July 15, 2011

The Honorable Martin J. O'Malley
The Honorable Thomas V. Mike Miller, Jr.
The Honorable Michael E. Busch

Gentlemen:

On behalf of the Public Employees' and Retirees' Benefit Sustainability Commission, I am pleased to report that the commission has completed its work and submits this letter as its final report, as mandated by the Budget Reconciliation and Financing Act (BRFA) of 2010 (Chapter 484 of 2010). This letter is intended as a closing statement to the commission's 2010 Interim Report, submitted to you in January 2011. The letter examines the accomplishments made in the 2011 legislative session and discusses issues to examine if additional changes need to be made.

The 2010 BRFA created the commission to study and make recommendations with respect to State-funded health care benefits and pensions provided to State and public education employees and retirees. The commission met seven times from October through December 2010 to hear briefings and deliberate about the options available to address its charge; at its final meeting, members approved actionable recommendations. The documents presented at all commission meetings can be found on the Maryland General Assembly's website at http://mlis.state.md.us/other/BenefitsSustainabilityCommission/index.htm.

The Administration proposed changes to State pensions and employee and retiree health care at the beginning of the 2011 legislative session in House Bill 72 (2011 BRFA). These changes were amended and adopted by the General Assembly. The changes made by the Governor and General Assembly address the two key issues facing benefits: affordability, which is the ability of the State budget to support benefit costs; and sustainability, which is the long-term funded status of the benefits.

The commission is concerned that these steps may in the future turn out not to have gone far enough and that additional actions may need to be taken. In December 2010, the commission recommended that the affordability and sustainability of employee and retiree benefits be reviewed periodically. In line with this, Section 30 of the 2011 BRFA (Chapter 397) requires that the Board of Trustees for the State Retirement and Pension System provide the Governor and legislature's Joint Committee on Pensions with a biennial report on the funding progress of the systems.

Since the submission of the 2010 Interim Report, the commission has held two additional meetings, the first on May 23, 2011, and the second on July 7, 2011. At the first meeting, the commission received presentations on (1) the pension and retiree health reforms adopted by the General Assembly during the 2011 legislative session and enacted by the Governor's signature; (2) a proposal by the State Retirement and Pension System's Board of Trustees to alter the system's funding model; and (3) the pension reform proposal put forth by the House Republican caucus (HB 1344 of 2011). At the second meeting, the commission discussed and approved this final report. The briefing documents can be found on the General Assembly website with the 2010 Interim Report. These briefings did not address any issues that the committee had not already considered. Rather they summarized 2011 session actions or recommended specific proposals that addressed concerns raised by the commission. As such, this report will not specifically address what was presented at these meetings; instead the report considers them in the context of additional actions that the State may need to take.

The remainder of this report is divided into two sections. The first reviews the commission's earlier recommendations and the progress made on those recommendations during the 2011 legislative session. The second section provides the commission's recommendations for further legislative action to build on the work undertaken during the 2011 legislative session.

Progress Made in the 2011 Legislative Session

This section compares the recommendations made by the commission to the actions taken by the Governor and General Assembly.

Employee Health Care Costs

Recommendations: The State should adopt a goal of reducing State expenditures on employee and retiree health benefits by 10% (or roughly $100 million) to bring them closer to those of peer states. This goal should be accomplished through a combination of reductions to State premium subsidies for employees and retirees and plan design changes that reduce the State share of covered charges for medical services and/or prescription drugs. Special consideration should be given to the financial effects of these changes on low-income employees and retirees, and efforts should be made to minimize those effects. The Department of Budget and Management should continue to monitor the structure of the health plan as it relates to the total compensation package provided to State employees.

Evaluation: The statutory changes adopted during the 2011 session include an increase in prescription drug out-of-pocket limits and a reduction in the premium subsidy for retirees; out-of-pocket limits for active employees were increased through the regulatory process. In addition, prescription drug copayments will increase for both active employees and retirees;

Exhibit 1 summarizes these changes. Combined, these changes reduce State expenditures by approximately $36.9 million, or roughly 4% of State health benefit expenditures; general fund savings represent $20.2 million of the total. This falls short of the recommended 10% reduction in State expenditures. **The commission's recommendations were partially adopted.**

Exhibit 1
Prescription Plan Changes

	Fiscal 2011 Plan for Both Actives and Retirees	Fiscal 2012 Active Employee Rx Plan	Fiscal 2012 Retiree Rx Plan
Co-pays			
Generic	$5	$10	$10
Preferred brand	$15	$25	$25
Non-preferred brand	$25	$40	$40
Out-of-pocket cap for individual/ individual and spouse	$700/$700	$1,000/$1,500	$1,500/$2,000
Retiree share of total premium	20%	20%	25%

Source: Department of Legislative Services

Retiree Health Liabilities

Recommendations: The State should establish a goal of reducing its unfunded actuarial liability for other post employment benefits (OPEB) by 50% and also commit to fully funding its annual required contribution (ARC) within 10 years. Toward that end, the State should make the following changes to the eligibility requirements for new employees and for current employees with fewer than 15 years of service credit to qualify for retiree health benefits:

- employees must have 15 years of State service credit, up from 5, to qualify for participation in the State health plan as retirees;

- employees should be required to earn 25 years of service credit with the State, up from 16, to qualify for the maximum premium subsidy provided to retirees, with the subsidy prorated for those with between 15 and 25 years; and

- employees should be required to retire directly from the State to qualify for retiree health benefits from the State.

The commission also recommended that the State establish a requirement in statute that, by the year 2020, all Medicare-eligible State retirees must join Medicare Part D for prescription drug benefits; they would no longer be eligible to participate in the State prescription drug plan. Last, the General Assembly should review provisions in State pension law that govern transfers of service credit between State and local pension plans, with special attention given to how those rules govern eligibility for retiree health benefits for employees who transfer between systems.

These recommendations were projected to reduce the State's unfunded OPEB liability by $7.7 billion (48%) and the ARC by $647 million (53%).

Evaluation: The changes enacted raise the initial eligibility for retiree health benefits from 5 to 10 years (not 15), with retirees eligible for the full State premium subsidy after accruing 25 years of service. However, these changes apply only to new employees as of July 1, 2011, but do not affect any current employees. Also, the recommendation that employees be required to retire directly from the State to qualify for retiree health benefits was not adopted. The Medicare Part D requirement by 2020 was put into statute, and the Joint Committee on Pensions will study the transfer provisions in State pension law during the 2011 interim.

The changes adopted are projected to reduce the State's unfunded OPEB liability by $6.7 billion (42%) and the ARC by $534 million (44%). These are slightly below the projected level of savings for the commission's recommendations, due to the lower level of State savings on health benefits and the decision not to apply retiree health eligibility changes to any current active employees. As our January 2011 report pointed out, the Medicare Part D requirement is responsible for roughly $5.5 billion of an estimated $6.7 billion reduction in the unfunded OPEB liability, with the prescription plan and eligibility changes responsible for the difference. **The commission's recommendations were partially adopted.**

Pension Benefits

Recommendations: The State should adopt dual goals: achieving an actuarial funding level of 80% within 10 years and 100% in 30 years. Benefits should be restructured for both current and future State Retirement and Pension Systems (SRPS) members. For future members hired after June 30, 2011, vesting in SRPS plans that currently have a 5-year vesting requirement should increase to 10 years. For new and nonvested members of the Teachers' Pension System (TPS) and Employees' Pension System (EPS), eligibility for a normal service retirement should be either age 62 with 10 years of service or a combination of age and years of service adding to 92; corresponding changes to eligibility for early retirement were also recommended. Current members of TPS and EPS should be given a menu of options for future benefits, with at least one option requiring a higher member contribution but retaining the current benefit structure, and the other providing a lesser benefit going forward for the same 5% member contribution. The State should give serious consideration to allowing current members to convert their benefits to a cash balance plan.

Automatic annual cost-of-living adjustments (COLA) should be discontinued for future SRPS retirees in favor of inflation-based benefit adjustments that are contingent on investment returns meeting or exceeding the actuarial target rate.

The Deferred Retirement Option Program (DROP) should be modified for members of the State Police Retirement System (SPRS) and Law Enforcement Officers' Pension System (LEOPS) not currently enrolled in DROP. Specifically, the interest rate earned on DROP accounts should be reduced from 6% monthly compound interest to 4% annual compound interest. The State should explore, through the collective bargaining process, requiring members of SPRS to hold a referendum on whether to join Social Security.

Finally, the State should use the savings generated by the restructured benefits to increase funding levels for the system. The amount of savings that is reinvested should be subject to a cap that provides enough additional contribution to achieve the commission's goal of achieving 80% funding in 10 years, with excess savings credited to the appropriate funding sources.

Evaluation: The pension reform provisions that were enacted establish a statutory goal of reaching 80% actuarial funding within 10 years by reinvesting a portion of the savings generated by restructuring pension benefits into the pension system in the form of increased State contributions above the contribution required by statute. In fiscal 2012 and 2013, all but \$120 million of the savings generated by the benefit restructuring are reinvested, with the \$120 million dedicated to budget relief each year. Beginning in fiscal 2014, the amount reinvested in the pension fund is subject to a \$300 million cap, with any savings over that amount dedicated to budget relief.

This paragraph summarizes benefit changes that affect both current and future SRPS members. Member contributions for current and future members of EPS and TPS increase from 5% of earnable compensation to 7% of earnable compensation. Member contributions for current and future members of LEOPS increase from 4% to 6% in fiscal 2012 and from 6% to 7% beginning in fiscal 2013. Member contribution rates for other SRPS plans remain unchanged. For service credit earned after June 30, 2011, COLAs for all SRPS members will be linked to the performance of the SRPS investment portfolio. If the portfolio earns its actuarial target rate (currently 7.75%), the COLA is subject to a 2.5% cap. If the portfolio does not earn the target rate, the COLA is subject to a 1% cap. For service credit earned before July 1, 2011, the COLA provisions in effect during that time still apply for each plan. The COLA provisions do not apply to current or future retirees of the Judges' Retirement System (JRS) or the Legislative Pension Plan (LPP) because their benefit increases are linked to the salaries of current judges and legislators, respectively, and not to the Consumer Price Index (CPI); benefits structures for members of these two plans are referred for further study. The interest rate on DROP accounts for current and future SPRS and LEOPS members who enter DROP after June 30, 2011 is reduced from 6% interest compounded monthly to 4% interest compounded annually.

This paragraph summarizes changes affecting only new SRPS members as of July 1, 2011. For all new members of SRPS, except for judges and legislators, vesting increases from 5 to 10 years. The calculation of average final compensation (AFC) used to calculate retirement allowances will be based on the five consecutive years that provide the highest average compensation, rather than three years. New members of EPS/TPS will receive a retirement allowance equal to 1.5% of AFC for each year of creditable service (compared with 1.8% for current members). They will qualify for a normal service retirement benefit either upon reaching age 65 with at least 10 years of service or when the sum of their age and years of service reaches 90 (compared with age 62 with 5 years of service or 30 years of service regardless of age for current members). They will also qualify for a (reduced) early retirement benefit at age 60 with at least 15 years of service (compared with age 55 for current members). New State Police officers qualify for a normal service retirement upon reaching age 50 or with 25 years of service regardless of age (up from 22 years of service for current members).

These pension reform provisions largely reflect the recommendations made by the commission. They do not include a benefit choice for current members as recommended by the commission because the State Retirement Agency (SRA) advised that the type of choice envisioned by the commission may run afoul of a new interpretation of federal law by the Internal Revenue Service. In some instances, the enacted changes went beyond the commission's recommendations (*e.g.*, the provisions affecting calculation of average final compensation), and in some cases they reflect the overall intent of the commission's recommendations but fell just short of matching them (*e.g.*, the adoption of a Rule of 90 instead of a Rule of 92). **On balance, the commission's recommendations were adopted.**

Local Cost Sharing of Pensions

Recommendations: The cost of teacher retirement costs should be shared with local boards of education so that the State provides 50% of the combined cost of Social Security and pensions for teachers. The sharing of teacher pension costs should be phased in over several years, and local tax capacity should be taken into consideration in implementing a cost-sharing methodology. This was projected to save the State $233 million if fully implemented in fiscal 2012.

Evaluation: The pension reform provisions do not address the sharing of retirement costs with local school boards. However, they do require local school boards and community colleges to pay their prorated share of SRA's administrative costs, based on the number of their employees who are members of TPS or the Teachers' Retirement System. This is projected to save the State approximately $16.6 million in fiscal 2012. **The commission's recommendations were not adopted.**

Future Considerations

The commission acknowledges and applauds the steps taken by the Governor and General Assembly to improve the sustainability and affordability of State pension and retiree health benefits. Together, they have taken meaningful and necessary steps to address both the short- and long-term challenges confronting the State with respect to pension and retiree health care costs. However, the commission is concerned that additional changes may need to be made. This section identifies issues that have the most substantial effect on the affordability and sustainability of employee and retiree benefits.

Local Cost Sharing of Pension Benefits

The Bridge to Excellence in Public Schools Act was enacted in 2002. The Act provided for a six-year phase-in of funding enhancements for Maryland public schools that eventually added $1.3 billion annually to the State's contribution to local school budgets. Many people have benefited from the passage of the Act. Specifically, teachers have benefitted from higher salaries, teachers' unions have benefitted as local school systems hired additional personnel, and Maryland families have benefitted as a result of the additional resources devoted to public schools. Moreover, with State funds fueling school board budgets and rising home prices increasing local property tax collections, local governments, which had been providing more than half of total funding for schools prior to the Bridge to Excellence Act, were able to redirect portions of their growing revenue bases toward other priorities, including compensation for local police officers, firefighters, and other public employees. However, given the range of interests that have benefitted from budget decisions made over the last decade, a more balanced approach in which all parties – the State, counties, school boards, public employees, and their representatives – respect the need to share the burden of restructuring and paying for public employee benefits must now be achieved.

To accomplish this goal, the commission recognizes that changes must be phased in carefully to avoid dramatic swings in statewide priorities. Shifting a portion of teachers' pension costs to local school systems may take three to five years but is a vital component of a sustainable system. And, while the transfer of pension costs may have an impact on the number of teaching positions and future salary and benefit negotiations, a phased transfer will minimize classroom impact as all interested parties operate within this new economic reality.

As a result, the commission reiterates its recommendation from its January 2011 report to phase in a requirement that local boards of education pay half of the total retirement costs for their employees who are members of the Teachers' Retirement System or Teachers' Pension System. In so doing, the commission hopes that this recommendation is met with a spirit of cooperation by all interested parties that will enable the State to develop a consensus model that protects the benefits of State and local public employees, maintains Maryland's ability to recruit and retain top talent, and secures the sustainability of the State's employee benefit system in the years ahead.

Health Insurance

The changes to employee and retiree health insurance made during the 2011 session began to address the issues raised by the commission in its January 2011 report. The statutory termination of the State's prescription drug benefit for all Medicare-eligible State retirees in 2020 begins the recommended transition to a sustainable benefit package. Yet, the significant differences in the structure of the extant retiree prescription plan from a typical Medicare Part D plan like those current and future retirees will be joining in 2020 requires additional action. Such action will be facilitated by the separation of the active and retiree prescription programs during the 2011 session, in recognition of the substantial differences in the two benefit offerings. **The commission recommends the development of a comprehensive transition strategy whereby the retiree prescription plan components are altered to mirror Medicare Part D plan but the benefit levels are altered over time to allow retirees and those contemplating retirement ample time to plan for their future health care needs.**

Additional Pension Options

In its initial report, the commission recommended examining a cash balance plan, or a similar hybrid plan, as a retirement option for the State workforce. This type of benefit responds to considerations that will likely become more relevant in the coming years. Changing demographics and attitudes toward retirement benefits common among younger workers suggest that the provision of such a benefit may be a crucial piece of future recruitment efforts. Along these lines, merely having an option, like the choice currently available to higher education employees who may elect participation in the Optional Retirement Plan instead of the pension system, broadens the potential pool of qualified workers the State may attract. Finally, these options clearly define the State's retirement liabilities. By moving much of the investment risk away from the State's budget, which currently must supplement underachievement in the traditional pension design, these plans are predictable and sustainable.

At the same time, the commission recognizes the concerns of the SRPS board of trustees with regard to a cash balance option. Specifically, the board is concerned that a cash balance option will necessitate a significant change in the system's asset allocation to a much more conservative, absolute return investment strategy due to the higher liquidity demands of cash balance plans compared with traditional defined benefit plans. This would potentially result in lower overall returns to the system, an increase in the unfunded liability of the other defined benefit options, and greater cost to the State.

The commission reiterates its recommendation that the State continue to study adding a hybrid benefit option for new employees to the State's retirement offerings. Any study undertaken in response to this recommendation should examine the potential fiscal and human resource advantages of offering an alternative hybrid plan in addition to a defined benefit plan as well as the potential financial risks outlined above.

Pension Cost-of-living Adjustments

During the course of the commission's work, questions were raised concerning what changes could be made to the COLA. In particular, some of the commission members raised the issue of the ability of the State to make COLAs for current employees and retirees contingent on fund performance.

There is case law in Maryland holding that prospective changes to COLA formulas are permissible. Altering the COLA formula and applying the new formula to time earned by employees after the formula takes effect does not create an impairment of contract. *Howell v. Anne Arundel Co.*, 14 F.Supp.2d 752 (D.Md. 1998). This is referred to as a "bifurcated COLA" and was implemented by the General Assembly as part of its pension reform during the 2011 legislative session.

However, the issue of applying a change to the COLA formula to time already earned – affecting existing employees and retirees – has not been directly addressed by the courts. The case law in Maryland has been focused on whether there has been a retroactive diminution of vested benefits. *Maryland State Teachers Assoc., Inc. v. Hughes*, 594 F.Supp. 1353 (D.Md. 1984), *City of Frederick v. Quinn*, 35 Md.App. 626 (1977), *Andrews v. Anne*

Arundel County, 931 F.Supp 1255 (D.Md 1996). A finding that there is an impairment of contract could prevent the State from applying such a change to time already earned. The courts have not specifically addressed whether a change in the COLA formula that would affect existing employees and retirees would be considered a retroactive diminution of vested benefits and an impairment of contract. There are ambiguities as to whether a COLA vests with time as the time is earned, or whether it vests when given each fiscal year. It is also unclear whether a change to the COLA formula applied to retirees would be considered a retroactive diminution if it does not result in a reduction of the monthly benefit payments a retiree receives, and only affects the amount of future COLAs. Historically, the COLA formula in Maryland could have resulted in a reduction to a retiree's monthly allowance, but legislation enacted in 2010 subjects future COLAs to an offset in years following reductions in the Consumer Price Index. **Given the ambiguous nature with which Maryland case law might be applied to changes to the COLA formula for existing employees and retirees, and in light of recent state court decisions in Minnesota and Colorado, the commission recommends that the issue be given further consideration, including the solicitation of an Opinion of the Attorney General, if additional changes are necessary to maintain the pension system's affordability and sustainability. Further consideration of the issue, if necessary, should also be informed by the outcome of the case currently pending in the U.S. District Court for the District of Maryland, *Cherry et al v. Mayor and City Council of Baltimore City et al*, Case 1:10-cv-01447MJG, with respect to the issue of retroactive changes to COLAs that have been challenged by the plaintiff police and firefighters.**

Corridor Funding Method

The commission acknowledges that the State's current pension funding model, specifically the corridor method, is neither actuarially sound nor sustainable over the long term as the pension system approaches an adequate funding level, but recognizes that it will be maintained in its current form until State finances and the funded status of the pension plan improve significantly. The current model has served to restrict the rate of growth of State pension contributions while ensuring a guaranteed and stable source of funding to the pension fund, even in the face of competing fiscal demands and during difficult economic conditions. It has also, directly or indirectly, enabled the State to fund other budgetary priorities, including the Bridge to Excellence Act for public education.

The commission notes that the pension reforms enacted in 2011 directly address the underfunding of the pension system by requiring that the State contribute up to $300 million in excess of the corridor contribution rate. This approach addresses concerns about the underfunding of the pension system, accelerates the improvement in the fiscal health of the pension fund, and meets the commission's objective of achieving 80% funding in 10 years. Of concern to the commission is the prospect that State contribution rates will continue to grow, even as a percent of compensation. The accelerated contributions to the plan will help mitigate that projected growth, but they will not eliminate it. In light of the enacted plan's deliberate overpayment, which will be fully realized in the fiscal 2014 budget, the commission recognizes the difficulty the State (and potentially local school boards) would face if it were to make the additional contributions over the next five years that would be required under an alternative funding plan proposed by the pension board.

The commission recommends, however, that as economic conditions improve and pension liabilities are reduced, the General Assembly and Governor, in consultation with the board, should work together to develop an alternative funding model that provides for both adequate funding for the pension system and relatively stable contribution rates over the long term. Such a plan should include the termination, at the appropriate times, of both the corridor funding method and the transitional excess contributions required by the 2011 reforms. It should be actuarially sound, based on reasonable projections of inflation and asset growth, maintain adequate funding levels for the payment of future retirement benefits, and comply with the public sector accounting standards promulgated by the Governmental Accounting Standards Board. The funding method should be reviewed by the General Assembly at least every five years to ensure that it accomplishes the desired objectives in a straightforward manner.

In closing, I thank you for the opportunity to serve you and the citizens of Maryland in this important endeavor. I want to express my sincere gratitude to all of the members of the commission for their dedication and collaboration in working toward a common solution to the difficult issues put before us. I also want to thank the staff from the Department of Legislative Services for their hard work and professionalism over the past year.

Sincerely,

Casper R. Taylor, Jr., Chairman
Public Employees' and Retirees'
Benefit Sustainability Commission

CRT/MCR/tas

cc: Members, Public Employees' and Retirees' Benefit Sustainability Commission
Senator Edward J. Kasemeyer
Senator Verna L. Jones-Rodwell
Delegate Norman H. Conway
Delegate Melony G. Griffith
Mr. R. Dean Kenderdine
Mr. Karl S. Aro
Mr. Warren G. Deschenaux