Legislative Analysis

HOUSE FISCAL AGENCY

Mitchell Bean, Director
Phone: (517) 373-8080
http://www.house.mi.gov/hfa

MUNICIPAL BONDS FOR RETIREE HEALTH CARE

House Bill 4451 (Substitute H-1)
Sponsor: Rep. James Marleau
1st Committee: Intergovernmental, Urban and Regional Affairs
2nd Committee: Retiree Health Care Reform

House Bill 5465 (Substitute H-1)
Sponsor: Rep. Marc Corriveau
Committee: Retiree Health Care Reform

House Bill 5466 without amendment
Sponsor: Rep. Mary Valentine
Committee: Retiree Health Care Reform

First Analysis (12-5-07)

BRIEF SUMMARY: The bills would amend the Revised Municipal Finance Act (MCL 141.2101 *et seq.*) to allow eligible counties, cities, villages, and townships to issue municipal securities (bonds) through September 30, 2010 to pay for the costs of unfunded accrued retiree health care benefits.

- House Bill 4551 would add definitions of "**health care trust fund**" and "**unfunded accrued liability**" to the act.

- House Bill 5465 would authorize eligible counties, cities, villages, and townships to issue municipal securities (bonds) to pay for the costs of unfunded accrued retiree health care benefits and set forth requirements and approval procedures for this type of bond issuance.

- House Bill 5466 specifies that the bonds issued would be secured by the general fund of the local unit and could include the phrase "general obligation limited tax" in the resolution authorizing the issuance. It also specifies that a local unit issuing securities without voter approval would not be authorized to levy any tax not authorized by law at the time of the issuance to pay for the municipal securities.

The three bills are tie-barred, meaning that none will go into effect unless all three bills are enacted.

FISCAL IMPACT: The bills may increase the short term revenue of local units of government by permitting bonding through the use of general obligation bonds to pay the cost of unfunded retiree health care obligations. The Michigan Municipal Employees Retirement System (MERS) reports that its 659 local government participants collectively owed $1.7 billion in unfunded actuarial accrued pension liabilities as of December 31, 2006. Of course, this short term revenue increase will result in higher future debt service payments to retire any such

bonding for up to 30 years, which is the normal maximum for municipal bonds. The proceeds of such bonds must be invested as provided for in the Public Employee Retirement System Investment Act.

The bills may also potentially increase the state's share of costs for the Medicaid program beginning in Fiscal Year 2009-10. According to the Department of Treasury's preliminary estimate, the additional Medicaid costs for the State of Michigan would be approximately $11 million annually for 3 years.

The federal Medicaid match rate is established based on each state's per capita income as determined by the Bureau of Economic Analysis. Currently, the federal share of Michigan's Medicaid costs is 58.10 percent. An employer's pre-funding contribution to a pension or health insurance fund through bonding or other mechanisms could be enough to significantly affect the calculation of state's personal income, thereby also lowering the federal Medicaid match rate and increasing Michigan's share of program costs. A previous pension pre-funding adjustment by General Motors for its employees and retirees reduced the Medicaid match rate by approximated 0.5 percent which cost the state an estimated $40-$50 million annually in lost federal Medicaid revenues.

Because the Medicaid match rate is based on a three-year rolling average of per capita income comparisons with other states, the impact of a significant increase in personal income would occur over three consecutive years. Due to the time lag in finalizing personal income data for all states and establishing federal Medicaid match rates, the earliest that any changes would likely affect Medicaid funding in Michigan is Fiscal Year 2009-10.

At this time, it is uncertain whether large lump sum employer pension and insurance contributions will continue to be used in calculating each state's personal income levels as it relates to Medicaid. It should be noted that legislation has been passed at the federal level, but not enacted, to disregard "significantly disproportionate employer pension or insurance fund contributions" in computing per capita income for Medicaid match rate purposes.

THE APPARENT PROBLEM:

Many Michigan counties, cities, and townships have promised retiree health care benefits to some of its former or current employees. Unlike traditional defined benefit pensions which are required by federal law to be funded over time, neither federal nor state law requires any prefunding of retiree health care benefits or other types of other (than pension) post-retirement employee benefits (sometimes referred to as "OPEB" benefits). Accordingly, many, but not all, of Michigan's local units of governments have paid for and reported retiree health care benefits on a "pay as you go" basis—paying for current retiree health care claims or premiums one year at a time without setting aside any money to be invested to help defray the cost of future benefits for current workers. The current year's premiums or claims are reported as the cost of providing the benefits.

Many government workers are reaching or approaching retirement age, and health care costs have been rising steadily. In light of dramatically rising costs of health care, and in light of new rules by the governmental accounting standards board (GASB) requiring the

disclosure of a local unit of government's total accrued post-retirement benefit liabilities in a footnote on municipal financial statements, many municipalities are reviewing the extent of their unfunded obligations and how best to meet them. The new GASB reporting and disclosure requirements became effective in 2007 for governments with annual revenues in excess of $100 million, and will begin in 2008 for those with annual revenues of $10 to $100 million, and in 2009 for those with revenues of less than $10 million.

In addition to the new GASB requirements, the SEC has encouraged municipalities to report OPEB liabilities in bond offering documents, or else risk being charged with withholding material information from investors. Some benefits consultants say that communities that do not prefund their retiree health care obligations in some fashion will have worse projected liabilities and their credit ratings will suffer, increasing the cost of municipal borrowing for other purposes such as construction projects.

Although some bond professionals and benefits consultants are urging municipalities to consider issuing municipal bonds as a method of obtaining capital to place in a fund to invest for retiree health care benefits, municipal bonds for this purpose are not currently allowed under Michigan municipal finance law. Because municipal bonds for this purpose are not currently allowed (and because a bill that would have allowed bond issuances for this purpose was pocket vetoed last session), at least one local unit of government, Oakland County, accomplished the same goal—setting aside funds for retiree health—by issuing certificates of participation for the same purpose. County representatives say, however, that issuing certificates rather than bonds required them to pay about $19 million dollars more to investors than had they been able to issue municipal bonds.

In short, the bill is intended to give communities with relatively stronger credit ratings (in the A category) an additional tool to deal with unfunded retiree health care liabilities. The proceeds from the bond issue would be placed in a trust, and, if all goes well, the trust's investment earnings will exceed the debt service payments that the local unit must make and the difference will help pay for the cost of providing retiree health care benefits. Some say this would save taxpayers money in contrast to the "pay as you go" system--because part of the cost of paying for future benefits would be covered by the fund's investment earnings.

THE CONTENT OF THE BILLS:

House Bill 4451

House Bill 4451 (Substitute H-1) would add definitions of "health care trust fund" and "unfunded accrued liability" to Section 103 of the act:

- "**Health care trust fund**" would mean a trust or fund created in accordance with the state Public Employee Health Care Fund Investment Act, or other state or federal statute, and used exclusively to provide funding for post-employment health care benefits for public employee retirees. The term also would include the retiree health fund vehicle administered by the Municipal Employees Retirement System for a local

unit of government that had adopted that system to provide funding for retiree health care benefits.

- "**Unfunded accrued liability**" would mean the difference between the assets and liabilities of a health care trust fund as determined by an actuarial study conducted under Governmental Accounting Standards Board Rule 43 or 45.

House Bill 5465

The bill would add Section 518 to the act to allow eligible counties, cities, villages, and townships, through September 30, 2010, to issue municipal securities (bonds) to pay for the costs of their unfunded accrued retiree health care liabilities. Eligible counties would be those with a credit rating in "the A category" (instead of "AA category" as originally drafted).

<u>Bond issuance not to be construed as contract</u>. The bill states that issuance of bonds to help pay for retiree health care benefits does not necessarily mean that the municipality is obligated to pay the benefits or cannot reduce them. A bond issuance under this act would not constitute a contract to pay for such benefits.

<u>Limited bond issuance authorized by resolution or ordinance without approval of local voters.</u> A bond issuance under Section 518(1) would be authorized by adoption of a resolution or ordinance and would *not* require approval of local voters, provided the amount of taxes needed to pay the principal and interest, together with taxes levied for the same year, did not exceed the limit authorized by law. (In contrast, under Section 518(3) a local unit could issue municipal securities pledging its unlimited taxes to pay the costs of an unfunded accrued liability with a resolution *and* the approval of local electors.)

<u>Public notice; petition for a referendum</u>. Before issuing the municipal securities, a local unit would have to publish a notice of intent meeting the requirements of Section 517(2) (the section of the act setting forth requirements for the issuance of municipal securities for the payment of capital improvement items generally), except that voters would have 60 days, instead of 45 as in the case of capital improvement bonds, after the publication of the notice of intent to file a petition for a referendum. A petition would need the signatures of at least five percent of registered electors, or 10,000 registered electors, whichever was less (instead of at least at least 10 percent of registered electors, or 15,000 registered electors, whichever is less, as in the case of capital improvement bonds).

<u>Use of proceeds; trust funds</u>. The bill would permit the proceeds of the municipal security issuance to be used to pay the costs of the bond issuance. The proceeds of the bond issuance would have to be deposited in (1) a health care trust fund; (2) a trust fund which has as its beneficiary a health care trust fund; or (3) in the case of a county, city, village, or township, a restricted fund within a trust that would only be used to retire municipal retiree health care securities. A local unit could create a new trust which would be required to invest its funds in the same manner as a health care trust fund, use generally accepted accounting principles, and maintain tax exempt status under the Internal Revenue Code.

Comprehensive financial plan. Before issuing the municipal securities, a local unit would also have to prepare and make available to the public a comprehensive financial plan. Such a plan would have to include:

- Evidence that issuance of the securities, together with other funds, will be sufficient to eliminate the unfunded accrued liability.
- A debt service amortization schedule and a description of the actions required to satisfy the schedule.
- A certification by the person preparing the plan that the comprehensive financial plan is complete and accurate.
- Documentation that the issuance of the municipal securities will result in projected present value savings regarding the unfunded accrued liability.
- A plan in place from the county, city, village, or township to mitigate the increase in health care costs, which could include a wellness program.

Limit on outstanding securities as a percentage of local property values. The municipal securities issued and outstanding (under either subsection (1) or (3)) could not exceed five percent of the state equalized valuation of the property assessed in the county, city, village, or township issuing the securities.

Indentures and other agreements. A local unit issuing municipal securities to pay for retiree health care could enter into indentures or other agreements with trustees and escrow agents for the issuance, administration, or payment of the municipal securities.

Limit on cumulative outstanding securities as a percentage of unfunded accrued liabilities. Municipal securities could not on a cumulative basis exceed 75 percent of current unfunded accrued liabilities for retiree health care benefits owed to employees of the local unit existing on the bill's effective date.

Eligible local units. A county, city, village, or township could not issue a security under the bill unless it had been assigned a credit rating in the A category or higher by at least one nationally recognized rating agency. (As introduced, the bill was limited to local units with a credit rating in the AA category.)

Projected investment earnings would have to exceed projected interest rate by at least one percent. A municipality could not issue securities under the bills unless the projected difference between the assumed rate of return on the health care trust fund investments and the projected actual interest rate paid on the municipal securities is not less than 100 basis points. [Note: 100 basis points is the equivalent of one percent.]

Treasury Department approval. A county, city, village, or township would have to obtain the approval of the Department of Treasury before it offers securities under the bills. The Department of Treasury would have to review the proposed issuance, and if it verified that the local unit met specified requirements, the department would have to approve the issuance of the securities.

House Bill 5466

House Bill 5466 specifies that the securities issued would be secured by the general fund of the local unit and could include the phrase "general obligation limited tax" in the resolution authorizing the issuance. It also specifies that a local unit issuing securities without voter approval would not be authorized to levy any tax not authorized by law at the time of the issuance to pay for the municipal securities.

BACKGROUND INFORMATION:

New GASB Accounting rules:

- *GASB Statement 45 on OPEB Accounting by Governments/A few Basic Questions and Answers*, http://www.gasb.org/project_pages/gasb_st45_basic_q&a.pdf

- *You Dropped a Bomb on Me, GASB,* Credit Suisse Report, March 22, 2007, *http://online.wsj.com/public/resources/documents/DroppedB.pdf*

ARGUMENTS:

For:

For some municipalities, a bond issuance could save taxpayers money. Although a bond issuance would not be appropriate for every municipality, for local units of government with financial expertise and solid credit ratings funding retiree health care obligations through a bond issuance could make sense—it could save tax dollars and safeguard the municipality's creditworthiness. The bond proceeds would be invested in a health care trust and allowed to grow over time with the expectation that some of future retiree health care costs would be paid out of investment earnings rather than revenue.

In light of GASB rule changes, municipalities that do not address their unfunded retiree health care obligations in some fashion, may have their credit ratings downgraded and thus borrowing for other purposes will cost more.

Response:

A bond issuance is a way for municipalities to borrow money to prefund these obligations. The bill contemplates that municipalities would then engage in a form of arbitrage--that is, the bond proceeds would be invested in equities and other investments that would be expected to earn at least one percent more than what the municipality would have to pay out to its bond investors. The problem, of course, is higher expected earnings are associated with riskier investments, so municipalities would be making a bet that their investments would exceed the costs of servicing the bond debt by at least one percent. Such a bet may or not be successful, especially when you factor in the high professional fees associated with a bond issuance and subsequent management of the trust into which the bond proceeds are placed. If the trust's investment's do not perform as expected, the municipality has traded a soft, flexible liability for a hard fixed liability (bond service payments) and has increased, rather than minimized, the costs of providing retiree health care for municipal employees.

Against:

The issuance of such bonds could reduce Medicaid funding for Michigan because of the way state personal income is determined by the federal Bureau of Economic Analysis. In past years, extraordinary pension contributions made by General Motors to its pension funds had the anomalous effect of reducing Michigan's Medicaid contributions from the federal government because of the way that the federal Bureau of Economic Analysis calculates state income. Some fear that if municipalities issue bonds and set aside large lump sums toward future retiree health care obligations, this sudden influx of funding into health care trusts might be treated similarly by the Bureau of Economic Analysis, and likewise reduce Michigan's federal Medicaid funding. [See Fiscal Impact earlier in the analysis.]

The Department of Treasury should be given a timeframe for approving a proposed issuance of municipal securities. The bills do not set a deadline by which the Department of Treasury must complete its review and approve or deny a proposed municipal bond issuance for retiree health care. Some municipalities would like to see the bills include such a deadline.

Municipalities should be allowed to issue bonds covering 100 percent of their unfunded accrued liabilities, not just 75 percent. Some municipalities would like to issue bonds covering 100 percent of their unfunded accrued liabilities. Others say, however, that allowing 100 percent funding might tempt some municipalities into thinking they can bond their way out of their OPEB liabilities and that allowing 100 percent funding would run the risk of "market timing."

The referendum period is too long. Some say that the public should be given 45 days, not 60, to file a petition for a referendum on the bond issuance. 60 days is longer than the 45 days that applies to capital improvement bond issues, for instance.

A taxpayer vote should be required. Some say that a municipality should not be allowed to issue bonds to fund retiree health care obligations without a popular vote.

POSITIONS:

The Department of Treasury testified that it was generally comfortable with the substance of the bills but seeks an amendment to require the Department of Treasury to certify that there would be no material reduction in Michigan's Medicaid funding before approving a bond issuance. (11-29-07)

City of Dearborn indicated its support of the bill. (11-29-07)

City of Farmington testified in support of the bill. (11-29-07)

City of Grand Rapids testified in support of the bill. (11-29-07)

Michigan Association of Counties indicated its support of the bill. (11-29-07)

Michigan Association of Public Employee Retirement Systems indicated its support of the bill. (11-29-07)

Michigan Government Finance Officers Association, Legislative Committee, testified in support of the bill. (11-29-07)

Michigan Health and Hospital Association testified in support of the bill. (11-29-07)

Michigan Municipal League testified in support of the bill. (11-29-07)

Municipal Employee Retirement System indicated its support of the bill. (11-29-07)

Washtenaw County indicated its support of the bill. (11-29-07)

Legislative Analyst: Shannan Kane
Fiscal Analyst: Richard Child
William Fairgrieve

■ 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.