State Notes

TOPICS OF LEGISLATIVE INTEREST

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Explaining "Stranded" and "Legacy" Costs in Retirement Systems
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Over the past decade or so, interest in privatization, at both the State and local levels, has grown steadily. Part of the appeal of privatization stems from the option that private providers have of offering different and often scaled-back, or nonexistent, retirement options for the contracted employees, relative to the retirement plans offered by State and local government. When there are no "legacy" costs for the public employees, a comparison between the costs of public versus contracted or private employees is much simpler. However, at times like the present when significant legacy costs do exist, the analysis is somewhat more complicated. This article will explain "stranded" and "legacy" costs associated with the State Employees' Retirement System (SERS) and the Michigan Public School Employees' Retirement System (MPSERS), examine what privatization means when bids are analyzed, and explain the impact of stranded costs on the State budget.

What Are Stranded and Legacy Costs?

The costs of each year's benefits are fully paid in that year. This is the *normal cost*. *Legacy costs* (or unfunded actuarial liability, UAL) result from market crashes, recessions, population loss/ privatization, unfunded benefit giveaways (e.g., early outs at the local or statewide level), and other factors that throw the actuarial assumptions off.

When assumptions are off, it is not always to the bad. Sometimes there is negative UAL (i.e., the plan is overfunded, which has happened before). More recently, there has been positive UAL, meaning the plan is currently underfunded. Therefore, *legacy costs* refer to the costs of providing benefits that were promised and earned, for which there presently is a shortfall of assets available to pay.

In somewhat simplistic terms, this can be most easily equated with the amount of unfunded accrued liability there is in a retirement system, and the shortfall must be funded regardless of whether employees remain directly hired by State or local government, or privatization occurs.

Stranded costs refer to the phenomenon that occurs when an employer deliberately reduces the number of employees covered by the retirement system (through privatization or downsizing, for example) for the purpose of not having to pay retirement contributions, and the legacy costs that were being partly paid for as a charge against that covered payroll are instead transferred to the remaining payroll of employees covered by the retirement system. In other words, the responsibility of the employer to pay its fair share of the legacy costs is stranded to the extent of the privatization or downsizing, and, since the same dollar amount must be generated in order to pay down the shortfall (like paying off a mortgage), the remaining employers or covered payroll must pick up the stranded cost.

With the State being one single employer managing employees in SERS, the analysis is somewhat more direct when reviewing the impact of legacy and stranded costs. However, when looking at hundreds of school district employers that are all part of one retirement system, the analysis is somewhat more complex. The next section of the article provides examples illustrating what happens to the legacy costs if they are stranded by an employer.

First, however, Table 1 shows how much funding must be collected as a percentage of payroll for fiscal year (FY) 2013-14 in order to make the annual payment toward the legacy costs, in both SERS and MPSERS. The legacy costs, or the unfunded accrued liability, are on a 25-year payoff plan, such that, if sufficient payments continue to be made on a scheduled basis and actuarial assumptions (e.g., market returns or mortality tables) are met, the legacy costs will be paid off by 2038.

Table 1

Employer Normal Costs and Legacy (UAL) Costs for FY 2013-14, as Percent of Payroll

	SERS Defined Benefit (DB)	SERS Defined Contribution (DC)	MPSERS Basic/Member Investment Plan (MIP)	MPSERS Hybrid
Normal				
Pension Normal	3.30%	7.00%	2.90%	2.67%
Health Normal	4.18%	4.18%	0.93%	0.93%
Total Normal	7.48%	11.18%	3.83%	3.60%
Legacy (UAL)				
Pension UAL	17.54%	17.54%	15.44%	15.44%
Health UAL	20.01%	20.01%	5.52%	5.52%
Total UAL	37.55%	37.55%	20.96%	20.96%
Health UAL Paid by State through the School Aid Fund	n/a	n/a	4.56%	4.56%
Total Rate[1)]	**45.03%**	**48.77%**	**29.35%**	**29.12%**

[1)] Total rate excludes FICA, reconciliation, and MPSERS Hybrid DC employer contributions

Note: SERS DB does not include Corrections or Conservation Officers; their rates are slightly higher. MPSERS Basic/MIP and Hybrid were chosen as they represent the largest numbers of employees.

Legacy costs can be thought of as similar to a mortgage: regardless of the changes or makeup of household income, the mortgage payment must be made in order for the principal and interest to be paid by its scheduled payoff date. Unlike a personal mortgage, however, where a house could be sold if household income fell below a level necessary to pay for the mortgage, the State Constitution protects pension benefits earned; therefore, the legacy costs associated with accrued pension service cannot be avoided. Legacy costs associated with earned health care benefits may be subject to change, but the courts would have to decide to what extent changes would be acceptable. Table 1 shows that for FY 2013-14, in SERS, more than 37% applied to payroll must be remitted to make the annual payment toward legacy or UAL costs. For MPSERS, nearly 21% of payroll must be levied to make the annual payment.

Table 1 also illustrates the "normal" retirement costs, which represent the cost today of providing an additional year of pension and/or health benefits accrued for the future. Looking at the table for SERS, for example, the "normal" cost to provide one more year of pension and health care benefits for a State defined benefit (DB) worker is 7.48% of pay. (Defined benefit now is a closed system: since March 31, 1997, no new employees have been eligible.) For MPSERS workers in the Basic or Member Investment Plan (also closed with no new eligible participants), the normal cost is 3.83% of pay, and for members in the Hybrid plan (for members hired on or after July 1, 2010), the normal cost is 3.60% of pay.

As of the FY 2011-12 valuation for the State Employees' Retirement System, the unfunded accrued pension liability was $6.2 billion and the unfunded accrued health liability was $8.4 billion. The sum of these two can be considered the legacy costs, to be paid off over 25 years, and the yearly "mortgage payment" in dollar terms must be made regardless of the size of the direct State payroll, or how many employees are laid off or privatized. In a given year, the "legacy" (UAL) cost is a fixed dollar amount

where the *method* of raising the dollars necessary to make the "mortgage payment" is to collect the dollars as a percentage of current covered payroll (again, 37.55% for SERS DB members in FY 2013-14), and the legacy costs reflect the shortfall of assets to pay for previously accrued benefits.

Turning to the Michigan Public School Employees' Retirement System, the FY 2011-12 valuation indicated an unfunded accrued pension liability of $24.3 billion and an unfunded accrued health liability of $21.8 billion. However, it should be noted that the accrued liabilities found in the FY 2011-12 valuation for MPSERS do not reflect the reduction in health care liability that will occur beginning in FY 2012-13 due to prefunding (rather than paying on a cash basis) other post-employment benefits (OPEB), and other changes enacted in 2012. At the time of the change to prefunding (part of Public Act 300 of 2012), it was estimated that OPEB liabilities would be reduced by roughly $14.0 billion beginning in FY 2012-13.

State Employees' Retirement System

The State of Michigan is a single employer in the State Employees' Retirement System. Therefore, the normal and legacy costs within SERS are paid entirely by the State via appropriations to all of the State departments, which then remit the required amounts to the pension system. Total State payroll is roughly $3.1 billion; applying the total UAL of roughly 37.6% to $3.1 billion payroll equates to a yearly payment toward legacy costs of about $1.2 billion.

What often is misunderstood is that simply shrinking State payroll (such as by privatizing services) does not reduce the legacy costs. The $1.2 billion annual payment actually is derived first, calculated by the independent actuaries contracted by the State to oversee the financing of the pension systems. The actuaries determine the *monetary* amount necessary to "make the mortgage payment" on the unfunded accrued liabilities, such that the "mortgage" will be paid off within a specified period of time, in this case, 25 years. Then, the State Budget Office, with the Office of Retirement Services and the actuaries, determines the percentage that must be collected on payroll in order to generate the necessary dollar contribution in any given year. In this case, $1.2 billion is the amount necessary to be raised, and it represents 37.6% of State payroll. If one-quarter of State payroll were to be privatized, bringing total State payroll down to $2.3 billion, then the percentage of payroll necessary to generate $1.2 billion in the required contribution would increase from 37.6% to 52.1%. Therefore, regardless of privatization or other methods of reducing active State payroll, the legacy costs still would have to be paid; they would just be spread out among a smaller payroll base (meaning a higher percentage applied to payroll).

For the reasons stated above, when examining bids for privatizing services it is necessary to make a comparison that accounts for the fact that legacy costs associated with the past must be paid regardless of whether employees are State employees or private employees. Table 2 illustrates a comparison between a hypothetical State department and two bids from private companies. In the table, the cost to use State employees in the example totals $14.7 million, of which $10.9 million would be payroll and "normal" costs and another $3.8 million would be "legacy" costs. When comparing this to private bids, the "legacy" costs must be added to the bid price, since they have to be paid regardless of whether the employer is the State or a private company. In the first bid, wages are 10% lower than the State's and the company offers no retirement benefits, for total costs of $12.8 million, or savings of $1.9 million (13.2%). In the second bid, wages and benefits at the private company are 20% lower than the total State cost of $14.7 million, which, at first glance would seem to produce savings. However, when the legacy costs are added in, the total cost of the second bid exceeds the cost of retaining the employees at the State level, making privatization more costly.

Table 2

Current Situation	
Payroll paid to State employees	$10,000,000
Normal pension/health costs (avg. 9.33%)	$933,000
Subtotal of non-legacy costs	$10,933,000
Legacy costs	+
UAL costs (37.59%)	$3,759,000
Total Appropriation to Cover Compensation	$14,692,000
New Bid 1 - 10% Lower Wages and No Retirement Benefits Offered	
Payroll plus private retirement contributions (if any)	$9,000,000
Plus	+
Legacy costs	$3,759,000
True total privatization cost	$12,759,000
Net Cost (Savings) Compared to Current Situation	**($1,933,000)**
New Bid 2 - 20% Less than Total State Cost, but Legacy Costs Added	
Payroll plus private retirement contributions (if any)	$11,753,600
Plus	+
Legacy Costs	$3,759,000
True total privatization cost	$15,512,600
Net Cost Compared to Current Situation	**$820,600**

Michigan Public School Employees' Retirement System (MPSERS)

Legacy and stranded costs are present in the Michigan Public School Employees' Retirement System, as in SERS. The difference between MPSERS and SERS, though, is that there are hundreds of local employers within MPSERS compared with the sole employer (State of Michigan) in SERS. Before Public Act (PA) 300 of 2012 capped the unfunded accrued liability percentage paid by local employers at 20.96% of payroll, when an employer in MPSERS (school district, intermediate school district, community college, or participating library or charter) reduced its covered payroll (such as by downsizing, privatizing, or converting to a charter school), the employer would immediately shift that portion of its legacy costs to the payroll remaining in the system statewide, thereby resulting in "stranded costs" that were spread to other employers.

However, due to the MPSERS rate cap on unfunded liabilities that was enacted as part of PA 300 of 2012, any reduction in covered MPSERS payroll now will result in a cost to the School Aid Fund, until such a time when the rate contributed by local employers toward the UAL falls below 20.96%. The reason is that, again, in any given year, the money that must be raised to pay down the legacy costs is a fixed dollar amount, like a mortgage. Whether that dollar amount is spread among a larger payroll (generating a smaller percentage rate) or among a smaller payroll (generating a larger percentage rate), the same *dollar* amount must be raised. Since the enactment of PA 300, if the MPSERS payroll declines and the percentage that must be collected against payroll rises to generate the fixed UAL payment, the School Aid Fund will have to pay for any *percentage of payroll* in excess of 20.96%.

Once the "mortgage" is paid off, scheduled in 25 years, then the stranding of costs again could occur among employers in the event of shifting of payroll, if unfunded liabilities accrue in the future.

Continued expansion in the number of nonparticipating charter schools, the conversion of school districts to charter schools, and the introduction and expansion of the Education Achievement Authority schools all draw covered payroll away from providing financial structure for the system. In addition, the recent enactment of House Bills 4813 and 4815 (Public Acts 96 and 97 of 2013) provides for an expansion in the dissolution of schools, and the extent to which the dissolution of schools results in a reduction in MPSERS payroll, it also will result in "stranded" costs and an increased cost to the School Aid Fund. If the covered payroll does not grow at the actuarially assumed 3.5% per year for any of these reasons, or any other reasons, there will be additional yearly costs to the School Aid Fund to meet the required payment toward legacy costs.

As shown in Table 1, the normal cost to the employer for an employee accruing a year of service in MPSERS is less than 4% of payroll, and the amount the employer must contribute to pay down the "mortgage" of the historical legacy costs is just under 21% of payroll (statutorily capped by PA 300 of 2012). The legacy costs actually are higher than 21% of payroll, and Table 1 shows that the additional State support toward the employer contribution rate for FY 2013-14 is 4.56% of payroll, which equates to roughly $403.6 million in the School Aid budget and another $31.4 million in the Community Colleges budget. The estimated cost in FY 2014-15 to the School Aid Fund to pay for the MPSERS rate cap is more than $650.0 million. An expansion in covered payroll (such as bringing all K-12 alternatives into the retirement system) could substantially reduce the costs paid directly by the School Aid Fund in the future.

Conclusion

Several items of note should be considered when reviewing retirement issues. First, legacy costs are historical costs that are tied to benefits that have already been earned and that must be paid, but for which there is currently a shortfall in system assets due to factors that have thrown actuarial assumptions off. Closing a system will not eliminate legacy costs related to pensions, and courts would have to rule on whether closing out health care benefits would be allowable. Second, in order to compare privatization to State employment, or competitive bidding, the costs attributed to legacy costs must be included in the analysis in order to compare "apples to apples". Again, this is because legacy costs from the previous system will have to be paid regardless of whether employment remains at the State level or is privatized. Third, with the enactment of PA 300 of 2012, any reduction in covered payroll in MPSERS will mean an increase in State costs to the School Aid Fund due to the employer rate cap of 20.96% of payroll, at least until the rate levied to pay off the unfunded accrued liabilities falls below that level.