Approved: March 26, 1999
Date

MINUTES OF THE HOUSE FINANCIAL INSTITUTIONS.

The meeting was called to order by Chairperson Ray Cox at 3:30 p.m. on March 17,1999 in Room 527-S of the Capitol.

All members were present except: Representative Cindy Empson - Excused

Committee staff present: Dr. Bill Wolff, Legislative Research
Bruce Kinzie, Office of Revisor
Maggie Breen, Committee Secretary

Conferees appearing before the committee: Vern Chesbro, KPERS Board of Trustees Chairman
Jerry Boettcher, KPERS Board of Trustees Vice Chairman
Rob Woodard, KPERS Chief Investment Officer
Dr. Bruce Morgan, State Banking Board Chairman

Others attending: See attached list

Chairman Cox opened the Hearing on:

HCR 5037 - Constitional amendment to allow KPERS and other retirement systems authorized by Kansas law to be a stockholder in banking institutions.

Vern Chesbro, KPERS Board of Trustees Chairman, appeared to say the Board of Trustees was in favor of the bill and that Vice Chairman Boettcher would present their testimony.

Jerry Boettcher, Vice Chairman, Board of Trustees of KPERS, appeared in favor of **HCR 5037.** Current constitutional and statutory restrictions prevent KPERS from being a stockholder in any banking institution, savings and loan or credit union. The most significant impact of this restriction is the potential reduction of gain associated with an inability to freely direct capital to its highest and best use, and consequently its greatest perceived potential return. In the index alone, over the last several years, the consequence of not being able to invest in banks has cost the system $25 million. He admitted that having the restriction also kept KPERS out of the Japanese Banks. The restrictions serve no useful purpose to the State or participants of the System. He pleaded for the committees' support The fund is $9 billion plus and it needs to be invested in a variety of things. **HCR 5037**. **(Attachment 1)**

Representative Cox asked Ron Woodard what kind of annual rate of return KPERS has had the last few years. The answer was about 12 percent annually for the last 10 years.

Representative Minor asked if the restriction included buying stock in a company that owned banks. The staff answered that the Attorney General has ruled that if for example Ford Motor Company has a domestic subsidiary, which includes a bank that finances car purchases, KPERS can buy and own it.

Representative Burroughs asked what percent credit unions were of the 9.2% in the S&P 500 Index that represents stocks of banks, savings and loans and credit unions. Mr. Boettcher answered that credit unions and savings and loans make up a very small part of the 9.2%.

Chairman Cox asked Meredith Williams if he had anything to add. Mr. Williams said only that the $25 million Mr. Boettcher referred to was per year.

MINUTES OF THE HOUSE FINANCIAL INSTITUTIONS, Room 527-S Statehouse, at 3:30 p.m. on March 17, 1999.

Chairman Cox asked **Rob Woodard** to explain how the KPERS portfolio is made up. Mr. Woodard said that as a defined benefit plan KPERS is contractually obligated to deliver the retirees' benefits as they are set forth by law. The flip side is that if the benefits are not available, the taxpayer has to make up the rest. Their job is to make enough money to provide these benefits with as little overhead and as little excess tax dollar or employer input as they can. To provide for the benefits, they do a very rigorous, empirical, statistical, and historical analysis to discern what they believe a reasonable expectation might be for any given asset class whether it be stocks, bonds, international stocks or bonds, or currencies - what they reasonably expect to see in terms of return over the upcoming 5 to 10 year period. In addition to the return, they spend a lot of time looking at what the risks are. Risks in the investment business are typically defined as not getting what you expect to get in terms of return, or the variability of returns. They do some very sophisticated modeling of those risks and look at what happens when you put different combination of asset classes together that typically or historically have not moved in lockstep with one another. This same sort of concept applies when you look at domestic investment relative to international investments. They use an operations algorithm to put together the expected returns, the variability of those returns, and the long term correlation of those returns, to discern what they believe to be the most efficient portfolio. Efficiency being defined as the highest expected return relative to the amount of risk they're putting into the portfolio. When determining the appropriate amount of risk to put into the portfolio, they literally break down by the demographic profile, all 220,000 people in KPERS, their age, what their expected retirement dates are, what their expected benefits might be based on their salary, the possibility of them becoming disabled or dying, or quitting state service and taking some of the money out. All those liability characteristics are taken into consideration in trying to define and discern what might be the best overall risk profile to take. Once the asset allocation is defined, the board charges staff with implementation decisions to go out and hire and interview the very best and brightest money managers in the world. And frankly, KPERS has an investment staff that he would put up against any state in the country. KPERS has the biggest, the best, the brightest, and the most well resourced managers all around the globe. Managing the portfolio is a very well-defined and well-articulated process which is very well designed and integrated.

Chairman Cox closed the hearing on **HCR 5037.**

Representative Minor made a motion to pass **HCR 5037** out favorably. Representative Sharp seconded the motion. The motion carried with Representative Burroughs voting nay.

Chairman Cox said the committee would work **Sub 260 - State banking board; transfer of certain powers and duties to the state bank commissioner.**

After the bill was heard in committee, Chairman Cox had some calls from the Banking Board itself, as have some other members on the committee. Last Monday, Representative Humerickouse, Representative Burroughs and he met with Bill New and Bruce Morgan, who serve on the board. They have been invited to be here today to share with the committee what was said in that meeting because the committee needs their input.

Dr. Bruce B. Morgan, Chairman, Kansas State Banking Board, said he was there representing the views of the Banking Board. The board is made up of 6 bankers and 3 public members appointed from different political parties and different congressional districts to insure that all areas of the state are fairly represented. The Board unanimously adopted a motion to express to the committee their concerns about **Sub 260** prior to the bill being worked. Their concern is that it transfers too much power to one person, the State Bank Commissioner, without the supervision of an oversight board. It changes, amends, and repeals 41 laws affection state banking. It contains over 60 provisions shifting duties from the State Banking Board to the State Banking Commissioner. The State Banking Board has no objection to 7 of the proposed shifts in duties. The Banking Board's objections can be summarized in 6 policy areas. 1) Community and public input on new charter and branch applications; 2) Bank capital issues; 3) Appeal of State Bank Commissioner decisions; 4) Review of Proposed Rules and Regulations; 5) Establishment of securities subsidiaries; 6) Authority of State Banking Board to perform their duties. He discussed each briefly and referred the committee to a crossreference sheet in his handout that referenced which laws were being changed with each duty shift. **(Attachment 2)**

Representative Burroughs asked Dr. Morgan why the State Bank Board would not be allowed access to the records in the Bank Commissioners Office. Dr. Morgan said he didn't know why it would be denied but in the proposed bill, on page 39, section 38, lines 31 and 32 are being struck.

Representative Humerickhouse asked if Dr. Morgan was able to appear when the Senate held their meetings. Dr Morgan answered no. There was a subcommittee that put the bill together, then it went to the full committee. Dr. Morgan said they did meet with Senator Praeger and Senator Feleciano who were co-chairs of the subcommittee. They expressed their views to them, asking them specifically if there would be an opportunity to testify and if they would be notified. The Senators assured them that they would. In conversations with Senator Steffes' office staff person, he learned the committee was going to meet on a certain date to take up the bill. He asked if it were possible for the State Bank Board to come and present testimony, and he was told no. He could come and observe the committee working the bill but the committee would not be taking testimony. When it went to the Senate hearing he asked the question of staff, could he come and testify on the bill. He was told the bill was already done, that it's a done deal. So he had asked directly and specifically to testify on the bill. The Bank Board is appointed by the Governor just like the Bank Commissioner. This bill dramatically affects the State Banking Board and he thinks if you're going to change this much Kansas legislation in one bill, you'd at least ask the people affected by it to voice an opinion about it.

Chairman Cox said he would work **Sub 260.**

Representative Grant made a motion to table **Sub 260.** Representative Vickrey seconded the motion. The motion carried.

The meeting was adjourned at 4:27 p.m.

The next meeting is scheduled for March 22nd.

HOUSE FINANCIAL INSTITUTIONS COMMITTEE GUEST LIST

DATE: March 17, 1999

NAME	REPRESENTING
Roger Franzke	KGC
Bill New	State Banking Board
BRUCE MORGAN	STATE BANKING BOARD
Alan Steppat	Community Bankers Assn.
Robt Ward	KPERS
Matt Goddard	HCBA
Judi Stork	OSBC
Kevin Glendening	OSBC
Sonya Allen	OSBC
Regan R. Cheesboro	KPERS
Carold W. Brothers	KPERS
M. Lith Williams	KPERS
Jack Hawn	KPERS
Chuck Stones	KBA
Jim Maag	KBA
Kathy Olsen	KBA
Greg Hill	Federico Consulting

Financial Institution Restrictions

Background

Current constitutional and statutory restrictions prevent the Retirement System from investing in the securities of any "banking institution, savings and loan or credit union which positions the System as a shareholder or owner of such banking institution, savings and loan or credit union", (K.S.A. 74-4921 (5)(d). The Kansas Constitution, Article13, Section 2, provides "The State shall not be a stockholder in any banking institution." This constitutional restriction was originally adopted by the Wyandotte Constitution on July 5, 1859, and ratified by electors on October 4 of the same year. In researching this issue, it appears that the restriction was "in keeping with the trends of the time" and probably reflected a mistrust of the yet to be standardized national banking system.

According to a May 18, 1987, opinion from the Office of the Attorney General of the State of Kansas, the Retirement System is the "State" for the purposes of the Kansas Constitution. In a December 15, 1992 letter, the Attorney General opined that the statute does not prohibit the System from investing in equity issues of non-bank financial institutions, debt securities of a banking institution, savings and loan association or credit union, or from investing in a corporation which is a parent company to a subsidiary banking institution, savings and loan or credit union.

As a consequence of these laws and subsequent interpretations, the Retirement System is precluded from making a common stock investment in any bank, savings and loan or credit union of domestic or international origin.

Impact of Restrictions

These restrictions impact the System in several ways, each of which stems from the consequences of artificially restricting the investable universe. The most significant impact of restricting investments is the potential reduction of gain associated with an inability to freely direct capital to its highest and best use, and consequently its greatest perceived potential return.

The System uses both actively and passively managed portfolios in the domestic and international equity allocations. The System expects active managers to outperform their benchmark. These managers are somewhat hindered from adding value to portfolios where their universe of investable securities is limited. Passive managers attempt to match the risk and return of a specified benchmark by investing in all or a significant portion of the underlying index securities. It is difficult to quantify how active mangers would perform relative to their benchmark if the limitations were lifted. However, it is much

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easier to calculate the impact that the restrictions have had on the passive portfolios, where the System has allocated approximately 39% of their domestic and international equity investments. The restrictions historical impact can be quantified by comparing the returns of the broad market to the returns of the broad market less banks, savings and loans and credit unions.

As the tables below illustrate, the unrestricted U.S. stock universe has outperformed the bank restricted U.S. stock universe for the latest one, three and five year time periods. The annual under performance experienced by the restricted universe has been .62% for the five year period ended June 30, 1998.

U.S. Stocks vs. U.S. Stocks Less Restricted Securities

Fiscal Years Ended 6/30/98, Annualized	S&P 500 less Banks	S&P 500	Return Differential
Latest Year	29.44	30.30	-0.86
Latest 3 Years	29.28	30.34	-1.06
Latest 5 Years	22.51	23.13	-0.62

The restricted international universe has performed better than the unrestricted international universe over the past one and three years. Over these time periods international banks, and Japanese banks in particular, have lagged the other industries. However over the latest five years the relative under performance of the restricted universe resurfaces.

International Stocks vs. International Stocks Less Restricted Securities

Fiscal Years Ended 6/30/98, Annualized	EAFE less Banks	EAFE	Return Differential
Latest Year	6.68	6.38	0.30
Latest 3 Years	11.72	11.01	0.71
Latest 5 Years	10.08	10.34	-0.26

The inability to own the broad market, including banks, has "cost" the System in total return terms. The return impact of the restrictions can be very sensitive to the time period being analyzed. However, if one assumes that the longer term (latest five year) return differential continues, the bank restriction could cost the System approximately $25 million per year, calculated as follows:

Domestic Equity Portfolio $3.5 billion x .62% = $21.7 million
International Equity Portfolio $1.3 billion x .26% = $3.4 million

Another significant impact of restricting the investable universe has to do with risk. As of June 30, 1998, the stocks of banks, savings and loans and credit unions represented about 9.2% of the S&P 500 Index. In international markets, the concentrations of banks as a percentage of the index was approximately 12%. By restricting the number of stocks which can be used for diversification, the restriction has the effect of increasing the risk of the portfolio relative to these benchmarks.

There are other costs associated with the restrictions. The System pays higher management fees since the portfolio must be managed in a separate account. Stated another way the System cannot invest in commingled equity funds that are typically offered by the System's passive investment managers. Without the bank restrictions the System may be even more successful in negotiating competitive fees with all equity managers since the portfolio could be managed in the same manner as other portfolios. In addition, the construction and maintenance by outside parties of customized benchmarks with which the System measures performance within the restricted portfolios can cost thousands of dollars per year.

Conclusions

Over longer periods of time the banking restriction artificially reduces the investable universe for the System, imposes opportunity costs which results in reduced returns and in the process, has created less efficient portfolios when measured in terms of risk and added costs for customized indexes and segregated portfolio management. Finally, these restrictions serve no useful purpose to the State or participants of the System.

Remarks of Dr. Bruce B. Morgan, Chairman, Kansas State Banking Board, at House Financial Institutions Committee, on March 17, 1999.

Mr. Chairman and Members of the Committee, on behalf of the State Banking Board, I would like to thank you for allowing us to offer our comments on the House Substitute for Senate Bill No. 260 related to the State Banking Board and proposal to transfer certain powers to the State Bank Commissioner.

My name is Bruce B. Morgan, and I am a banker appointed to the State Banking Board and this year serve as its Chairman. Bill E. New is also a member of the State Banking Board and joins me here today representing the views of the Board.

The State Banking Board is comprised of nine members appointed by the Governor and confirmed by the Senate. At the present time, the State Banking Board performs several duties assigned to it by the Kansas legislature in conjunction with the activities of the State Banking Department and the Office of State Bank Commissioner. The Board is made up of six bankers and three public members appointed from different political parties and different congressional districts to insure all areas of the state are fairly represented. Board members are appointed after due diligence by the Governor's office, are subjected to Senate confirmation hearings, and an extensive KBI background check.

The State Banking Board received copies of the proposed Senate Bill No. 260 at our February, 1999, meeting, and discussed it in our March, 1999, meeting. The State Banking Board unanimously adopted a motion to express to you our concerns about this bill prior to your working the bill, recommendation to the house, and your final vote.

The State Banking Board has a deep concern, as expressed by the vote of its members, that Senate Bill No. 260 transfers too much power to one person, the State Bank Commissioner, without supervision of an oversight board.

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In the past two years, a great deal of discussion has taken place regarding the duties of the State Bank Commissioner and in fact this House has passed legislation regarding notice under the so-called "wild card" statute so you would be better informed about the activities of this office. The State Banking Board has strong reservations about Senate Bill No. 260 without further study and deliberation on your part.

The proposed Senate Bill No. 260 changes, amends, and repeals 41 laws affecting state banking. The bill contains over 60 provisions shifting duties from the State Banking Board to the State Banking Commissioner. The State Banking Board believes the bill is transferring excessive power to the State Banking Commissioner with little to no oversight.

In Attachment A, an exhibit given to members of the Legislature on the Duties of the State Banking Board, I have tried to "map" the specific KSA laws being changed, the bill's page number, and specific policy issues for your consideration.

The State Banking Board has no objection to seven of the proposed 27 shifts in duties from the Banking Board to the State Bank Commissioner.

The State Banking Board objections to Senate Bill No. 260 can be summarized in six policy areas:

1. Community and public input on new charter and branch applications;
2. Bank capital issues;
3. Appeal of State Bank Commissioner decisions;
4. Review of Proposed Rules and Regulations;
5. Establishment of securities subsidiaries;
6. Authority of State Banking Board to perform their duties.

Briefly, I will discuss each of these in the context of Attachment A.

Community and public input on new charter and branch applications: Present law allows for a public hearing to be held in the community if objections are filed on branch bank applications. The bill eliminates this process and only provides for input in Topeka before an application is finally approved or disapproved. Our representative democracy is founded on the principal that citizens can make their voice heard. The State Banking Board feels the public hearing provision should not be eliminated and is a useful tool to elicit public input on applications. (See Attachment A, items 1, 2, 3, 12)

Bank Capital Issues: A number of changes proposed relate to the State Banking Board review of changes in a bank's capital structure. Banking is a "public confidence" business. A bank's equity capital is to protect the "uninsured" depositor in the event of a banking crisis. It has been the experience of several present and prior State Banking Board members that we have advocated higher bank capital standards than staff. We feel these sections of Kansas banking law should not be changed. (See Attachment A, items 5, 6, 7, 11)

Appeal of State Bank Commissioner Decisions: Several provisions in the bill (items 21-25 in Attachment A) now provide for appeals of decisions of the State Bank Commissioner be made to the State Banking Board. The bill changes this procedure so that decisions of the State Bank Commissioner are "appealed to the Commissioner". How can an aggrieved party get a fair and impartial review of the decision by the person that made the decision?

Review of Rules and Regulations: The State Banking Department and State Bank Commissioner promulgate various rules and regulations impacting Kansas state banks. The present legislation requires these rules and regulations be reviewed and approved by the State Banking Board. In Senate Bill No. 260, the State Bank Commissioner only is granted the power to approve the rules and regulations. This is an example of lack of oversight by a Board representing both the industry and public members and vesting that power in one person. (Attachment A, item 19)

Establishment of Securities Subsidiaries: This is similar to approving a new charter, branch or trust company. In Kansas banking history, we have received and reviewed only one application to establish a securities subsidiary. In the future, as the lines become more "blurred" in financial services, we probably will have future applications and feel they should be reviewed under the same standards as new charters and branches. (Attachment A, item 16)

Authority of State Banking Board to Perform Their Duties: At the present time, the State Banking Board annually elects one of its nine members to be Chairman and the State Bank Commissioner serves as Secretary. This has worked for a number of years. The proposed Senate Bill No. 260 makes the State Bank Commissioner "permanent" Chairman of the State Banking Board. Also, the bill removes the State Banking Board from having access to all of the records in office of State Bank Commissioner, removes their ability to call a meeting, and removes their oversight from matters pertaining to the "conduct and welfare of the banking department". In a democracy, we have checks and balances; in an autocracy, we do not. These changes do not advance the cause of democracy for the citizens of Kansas. (Attachment A, item 8 & 10)

We support Senate Bill No. 240, with your amendments, and believe the office of State Bank Commissioner will be strengthened with its passage. We offer no comment on Senate Bill No. 271 because it addresses an administrative consolidation of two departments of state government and there are others better able to speak about these matters.

It is our understanding, regarding the State Banking Department, that the concern and discussion expressed by members of the Kansas Legislature the past two years have dealt with the power, authority, and decisions of the State Bank Commissioner and need for reform in the office with a full time bank commissioner. We support these reform efforts. We have heard no expression of support from the citizens of Kansas, elected representatives, or banks that it is in the State of Kansas' best efforts to create a "regulatory czar" in the office of State Bank Commissioner.

I would like to thank the Committee for allowing us to present these views and would welcome any questions.

ATTACHMENT A

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DUTIES OF THE STATE BANKING BOARD

NO OBJECTION BY BANKING BOARD

VSA	DUTY	CURRENTLY	SB260	AS PROPOSED UNDER SB260	# of Appls. last 3 years	DUTIES #1-#3
9-1[illegible]	(1) Approval of new bank and trust company charters	Banking Board	p2 SEC 4; p17 ¶(3)(g)(h) through 20	Banking Board	7	REMOVES PUBLIC HEARING IN COMMUNITY FOR PUBLIC INPUT
9-1111	(2) + Approval of branch banks	Banking Board	p12 ¶(g)(h)(i)	Banking Board	72	
	(3) Approval of relocation of a bank or trust company	Banking Board		Banking Board	17	
9-1606(b) 9-812	(4) Approval of change of bank or trust company name OK	Banking Board	p23 SEC 20; p2 SEC 5	Commissioner	8	
9-904	(5) Approval of the reduction of the capital stock of a bank	Banking Board	p3 ¶(b)	Commissioner	2	
9-908	(6) Approval of the issuance of preferred stock by a bank	Banking Board	p3 SEC 7	Commissioner	1	
9-912	(7) Approval of the reduction of a bank's surplus account	Banking Board	p4 SEC 8	Commissioner	9	
74-3004	(8) REMOVES BOARD ACCESS TO RECORDS; ABILITY TO CALL MEETING		p39 ¶38			USURPS BOARD ABILITY TO PERFORM DUTIES
	(9) Approval for a bank to continue to hold a life insurance policy for deferred employee compensation plans when no liability exists under the plan OK	Banking Board		Commissioner	1	
74-3004	(10) COMMISSIONER AS CHAIRPERSON VS SECRETARY 74-3005		p38-39 ¶36 & 37			USURPS BOARD AUTHORITY
9-1101a	(11) Approval of the issuance of capital notes/debentures by a bank	Banking Board	p10 SEC 12	Commissioner	0	
9-1714	(12) Relieving a special deputy commissioner from their duties	Banking Board	p24-25	Commissioner	0	REMOVES HEARING
9-1805	(13) x Removal of bank officer	Banking Board	p27-30	Commissioner	0	
74-3004	(14) ADDING "STATE SAVINGS & LOAN" EXPERIENCE		p38 SEC 36			WHY?
	(15) Issuance of Cease and Desist orders	Banking Board		Commissioner	1	
9-1713	(16) Establishment of a ~~bank service corporation~~ SUBSIDIARY ENGAGED IN SECURITIES ACTIVITY	Banking Board and Commissioner	p7 ¶(21)	Commissioner	1	
	(17) Determination of a bank's reserve ratio OK	Banking Board and Commissioner		Commissioner	0	
9-1101	(18) Establishment of maximum rates of interest on deposits OK	Banking Board and Commissioner		Commissioner	0	
9-1127(b) 9-935 9-1713	(19) Approval of rules and regulations	Banking Board and Commissioner	p24 SEC 23; p16 ¶(b); p2 SEC 2	Commissioner	2	
9-1127(b)	(20) APPROVAL OF BANKER'S BANK INVESTMENT	BANKING BOARD & COMMISSIONER	p15 (a)(b)(c)(d)	COMMISSIONER	0	DUTIES #21-#25
	(21) * Appointment of a special deputy	Commissioner		Commissioner	0	APPEAL OF COMMISSIONER'S DECISION TO COMMISSIONER NOT BANK BOARD
9-1716	(22) * Issuance of an order to cease the declaration or payment of dividends	Commissioner	p25 SEC 25	Commissioner	0	
9-935	(23) * Approval of acquisitions of Kansas banks by HCs	Commissioner	p1 ¶(b)	Commissioner	40	
9-935	(24) * Approval of the change of control of a bank	Commissioner	p1 ¶(b)	Commissioner	14	
9-1709	(25) * Approval of contracting trustees; trust service desk; trust service offices; trust branch banks OK	Commissioner	p31-38; p14 ¶(b)	Commissioner	5	
	(26) ESTABLISHMENT OF BANK SERVICE CORP. OK	BANKING BOARD & COMMISSIONER		COMMISSIONER	0	

+ The Banking Board makes the decision. The appeal is under the Act for Judicial Review and Civil Enforcement of Agency Actions (KJRA).
*Appeal of the decision was to the banking board, is now to the Commissioner.
x Hearing is PRIOR to the decision. Was with the banking board, is now to the Commissioner.

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9-1107 (27) BORROWING FOR TEMPORARY PURPOSES OK p10 SEC 12 0