

DATE: 2/3/2010

TO: All Interested Parties

FROM: Bethany Wicksall, Senior Fiscal Analyst

RE: Converting MPSERS from a Defined Benefit (DB) to a Defined Contribution (DC) System

A discussion of the fiscal impact of closing the Michigan Public School Employees' Retirement System's (MPSERS) DB plan and moving to a DC plan follows below. This change would create significant cost increases in the near term, which would diminish annually but continue for at least 14 years. The increased costs and potential long-term savings are described in more detail below. The figures below are based on the Sept. 30, 2008 MPSERS actuarial valuation, which is the most recent valuation available. An updated memo will follow when the 2009 valuation is completed.

Current DB Plan

Currently school districts pay the employer portion of retirement costs as a percent of current payroll. The employer contribution rate for the pension, determined annually by the Office of Retirement Services (ORS), is 9.60%. This includes a normal cost of 4.21% for employee pension benefit costs and 5.39% for the Annual Required Contribution (ARC) to pay the unfunded accrued actuarial liabilities (UAAL) of \$8.9 billion over 28 years.

In addition to employer contributions, the system is supported by school employee contributions. School employees hired after 1990 and those who were hired before but converted to the Member Investment Plan (MIP) are required by statute to contribute a percent of their salary each year toward retirement. The employee contribution was increased for new employees hired after July 1, 2008 and is summarized in Table 1.

Table 1: MPSERS MIP Employee Contribution Rates		
Hire Date	Contribution on first \$15,000 of Salary	Contribution on portion of Salary over \$15,000
Prior to Jan. 1, 1990	3.9%	3.9%
Jan. 1, 1990 to June 30, 2008	\$150 plus 3.6% on salary between \$5,000 and \$15,000	4.3%
After July 1, 2008	\$150 plus 3.6% on salary between \$5,000 and \$15,000	6.4%

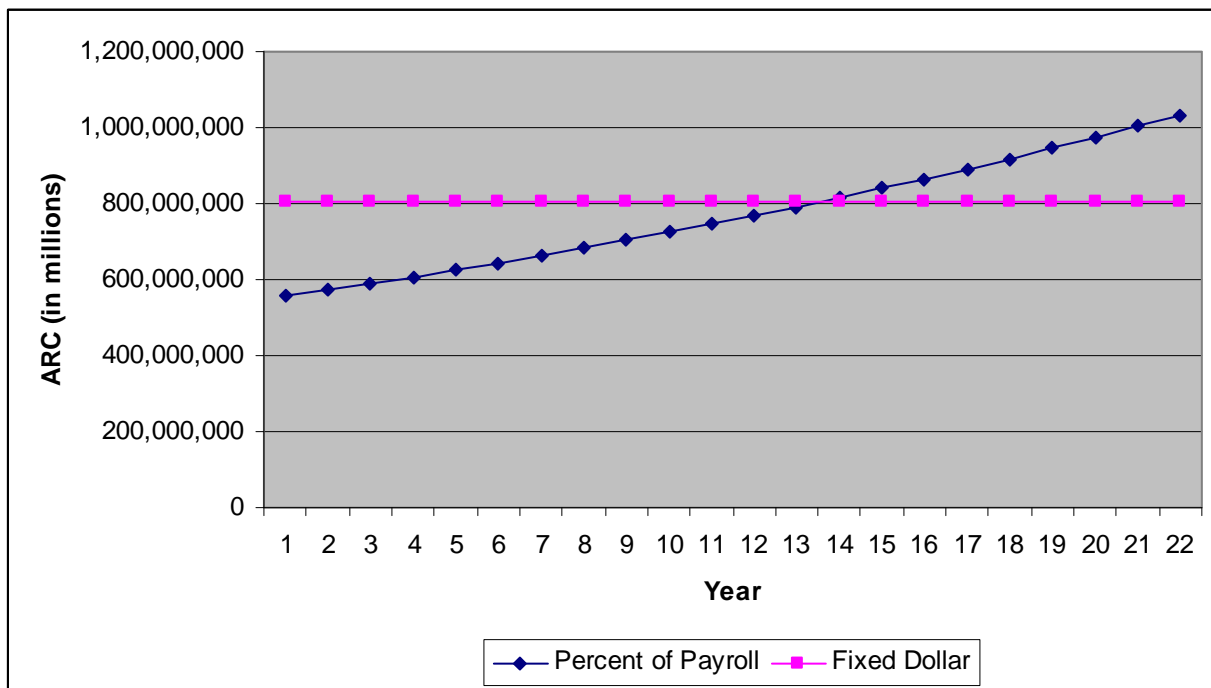
GASB Requirements for a Closed DB Plan:

The ARC is paid as a percent of payroll, currently 5.39% as mentioned above. When a defined benefit pension system with an unfunded liability is closed, the Government Accounting Standards Board (GASB) requires that the ARC be paid on a fixed-dollar basis as opposed to a percentage of

payroll. Initially, the annual fixed-dollar contribution required would be higher than what the State would have otherwise paid as a percent of payroll as payroll is expected to increase over time. However, the difference in the ARC between the two payment methods would decrease gradually over time, and eventually the fixed-dollar contribution would be less than the ARC would have been under a percentage basis.

The graph below gives a simplified illustration of this scenario. According to ORS, based on the FY 2007-08 valuation, in Year 1, the difference between the current percentage basis ARC and the fixed-dollar basis ARC would be approximately \$250 million. (However, the FY 2008-09 valuation is due out shortly and will show an increased UAL due to investment losses in 2008 and 2009, which will increase the \$250 million estimate.) ORS estimates that the fixed-dollar ARC would reach a point where it equaled the percentage basis ARC at some point after year 14 of 28 years. Market and actuarial fluctuations make it impossible to estimate reliable annual figures and the breakeven point of such a conversion, thus the graph below does not include detailed annual estimates.

Annual Required Contribution: Percent of Payroll vs. Fixed Dollar



Comparing the Normal Cost of Current DB Plan vs. a DC Plan

The normal cost of a DC plan would depend on the level of employer contribution, but the DC plan for State employees may be used for comparison. The estimates below are based on a DC plan identical to the State's plan. A plan with lower benefits would decrease the normal cost and potentially avoid additional costs.

In 1997, the State Employees' Retirement System (SERS) closed its DB system and created a DC system for all new employees. According to ORS, for SERS the DC plan has a normal cost of 6.55% of payroll. Because state employees had not previously contributed toward their retirement, the previous DB normal cost for the employer contribution was much higher and switching from a DB to a DC plan created a significant savings for the state.

Because current MPSERS employees contribute an average of between 4%-6% depending on hire date, however, the normal cost for MPSERS employers is only 4.21% of payroll. Converting to a DC plan identical to the State's, assuming the MPSERS participation level was equal, would actually cost districts an extra 2.34% of payroll each year. And if participation was 100% of the match, it could cost districts an additional 2.79% of payroll each year. This would equate to an increase of between \$234 million and \$279 million per year respectively once fully implemented based on current payroll. Estimates from ORS on the first three years' costs for either scenario are in Table 2 on the next page.

Year	Normal Cost 6.55% Equal to SERS Participation	Normal Cost 7.00% with 100% Participation
1	\$6 million	\$8 million
2	\$21 million	\$28 million
3	\$34 million	\$45 million
Fully Implemented	\$234 million	\$279 million

Potential Savings of DC Plan

The potential savings in a DC plan come from eliminating the possibility of unfunded liabilities or essentially from shifting the risk of long term market performance from the employer to the employee. There have been years in which the pension system was fully funded and therefore the UAAL was \$0. In such a period there would be no savings generated by switching to a DC plan. In fact, there would be potential added normal costs as mentioned above.

However, there would be savings when compared to the current situation where the most recent figure for the UAAL is \$8.9 billion and current employer contribution rate toward the UAAL is 5.39%. Although it would take between 30 - 40 years for the full savings to be realized, all else held equal, it would save approximately \$539 million compared to current costs of the UAAL. When compared to the additional costs of a DC plan identical to the state's plan, the net savings would be \$304 million.

Conclusion

The primary benefit of having a DC system is the consistency of the contribution rates over time. After the initial UAAL from closing the DB system was paid, the system would never incur a future unpaid liability. However, a DC system is not inherently cheaper than a DB system and the potential savings would take more than 30 years to be fully realized.

Making the switch for MPSERS would have three significant fiscal considerations. First, the accounting changes required from closing the DB system would create significant up front costs currently estimated at \$250 million in the first year. Second, because of significant employee contributions presently, switching MPSERS from a DB system to a DC system would create additional normal costs of between \$234 million and \$279 million annually, unless a plan with a lower benefit than the current State DC plan were offered. Finally, if a DC plan were fully in place today, it could save \$539 million by eliminating any State responsibility or risk associated with unfunded pension liabilities, but it will take at least 30 years for full implementation and to realize those savings.