

**G20J01**  
**State Retirement Agency**

***Operating Budget Data***

(\$ in Thousands)

	<b><u>FY 17</u></b> <b><u>Actual</u></b>	<b><u>FY 18</u></b> <b><u>Working</u></b>	<b><u>FY 19</u></b> <b><u>Allowance</u></b>	<b><u>FY 18-19</u></b> <b><u>Change</u></b>	<b><u>% Change</u></b> <b><u>Prior Year</u></b>
Special Fund	\$20,070	\$22,818	\$26,912	\$4,095	17.9%
Adjustments	0	-186	106	292	
<b>Adjusted Special Fund</b>	<b>\$20,070</b>	<b>\$22,632</b>	<b>\$27,018</b>	<b>\$4,386</b>	<b>19.4%</b>
Reimbursable Fund	10,660	11,998	13,618	1,620	13.5%
Adjustments	0	0	57	57	
<b>Adjusted Reimbursable Fund</b>	<b>\$10,660</b>	<b>\$11,998</b>	<b>\$13,675</b>	<b>\$1,677</b>	<b>14.0%</b>
<b>Adjusted Grand Total</b>	<b>\$30,730</b>	<b>\$34,630</b>	<b>\$40,693</b>	<b>\$6,063</b>	<b>17.5%</b>

Note: FY 18 Working includes targeted reversions, deficiencies, and across-the-board reductions. FY 19 Allowance includes contingent reductions and cost-of-living adjustments.

- The Governor's fiscal 2019 allowance grows by a total of \$6.1 million (17.5%) over the fiscal 2018 appropriation, after accounting for across-the-board reductions and cost-of-living adjustments. The increase stems almost entirely from funding for a major information technology (IT) project (Phase 3 of the Maryland Pension Administration System (MPAS-3)).
- Absent funding for MPAS-3, the agency's fiscal 2019 allowance would have *decreased* by about \$859,000.
- The fiscal 2019 allowance exceeds the agency's statutory cap on administrative expenses by about \$2.7 million, which may require a legislative remedy.

Note: Numbers may not sum to total due to rounding.

For further information contact: Michael C. Rubenstein

Phone: (410) 946-5510

## ***Personnel Data***

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	<b><u>FY 17</u></b>	<b><u>FY 18</u></b>	<b><u>FY 19</u></b>	<b><u>FY 18-19</u></b>
	<b><u>Actual</u></b>	<b><u>Working</u></b>	<b><u>Allowance</u></b>	<b><u>Change</u></b>
Regular Positions	197.00	197.00	197.00	0.00
Contractual FTEs	<u>8.00</u>	<u>8.00</u>	<u>8.00</u>	<u>0.00</u>
<b>Total Personnel</b>	<b>205.00</b>	<b>205.00</b>	<b>205.00</b>	<b>0.00</b>

### ***Vacancy Data: Regular Positions***

Turnover and Necessary Vacancies, Excluding New Positions	13.79	7.00%
Positions and Percentage Vacant as of 12/31/17	11.00	5.58%

- The number of regular positions and contractual full-time equivalents remains unchanged from the fiscal 2018 appropriation.
- The agency's turnover rate increases from 5% to 7% to reflect persistently high vacancy rates within the agency; however, following a series of new hires in fall 2017, the current number of vacancies (11.0) is lower than in recent years and below the allowed amount (13.8).

## ***Analysis in Brief***

### **Major Trends**

***Investment Returns Meet Targets but Lag Behind Peers:*** Returns exceeded both the policy benchmark and actuarial target but continue to dramatically underperform other large public pension plans. **The agency should comment on its plans, if any, to generate higher returns given that equity markets are surging.**

***Call Center Performance Improves Dramatically:*** Call center performance has met not only new (less challenging) goals but would have also met the old goals. **The board and agency should comment on the factors that contributed to the significant improvement in call center performance, as well as any steps necessary to sustain that performance going forward. They should also comment on how the new goals compare to industry standards for call centers and whether the goals in effect prior to fiscal 2018 should be restored given the call center's improved performance.**

## Issues

***Phase 3 of the Maryland Pension Administration System Enters a Critical Stage:*** The Governor's allowance includes \$9.2 million for the third and final phase of the agency's major IT project. **The board and agency are asked to update the committees on the current status of MPAS-3 and describe the expected application of those funds.**

***Joint Committee on Pensions Agrees to Sponsor Legislation for Investment Division Autonomy:*** The legislation would give the board of trustees the independent authority to create/eliminate positions in the Investment Division and to establish compensation levels for those positions, including performance bonuses. **The Department of Legislative Services (DLS) recommends a reduction of \$7.99 million contingent on enactment of this legislation, allocated between special and reimbursable funds. It also recommends that operational expenses for the Investment Division continue to be paid from administrative fees and not from the pension trust fund.**

***Delays in Procuring New Custodial Banking Contract Result in Large Surpluses:*** The system originally expected to have a new custodial banking contract in place by January 2017 and budgeted for an anticipated increase in contract costs. However, the contract is not expected to take effect until February 2018. **DLS recommends a reduction of \$1.2 million for fiscal 2019 to reflect the lower cost of the new contract, allocated between special and reimbursable funds.**

## Operating Budget Recommended Actions

	<u>Funds</u>
1. Add language to reduce the authorization to expend reimbursable funds contingent on legislation for the Investment Division.	
2. Reduce reimbursable fund spending authorization due to a lower banking contract.	
3. Add language for a contingent reduction of \$4.5 million for Investment Division staffing upon enactment of legislation.	
4. Reduce funding for the new custodial banking contract.	\$ 800,000
5. Reduce reimbursable funds for the Retirement Agency custodial banking contract.	
6. Reduce funding for the Investment Division.	
<b>Total Reductions</b>	<b>\$ 800,000</b>

## **Updates**

***Temporary Relief from Expense Cap May Be Necessary:*** DLS recommendations are not sufficiently large to get total spending below the cap. However, the Joint Committee on Pensions agreed to sponsor legislation for a temporary increase to the cap until MPAS-3 is completed. If the Investment Division legislation is enacted, the expense cap increase will not be needed. If neither piece of legislation is enacted, additional cuts to the agency’s budget will be needed.

***Restoring Five-year Vesting Has Significant Long-term Costs:*** The agency submitted the actuarial analysis requested in the 2017 *Joint Chairmen’s Report*. Initial costs of restoring five-year vesting for members of the State Retirement and Pension System are relatively small, but cumulative costs over the next 20 years are significant.

**G20J01**  
**State Retirement Agency**

***Operating Budget Analysis***

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**Program Description**

The State Retirement Agency (SRA), under the direction of the 15-member Board of Trustees for the State Retirement and Pension System (SRPS), is responsible for administering the State's retirement and pension systems. The board-appointed executive director is responsible for policy development, legislation, and legal affairs.

The agency has identified four fundamental goals for its operation:

- to prudently invest system assets in a well-diversified manner to optimize long-term returns while controlling risk through excellence in the execution of the investment objectives and strategies of the system;
- to effectively communicate to all retirement plan participants to inform them about the benefits provided by the system and to educate them about planning and preparing for all aspects of their defined benefit system;
- to pay all retirement allowances provided by State pension law to the system's retirees and their beneficiaries in an accurate and timely manner; and
- to efficiently collect the required employer and employee contributions necessary to fund the system.

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 (34.0%) of agency operations, and revenue from local employers pays for the remaining two-thirds (66.0%). Based on the Governor's allowance and certified membership of 192,373, participating employers will pay approximately \$210 per member in fiscal 2018, a \$54 increase over fiscal 2017 (34.7%); however, the final per member fee is based on the budget enacted by the General Assembly. Reimbursable fund revenues represent State agency payments for administrative costs, 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 cap for fiscal 2019 is \$38 million.

As of June 30, 2017, the market value of the system's assets totaled \$49.1 billion, an increase of about \$3.6 billion from the end of fiscal 2016.

## Performance Analysis: Managing for Results

### 1. Investment Returns Meet Targets but Lag Behind Peers

By two key measures, the system's investment portfolio exceeded expectations in fiscal 2017, but it continues to underperform relative to its peers. For the third time in the last five years, the system's fiscal 2017 investment return of 10.0% exceeded its actuarial target of 7.55%. As a result, five-year annualized returns of 7.6% (net of fees) over that span also exceed the actuarial target, which is a major factor in restricting the growth in employer contribution rates for fiscal 2019.

In addition, the system's return exceeded its own policy benchmark by 15 basis points; it has exceeded its policy benchmark in four of the past five years. The policy benchmark is the expected return if all of the system's investments exactly meet their respective benchmarks, so excess performance indicates that the system's active management of its portfolio generates positive results, net of fees. **Exhibit 1** shows the system's performance against both the actuarial target and the policy benchmark over the past five years. The Department of Legislative Services (DLS) notes that the system's board of trustees has approved a measure to lower its actuarial target to 7.45% over two years.

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**Exhibit 1**  
**Pension Fund Investment Performance**  
**Fiscal 2013-2017**

	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>
Actuarial Target	7.70%	7.65%	7.55%	7.55%	7.55%
Policy Benchmark	8.48%	14.16%	0.88%	1.69%	9.88%
One-year Actual Returns	10.57%	14.37%	2.68%	1.16%	10.02%
Five-year Annualized Returns	3.97%	11.68%	9.36%	5.68%	7.64%

Note: One-year returns are net of fees; five-year returns since 2015 are also net of fees.

Source: State Street Bank; State Retirement Agency; Department of Legislative Services

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However, the system's investment program continues to underperform its public pension peers, in large part because of its underweight to public equities. The Wilshire Trust Universe Comparison Service (TUCS) rankings are useful for providing a big-picture, snapshot assessment of the system's performance relative to other large public pension plans. In the TUCS analysis, the one-hundredth percentile represents the lowest investment return, and the first percentile is the highest investment return. According to TUCS, the system's fiscal 2017 investment performance was rated in the ninety-fifth percentile among the public pension funds with at least \$25 billion in assets, as shown in **Exhibit 2**. As the system has a low allocation to equity investments compared to its peers, the system's

investment policy will have a low TUCS ranking when equity markets are experiencing strong performance, as was the case during fiscal 2017. With the exception of the one-year return for fiscal 2016, long-term performance rankings place SRPS in the bottom quartile for every timeframe examined. The TUCS rankings are based on returns gross of fees. **The agency should comment on its plans, if any, to generate higher returns given that equity markets are surging.**

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**Exhibit 2**  
**TUCS Percentile Rankings for Periods Ending June 30**  
**Fiscal 2014-2017**

	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>
1 Year	94	81	57	95
3 Years	94	88	95	91
5 Years	84	88	95	87
10 Years	99	91	95	100

TUCS: Wilshire Trust Universe Comparison Service

Note: Rankings for systems greater than \$25 billion.

Source: Wilshire Trust Universe Comparison Service

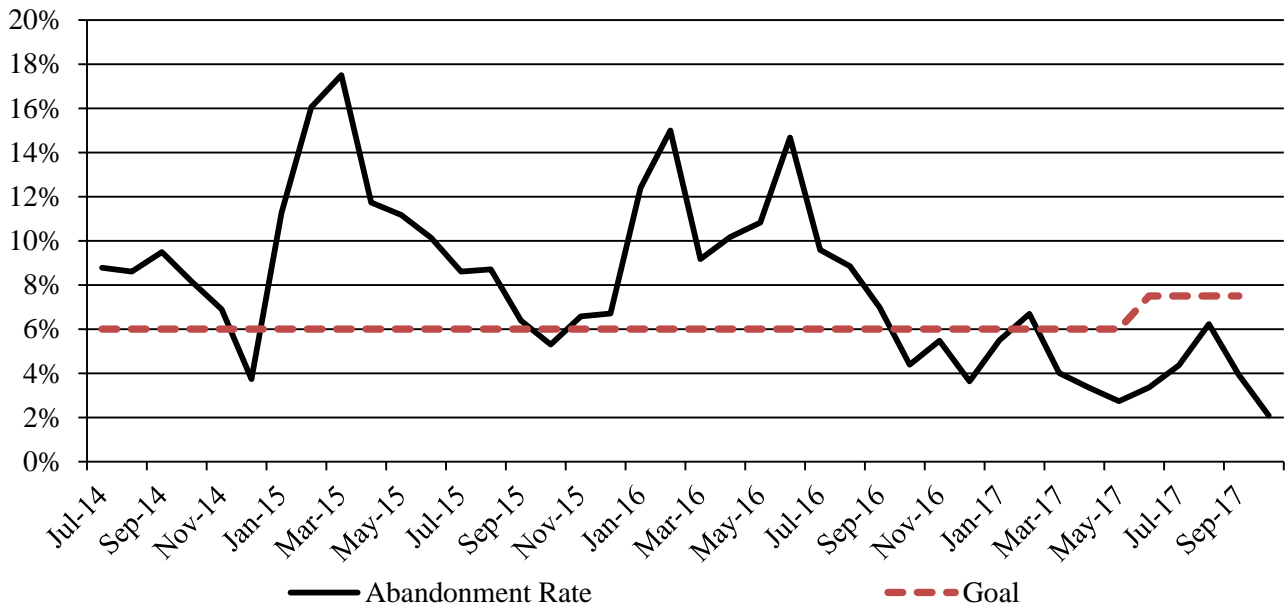
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## **2. Call Center Performance Improves Dramatically**

Over the past 12 months, the agency has significantly reduced the number of dropped calls and the average wait time for its member services call center. After struggling for several years to meet its dual goals of fewer than 6.0% of calls being dropped and callers waiting no more than 1:45 minutes for a counselor to pick up their call, the agency raised its call center goals for fiscal 2018 to no more than 7.5% of calls being dropped and callers waiting no more than 2:15 minutes. However, as shown in **Exhibits 3 and 4**, dropped calls have consistently been below 6.0% (for all but two months), even after the goal was raised, and wait times have been below 1:45 minutes, even after the goal was raised.

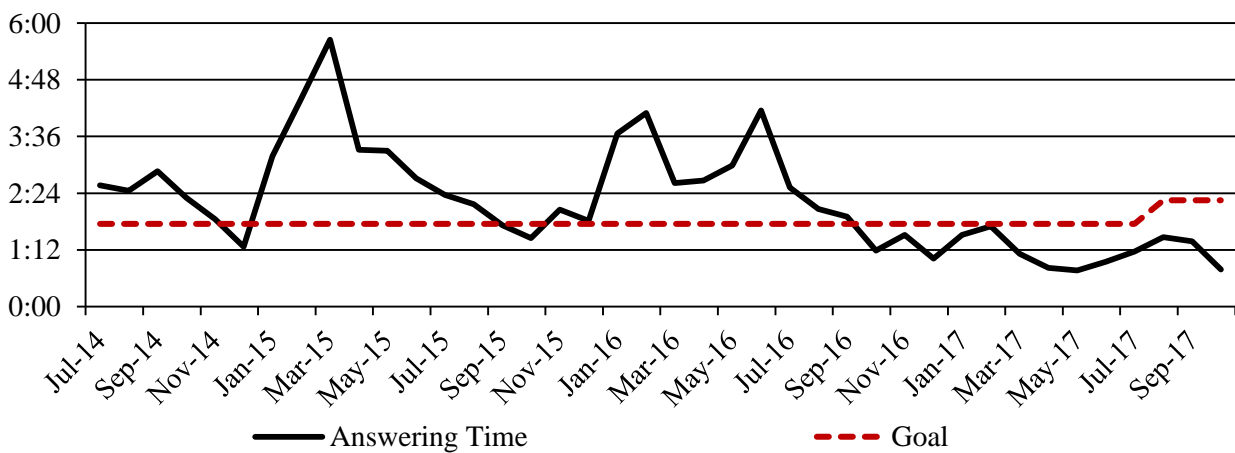
**The board and agency should comment on the factors that contributed to the significant improvement in call center performance, as well as any steps necessary to sustain that performance going forward. It should also comment on how its new goals compare to industry standards for call centers and whether the goals in effect prior to fiscal 2018 should be restored given the call center's improved performance.**

**Exhibit 3**  
**Member Services Call Abandonment Rate**  
**July 2014 to October 2017**



Source: State Retirement Agency

**Exhibit 4**  
**Member Services Call Answering Time (in Minutes)**  
**July 2014 to October 2017**



Source: State Retirement Agency



## Fiscal 2018 Actions

### Across-the-board Employee and Retiree Health Insurance Reduction

The budget bill includes an across-the-board reduction for employee and retiree health insurance in fiscal 2018 to reflect a surplus balance in the fund. This agency's share of this reduction is \$186,053 in special funds.

## Proposed Budget

As shown in **Exhibit 5**, the Maryland Pension Administration System, Phase 3 (MPAS-3) (\$6.9 million) accounts for most of the increase in the agency's allowance. It is discussed in greater detail below. After a surge in other IT (information technology)-related costs (-\$1.3 million) over the previous two years in preparation for MPAS-3, those costs decline sharply with the completion of the work. Increases for postage and board of trustee elections (totaling \$296,540) are prompted by the potential need to hold two elections during fiscal 2019 to fill the seats of two elected members of the board whose terms expire. Personnel costs increase only modestly, with the general salary increase and growing health insurance costs largely offset by the increase in the agency's turnover allowance.

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### Exhibit 5 Proposed Budget State Retirement Agency (\$ in Thousands)

<b>How Much It Grows:</b>	<b>Special Fund</b>	<b>Reimb. Fund</b>	<b>Total</b>
Fiscal 2017 Actual	\$20,070	\$10,660	\$30,730
Fiscal 2018 Working Appropriation	22,632	11,998	34,630
Fiscal 2019 Allowance	<u>27,018</u>	<u>13,675</u>	<u>40,693</u>
Fiscal 2018-2019 Amount Change	\$4,386	\$1,677	\$6,063
Fiscal 2018-2019 Percent Change	19.4%	14.0%	17.5%

#### Where It Goes:

##### Personnel Expenses

General salary increase .....	\$162
Other compensation .....	59
Employee and retiree health insurance .....	186
Turnover adjustments .....	-361
Other fringe benefit adjustments .....	31

*G20J01 – State Retirement Agency*

**Where It Goes:**

**Other Changes**

Major information technology (IT) project (MPAS-3).....	6,922
Non-MPAS IT expenses .....	-1,254
Postage.....	192
Board of Trustees elections .....	104
Actuarial services .....	126
Rent.....	-38
Travel.....	-47
Other operating .....	-19
<b>Total</b>	<b>\$6,063</b>

MPAS-3: Maryland Pension Administration System Phase 3

Note: Numbers may not sum to total due to rounding.

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**General Salary Increase**

The fiscal 2019 allowance includes funds for a 2.0% general salary increase for all State employees, effective January 1, 2019. These funds are budgeted in the Department of Budget and Management's statewide program and will be distributed to agencies during the fiscal year. This agency's share of the general salary increase is \$105,597 in special funds and \$56,842 in reimbursable funds. In addition, employees will receive another 0.5% increase and a \$500 bonus effective April 1, 2019, if actual fiscal 2018 general fund revenues exceed the December 2017 estimate by \$75 million. These funds have not been budgeted. The Administration will need to process a deficiency appropriation if revenues are \$75 million more than projected.

## ***Issues***

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### **1. Phase 3 of the Maryland Pension Administration System Enters Critical Stage**

In August 2010, the agency completed the first phase of the replacement of its more than 30-year-old legacy information technology (IT) system with MPAS. The first phase replaced the legacy IT infrastructure with a more modern and agile computing platform, but the new system was configured to replicate the system’s traditional business practices in order to minimize the need for new staff training, among other reasons. Competing IT demands within the agency delayed the start and completion of Phase 2 of the project, which entailed verifying and correcting the service credit and salary data in the system and establishing protocols to ensure that new data entered into the system is accurate. Phase 2 was completed in July 2017, setting the stage for Phase 3.

Phase 3 entails modernizing the agency’s business practices to take full advantage of the power and agility of the new technology installed during Phase 1. In addition to automating internal practices and transactions, it includes establishing online user interfaces that allow members to check their accrued service and retirement “balances” and to project their future benefit payments. Phase 3 is projected to cost a total of \$19.4 million over five years. **Appendix 2** has additional information about the project timeline, status, and cost.

The fiscal 2018 legislative appropriation included \$750,000 to launch Phase 3, including the procurement of a business practice consultant and a project manager. That amount was later increased to \$975,000 by reallocating unneeded funds from other IT-related projects. The Information Technology Project Request for MPAS-3 that the agency submitted to the Department of Information Technology proposed fiscal 2019 expenditures of \$7.8 million for contractual services and \$1.4 million for new equipment, for a total expenditure of \$9.2 million. The Governor’s allowance includes that full amount, with \$1.3 million provided as a fiscal 2018 deficiency and the remaining \$7.9 million included in the fiscal 2019 allowance. The agency proposes to divide the allocation as shown in **Exhibit 6**.

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**Exhibit 6**  
**Allocation of MPAS-3 Funding**  
**Fiscal 2019**

<b><u>Budget Category</u></b>	<b><u>Amount</u></b>	<b><u>Short Description</u></b>
Telecommunications	\$11,160	Internet bandwidth to support the project.
Computer Maintenance Contracts	225,000	Licenses for secure member portal and other MPAS components.
Applications Software	2,400,000	Acquisition, installation, and support of software packages for customer relationship management, workflow management, authentication, and document management.
Systems Software	625,000	Software development tools.
Programming Services	3,692,511	Approximately 14 contracted positions consisting of programmers, web developers, and business analysts.
Contractual Services	400,000	Project management and business process consulting fees – to be adjusted based on newly awarded contract.
Contractual Services	437,860	Department of Information Technology project oversight fee.
New and Replacement Equipment	1,405,000	Servers, workstations, storage area network, switches, routers, etc.
<b>Total</b>	<b>\$9,196,531</b>	

MPAS-3: Maryland Pension Administration System Phase 3

Source: State Retirement Agency

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The fiscal 2018 deficiency represents a reallocation of funds appropriated but not expected to be spent for the agency's custodial banking contract in that same year. As described below, the agency anticipated awarding a new custodial banking contract costing about \$4.0 million, but the completion of that procurement was delayed and the final contract award, expected to occur in January or

February 2018, is now projected to be closer to \$2.8 million per year. Therefore, a substantial portion of the difference is being reallocated to MPAS-3 through a combination of a fiscal 2018 deficiency appropriation (for the portion paid by special funds) and a budget amendment to be submitted to the Board of Public Works (for the portion paid by reimbursable funds).

**The agency is asked to update the committees on the current status of MPAS-3 and describe the expected allocation of fiscal 2019 funds.**

## **2. Joint Committee on Pensions Agrees to Sponsor Legislation for Investment Division Autonomy**

At the request of the board of trustees, the Joint Committee on Pensions (JCP) agreed to sponsor legislation this session to give the board authority to create/eliminate staff positions within the Investment Division and to establish compensation levels for those positions, including potential performance bonuses. JCP elected to specify that compensation and other operational expenses for Investment Division personnel is to be paid out of the accumulation funds of the several systems (the “pension trust fund”) instead of from special and reimbursable funds representing the administrative fees collected from participating employers for agency expenses. Therefore, their compensation and operating costs will not count against the agency’s expense cap, nor will it be used to calculate the annual administrative fee. **DLS recommends that only compensation, but not operational expenses, for the Investment Division be paid from the accumulation funds of the several systems. Operational expenses should continue to be paid from administrative fees to minimize the effect on the accumulation funds.**

If enacted, the proposed legislation will initially have a negative effect on the system’s investment program because compensation for Investment Division staff will be taken directly from the pension system’s assets instead of being paid by administrative fees. Those funds will not be available for investment, creating a minimal drag on investment performance. However, the agency’s long-range plan is to take advantage of the division’s increased staff capacity allowed by its autonomous status to initiate some in-house management of pension assets instead of relying exclusively on external managers. This should ultimately reduce management fees paid to external managers from the trust and more than offset the increased compensation costs. If the system can generate at least comparable performance through internal management as it does with external management, the shift will ultimately be beneficial to the system and its participants.

Enactment of the legislation will have several immediate effects on the agency. First, it will reduce special and reimbursable fund expenditures by about \$7.99 million, as Investment Division compensation instead will be paid from the accumulation fund (a budget amendment will be necessary). **DLS, therefore, recommends a contingent reduction of \$7.99 million if the legislation is enacted, allocated between special and reimbursable funds.** Second, the board anticipates using its authority to add at least 8 new positions to the Investment Division in fiscal 2019, as described in **Exhibit 7**.

**Exhibit 7**  
**Potential New Investment Division Positions**  
**Fiscal 2019**

<u>Grade</u>	<u>Title</u>	<u>Target Salary</u>
ES9	Managing Director – Fixed Income	\$150,000
22	Senior Investment Analyst – Fixed Income	103,743
22	Senior Investment Analyst – Compliance	103,743
20	Associate	73,946
20	Associate	73,946
20	Associate	73,946
17	Assistant Director – Administration	60,815
17	Accountant Lead Specialized	60,815

Source: State Retirement Agency

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Finally, the board will likely increase compensation levels for all new and existing Investment Division staff, including the establishment of performance-based bonuses authorized in the proposed legislation. This is based on the findings from a compensation study conducted by the McLagan Group, which found that compensation levels for Investment Division staff were generally below the industry norm for large public pension plans. It is estimated that total compensation for the Investment Division may increase to as much as \$8.0 million from its current level of \$3.1 million, assuming all employees earn a maximum bonus, as determined by the board. **The board and the agency are asked to comment on their short- and long-term expectations for Investment Division staffing levels and compensation, including any planned performance bonuses, if the proposed legislation is enacted.**

### **3. Delays in Procuring New Custodial Banking Contract Result in Large Surpluses**

The main function of the system's custodial bank is to track and report on the performance of the agency's many fund managers. The system's longstanding contract with State Street was due to expire in January 2017. Under State law at the time, the State Treasurer's Office (STO) was responsible for carrying out all procurements for banking services on behalf of State agencies, so STO initiated a procurement that was expected to be completed by January 2017. Over the term of its then-existing contract, the system's investment portfolio had changed dramatically, growing from fewer than 100 managers to more than 300, and expanding from consisting primarily of public equity and fixed-income managers to including multiple alternative asset types, including private equity, commodities, and hedge funds. Based on its survey of the market for custodial banking services, the agency anticipated the annual cost of the contract increasing from \$900,000 to about \$4.0 million.

*G20J01 – State Retirement Agency*

Anticipating this increase, the fiscal 2017 appropriation included an increase of \$1.57 million (for a total appropriation of about \$2.5 million) to cover the pro-rated cost of the new contract in fiscal 2017.

The STO procurement ultimately failed to produce a successful offer, leaving the agency with a surplus of about \$1.3 million due to the increased appropriation. Those funds were reallocated to various uses, including hiring a management consultant for the Investment Division, increasing the number of contracted IT programmers to assist with a backlog of IT projects in anticipation of the launch of MPAS-3, and purchasing new and replacement IT equipment.

The unsuccessful STO procurement required a new procurement, this time – because of a change in State law during the intervening period – carried out by the agency. The new procurement was expected to be completed by July 2017, so the fiscal 2018 appropriation again increased by \$1.5 million (for a total appropriation of \$4.0 million) to cover a full year under the new contract. However, completion of the procurement has been delayed at least through January 2018 and possibly into February, resulting in an anticipated surplus of about \$1.3 million in fiscal 2018. The Governor's allowance reallocates that amount to MPAS-3 in fiscal 2018; it will likely mostly be encumbered and spent in fiscal 2019.

The agency advises that it is nearing completion of the procurement for the new custodial banking contract and that the anticipated first year cost is expected to be about \$2.8 million. **The Governor's fiscal 2019 allowance again includes \$4.0 million for the contract, so DLS recommends a reduction of \$1.2 million for fiscal 2019 to reflect the lower cost of the new contract, allocated between special and reimbursable funds.**

## ***Operating Budget Recommended Actions***

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1. Add the following language:

Provided that contingent on the enactment of SB 899 or HB 1012, authorization to expend reimbursable funds is reduced by \$2,316,965.

**Explanation:** Contingent on legislation to grant compensation authority for the Investment Division, this action would reduce the State’s share of reimbursable funds. If the bill is enacted, Investment Division compensation and operating expenses would be paid from the accumulation fund and not from a share of State administrative fees.

2. Add the following language:

Further provided that authorization to expend reimbursable funds is reduced by \$400,000.

**Explanation:** The Governor’s fiscal 2019 allowance includes \$4.0 million for a new custodial banking contract, but the new contract is expected to cost only \$2.8 million in the first year. This cut consists of this reduction in authorization to spend \$400,000 in reimbursable funds and a special fund reduction of \$800,000.

3. Add the following language to the special fund appropriation:

, provided that the appropriation made for the purpose of the Investment Division staff compensation and operating expenses shall be reduced by \$4,474,108 contingent on enactment of SB 899 or HB 1012 (State Retirement and Pension System – Investment Division), which establishes that compensation and operating expenses for the Investment Division staff is not to be paid from special funds, but instead is paid from the accumulation funds of the several systems.

**Explanation:** SB 899 or HB 1012 grants the Board of Trustees of the State Retirement and Pension System independent authority to create/eliminate positions within the Investment Division and to establish compensation levels for those positions, including performance bonuses. They also specify that compensation for those positions and other operating expenses of the Division, are to be paid from the accumulation funds of several systems (the “pension trust fund”) rather than from special funds or reimbursable funds consisting of the administrative fees collected from the State and participating employers. This action reduces the special fund portion paid by local jurisdictions and other participating employers, contingent upon enactment of either bill.



*G20J01 – State Retirement Agency*

- |   | <u>Amount<br/>Reduction</u> | <u>Position<br/>Reduction</u> |
|---|-----------------------------|-------------------------------|
| 4. The Governor's fiscal 2019 allowance includes \$4.0 million for a new custodial banking contract, but the new contract is expected to cost only \$2.8 million in the first year. This reduction consists of a reduction of \$800,000 in special funds and \$400,000 in reimbursable funding. | \$ 800,000                  | SF                            |
| 5. Add the following section:   |                             |                               |

**Section 39 Reduce Custodial Banking Contract Costs in the State Retirement Agency**

SECTION 39. AND BE IT FURTHER ENACTED, That the reimbursable fund appropriation in the State Retirement Agency, G20J01.01, shall be reduced by \$400,000. The Governor shall develop a schedule for allocating this reimbursable fund reduction across State agencies. The reduction shall equal at least the amount indicated for the funds listed:

<u>Fund</u>	<u>Amount</u>
General	\$240,000
Special	\$80,000
Federal	\$80,000

**Explanation:** The Governor's fiscal 2019 allowance includes \$4.0 million for a new custodial banking contract, but the new contract is expected to cost only \$2.8 million in the first year. This action consists of an \$800,000 reduction in special funds and this \$400,000 reduction in reimbursable funds.

6. Add the following section:

**Section 40 Reduce Positions and Operating Expenses for the Investment Division of the State Retirement Agency**

SECTION 40. AND BE IT FURTHER ENACTED, That contingent upon the enactment of SB 899 or HB 1012, the reimbursable fund appropriation in the State Retirement Agency, G20J01.01, shall be reduced by \$2,316,965. The Governor shall develop a schedule for allocating this reimbursable fund reduction across State agencies. The reduction shall equal at least the amount indicated for the funds listed:

<u>Fund</u>	<u>Amount</u>
General	\$1,390,179
Special	\$463,393
Federal	\$463,393

*G20J01 – State Retirement Agency*

**Explanation:** SB 899 or HB 1012 grants the Board of Trustees of the State Retirement and Pension System independent authority to create/eliminate positions within the Investment Division and to establish compensation levels for those positions, including performance bonuses. They also specify that compensation for those positions and other operating expenses of the Division, are to be paid from the accumulation funds of the several systems (the “pension trust fund”) rather than from special funds or reimbursable funds consisting of the administrative fees collected from the State and participating employers. This action reduces the reimbursable fund portion paid by the State and allocated the reduction across State agency budgets, contingent upon enactment of either bill.

<b>Total Special Fund Reductions</b>	<b>\$ 800,000</b>
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## ***Updates***

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### **1. Temporary Relief from Expense Cap May Be Necessary**

As noted above, the agency operates under a statutory spending cap of 0.22% of active member payroll, which is calculated at \$38.0 million for fiscal 2019. The Governor's allowance totals \$40.7 million (all funds), an excess of \$2.7 million. DLS recommended a \$1.2 million reduction that is not sufficient to bring the agency under the calculated cap.

The fiscal 2018 DLS analysis pointed out that the methodology used by the agency to calculate its spending cap did not conform to a statutory requirement that it use only payroll of active members. Instead, the calculation used as its basis the sum of active payroll, earnable compensation of vested former members, and retiree benefit payments. DLS asked the agency to prepare a report for JCP explaining the discrepancy, and the agency presented its report in November 2017. The report explains that the current methodology for calculating the spending cap was enacted by Chapter 372 of 2000, subject to a three-year sunset. However, when the new formula terminated in 2004, neither the agency nor DLS noted the change and the agency has continued to use the revised formula to calculate its spending cap.

In response, JCP agreed to sponsor legislation codifying existing practice regarding the calculation of the spending cap. Failure to do so would result in the agency having to cut expenditures by about \$15 million, which would be extremely disruptive to its operations. At the agency's request, the JCP agreed to include a temporary increase to the fee cap through fiscal 2022 to accommodate the temporary increase in agency spending for MPAS-3. The precise amount of the increase was left undetermined pending more information about the cost of the project and the Governor's allowance.

However, if the Investment Division legislation described above is enacted, it would remove an additional \$3.1 million in agency expenditures, representing compensation for Investment Division staff, from the calculation of agency spending, bringing agency expenditures below the existing cap. Even if the temporary increase in the cap is rendered unnecessary by the enactment of the Investment Division legislation, the codification of the agency's current methodology for calculating the expense cap is still necessary to maintain current levels of service.

If neither the Investment Division legislation nor the temporary fee cap legislation are enacted, additional cuts to the agency's budget will be needed to keep expenditures below the cap. DLS has a high level of confidence that, at a minimum, at least one of those pieces of legislation will be enacted, and therefore, is not recommending a contingent reduction at this time. Nevertheless, the committees should be aware of the remote possibility that additional cuts may be needed.

## **2. Restoring Five-year Vesting Has Significant Long-term Costs**

The 2017 *Joint Chairmen's Report* asked SRA to report on the potential costs associated with restoring five-year vesting for all members of SRPS. Chapter 397 of 2011 increased the vesting period from 5 to 10 years for almost all SRPS members hired on or after July 1, 2011 (members of the Judges' Retirement System and Legislative Pension Plan were excluded). However, there is renewed interest in making it easier to recruit and retain State employees to fill many vacant positions and replace retiring Baby Boomers. The long vesting period is viewed as one of many obstacles to recruiting candidates to State employment.

When Chapter 397 was enacted, the increase in vesting was projected to have only a minimal effect on State contributions over the short term because it applied only to new members, and it would take many years for the number of new members to rise to a level that would generate meaningful savings from the vesting provision. Total first-year savings from the vesting change were projected to be less than 1% of the total projected savings of about \$315 million.

Today, about one-third of the members of the Teachers' Pension System/Employees' Pension System (TPS/EPS) are in the Reformed Contributory Pension Benefit (RCPB) and are therefore subject to the 10-year vesting period. Based on the agency's actuarial analysis, restoring a five-year vesting period for current and future members of RCPB results in a first year cost of \$7.9 million. However, as the number of TPS/EPS members in RCPB increases due to member turnover, the long-term costs accelerate. Over the first 5 years, the cumulative cost is \$52.0 million (an average of \$10.4 million per year), and over 21 years, the cumulative cost is \$427 million (an average of \$20.3 million per year).

**Appendix 1**  
**Current and Prior Year Budgets**  
**State Retirement Agency**  
**(\$ in Thousands)**

	<b><u>General Fund</u></b>	<b><u>Special Fund</u></b>	<b><u>Federal Fund</u></b>	<b><u>Reimb. Fund</u></b>	<b><u>Total</u></b>
<b>Fiscal 2017</b>					
Legislative Appropriation	\$0	\$20,196	\$0	\$10,786	\$30,982
Deficiency Appropriation	0	0	0	0	0
Cost Containment	0	0	0	0	0
Budget Amendments	0	193	0	104	297
Reversions and Cancellations	0	-318	0	-230	-549
<b>Actual Expenditures</b>	<b>\$0</b>	<b>\$20,070</b>	<b>\$0</b>	<b>\$10,660</b>	<b>\$30,730</b>
<b>Fiscal 2018</b>					
Legislative Appropriation	\$0	\$22,818	\$0	\$11,998	\$34,816
Cost Containment	0	0	0	0	0
Budget Amendments	0	0	0	0	0
<b>Working Appropriation</b>	<b>\$0</b>	<b>\$22,818</b>	<b>\$0</b>	<b>\$11,998</b>	<b>\$34,816</b>

Note: The fiscal 2018 appropriation does not include deficiencies, targeted reversions, or across-the-board reductions. Numbers may not sum to total due to rounding.

## **Fiscal 2017**

Budget amendments provided salary increments totaling \$192,898 in special funds and \$103,868 in reimbursable funds for State Retirement Agency employees.

The agency finished the fiscal year with a surplus of \$548,521, due to overbudgeted health insurance costs that are subject to reversion under the fiscal 2017 budget bill.

## **Fiscal 2018**

There are no changes in the fiscal 2018 appropriations.

**Appendix 2**  
**Major Information Technology Projects**  
**State Retirement Agency**  
**Maryland Pension Administration System – Phase 3**

<b>Project Status</b>	Planning.			<b>New/Ongoing Project:</b>		Ongoing.		
<b>Project Description:</b>	Automation of business practices and provision of real-time member account services.							
<b>Project Business Goals:</b>	Creating operational efficiencies and establishing real-time viewing of existing records and online transactions.							
<b>Estimated Total Project Cost:</b>	\$19.4 million			<b>Estimated Planning Project Cost:</b>		\$975,000		
<b>Project Start Date:</b>	July 2018.			<b>Projected Completion Date:</b>		June 2022.		
<b>Schedule Status:</b>	A project manager and business process consultant have been retained; planning for project implementation beginning in fiscal 2019 is underway.							
<b>Cost Status:</b>	\$975,000 is appropriated in fiscal 2018 for planning and project management services.							
<b>Scope Status:</b>	n/a.							
<b>Project Management Oversight Status:</b>	Procurement of project manager completed in fall 2017.							
<b>Identifiable Risks:</b>	Funding and resource availability in the out-years; supportability and integration of commercial off-the-shelf software applications with the Maryland Pension Administration System (MPAS) framework.							
<b>Additional Comments:</b>	This project has been envisioned since the MPAS infrastructure was first installed beginning in fiscal 2006.							
<b>Fiscal Year Funding (\$ in Thousands)</b>	<b>Prior Years</b>	<b>FY 2019</b>	<b>FY 2020</b>	<b>FY 2021</b>	<b>FY 2022</b>	<b>FY 2023</b>	<b>Balance to Complete</b>	<b>Total</b>
Personnel Services	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Professional and Outside Services	975.0	7,797.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Expenditures	0.0	1,400.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total Funding</b>	<b>\$975.0</b>	<b>\$9,197.0</b>	<b>\$6,668.0</b>	<b>\$1,260.0</b>	<b>\$600.0</b>	<b>\$0.0</b>	<b>\$18,454.0</b>	<b>\$19,429.0</b>

**Appendix 3**  
**Object/Fund Difference Report**  
**State Retirement Agency**

<u>Object/Fund</u>	<u>FY 17 Actual</u>	<u>FY 18 Working Appropriation</u>	<u>FY 19 Allowance</u>	<u>FY 18 - FY 19 Amount Change</u>	<u>Percent Change</u>
<b>Positions</b>					
01 Regular	197.00	197.00	197.00	0.00	0%
02 Contractual	8.00	8.00	8.00	0.00	0%
<b>Total Positions</b>	<b>205.00</b>	<b>205.00</b>	<b>205.00</b>	<b>0.00</b>	<b>0%</b>
<b>Objects</b>					
01 Salaries and Wages	\$ 19,508,480	\$ 19,981,765	\$ 19,710,049	-\$ 271,716	-1.4%
02 Technical and Spec. Fees	766,310	759,814	758,056	-1,758	-0.2%
03 Communication	645,547	796,538	992,579	196,041	24.6%
04 Travel	158,681	228,479	181,479	-47,000	-20.6%
07 Motor Vehicles	132,610	135,779	135,324	-455	-0.3%
08 Contractual Services	6,829,828	10,112,515	14,780,556	4,668,041	46.2%
09 Supplies and Materials	131,882	141,344	118,344	-23,000	-16.3%
10 Equipment – Replacement	347,984	281,601	115,251	-166,350	-59.1%
11 Equipment – Additional	121,726	67,275	1,465,000	1,397,725	2077.6%
12 Grants, Subsidies, and Contributions	382,426	382,426	382,426	0	0%
13 Fixed Charges	1,704,819	1,928,503	1,891,514	-36,989	-1.9%
<b>Total Objects</b>	<b>\$ 30,730,293</b>	<b>\$ 34,816,039</b>	<b>\$ 40,530,578</b>	<b>\$ 5,714,539</b>	<b>16.4%</b>
<b>Funds</b>					
03 Special Fund	\$ 20,070,260	\$ 22,817,641	\$ 26,912,303	\$ 4,094,662	17.9%
09 Reimbursable Fund	10,660,033	11,998,398	13,618,275	1,619,877	13.5%
<b>Total Funds</b>	<b>\$ 30,730,293</b>	<b>\$ 34,816,039</b>	<b>\$ 40,530,578</b>	<b>\$ 5,714,539</b>	<b>16.4%</b>

Note: The fiscal 2018 appropriation does not include deficiencies, targeted reversions, or across-the-board reductions. The fiscal 2019 allowance does not include contingent reductions or cost-of-living adjustments.



**Appendix 4  
Fiscal Summary  
State Retirement Agency**

<b><u>Program/Unit</u></b>	<b><u>FY 17 Actual</u></b>	<b><u>FY 18 Wrk Approp</u></b>	<b><u>FY 19 Allowance</u></b>	<b><u>Change</u></b>	<b><u>FY 18 - FY 19 % Change</u></b>
01 State Retirement Agency	\$ 30,730,293	\$ 33,841,039	\$ 32,634,047	-\$ 1,206,992	-3.6%
02 Major Information Technology Development	0	975,000	7,896,531	6,921,531	709.9%
<b>Total Expenditures</b>	<b>\$ 30,730,293</b>	<b>\$ 34,816,039</b>	<b>\$ 40,530,578</b>	<b>\$ 5,714,539</b>	<b>16.4%</b>
Special Fund	\$ 20,070,260	\$ 22,817,641	\$ 26,912,303	\$ 4,094,662	17.9%
<b>Total Appropriations</b>	<b>\$ 20,070,260</b>	<b>\$ 22,817,641</b>	<b>\$ 26,912,303</b>	<b>\$ 4,094,662</b>	<b>17.9%</b>
Reimbursable Fund	\$ 10,660,033	\$ 11,998,398	\$ 13,618,275	\$ 1,619,877	13.5%
<b>Total Funds</b>	<b>\$ 30,730,293</b>	<b>\$ 34,816,039</b>	<b>\$ 40,530,578</b>	<b>\$ 5,714,539</b>	<b>16.4%</b>

Note: The fiscal 2018 appropriation does not include deficiencies, targeted reversions, or across-the-board reductions. The fiscal 2019 allowance does not include contingent reductions or cost-of-living adjustments.