Legislative Analysis

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CLOSE MPSERS HYBRID PENSION PLAN AND REPLACE WITH DEFINED CONTRIBUTION

House Bill 4647 as introduced
Sponsor: Rep. Thomas Albert
Committee: Education Reform
Complete to 5-24-17

BRIEF SUMMARY:

House Bill 4647 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.

- Replace it with a defined contribution (DC), or 401k-style, plan. The DC plan 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.

- 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 an estimated $410 million in FY 2018-19, the first year in which the bill's amendments to the actuarial calculations take effect, and could cost as much as $46.4 billion over the 40-year amortization period covered by the bill. A more detailed fiscal impact statement begins on page 3.

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].
- 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.

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[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

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:

<u>Close Hybrid Plan and Replace with Defined Contribution</u>
The bill would close the current hybrid pension plan to new employees hired as of October 1, 2017, and would replace it with a defined contribution (DC), 401k-style plan. The DC plan 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.

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 bill would require that the Office of Retirement Services provide, in addition to the current 401k investment options, a menu of lifetime annuity options, including fixed, variable, or combination annuities. Annuities offered under this provision could include both nominal and inflation-protected options.

<u>Guarantee Accrued Benefits</u>
The bill adds a provision reiterating Article IX, Section 24 of the Michigan Constitution, providing that accrued financial benefits of the pension plan and retirement system created in the Act are a contractual obligation of the state that shall not be diminished or impaired.

<u>Employer Contribution Rates</u>
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 2018-19, 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.

The bill would also require that the UAAL contribution rate be calculated using a level percentage of payroll amortization method, codifying current practice.

Unfunded Actuarial Accrued Liability Amortization Period

The bill would codify the remaining 21 years in the UAAL amortization period for the currently calculated unfunded liability, aligning with the current practice and providing that the unfunded liability would be paid by September 30, 2038.

However, the bill would create a separate amortization period ending September 30, 2057, for any increased unfunded liability calculated due to a change in the long-term reduction in the assumed investment rate of return recommended by the actuary based on cash-flow concerns created by closing the pension plan.

Reporting Requirements

The bill would require that by April 1, 2020, and on that date every 4 years thereafter, 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%, 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 increase the cost of MPSERS employer contributions for both applicable MPSERS employers and the state by an estimated $410 million in the first full year of implementation, FY 2018-19, and by an estimated $46.4 billion over the 40-year amortization period covered by the bill.

Close Hybrid Plan and Replace with Defined Contribution
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 up to 3% of compensation through an annual appropriation.

According to the Office of Retirement Services, the total increased normal costs are estimated at $20.0 million for FY 2017-18 and would increase annually as the number of employees in the DC plan grows. The long-term costs of the increased normal costs total $21.7 billion over 40 years and are detailed column (1) of Table 1 below.

Table 1: House Bill 4647 Fiscal Impact
(in Millions)

	(1)	(2)	(3)	
Fiscal Year	**Additional Annual Normal Cost of DC for New/ Converted Employees**	**Additional Annual Cost for MPSERS UAAL**	**Total Additional Annual Cost for Other State Plans' UAAL**	**Total Additional Annual Cost***
2018	$20	$0	$0	**$20**
2019	$33	$280	$96	**$410**
2020	$48	$290	$98	**$436**
2021	$63	$300	$100	**$464**
2022	$80	$311	$102	**$493**
2023	$98	$322	$104	**$524**
2024	$117	$333	$106	**$557**
2025	$139	$345	$108	**$592**
2026	$162	$357	$111	**$629**
2027	$186	$369	$116	**$669**
5-Yr Total	**$245**	**$1,182**	**$396**	**$1,822**
10-Yr Total	**$948**	**$2,907**	**$939**	**$4,793**
20-Yr Total	**$4,374**	**$7,389**	**$2,079**	**$13,842**
30-Yr Total	**$11,107**	**$13,712**	**$2,079**	**$26,898**
40-Yr Total	**$21,717**	**$22,630**	**$2,079**	**$46,427**

*Columns may not sum to total due to rounding.

Revised Investment Rate of Return Assumptions and Amortization Period
Currently the MPSERS Board approved rate of return assumption is 7.5% for the pension plans other than the Hybrid plan and 7.0% for the Hybrid plan. The actuary has recommended that the long-term investment rates of return must be reduced incrementally, beginning in FY 2034, to 5.0% by 2038 to avoid cash flow concerns once the unfunded liability payments end

and cash contributions into the system diminish significantly. The actuary's recommended schedule is displayed in Table 2 below.

Reducing the assumed rate of return would include reducing the risk in the investment asset allocations to protect the asset pool to manage cash flow once benefit payments significantly exceed contributions. However, reducing the assumed rate of return also means reducing the assumed growth of investment income in the system, which decreases the actuarial estimate of long-term assets, and thereby increases the estimated UAAL. The increased UAAL increases the annual required contributions necessary to fund the system.

Table 2: Long-term Investment Rate of Return Reductions

Date	Assumed Rate of Return
September 30, 2034	7.25%
September 30, 2035	7.00%
September 30, 2036	6.50%
September 30, 2037	6.00%
September 30, 2038	5.00%

The bill would require that the increased MPSERS UAAL related to the reduction in the assumed rate of return be amortized over a longer period, ending September 30, 2057, than the current amortization period which would end September 30, 2038. The additional MPSERS UAAL payments would begin in FY 2018-19 and would equal approximately $280 million in the first year, and would grow annually along with an estimated 3.5% growth in total MPSERS payroll, totaling $22.6 billion over the 40-year period. See column 2 of Table 1 for additional annual cost detail.

Other Retirement Systems Impact

MPSERS plan assets are pooled with the assets of other state retirement systems including the State Employees Retirement System (SERS), the State Police Retirement System (SPRS), and the Judges' Retirement System (JRS). SERS and JRS were closed in 1997 and replaced with a DC plan. SPRS has had a hybrid plan since 2012. The combined assets of all four plans are managed by the Department of Treasury, Bureau of Investments.

While the bill is silent regarding these other systems, reducing the assumed rate of return for MPSERS, for which the assets far outweigh those of the other systems combined, requires that Treasury revise the asset allocation of the entire asset pool. As described above, a reduction in the assumed rate of return reduces the long-term actuarial estimates of assets and increases the UAAL. The increased UAAL increases the annual required contributions into the state plans, which are funded as part of employee economics across all state departments in the annual appropriation process. The increased costs for the other state plans is estimated at $96.0 million in the first year, FY 2018-19, and would increase annually throughout the remaining years in the amortization period, currently set to end as of September 30, 2036. The additional cost is estimated at $2.1 billion. See column 3 of Table 1 for additional annual cost detail.

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.

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