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BILL ANALYSIS

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Senate Bills 407 and 408 (as introduced 6-7-11)
Sponsor: Senator Roger Kahn
Committee: Appropriations

Date Completed: 6-21-11

CONTENT

Senate Bill 408 would amend the State Employees' Retirement Act in numerous ways, including requiring new contributions for State employees currently in the Defined Benefit (DB) plan (if those 20,000 employees wanted to remain in the DB plan accruing service credit), and creating a new system of retiree health care for State employees hired on or after March 31, 1997, and currently in the Defined Contribution (DC) plan (around 30,000 employees). Specifically, the bill would do the following:

- Require DB employees to contribute 4.0% of salary if they wanted to remain in the DB plan for the purpose of accruing years of service and compensation levels for calculation of a pension.
- Require DB employees who decided to remain in the DB plan and make 4.0% contributions to specify whether they would do so only until reaching 30 years of service or terminating employment if prior to 30 years, or would make the contributions until they left employment with more than 30 years of service.
- Freeze a DB employee's years of service and compensation for the purpose of the employee's pension calculation (continuing to accrue service toward eligibility) at the levels on September 30, 2011, if the employee chose not to make the 4.0% contribution; and place the employee into the State's DC plan until termination or retirement.
- Rescind and refund the existing 3.0% State employee contributions for retiree health care, by October 1, 2011.
- Provide State coverage of health care premiums only for vested DB employees, or for DC employees who retire and are receiving health care coverage by September 30, 2011; and eliminate retiree health insurance for all other employees in the DC plan hired on or after March 31, 1997.
- Stop the accrual of service credit for purpose of vested (with four years or more of service) DC employees' graded health care premiums, and calculate vested DC employees' service to date as an amount to be credited to a health reimbursement account only upon retirement from the State (age 60 with 10 years of service, or age 55 with 30; benefits are not portable).
- Eliminate any health care obligation for nonvested DC employees (those with fewer than four years as of September 30, 2011), or new DC employees hired on or after October 1, 2011, and provide a $2,000 credit into a health reimbursement account upon retirement from the State at age 65 with at least 10 years of service.

The bill also would do the following:

- Allow for "double-dipping" if the State Budget Director determined that the retirant had specialized experience that made the reappointment the most cost-effective option for the State.
- Exclude overtime pay earned October 1, 2011, or later from the definition of compensation, thereby not including overtime pay in the calculation of a pension or the 4% contribution paid by members electing to remain in the DB plan.
- Provide for the unfunded accrued liability to be spread over both the DB and DC payrolls, thereby ensuring more equity among departments regardless of their percentages of DB and DC payrolls.
- Appropriate $1.9 million to the Office of Retirement Services for implementation.

The bill is tie-barred to Senate Bill (S.B.) 407.

<u>Further Discussion of Pension Changes for Members of the Defined Benefit System</u>

Senate Bill 408 would require members of the DB part of the State Employees' Retirement System (members hired before March 31, 1997, who did not elect to become participants in the Tier 2 DC plan) to make a designation between July 1, 2011, and August 31, 2011, whether they would continue as members of the DB plan or whether they would freeze their service credit and compensation level as of September 30, 2011, and become participants in the DC plan. If a member designated to remain part of the DB system, he or she would have to pay 4.0% of his or her compensation to the pension trust. An employee who did not elect to remain in DB would be placed in the DC plan.

A member choosing to pay 4.0% of compensation in order to remain in the DB plan would be allowed to designate whether that payment would continue until the member reached the "attainment date", i.e., either 30 years of service, or termination, whichever occurs first. A member who did not make such a designation, would continue to pay the 4.0% of compensation and accrue service credit until retirement. In other words, there would be three options for a DB member choosing to pay 4.0% and remain in the system: pay 4.0% until reaching 30 years of service and then switch to DC; pay 4.0% until termination prior to 30 years of service; or pay 4.0% until retirement that would occur after 30 years.

A member choosing to pay 4.0% of compensation in order to remain in the DB plan would use his or her compensation level at the time of reaching the attainment date or retiring (as designated) for purposes of calculating the member's pension. An employee's yearly pension is calculated by multiplying years of service times 1.5% times the employee's final average compensation (FAC). The FAC is based on the three consecutive years of the employee's highest compensation, and the FAC includes the value of the employee's leave payout for up to 240 hours of leave time only if the employee's final three years of employment are used in his or her FAC. Under this bill, up to 240 hours of annual leave held at separation could be included in the FAC, but at the rate of pay as of September, 30, 2011, the attainment date or retirement, as applicable.

Members who did not elect to contribute 4.0% would have their service credit frozen as of October 1, 2011. Their frozen service credit would include earned service to that point, military service, service credit purchased before October 1, 2011, and any service being purchased in tax deferred payment plans already in progress. Also, members who did not elect to contribute 4.0% would have their compensation for the purpose of calculating FAC frozen as of September 30, 2011. Further, up to 240 hours of annual leave held at separation could be included in the FAC, but at the rate of pay as of September 30, 2011. Service credit would continue to accrue for these members, but only for the purpose of determining retirement eligibility.

Members who did not elect to contribute 4.0% would become part of the State's DC plan for their remaining years of service.

However, such members would not see a change in their retiree health benefits.

Under the bill, DB members who worked before 1997 but are currently not actively working could return to work by July 1, 2011, and could elect to remain in DB (and contribute 4.0%) or move to DC. However, anyone returning to work after July 1, 2011, would not get to make this election, and instead would become part of the DC plan.

The service credit of deferred members (those vested, but who have left State employment and are not yet drawing retirement benefits) reemployed on or after July 1, 2011, would be frozen under Senate Bill 408 and the members placed into DC if they return to work for the State. Nonvested, nonworking DB members who come back to work for the State would be placed into DC and would not receive any monetary credit for their former DB service, though their DB service would count toward vesting in the DC plan. Also, deferred school employee (MPSERS) members who start working for the State would be placed into DC.

Further Discussion of Retiree Health Changes for Participants in the Defined Contribution System

Senate Bill 408 proposes substantial changes to retiree health care for employees hired by the State on or after March 31, 1997 (those in the DC plan who did not switch from the DB plan). Under current law, DC participants are subject to a graded health care premium, as follows: with 10 years of service, the State pays 30.0% of the health care premiums, and with each additional year of service, the employee earns another 3.0% of State cost sharing, for a maximum of 90.0% coverage after 30 years of service. However, employees hired on or after April 1, 2010, are capped at 80.0% State coverage, rather than 90.0% maximum State coverage for employees hired before that date. Under current law, DC employees are not required to retire from the State in order to receive retiree health care benefits, but do have to work at least 10 years to vest, and be at least age 55 with 30 years of service, or age 60 with 10 years of service before drawing those benefits. (Eligibility qualifications are different for corrections and conservation officers.)

The bill proposes to eliminate the graded health care coverage, and instead "monetize" the amount of premium earned so far, but only for DC participants with at least four years of service. For these DC employees, the Office of Retirement Services would calculate an amount to be credited to an individual's health reimbursement account at termination, based on his or her years of service. However, a DC employee would have to retire from the State in order to receive this credited amount, with either 30 years of service and age 55 or 10 years of service and age 60. Therefore, unlike a DC participant's 401k assets, the value of the health care credit would not be portable; the employee would have to be eligible and retire from the State in order to receive the monetized value for health care benefits earned to date.

The credit would be based upon years of service, an average monthly premium of $1,000 payable for life, and a deferred life annuity factor, and this amount would have to be increased with interest each year. Please see Table 1 for estimates of health reimbursement account credits, based upon varying years of DC service to date.

The State would cease to provide any health care benefit or credit for future years of service worked by a DC employee. The State's health care liabilities would be truncated at the monetized value of health care premium cost sharing earned as of September 30, 2011 (with adjustments for inflation), and any future years of service would not generate additional State payment, credit, or State cost-sharing of a DC retiree's health care.

For DC employees with less than four years of service as of September 30, 2011, or for new DC employees first hired on or after October 1, 2011, the State would credit their health reimbursement account $2,000 when the employee retired from the State no earlier than age 65 with at least 10 years of service.

Senate Bill 407 would amend the Public Employee Retirement Health Care Funding Act to establish individual health reimbursement accounts that would receive the monetized credits for DC retirees described above, $2,000 deposits for nonvested or new DC employees retiring from the State, or other mandatory or optional contributions by employers and employees, for the purpose of paying retiree health care costs. The bill is tie-barred to S.B. 408.

MCL 38.2731 et al. (S.B. 407)
38.1b et al. (S.B. 408)

Table 1

SERS - Tier 2 Retiree Health Benefit Cash-Out Proposals - Examples						
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 Then[2] 3% Interest Credit[3]**
1	29	4	12%	55	$7,977	$17,203
2	52	13	39%	60	$47,079	$59,638
3	25	5	15%	55	$8,506	$20,646
4	35	5	15%	60	$9,089	$19,030
5	35	13	39%	55	$32,928	$59,472
6	45	5	15%	60	$13,582	$21,160
7	45	13	39%	60	$35,312	$55,015
8	55	5	15%	60	$20,556	$23,830
9	55	13	39%	60	$53,445	$61,957
10	60	5	15%	65	$17,619	$20,425
11	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:
The monthly single life premium at normal retirement age is assumed to be $1,000. The interest discount for all future years is 4.0% per year (designed to reflect an 8.0% interest discount and a 4.0% premium increase assumption).
The mortality table used is a 50% - 50% Male/Female blend of the 1994 Group Annuity Mortality Table set forward one year for both males and females.

Source: Office of Retirement Services

FISCAL IMPACT

4.0% DB Employee Contributions or Switching to DC

There are several components to Senate Bill 408 that would have an impact on the State. First, related to the 4.0% employee contributions to remain in the pension system, if all DB members chose to remain in DB and pay the 4.0%, the State would see savings of around $56.0 million. Savings would continue as long as there were DB members to pay the 4.0%, with estimated savings over the next 15 to 20 years of $300.0 million to $350.0 million. If all DB members chose to freeze their DB service and move to DC, the first-year savings would be around $50.0 million, and long-term liabilities would be decreased by around $500.0 million.

Rescinding and Refunding of 3.0% Contributions for Retiree Health Care

Regarding the rescinding and refunding of all State employees' 3.0% contributions for retiree health, there is currently a lawsuit on this contribution, with employees' contributions held in escrow. Therefore, at

the current time, the State is not realizing savings from the 3.0% contributions. However, if the lawsuit were to find in favor of the State, and the State could collect the 3.0% retiree health contributions and use those funds for paying retiree health care, then the elimination of this payment under S.B. 408 would result in lost or foregone revenue of about $85.0 million annually, for the three years that contribution is required to be paid.

Capping and Monetizing of Earned Health Care Coverage for DC Employees

With the proposed change capping DC employees' health benefits at levels earned to date, and requiring those employees to actually retire from the State in order to receive any credits deposited to their health reimbursement accounts, it is estimated that the annual required contribution for health care for the monetized population would be $50.0 million less than under current law. These savings are based on the two factors: one, the capping or freezing of health care at today's levels and not allowing DC employees to accrue more State coverage; and two, the expectation that a certain portion of the DC employees will not remain with the State their entire careers and will not retire from the State, and therefore would not have their monetized health care deposited into a health reimbursement account.

There are additional significant savings that would accrue to the State from the proposal to pay only $2,000 into a currently nonvested or new DC employee's health reimbursement account upon the employee's retirement from the State (no earlier than age 65 with at least 10 years of service). At a minimum, under current law, DC employees vest in retiree health care benefits at 10 years of DC service, with State premium cost-sharing of 30.0%. Monetizing that minimal vested amount would give a present value today of about $17,000, or about $40,000 at retirement. Clearly, paying $2,000 at retirement compared with $40,000 under current law for a minimally vested DC employee would yield significant savings, which would be even larger if an assumption is made that a DC employee will work longer than 10 years and earn a larger amount of State coverage under the existing graded health care.

Prefunding of Health Care Benefits

Michigan currently funds retiree health care on a "pay as you go" basis, and will continue to do so unless and until the system is considered fully prefunded (like the pension system). Michigan's actual FY 2011-12 "pay as you go" State retiree health care spending is expected to be around $420.0 million, which is paid for by charging State departments an amount levied against payroll.

On its own, this package of bills does not constitute prefunding. Only when a state meets the annual required contribution (ARC) does "prefunding" occur, which then allows the state to reduce its accounting of retiree health care liabilities. The ARC is a measurement of the necessary yearly contribution today in order to have enough funding available in the future to pay for the obligations incurred to date. The State and the actuary set the retirement contribution rates in order to meet the ARC for pensions, but, until now, have not attempted to meet the ARC for retiree health care. The State employee retiree health care ARC for FY 2011-12 is $736.0 million, or $316.0 million above the "pay as you go" level.

For Michigan, if S.B. 408 were enacted, then the fiscal year 2011-12 ARC would fall by $50.0 million from $736.0 million to $686.0 million, and if that level of spending on retiree health occurred, then the State's retiree health care liability (also known as OPEB, or other postemployment benefits, liability) as reported on the State's financial reports would fall from $14.7 billion to $9.1 billion. However, this does not translate to a reduction in current-year State costs, and in fact would represent an increase in short-term costs, since the pay as you go cost is $420.0 million, but meeting the ARC of at least $686.0 million (reflecting the changes under S.B. 408) would require an additional $266.0 million above minimal funding levels.

As part of budget target negotiations, the Administration and Legislature agreed to set

aside $140.0 million GF/GP to pay for OPEB liabilities, with a further $140.0 million in other fund sources likely to be matched. This $280.0 million, along with the estimated $50.0 million in ARC savings under S.B. 408 would provide sufficient funding for accounting rules to consider Michigan as meeting its ARC for the upcoming year, and the financial reporting of OPEB liabilities would decline from $14.7 billion to $9.1 billion. However, if S.B. 408 were not enacted, the State could still choose to prefund retiree health, but would need to fund the ARC of $736.0 million, rather than the ARC of $686.0 million if S.B. 408 were enacted.

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.