Approved May 1, 2003

SELECT COMMITTEE ON PENSIONS

April 2, 2003
Room 519-S Statehouse

Members Present:
Chairman, John Edmonds
Vice-Chair, Bill McCreary
Ranking Minority, Geraldine Flaharty
Representative Ray Cox
Representative Vaughn Flora
Representative Margaret Long
Representative Melvin Neufeld
Representative Sharon Schwartz

Staff Present
Julian Efird, Kansas Legislative Research Department
Gordon Self, Office of the Revisor of Statutes
Carol Doel, Committee Secretary

Committee Conferee
Senator Steve Morris
Glen Deck, Executive Director of KPERS

Chairman Edmonds called the meeting to order at 1:30 p.m. in Room 519-S of the Statehouse, and opened the floor for public hearing on **SB 260.** He requested that Mr. Efird of Legislative Research make a brief explanation of the bill.

Mr. Efird explained that **SB 260** was recommended by Senate Ways and Means Committee. In brief the bill authorizes the issuance of a maximum of 750 million dollars of taxable revenue bonds for the purpose of reducing a portion of the unfunded actuarial liability of KPERS (Kansas Public Employees Retirement System), specifically the state and school groups would be the beneficiaries of any bonds that might be issued. The bonds could be used to pay a portion of the pension liability, pay the cost of issuing the bonds and to provide for any required reserves needed for the bonds. The repayment of these bonds according to the bill would be from monies appropriated by the State.

The second part of the bill provides the finance mechanism. The bill also would increase the monies that the State must appropriate for its contributions as the employers share to KPERS for the annual payments and that would be for the state and school groups only. Beginning in fiscal year 2006, the statutory cap of 2/10 of 1% that is current law would be raised to 4/10 of 1% and in subsequent fiscal years would have a staggered increase to .5% and .6% by fiscal year '08. With this multiplier effect, the State would be contributing much greater amounts of money.

The third part of the bill is the safety mechanism that delegates authority to the State Finance Counsel to act on the Legislatures behalf. Prior to issuing any bonds a procedure is established in the bill that has to be followed. The Finance Council has authority first to make a decision whether or not to issue any bonds, the amount of the bonds to be issued or multiple issues, if that is the case, would have to be determined by the Finance Council as well as the interest rates and the periods of maturity. The second part of the bill would require that the terms for repayments of these bonds be included in contracts between the Department of Administration and KDFA subject to approval by the Finance Council. These contracts would have to include the payment arrangements regarding the amounts and procedures for the transfer of state monies, terms and conditions regarding the principal amount plus the interest rates, the maturity schedules and other things that are necessary or desirable to repay these bonds and to secure the bonds. The bill is effective upon publication in the register. The bill itself is really a skeleton for a procedure.

Chairman Edmond introduced Senator Steve Morris as a proponent of **SB 260**. Senator Morris explained that in 1993 there was a significant change in the benefits for KPERS. At that time the actuary allowed them to increase the contribution rate to 1/10 of 1% per year and keep up with what they needed to do with unfunded liability. Two years later the actuary died and a different actuary was obtained. This actuary told them that the first actuary had some incorrect conceptions and the unfunded liability was actually closer to 1.5 billion at that time. At that point in time, it was decided that the contribution rate needed to be increased and it was decided to go to 2/10 of 1%. This was continued for several years mainly due to the fact that the stock market was performing well during the 1990's. They were making progress toward the unfunded liability and making progress toward reaching equilibrium. Unfortunately, around 2000 the stock market started dropping and the last two years there has been a loss of at least 2 billion dollars out of the portfolio. As a result of that loss, the unfunded liability keeps growing. Adjustments will have to be made. A number of options have been discussed. The opportunity to get low interest rates on bonds may not be available forever. This is the primary reason for doing something at this stage of the session this year. There is some risk included with these bonds and that is the reason for trying to put up some safeguards. The positive aspect of this outweighs the risks. The positive part is that if this is used as one part of the attempt to address unfunded liability, gain can actually be made over the long term. Obviously more is going to have to be done other than pension obligation bonds. There is the need to start increasing the contribution rate. This bill would call for an increase in contribution rates starting in 2006 going to 4/10 of 1%. The next year it would be 5/10 and in 2008, 6/10 and remain at 6/10 until either equilibrium was reached or the Legislature took other action. (Attachment 1)

Glen Deck, Executive Director of KPERS addressed the committee remaining neutral to **SB260**. Mr. Deck submitted a hand-out from KPERS on long-term funding and pension obligation bonds, with information regarding the long-term funding outlook, updated funding projections, funding projections and alternatives, pension obligation bond overview, market overview, interest rates, structure, POB issues to consider, as well as pension obligation bond issues in other states. (Attachment 2)

With no further conferees on **SB 260**, Chairman Edmonds closed the hearing.
There being no further business before the committee, the Chairman adjourned the meeting at 2:30 p.m.

SELECT COMMITTEE ON PENSIONS

GUEST LIST

Date April 2, 2003

[illegible signature]	
KENT HURN	
Vickie Burgess	
Kim Rollenhagen	
SUE PETERSON	K-STATE
DICK CARTER	KBOR
Eric Sexton	WSU
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AGRICULTURAL AND RURAL DEVELOPMENT

TESTIMONY
BY
Sen. Steve Morris

RE: SB 260

House Select Committee on Pensions
Room 519-S

April 2, 2003

Mr. Chairman, members of the Committee, during the 2002 Interim, I served on the Joint Committee on Pensions, Investments and Benefits, when the long-term KPERS financing problem was reviewed. In developing alternatives to address how to reduce the unfunded liability and the gap between what is paid by the state and what needs to be paid, the concept of pension obligation bonds was reviewed by the Joint Committee.

In order to jump-start discussions about addressing the long-term KPERS funding problem, we felt it was necessary to introduce SB 260, as an alternative financing plan involving bonds and increased employer contributions to focus attention on the matter. The longer the Legislature waits to act, the more the problem will grow in magnitude, and this is a very favorable time in the bond market. The combination of bonds and higher state contributions should be available as alternatives to address the problem.

I urge you to favorably consider passage of SB 260 to help address the KPERS long-term financing problem.

SELECT COMMITTEE ON PENSIONS
Attachment 1
Date 4-2-03

SELECT COMMITTEE ON PENSIONS
Attachment 2
Date 4-2-03

KPERS

Long-Term Funding and Pension Obligation Bonds

House Select Committee on Pensions

April 2, 2003

2-2

Long-Term Funding Outlook

The December 31, 2001 actuarial valuation showed that the Retirement System's funding situation had deteriorated and the System was not in "actuarial balance."

- In fiscal year 2005, the State should be contibuting 7.69 percent of compensation to pay for benefits promised to existing and former members. The statutory (capped) employer rate for this group is scheduled to be 4.78 percent. This difference has resulted in a long-term funding shortfall, and the State's annual contribution would need to increase by approximately $100 million to contribute at the full actuarial rate.
- The System's consulting actuary strongly recommended that action be taken to increase future contributions to a level that would restore the System to actuarial balance.
- The System's unfunded actuarial liability had grown to approximately $1.8 billion at December 31, 2001.
- The funded ratio (ratio of actuarial value of assets to actuarial liabilities) had declined to 82 percent for the State/School group and 89 percent for the local group.
- KPERS staff have been working closely with the Joint Comittee on Pensions, Investments and Benefits to educate members of the Legislature, executive officials and other interested parties about the long-term funding sitiuation.

Updated Funding Projections

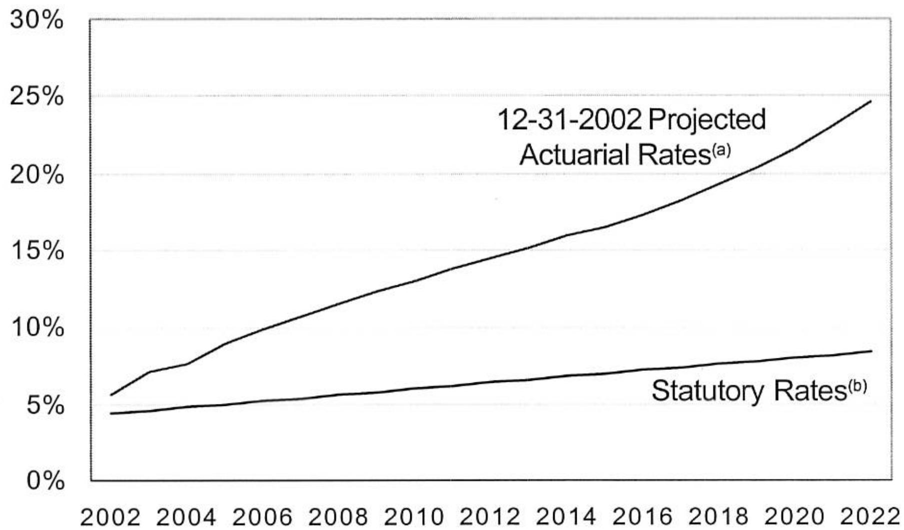
Funding projections presented in August 2002 were based on actuarial valuation and investment performance as of December 31, 2001. For the calendar year ended December 31, 2002, the System's portfolio returned negative 6.9 percent. The System's assets declined from $9.1 billion to $8.2 billion during the same period.

Incorporating these additional negative returns and the resulting lower asset value into the projection model increases the unfunded actuarial liability (UAL) and contribution rates necessary to reduce the UAL.

Funding projections are very long-term and volatile:

- All projections represent assumptions based on an average of several decades, not years.
- Actual results will more likely rest somewhere between the extremes of 2000 and 2003.

Employer Contribution Rates



(a) 12-31-2002 Projected Actuarial Rates based on actuarial valuation as of 12-31-2001, investment performance through 12-31-2002, and assumed annual investment return of flat 8 percent beginning 1-1-2003.

(b) Current statutory rates increase by 0.2 percent annually.

Funding Projections and Alternatives

Increased employer contributions are essential to the System's long-term financial health.

Various studies have shown that KPERS employer contribution rates are low when compared with employer rates for comparable public systems.

Alternatives for increasing employer contributions include:

- Various rates of increase to actuarially-required rates
- Employer contribution increases and issuance of pension obligation bonds
- Employer contribution increases coupled with changes in amortization period and other actuarial methods

Funding Projections and Alternatives

2-5

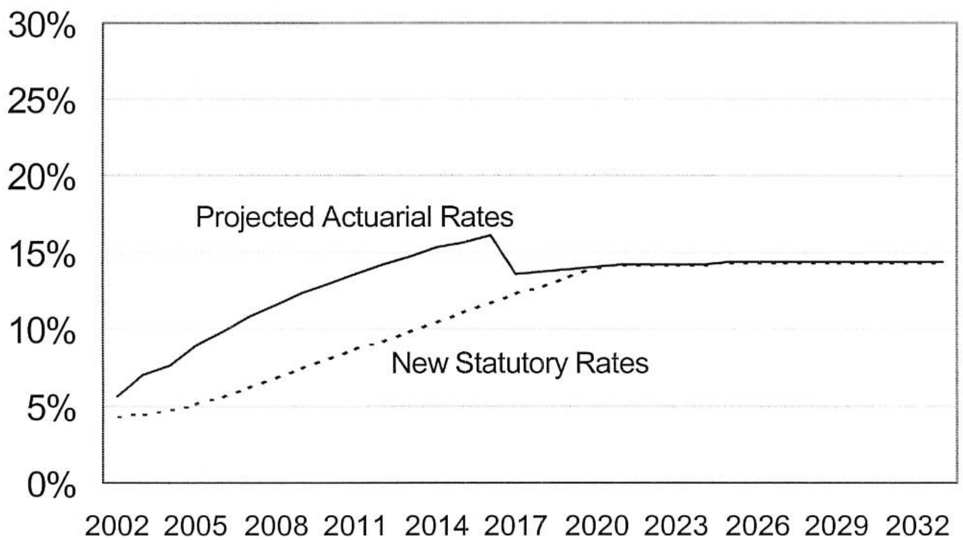
The funding outlook improves by moving toward actuarially sound contribution levels.

The following example illustrates the potential impact of increasing employer contributions beginning in fiscal year 2006 and reamortizing the unfunded actuarial liability in 2015.

Alternative: Reamortize the Unfunded Actuarial Liability in 2015[a]
Increase Employer Contributions Beginning July 1, 2005[b]

- State/School group equilibrium rate of 14.06 percent in fiscal year 2021

Employer Contribution Rates



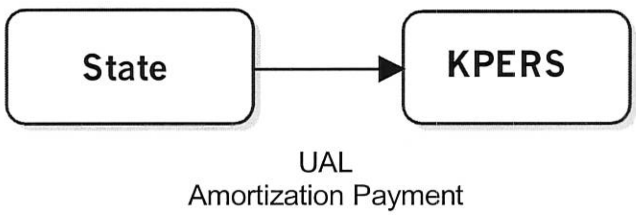
Fiscal Year	Contributions ($millions) Current	This Alternative	Difference
2005	$ 166.2	$ 166.2	$ --
2006	177.9	185.0	7.1
2007	190.0	208.3	18.3
2008	202.5	236.3	33.9
2009	215.4	265.6	50.2
2010	228.8	296.2	67.3
2015	305.3	471.9	166.6
2020	406.4	704.1	297.7
2025	543.0	1,019.2	476.2

(a) Assumes the UAL is reamortized in 2015 to a fixed period of 30 years with a floor of 10 years and investment returns average 8 percent beginning January 1, 2003.

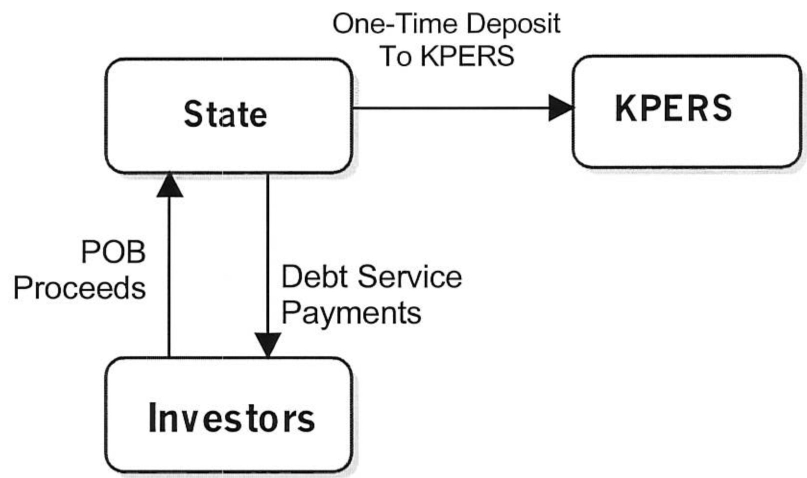
(b) Assumes employer contributions increase by 0.4 percent for fiscal year 2006, 0.5 percent for fiscal year 2007, and 0.6 percent for fiscal year 2008 and beyond.

Pension Obligation Bond Overview

Current Plan



After POB Transaction



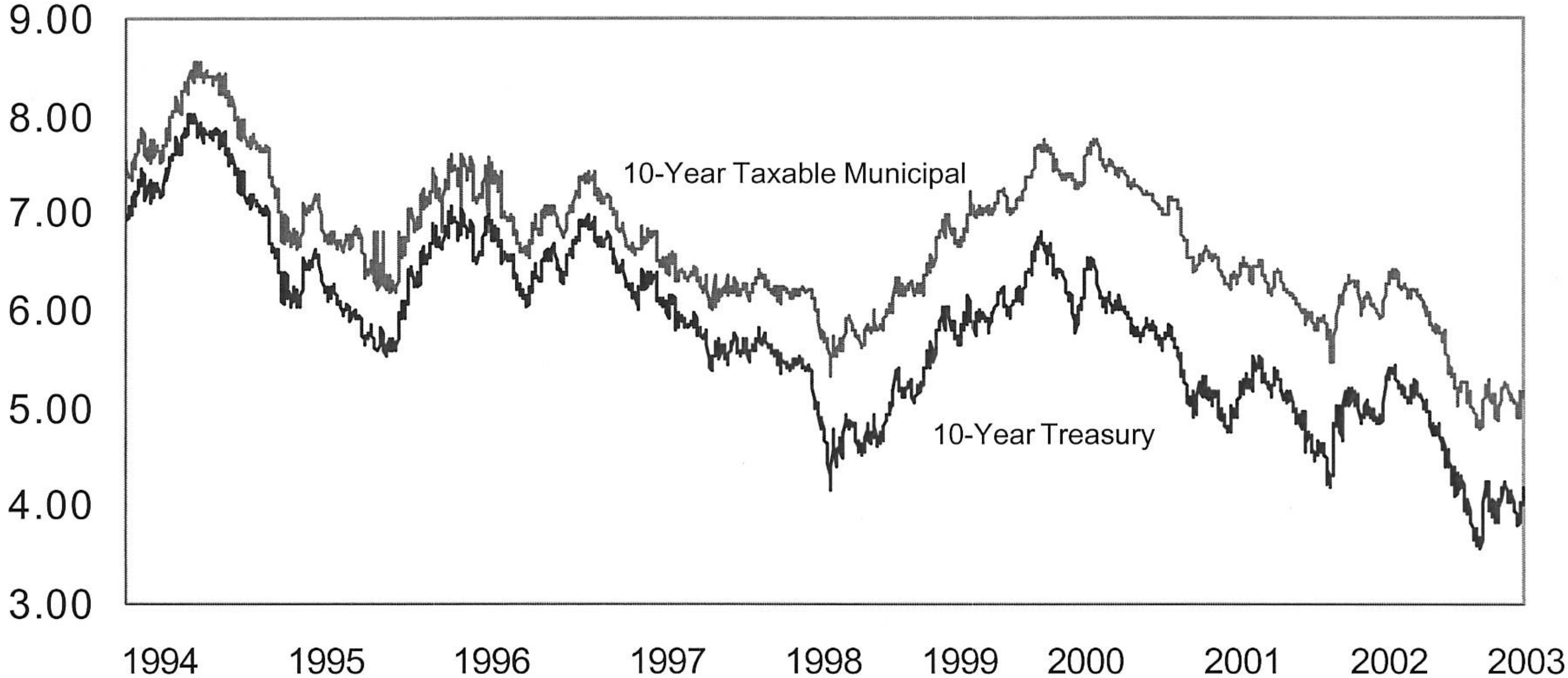
- Proceeds of pension obligation bond (POBs) deposited in pension fund.
- State obligation to make UAL payments replaced with principal and interest payments to bondholders.
- Net effect is to lower expected KPERS payments.

Market Overview

2-7

Pension obligation bonds are issued on a taxable basis and, therefore, priced relative to U.S. Government Bonds.

Interest rates are very low. Recently, the yield on 10-year Treasury notes fell to its lowest level in 44 years.



Bond Interest Rates

Currently, the State could issue POBs at interest rates below the 8 percent investment return assumption.

Current Estimated True Interest Cost (TIC) of 30-year issue is approximately 6 percent.

Estimated Pension Obligation Bond Scale*

Maturity	Year	US Treasury Yield	POB Spread to Treasuries	POB Yields
1	2004	1.24	65	1.89
2	2005	1.49	70	2.19
3	2006	1.85	75	2.60
4	2007	2.24	85	3.09
5	2008	2.62	90	3.52
6	2009	2.83	95	3.78
7	2010	3.03	95	3.98
8	2011	3.24	102	4.26
9	2012	3.44	108	4.52
10	2013	3.65	115	4.80
11	2014	3.76	115	4.91
12	2015	3.87	115	5.02
13	2016	3.99	115	5.14
14	2017	4.10	115	5.25
15	2018	4.21	115	5.36
16	2019	4.32	115	5.47
17	2020	4.43	115	5.58
18	2021	4.55	115	5.70
19	2022	4.66	115	5.81
20	2023	4.77	115	5.92
21	2024	4.77	120	5.97
22	2025	4.77	120	5.97
23	2026	4.77	120	5.97
24	2027	4.77	120	5.97
25	2028	4.77	120	5.97
26	2029	4.77	120	5.97
27	2030	4.77	120	5.97
28	2031	4.77	120	5.97
29	2032	4.77	120	5.97
30	2033	4.77	120	5.97

* Based on March 4, 2003 rates from the Federal Reserve Statistical Release.

Source: Kansas Development Finance Authority

2-8

Bond Issue Structure

Pension obligation bonds could be issued for a portion or nearly all of the System's unfunded actuarial liability.

Various options could be structured to provide alternate payment schedules:

- 30-year vs. shorter term
- Level annual debt service
- Gradually increasing debt service
- One large issue or several small series over a 2-3 year period depending on the market

The modeled POBs assume a level debt payment structure.

Actual structure would be a function of interest rates (the shape of the yield curve), cash-flow targets and market demand.

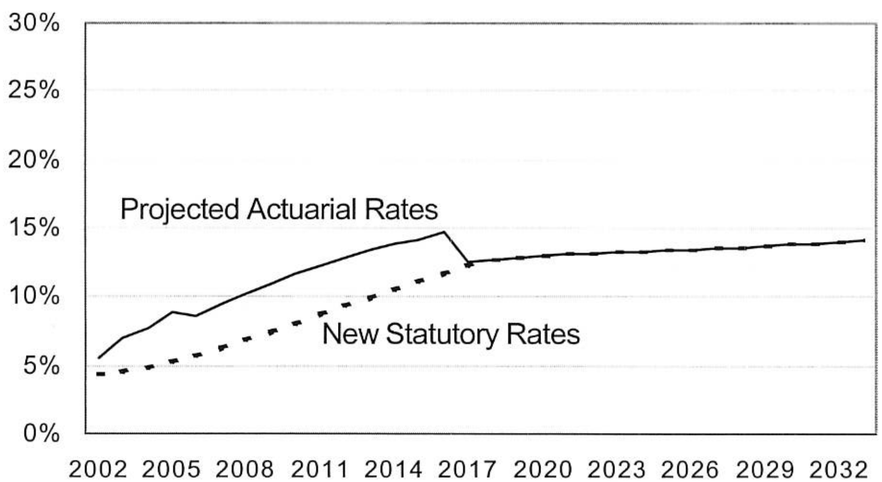
Funding Alternatives with POBs

The following example illustrates the potential impact of issuing POBs (with level debt service payments) coupled with reamortization and employer contribution rate increases.

Alternative: Issue $750 Million POBs in 2003
Reamortize the Unfunded Actuarial Liability in 2015[(a)]
Increase Employer Contributions Beginning July 1, 2005[(b)]

- State/School group equilibrium rate of 12.66 percent in fiscal year 2019.
- The estimated present value of the difference in contributions is $137 million[(c)].

Employer Contribution Rates



	Contributions ($millions)		
Fiscal Year	Current	This Alternative	Difference
2005	$ 166.2	$ 166.2	$ --
2006	177.9	185.0	7.1
2007	190.0	208.3	18.3
2008	202.5	236.3	33.9
2009	215.4	265.6	50.2
2010	228.8	296.2	67.3
2015	305.3	471.9	166.6
2020	406.4	669.6	263.2
2025	543.0	821.3	278.3

(a) Assumes the UAL is reamortized in 2015 to a fixed period of 30 years with a floor of 10 years and investment returns average 8 percent beginning January 1, 2003.
(b) Assumes employer contributions increase by 0.4 percent for fiscal year 2006, 0.5 percent for fiscal year 2007, and 0.6 percent for fiscal year 2008 and beyond.
(c) As compared with the employer contribution increases described in (b) without the POB issue.

2-11

POB Issues to Consider

Risk of investment performance not achieving the borrowing rate:

- 10 year average investment performance of 8.1 percent
- 3 year average investment performance of negative 4.5 percent
- 1 year return of negative 6.9 percent

Timing of one-time deposit of bond proceeds in relation to market performance

Debt capacity of State and impact on State credit and other borrowing

Reduced flexibility to State budget of converting a portion of employer contributions into fixed debt service payments

2-12

POB Issuance Process

Authorizing legislation (SB 260) establishes bond issuance authority and process:

- Kansas Development Finance Authority (KDFA) is the borrowing entity.
- Agreement between KDFA, State (Department of Administration) and KPERS to carry out transactions.
- KDFA would work with underwriting team to develop final bond issue structure.
- Final transaction approval delegated to the State Finance Council.
- Debt service on bonds would be paid through annual appropriation.

2-13

Conclusion

KPERS objective is to develop a consensus among the Board of Trustees, the Governor, the Legislature, and other state and local officials on a long-term funding plan to ensure the System's financial health.

KPERS Board and staff are available to provide any information or assistance requested by the Legislature or the Governor regarding funding alternatives and pension obligation bonds.

2-14

Appendix

Summary of Pension Obligation Bond Issues in Other States

Pension Obligation Bond Issues in Other States

2-15

Date	Amount	Issuer	State	Sale Type	Objective[a]
10-10-02	$ 774,663,000	Oregon School Board	OR	neg	
9-17-02	737,340,000	San Diego County	CA	neg	
3-15-02	228,615,000	Oregon Local Governments	OR	neg	
3-13-02	117,055,000	Fresno County	CA	neg	Near/Immediate Budget Relief
1-23-02	205,335,000	City of Fresno	CA	neg	
10-03-01	195,639,000	City of Oakland	CA	neg	
7-7-01	111,000,000	City of Portland	ME	neg	Long-Term Savings, Pension Funding
3-8-01	107,005,000	Contra Costa County	CA	neg	
12-10-00	171,685,000	City of New Orleans	LA	neg	Immediate Relief, Pension Funding
8-22-00	350,000,000	City of Bridgeport	CT	neg	Long-Term Budget Relief and Pension Funding
7-11-00	105,650,000	City of Fresno	CA	neg	Long-Term Savings, Pension Funding
7-11-00	105,650,000	City of Fresno	CA	neg	
11-17-99	184,548,160	Multnomah County	OR	neg	
10-22-99	150,848,346	City of Portland	OR	neg	
7-29-99	101,940,000	Pasadena	CA	neg	
1-21-99	1,291,913,112	City of Philadelphia	PA	neg	Intermediate Relief, Pension Funding
12-8-98	220,979,365	City of Worcester	MA	neg	Pension Funding
3-12-98	184,910,000	Fresno County	CA	neg	
2-3-98	255,865,000	Pittsburgh	PA	comp	
7-9-97	384,168,000	Denver Public Schools	CO	neg	Long-Term Budget Relief, Pension Funding
6-25-97	2,803,042,000	State of New Jersey	NJ	neg	Near-Term Budget Relief
2-15-97	436,289,659	City of Oakland	CA	neg	Intermediate Term Relief, Pension Funding
1-7-97	136,923,000	Orange County	CA	neg	
12-12-96	306,863,000	Alameda County	CA	neg	
11-1-96	773,475,000	NYS Dorm Authority	NY	neg	Debt Service Savings vs hard UAAL obligation
6-6-96	121,680,000	Orange County	CA	neg	
4-27-96	327,400,000	Los Angeles County	CA	neg	
11-30-95	154,510,000	Ventura County	CA	neg	
11-22-95	420,527,000	San Bernadino County	CA	neg	
11-10-95	227,818,000	Kern County	CA	neg	Long-Term Budget Relief, Pension Funding
10-25-95	108,635,000	City of Long Beach	CA	neg	
10-19-95	600,000,000	Los Angeles County	CA	neg	
9-13-95	108,970,000	Stanislaus County	CA	neg	
6-22-95	538,060,000	Sacramento County	CA	neg	
4-12-95	310,150,000	Alameda County	CA	neg	

Pension Obligation Bond Issues in Other States (continued)

Date	Amount	Issuer	State	Sale Type	Objective[a]
10-13-94	$ 1,965,230,000	Los Angeles County	CA	neg	
9-23-94	320,040,000	Orange County	CA	neg	
3-17-94	245,555,000	City of Fresno	CA	neg	
2-15-94	337,365,000	Contra Costa County	CA	neg	
2-3-94	430,430,000	San Diego County	CA	neg	
Pending - Underwriters Named					
	$ 3,900,000,000	West Virginia	WV	neg	Awaiting court test, goal of pension funding
	400,000,000	Government of Guam		neg	Budget Relief, Pension Funding
	200,000,000	Sonoma County	CA	neg	Budget Relief, Pension Funding
	250,000,000	Kern County	CA	neg	Budget Relief, Pension Funding
	200,000,000	Sacramento County	CA	neg	
Under Consideration per Bond Buyer - No Legislation, Firm Plans or Banking Team Named					
	$ 5,000,000,000	Illinois	IL		Near/Immediate Relief, Pension Funding
	750,000,000	Wisconsin	WI		Near/Immediate Relief
	1,500,000,000	California	CA		Near-Term Relief, Normal Cost Takeout

(a) POB objective represents the opinion of experienced POB market participants.

Source: *UBS Paine Webber*