Public Employees' and Retirees' Benefit Sustainability Commission

2010 INTERIM REPORT

Annapolis, Maryland
January 2011

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THE MARYLAND GENERAL ASSEMBLY
Annapolis, Maryland 21401-1991

January 2011

The Honorable Martin J. O'Malley
The Honorable Thomas V. Mike Miller, Jr.
The Honorable Michael E. Busch

Gentlemen:

On behalf of the Public Employees' and Retirees' Benefit Sustainability Commission, I am pleased to submit our report and recommendations. The report and recommendations were adopted favorably by the commission.

The commission was created by the Budget Reconciliation and Financing Act of 2010 (Chapter 484 of 2010) to examine the benefits for State employees and retirees. The legislation clearly states that the commission should develop specific and actionable recommendations in time for the 2011 legislative session.

To develop specific and actionable recommendations, the commission has met and examined State employee health insurance benefits, retiree health insurance benefits, pension benefits, and the sharing of the cost of local teacher pension benefits between State and local education boards. Although a number of issues still remain unresolved, the commission was able to recommend policy changes that reduce the State's unfunded liabilities for both pension and Other Post Employment Benefits, thus making these benefits more sustainable. The recommendations also continue the State's policy of providing meaningful benefits for State employees. To move the process forward in 2011, the commission identifies specific issues that need to be examined further.

I would like to express appreciation to the members who served on the commission. I am truly grateful for their willingness to engage in public service that will enhance the sustainability of the State employee and retiree benefits. I would also like to recognize the outstanding staff support provided to the commission.

Sincerely,

Casper R. Taylor, Jr., Chairman
Public Employees' and Retirees'
Benefit Sustainability Commission

CRT/PSF/lab

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Executive Summary

The Budget Reconciliation and Financing Act (BRFA) of 2010 (Chapter 484 of 2010) created the Public Employees' and Retirees' Benefit Sustainability Commission to study and make recommendations with respect to State-funded health care benefits and pensions provided to State and public education employees and retirees. As part of its work, the commission is charged with reviewing and evaluating the recruitment practices, retention incentives, actuarial liabilities, actuarial funding method, cost drivers, employee contribution rates, and the comparability and affordability of benefit levels. The commission must also evaluate the appropriate levels of contribution for the direct employer of public education employees in the State. The legislation requires that the commission prepare a report with specific and actionable recommendations by December 15, 2010. The commission is required to complete its final report on or before June 30, 2011. The legislation also expressed the intent of the General Assembly that the recommendations of the commission be implemented no later than fiscal 2013. The commission terminates on June 30, 2012.

The commission met seven times from October through December of 2010 to hear briefings and deliberate about the options available to address its charge; at its final meeting, members approved the recommendations contained in this report. Unless otherwise noted in the report, all recommendations were adopted unanimously.

Commission briefings revealed that employee benefits, including employee and retiree health insurance, State employee pensions, and State costs for pensions for local employees, are growing at unsustainable rates. That is, in total, they have grown as a percentage of the total State budget, from 7.1% in fiscal 2002 to 9.0% in fiscal 2011. Moreover, the cost of those benefits is growing much faster than the State's general fund revenues. From fiscal 2002 to 2011, general fund revenues grew by 39.0%, but State employee fringe benefits (including health insurance and pensions) grew 59.0% and the cost of pensions for local employees grew 159.0%. From fiscal 2012 to 2015, general fund expenditures on both pensions and health insurance for State employees and local employees are projected to grow at least twice as fast as general fund revenue. These trends cannot continue without imposing very significant cuts in other vital State programs and employee compensation.

The commission, therefore, recommends a series of changes to the structure and funding of these benefits to secure retention of pension and health benefits at sustainable cost levels. In recommending these changes, the commission's goal is to maintain meaningful and viable benefit packages for public employees that assist in the recruitment and retention of a talented workforce and provide income security during retirement. At the same time, the commission recognizes that the cost of employee benefits must remain within the State's ability to adequately fund them without impinging on other critical State functions.

Like the report, this executive summary is divided into four sections that reflect the four areas examined by the commission:

- State employee health care costs;
- retired State employee health care liabilities;
- State pension costs; and
- pension costs for teachers employed by units of local government.

Employee Health Care Costs

Compared with plans offered by other states, the Maryland health program for employees and retirees is among the most generous. Although covered charges vary among states, Maryland pays 95% of covered charges for active employees and 98% of covered charges for retirees, compared with an average of 83% for other state programs. Plan features such as 100% coinsurance for in-network services and 45_day supplies of prescription drugs for a single copay are not commonly found in other states, while most other plan features are at least as generous as those found in most states.

Therefore, the commission recommends that the State adopt a goal of reducing State expenditures on employee and retiree health benefits by 10% to bring them closer to those of peer states.

The commission further recommends that this goal be accomplished through a combination of reductions to State premium subsidies for employees and retirees and plan design changes that reduce the State share of covered charges for medical services and/or prescription drugs purchased by State employees and retirees. Such a blended approach spreads the expenditure across a wide base of users by including coverage components so that no single usage group is disproportionately affected, but contains plan design changes that have the potential to alter behavior of enrollees that may reduce total program expenditures over the long-term and enhance the sustainability of the program.

Given the continually evolving nature of public employer health benefit offerings, the Department of Budget and Management (DBM) should monitor the structure of the State health plan on an ongoing basis to ensure that the State's share of covered charges continues to be equivalent with that of other states. Further study should be undertaken to determine how any changes to the health program could impact the total compensation package that is adequate to recruit and retain a high-quality workforce.

Finally, special consideration in designing all changes should be given to their financial effects on low-income employees and retirees. Efforts should be taken to minimize those effects, such as the use of limitations on out-of-pocket expenditures.

Retiree Health Liabilities

The State faces a $15.9 billion unfunded liability for Other Post Employment Benefits (OPEB), stemming from its commitment to provide subsidized health insurance to retired State employees. Historically, the State has funded its retiree health obligations on a pay-as-you-go basis, but as health insurance costs escalate, future generations will bear the burden of paying for the State's obligations. Beginning in fiscal 2007, the State began making payments into a trust fund to begin paying down its liabilities, but all payments halted in fiscal 2010 for budgetary reasons. As a result, the State's OPEB liability is just 1.2% funded.

Eligibility criteria for retiree health benefits are not very stringent. Employees qualify to participate in the State health program as retirees after just 5 years of service, benefitting from a blended premium because they share the risk pool with younger State employees. They earn the maximum State subsidy for health benefits after just 16 years of service. Moreover, employees with 16 years of service can leave State employment and still claim their benefit when they reach normal retirement age even if they do not retire directly from the State.

To address the State's OPEB liabilities, the commission recommends that the State establish a goal of reducing its unfunded actuarial liability for OPEB by 50% and also commit to fully funding its annual required contribution within 10 years.

The commission believes that retiree health benefits should be reserved for State employees who devote at least a majority of their career to the State and, like pensions, should further reward those who spend their whole career in State service. Therefore, the commission recommends that the State achieve the goals set forth above in part by making the following changes to the eligibility criteria for retiree health benefits:

- **Employees with less than 15 years of service credit as of June 30, 2010, should be required to earn 15 years of service credit with the State, up from 5, to qualify for participation in the State health plan as retirees.**

- **Employees with less than 15 years of service credit as of June 30, 2010, should be required to earn 25 years of service credit with the State, up from 16, to qualify for the maximum premium subsidy provided to retirees, with the subsidy prorated for those with between 15 and 25 years of service credit.**

- **Employees should be required to retire directly from State service to qualify for retiree health benefits from the State; former employees who were eligible for retiree health benefits at the time they separated from State service should still be eligible to receive retiree health benefits from the State when they reach normal retirement age.**

In addition, during the 2011 interim, the General Assembly should review the current provisions under Title 37 of the State Personnel and Pensions Article that govern transfers of service credit between any State or local retirement or pension system and how those rules affect eligibility for both retiree health benefits and pension benefits for employees who transfer between State and local government service.

Last, the commission recommends that the State establish in statute a requirement that, by the year 2020, all Medicare-eligible State retirees must join Medicare Part D for prescription drug coverage, just as they are currently required to join Medicare for medical benefits. Consequently, they would no longer be eligible to participate in the

State prescription drug plan. This recommendation is largely based on the assumption that, under the federal Patient Protection and Affordable Care Act of 2010, the Part D coverage gap will be eliminated by 2020. To the extent that the coverage gap is not eliminated, the commission recommends that DBM devise a contingency plan to provide supplemental pharmaceutical drug benefits through an Employer Group Waiver Plan or other similar mechanism.

State Pension Costs

The State Retirement and Pension System (SRPS) faces considerable fiscal challenges. Although benefits promised to current employees and retirees are not at risk, the system's current benefit structure cannot be sustained over the long-term without serious adverse effects on other necessary State services. Beginning in fiscal 2000, the system's actuarial liabilities have consistently grown faster on an annual basis than its actuarial value of assets. This has resulted in its unfunded liabilities increasing each year to the present. As a result, the system's actuarial funded status, which reached 100.0% in fiscal 2000, has dropped to 64.1% as of June 2010, considerably below the 80.0% level that experts consider to be the indicator of a healthy plan. As noted earlier, this has prompted the growth rate for State pension contributions to far outpace the growth rate for general fund revenues, and projections show that this trend will persist.

To reverse these trends and place the system on a path to financial stability, the commission recommends that the State establish two goals: achieving actuarial funding levels of 80% within 10 years and 100% within 30 years for SRPS. Based on data presented to the commission, these goals can be accomplished only by increasing the flow of assets into the system to pay down the unfunded liabilities. However, in the current economic and budgetary environment, the State simply does not have the resources necessary to infuse the system with sufficient funds to accomplish either goal. Closing the current plans does not eliminate the unfunded liabilities they carry or the State's responsibility for paying them, and deprives the system of employee contributions that help sustain the plans.

Therefore, the commission recommends that the State consider options for restructuring benefits for both current and future SRPS members in a manner that reduces its accrued liabilities but does not diminish accrued benefits protected by law. The commission further recommends that the State use the savings generated by those changes to increase funding levels for the system. The amount of savings that is reinvested in the system annually should be subject to a cap that provides enough additional contributions to achieve the commission's goal of achieving 80% funding in 10 years, with excess savings credited to the appropriate funding sources.

For new and currently nonvested members of SRPS, the commission recommends that benefits be redesigned in the following manner:

- **For new and nonvested members, increase the vesting requirement for all SRPS plans from 5 to 10 years.**

- **For new and nonvested members, eligibility for a normal service retirement in the Teachers' Pensions System (TPS) and the Employees'**

Pension System (EPS) should be age 62 with at least 10 years of service or a combination of age and years of service adding to 92 (the Rule of 92). Concurrently, eligibility for early retirement should be age 57 with at least 20 years of service.

- **For members of the State Police Retirement System and the Law Enforcement Officers Pension System not currently enrolled in the Deferred Retirement Option Program (DROP), the program should be modified to provide 4% compounded annual interest on DROP account balances instead of the current 6% compounded monthly interest. The commission further recommends that the State explore, through the collective bargaining process, requiring members of the State Police Retirement System to hold a referendum on whether to join Social Security.**

- **The commission recommends that the General Assembly Compensation Commission and the Joint Committee on Pensions study the benefit structures provided under the Legislative Pension Plan and the Judges' Retirement System, respectively, and recommend any necessary changes to the General Assembly and Judicial Compensation Commission. In determining whether to recommend any changes, the respective studies and compensation commissions should consider the changes made to other State pension plans in the intervening period.**

For current members of the EPS and TPS, the commission recommends that the State provide them with a menu of options for future benefits with the following characteristics:

- **at least one option should protect all accrued benefits while potentially providing a lesser benefit level going forward; and**

- **at least one option should allow members to retain their current benefit structure going forward in exchange for a higher member contribution rate.**

In designing the menu, the State should give serious consideration to offering current members the opportunity to convert their accrued benefits into a cash balance plan that would be administered by the State Retirement and Pension System.

Future EPS and TPS members should also have to select from among the plan options developed.

Pension Costs for Teachers

The State pays pension costs for qualifying employees of local boards of education, local boards of library trustees, and local boards of community college trustees. The employees are member of the State's combined teacher pension systems and receive retirement benefits equivalent to State employees. The State pays the pension costs on behalf of the local boards, which are responsible for setting local salaries and budgets. In effect, the State pays a portion of the cost of each new employee hired by one of the boards and of every salary increase granted by a board. Although there are several reasons why this somewhat unusual structure may have been established and has been maintained, the primary reason for its perpetuation seems to be a reluctance to change a system that has been around so long.

From fiscal 2006 to 2011, pension costs for local teachers more than doubled from $431.1 million to $900.4 million. The striking increases can be attributed to at least three factors: heavy pension fund asset losses brought on by the two recessions that occurred during the last decade; rapid increases in the salary bases for local boards' employees due at least in part to growth in the teacher workforce; and the pension enhancement enacted in 2006.

The commission finds that the current structure of 100% State-paid pensions for local employees is unsustainable. Current estimates suggest that the State contribution rate for teachers' pensions will increase 36.8% over the next five years (from 14.34% of the teacher salary base in fiscal 2011 to 19.61% by fiscal 2016), driving up pension costs significantly even with relatively minimal salary base increases. With nearly 95.0% of the State's retirement aid spent in support of local board of education employees, reducing State pension costs for local school employees will have the greatest impact on long-term sustainability. Shifting some of the costs to local school boards will also help to mitigate the budget hole that will be left when the $228.1 million in federal stimulus funds being used to support fiscal 2011 teacher pension costs is no longer available in fiscal 2012. The commission also believes that shifting some of the responsibility for paying teacher pension costs to the local boards of education, the entities that set budgets and negotiate the salaries of school employees, is simply a good, commonsense policy.

Based on these findings, the commission recommends shifting some of the costs of teacher pensions to the local boards of education. With one member abstaining, the commission recommends that, over the course of a brief phase-in period beginning in fiscal 2012, combined pension and Social Security costs be shared so that the State provides 50% of the costs and the local boards of education support the remaining 50%. The commission suggests that the cost shift begin in fiscal 2012 in recognition of the fiscal challenges the State is facing and the hole that will be left in the budget when the $228.1 million in federal stimulus funds being used to support teacher pension costs is no longer available.

In the spirit of "One Maryland" and long-standing wealth equalization principles established for State education aid, the commission also recommends (with one member abstaining) that local tax capacity be taken into consideration in implementing a cost-sharing methodology. In other words, school systems in jurisdictions with larger local tax bases will pay a greater proportion of the pension costs for their employees. The commission specifically recommends an equalization methodology that combines an enhancement of existing education aid formulas with the shift in pension costs. Under this approach, the State would shift a greater portion of employee pension costs to local boards of education than it would under a nonequalized model, but the formula enhancements would pay for half of the pension cost on a statewide basis.

Chapter 1. Commission's Purpose

The Budget Reconciliation and Financing Act (BRFA) of 2010 (Chapter 484 of 2010) created the Public Employees' and Retirees' Benefit Sustainability Commission. The commission consists of the State Treasurer, three members appointed by the Governor, two members appointed by the President of the Senate, and two members appointed by the Speaker of the House of Delegates. Except for the State Treasurer, the commissioners may not be members of the General Assembly, members of the Board of Trustees for the State Retirement and Pension System, employees of a governmental agency, or employees of an organization that represents either a governmental agency or employees of a governmental agency. The law requires that the Department of Legislative Service (DLS) provide staff for the commission, with support from the Department of Budget and Management (DBM), the State Treasurer's Office (STO), and pension and health actuaries. The legislation is included in **Appendix 1.**

The purpose of the commission is to study and make recommendations with respect to State-funded health care benefits and pensions provided to State and public education employees and retirees. As part of its work, the commission is charged with reviewing and evaluating the recruitment practices, retention incentives, actuarial liabilities, actuarial funding method, cost drivers, employee contribution rates, and the comparability and affordability of benefit levels. The legislation requires that the review include examining long-term estimated increases in the State's annual required contributions to maintain the current benefit structures and evaluating the sustainability of the State funding. The commission must also evaluate the appropriate levels of contribution for the direct employer of public education employees in the State. The legislation requires that the commission prepare an initial report by December 15, 2010, and a final report on or before June 30, 2011. Both reports are required to have specific and actionable recommendations. It is the intent of the General Assembly that the recommendations of the commission be implemented no later than fiscal 2013. The commission shall terminate on June 30, 2012.

State Budget

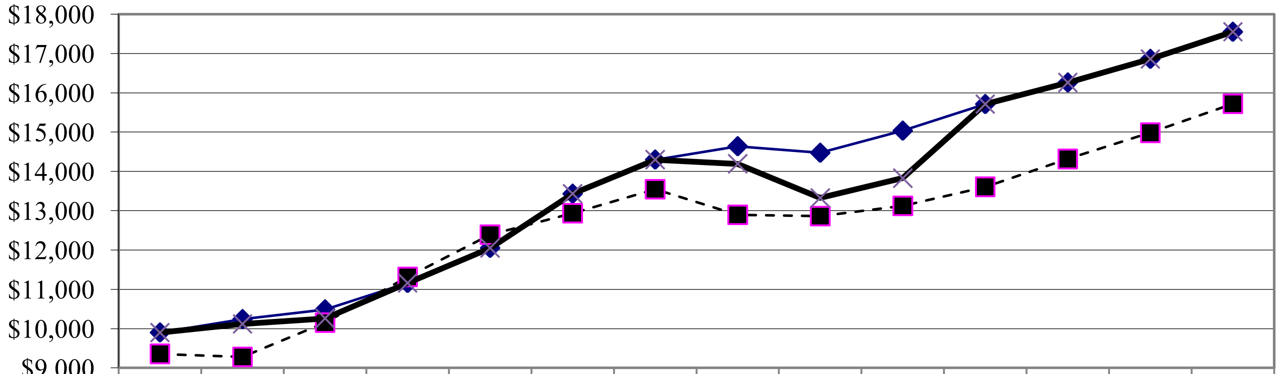
In December 2009, the Spending Affordability Committee projected that the annual operating budget structural deficit would exceed $2.4 billion by fiscal 2015. The 2010 BRFA reduced the out-year deficit by as much as $800 million per year. However, this was not sufficient to close the entire gap. **Exhibit 1.1** shows a structural deficit of over $2.0 billion in fiscal 2012. Though the deficit shrinks in the out-years, it remains above $1.8 billion through fiscal 2015.

Exhibit 1.1

Ongoing State Spending Compared to Ongoing State Revenues

Fiscal 2002 to 2015

($ in Millions)



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Ongoing Spending	$9,901	$10,240	$10,488	$11,159	$12,052	$13,430	$14,298	$14,638	$14,472	$15,034	$15,710	$16,260	$16,859	$17,549
Ongoing Revenues	9,356	9,281	10,151	11,317	12,390	12,935	13,545	12,893	12,864	13,122	13,607	14,316	14,983	15,722
Structural Balance	-545	-959	-337	158	338	-495	-753	-1,745	-1,608	-1,912	-2,103	-1,944	-1,876	-1,827
Spending Excluding Federal Stimulus	9,901	10,117	10,261	11,159	12,052	13,430	14,298	14,193	13,328	13,828	15,710	16,260	16,859	17,549

Source: Department of Legislative Services, November 2010

Actions taken to reduce the long-term structural deficit include controlling personnel costs by eliminating positions. For example, Executive Branch positions (excluding higher education positions) decline from 55,980 at the end of fiscal 2002 to 51,368 in the fiscal 2011 legislative appropriation. There was also a reduction in employees' salary's share of the State budget over the same period. **Exhibit 1.2** shows that State salary expenditures decline from 17.7% of State spending in fiscal 2002 to 15.4% of State spending in fiscal 2011, a reduction of 2.3%. However, these costs are offset by State benefits increasing their share of State costs. Over the period, health insurance, State retirement, and local pension costs increase by 0.5, 0.7, and 1.2%, respectively.

Exhibit 1.2
Salaries Decline as a Component of State Budget While Fringe Benefits Increase
Fiscal 2002 to 2011

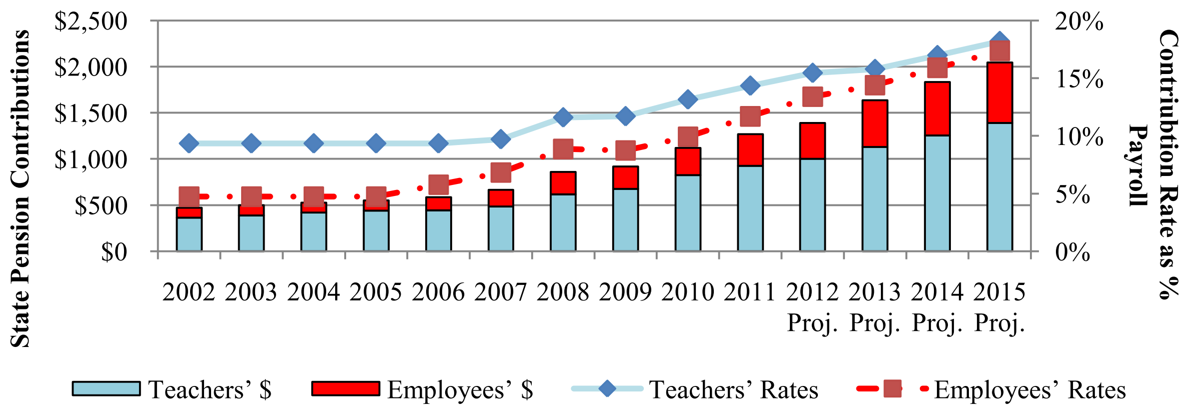
Compensation Component	2002 Expenditures	2011 Legislative Appropriation	Change
State Salary	17.7%	15.4%	-2.3%
State Fringe Benefit	5.5%	6.2%	0.7%
Active/Retiree Health Insurance	*2.3%*	*2.9%*	*0.5%*
State Retirement	*1.1%*	*1.8%*	*0.7%*
Local Pensions*	1.6%	2.8%	1.2%
Total	**24.8%**	**24.4%**	**-0.4%**

* Local Pensions includes teachers, librarians, and community college employees whose pension costs are currently paid for by the State

Source: Department of Legislative Services, December 2010

In the out-years, the costs of benefits are projected to continue increasing. **Exhibit 1.3** shows that pension contribution costs are projected to increase through fiscal 2015 to approximately $2 billion. The concern is that the cost of the benefits is increasing at a higher rate than the revenues supporting the benefit.

Exhibit 1.3
Pension Contribution Costs Projected to Increase in Out-years
Fiscal 2002 to 2015
($ in Millions)



Source: Department of Legislative Services, December 2011

In sum, the State has reduced the structural deficit. Among the actions taken was controlling personnel costs by eliminating positions. However, actions taken to reduce the deficit have not been sufficient. Employee benefit costs have become a larger share of total employee compensation costs, and this trend is expected to continue. To provide a comprehensive examination of the sustainability of personnel benefit costs, the General Assembly created the Public Employees' and Retirees' Benefit Sustainability Commission.

Commission's Actions

The commissioners were appointed in September 2010. The commission met seven times from October to December 2010. All documents presented at the hearings can be found on the Maryland General Assembly website. At the final meeting in December, the commission approved specific and actionable recommendations for considerations by the Governor and legislature. Unless otherwise noted in the text, all recommendations were adopted unanimously. A letter summarizing these recommendations was sent to the Governor and Presiding Officers on December 21, 2010, as shown in **Appendix 2**. The remaining four chapters of this report address the committee's findings and recommendations. Each of the chapters examines one of the four subjects:

- State employee health care costs;
- retired State employee health care costs;
- State pension costs; and
- local contributions to Teacher's Retirement and Pension Systems.

The commission also recognizes that additional work must be done and has identified specific issues that need to be examined, which are listed in **Appendix 3**. The appendix also identifies who should examine the issues and when they should be examined. Finally, the commission is concerned that it has insufficient time to complete its work by June 30, 2011; therefore, the commission requests that legislation be introduced to extend the completion of the commission's final report to October 1, 2011.

Chapter 2. State Employee Health Insurance

Summary of Background Information on State Employees and Retirees Health and Welfare Benefit Program

The commission began its examination of the State's employee and retiree health insurance benefit program with briefings from Department of Legislative Services staff; the Department of Budget and Management (DBM); and Gabriel Roeder Smith & Company (GRS), the State's benefits actuary/consultant. The briefings detailed:

- eligibility for the program;
- the health plans offered to enrollees and the cost-sharing relationship between the State and enrollees;
- recent membership and cost trends;
- the potential impact of federal health reform on the program; and
- comparisons to peer states.

This section will summarize the key background material presented in these briefings.

Program Eligibility

For active employees, all full-time and part-time State employees working at least 50% of the work week and receiving regular pay/wages are eligible for the program, and receive the full State subsidy. Contractual employees do not receive a State subsidy but may participate in the program.

For retirees to enroll, the individual must be currently receiving a periodic State retirement allowance <u>and</u> meet one of the following:

- left State service with at least 16 years of creditable service;
- retired directly from the State service with at least 5 years of creditable service;
- left State service, deferring retirement allowance, with at least 10 years of creditable service and within 5 years of normal retirement age;
- retired directly from State service with a disability retirement allowance; or

- State employment ended before July 1, 1984.

After establishing eligibility, the amount of the State subsidy available to the retiree is based on years of service. Retirees with 16 years of qualified State service receive the maximum subsidy, while those with fewer than 16 years receive a pro-rated amount, starting at the minimum amount provided to those eligible retirees with 5 years of service: 5/16 of the maximum subsidy.

Dependents of enrollees also constitute a large portion of those receiving health services in the program. Current eligibility rules allow all verified spouses, same-sex domestic partners, children, grandchildren, and legal wards to be added by enrolled members as dependents. Note that participants in the Optional Retirement Program (employees of participating institutions of higher learning) have slightly different retiree health benefit eligibility requirements.

Benefit Plans and Cost-sharing Structure

Medical

In general, all options under each type of plan offered by the State cover the same services. However, the participating provider networks for the plans vary by vendor but do overlap. The three types of health benefit plans available are:

- ***Preferred Provider Organization (PPO):*** The plan has contracts with a network of "preferred" providers from which the member may choose but offers a reduced benefit for out-of-network services. PPOs do not require enrollees to select a primary care physician (PCP) or obtain referrals to see any providers, in- or out-of-network.

- ***Point of Service (POS):*** Medical care is directed by a PCP within a network of physicians and also includes reduced coverage of out-of-network services.

- ***Exclusive Provider Organization (EPO):*** The member receives all health care from a network provider. EPOs require the selection of a PCP who is responsible for managing and coordinating all of the member's health care. No benefits are payable for out-of-network services (except for emergency care).

There are two PPO plans and three POS plans. Among their shared key features are: copays of $15 for PCP visits and $25 for specialist visits; 100% in-network and 80% out-of network coinsurance; and $250 annual out-of-network deductible for individuals and $500 for families, which are capped by out-of-pocket maximums of $3,000 for individuals and $6,000 for families. There are also three EPO plans. These have the same copayments for physician visits but do not provide out-of-network coverage, except for emergency care, generally resulting in lower premiums.

In terms of the State subsidy for employees, the State pays 85% of the premium for enrollees in EPOs, 83% for enrollees in POS plans, and 80% for enrollees in PPOs. These also represent the maximum subsidies for retirees, based on their years of service.

Prescription Drug

In terms of the State subsidy, the State pays 80% of the premium for all enrollees in the lone prescription plan offered. Then, at retail, a copay of $5 for generic drugs, $15 for preferred brand name drugs on the pharmacy benefit manager's formulary, or $25 for nonformulary brand name drugs is required when program members purchase up to a 45-day supply of prescriptions. The amount of the copays doubles for a 90-day supply filled at a retail pharmacy. Mail order copays have a $20 maximum regardless of the days supply. Once an enrollee has paid $700 out-of-pocket in prescription copays in a Plan Year, the State absorbs the copays until the start of the next Plan Year

A more detailed description of medical and prescription plan characteristics can be found at http://dbm.maryland.gov/benefits/Documents/PlanYear2011/FY2011BenefitDescriptions.pdf.

Cost and Membership Trends

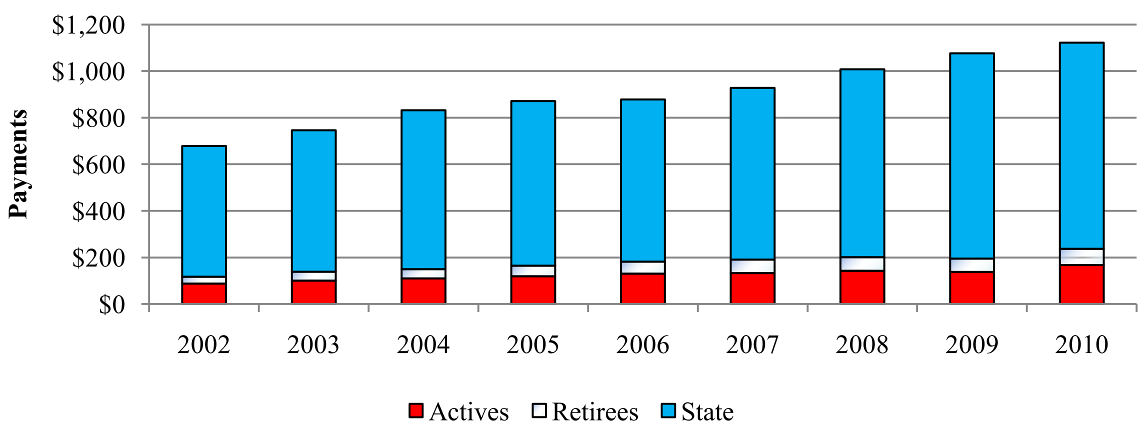
In fiscal 2010, State spending for this program was approximately $900 million, nearly double fiscal 2002 levels. Expected spending for fiscal 2011 is $1 billion. **Table 2.1** shows the historical expenditures for this fringe benefit.

Exhibit 2.1

State Health Insurance Program Expenditures by Source

Fiscal 2002-2010

($ in Millions)



Source: Department of Budget and Management

This growth has been fueled by medical inflation, which averaged approximately 10% annually across the nation from 2000 to 2010. Yet, membership growth has also been a factor. In fiscal 2010, there were approximately 71,500 active enrollees in the medical plan and 37,800 retirees. These totals represent increases of 1,500 among actives and 8,400 among retirees since fiscal 2002, a growth in enrollment of nearly 10%. There were similar enrollment increases in the prescription plan.

The recent economic downturn and State workforce reductions have stalled the expansion of active employee enrollment. As economic conditions make the State plan more attractive to spouses and their dependents relative to other offerings, there has been a marked increase in the addition of dependents by retirees and actives, such that dependents have come to represent nearly half of all plan participants in fiscal 2011. Retiree enrollment, which is more expensive to the plan due to higher usage typically required by older individuals, especially of prescription drugs, has become a major factor in cost growth.

In light of these continuing trends, program costs are expected to rise approximately 8.0% annually due to medical inflation trends and population demographic change. Meanwhile, the general fund revenues supporting this expenditure are only forecasted to grow by 4.9% annually, indicating an unsustainable liability mismatch.

Federal Health Care Reform

The most immediate impact of benefit plan changes proposed by the commission under the federal Patient Protection and Affordable Care Act of 2010, commonly referred to as Health Care Reform (HCR), is the possible loss of the Maryland program's grandfathered status. Because the State plan was in effect on March 23, 2010, Maryland's offerings are grandfathered, and thus exempt from certain aspects of HCR, such as not being required to implement $0 copay for preventive services, or to expand preventive services covered, or to implement ERISA-like internal/external claims appeals procedures. This status is applied on a plan by plan basis rather than program-wide, so changes can be made to one plan without altering the status of the entire program.

However, significant plan changes may jeopardize the State's grandfathered status under the HCR rule set. Changes that could cause Maryland to be subject to all of the recently implemented HCR rules are:

- raising the percentage of coinsurance paid by the participant or increasing deductibles or out-of-pocket maximums in any manner;

- raising copayments by more than the greater of $5 or 15% above medical inflation as of March 23, 2010;

- decreasing the employer contribution rate by more than 5% points below the rate in effect on March 23, 2010, measured tier by tier;

- adding new annual limits;
- significantly reducing or eliminating a covered benefit; or
- changing insurance companies or changing insurance policies that result in a network change.

Some plan changes are permissible under current grandfathering rules, such as plan changes to voluntarily comply with HCR, any increase in benefits, or copay increases that do not exceed the greater of $5 or 15% above medical inflation as of March 23, 2010.

The total cost associated with the loss of grandfathered status that would accompany significant plan changes is uncertain at this point. DBM estimates that the elimination of cost sharing for preventive services and the administrative burden of complying with the rules Maryland is currently exempt from would add a minimum of $5.4 million in additional annual costs to the program. Therefore, any savings from plan changes must net out the additional costs to the program associated with the loss of currently held exemptions from HCR guidelines.

Numerous issues related to HCR will affect the program in the longer term, as their components are unrolled over the next decade. These are summarized in **Appendix 4**.

Comparisons to Peer States

The commission requested information detailing how Maryland's health insurance benefit offerings compare with those provided by similar public employers. To ensure that comparisons in the complex environment of health insurance plans, and their many possible variations, were balanced, the commission reviewed national studies and particular case comparisons of health insurance programs provided by public employers.

Components of Employee Health Benefits and Difficulty of Comparisons

The major components of typical health insurance programs were discussed, as all comparisons require an understanding of the total package to evaluate the value of the benefit. Similarly, any potential changes to the State program would affect one of the following areas:

- ***Premium Cost:*** Monthly payment by employee to obtain coverage.
- ***Premium Subsidy:*** Employer portion of the premium as a percent of total.
- ***Deductibles:*** Amount of money the employee must pay before receiving benefits under the plan.

- ***Copay:*** Employee up front payment at time of outpatient medical or prescription services.

- ***Coinsurance:*** Shared payment percentage applicable to the enrollee and plan for medical service claims administered by the plan after the deductible has been paid.

The difficulty of comparing health benefits across states stems from the fact that the employer can tailor the cost-sharing characteristics of health insurance benefits to balance cost levels and utilization incentives. For example, two states with equivalent premium subsidy percentages may be offering vastly different dollar value benefits depending on the other cost-sharing variables. Additionally, each state plan has its own combination of plan types that are not shared by its peers, and within each plan type there are multiple carriers, so the value of access to these networks varies. Most obstructive of timely comparisons is the fact that all plans go through frequent, periodic contract alterations, so plan characteristics change rapidly.

Moreover, individual components of each health insurance package have their own internal permutations that must be accounted for in comparisons. For example, premium subsidies may not represent similar values because some bundle a combination of medical, dental, vision, and Rx in one premium, whereas others separate the premium for each service. Similarly, other distinctions based on salary, union-negotiated rates, participation in wellness programs, and regional offerings can cloud the true dollar value of plan provisions.

National Comparative Studies Factors for Active Employee Health Benefits

Mindful of these caveats, the *Study of State Employee Health Benefits* published by The Segal Company in 2009 surveyed all 50 states and Washington, DC to compare the benefits provided to full-time active state employees. It details what type of plans the employers provide and compares certain benefit levels. In terms of medical coverage, it compares offering of the following plan types:

- ***PPO:*** The plan similar to the Maryland offering described above.

- ***HMO:*** The member receives all health care from a network provider. The plan requires the selection of a PCP who is responsible for managing and coordinating all of the member's health care and is similar to the Maryland EPO plans but with a more limited network.

- ***High Deductible Health Plan (HDHP):*** This plan has lower premiums and higher deductibles than other options and an out-of-pocket maximum to cover catastrophic incidences.

- ***Indemnity Plan:*** Each individual family member must meet a deductible before the carrier pays for claims. After the deductible, the member is responsible for coinsurance up to a specific annual out-of-pocket maximum. It provides freedom of choice of providers for participants.

The study showed that multiple plan types are available in many states. PPOs are the most frequent plan type and are typically the prominent offering of large states, as is the case in Maryland. More common among small-sized states were the HDHPs, due to the lower employer cost attractive to smaller employers.

In terms of premium subsidies provided by the public employer, the study indicates that PPO premiums are subsidized by the employer at 80% or higher in over half of the state plans, as is true in Maryland. **Exhibit 2.2** further shows that employers offering HMOs and HDHPs provide higher premium subsidies than those with PPOs, but this is generally the case because the employer's claim cost liability is reduced. Indemnity plans see the least employer support due to their higher claim costs as a result of the lack of network negotiated rates. While this information applies to employee-only coverage, the study documents that subsidy amounts generally decline when the premiums for family coverage are included.

Exhibit 2.2

Percentage of State Plans Offering Various Subsidy Levels for Employee-only Coverage, by Type

Subsidy	PPO	HMO	HDHP	Indemnity
100%	14%	5%	24%	20%
81-99%	40%	62%	48%	10%
61-80%	31%	18%	24%	40%
41-60%	14%	14%	5%	30%
<40%	1%	1%	0%	0%

HDHP: High Deductible Health Plan
HMO: Health Maintenance Organization
PPO: Preferred Provider Organization

Source: Segal

Because of the variations of premium valuations explained above, another study was employed to further orient Maryland's offerings in the national environment. From 2006-2008, the National Conference of State Legislatures compared family coverage using the "standard benefit package," typically the lowest cost HMO available. Of 47 states surveyed, the average state subsidy was 81%, or $880 of $1,075 total monthly premium cost. Maryland, whose subsidy was 85% for the lowest cost plan, paid more of the premium than 28 states. Also, 6 states pay 100% of the premium.

In terms of prescription plans, the Segal study shows that most common generic copays are in the $10 to $19 range, so Maryland's $5 generic copay is below average. Formulary brand name scripts are also in this range, as is Maryland's $15 charge. A majority of state plans require a $21 to $40 copay for nonformulary brand name drugs, so Maryland's $25 copay is again average. Yet, 40% of plans charge more than $40 for this high-cost benefit. This information is pertinent because brand name (both formulary and nonformulary) medication accounted for 36% of total prescriptions in Maryland but over 82% of total costs in fiscal 2010.

The copay levels do not reflect two facets of Maryland's plan that are uncommon and increase the State's cost of providing this benefit: the $700 out-of-pocket prescription maximum and the usage of 45-day drug supplies. As mentioned above, once an individual or family has paid $700 in prescription copays during a single plan year, the cost of all subsequent copays is assumed by the State. While 11 states have an out-of-pocket limit, these are typically tied to high deductible plan limits, not on top of existing coverage as in Maryland. This maximum increases plan costs by $8 million annually when compared to having no maximum at all. Moreover, Maryland's prescriptions are filled with a 45-day supply for a single copayment, instead of the industry standard 30-34 day supply. Only 2 other states, Arkansas and Maine, offer supplies higher than the standard. This practice increases State costs by $7 million annually.

National Comparative Studies Factors for Retiree Health Benefits

With reference to the retiree portion of the plan, the commission also reviewed the Center for State & Local Government Excellence's 2008 study *Retiree Health Plans: A National Assessment.* The analysis showed that 24 states allow any retiree that receives a pension benefit to participate in their health insurance systems. Alternatively, the other 26 states have additional requirements such as a minimum number of years of service (*e.g.*, 20 years of service) greater than the pension system's vesting requirement, previous enrollment in the plan as an active employee, or direct retirement from service.

All states provide dependent coverage for retirees, but this is often limited to those enrolled as such during the employee's active service. When the retiree reaches age 65 and becomes eligible for Medicare, 45 states require enrollment in the federal program. The state coverage typically becomes secondary in this case, which is often a separate retiree-only plan with a distinct premium. Only Nebraska ceases all coverage upon Medicare eligibility.

In terms of employer subsidization of health insurance premiums for retired enrollees, the commission discussed the fact that providing coverage in a plan linked to the active employees, even if no premium contribution is made, is a sizeable benefit, often termed the implicit subsidy. This is true because the premium is adjusted to track the average cost per enrollee in the plan, rather than separating the average cost of active employees versus retirees, but the cost of health insurance typically rises with age. Thus, retirees participating in an enrollment pool that includes active workers benefit from a lower premium than they would have paid if the plan covered only retirees, although this situation increases the cost to active employees.

In addition to the base benefit of pooled membership, the study showed that 22 states have a subsidy system under which the state and the retiree each pay a part of the premium for health coverage. This sharing can be accomplished through various mechanisms such as a sliding scale with increasing state contributions for each additional year of credited service (which can be capped at a certain percentage subsidy), a flat dollar amount, or flat rates.

Fourteen states paid the entire premium for at least some portion of the retiree population, with 6 of these paying the entire amount in all cases. The remaining 14 states did not contribute to the premium for retired workers, so the retiree paid the entire cost of the premium.

Actuary's Case Comparisons for Employee and Retiree Health Benefits

GRS serves as the actuary to the State of Maryland for its health benefit program. Through its monitoring of the State's program and because of the variability of plans and subsidies discussed above, GRS advised that plan efficiency is an effective cost measure. Plan efficiency is the dollar value of covered charges under the health plan paid by the employer as a percentage of the total dollar value of paid claims. This measure reflects how members that make frequent and costly use of the health plan receive a greater dollar benefit than those strictly paying the premium.

Using its warehouse of health insurance plan data from numerous peer states, GRS calculated that the typical plan efficiency figure for a large public plan is 83%. This means that after receiving and applying the employee/retiree premium contribution, copays, and out-of-pocket payments, the state plans typically contribute 83% of the actual amount paid for the claim. By way of comparison, Maryland's efficiency is 95% for its medical plans for active employees, or more than 10% above its peer states.

GRS then presented several comparative case studies which showed how peer states were trying to reduce their program costs in light of budget difficulties and increasingly costly health offerings. This information indicated that the comparison to Maryland under review is dynamic, and the value of the State's program, if unchanged, would be increasingly more generous than what is offered by similar public employers.

Summary of Maryland's Program Compared to Other States

In sum, the combination of benefits provided by Maryland results in a cost-sharing structure whereby the State pays a greater share of claims costs than the average state of a similar size. This is particularly true given its comparative standing, as described by staff and departmental analysis.

- Plan type variety and employee/retiree coverage is consistent with national offerings.

- The combination of all plan characteristics shown in plan efficiency indicates Maryland pays a greater portion of benefits than its peers.

- premium subsidy levels are slightly above average;
- prescription out-of-pocket maximum and 45-day supply are uncommon benefits; and
- retiree premium subsidy is above average due to low requirements to receive benefit and the rapid scaling to the maximum employer subsidy.

State's Legal Obligation to Provide Health Benefits

To the extent that changes to the level of benefit coverage or subsidy is subject to the collective bargaining process between the Administration and State employees, these issues are required to be submitted to that process. However, in the event that the Administration and State employees reach an impasse with regard to collectively bargaining these issues, the Governor may still include changes through the annual budget process. Accordingly, the Governor and the DBM Secretary enjoy relatively unfettered discretion to set health care benefit levels. Moreover, the General Assembly may implement changes to health care benefit levels through budget amendments. Specific changes to eligibility for State health care benefits would require legislative action by the General Assembly inasmuch as the provisions currently governing eligibility for these benefits are codified under Title 2, Subtitle 5 of the State Personnel and Pensions Article.

Approaches to Aligning Health Benefits with Peer States

Based on the information presented, the commission requested actuarial analyses that would model potential changes to the program to align Maryland's health benefit with that offered by peer states. The initial analyses assumed one of two extremes based on the nature of health insurance cost structures: either all of the savings to the State being generated by adjustments to coverage factors, principally the premium subsidy; or all savings would be generated by adjustments to plan design components, such as copayments and coinsurance charges.

Cost Realignment Approaches

The results showed that a 10% reduction to State expenditures would generate a total annual savings of approximately $100 million. The coverage adjustment approach primarily focused on coverage factors would affect all enrollees equally, regardless of usage levels, while the plan design focused model was more expensive to those who use medical services more and showed potential to alter enrollee behavior. The average annual increased cost to enrollees using either approach was between $1,000 and $1,250, but the range of possible impacts was greater for the plan design approach given its emphasis on usage charges.

Seeing the initial results, the commission requested approaches that combined elements of the two methods. A combination was deemed appropriate because although the coverage model spreads the costs across all users, making its effects more equally distributed, it simply shifts costs. On the other hand, the plan design model does impact frequent users of services more than others but has the potential to reduce long-term liabilities by altering behavior through cost disincentives to the unnecessary usage of medical services. A combination of the two would achieve both goals of immediate savings to the State and long-term liability reductions, while tempering the cost increases to certain users.

Along these lines, the commission indicated that the analyses should chart the impact of any adjustments on employees by salary cohort, with emphasis on those earning less than $40,000 annually. Three approaches were consequently developed for illustrative purposes, to show both the desired savings for the State and to allow for an estimate of the additional expenditures that would be borne by enrollees under each approach. **Exhibits 2.3, 2.4**, and **2.5** detail the coverage approach, the dependent and coinsurance approach, and the plan design approach, respectively .

Exhibit 2.3

Coverage Approach

Action	% Savings to Program	$ Annual Impact on Average Enrollee
State subsidy reduced to 75% for all plans	**4.5%**	$522
Institute an in-network deductible of $250/$500	**2.4%**	273
Out-of-network deductible to $500/$1,000	**0.5%**	59
Rx copays to $10/$25/$40	**1.8%**	211
Rx out-of-pocket max to $1,000/$1,500	**0.6%**	73
30-day Rx supply per copay	**0.2%**	26

Exhibit 2.4
Dependent and Coinsurance Approach

Action	% Savings to Program	$ Annual Impact on Average Enrollee
Coinsurance to 90% in-network/70% out-of-network with an out-of-pocket maximum to $2000/$4000	**3.9%**	$447
Spouses eligible under own employer must enroll in employer plan	**5.9%**	Varies
Office visit copays to $20/$30	**0.4%**	51
State subsidy remains as it is for all plans	**0.0%**	0

Exhibit 2.5
Plan Design Approach

Action	% Savings to Program	$ Annual Impact on Average Enrollee
State subsidy reduced to 75% for preferred provider organization only	**1.9%**	$522
Maximum State subsidy for all retiree plans to 75% for retiree & 50% for dependents	**1.8%**	273
Coinsurance to 90% in-network/70% out-of-network with an out-of-pocket maximum to $2,000/$4,000	**3.9%**	447
Office visit copays to $20/$30	**0.4%**	51
Mandatory mail order for maintenance medications	**1.0%**	n/a
Emergency room copays to $100/$100	**0.4%**	51

Utilization Cross-referenced with Income

While the tables above show the average impact to enrollees under each scenario, which remained in the $1,000 to $1,250 annual cost-increase range, the commission reviewed this data in the context of employee salaries and utilization. Staff reported that there are approximately 12,250 employees in the State Personnel Management System (SPMS) who earn less than $40,000 annually. Of these individuals the average salary for fiscal 2010 was just over $34,000. Across all salary ranges, the average SPMS employee salary is $48,500.

These figures were then cross-referenced with information provided by GRS on the utilization of health insurance services by State employees and retirees. GRS identified high, medium, and low utilization categories based on actual Maryland program experience. Under these categories, just over 10,000 employees in the entire State workforce, which includes SPMS, higher education, and transportation employees, earn a salary below $40,000 and qualify as either high or medium health care users, representing 14.6% of all employees.

The same groupings were discussed for retirees. Nearly 76% of retirees receive an annual benefit payment of less than $40,000 and are high or medium health care users. However, the income contemplated was solely the State pension benefit to the enrollee while other probable earning components, such as Social Security, personal savings, and other family income, were not available, and hence excluded. Therefore, such means-testing for retirees does not hold the same significance as it does for active employees.

With the utilization and salary categories established, the final piece of actuarial analysis showed the average annual dollar cost to the user and the estimated increase associated with each of the three cost realignment approaches. The figures were generated by GRS for a single (unmarried) enrollee, as shown in **Exhibit 2.6**, and for a typical family (one with a spouse and dependents) enrollee, as shown in **Exhibit 2.7**.

Exhibit 2.6
Single Enrollee

Utilization		Coverage	Dependent & Coinsurance	Plan Design
High	Total Estimated Enrollee Out-of-pocket Cost	$3,176	$4,307	$4,626
	Estimated Increase from Current Costs	949	2,080	2,399
Medium	Total Estimated Enrollee Out-of-pocket Cost	2,396	2,492	2,851
	Estimated Increase from Current Costs	719	815	1,174
Low	Total Estimated Enrollee Out-of-pocket Cost	2,056	1,662	2,151
	Estimated Increase from Current Costs	399	5	494

Exhibit 2.7
Family Enrollee

Utilization		Coverage	Dependent & Coinsurance	Plan Design
High	Total Estimated Enrollee Out-of-pocket Cost	$5,724	$6,345	$7,174
	Estimated Increase from Current Costs	1,459	2,080	2,909
Medium	Total Estimated Enrollee Out-of-pocket Cost	4,944	4,530	5,399
	Estimated Increase from Current Costs	1,229	815	1,684
Low	Total Estimated Enrollee Out-of-pocket Cost	4,604	3,700	4,699
	Estimated Increase from Current Costs	909	5	1,004

The commission focused on the medium utilization level, where most employees earning $40,000 or less are found. A single employee with no dependents in this category would likely pay, on the high end, about $1,174 per year more than is presently the case. Given that the average salary in the Executive Branch for positions with a salary of $40,000 or below is $34,000, the changes would represent approximately 3.5% of salary if all of the health services modeled at the medium utilization level were required. Under the same analysis, but with a family employee in the medium utilization category, the enrollee would experience an increase of $1,684, or about 5.0% of salary.

Notably, the average high utilization user would see cost increases of up to $2,399 for a single member and $2,909 for one with a family. However, the commission requested that various out-of-pocket maximums be included to limit the cost exposure to employees with significant medical needs. Moreover, once the adjustments to the coverage and plan design components were made, the State would still be paying for 85% of all covered health charges.

Commission Recommendations on Health Insurance Program

Upon discussion of the above data, the commission recommends that the State adopt a goal of reducing State expenditures on employee and retiree health benefits by 10% to bring them in line with those of peer states.

The commission further recommends that this goal be accomplished through a combination of reductions to State premium subsidies for employees and retirees and plan design changes that reduce the State share of covered charges for medical services and/or prescription drugs purchased by State employees and retirees. Such a blended approach spreads the expenditure across a wide base of users by including coverage components so that no single usage group is disproportionately affected but contains plan design changes that have the potential to alter behavior of enrollees that may reduce total program expenditures over the long-term and enhance the sustainability of the program. A more detailed recommendation was deemed unfeasible, given the Administration's duty to submit potential changes to the collective bargaining process with representatives of State employees.

Given the continually evolving nature of public employer health benefit offerings, DBM should monitor the structure of the State health plan on an ongoing basis to ensure that the State's share of covered charges retains equivalency with that of other states. Testimony from the health benefits actuary and DBM indicated that the factors used for guidance are continually in flux and, in fact, other public employers are presently reducing the generosity of their health benefits. Therefore, any current action to align State costs to its peers should be seen as the first step in a continuing process. Importantly, further study should be undertaken to determine how any changes to the health program could impact the total compensation package that is adequate to recruit and retain a high-quality workforce.

Finally, special consideration in designing all changes should be given to their financial effects on low-income employees and retirees. Efforts should be taken to minimize those effects, such as the use of limitations on out-of-pocket expenditures.

Chapter 3. Retiree Health Insurance

The commission examined the State's unfunded liability with respect to Other Post Employment Benefits (OPEB), which stem from the State's provision of subsidized health care to retired State employees. In particular, it focused its attention on the following issues:

- the implications of new OPEB accounting standards issued by the Governmental Accounting Standards Board (GASB) in 2004;
- the calculation of the State's unfunded OPEB liabilities and net OPEB obligation;
- eligibility requirements for retiree participation in the State's health program;
- the State's legal obligation to provide and maintain retiree health coverage; and
- the relationship between the State's retiree health coverage and Medicare, including the implications of the establishment of Medicare Part D in 2003.

This section summarizes the commission's findings in each of these areas and concludes with recommendations for addressing the State's OPEB liability.

Overview and Background of OPEB Liabilities

In 2004, GASB issued new standards that require State and municipal governments to recognize OPEB liabilities on their balance sheets as they accrue rather than on a pay-as-you-go (PAYGO) basis. In effect, the new standards require public employers to account for OPEB benefits (typically health insurance coverage for retirees) in a manner very similar to the way that they treat pension benefits. The standards required Maryland to conduct an actuarial valuation of its OPEB liabilities at least every two years and to reflect any unfunded portion of those liabilities on its annual balance sheet beginning in fiscal 2008.

GASB does not have the authority or means to enforce its standards, but state compliance with the standards is considered by the bond rating agencies, and it has long been Maryland State policy to follow GASB standards. All three major rating agencies have indicated that they will examine states' compliance with the GASB standards during their reviews. However, they have all acknowledged that they will give states several years to devise a strategy to comply with the new standards before there are any rating implications. Moreover, they acknowledge that OPEB liabilities, even more than pension liabilities, are considered "soft" debt and will be treated differently than bonded debt.

Retired State employees' eligibility for State-subsidized health benefits is addressed in the previous chapter and, therefore, is not repeated here.

Funding OPEB Liabilities

Like almost all states, Maryland previously accounted for and funded its retiree health benefits on a PAYGO basis. Current PAYGO costs, based on medical claims data, are estimated by the actuary to be $379 million. In 2006, largely in response to the looming GASB requirement, the State conducted its first actuarial valuation of its OPEB liability and has conducted OPEB valuations each year since then. The 2010 valuation of the State's OPEB liabilities put the unfunded liabilities at $15.9 billion, with an annual required contribution (ARC) of $1.2 billion. The ARC represents the sum of the 30-year amortization payment of the accrued liabilities and the normal cost, or the liabilities accrued by active employees in the current year. If the State funds the ARC by paying the full amount into an irrevocable trust for the purpose of paying future retiree health care costs, it will have no net OPEB obligation under the GASB standards. Any portion of the ARC that is not funded on an annual basis appears as a liability on the State's balance sheet and accrues interest.

If the State fully funds the ARC, GASB allows it to use a higher discount rate in projecting its liabilities. The unfunded discount rate used by the actuary is 4.25%; the full funding discount rate is the same rate used by the State pension fund, or 7.75%. Under the full-funding scenario, the State's OPEB liabilities drop to $9.2 billion, with an ARC of $809 million.

In an effort to begin prefunding its OPEB liabilities, the State set aside funds in fiscal 2007, 2008, and 2009. The fiscal 2007 budget set aside $100.0 million into the Dedicated Purpose Account, which was later transferred to the OPEB trust fund once it obtained the necessary IRS clearance as an irrevocable trust. The fiscal 2008 budget as enacted also set aside $100.0 million in general funds in the Dedicated Purpose Account toward prefunding the State's liabilities. During the 2008 legislative session, however, the General Assembly cut that figure in half. The Governor's fiscal 2009 allowance included a $210.0 million contribution, all funds, to the OPEB trust fund. As enacted, the fiscal 2009 budget contained half that amount. In October 2009, the Board of Public Works cancelled the remaining $46.0 million that had yet to be paid into the trust fund as a cost containment measure. The State made no additional contributions to the trust fund in fiscal 2010 or 2011. As of September 2010, the OPEB trust fund held $186.9 million, which represents approximately 1.2% of the State's total OPEB liability.

The net OPEB obligation (NOO) is the specific calculation that GASB requires be reported in the State's annual financial reports as a measure of the State's unfunded obligation. The NOO represents the accumulation of previous ARCs and the annual interest charged on the NOO at the end of each year, net of State contributions to the trust fund, including PAYGO costs. **Exhibit 3.1** details the calculation of the NOO for fiscal 2007 through 2009. As the exhibit shows, Maryland's NOO continues to expand virtually unabated as the liability and ARCs continue to grow and the State is no longer setting aside any assets beyond its PAYGO costs to cover its obligations. In the absence of additional funding, the State's future obligation will continue to grow, and the cost of providing retirees with health benefits will be passed on to future generations. This situation greatly increases the total ultimate cost, since there are only liabilities and no accumulated assets compounding over time.

Exhibit 3.1

Maryland's Net OPEB Obligation

	FY 2007	FY 2008	FY 2009
Beginning NOO	**$0**	**$695,921**	**$1,478,602**
Total Annual Cost	**$1,086,240**	**$1,148,597**	**$1,190,780**
ARC	1,086,240	1,118,672	1,127,220
Interest on NOO	0	29,925	63,560
Total Contributions	**$390,319**	**$366,388**	**$360,308**
PAYGO Costs	271,435	315,257	360,308
Prefunding	118,884	51,131	0
Net OPEB Obligation	**$695,921**	**$1,478,602**	**$2,308,602**

ARC: annual required contribution
NOO: net OPEB obligation
OPEB: Other Post Employment Benefits
PAYGO: pay-as-you-go

Source: Gabriel Roeder Smith & Company

Legal Status of Retiree Health Benefits

The commission received a briefing by the Attorney General's Office regarding the State's legal obligation to provide retiree health benefits to its retired State employees. In accordance with Title 2, Subtitle 5 of the State Personnel and Pensions Article, the Secretary of Budget and Management is required to administer the State Employee and Retiree Health and Welfare Benefits Program for all State employees and retired State employees. In addition, the Secretary is required to provide a prescription drug program for these individuals. The program for both State employees and retired State employees is funded through the annual budget process.

Unless limited by the federal constitution, the General Assembly may amend the Secretary's statutory obligation to administer the program. A limitation under the federal constitution would occur if the proposed change would constitute a law that would impair the obligation of contracts for State employees or retired State employees. However, according to the Attorney General's analysis, the provisions of the State Personnel and Pensions Article that govern the program do not create a contractual right since no explicit promise of a particular level of benefits or subsidy to State employees or retired State employees is included in these provisions. Moreover, the governing provisions of the program do not provide clear or express language that says a State employee vests for retiree health care benefits. Finally, Maryland courts have not held that State health benefits authorized by statute are a contractual right. Consequently, there is no contractual right to State health benefits that would be impaired if the General Assembly were to amend the State Personnel and Pensions Article to specifically alter eligibility criteria, benefit levels, or subsidy amounts for State employees or retired State employees.

Blue Ribbon Commission

Chapter 433 of 2006 established the Blue Ribbon Commission to Study Retiree Health Care Funding Options. The membership of the commission includes legislators, elected officials and appointees of the Executive Branch, and members of the public with expertise in either funding retiree health benefits, the economics of affordable retiree health care programs, or investing pension fund assets. The commission contracted with an actuarial consulting firm that has conducted three annual actuarial valuations of the State's retiree health care liabilities and has provided ongoing services to the commission throughout its existence.

The full commission met twice during the 2007 interim and once during the 2008 interim to hear presentations by the commission's actuary, the Department of Legislative Services, and various experts in the area of retiree health care. In December 2008, the commission issued its interim report summarizing its work to that point. The commission has not resumed meeting since that time.

Retiree Health Benefits and Medicare

Retired State employees who reach age 65 are required to enroll in Medicare as their primary insurer, and the State health plan provides secondary coverage to Medicare. Because Medicare did not provide prescription drug coverage prior to 2003, retirees have been allowed to participate in the State's prescription drug plan even after enrolling in Medicare.

The Medicare Modernization Act of 2003 established Part D, which provides a prescription drug benefit for Medicare participants. To dissuade employers that already provide prescription drug benefits to their retirees from terminating those benefits, Medicare provides a subsidy to employers that offer an actuarially equivalent benefit to that provided by Part D. Maryland, like the vast majority of employers, accepts the subsidy in exchange for maintaining its prescription drug benefit for Medicare eligible retirees. The subsidy has consistently provided about $20 million to the State annually since its inception. State law requires that the Part D subsidy be deposited in the OPEB trust fund, but for fiscal 2010-2012, legislation redirected those funds to support the State's employee and retiree health program.

Under GASB rules, however, employers cannot apply the Part D subsidy payments as a credit against the retiree health liabilities they must calculate under GASB 45. If GASB allowed employers to reflect these payments in calculating their actuarial liabilities, the State's liabilities would decrease by approximately $1.5 billion. Under GASB guidelines, the State can apply the Part D subsidy as a credit against its liabilities if it opts for one of two alternative benefit designs. The first, known as the Employer Group Waiver Plan (EGWP), allows the employer to apply to become a qualified insurer of its prescription drug benefit. The State would continue to receive Part D subsidies, which would be reflected in its GASB 45 valuation of retiree health liabilities. The second option would be to contract with a drug benefit manager to create an EGWP. The private contractor would collect the subsidy from Medicare and pass it on to the State in the form of reduced premiums. Once again, federal subsidies collected in this manner would be reflected in GASB 45 valuations in the form of reduced liabilities.

Part D provides a standard benefit administered directly by Medicare but also allows private pharmacy benefit managers to offer alternative plans to Medicare participants. The standard plan has the following characteristics:

- annual premium of $388;
- deductible of $310;
- 25% coinsurance for prescription drugs, up to $2,840 in out-of-pocket (OOP) expenses (subject to annual adjustments for inflation);
- a coverage gap in which no reimbursement is provided for drugs purchased between $2,840 and $4,550 in OOP expenses (also subject to adjustment); and
- 5% coinsurance for "catastrophic coverage" above $4,550 in OOP expenses.

The Patient Protection and Affordable Care Act of 2010 phases out the coverage gap (also called the "doughnut hole") over the next 10 years, thereby extending the 25% coinsurance for all drugs purchased up to the level for catastrophic coverage. In addition, most major manufacturers of pharmaceutical drugs have agreed to provide 50% price rebates for name brand drugs purchased in the coverage gap until the gap is completely closed, so Part D participants will realize immediate OOP reductions.

Commission Recommendations

For three main reasons, the commission believes that the State must begin taking steps immediately to address its sizable and growing liability for retiree health benefits. First, the commission believes that maintaining a viable and meaningful retiree health benefit is critical to ensuring that State employees who have devoted their lives to public service enjoy a secure retirement. Given that the State's wages and salaries tend to be below those offered for comparable jobs in the private sector, the commission believes that maintaining the State's retiree health benefit is an important recruitment and retention tool for the State. Providing long-term employees with access to the group plan and a significant employer subsidy is unquestionably an attractive benefit that contributes to a stable State workforce. Second, failure to fund these benefits will push their costs to future generations of taxpayers. This intergenerational transfer of liabilities is not acceptable and could threaten the sustainability of the benefit because future taxpayers may not be willing to pay for liabilities accrued before their time. Third, failure to act may endanger the State's AAA bond rating, resulting in higher costs to borrow money for important infrastructure projects and other State needs.

Therefore, the commission recommends that the State establish a goal of reducing its unfunded actuarial liability for Other Post Employment Benefits by 50%, and also commit to fully funding its annual required contribution within 10 years. The changes to the employee and retiree health plan outlined in the previous chapter are an important component of the overall strategy to achieve both of these goals, but additional steps are required. Therefore, the commission recommends that the State change the eligibility criteria for State employees to qualify for retiree health benefits in the ways described below. These changes are designed to provide this valuable retirement benefit only to those employees who have dedicated at least the majority of their professional careers to State service, and to specifically reward those employees who spend their entire careers with the State.

The commission believes that the steps outlined below will make the retiree health benefit sustainable for years to come but also recognizes that if current and future national health care reform efforts do not restrict the growth of medical care and prescription drug costs, the State's retiree health liability may continue to grow at a rate beyond its ability to sustain the benefit. Therefore, the commission recommends that the Department of Budget and Management (DBM) develop a contingency plan for further restricting the scope of the retiree health benefit, including potentially restricting access to those benefits only to Medicare-eligible retirees, if liabilities continue to grow at a rate that is not sustainable. DBM should report the details of its contingency plan to the General Assembly.

Specifically, the commission recommends that the State enact in statute the following changes to the eligibility criteria for retiree health benefits:

- **Employees with less than 15 years of service credit as of June 30, 2010, should be required to earn 15 years of service credit with the State, up from 5, to qualify for participation in the State health plan as retirees.**

- **Employees with less than 15 years of service credit as of June 30, 2010, should be required to earn 25 years of service credit with the State, up from 16, to qualify for the maximum premium subsidy provided to retirees, with the subsidy prorated for those with between 15 and 25 years of service credit.**

- **Employees should be required to retire directly from State service to qualify for retiree health benefits from the State; former employees who were eligible for retiree health benefits at the time they separated from State service should still be eligible to receive retiree health benefits from the State when they reach normal retirement age.**

- **During the 2011 interim, the General Assembly should review the current provisions under Title 37 of the State Personnel and Pensions Article that govern transfers of service credit between any State or local retirement or pension system, and how those rules affect eligibility for both retiree health benefits and pension benefits for employees who transfer between State and local government service.**

Last, the commission recommends that the State establish in statute a requirement that, by the year 2020, all Medicare-eligible State retirees must join Medicare Part D for prescription drug coverage, just as they are currently required to join Medicare for medical benefits. Consequently, they would no longer be eligible to participate in the State prescription drug plan. This recommendation is largely based on the assumption that, under the federal Patient Protection and Affordable Care Act of 2010, the Part D coverage gap will be eliminated by 2020. To the extent that the coverage gap is not eliminated, the commission recommends that DBM devise a contingency plan to provide supplemental pharmaceutical drug benefits through an Employer Group Waiver Plan or other similar mechanism. This approach would allow the State to continue receiving the Part D subsidy and also to begin crediting the subsidy against its liabilities. Conversely, to the extent that retiree OOP expenses under Part D are reduced through mechanisms such as pharmaceutical manufacturer rebates, the State may explore requiring Part D participation at an earlier date, either with or without supplemental coverage from the State.

Financial Effects of the Commission's Recommendations

The commission's recommendations with regard to eligibility for retiree health benefits will have no immediate fiscal effect on State finances because the State is not prefunding those benefits at the current time. However, as **Exhibit 3.2** shows, they are designed to bring full funding within reach, enabling the State to meet its future obligations and curtail the growth of the NOO.

Exhibit 3.2

Effect of Proposed Changes on the State's OPEB Liability

($ in Thousands)

	Unfunded Liabilities (1)	ARC (2)	Exp. FY 2011 Benefit Payments (3)
Baseline Valuation Results	**$15,915,214**	**$1,225,206**	**$379,237**
a. Implement plan design changes	-1,301,440	-106,779	-351
b. Raise Necessary Eligibility Years of Service from 5 to 15	-255,008	-43,407	-1,487
c. Maximum Subsidy at 25 Years; Prorate if Less	-302,891	-40,107	-287
d. Eliminate Eligibility through Deferred Retirement	-385,291	-36,229	-2,964
e. Shift All Medicare-eligible Retirees to Medicare Part D in 2020	-5,503,519	-420,894	0
Valuation Results after Implementing A-E	**$8,167,065**	**$577,790**	**$374,148**

Source: Gabriel Roeder Smith & Company

As the exhibit shows, implementing the plan design changes recommended in the previous chapter significantly reduces the State's OPEB liability but does not accomplish the commission's goals of reducing the liability by 50%. However, changing the retiree health eligibility criteria in the manner recommended in this chapter together with the plan design changes does accomplish the commission's goal. Total unfunded liabilities are reduced from $15.9 billion to $8.2 billion. Also, the gap between current PAYGO expenses and the ARC is reduced from almost $850 million to about $200 million. This puts the ARC within reach of full funding. As the State's fiscal condition improves in the coming years, it can begin phasing in additional contributions to the OPEB trust fund until it reaches the ARC in 10 years.

Chapter 4. Pensions

To restore the State Retirement and Pension System (SRPS) to fiscal health, the commission recommends a series of changes to its benefit structure and funding methodology. For many reasons, the system's fiscal health has gradually deteriorated over the past decade. Beginning in fiscal 2000, the system's actuarial liabilities consistently grew faster on an annual basis than its actuarial value of assets, resulting in its unfunded liabilities increasing each year to the present. As a result, the system's actuarial funded status, which reached 100.0% in fiscal 2000, has dropped to 64.1% as of June 2010. This has prompted the growth rate for State pension contributions to far outpace its revenues. From fiscal 2002 to 2011, for instance, the annual State cost of teacher pensions grew 159.0%, while general fund revenues grew just 39.0%. Current projections predict that annual State general fund expenditures on pensions for both State employees and teachers will grow at twice the annual rate of general fund revenues between fiscal 2012 and 2015. While general fund revenues are expected to grow 4.9% annually during that time, pension costs are projected to grow 9.9% annually. These trends make the current structure of State pension benefits unsustainable.

Overview of the State Retirement and Pension System

SRPS currently serves more than 320,000 individuals, including almost 175,000 active members and approximately 148,000 retirees, beneficiaries, and vested former members. The vast majority of current active members are either in the Employees' Pension System (EPS) for regular State employees or the Teachers' Pension System (TPS), but smaller plans also serve, separately, State Police officers, correctional officers, other State law enforcement officers, judges, and legislators. **Appendix 5** details the membership in the various plans and other related demographic information. In addition, county and municipal governments are eligible to participate in the system, but they pay the full employer cost of benefits for their participating employees. There are currently about 120 participating local governmental units, representing an additional 46,000 active and retired members.

Total State expenditures for employee and teacher pensions is projected to be $1.54 billion in fiscal 2012, of which $975.6 million is projected to be for teachers, community college faculty, and librarians employed by local governments. Of the total figure, about 84% is projected to be paid from State general funds, with the remainder evenly divided between special and federal funds. As noted above, State pension contributions have grown at an accelerated pace over the past decade. As recently as fiscal 2006, the State contribution was approximately $652.4 million, less than half the current payment.

State Pension Benefits

For most State employees and teachers, membership in the appropriate State pension plan is a condition of employment. The plans provide a defined benefit at retirement, which is based on the member's average final compensation (AFC), years of service, and a benefit multiplier established in statute. The multiplier represents the percentage of AFC that is paid in an annuity for each year of service accrued. For a member with an AFC of $50,000 at the time of retirement, for instance, a benefit multiplier of 1.8%, means that the retiree receives an annual payment of $900 (0.018 x $50,000) for each year of active service. All State plans are contributory, meaning that members contribute a portion of their compensation to their benefit. The plans include disability and death benefits as well as optional survivor benefits. **Appendix 6** summarizes the benefits and other characteristics of each plan.

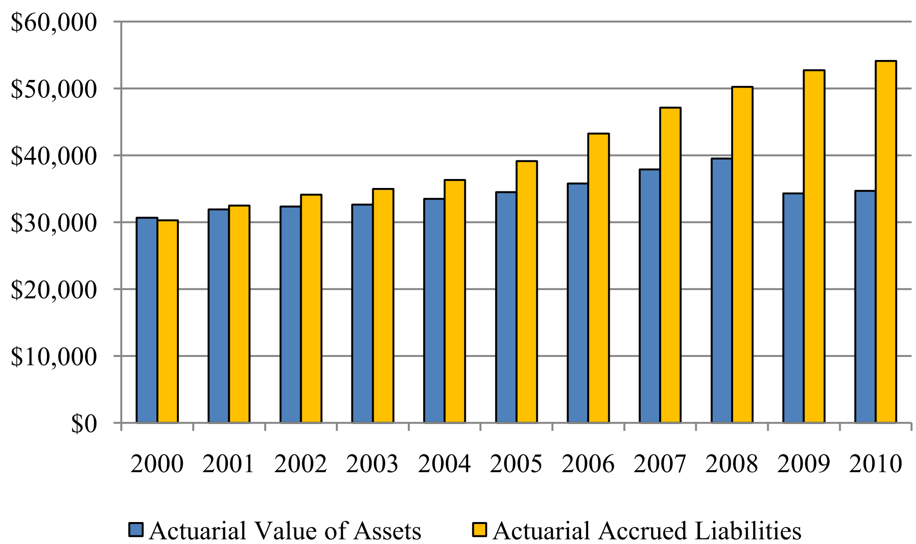
University and community college faculty and designated higher education staff may opt out of their respective State plans and instead participate in the Optional Retirement Program (ORP). ORP is a defined contribution plan that provides a 7.25% employer contribution into individual retirement savings accounts. Unlike the SRPS plans, the accounts are completely portable. Also, all State employees may participate in the Maryland Supplemental Retirement Plans, which are optional tax-deferred savings plans. Regular State employees are eligible for a maximum $600 employer match if they participate, but the match has been suspended for five of the last eight years for budgetary reasons.

Pension Funding and the Corridor Method

Pension funding is, by its nature, a long-term endeavor. Benefits accrued by a new active employee may not be paid out for 30 years or longer, and benefit payments are spread out over the entire remaining life span of the retiree. State law requires that the system be funded on an actuarial basis, which means that annual employer contributions to the pension fund must cover the cost of all employee liabilities accrued in the current year based on economic, demographic, and actuarial assumptions. To the extent that actual experience each year creates additional liabilities not anticipated by the assumptions, the resulting liabilities must be amortized and funded over 25 years.

Exhibit 4.1 shows the growing gap between the system's liabilities and assets, which is the fundamental problem underlying all of the system's funding issues. A key point to be gleaned from the exhibit is that the gap between liabilities and assets has grown every year since fiscal 2000, even during the middle portion of the decade when financial markets helped the system generate double-digit investment returns. One major reason for that persistent trend is the asset smoothing strategy used by the SRPS Board of Trustees. To mitigate against the potentially volatile fluctuations in the market value of its assets, the board smoothes asset gains and losses over five years. Therefore, market losses in 2001 and 2002 still represented a drag on the system's asset values five years later. Similarly, losses experienced in 2008 and 2009 will continue to be recognized until June 2013 and 2014, respectively. While providing a safeguard against wild fluctuations in asset values, the smoothing strategy also makes it very difficult for the system to close funding gaps once they emerge because, except in periods of sustained economic expansion, it is almost always recognizing investment losses from a prior year.

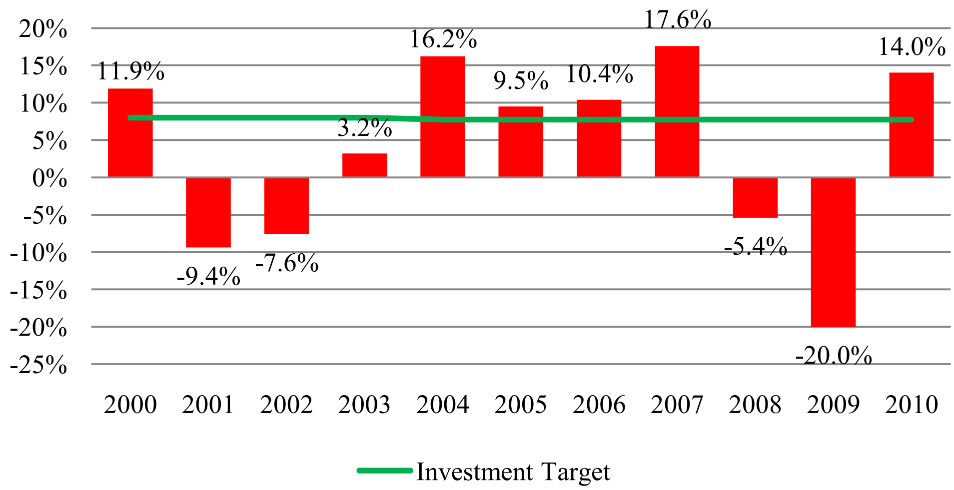
Exhibit 4.1
State Retirement and Pension System
Actuarial Assets and Liabilities
($ in Millions)



Source: State Retirement and Pension System

The commission received several briefings detailing the reasons behind the system's deteriorating fiscal condition and concludes that several factors have contributed to the negative trends described above. By far, the largest factor has been the anemic investment returns earned over the past 10 years. As **Exhibit 4.2** shows, the two recessions that bookended the decade prompted severe downturns in financial markets, which resulted in the system's average annual investment return reaching only 2.1% from fiscal 2000 to 2010, well below the system's investment return assumption of 7.75%. In accordance with the rules of actuarial funding, the gap between the system's actual investment experience and its investment return assumption created additional unfunded liabilities. Other factors that have played a role include rapid growth in payroll during the middle portion of the decade, the enactment of a retroactive pension benefit enhancement for EPS and TPS members in 2006, rising life expectancy rates for retirees, and the corridor funding method adopted during the 2002 legislative session.

Exhibit 4.2
State Retirement and Pension System
Annual Investment Returns
Fiscal 2000-2010



Source: State Retirement and Pension System

During the 2002 session, the fiscal 2003 budget as introduced by the Governor included \$65 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 million. In addition to this budgetary shortfall, during the 2002 session, the General Assembly was also confronted with diminished revenue projections due to the effects of a recession that had begun in March 2001. In that context, during the 2002 session, the State's actuary developed a new pension contribution methodology that was considered actuarially sound at the time but that currently does not conform to generally accepted accounting practices.

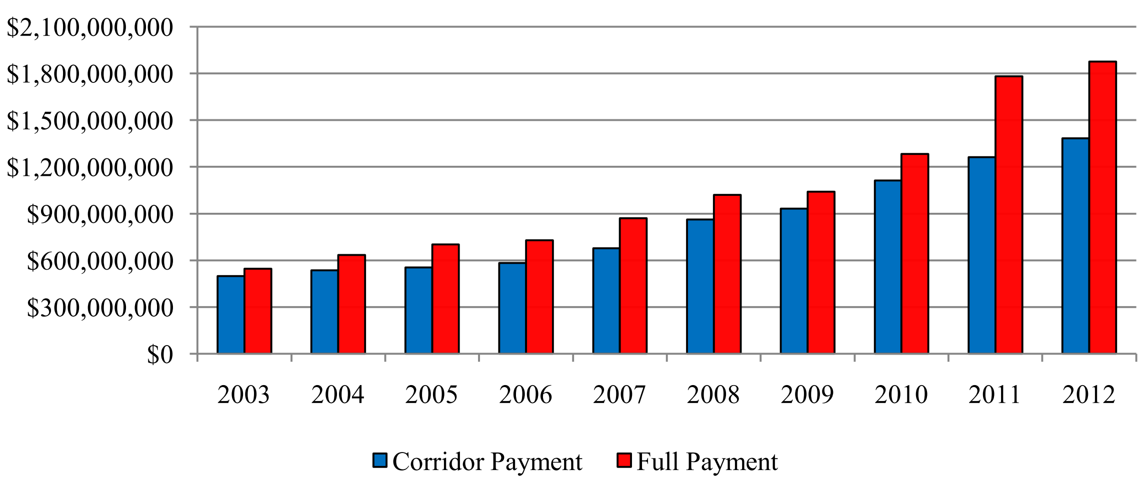
As a result, rather than adopting the Governor's proposed approach, the General Assembly passed legislation altering the State's actuarial full-funding methodology (Chapter 440). The methodology was changed from one in which the State's pension contribution rates vary from year to year to one in which 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 remained 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 remained 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 are not subject to the corridor method.

Under 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.

As **Exhibit 4.3** shows, the corridor method has resulted in meaningful savings to the State. These savings in employer contributions have ranged in size from a low of $46.2 million in fiscal 2003 to a high of $519.8 million in fiscal 2011. However, it is important to note that while the State accrued significant savings from the corridor method, during this same period of time the funding level of SRPS declined from 92.9% in 2003 to 83.3% in 2006, before reaching its current level of 64.1%. The commission notes that actuarial studies have shown that while the corridor funding method has indeed contributed to the system's deteriorating fiscal condition by providing less than full actuarial funding, the corridor's effect on State contribution rate increases over the past decade have been negligible, especially when compared with the effect of underperforming investment returns.

Exhibit 4.3
State Retirement and Pension System
Corridor vs. Full Actuarial Funding
Fiscal 2003-2012



Source: State Retirement and Pension System, Department of Legislative Services

Legal Protections for Pension Benefits

The commission received a briefing by the Attorney General's Office regarding the State's legal obligation to provide pension benefits to its retirees, which concluded that retirees of SRPS have a contractual right to their accrued pension benefits. This conclusion was reached based on several references throughout the Division II of the State Personnel and Pensions Article. For example, language in the governing provisions for each of the several systems provides that membership in that particular pension plan is mandatory. In addition, the governing provisions also specifically address when a member vests in that particular pension plan. Division II of the State Personnel and Pensions Article also states that the payment of allowances and other benefits is an obligation of the State and the State guarantees the payment of any retirement allowance provided under those provisions. Finally, several Maryland courts have held that the governing provisions under Division II of the State Personnel and Pensions Article create a contract between the State and its employees and teachers.

Nevertheless, although contractual, pension benefits are not unalterable. Specifically, the General Assembly may make changes to pension benefits payable to future employees. However, any legislative action that modifies the existing law governing pension benefits that have already been promised to current employees would be analyzed for purposes of determining if the change created a substantial impairment of contract for the affected individuals. To make this determination, the following factors would be considered:

- Was there an actual reliance on the abridged right or contract term by the affected individuals?
- Did the contract explicitly indicate that the abridged right or contract term was subject to an impairment?
- Was the abridged right or contract term previously subject to regulation?
- How extensive is the modification to the abridged right or contract term?
- Was the abridged right or contract term essential in nature to underlying contract?

At the briefing received by the commission, the Attorney General's Office reported that a substantial impairment of contract was found to exist when a change in pension law resulted in the retirement age retroactively increasing from age 50 to 60 and the benefit formula retroactively decreasing from 2.5 to 2.0%. Conversely, the Maryland Court of Special Appeals did not find that an impairment of contract occurred in 1984 when the General Assembly amended the State Personnel and Pensions Article to prospectively reduce the maximum amount of the cost-of-living adjustments (COLAs) for retirees but did not deny retroactively, vested rights to retirees. Notwithstanding these examples, the commission was also informed that not every instance of an impairment of contract to pension benefits would be unconstitutional.

If the Maryland courts find that a substantial impairment of contract has occurred as a result of a modification of the governing provisions for pension benefits under the State Personnel and Pension Article, the courts will consider whether the impairment was nonetheless permissible as a legitimate exercise of the State's sovereign powers. This analysis is done by considering whether the modification is reasonable and necessary to serve an important public purpose. Specifically, the Maryland Court of Special Appeals concluded that when determining whether the impairment was "reasonable" it would analyze whether the modified contractual obligation, when originally created, resulted in unforeseen and unintended consequences by the legislature. The Maryland Court of Special Appeals concluded that when determining whether the impairment was "necessary," it would consider if a less drastic modification could have been implemented. Finally, the Maryland Court of Appeals has held that the government may unilaterally modify pension benefits provided the changes do not adversely alter the benefits, or if adversely altered, are replaced with comparable benefits.

Historical Context for the Commission's Recommendations

The commission notes that this is not the first time that the State has confronted a fiscally distressed pension system, and the commission has drawn from the lessons of the State's past experience in crafting its recommendations to address the sustainability of the current pension system. Concern about the fiscal soundness of State's pension plans began to arise in the mid-1970s in response to a congressional report that expressed concern that public pension plans had promised greater benefits than they could afford to pay. Joint Resolution 27, adopted by the General Assembly in 1975, requested that the General Assembly 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, which at the time consisted of four principal retirement plans: (1) the Employees' Retirement System (ERS); (2) the Teachers' Retirement System(TRS); (3) the State Police Retirement System; and (4) the Judicial Pension Plan. The Pensions Study Commission began its work that year.

In the 1970s, the financing policy of the plans was based on two funding methodologies. Some of the benefits were financed by advance (actuarial) funding and some 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. A study conducted for the Pensions Study Commission by Winklevoss and Associates concluded that the system was only 56% funded, and that the funding mechanism in place at the time would increase the system's funding level only to 69% by 2026.

As a result of the commission's work, legislation was enacted in 1979 to close ERS and TRS, the two largest plans at the time, to new members, and replace them with two new actuarially funded plans – EPS and TPS (Chapters 23 and 24). All employees and teachers hired on or after January 1, 1980, were required to join their respective new pension systems as a condition of employment. In addition, existing ERS/TRS members were given the opportunity to transfer into the new pension systems. 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 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 COLAs based on the Consumer Price Index but changing the adjustments from unlimited compounded adjustments to simple adjustments capped at 3.0%.

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. However, this turned out not to be the case. By fiscal 1985, the State's contribution was 17.6% of the applicable payroll, up from 16.6% in fiscal 1984. 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. From fiscal 1975 through 1984, the average COLA for retirees in ERS and TRS was 9%, with four of those years reporting increases above 10%. Actuarial miscalculations and adverse experience, most notably the increased life expectancy of retirees, also contributed to the increased costs.

Consequently, in 1984, the General Assembly passed legislation that modified the benefit and contribution structure for members who had remained in ERS/TRS. Specifically, the legislation provided that active ERS/TRS members 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 COLA; or (2) to receive benefits under the old systems without limitation on the COLA, 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. 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."

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 teachers. With the implementation of these changes, the financial and actuarial condition of this system steadily improved until it reached the 100% funding level in 2000.

From this experience, the commission concludes that addressing SRPS's current financial hardship requires more than just closing the existing underfunded plans and launching a new, less generous plan structure going forward. As the experience from 1980 to 1984 shows, such an approach does not address the persistent unfunded liabilities in the closed plans, and those liabilities will continue to put a fiscal strain on the State unless they are addressed directly. However, the legal protections afforded to accrued benefits make addressing those liabilities a difficult proposition. In 1984, the State successfully addressed this issue by providing active members of ERS/TRS a choice of three options, including one that protected their accrued benefits but provided lesser benefits going forward. The courts sanctioned this approach, and in addition to proposing benefit changes for new and nonvested members, it is such an approach that the commission recommends today.

Options Considered by the Commission

Maryland is not alone in confronting pension funding challenges. By October 2010, when the commission heard a presentation by Mr. Ron Snell of the National Conference of State Legislatures, more states (19) had enacted significant pension reform legislation in 2010 than in any other year in recent history. In December 2010, Pennsylvania enacted pension reform, bringing the total to 20. In virtually all instances, the pension reforms involved reducing benefits and/or increasing member contributions for future employees and, in several cases, for current members and retirees. Changes included raising vesting and retirement eligibility requirements, reducing benefit multipliers, increasing member contributions, and capping or reducing annual COLAs. Several states adopted sweeping changes involving conversions from defined benefit to defined contribution or hybrid plans. The commission reviewed and considered many of these changes, and ultimately endorsed some of them. However, after careful consideration, the commission declined to endorse three options: converting the State's pension plans to defined contribution plans; phasing out the corridor funding method; and suspending or reducing COLAs for current retirees.

The Defined Contribution Option

The private sector has seen a marked decline in the availability of defined benefit pension plans since the mid-1970s, following the enactment of the federal Employees' Retirement Income Security Act. As the commission learned in a briefing, the percentage of private sector employees with access to a defined benefit pension plan has dropped from 38.0% in 1980 to 21.0% in 2009, while the percentage of public sector employees with access to such plans has remained steady at between 80.0 and 90.0%. Instead of defined benefit plans, private sector employers are more likely to offer defined contribution (DC) plans that provide individual retirement accounts for employees and a fixed employer contribution and/or employer match that employees may invest in a variety of investment vehicles. This trend has prompted calls from some advocates for state and local governments to also close defined benefit plans in favor of DC plans that provide employers with greater budgetary stability. A presentation by representatives of TIAA-CREF, which administers the State's ORP for university faculty advised that a DC plan requires an annual contribution rate of 10.0 to 15.0% to provide sufficient income security in retirement. With the composite State pension contribution reaching 15.67% in fiscal 2012, advocates see the opportunity to both reduce and cap future State pension contributions.

The commission considered the DC option in light of the full array of employee compensation and benefits used to recruit and retain a State workforce and ultimately rejected it for several reasons. First, most recent analyses show that, on average, public sector employees are paid less than private sector counterparts after accounting for differences in education levels, age, and gender. Therefore, to attract and retain talented employees, the public sector must make up the compensation difference by providing attractive benefit packages. The commission believes that the attractiveness of a defined benefit plan makes up for at least some of the pay gap between public and private sector employees. Second, a recent study by the National Institute on Retirement Security found that defined benefit plans can provide retirement benefits more efficiently than DC plans by taking advantage of shared risk pools and professional investment management. Last, as **Exhibit 4.4** shows, based on a comparison with full actuarial funding, conversion to a DC plan with a 10% employer contribution (the lowest level recommended by TIAA-CREF) actually increases costs to the State in the short term. The higher cost of a DC conversion could last as long as a generation until current members retire and are replaced by new members in a DC plan.

Exhibit 4.4
Defined Contribution Conversion Scenario

	Normal Cost Rate/ Annual Defined Contribution		Accrued Liability Rate		Total Contribution	
	Employees	**Teachers**	**Employees**	**Teachers**	**Employees**	**Teachers**
Current Plan*	6.47%	7.23%	13.78%	12.68%	20.25%	19.91%
Defined Contribution	10.00%	10.00%	13.78%	12.68%	23.78%	22.68%

*Contribution rates are fiscal 2012 full actuarial rates prior to the application of the corridor funding method

Source: Gabriel Roeder Smith & Company; Department of Legislative Services

The Corridor Phase-out Option

The SRPS Board of Trustees requested that the commission endorse its plan to restore the system to full actuarial funding by:

- phasing out the corridor funding method over 10 years;
- adopting a 20-year open amortization period instead of the current 25-year closed period; and
- smoothing the unrecognized losses from fiscal 2009 over 10 years instead of the 3 years remaining on the smoothing timeline.

The commission notes that the board's plan has several attractive features, but ultimately falls short of the commission's goals for the system. Based on actuarial projections, the board's plan has lower maximum contribution rates for both the employees' plan and the teachers' plan than are projected under the corridor method. For instance, under the board's plan, the maximum rate for the teachers' plan reaches 20.45% in fiscal 2015, compared with 22.65% in fiscal 2025 under the corridor method. Also, the board's plan accelerates the reduction in contribution rates once the maximum rates are reached. Under the corridor method, contribution rates for the teachers' plan remain at or above 22.0% for almost 20 years, whereas under the board's plan, they begin declining immediately after reaching their peak in fiscal 2015.

However, the board's plan has two critical shortcomings. First, it is projected to require additional State contributions totaling $603 million over the next seven years compared with corridor method contributions. In the face of a $1.6 billion budget deficit for fiscal 2012 and a persistent structural deficit in succeeding years, the commission does not believe it is feasible to require additional State pension contributions at this time. Second, the board's method does not achieve full actuarial funding for at least 40 years, which does not conform to the commission's goal (see below) of achieving full actuarial funding within 30 years.

The COLA Suspension Option

As the State learned in the 1970s and early 1980s, automatic COLAs represent a significant cost to pension systems that employ them. Some state pension plans do not employ automatic COLAs for that reason, relying on legislative initiatives to grant benefit adjustments when they are affordable. When the State established EPS and TPS, it retained automatic COLAs, initially linking them to inflation but capping them at 3% of the initial benefit (a "simple" COLA). In 1998, the State retained the 3% cap but converted it to a compound COLA instead of a simple COLA. Although the State Police Retirement System and the Correctional Officers' Retirement System still have unlimited COLAs, low inflation rates for the past 25 years have limited the cost of providing unlimited COLAs.

The commission considered several proposals to freeze, suspend, or reduce COLA payments to current retirees in an effort to reduce liabilities. Three other states adopted lower COLA caps or COLA suspensions for current retirees in 2010, and all were challenged in their respective state courts. Rulings are pending in each of those cases, but the Attorney General's Office advised that Maryland courts are not likely to sanction similar COLA suspensions or cap reductions for current retirees because they would be viewed as an impairment of the pension contract with retirees. Therefore, none of the commission's recommendations include any suspension or reduction of COLAs for current retirees.

Commission Recommendations

As noted above, the biggest challenge confronting SRPS is the persistent and unabated growth in its unfunded accrued liabilities over the past decade, resulting in a funded status of 64.1% as of June 2010 and unsustainable growth in the State's pension contributions. The funded status is well below the 80% level that is considered to be the standard for a fiscally sound public pension plan. Of greater concern, the system's funded status is projected to continue to deteriorate for several more years before it begins to recover, and even then is projected to reach only 68.9% under the corridor method by fiscal 2020. Moreover, even that limited recovery will entail annual pension contributions that are projected to exceed 20.0% in just four years; in the current economic and fiscal environment, the State simply cannot afford to make those payments and still maintain the current level of State services. The commission reminds readers that the State embraced dramatic structural reform to its pension system in 1979 when the employer contribution rates exceeded 17.0% of payroll and were projected to increase further; current projections are equally dire.

Therefore, in an effort to restore the pension system to solid financial ground, the commission recommends that the State adopt two related goals: achieve an actuarial

funding level of 80% within 10 years and an actuarial funding level of 100% in 30 years. By reducing the funding imbalance on an accelerated timetable, the State will restrain the growth of future pension contributions to levels that should be sustainable going forward. Accomplishing these goals will require a combination of benefit restructuring and fiscal discipline by the State.

Closing the gap between pension liabilities and pension assets can be accomplished in only two ways: increasing assets or reducing liabilities. On the asset side of the ledger, the commission's consulting actuary estimates that an additional $340 million in employer contributions in fiscal 2013, growing by 4% annually thereafter for each of 10 years, is necessary to reach the commission's goal of 80% funding in 10 years. However, the current fiscal situation precludes the State from directing additional general funds to the pension fund. On the liability side of the ledger, the Attorney General's office advises that, because the growing unfunded liabilities have already been accrued, the benefits underlying those liabilities can only be reduced under extraordinary circumstances. The enduring lesson from the 1980 to 1984 pension reform is that restructuring benefits only for new employees does not address unfunded accrued liabilities and, therefore, does not help in reaching the short-term goal of 80% funding within 10 years. However, restructuring benefits for future employees can play a major role in addressing the long-term goal of achieving 100% funding in 30 years by aligning benefits with demographic trends. The commission concludes that the only solution available to achieve the short-term goal is to generate savings within the system by restructuring its benefits, and then direct those savings back into the system in the form of increased contributions.

The challenge then is to restructure current benefits in a manner that passes constitutional muster. Changing benefits for future and nonvested members does not confront any constitutional restrictions because those benefits have not been accrued or vested. Therefore, the remainder of this section divides its recommendations into those affecting new and nonvested employees and those affecting current vested members.

Benefit Restructuring for New and Nonvested Members

Americans are working and living longer, and the commission believes that Maryland, like the nation and other states, should restructure its pension plans to reflect these changes. Maryland's vesting and retirement eligibility criteria for EPS and TPS are on a par with or slightly less stringent than most other State plans, but there is a national trend toward increasing both vesting requirements and retirement eligibility criteria to conform to demographic patterns. In 2010 alone, at least 10 states enacted increased retirement eligibility criteria for State employees and/or teachers, and 5 states enacted higher vesting requirements, including several states that increased vesting to 10 years, the highest level in the country. And not to be overlooked, the President's Commission on Fiscal Responsibility and Reform recommended indexing the Social Security retirement age to life expectancy, which has been increasing steadily.

Under EPS and TPS, members can retire with an unreduced pension at age 62 with 5 years of service or with 30 years of service regardless of age. Thus, a member who enters

State service at age 22 after college can retire as early as age 52. Almost half of all state employee plans (23) have retirement ages higher than the EPS/TPS retirement age of 62, and more than half of the states (27) do not provide an unreduced service retirement option based only on years of service, as does Maryland. Many of those states require that members achieve a combination of age and years of service to earn an unreduced benefit. Several states, including Pennsylvania, recently adopted a Rule of 92 requirement, whereby age and service must add up to 92 to earn an unreduced benefit in lieu of reaching the normal retirement age.

The commission considered recommending changing retirement eligibility for EPS and TPS to either the Rule of 92 or the Rule of 95. **Exhibit 4.5** shows the implications of both options. Under the Rule of 95, younger members would have to work up to seven additional years to qualify for an unreduced benefit but only five additional years under the Rule of 92. In part because no other states have adopted the Rule of 95, the commission opted to recommend the Rule of 92.

Exhibit 4.5
Retirement Eligibility Under Different Scenarios

Starting Age	Eligibility Under Current Rules	Eligibility Under Age 62 or Rule of 95	Eligibility Under Age 62 or Rule of 92
Age 22	Age 52	Age 59	Age 57
Age 25	Age 55	Age 60	Age 59
Age 30	Age 60	Age 62	Age 61
Age 35	Age 62	Age 62	Age 62

Source: Department of Legislative Services

The commission recommends that the State enact legislation that makes the following changes:

- **for all SRPS plans that currently have a 5-year vesting requirement, increase vesting to 10 years for current and future members who are not vested as of June 30, 2011;**

- **for current and future members of EPS and TPS who are not vested as of June 30, 2011, change eligibility for normal service retirement to either age 62 with 10 years of service or a combination of age and years of service adding to 92 (the Rule of 92);**

- **for members of EPS and TPS who are not vested as of June 30, 2011, make a corresponding change to eligibility for early service retirement to age 57 with at least 20 years of service; and**

- **automatic annual COLAs should be discontinued for future retirees in favor of inflation-based benefit adjustments that are contingent on investment returns for the pension trust fund meeting or exceeding the actuarial target rate (currently 7.75%).**

The commission does not recommend any changes to the retirement eligibility criteria for members of the various public safety plans (State Police, Law Enforcement Officers' Pension System (LEOPS), and correctional officers). Those criteria reflect both the need for members of those plans to be in peak mental and physical condition to carry out their duties and the higher stress levels associated with their jobs. The commission does not believe they should be changed at this time. However, in the interest of equity, the commission recommends one change to benefits for members of the State Police Retirement System and LEOPS who are not currently enrolled in the Deferred Retirement Option Program (DROP).

DROP allows members of both plans who are otherwise eligible to retire to officially retire but continue to work and earn a full salary for up to four (State Police) or five (LEOPS) years. During their time in DROP, their retirement benefits, including all COLAs, are deposited into individual DROP accounts and earn 6% interest, compounded monthly. Upon completing their time in DROP, members are entitled to a lump sum payment of the balance contained in their DROP accounts. DROP programs are designed to enhance retention of experienced officers by allowing them to simultaneously earn a salary and draw a pension benefit but have also been criticized as a sanctioned mechanism for "double dipping." The commission considered recommending ending the DROP program but ultimately decided to recommend adjusting the terms of the programs to bring them more in line with current financial realities.

The commission recommends that for members of the State Police Retirement System and the Law Enforcement Officers Pension System not currently enrolled in the Deferred Retirement Option Program, the program should be modified to provide 4% compounded annual interest on Deferred Retirement Option Program account balances instead of the current 6% compounded monthly interest. The commission further recommends that the State explore, through the collective bargaining process, requiring members of the State Police Retirement System to hold a referendum on whether to join Social Security. The State Police Retirement System is the only plan in the State Retirement and Pension System whose members do not participate in Social Security.

With regard to the two smallest State plans, the Legislative Pension Plan and the Judges' Retirement System, benefits for those two plans are reviewed every four years by the General Assembly Compensation Commission (GACC) and the Judicial Compensation Commission, respectively. Because the State Constitution prohibits legislators from voting directly on their own compensation, the GACC proposes annual compensation and benefit levels at the end of every four year term, and the General Assembly votes only to approve or reject the GACC's recommendations; changes do not take effect until the following legislative term. A similar process is in place for judicial compensation, although the process is established in statute rather than in the constitution, and the legislature is not barred from modifying provisions of the Judicial Retirement System at its own initiative.

The commission recommends that the General Assembly Compensation Commission and the Joint Committee on Pensions study the benefit structures provided under the Legislative Pension Plan and the Judges' Retirement System, respectively, and recommend any necessary changes to the General Assembly and Judicial Compensation Commission. In determining whether to recommend any changes, the respective studies and compensation commissions should consider the changes made to other State pension plans in the intervening period.

Benefit Restructuring for Current EPS/TPS Members

The commission concludes that the State has limited options with regard to addressing SRPS's funding imbalance but can devise a strategy that accomplishes its goal of reaching 80% funding in 10 years. In the current fiscal environment, the State lacks the resources to increase its contributions to the pension fund, either by eliminating the corridor method or any other means, and legal protections for accrued benefits limit its ability to address current unfunded liabilities. In 1984, however, the courts sanctioned a State approach to reducing accrued liabilities within the two closed retirement systems, and the commission recommends a similar approach to addressing the unfunded liabilities in the two pension plans.

The menu of options presented to ERS and TRS members in 1984 included two options that can best be described as benefit reductions. The first allowed members to retain their unlimited COLA but increase their member contribution from 5.0% of pay to 7.0%, thereby making their benefit more expensive. The second option retained the 5.0% contribution rate but capped the inflation-based COLAs on all service credit, including past service, at 5.0%. It was the third option, however, that the Court of Appeals noted protected member's accrued benefits while reducing benefits for future service. This so-called "bifurcated" option provided members with all benefits accrued in the retirement systems up to that time, and benefits under the new pension plans for all future service. Benefit payments and COLAs would be weighted based on the amount of service credit accrued with the retirement system multiplier of 1.8% and an unlimited COLA and the amount of service credit accrued under the pension system's 0.8% multiplier and 3.0% COLA cap. The courts concluded that as long as members had the option of retaining all accrued benefits under the bifurcated option, the State could offer additional options that reduced the value of those benefits. It did not matter that few members opted for the bifurcated option (the vast majority selected the 7.0% contribution option) as long as the option was available to them.

An approach similar to the one used in 1984 has the potential to dramatically reduce the unfunded liabilities within EPS and TPS, the system's two largest plans, while also securing approval from the courts. The steps taken in 1979 and 1984 together placed SRPS on a path to full funding that it ultimately reached in just 20 years. Similar steps taken in 2011 can again put the system on a path to fiscal health.

The commission recommends that the State provide EPS and TPS members with a menu of options for future benefits with the following characteristics:

- **at least one option should protect all accrued benefits while potentially providing a lesser benefit level going forward; and**

- **at least one option should allow members to retain their current benefit structure going forward in exchange for a higher member contribution rate.**

In designing the menu, the State should give serious consideration to offering current members the opportunity to convert their accrued benefits into a cash balance plan that would be administered by the State Retirement and Pension System. The cash balance plan could be used as the option that protects accrued benefits because both federal courts and the Internal Revenue Service have approved multiple defined benefit plan conversions to cash balance plans in the private sector, as long as they follow specified guidelines that protect the value of accrued benefits.

Cash balance plans, which originated in the mid-1980s, are considered hybrid pension plans because they mirror a DC plan design but also provide a guaranteed benefit. Under cash balance plans, members have notional individual accounts into which their employer deposits a fixed employer contribution. Member contributions are allowed with cash balance plans, but are not always required. Unlike DC plans, however, individuals do not manage their own assets; instead, the assets are managed centrally, thereby deriving the benefits of professional and pooled asset management. The defined benefit provided under cash balance plans is in the form of a guaranteed investment return, which is set by the employer and is often linked to an independent index. Upon retirement, members can withdraw the balance in their accounts as a lump sum or convert it to an annuity. More than 1,000 private sector employers, including such large corporations as IBM and Bank of America, use cash balance plans.

Unfortunately, the commission lacked sufficient time to fully explore the implications of a cash balance conversion option, and some members expressed concern about its potential effects on SRPS investment policy and members' retirement security. Therefore, the commission refrains from endorsing the cash balance option at this time but suggests that it merits further study and consideration as part of an approach to address the system's funding issues. If the pension funding issue is not fully addressed during the 2011 legislative session, the commission may choose to continue studying this option when it reconvenes after the session to prepare its final report.

Potential Savings and Reinvestment

The commission recommends that the State use the savings generated by restructured benefits for current EPS and TPS members to increase funding levels for the system. The amount of savings that is reinvested in the system annually should be subject to a cap that provides enough additional contributions to achieve the commission's goal of achieving 80% funding in 10 years, with excess savings credited to the appropriate funding sources. As noted above, the actuary estimates that approximately $342 million would be required in the first year; any first-year savings generated by the benefit redesign in excess of that amount would be retained by the appropriate funding sources. If the savings generated by the restructuring falls short of that amount, the entire savings would be contributed to the pension fund.

The commission examined various scenarios that fulfill its basic recommendation that EPS and TPS members (including future members) be offered a menu of options, and offers one such scenario as an illustration of the potential of this approach to generate savings within the pension system. The commission does not specifically endorse this particular scenario, especially since it includes a cash balance option that requires additional study, but offers it as an example of an approach that may be considered. Other approaches may, for instance, offer a bifurcated option instead of the cash balance option, or offer different benefit levels going forward. The scenario includes four plan options, as follows:

- **Cash Balance:** Convert to a cash balance plan with fixed 10.0% employer contribution, 5.0% employee contribution, and guaranteed 5.0% annual return on account balances

- **Stable Benefit:** (current members only) Retain current defined benefit plan with an 8.0% employee contribution, of which 2.0% would be directed to paying down the unfunded liability;

- **Stable Contribution:** Maintain a defined benefit structure, with an employee contribution of 5.0%, 1.6% multiplier for service credit earned after June 30, 2010, and a COLA capped at 1.5% for all service credit, including past service; or

- **Basic Savings:** Maintain a defined benefit plan with a 3.0% employee contribution, 1.4% multiplier for service credit earned after June 30, 2010, and no retirement COLAs.

Based on this scenario, commission staff asked the consulting actuary to calculate the net present value of future benefits for each current EPS and TPS member under each of the four plan options. The actuary then determined which plan option provided each member with the highest net present value and assumed that the member would select that plan option. Based on this analysis, the actuary estimates that this particular scenario, when combined with the earlier recommendations regarding vesting, retirement eligibility, and COLAs, could reduce State pension contributions by $310 million in fiscal 2013 and by $391 million in fiscal 2018. Since the first year savings does not exceed the $342 million cap, the employer contribution would increase by the full amount of the savings and the State (and other funding sources) potentially would not realize any cash savings in the first year. The commission notes that members' actual selection patterns among the different options may vary from the assumptions used in calculating the savings under this scenario, and that other scenarios may prompt different selection patterns among current members and generate different levels of savings. Additional actuarial analyses would therefore be necessary to gauge the effect of alternative scenarios on contributions. Overall, however, the commission believes this general approach will allow the pension system to achieve fiscal stability in 10 years.

Chapter 5. Local Cost Sharing of Pensions

Background

Evolution

The State pays pension costs for qualifying employees of local boards of education, local boards of library trustees, and local boards of community college trustees. The employees are member of the State's combined teacher pension systems and receive retirement benefits equivalent to State employees. The State pays the pension costs on behalf of the local boards, which are responsible for setting local salaries and budgets. In effect, the State pays a portion of the cost of each new employee hired by one of the boards and of every salary increase granted by a board. Although there are sevreal reasons why this somewhat unusual structure may have been established and has been maintained, the primary reason for its perpetuation seems to be a reluctance to change a system that has been around so long.

Chapter 344 of 1927 established the "Teachers' Retirement System of the State of Maryland" for new and existing teachers in Maryland's local school systems. The State system mimicked the retirement system that Baltimore City had established for its teachers several years earlier, offering the same benefits to county teachers. Retirement costs were paid by the State, and Baltimore City was reimbursed for the costs of supporting pensions for its teachers. In 1971, Baltimore City teachers were transferred into the State's Teachers' Retirement System, joining the other 23 local school systems.

The Code of Maryland Regulations enumerates 16 categories of local school employees who participate in the retirement system and 53 positions that are not eligible for State-funded benefits. A partial list of eligible and ineligible local school positions is shown in **Exhibit 5.1**. In general, professional positions involved in the instruction of students are eligible for State-funded pensions, and other positions are not.

Local library employees were added to the Teachers' Retirement System in 1945, and community college employees were added in 1961. The laws bringing these employees into the State system specified that "professional and clerical" staff of libraries and community colleges were to participate in the system. In 1967, library employees in Montgomery County were removed from the State's retirement system and were instead placed in a county retirement program. In lieu of payments to the teachers' pension system, the State gives Montgomery County a grant that is equivalent to the lesser of the cost for participation in the local system or the cost that would be incurred under the State's system.

Exhibit 5.1
Participation the State Retirement/Pension System
By Local School Employees

Qualifies (16 positions)	Does Not Qualify (53 positions)
Certificated Employees (Teachers/Principals)	Bus Drivers and Transportation Personnel
Specified Central Office Supervisors	Food Service Workers
Audiologists and Speech Pathologists	Custodians and Janitors
Psychiatrists, Psychologists, Social Workers	Maintenance Workers
Classroom Teacher Aides	Security Personnel
Bus Attendants for Handicapped Students	Architects, Engineers, and Draftsmen
Registered Nurses	Laboratory Aides/Technicians
Bookmobile Drivers	Administrative Assistants to Superintendent
Occupational and Physical Therapists	Assessments Specialists
Dietitians	Student Affairs and Activities Personnel
Braillists	School Business Managers

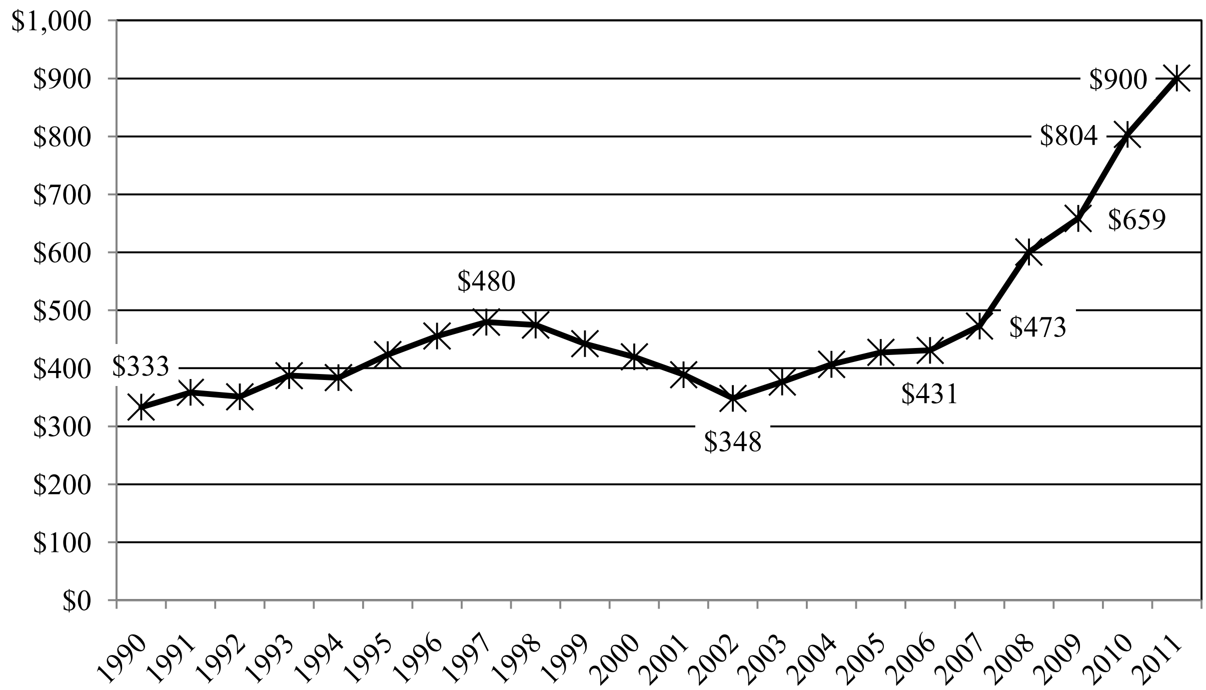
Source: Code of Maryland Regulations

Costs of Pensions for Local Employees

Excluding the Optional Retirement Program available to professional community college staff as an alternative to the pension system, the State is paying $900.4 million in pension costs for local employees in fiscal 2011. Most of this amount, $849.8 million, or 94.4%, is attributable to local board of education employees. Much smaller amounts were paid for local library ($16.9 million, or 1.9%) and community college ($33.7 million, or 3.8%) pensions.

The long-term trend in local pension costs is shown in **Exhibit 5.2**. Although there were fluctuations in the 1990s, long-term growth in teacher pension costs was relatively modest from fiscal 1990 to 2006. Over that time period, costs increased almost $100.0 million, from $333.1 million in fiscal 1990 to $431.1 million in fiscal 2006. This represented average annual increases of 1.6%, a sustainable level of growth. From fiscal 2006 to 2011, however, pension costs for local teachers more than doubled to $900.4 million. The striking increases can be attributed to at least three factors: heavy pension fund asset losses brought on by the two recessions that occurred during the last decade; rapid increases in the salary bases for local boards employees; and the pension enhancement enacted in 2006.

Exhibit 5.2
State Pension Costs for Local Employees
Fiscal 1990 to 2011
($ in Millions)



Note: Chart excludes State funding for the Optional Retirement Program available to professional community college employees.

Source: Department of Legislative Services

Barring any changes to the current structure, teacher pension costs are expected to continue increasing sharply in the coming years. Fiscal 2012 costs are projected to increase $78.3 million (8.7%) to $978.8 million despite very modest growth (0.9%) in the salary bases of local boards. By fiscal 2015, pension costs for local employees are expected to approach $1.3 billion.

Proposals for Local Cost Sharing of Pension Costs

Legislative Proposals from Prior Years

Several legislative proposals for cost-sharing have been introduced in recent years. In the 2007 special session, House Bill 50 would have split teacher pension costs 50/50 with the counties. Costs for school and library personnel would have been split through a "wealth-equalized" formula, requiring counties with greater tax capacity to pay more than 50% of local pension costs and less wealthy counties to pay less than 50% of local pension costs. Costs for community college pensions would have simply been split 50/50 between the State and the counties. Senate Bill 710 of 2009 would have frozen State pension contributions and would have required the local boards to pay any future increases in pension costs. Senate Bill 959 of 2010 would have required local boards to pay the pension contributions for any new employees and for any increases in employee salaries.

None of these bills were passed by the committees to which they were assigned; however, they did suggest different ways of sharing pension costs with local entities. Senate Bill 710 and Senate Bill 959 would have phased in local cost-sharing. House Bill 50 included no phase-in of the cost-shift but did propose a wealth-equalized allocation of local pension costs. House Bill 50 also would have required counties to pay retirement costs, while Senate Bill 710 and Senate Bill 959 would have required the local boards to pay the local shares of pension costs.

Although the provisions shifting some pensions costs to local boards were ultimately unsuccessful, Senate Bill 141 of 2010, the Budget Reconciliation and Financing Act of 2010, represents the most successful legislative cost-sharing proposal to date. As passed by the Senate, the proposal would have required the local boards to pay a percentage of their salary bases towards pensions. The phase-in would have begun in fiscal 2012 with local boards contributing 1.0% of their salary bases to the State pension system. This percentage would have phased up to 3.0% in fiscal 2013 and 5.0% in fiscal 2014 and 2015. Recognizing that local boards already contribute to Social Security costs for their employees (at 7.65% of local salaries), the local contribution percentage would have been recalculated in fiscal 2016 and annually thereafter to support 50.0% of total pension and Social Security costs for local employees. The proposal would have saved an estimated $60 million in fiscal 2012 and more than $300 million by fiscal 2014. The cost-sharing provisions were stripped from the bill in Conference Committee and were replaced with provisions establishing this commission and requiring the commission to review the Senate's proposal.

Options Considered by the Commission

The commission was presented with several options for shifting some pension costs to local employers. The first option would require local boards to support 50% of employee pension costs. With nearly $1 billion in projected pension costs for fiscal 2012, this option would have shifted almost $500 million in costs to local boards of education, libraries, and community colleges. The second option presented to the commission would acknowledge local contributions to Social Security and would split total retirement costs (pension system plus Social Security) evenly between the State and the local boards. This proposal would generate lower savings for the State by shifting approximately $250 million to local boards. Finally, the commission also reviewed an option that would shift just 40% (rather than 50%) of total retirement costs to local boards, with the State paying 60% of the total costs. A summary of the three options is shown in **Exhibit 5.3**.

Exhibit 5.3
Cost-sharing Options Reviewed by the Commission
Based on Fiscal 2012 Pension Costs
($ in Millions)

	State Savings/ Local Cost	Percent Paid by Local Boards* Of Pension Costs	Of Social Security (SS) Costs	Of Total Retirement Costs (Pension + SS)
Option 1: 50/50 Pension Split				
Boards of Education	$461.6			
Libraries	8.9			
Community Colleges	18.8			
Total	$489.4	50.0%	100.0%	66.6%
Option 2: 50/50 Total Retirement Split				
Boards of Education	$233.1			
Libraries	4.5			
Community Colleges	9.5			
Total	$247.1	25.2%	100.0%	50.0%
Option 3: 60/40 Total Retirement Split				
Boards of Education	$95.0			
Libraries	1.8			
Community Colleges	3.9			
Total	$100.7	10.3%	100.0%	40.0%

*The State provides roughly 45% of operating revenues for local boards of education, 22% of operating revenues for local community college boards, and 14% of operating revenues for local library boards.

Source: Department of Legislative Services

The commission also discussed the possibility of phasing in any of these cost-sharing options rather than implementing them in a single fiscal year. In addition, the commission was informed that any of the options could include a wealth equalization component that would lessen the fiscal impact on boards in low-wealth jurisdictions.

Findings and Recommendation

Local Boards of Education

The commission finds that the current structure of 100% State-paid pensions for local employees is unsustainable. Current estimates suggest that the State contribution rate for teachers' pensions will increase 36.8% over the next five years (from 14.34% of the teacher salary base in fiscal 2011 to 19.61% by fiscal 2016), driving up pension costs significantly even with relatively minimal salary base increases. With nearly 95% of the State's retirement aid spent in support of local board of education employees, reducing State pension costs for local school employees will have the greatest impact on long-term sustainability. Shifting some of the costs to local school boards will also help to mitigate the budget hole that will be left when the $228.1 million in federal stimulus funds being used to support fiscal 2011 teacher pension costs is no longer available in fiscal 2012. The commission also believes that shifting some of the responsibility for paying teacher pension costs to the local boards of education, the entities that set budgets and negotiate the salaries of school employees, is simply a good, commonsense policy.

With these findings, the commission recommends shifting some of the costs of teacher pensions to the local boards of education. Specifically, with one member abstaining, the commission recommends that, over the course of a brief phase-in period beginning in fiscal 2012, combined pension and Social Security costs be shared so that the State provides 50% of the costs and the local boards of education support the remaining 50% (Option 2 from above). The commission suggests that the cost shift begin in fiscal 2012 in recognition of the fiscal challenges the State is facing and the hole that will be left in the budget when the $228.1 million in federal stimulus funds being used to support teacher pension costs is no longer available.

In the spirit of "One Maryland" and long-standing wealth equalization principles established for State education aid, the commission also recommends (with one member abstaining) that local tax capacity be taken into consideration in implementing a cost-sharing methodology. In other words, school systems in jurisdictions with larger local tax bases will pay a greater proportion of the pension costs for their employees. The commission specifically recommends an equalization methodology that combines an enhancement of existing education aid formulas with the shift in pension costs. Under the recommendation, the State would shift a greater portion of employee pension costs to local boards of education than it would under a non-equalized model, but the formula enhancements would pay for half of the pension cost. **Exhibit 5.4** compares the wealth-equalized model to the nonequalized model to show that the net effect on the State is the same under either scenario. However, since the formula enhancements will be allocated through existing wealth-equalized formulas, the cost-shift will generally be less burdensome for school boards in jurisdictions with lower tax capacities and more burdensome for school boards in the wealthier counties. Although the impact on the State is the same under the equalized and nonequalized models, the impact on individual school boards will be different.

Exhibit 5.4
Comparison of Net Effect of Nonequalized and Equalized Cost-sharing Models Based on Fiscal 2012 Pension Costs
($ in Millions)

	Nonequalized Model	Equalized Model
Additional Education Aid Allocated through Formulas	$0	$233
Pension Costs Shifted to Local Boards of Education	-233	-466
Net Effect on State Expenditures	**-$233**	**-$233**

Source: Department of Legislative Services

The estimated impact on individual school systems is detailed in **Exhibit 5.5**. The chart shows the estimated increase in State aid and the projected pension cost for each system, and calculates a net impact based on the additional aid and the new pension costs. The final column in the table shows the net impact per pupil in order to add perspective to the net impact figures. The effect on local school systems averages -$283 per pupil statewide and ranges from -$61 per pupil in Baltimore City to -$565 per pupil in Worcester County.

Local Library and Community College Boards

At this time, the commission is hesitant to shift pension costs to the local libraries and community colleges. Pension costs for these employees make up a relatively small percentage of the total pension costs, and sharing these costs with local boards will not materially impact sustainability in the short-term. Furthermore, the State already provides a much smaller share of the funding for libraries and community colleges than it does for local boards of education; shifting pension costs to these entities would further reduce the State's contributions.

The commission will continue its review of pension costs for local employees with the added perspective of any 2011 legislative changes that might be made to share pension costs with local boards of education. If the commission determines that cost-sharing arrangements with the libraries and community colleges are fair, justifiable, and necessary for the long-term sustainability of the pension structure, further cost-sharing options will be recommended in the final report.

Exhibit 5.5

Estimated Impact of Commission's Cost-sharing Recommendation Based on Fiscal 2012 Pension Costs

	($ in Thousands)		
County	**Direct Aid Increase***	**Pension Costs**	**Net Impact**
Allegany	$3,252	$5,034	-$1,782
Anne Arundel	14,560	38,791	-24,231
Baltimore City	38,764	43,563	-4,799
Baltimore	26,148	52,762	-26,614
Calvert	4,138	9,336	-5,198
Caroline	1,950	2,672	-722
Carroll	6,990	13,766	-6,776
Cecil	4,881	8,237	-3,356
Charles	7,572	13,504	-5,932
Dorchester	1,512	2,289	-777
Frederick	10,988	20,156	-9,168
Garrett	971	2,326	-1,355
Harford	10,447	18,727	-8,280
Howard	10,518	32,653	-22,135
Kent	350	1,269	-918
Montgomery	27,483	94,009	-66,525
Prince George's	42,128	68,756	-26,627
Queen Anne's	1,496	3,731	-2,235
St. Mary's	4,476	8,185	-3,709
Somerset	1,080	1,623	-543
Talbot	505	2,132	-1,627
Washington	7,206	10,639	-3,433
Wicomico	5,146	7,658	-2,512
Worcester	791	4,292	-3,501
Total	**$233,353**	**$466,111**	**-$232,757**

*Aid increase results from an increase in the fiscal 2012 per pupil amount of $365.

Source: Department of Legislative Services

State Board of Dental Examiners Fund	*16,892*
State Board for Morticians and Funeral Directors Fund	*922*
State Board of Occupational Therapy Practice Fund	*3,341*
State Board of Examiners in Optometry Fund	*1,534*
State Board of Pharmacy Fund	*32,821*
State Board of Physical Therapy Examiners Fund	*15,311*
State Board of Podiatric Medical Examiners Fund	*1,647*
State Board of Examiners of Psychologists Fund	*3,724*
State Board of Social Work Examiners Fund	*6,766*
State Board of Examiners for Audiologists, Hearing Aid Dispensers, and Speech Language Pathologists Fund	*1,954*
Kidney Disease Fund	*134*
Board of Nursing Fund	*289,754*
Board of Physicians Fund	*40,829*
Department of Labor, Licensing, and Regulation:	
State Occupational and Professional Licensing Design Boards' Fund	*13,043*
Department of Agriculture:	
Registration and Inspection Fees	*4,018*
Department of the Environment:	
Special Indirect Cost Recoveries	*21,951*
Department of Transportation:	
Transportation Trust Fund	*9,725*
Department of Natural Resources:	
Waterway Improvement Fund	*788*
Maryland Insurance Administration:	
Insurance Regulation Fund	*1,418*

SECTION 46. AND BE IT FURTHER ENACTED, That:

(a) There is a Public Employees' and Retirees' Benefit Sustainability Commission.

(b) (1) Subject to the provisions of paragraph (2) of this subsection, the Commission consists of the following members:

(i) the State Treasurer, ex officio;

(ii) three members appointed by the Governor;

(iii) two members appointed by the President of the Senate; and

(iv) two members appointed by the Speaker of the House.

(2) (i) In the appointment of members to the Commission, special consideration shall be given to individuals who have knowledge of public or private compensation practices, benefits, and financial matters.

(ii) Except as provided in paragraph (1)(i) of this subsection, the following individuals may not be members of the Commission:

1. a member of the General Assembly;

2. a member of the Board of Trustees for the State Retirement and Pension System;

3. an employee of the State Retirement Agency; or

4. an individual that is employed by an organization that represents:

A. a governmental entity; or

B. employees of a governmental entity.

(c) The Governor shall designate the chair of the Commission.

(d) (1) The Department of Legislative Services shall provide staff for the Commission.

(2) The Department of Legislative Services' consulting actuary shall provide pension analysis for the Commission.

(3) The Department of Budget and Management's consulting actuary shall provide analysis of postemployment benefits for the Commission.

(4) At the request of the Commission, the Department of Budget and Management and the State Retirement Agency shall provide information necessary to assist in the work of the Commission.

(e) A member of the Commission:

(1) may not receive compensation as a member of the Commission; but

(2) is entitled to reimbursement for expenses under the Standard State Travel Regulations, as provided in the State budget.

(f) (1) The costs of the Commission relating to the evaluation of pensions shall be paid by the State Retirement Agency.

(2) The costs of the Commission relating to the Retiree Health Benefits evaluation shall be paid by the Department of Budget and Management.

(g) (1) The Commission shall study and make recommendations with respect to all aspects of State funded benefits and pensions provided to State and public education employees and retirees in the State.

(2) The Commission shall review and evaluate the recruitment practices, retention incentives, actuarial liabilities, actuarial funding method, cost drivers, employee contribution rates, and the comparability and affordability of benefit levels of:

(i) the State Employees' Retirement and Pension Systems;

(ii) the State Employee and Retiree Health Benefit Program; and

(iii) the Teachers' Retirement and Pension Systems.

(3) The review of the Commission shall include:

(i) long–term estimated increases in the annual required contributions for the State and evaluation of the sustainability of State–only funding of the long–term contribution levels for the current benefit structure; and

(ii) an evaluation of the appropriate levels of contribution for the direct employer of public education employees in the State, including an evaluation of the related provisions of Senate Bill 141 of the 2010 Regular Session of the General Assembly as it passed the Senate of Maryland.

(h) (1) On or before December 15, 2010, the Commission shall issue a report of its findings and recommendations that are specific and actionable to the Governor and, in accordance with § 2–1246 of the State Government Article, the Senate Budget and Taxation Committee, the House Appropriations Committee, the Joint Committee on Pensions, and the Blue Ribbon Commission to Study Retiree Health Care Funding Options.

(2) On or before June 30, 2011, the Commission shall issue a final report of its findings and recommendations that are specific and actionable to the Governor and, in accordance with § 2–1246 of the State Government Article, the Senate Budget and Taxation Committee, the House Appropriations Committee, the Joint Committee on Pensions, and the Blue Ribbon Commission to Study Retiree Health Care Funding Options.

(i) It is the intent of the General Assembly that the recommendations of the Commission begin to be implemented no later than fiscal year 2013.

(j) The Commission shall terminate on June 30, 2012.

SECTION ~~39.~~ ~~44.~~ *47.* AND BE IT FURTHER ENACTED, That, if any provision of this Act or the application thereof to any person or circumstance is held invalid for any reason in a court of competent jurisdiction, the invalidity does not affect other provisions or any other application of this Act which can be given effect without the invalid provision or application, and for this purpose the provisions of this Act are declared severable.

SECTION ~~40.~~ ~~45.~~ *48.* AND BE IT FURTHER ENACTED, That the provisions of Sections 2, 4, ~~6, and 28~~ 8, and 33 of this Act shall be construed retroactively and shall be applied to any taxes, interest earnings, payments, or other revenue received by the State on or after June 1, 2009.

SECTION 49. AND BE IT FURTHER ENACTED, That § 8–504 of the Human Services Article as enacted by this Act shall be construed to apply retroactively to July 1, 2009, and shall be applied to and interpreted to affect any contract invoices submitted on or after July 1, 2009.

SECTION ~~46.~~ *50.* AND BE IT FURTHER ENACTED, That Section 6 of this Act shall take effect January 1, 2011, contingent on the failure of the federal government to act, on or before December 31, 2010, to extend beyond December 31, 2010, the increase in the State's federal medical assistance percentage as provided in the American Recovery and Reinvestment Act of 2009, and if the federal government acts, on or before December 31, 2010, to extend beyond December 31, 2010, the increase in Maryland's federal medical assistance percentage as provided in the American Recovery and Reinvestment Act of 2009, Section ~~5A~~ *6 of* this Act shall be null and void without the necessity of further action by the General Assembly.

~~SECTION 41. AND BE IT FURTHER ENACTED, That Section 10 of this Act shall be applicable to all taxable years beginning after December 31, 2009.~~

SECTION ~~42.~~ ~~47.~~ *51.* AND BE IT FURTHER ENACTED, That Section ~~35~~ 40 of this Act shall be construed to apply retroactively and shall be applied to and interpreted to affect any Executive Order issued on or after January 20, 2010.

SECTION ~~43.~~ ~~48.~~ *52.* AND BE IT FURTHER ENACTED, That, except as otherwise provided in this Act, this Act shall take effect June 1, 2010.

Approved by the Governor, May 20, 2010.

Appendix 2

December 21, 2010

The Honorable Martin J. O'Malley
The Honorable Thomas V. Mike Miller, Jr.
The Honorable Michael E. Busch

Gentlemen:

At the December 20, 2010 meeting of the Public Employees' and Retirees' Benefit Sustainability Commission, commission members endorsed a set of recommendations to be included in the commission's first report, required under Chapter 484 of 2010. The complete report will be delivered to you in advance of the 2011 legislative session. The recommendations address four main areas examined by the commission at the seven meetings it held during the 2010 interim, which are:

1. health benefits for State employees and retirees;

2. projected State liabilities for retiree health benefits;

3. pension benefits for State employees and teachers; and

4. the distribution of the employer contribution toward pension benefits for employees of the school boards, community colleges, and library boards who are members of the combined teachers' pension and retirement system.

This letter summarizes the commission's key recommendations in each area. Additional background information, rationale, and details regarding these recommendations will be provided in the aforementioned report.

Health Benefits

The commission recommends that the State adopt a goal of reducing State expenditures on employee and retiree health benefits by 10% to bring them in line with those of peer states. Data presented to the commission shows that, on average, the State pays between 95 and 98% of covered charges under its health plan, whereas the share of costs paid by other large state plans is between 83 and 85%. The commission further recommends that this goal be accomplished through a combination of reductions to State premium subsidies for employees and retirees and plan design changes that reduce the State share of covered charges for medical services and/or prescription drugs purchased by State employees and retirees. To the extent that these changes are subject to collective bargaining with representatives of State employees, they should be submitted to that process. The Department of Budget and Management should monitor the structure of the State health plan on an ongoing basis to ensure that the State's share of covered charges retains equivalency with that of other states, and that a total compensation package adequate to recruiting and retaining a high-quality workforce remains in place. Moreover, special consideration in designing these changes should be given to their financial effects on low-income employees and retirees, and efforts should be taken to minimize those effects, such as the use of limitations on out-of-pocket expenditures.

Retiree Health Liability

The commission recommends that the State establish a goal of reducing its unfunded actuarial liability for other post-employment benefits by 50%, and also commit to fully funding its annual required contribution within 10 years. The changes to the employee and retiree health plan outlined above are an important component of the overall strategy to achieve both of these goals, but additional steps are required. Therefore, the commission recommends that the State change the eligibility criteria for State employees to qualify for retiree health benefits in the ways described below. To the extent that the State's liability associated with the retiree health benefit continues to grow at an unsustainable rate even after the implementation of these changes, the Department of Budget and Management (DBM) should establish a contingency plan to further restrict the scope of retiree health benefits, including potentially restricting access to those benefits only to Medicare-eligible retirees. DBM should report the details of its contingency plan to the General Assembly.

- Employees with less than 15 years of service credit as of June 30, 2010, should be required to earn 15 years of service credit with the State, up from 5, to qualify for participation in the State health plan as retirees.

- Employees with less than 15 years of service credit as of June 30, 2010, should be required to earn 25 years of service credit with the State, up from 16, to qualify for the maximum premium subsidy provided to retirees, with the subsidy prorated for those with between 15 and 25 years of service credit.

- Employees should be required to retire directly from State service to qualify for retiree health benefits from the State; former employees who were eligible for retiree health benefits at the time they separated from State service should still be eligible to receive retiree health benefits from the State when they reach normal retirement age.

- During the 2011 interim, the General Assembly should review the current provisions under Title 37 of the State Personnel and Pensions Article that govern transfers of service credit between any State or local retirement or pension system, and how those rules affect eligibility for both retiree health benefits and pension benefits for employees who transfer between State and local government service.

Last, the commission recommends that the State establish in statute a requirement that, by the year 2020, all Medicare-eligible State retirees must join Medicare Part D for prescription drug coverage, and that they no longer be eligible to participate in the State prescription drug plan. This recommendation is largely based on the assumption that, under the federal Patient Protection and Affordable Care Act of 2010, the Part D coverage gap will be eliminated by 2020. To the extent that the coverage gap is not eliminated, the commission recommends that DBM devise a contingency plan to provide supplemental pharmaceutical drug benefits through an Employer Group Waiver Plan or other similar mechanism. Conversely, to the extent that retiree out-of-pocket expenses under Part D are reduced through mechanisms such as pharmaceutical manufacturer rebates, the State may explore requiring Part D participation at an earlier date, either with or without supplemental coverage from the State.

Pension Benefits

The commission recommends that the State establish two goals: achieving actuarial funding levels of 80% within 10 years and 100% within 30 years for the State Retirement and Pension System (SRPS). Based on data presented to the commission, these goals can be accomplished only by increasing the flow of assets into the system to pay down the unfunded liabilities. However, in the current economic and budgetary environment, the State simply does not have the resources necessary to infuse the system with sufficient funds to accomplish either goal. Moreover, over the past decade, pension contributions paid by the State have grown more than three times faster than revenues, making the current benefit unsustainable. Therefore, the commission recommends that the State consider options for restructuring benefits for both current and future SRPS members in a manner that reduces future liabilities but does not diminish accrued benefits. The commission further recommends that the State use the savings generated by those changes to increase funding levels for the system. The amount of savings that is re-invested in the system annually should be subject to a cap that provides enough additional contributions to achieve the commission's goal of achieving 80% funding in 10 years, with excess savings credited to the appropriate funding sources.

The benefit restructuring recommended by the commission should include all plans within the system over which the General Assembly has jurisdiction, but by necessity should focus on the system's two largest plans, the Teachers' Pension System (TPS) and Employees' Pension System (EPS). In particular, the State should consider the feasibility of offering current and/or future members of TPS and EPS a menu of benefit options. After determining that it will not unduly compromise the investment potential of the pension fund or the competiveness of the total compensation package, the State should consider including in the menu an option that allows current members to convert accrued benefits into a cash balance account. Additional plan options should either require members to contribute more to retain their current benefits or provide lower benefit multipliers for service after June 30, 2011. In addition, annual cost of living adjustments should be discontinued in favor of inflation-based benefit adjustments for future retirees that are contingent on investment returns for the pension trust fund meeting or exceeding the actuarial target rate (currently 7.75%).

Additional pension benefit changes recommended by the commission include:

- For new and nonvested members, increasing the vesting requirement for all SRPS plans from 5 to 10 years.

- For new and nonvested members, eligibility for a normal service retirement in TPS/EPS should be age 62 with at least 10 years of service or a combination of age and years of service adding to 92 (the Rule of 92). Concurrently, eligibility for early retirement should be age 57 with at least 20 years of service.

- For members of the State Police Retirement System and the Law Enforcement Officers Pension System not currently enrolled in the Deferred Retirement Option Program (DROP), the program should be modified to provide 4% compounded annual interest on DROP account balances instead of the current 6% compounded monthly interest. The commission further recommends that the State explore, through the collective bargaining process, requiring members of the State Police Retirement System to hold a referendum on whether to join Social Security.

- The commission recommends that the General Assembly Compensation Commission and the Joint Committee on Pensions study the benefit structures provided under the Legislative Pension Plan and the Judges' Retirement System, respectively, and recommend any necessary changes to the General Assembly and Judicial Compensation Commission.

Distribution of Employer Contributions for Pension Benefits

The commission recommends that the State phase in over at least three years a requirement that local boards of education, community colleges, and libraries pay half of the total retirement costs for their employees who are members of the combined teachers' retirement and pension system; total retirement costs are defined as the sum of the employer contribution for members of combined teachers' pension and retirement system and the employer share of Social Security costs for teachers. This recommendation acknowledges that the State plays no role in determining annual salary increases that are negotiated by these local boards and that represent a major component of growing retirement costs. Therefore, the commission concludes that local boards should bear an equal share of the financial burden created by their salary actions. The commission also recommends that, consistent with the tenets of One Maryland, a school board's share of retirement costs be based on its capacity to bear those costs; therefore, school boards in wealthier counties would pay a greater share of retirement costs than those boards in less wealthy counties

Finally, the commission approved a motion to request that legislation be introduced during the 2011 legislative session to extend the deadline for the commission's final report from June 30, 2011, until October 1, 2011, so that the commission has sufficient time to complete its work following the legislative session.

Sincerely,

Casper R. Taylor, Jr., Chairman
Public Employees' and Retirees'
Benefit Sustainability Commission

CRT/MCR/lab

cc: Members, Public Employees' and Retirees' Benefit Sustainability Commission
Senator Edward J. Kasemeyer
Senator Verna L. Jones-Rodwell
Senator Nathaniel J. McFadden
Delegate Norman H. Conway
Delegate Melony G. Griffith
Mr. Karl S. Aro
Mr. Warren G. Deschenaux

Appendix 3

Issues Requiring Additional Study

Issue to Examine	Examined by	Timeframe
Monitor State health plan to ensure that the State's share of covered charges retains equivalency with other states	DBM	Ongoing
Contingency plan to further restrict the scope of retiree health care benefits if costs continue to grow at an unsustainable rate	DBM	Ongoing
State consider options to restructure pension benefits	General Assembly	2011 Regular Session
Develop contingency plan to further restrict retiree health care benefits if benefits continue to grow at an unsustainable rate	DBM	2011 Regular Session
Review statutes that govern transfers of service between State and local retirement systems	General Assembly	2011 Interim
Devise a contingency plan to provide supplemental drug benefits through Employer Group Waiver Plan or other similar mechanism	DBM	Ongoing
Explore feasibility of requiring retired State employees to participate in Medicare Part D before 2020	DBM	Ongoing
Consider options to restructure pension benefits that do not diminish accrued benefits but reduces future liabilities. This should include examining the feasibility of offering a menu of benefit options, including a cash balance plan	General Assembly or DBM	2011 Regular Session
Examine the effect of a cash balance plan on the State pension fund's financial performance	SRA	September 1, 2011
Through the collective bargaining process, explore holding a referendum on whether the State Police Retirement System should join Social Security	Superintendent of State Police	Before next Collective Bargaining Agreement
Study benefit structures of the Legislative Pension Plan	General Assembly Compensation Commission	By December 31, 2013
Study benefit structures of the Judges' Retirement System	Joint Committee on Pensions	2011 Interim
Examine the effects of wealth equalization	DBM and MSDE	2011 Interim
Effect of fringe benefit changes on recruitment and retention of State employees	DBM	2011 Interim

DBM: Department of Budget and Management
SRA: State Retirement Agency
MSDE: Maryland State Department of Education

Healthcare Reform Planning Tool
Updated January 4, 2011

Effective Date	Item Description	Party Impacted	Comments
3/31/2010	Relaxation of tax criteria for children under the age of 27	All participants	For specific types of children; son, daughter, stepson, stepdaughter, adopted child and eligible foster child (others are included but are outside our eligibility definitions) the child no longer needs to meet either the Qualifying Child or Qualifying Relative as long as the child meets the new tax criteria test applicable under the reform legislation.
6/1/2010	Early retiree healthcare federal reinsurance	Retiree population between ages of 55 and 64, not on Medicare and not actively working for another employer providing health insurance	Feds will reimburse medical and prescription costs incurred by State between $15,000 and $90,000 per retiree. Regulations issued. Awaiting application. Money can be used to either reduce retiree or employer's cost. Only $5B allocated and program ends when out of money. Employer required to implement cost savings programs and procedures for chronic and high cost conditions. Submitted claims based on actual amount expended by plan and includes retiree copays, deductibles, coinsurance, etc.
1/1/2011	OTC medicines without an Rx no longer reimbursable under healthcare FSA	Active employees	Does not impact retirees or direct pay participants. Takes away a useful tool by which participants could spend down balances at the end of each plan year to avoid forfeiture of balance. Prescribed OTC medicines and insulin are eligible for reimbursement however.
7/1/2011	Expansion of child coverage to age 26	All participants	Expands coverage for one more year - to end of month in which child reaches 26. Child can be married and not living at home. We are not required to cover spouse and children if child is married. Regulations issued in May 2010; will be final for plan years after Sept. 2010. Regs prohibit using any criteria other than relationship to employee/retiree to determine elig for coverage. Premium for all dep children under 26 must be the same. No subsidy variation permitted. **Grandfathered plans can exclude children with access to other employer-sponsored coverage until 2014.**

Effective Date	Item Description	Party Impacted	Comments
7/1/2011	Elimination of lifetime dollar maximums on health plans	All participants	Results in the removal of the $2M LT max on PPO and POS. May impact IVF if considered an essential service. Essential service not fully defined yet, but general categories include: ambulatory patient services, emergency services, hospitalization, maternity/newborn care, mental health and substance use, prescription drugs, rehabilitative services and devices, prevention and wellness, chronic disease management, pediatric - including dental/vision.
7/1/2011	Elimination of annual dollar limits on essential benefits	All participants	HHS has not yet defined essential benefits.
7/1/2011	Elimination of cost sharing on preventive care, inclusion of additional preventive care services	All participants	**Grandfathered plans are exempt**.
7/1/2011	Elimination of pre-existing condition exclusions for children under 19	None	Our plans do not include any pre-existing condition limitations - no impact.
7/1/2011	Referral and/or preauthorization requirements for OB/GYN, Pediatrician and ER services prohibited. OON ER services must be covered at same level as IN.	All participants	Plans must allow free choice of primary care pediatricians, as well as gynecologists and obstetricians and emergency care. Currently, have eliminated referrals except under CareFirst POS. Plans currently permit pediatrician selection as PCP and self-referral to OB/GYN. Further, all of our plans provide coverage for emergency care out of network. **Grandfathered plans are exempt.**
7/1/2011	Prohibition on Rescissions	All participants	Coverage may be rescinded only for fraud or intentional misrepresentation of material fact as prohibited by the terms of coverage. Prior notification required of at least 30 days. Retroactive terminations permitted for non-payment of premiums, not permitted for DVA.

Effective Date	Item Description	Party Impacted	Comments
7/1/2011	Insured plans become subject to same non-discrimination rules as self-insured ERISA plans.	All participants	We are not currently subject to ERISA and none of our medical plans are insured. Need HHS clarification to determine if dental plans fall under this requirement. **Grandfathered plans are exempt.**
7/1/2011	Employer annual reporting to participants and HHS.	State	Reports must be provided to participants prior to open enrollment regarding group health plan and healthcare provider reimbursement structures that improve quality of care including wellness and health promotion activities. **Grandfathered plans are exempt.**
1/1/2012	Reporting plan value on W-2	Active employees	CPB must prepare to report combined cost of medical and dental on the 2011 W-2. Value of FSAs excluded, but need to know if Rx is assumed to be part of medical. Probably yes because Rx is listed in minimum coverage requirement. Value is based on COBRA rates. HHS deferred to 2012 - reporting is optional for 2011, mandatory in 2012.
7/1/2012	Mandatory internal and external appeals process must be included, similar to ERISA process.	All participants	Our plans already provide appeals processes through the carrier and then through the Benefit Review Committee. **Grandfathered plans are exempt**.
7/1/2012	Uniform explanation of coverage	All participants	It must be four pages, culturally and linguistically appropriate, using 12 pt font. Must include statement that Program provides minimum essential coverage whether Program pays less than 60% of total cost of coverage. It must be distributed annually; material changes must be updated within 60 days of change. HHS will issue the standards within 12 months, first summary is due within 24 months of 9/23/10.
1/1/2013	Healthcare FSA annual contribution max capped at $2,500	Active employees	Currently there is no regulatory limit, but our Program caps the annual contribution at $3,000.
1/1/2013	Medicare hospital insurance tax increase	Employees only, not employers.	Employee portion of FICA tax increase from 1.45% to 2.35% for individuals earning $200,000 per year or more ($250,000 for joint filers)

Effective Date	Item Description	Party Impacted	Comments
3/1/2013	Employee notices regarding Exchange	State	Notice provided to all new hires at time of hire, by 3/1/13 for all other employees. Must inform employee of existence of exchange, its services, how to contact and the State's share of total plan costs, that employee may be eligible for premium tax credit or cost sharing reduction, that if employee purchases exchnage coverage will lose State contribution.
3/1/2013	Employee notices regarding Exchange	State	If the actuarial value of the plan is below 60%, employees under 400% of the federal poverty level are eligible for subsidized Exchange coverage. If those employees elect Exchange coverage, employer is assessed the Pay and Play penalty. It appears that the actuarial value looks to see if the plan pays less than 60% of the total cost of benefits provided under the plan.
7/1/2013	Comparative effectiveness research tax	State	Tax on insured and self-insured plans equal to $1 per participant per year for the first year, increase to $2 in the second year and indexed thereafter. Additional taxes need to be accounted for in budgeting process.
1/1/2014	Employer reporting to IRS regarding coverage offered	State	For the purposes of applying employer penalties, large employers are required to file a report with the IRS by 1/31 of following year that provides certification that it offers FTEs an opportunity to enroll in minimum essential coverage and includes information on waiting periods for coverage, premium costs, total cost paid by employer, number of FTEs and information on each FTE and the months covered under the plan. This same information must also be provided in a statement to each FTE.
1/1/2014	Employee vouchers for Exchange coverage	State and participants	Employers offering plans that meet the Minimum Essential Coverage and subsidize that coverage are required to provide vouchers to eligible employees for purchasing coverage in an Exchange. Employees are eligible if their contribution s between 8 and 9.8% of the employee's household income AND the employee's household income does not exceed 400% of FPL. Percentages are indexed thereafter. The voucher equals the highest amount of employer subsidy for single (or family) coverage offered by the employer.

Effective Date	Item Description	Party Impacted	Comments
7/1/2014	Coverage for routine patient costs for care in connection with clinical trials required.	All participants	Our plans already provide coverage for care related to clinical trials, but grandfathered plans are exempt from this requirement as well. Additional details are needed to compare our Program coverage to the specific language (not yet provided) within the bill. **Grandfathered plans exempt.**
7/1/2014	Pay and Play Penalty	State	For employers who provide coverage, if employees choose to opt out of the employer plan and enroll in Exchange coverage, the employer must pay $3,000 (indexed) for each full-time employee who enrolls in the Exchange and receives a subsidy; there is an aggregate cap of $2,000 times the total number of full-time employees. To be eligible for a subsidy through the Exchange, the employee's household income must be between 133-400% of FPL and either the employee's contribution under the employer plan exceeds 9.5% of household income, or the employer failed the 60% minimum test. Note, there is no penalty for any employee receiving a "free choice voucher."
1/1/2018	Cadillac Plan Excise Tax	State	40% tax applies to plans with a value in excess of $10,200 for Individual coverage and $27,500 for Family coverage. This will be indexed at CPI-U +1% for 2019 and CPI-U only thereafter. The limits are higher for retiree coverage. For self-insured plans, the plan administrator (i.e. the State) is considered the coverage provider. The tax does not apply to LTC, dental, vision, or specific disease or hospital indemnity policies. Adjustments are also made for high risk professionals and for age and gender. The employer is responsible for calculating the tax, notifying providers and notifying HHS.
Unknown	Voluntary long term care program available to all employed Americans	Active employees	Government-run long term care program that provides community assistance or daily allowance for long term care services. Five-year waiting period during which premiums must be paid and employee must have worked for at least three of the five years. Employers may, but are not required to, allow for payroll deductions and automatically enroll employees. Guidance and regulations to come from DHHS.

Effective Date	Item Description	Party Impacted	Comments
Unknown	Automatic enrollment of employees into employer plan	State and participants	The effective date ispending HHS guidance. Employers with more than 200 FTEs that offer benefit coverage must automatically enroll employees, but allow employee to opt-out. Employers with multiple plans appear to have the ability to select a default plan.

Source: Department of Budget and Management

Membership Profile

State Retirement and Pension System

(As of June 30, 2009)

	Employees' Combined*	Teachers' Combined	State Police**	LEOPS	Judges
Active Members	63,856	106,107	1,408	2,445	297
Vested Former Members	22,114	22,995	68	189	6
Retirees and Beneficiaries	43,794	55,756	2,226	1,067	348
Total Members	**129,764**	**184,858**	**3,702**	**3,701**	**651**
Average Active Pay	$50,040	$58,382	$60,785	$57,289	$135,577
Average Retiree Payment	$18,114	$25,009	$42,283	$30,636	$67,667

LEOPS: Law Enforcement Officers' Pension System

* Employees' Combined plans include correctional officers and legislators, but not municipal employees.
** The State Police Retirement System is the only State system whose members do not participate in Social Security.

Source: Department of Legislative Services

Comparison of Maryland State Retirement Plans

	Employees and Teachers[1]	State Police	Correctional Officers' System	Law Enforcement Officers' System	Judges	General Assembly	Governor
Participation	Condition of employment	Condition of employment	Condition of employment	Condition of employment	Condition of employment	Optional	Automatic
Vesting	5 years of service	5 years of service	5 years of service	5 years of service	Immediate	8 years of service	One full term
Employee Contribution	5.0% of salary	8.0% of salary	5.0% of salary	4.0% of salary	6.0% of salary (for 16 years)	5.0% of salary (for 22 years, 3 months)	None
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	Age 60 (Age 50 with 8 years reduced benefit)	Age 55
Allowance	1.8% of salary for years service after 7/1/98; plus 1.2% of salary for years 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 LEOPS modified pension benefit; otherwise 2.3% for first 30 years and 1.0% for each year thereafter	2/3 of active judge salary at 16 years	3.0% of current legislative salary per year of service	1/3 of current gubernatorial salary for one term; or 1/2 of annual salary for 2 terms
Post Retirement Adjustments	Limited to 3.0% annual COLA	Unlimited annual COLA	Unlimited annual COLA	Limited to 3.0% annual COLA	Based on salary of active judges	Based on salary of active legislators	Based on salary of active governor

COLA: cost-of-living adjustment

[1]Table reflects the provisions of the Employees' Pension System and Teachers' Pension System.

Source: Department of Legislative Services