

February 1, 2012

Senate Majority Leader Randy Richardville
House Speaker Jase Bolger
Michigan Legislature
Lansing, MI

Dear Senate Majority Leader Richardville and Speaker Bolger:

We hereby forward to you the report on the Michigan School Employees Retirement System (MPERS) required under the School Aid Act, MCL 388.1747b. The provision states it is the intent of the legislature to have a workgroup evaluate MPERS and consider possible reforms.

The provision also requires a report from said workgroup to the Speaker of the House of Representatives or the Senate Majority Leader by February 1, 2012, on any identified reforms, timelines for implementing the reforms, and the estimated costs and savings of the identified reforms.

While the report addresses the above stated issues, the workgroup has not received from the Office of Retirement Services all of the data needed to finalize its recommendations. This report contains a list of potential reforms, but until the final feasibility has been determined, a firm recommendation cannot be made.

Sincerely,

Sen. Mark Jansen

Sen. Howard Walker

Sen. Phil Pavlov

Sen. Roger Kahn

Rep. Chuck Moss

Rep. Bill Rogers

Rep. Jeff Farrington

Rep. Rick Olson

Background

Pursuant to section 147b of the School Aid Act (MCL 388.1747b), a legislative workgroup has been appointed to research potential reforms to the school employee retirement system, determine which reforms might reduce costs and in what timeframe, and to propose a possible implementation timeline. These are presented below.

Any reforms ultimately identified and pursued also should meet one or both of the following criteria: to address the level of member employer contribution rates so that more dollars go to the classroom; to contain the level of unfunded liability in both the pension and health care components of MPSERS so that the system can meet its legal obligations to retirees without further damaging the public education system over the long term.

MPSERS Status

The Michigan Public School Employees Retirement System (MPSERS) is currently carrying an unfunded actuarially accrued liability (UAAL) of more than \$45 billion. As of the September 30, 2010 valuation, the pension portion of the unfunded liability was \$17.6 billion and the healthcare portion was \$27.6 billion.¹

The primary reason for the unfunded pension liability is the failure of the pension plan to achieve the assumed rate of return on invested assets over the past 10 years. The health care side of MPSERS is funded on a "pay-as-you-go" basis. It is not impacted by market returns. Instead, this portion of the liability reflects the fact that there are no prefunding mechanisms or assets currently in place for retiree health care.

Due to the level of unfunded liability, employer MPSERS payroll levy increased to roughly 24% for fiscal year 2011-2012, of which 21% is for healthcare and pension unfunded liability costs¹. If nothing changes, the Office of Retirement Services (ORS) estimates project the employer MPSERS payroll levy will exceed 30% by fiscal year 2013-14, even if the market performs at the statutorily-assumed 8% rate for investment returns.

Longer term, the level of contributions required will exceed \$4 billion per year from the public employers. With MPSERS payroll stable at about \$10 billion since 2003, this could result in MPSERS employer contributions of up to 40% of payroll by the end of the decade if nothing changes.

This would create tremendous stress on our school districts, and impact the level of education services provided to students as they prepare for a global economy.

There have also been discussions revolving around the 3% of salary that is being collected for retiree healthcare costs from current employees. Currently subject to legal proceedings brought by the MEA, the outcome of those legal proceedings is not expected to be known until August 2013.

Potential Reforms and Estimated Costs or Savings

The following reforms could help stabilize, reduce, or eliminate portions of the liability either in the short term or in the long run:

- Move to a defined contribution system *for new employees, with option for current employees*: additional cost of \$730 million over the next eight years to frontload ARC plus additional normal costs of \$12 million in year 1, \$27 million in year 2, \$42 million in year 3 and growing as new hires are added to the system. *However, these near-term fiscal costs could be offset in the future by decreased risk to the system in the form of additional unfunded liabilities, and a DC plan could provide greater portability for employees.*
- Increase current employee contributions *for the Basic Plan and MIP Plan*: *Cost savings to employer/system depend on contributions chosen. For example; 4%/6.4% MIP raises \$140 million, 3%/7% raises \$130 million, or other options may raise differing amounts. This would be consistent with SERS reform where employee contributions were increased from 0% to 4%.*
- Increase the portion of the retiree healthcare premium paid by the retiree: up to \$120 million/yr savings if cost sharing is 80/20 for all current and future retirees.
- Move employees to a retirement health savings account system: if it mirrors the 2011 SERS legislation for state employees, then additional costs are estimated at \$5 million per year, cumulative, to reflect 2% employer contribution into 401k for new hires. Eventually, significant savings are expected when no future retirees are drawing down a premium coverage.
- Lower the assumed rate of return on investments for the PensionPlus plan, which would reduce the potential for increases in unfunded liability due to insufficient market returns. This would raise the amount of funding necessary to be contributed to the system (normal cost), which could be balanced by an increase in either employee or employer contributions.
- Change the number of years included in the final average compensation for the purposes of calculating pension amounts: request pending with ORS.
- Reduce the multiplier used to calculate pension amounts under certain circumstances: request pending with ORS.
- Eliminate cost-of-living increases for certain retirees: request pending with ORS and would depend upon structure of plan. Average 2010 pension was \$20,300. MIP members receive a 3% non-compounding yearly COLA.
- Raise the eligibility age for retiree healthcare: request pending with ORS.
- Put all or some additional employees on a graded healthcare premium system or tweak the current plan: request pending with ORS.

- Pay some or all of the unfunded liability 'above the line' on an annual basis using money from the School Aid Fund. For example, using \$100 million of SAF money would reduce the MPSERS payroll levy by about 1% of payroll.
- Address stranded costs resulting from schools privatizing or contracting some services, or resulting from reductions in MPSERS payroll for other reasons: impact would depend upon method chosen.
- Account for liabilities incurred by the system at the local employer level: this would likely impose administrative costs at the State level, but would more accurately attribute liabilities to the original employer than may be the case at the present time.
- Purchase life insurance on employees and if proceeds outweigh the cost of insurance, use the potential proceeds to help pay off the unfunded liability: additional work is needed to determine the feasibility of this option.

Note that there will be additional discussion as to whether savings generated are used to reduce long-term unfunded liabilities, current employer contribution rates or some combination thereof. In addition, some items may increase short-term contributions from either the state or the employer, but have a positive impact over the medium or long-term in eliminating or reducing the level of unfunded liabilities.

Timeline

On completion of the due diligence process with the administration, the workgroup intends to draft a timeline for introduction and implementation of those reforms that meet the workgroup's criteria.

¹ Employer contributions for MPSERS are allocated to three areas; to pension, to healthcare and to the pension unfunded liability. The portion that currently goes toward the pension is 3.47% of MPSERS payroll for employees hired prior to July 1, 2010. For employees hired after July 1, 2010, the employer contributes 2.24% for pension and 1% for 401-K; the portion that goes toward retiree healthcare is 8.50%; and the portion that goes toward the pension unfunded liability is 12.49%, applied to MPSERS payroll.