

G50L00
Maryland Supplemental Retirement Plans

Operating Budget Data

(\$ in Thousands)

	<u>FY 02</u>	<u>FY 03</u>	<u>FY 04</u>	<u>FY 02-04</u> <u>Change</u>	<u>FY 05</u>	<u>FY 04-05</u> <u>Change</u>
Operations	\$1,244	\$1,270	\$1,200	-\$44	\$1,302	\$102
Contractual Services	243	194	199	-\$44	187	-13
Contingent & Back of Bill Reductions	0	0	0	\$0	-9	-9
Adjusted Grand Total	\$1,487	\$1,465	\$1,399	-\$88	\$1,480	\$81
Special Funds	1,487	1,465	1,399	-\$88	1,489	89
Contingent & Back of Bill Reductions	0	0	0	\$0	-9	-9
Adjusted Special Funds	\$1,487	\$1,465	\$1,399	-\$88	\$1,480	\$81
Adjusted Grand Total	\$1,487	\$1,465	\$1,399	-\$88	\$1,480	\$81
Annual % Change		-1.5%	-4.5%		5.8%	

- The Governor's fiscal 2005 allowance essentially maintains the agency at fiscal 2002 funding levels. The agency was directed to take \$221,000 in fiscal 2003 cost containment but was only able to save \$106,000 through miscellaneous expense reductions. The agency submitted a budget amendment for \$115,000 to close out fiscal 2003 without a deficiency.
- Agency personnel costs increase as a result of increments, health insurance increases, and a reduction in projected turnover expectancy.
- Other agency costs decrease as part of an effort to balance expenditures to available revenues.

Personnel Data

	<u>FY 02</u>	<u>FY 03</u>	<u>FY 04</u>	<u>FY 02-04</u> <u>Change</u>	<u>FY 05</u>	<u>FY 04-05</u> <u>Change</u>
Regular Positions	16.5	16.5	16.5	0	16.5	0.0
Contractual FTEs	0.0	0.0	0.0	0	0.0	0.0
Total Personnel	16.5	16.5	16.5	0	16.5	0.0

Vacancy Data: Regular Positions

Turnover Expectancy	0.00	0.00%
Positions Vacant as of 12/31/03	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

Active Participants Remain Level, but Deferrals Increase Substantially: While the agency notes growth of active accounts of only ten in fiscal 2003, deferrals/transfers to those active accounts increased by \$11.2 million over fiscal 2002 deferrals/transfers. This growth is likely related to two factors. First, federal tax law has increased the maximum annual contribution to tax deferred accounts in each of the last two years. Second, the resurgence of the stock market in 2003 may have persuaded employees to take greater advantage of the deferred plans available to them.

Mutual Fund Rebates Have Declined Since Calendar 2001: Rebates from mutual fund companies had reached a peak of 0.20% of assets in calendar 2001. While the rebates in that year also reflected some rebates accrued in calendar 2000, rebates as a percentage of total assets have declined from 0.13% in 2002 to 0.11% in 2003.

Issues

Many of the Agency's Functions Are Redundant: The primary operational functions of the State's payroll deferral retirement savings programs are handled by the agency's third-party administrator. Many of the functions that are performed by the agency – member education and communications and selection of investment options – could be handled either by the outside administrator or by another State agency. Hence, the agency's operations could be scaled back with virtually no impact on member services and with reduced member fees. **DLS recommends reducing staffing at the agency by 10.5 positions and transferring the agency's responsibilities to the Office of Personnel Services and Benefits in the Department of Budget and Management.**

Agency Revenues Do Not Correlate in Any Way with Agency Expenditures and Operations: The agency finances its operations through an asset-based fee collected from plan members based on the members' account value. Revenues are extremely volatile because they track the performance of the general investment markets. The agency raised its fee by 83% in January 2003 to ensure sufficient revenues during a period of market losses by members. In addition, the agency has charged "one-time" flat fees in each of the past two fiscal years. **DLS recommends that the board and agency staff comment on the volatility and unpredictable nature of its funding stream.**

The Deferred Compensation Match Has Been Eliminated from the Budget: The Governor's fiscal 2005 allowance provides contingent language eliminating funding for the deferred compensation employer match in fiscal 2005 and beyond. Out-year projections in the Governor's budget assume that the deferred compensation match program will not be funded in any future year. **DLS recommends that the board and agency staff comment on the elimination of funding for the employer match program and its impact on employee participation.**

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Recommended Actions

	<u>Funds</u>	<u>Positions</u>
1. The Department of Legislative Services (DLS) recommends that the agency be restructured and transferred. This recommendation would include two separate actions: eliminating positions and associated operating expenses in the agency and transferring the remaining functions of the agency to the Office of Personnel Services and Benefits in the Department of Budget and Management.	\$ 948,636	10.5
Total Reductions	\$ 948,636	10.5

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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; and the 401(a) employer deferral plan. 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 on assets to support its activities. In addition, the board imposed a “one-time” per-account fee of \$8 in fiscal 2002 and another such “one-time” per-account fee of \$6 in fiscal 2003.

The board has contracted out administration of all the plans to the Nationwide Retirement Solutions, Inc., a third-party plan administrator. Under a 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 a 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. Recent market improvement has led to substantial asset growth and the agency has also noted substantial deferral increases. While the lack of State employee pay raises and the suspension of the \$600 employer match in fiscal 2004 may have retarded growth in actively deferring accounts, it does not appear to have impacted the willingness of employees already participating to increase their deferrals.

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**Exhibit 1
Program Measurement Data
Maryland Supplemental Retirement Plans
Fiscal 2001 through 2005**

	<u>2001 Actual</u>	<u>2002 Actual</u>	<u>2003 Actual</u>	<u>2004 Est.</u>	<u>2005 Est.</u>	<u>2001-03 Ann. Chg.</u>	<u>2003-05 Ann. Chg.</u>
Plan Assets (\$ in Millions)	\$ 1,617.3	\$ 1,507.0	\$ 1,614.6	n/a	n/a	-0.1%	n/a
Deferrals/Transfers (\$ in Millions)	\$ 128.1	\$ 139.5	\$ 150.7	\$ 158.2*	\$ 162.1*	8.5%	3.7%
Active Accounts	43,766	45,571	45,581	45,700	46,600	2.1%	1.1%
Nationwide Fees (\$ in Thousands)	\$ 3,617.3	\$ 3,555.9	\$ 3,242.5	n/a	n/a	-5.3%	n/a
Board Fees (\$ in Thousands)	\$ 1,019.9	\$ 1,514.4	\$ 1,626.8	n/a	n/a	26.3%	n/a

* DLS Estimates

Note: Except where otherwise noted, out-year estimates provided by agency. Plan assets are based on individual investment performance and therefore cannot be reliably estimated. Nationwide and board fees are based solely on assets. This is discussed i

Source: Maryland Supplemental Retirement Plans; DLS

As illustrated in **Exhibit 2**, the agency's mutual funds have performed better than its 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 own composite index.**

**Exhibit 2
Performance Measure: Mutual Fund Investment Returns
Maryland Supplemental Retirement Plans
Annual Rates of Return as of June 30, 2003**

<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	2.2%	-6.1%	1.9%	9.4%
Benchmark: Average of All Investment Asset Class Indices	0.9%	-7.3%	0.4%	8.0%

Analysis of the FY 2005 Maryland Executive Budget, 2004

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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, Nationwide, rather than the mutual fund provider, prepares the members' quarterly statements, and both Nationwide and the agency provide communication material that might otherwise be provided by the mutual fund provider. **Exhibit 3** shows the value of these rebates in comparison to total plan assets.

Exhibit 3
Performance Measure: Mutual Fund Rebates Negotiated by
Maryland Supplemental Retirement Plans
Calendar 1997 through 2003

	1997	1998	1999	2000	2001	2002	2003
Mutual Fund Rebates	\$552,404	\$663,860	\$975,368	\$1,481,832	\$3,215,998*	\$1,911,787	\$1,973,583
Plan Assets (\$ in Millions)	\$1,108.0	\$1,306.3	\$1,484.8	\$1,646.1	\$1,617.3	\$1,507.0	\$1,749.9
Rebates as a Percent of Assets	0.05%	0.05%	0.07%	0.09%	0.20%	0.13%	0.11%

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

Source: Maryland Supplemental Retirement Plans

The recent reduction in rebates is likely tied to the performance of the markets and not a lack of effort on the part of the plan administrator to negotiate rebates. As funds lost money in 2001 and 2002, there was less profit available for distribution as rebates. System rebates are still ahead of the level of rebates achieved in 2000.

Governor's Proposed Budget

As indicated in **Exhibit 4**, the agency's budget grows by 5.8% between its fiscal 2004 working appropriation and the Governor's fiscal 2005 allowance. The agency experiences growth in personnel expenditures due to statewide factors such as increments and employee and retiree health costs. These personnel expenditures also grow considerably over the prior year because the fiscal 2005 allowance reflects a 0.0% turnover factor. The agency has not had a vacant position since December 2000.

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To offset these personnel increases, the agency has again attempted to control growth in its budget by reducing non-personnel 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 non-personnel expenditures, including a \$17,000 reduction in travel and a \$13,000 in reduced printing and telecommunications contracts. 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.

**Exhibit 4
Governor's Proposed Budget
Maryland Supplemental Retirement Plans
(\$ in Thousands)**

	<u>FY 03</u>	<u>FY 04</u>	<u>FY 05</u>	<u>FY 04-05</u>	<u>FY 04-05</u>
	<u>Actual</u>	<u>Approp.</u>	<u>Allowance</u>	<u>Change</u>	<u>% Change</u>
Special Funds	\$1,465	\$1,399	\$1,489	\$89	6.4%
Contingent & Back of Bill Reductions	0	0	-9	-9	
Adjusted Special Funds	\$1,465	\$1,399	\$1,480	\$81	5.8%
Adjusted Grand Total	\$1,465	\$1,399	\$1,480	\$81	5.8%

Where It Goes:

Personnel Expenses

Increments and other compensation	\$15
Employee and retiree health insurance	25
Turnover adjustments	91
Other fringe benefit adjustments	-9

Subtotal – Personnel **122**

Other Changes

Travel.....	-17
Printing and telecommunications contracts	-13
Other non-personnel	-11

Total **\$81**

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

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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 2005 allowance reflects the elimination of \$8,500 in appropriations for matching employee deferred compensation contributions of up to \$600 per employee, contingent upon legislation.

The agency was assigned \$221,000 in fiscal 2003 cost containment by the Department of Budget and Management. The agency was able to contain \$106,000 through miscellaneous reductions in postage and travel expenses but could not meet its full cost containment target. In order to close out fiscal 2003 without a deficiency, the agency was required to submit a budget amendment for \$115,000.

Issues

1. Many of the Agency's Functions Are Redundant

The board currently employs a staff of 16.5 positions to oversee the three payroll deferral plans and the 401 (a) employer match program. Almost all of these oversight functions, however, are duplicative with activities currently undertaken by the agency's outside administrator.

Program Administration: The three payroll deferral plans – 401(k) deferral, 403(b), and 457 plans – and the 401(a) employer match program are currently administered by Nationwide Retirement Solutions, Inc. (Nationwide). Nationwide is an outside administrator that operates under a five-year contract with the board and is compensated via an asset fee charged to member accounts. The outside administrator is responsible for enrolling new State employee members, consulting with individual members about retirement planning transactions, processing any such transactions (including changes to deferral amounts, payout amounts, or investment choices), and mailing out quarterly statements.

Communication: The board's current communication functions are split between Nationwide and the agency. The board prepares member newsletters and other communications materials that Nationwide distributes for the board via its statement mailings. Nationwide representatives visit State agencies and make presentations about deferred compensation. The board's newsletter, *MSRP Retirement News*, is developed and distributed by the agency. In addition, the agency employs field staff to make similar presentations to State employees and to distribute communications materials. The agency maintains this field staff even though there is significant overlap between its educational efforts and the presentations made by Nationwide. The agency's communications functions could be assumed by Nationwide. In addition, to the extent that the Department of Budget and Management (DBM) provides information to State employees through benefits coordinators, inclusion of deferred compensation in standard personnel benefits materials should occur.

Investment Oversight: The board is responsible for determining the number and type of investment options available to participants, including the removal of underperforming options. The board is assisted in this oversight by agency staff and an outside investment consultant. These responsibilities could be transferred to DBM without impacting the ability of the board to function effectively.

Responsibility Transfer: DLS recommends that agency functions be transferred to the Office of Personnel Services and Benefits (OPSB) in DBM. OPSB provides policy direction for the human resources system established by the State Personnel and Pensions Article. OPSB provides salary administration and classification, employee development and training, recruitment and examination, employee relations, employee benefits, and medical services for all State employees.

Within OPSB, the Division of Employee Benefits (the division) administers benefit programs for State employees and retirees, satellite agencies, and contractual employees. The division also administers medical benefits, other health related insurance programs, life insurance, and flexible spending accounts. These flexible spending accounts for health and child care are tax deferred

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accounts that permit individual employees to defer a portion of each paycheck. The division's programs provide multiple options within each type of benefit.

The division also provides educational training and other information about employee benefit programs to State agency personnel officers and to individual State employees. The division has implemented continuing education and training of Agency Benefits Coordinators and Human Resource Directors on each of the benefit types currently provided. The division also works directly with State employees to assist them in receiving and understanding their benefits.

While the participant account will be used by participants to fund retirement, the opportunity to open that account and the program management and management of investment options are essentially employee benefits. The State provides benefits such as health care, flexible spending accounts, paid annual and sick leave, among others. The ability to participate in a deferred compensation program simply extends the range of employee benefits offered to the State employees. None of the functions of the agency are directly related to retirement. They are instead a function of maintaining an employee's ability to defer compensation into a tax sheltered investment account.

In 1994, at the request of the budget committees, the former Department of Budget and Fiscal Planning (DBFP) studied the issue of consolidating the Supplemental Plans with the State Retirement Agency. DBFP identified little cost savings from consolidation and expressed concerns that the deferred compensation plans might receive less focus. In fact, the report understated the potential savings at the time, and those cost savings have increased since the time of the report as board's staff and expenditures have increased. **Given these redundancies and the current inability of the agency to sustain its operations without eventually increasing charges to participants or seeking State subsidy, the following is recommended:**

- **Staffing of the agency be reduced from 16.5 to 6 positions and consolidated within DBM's Office of Personnel Services and Benefits. Remaining operations should be limited to monitoring investment plan selection and contractor performance and should be transferred to OPSB in DBM. This should be implemented through provisions in budget reconciliation legislation during the 2004 session.**
- **Plan promotion, investment counseling, and like activities should be performed through the State personnel management system or the plan contractor. Up to \$250,000 of the agency appropriation should be restricted by the agency to defray the cost of any necessary inter-agency reimbursement or contractor payments required.**
- **The board should be instructed to adjust fees assessed to members to recognize any resulting reduction in program cost.**

The board and agency staff should comment on the redundancy of staffing and responsibilities and the economies that a reduction in staffing would create. Specifically, the board and agency staff should comment on the functions of agency staff that have direct overlap with functions performed by the plan administrator and/or investment consultant.

2. Agency Revenues Do Not Correlate with Agency Expenditures and Operations

The agency finances its operations through an asset-based fee collected from plan members based on the members' account value. Revenues are extremely volatile because they track the performance of the general investment markets. The agency raised its fee by 83% in January 2003 to ensure sufficient revenues during a period of market losses by members. In addition, the agency has charged "one-time" flat fees in each of the past two fiscal years.

Even if the agency were able to provide a stable revenue stream, it appears unable to provide clear expenditure controls. The agency submitted a budget amendment for \$115,000 in the summer of 2003 to close a gap that resulted from the agency's inability to meet the fiscal 2003 cost containment target from the Department of Budget and Management. In closing the fiscal 2003 deficit, the agency took the same one-time steps to close its budget imbalance that were used in fiscal 2002. Instead of meaningful and structural cost containment measures, the agency reduced miscellaneous expenditures by \$106,000 and submitted a budget amendment for \$115,000 to cover the portion of cost containment it was unable to meet.

The board and agency staff should comment on its ability (or inability) to reduce structural expenditures to meet revenues. The agency should provide justification for its repeated use of budget amendments which circumvent the legislature's ability to oversee and restrain agency expenditures. DLS recommends that the board and agency staff comment on the volatility and unpredictable nature of its funding stream and whether there is data available on the funding mechanisms for deferred compensation programs in other states.

3. The Deferred Compensation Match Has Been Eliminated from the Budget

The Governor's fiscal 2005 allowance provides contingent language in Section 29 of Senate Bill 125/House Bill 200 that eliminates funding for the deferred compensation employer match in fiscal 2005. Out-year projections in the Governor's budget assume that the deferred compensation match program will not be funded in fiscal 2006 through fiscal 2009. It is unclear if the Administration intends to repeal the program permanently or for only the fiscal 2005–2009 period. Savings of \$7.7 million in general funds are attributed to this action.

The employer match program is operated under Internal Revenue Code 401(a). Participation in this plan, which became operational on July 1, 1999, is open to all State employee members of the Employees' Pension System (EPS). Upon the inception of the 401(a) deferral plan, the State contributed a dollar-for-dollar amount not to exceed \$600 for each participant. For fiscal 2003, budget bill language reduced the State's maximum contribution to \$500. The fiscal 2004 budget eliminated funding for the match for one year.

Board members and agency staff should comment on the match program, its effectiveness in increasing membership and the impact its loss would have on levels of employee participation.

Recommended Actions

	<u>Amount Reduction</u>	<u>Position Reduction</u>
1. The Department of Legislative Services (DLS) recommends that the agency be restructured and transferred. This recommendation would include two separate actions: eliminating positions and associated operating expenses in the agency and transferring the remaining functions of the agency to the Office of Personnel Services and Benefits (OPSB) in the Department of Budget and Management.	\$ 948,636 SF	10.5
<p>DLS recommends the restructuring of the agency to include the elimination of 10.5 positions and associated expenditures related to communications, field staff, and administrative/fiscal staff. DLS recommends that all positions associated with communications and field staff be eliminated. Additionally, DLS recommends that administrative oversight and financial staffing be reduced accordingly. Position numbers included for reduction in this recommendation are: 57176, 57177A, 69721, 74261, 68724, 64943, 74259, 68722, 68301, 68721A, 68721B, and 74260.</p> <p>DLS further recommends the adoption of a provision in 2004 budget reconciliation legislation that eliminates the agency and transfers oversight of the plan administrator, trust functions and responsibilities, and selection of the plan investment options to OPSB.</p>		
Total Special Fund Reductions	\$ 948,636	10.5

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 2003					
Legislative Appropriation	\$0	\$1,351,085	\$0	\$0	\$1,351,085
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	115,000	0	0	115,000
Cost Containment	0	0	0	0	0
Reversions and Cancellations	0	-1,513	0	0	-1,513
Actual Expenditures	\$0	\$1,464,572	\$0	\$0	\$1,464,572
Fiscal 2004					
Legislative Appropriation	\$0	\$1,399,177	\$0	\$0	\$1,399,177
Cost Containment	0	0	0	0	0
Budget Amendments	0	0	0	0	0
Working Appropriation	\$0	\$1,399,177	\$0	\$0	\$1,399,177

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

Fiscal 2003

The agency was directed to take \$221,000 in fiscal 2003 cost containment but was only able to save \$106,000 through miscellaneous expense reductions. The agency submitted budget amendment for \$115,000 to close out fiscal 2003 without a deficiency.

**Object/Fund Difference Report
Maryland Supplemental Retirement Plans**

<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>
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	\$ 1,083,566	\$ 1,017,931	\$ 1,148,226	\$ 130,295	12.8%
02 Technical & Spec Fees	11,604	7,500	4,500	-3,000	-40.0%
03 Communication	23,783	30,734	26,105	-4,629	-15.1%
04 Travel	30,310	29,000	11,600	-17,400	-60.0%
07 Motor Vehicles	14,580	15,552	15,552	0	0%
08 Contractual Services	194,075	199,494	186,550	-12,944	-6.5%
09 Supplies & Materials	22,754	8,650	3,800	-4,850	-56.1%
10 Equip - Replacement	0	0	870	870	N/A
11 Equip - Additional	200	2,000	1,200	-800	-40.0%
13 Fixed Charges	83,700	88,316	90,127	1,811	2.1%
Total Objects	\$ 1,464,572	\$ 1,399,177	\$ 1,488,530	\$ 89,353	6.4%
Funds					
03 Special Fund	\$ 1,464,572	\$ 1,399,177	\$ 1,488,530	\$ 89,353	6.4%
Total Funds	\$ 1,464,572	\$ 1,399,177	\$ 1,488,530	\$ 89,353	6.4%

Note: The fiscal 2004 appropriation does not include deficiencies, and the fiscal 2005 allowance does not reflect contingent reductions.