# MUNICIPAL STABILITY BOARD

## CORRECTIVE ACTION PLAN DEVELOPMENT: *BEST PRACTICES AND STRATEGIES*

***Issued Under Authority of Michigan's Public Act 202 of 2017***

***July 2019***

**Goal:**
To provide best practice options to Michigan's local governments so they may sustain fiscally stable retirement systems, protect benefits for retirees, and provide high-quality public services to residents. Underfunded local governments are encouraged to utilize this information to assist in developing a Corrective Action Plan (CAP) in compliance with Sec. 8 (*MCL 38.2808*) of Public Act 202 of 2017 (the Act). Each local government and their governing body will have to agree on a uniquely constructed plan to *address their underfunded status* for retirement pension and/or retirement health care systems.

**Best Practice Principles:**
The following three principles may be utilized in developing a CAP for local governments with an underfunded retirement pension system and/or retirement health care system[1]:

1.) Plan Funding
2.) Modern Plan Design
3.) Effective Plan Administration

**Best Practice Options:**
Corrective options may include, but are not limited to, the options listed below. This list includes the corrective options outlined in Sec. 10(7) of the Act (*MCL 38.2810*).

## 1. Plan Funding

- Funding options to sustain legacy costs and future retirement benefits:
  - Fund the actuarially determined contribution (ADC), which pays the expected cost of all promised benefits for both pension and retirement health care systems (i.e. fund the annual service cost of active employee benefits plus any unfunded actuarial accrued liabilities (UAAL))
  - Add funding to the annual budget in addition to the ADC, e.g. placing additional contributions into a surplus fund. This practice will reduce the unfunded liabilities and allow for potential increased investment income
  - Transfer funds from reserves to increase retirement assets, which will reduce the unfunded liabilities and allow for potential increased investment income
  - Dedicate additional revenue sources to pay for retirement benefits (e.g. Public Act 345 of 1937 millage, increased operating millage, other special millage)
  - Establish a qualified medical trust designated for retirement health care system funding
  - Add or increase employee contributions for pension systems and health care systems
  - Add or increase retiree contributions for health care systems
  - Implement a closed amortization period of no more than twenty years
  - Calculate amortization payments based on a "level-dollar" amortization schedule

## 2. Modern Plan Design

- The goal of a retirement system is its ability to attract and retain a talented workforce while providing a secure retirement for beneficiaries. To accomplish this goal, local governments can develop modern plan solutions that can adapt alongside a changing work environment.
- Modern plan design options for defined benefit pension systems:
  - Implement a "bridged multiplier" for active employees
  - Implement a bridged cost of living adjustment (COLA)

[1] As defined in the Act, retirement health benefit means an annuity, allowance, payment, or contribution to, for, or on behalf of a former employee or dependent of a former employee to pay for any components: (i) Expenses related to medical, drugs, dental, hearing, or vision care. (ii) Premiums for insurance covering medical, drugs, dental, hearing, or vision care. (iii) Expenses or premiums for life, disability, long-term care, or similar welfare benefits for a former employee. These benefits are also commonly referred to as Other Post-Employment Benefits (OPEB).

- Implement final average compensation (FAC) standards
- Evaluate the affordability of the plan and the need to reduce or eliminate future defined benefit accruals by changing to a defined contribution plan or hybrid plan for:
  - Active employees
  - New hires
- Limit defined benefit options for newly hired employees, including multipliers, cost of living increases, retirement age, and benefit vesting periods
- Evaluate the financial implications of any early retirement incentive buyouts
- Limit the dual payment of both a pension and a salary to any employee who is rehired after retirement by the same employer, in accordance with IRS regulations

- Modern plan design options for retirement health care systems:
  - Require cost sharing of premiums and reasonable copays
  - Implement a cap on the employer portion of retiree health care costs
  - Require mirroring of retiree health care plans with active employee health care plans within the same local government
  - Require retirees to use their current employer's health benefits or their spouse's health benefits, if available
  - Require use of Medicare as primary insurance for retirees 65 and older and/or consider alternative methods of coordinating or delivering benefits for those eligible for Medicare
  - Enroll new hires in a defined contribution retiree health care plan
  - Evaluate the financial implications of any early retirement incentive buyouts
  - Raise the eligibility age and/or service requirements for retiree health care benefits
  - Implement vesting rules that provide levels of benefits based on years of service
  - Use a market driven approach to evaluate benefit offerings and carriers

**3. Effective Plan Administration**

- Local governments should use a variety of options to ensure that their retirement benefits are being administered as effectively as possible
- Administration options to maintain fiscally stable retirement systems:
  - Work with system providers to determine appropriate solutions
  - Require all retirement systems to be 100 percent funded before any benefit increases can take effect
  - Obtain an annual actuarial valuation for both pension and retirement health care systems with greater than 50 members
  - Ensure proper assumptions are utilized according to Actuarial Standards of Practice
  - Require an experience study by the plan's actuary at least every five years
  - Require a peer actuarial audit to be conducted by an actuary that is not the plan actuary or change actuaries at least every eight years
  - Provide projections within the annual valuations for ADCs, retirement benefit payments, assets, and liabilities until the system is at least 100% funded
  - Calculate ADCs in accordance with Treasury's Numbered Letter 2018-3, the sum of the normal cost payment and the annual amortization payment for past service costs to fund the unfunded actuarial accrued liability
  - Apply a blended discount rate that reflects a 20-year, tax-exempt general obligation municipal bond index rate, to the extent that system assets are not sufficient to make projected benefit payments
  - Use asset smoothing in the valuation to reduce the impact of significant investment losses on ADC amounts
  - Consult with the system provider about diversifying the investment portfolio
  - Ensure management and oversight boards have proper experience, skills, and training to administer retirement systems

- Create a retirement benefits committee consisting of all stakeholders (employees, retirees, and employer representation) to evaluate benefit options
- If sustainable, and a compelling reason is provided as determined by the Board, enterprise funds may be utilized to support applicable retirement costs to offset pressure on the governmental fund
- Conduct an annual review of all retiree health care systems to ensure retirees and their dependents still qualify for retiree health care. This would include an audit for those plans that are different for people that are on Medicare.
- Evaluate retirement benefit eligibility for part-time elected officials

**CAP Approval Criteria:**
To further assist local governments in developing their CAP, the Municipal Stability Board (the Board) is updating its approval criteria. The Board will be considering this criteria in their review of each CAP. Local governments are encouraged to use a balanced approach from one or more of the best practice principles outlined above to address their underfunded status, however, it is ultimately the responsibility of the local government to determine the components of their CAP. At a minimum, proposed actions must be feasible, meaning that they are reasonably achievable, and address the following:

1. **Underfunded Status**
   - **A local government must address its underfunded status in a reasonable timeframe.**
     - **Primary and Non-Primary Governments:** The CAP must demonstrate, through detailed supporting documentation, how and when the retirement system will reach a sixty percent funded ratio for pension systems and/or a forty percent funded ratio for retirement health care systems. These minimum funding ratio percentages are determined by Sec. 5(4)(a) and Sec. 5(4)(b) of the Act.
       - Supporting documentation must include an actuarial projection, an actuarial valuation, or an internally developed analysis which illustrates how and when the local government will reach the minimum funding ratio percentages.
         - It is recommended that the supporting documentation shows a projection for the duration of the CAP that includes, but is not limited to, assets, liabilities, funded ratios, normal cost payments (if applicable), actuarial assumptions, and retiree benefit payments.
       - As general guidance, a local government with a severely underfunded pension system (45% or less) should reach a funded ratio of sixty percent within twenty years. A local government with a severely underfunded retirement health care system (25% or less) should reach a funded ratio of forty percent within thirty years.
       - If the CAP includes future funding to address underfunded status, a resolution or motion approving the additional funding by the governing body should be included.
       - The prospective actions listed in a CAP should have a start date assigned, which will indicate when implementation will begin for that action. After approval by the Board, the local government has up to 180 days to begin to implement the corrective actions.

   **<u>Or</u>**

     - **Primary Governments:** If the local government is a city, village, township, or county, it must demonstrate through detailed supporting documentation how and when its ADC will be less than 10 percent of the general fund operating revenues for pension systems and/or will be less than 12 percent of the general fund operating revenues for retirement health care systems. The Board may consider this as means to address underfunded status in accordance with the Act.
       - Supporting documentation must include an actuarial projection, an actuarial valuation, or an internally developed analysis for ADC. The local government must project general fund operating revenues using a reasonable forecast based on historical trends and projected rates of inflation.

- For local governments who are addressing underfunded status through the ADC/Revenue trigger in their CAP, the local government must show how it will get below the PA 202 established ADC/Revenue trigger within 5 years.

**2. Legality**

- A CAP must follow all applicable local, state, and federal laws.
- **The governing body of the local government must approve the CAP**, and the local government must attach proof of the governing body approval with the submission of their CAP.
  - Common examples of governing body approval include official minutes, draft minutes, excerpt of minutes signed by clerk, or formal resolution.
- The local government's administrative officer or designee certifies that it will implement the CAP.

3. **Affordability**

- The local government must confirm that corrective actions listed in the CAP allow for the local government to make, at a minimum, the actuarially determined contribution (ADC) payment for pension plans and/or the retiree healthcare premium payment, as well as the normal cost payment for new hires for retirement health benefits (*Sec. 4(1) of the Act, MCL 38.2804*). This section confirms that a local government has linked long-term future payment expectations with revenue expectations and has concluded that those payments are affordable now and into the future without additional changes to their CAP.
- The practice of affordability means the ability to meet a local government's current and future obligations, without using a significant percentage of the annual budget. Affordability is defined as follows:
  - In accordance with the Act, the ADC for all retirement systems should not be greater than 22 percent of general fund operating revenues.
  - The ability of a local government to offer residents critical public services while paying for legacy obligations.
  - The ability of a local government to prefund retirement benefits, earn investment income, and build savings to afford future payments.
  - Affordability is reached through plan funding, modern plan design, and effective plan administration.

**Implementation:**

Approved CAPs will be monitored by the Board for compliance not less than every two years. As a local government implements prospective changes, there is a recognition that specific solutions may need to be adjusted to address its underfunded status. If a local government feels that their approved CAP is no longer materially in effect, they may submit a revised CAP for review by the Board.

# Glossary of Terms

***Actuarial Accrued Liability:*** The present value of all future benefit payments to current annuitants, plus the accumulated normal costs allocated to the years before the valuation date for future annuitants.

***Actuarial Standards of Practice:*** The Actuarial Standards Board sets standards for appropriate actuarial practice in the United States through the development and promulgation of Actuarial Standards of Practice. These standards describe the procedures an actuary should follow when performing actuarial services and identify what the actuary should disclose when communicating the results of those services.

***Annual Actuarial Valuation:*** The process that estimates retirement plan liabilities and employer contribution requirements in order to fund the individual employer plan.

***Actuarially Determined Contribution (ADC):*** As defined by Treasury's Numbered Letter 2018-3, the sum of the normal cost payment and the annual amortization payment for past service costs to fund the unfunded actuarial accrued liability.

***Bridged cost of living adjustment (COLA):*** An employee or retiree's COLA is reduced or eliminated on future service credit. Previous COLA is only applied to portion of benefit earned prior to bridge.

***Bridged Multiplier:*** An active employees' multiplier remains at the previous multiplier, but all future service accrues at the new, reduced multiplier.

***Closed Amortization:*** A closed or fixed period to amortize any unfunded actuarial accrued liability.

***Defined Benefit Systems:*** A retirement plan in which an employer promises a specified payment, lump-sum, or combination thereof, on retirement that is predetermined by a formula based on the employee's earnings history, tenure of service and age, rather than depending directly on individual investment returns. In these types of plans, investment and longevity risk are generally borne by the employer.

***Defined Contribution Systems:*** A retirement savings plan where the employer and employee contributions are defined and known in advance, but the benefit to be paid out is not known in advance. In these types of plans, investment and longevity risk are generally borne by the employee.

***Dual Payment:*** Payments of both a pension and a salary to an active employee who returned to employment for the organization s/he retired from.

***Final Average Compensation (FAC):*** The average salary used for determining pension payments in a defined benefit plan. The period for which salary is averaged and the type of salary used in the calculation is generally determined through state law or plan terms.

***Funded Ratio:*** The value of assets expressed as a percentage of the liability. The funding ratio is reported in the most recent audited financial statement reporting a local government's retirement pension benefits and retirement health benefits.

***Level Dollar Amortization:*** This amortization method amortizes the unfunded actuarial accrued liability into equal dollar amounts to be paid over a given number of years.

***Minimum Funding Ratio:*** As determined by Public Act 202 of 2017, the actuarial accrued liability of a pension plan according to the most recent set of audited financial statements is at least 60% funded for pension systems, and at least 40% funded for retirement health care systems.

***Normal Cost:*** The annual service cost of retirement health benefits as they are earned during active employment of employees of the local government in the applicable fiscal year, using an individual entry-age normal and level percent of pay actuarial cost method.

***Prefund:*** The practice of funding a defined benefit during an employee's working lifetime.

***Qualified Medical Trust:*** A tax exempt investment vehicle designed to set aside money to pay for retiree healthcare.

***Underfunded Status:*** The State Treasurer has determined that the local unit of government is underfunded under the review provided in Section 5 of Public Act 202 of 2017 (*MCL 38.2805*) and the local unit of government does not have a waiver under Section 6.

***Unfunded Actuarial Accrued Liabilities (UAAL):*** The UAAL is the difference between actuarial accrued liability and valuation assets.

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