HB 780

Department of Legislative Services

Maryland General Assembly
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FISCAL AND POLICY NOTE

House Bill 780 (Delegate Aumann, *et al.*)
Appropriations

State Employees Pension Choice Act

This bill makes membership in the Employees' Pension System (EPS) and Teachers' Pension System (TPS) optional for all new State employees, public school educators, and librarians hired after June 30, 2013, and makes those individuals eligible to participate in the Optional Retirement Program (ORP), a defined contribution (DC) plan. Under current law, newly eligible employees must decide whether to participate in ORP or the appropriate defined benefit (DB) plan within one year of first becoming eligible. The bill does not apply to members of participating governmental units who participate in EPS.

The bill takes effect July 1, 2013.

Fiscal Summary

State Effect: The bill's effect on State pension liabilities and contribution rates cannot be reliably estimated because it depends on the number and demographics of the new employees who opt to join ORP, which cannot be predicted. Based on an illustrative example, total employer contributions decrease beginning in FY 2016, even accounting for increased ORP contributions. However, under the example, beginning in FY 2017, State contributions increase on behalf of teachers because most of the savings accrue to local school boards, but decrease on behalf of State employees, yielding a modest net savings in State contributions.

Local Effect: The bill's effect on local school boards' share of employer contributions on behalf of TPS members cannot be reliably estimated for the reasons given above. Based on an illustrative example, local school boards' employer contributions on behalf of TPS members decrease beginning in FY 2017.

Small Business Effect: None.

Analysis

Current Law: Membership in EPS/TPS is a condition of employment for most State employees and certain employees of local boards of education and libraries who are eligible for participation in those plans, with the exception of 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; and
- professional employees of St. Mary's College of Maryland or 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 pays 100% of the employer contribution on behalf of participating employees.

Chapter 1 of the 2012 first special session (SB 1301) requires local school boards to pay the normal cost for their employees who are members of the Teachers' Retirement System (TRS)/TPS, phased in over five years. Prior to that, the State paid 100% of the annual employer contribution on behalf of teachers in the State, and it will continue to do so on behalf of librarians and community college faculty who remain in TPS. Based on 2012 projections of the normal cost, local school boards pay 50% of the normal cost in fiscal 2013, phasing up to 100% of the normal cost by fiscal 2016. For those four years, Chapter 1 specifies the exact dollar amount to be paid by each local school board based on the projected normal cost and the local share of that cost. Beginning in fiscal 2017, however, local school boards must pay 100% of the *actual* normal cost. Also beginning in fiscal 2013, Chapter 1 requires county governments (including Baltimore City) to adjust their maintenance of effort payments to local school boards to fully compensate

them for teacher pension costs. Beginning in fiscal 2017, the fiscal 2016 payments by the counties are included in subsequent years' maintenance of effort calculations, so local school boards are responsible for any increase in normal cost payments between fiscal 2016 and each succeeding year.

Background: EPS/TPS are DB plans for all regular (*i.e.*, not public safety) State employees and teachers, respectively, including employees who are not eligible for ORP. Members hired after June 30, 2011, which includes everyone affected by the bill, vest after 10 years of service, pay 7% of earnable compensation, and receive an annual benefit upon retirement equal to 1.6% of average final compensation for each year of service. Retirees receive automatic annual cost-of-living adjustments equal to the Consumer Price Index for all Urban Consumers, subject to a cap of either 2.5% or 1.0%, based on the system's investment performance in a given year. As of June 30, 2012, there are 101,654 active TPS members and 76,061 active EPS members.

ORP is a 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 the State Retirement and Pension System (SRPS). Current plan administrators are TIAA-CREF and Fidelity Investments. Upon retirement, members may elect to purchase annuities with their accumulated funds.

A 2009 study by Milliman, Inc. examined the choices made by employees in six states who were given a choice between a DB plan or a DC plan, as is the case with this bill. In each case, the DB plan was the default option if a member did not make an active choice. Only the two Ohio plans gave members the option of choosing a hybrid plan that included elements of both types. **Exhibit 1** shows that the percentage of employees who chose DC plans instead of DB plans under these conditions ranged from a low of 3% for Ohio state employees to a high of 26% in Florida.

TPS and EPS employer contribution rates are subject to the corridor funding method. Chapter 440 of 2002 (SB 323) enacted the corridor funding method, which sought to mitigate the effects of fluctuations in market returns on employer contribution rates to SRPS by spreading out those effects over five years. The corridor method froze employer contribution rates for the employees' and teachers' combined systems at their fiscal 2002 levels as long as the two systems remained actuarially funded between 90% and 110%. As the plans fall out of their corridors, the employer contributions increase by an amount equal to one-fifth of the difference between the prior year's rate and the "true" actuarial rate required to fully fund the systems. The employees' combined systems fell out of their corridor in fiscal 2005, followed by the teachers' combined systems in fiscal 2006.

Exhibit 1
Other State Pension Plans that Provide Members with a Choice between Defined Benefits and Defined Contributions

	DB by Default or Active Choice	DC Active Choice	Combined Plan
Colorado	82%	18%	Not Offered
Florida	74%	26%	Not Offered
Montana	90%	10%	Not Offered
North Dakota	88%	12%	Not Offered
Ohio Employees	95%	3%	2%
Ohio Teachers	86%	11%	4%
South Carolina	80%	20%	Not Offered

Source: Milliman, January 2009

State/Local Fiscal Effect: A definitive estimate of the bill's fiscal effect cannot be determined because it depends largely on the number and characteristics of new EPS/TPS members who opt for ORP instead of their respective DB plans. As Exhibit 1 shows, the range of participation rates in DC plans for state employees who are given a choice is quite large and cannot be predicted for new TPS/EPS members. Moreover, the number of new members of TPS/EPS fluctuates every year; for instance, according to data provided by the State Retirement Agency (SRA), there were almost 10,800 new members of TPS in fiscal 2008 but about 6,600 in fiscal 2010. *For illustrative purposes only*, the General Assembly's consulting actuary modeled the effect of the bill if 20% of employees hired on or after July 1, 2013, choose ORP, leaving 80% of new employees in TPS/EPS. This is consistent with the proportion of employees who opted for a DC plan in Milliman's study. For this analysis, it is also assumed that, on average, the new members are younger than the average age of the current membership.

The 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. SRPS calculates its actuarial liabilities and employer contribution rates once a year. The actuarial valuation is performed by the actuary as of June 30 of each year. Members hired on or after July 1, 2013, will make their selection that year, and their membership in either TPS/EPS or ORP will, therefore, be reflected for the first time in the valuation as of June 30, 2014. That valuation determines employer contribution rates for fiscal 2016.

If 20% of new employees select ORP, TPS/EPS payrolls decrease from projected levels, and total employee contributions also decrease from projected levels, in both cases because fewer people than projected become members of TPS/EPS. There is little immediate effect on accrued liabilities because the bill does not affect current members who have accrued those liabilities in the system. Therefore, the actuary advises that, in this scenario, contributions coming into the system decrease at a faster rate than liabilities decrease, resulting in a net increase in the system's unfunded liability. That increase, when amortized, causes employer contribution rates to increase slightly, but their growth is restricted by the corridor method.

The actuary advises that, even though employer contribution rates increase slightly, total State contributions to TPS/EPS (in dollars) decline because the decrease in TPS/EPS payroll more than offsets the increase in contribution rates. Under this illustrative example, employer contributions to TPS/EPS decrease by $19.0 million in fiscal 2016, most of it due to a decrease in normal cost payments as a result of fewer new members entering the plans.

However, the decrease in TPS/EPS contributions is somewhat offset by an increase in ORP contributions. Again, assuming 20% of new employees select ORP, ORP payroll increases by $109.0 million in fiscal 2014, and continues to increase thereafter. As a result, employer contributions to ORP increase by $7.9 million in fiscal 2016, which accounts for the 7.25% employer contribution under ORP. Therefore, the *net effect* on total employer contributions is a decrease of $11.1 million in fiscal 2016.

As noted above, the bulk of the short-term savings generated by the bill comes from reduced normal cost payments. With respect to TPS, beginning in fiscal 2017, those payments are made entirely by local school boards. Therefore, the benefits of reduced normal cost payments accrue to local school boards, not the State. Under the illustrative example, TPS normal cost payments decrease by $13.0 million in fiscal 2017 (the first year that local boards pay 100% of the actual normal cost), compared with a total decrease of $18.0 million in employer contributions. Therefore, State contributions decrease by only $5.0 million and are more than offset by an increase in ORP contributions (which are strictly the responsibility of the State) of $8.0 million, resulting in a net increase in State contributions on behalf of teachers of $3.0 million. For EPS, in fiscal 2017, State contributions decrease by $14.0 million in the illustrative example, and ORP contributions increase by $7.0 million, for a net decrease of $7.0 million. The combined TPS/EPS effect in the example, therefore, is a net decrease of $4.0 million in fiscal 2017.

To the extent that new employees who select ORP are substantially younger than current members, the normal cost for current members may increase minimally, reflecting the increased value of benefits earned by older members who remain in TPS/EPS. The

actuary advises that any such increase is likely minimal in the short term, but it may have a more substantial effect in the long term.

Additional Comments: SRA advises that ORP was established under Section 403(b) of the Internal Revenue Code, which limits participation to employees of public schools, colleges and universities, and specified charitable entities. Therefore, the bill cannot be implemented because most State employees are not eligible to participate in ORP; their participation would jeopardize ORP's tax-exempt status under the Internal Revenue Code.

Additional Information

Prior Introductions: HB 843 of 2011, a similar bill, received an unfavorable report from the House Appropriations Committee.

Cross File: None.

Information Source(s): Cheiron, State Retirement Agency, Maryland Supplemental Retirement Plans, Department of Legislative Services

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mc/rhh

Analysis by: Michael C. Rubenstein

Direct Inquiries to:
(410) 946-5510
(301) 970-5510