MEMORANDUM

DATE: August 29, 2012

TO: House Appropriations Committee

FROM: Kyle I. Jen, Deputy Director, and Bethany Wicksall, Senior Fiscal Analyst

RE: Projected State Contributions to MPSERS

Senate Bill 1040 has been presented to the Governor, who is anticipated to sign the bill in the near future. This memo provides a brief summary of the bill, presents preliminary projections of new state-level retirement system contributions under the bill's provisions, and describes two major uncertainties surrounding those projections: payroll growth and ongoing legal proceedings.

Bill Summary

Senate Bill 1040 makes a number of changes to the provisions of the Michigan Public School Employees Retirement System (MPSERS) Act, including the following:

- Requiring employees in the traditional pension plans to choose one of three options: make higher contributions, receive a reduced multiplier for future years or service, or move into a defined contribution (DC) plan for future service.
- Offering new employees the choice between the existing hybrid plan or an optional DC plan.
- Requiring 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.
- Increasing contributions toward health insurance premiums for current and future retirees.
- Eliminating retiree health insurance benefits for new employees, replacing it with a DC-style benefit.
- Continuing the 3% employee contribution for retiree health benefits but guaranteeing an individual's contributions.
- Shifting 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 were found to be unconstitutional, the system would revert to a pay-as-you-go method.)
- Capping the local employer rate for the unfunded accrued liability at 20.96%, for a total rate equal to approximately 24.46% of payroll (the maximum FY 2011-12 rate) and providing for state School Aid Fund contributions to pay the amount of the annual required contributions that exceed the employer maximum rate.[1]

The combination of prefunding health benefits and capping the local employer rate will have significant implications for the state budget in FY 2012-13 and the subsequent few years. 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.[2] Capping the local

[1] 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.

[2] The shift to prefunding retiree health benefits will reduce the calculated unfunded accrued liability for those benefits by approximately $10.8 billion due to the assumed investment returns as the discount rate applied to future liabilities is increased from 4% to 8%. The state similarly began prefunding state employee retiree health benefits in FY 2011-12: http://www.house.mi.gov/hfa/PDFs/FINAL%20OPEB%20memo%20sept2011.pdf.

employer rate, meanwhile, will result in the state bearing the responsibility for any increases in overall MPSERS costs relative to MPSERS payroll.

Projected State Contributions

An attached table shows preliminary House Fiscal Agency (HFA) projections for required state contributions to MPSERS under the provisions of Senate Bill 1040, as well as resources expected to be available to fund those contributions. Data items included in the projections are described below.

State MPSERS Contributions

MPSERS payroll amounts and contribution rates are based on projections from the Office of Retirement Services. 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 in Senate Bill 1040 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 unfunded accrued liability.

School Aid Budget Projections

The School Aid Fund (SAF) beginning balance for FY 2012-13 is based on current HFA estimates. Projected revenue amounts are based on May 2012 consensus revenue estimates through FY 2015-16 (adjusted for recent tax law changes) and 2.7% annual growth in FY 2016-17. 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 drops from $283 million in FY 2012-13 to $101 million in subsequent years as a result of $182 million designated as a one-time contribution in FY 2012-13.

The School Aid budget for FY 2012-13 reflects the initial budget that has been signed into law for that year. For subsequent years, one-time funding of $41 million for a MPSERS Reserve Fund deposit is removed. The baseline budget figures assume no increase to the per-pupil foundation allowance over the next five years 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 2012-13, 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.
- $541 million in 3% employee contributions for retiree health costs currently being held in escrow due to the legal dispute regarding 2010 MPSERS legislation (estimated based on two full years of collections).

The total assumed combined balance of $714 million can be used to pay projected state MSPERS 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 $259 million. 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 $259 million equates to less than 1.0% of projected SAF revenues over the next three years. Based on these projections, the reserve fund would no longer be needed beginning in FY 2015-16.

The current FY 2012-13 School Aid budget will likely need to be adjusted through a supplemental budget bill to account for the new state MPSERS contribution and the projected withdrawal from the MPSERS Reserve Fund. The withdrawal may vary somewhat from the $33 million figure shown in the long-term projections as the first-year costs under Senate Bill 1040 are calculated more precisely.

Major Uncertainties

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 Senate Bill 1040. There are, however, two key uncertainties that could alter those projections.

<u>Payroll Growth</u>

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.

As shown in the attached chart, the MPSERS payroll decreased from $10.0 billion in FY 2002-03 to $9.5 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 28% 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
- Retirees returning to work under contract (no longer allowed for employees retired after July 1, 2010)
- 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 resulting reductions in traditional public school enrollments and employment levels

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
- The creation of the Educational Achievement System (EAS), which will take over low-performing schools under certain circumstances
- Expanding the use of cyber schools
- Allowing a local vote to convert school buildings to charter schools ("conversion schools") (legislation pending)

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 MSPERS will increase, since the local employer rate is now capped.

The independent third-party study required under Senate Bill 1040 is to include "options regarding the use of current operating expenditures or an alternate measure as the basis for charging unfunded actuarial accrued liability costs to public local school districts." Current operating expenditures (COE) are a broader measure of school district financial activity; this measure 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 merely be shifted to other districts. 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. (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 third-party study, which will also examine the costs and benefits of moving to a mandatory DC plan for new employees and other potential MPSERS plan changes, is due to be delivered to the Legislature no later than November 15 of this year.

Legal Proceedings

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, 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.[3]

To date, the employee contributions 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 (assuming that the State appeals the case) and (2) how the effective change in the use of the contributions under Senate Bill 1040 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, Senate Bill 1040 provides that, if the 3% contribution requirement is found to be unconstitutional, funding for retiree health benefits will revert to a pay-as-you-go method, which will reduce short term MPSERS funding requirements but also revert the system's calculated unfunded accrued liability to a higher amount.

Please call if you have any questions regarding this information.

Attachments (2)

[3] Majority opinion:
http://coa.courts.mi.gov/documents/OPINIONS/FINAL/COA/20120816_C303702_45_303702.OPN.PDF.
Dissenting opinion:
http://coa.courts.mi.gov/documents/OPINIONS/FINAL/COA/20120816_C303702_46_303702P.OPN.PDF.

MPSERS Prefunding Scenario

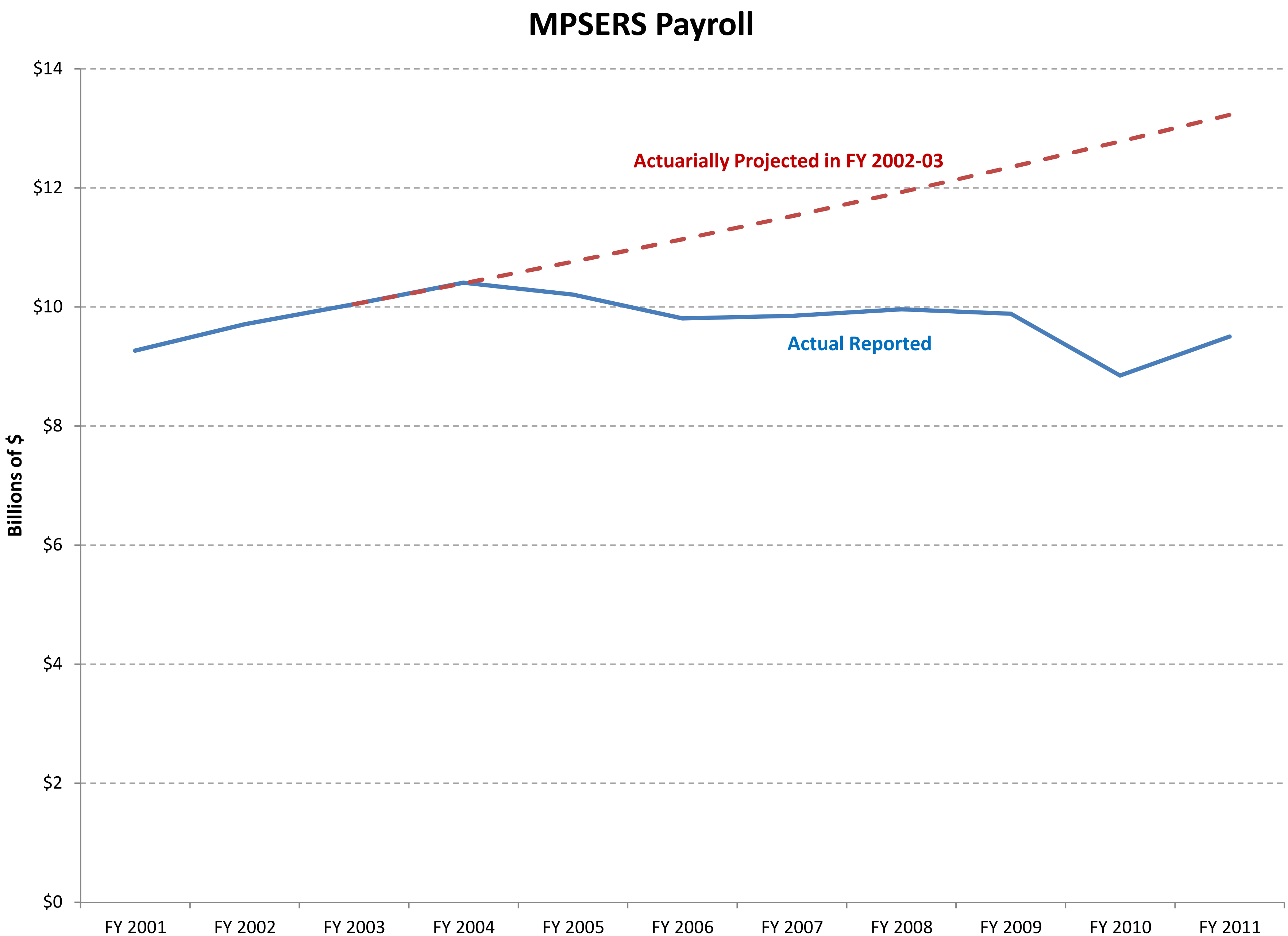
Based on Enrolled Senate Bill 1040 and FY 2012-13 Enacted School Aid Budget

Millions of $

	State MPSERS Contributions				School Aid Budget Projections								Reserve/Escrow	
Fiscal Year	MPSERS Payroll	Total MPSERS Rate	State MPSERS Rate (> 24.46%)	State MPSERS Contrib	SAF Beginning Balance	SAF Revenue	GF/GP Contrib	Total Revenue	School Aid Budget Excl MPSERS Contrib	State MPSERS Contrib	Total Costs	SAF Ending Balance	MPSERS Reserve/ Escrow Withdrawal	Remaining Balance
														$714
FY 2012-13	$10,177	25.9	1.5	$150	$195	$11,151	$283	$11,629	$11,512	$150	$11,662	($33)	($33)	681
FY 2013-14	10,533	27.6	3.2	332	0	11,459	101	11,560	11,471	332	11,803	(243)	(243)	438
FY 2014-15	10,902	29.7	5.3	572	0	11,763	101	11,864	11,471	572	12,043	(179)	(179)	259
FY 2015-16	11,284	30.5	6.1	683	0	12,087	101	12,188	11,471	683	12,154	35	--	--
FY 2016-17	11,679	30.5	6.1	707	35	12,414	101	12,549	11,471	707	12,178	372	--	--

Notes

1. MPSERS rates based on ORS projections, with additional quarter point due to applying 90/10 health premium cost share to current Medicare-eligible retirees instead of 80/20.
2. MPSERS contributions presented on payroll basis; assumes 3.5% annual growth. If that assumption is not met, the State contribution rate would increase.
3. Revenue: Consensus estimates through FY 2015-16 with mid-year adjustments, 2.7% annual growth for FY 2016-17.
4. Assumes foundation allowance is held flat and future baseline costs (including SAF contributions to Community College and Higher Education budgets) are approximately flat.
5. Removes $41 million MPSERS reserve deposit from budget costs beginning in FY 2013-14.
6. MPSERS Reserve/Escrow: $540 million in escrow plus $174 million in reserve fund ($133 million FY 2011-12 appropriation plus $41 million FY 2012-13 appropriation).


MPSERS Payroll
$14
$12
$10
$8
$6
$4
$2
$0
Billions of $
Actuarially Projected in FY 2002-03
Actual Reported
FY 2001
FY 2002
FY 2003
FY 2004
FY 2005
FY 2006
FY 2007
FY 2008
FY 2009
FY 2010
FY 2011