

Maryland Association of Counties' Pension Blog Series 2012, first published in *Conduit Street*, written by Robin Clark, Policy Analyst, Maryland Association of Counties

State Pension System – Governance and Oversight

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In 2012, the State began a [shift of \\$255 million](#) of costs associated with the Maryland State Retirement and Pension System to local governments. This blog series, which will run over the course of the next several months, will serve to educate public officials and others on the [Maryland State Retirement and Pension System](#) (the “System”), including the county’s current stake in pension expenses; the financial health of the System; pension investment strategies, and the topic of rate of return. In the last installment, we will share some of the possible legislative actions that MACo will seek in the upcoming session.

Maryland State Retirement and Pension System – Overview

The Maryland State Retirement and Pension System (the “System”) administers death, disability and retirement benefits on behalf of more than 350,000 active and former State employees, teachers, State police, judges, law enforcement officers, correctional officers and legislators. Over 100 local governmental agencies voluntarily participate in the System, though the State of Maryland being the largest sponsor.

Key benefits and services on the System are survivor protection for employees who die before reaching retirement; disability coverage in the event that an employee is unable to continue working due to a disabling injury or illness; and a basic monthly retirement allowance based on the member’s age, service, and salary upon retirement with options for payment of a continuing allowance to the member’s survivor. The System includes annual cost-of-living adjustments.

The Board of Trustees

A 14-member [Board of Trustees](#) manages the System’s multi-billion dollar investment portfolio. The Board is made up of the following members:

Three *ex officio* state government officials including:

1. The Secretary of Budget and Management;
2. The State Comptroller; and
3. The State Treasurer.

Five representatives of the various retirement plans, elected by their membership to serve four-year terms, including:

1. A representative elected by the active members of the Employee's Retirement System, the Employees' Pension System, the Correctional Officers' System, the Legislative Pension Plan, the Local Fire and Police System, and the Law Enforcement Officers' Pension Plan;
2. A representative elected by the retired members of the Employee's Retirement System, the Employees' Pension System, the Correctional Officers' System, the Legislative Pension Plan, the Local Fire and Police System, and the Law Enforcement Officers' Pension Plan;
3. A representative elected by the active members of the Teachers' Retirement System and the Teachers' Pension System;
4. A representative elected by the retired members of the Teachers' Retirement System and the Teachers' Pension System; and
5. A representative elected by the active and retired members of the State Police Retirement System.

One representative of participating governmental units (mostly county and municipal governments, but also including certain independent agencies), appointed by the Governor to a four-year term.

Five members of the public with experience overseeing pension systems or other similar organizations, appointed by the Governor with the advice and consent of the Senate to four-year terms.

In general, the Board of Trustees is responsible for the management, general administration, and proper operation of the System. This includes maintaining fiduciary duty for the operation of the retirement and pension plans and making sure that all assets of the System are held exclusively to benefit the members of the System.

The Board adopts the actuarial assumptions necessary to properly fund the System and approves qualified disability retirements. The Board also regularly adopts rules, regulations, policies, and procedures necessary to administer the various plans. The Board of Trustees also exercises oversight of the Maryland State Retirement Agency by its authority to appoint the Agency's Executive Director and Chief Investment Officer.

The Board of Trustees appoints boards and committees to advise it on specific and technical matters. These include the Investment Committee, an actuary, and one or more medical boards. The Board designates a medical board to arrange and evaluate medical examinations required by the System plans and to investigate applications for disability retirement. Each medical board is composed of three physicians ineligible to participate in the System.

Though not legislatively required, the Board of Trustees have appointed an administrative committee to review issues that require additional study and report back to the full Board. The Board has also created an audit committee, a corporate governance committee, and a securities litigation committee. Current Board members and committee members may be found [here](#).

The Maryland State Retirement Agency

The Maryland State Retirement Agency operates under the [supervision](#) of the Board of Trustees, and its Executive Director is appointed by the Board. The agency's five divisions, administrative, finance, investment, internal audit and information services operated with a [\\$29.9 million budget in fiscal 2010](#). The investment division of the agency is responsible for the management, control, and investment of the System's funds, and maintaining the equity and bond index funds, the self-liquidating bonds and the reinvestment reserve. The investment division's [Chief Investment Officer](#), who is a direct appointment of the Board, has the authority to hire and fire asset managers.

Legislative Oversight

Since 1975, the General Assembly has exercised oversight of the State Retirement and Pension System. The President of the Senate and the Speaker of the House of Delegates each appoint members to an interim Joint Committee on Pensions. This committee's membership is typically drawn from the Senate Budget and Taxation Committee and the House Appropriations Committee, which handle pension legislation during the regular session.

Recent legislation passed by the General Assembly has modified the System in an effort to reduce its cost and to shift costs to local governments. The Assembly passed [Chapter 397](#) into law in 2011, increasing member contributions, linking cost-of-living adjustments to investment returns, and increasing vesting and retirement eligibility requirements for the System. Then, in 2012, the [Budget and Reconciliation and Financing Act](#) shifted funding responsibility of pension costs for local school, library, and community college personnel who are members of the Teachers' Retirement System or Teachers' Pension System to local

governments. Both of these legislative changes will be described in more detail in subsequent articles in the blog series.

Two thorough documents dealing with the roles of the Board and the Executive Director are also available online from the System website, for fuller detail on these structures:

[Charters](#) –This document defines the Board of Trustees and its functions and responsibilities as overseers of the System.

[Governance Policy](#) — This document describes the manner in which the members of the Board of Trustees conduct themselves in their respective duties and the governance rules for the Board as a whole.

The Financial Health of the Maryland State Pension System

November 5, 2012

As counties take over a share of the costs of the Maryland Teachers' Pension, they have a greater interest in the state pension system's overall financial health. In this post, we review the vital signs of the whole system, compare it to other public pensions and explore the effects of legislative reform and market trends. Our review finds that recent reforms of the system set it on-course for improved funding levels, despite varied investment returns.

Public Pension Pandemic

In recent years, pension plans across the country have been struggling. Public pension plans are underfunded and the ability of investment returns alone to close those gaps proves difficult in a lagging economy. As [reported](#) in *Governing*,

The Pew Center on the States estimates that all funds combined currently operate at a \$1 trillion deficit [45% of which is pension cost; 55% health care], leaving many state public pensions funded well below the 80 percent level suggested by the U.S. Government Accountability Office.

The Maryland pension system is underfunded, too, [reporting](#) a funding level of 67% in June 2011. However, the Board of Trustees expects the system to reach a healthy level of 80% funding by 2023 as a result of pension reforms enacted by the General Assembly in 2011.

Legislative Doctoring

Over the years, the General Assembly's attempts to reform the pension system helped improve its funding, while the benefit enhancements and funding exceptions they enacted created further set-backs. According to the Department of Legislative Services, the General Assembly began working in 1979 and 1984 to avoid a future of ever increasing pension costs. The 1984 reforms had a positive effect, and the financial and actuarial condition of the system steadily improved throughout the twenty years following their enactment. As [described](#) by the Department of Legislative Services,

The State's overall contribution rate for the system decreased from 17.6% of payroll in fiscal 1985 to 7.97% in fiscal 2005. The market value of the system's assets increased from \$2.3 billion in fiscal 1980 to over \$32.1 billion at the end of fiscal 2005. Moreover, for the first time in the history of the system, at the end of fiscal 2000 (approximately 20 years ahead of statutory schedule), the system was fully funded on an actuarial basis with an overall funding ratio of assets to liabilities of 101%.

In 2002, the General Assembly enacted the Bridge to Excellence ("Thornton") legislation, providing additional funding for education. Some of this funding translated into jobs and salary increases for educators, which created additional liabilities for the pension system. In the seven years following Thornton, general fund expenditures for teacher pensions grew by [93%](#), and teacher pension costs grew by [159%](#).

Also in 2002, the General Assembly also changed the rules regarding funding for the pension system by enacting the "corridor" funding method. As [described](#) by the Department of Legislative Services,

Faced with the prospect of dramatic increases in State contribution rates in fiscal 2002 due to investment losses, the State adopted a proposal to reduce the volatility of its contribution rates while still maintaining advance funding of its pension liabilities. Under the new approach, which was incorporated into the Budget Reconciliation and Financing Act of 2002 (Chapter 440), the rates for the largest systems – the employees' and teachers' systems – remained fixed at the fiscal 2002 certified rate as long as their funding levels remained in a "corridor" of actuarial funding from 90 to 110%.

In [2006](#), the General Assembly increased benefits and increased the multiplier used to calculate pensions from 1.4 to 1.8 for the Teachers' and Employees' pension systems. The benefit enhancement was made retroactive to 1998, so it affected a large number of employees, increasing liabilities by [\\$1.9billion](#). Since pension benefits are calculated by multiplying (years

of service) x (average final compensation) x (this multiplier), the more generous multiplier significantly increased the system's costs.

Following these changes, the contribution rate doubled, rising to [13.40%](#) in fiscal 2012. The General Assembly acted to counter this trend in 2011, passing significant system reforms. These reforms raised employee contributions to 7%, delayed pension vesting from five to ten years, and required the last five highest years of salary, rather than the last three, to be used in calculating retirement benefits.

Market Maladies

Poor investment returns in periods of economic downturn have contributed to the underfunded status of the pension system. According to the State Retirement Agency, the increase in contribution rates in recent years was affected by the "dot com" bubble burst of 2001-2002 and the financial market collapse of 2008-2009. The "dot com" bubble burst [effected](#) a -7.6% return for the Maryland State Retirement and Pension System in 2002. The market failures of 2008 created an additional increase in actuarial liabilities. As the Department of Legislative Services [describes](#),

The most dramatic decrease was from the end of fiscal 2008 to the end of fiscal 2009, when the funding status decreased from 78.62 to 65.02%, a change of almost 14.0%. This decline is largely attributable to the effects of the turmoil in the financial markets that began in fall 2008 and carried through spring 2009.

Pension Pulse

In more recent years, pension investment returns have been variable. The State Retirement Agency recently [reported](#) a 0.36% investment performance in 2012, down from 20.04% in 2011. The Board of Trustees is contemplating further statutory reforms in 2013 to address both funding and administrative issues with the systems. Proposals [presented](#) to the Joint Committee on Pensions last week include a range of oversight and financial matters, and the committee is expected to continue analyzing related policies through the remaining interim.

The County Stake in the State's Pension

October 10, 2012

The Maryland State Pension System is made up of [nine retirement plans](#), and local governments participate in six of those plans. Local school system employees are members of the teachers' pension and retirement plans. And many other local government employees are members of the employees' and law enforcement officers' retirement and pension plans through their governments' participation in the state system. In addition, some librarians and elected officials have the option to join the state system. The local government role as participant in these plans, and its new role as payer of teacher pension costs translate to a major county stake in the Maryland State Pension System.

Participating Governmental Units

Various types of local governments participate in the Maryland State Pension System. According to the Department of Legislative Service's 2010 [report](#), 121 local governmental units, including towns, counties, and special taxing districts participate. Public library associations, fire departments, and public boards or commissions add to the number.

Local participation creates an interest in the System's overall financial health. For several years, and especially following the [2009 recession](#), there has been [concern](#) that the System was not adequately funded. A recent [law](#) passed by the General Assembly established reforms of the System and a reporting requirement. In addition, the law states that

The Secretary of the Department of Budget and Management shall report biennially, beginning on January 1, 2013, to the Governor and the General Assembly. . . on the financial health of the [System]. The Secretary's report shall reflect the State system's progress towards achieving the statutory funding goals, and shall include recommendations concerning modifications to the funding methods or benefits structure.

In 2011, the Board of Trustees [reported](#) a goal to reach approximately 80% funding by fiscal year 2023. The current funding level was well below that ratio, as reported,

At June 30, 2011, the System's actuarial accrued liability was \$55.9 billion and the unfunded actuarial accrued liability totaled \$19.7 billion, resulting in a funded status ratio of 64.7%.

Teacher Pension Shift

The costs of maintaining the Maryland State Pension System, especially through the recent recession has created a strain on the state budget. This year, in the final hours of a special session, the General Assembly passed the [Budget Reconciliation and Financing Act \(BRFA\) of 2012](#). Among many provisions in the \$35.5 billion budget plan, the BRFA 2012 shifted the cost of teacher retirement and pension plans to county governments.

According to the BRFA, the cost shift will be [phased-in](#) initially, over four years, beginning in FY 2013. Pension costs for each local school board differ based on the number of employees in the teachers' system, other participants in the teacher pension such as library and community colleges employees are still funded by the state. Local school boards will pay a total of \$136.6 million in state fiscal year 2013.

When the phase-in is complete, counties will have to pay the normal contribution rate to the state pension system multiplied by the total annual compensation of all the employees in the system. For fiscal year 2016, the total cost is estimated to be [\\$254.8 million](#). While the school boards are nominally making the direct payments to the state, the BRFA bill directs each county to make a required appropriation to its schools (above and beyond the maintenance of effort funding level already required) in an amount calculated to offset the new shared costs.

Maryland State Pension System: Investment Strategy and Management

November 15, 2012

As county governments assume a share of the financial responsibility for the Maryland Teacher's Pension, they have a greater interest in the way that the system's funds are invested. This article provides a brief overview of the current investment strategy and its management.

Asset Allocation

The Maryland State Retirement and Pension System (MSRPS) diversifies its portfolio among a variety of asset allocations and sets targets for each. These target allocations, as captured in the MSRPS' [Quarterly Investment Update](#), show a substantial percentage in public equity (36%), and the remaining investments in fixed income (10%), real return (15%), real estate (10%), private equity (10%), credit/debt strategies (10%) and absolute return (7%).

According to the [Quarterly Investment Update](#), real return investments are expected to exceed the rate of inflation over an economic cycle. Examples of real return investments include treasury inflation-protected securities (TIPS), global inflation linked bonds, commodities, infrastructure, timber and other natural resources. Absolute investments are expected to deliver returns greater than zero in any market condition. Examples of absolute return investments include global macro and multi-strategy hedge funds. The following chart depicts the long-term policy allocations of the System's investments.

36.0%	Public Equity
10.0%	Fixed Income
10.0%	Credit/Debt Strategies
10.0%	Real Estate
15.0%	Real Return
10.0%	Private Equity
7.0%	Absolute Return
2.0%	Cash

As reported by the Trust Universe Comparison Service (TUCS), referenced in the Department of Legislative Services' [Annual State Retirement and Pension System's Investment Overview](#), the system's fiscal 2011 investment performance placed it in the bottom half for public pension funds with at least \$25 billion in assets. This was a decline from 2010, when the system was ranked in the top 35%. Performance relative to peer funds is determined primarily by asset allocation. It shifts year to year based on market conditions.

Passive and Active Management

The System's investment allocations were critiqued in a recent [report](#) by the Maryland Public Policy Institute. The report suggested that the State Pension Fund should move away from alternative investments such as real estate, real return, private equity, and absolute return to reduce risk and save money spent on investment managers.

Not all experts agree with this critique, however. [Governing Magazine](#) presented a different viewpoint, [reporting](#)

Pension experts interviewed for this story . . . question the validity of the [Maryland Public Policy] report, which compares investment firm fees with each plan's net assets. Even with the higher fees, they say additional returns from investment managers outweigh the added cost in the long run, and tossing more money into equity index funds wouldn't diversify portfolios.

In addition, DLS found the MPPI report's recommendations "ill advised," [saying](#)

Indexing the entire portfolio would have several negative consequences for the system, including:

- Reducing, not enhancing, diversification
- Eliminating mandates that have historically added value to the portfolio; and
- Potentially placing the system in the risky position of having to liquidate holdings with no guarantee of favorable pricing for those assets.

Alternative investments of real estate and private equity were among the most robust asset classes in the past year, and similar pension funds more invested in them outperformed Maryland, as reported in the Department of Legislative Services Annual State Retirement and Pension System's Investment Overview. And, according to the MSRPS, Maryland already utilizes passive management for domestic and international public equity where potential for gains from active management is limited. Choices between management strategies and investments are determined by those who manage Maryland's Pension and Retirement System investments.

Investment Management

The Board of Trustees of the Maryland State Retirement and Pension System, the Board's Investment Committee, and the Retirement Agency's Chief Investment Officer each have prominent roles in the system's investments.

As described in the Board of Trustees [Governance Charters](#), "the Board has the full power to invest the assets of the System."

In carrying out its fiduciary duties with respect to the assets of the System, the Board shall:

- a. Consider and act upon recommendations made by the Investment Committee, with respect to: i. The investment programs, and ii. Compliance of the investment programs with Board policies;
- b. Adopt an Investment Policy Manual . . .
- c. Review compliance with, and the continued appropriateness of, the provisions of the Investment Policy Manual;

- d. Monitor the performance of the total fund, each asset category, and each investment manager of the Fund;
- e. Review the performance of the General Investment Consultant;
- f. Review a study of the relationship between the System's assets and liabilities performed at least every two years; and
- g. Consider appropriate corporate governance actions.

According to the Board of Trustees [Governance Charters](#), the Investment Committee advises the Board and makes recommendations on a variety of investment matters, including management staff, vendors and even particular approaches such as the use of active and passive investment strategies. The Committee makes recommendations to the Board regarding the Chief Investment Officer's appointment, compensation, leave, financial incentives, or termination. The Committee recommends a General Investment Consultant, Optional Retirement Program vendors, and custodian banks for the System. The Committee also monitors and reviews several specific aspects of the investment program. As described in the [Charters](#),

The Investment Committee shall:

- a. Monitor compliance with the Investment Policy Manual and report to the Board as appropriate;
- b. Monitor asset allocation strategies utilized in the investment programs;
- c. Monitor active and passive and internal and external investment management strategies utilized in the investment programs;
- d. Review the performance of each asset class within the investment programs;
- e. Review both internal and external investment manager performance;
- f. Review staff's due diligence activities concerning the selection of investment managers and consultants;
- g. Review the cost effectiveness of the investment program, including trading efficiency; and
- h. Review the performance and independence of the General Investment Consultant.

The Chief Investment Officer has the responsibility for managing and overseeing the investment process. As described in the [Investment Policy Manual](#),

The Chief Investment Officer is delegated the responsibility for managing and overseeing the investment process, including

- (i) hiring external investment managers to invest the assets of the several systems,
- (ii) selecting and purchasing interests in specific investment vehicles, including limited partnerships, private equity fund investments, and private real estate fund investments,
- (iii) ensuring legal review of proposed investments by the Office of the Attorney General and
- (iv) monitoring compliance with investment contracts, State law, and both the public market and private market program policies and processes enumerated in this Investment Policy Manual.