Approved: March 16, 1995
Date

MINUTES OF THE HOUSE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE.

The meeting was called to order by Chairperson Bill Bryant at 3:30 p.m. on March 13, 1995 in Room 527S of the Capitol.

All members were present except: Representative Welshimer, Excused

Committee staff present: Bill Wolff, Legislative Research Department
Bruce Kinzie, Revisor of Statutes
Nikki Feuerborn, Committee Secretary

Conferees appearing before the committee: Leo Hafner, Legislative Post Audit
Sally Thompson, State Treasurer

Others attending: See attached list

Leo Hafner of Legislative Post Audit reviewed the report "Examining the Investment Practices of the Municipal Investment Pool" which was authorized in 1992 (Attachment 1, Report on file in House FI&I Committee files). He explained that investments purchased for the Pool may have too long a maturity given the average amount of time that municipalities have committed funds to the Pool. Rising interest rates cause municipalities to withdraw funds from the Pool to invest at higher rates which create liquidity problems for the Pool. The method for computing value of the securities being exchanged between separate portfolios was questioned: net present value (used by the Treasurer) vs. market values. The Treasurer assumed that securities with an average maturity of 77 days would earn the same rate of return as securities with an average maturity of 481 days which caused overvaluation of the securities in the Short-Term Pool in relation to securities in the idle funds portfolio. Mr. Hafner said their audit revealed that the Treasurer bought longer-term investments that she should have for this type of Pool.

Sally Thompson, State Treasurer, defended her management of the Municipal Investment Pool and assured Committee members that "no participant has lost a dime" and the Pool has returned over $75.0 million in interest income to its users (Attachment 2). The Treasurer stated there was no market loss due to the exchange of securities between the three portfolios because the securities will be held to maturity. Trading losses were due to selling before maturity so the funds could be reinvested at the current market rate.

Representative Donovan moved that the minutes of the March 8 meeting be approved. Representative Correll seconded the motion. The motion carried.

The meeting adjourned at 4:45 p.m. The next meeting will be held on March 14, 1995.

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Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

HOUSE FINANCIAL INSTITUTIONS AND INSURANCE COMMITTEE GUEST LIST

DATE: 3/13

NAME	REPRESENTING
Jama Wagner	STO
Sally Thompson	STO
[illegible] Pinon	STO
Chuck Stones	KBA
Roger Franzke	FFC
Carriann Richey	Golden Rule Insur. Co
Danielle Noe	KCUA
Leo Hafner	Legislative Post Audit
[illegible] Patton	Legislative Post Audit

LEGISLATURE OF KANSAS
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January 30, 1995

To: Members, Kansas Legislature

When this audit of the Municipal Investment Pool was presented to the Legislative Post Audit Committee January 26, a number of somewhat technical questions were raised. Among other things, those questions covered the methodology used in the exchange of securities between the Municipal Investment Pool and the State's idle funds portfolio. These issues are summarized on pages 25-27 of the report.

This letter has been inserted in the audit report to provide some additional information that may help clarify those issues.

1. What is the best way to "value" securities being exchanged between two separate investment portfolios?

The State Treasurer noted at the meeting and in her response to the audit that there was a disagreement between her staff and our office as to whether actual market values or "net present values" would be the most appropriate way to value securities that were being exchanged.

During the audit, officials in the State Treasurer's Office told us they used the net present value method in an attempt to ensure that each exchange of securities between the Short-Term Municipal Investment Pool and the State's idle funds portfolio was equitable. (A net present value calculation is a way to compare future and present cash amounts. That calculation takes into account the fact that present cash amounts can be invested to earn additional moneys in the future.)

The net present value method is simply a mathematical approach that can be used <u>to try to approximate the current value</u> of a security. However, all the bond experts we talked with in Kansas and in other states during this audit told us they would use market values to measure the value of securities being exchanged, if that information were available. The market value of a security represents what an informed buyer would be willing to pay for that security. That market value "automatically" takes into account future cash flows, and when they will occur. Thus, the market value of a security is the best measure of its current value. For these securities, the State Treasurer's Office had market value information readily available.

The analyses we performed in the audit report--and our conclusions that the exchanges resulted in a $2 million loss to the State's idle funds--were based on the market value of the securities that were exchanged.

2. Why didn't the "net present values" the State Treasurer's Office calculated approximate the market value of the securities exchanged

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between the Short-Term Pool and the idle funds portfolio, as would have been expected?

At the meeting, we noted that the "present values" the State Treasurer's Office had calculated and used in making the exchanges were incorrect in part because of a $500,000 typographical error we identified on one of the exchanges. We pointed out that error in a list of questions submitted to the Treasurer's Office on January 9. On January 23, the Office notified us that a $500,000 security had been transferred from the Short-Term Municipal Investment Pool to the State's idle funds portfolio to correct that error.

During the audit, however, we identified another major contributing factor.

In performing a net present value calculation in this situation, a person has to select a rate of return that could be earned on the securities in <u>each</u> portfolio. A person should expect to receive a higher rate of return on longer-term securities than on shorter-term securities.

In its calculations, the Treasurer's Office assumed that securities with an average maturity of 77 days would earn the <u>same</u> rate of return as securities with an average maturity of 481 days. The effect of the Office's assumption was to overvalue the securities in the Short-Term Pool in relation to securities in the idle funds portfolio. Again, the bond experts we talked with in Kansas and around the country said that the rates of return selected for these calculations should reflect the current market rates of return for such investments.

When we calculated the net present value of the securities that had been exchanged--after correcting the $500,000 typographical error and selecting rates of return that took into account the length of the investments being exchanged--the resulting figures were very close to the market values for those securities. In our opinion, if the net present values of the securities being exchanged had been calculated correctly, the State Treasurer's Office wouldn't have exchanged the securities that were exchanged, and would have been able to identify securities to exchange that were of equivalent values.

I hope this information is helpful in your understanding of the issues raised in this audit report. As always, please let me know if you have any questions.

Sincerely,

Barbara J. Hinton

Barbara J. Hinton
Legislative Post Auditor

K A N S A S

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March 13, 1995

There is a misunderstanding in regard to losses in the Municipal Investment Pool. I have taken the liberty of outlining the four separate "loss" issues. It should be noted that no participant has lost a dime and that the MIP has returned over $75.0 million in interest income to its users.

1. **Market Value:** As with all fixed income portfolios, the Municipal Investment Pool has suffered market losses in this year of rapidly increasing interest rates. As you know, if the securities are held to maturity there is no loss. Since we will be able to hold these securities to maturity, this is not a loss that will be felt by either the MIP or the State. As of 01-31-95 the market value of the MIP is $6.1 million below the value to be received at maturity and does not include $5.4 million in early withdrawal penalties.

2. **Exchanges:** The State Treasurer exchanged securities between the State Idle Pool and the Municipal Investment Pool. The exchanges were made to provide liquidity in the Municipal Investment Pool. It is the Treasurer's position there was no market value loss. When a government security is held to maturity all the principal and interest is received. The idle funds are still holding the securities. A representative of Arthur Andersen & Co., the former State auditor, reviewed the accounting theory and agreed that net present value would be a reasonable method to use in this transaction.

Legislative Post Audit's schedules, on a cash flow basis, show the idle fund gained over $8.0 million more in interest income as a result of the exchange.

The Treasurer has requested that the State's new audit firm, a consortium of Berberich Trahan & Co. PA. and Allen, Gibbs & Houlik, L.C., review the transaction and that a definitive opinion be issued.

3. **Trading Losses:** The Treasurer has sold securities before maturity. Most were sold so that funds could be reinvested at the current market rate. The Treasurer plans to recover these losses with the enhanced interest earnings.

4. **Idle Fund Participation in the Municipal Investment Pool:** The State Idle Funds became a participant in the MIP on January 30, 1995. The State Idle Funds participation provides stability to the MIP. Certainly, at this time the state idle funds are experiencing a lost "interest rate opportunity."

However, the Treasurer believes the state idle fund will benefit financially from its participation in the MIP, just as state agencies have benefited from their involvement. State agencies have earned $12.7 million in the MIP since April of 1993.

The Municipal Investment Pool continues to gain new accounts each month. The rates paid by the MIP have continued to rise over the months since March 1994.

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