DEPARTMENT OF
BUDGET & MANAGEMENT

MARTIN O'MALLEY
Governor

ANTHONY BROWN
Lieutenant Governor

T. ELOISE FOSTER
Secretary

DAVID C. ROMANS
Deputy Secretary

January 15, 2014

The Honorable Martin O' Malley,
Governor
100 State Circle
Annapolis, Maryland 21401-1991

The Honorable Edward J. Kasemeyer
Chairman, Senate Budget and Taxation Committee
3 W Miller Senate Office Building
Annapolis MD 21401-1991

The Honorable Norman H. Conway
Chairman, House Appropriations Committee
120 House Office Building
Annapolis MD 21401-1991

The Honorable Verna Jones-Rodwell
Co-chair, Joint Committee on Pensions
420 Miller Senate Office Building
Annapolis MD 21401-1991

The Honorable Melony G. Griffith
Co-Chair, Joint Committee on Pensions
307 House Office Building
Annapolis MD 21401-1991

Dear Governor O'Malley, Chairman Kasemeyer, Chairman Conway, Chairman Jones-Rodwell and Chairman Griffith:

Language on Page 186 of the 2013 Joint Chairmen's Report requires the Department of Budget and Management, in conjunction with the State Retirement Agency, to provide a determination of whether a Maryland State Retirement and Pension System (MSRPS) reinvestment contribution in excess of the amount funded in fiscal year 2013 is appropriate in light of the State's simultaneous goals of reducing unfunded liabilities and budget sustainability. The report is to be provided to the Governor, the budget committees of the General Assembly, and the Joint Committee on Pensions. The attached report is submitted in compliance with this reporting requirement.

If you have any questions regarding this report, you may contact me at eloise.foster@maryland.gov or 410-260-7041.

Sincerely,

T. Eloise Foster
Secretary

Attachment

cc: The Honorable Nancy K. Kopp, Chairman, Maryland State Retirement and Pension System
Mr. Dean Kenderdine, Executive Director, Maryland State Retirement Agency

Report to the Maryland General Assembly
Maryland State Retirement and Pension System (MSRPS) Reinvestment Contributions

Language on Page 186 of the 2013 Joint Chairmen's report directs the Department of Budget and Management (DBM), in conjunction with the State Retirement Agency (SRA), to report to the Governor, the budget committees of the General Assembly and the Joint Committee on Pensions a determination of whether a Maryland State Retirement and Pension System (MSRPS) reinvestment contribution in excess of the amount funded in fiscal year (FY) 2013 ($191 million) is appropriate in light of the State's simultaneous goals of reducing unfunded liabilities and budget sustainability. DBM's recommendation is to reduce the annual reinvestment amount to $200 million beginning in FY 2014, delaying by only one year the achievement of the State's 80% funding goal while substantially improving budget sustainability.. SRA's recommendation is to maintain the current commitment to reinvest $300 million annually. The following is an analysis of the MSRPS reinvestment options facing the State.

Background

Pension reform legislation enacted in 2011 generated savings that reduced the annual amount the State must contribute to the pension system. To accelerate the pension system's return to financial health, the legislation requires the Governor to reinvest a portion of the savings generated by reform in the pension system. The required reinvestment amount was phased-in over three years reaching $300 million for FY 2014 and each year thereafter.

The O'Malley Administration's FY 2014 budget submission reinvested the required $300 million in the pension system, $109 million more than the FY 2013 reinvestment amount. The General Assembly set-aside $100 million of the FY 2014 funding (roughly the increase in reinvestment funding over FY 2013) pending the Governor's decision about whether the funding is required to support critical programs impacted by federal sequestration. If the Governor determines the funds are not needed, he is authorized to transfer the funds to the pension system as originally intended.

Analysis of Reinvestment Options

<u>Impact of Reinvestment Dollars on Funded Status of the Pension System</u>

Annually reinvesting $300 million in the State pension system will modestly accelerate improvement in the System's funded status. The pension system is currently 64.6% funded. Achieving an 80% funded status is a benchmark of system health relied upon by many national experts. Reinvesting $300 million annually in the system will result in achieving the recommended 80% funding in 2024. If no additional funds are reinvested, it will take an additional three years to reach the 80% funding goal.

<u>Budget Sustainability</u>

DBM's forecast for FY 2015 shows a gap between revenues and spending of about $400 million. While the projected gap is expected to shrink once all authorized gambling venues become operational in 2018, gambling revenues will not resolve the imbalance between revenues and spending.

Impact of Different Pension Reinvestment Levels on Pension System and Budget Sustainability

The table below depicts the impact that different levels of reinvestment have on the funded status of the pension system and the State budget. If the commitment to reinvesting $300 million annually is maintained, the pension system is expected to realize 80% funding in 2024 – three years faster than if no additional funds were reinvested. Reducing the reinvestment amount to $200 million only delays achievement of the 80% funding goal by one year (till 2025) while generating more than $450 million of budget savings for the State over the next five years. Under all three scenarios, the State will realize 100% funding by 2039.

Exhibit 1. Impact of Reinvestment Options

			$ in Millions	
	Funded Status Achieved		General Fund Savings	5 Year
Options	**80%**	**100%**	**FY 14 & FY15**	**Savings**
Current Policy - Reinvest $300M Annually	2024	2039	0	0
Reinvest $200M Annually (effective FY14)	2025	2039	174	459
Reinvest $200 M in FY 14/$0 thereafter	2027	2039	348	1,207

Recommendations

Department of Budget and Management (DBM) Recommendation

The Department of Budget and Management recommends reducing the State's ongoing reinvestment contribution from $300 million to $200 million beginning in FY 2014. This recommendation will:

- Generate much needed general fund savings of $174 million ($87 million in each FY 14 and FY 15) to apply against the State's current budget shortfall.
- Improve budget sustainability by reducing the structural deficit.
- Delay achievement of 80% funded status for the pension system by only one year.
- Maintain the State's commitment to reinvest a portion of pension reform savings in the pension system.
- Provide the pension system with contributions in excess of the amount required to transition from the current corridor funding method to an actuarially preferred funding method.

State Retirement Agency (SRA) Recommendation

The State Retirement Agency, on behalf of the Board of Trustees ("Board") for the State Retirement and Pension System, strongly recommends that the State adhere to the pension funding policy established with the reforms of 2011 as stated in §21-308; "For fiscal year 2014 and each fiscal year thereafter, in addition to the amounts required under paragraph (2) of this subsection, the Governor shall include in the budget bill $300,000,000."

The Board believes that the goals set forth by the Public Employees' and Retirees' Benefit Sustainability Commission and adopted by the General Assembly in 2011 should be pursued. In its report to the General Assembly, the Commission stated that "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." The report goes on to assert that "[a]ccomplishing these goals will require a combination of benefit restructuring and fiscal discipline by the State", and 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 reforms of 2011 were designed and enacted with the understanding among employer and employee, that sustainability of Maryland's defined benefit system would be achieved through shared responsibility. The Board believes that it is not unreasonable to assume that the active System members whose increased contributions have provided the greatest portion of the reform savings to date, have expected their employer to honor the commitment it made in 2011. It should be noted that of the total $300 million reinvestment, approximately two-thirds is a result of the fact that the reforms increased employee contributions. The remaining one-third is related to the fact that the reforms decreased benefits. With the combined effect of the employee contribution increase and the reductions to benefits exceeding $300 million, it is clear that the impact sustained by the employees through the 2011 reforms has resulted in State employees bearing the majority of the burden necessary to strengthen the system. Meanwhile, the State's General Fund is realizing all savings in excess of those required to be reinvested in the System. The System's actuary has projected that approximately $55.6M in reform savings will flow to the State's General Fund in FY2015. This amount is projected to grow by about 8% over the next five fiscal years. These projections assume that all actuarial assumptions are met and assume that the full $300M of savings are reinvested back into the System.

The State Treasurer has been very clear in her representation of the views of the rating agencies concerning Maryland's public pension plans and the reforms of them. The agencies have been consistently concerned over the underfunding of the System, including the Corridor Funding Method. See Attachment A, taken from the System's FY2013 Comprehensive Annual Financial Report showing the System's funding progress for the past 10 years. The Corridor Funding Method is now being phased out, an action that has been favorably acknowledged by the rating agencies. They have also favorably acknowledged the 2011 reforms of the System, including the reinvestment of savings element of those reforms.

Making such reforms and remaining faithful to them is of great importance to the rating agencies. It is fair to expect that any further reneging on the State's reform plan will be dimly viewed.

It is also important for the System and the State to be mindful of the new accounting rules under the Government Accounting Standards Board (GASB) that will take effect for the State's FY2015 financial statements. Under these rules, if the State gets to a point where assets (including all anticipated contributions and investment earnings) are insufficient to pay the accrued liabilities, it will be necessary for the State to measure its liabilities, for accounting purposes, using a blend of the System's assumed rate (now 7.70%) and the rate for high quality municipal bonds as of fiscal year end. The use of a blended rate will increase the size of the liabilities that will be booked on the State's financial statements. Thus, a reduction in the State's future contributions increases the likelihood (albeit undetermined at this point) that the use of a blended assumed rate of return will be required.

Attachment A

The Maryland State Retirement and Pension System's Funding Progress, 2004-2013

Actuarial Valuation Date June 30,	Actuarial Value of Assets a	Actuarial Accrued Liability (AAL) b	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll c	UAAL as a Percentage of Covered Payroll [(b-a)/c]
2004	$ 33,484,657	$ 36,325,704	$ 2,841,047	92.18%	$ 8,069,481	35%
2005	34,519,500	39,133,450	4,613,950	88.21%	8,603,761	54%
2006	35,795,025	43,243,492	7,448,467	82.78%	9,287,576	80%
2007**	37,886,936	47,144,354	9,257,418	80.36%	9,971,012	93%
2008	39,504,284	50,244,047	10,739,763	78.62%	10,542,806	102%
2009	34,284,569	52,729,171	18,444,602	65.02%	10,714,241	172%
2010	34,688,346	54,085,081	19,396,735	64.14%	10,657,944	182%
2011	36,177,656	55,917,543	19,739,887	64.70%	10,478,800	188%
2012	37,248,401	57,869,145	20,620,744	64.37%	10,336,537	199%
2013	39,350,969	60,060,091	20,709,122	65.52%	10,477,544	198%

** Beginning July 1, 2006, the system changed its funding method from the Aggregate Entry Age Normal method to the Individual Entry Age Normal method. Due to an actuarial error, the Schedule of Funding Progress presented in the June 30, 2007 Comprehensive Annual Financial Report overstated the Actuarial Accrued Liability. The 2007 funding results have been restated above to reflect the corrected actuarial valuation results.