G50L00
Maryland Supplemental Retirement Plans

Operating Budget Data

($ in Thousands)

	FY 06 Actual	FY 07 Working	FY 08 Allowance	FY 07-08 Change	% Change Prior Year
Special Fund	$1,304	$1,365	$1,392	$27	2.0%
Total Funds	**$1,304**	**$1,365**	**$1,392**	**$27**	**2.0%**

- The Governor's allowance for the Maryland Supplemental Retirement Plans increases by 2.0%, maintaining existing agency functions with no significant changes. Absent one-time savings for health insurance costs, the agency's allowance would grow by 6.3%.

Personnel Data

	FY 06 Actual	FY 07 Working	FY 08 Allowance	FY 07-08 Change
Regular Positions	14.00	14.00	14.00	0.00
Contractual FTEs	0.00	0.00	0.00	0.00
Total Personnel	**14.00**	**14.00**	**14.00**	**0.00**
Vacancy Data: Regular Positions				
Turnover, Excluding New Positions		0.50	3.00%	
Positions Vacant as of 12/31/06		0.50	3.60%	

- The Governor's allowance includes no change in positions.

- The agency's vacancy rate increases from 0 to 3.6% due to a 0.5 full-time equivalent position vacancy that occurred in September 2006. As of January 2007, the agency's director of finance resigned.

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

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Analysis in Brief

Major Trends

Membership Increases for First Time in Three Years: More eligible employees are deferring into their accounts, but the agency is well short of its 85% participation goal.

Board Strengthens Menu of Investment Options: Available mutual funds offer strong long-term returns but weak short-term returns. The agency has replaced several low-performing funds with better-performing options.

Issues

Revenue Structure Remains Unpredictable: A large fund balance may require a fee suspension or rebate.

Recommended Actions

1. Concur with Governor's allowance.

Updates

Life Cycle Funds to Debut Early in 2007: Funds offer members asset allocation mixes that adjust automatically as they approach retirement.

Maryland Supplemental Retirement Plans

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 under IRC Section 401(a).

Maryland Supplemental Retirement Plan (MSRP) staff provide education programs and supporting information to State employees and human resource 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 support the board's work in selecting investment options and overseeing their operation.

MSRP finances its operations through a fee imposed on its members' accounts, based on a percentage of assets in the plans. For fiscal 2007 and 2008, the board fee is 0.05% of assets. In addition, the board contracts with Nationwide Retirement Solutions, Inc., for administration of all four plans. Under a five-year contract that expires December 31, 2007, the administrator imposes a 0.23% fee on assets in those plans. Therefore, the combined asset fee paid by participants is 0.28%.

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. With respect to the first goal, the agency has established a goal of 85% participation in the plans by eligible State employees.

Membership Increases for First Time in Three Years

Exhibit 1 shows that while overall participation in the State's deferred compensation plans increased in fiscal 2006, it fell well short of the agency's goal of 85% participation. As of June 30, 2006, 59,022 of the 80,700 eligible State employees, or 73%, were members of one or more supplemental retirement plan. Nevertheless, the percentage of employees actively deferring to their accounts, and the value of their contributions, both increased for the first time in three years. In fiscal 2006, 40,869 members were actively deferring a portion of their gross annual salary into at least one account. This represents a 4.2% increase in deferring members over fiscal 2005, when 39,218 employees were actively deferring. The dollar value of their deferrals increased from $142.2 million in fiscal 2005 to $163.9 million in fiscal 2006. The most likely explanation for this reversal is the return of the State matching contribution after it was suspended during fiscal 2004 and 2005. The return of the State match, capped at $400 per employee, together with improved performance in equity markets, appears to have had an immediate positive effect on deferral rates in fiscal 2006. However, the agency still has much work to do to reach its goal of 85% participation among eligible State employees. Even a fully funded match of $600 in fiscal 2007 is unlikely to increase participation enough to reach the agency's goal. **The Department of Legislative Services (DLS) recommends that the board comment on plans to reach its stated goal, and whether it would be more appropriate to adopt a goal based on the number of members with active deferrals instead of total members.**

Exhibit 1

Plan Participation, Deferrals, and Assets

	Actual 2005		Actual 2006		% Change 2004-2005
	Number	% of Total	Number	% of Total	
Total Members	57,013	71%	59,022	73%	3.5%
Contributing Members	39,218	49%	40,869	51%	4.2%
	($ in Thousands)		($ in Thousands)		
Contributions	$142.2		$163.9		15.3%
Total Assets	$2,007.8		$2,183.8		8.8%

Source: Maryland Teachers' and State Employees' Supplemental Retirement Plans

In addition to consistent funding of the State's $600 matching program, another way to increase participation of State employees would be to make participation in the matching plan automatic. That is, a portion of pay would automatically defer into a qualified plan, and the employee would have to opt out in order to not contribute to a plan. The federal Pension Protection

Act of 2006 includes provisions that encourage employers with defined contribution plans to initiate automatic enrollment. The argument against this change would be that by fiscal 2009, the State's defined benefit pension plan will require an automatic 5% contribution from salary, and State employee salaries may not support an additional automatic withdrawal. One way to temper the impact of this change would be to limit the automatic deferral only to the point at which the State match for that fiscal year is reached. **DLS recommends that the board comment on the advantages and disadvantages of instituting automatic enrollment for State employees.**

Board Strengthens Menu of Investment Options

Exhibit 2 shows the mixed record of performance for the investment options offered by MSRP. It provides a snapshot of the composite returns generated by the plans' investment options as of June 30, 2006. Consistent with similar data from past years, five- and ten-year returns for the mutual funds available to plan participants exceed the composite returns for the benchmark indices against which the mutual funds are measured, but one- and three-year returns lag behind those same benchmarks.

Exhibit 2
Annual Average Rates of Return as of June 2006

	One Year	Three Years	Five Years	Ten Years
Average Returns for all MSRP Options	9.4%	12.6%	6.1%	10.1%
Average Returns for all Benchmark Indices	9.9%	13.0%	5.8%	8.6%

Source: Maryland Teachers' and State Employees' Supplemental Retirement Plans

Exhibit 3 offers a fund-by-fund perspective, comparing the performance of each fund available to participants against its own benchmark index, as of September 2006. It shows that the board has made significant progress in eliminating chronically low-performing funds from its menu of options, an issue highlighted in last year's DLS analysis. Since June 30, 2006, the board has either closed or decided to close five funds: Fidelity Growth and Income Fund, Federated U.S. Government Securities Fund, DWS Value Builder Fund, Delaware Trend Fund, and MainStay Small Cap Fund. As the exhibit shows, these funds have been among the weakest performers available to members when compared against their benchmark indices. Fidelity Growth and Income (not shown because it was closed before September 30) was replaced by the Neuberger Berman Equity Fund, a strong performer. Assets from Federated and DWS were transferred to existing funds with strong records (PIMCO and Fidelity Puritan, respectively.) While MainStay has performed well, the two fund managers responsible for its solid performance left the fund shortly after it was added to the board's list of investment options. A sixth poorly performing fund, the Washington Mutual Investors Fund, was assigned to the board's "watch list" for closer monitoring. The board's new investment consultant, Mercer Investment Consulting, which replaced Segal Advisors in July 2006, has been active in identifying funds for closure and recommending new funds to replace them.

Exhibit 3
MSRP Mutual Fund Performance
Compared with Benchmark Indices as of September 2006

MSRP Investment Options	**One Year**	**Three Year**	**Five Year**	**Ten Year**
EuroPacific Growth Fund	▲	▲	▲	▲
Vanguard Institutional Index Fund	▲	▲	▲	▲
Fidelity Puritan Fund	▲	▲	▲	▲
Growth Fund of America	▲	▲	▲	▲
Neuberger Berman Equity Fund	—	▲	▲	▲
PIMCO TotalReturn Fund	—	▲	▲	▲
Vanguard Prime Money Market	▲	▲	—	▲
Legg Mason Value Trust	—	—	▲	▲
T. Rowe Price Small Cap Stock	—	▲	—	▲
Van Kampen Midcap Growth Fund	—	▲	—	▲
Dreyfus MidCap Index Fund	—	—	—	▲
LordAbbett MidCap Value	—	—	—	▲
Washington Mutual Investors	—	—	—	—
Funds Closed or Designated for Closure				
DWS Value Build Fund	—	—	—	▲
Delaware Trend Fund	—	—	—	▲
Federated US Gov't Securties	—	—	—	—
MainStay Small Cap Fund	—	▲	▲	▲

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

Source: Nationwide Retirement Solutions

Governor's Proposed Budget

Exhibit 4 shows that personnel costs remain largely unchanged, due to the one-time savings on retiree health insurance and increased turnover. Other cost increases reflect inflation and new contract rates for outside vendors. Postage costs fall as the agency relies more on electronic distribution of member information.

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

How Much It Grows:	Special Fund	Total
2007 Working Appropriation	$1,365	$1,365
2008 Governor's Allowance	1,392	1,392
Amount Change	$27	$27
Percent Change	2.0%	2.0%

Where It Goes:	
Personnel Expenses	
Increments and other compensation	$42
Retirement	18
Other fringe benefit adjustments	3
Staff training	2
Turnover	-7
Health insurance costs decline due to one-time savings	-56
Other Changes	
Rent	7
Travel costs increase but remain below fiscal 2006 actual	6
Investment consultants	5
Annual audit	5
Supplies and equipment	4
Other contractual services	2
Communication	-4
Total	**$27**

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

Issues

1. Revenue Structure Remains Unpredictable

The board receives funds for operating expenditures through fees on user accounts. As the fees are based on a percentage of the asset base, the revenue generated is subject to market fluctuations. In 2002 and 2003, in response to overall poor market returns, the board imposed a flat per account fee of $8 and $6 respectively, to meet revenue shortfalls. These flat fees were determined to be the most efficient way to meet the revenue needs. The flat fees did not impose an administrative burden on the agency and were calculated to be the precise amounts needed to fill the gap in revenue. As seen in **Exhibit 5,** collections grew from $1.4 million in fiscal 2002 to $1.8 million in fiscal 2004, a 32% increase, before falling slightly in fiscal 2005. In fiscal 2006, revenue was restored to pre-2003 levels and came into line with actual agency expenditures: total revenues were $1.3 million and total expenditures were also $1.3 million. However, the agency continues to carry a cumulative reserve balance of $823,864 from past years. This carryover balance of 63% of revenue far exceeds the agency's target of 25% of annual revenue.

The high rate of participation in the supplemental plans and a prolonged rebound in market conditions has allowed the board to reduce its fees from a high of 0.11% to its current level of 0.05% without adversely affecting its operation. As noted above, the lower fee in fiscal 2006 generated only marginally lower revenues than a higher fee in fiscal 2002 due to the 45% growth in plan assets over that five-year span. As a result, the board has not had to draw down its large reserve to maintain operations at existing levels. Although the board projects that its reserve will decline to 42% of revenues in fiscal 2007, this still far exceeds the board's target. Instead, a one-time fee reduction or fee rebate would force the board to draw down its reserve to its target level of 25%. This would benefit members who funded the growth of the reserve fund through their *ad hoc* fees. Once the reserve reaches the desired level, the board fee could be restored to its current level of 0.05%.

Exhibit 5
Participants' Fees and Agency Operating Budgets
Fiscal 2002-2007

	2002	2003	2004	2005	2006	Projected 2007
PEBSCO/Nationwide Fees	$3,555,869	$3,242,450	$3,690,947	$4,135,755	$4,505,329	$5,100,000
As Percent of Assets	0.28%	0.23%	0.23%	0.23%	0.23%	0.23%
Board Fees + Adjustments	$1,386,603	$1,586,478	$1,833,852	$1,719,944	$1,301,598	$1,120,000
As Percent of Assets	$8 + 0.06%[1]	$6 + 0.11%[2]	0.11%	0.11%/0.07%[3]	0.07%/0.05%[4]	0.05%
Operating Expenses (Actual)	$1,517,455	$1,464,572	$1,534,177	$1,338,905	1,303,763	$1,364,663
Carryover Balance	$23,399	$145,305	$444,990	$826,029	$823,864	$579,201
Carryover Balance as Percent of Operating Expenses	1.50%	9.90%	29.00%	61.70%	63.20%	42.40%

[1] Special one-time board fee of $8 per account collected March 2002

[2] Special one-time board fee of $6 per account collected March 2003

[3] Board fee reduced January 1, 2005

[4] Board fee reduced January 1, 2006

Source: Maryland Teachers' and State Employees' Supplemental Retirement Plans; Department of Legislative Services

Looking ahead, the frequent change in asset-balance fees 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, however, to continued difficulty in asset fee projection, raising questions as to whether this is the appropriate means of generating agency operating revenue. One route to providing more predictability for revenues may be to institute a sliding per-account fee. As an example, account balances up to $10,000 would be charged a $50 fee. An additional amount could be then charged for each subsequent increment *e.g.*, each additional $10,000. This practice has been adopted in other state-deferred compensation programs and provides a more consistent revenue stream. While revenues are still based on the asset base, the amount generated will not fluctuate substantially each year. **DLS recommends that the board comment on the appropriateness of its fee structure, its willingness to explore alternative fee structures, and its plans to reduce the size of its reserve to appropriate levels**.

Recommended Actions

1. Concur with Governor's allowance.

Updates

1. Life Cycle Funds to Debut Early in 2007

In August 2006, the board approved the addition of life cycle funds administered by T. Rowe Price to its list of investment options. Life cycle funds are mutual funds that feature an asset mix that adjusts over time as the individual investor ages. For instance, a life cycle fund for an investor in his or her twenties might begin with an aggressive approach centered on equity growth funds but over time gradually shifts its asset allocation into more conservative income-generating investments (*e.g.*, income funds or bond funds) to protect the principal. The board opted to include life cycle funds because its own research showed that more than half of its members had not adjusted their asset allocation for more than two years. With life cycle funds, asset allocation is handled by the fund managers, so members in essence receive investment management services for the same fees they currently pay to individual mutual fund managers. Life cycle funds are growing in popularity among defined contribution programs and are already offered by the Maryland College Savings Plan.

After an extensive period of outreach and procurement, the board selected the T. Rowe Price array of life cycle funds. T. Rowe Price offers 12 different funds, beginning with a plan designed for individuals planning to retire this year, and then at five-year intervals up to those planning to retire in 2055. Fees and mutual fund rebates for life cycle funds are comparable to those for other mutual fund options offered by the board.

Implementation of the life cycle funds is planned for February 2007. Leading up to the debut of life cycle funds, MSRP is planning extensive agency and member outreach in collaboration with Nationwide Retirement Solutions. All MSRP members will be required to "re-enroll" by either explicitly confirming their existing deferral decisions or opting to defer to a life cycle fund. Members who do not actively re-enroll will have their deferrals placed in a life cycle fund appropriate to their age. However, as with all deferrals, they are free to reverse that decision at any time.

Appendix 1

Current and Prior Year Budgets

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

	General Fund	**Special Fund**	**Federal Fund**	**Reimb. Fund**	**Total**
Fiscal 2006					
Legislative Appropriation	$0	$1,304	$0	$0	$1,304
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	0	0	0	0
Reversions and Cancellations	0	0	0	0	0
Actual Expenditures	**$0**	**$1,304**	**$0**	**$0**	**$1,304**
Fiscal 2007					
Legislative Appropriation	$0	$1,365	$0	$0	$1,365
Budget Amendments	0	0	0	0	0
Working Appropriation	**$0**	**$1,365**	**$0**	**$0**	**$1,365**

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

Object/Fund Difference Report
Maryland Supplemental Retirement Plans

Object/Fund	FY06 Actual	FY07 Working Appropriation	FY08 Allowance	FY07-FY08 Amount Change	Percent Change
Positions					
01 Regular	14.00	14.00	14.00	0	0%
Total Positions	**14.00**	**14.00**	**14.00**	**0**	**0%**
Objects					
01 Salaries and Wages	$ 950,782	$ 977,498	$ 977,510	$ 12	0%
02 Technical and Spec. Fees	2,292	3,500	5,000	1,500	42.9%
03 Communication	13,889	36,974	32,750	-4,224	-11.4%
04 Travel	20,487	10,000	16,000	6,000	60.0%
07 Motor Vehicles	14,834	14,796	14,796	0	0%
08 Contractual Services	201,210	217,685	229,712	12,027	5.5%
09 Supplies & Materials	10,656	9,100	11,100	2,000	22.0%
10 Equip – Replacement	0	2,649	1,000	-1,649	-62.2%
11 Equip – Additional	508	397	5,400	5,003	1260.2%
13 Fixed Charges	89,105	92,064	98,687	6,623	7.2%
Total Objects	**$ 1,303,763**	**$ 1,364,663**	**$ 1,391,955**	**$ 27,292**	**2.0%**
Funds					
03 Special Fund	$ 1,303,763	$ 1,364,663	$ 1,391,955	$ 27,292	2.0%
Total Funds	**$ 1,303,763**	**$ 1,364,663**	**$ 1,391,955**	**$ 27,292**	**2.0%**

Note: The fiscal 2007 appropriation does not include deficiencies, and the fiscal 2008 allowance does not reflect contingent reductions.

Appendix 2

Fiscal Summary
Maryland Supplemental Retirement Plans

Program/Unit	FY06 Actual	FY07 Wrk Approp	FY08 Allowance	Change	FY07-FY08 % Change
01 General Administration	$ 1,303,763	$ 1,364,663	$ 1,391,955	$ 27,292	2.0%
Total Expenditures	**$ 1,303,763**	**$ 1,364,663**	**$ 1,391,955**	**$ 27,292**	**2.0%**
Special Fund	$ 1,303,763	$ 1,364,663	$ 1,391,955	$ 27,292	2.0%
Total Appropriations	**$ 1,303,763**	**$ 1,364,663**	**$ 1,391,955**	**$ 27,292**	**2.0%**

Note: The fiscal 2007 appropriation does not include deficiencies, and the fiscal 2008 allowance does not reflect contingent reductions.