Legislative Analysis

HOUSE FISCAL AGENCY
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STATE EMPLOYEE RETIREMENT REVISIONS

House Bill 4701 as introduced
Sponsor: Rep. Bill Rogers

House Bill 4702 as introduced
Sponsor: Rep. Chuck Moss
Committee: Appropriations

Complete to 6-9-11

A SUMMARY OF HOUSE BILLS 4701 & 4702 AS INTRODUCED 5-31-11

The bills would amend the State Employees' Retirement Act and the Public Employee Retirement Health Care Funding Act to make the following changes to State Employees' Retirement System (SERS) benefits beginning October 1, 2011:

- Eliminate the 3% employee contribution for retiree health care required of all employees since 2010 and refund contributions to employees.
- Require employees in the SERS pension or defined benefit (DB) plan to choose between remaining in the plan and contributing 4% of their compensation toward the plan or freezing their pension benefit and continuing their future service under the SERS 401(k) or defined contribution (DC) plan.
- Allow the State Budget Director to waive the requirement that retirees suspend their pension if they are directly or indirectly reemployed by the State.
- Eliminate retiree health insurance for employees in the DC plan hired after March 31, 1997, (excluding former DC employees with more than 10 years of service, who have retired and are currently receiving the health insurance benefit).
- Provide DC plan employees (other than those excluded above) a lump sum contribution into a health reimbursement account upon retirement from the State in lieu of retiree health insurance. For employees with more than 4 years of service, the amount would be calculated as described below. For those with fewer than 4 years of service or new employees, the amount would be $2,000.
- Establish health reimbursement accounts for employees within the irrevocable health care trusts established in 2010 to receive and hold employer and employee contributions for retiree health benefits or reimbursement of medical expenses.
- Exclude overtime pay from the definition of compensation, thereby excluding overtime pay from an employee's pension calculation and compensation for the purposes of calculating employee contributions into the pension plan.

The bills are tie-barred to each other so that neither could go into effect unless the other were also enacted into law. A detailed description of each bill follows, and a fiscal analysis of the bills begins on page 6.

House Bill 4701

House Bill 4701 would amend the State Employees' Retirement Act (MCL 38.1 et al.) to make the following changes to SERS benefits:

Eliminate Mandatory 3% Employee Contribution for Retiree Health Care
PA 185 of 2010 began requiring in November 2010 that all employees in SERS contribute 3% of their compensation into an irrevocable trust for retiree health care costs. The employee contributions are currently being held in an escrow account pursuant to *AFSCME, et al. vs Michigan State Employees' Retirement System, et al.* while the legality of the mandatory contributions is litigated. House Bill 4701 would cease these contributions as of October 1, 2011, and would refund the contributions to employees with any actual interest earned on those contributions in a manner to be determined by the State Budget Director and the retirement system.

Require 4% Employee Contribution to Remain in Defined Benefit (DB) Pension Plan
House Bill 4701 would require that employees currently in the DB pension plan choose between contributing 4% of compensation toward pension costs beginning October 1, 2011, and remaining in that plan or freezing the service they have earned in the pension plan and converting to the DC 401(k) plan for future service.

Employees could elect to contribute 4% and remain in the DB pension plan until retirement or could designate that the 4% contribution would continue only until their attainment date, which the bill would define as the day they reach 30 years of service, at which point their pension benefit would be frozen and they would transition into the DC 401(k) plan for any additional service. Employees who are employed as of June 30, 2011, would have to make the election during the specified period of July 1, 2011, through August 31, 2011, including the designation of the 4% percent contribution as permanent or continuing only until their attainment date. Elections and designations could be rescinded until August 31, 2011. Contributions would be made through pre-tax payroll deductions.

Employees who elect to make the contribution, but designate that it would end on their attainment date, would have their service and compensation, for the purposes of calculating their pension, frozen as of their attainment date and would become a qualified participant in the DC 401(k) plan as of the day after their attainment date. Credited service would include service accrued as of their attainment date, applicable military service credit, service credit purchased as of their attainment date, and service credit purchased under a payment plan that is in effect as of their attainment date.
Compensation for the purposes of calculating the pension for an employee who elects to make the contribution and makes this designation would include compensation received as of their attainment date as well as 240 hours of accrued annual leave paid at separation multiplied by the hourly rate of pay for the member on their attainment date, which for the purposes of calculating a final average compensation, would be treated as having been paid on their attainment date.

Employees who do NOT elect to make the contribution would have their service and compensation, for the purposes of calculating their pension, frozen as of September 30, 2011, and would become a qualified participant in the DC 401(k) plan as of October 1, 2011. Credited service would include service accrued prior to October 1, 2011, applicable military service credit, service credit purchased prior to October 1, 2011, and service credit purchased under a payment plan that is in effect as of September 30, 2011. Compensation for the purposes of calculating the pension for an employee who elects not to make the contribution would include compensation received prior to October 1, 2011, as well as 240 hours of accrued annual leave paid at separation multiplied by the hourly rate of pay for the member on September 30, 2011, which for the purposes of calculating a final average compensation, would be treated as having been paid on September 30, 2011.

For both groups of employees who transfer into the DC 401(k) plan, either as of October 1, 2011, or as of their attainment date, their years of service would be used toward the 401(k) vesting schedule. They would be vested immediately in their own contributions and would be 100% vested in employer contributions as long as they had accrued more than 4 years of service, which is likely to include all employees in the DB plan.

For certain employees who are not currently employed by the State, the impact would be as follows:

- _A former employee, who is vested in the DB pension plan_, and returns to State employment after July 1, 2011, would be treated like an employee who did not elect to make the contribution and would have their former service and compensation frozen and would become a DC member for future service.

- _A former nonvested employee_ who returns to State employment after July 1, 2011, would not be a member of the DB pension plan and would be treated as having been first employed as of his or her date of reemployment and would therefore be in the DC 401(k) plan.

- _A former employee in the Michigan Public School Employees Retirement System_ (MPSERS) who begins employment with the State after July 1, 2011, would be in the DC 401(k) plan.

Defined Contribution (DC) Health Care Revisions

Currently employees in the DC 401(k) who were hired on or after March 31, 1997, vest into a graded premium health insurance coverage after completing 10 years of service. They earn an employer contribution of 3% of the insurance premium for the health care insurance provided by SERS for each year of service completed, up to a maximum of 90% after 30 years. Employees become eligible to elect health insurance coverage after they reach age 55 if they have 30 years of service or age 60 if they have 10 years of service. Employees are not currently required to retire from the State in order to receive an earned benefit.

House Bill 4701 would eliminate retiree health insurance coverage for most of these employees in the DC 401(k) who were hired on or after March 31, 1997. The bill would not affect health care benefits for employees who were hired prior to March 31, 1997, and were originally members in the DB pension plan and transferred into the DC 401(k) plan either when it opened in 1997 or under the pension plan changes described above.

House Bill 4701 would create one exception and maintain these benefits for a *former employee in the DC plan who has completed 10 years of service and who has retired and is already receiving the DC health benefit as of September 30, 2011*. Since employees currently have a maximum of 14 years in the DC plan, this equates to an employer paid premium share of between 30% and 42%. The bill would change the words "vested in" to "eligible for" in regard to the provided health insurance coverage.

House Bill 4701 would provide a monetized lump sum payment into a health reimbursement account (HRA) created under House Bill 4702 based on the actuarial formula described below for the following two employee groups:

- *An employee in the DC plan who has completed more than 4 years of service and is currently employed as of September 30, 2011*. The deposit would be made once he or she is at least 55 years old with 30 years of service or 60 years old with 10 years of service at termination of employment. An employee would be eligible for the deposit if he or she is employed by the State immediately prior to retiring without previously having left State employment for more than 60 consecutive months after October 1, 2011.

- *A former employee in the DC plan who has completed 10 years of service, left state employment, and is NOT receiving a DC health benefit as of September 30, 2011*. The deposit would be made once they reach age 55 with 30 years of service or age 60 with 10 years of service. They would be eligible for the deposit either if they are never reemployed by the State or if they are reemployed by the State in the future, as long as they do not separate from the State for longer than 60 consecutive months after their subsequent reemployment and they retire from the State.

House Bill 4701 would calculate the monetized lump sum to approximate the actuarial present value as of September 30, 2011, of the projected retirant health benefit based on the current benefit structure and the employee's years of service as of September 30, 2011. The amount would be equal to the product of an average monthly premium of $1,000 payable for the life of the employee times the frozen employer premium share percentage (equal to 3% times the number of years of service) times a deferred life annuity factor (equal to the present value as of September 30, 2011, of $1.00 per month payable for the life of the employee). The deferred life annuity factor is based on the following actuarial assumptions:

- An interest discount rate of 4% annually, which approximates the use of an assumed investment rate of return of 8% combined with an assumed annual growth rate for average premium costs of 4%.

- Mortality rates based on 50% Male - 50% Female blend of the 1994 group mortality table.

- Commencement of the deferred life annuity based on an employee retiring at the earliest date under which they would have been eligible to begin receiving health benefits under the current benefit structure.

Under House Bill 4701 the amount calculated above for each employee would be increased at a special yearly interest rate until the date they retire from the State. The special yearly interest rate would be calculated annually equal to the change in the consumer price index (CPI) from each year to the next, but the rate would not be less than 0% and would not be allowed to exceed 3%.

See Appendix for examples of what the monetized amount would equate to for various employees as calculated by the Office of Retirement Services.

Rather than calculating a monetized lump sum based on currently accrued years of service, House Bill 4701 would deposit a lump sum of $2,000 into an HRA for the following employee groups:

- *An employee in the DC plan who has completed fewer than 4 years of service and is currently employed as of September 30, 2011 or an employee newly hired after September 30, 2011*. The deposit would be made once he or she is at least 65 with 10 years of service at termination of employment. An employee would be eligible for the deposit if he or she is employed by the State immediately prior to retiring without previously having left State employment for more than 60 consecutive months after October 1, 2011.

- *A former employee in the DC plan who has completed fewer than 10 years of service and left state employment prior to September 30, 2011*. The deposit would be made once they reach age 65 with 10 years of service at termination of employment. They would be eligible for the deposit if they are reemployed by the State in the future, as long as they do not separate from the State for longer than 60 consecutive months after their subsequent reemployment, and they retire from the State.

Exclude Overtime Pay from Compensation

House Bill 4701 would change the definition of compensation for the purposes of calculating a pension allowance and the purposes of employee contributions toward the pension to exclude payment for overtime services rendered beginning October 1, 2011. This would reduce future pension allowances for employees who perform significant overtime service but would also reduce the compensation on which the 4% employee contribution for pensions would be applied.

Retirees who Return to State Employment
PA 95 of 2007 required that as of October 2, 2007, a former employee who retires and returns to work (directly or indirectly) for the State has their pension suspended during the period they are reemployed by the State to prohibit what is often referred to as "double dipping". House Bill 4701 would allow the State Budget Director to waive this requirement to engage the services of a retiree if the State Budget Director determines that the retiree possesses specialized expertise and experience necessary for that engagement and that the engagement is the most cost-effective option for the State.

House Bill 4702

House Bill 4702 would amend the Public Employee Retirement Health Care Funding Act (MCL 38.2731 et al.) to create individual health reimbursement accounts (HRAs) within the irrevocable health care trusts created under PA 77 of 2010. The HRAs would hold the one-time lump sum employer contributions toward retiree health care costs as calculated and provided upon retirement to applicable DC employees under House Bill 4701.

Additional employer contributions and any future mandatory employee contributions as required by each applicable retirement act could also be deposited in the HRAs. Currently, voluntary employee contributions are not permitted for deposit into an HRA due to its tax-exempt status; however, House Bill 4702 would allow voluntary employee contributions to be deposited into an HRA if they are determined to be permitted by both state and federal laws in the future.

Funds deposited into an HRA for the benefit of a former employee could be used for the reimbursement of medical expenses after retirement for the former employee or their dependents. House Bill 4702 defines an eligible medical expense as an expense that otherwise would qualify under Section 213(d) of the Internal Revenue Code and is not reimbursed by any other source.

An employee would be 100% vested in employee contributions immediately, and would vest in employer contributions into an HRA based on the same schedule as employer contributions into the DC plan: 50% after earning 2 years of service, 75% after earning 3 years of service, and 100% after earning 4 years of service.

FISCAL IMPACT:

House Bill 4701 would create both quantifiable short-term savings as well as long-term savings, which cannot be precisely quantified, for the State due to various provisions of the bill, which are described in more detail below.

Eliminate Mandatory 3% Employee Contribution for Retiree Health Care
The requirement of an employee contribution of 3% of compensation toward retiree health care costs under PA 185 of 2010 was intended to reduce the current State costs for providing these benefits. At the time, the 3% employee contribution was expected to

generate approximately $75 million Gross ($30 million GF/GP) in savings in FY 2010-11 and nearly $82 million Gross ($33 million GF/GP) annually for FYs 2011-12 and 2012-13. The elimination of the 3% contribution would eliminate these savings; however, the State is not currently realizing those savings because of the injunction in *AFSCME, et al. vs Michigan State Employees Retirement System, et al.*

Require 4% Employee Contribution to Remain in DB Pension Plan
If 100% of the current employees in the DB pension plan choose to remain in the DB pension plan and contribute 4% of their compensation toward pension costs, it would save the State approximately $50 million Gross ($25 million GF/GP) for the first year. The annual savings would diminish each year as the proportion of State employees in the DB pension plan decreases. The Office of Retirement Service (ORS) estimates that it would save the State between $300 million and $350 million cumulatively over the next 15-20 years until the point at which there are no longer any active employees in the DB pension plan. To the extent that some employees choose not to pay the 4% and instead freeze their pension benefits and move into the DC 401(k) plan for future service, the State may not realize the full potential savings from the 4% employee contribution in the near term but would experience long-term savings as future pension obligations would decrease.

Defined Contribution (DC) Plan Health Care Revisions
House Bill 4701 would create an indeterminate amount of future savings for the State related to future retiree health care obligations by doing the following:

- Eliminating the health insurance premium coverage currently provided to employees in the DC plan who were hired on or after March 31, 1997.

- Converting the currently earned benefit of employees with more than 4 years of service into a monetized lump sum payment to be deposited into an HRA and capping the growth of the present value of that payment at the rate of inflation or 3%, whichever is less, and requiring that an employee retire from the State in order to receive that payment.

- Providing a lump sum of $2,000 for new employees or those with fewer than 4 years of service to be deposited into an HRA upon retirement.

For the most part the State would not begin to realize these savings for at least 15 years until a substantial number of employees in the DC plan, who currently have a maximum of 14 years of service, begin to reach retirement age. However, the changes above would have one immediate fiscal impact for the State related to a recent change in the anticipated funding method for retiree health care.

As background, currently the State funds retiree health care on a pay-as-you-go basis rather than pre-funding future retiree health obligations. The Governor and Legislature have agreed, as part of the budget agreement, to begin pre-funding the future retiree health care liabilities in FY 2011-12 in order reduce future unfunded liabilities. According to the Office of Retirement Services, based on current benefits, this will

require an increased payment of $316 million, in addition to the $420 million currently expended for retiree health care. This is the minimum amount necessary to meet the Annual Required Contribution (ARC) that will trigger the change in the accounting method used to determine future unfunded liabilities. The change in accounting method allowed by the budget agreement to begin pre-funding will reduce the future unfunded liabilities from $14.7 billion to $9.1 billion.

The changes proposed for retiree health care in House Bill 4701 would reduce the amount required for the increased pre-funding payment by $50 million from $316 million to $266 million. These estimates include both Federal and State fund sources; the impact related to the General Fund is likely to be half or approximately $25 million.

Unfunded Accrued Liability Employer Contribution Rate

House Bill 4701 would revise the payment schedule for the unfunded accrued liability (UAL) associated with SERS retirement benefits, which is currently based on and applied to the DB portion of payroll for each state department, in order to spread the UAL over both DB and DC portions of payroll. This would solve the issue of how to charge departments for retirement contributions created by the bill once some employees are in both the DB plan at a frozen level for past service and the DC plan for current service. Now that the DB proportion of all employees is less than half of the total, this would also serve to lower the UAL contribution rate by applying it to the entire SERS payroll and applying it across all departments equally. Currently departments that have a disproportionately higher share of high seniority staff in the DB plan experience higher retirement costs than departments with more employees in the DC plan. This would not have an overall fiscal impact on the state but would change the distribution of retirement costs among state departments.

Office of Retirement Services Appropriation

House Bill 4701 would also appropriate $1,900,000 for FY 2010-11 for the Office of Retirement Services in the Department of Technology, Management and Budget to administer the changes proposed in the bill and would designate the appropriation as a work project which would allow funds unexpended at the end of FY 2010-11 to be carried forward into FY 2011-12 for the same purpose.

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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

APPENDIX

House Bill 4701 As Introduced
State Employees' Retirement System - DC Retiree Health Benefit Monetization

Examples Calculated by the Office of Retirement Services for Illustration Purposes

Case	Current Age	Current Service	Frozen Accrual Percent	Normal Retirement Age (NRA)[1]	Lump Sum Present Value In 2011[2]	Lump Sum at NRA If Still Employed [2] 3% Interest Credit [3]
A	25	5	15%	55	$8,506	$20,646
B	35	5	15%	60	$9,089	$19,030
C	35	13	39%	55	$32,928	$59,472
D	45	5	15%	60	$13,582	$21,160
E	45	13	39%	60	$35,312	$55,015
F	55	5	15%	60	$20,556	$23,830
G	55	13	39%	60	$53,445	$61,957
H	60	5	15%	65	$17,619	$20,425
I	60	13	39%	60	$66,642	$66,642

[1]Future service is used to determine the normal retirement age. Normal retirement age for all members is the earlier of age 55 with 30 years of service, or age 60 with 10 years of service. Special retirement conditions for Corrections Officers and Conservation Officers are not considered.

[2]Lump sum is not available until normal retirement age, assuming member is still employed at that time.

[3]Lump sum at normal retirement age depends on actual annual interest credits, which will equal the annual increases in the Consumer Price Index, with a maximum annual credit of 3%. The maximum annual 3% interest credit is shown in the examples above.

Notes:

1. The monthly single life premium at normal retirement age is assumed to be $1,000. The interest discount for all future years is 4% per year (designed to reflect an assumed 8% investment rate of return and a 4% health insurance premium increase assumption).
2. The mortality table used is a 50% - 50% Male/Female blend of the 1994 Group Annuity Mortality Table set forward 1 year for both males and females.