HB 225

Department of Legislative Services
Maryland General Assembly
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FISCAL AND POLICY NOTE
First Reader

House Bill 225 (Delegate Chang, *et al.*)
Appropriations

Correctional Officers' Retirement System - Deferred Retirement Option Program

This bill creates a Deferred Retirement Option Program (DROP) for members of the Correctional Officers' Retirement System (CORS).

The bill takes effect July 1, 2017, but is contingent on the Internal Revenue Service (IRS) issuing an affirmative determination letter confirming that the addition of DROP has no effect on CORS' status as a qualified plan under the Internal Revenue Code.

Fiscal Summary

State Effect: State accrued pension liabilities increase by $33.1 million and pension normal costs increase by $2.0 million based on the assumptions discussed below. Amortizing the liabilities over the remaining years of the closed 25-year amortization period and adding the increased normal cost results in a $4.5 million increase in State pension contributions in FY 2019. Future-year costs increase according to actuarial assumptions and are assumed to be allocated 60% general funds, 20% special funds, and 20% federal/other funds. This analysis assumes that DROP is accounted for in the 2017 actuarial valuation; any delay in implementation resulting from the lack of an IRS determination letter delays DROP's fiscal effect. State Retirement Agency (SRA) expenditures increase for contractual staff to handle the increased workload for three years beginning in FY 2018, but they are not accounted for below. State retiree health liabilities increase but have no practical effect on State expenditures. No effect on revenues.

(in dollars)	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
Revenues	$0	$0	$0	$0	$0
GF Expenditure	0	2,676,000	2,772,000	2,904,000	3,012,000
SF Expenditure	0	892,000	924,000	968,000	1,004,000
FF Expenditure	0	892,000	924,000	968,000	1,004,000
Net Effect	$0	($4,460,000)	($4,620,000)	($4,840,000)	($5,020,000)

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

Local Effect: Local pension liabilities increase by $500,000 and the normal cost increases by $40,000, resulting in pension contributions by participating governmental units (PGUs) increasing by $70,000 in FY 2019. Those costs grow annually according to actuarial assumptions and are shared among approximately 120 PGUs. No effect on revenues.

Small Business Effect: None.

Analysis

Bill Summary: The bill creates DROP, a program that allows eligible CORS members to officially retire while continuing to work and earn salary and health benefits in their current jobs for a fixed period of time. CORS members with between 20 and 25 years of service may participate in DROP for up to 5 years. Members have to meet the eligibility criteria and submit a binding letter of resignation announcing their intention to participate in DROP and specifying their date of termination. A decision to participate in DROP is irrevocable.

During their participation in DROP, members earn the same retirement benefits that they would have received if they had fully retired, including cost-of-living adjustments (COLAs) based on the Consumer Price Index for All Urban Consumers. Those benefits are deposited into DROP on behalf of the members and earn 4% interest, compounded annually. During their participation in DROP, members do not earn service or eligibility credit in CORS and do not make employee contributions to CORS. Also, their compensation earned while participating in DROP is not used in determining their average final compensation (AFC) for the purpose of calculating their normal retirement benefits. DROP participants continue to receive compensation and health benefits available to regular employees, and they are subject to all relevant personnel law, regulations, and policies.

Upon exiting DROP, participating members receive the amount accrued to their benefit in DROP in a single lump-sum payment, subject to income tax withholding. They also receive ongoing normal service retirement benefits calculated using their years of service and AFC at the time they began participating in DROP. DROP participants or their beneficiaries may request that their lump-sum DROP payments be deposited directly into an eligible retirement savings plan.

A CORS member's participation in DROP ends when the member:

- separates from employment;
- dies;
- is terminated from employment by the member's employer;
- provides written notice that the member is shortening his or her DROP term; or
- accepts an accidental disability retirement allowance.

If a DROP participant dies before completing the DROP term, the designated beneficiary is entitled to full payment of the participant's accrued DROP balance and any survivor benefit selected by the DROP participant.

If a DROP participant receives an accidental disability retirement allowance while enrolled in DROP, the participant receives the accumulated balance in his or her DROP account at the time the participant begins receiving an accidental disability allowance, but waives his or her right to all future DROP benefits.

On or before July 1, 2017, SRA must submit a request for a determination letter from the IRS.

Current Law: There is no DROP program for CORS members, but both the State Police Retirement System (SPRS) and Law Enforcement Officers' Pension System (LEOPS) offer DROP programs.

Membership in CORS is a condition of employment for State employees who are:

- correctional officers in the first six job classifications;
- security attendants at the Clifton T. Perkins Hospital Center;
- correctional dietary, maintenance, and supply officers;
- specified employees of Maryland Correctional Enterprises;
- specified correctional officers serving as security chiefs, facility administrators, assistant wardens, or wardens; and
- case management specialists, supervisors, or managers.

All CORS members, regardless of employment, are eligible for a normal service retirement after 20 years or if they:

- are at least age 55; and
- have at least 5 years of service credit if they became a CORS member before July 1, 2011, or have at least 10 years of service credit if they became a CORS members on or after July 1, 2011.

CORS members who retire with a normal service benefit receive a retirement allowance equal to one fifty-fifth (1.818%) of their AFC for each year of service.

SPRS and LEOPS DROP Programs

SPRS members hired before July 1, 2011, must be younger than age 60 and have between 22 and 28 years of service to qualify for DROP. SPRS members hired on or after

July 1, 2011, must also be younger than age 60 and have between 25 and 29 years of service. In all cases, SPRS members may participate in DROP for up to 4 years or until they reach age 60.

LEOPS members must have between 25 and 30 years of service to qualify for DROP regardless of when they were hired. They may participate in DROP for up to 5 years or until they reach 30 years of service.

Background: DROP programs are a common tool used to retain experienced personnel, particularly law enforcement officers. Although DROP participants forgo earning additional years of service credit while enrolled in DROP, the benefits of participating in DROP include:

- continuing to earn regular compensation while earning full retirement benefits, including annual COLAs, in the DROP account;
- earning generous interest rate payments on DROP accounts; and
- maintaining health and disability benefits.

As of June 30, 2016, there were 7,297 active CORS members, including 93 active members employed by Worcester County, the only PGU that participates in CORS; the remainder are all State employees. Among State members, the average age is 42.8, and their average years of service is 11.4.

State Expenditures:

Pension Effects

In general, costs associated with DROP programs stem from members electing to "retire" sooner than they otherwise would. Although CORS members are eligible to retire with 20 years of eligibility credit, which is the same amount of service credit they need to participate in DROP, very few CORS members actually elect to retire when they are first eligible. Under the bill, however, they can elect to enter DROP with 20 years of service credit, and the bill explicitly states that DROP participants are considered retirees of CORS. **Exhibit 1** shows the rates of normal retirement at first eligibility for CORS, SPRS, and LEOPS; the retirement rates listed are the same for both male and female members. As noted above, CORS members are eligible to retire with 20 years of service; SPRS members must have at least 22 years, and LEOPS members must have 25 years.

Exhibit 1
Normal Service Retirement Rates at First Eligibility

	CORS Eligible at 20 years	SPRS Eligible at 22 years*	LEOPS Eligible at 25 years
Member Age 45	15%	35%	40%
Member Age 50	13%	30%	32%
Member Age 55	12%	35%	23%

CORS = Correctional Officers' Retirement System
SPRS = State Police Retirement System
LEOPS = Law Enforcement Officers' Pension System

*SPRS members are eligible to retire with 22 years of service if they were hired before July 1, 2011; those hired on or after that date must have 25 years of service.

Source: Gabriel, Roeder, and Smith, Inc.

As Exhibit 1 shows, retirement rates for CORS members who accrue at least 20 years of service credit are quite low, especially compared to comparable rates for other law enforcement-related plans. Indeed, much of the difference may be attributable to the availability of DROP in the other two plans. Regardless of age, fewer than 20% of CORS members retire upon reaching 20 years of service credit.

For this analysis, the consulting actuary assumes that retirement rates for CORS members double for all age groups, meaning that CORS members are twice as likely to retire at any given age because of the availability of DROP. This is consistent with observed rates in SPRS and LEOPS. Moreover, this analysis uses the same assumption as the system's actuary that 50% of SPRS and LEOPS members who retire elect to participate in DROP. The increase in retirement rates accounts for the bill's fiscal effect. Earlier retirements increase pension liabilities because benefit payments are made over a longer period of time.

The General Assembly's actuary estimates that State pension liabilities increase by $33.1 million and that pension normal costs increase by $2.0 million. Amortizing the new liabilities, combined with the increased normal cost, over the remaining years of the system's closed 25-year amortization period yields a $4.46 million increase in State pension contributions in fiscal 2019. Pension contributions increase thereafter according to actuarial assumptions. They are assumed to be split 60% general funds, 20% special funds, and 20% federal funds.

This analysis is based on the following assumptions:

- retirement rates for CORS members are double the current rates based on the availability of DROP;
- 50% of CORS members who retire elect to participate in DROP, based on experience with the SPRS and LEOPS DROP programs;
- DROP participants spend an average of 4.83 years in DROP, which accounts for a small number of CORS members electing to participate in DROP with more than 20 years of service and, therefore, being unable to participate for the full 5 years; and
- the DROP program is accounted for in the June 30, 2017 actuarial valuation; to the extent that the implementation of DROP is delayed while the system awaits an IRS determination letter, the fiscal effects remain the same but are delayed until the program begins.

Retiree Health Effects

Just as earlier retirements increase pension liabilities, they also increase the State's liabilities related to providing health benefits to retired State employees because it provides those benefits over a longer period of time. Although the earlier retirements prompted by the bill have the potential to significantly increase State retiree health liabilities, several factors prevent this increase from having an effect on State expenditures. First, the bill indicates that CORS members in DROP are considered active employees for the purpose of health benefits, so there is no immediate effect on State expenditures for health benefits. Second, retired State employees generally receive the same health benefits as active employees, so any increase in retiree health liabilities is an accounting shift from paying for benefits for retired versus active employees. Finally, unlike pension benefits, which are prefunded, the State continues to pay for retiree health benefits on a pay-as-you-go basis, so any increase in long-term liabilities has no practical effect on State expenditures for health benefits.

Recruitment Effects

The DROP program has the potential to increase retention among experienced correctional officers, but it likely does not reduce costs for recruiting and training new correctional officers. As of January 2017, the Department of Public Safety and Correctional Services (DPSCS) had 985 vacant correctional officer positions, so it is constantly recruiting for new positions already. Even with the proposed abolition of 400 positions in DPSCS (not all of whom will be correctional officers) in the Governor's proposed fiscal 2018 budget, a large number of vacancies would still have to be filled before any effect from DROP could be felt. Given frequent turnover among correctional officers, DROP would have to lead to a dramatic decrease in the number of new correctional officers in order for DPSCS to realize any savings from its training budget. Based on the likely levels of participation in DROP, such reductions are not anticipated.

Administrative Costs

SRA advises that the bill likely increases the agency's workload, necessitating additional contractual support to process and manage the CORS DROP program. SRA notes that total membership in CORS is more than SPRS and LEOPS combined and that 549 CORS members would be eligible to join DROP immediately following enactment. This would roughly double the number of DROP members in the system. SRA has not yet automated the administration of DROP membership and accounts, so the increased workload likely requires additional contractual support until its planned effort to automate DROP administration is completed in three to five years. However, the agency was unable to provide a reliable estimate of the likely cost for inclusion in this analysis.

Local Expenditures: Although Worcester County is the only PGU that participates in CORS, the increased costs associated with the DROP program are shared among all PGUs. For purposes of the annual actuarial valuation that determines employer pension contributions, CORS is included with the Employees' Combined Systems (ECS), so that any increase in CORS PGU costs is shared among all PGUs that participate in ECS. Total PGU pension liabilities increase by $500,000 and the normal cost increases by $40,000, resulting in PGU employer contributions increasing by $70,000 in fiscal 2019 and growing annually according to actuarial assumptions. As those costs are divided among approximately 120 PGUs, the effect on any one PGU is likely to be negligible.

Additional Information

Prior Introductions: SB 1031 of 2016, a substantively identical bill, received a hearing in the Senate Budget and Taxation Committee, but no further action was taken on the bill.

Cross File:SB 147 (Senator McFadden) - Budget and Taxation.

Information Source(s): Bolton Partners; Department of Budget and Management; Department of Public Safety and Correctional Services; State Retirement Agency; Maryland Supplemental Retirement Plans; Department of Legislative Services

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