SB 602

Department of Legislative Services
Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 602 (Senator Bates, *et al.*)
Budget and Taxation

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

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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 (TPS), 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, 2018, with a defined contribution (DC) savings plan. Participating governmental units (PGUs) are not affected.

The bill takes effect June 1, 2018, and applies to current and future EPS/TPS and ERS/TRS-Selection C members beginning July 1, 2018.

Fiscal Summary

State Effect: Assuming a State matching contribution of 3.5% to the DC savings plan established by the bill, State pension contributions increase by $109.1 million in FY 2019, which are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds. In FY 2020, the State recognizes savings from the reduced DB benefits and from local governments paying a higher share of retirement costs. State pension costs, therefore, decrease by $6.7 million in FY 2020, which are also allocated as above. If the State matching contribution is higher due to higher employee contributions beginning in FY 2019, the costs are also higher. No effect on revenues.

(in dollars)	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
Revenues	$0	$0	$0	$0	$0
GF Expenditure	0	91,618,800	(5,602,800)	(14,599,200)	(19,210,800)
SF Expenditure	0	8,725,600	(533,600)	(1,390,400)	(1,829,600)
FF Expenditure	0	8,725,600	(533,600)	(1,390,400)	(1,829,600)
Net Effect	$0	($109,070,000)	$6,670,000	$17,380,000	$22,870,000

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

Local Effect: Local employer contributions for pensions increase by $238.0 million in FY 2019 due to the higher employer normal cost for local school board employees, and community colleges and libraries being newly responsible for employer matching contributions. Those expenditures increase in the out-years to $422.1 million in FY 2022 according to actuarial assumptions and are shared among 24 local school systems and local governments. No effect on local revenues. **This bill imposes a mandate on a unit of local government.**

Small Business Effect: None.

Analysis

Bill Summary: Beginning July 1, 2018, 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 3.0% of earnable compensation. The benefit multiplier for service credit earned on or after July 1, 2011, is 1.0% of average final compensation. Members continue to be eligible for early retirement, disability benefits, and cost-of-living adjustments (COLAs), subject to the lower benefit level.

IPS members are also members of a new DC plan, the State Employees' and Teachers' IPS Savings Plan (Savings Plan), as a condition of employment. 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.

Employee contributions to the Savings Plan are not established, but employees are 100% vested in their contributions immediately. The employer then matches 100% of an employee's contribution to the Savings Plan, up to 3.0% of the employee's earnable compensation, and 50% of the employee's contributions between 3.0% and 5.0% of earnable compensation. Employees' interest in the employer's contributions to the Savings Plan begins after three years, 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 from the Savings Plan are not subject to 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 for State employees.

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.

Beginning in fiscal 2019, each local school board must continue to pay the normal cost for members of the Teachers' Retirement System.

Employees' Pension System/Teachers' Pension System

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.

In general, TPS/EPS members hired before July 1, 2011, are subject to the Alternate Contributory Pension Selection (ACPS), a benefit tier within TPS/EPS. Chapter 397 of 2011 added the Reformed Contributory Pension Benefit (RCPB) as a new benefit tier to TPS/EPS. In general, an individual who becomes a member of TPS/EPS on or after July 1, 2011, is automatically enrolled in RCPB (subject to limited exceptions). **Exhibit 1** compares the benefit structures under ACPS and RCPB.

Exhibit 1
Comparison of ACPS and RCPB Benefits

	ACPS	RCPB
Vesting	5 years	10 years
Normal Retirement	30 years of service, or age 62	age plus service add to 90, or age 65
Benefit Multiplier	1.8%/year since 1998 1.2%/year before 1998	1.5%/year
Member Contribution	7.0% of pay	7.0% of pay

ACPS: Alternate Contributory Pension Selection
RCPB: Reformed Contributory Pension Benefit

Source: Department of Legislative Services

Local Employer Contributions

Chapter 1 of the first special session of 2012 required local school boards to pay the normal cost for their employees who are members of TRS/TPS, phased in over five years. The phase-in period is complete, so beginning in fiscal 2017, local school boards pay 100% of the normal cost. Beginning in fiscal 2013, Chapter 1 also requires county governments and Baltimore City to adjust their maintenance of effort payments to local school boards to compensate them for teacher pension costs. Beginning in fiscal 2017, the fiscal 2016 payments by the counties are included in subsequent years' per-pupil maintenance of effort calculations. Depending on enrollment trends in each county, some local school boards may be responsible for a portion of any increase in normal cost payments between fiscal 2016 and each succeeding year.

Chapter 1 also established Teacher Retirement Supplemental Grants to provide financial support to local jurisdictions with limited capacity to pay their share of the normal cost. Under the grant program, nine local governments receive a total of $27.7 million annually in supplemental grants. In addition, Chapter 1 repealed the requirement that local school boards reimburse the State for their TRS/TPS employees paid with federal funds beginning in fiscal 2015.

"Normal contributions" (or "normal cost") is an actuarial term that is not defined in statute, but it refers to the actuarial value of pension benefits earned by an active member or group of active members in a given year. Statute defines the "normal contribution rate" as a fraction that has as its numerator the sum of all normal contributions, net of member contributions, and as its denominator, the aggregate annual earnable compensation of members of the State system.

Background: As of June 30, 2016, there were 104,823 active members of TPS, all but 8,958 of whom were employed by local governments. As of the same date, there were 74,702 active members of EPS, of whom 50,234 were State employees and the remaining members were employed by PGUs.

TRS was closed to new members in 1980; it currently has 724 active members, of whom 568 are employed by local governments. A reliable count of ERS members is not available as it includes members of the Correctional Officers' Retirement System. Selection C provides a bifurcated benefit that includes ERS benefits for service prior to electing EPS benefits. Very few members of TRS/ERS remain in Selection C.

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 6.0% 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, titled the Thrift Savings Plan, provides a 1.0% employer contribution for all members. Employee contributions are then matched 100% for the first 3.0% of compensation, and 50% for contributions between 3.0% and 5.0% of compensation.

State Fiscal Effect: For the purposes of this analysis, the General Assembly's consulting actuary makes the following assumptions:

- Employees pay 4.0% of compensation to the Savings Plan, thereby keeping their total contribution at the current level (3.0% of compensation for the DB component and 4.0% to the Savings Plan, for a total of 7.0% of compensation).
- Local school boards continue to pay the normal cost for their employees in TPS, while local school boards, community colleges, and libraries each pay the employer match (3.5% of compensation, based on the assumption above) for the employee contributions to the Savings Plan, as required by the bill.
- There is no change in the rate at which employees eligible for the Optional Retirement Program elect to participate in that program.

Accrued Liabilities and Normal Cost

The goal of actuarial funding of pension benefits is to pay for the benefits – into a trust fund – as they accrue so that future generations do not have to bear the burden of paying for benefits to retirees. The normal cost is an actuarial calculation that reflects the value of benefits earned in a given year, based on actuarial assumptions. In theory, payment of the normal cost into the trust fund should cover the cost of benefits accrued in that year. However, liabilities accrue when actual experience does not conform to the assumptions used to calculate the normal cost. The most common factor is when investments do not earn as much as projected, but other factors, such as actual rates of retirement, actual inflation, etc., can generate liabilities when they differ from the assumptions. Accrued liabilities are amortized, with the annual amortization payments added to the normal cost to generate an annual employer contribution (net of employee contributions). As of June 30, 2016, TPS/EPS had combined accrued liabilities of $17.9 billion.

By lowering the DB benefit multiplier from either 1.5% or 1.8% to 1.0%, the bill reduces future liabilities. Had the bill been in effect in fiscal 2016, the actuary estimates that accrued liabilities would have decreased by $2.7 billion combined for TPS/EPS.

The opposite is true for normal cost, which increases under the bill, as shown in **Exhibit 2**. Under the fiscal 2016 actuarial valuation, the employer normal cost is 4.47% of compensation for TPS and 3.86% for EPS, compared with a projected employer contribution of 9.92% for TPS and 9.11% for EPS under the bill. The higher figure includes an employer matching contribution of 3.5% for the Savings Plan; it also reflects the reduction in the employee contribution from 7.0% to 3.0% as the employer has to make up the difference in normal cost. Under current law, the State pays the full normal cost for all EPS members and for TPS members who are not employed by local school boards (including those employed by community colleges and libraries). Under the bill, the State pays more for every group. Had the bill been in effect in fiscal 2016, the actuary estimates that State normal cost payments would have increased by $184.7 million.

Exhibit 2
Normal Cost – Employer Contributions

	State Contributions		Local Contributions	
	Current	The Bill	Current	The Bill
EPS Members	3.86%	9.11%	n/a	n/a
State TPS Members	4.47%	9.92%	n/a	n/a
Local School Board TPS Members	0%	0%	4.47%	9.92%
Community College and Library TPS Members	4.47%	6.42%	0%	3.5%

EPS: Employees' Pension System
TPS: Teachers' Pension System

Source: Department of Legislative Services

Net Fiscal Effect

SRPS conducts annual actuarial valuations of the DB plan as of June 30 of each year. The valuation conducted as of June 30, 2017, determines contribution rates for fiscal 2019. As participation in the new DB benefit tier does not take effect until July 1, 2018, contributions for fiscal 2019 (calculated as of June 30, 2017) reflect the current benefit structure; any change in the DB benefits does not get reflected until the June 30, 2018 valuation, which affects contributions for fiscal 2020. However, employer matching payments to the Savings Plan begin July 1, 2018, so the increase in those payments is reflected in fiscal 2019.

Overall, net employer costs increase by $347.1 million in fiscal 2019 because the cost of the additional benefits (matching payments) in the DC Savings Plan is not fully offset by a reduction in liabilities in the DB plan. In fiscal 2019, both State and local costs increase due to the higher normal cost contributions since the DB liability savings are not reflected until the following year. Once those savings are recognized, State contributions after fiscal 2019 decrease as local governments pay a larger share of the overall costs. Changes in State contributions are assumed to be allocated 84% general funds, 8% special funds, and 8% federal and other funds.

Local Fiscal Effect: As shown in Exhibit 2, local governments pay substantially more in normal cost payments due to the bill. This is because the employer normal cost for the DB plan increases because the employee contribution drops from 7.0% of compensation to 3.0% of compensation, so the employer has to make up the difference. Moreover, local employers are now responsible for the employer match for the Savings Plan, projected to be an additional 3.5% of compensation. As a result, had the bill been in effect in fiscal 2016, the actuary estimates that local normal cost payments would have increased by $356.1 million.

Overall, local pension contributions increase by $238.0 million in fiscal 2019 due to the higher normal cost/employer contribution payments. They continue to increase to $422.1 million in fiscal 2022 according to actuarial assumptions and are shared by 24 local school systems and county governments.

Additional Information

Prior Introductions: HB 1289 of 2011, a similar bill, received an unfavorable report from the House Appropriations Committee.

Cross File: HB 896 (Delegate Aumann, *et al.*) - Appropriations.

Information Source(s): Bolton Partners; Maryland Association of Counties; State Retirement Agency; Department of Legislative Services

Fiscal Note History: First Reader - March 1, 2017
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