SB 478

Department of Legislative Services

Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 478 (Senator Eckardt, *et al.*)
Budget and Taxation

State Retirement and Pension System - Guaranteed Retirement Income Plan and Retirement Savings Plan

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This bill freezes benefits for current members of the Teachers' Pension System (TPS) and Employees' Pension System (EPS) and terminates their membership in the plans; closes both plans and the Optional Retirement Program (ORP) to new members; and requires current members of TPS/EPS as well as all new State employees hired as of June 1, 2018, to make an irrevocable choice between participating in a cash balance plan (the Guaranteed Retirement Income Plan or GRIP) or a defined contribution plan (the Retirement Savings Plan or RSP), both of which are established by the bill. The bill does not apply to participating governmental units (PGUs) that joined EPS on or before May 31, 2018.

The bill takes effect June 1, 2018.

Fiscal Summary

State Effect: No effect in FY 2018. State pension liabilities decrease by an estimated $5.9 billion and the State normal cost increases by approximately $373.6 million. Amortizing the decreased liabilities over the remainder of the closed 25-year amortization period and adding the normal cost results in State pension contributions decreasing by $43.5 million in FY 2019, under the assumptions discussed below. Those savings accrue over time according to actuarial assumptions and are assumed to be allocated 84% in general funds, 8% in special funds, and 8% in federal and other funds. 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	(36,523,200)	(47,678,400)	(69,854,400)	(81,900,000)
SF Expenditure	0	(3,478,400)	(4,540,800)	(6,652,800)	(7,800,000)
FF Expenditure	0	(3,478,400)	(4,540,800)	(6,652,800)	(7,800,000)
Net Effect	$0	$43,480,000	$56,760,000	$83,160,000	$97,500,000

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

Local Effect: Pension contributions for local governments increase by $7.1 million in FY 2019 under the assumptions discussed below. Although pension contributions decrease slightly for local school boards, they increase for community colleges and local libraries. No effect on current PGUs, and no effect on local revenues. **This bill imposes a mandate on a unit of local government.**

Small Business Effect: None.

Analysis

Bill Summary: Current members of TPS/EPS as of June 1, 2018, must elect between GRIP and RSP by June 15, 2018; membership in TPS/EPS terminates as of July 1, 2018. New employees of participating employers hired on or after June 1, 2018, must make a one-time irrevocable decision to join either GRIP or RSP at the time they are hired, and their participation begins on the first pay period after 180 days of full-time employment. Employees who do not make an active choice are automatically enrolled in GRIP.

For both GRIP and RSP, the bill establishes rules for the calculation of credited service, including credit for military service. It also establishes disability benefits and death benefits for surviving beneficiaries of active members.

Guaranteed Retirement Income Plan

GRIP is a cash balance (defined benefit) plan administered by the Board of Trustees of the State Retirement and Pension System (SRPS), which is responsible for deciding the eligibility and rights of any participating employee, computing the benefits payable to an employee or beneficiary, and authorizing disbursement of benefits. Board decisions on these matters are final. The board must develop regulations to implement the program.

Member contributions to GRIP are 4.0% of earnable compensation below the Social Security wage base and 8.0% of earnable compensation above the wage base; employees are immediately fully vested in their contributions and interest on those contributions. Members receive 5.0% annual interest on all member contributions, subject to requirements of the Internal Revenue Code (IRC). Interest is credited on a monthly basis.

The State contribution to GRIP is 8.0% of regular earnings, which earn 5.0% annual interest, subject to IRC requirements. For members of TPS employed by a local school board, the employer contribution is evenly divided between the State and local school board that employs the member. Members vest in the employer contributions after three years of service. Local school boards also pay the full normal cost for their employees who are members of the Teachers' Retirement System (TRS). Local community colleges and libraries are responsible for the full employer contribution for their employees.

Members must be age 62 with at least three years of service to qualify for a normal service retirement. There is no eligibility for early retirement. Benefits are payable as a lump-sum cash payment (by default), but members may also elect to receive a rollover distribution, a single life annuity, or a joint and survivor annuity.

Retirement Savings Plan

RSP is a defined contribution plan administered by the SRPS Board of Trustees, which is responsible for deciding the eligibility and rights of any participating employee, computing the benefits payable to an employee or beneficiary, and authorizing disbursement of benefits. Board decisions on these matters are final. However, any written decision of the board in response to a request from a member or beneficiary is subject to appeal to the Office of Administrative Hearings. The board must develop regulations to implement the program. The bill also establishes ethical standards, investment guidelines, and reporting requirements for the board.

RSP includes investment options designated by participating employees; if they do not make a valid selection, contributions are invested in appropriate investment options selected by the SRPS Board of Trustees. Employee and employer contributions for RSP are the same as for GRIP, including contributions by local school boards and other local employers, and are allocated to investment vehicles as specified by the employee. The State must make contributions to RSP, subject to appropriations. A participating employee vests in the employer contributions to RSP after three years of credited service.

Employees can make additional contributions, transfers, or rollovers to their accounts, and total contributions in a given calendar year may not exceed the lesser of any limits imposed by the Internal Revenue Service or 100% of the employee’s regular earnings. Any contributions that exceed these limits are placed in a suspense account and distributed as specified by the bill.

The board is authorized to deduct operating expenses from realized and unrealized gains of the plan, but State funds are also authorized to cover operating expenses. Participating employers must also pay any amount necessary to cover the employer’s operating expenses related to RSP.

RSP benefits are payable as a lump-sum distribution, a 50% joint and survivor annuity, a single life annuity, a period-certain annuity, as installment payments, or as a rollover distribution. If an annuity option is selected, the board must purchase the annuity from an insurance company authorized to do business in the State.

Current Law:

Employees' Pension System/Teachers' Pension System

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.

In general, TPS/EPS members hired before July 1, 2011, are subject to the Alternate Contributory Pension Selection (ACPS), a benefit tier within TPS/EPS. Chapter 397 of 2011 added the Reformed Contributory Pension Benefit (RCPB) as a new benefit tier to TPS/EPS. In general, an individual who becomes a member of TPS/EPS on or after July 1, 2011, is automatically enrolled in RCPB (subject to limited exceptions). **Exhibit 1** compares the benefit structures under ACPS and RCPB.

Exhibit 1
Comparison of ACPS and RCPB Benefits

	ACPS	**RCPB**
Vesting	5 years	10 years
Normal Retirement	30 years of service, or age 62	age plus service add to 90, or age 65
Benefit Multiplier	1.8%/year since 1998 1.2%/year before 1998	1.5%/year
Member Contribution	7.0% of pay	7.0% of pay

ACPS: Alternate Contributory Pension Selection
RCPB: Reformed Contributory Pension Benefit

Source: Department of Legislative Services

Optional Retirement Program

ORP is a tax-favored defined contribution retirement savings plan available to designated employees of the institutions listed below as an alternative to membership in SRPS:

- University System of Maryland (USM);
- Morgan State University (MSU);
- Saint Mary's College of Maryland (SMCM);
- the Maryland Higher Education Commission (MHEC); and
- community colleges or regional community colleges in the State, including Baltimore City Community College.

To join ORP, individuals in employing institutions must be eligible for membership in SRPS and be:

- members of the faculty of an employing institution;
- professional employees of a community college;
- employees of USM exempt from the federal Fair Labor Standards Act (FLSA);
- executive or professional administrative employees of MSU;
- employees of SMCM exempt from FLSA; or
- 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 defined benefit plans offered by the State. The State contributes 7.25% of members' earnable compensation to ORP; there is no employee contribution. Based on surveys of participating institutions, the Department of Legislative Services (DLS) estimates that 72% of eligible members elect to join ORP and the remaining 28% participate in TPS.

Local Employer Contributions

Chapter 1 of the first special session of 2012 required local school boards to pay the normal cost for their employees who are members of TRS/TPS, phased in over five years. The phase-in period is complete, so beginning in fiscal 2017, local school boards pay 100% of the normal cost. Beginning in fiscal 2013, Chapter 1 also requires county governments and Baltimore City to adjust their maintenance of effort payments to local school boards to compensate them for teacher pension costs. Beginning in fiscal 2017, the fiscal 2016 payments by the counties are included in subsequent years' per-pupil maintenance of effort calculations. Depending on enrollment trends in each county, some local school boards may be responsible for a portion of any increase in normal cost payments between fiscal 2016 and each succeeding year.

Chapter 1 also established Teacher Retirement Supplemental Grants to provide financial support to local jurisdictions with limited capacity to pay their share of the normal cost. Under the grant program, nine local governments receive a total of $27.7 million annually in supplemental grants. In addition, Chapter 1 repealed the requirement that local school boards reimburse the State for their TRS/TPS employees paid with federal funds beginning in fiscal 2015.

"Normal contributions" (or "normal cost") is an actuarial term that is not defined in statute, but it refers to the actuarial value of pension benefits earned by an active member or group of active members in a given year. Statute defines the "normal contribution rate" as a fraction that has as its numerator the sum of all normal contributions, net of member contributions, and as its denominator, the aggregate annual earnable compensation of members of the State system.

Background: As of June 30, 2016, there were 104,823 active members of TPS, all but 8,958 of whom were employed by local governments. As of the same date, there were 74,702 active members of EPS, of whom 50,234 were State employees and the remaining members were employed by PGUs.

TRS was closed to new members in 1980; it currently has 724 active members, of whom 568 are employed by local governments.

Cash balance plans, like GRIP, are a relatively new plan type, with the first one established in the mid-1980s. Since then, they have become common in the private sector, with more than 1,000 employers currently providing retirement benefits through a cash balance plan. However, they remain fairly rare in the public sector, with only three states providing cash balance plans to their employees or teachers (Kansas, Kentucky, and Nebraska). In 2009, Montgomery County established a cash balance plan (GRIP) as part of its Employees' Retirement System. The plan provides an 8.0% employer contribution and guaranteed annual interest of 7.25%, credited monthly; regular employees contribute 4.0% of compensation up to the Social Security wage base and 8.0% of compensation that exceeds the wage base; public safety employees pay 3.0% up to the wage base and 6.0% on any amounts above the wage base.

State Fiscal Effect: For the purposes of this analysis, the General Assembly's consulting actuary makes the following assumptions:

- for the purpose of calculating benefits paid to vested members, years of service and average final compensation (AFC) for current TPS/EPS members are frozen as of June 30, 2018; and
- any annuities purchased under either GRIP or RSP are actuarially equivalent to the lump-sum payment that would otherwise be paid.

Accrued Liabilities and Normal Cost

The goal of actuarial funding of pension benefits is to pay for the benefits – into a trust fund – as they accrue so that future generations do not have to bear the burden of paying for benefits to retirees. The normal cost is an actuarial calculation that reflects the value of benefits earned in a given year, based on actuarial assumptions. In theory, payment of the normal cost into the trust fund should cover the cost of benefits accrued in that year. However, liabilities accrue when actual experience does not conform to the assumptions used to calculate the normal cost. The most common factor is when investments do not earn as much as projected, but other factors, such as actual rates of retirement, actual inflation, etc., can generate liabilities when they differ from the assumptions. Accrued liabilities are amortized, with the annual amortization payments added to the normal cost to generate an annual employer contribution (net of employee contributions). As of June 30, 2016, TPS/EPS had combined accrued liabilities of $17.9 billion.

Accrued liabilities are calculated using each employee's projected final compensation. By freezing the plans, and thereby freezing AFC and service credit at June 30, 2018, instead of projecting them forward to retirement, the bill generates a substantial reduction in accrued liabilities. Had the bill been in effect in fiscal 2016, the actuary estimates that accrued liabilities would have decreased by $5.9 billion combined for TPS/EPS.

The opposite is true for normal cost, which increases under the bill, as shown in **Exhibit 2**. Under the fiscal 2016 actuarial valuation, the employer normal cost is 4.47% of compensation for TPS and 3.86% for EPS, compared with a required 8.0% employer contribution in both GRIP and RSP under the bill. Under current law, the State pays the full normal cost for all EPS members and for TPS members who are not employed by local school boards (including those employed by community colleges and libraries). Under the bill, the State pays more for every group except TPS members employed by community colleges and libraries because their contribution is paid for by local governments that employ them. Overall, State payments under the bill represent an increase over current payments, since the State currently does not pay any of the normal cost for TPS members employed by local school boards and State GRIP/RSP payments for most other TPS/EPS members are higher than the current normal cost. Had the bill been in effect in fiscal 2016, the actuary estimates that State normal cost payments would have increased by $373.6 million.

Exhibit 2
Normal Cost/Employer Contributions

	State Contributions		Local Contributions	
	Current	The Bill	Current	The Bill
EPS Members	3.86%	8.0%	n/a	n/a
State TPS Members	4.47%	8.0%	n/a	n/a
Local School Board TPS Members	0%	4.0%	4.47%	4.0%
Community College and Library TPS Members	4.47%	0%	0%	8.0%

EPS: Employees' Pension System
TPS: Teachers' Pension System

Source: Department of Legislative Services

Optional Retirement Program

The bill requires current ORP members to remain in the plan, so the bill affects only new hires, who are no longer eligible to choose ORP. Given that the 8.0% employer contribution for GRIP/RSP is greater than the 7.25% employer contribution under ORP, and that the vast majority of eligible members would have chosen the ORP, the bill generates an additional cost in employer contributions for new employees of ORP-eligible institutions.

Fiscal 2019 Effect and Net Effect

SRPS conducts annual actuarial valuations as of June 30 of each year. Under normal circumstances, the valuation conducted as of June 30, 2017, would determine contribution rates for fiscal 2019. That valuation would normally establish State contributions under the existing TPS/EPS provisions, which would still be in effect at the time of the valuation, instead of the bill's provisions. Under this scenario, DLS estimates that State contributions would increase by about $375.9 million in fiscal 2019, reflecting the State paying the full cost of the existing EPS/TPS provisions *and* the new, higher normal cost employer contributions to GRIP/RSP.

However, DLS assumes that the bill's delayed effective date of June 1, 2018, allows the SRPS actuary to estimate contributions for fiscal 2019 under the provisions of the bill. Assuming that savings generated by the bill would be recognized and incorporated into the calculated employer contributions for fiscal 2019, State pension payments decrease by $43.5 million in fiscal 2019.

In each year, the reduction in accrued liability payments is greater than the net increase in normal cost payments, based on the assumption above that the SRPS actuary would project the contributions under GRIP/RSP during the fiscal 2017 valuation. Those savings increase each year according to actuarial assumptions and are assumed to be allocated 84% in general funds, 8% in special funds, and 8% in federal and other funds. It bears mentioning that, on an annual basis, the decrease in accrued liabilities is greater than the increase in normal cost under TPS; for EPS, the opposite is true since the State pays the full 8.0% contribution for EPS members, but only 4.0% for most TPS members.

Local Fiscal Effect: Under the same assumptions used to estimate the State fiscal effect, local contributions for TPS increase by $7.1 million overall in fiscal 2019 due to local community colleges and libraries paying the full 8.0% employer contribution, whereas now they pay no employer contribution (the State pays it for them). The local school board share of employer contributions in fiscal 2019 under GRIP/RSP (4.0%) is less than the projected normal cost payments under TPS (currently 4.47%). Those costs increase over time according to actuarial assumptions and are allocated across 24 local governments.

Additional Comments: The actuary notes that cash balance plans are defined benefit plans, so that, like the current State plans, if actual investment returns fall short of expected returns (*i.e.*, 5.0% compounded annually), an accrued liability develops in the GRIP plan and employer contribution rates may need to be higher than the 8.0% required by the bill.

Additional Information

Prior Introductions: HB 1344 of 2011, a similar bill, received an unfavorable report from the House Appropriations Committee.

Cross File: HB 1064 (Delegate Krebs, *et al.*) - Appropriations.

Information Source(s): Bolton Partners, Inc.; Carroll, Harford, Montgomery, and St. Mary's counties; Maryland State Department of Education; Department of Budget and Management; State Retirement Agency; Maryland Supplemental Retirement Plans; Department of Legislative Services

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