Department of Legislative Services

Maryland General Assembly
2007 Session

FISCAL AND POLICY NOTE
Revised

House Bill 1333 (Delegate George, *et al.*)
Appropriations

Maryland Public Investments Protection Act

This bill bars the Board of Trustees of the State Retirement and Pension System (SRPS) from retaining a company to manage all or a portion of its assets unless the fund manager certifies in writing to the board and the State Treasurer that it does not invest pension fund assets in entities with economic ties to Iran, Syria, Sudan, or North Korea. Any transaction that violates this requirement is void or voidable, subject to the discretion of the board in its capacity as fiduciary for the system.

The bill takes effect July 1, 2007.

Fiscal Summary

State Effect: Significant increases in State pension contribution rates resulting from substantial transaction costs and investment losses incurred by SRPS.

Local Effect: Significant increases in participating governmental unit (PGU) pension contribution rates resulting from extensive transaction costs and investment losses incurred by SRPS.

Small Business Effect: None.

Analysis

Bill Summary: The bill defines a "forbidden entity" as:

- the governments and governmental subdivisions of Iran, Sudan, Syria, or North Korea;
- any "company" that is wholly or partially managed or controlled by those countries or their subdivisions; and
- any company established by, located in, or conducting business with those four countries.

A forbidden entity does not include nongovernmental organizations or other firms performing humanitarian functions in those countries.

Any company retained by the board to manage all or some of the system's assets must certify in writing that it has not invested any of the system's assets in a forbidden entity on or after July 1, 2007. On or after July 1, 2008, the manager must certify that at least 80% of the system's assets are not invested in a forbidden entity. By July 1, 2010, it must certify that none of the system's assets are invested in a forbidden entity, and that it will not invest any assets in a forbidden entity after that date.

Current Law: There is only one statutory restriction on the investment of SRPS assets: only up to 25% of assets invested in common stocks may be invested in nondividend paying common stocks.

Chapter 775 of 1985 prohibited SRPS from investing for two years any new assets (employee and employer contributions) in companies doing business in South Africa, subject to certain exemptions.

Background: Sudan, Iran, Syria, and North Korea have all been identified by the U.S. State Department as terrorist-sponsoring nations.

Institutional Shareholder Services (ISS), an investment research firm, has compiled a widely used list of companies with economic ties to these four countries plus Libya. According to ISS, there are approximately 450 companies with economic ties to the five nations. The State Retirement Agency (SRA) could not provide a count of the number of those companies it holds in its portfolio in time for this fiscal note, but the number is expected to be significant. SRA has already identified 14 companies with economic ties to Sudan in its portfolio.

State Fiscal Effect: SRPS relies on external managers selected by the board of trustees to manage its entire investment portfolio. All investment management fees are paid out of the system's assets, so increases in fees results in a decrease in the system's assets. As of June 30, 2006, SRPS had more than 50 fund managers responsible for its $34.3 billion in assets, including all domestic and international public equity, fixed income, private equity, and real estate holdings. The SRPS board indicates that its managers are advising it that they do not have sufficient information about the activities of financial institutions in which they invest or might invest in order to provide the necessary certifications. Therefore, many of its managers have indicated that they would not be able to provide the necessary certification, requiring them to either eliminate financial-sector companies from the system's portfolio or migrate the system's holdings to other investment instruments. If those new funds are less profitable than the system's current holdings, the pension fund could experience investment losses. The agency further estimates the transaction costs of migrating assets out of four of the system's largest funds, all managed by State Street Global Advisors, could be between $5 and $8 million. Additional costs would be incurred for other funds.

As a result, the SRPS board indicates that the bill's requirements are in conflict with the board's fiduciary responsibilities because the costs involved with implementing the bill would be too great to be consistent with the board's obligation to invest prudently.

Investment returns by SRPS can have a profound effect on State pension contribution rates. This is best illustrated by examining the years bracketing the stock market downturn of 2001-02. Prior to the downturn, State pension contributions had declined as a percentage of payroll for four consecutive years, as SRPS enjoyed robust investment returns that exceeded its investment assumptions by considerable amounts. In the two years following the downturn, when SRPS investments lost money, State pension contributions increased by 9.0% the first year and would have increased by another 8.4% the following year if the State had not acted to restrict their growth.

The transaction costs and potential investment losses described above would likely result in significant increases in State pension contribution rates, although the precise extent of their effect cannot be reliably estimated.

Local Fiscal Effect: To the extent that PGU pension contribution rates are also affected by the system's investment returns, PGU contribution rates could increase significantly, too.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Mercer Human Resources Consulting, Maryland State Retirement Agency, Department of Legislative Services

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