

**G20J01  
State Retirement Agency**

***Operating Budget Data***

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(\$ in Thousands)

	<u>FY 02</u>	<u>FY 03</u>	<u>FY 04</u>	<u>FY 02-04 Change</u>	<u>FY 05</u>	<u>FY 04-05 Change</u>
Operations	\$14,936	\$15,016	\$15,515	\$579	\$16,115	\$601
Contractual Services	4,629	4,736	4,743	114	5,124	381
Grants	0	0	0	0	0	0
Contingent & Back of Bill Reductions	0	0	0	0	-69	-69
<b>Adjusted Grand Total</b>	<b>\$19,565</b>	<b>\$19,752</b>	<b>\$20,258</b>	<b>\$693</b>	<b>\$21,171</b>	<b>\$913</b>
Special Funds	19,565	19,752	20,258	\$693	21,240	982
Contingent & Back of Bill Reductions	0	0	0	0	-69	-69
<b>Adjusted Special Funds</b>	<b>\$19,565</b>	<b>\$19,752</b>	<b>\$20,258</b>	<b>\$693</b>	<b>\$21,171</b>	<b>\$913</b>
<b>Annual % Change</b>		<b>1.0%</b>	<b>2.6%</b>		<b>4.5%</b>	

- The agency was not materially impacted by cost containment reduction between the fiscal 2002 and 2005 allowance. Four vacant positions were cut from the agency in fiscal 2004, but the funds associated with those positions were left intact in the agency budget.
- Personnel expenses increased due to increments and turnover reduction.
- Non-personnel expenses increase in information technology and investment monitoring. Other non-personnel expense increases include rent and travel.

***Personnel Data***

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	<u>FY 02</u>	<u>FY 03</u>	<u>FY 04</u>	<u>FY 02-04 Change</u>	<u>FY 05</u>	<u>FY 04-05 Change</u>
Regular Positions	177.0	168.0	164.0	-13	164.0	0.0
Contractual FTEs	29.8	24.5	29.5	0	29.5	0.0
<b>Total Personnel</b>	<b>206.8</b>	<b>192.5</b>	<b>193.5</b>	<b>-13</b>	<b>193.5</b>	<b>0.0</b>

***Vacancy Data: Regular Positions***

Turnover Expectancy	4.10	2.50%
Positions Vacant as of 12/31/03	11.00	6.70%

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

For further information contact: Daniel Tompkins

Phone: (410) 946-5510

***G20J01 - State Retirement Agency***

- The agency lost four regular positions in the cost containment action as part of Governor Robert L. Ehrlich's July 1, 2003, Board of Public Works (BPW) item. The Governor's position reduction allocation left the funds associated with the cut positions in the agency's budget.
- The agency received seven regular freeze exemptions/reclassifications and six contractual freeze exemptions/reclassifications. The reclassifications were primarily to bolster the agency's benefit estimate staff to reduce a backlog of requests from members. The agency used a portion of the funds remaining from position cuts to fund the \$75,000 cost of the reclassifications.

## *Analysis in Brief*

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### Major Trends

***Benefits Estimates Are Backlogged:*** The agency is facing a backlog of 1,685 requests for estimates of retirement benefits. The agency provides estimates of benefits to any member within one year of their eligibility to retire. The agency's computer system does not allow for automated processing of estimates. Agency staff must manually review and calculate each request for an estimate. Each estimate must move through several layers of review. In addition to internal processes that create substantial workloads, many members close to retirement will submit multiple estimate requests based on different estimated retirement dates.

### Issues

***Pension Contribution Rates for the Major Systems Remain Stable Due to Corridor Funding:*** The State's pension system is 92.9% funded on an actuarial basis and remains actuarially sound. For the employees' and teachers' systems (the two largest subsystems of the State Retirement Pension System), the State will maintain a constant employer contribution rate so long as those systems remain between 90 to 110% funded on an actuarial basis. For fiscal 2005 those systems will remain within their funding "corridors," and no change in State pension contribution rates is required. Absent significant investment gains in fiscal 2004, the funding levels for the two major systems will "fall out" of their corridors next year, resulting in increased contribution rates for teachers and employees in fiscal 2006. **The Department of Legislative Services (DLS) recommends that the board and agency staff comment on the actuarial funding level of the system and the implications of falling outside of the corridor in fiscal 2006.**

***Board Implements Investment Policy Restructuring:*** The board and agency have shifted the agency's investment operations from direct management to a focus on management oversight. Monitoring of manager performance has become the key focus of the investment staff at the agency. The board has removed actual fund management from the responsibilities of staff and placed a premium on formal procedures for monitoring the compliance of managers across all asset classes. **DLS recommends a reduction of five vacant positions as a result of the agency's investment policy restructuring and current vacancy rate.**

***State Retirement Agency Begins Planning for a New Computer Procurement Project:*** After canceling a failed computer system project this year, the State Retirement Agency is surveying and visiting other states' pension system agencies; hiring pension consultants to review business processes; developing code simplification proposals; and requesting funds in its fiscal 2005 budget to begin a new computer procurement project process. The initial development of the request for proposal will begin in fiscal 2005. The agency anticipates funding for the actual development will not begin until fiscal 2006 with implementation of the new benefit administration system sometime after that. **DLS recommends that the board and agency staff comment on the settlement of the failed strategic system procurement and agency plans for a new procurement.**

*G20J01 - State Retirement Agency*

**Recommended Actions**

	<u>Funds</u>	<u>Positions</u>
1. Draw down unneeded encumbered prior year funds associated with failed computer procurement.	\$ 5,010,720	
2. Delete five vacant PINs due to investment policy restructuring and excessive agency vacancies.	366,669	5.0
3. Reduce travel expenditures to maintain fiscal 2004 funding levels.	41,338	
4. Reduce contractual services expenditures for office assistance.	56,247	
<b>Total Reductions</b>	<b>\$ 5,474,974</b>	<b>5.0</b>

**Updates**

***State Pension Board Restructured:*** Chapter 403, Acts of 2003 altered membership on the board, included experience requirements for gubernatorial appointees, reduced membership for the State Police, and removed the Superintendent of Schools and the State Superintendent of Police from the board. To date, the Governor has appointed three new members to the board with significant pension and investment management experience. The bill required all trustees to receive at least eight hours of investment and fiduciary training each year. Additionally, the bill provided that the board is not responsible for considering benefit enhancement or reviewing the benefit structures of the system.

**G20J01**  
**State Retirement Agency**

***Operating Budget Analysis***

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**Program Description**

The State Retirement Agency (SRA), under the direction of the Board of Trustees of the State Retirement and Pension System (SRPS), is responsible for administering the State's retirement and pension systems. The agency is divided into four divisions. The administrative division is tasked with administering the payment of benefits, management of employee contributions, and membership counseling. The investment division is charged with the management, control, and implementation of investment policy for approximately \$27 billion in assets. The finance division provides accounting and financial reporting, budget administration, and procurement functions. The management information services division provides ongoing computer support and is in charge of the data processing upgrade. In addition to the overall direction of each of these divisions, the executive director's office is responsible for policy development, legislation, internal audits, and legal affairs. The administrative budget of SRA is funded solely through special funds drawn from the pension trust fund based on statutory authority.

**Performance Analysis: Managing for Results**

The two primary functions of the State Retirement Agency are (1) to properly administer the retirement system; i.e., to timely and accurately pay pension benefits and collect pension contributions from employers and employees; and (2) to manage the assets of SRPS so as to maximize the system's risk-adjusted return.

Regarding benefit administration, the agency's Managing for Results (MFR) provides various measures showing the accuracy and timeliness of benefit calculation and efficiency in collecting contributions. The agency is efficient and accurate in these capacities (the performance measures are all well over 99%). It is assumed that the agency will continue to maintain these high standards and that any slippage from those standards would trigger future discussion.

The agency, in response to legislative requests, tracks both the waiting times for incoming telephone calls and the number of calls that are abandoned because of lengthy waiting times. The agency continues to recognize that telephone waiting time is an important issue for members and retirees. As illustrated in **Exhibit 1**, after three years, the agency achieved its goals for improved service and has raised its expectations. The new goals have lowered the dropped call goal from 8.0 to 5.0% and the average wait time from 2 minutes to 1 minute and 45 seconds.

**Exhibit 1**  
**Performance Measures – Benefit Administration**  
**State Retirement Agency**  
**Fiscal 2001 – 2004**

	<u>FY 2002</u> <u>Actual</u>	<u>FY 2003</u> <u>Actual</u>	<u>FY 2004</u> <u>Est.</u>	<u>FY 2005</u> <u>Est.</u>
Percentage of incoming telephone calls abandoned by the automated telephone system	5.4%	4.5%	5.0%	5.0%
Average telephone waiting time in minutes: seconds	1:20	1:05	1:45	1:45

Note: Agency objective stated as: “On an ongoing basis, no more than 5.0% of incoming telephone calls will be abandoned by the phone system and waiting time for calls to be answered will be less than 1:45 minutes.”

Source: State Retirement Agency

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The agency has also reported a significant backlog of requests for an estimate of benefits by members eligible to retire within one year. Each estimate request must be calculated manually by agency staff. Members may request multiple benefit estimates based on multiple retirement dates. Each request must be processed by agency staff and reviewed for correctness. The agency’s legacy computer system is unable to perform these benefit estimates.

The current backlog of request is 1,685 and has risen from 1,400 just three months ago. The agency completed 15,698 estimates in fiscal 2003, of which 1,045 were for individuals who requested multiple benefit estimates in fiscal 2003. The greatest number of requests for any one individual in fiscal 2003 was eight. **Exhibit 2** details a five-year history of estimate requests processed, indicating that the number of individuals who request multiple estimates is increasing.

The agency has not included a measure of the number of requests, the resources available to process requests, or a goal of reducing or eliminating the backlog in its MFR submission. The agency has, however, directed resources through reclassifications and hiring freeze exemptions to address the backlog.

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**Exhibit 2**  
**Multiple Requests for Benefit Estimates**  
**Fiscal 1999 – 2003**

<u>Fiscal Year</u>	<u>Estimates Completed by Agency Staff</u>	<u>% Increase in Estimates Completed</u>	<u>Individuals Requesting Multiple Estimates</u>	<u>Greatest # of Estimates for One Individual</u>
1999	11,109		598	6
2000	11,524	3.7%	616	8
2001	11,683	1.4%	562	5
2002	13,337	14.2%	691	6
2003	15,698	17.7%	1,045	8
<b>Average 1999-2003</b>	<b>12,670</b>	<b>9.0%</b>	<b>702</b>	<b>7</b>

Source:

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The Department of Legislative Services (DLS) recommends the agency formally measure the requests for estimates, detail agency resources assigned to benefit estimates, and develop goals for reducing its substantial backlog in its MFR submission. Agency staff should be prepared to comment on the underlying causes of the backlog and the steps currently being taken to eliminate it.

Regarding investment performance, the agency offers a variety of MFR measures. In response to reported legislative requests, the agency and the board have included a comparative performance measure in its MFR response. The system has recently seen marked improvement in its investment returns as compared to peer pension systems. This performance is discussed in greater detail as a budget issue.

**Exhibit 3** is included to show that the agency's workload continues to grow, as the number of active members and retirees increases, as does total benefit payments.

**Exhibit 3**  
**State Retirement Agency**  
**Fiscal 2001 – 2005**

	<u>Actual</u> <u>2001</u>	<u>Actual</u> <u>2002</u>	<u>Actual</u> <u>2003</u>	<u>Est.</u> <u>2004**</u>	<u>Est.</u> <u>2005**</u>	<u>Ann.</u> <u>Chg.</u> <u>01-03</u>	<u>Ann.</u> <u>Chg.</u> <u>03-05</u>
Total participants*	311,984	321,845	326,397	339,000	348,000	2.3%	3.3%
Benefit payments (\$ in Millions)	\$1,239	\$1,372	\$1,551	\$1,750	\$2,000	11.9%	13.6%
Market value of invested assets (\$ in Billions)	\$29.5	\$26.6	\$26.7	n/a	n/a	-5.0%	n/a

\* Includes active employee, retirees, beneficiaries, and former employees with vested benefits.

\*\* Department of Legislative Services estimate.

Note: Market value of invested assets cannot be reliably estimated over the short-term.

Source: State Retirement Agency; Department of Legislative Services

## Fiscal 2004 Actions

### Impact of Cost Containment

The agency lost four vacant positions through cost containment action taken in fiscal 2004. The agency did not lose the funds associated with those four positions, and the Governor's allowance for fiscal 2005 has recycled those funds in the fiscal 2005 allowance. **DLS recommends a \$56,247 reduction of these recycled funds.**

### Governor's Proposed Budget

As illustrated in **Exhibit 4**, the agency's budget grows 4.5% between the fiscal 2004 working appropriation and the fiscal 2005 allowance. The exhibit shows that the majority of the growth is non-personnel expenses related to information technology and investment oversight functions. Personnel expenditure increases reflect the inclusion of increments in the allowance and a modest turnover adjustment. Employee and retiree health expenditures decrease by a small amount.

**Exhibit 4  
Governor's Proposed Budget  
State Retirement Agency  
(\$ in Thousands)**

	<u>FY 03 Actual</u>	<u>FY 04 Approp.</u>	<u>FY 05 Allowance</u>	<u>FY 04-05 Change</u>	<u>FY 04-05 % Change</u>
Special Funds	\$19,752	\$20,258	\$21,240	\$982	4.8%
Contingent & Back of Bill Reductions	0	0	-69	-69	
<b>Adjusted Special Funds</b>	<b>\$19,752</b>	<b>\$20,258</b>	<b>\$21,171</b>	<b>\$913</b>	<b>4.5%</b>
<b>Adjusted Grand Total</b>	<b>\$19,752</b>	<b>\$20,258</b>	<b>\$21,171</b>	<b>\$913</b>	<b>4.5%</b>

**Where It Goes:**

**Personnel Expenses**

Increments and other compensation .....	\$90
Employee and retiree health insurance .....	-10
Workers' compensation premium assessment .....	8
Turnover adjustments .....	38
Other fringe benefit adjustments .....	-1

**Other Changes**

Benefits Administration System maintenance .....	257
Rent.....	183
Investment monitoring software.....	158
Claims monitoring contracts .....	81
Major information technology (IT) project closeout and preparation for new major IT system .....	73
Travel.....	41
Other .....	-5

**Total** **\$913**

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

The agency is increasing information technology spending on maintenance of its legacy system by \$257,000. The agency is also increasing its budget by a net of \$73,000 to remove the last operating funds associated with its failed information technology project and to begin planning and preparation for the new procurement. Total reductions are \$212,000 which includes reduced

## *G20J01 - State Retirement Agency*

overtimes, an eliminated contractual quality assurance position, and hardware and software maintenance that will no longer be required. Increases include \$200,000 for a project management office and \$85,000 for a pension consultant to assist the agency in developing a request for proposals. These changes are discussed in further detail as a budget issue.

The Governor's allowance includes \$158,000 for two software packages that will allow the investment staff to assess various risk levels with different asset allocation models and also to track the portfolio's performance based on the assumed risk levels. The allowance also includes \$81,000 for contracts with outside legal firms to assist the system in determining whether or not it has standing as a class member in various investment class action lawsuits throughout the country and to what extent the system may be able to recover funds through pursuit of class member status. These items are discussed as budget issues.

Rent increased by \$183,000 in the fiscal 2005 allowance. The agency under-budgeted its fiscal 2004 rent payment by \$43,000. This fiscal 2005 allowance corrects for that error and also includes \$33,000 in additional cost per square foot, \$88,500 in increased amortized renovation expenses, and \$21,000 in additional expense recovery costs.

Travel expenses increase by \$41,000 over the fiscal 2004 working appropriation. The agency indicates that additional out-of-state travel is required as a part of its due diligence to monitor the performance of fund managers. Additionally, the agency's new chief investment officer is planning on visiting each of the system's fund managers throughout the year, and the executive director is planning on attending some of the out-of-state visits. Out-of-state visits to fund managers frequently involve multiple staff. Each fund manager also comes to SRA offices in Baltimore once per year for a performance review with agency staff. **DLS recommends reducing these expenses to fiscal 2004 levels.**

### **Impact of Cost Containment**

The fiscal 2005 allowance reflects the elimination of the appropriation for matching employee deferred compensation contributions up to \$600, contingent upon enactment of 2004 budget reconciliation legislation.

## Issues

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### 1. Pension Contribution Rates for the Major Systems Remain Stable Due to Corridor Funding

The system gained a 3.2% investment return in fiscal 2003, leaving the system with approximately \$26.6 billion in assets as of June 30, 2003. The State's pension system is 92.9% funded on an actuarial basis and remains actuarially sound. Moreover, the nature of a defined benefit pension system such as Maryland's – in which benefits are guaranteed and the employer accepts the funding risk – means that the benefits of current and future retirees will be unaffected by this year's investment losses. For reasons discussed below, the aggregate State employer contribution rate will decrease from 8.06% of payroll for fiscal 2004 to 7.97% of payroll for fiscal 2005. **Exhibit 5** lists the new contribution rates and actuarial funding levels by individual system.

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#### Exhibit 5 Fiscal 2004 and 2005 Employer Contribution Rates

<u>Plan</u>	<u>FY 2004 Rate</u>	<u>FY 2005 Rate</u>	<u>Actuarial Funding Level</u>
Employees	4.73%	4.73%	91.6%
Teachers	9.35%	9.35%	92.8%
State Police	7.58%	0.00%	121.0%
Judges	43.74%	36.72%	86.1%
Law Enforcement Officers	35.13%	37.73%	60.5%
<b>Aggregate</b>	<b>8.06%</b>	<b>7.97%</b>	<b>92.9%</b>

Source: Milliman USA, Inc.

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The General Assembly took action during the 2002 legislative session under the Budget Reconciliation and Financing Act of 2002 (Chapter 440, Act of 2002) to reduce the budgetary impact of volatile pension investment performance. For the employees' and teachers' systems (the two largest subsystems of SRPS), the State will maintain a constant employer contribution rate so long as those systems remain from 90 to 110% funded on an actuarial basis. For fiscal 2005 those systems will remain within their funding "corridors," and no increase in State pension contributions (beyond that reflecting payroll growth) will be required. The actuary advises that absent significant investment gains in fiscal 2004, the funding levels for the two major systems will "fall out" of their corridors next year, resulting in increased contribution rates for teachers and employees in fiscal 2006.

### *G20J01 - State Retirement Agency*

The rates for the other three State plans – judges, State Police, and law enforcement officers – continue to float each year according to the traditional methodology. Due to the high level of actuarial funding in the State Police Retirement System (121.0% funded), the State will not be required to make employer contributions for State Police in fiscal 2005.

Also, this year the actuary conducted its experience study of the system's actuarial assumptions, and the pension board voted to incorporate the recommended assumption changes into its valuation. While the actuary recommended a series of both positive and negative changes, the net effect of these changes was to improve the actuarial funding of the system. (The assumption study is required by statute and conducted every five years.)

### **Comparison to Other Public Funds**

SRPS reversed a two-year pattern of investment losses in fiscal 2003 and realized 3.22% investment gains. SRPS lost \$3.6 billion in fiscal 2001 and \$3 billion in fiscal 2002. DLS has reviewed the annual evaluation performed by the Trust Universe Comparison Service (TUCS). TUCS is a collaboration of 19 major banks, Wilshire Associates, and Greenshore Associates that track pension performance. As shown in **Exhibit 6**, Maryland's one-year ranking in the 2003 TUCS evaluation improved to the 75th percentile; however, the State's 10-year ranking remained at the 99th percentile. As viewed on a longitudinal basis, the Maryland ranking in the TUCS evaluation continues to demonstrate a consistent ranking in the last percentiles with the State's five-year and 10-year rankings in the 99th percentile.

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**Exhibit 6**  
**TUCS Comparison to Public Funds > \$1.0 Billion**  
**Periods Ending June 30, 2003 – Rolling Years**

	<u>3 Months</u>	<u>1 Year</u>	<u>5 Years</u>	<u>10 Years</u>
5th Percentile	12.99	8.90	4.79	9.47
25th Percentile	11.86	4.78	3.54	8.73
Median	10.99	4.02	2.71	8.30
75th Percentile	9.97	3.23	2.16	7.88
95th Percentile	6.26	2.34	1.32	6.87
<b>SRPS</b>	<b>11.69 (32)</b>	<b>3.22 (75)</b>	<b>0.89 (99)</b>	<b>6.64 (99)</b>

Source: State Street Analytics (TUCS Master Trust Report); State Retirement Agency

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Although it is unclear whether short-term rankings are the result of market fluctuations or management, it is important to note that the system has shown consistent improvement over the past year and was ranked in the top third (the 32nd percentile) among peer systems in the fourth quarter of

## *G20J01 - State Retirement Agency*

2003. In response to legislative initiatives, the board has restructured and refocused on fiduciary responsibilities, transparency of decision-making processes, and education of board members. The agency has settled several management and personnel issues and has restructured investment management to include formal procedures for reviewing external managers. Other changes included updating the Investment Operations Manual. Any effects of these positive management steps will take time to appear in the long-term years of TUCS or other longitudinal surveys of performance. For that reason, it is important to continue to monitor the system's progress relative to other systems.

### **Five-Year Experience Study Leads to Changes in Actuarial Methodology**

Maryland law requires the actuary designated by the system to perform an actuarial experience study at least once every five years. An experience study is a comparison of real experience of the system with the actuarial assumptions used over the same period of time. The actuary completed its most recent five-year experience study in 2003.

Based on the study's recommendations, the board recently revised its long-term investment return assumption to 7.75% from 8%. The 7.75% benchmark adopted by the Maryland system is consistent with the benchmarks adopted by a number of other public pension plans as shown in **Exhibit 7**.

Another notable change made by the board lowered the cost-of-living adjustment (COLA) assumption from 5.0 to 3.0%. The actuary advised the board that the 75-year historical average for COLA was 3.05%. The board adjusted assumptions related to salary growth down to 4.0% to reflect recent experiences and adjusted mortality rates down to keep pace with current demographic trends that indicate longer lived retirees. Finally, the board adopted a recommendation to adjust the various retirement rate assumptions for the system. Early, normal, and disability retirement rates and withdrawal rates vary by system (employee's, teacher's, State police, etc.) and the new assumptions reflect more recent experience for each type of retirement within each system.

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### **Exhibit 7 Comparison of Selected Pension Systems Investment and Real Rates of Return November 2003**

<u>System</u>	<u>Investment Return</u>	<u>Price Inflation</u>	<u>"Real" Rate of Return</u>
California Teachers	8.00%	3.50%	4.50%
Connecticut State Employees	8.50%	3.75%	4.75%
Delaware State Employees	8.50%	n/a	n/a
Florida Retirement System	8.00%	3.50%	4.50%
Idaho Public Employees' Retirement System	8.00%	4.00%	4.00%
Iowa Public Employees' Retirement System	7.50%	3.50%	4.00%

*G20J01 - State Retirement Agency*

<u>System</u>	<u>Investment Return</u>	<u>Price Inflation</u>	<u>"Real" Rate of Return</u>
Kansas Public Employees' Retirement System	8.00%	3.50%	4.50%
Los Angeles County	8.00%	4.00%	4.00%
Maine State Employees and Teachers	8.00%	4.00%	4.00%
<b>Maryland SRPS*</b>	<b>7.75%</b>	<b>3.00%</b>	<b>4.75%</b>
Minnesota (all statewide systems)	8.50%	4.00%	4.50%
Montana Public Employees' Retirement System	8.00%	3.50%	4.50%
Montana Teachers	8.00%	4.00%	4.00%
New Jersey Teachers	8.75%	4.00%	4.75%
Oregon Public Employees' Retirement System	8.00%	3.25%	4.75%
Pennsylvania State Employees & Public School Employees	8.50%	n/a	n/a
Texas County and District Employees' Retirement System	8.00%	3.50%	4.50%

\* Reflects Investment Return and Price Inflation adopted by the board in August 2003.

Source: Milliman USA, Inc.

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**The board and agency staff should be prepared to comment on the system's current funding level overall and the specific funding levels of the Teachers' and Employees' Systems. Comments should include an agency estimate of the impact on State contributions to the Teachers' and Employees' systems if the actuarial value falls outside of the corridor; the current status of funding in the Maryland State Police pension system; and the impact of actuarial assumptions changed as a result of the five-year experience study.**

## **2. Board Implements Investment Policy Restructuring**

In response to direction from the board and new agency management, oversight and monitoring of manager performance has become the key focus of investment department staff at the agency. The board has removed actual fund management from the responsibilities of staff and placed a premium on formal procedures for monitoring the compliance of managers across all asset classes. Staff is also working closely with the board to update the Investment Operations Manual, which is expected to be completed in spring 2004.

The system no longer manages funds with its own staff. External managers handle all of the system's funds with the exception of a small fixed income real estate holding. Instead, the board has directed agency staff, working closely with the system's outside investment consultant, to focus on oversight of fund managers and attention to maintaining the overall asset allocation goals of the portfolio.

**The board and agency staff should be prepared to comment on investment policy restructuring including the role of the outside investment consultant, the development of board policies, and the new roles that agency staff will play in the oversight of fund managers. Particular attention should be devoted to any reductions in workload associated with shifting the agency's investment staff from a fund management function to a manager oversight function. DLS recommends eliminating five vacant positions from the agency. There are currently 11 vacancies, one of which has been vacant since 2002. The agency's turnover only requires four vacant positions.**

### **3. State Retirement Agency Begins Planning for a New Computer Procurement Project**

As the committees are aware, the agency failed in its recent attempt to pursue a new computer system, at a total loss to the system of \$29.1 million. The agency settled the contract with Syscom, Inc., in 2003. The agency will be able to reduce several expenses in fiscal 2005 that related to planned implementation expenses for the computer project. The agency will not require \$31,500 in overtime, \$86,000 in computer equipment maintenance contracts, or \$78,000 in special payments payroll for a quality assurance consultant.

In preparation for second effort at a new system, SRA is surveying and visiting other states' pension system agencies; hiring pension consultants to review business processes; developing code simplification proposals; and requesting funds in its fiscal 2005 budget to begin a new computer procurement project process. The initial development of the request for proposal will begin in fiscal 2005. The agency anticipates funding for the actual development of the new benefit administration system will not begin until fiscal 2006.

The current system is over 30 years old, and information technology (IT) staff resources at the agency are dedicated almost entirely to maintaining the legacy system and patching existing programming errors. The Governor's allowance for fiscal 2005 includes \$200,000 to create a project management office and \$85,000 to hire a pension expert to assist the agency in the development of system requirements for the next request for proposal (RFP) the agency drafts. The project management office's initial goals will be to develop a business process reengineering program to allow the agency to clean data in preparation for the new computer system and to create a business process plan that the agency can include in the RFP.

The agency plans to shift its current Chief Information Officer (CIO) into the Project Management Office so that he can direct the new computer system project. The agency has reclassified a vacant position as a CIO to replace the current CIO. The current CIO has been hired by the agency through a memorandum of understanding with the University System of Maryland. The replacement CIO would be a regular State employee and would handle day-to-day operations and maintenance of the current legacy system.

*G20J01 - State Retirement Agency*

The board and agency staff should be prepared to comment on the final disposition of the failed computer project and on the budgetary and personnel changes being made by the agency to begin the new computer procurement. The agency should be prepared to discuss the role that the Department of Budget and Management will play in the new development and how the agency will manage its own legacy system and plan for a new system concurrently. Special attention should be given to additional resources devoted to pension experts and project managers and how those consultants will perform within the existing Major Information Technology Project review structure. Agency staff should also be prepared to comment on the repositioning of agency staff to project management functions. The board and agency staff should also comment on the complexity of Maryland's pension systems; what role that complexity may have played in the failure of the strategic system procurement; and what plans the board and the agency plan to alleviate that impact on the next strategic system procurement.

***Recommended Actions***

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	<u>Amount Reduction</u>		<u>Position Reduction</u>
1. Draw down unneeded encumbered prior year funds associated with failed computer procurement. The agency has \$5.0 million in encumbered funds related to the failed computer system procurement. The Department of Legislative Services recommends that the agency reduce its fiscal 2005 budget accordingly (from the personnel subobject) and use the encumbered funds to pay for operating expenses. The encumbered funds are no longer required because the agency has settled its claims with the contractor. Any additional charges from the vendor approved in the settlement agreement should be paid through a budget amendment to create a clearer audit trail of post-settlement payments.	\$ 5,010,720	SF	
2. Delete five vacant PINs due to investment policy restructuring and excessive agency vacancies. The board has shifted the focus of agency investment staff from direct management of funds to oversight of external managers. Additionally, the agency currently has 11 vacancies and requires only 4 to meet its turnover expectation. The PINs recommended for reduction are: 005348, 069718, 069719, 069720, and 075107.	366,669	SF	5.0
3. Reduce travel expenditures to maintain fiscal 2004 funding levels. Agency staff performs site visits to fund managers as part of its due diligence work. There are many planned trips that involve more than three agency staff members. The Department of Legislative Services recommends that the agency reduce the number of agency staff traveling out of state.	41,338	SF	
4. Reduce contractual services expenditures for office assistance. The agency has recycled funds associated with four cut positions into office assistance. There is no justification for the use of personnel funds for office assistance. The agency has sufficient turnover to fill administrative positions that are currently vacant.	56,247	SF	
<b>Total Special Fund Reductions</b>	<b>\$ 5,474,974</b>		<b>5.0</b>

## ***Updates***

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### **1. State Pension Board Restructured**

Chapter 403, Acts of 2003 restructured the board of the pension systems. Board membership will now include three ex-officio members, six members appointed by the Governor with the advice and consent of the Senate, and five elected members. Appointed members must have experience with similar fiduciary responsibilities.

Chapter 403 altered membership on the board, included experience requirements for gubernatorial appointees, reduced membership for the State Police, and removed the Superintendent of Schools and the State Superintendent of Police from the board. To date, the Governor has appointed three new members to the board with significant pension and investment management experience. The bill required all trustees to receive at least eight hours of investment and fiduciary training each year. Additionally, the bill provided that the board is not responsible for considering benefit enhancement or reviewing the benefit structure of the system.

The board has adopted new governance policies which include adoption of Robert's Rules of Order as the standard by which meetings are conducted; the direct line responsibilities of the executive director and the chief investment officer; and the board's evaluation mechanism for those positions. The policies state that the chief investment officer works for the executive director, and that communications between staff and board members should be facilitated through the office of the executive director. These policies are intended to assist the board in maintaining clear lines of responsibility within the agency and between the agency and the board.

## ***Current and Prior Year Budgets***

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### **Current and Prior Year Budgets State Retirement Agency (\$ in Thousands)**

	<b><u>General Fund</u></b>	<b><u>Special Fund</u></b>	<b><u>Federal Fund</u></b>	<b><u>Reimb. Fund</u></b>	<b><u>Total</u></b>
<b>Fiscal 2003</b>					
Legislative Appropriation	\$0	\$19,776	\$0	\$0	\$19,776
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	400	0	0	400
Cost Containment	0	0	0	0	0
Reversions and Cancellations	0	-425	0	0	-425
<b>Actual Expenditures</b>	<b>\$0</b>	<b>\$19,751</b>	<b>\$0</b>	<b>\$0</b>	<b>\$19,751</b>
<b>Fiscal 2004</b>					
Legislative Appropriation	\$0	\$20,258	\$0	\$0	\$20,258
Cost Containment	0	0	0	0	0
Budget Amendments	0	0	0	0	0
<b>Working Appropriation</b>	<b>\$0</b>	<b>\$20,258</b>	<b>\$0</b>	<b>\$0</b>	<b>\$20,258</b>

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### **Fiscal 2003**

The \$400,000 budget amendment was required to begin the contract for the board's independent investment consultant. Cancellations accrued due to the statewide hiring freeze.

**Object/Fund Difference Report  
State Retirement Agency**

<u>Object/Fund</u>	<u>FY03 Actual</u>	<u>FY04 Working Appropriation</u>	<u>FY05 Allowance</u>	<u>FY04 - FY05 Amount Change</u>	<u>Percent Change</u>
<b>Positions</b>					
01 Regular	168.00	164.00	164.00	0	0%
02 Contractual	24.45	29.50	29.50	0	0%
<b>Total Positions</b>	<b>192.45</b>	<b>193.50</b>	<b>193.50</b>	<b>0</b>	<b>0%</b>
<b>Objects</b>					
01 Salaries and Wages	\$ 10,575,626	\$ 10,787,994	\$ 10,981,990	\$ 193,996	1.8%
02 Technical & Spec Fees	1,121,749	1,403,888	1,358,478	-45,410	-3.2%
03 Communication	1,124,068	1,017,266	1,093,426	76,160	7.5%
04 Travel	113,561	122,284	163,622	41,338	33.8%
07 Motor Vehicles	140,092	137,148	139,042	1,894	1.4%
08 Contractual Services	4,735,729	4,743,321	5,124,479	381,158	8.0%
09 Supplies & Materials	183,125	210,773	195,623	-15,150	-7.2%
10 Equip - Replacement	2,899	48,188	216,473	168,285	349.2%
11 Equip - Additional	82,747	0	0	0	0.0%
13 Fixed Charges	1,671,959	1,787,189	1,966,845	179,656	10.1%
<b>Total Objects</b>	<b>\$ 19,751,555</b>	<b>\$ 20,258,051</b>	<b>\$ 21,239,978</b>	<b>\$ 981,927</b>	<b>4.8%</b>
<b>Funds</b>					
03 Special Fund	\$ 19,751,555	\$ 20,258,051	\$ 21,239,978	\$ 981,927	4.8%
<b>Total Funds</b>	<b>\$ 19,751,555</b>	<b>\$ 20,258,051</b>	<b>\$ 21,239,978</b>	<b>\$ 981,927</b>	<b>4.8%</b>

Note: Fiscal 2004 appropriations and fiscal 2005 allowance do not include deficiencies, cost containment, and contingent reductions.