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BILL ANALYSIS

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Senate Bill 1040 (as introduced 3-22-12)
Sponsor: Senator Roger Kahn, M.D.
Committee: Appropriations

Date Completed: 4-12-12

CONTENT

The bill would amend the Michigan Public School Employees' Retirement System (MPSERS) Act to make several substantial changes, including the following:

- **Beginning July 1, 2012, future compensation would no longer include merit pay, tax sheltered annuities, or longevity pay.**
- **For employees hired on or after July 1, 2012, final average compensation, as used in the calculation of a pension, could not exceed $100,000, adjusted annually by inflation. Employees hired before July 1, 2012, would not have their pension affected by this cap on final average compensation.**
- **Employees hired before July 1, 2010, would have the following choices: 1) make higher contributions in order to continue receiving a 1.5% multiplier for future years of service; or, 2) either a) continue paying current contributions but have a 1.25% multiplier for future years of service, or b) freeze pension benefits earned to date and move to a defined contribution plan for future years of service. "Hybrid" employees (those hired on or after July 1, 2010) would not be affected by these pension changes.**
- **For employees first hired on or after July 1, 2012, retiree health care premium coverage would be eliminated and replaced with matching employer contributions up to 2% of compensation, deposited into a 401k account; new hires would not have to remit the 3% employee contribution for retiree health that is in the law for current employees.**
- **The premium coverage paid by the State would decrease to a maximum of 80%, with retirees (both existing retirees and future retirees) paying at least 20% of health care premiums.**
- **The age eligibility for retiree health care would increase to at least age 60, for all employees retiring on or after July 1, 2012; a "rule of 85" phase-in would allow an employee retiring before July 1, 2013, with a combined age and years of service equal to at least 85, to receive retiree health care without being at least age 60.**
- **For all active employees hired before July 1, 2012, retiree graded health care premium coverage would be applied retroactively (as currently required for employees hired on or after July 1, 2008). This would not affect current retirees or those who retire prior to July 1, 2012.**

The bill also would appropriate $1.0 million to the Office of Retirement Services (ORS) for implementation of the legislation.

The proposed changes would address both pension and health care costs. As of the most recent Comprehensive Annual Financial Report, the unfunded accrued liability (UAL) for MPSERS pensions was $17.6 billion and the UAL for retiree health care was $27.6 billion. The bill would reduce the liabilities under both the pension and health sides, but most of the impact would affect the health care liability.

Definition of Compensation and Final Average Compensation

Senate Bill 1040 includes two proposals that would limit future pension payouts. The first would amend the definition of "compensation" to exclude from future compensation, beginning July 1, 2012, merit pay, tax sheltered annuities, and longevity pay. Any merit pay, tax sheltered annuities, or longevity pay earned before July 1, 2012, would be included in compensation earned in previous years, to the extent allowable under current law. However, going forward, those items would be eliminated from the definition of "compensation".

The second proposal would place a cap on final average compensation for employees first hired on or after July 1, 2012. Specifically, the cap for new hires would be $100,000, adjusted annually by inflation. Since a pension is calculated by multiplying an employee's final average compensation by the number of years worked, times a specified multiplier, both proposals would work to limit the final pensions paid out, by limiting compensation used in the calculation of the pension.

Increased Employee Contributions or a Reduced Multiplier or Conversion to DC

The next series of changes under Senate Bill 1040 relate to choices offered to employees as follows: 1) increase employee contributions and continue the multiplier (for pension calculation) of 1.5% for future years of service, OR, 2) keep the same level of employee contributions but have a reduced multiplier of 1.25% on future years of service, OR, 3) make no future contributions, but also receive no future years of service for a pension, and instead freeze existing pension benefits and convert to a defined contribution (DC), or 401k, plan.

Employees who wished to continue receiving the existing 1.5% multiplier for future years of service (for use in calculating a pension) would have to pay higher employee contributions than under current law. Specifically, employees hired before January 1, 1990 ("basic" plan members) would have to pay 5% of compensation; these employees currently make no contributions to the MPSERS. Employees hired between January 1, 1990, and July 1, 2010 ("Member Investment Plan", or MIP, members) would have to pay a flat 8% of compensation; these employees currently make graded contributions based on salary, currently ranging from 3% to 6.4%. Employees hired on or after July 1, 2010, are in the "hybrid" system and would not be affected by the proposed changes; they would remain in the hybrid plan.

If employees did not choose to make the higher contributions listed above, they would have two choices: 1) pay the existing employee contributions, but receive a 1.25% multiplier for future years of service, OR, 2) freeze the earned benefit to date and convert to a DC plan. The DC plan would require the employer to deposit 4% of compensation into a 401k account, but no future pension benefits would accrue to an employee choosing this option. Regardless of the option chosen, previously accrued service would be calculated at the 1.5% multiplier when determining pension benefits earned to date.

Retiree Health Care

Numerous changes to retiree health care are proposed under Senate Bill 1040. First, State premium coverage would be reduced to not more than 80%, with retirees paying at least 20% of retiree health care premium coverage, an increase from the current roughly 10%

cost sharing. This change would affect not only future retirees, but also people already retired.

Second, all current employees retiring on or after July 1, 2012, would have to be at least age 60 before being eligible to receive retiree health care premium coverage. Under current law, members in the "basic" plan can receive health care coverage at age 55 with 30 years of service, or at age 60 with 10 years; and MIP employees can receive coverage if at least age 46 and with 30 years of service, or at age 60 with 10 years of service. Senate Bill 1040 does include a one-year phase-in of this age-60 requirement, under which an employee not age 60 but whose age plus years of service were at least equal to 85 by July 1, 2013, could retire and receive coverage.

Third, the bill would retroactively apply the graded premium subsidy plan, currently in effect for employees hired on or after July 1, 2008, to all employees hired before that date as well. This plan would provide 30% premium coverage after 10 years of service, with an additional 3% coverage per year of service after 10 years, to a maximum coverage of 80%. This does differ somewhat from what is in current law, because the current plan provides 30% coverage after 10 years with a 4% growth for subsequent years. This would not affect current retirees or those who retire prior to July 1, 2012.

Finally, the bill would eliminate retiree health care coverage for employees first hired on or after July 1, 2012. Mirroring changes made for State employees under Public Act 264 of 2011, the bill would require an employer to make up to a 2% matching contribution into an employee's 401k account in lieu of retiree health care coverage. Employees would not be able to take loans out against the employer's contributions, under this proposal, which was also implemented under Public Act 264.

MCL 38.1303a et al.

FISCAL IMPACT

Table 1 is a summary document indicating the sections proposed for amendment and their estimated fiscal impact, if available. According to the Office of Retirement Services, if Senate Bill 1040 were enacted as introduced, the cumulative first-year pension savings would be $260.0 million and cumulative first-year health savings would be $120.0 million, for combined first-year savings of $380.0 million. Long-term pension liability would be reduced by $1.6 billion and long-term health liability would be reduced $6.0 billion, for an estimated total reduction in unfunded liability of $7.6 billion.

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Table 1

Section-by-Section Analysis of MPSERS Reform Legislation (As Introduced, March 22, 2012)		
Section Number and Purpose	**Proposed Change**	**Estimated Fiscal Impact**
Sec. 3a, Definition of Compensation	Beginning July 1, 2012, future compensation would no longer include merit pay, tax sheltered annuities, or longevity pay.	No estimated fiscal impact available because, until this point, compensation was not broken down into categories. Could slightly reduce payroll; which could increase employer contribution rate.
Sec. 4(12), Definition of Final Average Compensation	For new hires, compensation used to determine Final Average Compensation could not exceed $100,000, adjusted annually by inflation.	Year 1: $1 million savings Year 2: $3 million savings Year 3: $5 million savings …Year 10: $18 million savings Long-term hybrid employer rate reduced by 0.13% of payroll. Unfunded accrued liability (UAL) reduction of $55.0 million.
Sec. 43a Existing Employee Contributions Sec. 43g Proposed Employee Contributions	Employees would be given a choice to either 1) continue to pay existing contributions under Sec. 43a, but receive a reduced pension multiplier of 1.25% (rather than 1.5%) for future years of service, or 2) pay higher contributions under Sec. 43g in order to continue receiving the 1.5% pension multiplier. Basic Employees (hired before 1990) choosing option #2 would pay flat 5% of compensation (up from 0% current contribution) into pension system. Member Investment Plan (MIP) employees (hired between 1990 and 2010) would pay flat 8% of compensation (up from a graded system where contributions range from 3% to 6.4%, based on hire date and salary) into pension system. Hybrid members (hired after July 1, 2010) would remain in the hybrid plan, and continue contributing existing amounts.	5% Across the Board for Basics = $74 million 8% Across the Board for MIP (non-hybrid) = $279 million Total Additional Employee Contributions = $353 million Long-term reduction in employer contribution rate if employee contributions were directed to reduce employer costs is 2.8%. UAL reduction of $1.6 billion.

Section-by-Section Analysis of MPSERS Reform Legislation (As Introduced, March 22, 2012)		
Section Number and Purpose	**Proposed Change**	**Estimated Fiscal Impact**
Sec. 59 Employee Choices: Higher Contributions/Retain 1.5% multiplier for future years of service Same Contributions/Reduced 1.25% multiplier for future years of service No Contributions/Freeze Pension Earned to Date/Switch to DC for future years	All existing employees hired before July 1, 2010, would be given a choice to either pay higher contributions and retain the 1.5% pension multiplier, or, if choosing not to pay the higher contributions, then either retaining the existing contributions with a reduced multiplier (1.25%) OR freezing earned pension and transferring to a Defined Contribution plan. An employee choosing to make the higher contributions to retain the existing 1.5% multiplier for future service would be given a further choice to pay the higher contributions until termination or until reaching "attainment date" (i.e., 30 years of service). Employees choosing to pay the higher contributions until attainment date, after reaching 30 years of service, would return to the lower contribution levels, but at a 1.25% multiplier for years in excess of 30. An employee choosing not to pay the higher contributions who further chose to freeze the earned pension to date and transfer to DC, would make no contributions and would receive an employer contribution of 4% of pay into the employee's 401k account.	This section would implement the employee contribution sections referred to above, and therefore would have no standalone fiscal impact.
Sec. 84b Pension Calculations Based on Choices Made in Section 59	People choosing to make the higher contributions under Sec. 43g would retain the 1.5% multiplier for future years of service, in the calculation of their pension. If they chose to make the increased contributions only until attainment date, the 1.5% multiplier would be used for service accrued until they reached the attainment date, and a 1.25% multiplier would be used for years of service after the attainment date was reached. People choosing not to make the higher contributions under Sec. 43g, but choosing to continue making the contributions under Sec. 43a, would receive a 1.25% multiplier for future years of service, when calculating their pension.	This section would implement the employee elections section referred to above, and therefore would have no standalone fiscal impact.

Section-by-Section Analysis of MPSERS Reform Legislation (As Introduced, March 22, 2012)		
Section Number and Purpose	**Proposed Change**	**Estimated Fiscal Impact**
	People choosing not to make any future contributions would be frozen at the pension accrued to date, and switched to DC for future years of service. All previously accrued service would be calculated at a 1.5% multiplier.	
Sec. 91 Retiree Health Care	"80/20" All existing retirees would have State retiree health, dental, vision, and hearing coverage of 80%, rather than the existing 90% coverage. "Age 60" All current employees retiring after July 1, 2012, would not be able to receive retiree health care until at least age 60. Current law allows Basic employees to receive retiree health at age 55 with 30 years of service, or age 60 with 10 years of service. Current law allows MIP members hired before July 1, 2010, to receive health care at any age with 30 years of service, or age 60 with 10 years of service. Proposal includes one-year phase-in, whereby this would not affect people who, by July 1, 2013, have combined age plus years of service equal to at least 85. Retroactive "Graded Premium" In addition, all current employees retiring after July 1, 2012, would become part of the graded health care premium coverage plan, which currently only covers employees hired since July 1, 2008. This plan would provide 30% premium coverage after 10 years of service, with an additional 3% coverage per year of service after 10 years, up to a maximum of 80%. Retiree health care coverage would be eliminated for any employee first hired on or after July 1, 2012.	"80/20" Year 1: $90 million savings Year 2: $100 million savings Year 3: $110 million savings …Year 10: $183 million savings UAL Reduction of $3.3 billion. "Age 60" Year 1: $5 million savings Year 2: $28 million savings Year 3: $48 million savings …Year 10: $128 million savings UAL Reduction of up to $1.3 billion. The savings shown here for the "Age 60" changes likely would be reduced downward somewhat due to the "Rule of 85" phase-in. Retroactive "Graded Premium" Year 1: $5 million Year 2: $26 million Year 3: $48 million …Year 10: $222 million UAL Reduction of $2.8 billion. There could be some overlap of savings being captured under both the "Age 60" and "Graded Premium" proposals. Therefore, these savings could be reduced somewhat when eliminating the overlap. The savings shown were estimated as independent events, and now need to be estimated concurrently.

Section-by-Section Analysis of MPSERS Reform Legislation (As Introduced, March 22, 2012)		
Section Number and Purpose	**Proposed Change**	**Estimated Fiscal Impact**
Sec. 91a "401k" for Retiree Health	Combined with Sec. 91(15), retiree health care premium coverage would be eliminated for employees first hired on or after July 1, 2012. In place of retiree health care coverage, the employer would pay up to 2% in matching contributions to an employee's 401k account. New hires will not pay the 3% retiree health contribution required under Sec. 43e for all current employees, since they will not receive retiree health care upon retirement.	This would be a new cost in addition to payment of the cash costs of existing retirees, which would grow until a break-even point was reached in roughly 30 years, after which costs would decline, with significant savings achieved in 60 years. Eventually, long-term costs for retiree health care would max out at 2% of payroll. Year 1: $11 million additional cost Year 2: $22 million additional cost Year 3: $31 million additional cost …Year 10: $110 million additional cost
Appropriation for ORS to Implement	$1.0 million appropriation to the Office of Retirement Services for implementation of the bill.	$1.0 million appropriated from the retirement system's assets.
Total Fiscal Impacts		SFA estimated first-year reduction in MPSERS employer contribution rate if all savings were used to reduce employer contributions: 3.5% **Note:** FY 2011-12 MPSERS employer contribution rate is 24.46% of payroll, and, in the absence of any changes, the FY 2012-13 rate will be 27.37% (an increase of 2.91% of payroll over FY 2011-12) and the FY 2013-14 rate will be 31.21% (an increase of 3.84% of payroll over FY 2012-13).

Note: The reforms addressed in Senate Bill 1040 would not result in any State savings. Instead, they would produce short- and long-term reductions in costs in the retirement system, and would require additional employee contributions to the retirement system, if that option is chosen by the employees. The savings may be realized either by a lower-than-anticipated employer contribution rate (resulting in savings to local schools), or by directing those savings toward the unfunded accrued liabilities, or some combination of both. As noted in the Total Fiscal Impacts above, if all of the proposed reforms were enacted and the savings were realized by lowering the otherwise anticipated contribution rate, then the employer contribution rate for FY 2012-13 would remain near the level for FY 2011-12, rather than increasing the anticipated nearly 3% of payroll.