

State Notes

TOPICS OF LEGISLATIVE INTEREST

March/April 2007



Budgetary Savings from State Retirement Systems for FY 2006-07 **By Kirk Sanderson, Fiscal Analyst**

Introduction

Many changes have been proposed to address the General Fund and School Aid Fund revenue shortfalls in the current fiscal year's budget. One area where there have been efforts to find savings is the State's retirement systems. The State manages four retirement systems on behalf of public employees: the State Employees' Retirement System (SERS), the Michigan Public School Employees' Retirement System (MPERS), the State Police Retirement System (SPRS), and the Michigan Judges Retirement System. Some changes already have been passed while others are currently under consideration. This article describes the plans that are being implemented and proposed, their impact on the current year's budget situation, and some potential long-term implications.

Mark-to-Market

Five-Year Smoothing Mechanism

The first approach to saving money in the retirement systems is called Mark-to-Market. It is included in Executive Order 2007-3 for SERS and SPRS and is part of a proposal passed by the Senate to create savings in MPERS for the School Aid Fund. The mark-to-market proposal will revalue a retirement system's assets according to their actual market value as of September 30, 2006, for the purpose of determining the required amount of employer contributions. This is a change from the current method of using a "five-year smoothing" when determining the value of assets.

Under the present system, the annual return on investments is assumed at 8.0%. The difference between that assumed amount and the actual investment return gets spread over a five-year period, i.e., one-fifth of the gain or loss is accounted for in each of the next five fiscal years. The goal of this smoothing process is to reduce volatility in the value of assets and, in turn, the employer contribution rate. It helps protect the rate from the natural fluctuations in the stock market. Another effect is that the smoothed valuation does not reflect the actual value of a system's assets. For example, it produces a value that is lower after a string of years in which returns have been increasing, or that includes one or two previous years of negative returns.

Fiscal Impact of Revaluation

Revaluing a retirement system's assets to their market value as of September 30, 2006, will allow the system to realize gains in the stock market in the time leading up to the end of the last fiscal year. It also eliminates the inclusion of a portion of the negative returns experienced in 2002. This higher value allows for a lower contribution rate required of employers, i.e., the rate needed to raise a certain amount of dollars gets smaller as the value of the assets gets larger.



Mark-to-market was included in Executive Order 2007-3 for SERS, SPRS, and for all community colleges and the seven public universities that participate in MPERS. These savings, combined with the deferral of certain payments described in the following section, resulted in savings of \$99.2 million in General Fund dollars. A similar plan for school districts has passed the Senate and is awaiting action in the House. The mark-to-market portion of the Senate-passed plan would save an estimated \$175.6 million for the School Aid Fund.

In addition to the revaluation, this plan resets the five-year smoothing period. Therefore, for the next fiscal year, only one-fifth of any gain or loss from investments this fiscal year will be built into that next year's contribution rate. The rest will be accounted for in each of the following four years, along with a portion of any gains or losses from those years.

Deferred Pension Payments

Overview of Current Contribution Rate Breakdown

The second part of the proposed solution involves postponing a portion of the payments made to the retirement funds. The total rate of contributions paid into each retirement system is the sum of four different rates. This section outlines each of these payments and then describes the payment deferral in Executive Order 2007-3 and the budget plan passed by the Senate.

The first portion of the total contribution rate is called the normal pension cost. This portion of the rate funds the cost of the present value of the projected benefits of each individual included in the actuarial valuation. It is allocated on a level basis over the service of the individual between entry age and assumed exit age. In fiscal year (FY) 2006-07, this rate for the State Employees' Retirement System is 7.67%, out of an original total rate of 30.30%.

The second portion of the contribution is the unfunded accrued liability (UAL) payment. The UAL is the difference between each system's assets and liabilities. The unfunded liability is amortized over a 29-year period for FY 2006-07. This rate includes contributions for payments both on the UAL itself and on accumulated interest. This rate was 7.80% before the changes in Executive Order 2007-3.

The third portion of the payment is the pension reconciliation payment. Employer contributions to each system are in part determined using actuarial assumptions, such as the 8.0% investment return noted earlier. The contribution required to meet these assumptions may end up being more or less than is actually needed to fund the system. As a result, any amount that is greater or less than the assumed level is smoothed over a five-year period in a manner similar to the investment income smoothing. Before Executive Order 2007-03, this reconciliation payment was 2.63%.

The final portion of the contribution rate funds retiree health benefits. This portion of the rate determines employer contributions to cover health benefits for current retirees that are funded on a pay-as-you-go basis during the fiscal year in which the costs are incurred. This rate is 12.20% in FY 2006-07. These four payments add up to the 30.30% total contribution rate, as summarized in Table 1.



Table 1

Original FY 2006-07 Contribution Rates State Employee Retirement System (SERS)	
	Original FY 2006-07 Rate
Normal Cost	7.67%
UAL	7.80%
Reconciliation	2.63%
Insurance	<u>12.20%</u>
Total	30.30%

Deferral of Part of the Contribution Payments

Executive Order 2007-3 calls for a one-time change for FY 2006-07 for SERS and SPRS. It requires payments only for the pension normal cost and the interest payments on the UAL, suspending the remaining payments for the current fiscal year only. As stated above, the payment deferral and the mark-to-market combined will save the General Fund an estimated \$99.2 million. The health benefit payments are unaffected.

This deferral will have a small effect on future contribution rates to compensate for the lack of payment this fiscal year. For SERS, beginning in FY 2008-09 the contribution rate will be approximately 0.06 percentage point higher than it would have been if not for the deferral. The system's funded ratio (liabilities divided by assets) also will be approximately 0.2 point lower than it would have been beginning in FY 2007-08.

The Senate has passed a similar proposal that would affect the Michigan Public School Employees' Retirement System. The estimated savings for the School Aid Fund from making an interest-only payment on the UAL for that system are \$86.4 million in FY 2006-07. Effects on future contribution rates are likely similar to those in the SERS plan.

Health Sub-Account Savings

Background

The third piece of the General Fund reduction in the Executive Order involves closing the Health Advance Funding Sub-Account (HAFS). The HAFS is an account set up in 2002 to prefund health benefits for members of SERS, and includes a combination of General Fund dollars, State restricted revenue, and Federal funds. During FY 2002-03, however, \$58.2 million from the account was transferred to the State's General Fund as part of Executive Order 2002-22 to help offset that fiscal year's revenue shortfall.

The U.S. Department of Health and Human Services (HHS) has objected to the transfer, specifically the use of Federal money for purposes other than retiree benefits. The Federal portion of the transferred money must be repaid. The original amount plus interest totals \$15.2 million. According to the repayment request from HHS, repaying the money using General Fund/General Purpose (GF/GP) funds will allow a lower interest rate to be charged than if a different fund source were used. Using General Fund dollars to get this lower rate will save the State \$6.8 million.



Impact on FY 2006-07 Budgets

In order to use GF/GP money for the repayment, Executive Order 2007-3 directs \$24.0 million from the HAFS to replace an equal amount of GF/GP funding in each department's FY 2006-07 budget. The money will be applied toward the department's contribution into SERS. The \$24.0 million will be used almost exclusively for repayments to the Federal government and the State restricted funds that originally paid in the money. The net savings to the General Fund will be much lower. Of the \$24.0 million General Fund being taken out of the FY 2006-07 budget, \$15.2 million is being used to repay the Federal government. A net \$7.1 million is being paid back to the State restricted revenue. As a result, the closing of the HAFS will save \$1.7 million in the General Fund for FY 2006-07.

Potential Long-Term Impacts

The changes to the retirement systems described above are intended as one-time fixes to address revenue shortfalls in the current year's budget. If these plans are all enacted as described, they could produce savings of \$100.9 million for the General Fund and \$262.0 million for the School Aid Fund. The impacts of these changes on future contribution rates should be minimal.

Revaluing the assets will cause contribution rates to be lower in the short term than they otherwise would have been. This is because the actual value of each system's assets is higher than their five-year average. Revaluing the assets allows for the use of each system's true value instead of the "smoothed" value, which may better reflect the ability to pay out benefits in the future. Absent the revaluation, the rate necessary to get the required amount of contributions would be based on a value of assets that is *less* than what it actually is.

As described above, the impact of the interest-only payments on each system's UAL also will have minimal impact on future rates. Because the deferred payment can be spread over a number of years, the increase each year is expected to be less than 0.1 percentage point.