Department of Legislative Services

Maryland General Assembly
2014 Session

FISCAL AND POLICY NOTE

House Bill 609 (Delegates Serafini and Krebs)
Appropriations

Employees' Pension System - Cash Balance Plan Option

This bill allows all current and future members of the Employees' Pension System (EPS) to opt to participate in a cash balance plan instead of the traditional defined benefit (DB) plan that is currently a condition of their employment. The bill does not apply to participating governmental units (PGUs).

The bill takes effect July 1, 2014, 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 $9.1 million, and the normal cost decreases by $11.4 million. Amortizing the liability savings over the remaining years of the closed 25-year period and adding the full normal cost reduction results in State pension contributions decreasing by $12.4 million in FY 2018. This accounts for a one-year delay in implementation pending the receipt of a private letter ruling from the IRS. Savings continue to accrue annually according to actuarial assumptions and are assumed to be allocated 60% general funds, 20% special funds, and 20% federal funds. To the extent that employee participation in the cash balance option varies from the assumptions used in this analysis, the fiscal effect will also vary. This analysis does not include any potential administrative costs by the State Retirement Agency since it did not submit a fiscal estimate in time for inclusion in this fiscal and policy note. **This bill establishes a mandated appropriation.** No effect on revenues.

($ in millions)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
Revenues	$0	$0	$0	$0	$0
GF Expenditure	0	0	0	(7.4)	(8.0)
SF Expenditure	0	0	0	(2.5)	(2.7)
FF Expenditure	0	0	0	(2.5)	(2.7)
Net Effect	$.0	$.0	$.0	$12.4	$13.3

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 DB plan administered by the SRPS Board of Trustees, which is required to adopt regulations to implement the plan. Current EPS members have one year from the bill's effective date to choose to enroll in the cash balance plan; new EPS members have one year from their date of employment to choose to participate in the cash balance plan. Any eligible EPS member who does not elect to join the cash balance plan by the one-year deadline remains in EPS and may not join the cash balance plan. A decision to participate in the cash balance plan is a one-time irrevocable decision.

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. A member vests in the plan after five 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 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 is entitled to the benefits accrued in EPS prior to the termination of membership, in accordance with existing pension law. A nonvested member of EPS 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.

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

Exhibit 1
EPS 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 65 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 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 7.70%), 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%.

Background: As of June 30, 2011, there were 51,296 active members of EPS employed by the State. For fiscal 2015, the State is required to contribute 15.53% for each EPS member. In addition, under the pension reform enacted in 2011, the State is required to make an additional contribution of $300.0 million each year thereafter to pay down the system's unfunded liability; this amounts to an additional employer contribution of 2.77% of compensation for EPS members.

SRPS is phasing in a four-year reduction in its assumed rate of return on its investments from its prior level of 7.75%. The assumption is being reduced by five basis point each year beginning with the June 30, 2013 valuation; by June 30, 2016, the reduction will be finished at the rate of 7.55%.

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 assets in 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. They remain relatively rare in the public sector, but their number has grown in recent years. Among states, Nebraska was the only state for many years that had a cash balance plan for state employees (Nebraska teachers have a DB plan). Since 2012, however, Kansas, Louisiana, and Kentucky have all enacted cash balance plans for new state employees. In Maryland, Montgomery County established a cash balance plan in 2009 (the Guaranteed Retirement Income Program, or GRIP) as part of its Employees' Retirement System. For nonpublic safety employees, 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: This analysis assumes that SRPS receives an affirmative private letter ruling from the IRS and that the cash balance plan becomes active on July 1, 2015, one year after the bill's effective date. Therefore, any effect of the plan will be first recognized in the June 30, 2016 actuarial valuation of the system. That valuation determines State contribution rates for fiscal 2018, so there is no fiscal effect before that. The Department of Legislative Services (DLS) is aware that receipt of a private letter ruling may take longer, given a backlog of requests at the IRS; any delay in receiving an

affirmative letter merely delays the bill's fiscal effect. Of course, a negative ruling voids the bill and negates any fiscal effect.

There is no precedent for determining patterns of selection for individuals with a choice between a traditional DB plan and a cash balance plan. In Montgomery County, employees can choose between GRIP or a DC plan; there is no DB option. Other states offer a choice between DB and DC plans, but not cash balance plans. In those cases, previous research has shown that the percentage of employees who select the DC option range from 3% to about 26%, with the rest choosing the DB option. The bill's cash balance option presents several key benefits for State employees, especially those who do not intend to remain in State government for a long time. Those benefits include (1) a smaller member contribution; (2) faster vesting; (3) portability of benefits; and (4) a lower retirement age for those hired after June 30, 2011. Therefore, DLS believes that a meaningful number of newer employees will opt for the cash balance option.

At the same time, the value of benefits provided by the DB plan is greater than that provided by the cash balance plan for employees who vest and remain members of EPS for an extended period. Therefore, DLS assumes that all current vested EPS members remain in the DB plan. In the absence of any precedent regarding patterns of selection between a cash balance option and a traditional DB option, DLS made the following assumptions:

- 20% of current nonvested EPS members elect to transfer to the cash balance plan and convert their existing credit in EPS to the cash balance plan;
- 20% of all future hires will elect to participate in the cash balance plan.

To the extent that participation rates vary from these assumptions, the fiscal effect will also vary.

The DLS consulting actuary advises that, in accordance with standard practice with DB plans, the total employer contribution initially will not be exactly 5%, as specified in the bill. Instead, the gap between the 5% guaranteed rate of return for members and the system's 7.55% rate of return means that the system will credit that savings to the employer (the State). To the extent that the system does not achieve its assumed rate of return, future year contributions may be higher to compensate for the foregone returns. If returns exceed the assumption, contributions may be lower. Because the cash balance plan is considered a DB plan for actuarial purposes, the valuation of its benefits, including actuarial gains and losses, will be incorporated into annual actuarial valuations of EPS and be reflected in a composite EPS contribution rate.

Based on its analysis, the actuary estimates that State pension liabilities decrease by $9.1 million at the first valuation that includes cash balance participants, and the normal cost decreases by $11.4 million. The reduction in liabilities is prompted by current nonvested members converting their DB benefit to a cash balance benefit. Although the bill specifies that the conversion must be actuarially equivalent, it results in an actuarial gain because DB benefits are based on a calculation of average final compensation at the end of a career, whereas cash balance benefits are based on average career earnings, which tend to be lower because compensation is lower at the beginning of a career. The system currently has a closed 25-year amortization schedule of gains and losses that began July 1, 2013, so the decreased liabilities will be amortized over the remaining years of the closed period, with the full normal cost reduction credited in the first year. This results in State pension contributions decreasing by $12.4 million in fiscal 2018. Those savings continue to accrue annually according to actuarial assumptions as membership in the cash balance plan grows, and they are assumed to be allocated 60% general funds, 20% special funds, and 20% federal funds.

Over time, a cash balance plan may exert increased liquidity demands on the pension trust fund, which may eventually 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 either to a return of their *member* contributions with interest or 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*. A member who reaches normal retirement eligibility may also choose to be paid in a lump sum, an option that is not available to a current EPS member.

Any liquidity demands on the trust fund are not likely to exert themselves significantly until the plan matures because it takes at least five years for members to be vested in the plan, and even then the effects are likely to be felt gradually as small numbers of members separate from employment. The effects are felt more acutely as the first generation of cash balance participants reaches retirement eligibility. At that time, the fund may 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 7.55% expected rate of return. Given that the vast majority of members are expected to remain in the traditional DB plan, any adjustment is expected to be modest. Moreover, the value of benefits earned under the cash balance plan are actuarially less than those earned under the DB plan, so any foregone investment returns resulting from the asset allocation adjustment would reflect the fact that the system is paying less in benefits than it would if everyone remained in the traditional plan. DLS notes that

Nebraska and Montgomery County, which both have relatively young cash balance plans, use the same asset allocation for both their cash balance plans and their DB plans (for teachers in Nebraska and for public safety officers in Montgomery County).

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Department of Budget and Management, National Conference of State Legislatures, Cheiron, Nebraska Investment Council, Montgomery County, Milliman, Department of Legislative Services

Fiscal Note History: First Reader - February 9, 2014
ncs/rhh

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