



**House
Legislative
Analysis
Section**

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LOCAL GOVT. PENSION CHANGES

House Bill 5728 (Substitute H-2)
Sponsor: Rep. Jerry Vander Roest

House Bill 5729 (Substitute H-1)
Sponsor: Rep. Gary Woronchak

House Bill 5731 (Substitute H-2)
Sponsor: Rep. Mark Jansen

**Committee: Senior Health, Security and
Retirement**
First Analysis (4-17-02)

THE APPARENT PROBLEM:

In Executive Order 1999-13, Governor Engler established the Michigan Commission on Public Pension and Retiree Health Benefits to conduct a comprehensive review of relevant practices and issues regarding the funding, management, oversight, and fiscal integrity of public pension and retirement systems in Michigan. The commission was charged with reviewing state laws that govern or affect public pension systems, reviewing the adequacy of funding of pension systems and the extent of unfunded accrued liabilities, and recommending appropriate changes.

On February 1, 2001, the commission issued its report and recommendations. The commission reported that most state and local pension systems appear to be adequately funded at this time, and that most are well managed. However, there appear to be at least some instances of local governments borrowing from pension funds to pay operating expenses, and a few governmental units that have failed to adequately fund the employer share of pension benefits. There may be disagreement over how much is needed to fund the employer share, or budgetary restraints or other factors may result in underfunding. And, local units may adopt benefit increases without sufficient consideration of how to pay the future costs that will be incurred. Apparently, however, the state has very little authority to require that local governments meet their pension obligations, despite a constitutional requirement that pension benefits be fully funded each year to meet future obligations (benefits must be "prefunded"). Among the commission's recommendations, then, are the addition of several means of enforcing fiscal responsibility of local governments toward their

pension systems. Legislation has been introduced to implement some of these recommendations.

THE CONTENT OF THE BILLS:

House Bill 5728 would amend the Public Employee Retirement System Investment Act (MCL 38.1140h and 38.1140m) to require state and local government retirement systems to provide a supplemental actuarial analysis prior to adopting pension benefit changes. The bill would require that such an analysis be provided by the retirement system's actuary, and that it include an analysis of the long term costs associated with any proposed benefit change. The supplemental actuarial analysis would have to be provided to the retirement system's board and to the decision making body charged with approving the proposed pension benefit change at least seven days before the change is adopted. (A "proposed pension benefit change" would be defined as a proposal to change the amount of pension benefits received by persons entitled to benefits, and would not include a proposed change in health care plans or health benefits.)

Further, the bill would require that the governing board vested with the general administration, management, and operation of a system (or other decision making body that is responsible for implementation and supervision of any system) confirm in its annual actuarial valuation and the summary annual report required by the act that the plan provides for the payment of the required employer contribution. Further, the board (or decision making body) would have to confirm in its summary annual report that the system has received

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the required employer contribution for the year covered in the summary annual report.

The bill specifies that the required employer contribution is the actuarially determined contribution amount, and that it would consist of a current service cost payment and a payment of at least the annual accrued amortized interest on any unfunded actuarial liability and the payment of the annual accrued amortized portion of the unfunded principal liability. For fiscal years beginning before January 1, 2006, the required employer contribution would have to be determined using an amortization period of no greater than 40 years. After that time, the amortization period could be no greater than 30 years.

In a plan year, any current service cost payment could be offset by a credit for amortization of accrued assets, if any, in excess of actuarial accrued liability. A required employer contribution would have to allocate the actuarial present value of future plan benefits between the current service costs to be paid in the future and the actuarial accrued liability.

The bill would require the board (or other decision making body) to act upon the recommendation of an actuary, and the board and the actuary would be required to take into account the standards of practice of the actuarial standards board of the American Academy of Actuaries in determining the required employer contribution.

House Bill 5729. Under the Uniform Budgeting and Accounting Act (MCL 141.424), local governmental units are required to compile an annual financial report, and to file a copy with the state treasurer within six months after the end of the local unit's fiscal year. The bill would amend the act to specify that the state treasurer could require that an annual financial report by the pension system for any defined benefit plan of the local unit be submitted in electronic format, after timely notice. The bill would also delete a reference to a section of the former Municipal Finance Act.

House Bill 5731. The Local Government Fiscal Responsibility Act (MCL 141.1202 and 141.1251 et al.) requires the governor to appoint a review team to take certain steps to alleviate serious financial problems of local units of government and school districts, under certain circumstances. The bill would amend the act to add a new article to add similar provisions that would apply to local public pension systems experiencing severe financial distress.

Preliminary review. Under the bill, the state treasurer would be required to conduct a preliminary review of a local retirement system to determine the existence of a financial problem, if:

- the retirement system's board of trustees requested a review;
- the state treasurer determined or was made aware that the system's investment returns were significantly and consistently below the average investment returns for public pension plans in the state;
- the state treasurer received written notification that a system has not made required payments to beneficiaries or retirants and it has been at least seven days after the scheduled date of payment;
- the board of trustees violated the requirements of the Public Employee Retirement System Investment Act;
- the state treasurer received a resolution from either the House of Representatives or the Senate requesting a review; or,
- a local governmental unit that is the sponsor of a retirement system fails to file the annual financial report required under the Uniform Budgeting and Accounting Act.

In conducting a preliminary review, the state treasurer would be required to notify the board of trustees of the review and the appropriate local government, and to meet with the board to receive, discuss, and consider information concerning the financial condition of the pension system. Within 30 days after beginning a review, the state treasurer would have to inform the governor whether the pension system had a serious financial problem.

Review team. Upon being informed of a serious financial condition of a pension system by the state treasurer, or upon the request of the board of trustees of a pension system for assistance in meeting the ordinary needs of the pension system, the governor would appoint a review team consisting of the state treasurer, the auditor general, nominees of the Speaker of the House of Representatives and the Senate Majority Leader, and other state officials or other persons with relevant professional experience.

The review team would undertake a review of the financial condition of the pension system, and would have full power to examine the books and records of the system, to utilize the services of state agencies and employees, and to sign a consent agreement with

the board of trustees. Such an agreement could provide for remedial measures considered necessary, including a long range financial recovery plan requiring specific actions. The agreement could include the use of state financial management and technical assistance as necessary to alleviate the financial problem, and could also provide for periodic fiscal status reports to the state treasurer. Such an agreement would have to be approved by the board of trustees to take effect.

The review team would have to report its findings to the governor within 60 days, or earlier upon the governor's direction. Upon request, the governor could grant one 30-day extension. A copy of the review team's report would also have to be sent to the board of trustees, the Speaker of the House of Representatives and the Senate Majority Leader. The review team's report would have to specify either that:

- the pension system *did not* have a serious financial problem, or
- that the system *did* have a serious problem but that a consent agreement had been adopted to resolve the problem, or
- that there was a *serious financial emergency* because a consent agreement had not been adopted.

Finding of financial emergency. Within 30 days after receiving the review team's report, the governor would have to make a determination of which of the above listed conditions applied. If the governor determined that a serious financial emergency existed, he or she would notify the board of trustees and the local government of the determination and provide a concise and explicit statement of the underlying facts supporting the findings, and provide notice that the board had 10 days to request a hearing. Following the hearing (or after the 10 days expired without request for a hearing), the governor would either confirm or revoke the determination of financial emergency. If confirmed, the governor would provide a written report of the findings of fact or the continuing or newly developed conditions or events that provide a basis for the determination of an emergency, and a concise and explicit statement of the underlying facts supporting the findings.

If at any time the state treasurer or the review team informed the governor that the board of trustees was not abiding by the terms of a consent agreement, the governor would be required to determine that a financial emergency exists in that retirement system.

The board of trustees of a pension system could appeal a determination of a financial emergency to the circuit court of the county in which it is located, or to the Ingham County circuit court. The court could not set aside a determination of an emergency unless it found that the determination was not supported by competent, material, and substantial evidence on the whole record; or, that it was arbitrary, capricious, or clearly an abuse or unwarranted exercise of discretion.

Emergency financial management. If the governor determined that there were a financial emergency, he or she would assign the responsibility for managing the emergency to the Local Emergency Financial Assistance Loan Board created under the Emergency Municipal Loan Act. (The board consists of the state treasurer, the director of the Department of Consumer and Industry Services, and the director of the Department of Management and Budget.) The board would appoint an emergency financial manager, who would have to be chosen solely on the basis of his or her competence, and who could not have been an official of the affected retirement system for the five years immediately preceding his or her appointment. The manager would serve at the pleasure of the Local Emergency Financial Assistance Loan Board, and could receive compensation and reimbursement for expenses from the retirement system, as approved by the Local Emergency Financial Assistance Loan Board. The manager could also appoint staff and secure professional assistance necessary to implement the bill.

The emergency financial manager would be authorized to issue orders to the appropriate officials and employees of the retirement system necessary to accomplish the purposes of the bill, including orders for the timely and satisfactory implementation of a financial plan. The orders of the emergency financial manager would be binding on the officials and employees to whom they are issued.

Financial plan. In consultation with the board of trustees of the retirement system, the emergency financial manager would develop a written financial plan, providing for conducting the operations of the retirement system within the resources available, and for payment in full of the scheduled debt service requirements of all bonds and notes of the retirement system, and all other uncontested legal obligations.

After the initial development of the financial plan, the manager and the board of trustees would have to regularly reexamine the plan, and modify it if necessary to conform to estimates of available revenue.

The plan would be in a form and contain information as specified by the manager. The manager would have to make the plan public, but the plan would not be subject to public approval before it could be implemented.

Powers of emergency financial manager. The emergency financial manager would assume all powers of the board of trustees, including but not limited to the full authority to grant or deny benefits consistent with plan provisions, and could take any of the following actions:

- Analyze factors and circumstances contributing to the financial condition of the system and recommend steps to be taken to correct the condition.
- Amend, revise, approve, or disapprove the administrative budget of the system, and limit the total amount appropriated or expended during the financial emergency.
- Require and prescribe the form of special reports to be made by the finance officer of the system to its board of trustees, the system's creditors, the emergency financial manager, or the public.
- Examine all records and books of account, and require (under the procedures of the Uniform Budgeting and Accounting Act or the uniform system of accounting act, or both) the attendance of witnesses and the production of documents.
- Make, approve, or disapprove any contract, expenditure, or loan, the creation of any new position, or the hiring or firing of investment consultants, money managers, or other employees of the system.
- Review payrolls or other claims against the system before payment.
- Employ or contract for auditors and other technical personnel necessary to implement the bill.
- Require compliance with the orders of the emergency financial manager, by court action if necessary.
- Apply for a loan from the state on behalf of the system, in a sufficient amount to pay the expenses of the manager and for other lawful purposes.
- Change actuarial assumptions and funding requirements.

- Bring action against a local unit of government for failure to make timely contributions to the retirement system.

State immunity. The bill specifies that the state, the Local Emergency Financial Assistance Loan Board, and the emergency financial manager would not be liable for any obligation of or claim against a public pension system resulting from actions taken under the bill.

Local cooperation required. The board of trustees of a retirement system and local government elected officials would be required to provide assistance and information requested by a review team, the Local Emergency Financial Assistance Loan Board, or the emergency financial manager in the effectuation of their duties and powers under the bill. Failure of an elected official or by one or more members of a board of trustees to abide by the requirements of the bill would be considered gross neglect of duty, which the emergency financial manager would have to report to the Local Emergency Financial Assistance Loan Board. Following review and a hearing the board could recommend to the governor that the local official or one or more members of the board of trustees be removed from office.

Revocation of financial emergency. The governor could determine, upon recommendation from the Local Emergency Financial Assistance Board, that the conditions for revoking the financial emergency had been met.

BACKGROUND INFORMATION:

Commission recommendations. The governor's commission made a number of recommendations, including:

- The state should develop a comprehensive report card on governmental retirement plans.
- The legislature should clarify what is an appropriate required employer contribution and how the contribution should be determined. (This recommendation is addressed by House Bill 5728.)
- The state treasurer should be authorized to withhold revenue sharing or other funds to governmental units that fail to adequately fund retirement programs, and those payments should be applied to retirement plan shortfalls. (The recommendation is addressed in House Bill 5727.)
- The state should have increased power to address mismanaged retirement systems. (This is addressed in House Bill 5731.)

- There should be mandatory evaluation of the long-term impact of increased benefit costs, and the public should be informed about increased benefit costs before benefits are adopted. (This is addressed in House Bill 5728.)
- Penalties for improper use of retirement funds should be increased.
- The state should support ongoing education for trustees of public retirement systems.
- The state should encourage plan sponsors to educate employees enrolled in defined contribution programs, and plan sponsors should be required to offer a minimum number of “model” portfolios for participants’ investment choices.
- The county pension plan committee should be eliminated. (This is addressed by House Bill 5730.)
- Retirement system trustees and participants should understand liabilities for retiree health benefits, and more study should be done on the issue of retiree health benefits.

State administered retirement systems. The state administers retirement systems for state employees, public school employees, judges, legislators, and state troopers. Benefits are funded by a combination of employer contributions, investment earnings, and, in some cases, employee contributions. Statutes govern the structure of these plans, benefit levels, funding requirements, and so on.

Local government retirement systems. Local governments have broad powers to establish retirement systems for their employees under their general statutory and charter operating authority. Some municipalities and courts offer retirement plans for their employees under the auspices of the Municipal Employee Retirement System (MERS) Act. Formerly a state-administered retirement system, MERS now operates as an independent public corporation. Counties are authorized to establish retirement systems for county employees under Public Act 156 of 1851. While the statutory framework outlines benefit plans and employer contribution requirements, many local governments operate their own plans outside of this framework, and even within the statutes there are several optional benefit plans that may or may not be offered by a local unit. According to the commission’s report, “a vast array of local governmental units – counties, cities, villages, townships, county road commissions, library boards and others – provide some sort of retirement benefits to their employees. The benefits

offered include pension, health care and savings packages.”

There appears to be no comprehensive listing of local government pension plans; no person or government agency collects information about the existence of plans, and their financial health. One of the commission’s recommendations is for the state to develop a comprehensive “report card” on governmental retirement plans.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency, House Bill 5728 would have no fiscal impact on the state, and would have an indeterminate impact on local governments. (4-17-02)

ARGUMENTS:

For:

Pension benefits are often negotiated as part of labor contracts, and at times these changes may be swiftly implemented as part of the contract negotiation process, without full consideration of the long-term costs the benefits may impose on a retirement system. (It may be somewhat easier for elected officials to “spend” future dollars – in the form of promised pension benefit increases – than to raise salaries of employees, necessitating immediate budget increases.) According to the commission, “officials who find it easy to vote for increased benefits should also be made aware of the need for higher tax revenues to cover these improved benefits.” Thus, it recommended that there be mandatory evaluation of the long-term impact of increased benefit costs, and also that this information be available to the public prior to the adoption of new benefits. House Bill 5728 would address this issue by requiring that an actuarial analysis of proposed new benefits be prepared and provided to the board or decision making body at least seven days before changes are adopted.

Response:

Though the bill would require at least a seven-day period in which board members (or officials) would have cost information prior to adopting benefit changes, the commission has recommended that it should be available to both officials and to the public for at least 30 days, in order to allow proper consideration of the long-term impact.

Further, though the bill amends the Public Employee Retirement System Investment Act, which specifically applies to both *local* government retirement systems and to the *state* retirement

systems, the bill's provisions are directed only at local governments. Pension benefit changes for state employees, public school employees, legislators, judges, and state police troopers should perhaps be given the same level of scrutiny.

For:

The commission notes that employer contributions, employee contributions, and investment income earned on a retirement system's assets generally support retirement benefits. Determining the "employer contribution" is a crucial matter. The state constitution requires that current service costs be paid annually; sound pension management requires that the cost of new benefits and accrued liabilities (if any) also be paid. However, pension systems and local governments may disagree over the appropriate amount needed to meet these requirements, and local officials may face budgetary problems that discourage them from fully funding their pension systems. The commission recommends that the legislature create statutory guidelines for determining the required employer contribution, that the guidelines be based on the actuarial funding method which takes into account both current obligations and unfunded accrued liabilities, and that employers be required by law to make the required contributions. House Bill 5728 would implement this recommendation.

For:

It has been noted that there exist a vast array of public employee retirement systems in Michigan, yet no one seems to know how many or to be able to collect data on their financial soundness. The commission recommends that the state create a "report card" of public pension systems to make this information available. One way to build such a "report card" would be to use information submitted by local governments in their annual financial reports to the Department of Treasury. House Bill 5729 would require that certain pension information be submitted in electronic form to facilitate this effort.

For:

The commission has noted that a local pension system may become so mismanaged that it cannot meet its obligations. Under the Local Government Fiscal Responsibility Act, a preliminary review by the state treasurer of a local unit's financial problems can result if the unit fails to make the required minimum payment to its pension fund, but the act does not address the situation in when the local unit has made all of the necessary contributions but the trustees of the pension fund have failed to properly manage the fund. The commission has recommended that the Local Government Fiscal Responsibility Act

be amended to specifically provide that a public pension plan itself may be the subject of a review by state officials under the act. House Bill 5731 would add provisions to the act to do this, extending the process for preliminary review, a review team appointed by the governor, and finally, the appointment of an emergency financial manager to address pension systems that have been grossly mishandled.

Against:

Local governmental officials have expressed concern that House Bill 5731 would grant broad authority to an emergency financial manager, and excuse that person from all liability, yet it would not require that the manager be held to the fiduciary standards of a pension system manager.

POSITIONS:

The Department of Treasury supports the bills. (4-16-02)

The Michigan Townships Association supports the bills. (4-16-02)

The Michigan Association of Counties supports House Bill 5729 and is reviewing House Bill 5728. (4-16-02)

The Michigan Association of Public Employee Retirement Systems supports House Bills 5728 and 5729, and does not support House Bill 5731. (4-16-02)

The Michigan Municipal League supports House Bills 5728 and 5729, and does not support House Bill 5731. (4-16-02)

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.