HB 1354

Department of Legislative Services

Maryland General Assembly
2002 Session

FISCAL NOTE

House Bill 1354 (Delegate Bobo)
Appropriations

Retirement and Pensions - Investments

This pension bill prohibits the Board of Trustees of the State Retirement and Pension System (SRPS) from investing pension system assets in foreign currency or similar investment transactions involving foreign currency, forward contracts, options, or futures. Any such investments must be divested by December 31, 2002.

The bill takes effect July 1, 2002.

Fiscal Summary

State Effect: The SRPS would incur approximately $31 million in transaction costs due to the divestiture of all international investments. In addition, the system's ability to invest in this asset class would be prohibited, potentially reducing the system's risk-adjusted investment returns. The impact on State pension contributions cannot be reliably estimated at this time. For illustrative purposes, for each 1% return below the 8% actuarially assumed investment return, the State's pension contributions increase by approximately $16 million annually.

Local Effect: Employer pension contributions by governmental units that participate in the SRPS could increase as a result of the divestiture costs and potential reduced future investment returns.

Small Business Effect: None.

Analysis

Current Law: None applicable.

Background: Foreign currency transactions typically may be used for one of two purposes by investors. In one case, these transactions may be used by an investor in international securities (stocks or bonds) to protect the investor from the investment risk associated with changes in the relative value of the "home" currency of the investor as compared to the value of the currency of the security. This is known as "hedging," and usually is done in conjunction with the investment in the international security. (Some international securities investors opt not to hedge.)

In the other case, the investment in the foreign currency is not accompanied by an underlying investment in an international security. Rather, the transaction reflects a position (or "bet") by the trader solely on the direction of the currency market. The pejorative term for this type of foreign currency investing is "speculation." It appears that this type of trading, combined with fraudulent efforts to conceal trading losses, resulted in approximately $691 million in losses by Allfirst Financial, Inc., of Maryland. The State Retirement Agency advises that the pension board's Investment Operations Manual precludes the use of currency transactions for speculation.

State Expenditures: The bill as drafted would prevent the pension board from engaging in foreign currency transactions. As a result, the board would be required to eliminate investments in international securities, since currency transactions are needed to settle trades in the underlying securities. For example, if the SRPS purchases shares of Toyota, then the system must sell dollars in the spot market in exchange for Japanese Yen to purchase the Japanese stock. With the bill's restriction, the stock cannot be purchased.

Moreover, certain external investment managers contracted by the board to manage portions of SRPS assets engage in currency transactions for hedging purposes. For example, if a manager opts to "over-weight" Japanese stocks by 10% compared to the typical or average portfolio's weighting in Japan, then that manager is also "over-weighted in Yen exposure by 10% versus the comparison benchmark. In this case, the manager might sell the amount of Yen that results in leaving the manager with an equal weight" in Yen versus the benchmark. Hedging activities by the system's outside international investment managers is relatively small because they are measured against an unhedged benchmark.

The SRPS currently holds approximately $5 billion in international equities through five separate external managers. If the system were required to divest these international portfolios, the agency advises that it would incur approximately $31 million in transaction costs. The agency could also experience realized investment losses if the value of the securities in the portfolio is lower at the time of divestiture than when they were purchased.

Such a divestment would require that the $5 billion be reallocated to other asset classes. The impact on the system, and corresponding effect on State pension contributions, from the divestiture and reinvestment would depend on the risk-adjusted return of the new investments compared to the current investments. For illustrative purposes, the State's pension actuary informally estimates that for each 1% return below the 8% actuarially assumed investment return, the State's pension contributions increase by approximately $16 million annually.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): State Retirement Agency, Milliman USA, Department of Legislative Services

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