M E M O R A N D U M

February 9, 2011

TO: Councilmembers

FROM: Karen Orlansky, Director
Office of Legislative Oversight

SUBJECT: **Follow-up to OLO Report on Achieving a Structurally Balanced Budget: Comparison of the Governor s Proposed Pension Changes and Options Identified by OLO**

This memorandum responds to Councilmember Floreen s question about how the Governor s recently proposed changes to the State s pension plans compare to the options identified in OLO s report on *Achieving a Structurally Balanced Budget in Montgomery County* (OLO Report 2011-2, Part II).

While not identical, many of the changes proposed by Governor O Malley on January 21, 2011 parallel the pension options identified in OLO s report. The proposed changes to benefits of current and future employees participating in Maryland s State-run pension plans are described below and cross-referenced to OLO s options in the table attached at ©1.

In sum, the pension changes proposed by Governor O Malley that OLO s Part II report also included as options are to:

- Increase employees pension contributions;
- Decrease pension multipliers;
- Increase the minimum retirement age and/or minimum years of service required for full retirement; and
- Change the cap on retiree pension cost-of-living adjustments (COLAs).

The Governor s proposal would require newly hired employees to pay higher employee contribution rates (7%) and receive the lower pension multiplier (1.5%). However, current employees would be offered the choice to either: pay a higher contribution rate (7%) and keep the current pension multiplier (1.8%); or pay the current contribution rate (5%) and use a lower pension multiplier (1.5%).

Other changes to employee pension benefits proposed by Governor O Malley and not explicitly identified by OLO are to:

- Increase the period for an employee to become fully vested in the system;
- Close the Deferred Retirement Option Program (DROP) for public safety employees; and
- Change the calculation of an employee s average final compensation, a component in calculating an employee s pension.

These three additional changes proposed by Governor O Malley are viable options to consider as potential changes to the County agencies pension plans. For example, the vesting period for both the County Government s and State s pension plans is currently five years. The Governor proposes to increase the vesting period from five to ten years, which actually is similar to what the County Government s pension plan (prior to FY90) used to require.

It should be noted that OLO s Part II report also identified several options that Governor O Malley did not include in his proposal, some of which are specific to Montgomery County. These include options to:

- Close locally-funded defined benefit plans and enroll new employees in defined contribution and/or hybrid plans;
- Close locally-funded defined benefit plans and enroll new represented public safety employees in a new hybrid plan with defined benefit and defined contribution components;
- Reduce or eliminate the locally-funded MCPS pension supplement; and
- Integrate MCPS locally-funded pension plan with Social Security (MCPS locally-funded plan is identical to the State Teachers Pension System, which is not integrated with Social Security for service after 1998).

If you have any questions about the information in this memo, please contact Leslie Rubin at x77998 or leslie.rubin@montgomerycountymd.gov.

Attachments:

Chart comparing Governor s proposed pension changes to options identified by OLO
Excerpts from OLO Report 2011-2, Part II

Summary of Governor O Malley s Proposed Pension Changes with Cross-References to Options in OLO Report 2011-2, Part II

Category		Governor O'Malley's Proposed Change	OLO Options	O'Malley's Proposed Change Affects…	
				Active Employees	New Hires
Employees' Pension System and Teachers' Pension System					
1	Employee Contributions and Multiplier	Employees' Choice – higher employee contribution (7% instead of 5%) **or** lower multiplier (1.5% instead of 1.8%)	MCG #2, #3 MCPS #2, #3	✓	
2	Average Final Compensation	Change calculation from highest consecutive 3 years to highest consecutive 5 years	N/A	Non-vested only	✓
3	Employee Contributions	Increase from 5% to 7% of salary	MCG #2, #3 MCPS #3		✓
4	Multiplier	Lower from 1.8% to 1.5%	MCG #2 MCPS #2		✓
5	Retirement Age/Years of Service for Full Retirement	Increase from age 60 with 5 years of service, to age 65 with 10 years of service	MCG #2, #4		✓
6	Vesting Period	Increase from 5-year to 10-year vesting period	N/A		✓
7	Pension COLAs	Cap on retiree COLA – 3% if system achieves investment returns, 1% if not	MCG #5		✓
State Police and Law Enforcement Officers' Pension System					
8	Deferred Retirement Option Program (DROP)	Close the Deferred Retirement Option Program (DROP)	N/A	Non-vested only	✓
Judges' System					
9	Employee Contribution	Increase – 8% of salary (currently 6%)	MCG #3 MCPS #3		✓

COUNTY GOVERNMENT OPTION #2: New Hybrid Plan for New Public Safety Employees

Current Structure

All new County Government public safety employees represented by an employee bargaining unit join the County s defined benefit plan, the Employees Retirement System (ERS). All other new County Government employees join either the County s: defined contribution plan, the Employees Retirement Savings Plan (RSP); or hybrid plan, the Guaranteed Retirement Income Plan (GRIP).

In FY11, the County Government s retirement benefit cost for a public safety employee enrolled in the ERS (32%-38% of an employee s salary) is over three times higher than the cost for a new employee enrolled in the RSP (8%-10% of an employee s salary). The employer s cost for defined benefit plans is impacted by many variables in a pension formula. The table below summarizes the key variables that determine pensions for the public safety employees in the ERS.

Table 6. Summary of Pension Formula Variables for ERS Public Safety Members*

Employee Contribution	Avg. Final Earnings	Minimum		Multiplier	Max. # of Years Credited in Pension Calculation
		Service	Age		
4.75 - 5.5%**	Highest 36 months	20-25 years	Any age	2.4 – 2.5%	31 - 36
		15 years	55		

*Employees hired on or after July 1, 1978.
**Employee contributions increase for any portion of salary than that is greater than the Social Security wage base ($106,800 in 2010).

Alternative Structure

Close the ERS defined benefit plans to new hires and create a new hybrid retirement plan (different from the GRIP) for represented public safety employees hired after a certain date.[1] The new hybrid plan would include both a defined benefit and a defined contribution portion.

Defined benefit component. The new defined benefit portion of the plan would change the pension formula variables to create a significantly smaller annual pension. Changes could include:

- Raising employee contribution rates;
- Increasing the minimum number of years required for full benefits;
- Increasing the minimum age for retirement with full benefits; and/or
- Decreasing the multiplier.

Defined contribution component. The defined contribution portion of this hybrid plan option would supplement the defined benefit portion and could be structured in a number of ways. A defined contribution option could be structured like the RSP (mandatory, set employer and employee contributions) or the employee could choose a contribution level within a range (e.g., 1-5% of salary) with the County Government matching a portion of that contribution.

[1] This option is similar to the Federal Employees Retirement System, which has both a defined benefit and a defined contribution component.

Projected Savings

While this option offers the opportunity for long-term savings compared to the current plans, the actual amount would depend upon how the hybrid plan was structured. As indicated earlier, estimates of the specific amount and timeframe for cost savings would require actuarial analysis.

Effect on Employees

Current employees would see no change to their retirement plans or future retirement benefit levels. New public safety employees would join a hybrid plan with both defined contribution and defined benefit components.

This type of plan would marry the benefits and drawbacks of defined benefit and defined contribution plans and more evenly distribute future financial risk between the County Government and employees. For example, employees would be able to rely upon a stream of income from a pension, but could not take the benefit with them to another employer. Similarly, employees would have a portable retirement plan with the defined contribution component, but the total value would depend upon the rate of investment returns.

COUNTY GOVERNMENT OPTION #3: Increase Employee Contributions in Defined Benefit Plans

Current Structure

All County Government employees in the defined benefit plan (Employees Retirement System) contribute a portion of their salaries to help fund their pensions. In a defined benefit plan, employee contributions affect the annual contribution required from employers. Specifically, increased employee contributions result in decreased contributions for the County Government. The table below summarizes the current employee contribution rates set forth in County law.

Table 7. Current ERS Employee Contribution Rates as Percent of Salary (hired on or after July 1, 1978)

Group	Current Rate*
Non-Public Safety Employees hired before Oct. 1, 1994	4.0%
Deputy Sheriff and Corrections	4.75%
Police	4.75%
Fire	5.5%

*Employees contribute a higher percent of salary, ranging from 6% to 9.25%, for any portion of salary than that is greater than the Social Security wage base ($106,800 in 2010).

Alternative Structure

Increase the required employee contribution for all current and future employees in all ERS groups. For example, the County could increase the current rate for all groups by a set percent (e.g., a 50% increase) or establish a uniform but higher contribution rate for all groups (e.g., 7% for all members).

Projected Savings

Estimates of the specific amount and timeframe for cost savings would require actuarial analysis; however, a general description of how this option achieves savings follows.

If employees contribute a higher percent of salary to the ERS, the County s required contribution would decrease. While the decrease would not be dollar-for-dollar, the County s savings would reflect the magnitude of increased employee contributions. Table 8 shows that if employee contribution rates had been increased by 50% for all groups, employees would have contributed an additional $8.6 million to the ERS in FY11.

Table 8. Example of Potential County Government Savings from Increased Employee ERS Contributions

Employee Contribution		Difference
Current Structure	50% Increase	
$17.4 million	$26.0 million	+$8.6 million

Effect on Employees

Increasing employee ERS contributions would decrease the amount of money that employees take home in paychecks. For example, raising the employee contribution by 50% for an ERS public safety employee earning $50,000 annually and contributing 4.75% of salary would increase the employee s contribution by $1,188 annually.

COUNTY GOVERNMENT OPTION #4: Increase Minimum Retirement Age and Years of Service for New Public Safety Employees in the Defined Benefit Plan

Current Structure

Since 2001, pension benefit enhancements (such as lowering retirement age or increasing multipliers) have added to the ERS existing liabilities in amounts ranging from $27.5 million to $121.9 million. See Appendix (©93). County law establishes the minimum age and/or years of service requirements for an ERS member to retire with full benefits. Increasing or decreasing these requirements impacts defined benefit plan costs because it affects how long the plan will pay employee pensions.

Public safety members in the ERS retire at a much younger age than non-public safety members. The County s actuaries estimate that by age 54, 30% of public safety members of the ERS will retire compared to 5% of non-public safety members.[2] Earlier retirement for public safety employees is one factor that contributes to the higher cost of public safety members in the ERS compared to non-public safety members. The table below summarizes minimum age and years of service requirements for public safety members in the ERS.

Table 9. Current Minimum Age and Service Requirements for Public Safety Members of the ERS

Group	Deputy Sheriff and Corrections	Police	Fire
Minimum Age/ Years of Service	55/15	55/15	55/15
	Any/25	Any/25	Any/20

Alternative Structure

Increase the minimum age for retirement and minimum required years of services to qualify for full retirement benefits for public safety employees hired after a certain date. Possibilities include:

- Establish a minimum retirement age regardless of years of service;
- Raise the minimum retirement age by five years for members with 15 years of service; and/or
- Require at least 25 years of service for members retiring before age 55.

Projected Savings

While this option would offer the opportunity for long-term savings compared to the current plans, estimates of the specific amount and timeframe for cost savings would require actuarial analysis.

Effect on Employees

Current employees would see no change to their retirement plans. Higher minimum age and/or years of service requirements would result in new hires working longer than current active members in order to receive full retirement benefits.

[2] 2009 Actuarial Valuation for ERS Contribution in FY11.

COUNTY GOVERNMENT OPTION #5: Lower the Pension COLA Cap

Current System

Under current County law, retirees in the ERS receive an annual cost-of-living adjustment (COLA) to their pensions based on the rate of the Consumer Price Index (CPI). Retirees can receive a negative COLA if the CPI is negative for a given year. ERS members hired by the County Government before October 1, 1978 receive an annual COLA equal to 100% of the CPI. All members hired on or after October 1, 1978 receive a COLA based on the following formula:

- 100% of the CPI up to 3%;
- 60% of the CPI greater than 3%, not to exceed 7.5%; and
- 100% of the CPI for retirees age 65 or over.

ERS retirees hired after June 30, 1978 have received a COLA of, on average, 2.5% annually between FY01 and FY10.

Alternative Structure

Lower the annual COLA applied to retiree pensions for all current and future ERS retirees through structural changes to the retiree COLA formula. There are many different ways to accomplish this. For example, the County could provide all retirees with a set annual COLA of 1%, regardless of the CPI. Another example would be for the County to provide an annual COLA based on the CPI, but with a maximum of 2%. For a discussion of the legal issues related to implementing a change to pension cost of living adjustments for current and future retirees, see the County Attorney s memos in the Appendix (©8 and ©22).

Projected Savings

Estimates of the specific amount and timeframe for cost savings would require actuarial analysis; however, a general description of how this option achieves savings follows.

As noted above, the average COLA for retirees between FY01 and FY10 was 2.5%. If a structure had been in place that capped COLA s at a maximum of 2%, retiree s would have had smaller pension increases in eight of the past ten years. As a result, the overall County required contributions to the Employees Retirement System would have been lower.

Effect on Retirees

Under this option, retirees would likely receive smaller annual pension increases, at least in some years. The magnitude of the difference depends upon the specific structure adopted.

MCPS OPTION # 2: Eliminate MCPS' Local Pension Supplement

Current Structure

All MCPS employees participate in a locally-funded Pension Supplement, regardless of whether they participate in the State retirement plan or the Local retirement plan. A portion of the local Pension Supplement provided to employees in the State-funded plan is mandated by State law.[3]

In FY11, the Pension Supplement accounted for $25.9 million (41%) of MCPS $63.3 million in retirement plan contributions.

Table 10. FY11 Cost of MCPS Pension Supplement

Group	FY11 MCPS Contribution	FY11 Contribution Rate (% of salary)
Employees in State Plan	$22.1 million	1.92%
Employees in Local Plan	$3.8 million	1.90%
Total	**$25.9 million**	**--**

Alternative Structure

Eliminate the Pension Supplement for all MCPS employees hired after a certain date. This option would require a change to State law.

Alternatively, MCPS could eliminate the portion of the Pension Supplement ***not required*** by State law. MCPS could implement this change with no amendment to State law.

Projected Savings

Although this option would not yield significant agency savings in the short run, it would lead to substantial savings in the long run. Estimates of the specific amount and timeframe for cost savings would require actuarial analysis.

Because this option would only apply to employees hired after a specified future date, MCPS would continue to pay the pension supplement for current employees. Over the course of many years, MCPS costs for the Supplement ($26 million in FY11) would be vastly reduced and eventually eliminated.

Effect on Employees' Retirement

Current employees would see no change to their retirement plans or future retirement benefit levels. Employees hired on the effective date of the change would still receive a defined benefit pension; however, the pension would be based on a multiplier of 1.8% instead of 2%.

MCPS employees currently contribute 0.5% of salary annually toward their Pension Supplement. Employees hired after the effective date of the change would no longer be required to contribute that portion of their salary toward retirement.

[3] MCPS is required by State law to provide a 0.08% supplement to the pension multiplier; however, MCPS provides a 0.2% supplement. Montgomery County is the only Maryland County required to supplement State teacher pensions.

MCPS OPTION # 3:
Increase MCPS Employee Contributions to Pension Supplement

Current Structure

All MCPS employees participate in a locally-funded Pension Supplement, regardless of whether their Core retirement plan is funded by the State or by MCPS. A portion of the local Pension Supplement given to employees in the State-funded plan is established in State law.[4]

MCPS employees contribute 0.5% of their salary for the Pension Supplement (on top of the 5% they contribute toward their Core Pension). In a defined benefit plan, employee contributions affect the annual contribution required from employers. Specifically, increased employee contributions result in decreased contributions for MCPS. MCPS total required contribution in FY11 to fund the Pension Supplement is $25.9 million.

Alternative Structure

Increase required employee contributions for the local Pension Supplement. For example, MCPS could increase the required employee contribution from 0.5% to 0.75% of salary (a 50% increase).

Projected Savings

Estimates of the specific amount and timeframe for cost savings would require actuarial analysis; however, a general estimate of savings follows.

If employees contributed a higher percent of salary toward the Pension Supplement, MCPS required contribution would decrease. While the decrease would not be dollar-for-dollar, the MCPS savings would reflect the magnitude of increased employee contributions. Table 11 shows that if employee contribution rates to the Pension Supplement had been increased by 50%, employees would have contributed an additional $3.4 million in FY11.

Table 11. Example of Potential County Government Savings from Increased Employee ERS Contributions

Pension Supplement Employee Contribution[5]		Difference
Current Structure	50% Increase	
$6.7 million	$10.1 million	+ $3.4 million

Effect on Employees' Retirement

Changing employee contributions in a defined benefit plan does not change an employee s retirement plan or the future retirement benefit levels. An employee would have to contribute a higher portion of their salary toward their Pension Supplement benefit. In the example used above, an increase in the employee s contribution from 0.5% to 0.75% would mean that an employee earning $50,000 per year would contribute an additional $125 annually.

[4] Montgomery County is the only Maryland County required to supplement State teacher pensions.
[5] Calculated based on the MCPS approved FY11 tax supported salary costs of approximately $1.34 billion.