SB 627

# Department of Legislative Services

Maryland General Assembly
1999 Session

## FISCAL NOTE

Senate Bill 627 (Senator Mitchell)
Budget and Taxation

**State Retirement and Pension System - Investments - Mortgages for Low and Middle Income Individuals**

This pension bill requires the Board of Trustees of the State Retirement and Pension System (SRPS) to implement a pilot program to invest $25 million from the SRPS trust fund in mortgage loans and closing assistance for certain low and middle income individuals.

The bill takes effect July 1, 1999 and sunsets June 30, 2002.

## Fiscal Summary

**State Effect:** Increase in FY 2000 special fund personnel expenditures of $288,755 to administer mortgage program; future year increases reflect salary and turnover assumptions. State expenditures for employer pension contributions (all funds) could increase by an indeterminate amount. No effect on revenues.

| (in dollars) | FY 2000 | FY 2001 | FY 2002 | FY 2003 | FY 2004 |
|---|---|---|---|---|---|
| SF Revenues | $0 | $0 | $0 | $0 | $0 |
| SF Expenditures | 288,800 | 290,300 | 300,900 | 311,900 | 323,300 |
| Net Effect | ($288,800) | ($290,300) | ($300,900) | ($311,900) | ($323,300) |

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

**Local Effect:** For local governments that participate in the SRPS, expenditures for employer pension contributions (all funds) could increase by an indeterminate amount.

**Small Business Effect:** Minimal.

## Fiscal Analysis

**Bill Summary:** The bill requires that the $25 million investment must be made through existing or newly developed public or not-for-profit programs. Not less than 20% of the $25 million must be expended in federally designated, low income target areas.

The board, in consultation with the Department of Housing and Community Development (DHCD), must adopt regulations that specify the income and other requirements for recipients of the loans. The regulations must ensure that the $25 million is invested so as to provide a rate of return that is at least the rate of return on investments included in the actuarial assumptions adopted by the board (currently 8%).

On or before October 1, 2000 (and each year thereafter), DHCD, in consultation with the pension board, must submit a report to the House Appropriations Committee and Senate Budget and Taxation Committee that states: (1) the amount invested by the board under this bill; (2) the rate of return on the investments; and (3) a description of the areas and programs in which the money is invested.

**State Expenditures:** The bill requires that the pension board invest $25 million (or about 0.1% of its total assets) in mortgages for low and middle income individuals. There are two potential sources of increased expenditures from this bill: (1) additional administrative costs; and (2) diminished investment returns.

*Administrative Expenses*

Fiscal 2000 special fund expenditures of the State Retirement Agency could increase by $109,192, which reflects the bill's July 1, 1999 effective date. This estimate is based on two additional agency staff. The agency advises that it will need one attorney (Grade 18 base) to handle the legal requirements of mortgages directly owned by the board. The Department of Legislative Services (DLS) estimates that the agency will also require an additional investment officer (Grade 20 base) to oversee the program. Future year expenditures reflect 3.5% salary increases and 3% turnover.

The State Retirement Agency advises that it would require the services of an outside mortgage consultant for investment advice, at the cost of approximately $100,000. These expenses would be off-budget. DLS, however, believes that with the additional agency staff (described above) and at DHCD (described below), such outside services may not be necessary.

The bill does not specify whether DHCD or some other State or local agency (or non-profit) would provide the direct service. Given that DHCD currently administers two mortgage assistance programs - the Maryland Mortgage Program, in which the State purchases privately-originated mortgages, and the State Funded Loan Program, in which the State originates loans directly - it is likely that DHCD would provide this service as well.

During fiscal 1998, DHCD oversaw loan activity of $71.9 million in the two programs, using a staff of 20 with total administrative costs of $1.9 million. DHCD advises that it could handle the additional $25 million in loan activity with existing resources. DLS, however, believes that this is unrealistic, and even taking into account DHCD's existing fixed costs and administrative structure, the agency would require at least four additional loan officers (Grade 16 base), for an increase in fiscal 2000 expenditures of $179,563, which reflects the bill's July 1, 1999 effective date. Future year expenditures reflect 3.5% salary increases and 3% turnover. It is assumed that these expenditures would be paid from special fund revenue derived from the mortgage income.

In total, special fund expenditures would increase by $288,755 in fiscal 2000, increasing in future years based on assumed salary increases and turnover.

*Diminished Investment Returns*

The SRPS is a trust fund with assets of $28.3 billion as of December 31, 1998. Of these assets, approximately 65% were invested in equities, 31% in fixed income, 3% in real estate, and the remainder in cash reserves.

The bill mandates that this investment provide a return of at least 8%. It is assumed that this return is net of loan losses and administrative expenses. (Loan losses can be avoided if the borrower is required to obtain mortgage insurance. Such mortgage insurance, however, raises the total cost of the mortgage to the borrower and may make it more difficult for marginal borrowers to obtain mortgages because they may not be able to meet the insurer's qualifications.)

The SRPS's mortgages would therefore have to be issued at a rate above 8% in order to factor in administrative expenses and loan losses. Assuming approximately 0.25% for loan losses and approximately 1.0% for administrative expenses, the gross loan rate would have to be 9.25%. Administrative expenses are based on the estimates discussed above and do not include the cost of any outside investment advisors utilized by the pension board. If such advisors were used, then administrative expenses would increase further.
As of March 2, 1999, rates for 30-year fixed rate mortgages averaged 7.0% (excluding closing costs and mortgage insurance). Thus, the vast majority of borrowers, including low and middle income individuals, could obtain mortgages in the private market for less than the net return required by the SRPS. Those borrowers who could not obtain mortgages in the private market are likely to fall into two categories: those with past credit problems and

those with insufficient cash for a down payment. Thus, a substantial share of the SRPS borrowers could have credit problems that could indicate future higher-than-average loan losses. The requirement that not less than 20% of the $25 million (or $5 million) must be expended in federally designated, low income target areas could also increase loan losses.

Currently, the SRPS is 91% funded on an actuarial basis and by law must be fully funded by the year 2020. The SRPS 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. (To achieve the system's funding goals, the State's actuary has assumed an 8.0% 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.)

Investment policies that limit the board's capability to achieve maximum returns within acceptable levels of risk could have a deleterious effect on the return of the portfolio and subsequent State employer contributions. The required investment of $25 million of SRPS portfolio assets in low and middle income mortgages could reduce the overall earnings performance of invested assets and thereby increase State expenditures for pension contributions. The effect on expenditures would depend on the investment's performance and cannot be reliably estimated at this time. Given that the $25 million investment would be relatively small compared to the system's total assets and assuming that the investment would provide a positive return, however, the net effect on State pension contributions is likely to be minimal.

**Small Business Effect:** Small businesses that provide mortgages to low and middle income individuals could experience a loss of revenue if the State's program captures business they would have otherwise had. (As noted above, given current market rates, the State's program is not likely to do so.)

If the program is administered by small business non-profit organization(s) (rather than DHCD), then these organizations would experience an increase in operating revenue from administrative reimbursements.

---

**Information Source(s):** Department of Housing and Community Development, State Retirement Agency, Department of Legislative Services

**Fiscal Note History:** First Reader - March 9, 1999

lnc/jr

---

Analysis by: Matthew D. Riven Direct Inquiries to:

John Rixey, Coordinating Analyst
(410) 946-5510
(301) 970-5510