SB 486

Department of Legislative Services

Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 486 (Senator Serafini, *et al.*)
Budget and Taxation

State Employees and Teachers - Cash Balance Plan

This bill freezes benefits for current members of the Teachers' Pension System (TPS) and Employees' Pension System (EPS), terminates their membership in both plans, and requires current members of TPS/EPS whose membership is terminated to participate in a cash balance plan established by the bill as a condition of employment. The bill closes TPS/EPS and the Optional Retirement Program (ORP) to new members. All new employees hired on or after July 1, 2018, who would otherwise be eligible for EPS, TPS, or ORP must participate in the cash balance plan. The bill does not apply to participating governmental units (PGUs) that joined EPS before July 1, 2018.

The bill takes effect June 1, 2018.

Fiscal Summary

State Effect: No effect in FY 2018. State pension liabilities decrease by $5.9 billion and the normal cost increases by $101.1 million. Amortizing the decrease in liabilities over the remaining years of the closed 25-year amortization period and adding the normal cost increase results in State pension contributions decreasing by $329.1 million in FY 2019, assuming the bill's effects are reflected in the June 30, 2017 actuarial valuation, as discussed below. Those savings continue to accrue based on actuarial assumptions and are assumed to be allocated 84% general funds, 8% special funds, and 8% federal and other funds. 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	(276,444,000)	(296,637,600)	(328,255,200)	(349,280,400)
SF Expenditure	0	(26,328,000)	(28,251,200)	(31,262,400)	(33,264,800)
FF Expenditure	0	(26,328,000)	(28,251,200)	(31,262,400)	(33,264,800)
Net Effect	$0	$329,100,000	$353,140,000	$390,780,000	$415,810,000

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

Local Effect: Local expenditures decrease by $8.2 million in FY 2019, assuming that the bill's effects are reflected in the June 30, 2017 actuarial valuation, as discussed below. Local school boards initially experience a decrease in employer contributions, but community colleges and libraries begin paying employer contributions for the first time. By FY 2021, total local expenditures are more than under current law (by $1.6 million) due to the anticipated decrease in the normal cost for TPS. No effect on current PGUs, and no effect on local government revenues. **This bill imposes a mandate on a unit of local government.**

Small Business Effect: None.

Analysis

Bill Summary: The cash balance plan is a defined benefit (DB) plan qualified under the Internal Revenue Code (IRC) and administered by the Board of Trustees of the State Retirement and Pension System (SRPS), which is required to adopt regulations to implement the plan.

Under the cash balance plan, the State and member contributions are each 5.0% of earnable compensation, and members earn 5.0% interest compounded annually on account balances. Employee contributions, and interest earned on those contributions, are vested immediately; employer contributions and interest earned on those contributions are vested after three years of membership. A member is eligible to retire upon reaching age 62 with at least 10 years of service credit. A member who retires before that time may not receive payments from the plan until the July 1 following the next actuarial valuation of the plan. Benefits from the cash balance 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 the plan's requirements.

Local employers of cash balance plan participants (including local boards of education, community colleges, and public libraries) must pay 80% of the required employer contribution (*i.e.*, 4.0% of compensation) on behalf of their employees. They also pay the full normal cost for their employees who are members of the Teachers' Retirement System (TRS).

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 and employee

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.

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 may either receive a return of member contributions, with interest, or convert accrued benefits to an equivalent benefit in the cash balance plan.

Current Law:

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 + 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

Optional Retirement Program

ORP is a tax-favored defined contribution retirement savings plan available to designated employees of the institutions listed below as an alternative to membership in SRPS:

- University System of Maryland (USM);
- Morgan State University (MSU);
- Saint Mary's College of Maryland (SMCM);
- the Maryland Higher Education Commission (MHEC); and
- community colleges or regional community colleges in the State, including Baltimore City Community College.

To join ORP, individuals in employing institutions must be eligible for membership in SRPS and be:

- members of the faculty of an employing institution;
- professional employees of a community college;
- employees of USM exempt from the federal Fair Labor Standards Act (FLSA);
- executive or professional administrative employees of MSU;
- employees of SMCM exempt from FLSA; or
- professional employees of MHEC.

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 contributes 7.25% of members' earnable compensation to ORP; there is no employee contribution. Based on surveys of participating institutions, the Department of Legislative Services (DLS) estimates that 72% of eligible members elect to join ORP and the remaining 28% participate in TPS.

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 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.

Cash balance retirement plans are a relatively new plan type, with the first one established in the mid-1980s. Since then, they have become common in the private sector, with more than 1,000 employers currently providing retirement benefits through a cash balance plan. However, they remain fairly rare in the public sector, with only three states providing cash balance plans to their employees or teachers (Kansas, Nebraska, and Kentucky). In 2009, Montgomery County established a cash balance plan (the Guaranteed Retirement Income Program) as part of its Employees' Retirement System. The plan provides an 8.0% employer contribution and guaranteed annual interest of 7.25%, credited monthly; regular employees contribute 4.0% of compensation up to the Social Security wage base, and 8.0% of compensation that exceeds the wage base; public safety employees pay 3.0% up to the wage base and 6.0% on any amounts above the wage base.

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

- for the purpose of calculating benefits paid to vested members, years of service and average final compensation (AFC) for current TPS/EPS members are frozen as of June 30, 2018;
- all nonvested members of TPS/EPS convert their accrued balances in those plans to an opening account balance within the new cash balance plan rather than receive a refund of member contributions; and
- any annuities purchased under the plan are actuarially equivalent to the lump-sum payment that would otherwise be paid.

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.

Accrued liabilities are calculated using each employee's projected final compensation. By freezing the plans, and thereby freezing AFC and service credit at June 30, 2018, instead of projecting them forward to retirement, the bill generates a substantial reduction in

accrued liabilities. Had the bill been in effect in fiscal 2016, the actuary estimates that accrued liabilities would have decreased by $5.9 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 required 5.0% employer contribution under the bill. 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 1.0% for TPS members employed by all local governments. These State payments under the bill represent an increase over current payments, since the State currently does not pay any of the normal cost for TPS members employed by local school boards (there is a reduction in State payments for the much smaller number of TPS members employed by community colleges and libraries). Had the bill been in effect in fiscal 2016, the actuary estimates that State normal cost payments would have increased by $101.1 million.

Exhibit 2
Normal Cost/Employer Contributions

	State Contributions		**Local Contributions**	
	Current	**The Bill**	**Current**	**The Bill**
EPS Members	3.86%	5.0%	NA	NA
State TPS Members	4.47%	5.0%	NA	NA
Local School Board TPS Members	0%	1.0%	4.47%	4.0%
Community College and Library TPS Members	4.47%	1.0%	0%	4.0%

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

Source: Department of Legislative Services

Optional Retirement Program

The bill allows current ORP members to remain in the plan, so the bill affects only new hires, who are no longer eligible to choose ORP. Given that the 7.25% employer contribution for ORP is more than the 5.0% employer contribution under the cash balance plan, and that the vast majority of eligible members would have chosen the ORP, the bill generates an additional savings in employer contributions for new employees of ORP-eligible institutions.

Fiscal 2019 Effect and Net Effect

SRPS conducts annual actuarial valuations as of June 30 of each year. Under normal circumstances, the valuation conducted as of June 30, 2017, would determine contribution rates for fiscal 2019. That valuation would normally establish State contributions under the existing TPS/EPS provisions, which would still be in effect at the time of the valuation, instead of the bill's provisions. Under this scenario, DLS estimates that State contributions would increase by about $89.8 million in fiscal 2019, reflecting the State paying the full cost of the existing EPS/TPS provisions *and* the new, higher normal cost employer contributions to the cash balance plan.

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However, DLS assumes that the bill's delayed effective date of June 1, 2018, allows the SRPS actuary to estimate contributions for fiscal 2019 under the provisions of the bill. Assuming that savings generated by the bill would be recognized and incorporated into the calculated employer contributions for fiscal 2019, State pension payments decrease by $329.1 million in fiscal 2019. In each year, the reduction in accrued liability payments is greater than the net increase in normal cost payments, based on the assumption above that the SRPS actuary would project the contributions under the cash balance plan during the fiscal 2017 valuation. Those savings increase each year according to actuarial assumptions and are assumed to be allocated 84% general funds, 8% special funds, and 8% federal and other funds.

Local Fiscal Effect: Under the same assumptions used to estimate the State fiscal effect, local contributions for TPS decrease by $8.2 million overall in fiscal 2019 due to the local share of employer contributions under the cash balance plan being less than the projected normal cost payments under TPS. Savings continue, albeit smaller, in fiscal 2020, but eventually local governments pay more beginning in fiscal 2021. The TPS normal cost is projected to decrease over time, approaching and eventually moving below the 4.0% local contribution for local TPS members, which accounts for the diminished savings and eventual costs over time. Local school boards pay less initially under the bill, but community colleges and libraries, which currently do not pay any portion of the normal cost, begin paying employer contributions for the first time.

Additional Comments: The actuary notes that cash balance plans are defined benefit plans, so that, like the current State plans, if actual investment returns fall short of expected returns (*i.e.*, 5.0% compounded annually), an accrued liability develops and employer contribution rates may need to be higher than the 5.0% required by the bill.

Additional Information

Prior Introductions: HB 1317 of 2011, a similar bill, received an unfavorable report from the House Appropriations Committee.

Cross File: HB 1072 (Delegate Szeliga, *et al.*) - Appropriations.

Information Source(s): Bolton Partners, Inc.; Harford and Montgomery counties; Maryland Association of Counties; State Retirement Agency; Department of Legislative Services

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