Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

BILL ANALYSIS

Telephone: (517) 373-5383
Fax: (517) 373-1986
TDD: (517) 373-0543

Senate Bill 1360 (as discharged)
Sponsor: Senator Nancy Cassis
Committee: Finance

Date Completed: 10-19-06

RATIONALE

In addition to pensions, many governmental entities provide other postemployment benefits (OPEB), including health care benefits. Although the benefits will be paid in the future, their cost represents a present liability to the employer, called an actuarial accrued liability. In most cases, a governmental entity finances the OPEB plan on a pay-as-you-go basis, which does not reflect the actuarial accrued liability until the health care bills are paid. Other units of government use accrual-based funding, which reflects the current cost plus an amount for future payments. These include Oakland County, which has used the accrual method of funding since 1987 and has set aside approximately $265 million in the trust fund it established for the payment of health care benefits. Evidently, however, this amount is nearly $500 million less than the county's entire actuarial accrued liability of $752 million. In addition, the amount the county budgeted for its fiscal year 2006-07 annual required contribution (ARC) to the trust fund apparently is almost $9 million less than the amount recommended by the county's actuary. In order to meet the increasing costs of retiree health care, as well as eliminate its unfunded actuarial accrued liability, Oakland County officials have proposed the sale of municipal securities (bonds), whose proceeds would be deposited in the trust fund and invested in the stock market. Under current State law, however, municipalities do not have the authority to sell bonds in order to fund retiree health care obligations.

It has been suggested that other local units of government also might be interested in using this financing method to prefund their actuarial accrued liability. When governmental entities finance their OPEB on a pay-as-you-go basis, their financial statements do not report the fiscal effects of the benefits until they are paid to current retirees. Under standards issued in 2004 by the Governmental Accounting Standards Board (GASB), beginning in the next several years, governmental entities will be required to have an actuarial report (as already required for pension plans) that will show their OPEB unfunded actuarial accrued liability and the annual required contribution according to accrual-based accounting. A local unit that does not pay this ARC will have to record a liability on its financial statement, which will appear as a deficit and could impair the local unit's ability to issue debt in the future. In order to avoid this result, while complying with the GASB rules, it has been suggested that some local units might find it attractive to prefund their retiree health care obligation by issuing bonds and investing the proceeds, as Oakland County would like to do.

CONTENT

The bill would amend the Revised Municipal Finance Act to do the following:

- **-- Allow a county, city, village, or township to issue a municipal security to pay the costs of the unfunded actuarial liability of its public employee retirement system pension fund.**
- **-- Define "unfunded actuarial liability" as the amount by which a health care trust fund is short of the amount that will be necessary, without further**

payments into the trust fund, to pay postemployment health care benefits already earned by beneficiaries and participants of a public employee retirement system.

- **Require that the municipality make available to the public a comprehensive financial plan before issuing a municipal security for its health care trust fund.**
- **Require a referendum on the question of issuing the security if petitions containing a prescribed number of signatures were filed.**
- **Provide that outstanding securities issued for a health care trust fund could not exceed 5% of the State equalized valuation of the property assessed in the municipality.**
- **Provide that the taxes necessary to pay the principal and interest on the securities, plus the taxes levied for the same year, could not exceed the limit authorized by law.**
- **Require that municipal securities issued under the bill and municipal securities issued for capital improvement be secured by the general fund of the municipality.**

"Health care trust fund" would mean the fund created by a public employee retirement system and used to provide postemployment health care benefits for public employee retirees, and/or the costs of issuance of municipal securities.

Issuance of a Municipal Security

Under the bill, a county, city, village, or township, by resolution of its governing body and without a vote of its electors, could issue a municipal security to pay the costs of the unfunded actuarial liability of a public employee retirement system (PERS) pension fund of the municipality that the participants and beneficiaries of a PERS of the municipality were entitled to receive under agreements with the municipality (called a health care trust fund security, below). The amount of taxes necessary to pay the principal and interest on that municipal security, together with the taxes levied for the same year, could not exceed the limit authorized by law.

Before a county, city, village, or township issued a health care trust fund security, it would have to prepare and make available to the public a comprehensive financial plan that included all of the following:

- Evidence that the municipal security proceeds and required annual contributions would be adequate to meet the level of benefits required.
- An amortization schedule and a description of actions required to satisfy the schedule.
- Actuarial assumptions and a certification that the comprehensive financial plan was complete and accurate.
- Evidence that the issuance of municipal securities would result in projected present value savings.
- A plan from the PERS to reduce health care costs.

Publication of Intent; Referendum

Before a county, city, village, or township issued a health care trust fund security, it would have to publish a notice of intent to do so. The notice of intent would have to be directed to the electors of the county, city, village, or township, and be published in a newspaper with general circulation in the municipality. The notice would have to state the maximum amount of municipal securities to be issued; their purpose; the source of payment; the right of referendum on the issuance of the securities; and any other information the municipality determined necessary to inform the electors adequately of the nature of the issue. The notice of intent would have to be at least one-eighth page in size in the newspaper.

If, within 45 days of the publication of the notice of intent, a petition signed by at least 10% or 10,000 of the registered electors, whichever was less, residing in the municipality, were filed with the municipality's governing body requesting a referendum on the question of the issuance of the municipal securities, then the municipality could not issue the securities until authorized by the vote of a majority of the electors of the municipality qualified to vote and voting on the question at a general or special election. A special election called for this purpose could not be included in a statutory or charter limitation as to the number of special elections to be called within a period of time.

Terms, Size, & Maturity

Health care trust fund securities issued by a county, city, village, or township would have a maximum term of 30 years as determined by the municipality. Currently outstanding health care trust fund securities issued by a municipality could not exceed 5% of the State equalized valuation (SEV) of the property assessed in that county, city, village, or township.

Health care trust fund securities and the interest on and income from them would be exempt from taxation by the State or a political subdivision of the State.

A health care trust fund security could mature annually or be subject to mandatory redemption requirements, with the first annual maturity or mandatory redemption requirement to fall due five years or less from the date of issuance. Annual maturity and/or redemption requirements of the security after 10 years from the date of issuance could not be less than one-fifth of the amount of any subsequent annual maturity and/or redemption requirement.

A county, city, village, or township issuing health care trust fund securities could enter into indentures or other agreements with trustees and escrow agents for the issuance, administration, or payment of the securities.

Municipal General Fund Obligation

Municipal securities issued under Section 517 of the Act or under the bill would have to be secured by the general fund of the county, city, village, or township, and would have to include the phrase "general obligation limited tax" in the resolution authorizing the issuance. The county, city, village, or township issuing the municipal securities would not be authorized to levy any tax to pay for the securities if the tax were not authorized by law at the time the securities were issued.

(Section 517 allows a county, city, village, or township, by resolution of its governing body, and without a vote of its electors, to issue a municipal security to pay the cost of any capital improvement items, as long as the amount of taxes necessary to pay the principal and interest on the security, plus the taxes levied for the same year, do not exceed the limit authorized by law. Section 517 also requires publication of a notice of intent; requires a vote on the issuance if a sufficient number of petitions are filed; and prohibits municipal securities from exceeding 5% of the SEV of the property assessed in the municipality.)

MCL 141.2103 et al.

BACKGROUND

The Governmental Accounting Standards Board is an independent, private-sector, nonprofit organization that establishes standards of financial accounting and reporting for U.S. state and local governments. According to its website, governments and the accounting industry recognize the GASB as the official source of generally accepted accounting principles for state and local governments.

In May 2004, the GASB issued Statement 43, "Financial Reporting for Postemployment Benefit Plans Other Than Pension Funds", which addresses accounting by plans that administer OPEB. In August 2004, the GASB issued Statement 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions". Statement 45 establishes accounting and reporting requirements for state and local government employers that provide OPEB.

Under Statement 45, employers that participate in defined benefit OPEB plans must measure and disclose an amount for annual OPEB cost on the accrual basis of accounting. This cost is equal to the employer's annual required contribution to the plan, with certain adjustments if the employer has a net OPEB obligation for past undercontributions or overcontributions. The ARC is defined as the employer's required contributions for the year, calculated in accordance with certain parameters, and includes a) the normal cost for the year, and b) a component for amortization of the total unfunded actuarial accrued liabilities (or funding excess) of the plan over a period not to exceed 30 years. If a plan's method of financing does not meet the parameters (e.g., if the plan is financed on a pay-as-you-go basis), the parameters still apply for financial reporting purposes.

Employers that participate in defined contribution OPEB plans must recognize OPEB expense/expenditures for their required contribution to the plans and a liability for unpaid required contributions on the accrual or modified accrual basis, as applicable.

Implementation of Statement 45 will be phased in over a three-year period based on a government's total annual revenue in the first fiscal year ending after June 15, 1999. The Statement is effective for periods beginning after December 15, 2006, for governments with total annual revenue of $100 million or more; after December 15, 2007, for governments with total annual revenue of $10 million or more but less than $100 million; and after December 15, 2008, for governments with total annual revenue under $10 million.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

The bill would allow Oakland County and other local units of government to sell bonds in order to finance present and future health care benefits for their retirees. In the case of Oakland County, officials would like to pay off the county's entire unfunded actuarial accrued liability, which is close to $500 million, by selling bonds, depositing the proceeds in the county's health care trust fund, and investing the trust fund dollars in the stock market. According to Oakland County officials, this would enable the county to avoid reducing services in order to make its annual required contribution to the trust fund, and would produce new revenue for the county. County officials believe that they could sell the bonds at an interest rate of about 5.5% and earn interest on the investment at a rate of 7.5% or more. It is expected that the roughly 2.0% difference (the arbitrage earnings) would generate $145 million over the 20-year life of the proposed bonds.

Although current law allows local units to sell bonds for specific purposes, the law does not authorize the sale of bonds for retiree health care obligations, and the investment options presently available would not produce the level of income that could be earned in the stock market. For example, Oakland County could issue "certificates of participation", but these apparently are more difficult to market than bonds, resulting in higher interest paid to investors and lower arbitrage earnings. In addition, Public Act 20 of 1943 permits a local government to invest its surplus funds in U.S. government bonds and securities, certificates of deposit, savings accounts, and various other investment instruments. The Act does not, however, permit local units to invest funds in the stock market, which is the type of long-range investing that can best offset the soaring costs of health care benefits: something all local units are facing.

In Oakland County, each year from 1999 through 2005, actual health care costs for both retirees and active employees grew at an average annual rate of over 14%--a total cumulative increase of 86% during the six-year period. Over that time period, however, health care costs for active employees rose by 60% while actual retiree health care costs increased by 173%. It may be reasonable to believe that the same pattern exists statewide.

Also, in the next few years, all local units will be required to have an actuarial report showing their entire unfunded actuarial accrued liability and their annual required contribution, even if they continue to operate on a pay-as-you-go basis. Rather than showing a deficit, if a local unit does not make its ARC, the local unit might find it advantageous to prefund its retiree health care obligation. Issuing a municipal security would raise funds that could be deposited in the local unit's health care trust fund and invested in the stock market, generating income to repay the bond and make annual contributions to the trust fund.

In addition to allowing this investment mechanism, the bill contains several safeguards. A local unit would have to demonstrate that issuing municipal securities would result in savings, show that the bond proceeds and annual contributions would be adequate to pay for retiree health care benefits, and have a plan to reduce retiree health care costs. Also, the municipal securities could not exceed 5% of the SEV of assessed property in the local unit, and repaying the securities could not cause the local unit's tax burden to exceed the limit authorized by law. In addition, the issuance of the securities would require voter approval if sufficient petition signatures were submitted.

Response: The bill would not actually authorize a municipality to invest bond proceeds in stocks. A local unit would have that authority only if its retiree health care trust fund were created under the Public Employee Health Care Fund Investment Act, which authorizes municipalities to create such a fund and invest its assets in stocks and other investment instruments. The bill also does not specify that a local unit would have to deposit the proceeds of the bond issue into its health care trust fund. The bill should include this requirement and spell out how a local unit could invest the proceeds.

Opposing Argument

Selling bonds in order to buy stocks would carry the inherent risks of any investment in the market. If the investments did not perform as anticipated and failed to produce sufficient income to pay debt service and make required contributions to the health care trust fund, the local unit would find itself with a liability.

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

The bill would potentially increase both local unit revenue and expenditures by an unknown amount, as well as change the distribution and timing of revenue and expenditures. It is unknown how many local units have unfunded liabilities for the health care costs of retirees, or the number that would choose to issue securities to cover all or a portion of their unfunded liabilities. Furthermore, the impact on individual local units would vary depending on the amount of any unfunded liability, the number of current and future retirees, the economic structure of the community and its effect on future revenue, market returns that can be earned on funds, and future health care costs.

The bill likely would have no fiscal impact on State government.

Fiscal Analyst: David Zin