Department of Legislative Services
Maryland General Assembly
2013 Session

FISCAL AND POLICY NOTE

House Bill 819 (Delegate Schuh, *et al.*)
Appropriations

Prudent Pension Management Act

This bill prohibits the State and local governments from issuing pension obligation bonds (POBs). It also caps investments of local or State pension funds in specified alternative asset classes at 10% of total assets in each plan.

The bill takes effect July 1, 2013.

Fiscal Summary

State Effect: Likely significant decrease in investment returns for the State Retirement and Pension System (SRPS) due to the cap on alternative investments, which results in a significant increase in State pension liabilities and contribution rates (all funds). The extent of any such increase cannot be estimated reliably. The prohibition against the use of POBs has no practical effect on State finances.

Local Effect: Potential decrease in investment returns for local pension plans, to the extent that they currently or prospectively invest in alternative asset classes. The prohibition against the use of POBs limits local governments' flexibility to address pension liabilities, but its net fiscal effect on their finances cannot be determined reliably. **This bill may impose a mandate on a unit of local government.**

Small Business Effect: None.

Analysis

Current Law: The State and local governments are authorized to issue POBs; statute specifies procedures under which they may be issued and how proceeds from POBs may be used.

Fiduciaries of SRPS are (1) members of the Board of Trustees; (2) members of the Investment Committee of the board; and (3) an employee of the State Retirement Agency who exercises any discretionary authority or control over the management or disposition of assets or of the several systems. Fiduciaries must discharge their duties:

- solely in the interest of participants;
- for the exclusive purpose of providing benefits to participants and to cover administrative expenses;
- with the care, skill, prudence, and diligence that a prudent person would use;
- by diversifying investments to minimize the risk of large losses; and
- in accordance with laws, documents, and instruments governing the systems.

Trustees or officers in charge of any local pension or retirement system or fund, or other postemployment benefits fund, may invest, redeem, sell, exchange, and reinvest assets of the fund as provided by the laws of the local government. Moreover, they must comply with the fiduciary standards in State law, as summarized above.

Background:

Pension Obligation Bonds

POBs are typically general obligation debt that is issued by a government to pay down its unfunded pension liability (and thereby reduce its employer contribution to the pension plan). The rationale behind POBs is that governments can issue debt at low interest rates and reinvest the proceeds in public- and private-market investment instruments, thereby earning returns that meet or exceed the interest payments on the debt. The main risk associated with POBs is that returns on the investments fall below the interest owed on the debt, requiring a government entity to use operating revenue to cover at least a portion of the debt service payments.

The first POBs were issued in 1985 by Oakland, California. Those bonds were tax-exempt debt, but the federal Tax Reform Act of 1986 barred state and local governments from using tax-exempt POBs. Nevertheless, throughout the 1990s, taxable POBs remained a valuable tool used by some state and municipal governments to lower their pension liabilities in a favorable investment environment. State and local governments in California and Illinois were by far the most frequent sellers of POBs.

An analysis by the Center for Retirement Research (CRR) at Boston College of almost 3,000 POB sales from 236 governing units between 1986 and 2009 demonstrates the potential volatility of POBs. In 2007, at the peak of stock market performance, a substantial majority of POBs provided net savings to their issuers. In 2009, however, during the depth of the financial market collapse, a majority of POBs were net drains on government revenues. With more than 80% of POBs studied still outstanding at the time of the study, CRR could not make a final determination regarding their profitability.

Maryland has never issued POBs for SRPS, and CRR's research shows that they have virtually never been used by local governments in the State. However, in November 2012, Baltimore County sold $256 million in POBs at an interest rate of 3.43%. County officials estimate that total savings over 30 years will be $343 million, which represents the cumulative difference between its projected pension contributions plus debt service and its projected pension contributions in the absence of the proceeds from POBs.

Asset Allocation

SRPS's target annual investment return is 7.75%.

As of December 31, 2012, SRPS held 21.0% of its assets in the alternative asset classes covered by the bill, but investing in alternative asset classes is a relatively new strategy for SRPS. The current allocation includes 8.1% in credit/debt strategies, 5.9% in private equity, and 7.0% in absolute return (primarily hedge funds). However, as recently as fiscal 2008, total allocations in those same three asset classes were just 3.9% of the fund; the credit/debt allocation did not yet exist and the absolute return class had just been created under a different name (opportunity allocation).

SRPS's migration to alternative asset classes mirrors that of its peer funds in other states. **Exhibit 1** shows the asset allocation for SRPS and nine other state pension funds with at least $25.0 billion in assets. It demonstrates that Maryland's allocation to private equity trails that of most of its peers, and its allocations to hedge funds and credit are generally in the middle of its peer group. Exhibit 1 also shows that Maryland's fiscal 2012 return trails that of most of its peers. Over the past decade, SRPS annual returns have generally fallen below the median for other large state pension funds; the most commonly cited factor for that underperformance relative to its peers has been its relative underweight in private equity.

Exhibit 1
Performance and Asset Allocation of Public Pension Fund Peers
Fiscal 2012

		Asset Allocation								
	FY 2012 Return	U.S. Equity	Int'l. Equity	Fixed Income	Private Equity	Real Estate	Real[1] Return	Hedge Funds	Credit	Cash/ Other
Maryland	**0.36%**	**21.5%**	**20.9%**	**19.2%**	**5.7%**	**6.4%**	**10.0%**	**6.8%**	**7.8%**	**1.7%**
Virginia	1.40%	20.1%	22.8%	25.9%	9.1%	8.2%	n/a	n/a	13.6%	0.4%
Pennsylvania Teachers	3.43%	11.6%	11.4%	20.8%	22.0%	12.8%	4.3%	12.6%	n/a	4.5%
Massachusetts	-0.08%	19.3%	23.4%	13.0%	12.1%	9.7%	3.9%	9.9%	8.6%	0.2%
New Jersey	2.26%	25.4%	19.9%	23.6%	6.8%	4.7%	5.5%	5.2%	3.7%	5.4%
North Carolina	2.20%	47.4%		37.5%	4.0%	5.5%	2.0%	0.6%	3.0%	n/a
Florida	0.29%	56.5%		25.5%	5.3%	7.6%	n/a	4.3%	n/a	0.9%
California Teachers	1.80%	50.7%		18.4%	14.5%	14.2%	0.2%	n/a	n/a	2.0%
California Employees	1.00%	49.0%		18.0%	14.0%	9.0%	4.0%	2.0%	n/a	3.0%
Washington State	1.40%	36.0%		22.2%	26.0%	13.7%	1.4%	n/a	n/a	0.8%

Note: Asset allocation percentages for each system may not sum to 100.0% due to rounding.

[1]Includes inflation-linked securities, commodities, and timber.

Source: State Retirement and Pension System; annual investment reports of state pension funds

There are many risks associated with financial investments, but one of the most common measures of risk is the volatility of returns, which is typically measured by the standard deviation of those returns. In 2010, in response to concerns about the volatility of SRPS returns, the Department of Legislative Services (DLS) requested that the board's investment adviser, Ennis Knupp (now Hewitt Ennis Knupp), analyze the effects of the changes to asset allocation, namely the migration of assets from public equity and fixed income to alternative asset classes, on expected returns and portfolio risk. The calculations are based on Ennis Knupp's Capital Markets Modeling Assumptions in effect at the time the asset allocation changes were made.

Based on Ennis Knupp's analysis, the series of asset allocation changes that began in fiscal 2008 have generally improved the system's expected returns while reducing portfolio risk. **Exhibit 2** shows that, for the most part, each successive asset allocation change improved the expected geometric return and lowered risk as measured by the standard deviation. Only the last asset allocation change that was measured, which increased the allocation to credit/debt and lowered the allocation to private equity, lowered the expected return from 7.55% to 7.01%. However, it also significantly lowered the portfolio risk measure and increased the Sharpe Ratio, which measures the return that can be expected from each unit of risk. From a risk-only perspective, the first

round of changes in fiscal 2008, which lowered the fixed income and domestic equity allocations while increasing real estate and private equity allocations, increased portfolio risk but also raised the Sharpe Ratio. Subsequent changes lowered portfolio risk to a level below that of June 30, 2007, before the shift to alternative classes began. Based on this analysis, DLS concluded that there is no evidence that the board's asset allocation strategies, particularly the increased emphasis on alternative asset classes, have increased portfolio risk.

Exhibit 2
Risk/Return Profile of the SRPS Portfolio
Fiscal 2007-2010

	6/30/2007	6/30/2008	6/30/2009	6/30/2010
Expected Geometric Return	6.93%	7.33%	7.55%	7.01%
Risk (Standard Deviation)	11.49%	12.27%	11.92%	10.73%
Sharpe Ratio	0.242	0.284	0.345	0.377

SRPS: State Retirement and Pension System

Note: This exhibit uses Hewitt Ennis Knupp's assumed inflation rate of between 2.3% and 2.5%, which is lower than the SRPS's inflation assumption of 3.0%.

Source: Hewitt Ennis Knupp

State Fiscal Effect: The prohibition against POBs has no practical effect since the State has never used them and has no current plans to use them. To the extent that the State may wish to use POBs in the future, the bill's prohibition may be either helpful or detrimental to the State's finances, as discussed above.

Capping alternative investments by SRPS may reduce prospective returns and increase portfolio risk over the short and long term. As noted above, the State's underperformance with respect to its peer funds is generally attributed to its late entry into private equity and its current underweight in that asset class. Requiring SRPS to limit its investments in alternatives like private equity likely means that future returns will also lag its peers and its investment return assumption. Moreover, since the expanded use of alternative asset classes has reduced portfolio volatility, capping their use may make annual returns more volatile. Any prospective reduction in investment returns and increase in volatility likely increases State pension liabilities and contribution rates, perhaps significantly. Reduced exposure to alternative asset classes also likely reduces investment management fees paid by the system, as fees for those classes tend to be substantially higher than for traditional asset classes. Any reduction in fees is likely more than offset by foregone returns.

Local Fiscal Effect: Local effects mirror those of the State to the extent that local pension funds seek to use POBs in the future, and to the extent that they invest in alternative asset classes.

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): Maryland Supplemental Retirement Plans, State Retirement Agency, Boston College, Baltimore County, Hewitt Ennis Knupp, Department of Legislative Services

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mc/rhh

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