TO: Committee on Ways and Means / Subcommittee on Oversight

FROM: Municipal Employees Retirement System of Michigan

DATE: May 16, 2011

RE: Written Comments: Transparency and Funding of State and Local Pension Plans and HR 567

HISTORY OF MERS

The Municipal Employee Retirement System (MERS of Michigan) was established by the Michigan legislature in 1945 as the state pension pool system for municipalities. MERS operated under the direction of the Department of Management and Budget until 1996 when the system was removed by the legislature from direct state control. MERS has since operated under its statute as a public nonprofit governmental pension plan, an instrumentality of all the participating municipalities and courts of Michigan.

MERS membership is, and always has been voluntary. MERS offers defined benefit, defined contribution, and hybrid pension plans. Currently of the approximately 890 municipalities in Michigan offering pension benefits, 760 belong to MERS, representing over 2100 separate pension plans. The remaining 130 non-MERS municipalities manage their pension plans individually.

Recent studies indicate that over 91% of the 27,150 MERS plan retirees continue to live in Michigan and those retirees contribute over $451 million annually to Michigan's economy.

All told, there are over 250,000 public sector retirees living in Michigan, and those retirees support 57,300 jobs in Michigan.

FINANCIAL DATA

MERS combines the use of both in house investment management and outside contracted money managers. Currently about 15% of the defined benefit assets and 100% of the defined contribution pension investments are managed in house by MERS. As of April 1, 2011, total assets under investment were at $6.578 billion.

As of December 31, 2009, the average pension benefit in the MERS system was $16,991 a year, or $1416 each month, and it should be noted that National Association of State Retirement Administrators data indicates that nationwide, 28% of municipal employees and 70% of police and fire employees work in positions not covered by Social Security.

For every dollar of pension assets in the MERS defined benefit system, 64 cents comes from investment returns, 26 cents comes from the municipality and 10 cents comes from the employee. As the market downturn from 2008 works its way off the books, in response to robust investment returns in 2009 and 2010 (17.1% and 14.43% respectively) as the economy continues its recovery, assets are likely to further increase, as will the amount of required employee contributions. Additionally, pension system reforms will result in decreasing employer liabilities thus lowering their required contributions. Collectively, these reforms should decrease the amount of municipal dollars that will be required to fund a defined benefit system in the coming years.

US public pension fund assets comprise about 6% of the total worldwide economy. The 1000 largest public pension systems in the U.S. hold investments of $6.6 trillion, of that, $4.7 trillion are defined benefit plan assets while the remaining $1.9 trillion are in defined contribution.

FINANCIAL ISSUES

There has been much said about the funding sources and funding levels of public pension plans, and based on its experiences MERS has a difficult time understanding how many of the conclusions that are being asserted could have been reached. MERS also questions the general concept that municipalities would be best served by simply closing out existing defined benefit pension programs and placing all new hires into defined contribution plans. Our data and our experience in offering defined benefit, defined contribution and hybrid pension plans along with many other pension-related programs, indicates that in many cases, this is simply not accurate.

In a number of committee meetings, testimony has been given claiming the following:

"Employer contributions are not being made, resulting in serious underfunding situations for public pension funds."

The fact is that at the present time, only four of MERS 760 municipalities are past due in making their required pension contributions (representing about six-tenths of one percent of the total annual required employer contributions). The lowest funding level among the four municipalities is 83%. Historically, delinquent contributions have been almost nonexistent and when late payments do occur, they are typically the result of time lags in the municipality receiving funds due to them (such as a hospital awaiting Medicaid and Medicare payments from the state and federal government). Of the four entities that are currently past due, one is a hospital and one is a community that is in the process of having a Financial Manager appointed by the state. The extremely low rate of delinquent employer contributions is largely due to the mandate of the Michigan Constitution of 1963, Article 9, Section 24, requiring that local governments must prefund annual pension accruals (and make contributions on unfunded liabilities).

"No future employee contributions are likely to be made."

In Michigan, the average employee contribution to municipal defined benefit pension plans is just under 5% of the cost of the plan. Proposed legislation suggested by Governor Snyder would increase the employee contribution towards funding the cost of pension obligations (and 20% for health care, if health care benefits are offered to employees). Even without such legislation, many local government plans have already negotiated increases in the amount of required employee pension (or health care) contributions.

"The investment rate of return is well below what is required to fund public pension plans."

The market return on investment at MERS for 2009 was 17.1%, for 2010 it was 14.43% and the unaudited return on investments for the first quarter of 2011 is 4.33%. The investment return average for the past 25 years at MERS is 9.52%. The assumed rate of investment return has been 8% since 1981.

"Public pensions are using assumptions that mask serious problems that will result in the financial collapse of public pension systems."

MERS has used what is known as the entry age / normal costs actuarial funding method since 1993. This method requires that a municipality contribute the amount required to advance fund the pension benefits of an employee at the acceptable amount of normal cost for the expected term of their employment at the municipality. Using this method, a municipality is assured that they are regularly making a pension contribution that will cover the pension cost of that employee from the first day on the job until their final day of employment. MERS also uses the practice of "smoothing" investment returns above or below the assumed 8% return over a ten year period. This is done to avoid huge fluctuations in the contribution rates for municipalities from year to year. Smoothing results in more level employer contributions making it easier to budget pension obligations, but results in a municipality paying more than they would pay under a market value system (when returns are less than 8%) and less (when returns exceed 8%). The end result is the same, smoothing simply lessens the annual volatility in the required employer contributions that would result from a straight market value approach.

"Overly rich pension benefits have resulted in huge unfunded liabilities and many states face serious financial problems as a result."

There is no doubt that current financial situations have forced state and local units of government to take serious measures to reduce their short and long-term costs so that employer contributions may be lessened (or abated). As a result, municipalities have reformed pension plans and are seeking additional reforms to further reduce the cost of providing pension and health care benefits.

That said, as mentioned earlier, only four MERS municipalities are past due in making their defined benefit pension contributions. MERS assists municipalities in implementing reforms to limit or reduce both current and future costs, and continues to work with the legislature and Governor Snyder on statewide reforms to all public pension systems in Michigan.

An honest investigation into the states that currently suffer serious financial situations in their pension plans will disclose that this situation is often the result of actions taken by the legislative and executive bodies in those states that have diverted funds that were required or earmarked as employer pension contributions, to other programs. As a general rule, the states that have made their required pension payments enjoy fairly healthy pension systems. In Michigan, the pension systems remain fairly well funded despite the fact that the states' economy has been in a depression for the past ten years, and past governors and legislatures have twice covered shortfalls in the general operating budget by having the pensions use trust funds to cover expenses that were otherwise funded by the general fund. The actuarial funding requirement of the Michigan Constitution of 1963, Article 9, Section 24, has for almost 60 years enforced pension funding discipline on the state and local governments.

PENSION REFORMS IN MICHIGAN

Michigan Governor Rick Snyder and the current legislature have taken drastic measures to reform the structure of the public pension system in Michigan. A handful of these reforms have been signed into law, many are being considered by the legislature at the present time, and a number will be introduced in the coming months.

MERS has been allowed to play an active role in the development of these reforms, despite the fact that we are not totally supportive of every detail of many of these reforms; we are, in general, agreeable to the reforms and supportive of the efforts to make structural, long term reforms and improvements to the public pension systems.

An example of some of the reform measures include:

Reforms to the Emergency Manager Statute

Far-reaching legislation enacted in March 2011 greatly expands the powers of state appointed Emergency Managers for local units of government and school districts that are in serious financial distress. Among the most important of these newly expanded powers is allowing the Emergency Manager, under specific circumstances to strike any or all provisions of a collective bargaining agreement, remove any or all appointed or elected local officials, including pension board members, and with the approval of the state treasurer, take sole control of the pension system. The Emergency Manager would also have the power to appoint new members to boards including pension boards. When the municipality or school district is returned back to local control, there must be a two year, non-amendable budget in place and collective bargaining agreements in place cannot be changed for five years. The Emergency Manager also has the power to place a pension plan into MERS if the plan is currently independent.

Reforms to State / Local Revenue Sharing Agreements

Governor Snyder has proposed tying future state revenue sharing payments to municipalities based on firm municipal proposals for consolidation of services and pension reform. In order to receive future revenue sharing payments, a municipality must establish a pension plan structure that limits the employer cost at 10% of payroll or below, requires that final average compensation amounts be calculated on at least three consecutive years of employment and limits all one time pensionable payments to 240 hours, and requires that at least 20% of the cost of employee health care coverage be paid by the employee. This language is contained in the 2011 – 2012 General Government Budget that will be approved by the legislature in the next few weeks.

Pension Cost Containment

MERS has drafted legislation that should be introduced in the next few weeks that would put cost containment and anti-pension spiking language into statute that will apply to all local governmental pension plans in Michigan. At the present time, similar limitations exist in the MERS pension systems, but do not apply to the other municipal pension systems in the state.

The proposed amendments would not allow the enhancement of existing benefits or the approval of new benefits unless a pension system is at least 80% funded (using the entry age / normal cost actuarial funding method) **before and after** the proposed benefit change. Where the proposed change reduces actuarial liabilities, the 80% funding requirement does not apply (as the change will correspondingly increase the funding level). In addition, the proposed legislation would require that all pension benefits be calculated on a final average compensation that was calculated on at least three continuous years salary, and limit the amount of unused vacation time, sick time, overtime or other one time payments to a combined total of 240 hours.

MERS expects that these proposals will be approved by the legislature either as stand-alone legislation or as part of a single pension reform bill that is being drafted by the Department of Treasury.

COMMENTS ON HR 567

MERS strongly opposes HR 567 for a number of reasons. In general, we feel that this is an area that always has been, and should continue to be, a state and local responsibility. The federal government, in our opinion, has one role in this matter, and that role is to tell the states and local units of government that the federal taxpayers will not pay for any bailouts, loans or any other form of financial assistance due to pension problems. Beyond that, the federal government should leave it to each state and local unit to address its own problems. There is not a state in the union that has suffered the financial distress that has occurred in Michigan over the past ten years, but despite that, Michigan has been and is taking measures to address this matter. If Michigan can achieve this, there is no reason that every other state in the union cannot do the same in its own backyard.

The bill is also flawed in a number of areas. The requirement that the financial data be based upon market value is clearly designed to reach a desired, preconceived outcome. Basing financial data strictly on market value is an unrealistic requirement that will render any data received as unrealistic. Furthermore, the annual actuarial valuations for each MERS municipality's separate pension plan(s) has for many years reported the market value of assets. Under HR 567's disclosure requirement, most (if not all) governmental pension plans in the country would appear to be underfunded. Requiring the use of so called riskless rates of return will also result in unrealistic data. Requiring MERS to figure their investment rate of return at Treasury bill rates of 4% makes no sense when MERS actual rate of return is 17.01% in 2009, 14.43% in 2010 and 4.33% so far in 2011. It doesn't even make sense when you compare our 25 year return rate of 9.52%, unless, of course, the requirement is aimed at proving a distorted, preconceived conclusion.

MERS cannot understand why the bill has not, to our knowledge, been scored. It is difficult to believe that the US Department of Treasury is going to review and analyze hundreds of thousands of reports at no cost to the federal government. MERS alone has 760 municipal pension plans (containing 2100 separate plans) that would be required to file the report, so the number nationwide would likely be many thousands.

It is also difficult to understand how the federal government would strip the tax exemption from local municipal bonds. In Michigan, it is currently almost impossible to get bidders for municipal bond offerings. Already unattractive to investors, municipal bonds will become completely impossible to sell if the tax exempt designation would be at risk because the municipality failed to file a report that will be filled with nearly useless data.

It is not the intent of MERS to diminish the issue of underfunded pension plans where they exist. States and local governments need to immediately begin to focus on reforms that will be necessary to assure that their plans remain sustainable. MERS has been and is committed to this objective for our members. HR 567, and more importantly, the mind set of those who support the bill are, in our opinion headed completely in the wrong direction.