State Notes

TOPICS OF LEGISLATIVE INTEREST

Fall 2012

Update on Michigan School Employees' Retirement System
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On August 15, 2012, the Legislature sent Senate Bill 1040, a bill including numerous changes to the Michigan Public School Employees' Retirement System (MPSERS), to Governor Snyder and on September 4, 2012, Governor Snyder signed the bill and it became Public Act 300 of 2012. Subsequently, a lawsuit was brought against parts of the legislation, and Judge Aquilina in Ingham County Circuit Court issued two temporary restraining orders (TROs) in response. This State Notes article will provide a look at the System in general, a brief summary of Public Act (PA) 300, a description of the TROs, and a discussion of the impact on schools and the State budget arising from those orders. The article also briefly discusses issues related to the 3.0% contribution for school retiree health care, required by legislation enacted in 2010.

The Michigan Public School Employees' Retirement System

The Michigan Public School Employees' Retirement System (MPSERS) had 237,000 working members and 192,000 retired members as of September 30, 2011. Employers within MPSERS include all local school districts, intermediate school districts, participating charter schools, participating libraries, all 28 community colleges, and, for remaining eligible employees, the seven universities that withdrew from MPSERS for new hires in 1996. Before PA 300 of 2012 was enacted, the costs of providing pension and retiree health care benefits were borne entirely by employers (e.g., schools) and their employees and retirees; the State did not provide any direct support for the System.

The cost to employers in fiscal year (FY) 2011-12 was 24.46% of covered payroll for employees hired before July 1, 2010, and 23.23% of payroll for employees hired after July 1, 2010 (those employees in the hybrid plan, which provides a pension beginning at age 60 and a defined contribution savings account). The cost to covered employees ranged anywhere from 0%, up to 6.4% of pay above $15,000, depending on hire date and pension plan, and a further 2.0% contribution to a defined contribution account by employees in the hybrid plan. During FY 2010-11, employers contributed a total of $1.95 billion for pension and retiree health care benefits, and members (active and retired) contributed a combined $717.2 million. The employer rate for FY 2012-13, in the absence of any legislation, was expected to increase to more than 27.0% of covered payroll, and the rate for FY 2013-14 was expected to increase to more than 31.0%.

Senate Bill 1040: Public Act 300 of 2012

The signing of Senate Bill 1040 enacted numerous changes to the Michigan Public School Employees' Retirement System. The principal changes found in the bill include the following, summarized briefly here:

- For existing members hired before July 1, 2010, a choice of 1) higher employee contributions to retain the 1.5% pension multiplier for future years of service, 2) the current contributions with a lower 1.25% multiplier for future years of service, or 3) a freeze on earned benefits and conversion to a defined contribution plan, rather than a defined benefit plan (options referred to below as "pension choice").
- For new members, a choice between the existing hybrid pension plan and a defined contribution plan.

- For new members, the elimination of retiree health care upon retirement; in its place, a 401k-style plan with matching employer contributions up to 2.0% of compensation.
- An 80/20 cost sharing plan for retiree health care for all current and future retirees (except retirees at least age 65 as of January 1, 2013, who are "grandfathered" at 90/10).
- Prefunding of retiree health care, instead of pay-as-you-go.
- A capping of school employer contributions into the System, with the State required to pay additional costs above the capped rate.

A detailed analysis of the changes contained within SB 1040 may be found at the following:

http://www.legislature.mi.gov/documents/2011-2012/billanalysis/Senate/pdf/2011-SFA-1040-N.pdf

The changes listed above, along with other smaller changes enacted in the bill, were expected to have significant fiscal impacts on the State and on local school employers. While prefunding retiree health care is expected to generate significant long-term savings, there are short-term costs of depositing more money into the System's portfolio to generate investment earnings down the road. The additional costs to schools of prefunding retiree health care in the System were to have been offset by increased employee pension contributions from the pension choice, the increased premium cost-sharing, and an appropriation from the School Aid budget. (That appropriation was expected to be around $153.0 million in FY 2012-13. Although $130.0 million already was appropriated for this purpose, the 90/10 "grandfather" clause for health care requires an additional $23.0 million supplemental appropriation.) Table 1 illustrates how the employer contribution rate was expected to remain fairly flat in FY 2012-13, even with the additional costs of prefunding.

Table 1

Keeping the Employer Contribution Rate Relatively Flat in FY 2012-13 (Estimated before the TROs)	
FY 2012-13 Employer Rate without the Changes in Senate Bill 1040	27.37%
Positive health experience	-0.70%
80/20 retiree health care cost sharing	-0.79%
Use of 3% retiree health care contributions	-2.58%
Prefunding retiree health care (SB 1040)	6.13%
Pension choice (increased employee contributions to retain 1.5% multiplier, or same contributions but lower multiplier of 1.25%, on future years of service)..	**-2.07%**
Reamortization of early retirement incentive...	-1.30%
School Aid Fund appropriation..	-1.60% (about $153.0 million)
New FY 2012-13 Employer Contribution Rate	**24.46%**

Source: May 4, 2012 State Budget Office document adjusted for estimated 90/10 "grandfather" clause in retiree health care for retirees age 65 and older as of January 1, 2013

Table 2 illustrates what had been expected in the absence of any legislation, and the anticipated impact on schools, on the unfunded accrued liabilities of the retirement system, and on the State from enactment of PA 300 of 2012, before the TROs were issued.

Table 2

Fiscal Impact of PA 300 of 2012 for FY 2012-13 (Estimated before the TROs)		
	Current Law (No Changes)	**Senate Bill 1040 (PA 300 of 2012)**
Employer contribution rates (as % of MPSERS payroll)....	27.37%	≈ 24.46%
Pension unfunded accrued liability	$22.4 billion (from 2011 valuation)	$20.8 billion
Retiree health unfunded accrued liability...........................	$25.9 billion (from 2011 valuation)	$11.9 billion
Total Liability...	**$48.3 billion**	**$32.7 billion**
Additional School Aid Fund necessary to keep employer rate flat at 24.46%...	$0	$153.0 million

The issuance of the temporary restraining orders, however, has changed the fiscal landscape of MPSERS, at least for the time being.

Lawsuit, Temporary Restraining Orders, and Resulting Fiscal Impact

The Michigan Education Association (MEA) and the American Federation of Teachers (AFT) filed separate lawsuits in Ingham County Circuit Court alleging eight counts, including violation of contractual pension and retiree health care rights, violation of pension and retiree health care rights under the U.S. Constitution (impairment of contract and taking of private property) and the State Constitution (guarantee of an accrued financial benefit), and pension and retiree health care due process violations. On September 5, 2012, Judge Aquilina of the Ingham County Circuit Court issued two temporary restraining orders and consolidated the two lawsuits.

One of the TROs prohibits the State from enforcing the window during which employees were to choose between contributing higher amounts for their pensions in order to retain the 1.5% pension multiplier for future years of service, or accepting a lower multiplier but not facing an increase in contributions (pension choice). The second TRO provides that anyone who makes an election may withdraw that election if any portions of PA 300 are found to be unconstitutional. Because of the TROs, the Department of Technology, Management, and Budget (DTMB) issued a letter on September 21, 2012, stating that full implementation of PA 300 would not be possible, and the employer contribution rates could not be reduced as much as they would have been with full implementation of the legislation.

Instead of the anticipated 24.46% school contribution rate for FY 2012-13 and $153.0 million State appropriation (as illustrated in Table 1), the DTMB indicated in the letter that, beginning October 1, 2012, and until further notice, schools will have to pay 25.36% of payroll for employees hired before July 1, 2010, and either 23.20% or 24.13% of payroll for employees in the hybrid plan, depending on hire date. In addition, the State will have to pay an additional $106.0 million (on top of the previous $153.0 million).

Both the increased school cost and the increased State cost are the result of the inability to fully implement PA 300 due to the TROs. The bolded item in Table 1 ("pension choice") is the subject matter of the TROs, and is suspended until the TROs are lifted or a decision is made by the courts. Therefore, the 2.07% savings (about $207.0 million) expected from "pension choice" are not currently recognized, and those savings are made up for in roughly equal amounts, with schools paying about $91.0 million and the State paying the extra $106.0 million, as discussed above.

Since the remaining portion of the legislation is not suspended, implementation of all other portions of the Act is proceeding, including prefunding of retiree health care, until a decision is made on the entire Act. Table 3 illustrates the employer contribution rates in effect as of October 1, 2012, as published by the Department of Technology, Management, and Budget on September 21, 2012.

Table 3

FY 2012-13 Employer Contribution Rate Effective 10/1/12 (with TROs in Effect)

	First Worked before 7/1/10[a)]	First Worked on or after 7/1/10, through 9/3/12[b)]	First Worked on or after 9/4/12 and Remain Pension Plus	First Worked on or after 9/4/12 and Elect DC	
Pension Normal Cost	3.47%	2.24%	2.24%	0.00%	
Pension UAL	11.42	11.42	11.42	11.42	The employer contribution rates for the members' health and/or pension elections will be provided after the TRO is lifted.
Pension Early Retirement Incentive	1.36	1.36	1.36	1.36	
Pension Total Rate	**16.25%**	**15.02%**	**15.02%**	**12.78%**	
Health Normal Cost	0.93	0.93	0.00	0.00	
Health UAL	8.18	8.18	8.18	8.18	
Health Total Rate	**9.11%**	**9.11%**	**8.18%**	**8.18%**	
TOTAL	**25.36%**	**24.13%**	**23.20%**	**20.96%**	

a) Basic, MIP Fixed, MIP Graded, MIP Plus.
b) Pension Plus.

Source: September 21, 2012 DTMB letter

Next Steps and Options for the Legislature

Judge Aquilina has indicated that she will hear motions for summary disposition on November 28, 2012. The State filed an application for leave to appeal to the Court of Appeals (COA) and asked the COA to stay or lift the TROs. Although the COA granted the State's application for leave to appeal, it denied the request to stay the TROs. In light of that denial, the State filed an application for leave to appeal to the Michigan Supreme Court (MSC) and asked the Court to issue a ruling on or before October 19. Briefs have been filed but the MSC has yet to issue a decision.

In the meantime, the Legislature likely may need to decide whether to amend the MPSERS Act if the pension choice savings remain unavailable due to the litigation. Since prefunding retiree health care is a large up-front cost, if prefunding continues but the State is not able to collect and use the pension choice savings for the cost of prefunding, then the State will need to contribute in FY 2012-13 another $106.0 million in order to keep the employer rate capped as required under PA 300, unless the Act is amended.

The Legislature could amend the Act to include a trigger on the matter of prefunding retiree health care, whereby prefunding would occur only if the pension choice savings were found constitutional and collectable (on top of a trigger added for the 3.0% contributions for retiree health care). If prefunding does not occur, then nearly $11.0 billion of the $14.8 billion reduction in health care unfunded accrued liability (illustrated in Table 2) will not materialize, and instead of being paid off in an estimated 26 years, the accrued liabilities for retiree health care will take approximately 60 years to be paid off. Alternatively, the Legislature could remove the employer rate cap that was established in PA 300, which would mean the costs of prefunding retiree health care would be passed along to the local school employers. Finally, the Legislature could choose to retain prefunding and the employer rate cap, which, as already noted above, would require a new appropriation in FY 2012-13 of $106.0 million to pay the additional costs. Each of these options presumes that the pension choice contributions, currently the subject of the TROs, remain frozen and uncollectable for the entire 2012-13 fiscal year.

If the Legislature were to choose the third option outlined above, the only available source of revenue in the School Aid budget that could be used to pay the $106.0 million extra cost would be the MPSERS Reserve for Reforms, a categorical in the School Aid Act with $174.0 million in the fund at this time. However, this would only pay the costs of prefunding for one year, and prefunding itself will cost additional funding over the next few years. Continued support of prefunding will require a monitoring of School Aid Fund revenue growth in the future, and a judgment through the appropriations process whether appropriating dollars to support prefunding and the employer rate cap outweighs the benefits of other educational programs funded at the State level.

Brief Discussion of 3% Retiree Health Care Lawsuit and Implications

Thus far, this Notes article has addressed only the TROs associated with the lawsuits brought by the MEA and the AFT related to Senate Bill 1040. However, there is continuing litigation related to the 3.0% contributions for *retiree health care*. Public Act 75 of 2010 established a 3.0% contribution for retiree health care; employees have been making these contributions since July 1, 2010, but because of litigation, the contributions have been escrowed and the escrow account currently contains roughly $500.0 million. The Court of Appeals in August 2012 ruled that these contributions were unconstitutional, but the basis for the ruling was PA 75, and did not reflect the changes included in SB 1040 to address the constitutionality concerns. The State currently is appealing the COA's August 2012 ruling to the Michigan Supreme Court.

It should be noted that nearly half of the cost of prefunding retiree health care (2.58% out of 6.13%) is covered by using these 3.0% retiree health care contributions on an ongoing basis, as Table 1 illustrates, and in order to have a structurally balanced School Aid budget (while paying for prefunding and capping the employer rate), the $500.0 million in escrow also needs to be found constitutional (or another source of dedicated revenue will be required). Currently, schools are continuing to collect and remit the employee 3.0% contributions for retiree health, and, since October 1, 2012, and under the guidelines of SB 1040, the Office of Retirement Services has been using those 3.0% contributions for the cost of prefunding retiree health. According to the trigger in Senate Bill 1040, if a court of final jurisdiction finds the 3.0% contributions unconstitutional, then prefunding will cease and the money will be repaid. Clearly, then, in addition to the issues surrounding the TROs and the suspension of the "pension choice" contributions, resolution of this litigation likely will have an impact on the school employees' retirement system.