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BILL ANALYSIS

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Senate Bill 401 (Substitute S-1 as passed by the Senate)
Sponsor: Senator Phil Pavlov
Committee: Education

Date Completed: 6-30-17

CONTENT

The bill would amend the Public School Employees Retirement Act to do the following:

-- Require the Office of Retirement Services (ORS) to provide a form to each new employee hired on or after February 1, 2018, on which the employee could make an election into either a new defined contribution plan (detailed below), or into a new hybrid plan (with different assumptions and cost sharing), and require that form to include an acknowledgment that the employee had received a description of the benefit options.
-- Place all new school employees hired on or after February 1, 2018, into a 401k or 401k-style plan (i.e., a "defined contribution"/DC plan) unless a new employee elected to opt into the new hybrid plan (which would have different employee contributions than the current hybrid plan).
-- Provide that if no option were chosen, the employee would be considered to have selected the DC plan.
-- Provide that the new hybrid plan would have the same pension calculations and benefits as the existing hybrid, along with the same DC component; however, the new hybrid would assume a 6% rate of return on assets supporting the system, change what an employee pays into the system, and include a variable retirement age based on mortality experience (as discussed in more detail below).
-- Place all existing school employees who previously chose the DC option upon employment (which was a choice beginning in September 2012) into the new defined contribution plan, which would provide greater employer contributions.
-- Require the new defined contribution plan to be one in which the employer would deposit 4% of the employee's salary into a 401k or 401k-style plan, and match the employee's contributions, up to another 3% of salary (for a maximum possible employer contribution of 7% of salary, when an employee contributed at least 3%). (This is the same structure as the DC plan in place for State employees hired since March 31, 1997.)
-- Beginning with fiscal year 2018-19, prohibit the employer portion of the normal cost and the unfunded actuarial accrued liability (UAAL) contribution rates from declining from one year to the next (i.e., establish a "floor" for the employer's contribution rates as a percentage of payroll).
-- Require the School Aid Fund to reimburse the employer's matching contributions on the first 3% of payroll contributed by the employee into a DC plan.
-- Require the UAAL payment for school districts to be applied to the reporting unit's payroll, which may be adjusted. (For all other Michigan Public School Employees' Retirement System (MPSERS) employers, the UAAL would continue to be applied to that employer's payroll, which would not be subject to adjustment.)
-- Require a school district's payroll on which the UAAL rate is applied to be adjusted by the change in the district's current operating expenditures, and require that the adjusted payroll become the basis on which the UAAL contribution rate is determined.
-- Require the actuary to assume a 6% rate of return on investments in the hybrid plan for members first hired on or after February 1, 2018, who opt into the hybrid, and require the approval of the retirement board and director of ORS to change that rate.

-- Require the retirement board and ORS to study and adopt risk assumptions on which the actuarial valuations are based, after consultation with the actuary and the State Treasurer, and require a periodic review of those assumptions at least once every five years.
-- Require ORS and the State Treasurer to report every April 1 on the forecasted rate of return on investments at various probability levels; the actual rate of return on investments for various intervals; mortality, retirement age, and payroll growth assumptions; and, any other assumptions with material impacts on the retirement plans.
-- Define "current operating expenditures".
-- Allow for the determination of a separate contribution rate for members who were first hired on or after February 1, 2018, where any change in the UAAL would be amortized on a 10-year level-dollar schedule, with a new contribution rate calculated for each year.
-- Require normal cost and UAAL contributions for members first hired on or after February 1, 2018, to be paid on a cost-sharing basis of 50% by the employer and 50% by the employee, but provide that any UAAL caused by the failure of an employer to make a required contribution would not trigger an employee contribution to make up the shortfall.
-- Require a member who was first hired on or after February 1, 2018, who opted into the hybrid plan, to make contributions equal to 50% of the normal cost, instead of the existing contributions which are percentages that increase with salary.
-- Eliminate the purchase of service credit in the legacy retirement systems (with the exception of the purchase of military service credit) as of September 30, 2017. (This would prohibit out-of-system service; service at a nonpublic elementary, secondary, or postsecondary institution; State of Michigan service; service for sabbatical leave; service for parental leave; and the purchase of universal service credit after September 29, 2017.)
-- Define "regular retirement age" as age 60 for a member in the hybrid system who was hired between July 1, 2010, and January 31, 2018, and as age 60 for a member first hired on or after February 1, 2018, who opted into the hybrid system, unless an investigation study of mortality determined a difference of more than one year from the previous investigation study of mortality; and provide that, in that event, the regular retirement age would increase at least one year, unless the funded ratio of the pension plan were greater than 100%, after assuming an increase in mortality.
-- Prohibit an adjustment to the regular retirement age for a member who was within five years of the current regular retirement age, and allow the retirement board to prohibit a change in the regular retirement age for a person within five to eight years of retirement.
-- Place all new employees who were hired on or after 12 months after a "qualifying event" only into the defined contribution/Tier 2/401k plan.
-- Define "qualifying event" as one in which a valuation indicated that the funded ratio of the hybrid (for members hired since February 1, 2018), fell below 85% for two consecutive years, based on a five-year smoothing of investment returns.
-- Specify that the State would have 12 months after a qualifying event occurred to appropriate funding to avoid the closure of the hybrid.
-- Appropriate $5.0 million out of pension trust funds to ORS for administration of the changes in the Act.
-- Replace the current actuarially assumed interest rate of 8% with a rate determined by the ORS director and retirement board in consultation with the actuary, for purposes of determining actuarial equivalent retirement allowances under various sections.
-- Require the retirement system to offer access to at least one annuity option at institutional pricing.

MCL 38.1305 et al.

BACKGROUND

Public Act 75 of 2010 established a new "hybrid" pension plan for employees first hired on or after July 1, 2010. The hybrid consists of a defined benefit (DB) pension component and a defined contribution (DC) component. Under the hybrid, the earliest a person can begin drawing pension payments is age 60 (with at least 10 years of service), there are no cost-of-living adjustments in retirement, the purchase of service credit is prohibited in that system, and the rate of return assumed on assets invested for the system is 7%. The DC component

of the hybrid provides a 50% employer match on the first 2% of an employee's contributions (i.e., the maximum employer match in the DC component is 1% of pay).

Public Act 300 of 2012 provided an alternative DC-only plan for employees first hired on or after September 4, 2012. The optional DC plan provides a 50% employer match on the first 6% of an employee's contributions (i.e., the maximum employer match is 3% of pay). Roughly 20% of new employees choose the optional DC plan. In addition, Public Act 300 of 2012 eliminated retiree premium coverage for new hires, and replaced it with a plan that provides a maximum 2% employer match on an employee's 2% of contributions into a personal health care 401k savings account.

FISCAL IMPACT

Under the bill, there would be two areas of cost increases: the increase in costs due to implementing a DC plan that would provide greater employer contributions, and the increase in normal costs for the new hybrid, which would arise primarily because of a lower assumed rate of investment return (6% instead of 7%). Each of these is discussed below.

Cost Increase: Greater Defined Contribution Costs

Under current law, the maximum employer cost for a person who chooses the optional DC plan is 3%, because the employer matches 50% of the employee's first 6% of contributions. Under the bill, the employer would have to pay a mandatory 4% plus up to another 3% of matching contributions, for a total maximum cost of 7% of pay for a person choosing the proposed DC plan, or for those in the current DC plan. The bill specifies that the School Aid Fund (SAF) would reimburse employers for the (up to) 3% matching contributions.

The Office of Retirement Services has provided cost estimates based on assuming 59% of new hires choosing to participate in the new DC plan. (Under current law, roughly 20% of new hires choose the current DC plan, so this assumption is roughly triple the current participation rate.) The estimate of 59% of new hires choosing the new DC plan represents an assumption in which 95% of part-time people and 5% of full-time people would elect the new DC. Using those assumptions, the estimated State cost of reimbursing school employers for the increased DC match in fiscal year (FY) 2017-18 is $11.8 million, and the estimated State cost of this reimbursement in FY 2018-19 is $15.8 million. These State costs would grow over time as more payroll entered the DC plan, and as those already in the plan experienced salary growth.

Cost Increase: New Hybrid's Cost Assumptions Result in Higher Normal Costs

The proposed changes to the hybrid plan for employees opting into that plan would result in an increase in that hybrid's "normal" costs. Specifically, the reduction in the assumed rate of return on investments supporting the system from 7% to 6% drives a higher normal cost rate. The bill specifies that the normal cost of the new hybrid would be shared 50%/50% among the employer and the employee. This is a deviation from current practice, in which employees in the current hybrid pay set percentages based on salary.

In the current hybrid, the "normal" cost is 7.94% of salary, of which 3.05% is paid by school employers and the remaining 4.89% (on average) is paid by employees, although each employee's actual payment depends on salary. Under the proposed hybrid, the "normal" cost would be 12.04% of salary. The bill specifies that both the employer and employee would pay 50% of the normal cost, which means each would contribute 6.02% of salary. This represents a roughly 3% increase for employers, and, on average, an increase of over 1% for employees.

The ORS has provided estimates based on 41% of new hires choosing the new hybrid plan, where 5% of part-time new hires and 95% of full-time new hires choose the hybrid. Based on those assumptions, the increase in the employer normal cost is estimated at $11.3 million in FY 2017-18 and $23.1 million in FY 2018-19. These costs would grow over time as more payroll entered the hybrid, and as those already in the new hybrid experienced salary growth. The bill would not require these costs to be paid by the School Aid Fund.

Discussion of Assumptions Related to New Hires Choosing DC or Hybrid

The figures cited above are tied to ORS' assumptions of the numbers and types (i.e. part-time or full-time) of new hires choosing either the hybrid or the new DC. To the extent the actual figures deviate from the estimates, the mix of costs would change, but because each cost (higher DC match or higher hybrid normal) represents roughly 3% of salary, the total costs likely would not deviate much from the estimates provided above.

However, the extent to which the number of new hires choose the new DC plan could have an impact on costs tied to cash flow and liquidity needs in the future. If a "high number" of new hires, or new hires with "high" salary, elected the DC plan, it could lead to a situation in which not enough cash flow and liquidity were available for the support of benefit payments in the future. In other words, if a high number of new hires/salaries elected the DC plan, it could trigger an adjustment to the assumed rate of return (AROR) on investments in the MPSERS hybrid, which would affect the State's pension and retiree health care investment portfolios, and likely would necessitate additional deposits into those systems to ensure sufficient cash flow and liquidity. Conversely, if a "high number" of new hires/salaries did not choose the DC plan, there likely would be no adjustment needed to the AROR.

At this time, it is impossible to determine the point at which an adjustment in assumed rates of return would be necessary to preserve principle in the investment systems. The ORS has indicated that the experience study that would be analyzed in five years likely would provide a better understanding of how many and which type of new hires ended up choosing either the hybrid or the DC. At that time, and given that experience, the State Treasurer could review the experience, along with projected cash flow needs, and decide if adjustments to ARORs (and corresponding increased funding requirements) would be beneficial or necessary for the pension systems, or if the existing ARORs would be sufficient for cash flow and liquidity.

Under current law (with an open hybrid), ORS provided an estimated long-range negative draw on beginning-of-year assets (a measurement of cash flow) at roughly 4%, which was acceptable for cash flow purposes, and did not necessitate a change in rates of return to preserve principle. Under a scenario where the hybrid plan was entirely closed today (which is not proposed in this substitute bill), the estimated draw was a negative 16%, which is what would have triggered the lowering of ARORs, generating increased UAAL, and necessitating additional annual payments in the hundreds of millions of dollars. Therefore, those are the two extremes: a negative 4% to a negative 16% drain on beginning-of-year assets.

Under this bill, the cash flow analysis varies based on the percentage of people choosing the hybrid. If 10% of people chose the new hybrid, the negative draw is estimated at 10%; if 20% chose the new hybrid, the negative draw would be 8%;, and if 50% chose the new hybrid, the negative long-range draw on assets would be 5%. Therefore, a future analysis of actual participation rates under the two options (the new hybrid and new DC) and those impacts on cash flow analyses likely would be necessary to ensure sufficient liquidity in the long run.

Other Fiscal Considerations

New Hybrid

For the first time, the bill would require an employee to share in the cost of any unfunded accrued actuarial liabilities (UAALs) that arose in the new hybrid. (This would not affect anyone in any of the older plans, hired before February 1, 2018.) The cost sharing of the UAAL payment would be 50%/50%.

In addition, any change in the UAAL (positive or negative) in the new hybrid would be amortized over 10 years on a level dollar payment plan, with a 50%/50% employer/employee cost share, and with a new UAAL calculation each year.

The hybrid that would be available to new hires also would include an adjustment to the retirement age (age 60 under the current plan), if mortality tables indicated at least one additional year and the funded ratio of the plan would fall below 100%. However, if an employee in the new hybrid were within five years of retirement, that person's retirement age eligibility could not be changed. Also, the retirement board could prohibit a change if an employee were within five to eight years of the then-retirement age.

In terms of funding methodology, this adjustment to the retirement age, along with the more conservative AROR (6% instead of 7%), and the cost sharing of any UAAL, paid on a 10-year amortization schedule, make the new hybrid a more conservative version than the existing hybrid. There are no changes in the calculation of benefit payments for retirees under the new hybrid, other than the possibility of an adjustment in retirement age.

Finally, the bill would include a trigger for closure of the hybrid system. This trigger (termed a "qualifying event" in the bill) would be the publication of a valuation indicating, for the second year, that the system was less than 85% funded. If that trigger happened, the State, if it chose, would have 12 months to appropriate funds to bring the system's funded ratio above 85% and keep the system open. Otherwise, all new hires after those 12 months had elapsed would be placed into the DC plan.

If the hybrid were closed due to the trigger, a review of the system's cash flow and liquidity needs likely would be required. If the review determined a need for a more conservative investment strategy to preserve principle and assist in liquidity, additional costs likely would be incurred. However, the extent of those costs is indeterminate, and would depend upon when the closure occurred, cash flow projections, and funded status, among other things.

Funding Floor, COE, Service Credit

By establishing a "floor" on the employer's portion of normal costs and UAAL payments, in years when there was positive actual experience compared to assumptions, those positive gains would not be used to reduce either the employer's normal or UAAL payments in the future. Instead, those gains attributable to employer contributions would be redirected into the pension system, which could result in a reduction in overall UAAL or an earlier repayment date of the liabilities.

The UAAL payments on the old/legacy liabilities would be applied to the payroll of school districts, adjusted for any change in current operating expenditures (COE). Under this method, a school district that privatized services (whose payroll would drop out of MPSERS but remain in COE) would remit UAAL payments on a payroll that was adjusted to include the overall change in COE, thereby roughly capturing the payroll of the privatized services. This method should help to stabilize the UAAL payments remitted by school districts, perhaps resulting in less need for UAAL reconciliation payments.

The bill would eliminate the purchase of service credit in the legacy plans for all but military service and repayment of refunds. (The hybrid already does not allow the purchase of service credit.) To the extent service credit purchases cost, in actuality, more than the actuarially-determined payment made by an employee, this provision in the bill would reduce costs.

Summary of Fiscal Impact

Table 1 provides the estimated employer costs for the first five years. In FY 2017-18, the estimated cost to the School Aid Fund to pay for increased DC contributions would be $11.8 million. In FY 2018-19, that estimated cost to the School Aid Fund would be $15.8 million. In addition, for the portion of the additional normal cost in the new hybrid in FY 2017-18, the cost to employers would be $11.3 million, and the cost in FY 2018-19 would be $21.8 million.

Table 2 provides a 30-year estimate of combined employer costs. The actuary has noted that the 30-year cost analysis is very sensitive to profiles of new hires, and plan election percentages. Also noted, actual cost figures will depend on actual experience.

The requirement for ORS to provide a report every five years on assumptions and actual experience likely would not increase costs to the State. Every year, the valuations provide a look at how actual experience deviated from assumptions; those valuations contain much of the information that would be required of the five-year report.

Plan changes that include adjusting payroll based on current operating expenditures, a lower assumed rate of return in the new hybrid, amortizing unfunded accrued liabilities in the new hybrid over 10 years, and other changes likely would yield more stability in the pension system.

The extent to which new hires chose the DC-only plan could lead to a point at which a review of, and possible changes to, the assumed rates of return (ARORs) on assets supporting the legacy pension and retiree health care plans would be necessary; if the ARORs were reduced, additional costs to the State would ensue. If a qualifying event occurred and the hybrid were closed, a review of, and possible changes to, the assumed rates of return then would be necessary to determine cash flow and liquidity needs; if the ARORs were reduced, additional costs to the State would ensue.

Table 1

Estimated Employer Costs for First Five Years (millions of dollars)			
Fiscal Year	**Greater DC Match**	**Higher Normal Cost in New Hybrid**	**Total Estimated Cost**
2017-18	$11.8	$11.3	$23.1
2018-19	15.8	21.8	37.6
2019-20	19.3	32.5	51.8
2020-21	22.6	43.5	66.1
2021-21	25.7	54.9	80.6

Source: Office of Retirement Services

Table 2

Estimated Employer Costs for First 30 Years (millions of dollars)			
Year	**Estimated Total Increase in Employer Contributions**	**Year**	**Estimated Total Increase in Employer Contributions**
1	$23.1	16	$307.9
2	$37.6	17	$335.2
3	$51.8	18	$363.7
4	$66.1	19	$393.5
5	$80.6	20	$424.5
6	$96.2	21	$456.9
7	$112.7	22	$490.7
8	$130.1	23	$525.8
9	$148.6	24	$562.3
10	$168.2	25	$600.3
11	$188.8	26	$639.6
12	$210.4	27	$680.4
13	$233.1	28	$722.5
14	$256.9	29	$766.0
15	$281.8	30	$810.7

Source: Office of Retirement Services

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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.