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Maryland State Retirement Agency

Testimony of R. Dean Kenderdine, Executive Director

Before the

Senate Budget & Taxation Committee
February 11, 2019

&

House Appropriations Committee
February 14, 2019

Good afternoon, Chairman and members of the committee. As the Executive Director of the State Retirement Agency (SRA), it is my pleasure to present and discuss, on behalf of the System's Board of Trustees, the Agency's proposed budget for fiscal year 2021.

The SRA carries out two equally important business functions: the administration of member and retiree benefits, and the management of invested assets. The continued success of these two core processes is of critical importance to the more than 408,000 active, vested and retired State and local participating employees, teachers, police, judges, law enforcement officers, correctional officers and legislators whom we serve.

Investment Management

The Maryland State Retirement and Pension System earned a net investment return on invested assets of 6.46 percent in fiscal year 2019. After the payment of benefits, the market value of invested assets increased by approximately $2.1 billion, from $51.8 billion on June 30, 2018 to $53.9 billion on June 30, 2019, resulting in a funded ratio of 72.9 percent (72.2 percent, excluding participating governmental units) as of June 30, 2019 compared to 72.5 percent (71.6 percent, excluding participating governmental units) at the end of fiscal year 2018. The top-performing asset class for the year was Rate Sensitive, which consists of government and corporate bonds.

Net Returns as of June 30, 2019

	1 year	3 year	5 year	10 year
Total Plan	6.46%	8.17%	5.62%	8.61%
Policy Benchmark	7.09%	8.18%	5.36%	8.04%

According to preliminary performance reports as of December 31, 2019, the System's total investment portfolio returned 5.17 percent, net of all fees and expenses, on investments for fiscal year-to-date, trailing the policy benchmark by one basis point, or 0.01 percent. The market value of assets as of December 31, 2019 was approximately $56.1 billion.

The System's investment performance during fiscal year 2019 is summarized in the following exhibit:

	FY2019 SRPS Performance	FY 2019 Benchmark Performance	SRPS Allocation June 30, 2019
Public Equity	3.89%		36.4%
Custom Benchmark		4.65%	
U.S. Equity	8.2%		12.2%
Russell 3000		9.0%	
International Equity	0.4%		7.2%
MSCI World ex U.S.		1.3%	
Emerging Markets Equity	3.3%		9.4%
MSCI Emerging Markets		1.2%	
Global Equity	1.8%		7.5%
MSCI AC World Index		5.7%	
Private Equity	13.7%		14.0%
Custom State Street PE		10.9%	
Rate Sensitive	9.4%		18.2%
Custom Benchmark		9.8%	
BC U.S. Gov't Long Index		12.3%	
BC U.S. TIPS Index		4.9%	
Credit/Debt Strategies	6.5%		8.9%
Custom Benchmark		7.3%	
BC High Yield		7.5%	
S&P LSTA Leveraged Loan		4.0%	
JP Morgan GBI EM GD		9.0%	
JP Morgan EMBI GD		12.5%	
JP Morgan CEMBI Broad		10.7%	
Real Assets	5.3%		13.3%
Custom Benchmark		6.2%	

NCREIF ODCE		7.5%	
FTSE EPRA NAREIT		7.7%	
Natural Resources and Infrastructure Custom Benchmark		2.1%	
Absolute Return	3.0%		7.4%
Custom Benchmark		3.1%	
Multi-Asset	4.4%		1.3%
Custom Benchmark		7.1%	
Cash	2.3%		0.5%
3-Month T-Bill		2.3%	
TOTAL FUND	**6.5%**	**7.1%**	**100%**

The **public equity portfolio** returned 3.9 percent, compared with a return of 4.7percent for its blended benchmark. The program has three components: U.S Equity, International Developed Equity and Emerging Markets Equity.

The U.S. public equity portfolio returned 8.2 percent, trailing the return of the Russell 3000 Index by 82 basis points. The international equity portfolio returned 0.4 percent compared to 1.3 percent for its benchmark, the Morgan Stanley Capital International (MSCI) World ex-U.S. Index. The emerging markets equity program returned 3.3 percent, exceeding the 1.2 percent for its benchmark, the MSCI Emerging Markets Index, a broad measure of stock performance in emerging markets.

The **rate sensitive portfolio** returned 9.4 percent, compared to 9.8 percent for its blended benchmark: 53 percent Barclays US Government Long Bond Index, 13 percent Barclays US Investment Grade Corporate Index, 13 percent Barclays US Securitized Index, and 21 percent Barclays US TIPS Index.

The **credit/debt strategies portfolio** returned 6.5 percent compared to 7.3 percent for its blended benchmark. The portfolio has a blended benchmark of 78 percent U.S. (80 percent BC U.S. Corporate High Yield Index, 20 percent S&P LSTA Leveraged Loan Index), and 22 percent Non-U.S. (50 percent Bloomberg/Barclays Emerging Markets Local Government Index -30 basis points, 25 percent Bloomberg/Barclays Emerging Markets Hard Currency Sovereign Index, 25 percent Bloomberg/Barclays Emerging Markets U.S. Dollar Aggregate Corporate Index).

The **real assets portfolio** returned 5.3 percent, compared to 6.2 percent for its blended benchmark, which consists of 71 percent real estate (85 percent NCREIF ODCE Index, 15 percent FTSE EPRA/NAREIT Index) and 29 percent natural resources and infrastructure (60 percent S&P Global Natural Resources Index and 60 percent Dow Jones-Brookfield Infrastructure Index.

The **absolute return portfolio** returned 3.0 percent, trailing the 3.1 percent return of its customized benchmark, which is the Hedge Funds Research, Inc. (HFRI) Fund of Funds Conservative Index plus 1 percent.

The **private equity portfolio** returned 13.7 percent, compared to the 10.9 percent return of its customized benchmark, the State Street Private Equity Index (one quarter lag). The program is expected to produce returns in excess of the public equity markets.

The System's **Terra Maria** program is comprised of smaller investment management firms—including many that are minority and/or women owned—focusing primarily on equity and fixed income investments. For fiscal year 2019, the program returned -0.5 percent, compared to 0.3 percent for its customized benchmark. While annualized performance for the five years ending June 30, 2019 has been negative relative to it customized benchmark, the return since inception has added value. Since inception, the Terra Maria program has achieved an annualized return of 5.3 percent, compared to 4.8 percent for the benchmark. It should be noted that the Terra Maria program was restructured in the second half of fiscal year 2017, and since the restructuring was completed, performance has improved.

The Investment Division regularly solicits input on investment opportunities and best practices from several sources. The System's investment consultants are broadly utilized across the total portfolio in assisting staff in sourcing new investment ideas that improve the risk/return efficiency of the fund. Consultants are also helpful in providing insight into new trends and ideas among other public pension funds. The System also belongs to several trade associations, and participates in selected investment conferences, that are useful in establishing peer contacts and gaining market insight. By attending conferences that focus on emerging managers, the System can meet, and provide access to, promising smaller managers that might not be identified in the normal search process. Existing and prospective investment managers are also a valuable source of information in terms of market trends and investment opportunities.

Chapter 728 of the Acts of 2018 grants the Board of Trustees broader authority in its management and oversight of the investment of System assets. The law authorizes the Board to set and approve the budget for the personnel and operational expenses of the Investment Division. The Board is now able to determine and create the type and number of investment positions necessary for carrying out the functions of the Investment Division and set the compensation for these positions.

The Board began applying the new compensation criteria in March 2019 with salary adjustments for most Investment Division staff that moved compensation closer to industry peers. With a new, more competitive salary structure, the Investment Division has been able to hire four experienced investment professionals, three of whom will focus on the Board's initiative to begin managing System assets in-house. The System would not have been able to recruit these individuals under the prior pay scale, which was not competitive relative industry peers.

The transition to internal management will result in significant fees savings to the System net of the additional expenses to develop the program. The initial internal portfolio was funded on July 1, 2019 and invests in U.S. Treasury Inflation Protection bonds. As of December 31, 2019, the size of this account was $2.1 billion. It is expected that several new internal mandates will be funded over the next year as staff demonstrates continued skill and experience in the implementation of internal management.

Chapter 728 also provides the Board with the authority to determine the qualifications, salary levels and performance incentives for Investment Division staff, subject to certain restrictions. For example, increases in compensation may not exceed 10 percent in any fiscal year. In addition, the Board may not grant any increases in compensation in a fiscal year in which state employees are subject to a furlough.

Chapter 728 also requires the Board to adopt objective criteria for setting the qualifications and compensation of positions within the Investment Division, as well as awarding financial incentives. In developing these objective criteria, the Board was required to form an Objective Criteria Committee. The role of the Objective Criteria Committee was to work with a third-party compensation consultant to recommend objective compensation criteria to the Board.

In April 2019, the Board also approved an incentive compensation program for investment-focused staff. This program is designed to reward staff for investment performance that exceeds policy benchmark targets and the System's actuarial assumed rate of return. In compliance with the statute, the Board approved maximum annual incentive compensation up to 33% of base salary for select positions within the Investment Division. To date, no incentive compensation has been paid under the new incentive plan as the initial measurement period is the fiscal year ending June 30, 2020.

Business Process Re-Engineering and Organizational Transition

Starting in January 2018, the Agency formally commenced the third phase of its Maryland Pension Administration System (MPAS) strategy, or "MPAS-3" – a multi-year initiative to re-engineer the retirement administration's business function operations. MPAS-3 is a Major IT Development Project (MITDP) as directed by the General Assembly, under Department of Information Technology (DoIT) oversight.

During the past 12 months, three critical solutions have been achieved:

1. A customer relationship management (CRM) solution was purchased and implemented, providing a new and efficient way for our staff to view retirement data and track all contacts with participants, including phone calls, emails, and one-on-one counseling appointments. The CRM is the foundation from which the agency will track future cases. As we begin our business processing re-engineering, the CRM will provide the Agency with the tools to automate our business processes using the CRM workflow feature.

2. Member Document Storage (MDS), an application which serves as the central document repository for the Agency was created to provide greater flexibility to integrate with other systems, such as CRM. The Agency has successfully migrated over 13 million documents to the new system.

3. The implementation of a new scanning software solution that includes character and format recognition. The software properly identifies over 60 agency forms, including character recognition of the participant's name and Social Security number. This solution has increased the productivity of our office services division and has reduced indexing errors.

Finally, we are very excited to announce that *mySRPS*, our secure participant portal has just launched. This application will allow participants to view their account information, print asset and income verification letters, view and print Personal Statement of Benefits and 1099R tax documents. Retirees can also change their address information and tax withholdings online and in real time. For our active members, the feature that we are most excited to provide is the benefit estimate wizard. This feature will allow members to estimate their monthly retirement benefits at any time. We expect this feature to significantly reduce the number of estimates processed by our internal staff. A *mySRPS* "sneak preview" was conducted in December 2019 to universal acclaim. The portal is protected by a commercial internet web application firewall and monitored by several commercial products that were at the "proof-of-concept" stage a year ago.

During the implementation of *mySRPS*, the agency ran into significant issues with a 3rd party vendor, causing a delay in rolling out the site to our participants. However, the project is still on budget and on track to deliver the long-sought return on investment in terms of improving member service and increasing efficiency of Agency operations. The proposed FY21 budget will allow MPAS-3 to progress unabated toward completion.

Several Agency divisions will be impacted by this initiative, and budget-related considerations will be highlighted in sections that follow.

Information Systems

The Agency's data and voice technology platforms continue to operate reliably with virtually no production downtime. Most Agency IT staff are in-house; however, daily operations continue to be supported by two consulting and technical services systems development supplemental staffing task order contracts. Those two contracts also provide programmer and business analyst support for the third phase of the Maryland Pension Administration System (MPAS-3). The Agency requests approval of the Information Systems operating budget submission.

Fiscal Year 2020 to date has seen significant IT achievements, capitalizing on investments made over the past several years. Over the last year – in addition to the CRM, MDS, and mySRPS discussed under Business Re-Engineering – the Agency completed and deployed applications discussed at the 2019 legislative session:

- Significant progress in replacing existing Agency paper-based batch computing operations with online, real-time applications, now poised to extend those online operations to participants and employers over the next two years;
- Improved employer payroll data reporting, incorporating better up-front data editing to continue the Agency's progress in improving data integrity;
- A now one-year-old public web site, capable of being maintained by the Agency's External Affairs staff with little technical assistance;
- Improved data storage and back-up utilities, as foundations to handle future agency needs; and
- Provisions for business continuity/disaster recovery that reflect the additional technology.

SRA's technology profile evolves to match the Agency's increasing use of applications and sophisticated platforms to conduct business. The Agency has built and embraced a "hybrid" environment, combining on-premesis hardware and software with cloud-based applications and processing. Microsoft's Dynamics 365 CRM and Office 365 are now part of the primary production environment, and the *mySRPS* participant portal that is now going live, combines on-premesis and cloud-based technical components.

Adapting to the changes in the computing environment, new IT security tools have enhanced existing protections to provide a more secure processing environment. Where it has made practical and operational sense, commercial security products have been used. For example, baseline *mySRPS* user authentication is handled through a packaged product integrated with Agency software, all of which has been tested independently to ensure appropriate access controls and data integrity. As new features are incorporated into this portal, and the IT security risk profile evolves, the Agency plans to reflect these changes with improved/advanced commercial user authentication services.

The Agency notes that the MPAS-3 MITDP has supported the transition to these new levels of automation and customer service. This transition has been challenging, but anticipated benefits are coming to fruition. In addition to the requested FY21 operating budget, funds are requested to continue progress being made on MPAS-3, scheduled to be completed in FY22.

As discussed earlier, the Investment Division continues its progress towards internal portfolio management. The Information Systems Division supports this progress with more powerful workstation platforms, improved connections to external resources, integration with Internet-based investments management platforms, and a reliable computing environment that is in the process of being segregated from the Agency's other network components to improve performance and security.

In the last legislative session, five new IT positions were approved. Recruitment has moved forward to bring these resources on board, and to direct them to build and support the additional infrastructure, applications, and IT security needs discussed above.

Benefits Administration

Active membership increased slightly from 192,431 in fiscal year 2018 to 193,458 in fiscal year 2019. We also continue to see steady and consistent increases in the number of annuitants. At the end of fiscal year 2019, the number of retirees and beneficiaries receiving benefits increased slightly more than 2.8 percent to 164,892 compared to 160,374 in the previous fiscal year. Over a ten-year period, the total number of annuitants has grown slightly more than 37 percent from 120,247 in fiscal year 2010 to 164,892 in fiscal year 2019. Our current number of retirees and beneficiaries receiving monthly allowances is more than 167,000, as a result of new retirements since July 1, 2019.

As in previous fiscal years, the Benefits Administration Division has continued to experience a significant number of vacancies in most units. Recruitment challenges require constant re-allocation of staff within the production areas of the Division to ensure timely completion of critical tasks and to minimize delays and backlogs in less critical duties. Hiring and retaining qualified staff has remained a challenge for most units of the Division throughout the fiscal year.

Overall, the Member Services Unit's Call Center was not able to meet our performance measures for fiscal year 2019. This trend has continued into fiscal year 2020. The improvement of the Call Center's performance is a top priority for the Benefits Administration Division for the remainder of this fiscal year and until performance has significantly improved and we are once again meeting the performance goals.

One of the key challenges to the attainment of the performance goals remains the hiring, training, and retaining of staff who are able to handle the large volume of calls being received in the Call Center. Also affecting performance have been the numerous trainings required throughout the fiscal year as the Agency successfully rolled out several new applications, including: a new document imaging system, Member Document Storage, a new Customer Relationship Management (CRM) System. Additionally, numerous trainings have occurred to prepare staff in the Member Services Unit and particularly the Call Center for the roll out of the new secure member portal, *mySRPS*. While these new applications should lead to improved performance in the long term, in the short term the numerous training sessions and the learning curves for staff to become proficient in using them has had a negative effect on the Call Center's performance.

In addition to focusing on staffing and training improvements, we will also be working on several other initiatives to improve the performance of the Call Center. The goals of this initiatives will be to reduce the number of incoming calls, reduce the amount of time each call takes to resolve, and reduce the number of occurrences where a caller needs to call the Call Center more than one time. We will also be closely monitoring the effect of the roll out of *mySRPS* on the Call Center's performance. The Agency's Call Center performance measures for fiscal year 2019 are summarized below:

Performance Measure	**Performance Goal**	**FY2019 Performance Average**
Call Abandonment	Not to exceed 7.50%	14.88%
Average Wait Time	Not to Exceed 135 seconds	270 seconds

2011 Benefit Reform Scorecard

Reforms enacted by the Maryland General Assembly in 2011 and in subsequent years continue to show positive results for the System and, in fact, continue to exceed earlier projections (see chart below). The System is on track to be 80% funded by 2026; 85% funded by 2030; and 100% funded by 2039.

Projected June 30, 2019 Results
on June 30, 2010 Valuation

	Before Reforms	After Reforms	Actual Results 2019 Valuation
FY 2021 Contribution Rates No Reinvestment (% of Pay)			
ECS (State)	22.67%	18.84%	20.71%
TCS	22.19%	18.40%	14.96%
All State Plans	23.21%	19.35%	17.75%
June 30, 2019 Funded Ratio No Reinvestment			
All State Plans	67.4%	67.3%	71.2%
June 30, 2018 Funded Ratio Reinvestment			
All State Plans	67.4%	71.0%	72.2%

The 2010 valuation was the basis for the original estimates and projections related to potential effects of the 2011 reforms. Certain changes since implementation of reforms affect the comparability of the figures:

1) Systems are now receiving Actuarially Determined Contributions based on 25-year closed amortization of unfunded actuarial accrued liability (UAAL) ending in FY 2039. Elimination of the corridor funding method resulted in a large contribution increase for the Employees' Combined System (ECS). The change was very small for the Teachers' Combined System (TCS).
2) The General Assembly lowered reinvested savings to $75 million from the original $300 million in two steps beginning in FY 2014.
3) Both demographic and economic assumptions have changed since 2010 acting to increase contributions and decrease funded ratios.
4) There was an overall favorable experience since 2010 (except ECS) which decreased actuarial contribution rates and increased funded ratios.

Agency Response to Operating Budget Recommended Action

The Agency concurs with the analyst's recommendation.