

G50L00
Maryland Supplemental Retirement Plans

Operating Budget Data

(\$ in Thousands)

	<u>FY 02</u> <u>Actual</u>	<u>FY 03</u> <u>Approp.</u>	<u>FY 04</u> <u>Allowance</u>	<u>FY 03 - 04</u> <u>Change</u>	<u>FY 03 - 04</u> <u>% Change</u>
Special Funds	\$1,487	\$1,351	\$1,399	\$48	3.6%
Contingent & Back of Bill Reductions	0	-1	-9	-7	615.5%
Adjusted Special Funds	\$1,487	\$1,350	\$1,391	\$41	3.0%
Adjusted Grand Total	\$1,487	\$1,350	\$1,391	\$41	3.0%

- Agency personnel costs increase as a result of health insurance increases and a reduction in projected turnover expectancy.
- Other agency costs decrease as part of effort to balance expenditures to available revenues.

Personnel Data

	<u>FY 02</u> <u>Actual</u>	<u>FY 03</u> <u>Working</u>	<u>FY 04</u> <u>Allowance</u>	<u>Change</u>
Regular Positions	16.50	16.50	16.50	0.00
Contractual FTEs	0.00	0.00	0.00	0.00
Total Personnel	16.50	16.50	16.50	0.00

Vacancy Data: Regular Positions

Budgeted Turnover: FY 04	1.37	8.28%
Positions Vacant as of 12/31/02	0.00	0.00%

- There is no change in agency regular positions. All positions are currently filled.

Note: Numbers may not sum to total due to rounding.

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Analysis in Brief

Major Trends

Participant Assets Have Declined Significantly, but Employee Participation and Deferrals Hold Steady for Now: Declines in financial markets over the past three years have caused participants' assets to shrink, but so far State employee participation and deferrals are holding steady and have even increased slightly.

Issues

The Agency's Revenues Do Not Correlate in Any Way with Its Expenditures and Operations; a More Stable and Accountable Revenue Stream for the Agency Is Needed: The agency's special fund revenues are extremely volatile because they track the performance of the general investment markets, and the agency has responded to this volatility by dramatically adjusting its fees from year to year. Meanwhile, its expenditures continue to grow and do not correspond to agency workload. Department of Legislative Services recommends a reconfiguration of the board's revenue structure to provide greater accountability and stability.

Recommended Actions

1. Concur with Governor's allowance; however, see discussion of agency's fiscal structure and recommendation for fiscal reorganization.

Updates

Administration of the 401(K) Transfer Program Shifted to Outside Vendor: The agency complied with budget bill language and transferred administration of this program to its outside vendor, thereby providing greater security and plan features to participants and freeing up staff resources.

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Operating Budget Analysis

Program Description

The board was created to enable State employees to participate in voluntary tax-sheltered income deferral, tax-deferred annuity, profit sharing, and salary reduction plans. These plans offer members certain tax advantages as provided in the Internal Revenue Code. These plans include the 457, 403(b), and 401(k) employee payroll deferral plans, the 401(a) employer deferral plan, and the 401(k) transfer account for pension transfer refunds. The plans are overseen by a board of trustees and its supporting agency staff. Agency staff provides communications materials and education programs to State employees and supports the activities of the board of trustees in selection of investment options and other activities.

The board finances its operations through a fee imposed on the employee-participants, based as a percent of assets in the plans. As of January 1, 2003, the board imposes an 11 basis-point (0.11%) fee (increased from 6 basis points as of December 31, 2002) on assets to support its activities. In addition, the board imposed a “one-time” per-account fee of \$8 in fiscal 2002 and expects to impose another such “one-time” per account fee of \$6 in fiscal 2003.

The board has contracted out administration of all the plans to the Public Employees Benefits Services Corporation (PEBSCO), a third-party pension plan administrator. Under a new five-year contract that took effect January 1, 2003, the administrator imposes a 23 basis-point (0.23%) fee on assets in those plans (decreased from 28 basis points under previous contract). Member fees are capped at \$1,600 per member per year.

Performance Analysis: Managing for Results

Given that day-to-day administration and management of the program are handled by the third-party administrator, the agency’s two primary goals are to encourage knowledge of and participation in deferred compensation and to offer participants high-quality investment options. With input from the Department of Legislative Services (DLS), the agency has developed Managing for Results (MFR) measures that should give a useful indication as to whether the agency is accomplishing its goals.

As indicated in **Exhibit 1**, participation by State employees in deferred compensation (as measured by the number of active participants and total deferrals) has held steady, even as members lose money in their accounts due to financial market performance. The agency forecasts that financial markets will improve in the future, resulting in plan asset growth, and that participation and deferrals will continue to increase. DLS is less optimistic about asset growth. In addition, the lack of State employee pay raises and the temporary or permanent suspension of the \$600 employer match make it likely that participation and deferrals will decline in the near future.

Exhibit 1

Program Measurement Data
Maryland Supplemental Retirement Plans
Fiscal 2000 through 2004

	<u>2000 Actual</u>	<u>2001 Actual</u>	<u>2002 Actual</u>	<u>2003 Est.</u>	<u>2004 Est.</u>	<u>2000-02 Ann. Chg.</u>	<u>2002-04 Ann. Chg.</u>
Plan Assets - Agency Estimate (\$ in Millions)	\$1,646.1	\$1,617.3	\$1,507.0	\$1,619.1	\$1,771.8	-4.3%	8.4%
Plan Assets - DLS Estimate (\$ in Millions)	–	–	–	\$1,500.0*	\$1,500.0*	-4.3%	-0.2%
Deferrals/Transfers (\$ in Millions)	\$121.2	\$128.1	\$139.5	\$140.0*	\$130.0*	7.3%	-3.5%
Active Accounts - Agency Estimate	42,073	43,766	45,571	45,600	46,700	4.1%	1.2%
Active Accounts - DLS Estimate	–	–	–	45,600*	45,000*	4.1%	-0.6%
PEBSCO Fees (\$ in Thousands)	\$3,626.1	\$3,617.3	\$3,555.9	\$3,500.0*	\$3,500.0*	-1.0%	-0.8%
Board Fees (\$ in Thousands)	\$985.0	\$1,019.9	\$1,514.4	\$1,603.2	\$1,650.0	24.0%	4.4%

*Indicates Department of Legislative Services estimate.

Source: Maryland Supplemental Retirement Plans; Department of Legislative Services

Following the recommendation of DLS, the agency now measures the performance of its investment options compared to a composite benchmark of various financial indices over various time periods. As illustrated in **Exhibit 2**, the agency's mutual funds have performed better than this composite index. While this success is reassuring, DLS advises that it would be preferable if the comparison were structured to allow longitudinal comparisons – for example, showing the agency's performance this year (as measured by the ten-year benchmark) versus its performance last year. Also, the agency may wish to use a more nationally recognized measure of mutual fund performance, such as Morningstar, rather than its composite index.

Exhibit 2

**Performance Measure: Mutual Fund Investment Returns
Maryland Supplemental Retirement Plans
Annual Rates of Return as of June 30, 2002**

<u>Outcomes</u>	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>
Average Return for MSRP Investment Options	-11.8%	-2.4%	5.2%	10.9%
Benchmark: Average of All Investment Asset Class Indices	-10.3%	-4.4%	3.6%	9.5%

Source: Maryland Supplemental Retirement Plans

Finally, another component of the agency's performance that DLS has noted in the past is the agency's success in negotiating rebates from the providers of the mutual funds offered by the board. This practice of rebates from providers is common in the field of deferred compensation, and reflects the argument of the administrator (or in this case, the plan overseer) that the mutual fund provider's workload is reduced when it provides its product through an administrator rather than when it sells its fund directly to a retail customer. For example, PEBSCO, rather than the mutual fund provider, prepares the members' quarterly statements, and both PEBSCO and the agency provide educational material that might otherwise be provided by the mutual fund provider. Moreover, the larger the assets under administration, the larger the benefit to the mutual fund provider, so the rebates are often calculated as a percentage of assets, or under a "stair step" or other "economies of scale" structure. **Exhibit 3** shows the value of these rebates in comparison to total plan assets, indicating that the board has been successfully increasing the rebates as a percent of assets, as assets have grown.

Exhibit 3

**Performance Measure: Mutual Fund Rebates Negotiated
by Maryland Supplemental Retirement Plans
Calendar 1996 through 2002**

	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
Mutual Fund Rebates	\$472,104	\$552,404	\$663,860	\$975,368	\$1,481,832	\$3,215,998*	\$1,911,787
Plan Assets (\$ in Millions)	\$937.7	\$1,108.0	\$1,306.3	\$1,484.8	\$1,646.1	\$1,617.3	\$1,507.0
Rebates as a Percent of Assets	0.05%	0.05%	0.05%	0.07%	0.09%	0.2%	0.13%

*Reflects payments by some providers that were accrued in calendar 2000.

Source: Maryland Supplemental Retirement Plans

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The treatment of such rebates varies among deferred compensation administrators. In many cases, the administrator (i.e., the participant's employer) retains the rebates to offset the costs of administering the program. In the case of the Supplemental Retirement Plans, the board has opted to refund the rebates to the participants because the participants are already charged for the costs of administering the program (via the PEBSO asset fee) and the cost of overseeing the administrator (via the board's fee).

Fiscal 2003 Actions

Impact of Cost Containment

As a small specially-funded agency, the Supplemental Retirement Plans has generally avoided the various rounds of cost containment and is subject only to the statewide reductions. Fiscal 2003 cost containment reflects the reversion of appropriations to support free transit ridership for State employees, contingent upon enactment of a provision in the Budget Reconciliation and Financing Act of 2003.

Governor's Proposed Budget

As indicated in **Exhibit 4**, the agency's budget grows by 3.0% between its revised fiscal 2003 working appropriation and the Governor's fiscal 2004 allowance. The agency experiences significant growth in personnel expenditures due to statewide factors such as increased employee and retiree health costs. These personnel expenditures also grow over the prior year because the fiscal 2004 allowance reflects a more realistic turnover factor.

To offset these personnel increases, the agency has attempted to control growth in budget by reducing nonpersonnel expenditures, as illustrated in Exhibit 4. There are two downsides to this strategy, however. First, because almost three-fourths of the agency's costs are associated with personnel expenses, there is a limit as to how much the agency can reduce from nonpersonnel expenditures. Second, this strategy does not reflect the fact that the agency's workload for its personnel has declined. The relationship between agency expenditures and workload is discussed at greater length as a budget issue.

Impact of Cost Containment

As a small specially-funded agency, the Supplemental Retirement Plans has generally avoided the various rounds of cost containment and is subject only to the statewide reductions. The fiscal 2004 allowance reflects the elimination of \$9,000 in appropriations for matching employee deferred compensation contributions of up to \$600 per employee, contingent upon enactment of a provision in the Budget Reconciliation and Financing Act of 2003.

Exhibit 4

**Governor's Proposed Budget
Maryland Supplemental Retirement Plan
(\$ in Thousands)**

	<u>FY 02</u>	<u>FY 03</u>	<u>FY 04</u>	<u>FY 03 - 04</u>	<u>FY 03 - 04</u>
	<u>Actual</u>	<u>Approp.</u>	<u>Allowance</u>	<u>Change</u>	<u>% Change</u>
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Where It Goes:

Personnel Expenses

Turnover adjustments	\$130
Employee and retiree health insurance cost increase	53
Retirement contribution cost increase.....	3
Other adjustments	-4
Deferred compensation	-8

Other Changes

Communications	-7
Travel	-18
Printing.....	-57
Computer services and equipment	-23
Custodial charges	-25
Supplies	-13
Other changes and adjustments.....	10

Total **\$41**

Note: Numbers may not sum to total due to rounding.

Issues

1. The Agency's Revenues Do Not Correlate in Any Way with Its Expenditures and Operations; a More Stable and Accountable Revenue Stream for the Agency Is Needed.

As noted above, Maryland Supplemental Retirement Plans finances its operations through a charge that is collected from supplemental retirement plan members based on the assets of the members' accounts. These charges are collected in a special fund that the agency rolls over from year to year. As discussed in more detail below, these special fund revenues have proven to be extremely volatile because they track the performance of the general investment markets. The agency has responded to this volatility by dramatically, and frequently, altering its fee structure to generate sufficient revenue. In the past two years, the agency has also relied on accounting gimmicks, questionable transfers from its outside plan administrator, and ad hoc member charges in order to balance its budget.

On the other side of the ledger, the agency's expenditures have not declined in correspondence with the decline in the agency's revenues. Rather, the agency's expenditures – which are primarily driven by the personnel costs associated with its 16.5 positions – have increased in line with statewide personnel costs. Yet, as discussed in more detail below, the agency's workload has declined.

DLS recommends that the agency be converted from a special fund agency to a general fund agency, in order to provide a more stable, accountable revenue stream. Such a conversion would also allow the elimination of the fee that the agency charges its members. The increase in general fund expenditures could be offset by transferring to the general fund any rebates that the agency negotiates from its mutual fund vendors. This proposal would require a statutory change.

The Agency's Revenue Is Extremely Volatile...

As illustrated in Exhibit 1, the assets upon which the agency's revenues are based have declined significantly. At this time last year, DLS projected a fiscal 2002 agency shortfall of almost \$500,000. As a result, the legislature charged the board to take immediate, substantive steps to remedy this situation. With that in mind, the board charged a one-time fee of \$8 to each participant account in March 2002. As a result of this one-time fee, for the first time in three-years, fee collections by the board exceeded the board's annual costs. Discounting the total amount collected from this one-time fee (\$509,847), however, board fees for fiscal 2002 totaled \$1,004,551, reflecting a 10.9% decrease in fee collections from fiscal 2001. This decline is directly related to the slowdown of the market's performance over the past three-years and prior actions by the board reducing its fee structure.

In response to the market slowdown and correspondingly lower fee collections, the board increased its board asset fees from 6 basis points to 11 basis points beginning in January 2003. In addition, the board will implement an additional \$6 fee on each participant account in March 2003. The board anticipates that, together, this will generate \$1,603,226 in fee revenue during fiscal 2003.

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The agency has stemmed its immediate fiscal shortfall and is likely to have sufficient revenues to continue its operations in fiscal 2003. These actions, however, are problematic in several respects. First, the board proposes to increase its asset fee by 83% (from 6 basis points to 11 basis points), after reducing the fee by 25% (from 8 basis points to 6 basis points) only three years earlier. This reversal in its asset fee policy reflects the board's inability to accurately forecast the total asset base upon which the fees are based. This is understandable given the difficulty in projecting financial market performance. It does point out, however, that future asset fee projection is likely to be as unreliable, raising questions as to whether this is the appropriate means of generating agency revenue.

Second, the board's action to raise its asset fee by 83% simultaneous with the reduction in PEBSCO's fee is not an example of forthright policy making. It makes it more difficult for plan participants to identify the board's action. The reduction in PEBSCO's fees reflects the fact that the plans have grown to allow for greater economies of scale. These economies should apply to the agency as well, implying a reduction, rather than an increase, in its fee structure.

Third, the board was forced to resort to a one-time per-account fee in fiscal 2002, after having abandoned a per-account fee structure only several years earlier. At the time the board stopped the per-account fee, the board argued that it was regressive (because it resulted in members with smaller accounts paying more fees on a percentage basis). If this rationale was valid then, it is not clear why the board reversed itself to reimpose the per-account fee in fiscal 2002 (other than the necessity of quickly closing the 2002 deficit). Given that the board is projecting to impose another one-time fee in fiscal 2003, the board should straight-forwardly state whether this represents a return to a permanent per-account fee structure. If so, the board should indicate this change in policy to its members. However, the regressive nature of this fee structure remains problematic.

...While Agency Expenditures Grow Regardless of Revenues or Workload...

Meanwhile, the agency's expenditures have not declined in correspondence with the decline in the agency's revenues. Instead, given that almost three-fourths of the agency's expenditures are personnel-related, the agency's expenditures have increased in line with statewide personnel costs. As illustrated in **Exhibit 5** and discussed in previous years' budget analyses, the agency's budget-balancing strategy over the past several years has been based on (1) drawing down reserves; (2) arranging questionable ad hoc transfers from the outside vendor and other sources; and (3) temporarily reducing nonpersonnel expenditures by delaying or canceling various purchases. Only through personnel reduction, however, can the agency significantly reduce its expenditures. The agency has been unwilling to take this path.

Exhibit 5

Participants' Fees and Operating Budgets
Fiscal 1999 through 2003

	<u>FY 1999</u>	<u>FY 2000</u>	<u>FY 2001</u>	<u>FY 2002</u>	<u>Projected FY 2003</u>
PEBSCO Fees (\$ in Millions)	\$3.5	\$3.6	\$3.5	\$3.6	\$3.5 ⁵
As Percent of Assets in Base Points (hundreds of a percent)	28 bp	28 bp	28 bp	28 bp	28/23 bp ⁶
Board Fees + adj. (\$ in Millions)	\$1.1	\$1.0	\$1.1	\$1.5 ³	\$1.6
As Percent of Assets	10/8 bp ¹	8/6 bp ²	6 bp	6 bp + \$8 ⁴	6/11 bp + \$6 ⁷
Operating Expenses (\$ in Millions)	\$1.1	\$1.4	\$1.4	\$1.5	\$1.6
Carryover Balance (\$ in Millions)	\$0.8	\$0.4	\$0.1	\$0.1	\$0.2
Carryover Balance as Percent of Operating Expenses	67.0%	27.6%	7.3%	8.7%	11.7%

Notes: ¹Board fee reduced January 1, 1999.

²Board fee reduced January 1, 2000.

³Board Reserve corrective balance adjustment of \$66,230 in fiscal 2002.

⁴Special one-time board fee of \$8 per account collected March 2002.

⁵DLS estimate

⁶PEBSCO fee reduced January 1, 2003.

⁷Special one-time board fee of \$6 per account to be collected March 2003; board asset fee increased January 1, 2003.

bp=basis points

Source: Department of Legislative Services

The agency has consistently refused to reduce staffing, even when workload, upon which the agency's position complement is based, no longer exists. For example, the agency previously stated that appropriately administering the 401(k) transfer plan required the year-round services of at least two of its employees. But when that program was shifted to the outside administrator as part of last year's budget bill, the agency opposed any reduction to its staff. Similarly, the agency received four new positions in 1999 to address the start-up requirements of the employer matching program. The matching program is well established. The board, however, resisted position reductions that were recommended to reflect the reduced workload.

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It should be noted that of the agency's current complement of 16.5 FTE positions, only 6 are associated with the "line" responsibilities of the agency's mission – communications (2 FTE positions) and field education (4 FTE positions). The other 10.5 positions are managerial, administrative, or financial positions. In other words, the agency has 10.5 "staff" positions to support 6 field positions.

...Necessitating a Change in the Agency's Revenue Structure.

The board's inability to manage its fee structure in order to provide a stable revenue stream, as well as its unwillingness to adjust its baseline expenditures to either its revenues or its workload, suggest that an alternative revenue structure is needed.

DLS therefore recommends the following reforms to the agency's fiscal structure; these reforms would require statutory change:

- **The agency should be converted from a special fund agency to a general fund agency. A stable source of general funds would allow the agency to target its expenditures to its workload, rather than requiring drastic adjustments to reflect a volatile revenue structure;**
- **As an agency supported by general funds, the Supplement Retirement Plans would have a stable revenue source and would no longer need to charge members either an asset fee or per-account fee; and**
- **The mutual fund rebates negotiated by the agency should be earmarked as general fund revenues that would offset the general fund cost of overseeing the deferred compensation program. The agency advises that to comply with federal requirements, all rebate revenues and all plan administration expenses, must be separately accounted, such as in a special fund.**

Recommended Actions

1. Concur with Governor's allowance.

Updates

1. Administration of 401(k) Transfer Program Shifted to Outside Vendor

Language in the fiscal 2003 budget bill (which was recommended by DLS) required that the agency use its outside administrator to administer the 401(k) transfer program. This recommendation was made in light of the fact that the agency currently devotes a considerable amount of fiscal resources to administering the plan, as the plan has become more complicated to administer as a result of increasing allocation transactions. The board has indicated that beginning in January 2003, PEBSCO will begin administering the 401(k) transfer plan. DLS believes that such a transfer will more efficiently and effectively utilize the agency's resources, while reducing costs. In addition, transferring these administrative responsibilities to the outside vendor will provide members with more sophisticated plan management while reducing agency expenses.

Current and Prior Year Budgets

Current and Prior Year Budgets Maryland Supplemental Retirement Plans (\$ in Thousands)

	<u>General Fund</u>	<u>Special Fund</u>	<u>Federal Fund</u>	<u>Reimb. Fund</u>	<u>Total</u>
Fiscal 2002					
Legislative Appropriation	\$0	\$1,484	\$0	\$0	\$1,484
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	3	0	0	3
Reversions and Cancellations	0	0	0	0	0
Actual Expenditures	\$0	\$1,487	\$0	\$0	\$1,487
Fiscal 2003					
Legislative Appropriation	\$0	\$1,351	\$0	\$0	\$1,351
Cost Containment	0	-1	0	0	-1
Working Appropriation	\$0	\$1,350	\$0	\$0	\$1,350

Note: Numbers may not sum to total due to rounding.

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Appendix 2

Object/Fund Difference Report
Maryland Supplemental Retirement Plans

<u>Object/Fund</u>	<u>FY 02 Actual</u>	<u>FY 03 Working Appropriation</u>	<u>FY 04 Allowance</u>	<u>FY 03 - FY 04 Amount Change</u>	<u>% Change</u>
Positions					
01 Regular	16.50	16.50	16.50	0	0%
Total Positions	16.50	16.50	16.50	0	0%
Objects					
01 Salaries and Wages	\$ 1,053,675	\$ 836,446	\$ 1,017,931	\$ 181,485	21.7%
02 Technical & Spec Fees	14,502	9,700	7,500	-2,200	-22.7%
03 Communication	27,217	37,628	30,734	-6,894	-18.3%
04 Travel	36,293	46,500	29,000	-17,500	-37.6%
07 Motor Vehicles	14,085	16,915	15,552	-1,363	-8.1%
08 Contractual Services	243,307	288,122	199,494	-88,628	-30.8%
09 Supplies & Materials	14,293	21,400	8,650	-12,750	-59.6%
10 Equip - Replacement	0	2,500	0	-2,500	-100.0%
11 Equip - Additional	384	4,500	2,000	-2,500	-55.6%
13 Fixed Charges	83,720	87,374	88,316	942	1.1%
Total Objects	\$ 1,487,476	\$ 1,351,085	\$ 1,399,177	\$ 48,092	3.6%
Funds					
03 Special Fund	\$ 1,487,476	\$ 1,351,085	\$ 1,399,177	\$ 48,092	3.6%
Total Funds	\$ 1,487,476	\$ 1,351,085	\$ 1,399,177	\$ 48,092	3.6%

Note: Fiscal 2003 appropriations and fiscal 2004 allowance do not include cost containment and contingent reductions.