

G50L00
Maryland Supplemental Retirement Plans

Operating Budget Data

(\$ in Thousands)

	<u>FY 08</u> <u>Actual</u>	<u>FY 09</u> <u>Working</u>	<u>FY 10</u> <u>Allowance</u>	<u>FY 09-10</u> <u>Change</u>	<u>% Change</u> <u>Prior Year</u>
Special Fund	\$1,384	\$1,502	\$1,514	\$13	0.8%
Contingent & Back of Bill Reductions	0	0	-8	-8	
Adjusted Special Fund	\$1,384	\$1,502	\$1,506	\$5	0.3%
Adjusted Grand Total	\$1,384	\$1,502	\$1,506	\$5	0.3%

- The fiscal 2010 allowance increases by \$4,904, or 0.3%, over the fiscal 2009 working appropriation.

Personnel Data

	<u>FY 08</u> <u>Actual</u>	<u>FY 09</u> <u>Working</u>	<u>FY 10</u> <u>Allowance</u>	<u>FY 09-10</u> <u>Change</u>
Regular Positions	14.00	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	14.00	14.00	14.00	0.00

Vacancy Data: Regular Positions

Turnover and Necessary Vacancies, Excluding New Positions	0.35	2.50%
Positions and Percentage Vacant as of 12/31/08	0.00	0.00%

- The allowance contains no new positions. All agency vacancies had been filled as of December 31, 2008.

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

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Analysis in Brief

Major Trends

Absence of Match May Decrease Membership: Membership trends suggest that the absence of the State match program in fiscal 2010 may reduce plan participation levels.

Plan Investment Returns Exceed Benchmarks in Declining Market: The Maryland Supplemental Retirement Plan offerings beat its benchmarks across the board, posting smaller reductions than comparable market indicators.

Issues

Impact of Market Downturn on Fee Structure and Reserve Levels: Market declines have reduced reserve levels and may require additional board charges to meet agency expenditures. **The board is asked to comment on the ideal mixture of fee and budgetary adjustments to meet fiscal 2010 expenditures.**

Plan Administrator Removes Minority Business Enterprise Partners: Nationwide Retirement Solutions, Inc. terminated its relationship with two subcontractors that represent the majority of the administrator contract's Minority Business Enterprise (MBE) participation. **The board is asked to comment on the prospect of meeting the 25% MBE goal in the future.**

Recommended Actions

1. Concur with Governor's allowance.

Updates

Internet Access Page Updated for Members: Web-access to member accounts was enhanced in December 2008 with the launch of the new DCdirect service platform.

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Maryland Supplemental Retirement Plans

Operating Budget Analysis

Program Description

Title 35 of the State Personnel and Pensions 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 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).

The Maryland Supplemental Retirement Plans (MSRP) staff provides education programs and support 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 supports the board's work in selecting investment options and overseeing their operation.

MSRP finances operations through a fee imposed on members' accounts, based on a percentage of assets in the plans. For fiscal 2009, the board fee is 0.05% of assets. In addition, the board contracts with Nationwide Retirement Solutions, Inc., (Nationwide) for administration of all four plans. The fee charged by Nationwide is 0.14% of assets. Therefore, the combined asset fee paid by participants is 0.19%.

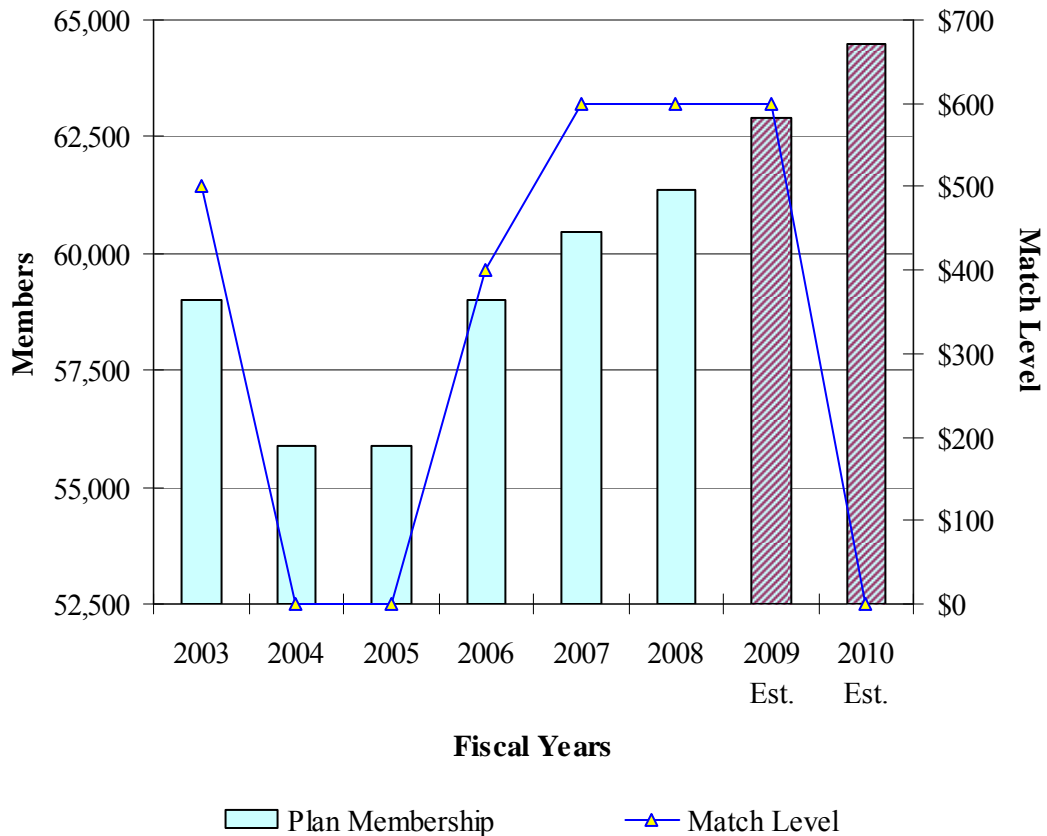
Performance Analysis: Managing for Results

With day-to-day administration and management of the plans handled by Nationwide, the agency's two primary goals are to (1) provide clear and complete information about the plans to employees to help 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.

Absence of Match May Decrease Membership

Exhibit 1 shows the annual member participation in the State's deferred compensation plans from fiscal 2003 to their projected levels at the end of fiscal 2010. Plan membership steadily increased from a low of 55,877 members in fiscal 2005 to an all-time high in fiscal 2008. As of June 30, 2008, 61,362 of 84,058 eligible State employees, or 73%, were members of one or more supplemental retirement plans. In spite of the increases, participation levels fell short of the agency's 85% MFR goal.

**Exhibit 1
MSRP Membership Levels vs. Employer Match Funding
Fiscal 2003-2010**



MSRP: Maryland Supplemental Retirement Plans

Source: Maryland Supplemental Retirement Plans; Department of Legislative Services

Exhibit 1 further indicates that the provision of State matching funds is correlated to the plans' membership totals. As the match grew from fiscal 2005 to 2008, so did membership levels. However, the recent extreme decline in market conditions may have altered this relationship. For example, while the fiscal 2008 appropriation included funding for the \$600 match, membership did not grow as predicted, growing by 1.5% instead of the 2.7% prognosticated by MSRP during the 2008 session. As the economic downturn has worsened in fiscal 2009, participation growth through December 2008 has become nearly stagnant. Through the mid-point of fiscal 2009, participant totals increased by 0.25%, or 161 members. This change is well behind MSRP's estimates of over 1,500 new participants joining during the fiscal year. Moreover, the number of employees actually contributing funds has decreased over the same period, albeit by less than 0.5%. Finally, the fiscal 2010 allowance, and the accompanying Budget Reconciliation and Financing Act of 2009

(HB 101/SB 166), plan on eliminating the match for the upcoming fiscal year. Given an outlook for prolonged recessive conditions and the absence of the match, achieving membership growth will be difficult. Nonetheless, MSRP's projections envision 5.0% membership growth by the end of fiscal 2010 over the levels recorded in fiscal 2008. **The Department of Legislative Services (DLS) recommends that the board comment on the impact the absence of the State match will have on the Plans and the projections for future membership.**

Plan Investment Returns Exceed Benchmarks in Declining Market

Exhibit 2 provides a snapshot of the composite returns generated by MSRP's investment options as of June 30, 2008, and compares the returns to the benchmark indices against which the mutual funds are measured. Comparable figures are provided from fiscal 2006 and 2007. In fiscal 2008, the plan posted a single year negative return of -8.9% due to declines in the financial markets. The MSRP offerings, however, beat the benchmarks across the board, as they had in fiscal 2007. **Appendix 2** offers a fund-by-fund perspective of these options, comparing the performance of each fund available to participants against its own benchmark index, as of December 2008.

Exhibit 2 MSRP Average Rates of Return Fiscal 2006-2008

Annual Average Rates of Return as of June 30, 2008

	<u>One Year</u>	<u>Three Years</u>	<u>Five Years</u>	<u>Ten Years</u>
Average Returns for all MSRP Options	-8.90%	6.20%	10.00%	6.00%
Average Returns for all Benchmark Indices	-9.20%	5.90%	9.60%	5.30%

Annual Average Rates of Return as of June 30, 2007

	<u>One Year</u>	<u>Three Years</u>	<u>Five Years</u>	<u>Ten Years</u>
Average Returns for all MSRP Options	18.20%	12.90%	12.20%	10.10%
Average Returns for all Benchmark Indices	17.40%	12.40%	12.10%	8.10%

Annual Average Rates of Return as of June 30, 2006

	<u>One Year</u>	<u>Three Years</u>	<u>Five Years</u>	<u>Ten Years</u>
Average Returns for all MSRP Options	9.40%	12.60%	6.10%	10.10%
Average Returns for all Benchmark Indices	9.90%	13.00%	5.80%	8.60%

MSRP: Maryland Supplemental Retirement Plans

Source: Maryland Supplemental Retirement Plans

Fiscal 2009 Actions

Impact of Cost Containment

The June 25, 2008, cost containment action reduced MSRP's special funds by \$7,928 for contributions toward employee health insurance that were funded from another fund source.

Proposed Budget

The fiscal 2010 special fund allowance grows by \$4,904, as shown in **Exhibit 3**. The largest increases come from higher retirement contributions of \$10,286, employee health insurance cost growth of \$10,080, and escalation of the plan's investment management contract worth \$9,590. The main decrease was the removal of Other Post Employment Benefits prefunding of \$20,852.

Impact of Cost Containment

Contingent and across-the-board reductions effected in this agency's budget delete \$7,800 in special funds for the deferred compensation match. This reduction will have larger ramifications for MSRP, as the fees depend on member contributions and associated plan asset values that are affected by match levels. These potential outcomes are discussed in the Issues section.

Exhibit 3
Proposed Budget
Maryland Supplemental Retirement Plans
(\$ in Thousands)

How Much It Grows:	Special Fund	Total
2009 Working Appropriation	\$1,502	\$1,502
2010 Allowance	<u>1,514</u>	<u>1,514</u>
Amount Change	\$13	\$13
Percent Change	0.8%	0.8%
Contingent Reductions	-\$8	-\$8
Adjusted Change	\$5	\$5
Adjusted Percent Change	0.3%	0.3%

Where It Goes:

Personnel Expenses

Retirement contribution.....	\$10
Employee and retiree health insurance pay-as-you-go costs.....	10
Turnover adjustments.....	9
Salary adjustments.....	-7
Deferred compensation (after reducing fiscal 2010 for contingent reductions).....	-8
Reduction in Other Post Employment Benefits' unfunded liability.....	-21
Other adjustments.....	1

Other Changes

Investment advisor management contract.....	10
Rent.....	4
Travel.....	2
Association dues.....	2
Training and staff development.....	2
Software upgrades.....	1
Garage rental payments.....	-3
Telecommunications.....	-6
Other.....	-1

Total **\$5**

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

Issues

1. Impact of Market Downturn on Fee Structure and Reserve Levels

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. As seen in **Exhibit 4**, the board's fee as a percentage of assets has fallen from 0.11% of assets in fiscal 2004 to the current 0.05% rate. These reductions were fueled by a steady increase in asset values prompted by double-digit investment returns and increasing member contributions that were partially inspired by the \$600 State match. Plan asset values, however, fell in fiscal 2008.

Exhibit 4
Assets and Participants' Fees and Agency Operating Budgets
Fiscal 2004-2009

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009 (Est.)</u>
Invested Assets (\$ in Millions)	\$1,826.8	\$1,969.3	\$2,148.1	\$2,496.0	\$2,365.8	\$1,923.0
Nationwide Fees	\$3,690,947	\$4,135,755	\$4,505,329	\$5,125,018	\$4,649,862	\$3,565,786
<i>as Percent of Assets</i>	0.23%	0.23%	0.23%	0.23%	0.23%/0.14% ³	0.14%
Board Fees + Adjustments	\$1,833,852	\$1,719,944	\$1,301,598	\$1,158,166	\$1,253,098	\$1,077,736
<i>as Percent of Assets</i>	0.11%	0.11%/0.07% ¹	0.07%/0.05% ²	0.05%	0.05%	0.05%
Operating Expenses	\$1,534,177	\$1,338,905	1,303,763	\$1,311,258	\$1,383,759	\$1,501,588
Carryover Balance	\$444,990	\$826,029	\$823,864	\$670,772	\$546,152	\$122,300
<i>Carryover Balance as Percent of Operating Expenses</i>	29.01%	61.69%	63.19%	51.15%	39.47%	8.14%

¹ Board fee reduced January 1, 2005.

² Board fee reduced January 1, 2006.

³ New administrator's contract ratified January 30, 2008 reduced Nationwide fee to 0.14%.

Source: Maryland Supplemental Retirement Plans; Department of Legislative Services

Reserve Reduction and Account Charges

The initial impact of the falling plan assets has been expressed in reductions to the reserves held. The agency's target for the reserve fund is 25.0% of annual revenue, a level the board has determined to be appropriate to facilitate cash flow needs and prevent frequent changes to the percentage fee it charges. In the past several years, the reserve had grown steadily, exceeding \$826,000, or 61.69% of revenues, in fiscal 2006. The aforementioned reduction of the board fees charged to member accounts helped reduce the reserve, as the balance was applied to agency expenses not met by the lower charge. By the end of fiscal 2008, the balance in the reserve was \$546,152, or 39.47% of revenues.

Under the market conditions prevalent between fiscal 2005 and 2008, the lower board fee reduced MSRP reserves by \$280,000 over three years. Over the first six months of fiscal 2009, reserves worth more than \$225,000 have been utilized to supplement declining fee revenues. The reserve stood at \$321,054 on December 31, 2008. The historic declines in equity markets endured in the past year, however, may keep asset values low enough to empty the reserves. Moreover, the absence of the employer match plan from the fiscal 2010 allowance could further decrease asset value growth, as members lose an incentive to place the minimum of \$600 into their plan accounts, while the State contribution itself will not be added. As such, additional funding to meet board expenses may be needed.

There are three alternatives to meeting fiscal 2010 expenditures, which are programmed to be \$1.5 million in the allowance: (1) the board could raise its asset-based charges; (2) the board could charge a per account fee in the hopes that market growth will render the 5-basis point charge tenable in the future; or (3) board expenditures could be reduced to equal projected revenues. The first two options have been employed in the recent past. In fiscal 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. Subsequently, it increased its asset-based charge from 0.06% in fiscal 2002 to 0.11% in fiscal 2003.

DLS has estimated the fiscal 2010 implication of each of these potential mechanisms if utilized alone to correct the projected imbalance:

- the board charge would need to be raised an additional 2.2 basis points, to 0.072% of assets, to meet expenditures;
- a per account fee of approximately \$6.25 across the 68,950 system accounts present at the end of fiscal 2008 would need to be levied; or
- MSRP's budgeted expenditures would need to be reduced by \$430,000.

These figures were developed on the assumption that asset values would remain at the \$1.92 billion value as posted on December 31, 2008, and that the reserve would be completely exhausted. For every 5% recovery of asset worth, either 0.3 basis points could be removed from the

charge; \$0.70 could be reduced from an account-based fee; or \$48,000 less would need to be reduced from the appropriation.

Any combination of measures could provide the desired result, putting revenues and expenditures at equilibrium. **Given the magnitude of the asset changes, and the potential duration of the economic downturn, the board is asked to comment on the ideal mixture of adjustments to meet expenditures in fiscal 2010. It should address the costs and benefits of assessing a per account fee, altering board-levied account fees, and/or reducing agency spending to meet expenditures.**

2. Plan Administrator Removes Minority Business Enterprise Partners

In January 2008, MSRP renewed its contract with its plan administrator, Nationwide, for a five-year term. One of the MSRP board's selection criteria was Nationwide's confirmation that it would meet the 25% Minority Business Enterprise (MBE) participation goal associated with the contract. Nationwide had met the MBE goal in the previous contract period through subcontracts for investment-related services with two area companies – GRW Capital Corporation (GRW) and Innova Securities, Inc. (Innova). Upon signing the new contract, these two firms were again the primary source of MBE participation. As an illustration of their weight in the plan administrator contract, MBEs received nearly \$1.3 million, or 29%, of the \$4.7 million total administrative revenues from MSRP accounts in calendar 2007, with GRW and Innova receiving approximately \$850,000 between them.

On June 1, 2008, Nationwide ended its relationships with both GRW and Innova, five months after reaffirming their roles in the contract. Nationwide cited audit findings that had uncovered compliance and regulatory risks related to recordkeeping, principal/supervisor reporting structures, and financial privacy issues as the motivation for their termination. At subsequent board meetings, it was disclosed that these problems stemmed from the business relationship Nationwide had developed to employ the MBEs. Nationwide was effectively using the financial service of the MBEs as pass-throughs by placing its own representatives at a site belonging to the subcontractors and paying their salaries and a managerial fee to each MBE in order to meet their contractual goals. Nationwide believed this arrangement to be the source of the abovementioned risk and consequently ended its MBE partnerships. With these companies no longer utilized as subcontractors, Nationwide's MBE spending fell to \$519,283 in calendar 2008, with just \$65,650 of the spending occurring from June 2008 to December 2008, after it severed ties with GRW and Innova.

Nationwide has updated the board and MSRP executives on its search for replacement subcontractors to meet the MBE contract goal, but the updates have contained potential contract and negotiation information that could not be disclosed to DLS. **The board is asked to comment on the prospect of meeting the 25% MBE goal in the future.**

Recommended Actions

1. Concur with Governor's allowance.

Updates

1. Internet Access Page Updated for Members

In December 2008, Nationwide, the contractual administrator for MSRP, completed the migration of user data onto the DCdirect web platform: www.MarylandDC.com. The change involved the movement of all MSRP participant accounts and payroll transactions to the new web-based system. The migration provides MSRP participants with several enhancements:

- Members have a single account to access on the web that provides an overview of all Internal Revenue Service and money sources they may have. So, account balances roll into one total, and the member does not have to choose different plan numbers to review multiple accounts.
- Social Security numbers are replaced with a unique account number to better protect members' sensitive information.
- Customer service response times will improve as Nationwide representatives can view participant accounts at levels of detail previously unavailable, and any changes made through the site will immediately update in member accounts.
- Self-service enhancements include dedicated accounts for beneficiaries and immediate updating of personal information, accessible for the first time on the new webpage.

The migration was successful, but several technical problems have arisen. The most significant change involved a payroll file transmission error that impacted 776 MSRP participants. Deferral amount data used was erroneous on some accounts because it omitted November and December 2008 web contribution changes. Therefore, incorrect amounts were withheld from some accounts, with 359 participants having too much money withdrawn from their paychecks and 417 participants having too little withdrawn. Corrective action was taken to ensure that the proper deferral amount is withdrawn from subsequent payroll transactions. Affected members were advised of the problem and restitution was made where necessary, while Nationwide's plan asset fees for all impacted members were waived. Because the situation was caused by a conversion issue, it should not recur in the future. Other minor issues involving webpage link connectivity and general information errors, such as erroneous phone numbers for local Nationwide offices, have also been identified and remedied.

Current and Prior Year Budgets

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

	<u>General Fund</u>	<u>Special Fund</u>	<u>Federal Fund</u>	<u>Reimb. Fund</u>	<u>Total</u>
Fiscal 2008					
Legislative Appropriation	\$0	\$1,392	\$0	\$0	\$1,392
Deficiency Appropriation	0	0	0	0	0
Budget Amendments	0	17	0	0	17
Cost Containment	0	0	0	0	0
Reversions and Cancellations	0	-25	0	0	-25
Actual Expenditures	\$0	\$1,384	\$0	\$0	\$1,384
Fiscal 2009					
Legislative Appropriation	\$0	\$1,492	\$0	\$0	\$1,492
Cost Containment	0	-8	0	0	-8
Budget Amendments	0	17	0	0	17
Working Appropriation	\$0	\$1,502	\$0	\$0	\$1,502

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

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Fiscal 2008

- A special fund amendment transferred \$16,952 to MSRP for the 2% cost-of-living adjustment (COLA) that was centrally budgeted in the Department of Budget and Management (DBM).

Fiscal 2009

- A special fund amendment transferred \$17,234 to MSRP for the 2% COLA that was centrally budgeted in DBM.
- As part of the June 25, 2008, fiscal 2009 cost containment action, \$7,928 of the plans' special fund appropriation was reduced for contributions toward employee health insurance that were funded from another source.

**MSRP Mutual Fund Performance Compared with Benchmark Indices
as of December 2008**

MSRP Investment Options

	One Year	Three Year	Five Year	Ten Year
Vanguard Prime Money Market	▲	▲	▲	▲
EuroPacific Growth Fund	▲	▲	▲	▲
Vanguard Institutional Index Fund	▲	▲	▲	▲
Vanguard Small Cap Growth Index Fund	▲	▲	▲	<i>n/a</i>
Vanguard Total International Stock Fund	▲	▲	▲	<i>n/a</i>
PIMCO Total Return Fund	—	▲	▲	▲
Van Kampen Midcap Growth Fund	—	▲	▲	▲
Goldman Sachs Large Cap Value Growth Fund of America	—	▲	▲	<i>n/a</i>
T. Rowe Price Small Cap Stock	▲	—	—	▲
Vanguard Small Cap Value Index Fund	▲	—	—	—
Vanguard Value Index Fund	▲	—	—	—
Fidelity Puritan Fund	—	—	—	▲
Neuberger Berman Equity Fund	—	—	—	▲
<i>LordAbbett MidCap Value</i>	—	—	—	▲
<i>Legg Mason Value Trust</i>	—	—	—	—
Washington Mutual Investors Fund	—	—	—	—
Dreyfus MidCap Index Fund	—	—	—	—

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

Note: Funds closed in 2008 are in italics.

Source: Nationwide Retirement Solutions

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

<u>Object/Fund</u>	<u>FY08 Actual</u>	<u>FY09 Working Appropriation</u>	<u>FY10 Allowance</u>	<u>FY09 - FY10 Amount Change</u>	<u>Percent Change</u>
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	\$ 976,558	\$ 1,081,638	\$ 1,083,254	\$ 1,616	0.1%
02 Technical and Spec. Fees	1,797	5,000	6,500	1,500	30.0%
03 Communication	31,368	28,947	22,666	-6,281	-21.7%
04 Travel	16,753	17,500	19,557	2,057	11.8%
07 Motor Vehicles	10,860	14,796	11,760	-3,036	-20.5%
08 Contractual Services	228,383	229,495	240,918	11,423	5.0%
09 Supplies and Materials	10,032	11,300	12,300	1,000	8.8%
10 Equipment – Replacement	0	1,500	700	-800	-53.3%
11 Equipment – Additional	9,432	5,400	5,400	0	0%
13 Fixed Charges	98,576	106,012	111,237	5,225	4.9%
Total Objects	\$ 1,383,759	\$ 1,501,588	\$ 1,514,292	\$ 12,704	0.8%
Funds					
03 Special Fund	\$ 1,383,759	\$ 1,501,588	\$ 1,514,292	\$ 12,704	0.8%
Total Funds	\$ 1,383,759	\$ 1,501,588	\$ 1,514,292	\$ 12,704	0.8%

Note: The fiscal 2009 appropriation does not include deficiencies. The fiscal 2010 allowance does not include contingent reductions.