Department of Legislative Services

Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE

House Bill 481 (Delegate Griffith) (Chair, Joint Committee on Pensions)
Appropriations Budget and Taxation

State Retirement and Pension Systems - Investments

This bill repeals the requirement that all real estate transactions carried out by the Board of Trustees of the State Retirement and Pension System be approved by the Board of Public Works. It also repeals a cap on fees for external real estate and alternative investment management services, and repeals archaic pension law language.

All real estate purchases or sales by the board must be approved by a majority of the Comptroller, Treasurer, and Secretary of Budget and Management, all of whom serve *ex officio* on the board. The board must report annually to the General Assembly regarding all real estate transactions approved in the previous year.

The archaic language being repealed requires that not more than 25% of the system's assets be invested in nondividend paying common stocks.

The bill takes effect July 1, 2008.

Fiscal Summary

State Effect: Potential increase or decrease in State pension liabilities and contribution rates, depending on the performance of SRPS real estate and alternative investment managers.

Local Effect: Potential increase or decrease in local pension liabilities and contribution rates, depending on the performance of SRPS real estate and alternative investment managers.

Small Business Effect: None.

Analysis

Current Law: All real estate sales or purchases approved by the board must be approved by the Board of Public Works, which consists of the Governor, the Treasurer, and the Comptroller. Current board procedures require that all real estate transactions be reviewed and analyzed by its primary real estate manager and a separate real estate consultant, both of which act as fiduciaries for the system. Approval of real estate transactions is delegated to the Real Estate Subcommittee of the board's Investment Committee before being forwarded to BPW for its approval.

The board is subject to a statutory cap of 1.2% of the market value of assets on the investment management fees it pays to external managers who manage the system's real estate holdings and alternative investments (generally private equity partnerships).

Background: Until January 2008, the board's asset allocation provided for a 5% allocation to real estate and a 2% allocation to private equity. The real estate allocation is divided among a core direct purchase component, primarily office buildings and grocery-anchored shopping plazas, a publicly traded component comprised of real estate investment trusts (REITs), and a private market component. The core component of the board's real estate allocation has been significantly hampered due to increased competitiveness in the commercial real estate market. The requirement that all sales and purchases be approved by BPW typically adds at least two weeks to the transaction schedule, which has effectively eliminated the board from consideration as a purchaser of commercial properties. The board advises that since two of the three members of BPW sit on the board, and the Secretary of Budget and Management represents the third member (the Governor), this proposal would allow for expedited approval of direct real estate purchases and sales without sacrificing State oversight.

The statutory fee cap for real estate and alternative investments was designed to control the growth of these nontraditional investment classes within the system's asset allocation policy. Since the system initiated exposure to both classes in the 1990s, real estate and private equity have proven to be among the system's leading asset classes, consistently generating annual returns near or above 20% in recent years. Although the fee structures for private equity managers (typically greater than 2%) greatly exceed the fees paid to managers of publicly traded assets, the returns generated to date have justified the larger fees. In response, the board approved a new asset allocation policy in January 2008 that raised the private equity target from 2% to 5% of total assets and the real estate target from 5% to 10%. This brings the system in line with asset allocation targets among its peers. However, the combination of high fees and anticipated growth in these two classes means that the system will likely exceed the statutory fee cap as early as fiscal 2009 or, at the latest, 2010.

The restriction on the purchase of nondividend paying common stocks has been obviated by the board's adherence to modern portfolio theory and the prudent investor standard.

State Fiscal Effect: Legislative Services cannot reliably predict the net effect of these measures because it depends on the performance of capital markets and, more specifically, of the real estate and alternative investment managers retained by the system. These measures are designed to enhance the system's investment performance. If successful, they would increase SRPS assets and lower its unfunded liabilities, which in turn would restrict the growth in State pension contributions. The proposals are not without risk, however. Lifting the fee cap on alternative investments will result in the system paying higher fees than it currently does, and those fees are paid directly from the pension trust fund. If alternative investments do not maintain their current high returns, SRPS assets could decrease as a result.

Local Fiscal Effect: Local participating governmental units are subject to the same risks and rewards as the State, depending on the performance of SRPS alternative investment and real estate managers. Improved investment performance would decrease or restrict the growth of their contribution rates, while worsening performance would increase their contribution rates.

Additional Information

Prior Introductions: None.

Cross File: SB 384 (Senator McFadden, *et al.*) (Chair, Joint Committee on Pensions) – Budget and Taxation.

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

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Analysis by: Michael C. Rubenstein

Direct Inquiries to:
(410) 946-5510
(301) 970-5510