BOARD OF TRUSTEES FOR THE MARYLAND STATE RETIREMENT AND PENSION SYSTEM MINUTES OF MEETING

September 20, 2016

The Board of Trustees for the Maryland State Retirement and Pension System met in the Board Room of the SunTrust Building, 120 East Baltimore Street, 16th Floor Board Room, Baltimore, Maryland beginning at 12:20 p.m.

The Trustees present included:

Nancy Kopp, Chairman, Presiding
Peter Franchot, Vice Chairman
James Bush, Jr.
James C. DiPaula
Kenneth Haines
David Hamilton
James Harkins
Linda Herman
Sheila Hill
F. Patrick Hughes
Charles Johnson
Theresa Lochte
Richard Norman

Other attendees included: John Kenney.

On a motion made by Mr. Hughes and seconded by Ms. Hill, the Board voted to meet in a Closed Session, beginning at 12:22 p.m., in the Board Room of the SunTrust Building at 120 East Baltimore Street, 16th Floor, for the purpose of:

1. reviewing the closed session Board minutes, pursuant to General Provisions Art., § 3-103(a)(1)(i), the exercise of an administrative function;

2. reviewing the Medical Board reports, pursuant to General Provisions Art., § 3-305(b)(13), to comply with a specific constitutional, statutory, or judicially imposed requirement that prevents public disclosures about a particular proceeding or matter namely, General Provisions Art., § 4-312 regarding the prohibition on disclosing retirement records, and General Provisions Art., § 4-329 regarding the prohibition on disclosing medical and personal information; and

3. discussing the Chief Investment Officer's Evaluation, pursuant to General Provisions Art., § 3-305(b)(1)(i), the appointment, employment, assignment, promotion, discipline, demotion, compensation, removal, resignation, or performance evaluation of an appointee, employee, or official over whom it has jurisdiction.

During closed session, the Board of Trustees discussed and took action on the following matters:

Closed Session Minutes	The Board reviewed and approved the August 16, 2016 closed session minutes.
Medical Board Reports	The Board reviewed and adopted the medical board reports from August 18, August 24, September 1, September 7 and September 15, 2016.
Chief Investment Officer's Performance Evaluation	The Board discussed the Chief Investment Officer's (CIO) performance evaluation and approved the award of financial incentives to the CIO.

On a motion made by Ms. Hill and seconded by Mr. Hughes, the Board returned to open session at 12:39 p.m. in the Board Room of the SunTrust Building at 120 East Baltimore Street, 16th Floor.

BOARD OF TRUSTEES FOR THE MARYLAND STATE RETIREMENT AND PENSION SYSTEM MINUTES OF MEETING

September 20, 2016

OPEN SESSION

The Trustees present included:

Nancy Kopp, Chairman, Presiding
Peter Franchot, Vice Chairman
James Bush, Jr.
James C. DiPaula
Kenneth Haines
David Hamilton
James Harkins
Linda Herman
Sheila Hill
F. Patrick Hughes
Charles Johnson
Theresa Lochte
Richard Norman

Agency Staff members attending included: R. Dean Kenderdine, Executive Director/Board Secretary

Margaret Bury
Melody Countess
Anne Gawthrop
Michael Golden
Ira Greenstein
Angie Jenkins
Van Lewis
Michelle Lowery
Andrew Palmer
Chandra Puranam
Harvey Raitzyk
Ken Reott
David Rongione
Janet Sirkis
Toni Voglino

Other attendees included: John Kenney and Nathan Bowen.

Consent Agenda

On a motion made by Ms. Hill and seconded by Ms. Lochte, the Board approved the consent agenda, which included:

- August 16, 2016 Open Meeting Board Minutes
- August 16, 2016 Audit Committee Meeting Summary
- August 16, 2016 Corporate Governance Committee Meeting Summary
- September 6, 2016 Administrative Committee Meeting Summary

Comptroller Franchot requested that the August 30, 2016, Ad Hoc Committee on Actuarial Valuations and Economic Assumptions Meeting Summary be pulled from the consent agenda, for purposes of discussion. The Board agreed.

Mr. Kenderdine reported to the Board that Linda Herman requested that corrections be made to the August 30, 2016 Ad Hoc Committee meeting summary to accurately reflect her remarks at that meeting. The Board was provided with a redlined version of the requested edits.

Comptroller Franchot reported that it was his understanding that a conclusion had not been reached concerning the actuarial assumed rate of return and that further Committee deliberations would not allow the System's actuary sufficient time to complete the FY2016 valuation.

Comptroller Franchot made a motion to reduce the assumed rate of return from 7.55% to 7.25% and recommend an inflation rate of 2.4% and a real rate of return of 4.85%. The motion was seconded by Mr. Johnson, for purposes of discussion.

Comptroller Franchot commented that the System's long term investment returns generally have decreased and that the fund currently faces difficult economic conditions, which only increases the difficulty in predicting future returns.

Mr. Johnson expressed his concern with Annapolis' support of the System and stated his opinion that the assumed rate of return needs to be lowered.

Mr. DiPaula commented that while he appreciated the discussion by the Board on this matter, the Ad Hoc Committee at its last meeting raised additional questions, for which additional information is needed for the Committee to make an informed decision and any recommendation.

Treasurer Kopp commented that the appointment of the Ad Hoc Committee is known to the legislature and that the System is carefully considering this issue. The System needs to be openly, transparently and methodically looking at what impact any change to the assumed rate of return would have.

Comptroller Franchot responded that the Committee will not be able to make a recommendation to the Board in time for the FY2018 budget and this is the time to let the Governor know what is needed.

The Comptroller requested that a vote be taken by the Board on his motion.

Therefore, on a motion made by Comptroller Franchot and seconded by Mr. Johnson, to reduce the assumed rate of return from 7.55% to 7.25% and recommend an inflation rate of 2.4% and a real rate of return of 4.85%, by a vote of 2 to 10, the motion failed. The Trustees in favor of the motion were: Comptroller Franchot and Mr. Johnson. The Trustees in opposition of the motion were: Treasurer Kopp, Mr. Bush, Mr. DiPaula, Mr. Haines, Mr. Harkins, Ms. Herman, Ms. Hill, Mr. Hughes, Ms. Lochte and Mr. Norman. Mr. Hamilton abstained.

Changes to the Investment Policy Manual Concerning Asset Allocation

Mr. Hughes, Chairman of the Investment Committee, reported that the Committee reviewed and approved, for recommendation to the Board, the amendments to the Investment Policy Manual concerning Asset Allocation.

On a motion made by Mr. Hughes and seconded by Ms. Lochte, the Board voted and approved the recommendation of the Investment Committee to adopt the changes to the Investment Policy Manual concerning Asset Allocation.

FY2018 Budget Proposal

Mr. Kenderdine provided a summary of the FY2108 budget proposal. Mr. Kenderdine reported that the Agency's FY17 operational budget totaled $31.2 million with 96% of the budget attributable to payroll, contractual obligations, fixed charges and communications, as is typical. The Department of Budget and Management (DBM) has given the Agency a FY18 budget target of $31.8 million, which reflects level funding plus additional funds to provide cost-of-living adjustments for Agency personnel. The proposed budget being submitted to the Board is at the level of the DBM target.

Mr. Kenderdine reported that the Agency is submitting, for the Board's consideration, the following four "Over the Target" requests for FY2018:

- additional personnel (10) to address the growing member service and benefit processing demand of the Agency, as well as enhance benefit administration internal control
- additional funds to meet anticipated custodial bank service costs
- salary enhancements for Investment staff to ensure the System's continued ability to achieve its return objective, enhance staff retention capability by aligning compensation with peer compensation levels, and enable internal management initiatives aimed at lowering System asset management costs; and
- additional resources aimed at providing member services through a secure website, achieving business process improvements, and enhanced/new technology to support them

In addition, Mr. Kenderdine reported that the Agency is also requesting two deficiency appropriations for FY2017, each directly tied to the over-the-target requests for the Investment Pay Plan Adjustment and the Business Process Re-engineering initiatives under the FY2018 requests.

Mr. Hamilton commented that at the last Audit Committee meeting there was a discussion about migrating to the Cloud and asked if that was still being considered.

Mr. Kenderdine responded that the Agency still has security concerns with moving data to the Cloud and the protection of member data and is therefore not connected to the Cloud.

On a motion made by Mr. Harkins and seconded by Mr. Bush, the Board the voted and approved the recommendation of the Administrative Committee to approve the FY2018 budget proposal.

Board Requested Legislation

The Board was provided with the 2017 legislative proposal as presented to the Administrative Committee. (*See attachment* A).

Ms. Gawthrop provided a brief summary of the proposals for the Board's consideration. If approved, the proposals will be presented to the Joint Committee on Pensions for its consideration to sponsor as legislation for the 2017 legislative session.

Ms. Herman requested a copy of the Private Letter Ruling mentioned in the proposal concerning the Membership Elections as it relates to the Optional Retirement Program.

On a motion made by Mr. Harkins and seconded by Mr. Bush, the Board the voted and approved the recommendation of the Administrative Committee to approve the legislative proposals for 2018 legislation session.

BOARD OF TRUSTEES FOR THE MARYLAND STATE RETIREMENT AND PENSION SYSTEM MINUTES OF MEETING

September 20, 2016

Chief Investment Officer's Report

Mr. Andrew Palmer provided the Board with a summary of the fund as of August 31, 2016, which indicated that the total fund value was $46.2 billion, with a 1-month return of 44 basis points and a 1-month policy benchmark increase of 52 basis points.

Executive Director's Report

Mr. Kenderdine updated the Board on the disability regulation amendments. Mr. Kenderdine reported that the proposed regulations were published in the Maryland Register and a comment was received by representatives of AFSCME, MSEA and other employee organizations offering an alternative approach. The AELR Committee recommended that the Agency meet with the employee organizations to address any concerns regarding the regulations, which staff did.

Mr. Kenderdine reported that on or about September 14, 2016, the Agency sent a letter to the Committee Chairs notifying them that the offered alternatives was unworkable under current law and of the Board's intent to proceed with the adoption of the disability regulations. The disability regulations are scheduled to be presented, for final adoption by the Board, at its October meeting.

Adjournment

There being no further business before the Board, on a motion made by Mr. Harkins and seconded by Ms. Lochte, the meeting adjourned at 2:32 p.m.

Respectfully submitted,

R. Dean Kenderdine
Secretary to the Board

BOARD OF TRUSTEES
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

AUDIT COMMITTEE MEETING SUMMARY
August 16, 2016

Contractual Audits Update

Mr. Rongione informed the Committee that the Credit/Debt Strategy Investments audit is wrapping up its fieldwork phase. A report is expected to be issued prior to the November Audit Committee meeting.

Mr. Rongione told the Committee that Internal Audit is working on an RFP seeking an outside firm to audit the processes associated with the System's private equity investments.

The Committee received the results of participating employer audits that were completed by CliftonLarsonAllen during FY 2016. Mr. Feilinger told the Committee that this is the seventh year that CliftonLarsonAllen has performed employer audits on behalf of the Agency. This year, there was a change in the selection of employers audited. Audits of small employers without significant prior findings were deferred, and replaced with University of Maryland and withdrawn employers. During FY 2016, 59 employer audits were performed.

Mr. Feilinger provided an overview of the audit's objectives, as well as the percentage of employers with findings for each objective, and their typical causes. He noted that there has been a steady decline in the number of findings related to the "sick leave reporting" objective over the years, and believes that this is attributable to Retirement Administration's efforts in this area.

Mr. DiPaula voiced concerns regarding the high percentages of employers that are not in compliance. Mr. Maranto discussed his analysis of the audited employers with repeat findings for misreporting payroll data. He noted that the overall number of affected individuals have decreased, when compared with the employers' previous audits. The Committee discussed possible solutions to help ensure compliance, including assessing penalties, or fees, on non-compliant employers, and one-on-one meetings with employers. Mr. Hughes suggested that the Administrative Committee should consider the issue, including possible legislation. Mr. Kenderdine agreed.

Ms. Bury informed the Committee that she now has a staff member that is dedicated to addressing audit findings with employers. They have already worked on resolving 24 of the audits. She added that other staff is working on webinar training for employers to help address common issues.

Internal Quality Assurance Results

Mr. Rongione discussed the results of quality assurance work performed by Internal Audit staff during CY 2015. There are two types of quality assurance work performed – reviews of individual audits performed by Internal Audit staff and outside contractors, and a review of Internal Audit's compliance with general professional standards. He noted that no reviews of individual audits were completed during CY 2015, due to a lack of staffing. A general standards review was performed, and there were no significant recommendations.

Mr. Bush requested additional information on Internal Audit Division staffing. Mr. Rongione responded that there is currently a staff of four, including one staff auditor that was added during the past year. There was one vacant position, which has since been lost. Mr. Kenderdine told the Committee that the position was lost as part of across-the-board reductions that were required of the Agency. Mr. Rongione informed the Committee that he would like to hire an investment auditor to perform audits that are currently contracted to outside vendors.

FY 2016 Internal Audit Division Time Report

Mr. Rongione provided the Committee with a comparison of hours spent by Internal Audit staff for FY 2016 to those in FY 2015. The comparison detailed the number of audit, administrative, and State-benefit hours. He noted that the administrative hours accounted for less than 20% of the total.

Mr. Rongione questioned the value of the report to the Committee. He noted that Internal Audit is the only division in the Agency required to track their time. After discussion, Mr. Bush suggested that Mr. Rongione propose changes to the current practice at a future meeting.

FY 2016 Internal Audit Division Performance Report

Mr. Rongione provided the Committee with the Internal Audit Division Performance Report for FY 2016. He noted that all performance goals were met with the exception of "Percentage of Annual Audit Plan" (completed). Only 96% of the audit plan was completed. The uncompleted portion is solely attributable to delays in the Credit/Debt Strategies audit, which is outsourced to an outside contractor.

FY 2017 Audit Plan Status

Mr. Rongione provided the Committee with a status update for the FY 2017 audit plan. Staff is currently performing an audit of network and server maintenance. Staff is also gathering preliminary information on an upcoming power-of-attorney audit.

Open Issues Log

The Committee received a listing of open audit issues. Mr. Rongione advised the Committee that progress is being made. He noted that ten open audit issues were closed in FY 2017, and that nine open issues were added, due to recently completed audits. Most issues are expected to be resolved in September, followed by a few in November and December. He indicated that some of these require legislation/regulations, or computer programming changes.

BOARD OF TRUSTEES
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

AUDIT COMMITTEE MEETING SUMMARY
August 16, 2016

Internal Audit Charter

Mr. Rongione informed the Committee that they are required to review and approve the Internal Audit Charter once every three years. He recommended one change to the Charter. Section V of the charter should be changed to indicate that the Charter is to be approved by the Audit Committee. This is consistent with what the Audit Committee's Charter requires. The Internal Audit Charter's current version states that it is to be approved by the Board of Trustees.

On a motion by Mr. Hamilton, seconded by Mr. Hughes, the Committee approved the Internal Audit Charter with the recommended change.

Completed Audits

Mr. Rongione summarized the results of recently completed audits of Disaster Recovery and Cash Flow Management, describing the objectives and findings. He noted that the Disaster Recovery audit had an overall rating of "green", and Cash Flow Management was rated "yellow". Management has agreed to implement corrective actions to address problems identified in the Disaster Recovery audit. The Committee discussed backup sites and the potential use of "the cloud".

Mr. Kenderdine told the Committee that a workgroup consisting of individuals from the Finance and Investment Divisions has been established to address findings identified in the Cash Flow Management audit. They will also review bank data over the past 16 months to identify instances where there was idle cash.

Proposed Audit Committee Meeting Dates

The Board of Trustees approved all Committee dates during the August 16th meeting, and the Audit Committee did not voice concerns for the following meeting dates in CY 2017:

- February 21, 2017;
- May 16, 2017;
- July 18, 2017; and
- November 14, 2017.

BOARD OF TRUSTEES
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

CORPORATE GOVERNANCE COMMITTEE MEETING SUMMARY
AUGUST 16, 2016

Update and Review of Iran-Sudan Divestment

The Committee considered staff's recommendation to reaffirm the System's Iran-Sudan Restricted List as no new companies meet the requirements of the Maryland Iran-Sudan divestment statute and no companies are eligible for removal from the Restricted List at this time. Ms. Voglino confirmed that all 21 companies on the Iran-Sudan Restricted List currently meet the requirements of the Maryland Iran-Sudan divestment statute SPP 21-123.1.

Ms. Voglino provided the semi-annual Iran & Sudan Divestment Impact Analysis to the Committee as prepared by Meketa Investment Group, the System's general investment consultant. The report provided an updated analysis of all companies on the Iran-Sudan Restricted List and the divestment impact regarding these companies.

On a motion by Mr. Haines and seconded by Mr. Brotman, the Committee unanimously agreed to approve staff's recommendation to reaffirm the Iran-Sudan Restricted List as noted, and to recommend the list to the Board of Trustees.

ISSUER NAME	Country	Sudan or Iran
ASEC Co for Mining SAE	Egypt	Sudan
AviChina Industry & Technology Company Limited	China	Sudan
Bharat Heavy Electricals Limited	India	Sudan
China National Petroleum Corporation	China	Both
Daelim Industrial Co.,Ltd.	Korea	Iran
El Sewedy Electric Co. SAE	Egypt	Sudan
Energy House Holding Company	Kuwait	Sudan
Harbin Power Equipment Co., Ltd	China	Sudan
Jiangxi Hongdu Aviation Industry Co., Ltd.	China	Sudan
Kuwait Finance House K.S.C.	Kuwait	Sudan
LS Industrial Systems Co., Ltd	Korea	Sudan
Managem S.A.	Morocco	Sudan
Oil and Natural Gas Corporation Limited	India	Sudan
Oil India Ltd.	India	Sudan
ONGC Videsh Limited	India	Sudan
Orca Gold Inc.	Canada	Sudan
Petroliam Nasional Berhad (Petronas)	Malaysia	Sudan
Petronas Capital Limited	Malaysia	Sudan
Petronas Global Sukuk Ltd	Malaysia	Sudan
Regency Mines PLC	UK	Sudan
Schneider Electric S.A.	France	Sudan

BOARD OF TRUSTEES
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

CORPORATE GOVERNANCE COMMITTEE MEETING SUMMARY
AUGUST 16, 2016

Institutional Shareholder Services Contract Renewal

The Committee considered staff's recommendation to exercise the System's first of two one-year extension options for Institutional Shareholder Services (ISS). Ms. Voglino detailed that the five-year contract for proxy voting services is due to expire June 30, 2017 and the System has the choice to either renew the contract for one year or solicit bids through the Request for Information (RFI) process.

On a motion by Mr. Brinkley and seconded by Mr. Brotman, the Committee unanimously agreed to approve staff's recommendation to extend the contract with ISS for proxy voting services through June 30, 2018.

MSCI ESG Contract Renewal

The Committee considered staff's recommendation to exercise the System's first of two one-year extension options for MSCI ESG. Ms. Voglino detailed that the five-year contract for Iran-Sudan research and data feed services is due to expire June 30, 2017 and the System has the choice to either renew the contract for one year or solicit bids through the Request for Information (RFI) process.

On a motion by Mr. Brotman and seconded by Mr. Haines, the Committee unanimously agreed to approve staff's recommendation to extend the contract with MSCI ESG for Iran-Sudan research and data feed services through June 30, 2018.

Council of Institutional Investors Update and Fall Conference Agenda

The Committee discussed the CII Fall Conference that will be held September 28, 2016 through September 30, 2016 and was provided an agenda.

Proposed 2017 Corporate Governance Committee Meeting Schedule

Staff proposed the following dates for the Corporate Governance Committee meetings in 2017:

- Tuesday, February 21, 2017 (*immediately following the Board meeting*)
- Tuesday, May 16, 2017 (*immediately following the Board meeting*)
- Tuesday, September 5, 2017 (*immediately following the Administrative Committee meeting*)
- Tuesday, November 21, 2017 (*immediately following the Board meeting*)

On a motion by Mr. Brinkley and seconded by Mr. Brotman the Committee accepted the proposed dates for committee meetings in 2017.

Other Business

The Committee discussed the Commonsense Corporate Governance Principals and asked that staff forward an electronic copy of the Principals to the Committee. The Committee asked to discuss the Principals at the next Corporate Governance Committee.

BOARD OF TRUSTEES
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

ADMINISTRATIVE COMMITTEE MEETING SUMMARY
SEPTEMBER 6, 2016

2017 Administrative Committee Meeting Dates

On a motion made by Ms. Hill and seconded by Mr. Haines, the Administrative Committee approved the 2017 Administrative Committee Meeting dates, as follows:

Tuesday, February 7, 2017	Tuesday, March 7, 2017
Tuesday, April 4, 2017	Tuesday, June 6, 2017
Tuesday, August 1, 2017	Tuesday, September 5, 2017
Tuesday, October 3, 2017	Tuesday, December 5, 2017

Recommendation from the Audit Committee

Mr. Kenderdine reported that at the Audit Committee at its meeting on August 16, 2016 received the results of the FY2016 Participating Governmental Units Audit, conducted by CliftonLarsenAllen. The audit is conducted to ensure that the enrollment and payroll being reported to the System by the PGUs is accurate. As a result of those findings the Audit Committee recommended that the Administrative Committee discuss possible solutions to help ensure compliance of those PGUs.

Staff recommended that the Chair and Vice-Chair of the Audit and Administrative Committees meet with the Executive Director and the Chief Internal Auditor to discuss possible remedies, and report back to the Committee.

Board Requested Legislation

THIS MATTER WILL BE DISCUSSED OUTSIDE OF THE CONSENT AGENDA IN OPEN SESSION.

Ms. Anne Gawthrop presented to the Committee an overview of the Board requested legislation proposals for the Administrative Committee's consideration to present to the Board of Trustees for inclusion in its 2017 legislative proposals to the Joint Committee on Pensions.

The Committee agreed to remove the Board of Trustees Budget Authority – Investment Division proposal from the legislative package and vote on that separately.

Therefore, on a motion made by Ms. Hill and seconded by Mr. Norman, the Administrative Committee approved the legislative proposals, the Board of Trustees Budget Authority – Investment Division proposal, for recommendation to the Board of Trustees. Ms. Brogan abstained from the proposal regarding IMEs and the small procurement cap.

On a motion made by Mr. Norman and seconded by Ms. Brogan, the Administrative Committee approved the Board of Trustees Budget Authority – Investment Division proposal, for recommendation to the Board of Trustees. Mr. Nicole abstained.

FY18 Budget Proposal

THIS MATTER WILL BE DISCUSSED AND VOTED ON OUTSIDE THE CONSENT AGENDA.

Mr. Kenderdine introduced the Agency's Budget Request for Fiscal Year (FY) 2018.

Mr. Kenderdine reported that the Agency's FY17 operational budget totaled $31.2 million with 96% of the budget attributable to payroll, contractual obligations, fixed charges and communications, as is typical. The Department of Budget and Management (DBM) has given the Agency a FY18 budget target of $31.8 million, which reflects level funding plus additional funds to provide cost-of-living adjustments for Agency personnel. The proposed budget being submitted to the Board is at the level of the DBM target.

Mr. Kenderdine reported that the Agency is submitting, for the Board's consideration, the following four "Over the Target" requests for FY2018:

- additional personnel (10) to address the growing member service and benefit processing demand of the Agency, as well as enhance benefit administration internal control
- additional funds to meet anticipated custodial bank service costs
- salary enhancements for Investment staff to ensure the System's continued ability to achieve its return objective, enhance staff retention capability by aligning compensation with peer compensation levels, and enable internal management initiatives aimed at lowering System asset management costs; and
- additional resources aimed at providing member services through a secure website, achieving business process improvements, and enhanced/new technology to support them

In addition, Mr. Kenderdine reported that, for the first time, the Agency is requesting two deficiency appropriations for FY2017, each directly tied to the over-the-target requests for the Investment Pay Plan Adjustment and the Business Process Re-engineering initiatives under the FY2018 requests.

On a motion made by Ms. Brogan and seconded by Mr. Haines, the Administrative Committee approved, for recommendation to the Board of Trustees, the FY18 Budget Proposal. Marc Nicole abstained.

Finance Reports Quarter Ending June 30, 2016

Ms. Patricia Wild presented the FY2016 Non-Budgeted Investment Manager and Service Related Fees Report. Ms. Wild indicated that when comparing basis points, the fees paid as a percent of assets during FY2016 were lower than the fees paid during FY2015 by 9.7 basis points.

Within the Equity and Fixed Income categories, the Agency is still experiencing a significant cushion under the statutory fee cap. All asset classes experienced a decrease in basis points. Ms. Wild reported that the equity asset class had a decrease of 8.9 basis points mainly resulting from lower performance fees.

The Fixed Income asset class had a decrease of 4.5 basis points due to a temporary fee break resulting from additional funds being reallocated from the Real Return space, which also had a decrease of 3.9 basis points. The Credit funds were lower by 14.8 basis points as a result of negotiated fees and additional funds being moved into this asset class.

Fees incurred for investment related service providers decreased due to a lower fee structure, which was negotiated by staff in the Record Currency program. Alternative investment experienced a decrease of .4 basis points for FY2016 mainly due to performance fees being lower, which offset the front loaded fees on the additional funds added during the year.

Ms. Melody Countess presented the Administrative Expenses Report for the quarter ending June 30, 2016. Ms. Countess reported that Agency had a surplus of $198,847, which was due to excess healthcare costs that was reverted at year-end.

Mr. Lewis presented the MBE Performance Report for the FY2016. Mr. Lewis reported that MBE Performance was 29.37, which is slightly above the Administrative MBE performance goal of 29.0%.

Member Services Update

The Committee was provided with a report on the June, 2016, including fiscal year end, and the July, 2016 performances of the Member Services Unit.

Ms. Bury reported that the abandonment rate for June and July, 2016 were 14.68% (with a FY average of 9.54%) and 9.59%, respectively. Ms. Bury further reported that the average caller wait time for the same periods were 249 second (with a FY average of 159 seconds) and 151 seconds, respectively.

Ms. Bury commented that since the unit has been unable to meet its call abandonment goal of 6.0% and its average call wait time goal of 105 seconds for some time, the Benefits Administrative Division is requesting to modify its goals in the 2018 Fiscal Year budget submission, Managing for Results. The Division is requesting that the call abandonment rate be set at 7.5% and the average caller wait time increased to 2 minutes 15 seconds.
Ms. Bury reported that the unit did not meet its performance goals for the month of May. Ms. Bury reported that the abandonment rate for May was 10.82% and the average speed of answer was 2:59 minutes.

BOARD OF TRUSTEES
MARYLAND STATE RETIREMENT AND PENSION SYSTEM

AD HOC COMMITTEE ON ACTUARIAL VALUATIONS AND ECONOMIC ASSUMPTIONS MEETING SUMMARY
AUGUST 30, 2016

Charge to Committee

The Committee is charged with examining the System's current actuarial economic assumption for the System's Investment Rate of Return and possibly make recommendations to the Board as to whether changes in the rate or its components should be implemented, and if implemented, where that assumption should be set.

Mr. Hughes reported that the Board approved the 7.55% Assumed Rate of Return in 2013.

Review of the July 19, 2016 Presentation to the Board of Trustees on Interest Rate

The Committee was provided a copy of the PowerPoint document presented, by Gabriel Roeder Smith & Company (GRS), to the Board at its July 19, 2016 meeting, entitled "MSRPS Interest Rate Discussion, July 19, 2016."

Brian Murphy from GRS reported that the current Maryland assumptions are reasonable even by the new standards, but if return expectations continue to fall, they may not remain reasonable much longer. Current assumptions are at the upper end of the acceptable range. Mr. Murphy recommended that the Committee's focus be on what is likely to occur.

Economic Outlook

Mr. Palmer discussed the long range outlook for inflation. He cited four factors that have contributed to the low inflation that has been realized in the United States in recent years. Those factors include: Globalization, Global Deleveraging, Global capacity surplus and demographics.

Inflation and Real Return Assumptions

When asked what his views on inflation were, Mr. Palmer responded that there are three ways to get out of debt; default, inflate or change terms, but that the most likely choice would be by inflation.

Mr. Brotman commented that there are two points that the Board can control, the first being what the System's assumptions will be and the second being how the portfolio is structured.

Discussion

Mr. Murphy commented that if decisions are made by the Board within the next month, they affect the FY2016 valuations and the contribution rates for the FY2018 budget.

Ms. Herman stated that the System is a long term investor and as such should not have a knee jerk reaction to the current market environment. She state the YTD thru July most pension systems are up 7-8%, Ms. Herman noted that the Board's discussion of lowering the investment now only to raise it in the future would not bode well with the bond rating agencies and would play havoc with the contribution rates paid by participating governments.

Mr. DiPaula commented that the Committee is charged with looking at the rate of return and that he was open to reducing the rate of return, but that the decision to do so, would be served best if the Committee looked deeper into the totality of the components.

Ms. Lochte commented that most Systems are reducing their assumed rate of return and that if Staff feels that the System is not going to hit the current assumed rate of return, then it would be prudent to reduce the System's rate of return.

Mr. Brotman commented that the funding ratio will go down if the Board does nothing and that changing the portfolio is the prudent thing to do.

Secretary Brinkley asked in what year is the System expected to be fully funded.

Mr. Kenderdine responded that the System is expected to be fully funded in 2027.

Mr. Murphy commented that, in his opinion, in the next 4-5 years, both inflation and the rate of return will be very low.

Ms. Brogan commented that it would be helpful for the Committee to have additional information on inflation and real return projections to help the Committee determine if the System's rate of return is realistic based on the current asset allocation and to make a more informed decision.

The Committee asked that staff schedule a follow-up meeting to review the additional information on inflation and real return rates, for its next meeting.

2016 Board Requested Legislation

The following legislative proposals are offered by the Board of Trustees for the State Retirement and Pension System for the Joint Committee on Pensions' consideration for the 2017 legislation session. These legislative proposals are intended to clarify or correct perceived inconsistencies within existing law, and in some instances, correct inconsistencies with federal law. These proposals, if approved by the board, will be presented to the joint committee for its consideration to sponsor as legislation for the 2017 legislative session.

References to the Reformed Contributory Pension Selection

When the Reformed Contributory Pension Benefit (RCPB) was created under Title 23, Subtitle 2, Part IV of the State Personnel and Pensions Article in 2011, reference to this new tier of the Employees' Pension System (EPS) was inadvertently omitted from various sections of this article. Staff has found two provisions addressing eligibility service in Title 23 (§§ 23-306.2(a) and (c)) that should have been amended in 2011 to include reference to the RCPB. Staff is recommending these sections be amended to now include the RCPB.

There is no cost associated with this proposal.

Purchase of Employment as a Legislative Employee

Section 23-307 of the State Personnel and Pensions Article addresses the purchase of service credit by members of the EPS. Specifically, this provision provides that members of the EPS may purchase various types of service, provided the member pays one-half of the employee cost and one-half of the employer cost for the service. One type of service that may be purchased under this section is up to 130 days of employment as an employee of a member of the Maryland Senate or House of Delegates, prior to the individual joining the EPS. However, the provisions of § 23-307 that address purchasing this service provide a different calculation than what is provided for all other eligible service under this section. Moreover, § 23-307 provides different calculations depending on whether the member commenced employment for the General Assembly on or after the start of the EPS, on January 1, 1980. Service purchased prior to January 1, 1980 is set at the amount that the member would have been required to contribute for that period of employment; plus interest compounded annually. For employment on or after January 1, 1980, the cost of service equals the amount that the member would have been required to contribute for that period of employment and the amount that the State would have been required to contribute for the member for that period of employment, plus interest on each piece, compounded annually. Finally, the interest rate for this purchase (regardless of when the employment occurred) is calculated using the same formula that was used beginning in 1984, to determine the amount of interest a member would receive on the member's refunded member contributions after transferring from the Employees' Retirement System (ERS) to the then non-contributory EPS. In an effort to encourage more members to transfer from the ERS to the EPS, in 1984, the interest rate paid on the member's contributions was changed from 4%, compounded annually, to the average annual realized rate of return on the System's investment portfolio for the five years preceding the transfer. This rate is referred to as the "transfer interest rate" and is the rate that is currently applied to the cost of service for employment as an employee of the General Assembly prior to joining the EPS. All other purchases under § 23-307, and throughout the State Personnel and Pensions Article for that matter, are calculated using either 4% or 5% interest, compounded annually.

Staff has researched this provision and cannot determine any member of the EPS in the past 10 years who has requested to purchase pre-membership employment with the General Assembly. Additionally, in 2004, all new legislative employees were required to join the EPS as a condition of employment. This was changed to provide these individuals with optional membership beginning in 2015, however, the option to join the EPS is now irrevocable and must be made at the commencement of employment. Therefore, since 2004, legislative employees commencing employment on or after July 1, 2004, will not have any service that could be purchased under § 23-307.

While staff recognizes that it is unlikely that any legislative employee will come forward in the future seeking to purchase up to 130 days of employment prior to joining the EPS, it is still possible. Therefore, in the event this would happen, staff would recommend amending the purchase provisions for this specific type of employment as follows:

(1) for employment before January 1, 1980, the amount that the member would have been required to contribute for that period of employment, plus 5% interest, compounded annually; and

(2) for employment on or after January 1, 1980, one-half of the employee cost and one-half of the employer cost for the service.

Staff recognizes that if § 23-307 is amended, as recommended, it would result in purchases of service at a lower cost than is currently provided for in statute. That being said, staff also believes that due to the fact that there has not been a request to purchase this type of employment in the last 10 years, coupled with the small period of time that can be purchased under the provision in question, the cost to the System would be de minimus.

Independent Medical Evaluations – Small Procurements

Independent medical evaluations are required through the Agency's regulations to be performed on ever disability applicant applying for a line of duty disability and at the discretion of the medical board for applicants applying for non-line of duty disability applicants. In order to stay under the small procurement cap, the Agency currently can pay only up to $25,000 each year to each doctor that performs independent medical evaluations. This amount can be reached quickly through examinations and testifying before the Office of Administrative Hearings and any other appeals that may occur. Once the $25,000 cap is reached, the Agency is placed in the position of either finding additional doctors willing to do independent medical evaluations or seek increases in funding through the regular procurement process, on a case by case basis. To avoid the seeking out additional doctors to perform the independent medical evaluations and the administrative burden and time delay incurred through navigating the State's regular procurement process, staff is recommending expanding the System's procurement exemption in the State Finance and Procurement Article to include an exemption for the services of physicians related to the medical board. These services would include independent medical examinations and any resulting testimony that would be required of the physicians.

Membership Elections - Prohibited

Recent Internal Revenue Rulings have alerted staff and legal counsel to issues regarding provisions within the State Personnel and Pensions Article that allow certain individuals the election to join various plans within the System throughout the employment careers of these individuals. Generally, these rulings address impermissible cash or deferred arrangements and limit the circumstances under which one-time irrevocable elections are permissible. Based on a review of these rulings, and on advice of tax counsel for the System, staff is recommending changes to several provisions in both the Optional Retirement Program (ORP) and the EPS that are currently in conflict with these rulings.

Optional Retirement Program

Presently, individuals employed as faculty or professional employees of the University of Maryland, Morgan State University, St. Mary's College, the Maryland Higher Education Commission or any community college have the option to join either the Teachers' Pension System (TPS) or the ORP within their first year of employment with one of these employing institutions. If no election is made within the first year of employment, the individual is enrolled in the TPS. This election is allowed even if the individual is currently, or previously has been, a member of another plan in the System. If the member accepts new employment with an employing institution, that individual has the option to join the ORP or the TPS. (In instances where the individual is already a member of the TPS, the election to move to the ORP or stay in the TPS is presented.)

Based on a review of the recent Internal Revenue Rulings, tax counsel has advised that current and former employees of the State or a participating governmental unit (PGU) who at some point in their careers have been members of one of the several systems, may no longer be offered an election to join the ORP. In addition, tax counsel has also advised that new employees, with no previous membership in one of the several systems may only be offered an election to join the ORP or the TPS at the commencement of employment. In other words, individuals joining the System for the first time may no longer have a year to elect either membership in the ORP or the TPS. Accordingly, staff is recommending changes to Title 30 of the State Personnel and Pensions Article that would reflect the advice of the System's tax counsel.

Optional Membership in Other State Systems

Tax counsel has also found provisions that provide for optional membership in the EPS that it is recommending be amended to comply with recent Internal Revenue Rulings. Specifically, § 23-209 allows the board the discretion to make membership optional for members in the TPS whose compensation is paid only partly by the State or whose employment is temporary or on other than a yearly basis. In addition, § 24-203 provides that the Secretary of State Police has the option to join either the State Police Retirement System (SPRS) or the EPS. Because the IRS is now only permitting optional membership at the commencement of employment, staff is recommending § 23-209 be amended, accordingly. Moreover, amendments to § 23-209 would also include language that would prohibit any election if the individual is currently a member of the TPS at the time the individual accepts employment that would qualify under this section. With regard to the Secretary of State Police, to avoid potential issues that would require the Secretary to become a member of the EPS due to earlier membership in that system, staff is recommending amending § 24-203 to remove the election entirely. Accordingly, the Secretary would then be required to become a member of the SPRS.

Finally, the last area of the State Personnel and Pensions Article that tax counsel is recommending be amended concerns elections made by employees of PGUs at the time a new PGU enters the System or an existing PGU withdraws from the System. According to the recent Internal Revenue Rulings, staff has been advised that current employees of an enrolling PGU may no longer be offered the option to join the EPS, Law Enforcement Officers' Pension System (LEOPS) or Correctional Officers' Retirement System (CORS), if at the time the PGU joins the System, it (1) participates in the "pick-up" program of either the EPS, LEOPS, or CORS, and prior to joining the EPS, LEOPS, or CORS had its own plan that participated in a pick-up program; and (2) the employee contribution rates between the State plan and the PGU plan are different. Additionally, this prohibition on elections would also apply if the same criteria were met for a PGU withdrawing from the plan. If the PGU is leaving to start a plan that participates in a pick-up program and has a different contribution rate from the State plan from which it is withdrawing, the employees of the PGU participating in the EPS, LEOPS, or CORS at the time of withdrawal would not be permitted to elect to leave and join the new plan offered by the PGU.

In order to remain in compliance with provisions of the Internal Revenue Code and recent Internal Revenue Rulings, staff is recommending the amendments proposed by tax counsel.

Optional Retirement Program – Annuity Contracts

In conducting its bi-annual review of the investment performance of the ORP, Segal Rogerscasey ("Segal") presented the Investment Division staff with several recommendations relating to the board's ORP agreement with TIAA CREF. Investment Division staff supported these recommendations and Segal and staff presented the recommendations to the Investment Committee during the May, 2016 Investment Committee meeting. Several of these recommendations were predicated on moving from TIAA's current individual annuity contract structure to a product known as the Retirement Choice contract. Segal and staff explained that the Retirement Choice contract has lower fees, allows for greater portability and provides a plan sponsor with greater flexibility in managing a plan's investment options.

Segal explained that "[w]hen TIAA was first retained as an ORP vendor, the only contract available to the State was the Retirement Annuity. These are individually-owned contracts or certificates that are controlled by plan participants. Because the contracts are controlled by the participants, the board does not have complete flexibility over investment options and the ability to map assets to other funds." Additionally, the Retirement Annuity structure limits the Board's ability to implement alternative fee sharing structures. Segal further advised that "as the retirement industry has evolved over time, TIAA has created and made available institutionally owned, group contracts (Retirement Choice contracts) as an alternative to the original individual contracts." Segal and Investment Division staff recommended moving to the Retirement Choice contract for all future contributions, including rollovers.

In order to implement the recommended Retirement Choice contract, §30-206 of the State Personnel and Pensions Article would need to be amended to allow the board to enter into a group annuity contract to provide benefits to participating employees. Amendments to §30-206 would clarify that an employee's rights under an annuity contract are nonforfeitable in accordance with IRC § 403(b)(1)(C), but would no longer require that annuity contracts purchased under the program "be issued to and become the property of the participating employees."

Reduction of Accidental Disability Benefits by the Amount of Related Workers' Compensation Benefits

Please see Attachment A.

Board of Trustees Budget Authority – Investment Division

Please see Attachment B.

ATTACHMENT A

Abolishing Statute Requiring the Reduction of Certain Accidental Disability Benefits by the Amount of Related Workers' Compensation Benefits

Background:

Maryland law generally prevents a government retiree covered by both workers' compensation and a governmental pension or retirement plan from recovering twice for a single injury. The General Assembly has enacted two intersecting laws to prevent double recovery.

Md. Code Ann., State Personnel & Pension Art. ("SPP"), § 29-118 provides:

> (1) Except as otherwise provided in this subsection, this section applies to a retiree and any designated beneficiary.
> (2) (i) This section does not apply to:
> 1. a retiree of a participating governmental unit, or a designated beneficiary of that retiree; or
> 2. a retiree of the Employees' Pension System or the Employees' Retirement System who receives a disability retirement benefit as a former employee of a county board of education or the Board of School Commissioners of Baltimore City, or a designated beneficiary of that retiree.
> (ii) A retiree described in subparagraph (i) of this paragraph, or a designated beneficiary of that retiree is subject to § 9-610 of the Labor and Employment Article.
> (b) Reduction in retirement allowance. --
> (1) The Board of Trustees shall reduce an accidental or special disability retirement benefit by any related workers' compensation benefits paid or payable after the effective date of retirement if the workers' compensation benefits:
> (i) are paid or payable while a pension is paid or payable; and
> (ii) are for an accidental personal injury arising out of and in the course of the retiree's employment by a participating employer.

Under SPP § 29-118, the Board of Trustees (the "Board") must reduce the accidental or special disability retirement benefit of a State retiree or a Teachers' Pension System/Teachers' Retirement System ("TPS/TRS") retiree by any related workers' compensation benefit paid or payable after the effective date of retirement if the two benefits are paid or payable during the same time period.[1]

Md. Code Ann., Labor & Employment Art. ("LE"), § 9-610 provides that:

> Except for benefits subject to an offset under § 29-118 of the State Personnel and Pensions Article, if a statute, charter, ordinance, resolution, regulation, or policy, regardless of whether part of a pension system, provides a benefit to a covered employee of a governmental unit or a quasi-public corporation..., payment of the benefit by the employer satisfies, to the extent of the payment, the liability of the employer and the Subsequent Injury Fund for payment of similar benefits under this title.

[1] The retirement allowance is not reduced "to be less than the sum of the retiree's annuity and the amount authorized to be deducted for health insurance premiums; or for workers' compensation benefits that are reimbursements for legal fees, medical expenses or other payments made to third parties and not the retiree." SPP § 29-118(b)(2).

Under this statute an employer, such as the State or a participating governmental unit ("PGU"), is required to offset a disability retiree's workers' compensation award payments by the amount of similar pension benefits that are not subject to an offset under § 29-118.

Because the Maryland State Retirement and Pension System ("MSRPS") is not involved in the workers' compensation process, its statutory duty regarding reducing an accidental disability award is often not fully understood by the Commission. Moreover, the Commission, the disability retiree and the attorneys that practice before the Commission, often do not understand the intricate interplay between LE § 9-610 and SPP § 29-118. Therefore, the Commission's awards may not acknowledge or consider the MSRPS's required reduction of certain accidental disability benefits when they grant or approve employer and insurer offsets to workers' compensation awards if an MSRPS accidental disability allowance is also being paid or will be paid.

The complicated statutory scheme for offsets and reductions for workers' compensation and retirement disability awards have resulted in a process that is disjointed, and sometimes inconsistent in its application. Moreover, the Retirement Agency finds that administering and monitoring the mandatory reduction of an accidental benefit in many instances can be unduly burdensome and time-consuming. Highlighted below are some examples of issues that the Retirement Agency has encountered with administering SPP § 29-118:

<u>Issue 1:</u> <u>Retroactive Accidental Disability Awards</u>

When an accidental disability retirement is *retroactively* awarded, the Retirement Agency has found it nearly impossible to recover the related workers' compensation payments if an offset based on LE § 9-610 for the ordinary disability award has been granted to the employer/insurer.

In these cases, the employer or insurer has already been credited an offset, thereby reducing the workers' compensation payments actually received by the disability retiree. Nonetheless, SPP § 29-118 requires the Retirement Agency to reduce the retiree's accidental benefits to recoup the amount of the workers' compensation award. To adhere to SPP § 29-118, the Agency would have to recoup money from the disability retiree that he or she never received, or seek a return of the money the employer/insurer.

For obvious reasons, the Retirement Agency has been reluctant to reduce a retiree's accidental disability retirement in this situation. Moreover, the Agency has been unsuccessful in recouping this money from the employer. Thus far, no employer has agreed to repay money to the disability retiree or the System, or to stop an ongoing offset. The employers' claim that the offset was based on a valid order or settlement signed by the Commission, and that at the time of the award or settlement, the offset was proper. In one case, the Retirement Agency went before the Commission to reopen a case. However, the Commission ruled that the Retirement Agency did not have standing to challenge the award.

<u>Example</u>:

- TPS employee was injured in a workplace accident on Jan. 1
- On Feb. 1, TPS member is granted and accepts an ordinary disability retirement by the Board ($800/mo. ($200/week)), but is appealing award for accidental disability.
- On March 1, TPS retiree receives a workers' compensation award of $200/week for Jan. 1 injury
- Under LE § 9-610, the Commission awards TPS retiree's former employer, a local school board, an offset of $200/week because of the overlapping ordinary disability award
- On July 1, Board retroactively grants TPS retiree an accidental disability award of $1200/mo ($300/week) for Jan. 1 accident

- Under SPP § 29-118, the Agency should recoup the $200/week workers' compensation award since March 1 (approx. $1600), and should reduce any overlapping accidental disability award by $200/week going forward.

Issue 2: Erroneous Commission Awards

The Agency has uncovered at least one instance where the Commission erroneously awarded an offset for an employer/insurer despite the fact that the retiree was granted an accidental retirement benefit subject to a SPP § 29-118 reduction. It is the Agency's position that it must reduce the accidental retirement allowance in accordance with § 29-118, regardless of the Commission's erroneous award. Nonetheless, this could create a hardship for the retiree who must seek to have the Commission amend the award, or take other legal action.

Example:

- TPS employee was injured in a workplace accident on Jan. 1
- On Feb. 1, TPS employee is granted and accepts an accidental disability retirement by the Board ($1000/mo. ($250/week))
- On March 1, TPS retiree is awarded workers' compensation ($200/week) for the Jan. 1 injury
- Under LE § 9-610 the Commission erroneously grants the employer, a local school board, an offset based on the accidental disability award. Because of the offset the TPS retiree is not receiving any money for workers' compensation award.
- Under SPP 29-118, the MSPRS must reduce the accidental disability award by $200/week based on the related workers' compensation award. Therefore, the TPS retiree is subject to two offsets, resulting in a monthly compensation of $50/week.

Issue 3: Delayed Notice of a Workers' Compensation Award

A workers' compensation award is often granted after an accidental disability has been awarded. Accidental disability retirees are instructed to notify the Agency if they are subsequently granted a workers' compensation award for the same injury for which they are receiving the accidental disability benefit. Many times, however, the disability retiree does not notify the Agency, and the Agency does not discover the related workers' compensation award until many months or years after the award. Recouping the double payment can lead to an almost total reduction of the retiree's monthly retirement allowance, resulting in claims of real or perceived hardship to the disability retiree.

Example:

- On March 1, EPS state employee is granted and accepts an accidental disability retirement for a Jan. 1 workplace accident for $1000/month.
- Agency instructs EPS retiree to report any subsequent workers' compensation awards
- July 1 Commission awards EPS retiree a $20,000 lump sum award
- EPS retiree does not report award to the Agency
- Two years later the Agency learns of lump sum award
- Agency reduces EPS retiree's monthly accidental disability benefit to maximum allowed to recoup the lump sum award, leaving little for retiree to live on.

Proposed Legislative Amendments:

Abolishing SPP § 29-118 and deleting reference to SPP § 29-118 from LE § 9-610

Abolishing SPP § 29-118 would mean the Board would no longer reduce accidental disability awards for related workers' compensation award payments. However, the retiree would not receive both accidental and workers' compensation benefits for the same injury. If SPP § 29-118 were abolished, LE § 9-610 would prevent the disability retiree from being paid for the same injury twice. In fact, LE § 9-610 would prevent the disability retiree from receiving any "similar" workers' compensation benefits. The employer or insurer that pays the workers' compensation award would reduce or "offset" the workers' compensation payments, based on the accidental disability award. In fact, this is the way all ordinary disability allowance offsets are handled now. In the case of State retirees, the State, through its third-party administrator, the Injured Workers' Insurance Fund ("IWIF"), would receive the offset.[2] In the case of TPS retirees, the respective local school boards would receive the offset. The Agency reports that because the local school boards now share in the costs of teachers' retirements their receipt of the workers' compensation offset is not a windfall to the local school boards.

The following charts demonstrate how the offset is taken when a MSRPS disability retiree receives a similar or related workers' compensation benefit currently and under the proposed amendments:

Offsets under the current law

	TPS/TRS retiree	State retiree	PGU retiree
Ordinary Disability	Employer reduces retiree's workers' compensation award (LE § 9-610)	State (IWIF) reduces retiree's workers' compensation award (LE § 9-610)	Employer reduces retiree's workers' compensation award (LE § 9-610)
Accidental/Special Disability	MSRPS reduces retiree's disability allowance (SPP § 29-118)	MSRPS reduces retiree's disability allowance (SPP § 29-118)	Employer reduces retiree's workers' compensation award (LE § 9-610)

Offsets under proposed amendments

	TPS retiree	State retiree	PGU retiree
Ordinary Disability	Employer reduces retiree's workers' compensation award (LE § 9-610)	State (IWIF) reduces retiree's workers' compensation award (LE § 9-610)	Employer reduces retiree's workers' compensation award (LE § 9-610)
Accidental/Special Disability	Employer reduces retiree's workers' compensation award (LE § 9-610)	State (IWIF) reduces retiree's workers' compensation award (LE § 9-610)	Employer reduces retiree's workers' compensation award (LE § 9-610)

=MSRPS offsets under the current law
=Offset provisions changed under the proposed legislation

[2] The State of Maryland's workers' compensation program is self-insured. LE § 10-102(d). IWIF is the third-party administrator of workers' compensation benefits to the State of Maryland. *Id.*

ATTACHMENT B

MEMORANDUM

TO: Administrative Committee

FROM: Andrew C. Palmer, CIO

THROUGH: R. Dean Kenderdine, Executive Director

DATE: September 6, 2016

RE: Board of Trustees Budget Authority – Investment Division

Executive Summary:

The MSRPS Investment Division is seeking legislative changes to invest the Board of Trustees of the Maryland State Retirement and Pension System with budgeting authority for the Investment Division. Specifically, the Board would have the authority to set compensation levels for staff, create and eliminate positions and approve investment-related expenditures to preserve and enhance the value of the System's assets. This recommendation is intended to alleviate the resource constraints faced by the division in attracting and retaining qualified personnel, creating additional positions, and providing other investment-related resources in a timely and responsive manner. These suggestions come after a review by the CIO found that the System's assets are at risk under the current process and the System is challenged to reduce fees through internal management and more broadly, meet the investment objectives of the System requires with the current level of budgetary flexibility.

Within existing statute, the CIO and the Board have authority to incur investment-related expenses, but excludes the work of the investment division from the definition of investment management expenses, which has been interpreted as fees paid to external managers. This legislative change would recognize the work of the investment division as investment management.

These requests stem from the CIO's assessment that:

1. The current level of staffing could put the System's ability to achieve its return objective at risk.
2. The compensation structure of staff contributes to turnover and poor alignment of interests between staff and the plan, which exacerbates the risk to the plan from low levels of staffing.
3. The level and compensation of staff are an impediment to internal management initiatives that are contemplated to lower System costs and improve the potential of achieving the System's return objectives.

4. The System's intention to create an internal investment capability and improve the System's potential to achieve its investment objectives requires more flexibility in obtaining investment management-related products and services.

Background:

Having joined the MSRPS Investment Division as CIO in July 2015, I have had the opportunity to review and analyze the division's staffing level and operations. I have found that the sophistication, size and complexity of the investment portfolio have outpaced the staffing levels. From the end of 2005 to the present, the plan has grown from 7 investment strategies and 50 accounts to 18 strategies and 380 investment accounts by 2016. During that same time, fund assets have grown from $33.7 billion to $46.2 billion, while Investments Staff has grown from 15 to 23.

During the past year, we have been examining our structure to identify opportunities to streamline processes and improve productivity and efficiency through software tools. Currently, we are evaluating client relationship management software to enhance our process to source, diligence and monitor the managers we engage. Another area of focus is the potential use of internal management to reduce the number of managers employed and the related fees. Internal management could also add value through tactical positioning of the portfolio based on perceived market opportunities.

While more accounts and a larger asset base may suggest that more staffing is appropriate, they do not provide guidance on the appropriate level of staffing. In 2015, the New York City Comptroller's Office contracted with the Funston Group to perform an operational review of the five pension systems and the investment office that supports them. The study is available on the Comptroller's website and provides some guideposts for staffing. A second, more limited study was performed for the New York Common Retirement Fund and is available on the state comptroller's website.

The reports suggest that the peer median number of investment staff with respect to asset size is .6 FTE/$1 billion. At 16 investment staff and $46 billion in assets, the MSRPS Investment Division has .35 FTE/$1 billion. The peer median investment staff for the System would be 27 full-time employees.

Funston further provided suggestions on the appropriate level of staffing per asset class. They found significant business risk in asset classes that were managed by only one person. The risks result from the lack of coverage depth, the lack of institutional continuity, periods of reduced oversight and opportunity cost from a reduced scope of inquiry into better investment alternatives. Currently, MSRA has six asset classes that are each managed by one person: fixed income, credit, absolute return, real estate, commodities and natural resources. In fact, four people are responsible for these six asset classes as well as the risk management function.

Lastly, Funston recommends a robust human resources function to reduce the risk of turnover. The elements they recommend are:

- Recruit superior investment talent
- Create strong onboarding practices
- Implement a robust training program
- Provide opportunity for career advancement

At present, MSRA does not have a robust human resources function. While the agency is able to recruit qualified individuals to work at the System, the compensation structure and lack of career advancement opportunities available in the division have limited the System to individuals who self-select into the agency because of geographic preference or the opportunity to rapidly gain experience that will be valuable to a subsequent employer.

The opportunity for career advancement within the Investment Division is limited due to the lack of hierarchy. Currently, there are two position levels, Senior Investment Analyst and Managing Directors. Barring turnover at the Managing Director level, analysts have no opportunity for advancement in position or salary, regardless of how their skills, experience or responsibilities expand. Managing Directors and the Deputy Chief Investment Officer have been offered some salary opportunity through the 2012 legislation that placed them in the Executive Salary Plan, but many of them are near the top of that pay scale. One recent Managing Director departure cited the pay cap as the primary reason for leaving.

Training and onboarding practices are weak given the limited overlap in asset classes to provide training to new employees.

In the New York City study, Funston noted that the poor compensation structure added to the risk of the System stemming from personnel issues. However, New York City was able to bypass this issue, highlighted in the study, because the Comptroller had already implemented a plan to improve compensation. For the New York Common Fund study, Funston found that:

> "...While the fund is currently well-managed, compared to most peers, it remains severely understaffed for its scale and complexity, with underdeveloped risk analysis and management capabilities and an over-reliance on outsourced investment management and support functions. In addition, independent compensation benchmarking indicates that PICM" (Division of Pension Investment and Cash Management)"staff compensation levels are in the bottom quartile for similar public pension funds. There is justifiable concern that current staff will leave if compensation is not increased, and it is likely that PICM will struggle to recruit needed new staff and stem turnover at current compensation levels."

The System's ability to attract and retain qualified personnel will depend on its ability to change the compensation structure within the division. Using publicly available data on compensation for state plans of similar size and structure, MSRA found that staff was in the bottom quartile of pay for most positions. This data compares MSRA salaries for 2015 against peer salaries from 2012 to 2015.

	MSRA	MSRA	2015 MSRA		PUBLIC DATA 2012-15		
Position	Title	Number	Mean Salary	Low Q	Median	Upper Q	Average
Executive Director	Executive Director	1	150.5		249.5	0	249.5
CIO	CIO	1	330	244	295	324	287
Deputy CIO	Deputy CIO	1	143.1	173	253	309	245
Team Leader Traditional Products	Managing Director	1	123.4	171	183	233	203
Team Leader Alternative Products	Managing Director	2	130.2	171	183	233	203
Senior Manager Ext	**NA**	**6**	**100**	**118**	**141**	**168**	**141**
Senior PM Fixed Income	Senior Analyst	0	0				
Senior Analyst Ext	Senior Analyst	2	94.3	100	110	126	111
Senior Compliance	Senior Compliance	1	90.7	n/a	n/a	n/a	n/a
Total/Average Investment Staff		13	108.2	122.6	143.7	174.5	147.8

The Peer group is highlighted in green in the table below and represents funds of similar size but only modest or no internal management.

Name	Total U.S. DB assets	% OF ASSETS MGD INTERNALLY
California Public Employees' Retirement System	$283,879	67%
California State Teachers' Retirement System*	$181,294	38%
New York State Common Retirement Fund	$173,541	57%
State Board of Administration of Florida	$139,231	43%
Teacher Retirement System of Texas	$125,327	36%
New York State Teachers' Retirement System	$101,828	63%
State of Wisconsin Investment Board*	$90,926	NA
North Carolina Retirement Systems	$85,511	26%
Ohio Public Employees Retirement System	$85,256	35%
New Jersey Division of Investment	$73,008	71%
Washington State Investment Board	$71,133	22%
Teachers Retirement System of Georgia	$62,529	100%
Retirement Systems of Alabama	$32,185	100%
Tennessee Consolidated Retirement System	$41,164	74%
Public Employees' Retirement Association of Colorado	$42,042	73%
State Teachers' Retirement System of Ohio	$68,676	70%
Employees Retirement System of Texas	$25,101	62%
State of Michigan Retirement Systems	$59,407	37%
Virginia Retirement System	$65,375	36%
Pennsylvania Public School Employees' Retirement System	$47,569	31%
Arizona State Retirement System	$33,680	26%
Oregon Public Employees Retirement Fund	$68,122	10%
Illinois Municipal Retirement Fund	$33,429	1%
Teachers' Retirement System of the State of Illinois	$43,450	0%
Minnesota State Board of Investment	$60,125	0%
Massachusetts Pension Reserves Investment Management Board*	$58,840	0%
Connecticut Retirement Plans & Trust Funds	$28,093	0%
South Carolina Public Employee Benefit Authority	$27,699	0%
Iowa Public Employees' Retirement System	$27,190	0%
Utah State Retirement Systems	$26,723	0%
Public School and Education Employee Retirement Systems of Missouri	$36,741	0%
Public Employees' Retirement System of Nevada	$32,991	0%
Commonwealth of Pennsylvania State Employees' Retirement System	$25,922	0%
Texas Municipal Retirement System*	$24,010	0%
Maryland State Retirement & Pension System	$43,691	0%

In addition to the staffing issues, we have identified additional resource issues that present challenges to the division under the existing budget process. The System's requirement for additional services and products changes from year to year as the asset allocation changes and markets evolve. In addition, staff's ability to engage in any level of internal management will require more flexibility in budgeting and timing than is afforded in the present process. The changing regulatory landscape is an additional driver of the need for responsiveness in the budgeting process.

Legislative Solution:

The staffing levels of the Investment Division present two areas of concern: systemic risk of understaffing and insufficient resources to develop an internal management function. The legislature has recognized the compensation issues facing the System and has made a number of changes that have provided the MSRPS Board salary-setting authority for the CIO, and with limitations, the Deputy CIO and Managing Directors. This authority has been effective in improving the System's ability to attract and retain senior staff, but has proven to be of temporary effectiveness as industry compensation has continued to expand. In addition, the compensation for the remainder of staff has become increasingly uncompetitive, and has been a significant impediment in attracting and retaining qualified staff.

Existing statute provides that investment management expenses are excluded from the state's budgeting process and are considered an expense of the fund. The work of the Investment Division has been interpreted to be an administrative expense and has been included in the State's annual budgeting process. In fact, the investment division performs the services of a fund-of-funds manager for the entirety of the System's assets. Its primary function is to preserve and enhance the value of the System's assets through advising the Board on asset allocation, making recommendations to the CIO on manager selection and termination, and monitoring the System's managers for compliance. All of these are investment management functions. In addition, to the extent the System manages assets internally, it will be directly supplying investment management services.

Expanding the Board's authority to encompass all of the resource needs of the Investment Division, both personnel and services, and redefining investment management expenses to include the expenses of the Investment Division will provide the needed flexibility to meet the System's needs and provide effective control of the expenses. In addition to the Board's oversight of these expenses, existing statute places a cap on investment management service costs incurred in public markets. MSRA expenses could be included in this maximum, providing an additional level of control.