Responsible Retirement Reform for Local Government *Task Force*



REPORT OF FINDINGS AND RECOMMENDATIONS FOR ACTION

2017

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II. Executive Summary

To be completed

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III. What is the Current Situation?

Michigan is reported to have slightly over 2,800 general and special purpose local government entities (Census Bureau, 2017). Of this, 1,858 are general purpose local governments (cities, villages, counties, townships) and about 1,000 are special purpose governments (school districts and other special districts). These governmental entities collect revenues, provide a wide variety of public services and employ personnel to carry out these functions. As part of the total compensation package of local government employees, deferred compensation in the form of retirement income (defined benefit or defined contribution) and access to retiree health care is often included.

Pension and OPEB System Overview

Based on estimates from MERS[1] and from individual local government financial reports, there are close to 900 local pension systems in Michigan with the majority of those being in MERs and approximately 130 or so independent systems. MERS membership tends to be the smaller and mid-sized local pension systems that would include most counties, county road commissions, other special purpose governments and cities, village and townships. It should also be noted that many small local governments in Michigan, especially general law townships, villages and small special purpose governments, do not maintain pension systems. Based on current data estimates, approximately 330 general purpose local governments have incurred other post-employment benefits (OPEB)[2].

Larger local governments, such as large and mid-sized cities and some counties in Michigan (for example Kalamazoo, Detroit, Lansing, Wayne County), generally maintain their own independent systems. One government may actually have more than one pension system, such as a general employee pension and a police and fire pension system.

Financial Health Varies by System and Type

On an annual basis, Michigan local governments must expend nearly 9.2 percent ($1 billion in 2015) of all government wide revenues ($10.9 billion) to cover pension expenses. This annual expense can range from as low as one percent of government wide revenues to well over 20 percent of government wide revenues depending on the jurisdiction. It is estimated that Michigan public pensions associated with all local governments owe a total unfunded liability of $6.5 billion. The best current estimates are that $22 billion in pension assets are held against $ 28.5 billion in total pension liabilities. The funded ratio for these systems is then approximately 78 percent. This places Michigan local pension systems at about the

[1] MERS is an independent, professional retirement services company that administers retirement plans for participating Michigan local governments on a not-for-profit basis.

[2] "Other postemployment benefits" (OPEB) is the term used to describe benefits promised to retirees and earned during their years of service. The most common benefit is healthcare for retiree and spouse. Some plans also include dental, life and other insurances. Though these benefits have been offered for decades, the majority of state and local governments did not calculate the respective liability until required to do so by accounting standards beginning in 2007. (FOOTNOTE)

ratio that is considered to be adequate for long term funding purposes.

On a long-term basis, Michigan local governments owe over $10 billion in unfunded OPEB liabilities[3]. This equates to an estimated actuarially required contribution (ARC)[4] of $800 million annually. Of this amount, it is estimated that local governments are only contributing approximately $500 million. This leaves a current gap of $300 million between annual expenditures and the ARC.

It is possible to assess changes in the OPEB liability landscape between 2012 and the beginning of 2016 for the municipal sector. Over that period, the total statewide funding level went from 11 percent to 14 percent[5]. The total level of liabilities has generally been relatively flat over that period. In 2012, total OPEB liabilities were $8.5 billion and had fallen to $8.35 billion in 2015. This is likely due the to the forces of growing health care inflation being offset by reduced benefit changes especially related to new employees that reduced long term liabilities. The funding level had changed because of an increase in OPEB assets over that same period. OPEB assets had grown from $800 million in 2012 to $1.3 billion in 2015. The growth in assets resulted from a few local units beginning pre-funding their commitments and a few units issuing OPEB bonds resulting in increased OPEB assets. The difference between total OPEB liabilities and total OPEB assets is the unfunded liability and the funding ratio. The current estimates are that OPEB unfunded liabilities are $7 billion and the funded ratio is 14% in 2015 in the municipal sector.

The county sector can also be assessed in these same terms but only for 2015 as data was not available from 2012 at this time. The total statewide county level OPEB liability is currently estimated to be $4.5 billion[6]. County level OPEB assets are estimated to be $1.4 billion[7]. The current estimates are that OPEB unfunded liabilities are $3 billion and the funded ratio is 34% in 2015 in the county sector.

Pension and OPEB Funding

Prefunding OPEB benefits is still a relatively new concept in Michigan, primarily due to the lack of funding requirements set in statute. This is not the case for pensions. Article IX Section 24 of the Michigan Constitution guarantees the payment and prefunding of public pensions. "Accrued" pension benefits must be paid, however, future unaccrued benefits can be reduced so long as existing labor agreements are not breached. In practice, this means

[3] The city of Detroit is not included in these figures. At the time of the bankruptcy, it is estimated that the city owed $6 billion in unfunded OPEB liabilities with no pre-funding. These liabilities were largely eliminated in the bankruptcy but are not included here either before or after bankruptcy.

[4] Recommended employer annual payments to pension plans consisting of a payment for benefits being accrued in the current year (the "normal cost") and a payment for the amortized value of unfunded actuarial accrued liability (UAAL). The combination of these payments is the actuarially required contribution (ARC).

[5] Note that while this is an improvement, it is far from the generally established level of 80 percent that is recommended for pre-funding

[6] These liability estimates will likely be altered as the Wayne County retiree health care changes come into full effect

[7] It is estimated that Oakland County represents nearly $1 billion of these OPEB assets due to the issuance of OPEB bonds

that any previously promised and currently earned benefits are constitutionally protected, but pension benefits and their calculations may be changed prospectively through the collective bargaining process.

The prefunding mandate, found in the same constitutional section, has been interpreted by the Michigan Supreme Court to require local units to prefund accrued pension liability during the fiscal year for which corresponding services are rendered.[8] Payment of this "normal" cost will keep pension funds current in their funding. In addition, state law requires annual funding of an amortized portion of any unfunded pension liability.[9] A full actuarially determined contribution, therefore, is the payment of the constitutionally required normal cost plus the statutorily required unfunded portion.

The pension funding requirement has forced municipalities to focus on funding the full ARC for pension, leaving most local units of government choosing to pay OPEB on a pay as you go basis. This has resulted in many OPEB systems being lowly funded. There are also a number of other reasons for this. First, local governments were not required by accounting standards to begin reporting OPEB liabilities until 2008. Thus, unlike for pension systems, there was no real commitment or perhaps even awareness regarding pre-funding and some local policy makers did not become aware of these challenges until very recently. Second, demographic forces are quickly increasing these retirement-based costs as the baby boom generation begins retiring in large numbers. Finally, the cost of health care has continued to increase faster than the general rate of inflation. For all of these reasons, retiree health care unfunded liabilities are the largest financial challenge facing Michigan local governments.

Legal Protections for Pension and OPEB Differ

In Michigan, legal protections for OPEB benefits differ from those protections covering pension benefits. Until 2005, the Michigan Supreme Court held that OPEB was a constitutionally protected "accrued financial benefit" just the same as pensions.[10] In 2005, however, the court reversed itself[11] and since then courts have consistently held that OPEB is not protected by Article IX, Section 24. Without this constitutional guarantee, OPEB benefits are only owed if there is an outstanding contractual claim for them. Only vested retirees are entitled to receive OPEB beyond the term of the contract which granted them. This is an important distinction, as non-vested retirees do not have any enforceable claim for health care, once their last collective bargaining agreement expires.

The issue of whether a retiree is vested has been fertile ground for litigation. The old vesting standard was laid out in a 6th Circuit Court of Appeals decision[12] and held that

[8] *Studier v. Michigan Public School Employees' Retirement Bd.*, 472 Mich. 642 (2005)
[9] See MCL 38.1140m
[10] *Musselman v. Governor*, 448 Mich. 503, (1995). Note that on rehearing, a six member court was split 3-3 and so the inclusion of OPEB within the protective meaning of Art. IX, §24 continued until *Studier* overturned it in 2005.
[11] *M & G Polymers USA, LLC v. Tackett*, 574 U.S. --, 135 S. Ct. 926 (2015)
[12] *UAW v. Yard-Man, Inc.*, 716 F.2d 1476 (1983)

lifetime OPEB benefits were assumed for any retiree who retired under a collective bargaining agreement. This old standard was overruled by the US Supreme Court in 2015, in the landmark case M & G Polymers USA, LLC v. Tackett. Since Tackett, retirees are only vested with OPEB if their contract "explicitly" grants OPEB for "lifetime" or for another clearly defined period of time. In its opinion, the *Tackett* court instructed that "when a contract is silent as to the duration of retiree benefits, a court may not infer that the parties intended those benefits to vest for life." Anecdotal evidence suggests that many retiree CBAs are in fact silent as to the duration of OPEB benefits.

Recent OPEB lawsuits have applied the *Tackett* standard and have found instances where retirees used to have lifetime OPEB under the old standard, but do not have any OPEB claim under the *Tackett* standard. For example, the City of Hamtramck reduced OPEB and was sued by retirees who pointed to CBA language which granted "Full benefits when the member or vested member has attained 25 years of service regardless of age . . ." The federal district court held[13] that this language was now insufficient to vest OPEB for life, and so the retirees lost.

If an OPEB claim is vested, any law which reduces it may violate the Contracts Clause of the federal or state constitution.[14] Courts have held that the Contracts Clause is not absolute, and that contracts can indeed be impaired by law if: The impairment is not substantial, or A three part test is passed:[15]

(1) The impairment is substantial
(2) The impairment is necessary for a compelling public interest, and
(3) The terms of the impairment are reasonable (many courts have held that impairments must be temporary)

If either of these standards are met, then even vested OPEB benefits can be reduced or changed by enactment of a new law. Unvested retirees do not have a contractual claim to be impaired and so are not involved in Contract Clause analysis.

Short-Term vs. Long-Term Decision Making

Michigan local governments have been recovering from the difficult period of the Great recession of 2008-09. Even as this recovery continues, other long-term forces are growing into the forefront and will force difficult decisions and choices in the near and long term. The largest financial challenge facing Michigan local governments today is related to unfunded liabilities of retiree health care and pension commitments to employees and retirees.

Because of the long-term nature of these benefits, it can be difficult for management or labor to accurately estimate the exact amount that these commitments will ultimately cost.

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[13] *Serafino v. City of Hamtramck*, Civil 14-14112 United States District Court, E.D. Michigan, Southern Division September 27, 2016
[14] Article I, §10 of both Federal and Michigan Constitutions
[15] *United States Trust Co. of New York v. New Jersey*, 97 S. Ct. 1505, 1518 (1977)

The first problem relates to the nature of committing current funds to a long-term liability. Best practice dictates that the ideal approach is to set money aside (both from the employer and employee) as employees are working to ensure that adequate funds are available to meet these commitments in the future. As funds are set aside, they can be invested and earn income over time. A lack of pre-funding, often called pay-as-you-go, increases the long-term costs of the benefits to both employers and employees. In a pay-as-go-approach, the employer may not be prepared for the significant cost increases as employees retire and the liabilities become annual cash outflows.

There is a second problem that can incur in terms of the long-term costs of these benefits. Actuaries must estimate for local officials the long-term liabilities and costs based on a set of assumptions about the future. These assumptions include: 1) longevity, 2) age of retirement, 3) number of new workers, 4) payroll growth, 5) annual employee income increases, 6) health care inflation, 7) investment returns from pre-funding and other factors. If these assumptions are wrong, the long term liability and cost estimates will be wrong and it is possible that government pre funding, if it exists, will not be as adequate as expected.

Thus, for a variety of reasons, it can be very challenging for local governments to keep pace with long-term benefit commitments. In Michigan, as with many other states, there has been a growing awareness of the scale and scope of these problems in the local government sector. The following section highlights the pension and retiree health care challenges facing local governments.

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IV. How Did We Get Here?

Past Government Practice

A combination of factors have collectively led to the underfunding of retiree liabilities within Michigan local governments. Historically, public employers have been known for utilizing deferred compensation. Deferred compensation is the concept whereby the employee accepts reduced wages in exchange for a promise of greater defined benefits to be received upon retirement. In this way, public employers made significant post retirement commitments at a rate generally greater then employers within the private sector.

Similarly, many public employers were slower than private employers to move away from defined benefit pensions and OPEB toward liability reducing defined contribution benefits. This reluctance to adopt modern benefit packages, along with no statutory requirement to prefund, allowed retiree unfunded liabilities to continue to increase longer than many private pension and OPEB systems.

Great Recession and Investment Returns

The benefit of prefunding a future liability is that assets under management can be invested and the earnings on these invested assets will reduce the total contributions of the local unit. As pension funds invest assets into equities, market risk is introduced into the pension system. In 2008, all major stock exchanges experienced dramatic shocks. The Dow Jones Industrial Average declined 33.84% during 2008 and pension and OPEB assets which were invested experienced similar losses. While the equity markets did recover and in 2013 actually surpassed the pre-recession values, not all funds recovered with the stock market.

There are two principle reasons for why some pension and OPEB investments followed the decline but not the recovery of the stock market. First, the least funded retirement systems had to liquidate significant holdings before the recovery in order to pay annual benefits to retirees. This essentially forced some systems to invest assets at high pre-recession values and sell at low recession prices. This effect also meant that fewer assets were invested when the markets recovered, diminishing the upswing in funding when it came.

The second reason that many pension and OPEB funds have not realized a recovery in step with the markets has to do with the nature of Michigan's property tax system. The 2008-9 recession was caused by an unexpected decline in real estate values and the resulting collapse of securitized mortgage backed securities. Local governments in Michigan generate much of their revenues from property taxes. When property values (and thus taxable values) fell during the great recession, many local units were deprived of the tax revenue necessary to prefund retiree liabilities. As an additional challenge, Article IX, Section 3[16] holds these taxable values low, only allowing them to increase at the lessor of

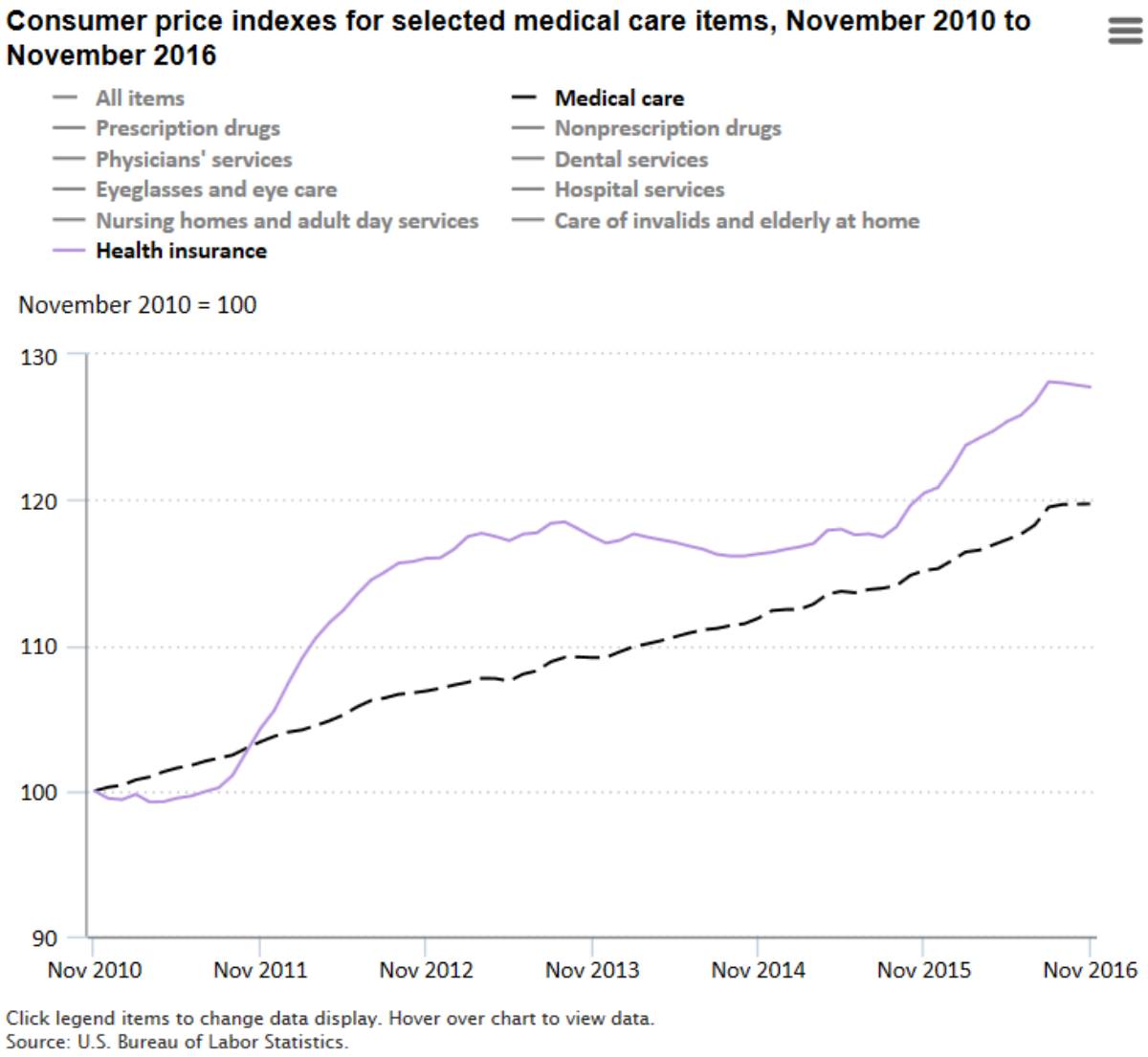
[16] Enacted by Proposal A (1994)

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inflation or 5% each year. Despite the general recovery of property values, many taxable values (and local government revenues) have not recovered to pre-recession values.

Rising Health Care Costs

An additional stressor for OPEB systems is that the cost of health insurance increases at a rate which outpaces general inflation. For example, for the calendar year 2016, health insurance prices rose 6% while the general inflation rate was 1.7%. The chart below is a graphical illustration of healthcare pricing data from the Federal Bureau of Labor Statistics.



Demographics

These deferred compensation systems impact both current employees and retirees. Based on the best data available, Michigan has approximately 250,000 local government full time

employees and another 130,000 part time employees (Census Bureau, 2017). This equates to about 300,000 full time equivalents (FTE). The largest number of local government employees are in education which is approximately 180,000 FTE. The focus of this report is on the other 120,000 FTE who work in general purpose local governments and non-school special districts. Based on the best available estimates, there are approximately 170,000 beneficiaries receiving some form of deferred compensation retirement benefit from Michigan local pension systems[17].

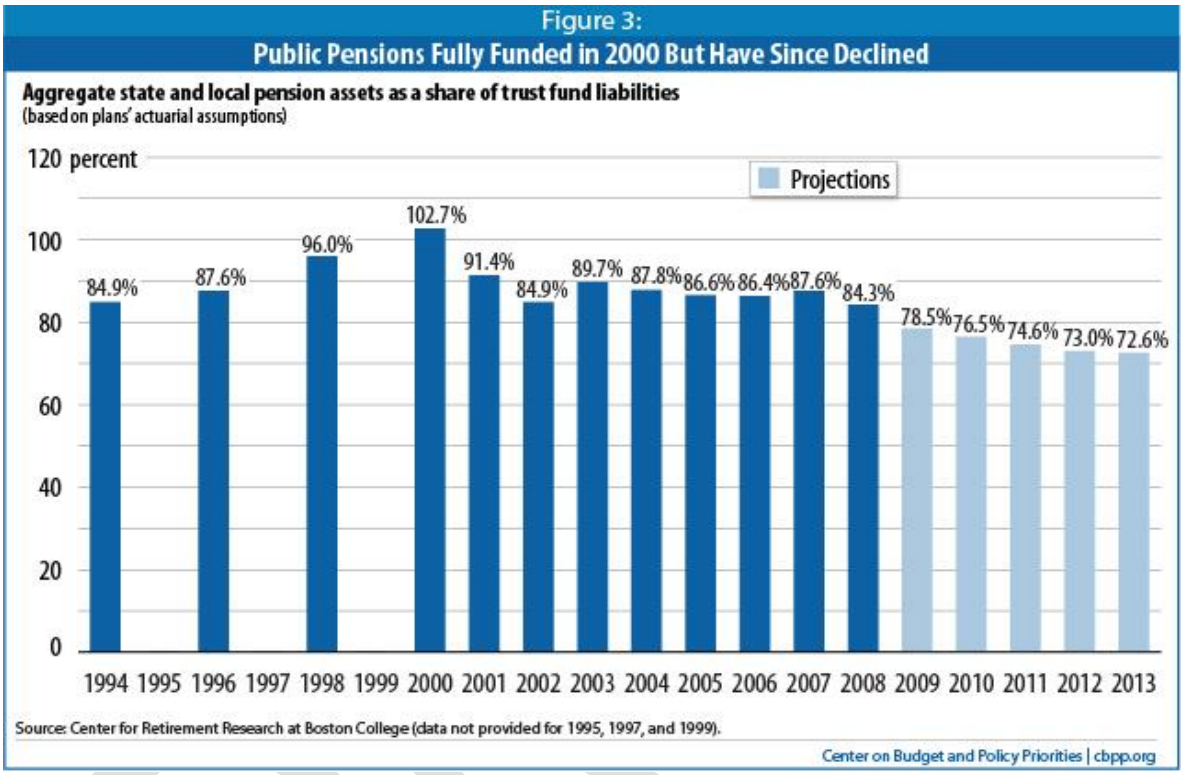
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[17] This number does not reflect the number of beneficiaries of retiree health care from local governments. That number is likely smaller than the pension number but inclusive of it. This is because there+ are more pension systems than retire health care systems.

V. Is Michigan Unique?

Michigan is not alone in this challenge. It is a systemic problem facing the entire U.S. On the pension side, state and local pensions have become increasingly less well-funded (see Figure 1).

Figure 1: State and Local Government Pension funding Trends



National Picture - Pensions

There are approximately 4,000 state and local pension systems in the United States covering over 20,000,000 million employees and retirees (Gale and Krupkin, 2016). These pension systems are estimated to owe an unfunded liability of over $3 trillion (Munnell and Aubry, 2016) and the overall average funding level has dropped to 80 percent which is considered to be just in the safe level. This overall increase in unfunded liabilities is likely less than expected investment returns and demographic changes in the country.

National Picture – OPEB

Although the retiree health care problem has only recently been fully recognized, the scale of the problem is rapidly approaching the same as the state and local pension situation. There are still more uncertainty over the exact size of the national problem, the best estimates place the total unfunded liability at $862 billion (Munnell et al. , 2016). Thus, at the national level, pension unfunded liabilities exceed OPEB liabilities by a factor of three to

one. It was also noted by Munnell et al. (2016) that the majority of OPEB unfunded liabilities, almost two-thirds, are located at the local level and are easier to tackle than pension problems due to legal differentials.

Michigan-National Comparison

Michigan, as noted previously, has a larger OPEB problem than a pension problem at the local level. This is in contrast to the national situation. This may due to Michigan local pensions be better funded at the local level than their state and local national counterparts.

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VI. What is the Path Forward?

Areas of Task Force Agreement

The Task Force thoroughly discussed and evaluated the extensive data and information available surrounding the current state of pension and OPEB unfunded liabilities of our local government units in Michigan. Unanimously, the Task Force agreed that something must be done, and done now, to address this growing problem. If not tackled, this problem will only continue to get worse and will ultimately put the quality of services and the quality of life of our communities in jeopardy, along with employees and retirees who depend on these benefits. The Task Force universally agreed that we must improve the fiscal stability of our communities, and center to this solution is addressing the growing unfunded pension and OPEB liabilities our communities face.

As local units across our state are unique and diverse, the Task Force agreed that there is not a one-size-fits-all solution to this problem – we must be flexible with our solutions. The Task Force agreed that the ultimate strategy developed must focus action on the local units experiencing the worst fiscal stress, while those in solid standing should be left alone. However, to ensure this problem does not grow further, solutions will need to address not only our new employees but also actives and retirees.

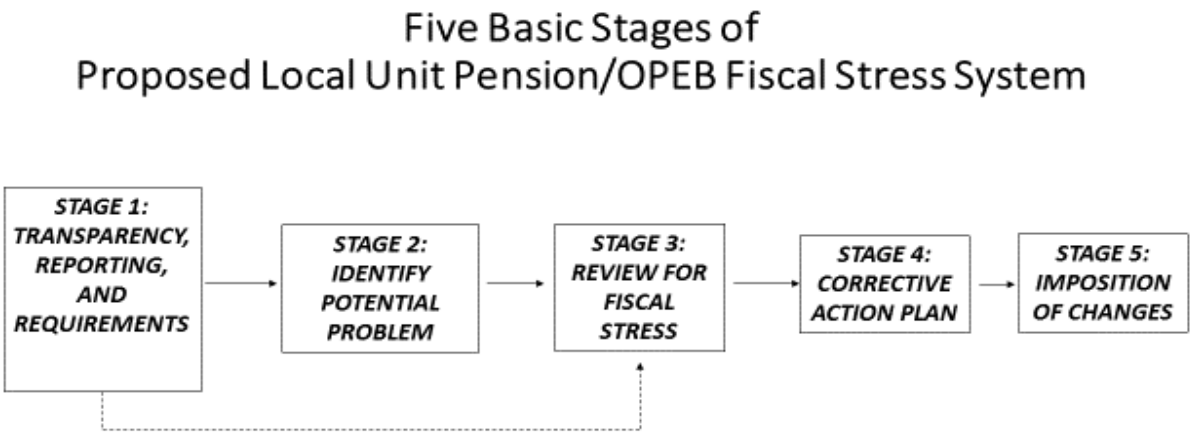
Additionally, the Task Force unanimously agreed that greater reporting and transparency must be required of all local units so that citizens, employees, and retirees, as well as state and local decisions-makers, can begin to fully understand the exact size and scope of the problem, and where our biggest challenges exist so that they can be addressed. And finally, the Task Force unanimously decided on an optimal structure, a Fiscal Stress System for Local Governments, which would allow for those in need of action and assistance to be addressed. This system, along with the creation of a new Municipal Stability Board, would assist local units in crafting solutions that would best position them to continue to serve their residents, while protecting benefits for employees and retirees. The Task Force therefore agreed that the proposed new system is necessary to ensuring this problem does not continue to grow any further.

Overview of Proposed Pension and OPEB Fiscal Stress System

The Task Force agreed that the creation of an optimal system would enable decision-makers to have the data and transparency for a full understanding of the fiscal stability or stress of our local units, and enable the most fiscally stressed to receive attention and action. The Task Force agreed on five basic stages of an optimal system, as illustrated below.

High-level Flow Chart of Pension/OPEB Fiscal Stress System

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Stage 1: Transparency, Reporting, and Requirements

Throughout the Task Force's discussion two themes continuously arose, the need for greater transparency and reporting and the need to ensure this problem does not grow any further. The Task Force agreed that pension and OPEB data should be reliably produced and widely available and, furthermore, that efforts to resolve the underfunding problems need to begin with a sound understanding of the current liabilities and funding situation. Additionally, the enactment of potential mandatory payments and best practices would assist local units in increasing fiscal stability into the future.

It is important to note that local units meeting the following discussed requirements would continue to Stage 2 for further evaluation. However, those that did not would go directly to Stage 3 for an in-depth review by the Department of Treasury.

Transparency and Reporting for All Local Units

Stage 1 would require transparency and increased reporting by all local units to Treasury. It is envisioned that data for Stage 1 would be collected electronically via Michigan Form F-65 ("Annual Local Unit Fiscal Report") which is required from all primary local units of government in the State of Michigan.

For pensions, under Public Act 314 of 1965, current reporting requirements include an annual summary report. With minimal changes to this Act regarding when annual pension reports must be submitted to Treasury, the Task Force agrees that sufficient reporting data is available.

However, with respect to OPEB, the Task Force recommends new legislation be enacted to require annual valuations, reporting of actuarial assumptions (such as expected investment returns on plan assets, discount rates for ARC calculation, medical inflation and cost trends used, and amortization period for OPEB liability), and posting of annual reports on the local unit's website (as is now required for pension reports).

As comparing data across local units can be difficult because of the use of different assumptions, the Task Force recommends that, for reporting purposes only, all local units be required to recalculate their funded ratio using assumptions rates set annually by Treasury for the following assumptions: assumed rate of return on plan assets, discount rate for ARC calculation, and wage and health care inflation assumptions. Additionally, at least every five years, local units conduct an experience study and a peer audit by an independent actuary (or rotate actuaries every five years). Exceptions would exist based upon the size of the local unit.

To allow citizens, employees and state and local decision makers to have easy access to this data, the Task Force recommends that Treasury be required to post reported data to the Local Government Dashboard (to be made available shortly).

New Funding and Plan Design Requirements for All Local Units

In addition to increased transparency and reporting, the Task Force thoroughly discussed the creation of mandatory minimum funding requirements, plan design requirements and best practices that would help to ensure this problem is addressed and does not grow any further.

Four options were discussed and are detailed below.

OPTION 1 – The hole doesn't get any bigger and requirements enable stable systems into the future:

For its pension systems, the local unit must have paid its ARC in full, Final Average Compensation standards are enacted, along with prohibiting "13th Checks."
For OPEB, the local unit must have paid its normal cost, paid its UAAL for active employees (i.e., prefund active employees), and paid is annual actual benefit payments (i.e., pay-as-you-go costs) for its retirees. In addition to these requirements, members discussed legislation to require that (1) retiree health care plans must use Medicare as its primary insurance for retirees 65 and older (2) all retiree health care plans of the same local unit mirror each other, (3) any benefit increases must be 100 percent funded and include notification to the public before such plan is considered, (4) systems must close off DB style OPEB benefits for all new hires, stipends will be negotiated, and local governments have the option to move to a retiree health savings account for current employees with less than 10 years of service, and (5) individuals should be required to use health plans of current employers if available, and spouses should utilize benefits from their employer, if available.

OPTION 2 - The hole doesn't get any bigger:
For its pension systems, the local unit must have paid its ARC in full.

For OPEB, the local unit must have paid its normal cost, paid its UAAL for active employees (i.e., prefund active employees), and paid is annual actual benefit payments (i.e., pay-as-you-go costs) for its retirees. No plan design requirements are required for all local units, only funding requirements.

OPTION 3 - Requirements enable stable systems into the future:

Unlike options one and two, the local unit will not be required to make payments, however best practices mentioned above will be required.

For pensions, Final Average Compensation standards are enacted along with use of standard assumptions within a reasonable range. "13th Checks" are also prohibited. For OPEB, the following best practices would be enacted and required: (1) retiree health care plans must use Medicare as its primary insurance for retirees 65 and older (2) all retiree health care plans of the same local unit mirror each other, (3) any benefit increases must be 100 percent funded and include notification to the public before such plan is considered (4) systems must close off DB style OPEB benefits for all new hires, stipends will be negotiated, and local governments have the option to move to a retiree health savings account for current employees with less than 10 years of service, and (5) individuals should be required to use health plans of current employers if available, and spouses should utilize benefits from their employer, if available.

Stage 2: Identify Potential Problem

The Task Force agreed that a critical stage of this system is identifying where problems exist. As such, task force members came to the consensus that Stage 2 would include use of criteria to determine the fiscal health of the local unit's pension and OPEB systems as well as the fiscal stress, if any, that may be put on the local unit's overall ability to provide services. A majority of local units should meet this criteria and therefore their participation in the process would end for the year.

In this stage, Treasury will perform calculations to compare each local unit's data again criteria regarding funding ratios and ARC as a percent of government-wide revenue. These criteria were chosen, in part, based on a recent study published by the Rockefeller Institute in which researchers examined how demographic characteristics affect plan funding risk and contribution risk. They identified two key types of risks; extremely low funded ratios and extremely high employer contributions that could pose potential risk to pension plans and their beneficiaries (The Rockefeller Institute of Government, 2016).

The following criteria would be used to identify communities that could be near financial distress and warrant a more in depth review.

Pension Criteria

Criteria #1: Pension funding level (assets/liabilities)
Less than 60 percent funded - This trigger is used because it indicates the long run ability of the pension system to fully meet its commitments. A low value indicates that a system will need to engage in difficult decisions to meet the full funding level over time including benefit reductions, contribution increases or a speculative increase in investment income

Criteria #2: Employer contribution (ARC) as a percent of government wide revenue
A value of 10 percent or greater- This trigger is based on a value that is considered to be significantly greater than the majority of local pension systems or is outside of the normal range for the burden of annual pension costs on government revenues. A pension system that is consuming this large a share of government revenues places that government at a liquidity or insolvency risk in the base of a major fiscal shock.

When analyzing pension data, criteria #1 would capture roughly 16% (85 of 511) of municipalities and criteria #2 would capture roughly 21% (109 of 511) of municipalities if these filters are applied.

OPEB Criteria

Given the complexities of OPEB, slightly different target percentages were selected. Like the pension filters, the following criteria may trigger the next step in the early warning process to identify communities that could be near financial distress:

Criteria #1: OPEB funding level (assets/liabilities)
Less than 40 percent funded- This trigger is used because it indicates the long run ability of the government to fully meet its OPEB commitments. A low value indicates that a system will need to engage in difficult decisions to meet the full funding level over time including benefit reductions, contribution increases or a speculative increase in contributions and investment income

Criteria #2: Employer contribution (ARC) as a percent of government wide revenue
A value of 12 percent or greater- This trigger is based on a value that is considered to be significantly greater than the majority of local governments or is outside of the normal range for the burden of annual OPEB costs on government revenues. An OPEB liability that is consuming this large a share of government revenues places that government at a liquidity or insolvency risk in the base of a major fiscal shock.

When analyzing OPEB data, criteria #1 would capture roughly 81% (81 of 100) of municipalities and criteria #2 would capture roughly 17% (17 of 100) of municipalities when those filters are applied.

Stage 3: Review for Fiscal Stress

The Task Force concluded that if a potential funding problem is determined for a local unit

in Stage 2 using the agreed upon triggers listed above, it will be the responsibility of Treasury to undertake a more individualized and comprehensive internal review of the local unit's pension or OPEB fund, discuss changes or reforms that have been made, and review actuarial projections, as described in greater detail below. The Task Force wanted to ensure that special attention will be directed toward the increasing liabilities and costs in future years and the local unit's ability to afford its commitment. Additionally, all members agreed that analysis of trends and forecasting must be part of the review process.

If the local unit already has a plan in place for how they will continue to fund their retirement system over time to meet the criteria of Stage 1 and 2, it may file an application for waiver to Treasury. To ensure local support and commitment, the Task Force concluded that the waiver application and plan must include that they have been approved by the local unit's administrative officer and local legislative body. Once a full review is complete, Treasury will determine if retirement systems are viable and headed in the right direction, or greater action is needed.

If the waiver is approved by Treasury, the local unit's participation in the process would end for the year.

If in Stage 3 a waiver is not requested or is requested but not approved, Treasury will confirm that a problem exits and that action is needed. Communities which are determined to be owners of fiscally stressed retirement or OPEB systems will be subject to oversight by a statutorily created Municipal Stability Board (MSB) and will move to Stage 4.

Stage 4: Corrective Action Plan

Critical to this system is Stage 4, implementing a plan for units that are under stress. During this stage, in order to develop a plan that meets the needs of the individual unit, a full review of all contracts and financials must take place. The local unit will develop and submit a Corrective Action Plan to the proposed Michigan Stability Board (MSB) for review. The local unit and the Board must agree on a uniquely constructed plan that enables the local unit to work toward financial stability, while providing critical services to residents.

Municipal Stability Board – Composition, Duties and Authority

The Task Force agreed that this board will be appointed members, composed of state and local officials, along with an employee/retiree representative(s). Appointees must have strong technical knowledge on retirement systems, practices, policies and law.

Corrective Action Plan Components

The Task Force unanimously agreed that because each local unit is unique, the components of the Corrective Action Plan will vary. The components will be determined by the local unit, and then must be agreed to by the MSB.

For pension, the components may include, but are not limited to, actions such as (1) closing

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the current defined benefit plan, (2) implementing a multiplier limit, (3) reducing or eliminating new accrued benefits, and (4) implementing final average compensation (FAC) standards.

For OPEB, the components may include, but are not limited to, actions such as of (1) requiring cost sharing of premiums and sufficient copays, and (2) capping employer costs. The Task Force agreed that important to this process is involvement of the residents of the local unit. As such, the Task Force suggested that the Corrective Action Plan may also include a local ballot proposal to reduce unvested benefits, raise taxes, or both.

Once the Corrective Action Plan is approved by the MSB, the local unit implements the Corrective Action Plan. The fiscal instability is considered addressed once the local unit meets the requirements of Stage 1 and the criteria of Stage 2. If a Corrective Action Plan is unsuccessful, or if the MSB does not approve the local units Corrective Action Plan, then the local unit moves to Stage 5.

Stage 5: Imposition of Changes

The Task Force agreed that action must be taken in Stage 5 to assist the local unit in meeting the criteria of Stage 2 so that they become fiscally stable into the future.

In the event that a corrective action plan fails or is not implemented by the local unit, the MSB will be able to exercise three powers in order to correct the financial circumstances: First, the MSB will be statutorily authorized to cause any non-vested OPEB benefits paid to retirees of the local unit to be reduced. Before this occurs, the MSB will solicit the local unit for an alternative benefit proposal and will consider whether this proposed benefit level will achieve adequate liability reductions.

Second, the MSB will be authorized to execute a statutory revenue sharing intercept agreement with the State Treasurer. Any intercepted monies will be used to satisfy funding contributions into the retirement system. If a local unit is properly prefunding its liabilities in agreement with best practices, then then no revenue intercept is authorized. In the event that a revenue intercept agreement is created, it would be junior to any prior intercept agreement which the local unit is subject to.

Lastly, the MSB will review all new collective bargaining agreements for the local unit. No collective bargaining or tentative agreement is effective without prior approval by the MSB.

The Task Force recognizes that there are currently a small number of local units that cannot raise taxes or reduce liabilities enough to fund their current commitments. The creation of this system will be unable to address the complexity that exists for those local units, however its creation is important to ensure local government fiscal stability into the future. Therefore, the Task Force recognizes that there is a potential need for further discussion on local revenue increases, potential statewide funding and other options such

bonding, under certain circumstances.

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V. Next Steps

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