Department of Legislative Services
Maryland General Assembly

FISCAL NOTE
Revised

House Bill 987 (Delegate Proctor, *et al.*)
Appropriations

Employees' and Teachers' Pension Systems - Modification of Benefits and Contributions - Optional Defined Contribution System

This pension bill provides an enhanced benefit formula for current and future active members of the Employees' Pension System (EPS) and the Teachers' Pension System (TPS). Excluded are employees of participating local governments and members who transfer from the old retirement systems after April 1, 1998. Under the enhancement, members receive a 1.4% flat benefit multiplier for service after July 1, 1998, versus the current two-tiered structure (0.8%/1.5%). Service prior to July 1, 1998 is calculated as the greater of 1.2% per year of service or the old formula. Cost-of-living adjustments are capped at 3% on a compound basis. Current law provides for a simple 3% cap. Members are subject to a mandatory 2% employee contribution.

The bill creates a defined contribution program for State EPS members that supplements the defined benefit system. The State will provide a 100% employer match for each dollar contributed by members of the pension systems into a tax-deferred defined contribution account, up to a maximum of $600 per year per employee. The bill takes effect July 1, 1998, but the defined contribution component does not take effect until July 1, 1999.

Fiscal Summary

State Effect: Expenditures (all fund types) increase by $150 million in FY 2000 for employer pension contributions (assuming no actuarial changes), increasing 5% per year thereafter based on actuarial assumptions. In addition (and not included in the table), special fund administrative expenditures increase by approximately $1.3 million in FY 1999.

(in millions)	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003
GF/SF/FF Rev.	$0	$0	$0	$0	$0
GF/SF/FF Expend.	0	150.0	157.6	165.4	173.7
Net Effect	$0	($150.0)	($157.6)	($165.4)	($173.7)

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

Local Effect: No impact for local governments that participate in the Employees' Pension System, because benefit enhancements do not apply to them.

Small Business Effect: None.

Fiscal Analysis

Bill Summary: This bill changes several aspects of the EPS and TPS for all active members except employees of participating local governments and members who transfer from the old retirement systems after April 1, 1998.

- Eligible members receive a 1.4% flat benefit multiplier (1.4% times years of service times average final compensation) for service after July 1, 1998. The current benefit formula is 0.8% of average final compensation up to the Social Security Integration Level (SSIL), which is $29,300 for calendar 1998, plus 1.5% of average final compensation in excess of the SSIL, multiplied by the years and months of service credits. Based on the salary of the average State EPS member, the current effective blended multiplier is approximately 0.9%.

- Service earned prior to July 1, 1998 is calculated as the greater of:
  - 1.2% of average final compensation for each year of service prior to that date; or
  - the two-tiered 0.8%/1.5% benefit formula.

- Cost-of-living adjustments are capped at 3% on a compound basis, versus a simple 3% cap under existing law, for all active and retired TPS and EPS members, except employees or retirees of current or withdrawn participating local governments.

- Eligible members will be subject to a mandatory 2% employee contribution; currently under the EPS and TPS, only employees earning more than the Social Security Taxable Wage Base must contribute.

- All State members of the Employees' Pension System will be eligible for a defined contribution program beginning July 1, 1999 in which the State contributes one dollar for each dollar of employee contribution to a tax-deferred savings account, up to a maximum $600 per person State contribution.

- The 98 local governmental units that participate in the Employees' Pension System (at their own cost) are not included in the bill and their employees will receive the existing EPS benefit formula.

State Expenditures: Increased expenditures as a result of this bill come from three areas: (1) enhanced defined benefit pension program; (2) new defined contribution pension program; and (3) administrative costs during implementation.

Enhanced Defined Benefit

There are currently 66,978 active members of the TPS and 48,842 members of the EPS. Total payroll for both groups was $5.0 billion as of June 1997. The actuary estimates that total actuarial liabilities will increase by $2.3 billion, of which employee contributions will finance $583 million, resulting in an increased actuarial liability to the State of $1.7 billion. This increased liability will be amortized over 20 years beginning in fiscal 2000, through the year 2020. The initial payment in fiscal 2000 will be $121 million and will increase approximately 5% per year thereafter.

Defined Contribution Program

Legislative Services estimates the employer match to the defined contribution program will cost a maximum of $29 million, assuming that each pension system member takes full advantage of the match. These costs will begin in fiscal 2000.

A breakdown of the pension enhancement costs is illustrated below:

Pension Enhancement Costs - $ in Millions

	1999	2000	2001	2002	2003
DC Program	$0.0	$29.0	$30.5	$32.0	$33.6
DB Enhancement	$0.0	$121.0	$127.1	$133.4	$140.1
Total	$0.0	$150.0	$157.6	$165.4	$173.7

Administrative Costs

In addition, the State Retirement Agency and Teachers' and State Employees' Supplemental Retirement Plans will incur additional administrative expenses to implement the proposal.

Based on the experience of administering the Workforce Reduction Act of 1996 (SB 1 of 1996), it is estimated that the State Retirement Agency will need approximately $1,047,300 in one-time spending authority in fiscal 1999 to implement the program, primarily for contractual employees to handle increased member contributions and retirement inquiries, computer programming to accommodate new benefit formulas and member contributions, and increased communications such as member notices.

These additional expenses are not included in the retirement agency's fiscal 1999 budget and will require a budget amendment. In addition to its special fund appropriation, the agency is further constrained by a statutory provision that limits the agency's administrative expenses to 20 basis points (0.20%) of the payroll of pension system members. The additional $1.0 million may cause the agency's total administrative expenditures to exceed the cap.

The supplemental retirement plans will also experience an increase in administrative costs in order to administer the defined contribution component of the program. Special fund expenditures could increase by an estimated $298,800 in fiscal 1999. This estimate reflects the cost of hiring three additional Administrative Officers and a Secretary to handle the additional membership workload. It includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses. These additional operating expenses include additional contractual services, including legal, audit, and investment consulting services.

Future year expenditures reflect (1) full salaries with 3.5% annual increases and 3% employee turnover; and (2) 1% annual increases in ongoing operating expenses. These additional expenditures will be of an ongoing nature because the membership participation in the agency's deferred compensation programs will increase by between 50% and 150% in the first year and remain at that level (with normal enrollment growth) thereafter. The additional expenditures would be offset by additional special fund revenues collected by the agency. These additional revenues cannot be reliably estimated at this time, but would be based on the assets of plan members; the amount of such revenue would depend on the number of new members, the amount of their assets, and whether the board adjusted its current fee level of 10 basis points (0.10%) of a member's assets.

The agency uses an outside administrator, PEBSCO, to administer the three payroll deferral plans (401(k), 457, and 403(b)) under a contract that extends through calendar 2002. PEBSCO charges a fee of 0.28% of member assets (in addition to the board's fee of 0.10%). These plans will be the vehicles for employee contributions under the defined contribution program; the State employer contributions will go into a 401(a) and therefore not count toward the federal limit for employee contributions into tax deferred accounts. The 401(a) account will also utilize an outside administrator, presumably PEBSCO. The creation of the matching defined contribution program will result in a significant increase in PEBSCO revenues from the three payroll deferral programs, and from the 401(a) plan if the same asset fee is applied. The bill therefore provides that the agency may separately negotiate the fee for the 401(a) plan.

Local Expenditures: The bill excludes employees of local governments that participate in the Employees' Pension System.

Additional Comments: The Board of Trustees of the Maryland State Retirement and Pension System (MSRPS) has proposed making two actuarial changes in conjunction with -- and conditional on -- passage of this bill. One actuarial change would recognize approximately 50% of the $2.4 billion in MSRPS assets that the actuary currently does not recognize (as part of standard actuarial practice to provide a cushion in event of market fluctuation). The other change would be to increase the system's assumed investment return from 7.5 to 7.75%. Together, the two changes would "reduce" system liabilities by $2.4 billion, if the system continues to achieve its investment return target. On an annual basis, these changes would reduce State pension contributions by between $129 and $151 million per year. Because these actuarial changes are at the discretion of the board of trustees, Legislative Services has estimated all costs in this bill as if the current actuarial assumptions remain in place.

The bill includes uncodified language expressing the General Assembly's intent that the board of trustees of the MSRPS modify the actuarial assumptions of the State systems in a manner consistent with actuarial principles and independent of any increase in accrued liability resulting from the bill.

The bill includes seven pension-related study items to be addressed during the 1998 interim.

Finally, the mandatory 2% employee contribution may result in upward salary pressure so that employees' take-home pay is not reduced. This may become an issue in collective bargaining or other fora.

Information Source(s): State Retirement Agency, Milliman & Robertson, Inc., Department of Legislative Services

Fiscal Note History:	First Reader - February 25, 1998
lnc	Revised - House Third Reader - March 30, 1998
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