

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

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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

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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.

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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 competitiveness 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.

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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

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