Department of Legislative Services

Maryland General Assembly
2013 Session

FISCAL AND POLICY NOTE

Senate Bill 474 (Senator Jones-Rodwell)(Chair, Joint Committee on Pensions)

Budget and Taxation Appropriations

State Retirement and Pension System - Funding Method and Amortization of Unfunded Liabilities or Surpluses

This bill modifies the funding model for the State Retirement and Pension System (SRPS). It phases out the corridor funding method over 10 years and replaces the current tiered amortization method with a closed, 25-year amortization period for all existing and future liabilities.

The bill takes effect July 1, 2013.

Fiscal Summary

State Effect: State pension contributions decrease by an estimated $19.0 million in FY 2015 due to the implementation of the bill's provisions and decrease further each year thereafter. The decreased contributions are assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds. No effect on revenues.

(in dollars)	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
Revenues	$0	$0	$0	$0	$0
GF Expenditure	0	(15,960,000)	(22,680,000)	(36,120,000)	(52,920,000)
SF Expenditure	0	(1,520,000)	(2,160,000)	(3,440,000)	(5,040,000)
FF Expenditure	0	(1,520,000)	(2,160,000)	(3,440,000)	(5,040,000)
Net Effect	$0	$19,000,000	$27,000,000	$43,000,000	$63,000,000

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

Local Effect: None. The bill affects only the employer amortization payment to SRPS, not the normal cost. Therefore, there is no effect on local school board payments to SRPS. Also, the funding policy changes affect only State plans, not participating governmental units.

Small Business Effect: None.

Analysis

Current Law/Background:

Amortization of Liabilities

Chapter 583 of 2001 (SB 222) required that all existing SRPS unfunded liabilities as of June 30, 2000, be amortized over 20 years. It also required that any new unfunded liabilities or surpluses that accrue in a given year due to experience gains or losses, changes in actuarial assumptions, or legislative changes be amortized over 25 years. Therefore, SRPS has a system of tiered 25-year amortization bases, each one reflecting gains and losses from a given year. The initial 20-year amortization of previous unfunded liabilities is set to expire in June 2020; five years later, the first of successive 25-year amortization bases (representing gains and losses from fiscal 2001) will expire.

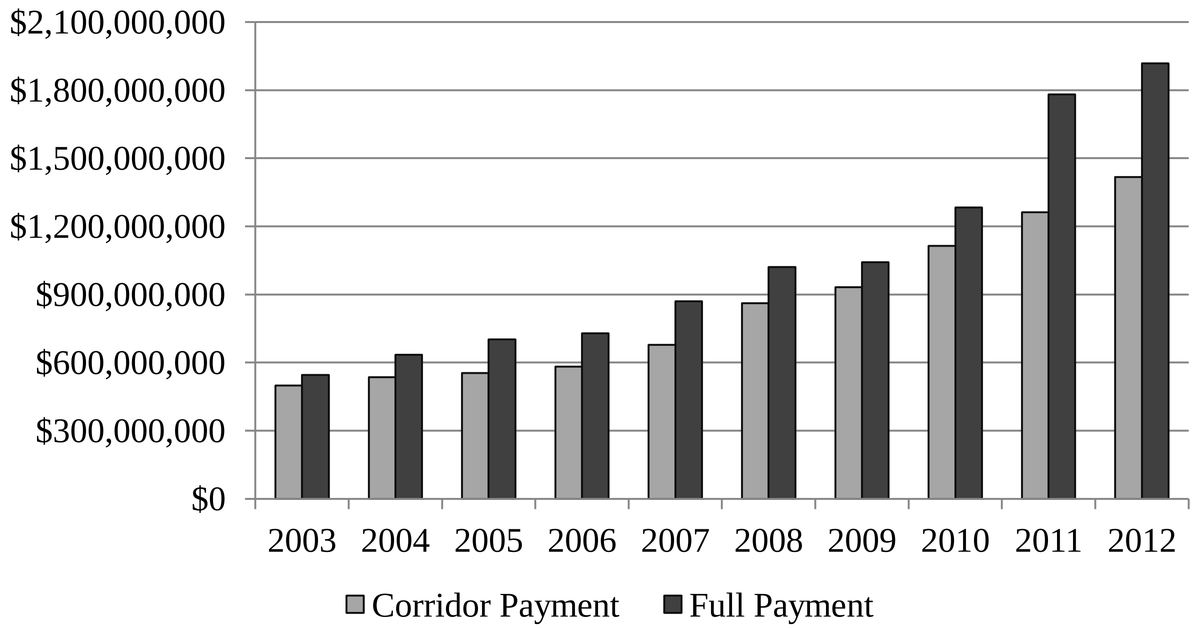
Corridor Funding Method

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" 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.

For the first eight years that the corridor method was in existence, it accomplished its primary purpose of mitigating the effects of fluctuations in market returns on contribution rates while having only a minimal detrimental effect on pension funding levels. Between fiscal 2003 and 2010, the difference between employer contributions calculated under the corridor method and the employer contributions necessary to fully fund the pension system fluctuated between $46.0 million and $192.0 million, as shown in **Exhibit 1.** This level of underfunding, when amortized over 25 years, resulted in minimal annual increases in State contribution rates in succeeding years, typically a fraction of a percentage point each year. However, in fiscal 2011 and 2012, the gap surpassed

$500.0 million each year. This level of underfunding has a more detrimental effect on pension funding levels and makes the corridor method unsustainable over the long term.

Exhibit 1
Corridor vs. Actuarial Employer Contributions
Fiscal 2003-2012



Source: State Retirement Agency, Department of Legislative Services

Because of its detrimental effects on the funded status of the system, which is currently funded at 64% of its actuarial liabilities, the SRPS Board of Trustees has repeatedly called on the General Assembly to repeal the corridor method and restore full actuarial funding. It proposed several different approaches to accomplishing that goal, but each time the General Assembly found the proposals to be too costly, especially during a time when State budgets were strained by declining revenues and slow economic growth. A proposal made to the Joint Committee on Pensions (JCP) during the 2011 interim, however, promised to accomplish the goal of repealing the corridor while generating potentially substantial cost savings. The proposal, however, did not account for several potential changes to actuarial assumptions under consideration by the board, which could have made the proposal more costly to participating employers.

In response, the 2012 *Joint Chairmen's Report* required the Department of Legislative Services (DLS) and the State Retirement Agency (SRA) to develop a collaborative proposal that took into consideration potential changes to actuarial assumptions, which were ultimately adopted by the board in summer 2012. The board's original 2011 proposal was to serve as the basis for the joint plan. DLS and SRA presented their joint plan to JCP in November 2012; this bill includes the statutory components of the plan. The plan consists of four components:

- phase out the corridor funding method over 10 years;
- replace the current tiered amortization method with a closed, 25-year amortization period;
- reduce the board's inflation assumption from 3.0% to 2.8%; and
- lower the board's investment return assumption from 7.75% to 7.55% over four years (five basis points each year).

JCP endorsed all of the recommendations, and this bill implements the first two recommendations.

State Fiscal Effect: This analysis reflects only the statutory components of the JCP plan that are encompassed in this bill: the phase-out of the corridor funding method and the adoption of a 25-year closed amortization policy. For a more complete analysis of the JCP plan that includes the changes in the board's inflation and investment return assumption, please see the Additional Comments section below.

Although the bill takes effect July 1, 2013, it is assumed that the implementation of the bill's provisions begins with the June 30, 2013 valuation, which determines the employer contribution rates for fiscal 2015. It has been standard practice that SRPS actuarial valuations reflect enacted legislation at the earliest feasible time. Therefore, any change to employer contributions resulting from the bill's provisions begins in fiscal 2015.

By phasing out the corridor calculation over 10 years, the bill gradually closes the gap between the lower employer contribution required under the corridor method and the higher employer contribution required to fully fund the pension system. This results in a slightly higher employer contribution each year until the corridor method is fully phased out in 10 years. This increase in annual employer contributions, however, is more than offset by the change in amortization policy. As noted above, the system has existing liabilities with varying payoff horizons. The oldest liabilities date to June 30, 2000; under the 20-year amortization period required by Chapter 583 of 2001, they will be fully paid off in about seven years. Liabilities incurred in fiscal 2001 will be paid off in approximately 12 years, under the 25-year amortization required for each new base. Under this bill, all remaining liabilities are re-amortized under the closed 25-year period. By spreading out the payment of those liabilities over a longer period of time, annual payments to SRPS decrease, thereby offsetting the increase due to the corridor phase-out.

The General Assembly's consulting actuary estimates that the net effect on State (employer) pension contributions is a decrease of approximately $19.0 million in fiscal 2015; savings increase each year, reflecting the continued benefits of the new amortization policy. Beginning in fiscal 2024, when the corridor phase-out is complete, total projected employer contributions are $450 million less than those currently projected under the corridor.

The State pays 100% of the amortization payments on behalf of members of the Teachers' Retirement System and Teachers' Pension System from general funds; payments for State employees are assumed to be allocated 60% general funds, 20% special funds, and 20% federal funds. Therefore, the total increase in employer contributions is assumed to be allocated 84% general funds, 8% special funds, and 8% federal funds.

Additional Comments: The implementation of the full JCP plan, which includes the changes to the board's actuarial assumptions with regards to inflation and investment returns, generates additional savings to the State beyond those of just the statutory components encompassed in this bill. The General Assembly's consulting actuary estimates that implementation of the full plan reduces the employer contribution by an estimated $45.0 million in fiscal 2015, compared with $19.0 million under the bill alone. Savings to the State remain higher under the full plan in each year going forward.

However, unlike the bill, changes to the board's actuarial assumptions affect the normal cost, which in turn results in an increase to the employer contributions made by local schools boards beginning in fiscal 2017. The General Assembly's consulting actuary advises that changes to the board's economic assumptions result in a slight increase to the normal cost. As a result, total school board contributions on behalf of their employees who are members of either the Teachers' Retirement System or Teachers' Pension System increase by $7.0 million in fiscal 2017. The difference between current projections for school board contributions and projections under the proposed assumption changes decreases by approximately $1.0 million each year until they converge in about fiscal 2024.

Chapter 1 of the first special session of 2012 (SB 1301) established a four-year phase-in for local school boards to share in pension costs for teachers by paying the normal cost for their employees. Under Chapter 1, school boards will pay a portion of the normal cost each year, reaching 100% in fiscal 2016 and beyond. The law also requires county governments to increase their maintenance-of-effort payments to the school boards by an amount equal to the increased pension costs in fiscal 2013 through 2016. Beginning in fiscal 2017, the fiscal 2016 cost is included in the annual maintenance-of-effort calculation for counties, which must provide at least the same amount per pupil to the school board as was provided in the prior year. Depending on enrollment growth and the growth in teacher salary bases in each school system, county payments to school boards beginning in fiscal 2017 may not cover the increase in the normal cost under the JCP plan.

Additional Information

Prior Introductions: None.

Cross File: HB 496 (Delegate Griffith)(Chair, Joint Committee on Pensions) - Appropriations.

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

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ncs/rhh

Analysis by: Michael C. Rubenstein

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