Department of Legislative Services

Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

House Bill 1289 (Delegate Serafini)
Appropriations

State Retirement and Pension System - State Employees and Teachers - Benefits

This bill establishes the State Employees' and Teachers' Integrated Pension System (IPS) as a new benefit tier for current and future members of the Employees' Pension System (EPS) and Teachers' Pension System, as well as Selection C members of the Employees' Retirement System (ERS-Selection C) and Teachers' Retirement System (TRS-Selection C). IPS combines a defined benefit (DB) component that provides a reduced benefit multiplier for service credit earned after June 30, 2011, with a defined contribution (DC) savings plan. Participating governmental units (PGUs) are not affected.

The bill takes effect July 1, 2011.

Fiscal Summary

State Effect: Assuming a State matching contribution of 3.25% to the DC savings plan established by the bill, State pension contributions increase by $293.0 million in FY 2012, which are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds. In FY 2013, the State recognizes savings from the reduced DB benefits, which are partially offset by the continuing employer matching contributions. State pension costs therefore decrease by $24.0 million in FY 2013, which are also allocated as above. If the State matching contribution is higher due to higher employee contributions, the savings in FY 2013 is less (or may generate a net increase in State costs until FY 2017). Special fund expenditures by the State Retirement Agency (SRA) increase significantly in FY 2012 to implement the bill. A reliable estimate is not possible but is likely in the millions of dollars.

(in dollars)	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Revenues	$0	$0	$0	$0	$0
GF Expenditure	246,120,000	(20,160,000)	(24,360,000)	(30,240,000)	(37,800,000)
SF Expenditure	23,440,000	(1,920,000)	(2,320,000)	(2,880,000)	(3,600,000)
FF Expenditure	23,440,000	(1,920,000)	(2,320,000)	(2,880,000)	(3,600,000)
Net Effect	($293,000,000)	$24,000,000	$29,000,000	$36,000,000	$45,000,000

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

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

Small Business Effect: None.

Analysis

Bill Summary: Beginning July 1, 2011, all current and future members of EPS and TPS, as well as current members of ERS-Selection C and TRS-Selection C participate in IPS and pay a member contribution rate of 3% of earnable compensation. The benefit multiplier for service credit earned on or after July 1, 2011, is 1.0% of average final compensation (AFC).

IPS members are also members of a new DC plan, the State Employees' and Teachers' IPS Savings Plan, as a condition of employment. Other individuals who are eligible for EPS or TPS but who are not members of those plans are eligible to participate in the savings plan. The savings plan is administered by the Board of Trustees of the State Retirement and Pension System, which is required to adopt regulations to implement the new plan. As the administrator of the savings plan, the board must establish DC supplemental plans that include a salary reduction plan qualified under § 401(k) of the Internal Revenue Code (IRC), or a tax-sheltered annuity plan qualified under § 403(b) of IRC.

As members of the savings plan, employees may contribute up to $16,500 annually to a supplemental plan, except that members age 50 or older may contribute up to $22,000 annually. The State matches 100% of an employee's contribution to the savings plan, up to 3% of the employee's earnable compensation, and 50% of the employee's contributions between 3% and 5% of earnable compensation. Employees' interest in the savings plan begins on the first day of the fourth year of their membership in the plan, when they become 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 IRC requirements and are not payable by the State. Benefits paid by the savings plan are not subject to annual cost-of-living adjustments (COLAs), but they also are not subject to early retirement reductions.

For members paid through the Central Payroll Bureau, the bureau is required to make the appropriate employer contributions as payrolls are paid, and to charge each payment to the unit employing a member. If a member'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 savings plan 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 is 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. With some exceptions, membership in TPS is a condition of employment for 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. 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 to 1.8% of 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.

TRS and ERS predate TPS and EPS, but they were closed to new members as of January 1, 1980, when they were replaced by the new pension systems. Under Chapter 7 of 1984, TRS and ERS each provide three benefit options to their members, known as Selections A, B, and C; active TRS/ERS members in 1984 were required to choose from among the three options. TRS/ERS members in Selection C chose to retain their TRS/ERS benefits for service credits earned prior to choosing Selection C, but to earn TPS/EPS benefits for service credits earned after choosing Selection C. Therefore, the accrual rates and COLAs applied to their benefit calculations are weighted according to the service credits earned under each plan. TRS/ERS members are eligible for a normal service retirement after 30 years of eligible service or upon reaching age 60. The normal service retirement benefit is equal to one fifty-fifth (1.82%) of a member’s AFC for each year of service.

Background: The Federal Employees’ Retirement System (FERS), enacted in 1986, closely resembles the IPS proposed by this bill. Besides Social Security benefits, FERS includes both a DB and DC component. The DB component requires an employee contribution of approximately 6% and provides a 1.0% benefit multiplier for each year of service. However, FERS members who retire at or after age 62 with at least 20 years of service receive a 1.1% benefit multiplier. The DC component, entitled the Thrift Savings

Plan, provides a 1% employer contribution for all members. Employee contributions are then matched 100% for the first 3% of compensation, and 50% for contributions between 3% and 5% of compensation.

Hybrid plans like the IPS proposed by this bill are not common in other states, but they do exist. Indiana has operated a hybrid plan similar to FERS and the IPS proposed by the bill for many years. In 2010, Michigan established a new benefit tier for all newly hired school employees that includes elements of both a DC and DB plan. The DB tier eliminates retiree COLAs and increases retirement eligibility requirements compared to the requirements for current school employees. The DC component provides a maximum 1% employer match (50% of first 2% of an employee's contribution). Other states, including Washington and Oregon, offer employees a choice between DB and DC plans.

State Fiscal Effect:

DB Benefit Reduction

The changes to the DB component of the plans result in the State's unfunded liabilities decreasing by $2.67 billion and the normal cost decreasing by $144.0 million. After amortizing the reduction in liabilities over 25 years and adding in the reductions to the normal cost, State pension contributions decrease by $326 million in fiscal 2013. Those savings grow according to actuarial assumptions and are assumed to be allocated 84% general funds, 8% special funds, and 8% general funds. Legislative Services notes that the bill does not reduce the employer contribution included in the Governor's budget for fiscal 2012, so the savings generated by the DB benefit reduction are not reflected in fiscal 2012. Instead, they will be captured in the actuarial valuation for June 30, 2011, and reflected in the fiscal 2013 contribution rates.

State Matching Contribution

The net cost or savings generated by IPS depends to a large extent on the State contribution required to match employee contributions to the savings plan. For this analysis, the General Assembly's consulting actuary calculated the State cost to match employee contributions of either 3.5% or 5.0% to the savings plan (in addition to the mandatory 3% contribution for the DB component). This reflects the tendency of higher-paid employees to contribute a higher percentage of compensation to retirement savings plans than lower-paid employees, and they tend to have a strong influence on average contribution rates. A 3.5% employee contribution yields a 3.25% employer match, while a 5.0% employee contribution yields a State match of 3.75%, which includes a slight offset to account for some employees not taking full advantage of the match. The actuary also assumed that any forfeitures of State contributions due to employees leaving before completing three years of service do not reduce State costs;

those forfeitures may be applied to reduce administrative costs, which are not factored into this analysis. DLS notes that, under the bill, employer matching contributions begin in fiscal 2012 through payroll (or other processes established in regulation for local employees). The actuary estimates, based on projected payroll levels and the assumed match levels, that State matching contributions to the savings plan increase State costs in fiscal 2012 by either $293 million (with a 3.25% employer match) or $338 million (with a 3.75% employer match). Those contributions are assumed to increase each year with payroll.

In fiscal 2012, therefore, the net fiscal effect is the cost of the State match because State pension contributions do not decrease. In fiscal 2013, when the State recognizes $326 million in savings from the DB benefit reduction and continues to pay the employer match as mandated by the bill, the net fiscal effect is either a decrease in State pension costs of $24 million in fiscal 2013 (for a 3.25% employer match) or an increase of $23 million (for a 3.75% employer match). Both the State matching contributions and the net savings or costs are also assumed to be allocated as described above.

The savings generated by the changes to the DB component grow faster than the cost of the State matching contributions, according to the actuary's analysis. As a result, by fiscal 2017, both State matching contribution scenarios generate a reduction in State pension costs (about $50 million for the lower match, and about $5 million for the higher match).

Administrative Costs

SRA advises that making changes to its computer system and implementing the new savings plan will be expensive endeavors, but SRA cannot provide a reliable estimate of the cost. Excluding PGUs from the benefit change requires carving them out within the agency's computer system; SRA advises that the cost to reprogram the system could be as high as $3.5 million in contractual costs. Legislative Services cannot assess this specific estimate but concurs that the cost may be significant in fiscal 2012. SRA also notes that establishing a new DC plan, which it currently does not administer, will require Internal Revenue Service approval, which can also be costly, due to the involvement of outside tax counsel, and a lengthy process, often taking two years to complete.

Additional Information

Prior Introductions: None.

Cross File: None.

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

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