Department of Fiscal Services

Maryland General Assembly

FISCAL NOTE

House Bill 718 (Delegate E. Burns, *et al.*)
Appropriations

State Retirement and Pension System - Board of Trustees - Divestiture of Assets

This pension bill requires the Maryland State Retirement and Pension System (MSRPS) to divest its holdings in any company that, directly or indirectly, writes, records, produces, advertises, markets, sells, or otherwise promotes songs, lyrics, or other musical works that:

- advocate, glamorize, or explicitly describe:
  - acts of violence, including murder, rape, sexual assault, robbery, battery, assault;
  - acts of sexual deviance, including necrophilia, pedophilia, and bestiality;
  - illicit drug or alcohol abuse;
  - violence against law enforcement officers;
  - acts associated with gang activity or criminal behavior;
- degrade, denigrate, or demoralize females;
- incite violence against members of a particular sex, race, or ethnicity.

The bill would prohibit any future investment in a company that, directly or indirectly, writes, records, produces, advertises, markets, sells, or otherwise promotes the above.

Fiscal Summary

State Effect: Increase in special fund expenditures of $571,800 in FY 1998 for additional State Retirement Agency personnel. Future year expenditures reflect annualization and growth. Significant indeterminate increase in expenditures (all fund types) for additional employer contributions resulting from diminished MSRPS investment performance, as discussed below **(not included in table)**.

(in dollars)	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
SF Revenues	0	0	0	0	0
SF Expenditures	$571,800	$766,400	$793,500	$821,500	$850, 600

Net Effect	($571,800)	($766,400)	($793,500)	($821,500)	($850,600)

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

Local Effect: Indeterminate increase in expenditures for participating local governments for additional employer contributions resulting from diminished MSRPS investment performance, as discussed below.

Small Business Effect: None. This bill would not directly affect small businesses.

Fiscal Analysis

State Expenditures: This bill alters the current $21 billion investment portfolio of the MSRPS by (1) requiring the system to divest current equity and bond holdings in companies that meet the above criteria; and (2) prohibiting any future investment in such companies. Currently, the MSRPS holds stock in 1,752 companies and holds bonds in 337 companies. The total worldwide universe of companies in which the system might invest exceeds 50,000.

Currently, the MSRPS and the State Retirement Agency do not do original research on corporate investments. That is, staff do not individually research each corporation when purchasing an investment. The system selects equity investments, for example, primarily through two methods: passive index funds and active outside managers. In index fund investing, the investor, such as the MSRPS, purchases shares in every stock that is included in a given index, such as the Standard & Poors 500, in order to replicate the investment return of that index. Active outsider managers are professional research and investment firms that buy and sell stocks on behalf of the MSRPS in order to generate returns above those available through passive index investing. In neither case does the MSRPS review the characteristics of an individual corporation before choosing whether to buy, sell, or hold that investment. Costs associated with this proposal derive from two sources: administrative costs and diminished investment returns.

Administrative Costs

The State Retirement Agency would need significantly more staff in order to perform the original research required under the bill. Special fund expenditures could increase by an estimated $571,838 in fiscal 1998, which reflects the bill's October 1, 1997 effective date. This estimate reflects the cost of hiring ten additional staff members by the Investment Division of the State Retirement Agency to research current and potential holdings for compliance with the bill's requirements. Because of the specialized nature of this investment work, including familiarity with a variety of foreign languages, it is estimated that at least five of these personnel would need to be Grade 21, Step 6, and the other five Grade 20, Step 6.

This estimate includes salaries, fringe benefits, one-time start-up costs, and ongoing operating expenses. The information and assumptions used in calculating the estimate are stated below:

- universe of 50,000 current and potential holdings;
- 250 workdays per person-year; and
- 20 companies reviewed per day per person.

Salaries and Fringe Benefits	$556,838
Operating Expenses	15,000
Total FY 1998 State Expenditures	**$571,838**

Future year expenditures reflect (1) full salaries with 3.5% annual increases and 3% employee turnover; and (2) 2% annual increases in ongoing operating expenses.

Diminished Investment Returns

The MSRPS is a trust fund that receives its revenues from three sources: employer contributions, employee contributions, and investment gains. Since employee contributions are fixed, any long-term decrease in investment gains will result in additional employer contributions in order to keep the system on a sound actuarial status. (Currently, the system is 80% funded on an actuarial basis and by law must be fully funded by the year 2020.) To achieve the system's funding goals, the State's actuary has assumed a 7.5% actuarial investment rate of return. While in many years the system's return is far higher than that, the actuarial return reflects long-term financial performance by offsetting individual annual returns that may be both above and below that mark.

The exact effect of this legislation on MSRPS investment performance cannot be determined at this time. Comparison to existing "socially-conscious" investment funds is not applicable because the prohibitions contained in this legislation are substantially broader than those of such existing funds. Because the legislation would appear to cover a significant number of large domestic and international firms, it is likely that the investment portfolio of the system would be altered substantially. Such alteration would include changes to both the system's passive indexed holdings and to the instructions that the MSRPS would give to its outside managers regarding the acceptability of different components of the outside manager's investment strategy. At the extreme, equity investment could prove unworkable. In that case, a portfolio of Treasury notes and real estate holdings would produce an expected return of 6% to 6.5%, or more than one percent lower than the actuarial rate of return.

Any long-term disparity between the realized rate of return and the actuarial rate of return will result in the system falling behind its schedule of full funding by 2020 and therefore require higher employer contributions. For example, the actuary estimates that a drop in investment performance of a quarter of 1 percent would increase the State's actuarial liabilities by $979 million. Amortizing these liabilities over 21 years through the year 2020 results in an annual payment of $48.8 million beginning in fiscal 1999 and increasing 5% per year until 2020.

Local Expenditures: For local governments that participate in the MSRPS, a quarter-point decline in the actuarial rate of return would increase the local governments' liabilities by $63 million. Amortizing these liabilities over 21 years through the year 2020 results in an annual payment of $3.2 million beginning in fiscal 1999 and increasing 5% per year until 2020.

Information Source(s): State Retirement Agency, Milliman & Robertson, Inc., Department of Fiscal Services

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