HOUSE FISCAL AGENCY

MEMORANDUM

DATE: September 20, 2011

TO: House Appropriations Committee

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

RE: State Employee Retiree Health Benefit Prefunding

Background Information

As part of its employee compensation plan, the State of Michigan provides certain health, dental, and vision benefits to retired state employees (also referred to as "Other Postemployment Benefits" or "OPEB") through the State Employees Retirement System (SERS). These benefits are received by employees enrolled in both the defined benefit (pension) and defined contribution (401(k)) retirement plans administered by the State. The benefits provide health insurance coverage to employees between the point of their retirement and the age at which they become Medicare eligible (generally 65) and then supplement Medicare coverage beyond that point. Eligible retirees currently contribute 10% of health benefit premium amounts.

Historically, the state has funded the costs of retiree health benefits on a pay-as-you-go basis, in contrast to pension benefits, which the state has generally prefunded. That is, for pension benefits, the state has made contributions to the retirement system as future liabilities are accrued due to the employee's service with the state. In the case of health benefits, the state has not made contributions until the costs of the benefits are actually realized post-retirement.

In FY 2009-10, a total of 50,462 retirees were eligible for health benefits under SERS, and 44,711 retirees actually received benefits (with a slightly higher number receiving dental or vision benefits). Total contributions by the state to provide those benefits were $360.1 million.

Prefunding in FY 2011-12 Budget

As part of the state budget agreement for fiscal year (FY) 2011-12, the Governor and Legislature have agreed to begin prefunding retiree health benefits in FY 2011-12 in order reduce future unfunded liabilities associated with the benefits. Funding amounts under the agreement were based on the September 30, 2009 SERS valuation, which established a minimum amount of approximately $700.0 million necessary to meet the Annual Required Contribution (ARC) to prefund retiree health benefits. An estimated $420.0 million was already budgeted for current retiree health benefit costs in FY 2011-12, so an additional $280.0 million is needed to meet the $700.0 million threshold.[1]

Under the September 30, 2010 SERS valuation, which was recently approved by the SERS board, the ARC will increase to approximately $743.0 million. The implications of that increase are discussed at the end of this memo.

The change in accounting method allowed by the budget agreement to begin pre-funding will reduce the calculated future unfunded liabilities for retiree health benefits from $15.2 billion to $9.4 billion (based on the September 30, 2010 SERS valuation). The accounting change relates to the discount rate applied to estimated future health benefit costs. Under governmental accounting rules, the

[1] The large increase in retiree health benefit costs from FY 2009-10 to FY 2011-12 is partially attributable to the 4,758 employees who retired under the 2010 early retirement legislation.

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discount rate can be increased from 4% to 8% once assets are available to be invested on an ongoing basis.

The $280.0 million in increased payments into SERS agreed to for FY 2011-12 in order to meet the ARC for retiree health benefit costs are to be funded from the following sources:

- **$140.0 million GF/GP** to be billed as payroll-related costs (as current pension prefunding and retiree health benefit pay-as-you-go costs are) and spread across GF/GP line items in the state budget that fund state employee costs through a supplemental appropriations bill. These funds were built into the overall budget agreement but adjustments were not made in the initially-enacted FY 2011-12 state budget because detailed information on specific line item adjustments was not yet available.

- Approximately **$80.0 million in restricted and federal funds** that will be spread across individual line items in conjunction with the $140.0 million in ongoing GF/GP funds. Retiree health benefit prefunding costs can be billed against federal sources for employees funded through those sources as long as the state is making comparable contributions for all state-funded employees.

- A **one-time appropriation of $60.0 million GF/GP** that was included in the General Government article of Public Act 63 of 2011, the FY 2011-12 omnibus budget act, to offset the costs across the entire state budget that would otherwise be billed against certain state restricted funds or federal funding sources that pay state employees. In some cases, restricted and federal fund appropriations could not be reevaluated in a short enough timeframe to adjust for these additional costs (transportation-related funds being a major example). In future years, reductions to other appropriations funded from those sources will need to be made to accommodate the retiree health benefit prefunding costs and allow for a total ongoing annual contribution of $140.0 million, or more, from federal and restricted sources.

The increase in the ARC under the September 30, 2010 SERS valuation will, under current retiree health benefit policies, presumably require an additional $43.0 million to be directed toward retiree health care prefunding. At least half that amount ($21.5 million) would be GF/GP funds, with additional GF/GP funds needed if state restricted and federal funding sources cannot be adjusted on a short timeline.

Alternately, the enactment of legislation making changes to retiree health policies for current or future state employees could reduce the ARC needed, making the funding amounts specified above sufficient for the first year of prefunding. The introduced versions of House Bills 4701 and 4702, for example, would reduce the ARC by an estimated $78.0 million.

Please call if you have questions regarding this information.