SB 899

Department of Legislative Services

Maryland General Assembly
2018 Session

FISCAL AND POLICY NOTE
Enrolled - Revised

Senate Bill 899 (Senator Guzzone)(Chair, Joint Committee on Pensions)
Budget and Taxation Appropriations

State Retirement and Pension System - Investment Division

This bill gives the Board of Trustees of the State Retirement and Pension System (SRPS) authority to determine and create positions necessary to carry out the professional investment functions of the Investment Division and to set their compensation, as specified in the bill. Compensation and operating expenses of the division are paid from the accumulation fund of each system and are *not* paid by participating employers. The bill also authorizes the board to invest the $75.0 million supplemental contribution paid by the State in State-based private equity and venture capital funds, as specified in current law. **The bill takes effect July 1, 2018.**

Fiscal Summary

State Effect: Special and reimbursable fund revenues and expenditures decrease by $6.8 million as expenses for the division are no longer paid by budgeted fees charged to participating employers of SRPS. Reimbursable fund savings by State agencies are assumed to be allocated 60% general funds, 20% special funds, and 20% federal/other funds. Instead, State Retirement Agency (SRA) nonbudgeted expenditures increase by $7.2 million beginning in FY 2019 due to Investment Division expenses being transferred, which results in a minimal increase in pension liabilities beginning in FY 2021 (not reflected below). State pension liabilities and contribution rates increase or decrease minimally depending on the performance of authorized investments, as discussed below.

(in dollars)	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
SF Revenue	($4,474,100)	($4,552,400)	($4,625,000)	($4,700,100)	($4,777,800)
ReimB. Rev.	($2,317,000)	($2,345,200)	($2,382,600)	($2,421,300)	($2,461,300)
GF Expenditure	($1,390,200)	($1,407,100)	($1,429,500)	($1,452,800)	($1,476,800)
SF Expenditure	($4,937,500)	($5,021,400)	($5,101,500)	($5,184,400)	($5,270,000)
FF Expenditure	($463,400)	($469,000)	($476,500)	($484,300)	($492,300)
NonBud Exp.	$7,204,500	$7,314,700	$7,445,200	$7,580,400	$7,720,600
Net Effect	($7,204,500)	($7,314,700)	($7,445,200)	($7,580,400)	($7,720,600)

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate increase; (-) = indeterminate decrease

Local Effect: Expenditures by local participating employers decrease by approximately $4.5 million in FY 2019 and by $4.8 million in FY 2023. Revenues are not affected.

Small Business Effect: None.

Analysis

Bill Summary:

Investment Division Staffing and Compensation

The SRPS board must adopt objective, performance-based criteria for setting the qualifications and compensation of the Chief Investment Officer (CIO) and division staff, including incentive compensation. It must also adopt objective criteria to determine appropriate staffing levels for the division. The bill establishes an Objective Criteria Committee to make recommendations to the SRPS Board of Trustees at least once every five years (beginning in December 2018) regarding the objective criteria that should be used for setting compensation levels and awarding financial incentives; the chairman of the board may not serve as chair of the committee. Members of the committee are fiduciaries of the system. The board may enter into an agreement with a consultant to assist the committee, but the consultant may not be actively providing consulting services to the board or division staff. The CIO acts in an advisory capacity to the committee, but may not participate in any deliberations regarding criteria for his or her own compensation.

Compensation for the CIO and division staff are not tied to cost-of-living adjustments or merit increases for other State employees. The board may not grant compensation increases or pay out incentive compensation to the CIO or division staff in years in which State employees are subject to a furlough.

Incentive compensation must be based on objective performance criteria, as specified by the bill, and is capped at 33% of base compensation. It must be paid out over multiple fiscal years in installments, but any unpaid incentive compensation may not be paid to the CIO or division staff after they separate from employment. Any incentive compensation not paid because of an employee furlough may be paid after the furlough period ends and only if the recipient is still employed by the division. Division staff that are not involved in investment-related decisions are not eligible for incentive compensation, and their base salary is subject to limitations based on comparable positions in State government.

The bill includes reporting requirements related to division staffing and compensation.

Private Equity and Venture Capital Investments

For fiscal 2019 through 2022, the $75 million supplemental contribution that is statutorily required to be paid by the State may be invested in private equity and venture capital in the State through an agreement with the Maryland Technology Development Corporation (TEDCO) or another entity, as specified in current law.

Current Law:

State Retirement and Pension System Administrative Expenses

SRA, under the direction of the 15-member SRPS Board of Trustees, is responsible for administering the State's retirement and pension systems.

An administrative charge to all employers for whom the agency administers retiree benefits provides the revenue to fund the agency. In proportion to total system membership, administrative charge revenue from State agencies pays for roughly one-third (34%) of agency operations, and revenue from local employers pays for the remaining two-thirds (66%). Reimbursable fund revenues represent State agency payments for administrative costs (paid from general, special, and federal funds in the State budget), and special fund revenues represent administrative payments by local school boards and participating governmental units.

The agency is subject to a statutory spending cap of 0.22% of the active payroll of system members. The calculated (nonstatutory) cap for fiscal 2019 is $38.0 million.

Investment Division

The division is charged with investing SRPS assets, as specified by the Board of Trustees. The CIO has the authority to hire and terminate external asset managers and to select the investment vehicles in which to invest. All positions, compensation, and operating expenses within the division (like the rest of SRA) are subject to approval by the Secretary of Budget and Management and appropriation by the General Assembly through the operating budget process.

On the recommendation of the Executive Director of SRA and its own Investment Committee, the SRPS Board of Trustees determines the qualifications and appointment of the CIO, which must be based on specified criteria. The board also sets the salary of the CIO and may elect to pay incentive compensation based on specified criteria recommended by the Investment Committee. Compensation paid to the CIO is paid from the administrative fees collected from participating employers and is subject to the agency's spending cap.

The SRPS board also determines the qualifications and compensation for the deputy CIO and managing directors within the division. However, their compensation (1) is subject to limitations based on the Executive Pay Plan (EPP) and (2) may not include incentive compensation. Compensation for remaining members of the division is subject to the salary schedule of the State Personnel Management System.

Private Equity and Venture Capital Investments

The State's annual pension contribution consists of three major components:

- the amount calculated by the actuary that is required to be paid annually to fully fund the State's pension liabilities;
- a supplemental contribution of $75 million required by statute; and
- an additional amount up to $50 million required by statute if the general fund surplus in the second prior fiscal year exceeds $10 million (this payment has been suspended by statute for fiscal 2018 and 2019).

Chapter 459 of 2016 authorized the SRPS Board of Trustees to enter into an agreement with TEDCO or another entity to make and manage investments on behalf of the board in private equity and venture capital in the State. It also expressed legislative intent that State contributions to the pension fund in excess of statutory requirements be invested in the State with a goal to increase the risk capital available in the State as long as the investments are consistent with, and do not compromise or conflict with, the SRPS board's fiduciary duties. The investments made under Chapter 459 are required to include a goal that 50% of the funds are invested in commercialization of technology sponsored or created by a university in the State. The fiscal 2017 budget included $25 million in excess of the three statutorily required payments described above, and that amount was made available for investment under an agreement between SRPS board and TEDCO.

Background: The SRPS board has sought independent salary authority for the division for many years. Chapter 368 of 2007 gave the board independent authority to establish compensation for the CIO, subject to specified criteria. Chapters 561 and 562 of 2012 gave the board authority to establish the qualifications and compensation of the deputy CIO and managing directors, subject to limitations based on EPP. However, it did not allow the board to pay them any incentive compensation.

SRA's fiscal 2019 budget, as enacted, includes 26 regular positions for the division (including audit and support personnel), $3.1 million for division compensation (excluding health insurance costs), and $3.7 million for operating expenses, including $2.8 million for the custodial banking contract. Thus, the division's total budget for fiscal 2019 is $6.8 million.

The board renewed its call for independent authority to create positions within the division and set their compensation following a compensation study conducted by the McLagan Group and a companion management analysis of the division, which together found that staffing levels and compensation for division staff were generally below the industry norm for large public pension plans. The Joint Committee on Pensions agreed to sponsor the legislation, with the added provision that compensation and operating expenses for the division would not be paid from administrative fees charged to employers.

Private Equity and Venture Capital Investments

SRA advises that the SRPS board finalized an agreement with TEDCO in November 2017 to administer the investment program authorized by Chapter 459. The first capital call, totaling nearly $2.0 million, occurred in February 2018, so it is too early to gauge the performance of the investments at this time. The bill *authorizes* the inclusion of the $75 million supplemental payment in the investment program operated by TEDCO through fiscal 2022.

State Fiscal Effect: Enactment of the bill means that compensation and operating expenses for the division are nonbudgeted and no longer paid from the administrative fees paid by participating employers but instead are paid from the accumulation funds of the several systems (*i.e.*, the "pension trust fund"), beginning in fiscal 2019. As nonbudgeted expenses, they will not be subject to appropriation by the General Assembly. Therefore, special and reimbursable fund revenues and expenditures decrease by $6.8 million, with the reduction allocated approximately $4.5 million in special funds from local participating employers (66%) and $2.3 million in reimbursable funds from State agencies (34%). The fiscal 2019 budget reduces the appropriation for Investment Division staff compensation and operating expenses (both special and reimbursable funds, as noted above), contingent on enactment of Senate Bill 899 or House Bill 1012. As the reimbursable funds are paid by State agencies, they are assumed to be divided 60% general funds, 20% special funds, and 20% federal and other funds. Out-year savings reflect anticipated 3.4% increases in compensation; any additional increases granted to division staff are not reflected because they are in excess of current budgeted levels.

Compensation and operating expenses for the division are instead paid from the pension trust fund, a nonbudgeted fund. As a result, pension fund assets decrease and nonbudgeted expenditures increase by $7.2 million in fiscal 2019, which includes employee health insurance costs that are not reflected in the State agency savings discussed above, and by increasing amounts each year thereafter. Any decrease in pension assets increases pension liabilities, which are amortized and paid over the remaining years of the system's 25-year closed amortization period. Any such effect is expected to be minimal and will have a negligible effect on annual required State pension contributions.

Private Equity and Venture Capital Investments

The effect of the expansion of the TEDCO investment program, if the SRPS board chooses to exercise the additional investment authority under the bill, will vary depending on the performance of those investments. The investments authorized by the bill may result in returns that are either higher or lower than they otherwise would be if the system elected to invest the money differently. Accordingly, State pension liabilities and contribution rates increase or decrease according to the performance of those investments, which cannot be reliably estimated.

An article dated March 19, 2018 in *Pensions & Investments* advises that venture capital, which is already considered one of the riskiest asset classes, is experiencing lower returns than the returns of over 20% that have been experienced in the recent past, for a variety of reasons. Restricting investments only to Maryland-based firms may further impede investment growth. As the amounts invested are relatively small compared with the overall size of the pension trust fund, and to date, the SRPS board has phased in the investments slowly, any effect on State pension liabilities and contribution rates (either positive or negative) is likely minimal.

Additional Information

Prior Introductions: None.

Cross File: HB 1012 (Delegate B. Barnes)(Chair, Joint Committee on Pensions) - Appropriations.

Information Source(s): State Retirement Agency; *Pensions & Investments*; Department of Budget and Management; Department of Legislative Services

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