Department of Legislative Services

Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

House Bill 1290 (Delegate Serafini)
Appropriations

State Employees' and Teachers' Retirement Savings Plan

This bill establishes a new defined contribution (DC) State Employees' and Teachers' Retirement Savings Plan (RSP) and terminates membership for current members of the Employees' Pension System (EPS) and Teachers' Pension System (TPS). All former EPS and TPS members become members of RSP as a condition of employment, as do eligible employees hired on or after the bill's effective date. Beginning in fiscal 2017, the bill phases in a requirement that local employers of RSP participants pay the employer matching contributions on behalf of their employees. Employees of participating governmental units (PGUs) are not affected, and new employees hired by PGUs that participate in EPS continue to be eligible for EPS.

The bill takes effect July 1, 2011.

Fiscal Summary

State Effect: State pension contributions increase by $293.0 million in FY 2012 to pay the State matching contribution for members of RSP. In FY 2013, State pension contributions decrease by $692.0 million when the State recognizes actuarial savings from the freezing of TPS/EPS. Those savings increase annually according to actuarial assumptions and are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds. Special fund expenditures by the Maryland Supplemental Retirement Plans increase by $1.4 million in FY 2012 for staff and related operating costs to implement the bill's provisions; they are assumed to be offset by a corresponding increase in special fund revenues due to an increase in the per-account administrative fee. The analysis does not include any impact related to employees who would otherwise be eligible for ORP.

($ in millions)	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
SF Revenue	$1.38	$1.60	$1.67	$1.74	$1.81
GF Expenditure	$246.12	($581.28)	($617.40)	($663.60)	($714.00)
SF Expenditure	$24.82	($53.76)	($57.13)	($61.46)	($66.19)
FF Expenditure	$23.44	($55.36)	($58.80)	($63.20)	($68.00)
Net Effect	($293.00)	$692.00	$735.00	$790.00	$850.00

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: In FY 2017, local expenditures increase by an estimated $49.1 million to begin paying a portion of the employer matching contribution. Local governments are responsible for the full matching contribution by FY 2021. The bill does not affect current PGUs. **This bill imposes a mandate on a unit of local government.**

Small Business Effect: None.

Analysis

Bill Summary: Employees eligible for RSP include all employees who otherwise would be eligible for TPS or EPS, either as a condition of employment or by choice. Employees eligible to join the Optional Retirement Program (ORP) may also join RSP; only existing members of ORP may remain in ORP. A vested former member of EPS and TPS is entitled to the benefits accrued prior to the termination of membership, in accordance with existing pension law. A nonvested member of EPS or TPS receives a return of member contributions, with interest.

RSP is administered by the State Board of Trustees of the Maryland Teachers and State Employees Supplemental Retirement Plans. The board must adopt, implement, and maintain supplemental retirement plans and ensure that the specific plans offer investment classes that include fixed or guaranteed money market, bond, stock, and various options within those investment classes. The board is required to adopt regulations to implement the bill.

An employee participating in RSP may elect to contribute to individual savings accounts when the employee first becomes eligible to participate. If the employee does not choose to participate at that time, the employee can begin participation only on July 1 of that or any succeeding year. For an employee who elects to contribute to RSP, the minimum contribution rate is 3% of earnable compensation, which increases automatically by 0.25% each year, up to 10%. The employee may freeze the growth of the contribution at any time but may resume the automatic increases only on July 1 of any year. A participating employee may make post-tax deferrals to a Roth 401(k) instead of, or in addition to, pretax deferrals to a traditional 401(k) plan.

It is assumed that the intent of the legislation is that the State contributes at least 3% of each eligible employee's earnable compensation into the RSP, regardless of whether the employee participates. The State also matches 25% of employee contributions that exceed 6% of compensation but are less than 10% of compensation. This yields a maximum State contribution of 4%.

An employee's interest in the RSP employer contributions begins on the first day of the fourth year of membership in the plan, at which time the employee becomes 100% vested in the benefits. Benefits from the savings plan are payable as a lump sum or as an annuity beginning at the time of retirement with either (1) no survivor benefit; (2) a 100% joint and survivor benefit; or (3) a 50% joint and survivor benefit. The benefits must be paid in accordance with Internal Revenue Code requirements and are not payable by the State.

Beginning in fiscal 2017, local employers of RSP participants (including local boards of education, community colleges, and public libraries) must begin paying a portion of the employer contribution on behalf of their employees. In fiscal 2017, local employers are responsible for 20% of the employer contribution on behalf of their employees, which increases by 20% each year until it reaches 100% in fiscal 2021 and each year thereafter.

For employees paid through the Central Payroll Bureau, the bureau is authorized to make the appropriate employer contributions as payrolls are paid, and to charge each payment to the unit employing a participant. If an employee's salary is paid from special or federal funds, the employer contribution must be made from the same source. The board must issue regulations to establish a process for the payment of employer contributions for members not paid through the Central Payroll Bureau. The Governor must include sufficient funds in the annual budget to pay the necessary employer contributions.

Participating employees with at least $2,000 in the RSP may borrow up to 50% of the account balance, not to exceed $50,000. The loan must be repaid within five years, unless the loan was applied to a primary residence.

Current Law: With a few exceptions, membership in EPS is a condition of employment for regular State employees hired since January 1, 1980, and whose compensation is provided by State appropriation or paid from State funds, as well as other individuals designated in statute. Membership in TPS is a condition of employment for most employees of a day school under the supervision of a county board of education, faculty employees of educational institutions supported by and under the control of the State, professional and clerical employees of local community colleges, librarians or clerical employees of public libraries, and other education-related employees designated in statute and hired since January 1, 1980. Membership in TPS is optional for 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; and
- professional employees of St. Mary's College.

ORP is authorized under § 403(b) of the Internal Revenue Code, which applies only to employees of educational institutions and specified nonprofit organizations. 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 (DB) plans offered by the State. The State contributes 7.25% of members' earnable compensation to ORP.

EPS/TPS members pay a member contribution equal to 5% of earnable compensation. They are eligible for a normal service retirement after 30 years of service or upon reaching 62 years of age with 5 years of service. A normal service retirement allowance is equal 1.8% of average final compensation (AFC) multiplied by years of service credit earned after June 30, 1998, plus 1.2% of AFC multiplied by years of service before that date.

The State pays the full employer contribution on behalf of members of TPS who are employed by local governments, including local school boards, community colleges, and public libraries.

The State Board of Trustees of the Maryland Teachers and State Employees Supplemental Retirement Plans administers four tax deferred, salary reduction, or deferred compensation plans established under §§ 401(a), 401(k), 403(b) and 457 of the Internal Revenue Code. The board is required to obtain approval from the Internal Revenue Service for each plan it offers. State employees, employees of local boards of education, and other individuals designated in statute and who meet federal criteria are eligible to participate in one or more of the plans offered.

Background: As of June 30, 2010, there were 103,162 active members of TPS, all but 1,906 of whom were employed by local governments. As of the same date, there were 77,660 active members of EPS, of whom 52,292 were State employees and the remaining members were employed by PGUs.

Although many states offer a DC plan similar to the RSP as a retirement option or as part of a hybrid (DB and DC) plan for state employees or teachers, only Michigan and Alaska (and the District of Columbia) currently offer only mandatory DC plans to state employees. State employees in Michigan hired beginning in 1997 have been required to join a DC plan as a condition of employment. In 2005, Alaska began requiring new state employees to participate in a DC plan instead of a DB plan. In Michigan and Alaska, teachers participate either in a DB plan or a hybrid plan. In 1991, West Virginia required teachers to participate in a DC plan but closed the plan to new members in 2005. The plan later merged with the state's DB plan.

In fiscal 2010, the Maryland Supplemental Retirement Plans (MSRP) had a total of 60,188 members with at least one account. Of those, 38,320 actively contributed to their accounts during the year. MSRP currently has a staff of 14 who provide education programs and support information to State employees and human resource personnel in State agencies. These efforts are designed to create awareness among State employees of the need and mechanisms available to save for their own retirement. Staff also supports the board's work in selecting investment options and overseeing the operation.

MSRP finances operations through a fee imposed on members' accounts, based on a percentage of assets in the plans along with a newly instituted flat-rate monthly charge. For fiscal 2011, the board fee is composed of two parts, a 0.05% of assets charge and an additional monthly per account charge of $0.50 ($6 annually). In addition, the board contracts with Nationwide Retirement Solutions, Inc., (Nationwide) for administration of all four plans. The fee charged by Nationwide is 0.14% of assets.

State Fiscal Effect:

Employer Contributions

Under the bill, vested EPS and TPS members retain their vested benefits, which they can claim under current eligibility requirements (*i.e*, when they qualify for early or normal service retirement benefits under current law). The calculation of benefits is assumed to be based on service and AFC as of June 30, 2011. The General Assembly's consulting actuary also assumes that vested members are entitled to disability and line-of-duty benefits under current law, but that they are capped based on accrued benefits prior to terminating membership in EPS or TPS.

The actuary advises that use of level-percent-of-pay amortization may not be appropriate for frozen pension plans because payroll in the plan is declining as members retire rather than increasing, as is assumed for open plans. The current actuarial assumption for all State Retirement and Pension System plans is that payroll increases by 3.5% annually. Therefore, the actuary recommends, in accordance with standards promulgated by the Governmental Accounting Standards Board, that a level-dollar amortization be used, which generally increases costs (or decreases savings) in the early years. This analysis is based on a level-dollar amortization of unfunded liabilities in the frozen EPS/TPS plans. Specifically, remaining unfunded liabilities in the plans are reamortized over 25 years on a level-dollar basis, and a new 25-year level-dollar amortization is conducted for the reduction of accrued liabilities due to the bill's provisions.

As a result, State pension liabilities decrease by $7.2 billion, and the normal cost decreases by $645 million. Amortizing the decrease in liabilities over 25 years (on a level-dollar basis) and adding the decrease in normal costs yields a first-year savings of $994 million in State pension contributions. The savings would be greater if the level-percent-of-pay amortization method was still used. Legislative Services notes that the bill does not reduce the State's pension contribution in the Governor's proposed fiscal 2012 budget, so there are no savings recognized in fiscal 2012 from the freezing of TPS/EPS. Instead, the reduced pension liabilities will be recognized in the June 30, 2011 actuarial valuation, which will lower the fiscal 2013 contribution rates. Those savings are presumed to grow according to actuarial assumptions and are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds.

Under the bill, State payments for the matching contributions begin in fiscal 2012 through payroll (or other method established in regulation for local employees). Separate estimates were developed based on two different levels of anticipated employee contributions. For an average employee contribution of 6.5%, the anticipated State contribution is approximately 3.25% (rounded to the nearest quarter percentage); for an average employee contribution of 8.0%, the State contribution is approximately 3.5%. State contribution totals do not differ significantly under the two scenarios, with the State contributing $293 million in fiscal 2012 under the lower assumption, and $315 million under the higher assumption.

Since the actuarial effects of freezing TPS/EPS are not recognized until fiscal 2013, total State pension expenditures for fiscal 2012 increase by the projected total of the State matching contribution. In fiscal 2013, when the State recognizes savings from freezing of TPS/EPS, net State savings is $692 million under the lower assumption, and $668 million under the higher assumption.

This analysis does not include any impact related to employees who would otherwise be eligible for ORP. Based on DLS's interpretation of the bill's intent, State contributions do not drop below 3% of compensation, even if no employees contribute to the plan, and do not exceed 4%.

Administrative Costs

Under the bill, membership in MSRP plans is expected to roughly triple as of July 1, 2011. Although Nationwide (or any other plan management firm hired to administer all or part of the plans) will be charged with absorbing much of the impact of the increase in membership, that level of increase also places additional demands on MSRP. The expansion will require MSRP to expand its educational programs for members; upgrade and reconfigure its informational technology systems to process and/or monitor contributions and distributions; and enhance its capacity to identify and monitor investment plan options for members, audit accounts, and monitor compliance with federal law.

Therefore, special fund expenditures by MSRP increase by $1,379,866 in fiscal 2012, which accounts for a 90-day start-up delay. This estimate reflects the cost of hiring 19 new staff to implement and manage the RSP. The estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses.

Positions	19
Salaries and Fringe Benefits	$866,468
Investment Consulting and Audit Services	243,750
Other Operating Costs	269,648
Total FY 2012 State Expenditures	**$1,379,866**

Future year expenditures reflect full salaries with 4.4% annual increases and 3% employee turnover as well as 1% annual increases in ongoing operating expenses.

It is assumed that MSRP increases its administrative fees to raise sufficient revenue to offset the increased costs. The actual fee increase will depend on the level of employee contributions into the funds. MSRP projects that initial per-account fee increases may be about 0.40%, which will decrease over time as asset totals increase.

Over time, SRA may experience reductions in personnel costs as the demands on the agency diminish with the freezing of TPS/EPS. However, those savings are not expected to materialize for some years because current retirees are not affected and because current TPS/EPS members continue to retire and be paid accrued benefits.

Local Fiscal Effect: Beginning in fiscal 2017, local governments would be responsible for 20% of the matching contributions for their employees. The actuary estimates that matching contributions total between $346 million and $373 million in fiscal 2016, which is assumed to increase 3.5% annually. Therefore, using an estimate of $372 million for fiscal 2017 (the midpoint between the two projected amounts for that year), and assuming that about two-thirds of those contributions are for local employees (based on the current ratio of local to State employees in TPS/EPS), the total contribution for local employees is estimated to be $245.5 million. In fiscal 2017, local governments would be responsible for 20% of that amount, or $49.1 million. Local contributions would increase by 20% each year until reaching 100% in fiscal 2021.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Mercer Human Resources Consulting, Maryland State Retirement Agency, Maryland Supplemental Retirement Plans, Department of Legislative Services

Fiscal Note History: First Reader - March 14, 2011
ncs/rhh

Analysis by: Michael C. Rubenstein

Direct Inquiries to:
(410) 946-5510
(301) 970-5510