to 2012

Until 1974, both employers and employees contributed toward the costs of funding MPSERS pension benefits. In that year, employees gave up a wage increase in exchange for the shift to a "non-contributory" plan.[4] From 1974 to 1986, employers paid the full cost of funding MPSERS pension benefits. Under this plan, now called the Basic Plan:

- Members could vest after 10 years of service and retire at either age 55 with 30 years of service or age 60 with 10 years of service.
- FAC was determined based on the five highest consecutive years.
- Retirees did not receive a cost of living adjustment.[5]

<u>Member Investment Plan</u>

Effective beginning with 1987, a new contributory plan, called the Member Investment Plan (MIP), was created. Under the MIP, employees began making a 3.9% contribution (based on salary) to fund a portion of the pension benefit costs in exchange for a more generous pension benefit, including the following advantages:

- An earlier retirement option: any age with 30 years of service (or age 60 with 10 years of service)
- A shorter period for calculating FAC: three highest consecutive years
- A non-compounding 3% annual pension benefit increase

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[3] MPSERS Comprehensive Annual Financial Report for the Fiscal Year Ending September 30, 2012. Available at: http://www.michigan.gov/documents/orsschools/MPSERS_2012_CAFR_412874_7.pdf.

[4] Analysis of House Bill 4192 as Enrolled, House Legislative Analysis Section (July 10, 1985).

[5] Basic plan retirees were eligible for a "13th check" payment in years when investments yielded over 8%. The system has not issued a 13th check to Basic retirees in many years.

Basic Plan members were given the option to switch to MIP, both in 1986 and then again in 1991, but had to purchase years already served. Beginning in 1990, all newly-hired employees automatically became MIP members.

Effective beginning in 1990, the employee contribution provisions were amended to reflect a progressive employee contribution schedule for new MIP members:

- 3.0% of an employee's first $5,000 of pay ($150)
- 3.6% of the next $10,000 of pay ($360)
- 4.3% of pay over $15,000

2007 Contribution and Benefit Changes

Legislation enacted in 2007, in response to the increases in employer contribution rates described later in this report, increased employee contribution rates toward pension benefits for employees hired beginning in July 2008 (all of whom would be MIP members) from 4.3% of pay above $15,000 to 6.4% of that income.[6]

The 2007 legislation also introduced a graded premium system for retirement health care benefits received by retirees hired beginning in July 2008 under which MPSERS pays 30% of premium costs if a retiree has at least 10 years of service (at which point he or she vests in health care benefits) plus 4% for each additional year of service, up to a maximum of 90% premium share (at 25 years of service). (Retirees hired prior to July 2008 received the full 90% after reaching the 10-year vesting period.)

Finally, the 2007 legislation revised service credit rules to reduce the ability of employees to use such credit to claim retirement benefits in certain situations.

Hybrid Plan

In 2010, a new "Hybrid" retirement plan, officially called the Pension Plus plan, was created for employees hired beginning in July 2010.[7] Under the Hybrid plan, employees continue to receive a pension benefit, but with a reduced level of benefit. The pension benefit under the Hybrid plan largely reversed the changes made for the MIP:

- Employees cannot retire until they turn 60 (with 10 years of service).
- The period for calculating FAC is lengthened from three years to five years.
- The 3% annual cost of living adjustment in the pension benefit is eliminated.
- Employees cannot purchase service credit.

Despite the lesser benefit, the employee contribution level remained the same, topping out at 6.4% on pay above $15,000, as for MIP employees hired between 2008 and 2010.

Employees in the Hybrid plan do receive an additional defined contribution (DC, or 401k-style) retirement benefit: if the employee contributes up to 2% of his or her salary to a DC investment account, he or she receives a 50% matching contribution up to a total of 1% of salary from the employer. Employees may contribute more of their salary to the tax-deferred investment account if they choose, but without any additional employer match (although local districts can negotiate an additional 50% match on up to an additional 4% employee contribution).

The 2010 legislation implemented several other significant changes to MPSERS:

- Provided for a lower assumed rate of investment return for the Hybrid plan than is used for the traditional MPSERS pension plans—7% vs. 8%—in order to reduce the risk that the plan would become underfunded in the future.

[6] Public Acts 110 and 111 of 2007 (Senate Bill 546 and 547).

[7] Public Act 75 of 2010 (Senate Bill 1227). The HFA analysis is available at: http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf.

- Began requiring a 3% employee contribution to be used to pay for retirement health care benefits.
- Created an additional incentive, through higher pension multipliers available on a temporary basis, for employees eligible for retirement or near eligibility for retirement to retire earlier than they might have otherwise.
- Required retirees to suspend retirement benefits if they return to work under certain circumstances, with the intent to eliminate the "double dipping" phenomenon.[8]

The 3% health care contribution created in 2010 has been litigated over the last three years. Most recently, the Court of Appeals ruled that the contribution was unconstitutional in August 2012. The case is pending review by the state Supreme Court. The changes made to the purpose of the 3% contribution under 2012 legislation (discussed later in this report) may have some bearing on that review. In the meantime, funds collected from that contribution prior to the 2012 statutory changes are being held in escrow.

Actuarial History

Under a prefunded pension system, the estimated value of future benefits to be paid to retirees is compared to the value of the assets held by the system to pay those benefits, utilizing generally accepted actuarial assumptions in both cases. The resulting percentage provides a measure of the system's financial health. Ideally, a system would be funded at 100%, although many experts point to a threshold of 80% as a rough benchmark for a system being financially sustainable.[9]

The largest factor driving changes in a retirement system's funding percentage is usually investment returns. A certain level of annual returns—8% for the traditional MPSERS pension plans—is assumed for the future, as assets are expected to grow over time, thereby reducing the overall amount of funds that needs to be contributed by employers to achieve a given level of retirement benefits. If actual returns are higher or lower than that assumption, it affects the system's funding percentage.

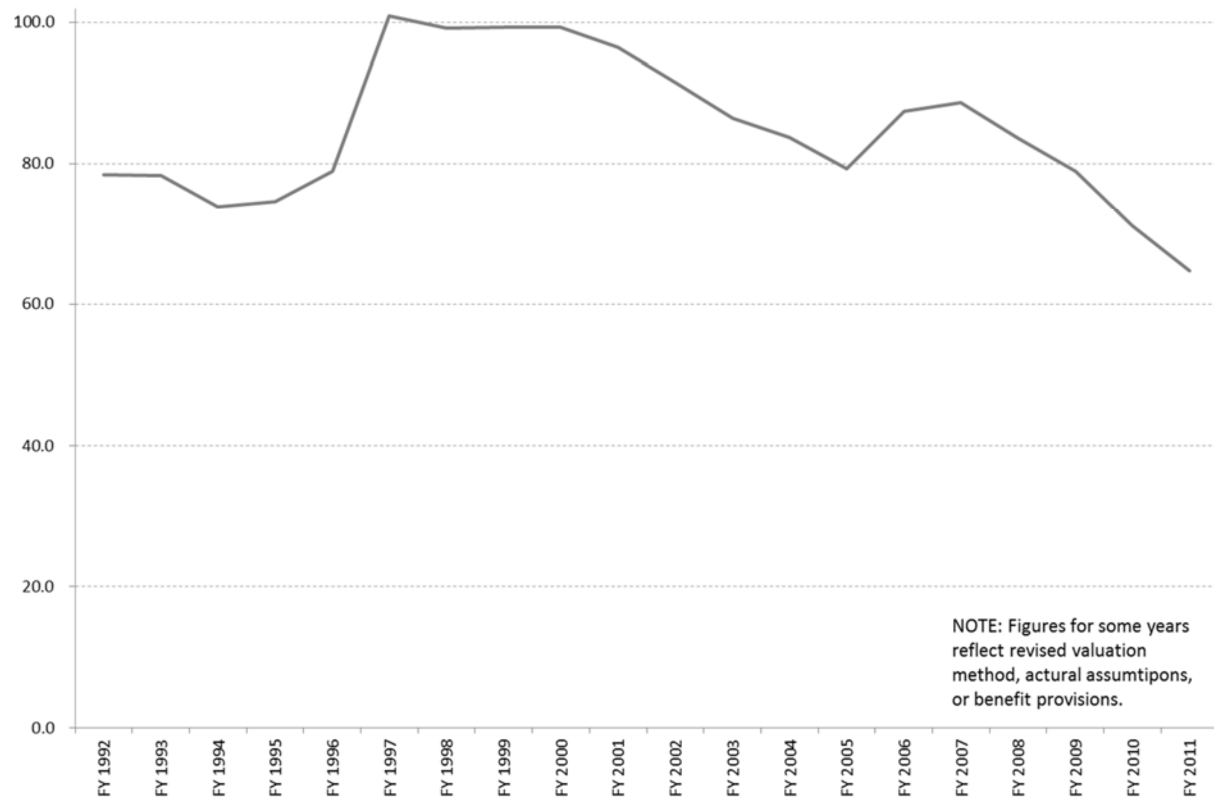
As shown in Figure 1, the funding percentage for MPSERS pension benefits peaked at just over 100% in FY 1996-97, in the midst of the strong stock market returns experienced in the 1990's. The percentage began to decline in FY 2000-01, but remained above 80% until FY 2008-09 when the large stock market losses of 2008 caused the funding percentage to drop below that level. Investment gains and losses are smoothed over a five-year period, so those losses continue to affect the system's funding percentage.

As of September 30, 2011, the actuarial value of the assets held by MPSERS of $41.0 billion was equal to only 64.7% of the system's actuarial accrued liability of $63.4 billion, resulting in an unfunded actuarial accrued liability (UAAL) of $22.4 billion.

For FY 2011-12, MPSERS realized an investment gain of 13.5%. That gain, along with the recent statutory changes discussed later in this report, should help improve the system's funding percentage over time. The FY 2011-12 valuation report for the system (which is separate from the CAFR) will be released in the near future.

[8] The provisions related to double-dipping were recently revised by Public Act 464 of 2012 (House Bill 5261). The HFA analysis is available at: http://www.legislature.mi.gov/documents/2011-2012/billanalysis/House/pdf/2011-HLA-5261-B58D56B3.pdf.
[9] See, for example, this report from the Pew Center on the States: http://www.pewstates.org/research/reports/the-widening-gap-update-85899398241.

FIGURE 1
Percentage of MPSERS Actuarial Accrued Liability Covered by Actuarial Value of Assets



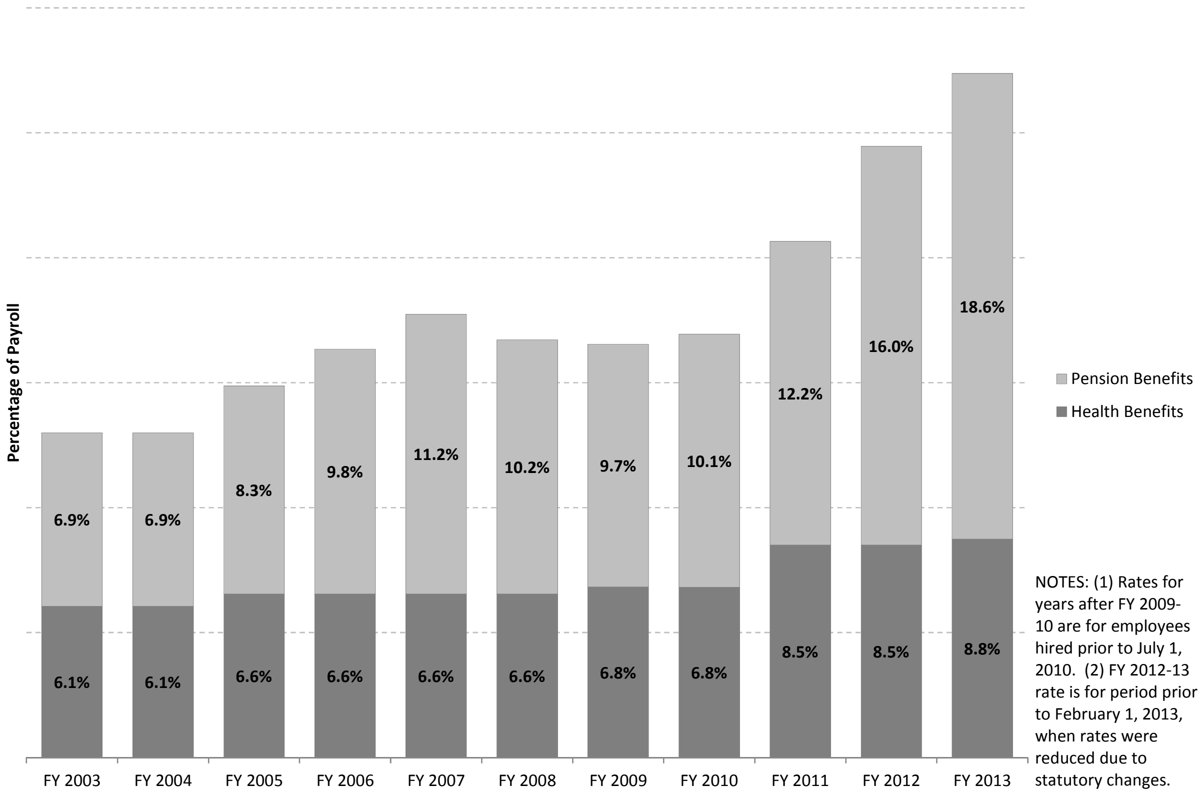
In addition to lagging investment returns, other factors have contributed to the decline in the MPSERS funding percentage. A "mark-to-market" adjustment made in 2007 recognized the full amount of recent investment gains immediately, allowing for short-term budget savings for local school districts, other MPSERS employers, and the state, but subsequently exacerbated the impact of the 2008 investment losses on the system.

Also, the early retirement incentive offered to MPSERS employees in 2010 increased the system's UAAL by providing somewhat larger benefits, at an earlier retirement date, than those reflected in the system's actuarial assumptions.

Retiree health care benefits provided under MPSERS have historically been funded on a pay-as-you-go basis. That is, employers fund the actual costs of the benefits as they are incurred, since funds have not been previously set aside to be invested and then pay for benefits in the future. The state had begun prefunding these benefits for a brief time period in the 1990's, but prefunding was abandoned when economic and budget difficulties subsequently emerged. As of September 30, 2011, the system held only $1.2 billion in assets for health care benefits, equal to just 4.3% of the actuarial accrued liability of $27.0 billion for those benefits.[10]

[10] The $27.0 billion figure is based on the assumption of a 4% annual investment gain. Source: MPSERS Health Benefits Annual Actuarial Valuation Report: As of September 30, 2011, Gabriel Roeder Smith & Company.

FIGURE 2
MPSERS Employer Contribution Rate History (Pre-2012 Statutory Changes)



Largely because of the substantial increase in the UAAL for pension benefits, the MPSERS contribution rate charged to employers has increased rapidly in recent years. As shown in Figure 2, the total rate increased from 13.0% of payroll in FY 2002-03 to 27.4% of payroll for the first portion of FY 2012-13. (The FY 2012-13 rate was reduced effective February 1, 2013, due to statutory changes discussed later in this report. Also, the FY 2012-13 rate shown is for employees hired prior to July 1, 2010—that is, employees in the traditional pension plans. Beginning with FY 2010-11, a separate rate has been charged for employees hired after that date. That rate is slightly lower than the rate for employees hired prior to July 1, 2010, due to the lower costs associated with the Hybrid plan.)

Generally, the contribution rate for retiree health benefits has been fairly flat, particularly in light of the high medical cost inflation experienced throughout the country. The MPSERS board has taken a number of actions over time to limit growth in health benefit costs, including a preferred provider network, a prescription drug optimization program, savings from the Medicare prescription drug benefit, participation in Medicare Advantage for three years, and increased retiree co-pays and deductibles. The increase in the health benefit contribution rate from FY 2009-10 to FY 2010-11 was the result of the 2010 early retirement incentive.

The employer contribution rate for health benefits does not reflect the savings associated with the 3.0% employee contribution for health care created in 2010, as those funds are being held in escrow pending the resolution of ongoing litigation.

Unlike the contribution rate for health benefits, the contribution rate for pension benefits has increased rapidly, more than doubling over the last decade. This is entirely a function of the growth in the system's UAAL over that time due to lower investment returns, declining payroll, and the 2010 early retirement incentive.

The initial FY 2012-13 pension contribution rate of 18.6% (prior to adjustments related to 2012 statutory changes) is composed of the following components:

- 3.5% for the normal costs of pension benefits under the Basic and MIP pension plans. Normal costs reflect the costs of the benefits accrued by an employee due to additional service time, calculated based on the system's actuarial assumptions. For Hybrid plan employees, this percentage is even lower: 2.2%.
- 12.5% to pay off the pension system's UAAL, amortized over a 30-year period that now has 25 years remaining in it.
- 2.7% to pay off costs associated with the 2010 early retirement incentive, amortized over a five-year period. (This amortization period is extended to 10 years under the 2012 legislation discussed below.)

The MPSERS contribution rate had, prior to legislation adopted in 2012, been projected to continue growing. The total rate was projected to increase and peak at about 36% in FYs 2014-15 through 2016-17. Those projected increases primarily reflected the continued smoothing in of investment losses from FYs 2007-08 and 2008-09.

The increase in the total MPSERS contribution rate over the last 10 years has placed increasing financial pressure on school districts and other MPSERS employers, at a time when most of those employers have experienced flat or declining financial support from state and local funding sources. In the case of school districts, the minimum per-pupil foundation allowance of $6,966 for FY 2012-13 is 4.8% lower than the peak of $7,316 for FY 2008-09, while MPSERS employer rate increases accelerated over the same time period.

2012 Legislation

In response to the growing UAAL and contribution rate for MPSERS, Public Act 300 of 2012 (Senate Bill 1040) made a number of changes to the system's provisions, including the following:

- Required employees in the traditional pension plans to choose one of three options:
    - Make higher contributions toward their own benefits and maintain the 1.5% pension multiplier: 4% of pay for Basic play employees and 7% for MIP employees (flat percentage; no graduated scale).
    - Receive a reduced multiplier of 1.25% for future years or service (or elect the reduced multiplier after reaching 30 years of service).
    - Move into a DC plan with a flat employer contribution of 4% for future service.
- Offers new employees the choice between the existing Hybrid plan or an optional DC plan with a 50% employer match, up to 3% of pay, of an employee's contribution.
- Required an independent third-party study of several potential plan changes, including closing the existing Hybrid pension plan and replacing it with a new mandatory DC plan identical to the one offered to state employees (which provides up to a 7% employer contribution).
- Increased contributions toward health insurance premiums for current and future retirees to at least 20% of premium costs, except that retirees who are Medicare-eligible (65 or older) as of January 1, 2013 will pay only 10%.
- Eliminated retiree health insurance benefits for new employees hired on or after September 4, 2012, replacing it with a DC-style benefit: an employer matching contribution of up to 2% of pay into a DC retirement account plus a lump sum payment of either $1,000 or $2,000 into a Health Insurance Reimbursement Account when the employee terminates employment.
- Continued the 3% employee contribution for retiree health benefits created in 2010 but guarantees an individual's contributions. These funds now will be used toward prefunding future retiree health benefits and are no longer being placed in escrow. Alternatively, an employee can opt to forego retiree health benefits and instead receive a 2% matching contribution toward a DC account.

- Shifted from paying for retiree health benefits on a pay-as-you-go method to prefunding the benefits with a combination of employee contributions, employer contributions, and state funding. (If the 3% employee contribution is found to be unconstitutional, the system would revert to a pay-as-you-go method.)
- Capped the local employer rate for the unfunded accrued liability at 20.96%, to approximate the total maximum FY 2011-12 rate of 24.46% of payroll, and provided for state contributions to pay the amount of the annual required contributions that exceed the employer maximum rate.[11]

Like the 2010 legislation, the 2012 legislation has also been challenged in court by certain school employee groups. An Ingham Circuit Court judge initially issued a temporary restraining order (TRO) delaying implementation of the deadline for current employees in the pension plans to make an election regarding their future retirement benefits. The judge subsequently issued a ruling that the changes made by the legislation were constitutionally valid, but this decision may be appealed to the Court of Appeals.

Meanwhile, Public Act 359 of 2012 (Senate Bill 1360) extended the deadline for employees to make their election from October 26, 2012, to January 9, 2013, with the changes in benefits to instead take effect February 1, 2013 (rather than December 1, 2012).

According to the Office of Retirement Services:

- 31% of employees chose to pay the higher contribution amounts for pension benefits (28% indefinitely, 3% through 30 years only), 64% accepted the lower pension multiplier of 1.25 rather than paying the higher contribution amounts, and 4% switched to the DC plan with a 4% employer contribution.
- About 11% of employees opted to move to the DC-style health benefit, rather than paying the 3% contribution for health benefits.
- About 20% of new employees are opting for the DC retirement plan with a 3% employer match rather than going into the Hybrid plan.

While prefunding health benefits requires higher employer contributions in the near term, higher employee contributions, reduced benefits, and the new state-funded portion combine to lower the employer contributions. The net result is a reduction in the projected employer contribution rate for MPSERS.

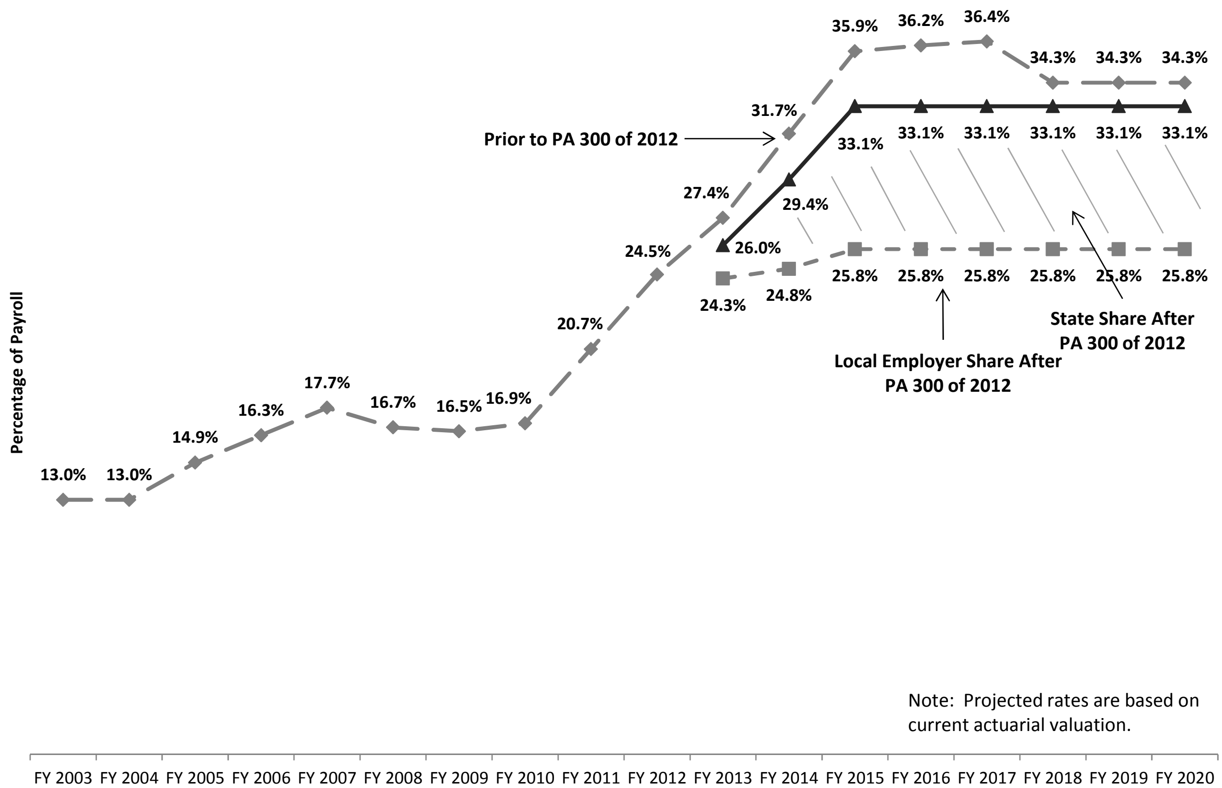
As shown in Figure 3, the total employer contribution rate is now expected to peak at 33%. The state will now be funding a portion of that rate—roughly seven percentage points per year within the next few years until the current UAAL is paid off—thereby reducing the rate paid directly by local employers. This new state contribution keeps local employer contribution rates roughly flat while also prefunding retiree health care benefits, as discussed in more detail later in the report.

Effective February 1, 2013, the total employer contribution rate for employees in the traditional pension plans dropped from 27.4% to 24.3%. The rate will increase slightly to 24.8% for FY 2013-14 and then to 25.8% for FY 2014-15 (based on revised normal cost calculations).

Additionally, an appropriation of $155.0 million included in the School Aid budget since FY 2011-12 effectively lowers the employer costs for K-12 school districts (but not for other MPSERS employers) by roughly 2 percentage points.

[11] A more complete summary of the bill is available on the Michigan Legislature website: http://www.legislature.mi.gov/documents/2011-2012/billanalysis/House/pdf/2011-HLA-1040-6.pdf.

FIGURE 3
Projected MPSERS Employer Contribution Rates



The 2012 legislation will also reduce the system's UAAL:

- The pension UAAL is projected to decrease from $22.4 billion to roughly $20.8 billion due to the higher level of employee contributions toward pension benefits (or reduced benefits).
- The health care UAAL is projected to decrease from $25.9 billion to roughly $11.9 billion. This is primarily the result of beginning to prefund health benefits, partly by using the 3.0% employee contribution for those benefits. That change allows for the use of a higher discount rate—8% rather than 4%—since funds will now be available to invest over time to pay future benefits. The higher contributions toward premium costs required from retirees also reduces the UAAL.[12]

The overall projected reduction in the MPSERS UAAL due to the 2012 legislation is $15.6 billion—from $48.3 billion to roughly $32.7 billion.

Current Benefit Comparison

The 2012 changes in retirement plan provisions, in combination with the changes enacted in 2008 and 2010, have resulted in a substantial increase in the contributions being made by employees in the traditional pension plans and have substantially reduced the costs associated with retirement benefits provided to new employees. Table 1 provides a comparison of retirement benefits received by and employee contributions made toward those benefits for each of six groups of employees following the 2012 changes.

[12] The state similarly began prefunding state employee retiree health benefits in FY 2011-12. See this September 2011 HFA memo on the topic: http://www.house.mi.gov/hfa/PDFs/FINAL%20OPEB%20memo%20sept2011.pdf.

TABLE 1
MPSERS Benefit Comparison

Retirement Plan	Basic	Member Investment Plan (MIP)			Hybrid	
Hiring Time Period	Before January 1, 1990 (if not opted into MIP)	January 1, 1987 to December 31, 1989 (optional)	January 1, 1990 to June 30, 2008 (all)	July 1, 2008 to June 30, 2010 (all)	July 1, 2010 to September 3, 2012	After September 4, 2012
Pension Benefits						
Vesting Period	10 years					
Years of Service (YOS) to Retire	Age 55 + 30 YOS or Age 60 + 10 YOS	Any age + 30 YOS or Age 60 + 10 YOS			Age 60 + 10 YOS	
Pension Formula	FAC x 1.5% x Years of Service (1.25% multiplier for Basic/MIP members electing lower contribution levels)					
Final Average Compensation (FAC) Period	5 highest consecutive years	3 highest consecutive years			5 highest consecutive years	
Cost of Living Adjustment?	No	3.0% (non-compounding)			No	
Purchase of Service Credit Allowed?	Yes				No	
Current Employee Contribution (% of Salary/Wages)	4% (or 0% if electing lower multiplier)	7% (or previous, lower levels if electing lower multiplier)			3.0% of first $5,000 3.6% of next $10,000 6.4% over $15,000	
Additional Defined Contribution (DC) Benefit	NA				Up to 1% employer match into DC account (with 2% employee contribution)	
Optional Alternate DC Plan	4% flat employer contribution				NA	Up to 3% employer match (with 6% employee contribution)
Annual Investment Return Assumption	8%				7%	
Health Care Benefits						
Vesting Period	10 Years					NA
Base Benefit	Medical insurance premium plus prescription/dental/vision/hearing coverage (or 2% DC matching contribution if electing not to pay 3% for health benefit)					Up to 2% employer match into DC account (with 2% employee contribution) plus $1,000/$2,000 lump sum at termination
% of Premium Costs Covered	80% (90% if older than 65 on January 1, 2013)			30% for 10 years plus 4% for each additional year, up to 80% maximum		NA
Current Employee Contribution	3% (or 0% if electing DC benefit in lieu of health benefit)					NA

Setting aside unfunded liability costs tied to benefits accrued by employees and retirees in previous years, employees are now paying the clear majority of costs currently being accrued annually for their pension and health benefits. For employees in the traditional pension plans:

- Employees' own contributions range from 7.0% to 10.0% of payroll: 4.0% for Basic or 7.0% for MIP, plus 3.0% for health benefits. (Hybrid employees would be in the middle, with the graduate contribution topping out at 6.4%.)
- The employer's share of normal costs, including health benefits, are just 3.4% for Basic and MIP employees (3.2% for Hybrid).

For MIP employees—who make up the large majority of employees in the traditional pension plans—the employee contributions now pay roughly three-quarters of the costs of funding their retirement benefits when UAAL-related costs are excluded.

New employees hired by MPSERS employers who do not choose the optional DC-only retirement plan now receive a more limited pension benefit under the Hybrid plan and no health care-specific benefit, with a total employer matching contribution of up to 3% toward a DC retirement account (1% under the previously-existing Hybrid plan and 2% to replace the previous health benefits). While MPSERS employers and the state continue to bear some risk that investment returns or plan factors will not meet the system's actuarial assumptions, that risk has been significantly reduced for employees hired since 2010 by lowering the assumed annual investment return from 8% to 7%.[13]

The independent study required by Public Act 300 was completed by The Segal Group and delivered to the Legislature and State Budget Director on November 15, 2012. Specific to the question of potentially implementing a mandatory DC retirement plan for school employees based on the plan offered to state employees, the report's Executive Summary stated the following:

> *. . . To compare the costs of the existing Hybrid plan and the State DC plan we compared the annual contributions over a 30-year period. Over this period, the annual contributions to the Hybrid plan would increase by $500 million and to the state DC plan by $1.6 billion. . . . As PA 300 provides a choice for new hires to selected the DC plan, determining an actual cost is difficult but over time is expected to result in cost savings.*
>
> *The MPSERS Legacy plan unfunded accrued liability must [be] addressed. Currently, the unfunded liability is being amortized over a 25-year period. If the existing plan were closed to new members, with new hires entering the DC plan, the closed group's active payroll would decrease resulting in the need to accelerate contributions. This study projects the required employer contributions for transition costs to be approximately $4.5 billion over the first 10 years. . . .*

The optional DC plan for school employees has a cost to the employer of up to 3%, whereas the state employee DC plan has a cost of up to 7%. The total potential employer cost for the Hybrid plan is roughly 3.2%: the normal pension cost of 2.2% plus up to 1% for the DC component.

Pursuant to the statutory language, The Segal Group's report covered a range of topics related to MPSERS, including comparisons to the private sector and other state retirement plans, analysis of the adequacy of retiree benefits under various alternative plans, and a comparison of methods for allocating UAAL costs to individual employers.[14]

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[13] For more information on assumed rates of return for pension systems, see the Fall 2012 Senate Fiscal Agency report, "Apples or Oranges: Making the Right Pick for Pension Accounting," available at: http://www.senate.michigan.gov/sfa/Publications/Notes/2012Notes/NotesFal12dz.pdf.

[14] The full report is available at: http://www.michigan.gov/documents/orsschools/MI_403885_7.pdf.

Projected State Contributions and Declining Payroll

The combination of prefunding health benefits and capping the local employer rate for UAAL costs under the 2012 MPSERS legislation has significant implications for the state budget beginning in the current fiscal year. Prefunding health benefits increases short-term costs to the retirement system but reduces long-term costs, as assumed investment gains eventually pay for a portion of retiree benefit costs. Capping the local employer rate, meanwhile, will result in the state bearing the responsibility for any increases in overall MPSERS costs relative to MPSERS payroll.

Table 2 shows current projections for required state contributions to MPSERS, as well as resources expected to be available to fund those contributions. Data items included in the projections are described below.

TABLE 2
MPSERS Prefunding Scenario
Millions of $

	School Aid Budget Projections								Reserve/Escrow	
Fiscal Year	SAF Beginning Balance	SAF Revenue	GF/GP Contri-bution	Total Revenue	Budget Excluding MPSERS Contri-bution	State MPSERS Contri-bution	Total Costs	SAF Ending Balance	MPSERS Reserve/ Escrow Withdrawal	Remaining Balance
										$682
2012-13	$254	$11,128	$283	$11,665	$11,454	$161	$11,615	$50	$0	682
2013-14	50	11,433	230	11,713	11,466	403	11,869	(156)	(156)	526
2014-15	0	11,769	233	12,002	11,475	649	12,124	(122)	(122)	403
2015-16	0	12,110	233	12,343	11,475	756	12,231	112	0	403

State MPSERS Contributions

MPSERS contribution rates are based on actuarial projections. Consistent with existing actuarial assumptions, payroll is assumed to increase by 3.5% annually. The projected contribution rates reflect both savings from the various contribution and benefits changes included under Public Act 300 and the additional short-term costs associated with prefunding retiree health benefits. The contribution rate and required state contribution increases over the next few years mainly due to the phased-in recognition of investment losses, which increase the system's UAAL.

A key assumption is that GF/GP funds will be utilized to fund required state MPSERS contributions for Community Colleges and libraries, as proposed in the FY 2013-14 Executive Budget. Those costs total an estimated $32.6 million in FY 2013-14 and $50.8 million in FY 2014-15. The state MPSERS contribution costs reflected above are for school districts only.

School Aid Budget Projections

The School Aid Fund (SAF) beginning balance for FY 2012-13 is a final figure. Projected revenue amounts are based on January 2013 consensus revenue estimates. Revenue projections assume no further changes are made to the state tax code. The General Fund/General Purpose (GF/GP) contribution to the School Aid budget is based on the amount proposed under the FY 2013-14 Executive Budget.

The School Aid budget for FY 2012-13 reflects the initial budget that has been signed into law for that year, adjusted for baseline cost revisions. The FY 2013-14 and FY 2014-15 budget amounts are based on the proposed Executive Budget. The baseline budget figure for FY 2015-16 assumes no increase to the per-pupil foundation allowance and that other cost adjustments have no net impact on the budget.

Accounting for the additional funds that will now be needed for state contributions to MPSERS, the projections show negative SAF ending balances for FYs 2013-14 and 2014-15. Beginning in FY 2015-16, SAF revenue growth would catch up to the increased costs associated with those contributions, leaving a positive year-end balance.

Reserve Fund and Escrow Account

The beginning balance shown for the MPSERS Reserve Fund and Escrow Account includes the following items:

- $133 million that was appropriated for deposit into the reserve fund in FY 2011-12.
- $41 million that has been appropriated for deposit into the reserve fund in FY 2012-13.
- An estimated $508 million in 3% employee contributions for retiree health costs currently being held in escrow due to the legal dispute regarding 2010 MPSERS legislation.

The total assumed combined balance of $682 million can be used to pay projected state MPSERS contributions exceeding available SAF resources over the next three years. At the close of FY 2014-15, the fund's balance is projected to decline to $403 million, with the reserve fund no longer needed beginning in FY 2015-16.

Those funds could effectively be spent to increase the per-pupil foundation allowance or other school-related funding items, or serve as a buffer against the possibility of unfavorable adjustments to revenue or budget estimates—recognizing that $403 million equates only 1.2% of projected SAF revenues over the next three years.

Based on current assumptions and projections, there will be sufficient resources available to the Legislature to fully prefund retiree health benefits by paying MPSERS costs above the local employer rate cap established in Public Act 300. There are, however, two key uncertainties that could alter those projections.

Legal Proceedings

As described earlier in this report, the 3% employee contribution for retiree health benefits was originally established by legislation adopted in 2010. That requirement was challenged in court by a group of school employee organizations. On August 16, 2012, the Court of Appeals ruled that the requirement is unconstitutional under both the federal and state constitutions, affirming the trial court ruling on the case.[15]

To date, the employee contributions collected under the 2010 legislation have been held in an escrow account, pending final resolution of the judicial proceedings. It remains to be seen (1) how the state Supreme Court will rule on the original case and (2) how the effective change in the use of the contributions under the 2012 legislation will affect the legal proceedings. Rather than being used to fund the health benefits for current retirees, the employee contributions will instead be used for prefunding of future retiree benefits and will be returned to employees who do not vest for retiree health benefits.

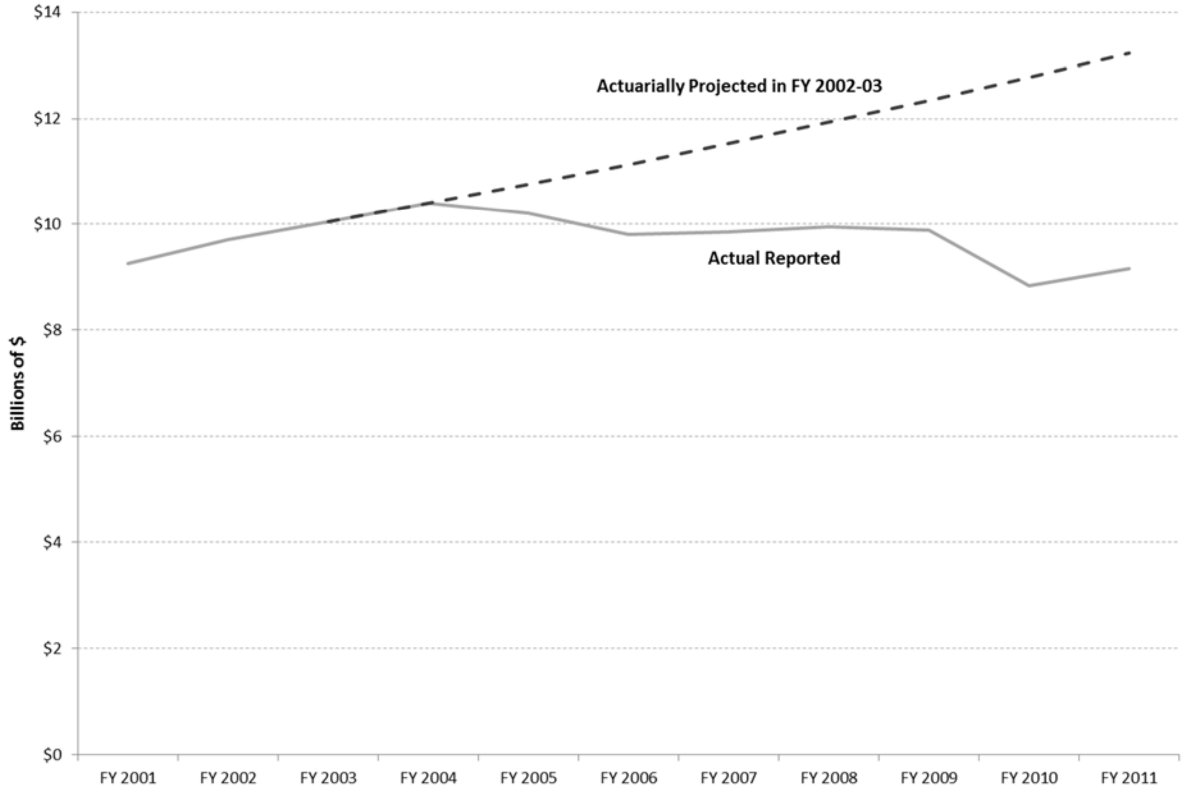
If the contributions currently being held in escrow are ultimately returned to employees, they would not be available to be used to pay a portion of the state's MPSERS contribution over the next several years. Meanwhile, Public Act 300 provided that, if the revised 3% contribution requirement is found to be unconstitutional, funding for retiree health benefits will revert to a pay-as-you-go method, which would reduce short-term MPSERS funding requirements but also revert the system's calculated unfunded accrued liability to a higher amount.

Payroll Growth

Consistent with existing actuarial assumptions, the MPSERS contribution rate projections are based on 3.5% annual payroll growth. Over the last decade, however, this assumption has not been realized. Other than investment returns underperforming relative to actuarial assumptions in recent years, the biggest factor driving the increase in the current unfunded liability contribution rates within MPSERS has been the decline in the amount of payroll against which system costs can be charged.

[15] Majority opinion: http://publicdocs.courts.mi.gov:81/opinions/final/coa/20120816_c303702(45)_rptr_113o-303702-final.pdf
Dissenting opinion: http://publicdocs.courts.mi.gov:81/opinions/final/coa/20120816_c303702(46)_rptr_113p-303702-final.pdf

FIGURE 4
MPSERS Payroll



As shown in Figure 4, the MPSERS payroll decreased from $10.0 billion in FY 2002-03 to $9.2 billion in FY 2010-11. In FY 2002-03, payroll was projected to grow to $13.2 billion in FY 2010-11 under actuarial assumptions. Thus, the current payroll is 31% lower than had been projected in FY 2002-03. This gap is due to a combination of factors:

- Declining statewide pupil counts
- Privatization of non-instructional staff and substitute teachers
- Flat or reduced state/local funding for school districts, resulting in lower wage growth
- The increase in the number of charter schools—which are not required to participate in MPSERS—and related reductions in traditional public school enrollments and employment levels

In total, the number of active employees in the retirement system declined from 326,938 in FY 2002-03 to 236,660 in FY 2010-11, a reduction of 28%.

While the factors above do not increase the amount of the system's unfunded liability at any given time, the same dollar amount collected on a smaller payroll base equates to a higher percentage of that payroll. Additionally, this phenomenon allows some school districts that have privatized more services to leave their "stranded" costs from former employees on the system as a whole, so that other districts face increased costs.

Recent legislation could accelerate the decline in MPSERS payroll relative to actuarial assumptions:

- Lifting the statewide cap on charter schools and making it easier for traditional districts to authorize and transition their own schools into charter schools
- Expanding the use of cyber schools
- The creation of the Educational Achievement Authority (EAA), which will take over low-performing schools under certain circumstances

To the extent these alternate educational models are utilized, they will result in further reductions in the number of employees covered under MPSERS, decreasing the likelihood the 3.5% payroll growth assumption will be realized in future years. If payroll grows at a lower rate, unfunded liability costs will be spread over a smaller base and the required state contributions to MPSERS will increase, since the local employer rate is now capped.

One possible solution to the issue of declining payroll is to use current operating expenditures (COE) to allocate UAAL costs to individual school districts.[16] COE is a broader measure of school district financial activity and, therefore, is more likely to meet, or come close to, the 3.5% growth assumption. This approach would result in school districts considering privatization of services to weigh the true savings associated with that action, given that unfunded liability costs would no longer be merely shifted to other districts. (A similar measure of financial activity would need to be identified for other types of local employers in MPSERS: intermediate school districts, community colleges, and libraries.)

The combination of charging unfunded liability costs based on COE and requiring state contributions above the local employer cap could effectively deal with the stranded cost factors described above. Additional UAAL rate increases resulting from the failure to meet the 3.5% annual growth assumption for other reasons (declining enrollments, charter schools, etc.) would still effectively be funded by the state and would be higher than those projected in this report.

The third-party study produced pursuant to Public Act 300 identifies and evaluates several other methods for allocating UAAL costs. Absent the Legislature amending the MPSERS statute to address the issue of declining payroll, additional costs beyond those projected in Table 2 are very likely to be incurred by the state over time.

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NOTE: This report was written by Kyle I. Jen, Deputy Director, and Bethany Wicksall, Associate Director. Kathryn Bateson, Administrative Assistant, prepared the report for publication. We appreciate the assistance provided by the Office of Retirement Services in providing information utilized in this report. The House Fiscal Agency is solely responsible for the content of the report.

[16] The House-passed version of Senate Bill 1040, which became Public Act 300, included a shift to using COE in this manner, but that provision was not included in the final version of the bill.