
Historical Overview of the State Retirement and Pension System

**Department of Legislative Services
Office of Policy Analysis
Annapolis, Maryland**

September 2010

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Origin of the State Retirement and Pension System

The State Retirement and Pension System had its genesis in the Baltimore City Employees' Retirement System, which was established by the city in 1924. This pension system was based on concepts promulgated by Mr. George B. Buck of New York.

Mr. Buck's concepts stated that people could receive an income in retirement if they contributed a portion of their earnings during their careers. This amount would be matched by the employer. Mr. Buck, trained in the life insurance actuarial discipline, had refined his concepts to the point whereby a contribution of 4 to 6% of pay by the employee would provide an annuity of 1/140 for each year of active service, and a similar contribution by the employer would provide a similar pension. Therefore, upon retirement, the employee would receive a retirement allowance of 1/70 (1/140 + 1/140) for each year of service. Thus, an employee who worked 35 years could retire at half pay (35/70), if interest earnings met assumptions.

In addition to city employees, the Baltimore City Employees' Retirement System, because of its unique education department arrangement, included city public school teachers. County school teachers throughout the State evidently demanded the same benefit as city teachers, because in 1927 legislation was enacted (Chapter 344) establishing the Maryland State Teachers' Retirement System.

The State Employees' Retirement System was established in 1941 (Chapter 377), which mirrored, in most instances, the Teachers' Retirement System. At the time of establishment, it was exclusively for State employees. However, in 1945, "municipal corporations" (defined as counties, incorporated municipalities, special taxing districts, or other political subdivisions) were allowed to participate in the system if they paid all of their respective costs. Thus, local government employees also were allowed to be members of this system (Chapter 969).

In 1956, elections were held to determine if Maryland public employees wanted to participate in the federal Social Security program. The members of the employees' and teachers' systems elected to participate in Social Security, while the members of the State Police system did not. Thus, all regular State employees and all teachers in the State became members of the Social Security system, with the State paying the employer's cost for both groups.

The Legislative Pension Plan was established in 1966 (Chapter 281) as a subsystem within the Employees' Retirement System, and intended to provide retirement allowances to individuals who served as legislators in the Maryland General Assembly. However, a constitutional amendment approved by voters in 1970 created a nine-member General Assembly Compensation Commission and specified that the commission submit salary, allowance, and

retirement benefit recommendations to the legislature every four years. Specifically, this constitutional provision (Article III, Section 15), as interpreted by the Attorney General, gives the commission exclusive jurisdiction over salaries, meal and lodging expense allowances, travel allowances, employee benefit programs, and the legislative retirement system.

In 1971, the first General Assembly Compensation Commission recommended to the General Assembly that the Legislative Pension Plan be completely redesigned. This resulted in benefit calculations changing from 5.0% of a legislator's highest salary earned prior to January 13, 1971, for each year the legislator served in the General Assembly, to 2.5% of a legislator's highest salary earned on or after January 13, 1971, for each year of service. While the commission's recommendations reduced the retirement benefit factor by 50.0% for new members to the Legislative Pension Plan, it also recommended increasing legislative salaries from \$2,400 annually to \$11,000 annually. Accordingly, this redesign resulted in an increase of maximum monthly retirement benefits from \$200 a month to \$550 a month. Additional elected official retirement benefits were also added in 1971, when legislation was enacted that established within the Employees' Retirement System special retirement benefits for former governors and their surviving spouses (Chapter 239).

Elected official retirement benefits were not the only retirement benefits addressed during the 1971 session. The General Assembly took up the issue of cost-of-living adjustments based on the work of the Legislative Council's Special Subcommittee on Retirement during the 1970 interim. In its 1970 interim report, the Special Subcommittee on Retirement stated that it believed the continuing increase in the cost-of-living posed the most crucial problem for persons living on retirement income and that it was imperative that a prompt and adequate solution be found.¹ Moreover, it stated that while the benefit increase the legislature had provided in 1969 (increasing the benefit multiplier from 1/70 to 1/60 for each year of service) was sufficient to offset past cost-of-living increases, the problem of future increases remained.² Consequently, legislation was enacted in 1971 that, for the first time, guaranteed unlimited and compounded annual cost-of-living adjustments for all retirees of the Employees' Retirement System, the Teachers' Retirement System, and the State Police Retirement System (Chapter 424). This cost-of-living adjustment, to be provided at the start of each fiscal year, would be based on the Consumer Price Index for the year ending the previous December 31. Until 1980, this benefit was provided for in the Governor's annual budget, to be paid on a pay-as-you-go basis. In 1975, when the adjustment was 11% for fiscal 1976, legislation to hold the cost-of-living adjustment to no more than 5% was introduced by the Governor and subsequently defeated.

The Optional Retirement Program for professional employees of public higher education institutions was established in 1975 (Chapter 556). Whereas all other State systems are defined benefit plans, this plan is a defined contribution plan. By arrangement with the State's higher education establishment, the original carrier of the plan was the Teachers Insurance Annuity Association and College Retirement Equities Fund. In 1993, authorization was provided for the addition of up to four more vendors for the Optional Retirement Program (Chapter 428). The

¹ *Report of the Special Subcommittee on Retirement*. Maryland Legislative Council. (1970).

² *Id.*

retirement agency conducted a competitive search for additional vendors for the Optional Retirement Program.

Fiscal Concerns Lead to Systemic Changes

Creation of the Teachers' and Employees' Pension Systems

The concern about the fiscal soundness of public pension plans began to arise after the passage of the federal Employee Retirement Income Security Act of 1974. Although the Employee Retirement Income Security Act of 1974 only applied to private pension plans, it contained a provision requiring a Congressional study of public pension plans. Congress expressed concern that:

“reports that in the case of governmental units, such generous pension promises have been made, and so little funding has been set aside currently, that the practical likelihood of imposing sufficient taxes to pay those benefits may be open to question”³.

In response to Congressional concerns, Joint Resolution 27 was adopted by the General Assembly during the 1975 session. The resolution requested the General Assembly to undertake a study of the State's retirement systems with particular emphasis on the actuarial and financial condition of the State Retirement and Pension System in existence at that time. The Pensions Study Commission, consisting of eight members of the legislature, the Governor, two executive cabinet members, the executive director of the State Investment Agency, and three representatives of employee unions, was established to conduct the study. At that time, the State maintained four principal retirement plans: (1) the Employees' Retirement System; (2) the Teachers' Retirement System; (3) the State Police Retirement System; and (4) the Judicial Pension Plan.

The financing policy of the plans was based on two funding methodologies. Part of the benefits were financed by advance funding and part by pay-as-you-go funding. In general, the benefits paid on a pay-as-you-go basis included the funding for all post-retirement increases based on changes in the Consumer Price Index, a certain additional pension benefit provided only for retirees under the Teachers' and Employees' Retirement System, and all benefits under the Judicial Pension Plan.

To assist the commission in its work, the commission engaged a consultant, Coopers and Lybrand, to assist in the effort. After studying the financial status of the retirement plans, Coopers and Lybrand recommended to the commission in June of 1976 that (1) a financing policy of full advance funding of retirement be adopted; (2) the benefit structures of the teachers' and employees' systems be integrated with Social Security; and (3) a cap be considered on

³ House Report No. 93-533, 93rd Cong., 2d Sess., U.S. Code Cong. & Adm. News 4639 (1974) as cited in the Defendant's Motion for Summary Judgment in MSTA v. Hughes.

annual cost-of-living increases for retirees.⁴ In the executive summary of Coopers and Lybrand's Study of the Maryland State Retirement Systems, it stated that the recommendation for full advance funding was the most important of all of the recommendations, inasmuch as this policy would impose an effective discipline on legislative authority to know and be prepared to meet the costs of benefits granted.⁵ In addition, Coopers and Lybrand supported their recommendation to integrate the benefit structures of the teachers' and employees' systems with Social Security by stating that the retirement income provided by the benefit structure in place in 1976, coupled with Social Security, far exceeded the amounts needed to maintain the pre-retirement standard of living for retirees. Moreover, the consultants went on to state that it was their strong belief that it was not in the best interest of taxpayers or of the general membership of the systems to utilize a formula which provides retirement benefits in excess of retirement needs.⁶ Finally, Coopers and Lybrand supported its recommendation to cap annual cost-of-living adjustments to provide cost protection against periods of high inflation.

As a result of the Coopers and Lybrand report, the Pension Study Commission recommended additional study before legislative action was taken. Consequently, in 1977, the Pensions Study Commission contracted with another consultant, Winklevoss and Associates, to study alternative means of funding the State plans. Similar to the Coopers and Lybrand study, Winklevoss recommended that the State adopt an actuarially sound, full advance funding methodology. Winklevoss contended that if the State were to continue with a combined funding methodology of advance funding and pay-as-you-go funding, the portions of pay-as-you-go costs would shift from 25% in 1976 to 90% in future years. Winklevoss went on to criticize the combined funding methodology by stating that "it fails to meet one of the important criteria of a suitable funding method; namely, that pension costs should be equitably apportioned among successive generations of taxpayers."⁷ Winklevoss also argued that under the 1976 funding methodology, the funded status of the plans would only increase from 56% in 1976 to 69% in 2026.⁸

After four years of work and significant discussion as to options for change, in 1979, legislation was enacted providing for full actuarial advance funding of the four existing retirement plans and for establishment of two new, fully funded plans – the Employees' Pension System and the Teachers' Pension System (Chapters 23 and 24). The employees' and teachers' retirement systems, the two largest plans, were closed to new members as of January 1, 1980, and all employees and teachers hired on or after that date were required to join one of the new pension systems as a condition of employment. In addition, existing members of the Employees' Retirement System and the Teachers' Retirement System were given the opportunity to transfer into the new pension systems. Many of the benefit recommendations suggested by Coopers and Lybrand in their 1976 study of the plans were incorporated into Chapters 23 and 24, and as a result, new members as of January 1, 1980, and members of the closed retirement systems who

⁴ *Report to the 1978 Session of the General Assembly*. Pensions Study Committee. (1978).

⁵ *Study of the Maryland State Retirement System (Executive Summary)*, Coopers and Lybrand (August 1, 1976).

⁶ *Id.*

⁷ *Study of the Suitability and Long-Term Financial Effects of the Current and Alternative Benefit Formulas for the Maryland State Retirement Systems*. Winklevoss and Associates (1977).

⁸ *Id.*

transferred to the new pension systems were now subject to new retirement benefits. The difference between the pension systems and the retirement systems included:

- increasing retirement age from 60 years of age regardless of service to 62 years of age and 5 years of service;
- reducing employee contributions from 5.0% of pay to noncontributory for annual compensation that was less than the Social Security Taxable Wage Base and 5.0% of annual compensation equal to or above the Social Security Taxable Wage Base;
- reducing the benefit multiplier from 1/55 for each year of service to 0.8% of the member's average final compensation that was not in excess of the Social Security integration level for each year of service plus 1.5% of the member's average final compensation that exceeded the Social Security integration level for each year of service; and
- continuing annual cost-of-living adjustments based on the Consumer Price Index but changing the adjustments from unlimited compounded adjustments to simple adjustments capped at 3.0%.

1984 Retirement and Pension Reform

Despite the enactment of the major changes in 1979, a variety of factors led to the continued deterioration of the financial and actuarial condition of the systems in general, and the older retirement systems in particular. In 1979, when Chapters 23 and 24 were enacted to fully fund the State's pension obligations, it was anticipated that the State's future contribution rate would be constant at approximately 11.66% of the applicable payroll.⁹ However, this turned out not to be true.

In fiscal 1983, investments for the State Retirement and Pension System experienced a 44.0% rate of return when the value of the fund's assets increased from \$2.63 billion in fiscal 1982 to \$3.79 billion. Yet, despite this investment success, the unfunded accrued liabilities increased by 3.27%¹⁰. By fiscal 1985, the State's contribution was 17.6% of the applicable payroll, up from 16.6% in fiscal 1984.¹¹ The State's 1985 appropriation of \$463.1 million at the 17.6% rate was \$155.9 million, or 51.0%, greater than was anticipated at the 11.66% rate that had been expected to be in effect when Chapters 23 and 24 were enacted.

The Joint Committee on Pensions attributed these significant increases to a number of factors. One of the prime aspects of the increases to the State's contribution rate was the unlimited cost-of-living increases given annually to the retirees of the old retirement systems.

⁹ *Report of the Joint Legislative and Executive Committee on Pensions*. (January, 1984).

¹⁰ *Id.*

¹¹ *Id.*

From fiscal 1975 through 1984, the average cost-of-living adjustment for retirees in the Employees' Retirement System and the Teachers' Retirement System was 9%, with four of those years reporting increases above 10%. Moreover, it had been revealed during the joint committee's review of the plans that the actuarial assumptions that had been used in 1979, when full advance funding had been implemented, had erroneously assumed the cost-of-living adjustment was done on a simple basis for the retirees of the old retirement systems, rather than a compound basis. When corrected, this had increased State costs and the unfunded accrued actuarial liability by amounts that had not been previously anticipated.¹²

The joint committee also attributed the increase in the State's contribution rate since 1979 to a discovery made by the 1980 experience study of the Teachers' Retirement System. The experience study revealed that teacher terminations for reasons other than retirement were not as great as assumed, but teachers were retiring earlier in substantial numbers, and then were living longer than anticipated. It was determined that these adverse actuarial experiences were responsible for a 3.52% increase in the State's contribution to the Teachers' Retirement System.¹³

Consequently, in 1984, the General Assembly passed legislation that modified the benefit and contribution structure of the old employees' and teachers' retirement systems. Specifically, the legislation passed provided that active members of the old employees' and teachers' retirement systems would receive benefits for service prior to July 1, 1984, calculated under the old systems, and benefits for service after that date under the new systems, unless members elected either (1) to receive benefits under the old systems subject to a limitation of 5% (compounded) on the annual post-retirement cost-of-living adjustment; or (2) to receive benefits under the old systems without limitation on the cost-of-living adjustment, but with a 2% increase in their contribution (generally from 5 to 7% of salary). In response to the legislation, the Maryland State Teachers Association and other employee groups filed suit in federal court that the legislation illegally violated constitutional contractual rights. The case was dismissed by the federal District Court.¹⁴ This decision was upheld by the United States 4th Circuit Court of Appeals. The *Baltimore Sun* referred to the legislation as the "most controversial issue of the 1984 General Assembly Session" and opined that the reform proposed was "not only sensitive but imperative."¹⁵

Also during the 1984 General Assembly session, legislation was enacted that (1) changed the actuarial cost method for funding the systems; (2) combined the employees' retirement and pension systems only for purposes of establishing a single annual employer contribution rate for all State employees; and (3) combined the teachers' retirement and pension systems only for purposes of establishing a single annual employer contribution rate for all teacher. With the implementation of these changes, the financial and actuarial condition of this system steadily improved.

¹² *Report of the 1985 Interim to the Maryland General Assembly*. Joint Committee on Pensions. (December 1985).

¹³ *Id.*

¹⁴ 594 F. Supp 1353 (D. Md. 1984).

¹⁵ *Baltimore Sun* Editorial. (March 6, 1984).

Shifting Social Security Costs for Teachers to the Locals

By fiscal 1993, the State's contribution rate to the State Retirement and Pension System had declined by 23.9%, from 17.6% of payroll in fiscal 1985 to 13.4% of payroll in fiscal 1993. In addition, the State Retirement and Pension System reported an investment return of 16.93% for fiscal 1993. This compared to a 14.2% investment return in fiscal 1992 and an 8.0% return in fiscal 1991. Nevertheless, while the financial health of the State Retirement and Pension System seemed to be improving following the legislative changes made during the 1984 session, the overall financial condition of the State was not experiencing similar success. At that time, the State was facing a \$450 million deficit in the fiscal 1993 budget.

On September 30, 1992, the Board of Public Works approved the Governor's request to reduce \$168.2 million from the fiscal 1993 budget as part of the Administration's deficit reduction plan. An additional \$90.7 million of the \$450.0 million deficit was reduced through administrative action, leaving \$190.0 million to be reduced through legislation (\$150.0 million in aid to local governments and \$40.0 million in special fund transfers). In an attempt to address this remaining deficit, the Governor convened a special session of the General Assembly on November 18, 1992.

During the 1992 special session, legislation was enacted that reduced State spending \$146.8 million by requiring each local jurisdiction to pay Social Security payroll taxes for its teachers, librarians, and community college employees (Chapter 2). Prior to the enactment of this legislation, the State paid, on behalf of local governments, all or part of the employer Social Security contributions for teachers, librarians, and community college employees who were members of the Teachers' Retirement or Pension System. The State paid 100.0% of the employers' share of Social Security costs through fiscal 1980. Legislation enacted in 1980 capped the State's contribution at 6.13% for employees of local boards of education. When the Social Security tax rate increased in 1981, the local boards of education paid the difference between the employees' contribution and the 6.13% cap on State contributions. In subsequent years, the State contributions for community college employees and librarians were capped at 6.70 and 7.15%, respectively. By fiscal 1992, the employer Social Security tax rate was 7.65% of the wage base. Accordingly, with the 6.13% 1980 cap, the State was paying approximately 80.0% of the Social Security costs for employees of the local boards of education. The State shares for community college faculty and librarians were approximately 88 and 94%, respectively. Chapter 2 resulted in shifting costs to the local jurisdictions in fiscal 1993 that ranged from \$521,000 in Kent County to \$27.3 million in Montgomery County.

Proponents of Chapter 2 argued that by not ending this State aid program, the State would continue to be subject to "an open-ended expense that would continue to grow every time local governments dispensed pay raises to their teachers, librarians, or community college employees."¹⁶ When the State began paying the employers' Social Security contributions in

¹⁶ *Baltimore Sun*, "Senate passes controversial Social Security measure, 29-17." (November 19, 1992).

1958, the cost was \$3.0 million. By fiscal 1992, this cost had increased to \$146.8 million and, at that time, was projected to increase to \$250.0 million by fiscal 2000.¹⁷

Pension Enhancement Legislation – 1998 to 2000

By fiscal 1998, the State Retirement and Pension System had reported a 15.6% return on investments. The State's contribution rate had continued to decline to 12.9% from its high of 17.6% in fiscal 1985. In addition, the funded status of the State Retirement and Pension System had increased steadily to 90.6%. At this time, the State Retirement Agency conducted a national survey of other state public pension plans. This survey showed that Maryland's pension and retirement plans ranked near the bottom among all State employee and teacher retirement plans as measured by total estimated benefits. It should be noted that most states surveyed required a significant employee contribution, while the State Retirement and Pension System remained a non-contributory plan for most employees. Nevertheless, this survey, coupled with continual favorable investment returns, found the State contribution rate decreasing each year, and a gradual increase in the funded status of the plans, prompted the General Assembly to pass legislation in 1998 that modified and increased the benefit formula for all active Employees' Pension System and Teachers' Pension System members except employees of participating local governments and members who chose to transfer from the old retirement systems after April 1, 1998 (Chapter 530).

The most significant benefit improvement included in Chapter 530 was the increase in the benefit multiplier. The benefit multiplier was increased from 0.8% of the member's average final compensation that was not in excess of the Social Security integration level for each year of service plus 1.5% of the member's average final compensation that exceeded the Social Security integration level for each year of service, to 1.2% of the member's average final compensation for service earned by June 30, 1998, plus 1.4% of the member's average final compensation for service earned after June 30, 1998. Chapter 530 also amended the cost-of-living adjustments for retirees from a 3.0% simple cost-of-living adjustment to a 3.0% compounded adjustment.

To share in the burden of funding the 1998 enhancement, Chapter 530 increased member contributions from noncontributory to 2% of all earnable compensation, eliminating the 5% contribution on compensation above the Social Security Wage Base. In addition, Chapter 530 also established a defined contribution program for State members of the Employees' Pension System. The defined contribution program was optional for all eligible employees and became effective July 1, 1999. Under the program, the State matches deferred compensation contributions up to a maximum of \$600 annually. This amount was reduced in fiscal 2003 through 2006 but was restored to \$600 per year in fiscal 2007 through 2009. However, no match was provided in fiscal 2010 and 2011.

To offset the costs of this enhancement, the Board of Trustees for the State Retirement and Pension System increased its investment rate of return from 7.5 to 8.0% in fiscal 1998.

¹⁷ *Id.*

Increasing the actuarial rate of return to 8.0% had the effect of lowering the system's unfunded liabilities by approximately \$1.7 billion, which in turn offset the increase in liabilities resulting from the enactment of Chapter 530. Following the enactment of Chapter 530 and the increase in the State's actuarial rate of return, the State's contribution rate for fiscal 1999 decreased from 12.9% in fiscal 1998 to 11.67% in fiscal 1999. In turn, the funded status of the plan increased from 90.1% in fiscal 1998 to 97.9% in fiscal 1999.

Following the 1998 enhancement, and again prompted by the continuing decrease in the State's contribution rate and increase in the funded status of the plans, the General Assembly passed legislation in 1999 and 2000 that provided enhanced retirement benefits for members and retirees of the State Police Retirement System and the Law Enforcement Officers' Pension System. In 1999, Chapter 122 enhanced several aspects of the State Police Retirement System, including:

- reducing the years of service required to receive a normal service retirement from 25 years of service regardless of age to 22 years of service regardless of age;
- increasing the benefit multiplier from 2.2% of average final compensation per year for a member's first 25 years of service and 1.1% per year thereafter to 2.55% of average final compensation for each year of service;
- setting employee contributions at 8.0% of pay throughout membership rather than 8.0% for the member's first 25 years and 4.0% thereafter; and
- establishing a Deferred Retirement Option Program that, in general, allows State Police members to "retire" from the State Police Retirement System but continue to be employed by the Department of State Police in the same position with the same rank and status for a fixed period of time.

When a member of the State Police Retirement System joins the Deferred Retirement Option Program, the member is considered a retiree of the system and the member's benefit payments (based on service credit and salary at "retirement") are maintained by the State Retirement and Pension System in an escrow account where the member earns interest and receives any cost-of-living adjustments to the basic retirement allowance. The member does not accrue any additional service during the Deferred Retirement Option Program period. At the end of the fixed period, the member terminates employment and receives a lump-sum payment equal to the value of the Deferred Retirement Option Program account and begins to receive the normal retirement allowance as well.

In addition to enhancing retirement benefits for members of the State Police Retirement System, Chapter 122 also increased the retirement allowances of State Police Retirement System retirees who retired before June 30, 1999, by providing annual lump-sum payments, as follows:

- \$1,200 for retirees who have been retired not more than 5 years;

- \$1,500 for retirees who have been retired more than 5 but less than 10 years;
- \$1,800 for retirees who have been retired more than 10 but less than 15 years; and
- \$2,100 for retirees who have been retired more than 15 years.

Chapter 395 of 2000 enhanced retirement benefits for members of the Law Enforcement Officers' Pension System by providing the following:

- increasing the employee contribution from noncontributory to 4% of the members annual salary;
- increasing the benefit multiplier from 1.0% of the member's average final compensation that is not in excess of the Social Security integration level plus 1.7% of the member's average final compensation that exceeds the Social Security integration level to 2.0% of the member's average final compensation;
- changing the cost-of-living adjustments for retirees from a 3.0% simple cost-of-living adjustment to a 3.0% compounded adjustment; and
- establishing the Deferred Retirement Option Program for members of the Law Enforcement Officers' Pension System.

Fiscal 2000 to 2010

With three major enhancements completed by the end of fiscal 2000, the State Retirement and Pension System was also fully funded on an actuarial basis. In the *Joint Committee on Pension's Report of the 2000 Interim*, the joint committee highlighted the significance of this milestone by noting that full-funding of the State Retirement and Pension System occurred almost 20 years ahead of the 40-year statutory schedule that was originally established by Chapters 23 and 24 of 1979.¹⁸ The joint committee also recognized that this milestone was achieved in large part to the generally strong performance of the financial markets in the previous 15 years and the restructuring of the system's benefit provisions in 1979 and 1984.¹⁹ Reflecting the system's full-funding, the State's actuary calculated the State's aggregate fiscal 2002 contribution rate at 7.98%, 14.29% lower than the State's aggregate contribution rate of 9.31% for fiscal 2001.

¹⁸2002 *Interim Report*. Joint Committee on Pensions. (December 2002)

¹⁹ *Id.*

Unfortunately, the success of full-funding was short lived. Within a year of achieving 100.5% funding, the State Retirement and Pension System reported investment losses for fiscal 2001 totaling more than \$3.0 billion. Total system assets declined from a high of \$33.1 billion as of June 30, 2000, to \$29.5 billion as of June 30, 2001. As a result of these losses, the State's annual aggregate contribution rate increased to 8.01% for fiscal 2003 from 7.98% for fiscal 2002. Additionally, the system slipped to 97.5% funded as of June 30, 2001. While significant investment losses occurred in almost all public pension systems across the country during fiscal 2001, a national evaluation performed by Trust Universe Comparison Service, a collaboration of 19 major banks, Wilshire Associates, and Greenshore Associates, indicated that the State Retirement and Pension System ranked in the last percentile as compared to the 2001 performance of other public plans exceeding \$1.0 billion in assets.

The State Retirement and Pension System experienced a second consecutive year of significant investment losses in fiscal 2002, when it lost an additional \$3.0 billion. This equated to a 10.2% decline in system assets since fiscal 2001, leaving the system with approximately \$26.5 billion in assets as of June 30, 2002. Notwithstanding the reduction in assets, the State's pension system remained actuarially sound with a funded status of 94.7%. In light of these losses, the aggregate State employer contribution rate also increased for the second consecutive year from 8.01% of payroll for fiscal 2003 to 8.06% of payroll for fiscal 2004.

New Funding Methodology

During the 2002 session, the fiscal 2003 budget as introduced by the Governor included \$65.0 million in general fund reductions to the State's pension contributions versus the statutorily required amounts. The total underfunding, including all fund types, was approximately \$79.0 million. In addition to this budgetary shortfall, during the 2002 session, the General Assembly was also confronted with the effects of a recession that had begun in March 2001. In fall 2001, the State was estimated to be facing a combined structural deficit of \$1.7 billion for fiscal 2002 and 2003. In mid-December, the Board of Revenue Estimates further wrote down general fund revenues by \$276.3 million. In that context, during the 2002 session, the State's actuary developed a new pension contribution methodology that was actuarially sound but also would reflect the State's fiscal ability to make pension contributions in fiscal 2003 and 2004, in spite of the Governor's initial underfunding of employer contributions in the fiscal 2003 budget.

As a result, rather than adopting the Governor's proposed approach, the General Assembly passed legislation altering the State's actuarial full-funding methodology (Chapter 440). The methodology was changed from one in which the State's pension contribution rates vary from year to year to one in which the rates for the largest systems, the employees' and teachers' systems, remain fixed as long as their funding levels remain within a certain range, or "corridor." Based on the corridor-funding mechanism, each rate remains equal to the fiscal 2002 certified rate (4.73% for the employees' systems and 9.35% for the teachers' systems), as long as funding for the employees' and teachers' systems remain within the 90.0 to 110.0% corridor. The mechanism provides that if the funding levels fall out of the corridor, the rates must be adjusted to account for 20.0% of the difference between the prior year's rate and

the actuarial full-funding rate. The three smaller plans, the State Police Retirement System, the Judges' Retirement System, and the Law Enforcement Officers' Pension System, and the "municipal pool" of participating local units, continue under the full-funding methodology, whereby the contribution rate is reset by the Board of Trustees for the State Retirement and Pension System and the actuary each year.

As a result of the corridor-funding methodology, the rate for the employees' system remained fixed at 4.73% in fiscal 2003 through 2005. By June 30, 2004, the funded status of the employees' systems fell to 89.2%. With the employees' system falling out of the corridor, the State contribution rate for the employees' system was increased to 5.76% in fiscal 2006. Under the corridor-funding methodology, the teachers' systems remained fixed at 9.35% from fiscal 2003 through 2006. By June 30, 2005, the funded status of the teachers' system fell to 89.3%. Accordingly, the State contribution rate for the teachers' system was increased to 9.71% in fiscal 2007.

While both the employees' and teachers' systems remained within the corridor from fiscal 2003 through 2005, the actual fiscal impact to the State under the corridor method for these years showed a savings of \$53.1 million in employer contributions in fiscal 2003, \$112.8 million in employer contributions in fiscal 2004, and \$182.4 million in employer contributions in fiscal 2005. In fiscal 2006, when the employees' systems fell out of the corridor and the employer contribution rate was increased from 4.35 to 5.76%, the State still experienced a savings of \$177.6 million. This savings can be attributed to the employer contribution rate for the teachers' systems remaining static at 9.35%, and the fact that, without the corridor-funding methodology, the employer contribution rates for the employees' and teachers' systems would have been 9.88 and 10.16%, respectively, under the full-funding methodology.

In fiscal 2007, the State experienced savings of \$228.4 million under the corridor-funding methodology. Again, this savings can be attributed to the difference between the employer contribution rates under the corridor-funding methodology for the employees' and teachers' systems and the employer contribution rates under the full-funding methodology. By fiscal 2007, the corridor rate for the employees' system was 6.83%, as opposed to the full-funding rate of 11.11%, and the corridor rate for the teachers' system was 9.71%, as opposed to the full-funding rate of 11.17%. However, it is important to note that while the State accrued significant savings during this same period of time as a result of the corridor-funding methodology, the funding level of the State Retirement and Pension System declined from 92.9% on June 30, 2003, to 83.3% on June 30, 2006.

2006 Employees' and Teachers' Enhancement

After expressing its intent in the Budget Reconciliation and Financing Act of 2005 to enhance teacher and State employee pensions during the 2006 session, the General Assembly passed the most significant pension enhancement legislation since 1998 for all members of the Teachers' Pension System and the Employees' Pension System (Chapter 110). Even after the 1998 enhancements, Maryland's pension benefits were viewed as inadequate by some groups representing teachers and employees. Specifically, the benefit multiplier for the Employees' and

Teachers' Pension Systems was among the lowest in the country, with only Indiana's multiplier lower than Maryland's. Regionally, Maryland's pension benefits put it at a disadvantage in recruiting and retaining teachers and employees. After 30 years of service, in their first year of retirement, retirees of the employees' and teachers' systems were scheduled to receive annual retirement payments totaling 42% of their average final salaries, compared with 75% for Pennsylvania teachers and 51% for Virginia teachers and employees.

Chapter 110 raised the pension benefit multiplier used to calculate a retiree's annual payment from its current level of 1.4 to 1.8%, and applied the higher multiplier retroactively to service credit earned since July 1, 1998. The retroactive feature was designed to improve teacher retention by giving experienced teachers an incentive to stay in Maryland instead of moving to states with higher pension benefits. To help pay for the enhanced benefits, teachers and employees contribute 5.0% of their annual compensation, up from the current level of 2.0%.

It was estimated by the State's actuary that the enactment of this enhancement would increase total State pension liabilities over the next 25 years by \$1.8 billion. With the State responsible for paying the full-employer share of that liability for all teachers and State employees, State pension contributions were expected to increase by \$120.4 million in fiscal 2008. Of that amount, \$104.6 million (87%) would be from general funds, with the remainder estimated to be equally divided between special and federal funds. The enhancement for members of the Teachers' Pension System would account for 68% of the total cost, while the enhancement for members of the Employees' Pension System enhancements would be responsible for the remaining 32%.

Collapse of Financial Markets

Following the collapse of the financial markets in 2008 and 2009, the State Retirement and Pension System experienced its worst single-year investment return in more than 20 years. Total system assets fell from an all-time high of \$40.9 billion on October 31, 2007, to \$36.6 billion on June 30, 2008, due largely to declines in the domestic and international public equity markets. This translated into a -5.4% return on investment in fiscal 2008. As of December 31, 2008, the value of the system's assets had fallen to \$27.6 billion, a 25.0% drop in value from June 30, 2008. However, by June 30, 2009, the value of the system's assets had increased slightly to \$28.45 billion, resulting in a 22.0% decrease in value from fiscal 2008. This dramatic decline in assets resulted in a -20.0% return on investments in fiscal 2009. The funding level for the State Retirement and Pension System also experienced a significant decline from 78.6% funded in fiscal 2008 to 65.0% funded in fiscal 2009.

Accordingly, under the corridor-funding methodology, total State pension contribution rates increased from 12.62% in fiscal 2010 to 14.33% in fiscal 2011. Based on projected payroll growth, total State pension contributions increased by \$189.0 million (13.3%), from \$1.236 billion in fiscal 2010 to \$1.425 billion in fiscal 2011. Specifically, under the corridor-funding methodology, the employer contribution rate for teachers increased from 13.15% in fiscal 2010 to 14.34% in fiscal 2011, and the contribution rate for State employees increased from 9.93% in fiscal 2010 to 11.69% in fiscal 2011. The increase in the employer

contribution rate for the teachers' in fiscal 2011 is estimated to increase the State's pension contributions by \$83.8 million (10.42%), from \$804.5 million in fiscal 2010 to \$888.3 million in fiscal 2011. The increase in the employer contribution rate for the employees' systems in fiscal 2011 is estimated to increase the State's contributions by \$83.2 million (20.12%), from \$413.6 million to \$496.8 million. If the full-funding methodology had been used to determine the fiscal 2011 employer contribution rates for the teachers' and employees' systems, State contributions would have been significantly higher. For fiscal 2011, State contributions for the teachers' systems under the full-funding methodology were estimated to be \$1.18 billion, while State contributions under the full-funding methodology for the employees' systems were estimated to be \$795.9 million.