

DATE: 2/25/2009

TO: All Interested Parties

FROM: Bethany Wicksall, Senior Fiscal Analyst

RE: Converting MPSERS from a Defined Benefit (DB) to a Defined Contribution (DC) System

A discussion of the fiscal impact of closing the Michigan Public School Employees' Retirement System's (MPSERS) DB plan and moving to a DC plan follows below. This change would create significant cost increases up front and would not create potential savings for at least 15 years. The increased costs and potential savings are described in more detail below.

Current DB Plan

Currently school districts pay the employer portion of retirement costs as a percent of current payroll. For FY 2008-09 the employer contribution rate for the pension, determined annually by the Office of Retirement Services (ORS), is 9.71%. This includes a normal cost of 5.15% for current employee pension benefit costs and 4.56% for the Annual Required Contribution (ARC) to pay the unfunded accrued actuarial liabilities (JAAL) of approximately \$5.8 billion (as of Sept. 30, 2007) over 30 years.

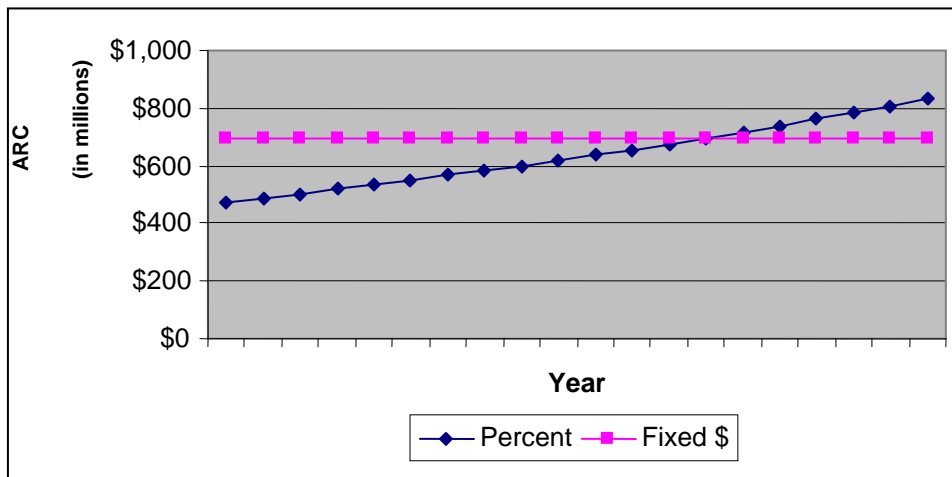
In addition, school employees hired after 1990 and those who were hired before but converted to the Member Investment Plan (MIP) are required by statute to contribute a percent of their salary each year toward retirement. The employee contribution was increased for new employees hired after July 1, 2008 and is summarized in Table 1.

Hire Date	Contribution on first \$15,000 of Salary	Contribution on portion of Salary over \$15,000
Prior to July 1, 2008	\$510	4.3%
After July 1, 2008	\$510	6.4%

GASB Requirements for a Closed DB Plan:

Currently the ARC is paid as a percent of payroll, 4.56% for FY 2009 as mentioned above. When a defined benefit system with an unfunded liability is closed, the Government Accounting Standards Board (GASB) requires that the ARC change to a fixed dollar amount. Initially, the fixed dollar contribution required would be higher than what the State would pay as a percent of payroll, but it would decline gradually over time and eventually be lower. The chart below gives a very basic illustration of this. According to ORS in Year 1, the difference between the current percent-based ARC and the fixed-dollar ARC would be approximately \$208 million (as of Sept. 30, 2008, but with serious market declines since that date, this number is likely to be much higher). ORS estimates that the fixed-dollar ARC would reach a point where it equaled than the percent-based ARC between years 15 and 20 out of 30 years. Market and actuarial fluctuations make it impossible to estimate reliable annual figures and the breakeven point of such a conversion.

Annual Required Contribution: Percent vs. Fixed Dollar



Comparing the Normal Cost of Current DB Plan vs. a DC Plan

In 1997, the State Employees' Retirement System (SERS) closed its DB system and created a DC system for all new employees. According to ORS, for SERS the DC plan has a normal cost of 6.55% of payroll. Because state employees had not previously contributed toward their retirement, switching from a DB to a DC plan created a significant savings for the state. However because current MPSERS employees contribute an average of between 4%-6% depending on hire date, the normal cost for MPSERS employers is only 5.15% of payroll. Switching to DC plan identical to the State's, assuming the MPSERS participation level was equal, would actually cost districts an extra 1.40% of payroll each year. And if participation was 100% of the match, it could cost districts an additional 1.85% of payroll each year. This would equal an increase of as much as \$185.0 million once fully implemented based on current payroll. These estimates are based on a DC plan identical to the State's plan. A plan with lower benefits would decrease the normal cost and potentially avoid additional costs.

Potential Savings of DC Plan

The potential savings in a DC plan come from eliminating the possibility of unfunded liabilities or essentially from shifting the risk of long term market performance from the employer to the employee. There have been years in which the pension system was fully funded and therefore the UAAL was \$0. In such a period there would be no savings generated by switching to a DC plan. In fact, there would be potential added normal costs as mentioned above. However, there would be savings when compared to the current situation where the most recent figure for the UAAL is \$5.8 billion and current employer contribution rate toward the UAAL is 4.56%. Although it would take about 40 years for the full savings to be realized, if a DC plan were fully in place today, and all else held equal, it would save approximately \$456 million compared to current costs.

Conclusion

The benefit of having a DC system is the consistency of the contribution rates over time. After the initial UAAL from closing the DB system was paid, the system would never incur a future unpaid liability. However, it is not necessarily cheaper and the savings would take nearly 40 years to be fully realized. Because of significant employee contributions, switching MPSERS from a DB system to a DC system would create additional normal costs unless a plan with lower benefits than the current State DC plan were offered. Finally, the accounting changes required from closing the DB system would create significant up front costs currently estimated at \$208 million in the first year.