HB 387

Department of Legislative Services

Maryland General Assembly
2013 Session

FISCAL AND POLICY NOTE

House Bill 387 (Delegate Bates)
Appropriations

State Retirement and Pension System - Truth in Pension Accounting Act

This bill requires that the Board of Trustees of the State Retirement and Pension System (SRPS) adopt, as its investment return assumption, the interest rates that apply to single-employer corporate defined-benefit plans specified in the federal Internal Revenue Code (IRC).

The bill takes effect July 1, 2013.

Fiscal Summary

State Effect: Total State pension contributions increase by $92.0 million in FY 2015 and by $188.0 million in FY 2016. Beginning in FY 2017, however, State pension contributions decline, by $303.0 million in FY 2017 and $320.0 million in FY 2018. They continue to decline in the out-years according to actuarial assumptions. State pension contributions are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds. No effect on revenues.

(in dollars)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
Revenues	$0	$0	$0	$0	$0
GF Expenditure	0	77,280,000	157,920,000	(254,520,000)	(268,800,000)
SF Expenditure	0	7,360,000	15,040,000	(24,240,000)	(25,600,000)
FF Expenditure	0	7,360,000	15,040,000	(24,240,000)	(25,600,000)
Net Effect	$0	($92,000,000)	($188,000,000)	$303,000,000	$320,000,000

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

Local Effect: Local school board contributions for members of the Teachers' Retirement System (TRS) or Teachers' Pension System (TPS) increase by $601.0 million in FY 2017 and continue increasing in the out-years according to actuarial assumptions.

Small Business Effect: None.

Analysis

Current Law/Background: The SRPS board is responsible for the management, general administration, and proper operation of the several systems. Among its specific responsibilities, it must select an actuary to conduct an annual valuation of the system's assets and liabilities for the purpose of certifying employer contribution rates to provide assets sufficient to pay for promised future benefits. The board may adopt generally accepted methods for determining the value of assets held, and it must adopt actuarial assumptions to be used by the actuary in calculating assets and liabilities.

Investment Return Assumptions

Accounting standards promulgated by the Governmental Accounting Standards Board allow public pension plans to use their assumed annual rate of return on investments as the discount rate for calculating plan liabilities.

However, the IRC dictates the specific interest and discount rates to be used in calculating the assets and liabilities of corporate defined-benefit plans, based on current corporate bond yield curves for varying maturities; public pension plans are not subject to the IRC requirements. Under the IRC requirements, the rate used by corporate plans is a blended rate consisting of corporate bond yields for three different time periods (segment rates). For benefits expected to be payable within five years, the segment rate on five-year corporate bonds is applicable. For benefits expected to be payable between 5 and 15 years, the segment rate applicable to bonds maturing in 5 to 15 years is used. For benefits expected to be payable after 15 years, the segment rate applicable to corporate bonds maturing after 15 years is applicable. The three rates are then weighted according to liabilities in the plan to arrive at the blended rate. The Internal Revenue Service (IRS) publishes the three segment rates monthly.

With bond yields at historically low levels for the 2012 plan year (the three segment rates for February 2013 are between 1.58% and 5.38%), corporate pension plans were under severe strain. Use of current rates to calculate plan assets and liabilities resulted in unusually high unfunded liabilities for corporate plans. In response, the federal Moving Ahead for Progress in the 21st Century Act (MAP-21), enacted in July 2012, allows corporate plans to use adjusted segment rates more in line with 25-year average yields. Under MAP-21, the applicable segment rates for February 2013 published by the IRS ranged from 5.54% to 7.52%, providing significant pension funding relief to corporate plans.

The SRPS board has adopted 7.75% as its investment return assumption. According to the National Association of State Retirement Administrators (NASRA), investment return assumptions for state pension plans range between 6.75% (Indiana) and 8.50% (three states), with 8.00% being the most common investment return assumption, even after 45 public plans have lowered their investment assumption since fiscal 2008. NASRA also notes that, as of December 2011, the median annualized rate of return for public pension plans over the previous 25 years is 8.30%. As of December 31, 2012, the SRPS 10-year annualized return is 7.25%, falling 50 basis points short of the system's investment target. However, the 25-year annualized return is 8.05%, which exceeds the target by 30 basis points.

Teacher Pension Costs

Chapter 1 of the 2012 first special session (SB 1301) requires local school boards to pay the normal cost for their employees who are members of TRS/TPS, phased in over five years. Prior to that, the State paid 100% of the annual employer contribution on behalf of teachers in the State. Based on 2012 projections of the normal cost, local school boards pay 50% of the normal cost in fiscal 2013, phasing up to 100% of the normal cost by fiscal 2016. For those four years, Chapter 1 specifies the exact dollar amount to be paid by each local school board based on the projected normal cost and the local share of that cost. Beginning in fiscal 2017, however, local school boards must pay 100% of the *actual* normal cost. Also beginning in fiscal 2013, Chapter 1 requires county governments (including Baltimore City) to adjust their maintenance of effort payments to local school boards to fully compensate them for teacher pension costs. Beginning in fiscal 2017, the fiscal 2016 payments by the counties are included in subsequent years' maintenance of effort calculations, so local school boards are responsible for any increase in normal cost payments between fiscal 2016 and each succeeding year.

Corridor Funding Method

Chapter 440 of 2002 (SB 323) enacted the corridor funding method to help mitigate the effects of fluctuations in market returns on employer contribution rates by spreading out those effects over five years. The corridor method froze employer contribution rates for the employees' and teachers' systems, the two largest pension plans operated by the board, at their fiscal 2002 levels as long as each of the two systems remained actuarially funded between 90% and 110%. As the plans fell out of their corridors, the employer contributions increased by an amount equal to 20% of the difference between the prior year's rate and the "true" actuarial rate required to fully fund the systems. The employees' combined systems fell out of the corridor in fiscal 2005, followed by the teachers' combined systems in fiscal 2006.

State/Local Fiscal Effect: For the purpose of this analysis, the General Assembly's consulting actuary projected segment rates under MAP-21 for the next four actuarial valuation cycles. Based on these projections, and the distribution of liabilities within SRPS, the effective rate for the June 30, 2013 valuation, which determines liabilities and employer contribution rates for fiscal 2015, is 6.70%. Because the normal cost consists of benefits earned in the current year and, therefore, falls within the initial five-year period under the IRC requirements, the first segment rate is used to calculate the normal cost. For fiscal 2015, that first segment rate is 5.23%. By the June 30, 2016 valuation, the blended rate drops to 5.86% and the first segment rate declines to 4.54%.

Although the bill takes effect July 1, 2013, it is assumed that the new investment return assumptions are reflected in the June 30, 2013 actuarial valuation, which determines employer contribution rates for fiscal 2015. It has been standard practice for SRPS actuarial valuations to reflect enacted statutory changes at the earliest feasible time

Based on the projected segment rates, the actuary estimates that total SRPS unfunded liabilities increase by $4.3 billion in fiscal 2015 and by $16.5 billion in fiscal 2018, due to the declining discount and investment return rates. The increased unfunded liabilities result in total employer contributions increasing by $92.0 million in fiscal 2015 and then increasing each year thereafter according to actuarial assumptions. Initially, these increases are borne exclusively by the State, but as shown below, beginning in fiscal 2017, local school boards assume a substantial portion of the total fiscal effect.

This portion of the analysis focuses on TRS/TPS. Whereas growth in total employer contributions under TRS/TPS is restricted by the corridor method, growth in the normal cost rate is not. Therefore, over time, the TRS/TPS normal cost grows at a much faster pace than total contributions, meaning that local school board contributions ultimately supplant a large portion of State contributions.

As noted above, Chapter 1 holds local school boards and counties harmless for changes in the normal cost through fiscal 2016. However, by fiscal 2017, when local school boards are responsible for paying 100% of the *actual* normal cost, the employer normal cost rate for TRS/TPS is projected to be 12.9% under the bill, compared with the current projection of 5.4%. That projects to a total school board contribution of $1.0 billion, with the total employer contribution being $1.6 billion for TRS/TPS. Therefore, beginning in fiscal 2017, State contributions are mitigated substantially by a $601.0 million increase in local school board contributions. These effects are summarized in **Exhibit 1**.

Exhibit 1
Effect of the Bill on TRS/TPS Employer Contributions
($ in Millions)

	Total Employer Contribution			Local Share			State Share		
	Current	**HB 387**	**Change**	**Current**	**HB 387**	**Change**	**Current**	**HB 387**	**Change**
2015	$1,240	$1,294	$54	$222	$222	NA	$1,018	$1,072	$54
2016	1,337	1,456	119	255	255	NA	1,082	1,201	119
2017	1,427	1,622	195	407	1,008	601	1,020	614	(406)
2018	1,518	1,798	280	421	1,162	741	1,097	636	(461)

Source: Cheiron

When the effects on TRS/TPS contributions are combined with the bill's effect on the other plans within SRPS, for which the State makes all employer contributions, State contributions for fiscal 2015 and 2016 increase by $92.0 million and $188.0 million, respectively, but decline in fiscal 2017 and 2018 by an estimated $303.0 million and $320.0 million, respectively. State contributions on behalf of TRS/TPS members are paid entirely from general funds; payments for State employees are assumed to be allocated 60% general funds, 20% special funds, and 20% federal funds. Therefore, the combined State contributions are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds.

Local school board contributions on behalf of TRS/TPS members remain unchanged in fiscal 2015 and 2016 because of the hold-harmless provisions of Chapter 1. However, in fiscal 2017 and 2018, total local school board contributions increase by $601 million and $741 million, respectively. They continue to increase according to actuarial assumptions.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Cheiron, Pension Benefit Guaranty Corporation, Internal Revenue Service, National Association of State Retirement Administrators, Department of Legislative Services

Fiscal Note History: First Reader - February 17, 2013
mc/rhh

Analysis by: Michael C. Rubenstein

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