State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2005

Membership and Contribution Rate Changes for Michigan's Two Largest Retirement Systems -- A 10-Year History
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The State of Michigan currently maintains and operates four pension plans on behalf of Michigan workers. These State-administered plans include: the Michigan State Employees Retirement System (MSERS), the Michigan Public School Employees Retirement System (MPSERS), the Michigan State Police Retirement System, and the Michigan Judges Retirement System. This update concentrates on Michigan's two largest systems, the MSERS and the MPSERS.

The Michigan State Employees Retirement System

The MSERS is administered by the State of Michigan and was created under Public Act 240 of 1943. The system provides retirement benefits to virtually all of Michigan's government employees. The plan also provides survivor and nonduty and duty disability benefits. Michigan judges, legislators, and State police officers are covered under separate retirement systems.

The MSERS is a defined benefit (DB) plan, which means that members receive a guaranteed monthly benefit upon retirement based on average final salary and years of service. Generally, members may retire with full benefits at age 55 with 30 or more years of service or at age 60 with 10 or more years of service. Their pension amount is determined by using the 36-consecutive-month period that produce the highest final average compensation (FAC).

As of March 31, 1997, the MSERS is a closed system, meaning that newly hired State employees cannot become members of the MSERS. Instead, newly hired State employees must become members of the new (as of April 1, 1997) defined contribution (DC) plan. For DC members, the State contributes a minimum of 4% of salary into an employee's private 401(k) account. The account is managed by the employee through a third-party administrator. Defined contribution members may contribute additionally to their plan with the first 3% matched dollar-for-dollar by the State. Upon retirement, DC plan members can choose to take their funds via a lump sum payment or in annuities. Defined benefit plan members may not contribute to their DB retirement plan, although, they may contribute to separate 401(k) or 457 individual accounts.

Due to new hires' having to become members of the DC retirement plan, total membership in MSERS has been on a steady decline over the past decade. As shown in Table 1 below, total membership in the plan fell from 94,900 members at the end of fiscal year (FY) 1995-96 to a low of 80,395 at the end of FY 2003-04, the last year for which complete figures are available. Due to budget cuts over the last three fiscal years, active membership has fallen by 8,288 employees from FY 2001-02 to FY 2003-04.

There are two additional causes for the decline in membership in the MSERS. The first is the closing off of the system and the creation of the new DC retirement plan for new hires. Currently, there are about 19,000 members in the DC plan who have been hired since the implementation of the new plan. Additionally, nearly 1,500 members who were vested in the DB plan, along with nearly 2,000 nonvested members, switched over to the new DC plan in 1997.

Table 1

Michigan State Employees Retirement System
Member, Wage, and Contribution Data – FY 1995-96 to FY 2004-05
(Thousands of Dollars)

	Fiscal Year									
Defined Benefit	**FY 1995-96**	**FY 1996-97**	**FY 1997-98**	**FY 1998-99**	**FY 1999-2000**	**FY 2000-01**	**FY 2001-02**	**FY 2002-03**	**FY 2003-04**	**FY 2004-05**
Active Members	63,807	55,434	49,717	49,612	47,778	45,852	43,064	36,536	34,776	N/A
Retired Members	31,093	36,123	36,185	36,346	36,705	37,111	39,666	45,491	45,619	N/A
Total Members	**94,900**	**91,557**	**85,902**	**85,958**	**84,483**	**82,963**	**82,730**	**82,027**	**80,395**	**N/A**
Pension Rate	10.28%	10.62%	5.37%	5.10%	5.04%	4.74%	3.68%	4.02%	7.87%	13.12%
Health Rate	5.69%	4.82%	5.01%	5.50%	6.00%	8.75%	9.00%	12.50%	13.05%	11.40%
Total Rate	**15.97%**	**15.44%**	**10.38%**	**10.60%**	**11.04%**	**13.49%**	**12.68%**	**16.52%**	**20.92%**	**24.52%**
Wages (DB)	$2,515,420	$2,273,203	$2,107,996	$2,213,851	$2,253,818	$2,230,562	$2,133,477	$1,859,555	$1,889,410	$1,946,092[a]
Pension Contribution	$258,585	$241,414	$113,199	$112,906	$113,592	$105,729	$78,512	$74,754	$148,697	$255,327
Health Contribution	$143,127	$109,568	$105,611	$121,762	$135,229	$195,174	$192,013	$232,444	$246,568	$221,854
Total Contribution	**$401,712**	**$350,982**	**$218,810**	**$234,668**	**$248,821**	**$300,903**	**$270,525**	**$307,198**	**$395,265**	**$477,181**

a) Assumes growth of 3% from prior year

Source: Michigan Office of Retirement Services

The second reason for the decline is two early retirement provisions that were adopted in 1997 and 2002. Michigan has offered two early retirement windows for State employees over the last decade. The first, in 1997, saw nearly 5,000 members take advantage of that early retirement opportunity. The second early retirement option occurred in 2002. That window saw just over 8,000 State employees retire early. Both early retirement provisions allowed members to retire with full benefits sooner than they otherwise would have been eligible to retire and with enhanced benefits. Current law allows DB plan members to receive 1.5% of their FAC times years of service as their pension. Both of the early retirement provisions allowed eligible members to retire using a 1.75% multiplier, compared with the normal 1.5% multiplier. These early retirements account for just over 13,000 of the 29,031-member decline in the active workforce in the MSERS over the 10-year period.

Table 1 also compares the changes in the contribution rates over the last 10 years. The contribution rate is the percentage of payroll that the State pays into the system each year to pay for the current and future retirement benefits for its members. The total contribution rate consists of two key pieces: the pension rate and the health insurance rate. The pension rate is the amount needed to pay for retirement benefits and is composed of two parts, the normal cost portion of the rate (the amount needed to pay normal pensions) and the unfunded accrued liabilities (UAL) portion of the rate. Unfunded accrued liabilities are the portion of pension payments (current or future) that are unaccounted for in the system. The largest contributors to the UAL portion of the pension rate are early retirements and lower-than-anticipated interest earnings on the pension system's assets.

As demonstrated in Table 1, the pension rate has fluctuated dramatically since FY 1995-96. The pension rate was nearly cut in half in FY 1997-98 due to a one-day valuation of the system's assets in FY 1996-97. To take advantage of the stock market gains of the mid 1990s, the MSERS performed a one-day valuation of its assets on September 30, 1997. This allowed the system's assets to be valued at the higher market rate (versus the five-year smoothed market rate) for that one day, which enabled the system to pay off all of its existing UAL, resulting in a lower pension rate. As seen, the pension rate has gradually grown over time due to the early retirement provisions of 1997 and 2002. The pension portion of the total rate has increased significantly for FY 2004-05, from 7.87% in FY 2003-04 to 13.12% in FY 2004-05. The reason for this large increase is the dropping off of the final "good market year" of 2000 and fully having to realize the "bad market years" of 2001 and 2002 that continue currently.

The second portion that makes up the total contribution rate is the health insurance rate. This is the percentage of payroll that is needed to pay the health insurance benefits for currently retired members. Health benefits for retired members are paid on a cash (pay-as-you-go) basis. This means that health benefits are paid as they are accrued. The health insurance rate then is the percentage of the active member payroll that is needed to pay those cash health benefits. As the number of retirees and the costs of health care increase, the percentage of payroll necessary to pay for those benefits also increases, and is the primary reason for the continuous rise in the health insurance rate from year to year as demonstrated in Table 1. Because the number of retirees has grown more rapidly than actuarially calculated as a result of the two early retirement provisions, the health insurance rate has doubled over the last 10 years from 5.69% in FY 1995-96 to the current 11.40% rate in FY 2004-05.

The Michigan Public School Employees Retirement System

The MPSERS is administered by the State of Michigan and was originally created under Public Act 136 of 1945. Since the Act was recodified in 1980, the system now operates under the provisions of Public Act 300 of 1980, as amended. The MPSERS provides retirement benefits to employees of the State's K-12 public school districts, public school academies, district libraries, all tax-supported community colleges, and seven of Michigan's 15 public universities. These universities include: Central Michigan, Eastern Michigan, Northern Michigan, Western Michigan, Ferris State, Lake Superior State, and Michigan Tech. Like the State Employees Retirement System, the MPSERS also provides survivor and non-duty and duty disability benefits.

The MPSERS also is a defined benefit plan. The biggest difference between the MPSERS plan and the MSERS plan, however, is that the MPSERS currently is still an open plan, meaning that there is no provision for members to be part of any defined contribution plan. All members, including new hires, are DB members. However, there are two types of DB members in the MPSERS plan.

Before January 1, 1987, all members were part of what is known as the Basic Plan. These members may retire at age 55 with 30 or more years of service or at age 60 with 10 years of service. Their pension amount is determined by using the 60 consecutive months that produce the highest final average compensation and there is no employee contribution required for members of the Basic Plan.

On January 1, 1987, the Member Investment Plan (MIP) was enacted. Then-current members were given an opportunity to become members of the new MIP or remain in the Basic Plan. Additionally, all new hires after January 1, 1990, are mandated to become members of the MIP. These members receive enhanced benefits that include: eligibility to retire at any age provided they have 30 or more years of service, eligibility to retire at age 60 with 10 or more years of service, and eligibility to retire at age 60 with five years of service provided that the member works through his or her 60th birthday and has credited service in each of the five immediately preceding years. The biggest benefit to MIP members is that their FAC is determined using a 36-consecutive-month period versus a 60-month period for Basic Plan members. This results in a higher FAC for MIP members and thus an enhanced benefit. However, MIP members must contribute to the plan. Those who became MIP members before January 1, 1990, contribute a fixed 3.9% of salary to the MIP, while those who became MIP members on or after January 1, 1990, contribute at the following fixed rates: 3% of the first $5,000 of salary; 3.6% of salary between $5,001 and $15,000; 4.3% of all salary above $15,000.

Unlike the State employee plan, total membership in the MPSERS has continually grown over the last eight years among both active and retired members, mainly due to the fact that the MPSERS does not offer a DC plan component. As shown in Table 2, total membership grew from 402,561 members in FY 1995-96 to 466,851 in FY 2003-04 (again, the last year complete figures are available). The growth in total membership of 64,290 over the eight-year period is composed of 26,167 in active members and 38,123 retirees. Due to the budget constraints over the last three fiscal years, the number of active members has grown at a slower pace than the number of retirees. In fact, the number of active members fell in FY 2003-04 for the first time during the period studied, dropping by 5,675 while the number of retired members has continued to grow.

Table 2

Michigan Public School Employees Retirement System
Member, Wage, and Contribution Data - FY 1995-96 to FY 2004-05
(Thousands of Dollars)

	Fiscal Year									
Defined Benefit	**FY 1995-96**	**FY 1996-97**	**FY 1997-98**	**FY 1998-99**	**FY 1999-2000**	**FY 2000-01**	**FY 2001-02**	**FY 2002-03**	**FY 2003-04**	**FY 2004-05**
Active Members	295,096	295,691	302,016	309,324	312,699	318,538	326,350	326,938	321,263	N/A
Retired Members	107,465	111,842	116,620	120,913	126,115	130,790	135,277	139,814	145,588	N/A
Total Members	**402,561**	**407,533**	**418,636**	**430,237**	**438,814**	**449,328**	**461,627**	**466,752**	**466,851**	**N/A**
Pension Rate	10.88%	11.22%	7.14%	6.73%	7.06%	6.61%	6.12%	6.94%	6.94%	8.32%
Health Rate	3.68%	3.95%	3.98%	4.04%	4.60%	5.55%	6.05%	6.05%	6.05%	6.55%
Total Rate	**14.56%**	**15.17%**	**11.12%**	**10.77%**	**11.66%**	**12.16%**	**12.17%**	**12.99%**	**12.99%**	**14.87%**
Wages (DB)	$7,807,029	$8,027,450	$8,265,463	$8,643,718	$8,984,737	$9,264,183	$9,707,281	$10,032,465	$10,150,428	$10,454,941[a]
Pension Contribution	$849,405	$900,680	$590,154	$581,722	$634,322	$612,362	$594,086	$696,253	$704,440	$869,851
Health Contribution	$287,299	$317,084	$328,965	$349,206	$413,298	$514,162	$587,291	$606,964	$614,101	$684,799
Total Contribution	**$1,136,704**	**$1,217,764**	**$919,119**	**$930,928**	**$1,047,620**	**$1,126,524**	**$1,181,377**	**$1,303,217**	**$1,318,541**	**$1,554,650**

a) Assumes growth of 3% from prior year.

Source: Michigan Office of Retirement Services

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The contribution rate for the MPSERS is broken down exactly as it is for the MSERS; that is, the total contribution rate consists of the pension rate and the health insurance rate. As shown in Table 2, the pension rate also declined sharply in FY 1997-98 due to the one-day valuation on September 30, 1997, as described earlier. The pension rate went from 11.22% in FY 1996-97 to 7.14% in FY 1997-98. Due to the one-day valuation, the MPSERS also was able to pay off its unfunded liabilities, which resulted in the lowering of the pension rate for the system. Unlike the State employee system, the 8.32% pension rate for the MPSERS in FY 2004-05 is still well below the pension rate of 11.22% in FY 1996-97 before the one-day valuation. As with the MSERS, the pension rate for the MPSERS rose more than normal from FY 2003-04 to FY 2004-05, again due to the last good year of stock market gains dropping off of the five-year smoothing actuarial assumption. The primary reason that the rate increases remain lower than those of the MSERS is that the MPSERS is still an open system and there have been no State-wide early retirement provisions adopted.

The health insurance portion of the rate for the MPSERS has increased only slightly since FY 1995-96. The health insurance rate has risen only by 2.87 percentage points over the 10-year period. As Table 2 shows, the rate has risen only a total of one percentage point (from 5.55% to 6.55%) from FY 2000-01 to the current FY 2004-05. The primary factor that has kept the health insurance rate increase so low is that the MPSERS has been using excess funds from the Stabilization Subaccount to help pay for a portion of the health insurance benefits for retired members.

The Stabilization Subaccount was created in 1997 for the deposit of any overfunding amounts. The MPSERS was able to use $140 million from this fund in both FY 2003-04 and FY 2004-05 to help pay for health benefits. The use of these funds from the Stabilization Subaccount allowed the health insurance rate that was applied to the active member salaries to remain at 6.05% for FY 2003-04. The rate increased by only one-half of one percentage point to 6.55% for FY 2004-05 as a result of the use of funds from the Stabilization Subaccount. The remaining $50.0 million in the Stabilization Subaccount will be used in FY 2005-06 again to defray the health insurance costs, thus lowering the amount of increase in the health insurance rate from what it otherwise would have to be.

Conclusion

Although there always will be fluctuations in both the membership and the contribution rates among the State's two largest retirement systems, it is safe to say that both systems remain sound and properly funded. According to the FY 2002-03 Annual Reports, the State Employees Retirement System is funded at 98.0% while the Public School Employees Retirement System is funded at 92.0%. This indicates that both systems are doing well. As the MSERS gets closer to retiring its final DB employees (in about 50 years), it will rely more and more on the assets in the system rather than on the contributions of the active members, since the number of active members will continue to decline. As for the MPSERS system, if the growth in the number of retirees continues to outpace the number of active employees, more stress will be placed upon the system's assets and will likely result in higher contribution rates down the road. Another problem facing the MPSERS is that as health care costs continue to rise, since all of the excess funds in the Stabilization Subaccount will have been depleted by the end of FY 2005-06, the health insurance rate also will rise. Due to the use of the funds from the Stabilization Subaccount, the health insurance rate will rise at some point by an amount necessary to make up for being kept artificially low for the three years that those excess funds were used.