

Department of Legislative Services
Maryland General Assembly
2011 Session

FISCAL AND POLICY NOTE

Senate Bill 6 (Senator Colburn)
Budget and Taxation

**Optional Retirement Program - State and Participating Governmental Unit
Employees - Participation**

This bill closes all of the State's defined benefit (DB) pension plans to new State employees and teachers hired after June 30, 2011, except for the Governor's plan, which closes upon the beginning of Governor O'Malley's second term in office. State employees and teachers hired on or after July 1, 2011, are members of the Optional Retirement Program (ORP), a defined contribution (DC) plan, as a condition of their employment. Current members of the State's DB plans remain in those plans, but they are eligible to transfer to ORP.

The bill takes effect July 1, 2011.

Fiscal Summary

State Effect: State pension contributions for new employees decrease by approximately \$3.6 million in FY 2012, reflecting the combined difference between the ORP contribution rate and normal cost rates for the State's DB plans. Those savings are assumed to be allocated 84% general funds, and 8% each for special and federal funds. The savings are also assumed to increase annually according to actuarial assumptions. Additional savings or costs may be realized, depending on the number and characteristics of current State Retirement and Pension System (SRPS) members who opt to join ORP and how their accrued DB benefits are calculated. No effect on revenues.

(\$ in millions)	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Revenues	\$0	\$0	\$0	\$0	\$0
GF Expenditure	(3.0)	(6.1)	(9.5)	(13.1)	(17.0)
SF Expenditure	(.3)	(.6)	(.9)	(1.2)	(1.6)
FF Expenditure	(.3)	(.6)	(.9)	(1.2)	(1.6)
Net Effect	\$3.6	\$7.3	\$11.3	\$15.6	\$20.2

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

Local Effect: Under the bill, participating governmental units (PGUs) are eligible to elect to participate in ORP, but unless they do so, the bill has no fiscal or operational effect on them.

Small Business Effect: None.

Analysis

Bill Summary: In addition to State employees and teachers generally, the bill applies to other specified State and local employees and officials. Existing State employees and teachers also may not transfer between any of the DB plans after June 30, 2011. The bill does not apply to the Legislative Pension Plan.

Employees hired after June 30, 2011, by PGUs remain eligible for the Employees' Pension System (EPS), Correctional Officers' Retirement System (CORS), and/or Law Enforcement Officers' Pension System (LEOPS) if the PGU became a participating employer before July 1, 2011. PGUs may not become participating employers of State DB plans on or after that date, but they may elect to participate in ORP under specified conditions.

Current Law: State Troopers and State Police cadets are members of the State Police Retirement System (SPRS) as a condition of their employment. Uniformed police officers employed by numerous State agencies are members of LEOPS as a condition of their employment. Correctional officers in the first six classifications and other specified correctional employees are members of CORS as a condition of their employment. State judges, including all circuit court and District Court judges, and other specified judicial personnel are members of the Judges' Retirement System as a condition of their employment.

Membership in EPS is a condition of employment for most regular State employees (*i.e.*, those who are not public safety employees, legislators, or judges) who were hired on or after January 1, 1980. Membership in the Teachers' Pension System (TPS) is a condition of employment for teachers and certain employees of local boards of education, community colleges, and libraries hired on or after January 1, 1980, with the exception of designated employees of:

- the University System of Maryland (USM);
- Morgan State University;
- St. Mary's College;
- the Maryland Higher Education Commission; 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.

ORP is authorized under § 403(b) of the Internal Revenue Code, which applies only to employees of educational institutions and specified nonprofit organizations. 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.

Background: **Exhibit 1** summarizes the key characteristics of the State's DB plans; due to space constraints and because it is not affected by the bill, the Legislative Pension Plan is not included.

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 SRPS. Current plan administrators are TIAA-CREF and Fidelity Investments. Upon retirement, members may elect to purchase annuities with their accumulated funds.

In the last 10 years, seven state pension plans have provided their new members with a choice between a DB plan or a DC plan. In each case, the DB plan is the default option if a member does not make an active choice. Only the two Ohio plans give members the option of choosing a hybrid plan that includes elements of both types. **Exhibit 2** shows that the percentage of employees who chose DC plans instead of DB plans under these conditions ranges from a low of 3% for Ohio state employees to a high of 26% in Florida.

Exhibit 1
Key Characteristics of State Retirement and Pension Plans

	<u>Employees and Teachers</u>	<u>State Police</u>	<u>Correctional Officers' System</u>	<u>Law Enforcement Officers' System</u>	<u>Judges</u>
Participation	Condition of employment	Condition of employment	Condition of employment	Condition of employment	Condition of employment
Vesting	5 years of service	5 years of service	5 years of service	5 years of service	Immediate
Employee Contribution	5% of salary	8% of salary	5% of salary	4% of salary	6% of salary (for 16 years)
Service Retirement Conditions	Age 62 or 30 years (Age 55 with 15 years reduced benefit)	Age 50 or 22 years of service	20 years service, with at least the last 5 years as correctional officer	Age 50 or 25 years of service	Age 60
Allowance	1.8% per year of service after 7/1/98; plus 1.2% per year of service prior to 7/1/98	2.55% per year of service	1.8% per year of service	2.0% per year if subject to the LEOP's modified pension benefit; otherwise 2.3% for first 30 years and 1.0% for each year thereafter	2/3 of active judge's salary at 16 years
Post Retirement Adjustments	Limited to 3% annual COLA	Unlimited annual COLA	Unlimited annual COLA	Limited to 3% annual COLA	Based on salary of active judges

COLA = cost-of-living adjustment

Source: Department of Legislative Services

Exhibit 2
Other State Pension Plans that Provide Members with a Choice between
Defined Benefits and Defined Contributions

	<u>DB by Default or</u> <u>Active Choice</u>	<u>DC Active</u> <u>Choice</u>	<u>Combined</u> <u>Plan</u>
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 Fiscal Effect: The bill's fiscal effects are divided into two parts: effects related to current SRPS members who can choose either to remain in a DB plan or join ORP, and effects related to new hires after June 30, 2011.

Current Employees

The State 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. The amortization payment includes projections of members' future liabilities based on turnover and mortality rates and other factors.

A firm estimate of the bill's fiscal effect for current employees cannot be determined because it depends largely on two factors that are not known:

- the number and characteristics of current SRPS members who opt for ORP instead of their current DB plan; and
- how the State calculates benefits for those individuals who have accrued benefits in a DB plan.

As Exhibit 2 shows, the range of participation rates in DC plans for state employees who are given a choice is quite large. Moreover, the bill does not specify how SRPS should calculate the benefits for members who are vested in a DB plan before switching to a DC

plan. Clearly, the member's years of service credit are frozen when the member switches to ORP, but it is not clear from the bill whether the average final compensation used to calculate the member's benefit allowance is based on compensation at the time the member makes the switch or at the time the member retires. That distinction may have a significant effect on State costs. If the State uses compensation at the time of the switch, that choice will almost certainly yield a significant reduction in accrued liabilities, which are based on an assumption that a member's compensation continues to grow by 3.5% annually until retirement. If the State uses compensation at the time of retirement, it likely has no effect on accrued liabilities or the State's amortization payment of those liabilities.

The State may recognize some savings from its normal cost payments, the second component of the employer contribution, depending on the distribution of current employees who select ORP. **Exhibit 3** compares normal cost rates for fiscal 2010 through 2012 with the ORP contribution rate of 7.25%. Normal cost rates can fluctuate, depending on the demographic characteristics of plan members and plan experience. The General Assembly's consulting actuary further advises that normal cost rates vary by member, with younger members typically having lower normal cost rates. As shown in Exhibit 3, in fiscal 2012 the State will pay substantially less for members of EPS than for ORP members, slightly more for TPS members, and substantially more for members of all other DB plans. Again, the distribution of members who choose ORP determines the short-term fiscal effects for the State. If the group that switches to ORP is heavily weighted to EPS members, State expenditures increase significantly, due to the higher ORP contribution compared to the EPS normal cost. If younger members favor ORP, which is likely given the portability of DC plans and the immediate vesting of ORP benefits, the expenditure increase is even larger because of their lower normal cost rates.

Exhibit 3
Normal Cost Rates and ORP Contributions
Fiscal 2010-2012

	<u>FY 2010</u>	<u>FY 2011</u>	<u>FY 2012</u>
EPS	6.91%	6.10%	6.14%
TPS	6.85%	7.26%	7.27%
CORS	NA	9.04%	9.06%
State Police	24.02%	25.51%	25.48%
Judges	28.54%	31.30%	31.79%
LEOPS	17.10%	18.06%	17.30%
ORP	7.25%	7.25%	7.25%

Source: Cheiron; Gabriel, Roeder, and Smith

Future Hires

To determine the bill's fiscal effect with regard to future employees hired after June 30, 2011, the General Assembly's consulting actuary assumed that the number of future hires and their normal cost rates are consistent with the numbers and normal cost rates for current members with fewer than five years of service, calculated separately for each system.

Based on that assumption, State pension contributions decline by \$3.6 million in fiscal 2012. However, as Exhibit 3 demonstrates, normal cost rates can vary from year to year. This reflects the combined difference between the ORP's 7.25% contribution rate and the projected normal cost rates if new hires had become members of their respective DB plans. To the extent that projected normal cost rates for new hires do not resemble those of recent new employees, the fiscal effect may be slightly higher or lower. Those savings are assumed to grow based on the actuarial assumption that payroll grows 3.5% annually. Employer contributions for teachers and judges are paid entirely from general funds; contributions for all other State employees are assumed to be allocated 60% general funds, 20% special funds, and 20% federal funds. Overall, 84% of State contributions are assumed to be general funds.

Additional Comments: The State Retirement Agency advises that the process for obtaining Internal Revenue Service approval for a parallel tax-qualified DC plan for State employees can take up to several years. Therefore, the Department of Legislative Services advises that the bill cannot be implemented as introduced. Because ORP is authorized only for employees of educational institutions, only new teachers and university faculty and staff hired after June 30, 2011, are eligible to join ORP. However, State employees hired after that date and who are not employed by a college or university are not eligible to join the current ORP. Since their eligibility in existing DB plans is terminated as of July 1, 2011, they are not eligible for any retirement or pension benefits as State employees. To the extent that the State does not make ORP employer contributions for new State employees until a new system is in place, the savings to the State are significantly greater.

Additional Information

Prior Introductions: SB 974 of 2010 received a hearing before the Senate Budget and Taxation Committee, but no further action was taken on the bill.

Cross File: None.

Information Source(s): Anne Arundel, Baltimore, Charles, Frederick, Montgomery, and Somerset counties; cities of Frederick and Havre de Grace; Department of Budget and Management; Governor's Office; Department of General Services; Maryland Higher Education Commission; Department of Health and Mental Hygiene; Judiciary (Administrative Office of the Courts); Department of Labor, Licensing, and Regulation; Department of State Police; Morgan State University; Maryland State Retirement Agency; Maryland Supplemental Retirement Plans; Maryland Department of Transportation; University System of Maryland; Mercer Human Resources Consulting; Department of Legislative Services

Fiscal Note History: First Reader - February 9, 2011
ncs/rhh

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