HB 843

Department of Legislative Services

Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

House Bill 843 (Delegate Kach)
Appropriations

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

This bill makes membership in the Employees' Pension System (EPS) and Teachers' Pension System (TPS) optional for all new members hired after June 30, 2011, and makes those individuals eligible to participate in the Optional Retirement Program (ORP), a defined contribution (DC) plan. Under current law, newly eligible employees must decide whether to participate in ORP or the appropriate defined benefit (DB) plan within one year of first becoming eligible. Annuity contracts paid to retirees by ORP are also authorized under § 401(a) of the Internal Revenue Code. The bill does not apply to members of participating governmental units (PGUs) who participate in EPS.

The bill takes effect July 1, 2011.

Fiscal Summary

State Effect: The bill's effect on State pension liabilities and contribution rates cannot be reliably estimated but would likely result in expenditure increases (all funds) in FY 2012 because ORP employer contributions are higher than normal cost rates for affected plans, especially for young members. If normal cost rates in the future exceed the ORP contribution, which may occur shortly for TPS, the overall effect of the bill will depend on the number and characteristics of new members who elect to join ORP, which cannot be reliably estimated. The State Retirement Agency (SRA) advises that costs related to the implementation of the bill's expanded annuity provision may be significant, but a reliable estimate is not possible.

Local Effect: None. The bill does not apply to PGUs.

Small Business Effect: None.

Analysis

Current Law: Membership in 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; and
- 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 DB plans offered by the State.

The State pays the full employer contribution for members of TPS and ORP who are employed by local boards of education and community colleges.

Background: 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 (AFC) for each year of service after June 30, 1998, and 1.2% of AFC for service credit earned prior to that date. Retirees receive automatic annual cost-of-living adjustments equal to the Consumer Price Index for all Urban Consumers, subject to a 3% cap. As of June 30, 2010, there are 103,162 active TPS members and 77,660 active EPS members.

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:

Employer Contributions

A firm estimate of the bill's fiscal effect cannot be determined because it depends largely on the number and characteristics of new EPS/TPS members who opt for ORP instead of their respective DB plans. As Exhibit 1 shows, the range of participation rates in DC plans for state employees who are given a choice is quite large and cannot be predicted for new TPS/EPS members. Moreover, the number of new members of TPS/EPS fluctuates every year; for instance, according to data provided by SRA, there were almost 10,800 new members of TPS in fiscal 2008 but about 6,600 in fiscal 2010.

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. New members accrue only prospective benefits, so their costs are reflected largely in the normal cost.

Under current conditions, the State is likely to incur additional costs for new TPS/EPS members who opt for ORP in fiscal 2012. **Exhibit 2** compares normal cost rates for fiscal 2010 through fiscal 2012 with the ORP contribution rate of 7.25%.

Exhibit 2
Normal Cost Rates and ORP Contributions
Fiscal 2010-2012

	EPS Normal Cost	TPS Normal Cost	ORP Contribution
FY 2010	6.02%	6.85%	7.25%
FY 2011	6.46%	7.22%	7.25%
FY 2012	6.47%	7.23%	7.25%

Source: Cheiron; Gabriel, Roeder, and Smith

Normal cost rates can fluctuate, as is clear from the EPS/TPS rates shown above, 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 2012, the State will pay slightly less for TPS members than for ORP members but substantially less for EPS members. Again, the distribution of members who choose ORP determines the short-term fiscal effects for the State, but in either case, the State incurs additional costs for any new TPS/EPS member who opts for ORP. If the group that chooses ORP is heavily weighted to EPS members, State expenditures increase significantly, due to the higher ORP contribution compared to the normal cost. Since only new members are eligible, it is likely that the group that opts for ORP will be skewed toward younger members with even lower normal costs, so the expenditure increase is even larger. Given the proximity of TPS normal costs to the ORP contribution rate, TPS normal costs may exceed the ORP rate in the near future, in which case the State would recognize savings for any TPS member who transferred to ORP. In that instance, the balance between EPS and TPS members who opt for ORP will ultimately determine whether the State experiences savings or incurs additional costs.

Implementation Costs

ORP was established under §403(b) of the Internal Revenue Code, which allows only employees of educational and nonprofit medical facilities to participate. SRA advises that implementing the expansion of ORP to include annuity contracts under § 401(a) of the Internal Revenue Code may be costly and time consuming, but SRA cannot provide a reliable estimate of the cost.

Additional Information

Prior Introductions: HB 1374 of 2010, a similar bill, received an unfavorable report from the House Appropriations Committee.

Cross File: None.

Information Source(s): Milliman; Cheiron; Gabriel, Roeder, and Smith; Mercer Human Resources Consulting; State Retirement Agency; Maryland Supplemental Retirement Plans; Department of Legislative Services

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