HB 1374

Department of Legislative Services

Maryland General Assembly
2010 Session

FISCAL AND POLICY NOTE

House Bill 1374 (Delegate Kach, *et al.*)
Appropriations

State Retirement and Pension System - Optional Retirement Program - Membership and Participation

This bill makes members of the Employees' Retirement System (ERS), Teachers' Retirement System (TRS), Employees Pension System (EPS), and Teachers' Pension System (TPS) eligible to participate in the Optional Retirement Program (ORP), a defined contribution plan, instead of remaining in those defined benefit plans. Under current law, newly eligible employees must decide whether to participate in ORP or the appropriate defined benefit plan within one year of first becoming eligible.

The bill takes effect July 1, 2010.

Fiscal Summary

State Effect: The bill's effect on State pension liabilities and contribution rates cannot be reliably estimated. The General Assembly's consulting actuary advises that the State's accrued liability may decrease or remain unchanged, depending on how benefits are calculated for members who switch to ORP, which is not specified in the bill. At the same time, ORP employer contributions are generally higher than normal cost rates for affected plans. The overall effect of the bill, therefore, depends on the number and characteristics of the active and new members who elect to join ORP, which cannot be known.

Local Effect: The bill's effects on pension liabilities and contribution rates for participating governmental units also cannot be reliably estimated for the same reasons given above.

Small Business Effect: None.

Analysis

Current Law: Membership in ERS/TRS or EPS/TPS is a condition of employment for most State employees and certain employees of local boards of education and libraries who are eligible for participation in those plans, with the exception of designated employees of:

- the University System of Maryland (USM);
- Morgan State University;
- St. Mary's College;
- the Maryland Higher Education Commission; and
- community colleges or regional community colleges in the State, including Baltimore City Community College.

Only the following employees of those institutions are eligible to join ORP:

- faculty members;
- professional employees of community colleges or regional community colleges;
- exempt employees of USM;
- professional or administrative employees of Morgan State University;
- professional employees of St. Mary's College.

A decision to join ORP is a one-time, irrevocable decision that must be made within one year of becoming eligible to join ORP. ORP members are not eligible to participate in any of the defined benefit plans offered by the State.

Background: ERS/TRS are defined benefit (DB) plans that were closed to new members in 1980. Members vest after five years of service, pay either 5% or 7% of earnable compensation, and receive an annual benefit upon retirement equal to 1.8% of average final compensation for each year of service. Retirees who paid 5% receive automatic annual cost-of-living adjustments (COLAs) equal to the Consumer Price Index for all Urban Consumers (CPI-U), subject to a 5% cap. Retirees who paid 7% receive an uncapped annual COLA. As these plans were closed 30 years ago, there are only a few thousand active members left in the two plans combined.

EPS/TPS are DB plans for all regular (nonpublic safety) State employees and teachers, respectively, including employees who are not eligible for ORP. Members vest after five years of service, pay 5% of earnable compensation, and receive an annual benefit upon retirement equal to 1.8% of average final compensation for each year of service. Retirees receive automatic annual COLA adjustments equal to CPI-U, subject to a 3% cap. As of June 30, 2009, there are 102,553 active TPS members and 79,418 active EPS members.

EPS members who are State employees are also eligible for up to a $600 annual State matching contribution to a defined contribution (DC) plan administered by the Maryland Supplemental Retirement Plans. The State match is suspended in fiscal 2010 and again in the Governor's proposed fiscal 2011 State budget.

ORP is a DC plan that provides an employer contribution of 7.25% of earnable compensation; there is no employee contribution. Vesting is immediate, member accounts are portable, and members may invest their accounts in any of many investment options offered by the plan administrators, which are selected by the Board of Trustees of the State Retirement and Pension System (SRPS). Current plan administrators are TIAA-CREF and Fidelity Investments. Upon retirement, members may elect to purchase annuities with their accumulated funds.

In the last 10 years, seven state pension plans have provided their new members with a choice between a DB plan or a DC plan. In each case, the DB plan is the default option if a member does not make an active choice. Only the two Ohio plans give members the option of choosing a hybrid plan that includes elements of both types. **Exhibit 1** shows that the percentage of employees who chose DC plans instead of DB plans under these conditions ranges from a low of 3% for Ohio state employees to a high of 26% in Florida.

Exhibit 1
Other State Pension Plans that Provide Members with a Choice between Defined Benefits and Defined Contributions

	DB by Default or Active Choice	DC Active Choice	Combined Plan
Colorado	82%	18%	Not Offered
Florida	74%	26%	Not Offered
Montana	90%	10%	Not Offered
North Dakota	88%	12%	Not Offered
Ohio Employees	95%	3%	2%
Ohio Teachers	86%	11%	4%
South Carolina	80%	20%	Not Offered

Source: Milliman, January 2009

Several studies, including the Milliman study referenced above, have found that investment returns in DB plans generally outperform those of DC plans. For instance, over a 20-year period in Nebraska ending in 2002, average annual returns in DB plans administered by the state for public safety personnel were 11%, compared with about 7% in a DC plan for state and county employees. As a result, employees in DB plans generally have higher replacement ratios (the ratio of annual income in retirement to annual income during employment) than employees in DC plans.

State Fiscal Effect: The State employer pension contribution consists of two components: an amortization payment that pays off a portion of the liabilities that current members of the plans have already accrued, and a "normal cost" payment that covers the cost of the liabilities that current members accrue in the current year. The amortization payment includes projections of members' future liabilities based on turnover and mortality rates and other factors.

A firm estimate of the bill's fiscal effect cannot be determined because it depends largely on two factors that are not known:

- the number and characteristics of current ERS/TRS and EPS/TPS members who opt for ORP instead of their current DB plan; and

- how the State calculates benefits for those individuals who have accrued benefits in a DB plan.

As Exhibit 1 shows, the range of participation rates in DC plans for state employees who are given a choice is quite large. Moreover, the bill does not specify how SRPS should calculate the benefits for members who are vested in a DB plan before switching to a DC plan. Clearly, the member's years of service credit is frozen when the member switches to the ORP, but it is not clear from the bill whether the average final compensation used to calculate the member's benefit allowance is based on compensation at the time the member makes the switch or at the time the member retires. That distinction may have a significant effect on State costs. If the State uses compensation at the time of the switch, that choice will almost certainly yield a significant reduction in accrued liabilities, which are based on an assumption that a member's compensation continues to grow by 3.5% annually until retirement. If the State uses compensation at the time of retirement, it likely has no effect on accrued liabilities or the State's amortization payment of those liabilities.

The State may recognize some savings from its normal cost payments, the second component of the employer contribution, but that seems unlikely under current circumstances. **Exhibit 2** compares normal cost rates in fiscal 2010 and 2011 with the ORP contribution rate of 7.25%. Normal cost rates can fluctuate, as is clear from the TRS/TPS rates shown below, depending on the demographic characteristics of plan members and plan experience. The General Assembly's consulting actuary further advises that normal cost rates vary by member, with younger members typically having lower normal cost rates. In fiscal 2011, the State will pay slightly more for TRS/TPS members than for ORP members, but substantially less for ERS/EPS members. Again, the distribution of members who choose ORP determines the short-term fiscal effects for the State. If the group that switches to ORP is heavily weighted to ERS/EPS members, State expenditures increase significantly, due to the higher ORP contribution compared to the normal cost. If younger members favor ORP, which is likely given the portability of DC plans, the expenditure increase is even larger because of their lower normal cost rates.

Exhibit 2
Normal Cost Rates and ORP Contributions
Fiscal 2010 and 2011

	ERS/EPS Normal Cost	TRS/TPS Normal Cost	ORP Contribution
FY 2010	6.02	6.85%	7.25%
FY 2011	6.10	7.26%	7.25%

Source: Cheiron; Gabriel, Roeder, and Smith

Additional Comments: The State Retirement Agency notes that ORP in State law is only approved by the Internal Revenue Service (IRS) for educational employees. IRS approval would be needed to establish an ORP for other employees as proposed by the bill.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Baltimore City Community College; Department of Budget and Management; Maryland State Department of Education; Judiciary (Administrative Office of the Courts); Morgan State University; Maryland State Retirement Agency; State's Attorneys' Association; Maryland Supplemental Retirement Plans; Mercer Human Resources Consulting; Milliman; Cherion; Gabriel, Roeder, and Smith; Department of Legislative Services

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