PA 300 of 2012: Response to MPSERS Study, 9/21/12

Funding Methods

CSR views the **current assumed long-run rates of return for MPSERS (8%/7%) as reasonable, given that Michigan is an ARC based state,** and would be concerned about shifting to a rate of return that is indexed to external and fluctuating factors. The legislature has recently passed SB 797, which would provide more tools for the Bureau of Investment to diversify asset allocation and meet these targets. At the September 6 Investment Advisory Committee (Dept. of Treasury), RVKuhns and Associates reported on their Asset/Liability study for SERS, a mature, closed system. In their remarks, they commented that it was "**good news" that Michigan is an "ARC based state",** making our prospects for meeting our earnings assumptions better than other states that do not adhere to such fiscally prudent standards**.**

Stranded Costs and Funding

According to the House Fiscal Agency (HFA), the **decline in statewide pupil enrollment has been the second biggest factor "in the increase of employer contribution rates for unfunded accrued liabilities.**"[1] From 1996-7 to 2003-4, the proportion of active to retired MPSERS members declined from 72.6% to 68.8%, even though during that same period, local district pupil membership increased from 1,634,074 to 1,640,929. Subsequently, pupil membership **has** declined, with an estimated local district membership of 1,412,500.[2] We understand that ORS estimates that 5% of the increase in employer pension contributions and 2% of their increase in retiree health care contributions are attributable to stranded costs. Thus**, CSR supports shifting UAL costs from payroll to employers' current operating expenditures (COE) to assure better that UAL related to previously earned benefits remains with the employer that created the cost.** Based on the data regarding pupil enrollment and the shifting ratio of active to retired employees, using COE would provide a more stable and growing base, which is also more equitable to employers.

Retiree Healthcare Funding

CSR strongly supports prefunding retiree healthcare **because even partial prefunding can substantially reduce future costs, due to the accumulation of investment earnings as well as to differences in earnings assumptions.** With pay-as-you-go, both liabilities and the Annual Required Contribution (ARC) are based on short term assumptions. However, if the ARC is fully funded in a qualified trust with a long range investment policy, liability and ARC are calculated based on an 8% (as opposed to 4% for pay-as your-go)discount rate applied to future liabilities, reducing the size of both. The HFA analysis of shifting prefunding retiree health benefits suggests that the calculated UAL for these benefits will be reduced by a**pproximately $10.8 billion.**[3] Rating agencies view prefunding OBEB benefits favorably as well, with Ken Kurtz of Moody's stating that employers should not "maintain Retiree Health Benefits with no plan and no funding."[4] Moreover, prefunding increases employees' sense of security that health benefits will be available to them upon retirement.

Shifting Newly hired School Employees from Hybrid to Defined Contribution plan

- <u>Frequency of changes in retirement benefits</u> Anecdotally, CSR has observed a substantial rise in member anxiety regarding the future security of retirement benefits. PA 300 implemented the third set of significant changes in retirement benefits for school employees in just 5 years, with PA 110-111 of 2007 implementing graded scale premium and increasing employee contributions, and PA 75 of 2010 placing new hires into a hybrid plan and requiring a 3% payment for non-guaranteed health benefits, among other changes. Active members are understandably concerned that Michigan is on a path to implement changes every few years that reduce benefits but increase employee and retiree costs, leading **to greatly increased insecurity about what impact future changes might have on their retirement**.

- Negative impact on investment return and other risk, including market volatility of DC Plans **Market volatility has more adverse impact on members in a defined contribution plan** because the employee does not have the tools of amortization and smoothing that are available to a defined benefit plan. Diversification is more difficult for individual investors than institutional investors because of the smaller size of the individual's assets, and because individuals, of course, lack the professional expertise held by, e.g., the Bureau of Investments. A member in a defined contribution plan is more susceptible to severe declines in investment earnings, solely because of when that particular individual retires, a choice restricted by birth date. In 2000, **Nebraska** created a hybrid plan for state and county workers after finding that its DC plans averaged only 6 % return, in contrast to 11% for the state's DB plans.[5] **West Virginia** began a defined contribution plan for educational employees in 1991 but closed it to new hires in 2005, in large part due to lower average rates of return on that plan than on its defined benefit plan—4.59% over a 7 year period for the DC plan, contrasted to a 7.74% for the DB plan.[6] Due to higher earnings and the higher employee contributions, the West Virginia Consolidated Retirement Board's actuary indicated that allowing public school employees to transfer to the defined benefit model would save that state $1.8 billion over 30 years.
- Benefit Adequacy Benefit adequacy of DC plans is another concern. When the Pension Plus (hybrid) employees approach retirement age, **they have the security of knowing that no matter how long they may live, they will not outlive the DB component of the plan**. In a system with a **high proportion of female members, concerns about "outliving" their pensions are particularly relevant.** According to the Society of Actuaries RP-2000 mortality tables, 50% of US females who reach 65 will live to age 85, 10 % will live to age 96 and 2 % will live to 100, percentages that can be expected to go up rather than down in the future.[7] Members who live into their 80's and beyond clearly benefit from the risk pooling provided by having a defined benefit component to their pension plans. Finally, CSR remains concerned **that lower-income school employees will select options based almost solely on contribution costs** under PA 300 as enacted, given that the income-based scale for employee contributions has been eliminated.
- Impact of Inadequacy of Benefits The National Institute on Retirement Security (NIRS) found that in both the private and public sectors**, DB plans help reduce the risk of poverty among older Americans.** NIRS found that rates of poverty were six times greater for older Americans without DB plans and that in 2006, **DB plans resulted in savings of about $7.3 billion in public assistance, approximately 8.5% of aggregate public assistance received by US households.**[8]
- Attraction/retention of employees, including portability and workforce management According to its survey, Diversified Investment Advisor's Report on Retirement plans, **84% of US companies offering a defined benefit plan believe their plans positively impact employee retention.**[9] Organizations representing teachers in West Virginia have told us that their state's shift back to a defined benefit plan has been helpful in retaining teachers. Younger employees, once they met the brief vesting requirements of a defined contribution plan, felt they have little to lose by switching to another field of employment, a particular problem in some critical shortage areas, including special education personnel and teachers of math, science. **North Dakota changed its DC plan to a DB plan in 1977** to assist the state in attracting and retaining quality employees. Although DC plans are more portable, the MPSERS system is already **substantially portable**, with employees able to move among all public school districts and community colleges in the state; additionally, under the Reciprocal Retirement Act, there are mechanisms for employees to move into other public employment while protecting retirement benefits.

Endnotes

[1] HFA Analysis SB 620, 9/18/12

[2] SFA Pupil Membership History, 9/18/12

[3] HFA Projected State Contributions to MPSERS, 8/29/12

[4] Contra Costa County. "Contra Costa County Employee Benefit Challenge." *Contra Costa County Employee Benefit Challenge*. n.p., 1 Mar. 2007.

[5] Anderson, Gary W, and Brainard, Keith. Profitable Prudence: The Case for Public Employer Defined Benefit Plans Pension Research Council, The Wharton School, University of Pennsylvania. 2004

[6] Olleman, Mark. "Public Plan DB/DC Choices." *PERiScope*. Milliman, Jan. 2009. Web.

[7] Society of Actuaries. "SOA - Society of Actuaries - The RP-"2000 Mortality Tables." *SOA*. Society of Actuaries, July 2000.

[8] Frank Porell and Beth Almeida, The Pension Factor: Assessing the Role of Defined Benefit Plans in Reducing Elder Hardships National Institute on Retirement Security, July 2009), 1.

[9] Diversified Investment Advisors. *Diversified/AHA Survey Reveals That Cost Cutting Measures and Need for Improved Plan Management Drive Retirement Plan Changes*. Harrison, NY: n.p., 2010. Print.