



Pension Oversight Commission

June 29, 2017

Mr. Allan Kittleman, County Executive  
Howard County Government  
3430 Court House Drive  
Ellicott City, MD 21043

Mr. Jon Weinstein, Chairperson  
Howard County Council  
3430 Court House Drive  
Ellicott City, MD 21043

Dear Mr. Kittleman and Mr. Weinstein:

Enclosed is, for your review, the Annual Report of the Pension Oversight Commission for the Howard County Retirement Plan and the Howard County Police and Fire Employees' Retirement Plan. The Annual Report is presented as one document for both Plans and covers the fiscal year 2016, ending June 30, 2016.

Should you have any questions, please feel free to contact us.

Sincerely,

Todd D. Snyder  
Chair

cc: Ms. Toshie Kabuto, Commission Member  
Mr. Mitchell Stringer, Commission Member  
Mr. Peter Hong, Commission Member  
Mr. Ken Barnes, Commission Member  
Ms. Wanda Hutchinson, Chair, Retirement Plan Committees  
Ms. Teresa Reider, Howard County  
Mr. Scott Southern, Howard County  
Ms. Cynthia Peltzman, Howard County

**ANNUAL REPORT BY THE HOWARD COUNTY PENSION OVERSIGHT COMMISSION  
FOR THE FISCAL YEAR ENDED JUNE 30, 2016**

**Introduction**

The Howard County Pension Oversight Commission (the “Commission”) hereby submits its annual report of the status of the Howard County Retirement Plan (the “Retirement Plan”) and the Police and Fire Employees’ Retirement Plan (the “Police and Fire Plan” and together with the Retirement Plan, the “Plans”) to the County Executive and the County Council for the fiscal year ended June 30, 2016. This report includes:

- i. The Commission’s assessment of the appropriateness of the actuarial assumptions used;
- ii. A statement of revenues, including contributions, investment earnings, and forfeitures;
- iii. The cost of the Plans, including an analysis of fees, commissions and expenses;
- iv. An evaluation of the administration of the Plans; and
- v. Any proposal or amendment of the Plans that the Commission may wish to recommend.

**Introduction**

The Actuarial Reports for the Plans dated July 1, 2016 submitted by Bolton Partners Inc. indicated the funding level, based on Market Value of Assets, for the Plans decreased at FYE 2016 compared to FYE 2015, as follows:

	FYE 2015	FYE 2016
Retirement Plan	81.8%	78.2%
Police and Fire Plan	94.0%	90.5%

Funding levels are higher assuming actuarial value of assets, which applies “smoothing” to investment returns.<sup>1</sup>

Despite these decreased funding levels, the funding level of the Plans appears to

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<sup>1</sup> Smoothing spreads market value investment gains or losses in excess of the assumed return over a 5-year period.

compare favorably to a survey of large public plans. The Public Fund Survey of the National Association of State Retirement Administrators (the "Survey") indicated an aggregate actuarial funding level of 73.7% for FY 2015.

While funding levels benefitted from lower than expected pay increases and COLA adjustments, the primary driver of the decrease in funding levels for the Plans appears to be investment performance below expected levels as follows:

	Current Actuarial Return Assumption	Actual Investment Return for FYE 2016	10 Year Investment Return as of FYE 2016
Combined Plans	7.5%	1.61%	5.65%

Over the past five years, the pension industry has seen increasing allocations to alternatives and real estate. The Plans allocation model has also increased its allocation to alternatives and real estate, and currently includes allocation to alternative investments and real estate, compared to the Survey, as follows:

	Target Allocation	Actual Allocation for FYE 2016	Survey Allocation
Alternative Investments	22%	22.07%	17.8%
Real Estate	7.5%	4.74%	6.3%

## Recommendations

The Commission makes the following recommendations with respect to the Plans:

1. **Periodic Re-Evaluation of Service Providers to the Plans.** Summit has been the Plans' investment consultant since 2004. While the Commission has no reason to believe that the services provided by Summit have been any less than best in class or otherwise insufficient, the Commission reiterates its recommendation from its previous report that the Plans adopt a formal policy to re-confirm the Plans' investment consultant and establish periodic independent reviews at least once in every five years to ensure that the County would receive best-in-class services available to retirement plans within the Plans' size at competitive fees. Factors to be considered in this regard include: (i) as the Plans grow in size, additional potential investment consultants may become available to the Plans that were not previously interested in the Plans due to limited size, (ii) comparison to offerings of other consultants may reveal additional or improved services of benefit to the Plans, (iii) there may be an opportunity for potential fee

reductions and (iv) a re-evaluation will allow for an evaluation and comparison of overall performance.

While a representative of the Retirement Plan Committees (the "RPCs") have recently indicated that they expect to re-assess the investment consultant in the next year through an RFP, the Commission believes a best practice would include a periodic re-assessment requirement, rather than ad-hoc re-assessments at the discretion of the RPC. The Commission also recommends that this requirement be applicable to other retained consultants hired at the discretion of the RPC, such as actuarial consultants, legal and other advisory functions. As such, the Commission recommends that the Howard County Council consider an amendment to the appropriate statute requiring a minimum periodic re-evaluation of any investment consultant or other material service provider retained by, or for the benefit of, the Plans.

2. **RPC Staffing.** In its letter to the County Council and the County Executive relating to the fiscal year ended June 30, 2015 (the "FYE 2015 Letter"), the Commission recommended that the County assess whether hiring an experienced internal investment professional would be beneficial and cost effective in the oversight of the Plans. While a representative of the RPC recently indicated they would take this recommendation under advisement, it does not appear that any action has been taken to date. The RPC representative indicated, generally, that the hiring of a full-time employee is unreasonable given the size of the plans below \$1 billion. It was also indicated that RPC members are encouraged to receive training and the Plans' investment consultant provides semi-annual education course.

The members of the RPC serve an important role to the Plans. The RPC and the Howard County Human Resources Department dedicated to the Plans include individuals with broad and varied capabilities that benefit the Plans. While we have not performed a detailed assessment of these capabilities, we continue to believe that the Plans should maintain an independent capability to assess areas of investment allocation and investment management advice being provided by any investment consultant, among other capabilities. Thus, regardless of whether such capabilities currently exist or not, we continue to recommend that such it be required that such services be available to the Plans separate from the services of the investment consultant, and that the existence of such capabilities be documented. The "check and balance" capabilities regarding investment allocation and investment management could come from an employee hired by the Human Resources Department, full or part-time, or could be provided an independent consultant hired to periodically attend meetings and advise the RPC regarding the services of the investment consultant and act as a second opinion as to recommendations.

With respect to RPC member education, we understand that certain members have obtained voluntary training and that the investment consultant provides semi-annual training. We recommend that the RPC establish a documented formal training and education requirement and program for its members, including a description of topics for which each member will obtain training. In

this regard, some topics are identified in a report issued by the American Federation of State, County and Municipal Employees (AFSCME) titled: Enhancing Public Retiree Pension Plan Security: Best Practice Policies for Trustees and Pension Systems.

3. **Code of Ethics.** In its 2015 FYE Letter, the Commission recommended that the Plans adopt of the Code of Conduct for Members of a Pension Scheme Governing Body issued by the CFA Institute. Apparently in response to the recommendation, the Plans adopted a Code of Conduct. However, the basis for the Code of Conduct established by the Plans is unknown, and the Plans have not provided any assessment as to whether the adopted Code addresses each of the areas addressed in the recommended Code of Conduct. The Commission recommends that the Plans demonstrate that the Code of Conduct adopted was based on a widely-recognized Code of Conduct for similar entities, and provide an analysis of any changes made to such widely-recognized Code of Conduct. The Commission believes that absent such analysis, it is difficult to assess whether the adopted Code of Conduct is sufficient. We note that the Commission does not have staff capable of making this comparison itself.
4. **Alternative and Illiquid Investments.** In its FYE 2015 Letter, the Commission recommended that the RPC evaluate the potential implications of increased allocation to alternative investments, such as real assets, private equity and certain hedge funds and that the Plans establish minimum investment criteria, such as a requirement that all alternative investments provide annual financial statements audited by a reputable accounting firm. It is unclear what steps have been taken in response to the recommendation, except that an RPC representative indicated, generally, that the RPC continually evaluates the risk tolerance of the Plans and feels that with the Plans still being young can take on more risky, illiquid types of investment.

Given the additional risk and illiquidity of alternative investments, including illiquid real estate investments, we believe the Plans should exercise care and a higher degree of scrutiny with such investments, and, at a minimum, evaluate the process and procedures implemented by the investment consultant with respect to assessing risks of such investments, both individually and in the aggregate.

The Commission also recommends that the Plans establish minimum investment standards for private illiquid investments that may include items such as a requirement for audited financial statements, independent valuation and custody of assets and key corporate governance considerations.

5. **Funding Goal.** In its FYE 2015 Letter, the Commission recommended the Plans require clear reporting to show how and when pension plans will be fully funded based on projected future contributions and reasonable actuarial assumptions. In response to the request that this requirement be implemented, a representative of the RPC indicated that there is no requirement that a pension plan be fully funded or attain full funding. While there may not be a legal requirement, the funding ratio of a pension plan is recognized indicator of financial health. For example, Standard & Poors' rating criteria for U.S. States

includes an assessment of pension liabilities that considers four criteria, one of which is the pension funded ratio. The criteria also discuss the estimated amortization of the unfunded liability. The Commission recommends that a plan for full funding of the Plans be a stated goal of the Plans and the Plans should have a plan in place to reach such goal over a reasonable period of time of no more than 20 years.

6. **Investment Return Assumption.** Generally, the Plans' investment return assumption has the greatest effect on the projected long-term cost of the Plans and measurements of overall health. Changes in the Plans' investment return assumption that may appear small can impose a disproportionate impact on a funding level and cost as reported in the Actuarial Reports for the Plans. For example, the Notes to the Audited Financial Statements for the Retirement Plan indicate that Net Pension Liability would increase from approximately \$58 million to approximately \$113 million if a 6.5% discount rate were used instead of a 7.5% rate.

A reoccurring recommendation by the Commission is to consider lowering the Plans' investment return assumption for the reasons set forth therein. While the investment return was lowered in 2015 from 7.75% to 7.5%, the Commission notes that Fitch Ratings recently changed its discount rate from 7% to 6% for public pension plans in connection with ratings criteria. Further, Summit, the Plans' investment consultant, indicated a 6.6% expected return for the Plans' allocation target in its September 29, 2016 review. It is noteworthy that the 6.6% expected return assumed that the investments would outperform the market (beta) by 0.6%, further indicating a market return expectation of 6% for the Plans' target mix, well below the 7.5% assumption used by the Plans.

The Commission continues to believe that the 7.5% assumption used by the Plans is potentially too high and may understate the liabilities of the Plans and, potentially overstate the health of the Plans themselves. The Commission recommends that the Plans be required to undertake an independent study to assess and validate the reasonableness of the investment return assumption adopted by the Plans for evaluation of the Plans and their actuarial report.

7. **Closed Meetings/Confidentiality.** The RPCs appear to hold certain meetings during closed sessions, including those relating to evaluation and discussion of investment in potentially riskier illiquid investments. Further, access to documentation regarding these investments appears to be limited by confidentiality agreements. To date, the Commission has not been provided to access to confidential and closed-door information regarding certain illiquid and potentially riskier assets, limiting its oversight function. Further, the inability of the public to have access to information regarding these investments limits transparency and the ability to assess risk of the Plans. While over 22% of the Plans' assets are invested in these alternative and illiquid investments, public documents and information available to the Commission, do not provide sufficient information to assess the Plans' monitoring and management of the various risks relating to such investments, including market risks, and fees.

In regard to closed-door meetings and investment in private alternative and illiquid investments discussed as such meetings, we recommend that the Commission be allowed to attend closed meetings to allow it to assess these investments as part of its oversight function relating to administration of the Plans, or that the Commission receive clarification that assessment of the risk profile of the Plans investments is outside the scope of Commission assessment. A member of the Commission disagreed with this recommendation by the Commission and believes that the Commission does not need to have access to confidential closed door meetings of the RPC as such access would be beyond the scope of the Commission.

8. **Documentation of Procedures.** While the Plans and its consultants have represented the existence of a substantial investment process, including due diligence, oversight and monitoring procedures, it does not appear that these procedures are fully documented. The Commission recommends that the Plans adopt written procedures to document their processes and procedures, and findings by applying such processes and procedures, for investment selection, monitoring and due diligence, and/or review and assess these processes and procedures implemented by its consultants. We also recommend that these policies and procedures be made available to the Commission for purposes of oversight and that a process be implemented to test adherence to the policies and procedures as an internal control.
9. **Access to Plan Materials.** During our review process, it has become apparent that information relating to documentation of the Plans that could be made available to the public, or otherwise to the Commission, is not easily accessible through an electronic database. We recommend that the County establish an internet-based document management system for all Plan information, such as financial statements, actuarial reports, RPC minutes and other materials, through a web-based system to allow access to the public, with respect to non-confidential information, and to the Commission, for other items that would be made available to the Commission.

### **Evaluation of the administration of the plans**

The Commission's evaluation of the administration of the plans includes the recommendations in the above Recommendations section.

### **Statement of revenues, investment earnings, and forfeitures**

The Plans' combined investment earnings were below expectations for the year ended June 30, 2016. Overall returns were 1.61% for the fiscal year, approximately 0.21% lower than the implementation index returns of 1.82%. A summary of changes in fiduciary net position for the fiscal year ended June 30, 2016 follows:

	Police and Fire Plan	Retirement Plan
Beginning Year Assets	\$410,270,616	\$354,412,830
Investment Income	7,797,088	5,857,896
Investment Expense	(1,338,181)	(1,114,525)
Contributions	28,677,162	17,185,416
Benefits	(17,889,631)	(13,700,350)
Administrative Expenses	(326,833)	(341,734)
End of Year Assets	\$448,948,629	\$362,299,533

### **Analysis of fees, commissions and expenses**

The Commission feels the Plans' fees and expenses at the Plan level appear to be reasonable and in line with the Plans' recent past.

However, we note that we were not provided with sufficient information to review and assess the fees and expenses for alternative and illiquid investments, especially at the underlying fund level with respect of fund of funds. These investments may contain complex fee arrangements, carried interests and fees at sub-funds in a fund-of-funds structure. While the County did provide some information, the fee levels were not compared to a competitive set, and included limited detail, especially relating to potential carried interests. We believe that further detail and analysis of the overall fees and expenses at for these types of investments may be beneficial.

### **Actuarial Review**

#### *County's Pension Contributions*

The Commission reviewed the Actuarial Valuation Reports dated July 1, 2016 submitted by Bolton Partners Inc. The principle objective of the reports is to determine the Plans' contributions for the fiscal year 2018 (starting July 1, 2017). The actuarially determined contribution amount for the Police and Fire Plan increased to \$25,940,154 for fiscal year 2018 from \$23,517,289 in the previous year. The contribution amount for the Retirement Plan increased from \$12,854,151 for fiscal year 2017 to \$13,647,657 for 2018. The primary risk incurred by a defined benefit plan sponsor is the risk of substantial increases in annual contributions.

#### *Funded Ratios*

The funded ratios, as reported in the Auditor's Report for the fiscal year 2016, are 76% for the Police and Fire Plan, and 86% for the Retirement Plan, respectively. The ratios are calculated using the market value of the plan assets as of June 30, 2016 and the present value of the plan liabilities. A ratio of less than 100% indicates that plan assets are less than estimated plan liabilities. The Government Finance Officers Association



(GFOA) recommends a target funded ratio of 100% or more (full funding) in their Best Practice<sup>2</sup>.

For the funded ratio calculation, the value of pension assets is simply determined based on the market value of the assets on the valuation date. Determining the value of pension liabilities is, however, more difficult and requires the following two components of assumptions: (1) the expected future cash stream of pension benefit payments and (2) the discount rate used to determine the present value of the expected future cash stream.

The expected future cash stream of the benefit payments is determined by an actuary with a set of assumptions, such as future salary increases, future mortality rates and disablement rates to mention a few examples. The details of the assumptions used to calculate the future cash stream of the pension benefit payments are based on the experience study issued on June 26, 2014 by Bolton Partners. The study covers the period from July 1, 2009 through June 30, 2013. The next experience study will be issued in 2018 covering the period from July 1, 2013 through June 30, 2017.

Once the actuary determines the expected future cash stream of payments, a discount rate is applied to calculate the present value of all the future benefit payments to determine the pension liabilities on the valuation date. As pension benefits are long-term in nature, the present value of the pension liabilities is extremely sensitive to the level of discount rate. The higher the discount rate, the lower the present value of the pension liabilities will be. To determine the pension liabilities for the fiscal year 2018, the discount rate used is 7.50%. The discount rate is selected based on the expected long-term rate of investment return of the plans.

To assess the appropriateness of the discount rate used for the pension liability calculations, the Commission reviewed the long-term capital market assumptions as of June 30, 2016 prepared by the Summit Strategies Group. Table 1 provides a summary of the review.

The Commission believes that the Summit Strategies Group's latest long-term capital market assumption, which is updated annually, are reasonable and reflect the low interest rate and low risk premiums environment. The Commission assessed the expected rate of investment return based on the target weight of each asset under the policy asset allocation. The expected rate of return of the portfolio would be 5.87% using the Summit Strategies Group's long-term capital market assumptions.

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<sup>2</sup> "Sustainable Funding Practices for Defined Benefit Pension Plans and Other Postretirement Benefits," January 2016

**Table 1. Long-Term Capital Market Assumptions and Investment Return**

	<b>Expected Sector Return</b>	<b>Expected Alpha Return</b>	<b>Target Weight</b>	<b>Expected Rate of Return</b>
Large Cap Composite	5.25%	0.25%	15.00%	0.83%
Non-Large Cap Composite	5.00% 1/	0.75% 1/	5.00%	0.29%
Intl. Developed Markets Composite	6.5% 2/	0.75% 2/	13.00%	0.94%
Emerging Markets Composite	8.50%	0.75%	7.00%	0.65%
Core Plus Fixed Income	2.75%	0.50%	25.00%	0.81%
Emerging Market Debt	6.25%	0.25%	5.00%	0.33%
Real Assets Composite	6.00% 3/	0.25% 3/	7.50%	0.47%
Private Equity	8.00%	1.00%	10.00%	0.90%
Hedge Fund Composite	4.50%	0.75%	12.50%	0.66%
Cash Composite	2.00%		0.00%	0.00%
<b>Plan Total</b>			<b>100.00%</b>	<b>5.87%</b>

Source: Summit Strategies Group, Asset Allocation Review, September 29, 2016

Note: 1/ Small Cap Sector Return

2/ Intl. Large Cap

3/ Core Real Estate

The Commission believes that the discount rate used to assess the present value of the pension liabilities for the fiscal year 2018 is too high relative to the rate of investment returns which would be reasonably expected in the long-term. Several Commission members had a conference call with Summit's representative on April 20, 2017. Summit's representative concurred that the County's 7.50% return target was too high, stating that a more realistic return assumption would be 6.60%. The two largest public pension funds (CalSTRS and CalPERS) recently announced their plans to lower their discount rates from 7.50% to 7.0% by 2018 and 2020, respectively. Fitch Ratings recently announced that they would be discounting public pension plan liabilities at a 6% discount rate. If a lower rate of return is used as a discount rate for the plans' present value calculation, the plan liabilities would be larger than they are today and the funded ratios would be lower.

### *Funded Ratio Sensitivity*

The independent auditor provided the estimates of the net pension liability for the fiscal year 2016 using different discount rates. According to their estimates, if 6.50% discount rate were used, the net pension liabilities for the Police and Fire Plan would be 61% higher and the net liabilities for the Retirement Plan would be almost double (Table 2). The use of a 6.50% discount rate seems reasonable considering Summit's long-term rate of return estimate (5.87%) based on its presentation from September 2016. If 6.50% discount rate were used, the funded ratios would be 62% instead of 76% for the Police and Fire Plan and 73% instead of 86% for the Retirement Plan.

**Table 2. Net Pension Liabilities Sensitivity to Changes in the Discount Rate**

	<b>1% Decrease (6.50%)</b>	<b>FY2016 Discount Rate (7.50%)</b>	<b>1% Increase (8.50%)</b>
<b>Net Pension Liability FY2016</b>			
Police and Fire Plan	225,539,351	140,277,118	70,281,424
Employees Plan	113,204,006	58,181,320	12,127,063
<b>Funded Ratio /1</b>			
Police and Fire Plan	62%	76%	88%
Employees Plan	73%	86%	97%

Source: Howard County Police and Fire Employees' Retirement Plan Financial Statements, June 30, 2016; and Howard County Retirement Plan Financial Statements, June 30, 2016

/1 Funded Ratio is a ratio of pension fiduciary net position to total pension liability adjusted with estimated net pension liability.