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Office of the Superintendent of Schools
MONTGOMERY COUNTY PUBLIC SCHOOLS
Rockville, Maryland

May 23, 2011

MEMORANDUM

To: Members of the Board of Education

From: Jerry D. Weast, Superintendent of Schools

Subject: Montgomery County Public Schools Employees' Pension Plan Changes

Executive Summary

The Maryland General Assembly made changes to the Maryland State Teachers' Pension System that will be implemented in Fiscal Year (FY) 2012. These changes reduce the benefits provided to employees who are hired after July 1, 2011, but preserve the benefits improved in 2006 for current employees. In addition, employees will be required to contribute more to their pensions after July 1, 2011, when the required employee contribution increases from five percent of salary to seven percent of salary. The Montgomery County Public Schools (MCPS) Employees' Pension Plan provides benefits that are similar to the Maryland State Teachers' Pension System to those MCPS employees who are not eligible to participate in the state plan. In order to ensure that parity between the two plans is maintained, I am recommending that the Board of Education make changes to the MCPS Employees' Pension Plan that parallel the changes to the state plan. In addition, I am recommending that the supplemental pension plan be aligned with the changes to the state and local core pension plans.

Background and History

On April 25, 2006, Governor Robert L. Ehrlich, Jr. signed pension reform legislation which improved the pension benefit of the Maryland State Teachers' Pension System. The legislation improved the benefit retroactively to 1998. Under the current formula, Maryland teachers hired since 1998 would have a pension benefit of 54 percent of their average final salary after a 30-year career. At the time, mandatory employee contributions were increased from two percent of salary to five percent of salary. The actuarial calculations indicated that these increased contributions would eventually fund the benefits earned after 2006.

Since that time, the turmoil in the financial markets and the economic downturn have caused most states to reexamine the funded status of their pension plans and reduce pension benefits, typically for newly hired employees. Over the past two years, more than half of all states have made changes to their benefit programs, according to the Pew Foundation. The Maryland General Assembly made significant changes to the Maryland State Teachers' Pension System, rolling back for new employees many of the improvements made in 2006, and requiring employees to pay more for their benefits.

Changes to the Maryland State Teachers' Pension System

For employees hired prior to July 1, 2011, there will be two changes:

1. Employee contributions to their pensions will increase from five to seven percent of salary. Employees will see the increase in contributions in the pension deductions in FY 2012 that begin on September 16, 2011 (payroll deductions are taken from 20 paychecks each year).
2. In addition, the cost-of-living increases on pensions for service after July 1, 2011, will have a different basis. The new cost-of-living increases will be based on the Consumer Price Index (CPI) with either a cap of 2.5 percent (if the state teachers pension trust earns or exceeds its target investment rate of return, currently 7.75 percent) or one percent (if the trust does not meet its investment return).

New employees hired after July 1, 2011, will see many more significant changes:

- Vesting of benefits will occur at 10 years, an increase from the current 5 years.
- The average final salary will be based on the highest five consecutive years, an increase from the current three years.
- The benefit formula will be 1.5 percent of final average salary for each year of service, a decrease from the current 1.8 percent.
- Retirement will be based on the "Rule of 90," meaning that the combination of service and age must total 90. Normal retirement age increases to 65 (with 10 years of service) from 62.
- Early retirement is age 60 with 15 years of service (previously it had been age 55 with 15 years of service). The early retirement penalty will be based on the normal retirement age of 65.
- Contributions and cost-of-living increases match the changes for current employees above.

The changes to the Maryland State Teachers' Pension System are summarized in the attached chart. As a result of these changes, a Maryland teacher hired on or after July 1, 2011, will have a pension benefit of 45 percent of his or her average final salary after a 30-year career.

Previous Action on Benefits for MCPS Employees

The history of retirement benefits for MCPS employees is important in understanding the improvements that were made in 2006 and the changes which are recommended now. MCPS began its own defined benefit program in 1968 for employees who were not covered by the state. At that time, all school systems and most local governments in Maryland (and many still today) paid the state to include their employees in the state program and provide them with retirement coverage. MCPS opted out of that program in order to improve benefits, lower costs, and align its pension benefits with those provided to Montgomery County Government employees. MCPS made improvements for employees remaining in the state plan (by providing a 10 percent improvement over the state benefit) and MCPS made the same changes for employees in the local plan. The effect was a 2 percent multiplier that resulted in a pension benefit equal to 60 percent of the final average salary for employees retiring after 30 years in either plan. There are approximately 400 active MCPS employees remaining under this provision. This is known as the “old retirement system.”

Changes in the state system in 1980 prompted further changes by MCPS. The new state pension system was integrated with Social Security and created a two-tiered system that significantly reduced benefits for teachers and other employees who were employed after July 1, 1980. At that time, MCPS amended its local plan to create a similar two-tiered integrated system but continued to provide a benefit that was 10 percent greater than provided by the state.

The two-tiered systems remained unchanged until 1998. Improvements at that time recognized that pension benefits were not keeping pace with original projections, dropping to as low as 30 percent of final average salary after a 30-year career for some employees. Legislative changes in 1998 resulted in the benefit formula that was in effect until June 30, 2006, which provided 1.2 percent multiplier for service prior to 1998 and a 1.4 percent multiplier for service after 1998. This change prompted revisions in the MCPS plan, improving the local formula to conform to the state program and providing a supplemental benefit that, when combined, surpassed the state’s pension benefit. When the change was approved in 1998, an MCPS employee who worked a 30-year career after 1998 would receive benefits equaling about 45 percent of average final salary (42 percent from the state and approximately 3 percent from the MCPS supplement).

In 2006, the state—and subsequently MCPS—improved the benefits to use a multiplier of 1.8 percent for all service after July 1, 1998. The MCPS supplement was changed to .2 percent, and MCPS employees could anticipate a pension of 60 percent of average final salary after a 30-year career with MCPS.

Recommended Changes to the Local Core Pension

The changes made in 2006 improved the competitiveness of the Maryland State Teachers’ Pension System. However, the competitive environment and budget challenges have resulted in changes to the benefits offerings for most states. Therefore, I am recommending changes to the

MCPS local pension plan to maintain parity for MCPS employees who are not covered by the state plan. This includes many employees in supporting services positions and some central services administrative positions, totaling approximately 22 percent of employees, with approximately 14.68 percent of salaries. The budgetary impact of increasing the contributions by 2 percent will be an additional $3,911,131.80 per year of employee contributions to the MCPS local pension fund.

The MCPS actuary estimates that the financial impact of the proposed changes will reduce the annual required contribution to the pension fund by $6.4 million. It will immediately improve the Actuarial Accrued Liability by $15 million and ultimately, when all active employees are those hired after July 1, 2011, improve it by $185 million.

The projected contribution rates over the next seven years will be reduced as listed below

Fiscal year	Board contribution before changes	Revised contribution	Savings
2013	6.11%	5.64%	0.47%
2014	6.76%	6.24%	0.52%
2015	7.20%	6.65%	0.55%
2016	7.24%	6.65%	0.59%
2017	7.30%	6.64%	0.66%
2018	7.32%	6.56%	0.76%
2019	7.35%	6.47%	0.88%

The purpose of a cost-of-living adjustment is to protect retiree benefits from erosion of buying power. The state plan has linked the cost-of-living adjustments to both CPI and the pension trust's investment returns. This shifts the investment risk to the retiree, who has no role in determining asset allocation or selecting investment vehicles. The professional management and protection from investment risk has been a long argued reason for offering defined benefit plans as opposed to defined contribution plans. The state decision to link the cost-of-living adjustment to the investment return has the potential to penalize retirees in times when inflation is present, the fund is adequately funded, and an investment strategy does not perform as expected.

Therefore, I am recommending that the cost-of-living adjustment in the MCPS local plan for benefits earned after July 1, 2011, be capped at 2 percent, subject to CPI with no link to plan investment returns. The financial impact presented above is based on this assumption.

During the Board of Education's Fiscal Management Committee meeting on May 9, 2011, two other possible cost-of-living adjustment options were discussed. One, proposed by the executive director of the Montgomery County Education Association, was to move to a 2 percent adjustment, not linked to CPI. The other, proposed by Board member and committee chair Philip Kauffman, was to align our cost-of-living cap with the state at 2.5 percent. The financial impact of these two options is relatively small, as the actuarially assumed average cost-of-living adjustment is 1.95 percent. For the seven years projected above, the 2 percent adjustment proposed by MCEA would reduce the FY 2012 contribution savings by $29,000 and the 2.5 percent cap would reduce contribution savings by $1,193,000. Over the long-term, however, the impact would be more significant, with the ultimate long-term savings projected to be reduced by $2.3 million and $21.7 million, respectively.

Recommended Changes to the Local Supplemental Pension

The provision of a supplemental pension benefit for MCPS employees continues to be a key factor in maintaining a competitive advantage in the recruitment and retention of teachers and other employees, particularly when compared to other Maryland systems. The high cost of living in our county continues to make this competition difficult. MCPS competes not only with school systems in the Washington, DC, Metropolitan Area and Maryland, but also with school systems in Virginia, Pennsylvania, and West Virginia. The supplemental pension benefit will support the competitive position of MCPS in attracting the most qualified teachers and other staff; therefore, I recommend maintaining the supplemental multiplier of .2 percent. The provisions of the supplemental plan need to align with an individual's core pension for vesting, average final salary, retirement eligibility, and cost-of-living calculation for administrative purposes. Therefore, I am recommending changes to the supplemental benefit provisions so that any individual's core and supplemental benefits are based on the same requirements.

Administrative Change for Efficiency

From time to time, employees' benefit amounts are very small, and the cost to administer a small monthly payment frequently exceeds the amount of the payment itself. This occurs when an employee works for MCPS for a short time and typically when their core benefit comes from the state. With the introduction of the 10-year vesting provision, the occurrence of these small payments should be less frequent. During 2010, there were 103 payments of less than $100 per month. Therefore, for the efficient administration of the plan, I am recommending that the plan be amended to permit a mandatory present value lump sum payment at the time of retirement in cases where the monthly benefit amount to be paid to an employee is less than $100 per month. The discount rate used in the pension plan for present value is five percent.

Summary of Recommendations

I am recommending that the Board of Education authorize the following changes to the MCPS Employees' Pension Plan:

- Adoption of the July 1, 2011, changes to the Maryland State Teachers' Pension System for employees hired on or after July 1, 2011, regarding multiplier, contributions, vesting, average final salary, and retirement eligibility

- An increased mandatory employee contribution of seven percent for all participants after July 1, 2011
- A cost-of-living adjustment for benefits based on service earned after July 1, 2011, subject to CPI with a cap of 2 percent
- Alignment of the MCPS supplemental pension benefit with the Maryland State Teachers' Pension System and local MCPS core pension plans
- A present value lump sum payment be introduced in cases where the payment to be made is less than $100 per month

The following resolution is recommended for approval by the Board of Education:

WHEREAS, The Board of Education approved the Montgomery County Public Schools Employees' Retirement System, effective July 1, 1968, for those employees who were not eligible to participate in the Maryland State Teachers' Retirement System; and

WHEREAS, The Montgomery County Public Schools Employees' Retirement System in 1968 provided a local core benefit equal to the benefit provided by the state retirement benefit which was 1.81 percent for each year of creditable service; and

WHEREAS, The Board of Education also approved in 1968 a supplemental benefit of 10 percent of the core benefit to all employees, for a total of 2 percent for each year of creditable service to attract and retain highly qualified employees; and

WHEREAS, In 1980, following action by the Maryland General Assembly to establish a new pension system for employees hired after July 1, 1980, the Board of Education approved a similar pension benefit for Montgomery County Public Schools employees not eligible to participate in the state program and amended the local retirement benefit supplement for employees hired after July 1, 1980; and

WHEREAS, In 1998, when improvements were made to the Maryland State Teachers' Pension System, the Board of Education amended the Montgomery County Public Schools Employees' Pension Plan and implemented a similar formula used to calculate retirement benefits, implementing a multiplier of 1.4 percent for all creditable service after 1998 and setting the benefit for pre-1998 service to the greater of either the 1980 formula or a multiplier of 1.2 percent; and

WHEREAS, In 2006, the Maryland General Assembly approved House Bill 1737, which was signed by the governor on April 25, 2006, improving state pension benefits, increasing the 1.4 percent multiplier to 1.8 percent for all service after July 1, 1998; and

WHEREAS, In 2011, the Maryland General Assembly adopted a budget that included changes to the Maryland State Teachers' Pension System for contributions and cost-of-living adjustments after July 1, 2011, and changes to benefits for employees hired after July 1, 2011; and

WHEREAS, Montgomery County Public Schools staff is recommending the following changes to the Montgomery County Public Schools Employees' Pension Plan:

- Adoption of the July 1, 2011, changes to the Maryland State Teachers' Pension System for employees hired on or after July 1, 2011, regarding multiplier, contributions, vesting, average final salary, and retirement eligibility
- An increased mandatory employee contribution of seven percent for all participants after July 1, 2011
- A cost-of-living adjustment for benefits based on service earned after July 1, 2011, subject to CPI with a cap of 2 percent
- Alignment of the MCPS supplemental pension benefit with the Maryland State Teachers' Pension System and local MCPS core pension plans

and

WHEREAS, The recommended changes were reviewed and supported by the Board of Education Fiscal Management Committee on May 9, 2011; and

WHEREAS, The Board of Education desires to provide the same pension benefit for all Montgomery County Public Schools employees, including those who are not eligible to participate in the state system; now therefore be it

Resolved, That the Board of Education increases the mandatory pension contribution to seven percent after July 1, 2011, for those employees not eligible to participate in the Maryland State Teachers' Pension System for their core benefit; and be it further

Resolved, That the Board of Education desires to change the provisions of the Montgomery County Public Schools Employees' Pension Plan to align with the Maryland State Teachers' Pension System for employees hired on or after July 1, 2011; and be it further

Resolved, That employees who receive their core benefit from the Montgomery County Public Schools Employees' Pension Plan who are hired on or after July 1, 2011, will be subject to 10-year vesting, an average final salary based on the five highest consecutive years, benefit multiplier of 1.5 percent, the rule of 90 for retirement eligibility, a normal retirement age of 65 (with 10 years of service), and early retirement based on age 60 and 15 years of service; and be it further

Resolved, That the cost-of-living adjustment in the Montgomery County Public Schools Employees' Pension Plan for benefits earned after July 1, 2011, be based on the Consumer Price Index with a 2 percent cap; and be it further

Resolved, That the Montgomery County Public Schools supplemental pension benefit be aligned with the Maryland State Teachers' Pension System and local core pension plans so that any individual's core and supplemental benefits are based on the same requirements; and be it further

Resolved, That the Board of Education desires to make lump sum present value payment mandatory at the time of retirement to employees whose benefit is less than $100 per month; and be it further

Resolved, That the superintendent of schools is authorized to complete all legally required documents to implement these resolutions.

JDW:LAB:SGD:sgd

Attachment