HB 1155

Department of Legislative Services

Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

House Bill 1155 (Delegate Smigiel)
Appropriations

Pension Reform Act of 2011

This bill closes the Teachers' Pension System (TPS) and Employees' Pension System (EPS) to new members, and makes membership in the Optional Retirement Program (ORP) mandatory for new hires after the bill's effective date. New employees of participating governmental units (PGUs) that remain in EPS are still members of EPS as a condition of employment. The bill also terminates, beginning in fiscal 2013, State-sponsored prescription drug benefits for Medicare-eligible State retirees. It bars the State Retirement and Pension System (SRPS) from using external investment managers, except in real estate, and requires that SRPS manage equity and fixed income assets using indices.

Fiscal Summary

State Effect: The bill's effect on State pension liabilities and contribution rates cannot be reliably estimated but would result in expenditure increases (all funds) in FY 2012 because ORP employer contributions are higher than normal cost rates for affected plans, especially for young members. If normal cost rates in the future exceed the ORP contribution, which may occur shortly for TPS, the overall effect of the bill will depend on the number and characteristics of new employees, which cannot be reliably estimated. The State Retirement Agency (SRA) advises that costs related to the implementation of the bill's expanded annuity provision may be significant, but a reliable estimate is not possible. As shown below, State expenditures for prescription drug benefits for Medicare-eligible retirees decrease by $155.5 million in FY 2013 due to the elimination of those benefits, which are assumed to grow by 8.0% annually and be allocated 60% general funds, 20% special funds, and 20% federal funds. Federal fund revenues decrease by approximately $24.0 million annually due to the loss of the Medicare retiree drug subsidy. Nonbudgeted expenditures for asset management by SRA decrease gradually upon the termination of existing asset management contracts. At the

same time, SRPS may have foregone investment returns and experience increased volatility in returns due to the effects of terminating external management of assets. There may be additional costs associated with establishing internal asset management structures within the agency, but those have not been estimated.

(in dollars)	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
FF Revenue	$0	($24,000,000)	($24,000,000)	($24,000,000)	($24,000,000)
GF Expenditure	-	($93,300,000)	($100,860,000)	($109,080,000)	($117,960,000)
SF Expenditure	-	($31,100,000)	($33,620,000)	($36,360,000)	($39,320,000)
FF Expenditure	-	($31,100,000)	($33,620,000)	($36,360,000)	($39,320,000)
NonBud Exp.	-	-	-	-	-
Net Effect	$0	$131,500,000	$144,100,000	$157,800,000	$172,600,000

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

Local Effect: None. The bill does not affect PGUs currently participating in EPS and TPS. To the extent a PGU elects to participate in ORP, costs may increase.

Small Business Effect: None.

Analysis

Bill Summary: Faculty members of community colleges, the University System of Maryland (USM), Morgan State University (MSU), St. Mary's College of Maryland (SMCM), and the Maryland Higher Education Commission (MHEC) who are employed by those institutions before July 1, 2011, are eligible to choose to enroll in ORP within one year of their employment. Otherwise they can remain in TPS.

On or after the bill's effective date, a governmental unit may elect to participate in ORP.

Annuity contracts under ORP are also authorized under § 401(a) of the Internal Revenue Code.

Current Law:

Prescription Drug Benefits for State Retirees

The State is required to maintain a prescription drug benefit plan that is available to State retirees, regardless of the enactment of federal Medicare reform legislation or any other federal legislation that allows states to discontinue prescription drug benefit plans for retirees.

A retired State employee may enroll in the State's Health and Welfare Benefits Program and receive the same health insurance benefits and premium subsidies provided to a State employee if the retiree:

- retired directly from State service with a State retirement allowance on or after July 1, 1984, and had at least 5 years of creditable service;
- ended State service with at least 16 years of creditable service;
- ended State service with at least 10 years of creditable service and within 5 years before the age at which he/she would be eligible to retire;
- ended State service on or before June 30, 1984; or
- retired directly from State service with a State disability retirement allowance on or after July 1, 1984.

Spouses and dependent children of eligible retirees may also participate, and surviving spouses or dependent children of deceased retirees may also participate in the program as long as the spouse or child receives a regular survivor's pension payment from the State. For the prescription drug benefit plan, the State subsidizes 80% of the premium for all retirees with at least 16 years of service credit; retirees with between 5 and 16 years receive a prorated subsidy.

SRPS Investments

Responsibility for the management, general administration, and proper operation of SRPS is vested in the board of trustees, whose members serve as fiduciaries of the system. In carrying out their fiduciary duties, members of the board must manage the assets with the care, skill, prudence, and diligence under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would use. SRA, under the supervision of the board, is charged with managing the system's assets. SRA's Chief Investment Officer is authorized to hire and terminate external managers to invest the system's assets.

TPS, EPS, and ORP

Membership in EPS is a condition of employment for most regular State employees (*i.e.,* those who are not public safety employees, legislators, or judges) who were hired on or after January 1, 1980. Membership in TPS is a condition of employment for teachers and certain employees of local boards of education, community colleges, and libraries hired on or after January 1, 1980, with the exception of designated employees of:

- USM;
- MSU;

- SMCM;
- MHEC; and
- community colleges or regional community colleges in the State, including Baltimore City Community College.

Only the following employees of those institutions are eligible to join ORP:

- faculty members;
- professional employees of community colleges or regional community colleges;
- exempt employees of USM;
- professional or administrative employees of MSU; and
- professional employees of SMCM.

Background:

Retiree Health Benefits

In 2004, the Governmental Accounting Standards Board (GASB) issued new standards that require state and municipal governments to recognize liabilities for Other Post Employment Benefits on their balance sheets as they accrue rather than on a pay-as-you go (PAYGO) basis. In effect, the new standards require public employers to account for OPEB benefits (typically health insurance coverage for retirees) in the same way that they treat pension benefits. The standards require Maryland to conduct an actuarial valuation of its OPEB liabilities at least every two years, and to reflect any unfunded portion of those liabilities on its annual balance sheet.

Like almost all states, Maryland previously accounted for and funded its retiree health benefits on a PAYGO basis. Current PAYGO costs, based on medical claims data, are estimated by the actuary to be $379 million. In 2006, largely in response to the looming GASB requirement, the State conducted its first actuarial valuation of its OPEB liability, and has conducted OPEB valuations each year since then. The 2010 valuation of the State's OPEB liabilities put the unfunded liabilities at $15.9 billion, with an annual required contribution (ARC) of $1.2 billion. The ARC represents the sum of the 30-year amortization payment of the accrued liabilities and the normal cost, or the liabilities accrued by active employees in the current year. If the State funds the ARC by paying the full amount into an irrevocable trust for the purpose of paying future retiree health care costs, it will have no net OPEB obligation under the GASB standards. Any portion of the ARC that is not funded on an annual basis appears as a liability on the State's balance sheet and accrues interest. To the extent that the State's unfunded OPEB liability multiplies at a rapid pace in the absence of a plan to restrain its growth, rating agencies may ultimately downgrade the State's AAA bond rating. The annual OPEB

valuations have all found that liabilities related to prescription drug costs make up about 50% of the State's total OPEB liabilities.

In an effort to begin prefunding its OPEB liabilities, the State began setting aside funds in fiscal 2007, 2008, and 2009. The fiscal 2007 budget set aside $100.0 million into the Dedicated Purpose Account, which was later transferred to the OPEB trust fund once it obtained the necessary Internal Revenue Service (IRS) clearance as an irrevocable trust. The fiscal 2008 budget as enacted also set aside $100.0 million in general funds in the Dedicated Purpose Account toward prefunding the State's liabilities. During the 2008 legislative session, however, the General Assembly cut that figure in half. The Governor's fiscal 2009 allowance included a $210.0 million contribution, all funds, to the OPEB trust fund. As enacted, the fiscal 2009 budget contained half that amount. In October 2009, the Board of Public Works cancelled the remaining $46.0 million that had yet to be paid into the trust fund as a cost containment measure. The State made no additional contributions to the trust fund in fiscal 2010 or 2011. As of September 2010, the OPEB trust fund held $186.9 million, which represents approximately 1.2% of the State's total OPEB liability.

The 2003 federal Medicare Prescription Drug, Improvement, and Modernization Act established a new prescription drug benefit for Medicare-eligible retirees. The basic plan under Medicare includes an annual premium of $388, a $310 deductible, and provides 75% coverage for the cost of prescription drugs up to $2,840 in out-of-pocket expenses (the member pays the other 25%). The plan provides no coverage for drugs between the $2,840 and $4,550 out-of-pocket levels, and then provides 95% coverage for drugs above the $4,550 out-of-pocket level. To dissuade employers that provide prescription drug coverage to their retirees from dropping that coverage in favor of the Medicare coverage, Medicare provides an employer subsidy for the cost of prescription drugs provided under employer-sponsored plans. Maryland receives approximately $24 million annually under the Retiree Drug Subsidy program.

SRPS Investments

SRPS incurred $183.7 million in nonbudgeted asset management fees in fiscal 2010. Management fees have recently grown at a substantially faster pace than assets. For instance, total assets grew by 10.7% from fiscal 2009 to 2010, but total fees grew by 74.8%. This trend is due largely to the expansion of holdings in alternative asset classes, which tend to have higher fee structures than traditional equity and fixed income managers. Fee structures for private equity contracts vary, but typically include a component that is based on the amount of capital that is committed by an investor. Even within the traditional classes, however, the system has expanded the number of active managers, who also have higher fees than passive managers.

Exhibit 1 shows the asset allocation and returns for SRPS investments. Five-year annualized returns are not available for several asset classes because those classes have been added within the past five years in an effort to diversify the system's portfolio. By diversifying its holdings, SRPS seeks to minimize risk, defined in terms of the volatility of returns. Indeed, an analysis conducted by its investment advisor at the request of the Department of Legislative Services (DLS) shows that, for the most part, the recent additions of these asset classes and the expansion of the portfolio's private equity holdings have reduced volatility and increased expected returns. The exhibit shows the advantages of a well-diversified portfolio. For instance, equities performed very well during fiscal 2010, but their long-term performance has been quite poor, as reflected by the negative 5- and 10-year returns for domestic equity. Conversely, while real estate has performed very poorly in recent years, its 10-year return is the highest of any asset class shown. Among the newest alternative asset classes, real return and credit opportunity have performed very well.

Exhibit 1
State Retirement and Pension System of Maryland
Fund Investment Performance for Periods Ending June 30, 2010[1]
($ in Millions)

			Time Weighted Total Returns Unaudited		
	Assets	**% Total**	**1 Year**	**5 Years**	**10 Years**
Domestic Equity	$6,250.9	19.51%	15.91%	-0.82%	-1.09%
International Equity	6,815.9	21.27%	15.17%	4.19%	1.56%
Fixed Income	5,918.2	18.47%	14.31%	5.96%	6.7%
Global Equity	2,941.8	9.18%	15.44%	n/a	n/a
Real Estate	2,041.4	6.37%	3.55%	0.47%	7.77%
Real Return	3,245.9	10.13%	12.1%	n/a	n/a
Private Equity	1,009.4	3.15%	14.16%	9.11%	3.51%
Absolute Return	1,422.1	4.44%	7.47%	n/a	n/a
Credit Opportunity	1,068.7	3.34%	19.23%	n/a	n/a
Cash and Other	1,329.1	4.15%	2.48%	n/a	n/a
Total Fund	**$32,043.4**	**100.0%**	**14.03%**	**2.30%**	**2.10%**

[1]Data presented here include the system's cash account and money invested by the system on behalf of the Maryland Transit Administration (totaling $119.8 million across all asset classes).

Note: Returns beyond one year are annualized. One-year returns are net of fees; returns beyond one year are gross of fees. Columns may not add to total due to rounding.

Source: State Retirement Agency

TPS, EPS, and ORP

TPS/EPS are defined benefit (DB) plans. Members contribute 5% of their earnable compensation to the plan, and vest after five years of service. They are eligible for a normal service retirement at age 62 (with 5 years of service) or after 30 years regardless of age. The normal service retirement allowance is equal to 1.8% of average final compensation (AFC) for each year of service after June 30, 1998, and 1.2% of AFC for each year of service prior to that date. Retirees receive automatic cost-of-living adjustments linked to the Consumer Price Index for all Urban Consumers, up to 3%.

ORP is a defined contribution (DC) plan that provides an employer contribution of 7.25% of earnable compensation; there is no employee contribution. Vesting is immediate, member accounts are portable, and members may invest their accounts in any of many investment options offered by the plan administrators, which are selected by the Board of Trustees of SRPS. Current plan administrators are TIAA-CREF and Fidelity Investments. Upon retirement, members may elect to purchase annuities with their accumulated funds.

ORP is authorized under § 403(b) of the Internal Revenue Code, which applies only to employees of educational institutions and specified nonprofit organizations. 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.

Benefit Sustainability Commission

The Budget Reconciliation and Financing Act of 2010 (Chapter 484) created the Public Employees' and Retirees' Benefit Sustainability 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's establishment was driven by the recent and projected growth in employer liabilities and costs for retiree health and pension benefits. Among the key concerns were that the funding level for SRPS had dropped to 64.1%, well below the 80% standard for health pension plans, and that the State had no plan to address its growing unfunded OPEB liabilities. The commission's January 2011 report included multiple recommendations for restructuring pension and retiree health benefits for State retirees and teachers. The commission also recommended that the State embrace the following goals:

- the State should achieve actuarial funding levels for SRPS of 80% within 10 years and 100% within 30 years; and

- the State should reduce its unfunded OPEB liability by 50% and commit to fully funding its ARC within 10 years.

State Fiscal Effect:

Retiree Prescription Drug Costs

The Department of Budget and Management, which administers the State's prescription drug benefit, projects that prescription drug claims costs for Medicare-eligible retirees will be $155.5 million in fiscal 2013. At the same time, the State would lose the Medicare drug subsidy payments, totaling about $24.0 million annually, because it would no longer be offering an employer-sponsored plan. Therefore, fiscal 2013 savings would be approximately $131.5 million, which is assumed to be allocated 60% general funds, 20% special funds, and 20% federal funds.

SRPS Investments

SRA advises that several of the asset classes in which it currently invests cannot be passively managed through indices. These include many of the alternative asset classes it recently added to the portfolio, including credit strategies, real return, and absolute return. Therefore, those asset classes would have to be removed from the portfolio. The system's investment advisor notes that their removal very significantly increases portfolio volatility (risk). The system would also have to eliminate actively managed components of its portfolio. The performance of active management compared to passive management has varied over time and by asset classes. Over the last five years, active fixed income management has added 60 basis points annually to the portfolio above passive indices. Currency management has added 100 basis points since 2009. However, active domestic equity managers, excluding those in the Terra Maria program, underperformed passive benchmarks by 101 basis points in fiscal 2010. To the extent that active managers would outperform passive indices, the system would experience foregone returns, which in turn would increase State pension liabilities and costs. DLS cannot quantify the effect of potential foregone returns.

The Terra Maria program was established in 2008 as the system's effort to invest in small, emerging asset management companies, many of which are owned by members of racial and ethnic minority groups. In fiscal 2010, the Terra Maria program had 100 external managers responsible for managing $2.5 billion in assets. Except for a handful of exceptions, Terra Maria managers outperformed their benchmarks. Under the bill, the Terra Maria program would be terminated or dramatically scaled back. Again, to the extent that Terra Maria managers have outperformed passive benchmarks, the system would have foregone investment returns.

DLS notes that index funds are managed by external managers. Fees for index funds tend to be dramatically lower than for active managers (typically 2 to 5 basis points for passive management compared with 25 to 50 basis points for active management). Nevertheless, the bill eliminates all external managers, including passive index managers, so SRA would have to manage all assets internally. Currently, the investment staff is not qualified to manage assets internally. Therefore, SRA would have to replace the vast majority of its investment staff and establish an investment division capable of managing assets internally. The agency did not provide an estimate of the cost of taking those steps, but it is assumed to be significant.

Retirement and Pension Reform

DLS cannot provide a reliable estimate of the potential cost or savings associated with closing EPS and TPS to new members and requiring them to participate in ORP as a condition of employment because it depends on the number and characteristics of new employees. The number of new members of TPS/EPS fluctuates every year; for instance, according to data provided by SRA, there were almost 10,800 new members of TPS in fiscal 2008 but only about 6,600 in fiscal 2010.

The State employer pension contribution consists of two components: an amortization payment that pays off a portion of the liabilities that current members of the plans have already accrued and a "normal cost" payment that covers the cost of the liabilities that current members accrue in the current year. New members accrue only prospective benefits, so their costs are reflected largely in the normal cost.

Under current conditions, the State is likely to incur additional costs for new TPS/EPS members who are required to join ORP in fiscal 2012. **Exhibit 2** compares normal cost rates for fiscal 2010 through 2012 with the ORP contribution rate of 7.25%.

Exhibit 2
Normal Cost Rates and ORP Contributions
Fiscal 2010-2012

	EPS Normal Cost	TPS Normal Cost	ORP Contribution
FY 2010	6.02%	6.85%	7.25%
FY 2011	6.46%	7.22%	7.25%
FY 2012	6.47%	7.23%	7.25%

Source: Cheiron; Gabriel, Roeder, and Smith

Normal cost rates can fluctuate, as is clear from the EPS/TPS rates shown above, depending on the demographic characteristics of plan members and plan experience. The General Assembly's consulting actuary further advises that normal cost rates vary by member, with younger members typically having lower normal cost rates. In fiscal 2012, the State will pay slightly less for TPS members than for ORP members but substantially less for EPS members. Again, the distribution of members who choose ORP determines the short-term fiscal effects for the State, but in either case, the State incurs additional costs for any new employees hired after June 30, 2011. If the new employees are heavily weighted to EPS members, State expenditures increase significantly, due to the higher ORP contribution compared to the EPS normal cost. Since only new members are eligible, it is likely that the new employees will be skewed toward younger members with even lower normal costs, so the expenditure increase is even larger. Given the proximity of TPS normal costs to the ORP contribution rate, TPS normal costs may exceed the ORP rate in the near future, in which case the State would recognize savings for any new employee otherwise eligible for TPS in current law. In that instance, the balance between EPS and TPS members will ultimately determine whether the State experiences savings or incurs additional costs.

Implementation Costs

ORP was established under § 403(b) of the Internal Revenue Code, which allows only employees of educational and nonprofit medical facilities to participate. SRA advises that implementing the expansion of ORP to include annuity contracts under 401(a) of the Internal Revenue Code may be costly and time consuming, but SRA cannot provide a reliable estimate of the cost.

Additional Comments: DLS notes that while many of the bill's provisions establish July 1, 2011, as a cutoff date for eligibility for ORP, TPS, and EPS, the bill does not take effect until October 1, 2011.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Budget and Management; Mercer Human Resources Consulting; Maryland State Retirement Agency; Cheiron; Gabriel, Roeder, and Smith; Department of Legislative Services

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