Legislative Analysis

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MPSERS – NEW HYBRID AND NEW DC PLANS

Senate Bill 401 as enacted *PA 92 of 2017*
Sponsor: Sen. Phil Pavlov
Senate Committee: Education
Complete to 7-20-17

BRIEF SUMMARY:

Senate Bill 401 would amend the Public School Employees Retirement Act (the Act) to

- Close the Michigan Public School Employees' Retirement System (MPSERS) hybrid pension plan, which has been in place since 2010, to newly hired employees as of February 1, 2018.

- Replace it with an optional revised hybrid plan that has the same benefit calculations but includes a 50/50 cost share between the employee and employer, including the costs of future unfunded liabilities, as well other revisions to the retirement eligibility age, plan assumptions, and unfunded liability payment methods.

- Create a trigger under which the new hybrid plan would be closed to new employees if the actuarial funded ratio falls below 85% for two consecutive years.

- Replace the current optional DC plan, which offers a 50% employer match capped at 3% of an employee's compensation, with a DC plan that would mirror the current plan for state employees, with an automatic employer contribution equal to 4% of a participant's compensation plus a 100% matching contribution capped at an additional 3% of a participant's compensation.

- Eliminate the purchase of service credit (other than credit for active duty in the armed forces) in the Basic and Member Investment Plans for employees hired prior to July 1, 2010 unless the purchase is initiated by September 29, 2017.

- Revise certain funding provisions related to the current pension plan.

The bill is described in more detail later in the summary.

BRIEF FISCAL IMPACT:

The bill would increase costs related to providing retirement benefits by $23 million in FY 2017-18 according to estimates provided by the Office of Retirement Services. The costs would grow annually as the number of employees in the new hybrid and DC plans grows. A number of other provisions would decrease the potential risk for future growth in unfunded liabilities. A more detailed fiscal impact statement begins on page 5.

BACKGROUND:

MPSERS has several different benefit plans depending on the hire date of employees:

- The Basic and Member Investment plans are traditional pension plans.
- They were replaced with a hybrid plan with both a pension and DC benefit for employees hired since 2010[1] with the following key components:
  - Pension formula: 1.5% x Final Average Compensation x Years of Service
  - Regular Retirement Age of 60
  - Graduated employee contribution rates as income rises, averaging 5%.
  - No Cost of Living increases.
  - Investment rate of return assumption equal to 7%.
  - Additional DC benefit with a 50% employer match capped at 1% of employee compensation.
- Since 2012, new hires may choose an optional DC plan instead of the hybrid plan[2].
- Employees hired prior to 2012 also receive retiree health care benefits.
- Those hired since 2012 receive a matching contribution of up to 2% of compensation into a personal health care fund 401k plan.

The costs of the various plans are paid through a combination of required employee contributions and employer contributions, which are made up of both employer operational funds and annual School Aid Fund appropriations.

The MPSERS pension and retiree health care plans have a total unfunded actuarial accrued liability (UAAL) equal to $38.6 billion as of September 30, 2016. The pension and retiree health plans are approximately 60% and 31% funded respectively. (The retiree health plan was funded on a pay-as-you-go basis until PA 300 of 2012 required prefunding retiree health costs.) The hybrid plan is currently 100% funded.

Applicable MPSERS employers include community colleges, intermediate school districts, school districts, certain district libraries, and participating public school academies. Participating universities would be excluded because their participation in MPSERS was closed to new employees in 1996, and their unfunded liability and contribution rate are calculated separately under Section 41a of the Act.

DETAILED SUMMARY:

Replace Current Hybrid Plan with a New Hybrid Plan

The bill would close the current hybrid pension plan to new employees hired as of February 1, 2018, and would replace it with an optional revised hybrid plan that has the same benefit calculations but is revised as follows:

- Requires that both the normal and UAAL costs be paid on a 50/50 cost sharing basis by the employee and employer. However, an employee cost must not be based on an unfunded liability caused by the failure of an employer to make a required contribution. Also, after the determination of the cost-sharing basis, the employer rate

[1] http://www.legislature.mi.gov/documents/2009-2010/billanalysis/House/pdf/2009-HLA-1227-7.pdf

[2] http://www.legislature.mi.gov/documents/2011-2012/billanalysis/House/pdf/2011-HLA-1040-6.pdf

would be subject to a floor described further on Page 4. The current ORS estimated normal cost rate is 12.4%, which would be 6.2% for both employee and employer. This represents an increase from approximately 5% to 6.2% for the employee and an increase from approximately 3% to 6.2% for the employer.

- Provides for a potential increase in the age of retirement eligibility, which is age 60 under the current hybrid and would initially be age 60 under the new hybrid, as follows:

    - Requires that beginning October 1, 2019 and for each fiscal year in which an experience investigation study is completed as required by the bill, if the most recent study of mortality of the system (using a 65-year-old, 50-50 male-female blend) shows an increase of 1 or more years from the previous study of mortality, the board shall increase the regular retirement age by at least 1 year up to the total increase in whole-year increments unless the most recent actuarial funded ratio is greater than 100% after accounting for an increase in mortality as reflected in the study.

    - Provides that an adjustment to the regular retirement age must take place within 12 months after the board adopts the most recent experience investigation study.

    - Requires that an increase in the regular retirement age must take into account the cumulative increase in mortality relative to the experience investigation study covering the period 2012 through 2017 less any actual increase already taken into account in a previous increase to the regular retirement age.

    - Provides that an increase in the regular retirement age would not apply to a member who is within 5 years of the then current regular retirement age as of the effective date of the increase.

    - Allows the retirement board to also exclude members who are within between 5 and 8 years of the then current regular retirement age as of the effective date of the increase.

- Assumes an investment rate of return equal to 6%.

- Requires that the contribution rate for an increase or decrease in the UAAL for the new hybrid plan be amortized on a 10-year level-dollar schedule with a new contribution rate calculated each year.

Trigger

Creates a trigger under which the new hybrid plan would be closed to new employees if the actuarial funded ratio (using a 5-year smoothing of investment returns) falls below 85% for two consecutive years unless either of the following applies:

- The actuarial funded ratio falls below 85% but would not have but for the failure of the employer or the state to make a required contribution as calculated under Section 41b.

- The state appropriates sufficient funds to bring the funded ratio above 85%.

The trigger date would be 12 months after the valuation that shows the funded ratio is below 85% for a second consecutive year is presented to the MPSERS board.

Replaces Current Optional DC Plan with a DC Plan with Greater Employer Contribution
Beginning February 1, 2018, the bill would create a new DC plan that would mirror the current plan for state employees, with an automatic employer contribution equal to 4% of a participant's compensation plus a 100% matching contribution capped at an additional 3% of a participant's compensation. The bill would require that an appropriation from the State School Aid Fund pay for the 3% employer matching contribution and that the appropriation assume 100% participation of all qualified participants.

Employees hired after February 1, 2018 would have the option of choosing either the new hybrid or the new DC plan, but in the absence of an election, the new DC plan would be the default plan. The bill would require that MPSERS provide every new employee with a form with which to make the election. The form must be accompanied by a description of the benefit options and must include an acknowledgment that the employee received the description of the benefit options.

Participants would vest employer contributions into their DC plan based on the existing statutory schedule: 50% after 2 years, 75% after 3 years, and 100% after 4 years. Participants could contribute additional funds into their DC accounts subject to the federal Internal Revenue Code.

The bill also would move current employees who opted out of the existing hybrid and into the current optional DC plan, which is capped at a maximum employer contribution equal to 3% of a participant's compensation, into the new DC plan described above. The automatic 4% contribution would begin with the first pay period after October 1, 2017, and the increased employer match would begin on February 1, 2018.

The bill would require that MPSERS offer, in addition to the current 401k investment options, access to at least one fixed and at least one variable annuity options.

Employer Contribution Rates
Currently, employer costs are calculated as a percentage of MPSERS payroll, and there are two separate contribution rates:

- The **Normal cost rate** which represents the actuarial estimate of the cost of the benefit earned in any given year by active employees. The normal rate varies depending on which pension and retiree health care benefit plan an employee is in.
- The **Unfunded Actuarial Accrued Liability (UAAL) rate** which represents the actuarial estimate of the current shortfall in the system between the long-term value of assets and the long-term liability of previously earned benefits that will be paid out in the future.

Beginning in FY 2017-18, the bill would create a floor for both the normal cost and UAAL contribution rates charged to MPSERS employers such that the rate for each year would not fall below the prior year rate. Currently both rates fluctuate up and down depending on the actual experience in a number of variables including, for example, investment rates of return, health care costs, and mortality rates. The floor would be permanent for the normal cost but would apply for the UAAL rate only until the UAAL has been fully paid.

Beginning in FY 2018-19, the bill would also revise the payroll base to which the UAAL rate is applied for employers that are school districts and intermediate school districts. An employer's payroll would be adjusted by the growth rate of the employer's current operating expenditures (COE) in the previous fiscal year based on methods determined by the retirement system. COE would be defined as it is in the Public School Accounting Manual Bulletin 1022 as of the effective date of the bill.

Purchase of Service Credit

Senate Bill 401 would eliminate the purchase of service credit (other than credit for active duty in the armed forces) in the Basic and Member Investment Plans (employees hired prior to July 1, 2010) unless the purchase is initiated by September 29, 2017. Employees in the hybrid plan hired since July 1, 2010 are not eligible to purchase service credit.

Experience Investigation Study and Reporting Requirements

The bill would require ORS to conduct and review an experience investigation study and adopt risk assumptions on which the actuarial valuations are to be based in consultation with the actuary and the state Treasurer at least once every 5 years.

The bill would require that by each April 1 after the periodic review of risk assumptions, the Office of Retirement Services, on behalf of both the Department of Technology, Management and Budget and the State Treasurer, shall submit a report to the Legislature that includes all of the following:

- Forecasted rates of return at 5%, 25%, 50%, 75%, and 95% probability levels.
- Actual rates of return for 10-, 15-, and 20-year intervals.
- Mortality assumptions.
- Retirement age assumptions.
- Payroll growth assumptions.
- Any other assumptions that have a material impact on the financial status of the retirement system.

FISCAL IMPACT:

The bill would have an indeterminate fiscal impact on the State and local units of government. According to the Office of Retirement Services, the bill would increase the cost of MPSERS employer contributions for both applicable MPSERS employers and the state by an estimated $23.1 million in the first year of implementation, FY 2017-18, and the costs would increase annually as the number of employees in the new plans increased.

Revised Hybrid Plan
According to the Office of Retirement Services the overall normal cost for the defined benefit component of the new Hybrid would be 12.4%, which would be split evenly by employee and employer. Currently the employer normal cost of the existing hybrid is approximately 3.1%, so the cost to local units would more than double. ORS estimates this cost would be $11.3 million in FY 2017-18 and would grow annually as the number of employees in the new hybrid plan grew. The 5-year costs are detailed column (1) of Table 1 below. Long-term estimates are not yet available.

The normal cost increases due to a lower assumed rate of return down to 6%, as well as adjusted mortality and withdrawal assumptions. The revised assumptions should reduce the risk of an unfunded liability developing in the new hybrid plan, and the 10-year amortization period with level dollar funding would pay down any new UAAL more quickly and at a lower overall cost than the current level percent of payroll method used for the other pension plans.

However, the ORS estimates assume that 5% of part-time employees and 95% of full-time employees, or 41% of total employees will elect the new hybrid plan. To the extent that the number that elect the hybrid plan changes, it would revise the costs and affect the split between local units and the state School Aid Fund.

If the number that elect the new hybrid plan is significantly less than assumed by ORS, than as with a full closure, the changes could affect the long-term liquidity of the pension plan, and could necessitate a reduction in the long-term assumed rate of return for investments in the existing pension plans as well as other state plans, because the investments from all the systems are pooled together. This could significantly increase both the required normal and UAAL contributions for the existing plans. An estimated cash-flow analysis of the system with the new plans is not yet available.

Additionally, the employee contributions would increase from approximately 5% to 6.2% initially.

New Defined Contribution Plan
For FY 2017-18, the maximum employer hybrid plan normal contribution rate is equal to 4.1% of a participant's compensation and the maximum normal rate for the optional DC plan is 3.0%. Under the bill, the maximum employer DC normal contribution rate would be 7.0%, including an automatic 4.0% contribution plus an additional matching contribution up to 3.0%.

The bill requires that the MPSERS employers would pay for the automatic 4%. The cost would be slightly less than the current hybrid cost and basically cost neutral. However, the bill would create an increase in costs equal to 1% of payroll on the employees who are currently in the optional DC plan but would be moved to the new DC plan under the bill, and on the estimated 20% of new hires that would have otherwise chosen the existing optional DC plan over the hybrid. The bill would make the state School Aid Fund responsible for the cost of the matching contribution equal to 3% of compensation through an annual appropriation.

According to the Office of Retirement Services, the total increased normal costs are estimated at $11.8 million for FY 2017-18 and would increase annually as the number of employees in

the DC plan grows. The 5-year costs are detailed column (2) of Table 1 below. Long-term estimates are not yet available.

However, the ORS estimates assume that 95% of part-time employees and 5% of full-time employees, or 59% of total employees will elect the new DC plan. To the extent that the number that elect the DC plan changes, it would revise the costs and affect the split between local units and the state School Aid Fund.

Table 1: Fiscal Impact of SB 401

	(1)	(2)	
Fiscal Year	**Additional Annual Normal Cost of New Hybrid Plan**	**Additional Annual Normal Cost of New DC Plan**	**Total Additional Annual Cost**
2018	$11.3	$11.8	**$23.1**
2019	$21.8	$15.8	**$37.6**
2020	$32.5	$19.3	**$51.8**
2021	$43.5	$22.6	**$66.1**
2022	$54.9	$25.7	**$80.6**
5-Yr Total	**$164.0**	**$95.2**	**$259.2**

Trigger
The bill's trigger would close the new hybrid plan if it were below 85% funded for more than 2 years. The trigger would prevent the unlimited future growth of a UAAL associated with the new hybrid.

However, if the trigger closed the hybrid plan, depending on when it happened, it could affect the long-term liquidity of the pension plan, and could necessitate a reduction in the long-term assumed rate of return for investments in the existing pension plans as well as other state plans, because the investments from all the systems are pooled together. This could significantly increase both the required normal and UAAL contributions for the existing plans.

Contribution Rate Floor
The bill would prevent both the normal cost and UAAL contribution rates from decreasing below the rate calculated in the prior year. Typically the rates fluctuate based on changes in actual experience versus actuarial assumptions regarding a number of factors like investment rates of return, payroll, mortality rates, etc. Negative experience compared to assumptions increases annual costs, while positive experience decreases them. Creating a floor creates more rate stability and will both reduce the risk of potential future growth in the UAAL by maintaining a higher normal rate and accelerate the reduction in the UAAL as benefits from positive experience will accrue to the system rather than reducing annual employer costs.

Adjusted Payroll Base for Districts and Intermediate Districts
The future costs of increased UAAL contributions would be redistributed among local school districts and intermediate districts due to the bill's use of a payroll base adjusted for each employer's growth in current operating expenditures, but the data regarding the change in cost allocation is not yet available. The adjusted payroll base would create an increasing base for employers even if the employer shifts existing MPSERS payroll employees to contract employees and avoid an individual employer further "stranding" costs with the system while lowering their UAAL contribution.

Office of Retirement Services Appropriation

The bill would appropriate $5.0 million in FY 2016-17 for the Office of Retirement Services to administer the bill's proposed changes. It would authorize unexpended funds to be carried forward as a work project to be expended in subsequent fiscal years.

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