

G50L00
Maryland Supplemental Retirement Plans

Operating Budget Data

(\$ in Thousands)

	<u>FY 05</u> <u>Actual</u>	<u>FY 06</u> <u>Working</u>	<u>FY 07</u> <u>Allowance</u>	<u>FY 06-07</u> <u>Change</u>	<u>% Change</u> <u>Prior Year</u>
Special Fund	\$1,339	\$1,304	\$1,365	\$61	4.7%
Total Funds	\$1,339	\$1,304	\$1,365	\$61	4.7%

- The Governor's allowance increases spending for the Maryland Supplemental Retirement Plans by 4.7% over the fiscal 2006 working appropriation. Growth in employee health insurance and retirement costs (\$37,012) and contractual services (\$30,814), especially legal services, account for most of the increased spending.
- Increased fringe benefit payments are partially offset by turnover expectancy (-\$24,478), which rose from 0% in fiscal 2006 to 2.5% in fiscal 2007.

Personnel Data

	<u>FY 05</u> <u>Actual</u>	<u>FY 06</u> <u>Working</u>	<u>FY 07</u> <u>Allowance</u>	<u>FY 06-07</u> <u>Change</u>
Regular Positions	16.50	14.00	14.00	0.00
Contractual FTEs	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Total Personnel	16.50	14.00	14.00	0.00

Vacancy Data: Regular Positions

Turnover, Excluding New Positions	0.34	2.46%
Positions Vacant as of 12/31/05	0.00	0.00%

- Personnel remain unchanged from fiscal 2006 levels.
- Increased turnover expectancy stems from a single vacancy that has since been filled.

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

For further information contact: Michael Rubenstein

Phone: (410) 946-5510

Analysis in Brief

Major Trends

Changes in Participation and Deferral Rates: Participation rates improved slightly in fiscal 2005, but employee deferrals declined. With the return of the State matching contribution in fiscal 2006, deferrals have begun to rebound.

Investment Performance: Overall, in fiscal 2005, investment options generated returns that exceeded benchmark indices over the long-term but underperformed those indices in the short-term. Five investment options have consistently underperformed their benchmarks.

Issues

Expenditure Controls: There are no structural limitations on the board's expenditures or ability to raise fees. Such restrictions could be in the form of a dollar limit that grows with inflation, or a percentage of plan assets, similar to the limitation imposed on the State Retirement Agency.

Recommended Actions

1. Concur with Governor's allowance.

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Operating Budget Analysis

Program Description

Title 35 of the State Personnel and Pension Article established the Teachers' and State Employees' Supplemental Retirement Plans and a Board of Trustees to administer them. The Board of Trustees has the responsibility of administering the State's:

- Deferred Compensation Program operated pursuant to Internal Revenue Code (IRC) Section 457;
- Tax-deferred Annuity Program for Educational Employees under IRC Section 403(b);
- Savings and Investment Program under IRC Section 401(k); and
- Employer Matching Plan operated under IRC Section 401(a).

Maryland Supplemental Retirement Plan (MSRP) staff provides education programs and supporting information to State employees and human resources personnel in State agencies. These efforts are designed to create awareness among State employees of the need and mechanisms available to save for their own retirement. Staff also supports the board's work in selecting investment options and overseeing their operation.

The board finances its operations through a fee imposed on the employee participants, based on a percentage of assets in the plans. As of January 1, 2006, the board lowered its fee from 0.07 to 0.05% of assets to support its activities.

The board has contracted with Nationwide Retirement Solutions, Inc., for administration of all four plans. Under a five-year contract that took effect January 1, 2003, the administrator imposes a 0.23% fee on assets in those plans (decreased from 0.28% in the previous contract). Therefore, the combined asset fee paid by participants is now 0.28%, down from 0.30%.

Performance Analysis: Managing for Results

With day-to-day administration and management of the plans handled by Nationwide Retirement Solutions, the agency's two primary goals are to (1) provide clear and complete information about the plans to employees and cultivate informed decisions about participation; and (2) provide effective, long-term investment opportunities for participants.

Changes in Participation and Deferral Rates

Exhibit 1 shows that while overall participation in the State’s deferred compensation plans increased in fiscal 2005, it fell just short of the agency’s goal of 85% participation. Also, the percentage of employees actively deferring to their accounts, and the value of their contributions, fell slightly. The mostly likely explanation for these decreases is the State’s decision to suspend its match for employee contributions for the second straight year. The return of a State match, capped at \$400 per employee, in fiscal 2006 appears to have had an immediate positive effect on deferral rates in fiscal 2006. Just three months into fiscal 2006, more than 3,000 plan members had resumed or begun deferring to their accounts. An increase in the cap on the State match to \$600 in fiscal 2007, combined with new MSRP investment counseling services, including one-on-one meetings with members, should push deferral rates in fiscal 2007 even higher. **The Department of Legislative Services (DLS) recommends that the agency comment on the desirability of setting a goal for increasing the number of actively deferring members, rather than the number of plan participants.**

Exhibit 1 Plan Participation, Deferrals, and Assets

	Actual <u>2004</u>		Actual <u>2005</u>		% Change <u>04-05</u>
	<u>Number</u>	<u>% of Total</u>	<u>Number</u>	<u>% of Total</u>	
Total Accounts	65,364	82%	65,752	83%	0.59%
Contributing Accounts	44,245	56%	43,380	55%	-1.96%
Contributions (\$ in Thousands)	\$143.3		\$142.2		-0.77%
Total Assets (\$ in Thousands)	\$1,866.5		\$2,007.8		7.57%

Source: Maryland Supplemental Retirement Plans

Exhibit 1 also shows that, in spite of declining member contributions during fiscal 2005, plan assets continued to increase, reflecting higher returns on equities (stocks) in the mutual funds that comprise the plans’ investment options.

Investment Performance

Exhibits 2 and 3 demonstrate the mixed record of performance for the investment options offered by MSRP. Exhibit 2 offers a snapshot of the composite returns generated by the plans’ investment options as of June 30, 2005. As a whole, five- and ten-year returns for the mutual funds available to plan participants exceed the composite returns for the benchmark indices against which

Exhibit 2
Annual Average Rates of Return as of June 2005

	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>
Average Returns for All Investment Options	8.00%	9.10%	3.30%	10.40%
Average Returns for All Benchmark Indices	9.20%	9.70%	2.10%	9.10%

Source: Maryland Supplemental Retirement Plans

Exhibit 3
MSRP Mutual Fund Performance Compared with
Benchmark Indices as of December 2005

	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>10 Year</u>
MSRP Investment Options				
EuroPacific Growth Fund	▲	▲	▲	▲
T. Rowe Price Small Cap Stock	▲	—	▲	▲
Dreyfus MidCap Index Fund	—	—	—	▲
Delaware Trend Fund	—	—	▲	▲
LordAbbett MidCap Value	—	—	—	▲
Fidelity Growth & Income Fund	—	—	▲	—
Legg Mason Value Trust	▲	▲	▲	▲
Vanguard Institutional Index Fund	▲	▲	▲	▲
Growth Fund of America	▲	▲	▲	▲
Washington Mutual Investors	—	—	—	—
Fidelity Puritan Fund	▲	▲	▲	▲
Scudder Flag Value Builder Fund	▲	▲	▲	n/a
PIMCO Total Return Fund	▲	▲	▲	▲
Federated US Gov't Securities	—	—	—	—
Vanguard Prime Money Market	▲	—	—	▲

▲ = Fund Equaled or Beat Benchmark Index
— = Fund Underperformed Benchmark Index

Source: Maryland Supplemental Retirement Plans; Nationwide Retirement Solutions

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the mutual funds are measured, but one- and three-year returns lag behind those same benchmarks. Exhibit 3 offers a more recent fund-by-fund perspective, comparing the performance of each fund available to participants against its own benchmark index.

As of December 31, 2005, 10 of the 15 investment options available to plan participants equaled or surpassed the performance of their benchmark indices most or all of the time. The remaining funds have consistently underperformed their benchmark indices. **DLS recommends that the agency comment on why underperforming investments continue to be offered to participants, and whether participants would be better served by replacing some or all of those options with index funds, which track the performance of their benchmarks.**

Governor's Proposed Budget

As shown in **Exhibit 4**, MSRP's fiscal 2007 allowance increases by 4.7% over the fiscal 2006 working appropriation. Increased fringe benefit costs and contractual expenses account for most of the increase. Travel expenses also increase to accommodate the agency's new investment counseling sessions for participants and regional workshops for human resources personnel throughout State agencies. Most other expenses are generally level-funded, after accounting for inflation-related adjustments.

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

How Much It Grows:	Special Fund	Total
2006 Working Appropriation	\$1,304	\$1,304
2007 Governor's Allowance	<u>1,365</u>	<u>1,365</u>
Amount Change	\$61	\$61
Percent Change	4.7%	4.7%

Where It Goes:

Personnel Expenses

Employee and retiree health insurance	\$29
Retirement and Social Security	8
Increments and other compensation	2
Turnover adjustments	-24

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Where It Goes:

Other Changes

Updated cost of Assistant Attorney General shared with the Comptroller’s office.....	25
Investment consultants	6
Travel.....	5
Rent and other fixed charges	5
Communication, motor vehicles, and supplies	4
Equipment.....	1
Total	\$61

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

Issues

1. Expenditure Controls

The agency submitted budget amendments to cover structural shortfalls of \$115,000 in fiscal 2003 and \$135,000 in fiscal 2004. Both these amendments imposed regressive per-account fees on top of the asset fees to cover nearly 10% of operating expenses. As a result, language was included in the fiscal 2006 budget bill that capped budget amendments at \$65,000. Any additional shortfalls would be required to be funded by deficiency appropriations in fiscal 2007. No budget amendments have been submitted thus far in fiscal 2006, and the agency does not anticipate a deficiency appropriation for fiscal 2007.

However, the budget amendments submitted in fiscal 2003 and 2004 highlight a second issue facing the agency, namely the absence of any structural restraints on agency spending. The board has the ability to set fees to meet its desired budget level. As participation and deferral rates are likely to increase, and plan assets continue to grow, the board has limited incentive to restrain each annual budget, and thus the fees on plan participants. That being said, the 2006 agency appropriation did eliminate 2.5 full-time equivalent positions. This will go a long way toward limiting expenditures, as 73.9% of the total fiscal 2006 appropriation was allotted to personnel expenditures.

One means to restrain spending is to cap annual revenues, just as annual revenues for the State Retirement Agency are capped at 0.22% of members' payroll. The board has the responsibility to provide the best plan possible for participants; however, the board operates with no constriction on its expenditure decisions. To control the agency's expenditures, and thus the fee participants pay, the General Assembly could adopt a revenue limit for the agency. This could be in the form of a dollar amount that would be allowed to grow with inflation, or as a percentage of plan assets. The agency would then be required to submit a budget within those defined constraints. **DLS recommends that the agency discuss the need for structural limitations on its expenditures.**

Recommended Actions

1. Concur with Governor's allowance.

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 2005					
Legislative Appropriation	\$0	\$1,480	\$0	\$0	\$1,480
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	0	0	0	0
Reversions and Cancellations	0	-141	0	0	-141
Actual Expenditures	\$0	\$1,339	\$0	\$0	\$1,339
Fiscal 2006					
Legislative Appropriation	\$0	\$1,304	\$0	\$0	\$1,304
Budget Amendments	0	0	0	0	0
Working Appropriation	\$0	\$1,304	\$0	\$0	\$1,304

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

Audit Findings

Audit Period for Last Audit:	January 30, 2001 – February 9, 2004
Issue Date:	October 2004
Number of Findings:	1
Number of Repeat Findings:	1
% of Repeat Findings:	100%
Rating: (if applicable)	

Finding 1: Proper internal controls have not been established over the processing of purchasing and disbursement transactions. The Office of Legislative Audits recommends that MSRP use the available Financial Management Information Systems.

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

<u>Object/Fund</u>	<u>FY05 Actual</u>	<u>FY06 Working Appropriation</u>	<u>FY07 Allowance</u>	<u>FY06 - FY07 Amount Change</u>	<u>Percent Change</u>
Positions					
01 Regular	16.50	14.00	14.00	0	0%
Total Positions	16.50	14.00	14.00	0	0%
Objects					
01 Salaries and Wages	\$ 900,749	\$ 962,500	\$ 977,498	\$ 14,998	1.6%
02 Technical & Spec Fees	10,842	3,500	3,500	0	0%
03 Communication	26,309	34,907	36,974	2,067	5.9%
04 Travel	19,565	5,500	10,000	4,500	81.8%
07 Motor Vehicles	12,653	15,552	14,796	-756	-4.9%
08 Contractual Services	251,759	186,871	217,685	30,814	16.5%
09 Supplies & Materials	12,762	6,000	9,100	3,100	51.7%
10 Equip - Replacement	9,263	800	2,649	1,849	231.1%
11 Equip - Additional	4,622	800	397	-403	-50.4%
13 Fixed Charges	90,381	87,500	92,064	4,564	5.2%
Total Objects	\$ 1,338,905	\$ 1,303,930	\$ 1,364,663	\$ 60,733	4.7%
Funds					
03 Special Fund	\$ 1,338,905	\$ 1,303,930	\$ 1,364,663	\$ 60,733	4.7%
Total Funds	\$ 1,338,905	\$ 1,303,930	\$ 1,364,663	\$ 60,733	4.7%

Note: The fiscal 2006 appropriation does not include deficiencies, and the fiscal 2007 allowance does not reflect contingent reductions.