HB 653

Department of Legislative Services

Maryland General Assembly
2012 Session

FISCAL AND POLICY NOTE

House Bill 653 (Delegate Serafini, *et al.*)
Appropriations

State Retirement and Pension Systems - Cash Balance Plan

This bill freezes benefits for current members of the Teachers' Pension System (TPS) and Employees' Pension System (EPS), closes TPS/EPS and the Optional Retirement Program (ORP) to new members, 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. All new employees hired on or after July 1, 2012, 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).

The bill takes effect July 1, 2012, but its provisions do not take effect until the State Retirement and Pension System (SRPS) receives a private letter ruling from the Internal Revenue Service (IRS) confirming the tax-exempt status of the new cash balance plan with respect to member contributions and distributions.

Fiscal Summary

State Effect: State pension liabilities decrease by $6.5 billion and the normal cost decreases by $270 million, effective June 30, 2013. Fiscal effects are not reflected until FY 2015 in part due to the anticipated delay in obtaining a private letter ruling from the IRS. Amortizing the decrease in liabilities over 25 years and adding the normal cost reduction results in State pension contributions decreasing by $856.4 million in FY 2015. Those savings are assumed to continue to accrue based on actuarial assumptions and are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds. In the long term, the pension trust fund may experience lower investment returns to the extent that asset allocation must be adjusted to accommodate increased liquidity demands by the cash balance plan. No effect on revenues.

(in dollars)	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017
Revenues	$0	$0	$0	$0	$0
GF Expenditure	0	0	(719,376,000)	(729,036,000)	(741,384,000)
SF Expenditure	0	0	(68,512,000)	(69,432,000)	(70,608,000)
FF Expenditure	0	0	(68,512,000)	(69,432,000)	(70,608,000)
Net Effect	$0	$0	$856,400,000	$867,900,000	$882,600,000

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

Local Effect: None. The bill does not affect PGUs.

Small Business Effect: None.

Analysis

Bill Summary: The cash balance plan is a defined benefit (DB) plan administered by the Board of Trustees of SRPS, which is required to adopt regulations to implement the plan.

Under the cash balance plan, the State and member contributions are each 5% of earnable compensation, and members earn 5% interest compounded annually on account balances; the State continues to pay the full employer contribution on behalf of TPS members employed by local governments. A member vests in the plan after three years of membership and is eligible to retire upon reaching age 62 with at least 10 years of service credit. A member who retires or separates from employment 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 Internal Revenue Code (IRC) requirements and the plan's requirements.

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: 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. Membership in TPS is optional for designated employees of:

- the University System of Maryland (USM);
- Morgan State University;
- St. Mary's College of Maryland;
- the Maryland Higher Education Commission (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 Morgan State University;
- professional employees of St. Mary's College of Maryland; and
- designated 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.

All EPS/TPS members pay a member contribution of 7% of earnable compensation, but vesting, eligibility, and benefits under EPS/TPS differ for members hired before July 1, 2011, and those hired on or after that date. **Exhibit 1** summarizes the benefits provided under the plans.

Exhibit 1
EPS/TPS Plan Characteristics

	Date of Hire	
	Before July 1, 2011	**On or After July 1, 2011**
Member Contribution	7% of earnable compensation	
Vesting	5 years	10 years
Retirement Eligibility	Age 62 with 5 years of service, or any age with 30 years of service	Age 62 with 10 years of service, or age plus years of service adding to 90
Average Final Compensation	3 highest consecutive years	5 highest consecutive years
Benefit Multiplier	1.2% for service credit prior to 1998; 1.8% for service credit after 1998	1.5%

Source: Department of Legislative Services

EPS/TPS retirees are also entitled to annual cost-of-living adjustments (COLAs) to their retirement benefits, which are calculated based on the Consumer Price Index for all Urban Consumers (CPI-U). For service credit earned prior to July 1, 2011, COLAs are equal to CPI-U, up to a maximum adjustment of 3%. For service credit earned on or after July 1, 2011, COLAs are contingent on the performance of the SRPS investment portfolio. For years in which the investments earn the target rate of return (currently 7.75%), the COLA is equal to CPI-U, up to a maximum of 2.5%. For years in which investments do not meet the target, the COLA is equal to CPI-U, up to 1.0%.

The State pays the full employer contribution on behalf of members of TPS who are employed by local governments, including local school boards, community colleges, and public libraries.

Background: As of June 30, 2011, there were 102,939 active members of TPS, all but about 1,900 of whom were employed by local governments. As of the same date, there were 51,861 active members of EPS employed by the State. For fiscal 2013, the State is

required to contribute 13.29% for each TPS member and 12.29% for each EPS member. In addition, under the pension reform enacted in 2011, the State is required to make an additional contribution of $190.4 million in fiscal 2013 and $300.0 million each year thereafter to pay down the system's unfunded liability.

Cash balance retirement plans are a relatively new plan type, with the first one established in the mid-1980s. Although considered DB plans for actuarial purposes, they are often called hybrid plans because they combine elements of defined contribution (DC) and DB plans. Like a DC plan, members have individual accounts that accumulate member and employer contributions plus investment earnings. The accounts are portable (after vesting), and payouts can be made either as a lump sum or an annuity. However, like a DB plan, there is a guaranteed benefit, which consists of a guaranteed minimum annual return on account balances, and plan assets are pooled and invested centrally instead of individually by each member.

Since their inception, cash balance plans have become common in the private sector, with more than 1,000 employers, including many Fortune 500 companies, currently providing retirement benefits through a cash balance plan, but they remain rare in the public sector. Among states, only Nebraska has a cash balance plan for state employees (Nebraska teachers have a DB plan). The Governor of Louisiana has proposed establishing a cash balance plan for new nonpublic safety state employees and making it optional for existing employees; teachers would not be affected. In Maryland, Montgomery County established a cash balance plan in 2009 (the Guaranteed Retirement Income Program) as part of its Employees' Retirement System. The plan provides an 8% employer contribution and guaranteed annual interest of 7.25%, credited monthly; members pay 4% of compensation up to the Social Security Wage Base, and 8% of compensation that exceeds the wage base.

State Fiscal Effect: For the purposes of this analysis, the General Assembly's consulting actuary assumes that all nonvested members of TPS/EPS select the option for their accrued contributions that gives them the greatest benefit; the actuary advises that for most young nonvested members, a return of accumulated contributions (rather than a rollover to the cash balance plan) usually provides the greatest benefit. Also, the actuary assumes that annuity payments under the cash balance plan would be designed to be actuarially equivalent to lump sum distributions, resulting in no actuarial difference between the two options for retirees or those who separate from employment prior to retirement.

Legislative Services assumes that a private letter ruling from the IRS would not be received in time to implement the cash balance plan during fiscal 2013. The State Retirement Agency advises that such rulings can take at least a year or longer to receive.

Therefore, it is assumed that no TPS/EPS members participate in the cash balance plan during fiscal 2013, and it is also assumed that the IRS ruling arrives on or about June 30, 2013, in time for the bill's effects to be calculated during the June 30, 2013 actuarial valuation. That valuation determines employer contributions for fiscal 2015, which is when the bill's effects would first be recognized.

Based on these assumptions, and the plan provisions described above, the actuary estimates that the State's unfunded pension liabilities decrease by $6.5 billion as of June 30, 2013, and the normal cost decreases by $270 million. Amortizing the reduction in liability over 25 years and adding the reduced normal cost results in State pension contributions decreasing by $856.4 million in fiscal 2015. Those savings continue to accrue according to actuarial assumptions. They represent smaller savings than those calculated for a similar bill introduced in 2011 (HB 1317) because the pension reforms enacted as part of Chapter 397 of 2011 lowered the value of future TPS/EPS benefits.

State payments for TPS are paid entirely with general funds; payments for State employees are assumed to be allocated 60% general funds and 20% each for special and federal funds, based on the distribution of positions funded by those sources. Combined, State pension contributions are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds.

Over time, a cash balance plan may exert increased liquidity demands on the pension trust fund, which may affect its asset allocation and expected rate of return. Under the current DB plan, vested members who separate from employment before becoming retirement eligible are entitled to a vested benefit *when they reach normal retirement age*. That benefit is then paid as an annuity based on the average final compensation and years of service that the member had at the time of separation from employment. Under a cash balance plan, however, a vested member who leaves before becoming retirement eligible may receive a lump sum distribution of his or her accumulated member and employer contributions, plus interest, which is payable approximately *one year after separation*. The liquidity demands on the trust fund would not begin to exert themselves until the plan matured substantially because it would take at least three years for members to be vested in the plan, and even then the effects would be felt gradually as small numbers of members separated from employment. As the effects were felt, however, the fund would most likely need to adjust its asset allocation to invest in more short-term liquid assets and fewer long-term illiquid investments (such as hedge funds and private equity), which help it attain its 7.75% expected rate of return.

To the extent that the trust fund would continue to be responsible for paying TPS/EPS benefits to former and retired members, which are based on the higher expected rate of return, the shift in investment strategy could put additional strain on the trust fund.

Eventually, as current TPS/EPS members exited the plan, the strain would dissipate, but that could take as long as 30 years or more. It bears noting that, for both Nebraska and Montgomery County, the primary employee retirement benefit at the time they adopted a cash balance plan was a DC plan, not a DB plan, so they have not confronted the liquidity strain due to the conversion.

Additional Information

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

Cross File: SB 958 (Senator Brinkley) - Budget and Taxation.

Information Source(s): Maryland State Retirement Agency; Cheiron, Inc.; *New Orleans Times-Picayune*; National Conference of State Legislatures; Department of Legislative Services

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