

## MEMORANDUM

To: House Insurance and Pensions Committee

From: Alan D. Conroy, Executive Director *A.D.C.*

Date: February 22, 2021

Subject: Testimony in Support of House Bill 2405; Pension Obligation Bonds

### **Board Support**

The KPERS Board of Trustees has not had the opportunity to specifically consider HB 2405. However, the Board strongly supports any legislative action that improves the funded status and sustainability of the KPERS System.

### **Bill Provisions**

HB 2405 authorizes the Kansas Development Finance Authority (KDFA) to sell one or more series of revenue bonds of \$1,000,000,000, net of fees, for deposit in the KPERS Trust Fund. The proceeds are to be applied to the KPERS unfunded actuarial liability.

For purposes of HB 2405, the unfunded actuarial liability is specifically defined as the unfunded actuarial liability of the KPERS School group. However, for funding purposes the State and School groups are combined so the addition of \$1,000,000,000 impacts the State/School employer contribution rate.

The bill stipulates that the State Finance Council must approve a resolution stating the parameters for principal, interest rates and final maturity of the bond issuance. However, the bill language as introduced sets a maximum total interest rate of 3.5%.

HB 2405 stipulates that the bonds are solely the obligations of KDFA and are not an obligation or indebtedness of KPERS. KDFA and the Department of Administration are responsible for establishing debt service payment for the bond issuances.

The current estimated annual debt service on a 30-year, taxable bond issue of \$1,000,000,000 at 2.75% is \$48.5 million.

### **Actuarial Cost Impact**

The addition of \$1,000,000,000 to the Trust Fund in CY 2021 has both immediate and long-term impacts on the funding of the State/School Group.

The additional assets in the Trust Fund immediately improve the funded ratio of the State/School group. Under the current financing plan, the State/School is projected to be



71.9% on 12/31/2021. With the addition of the bond proceeds the funded ratio is projected to be 76.7%, or 4.8% higher.

The unfunded actuarial liability is estimated to decrease from \$6.05 billion on 12/31/2021 under the current financing plan to \$5.01 billion after the bond proceeds are deposited. The difference is slightly more than \$1.0 billion on 12/31/2021 because the projection assumes the bond proceeds will be received in July and is accounting for 6 months on interest earnings on the bond proceeds.

HB 2045 does not change the financing schedule of the unfunded actuarial liability. The unfunded actuarial liability is still scheduled to be funded by 2035. However, with the additional assets from the bond proceeds, the amount of State/School employer contributions required to extinguish the unfunded liability is less.

The \$1.0 billion in bond proceeds would first be reflected in the 12/31/2020 actuarial valuation, which sets employer contribution rates for FY 2024. Projected state/school group contribution rates for FY 2023 through FY 2028 are summarized below.

| <b>KPERS State/School Employer Contribution Rates</b> |                               |                |                     |                                    |
|-------------------------------------------------------|-------------------------------|----------------|---------------------|------------------------------------|
| <b>Fiscal Year</b>                                    | <b>Current Financing Plan</b> | <b>HB 2405</b> | <b>% Difference</b> | <b>\$ Difference (in millions)</b> |
| FY 2023                                               | 13.86%                        | 13.86%         | 0.00%               | \$0                                |
| FY 2024                                               | 13.69%                        | 12.03%         | -1.66%              | \$(87.58)                          |
| FY 2025                                               | 13.52%                        | 11.84%         | -1.68%              | \$(90.83)                          |
| FY 2026                                               | 13.57%                        | 11.87%         | -1.70%              | \$(94.26)                          |
| FY 2027                                               | 13.17%                        | 11.47%         | -1.70%              | \$(96.26)                          |
| FY 2028                                               | 13.15%                        | 11.44%         | -1.71%              | \$(99.93)                          |

Applying the new, lower employer contribution rate to the project State/School group payroll (approximately \$5.0 billion in FY 2024) totals reduced contributions between \$88 million and \$100 million in the first five years after the bond proceeds are received by the Trust Fund. Over the 30-year projection period, total employer contributions are projected to be \$12.11 billion, which is \$1.4 billion less than the \$13.56 billion projected under the current financing plan. The total difference is greater than the \$1.0 bond proceeds because the assets are in the Trust Fund earlier and allowed to grow with investment returns over a longer period.

**Past Pension Obligation Bond Issues**

The Legislature has issued pension obligation bonds on two previous occasions to improve the funded status of the System. The first pension bond issue was approved in 2004 and was \$500,000,000 gross of fees. KPERS ultimately received about \$440 million in bond proceeds. The second bond issue was approved in 2015 for \$1,000,000,000, net of fees. Both bond issues are 30-year taxable bonds and the debt service is paid outside of KPERS.

The proceeds from the bond issuances are invested across KPERS portfolio consistent with the Boards asset allocation and investment practices. KPERS does not track the bond proceeds separately from the rest of the Trust Fund, but we do track the Trust Fund performance since the date of receipt.

Past performance does not guarantee future performance, but so far both bond issues have added value to KPERS Trust Fund and the State of Kansas. As of January 31, 2021, the investment returns of the Trust Fund have outperformed the bond rate on both bond issues. The total value added, after paying the debt service on the bonds, is \$734 million.

| Performance of Existing Pension Obligation Bonds                 |               |               |
|------------------------------------------------------------------|---------------|---------------|
| Bond Issue                                                       | March 2004    | August 2015   |
| Total Proceeds Received                                          | \$440 million | \$1.0 billion |
| Investment Return Since Deposit Date<br>(As of January 31, 2021) | 7.65%         | 8.44%         |
| Interest Rate on the Bonds                                       | 5.39%         | 4.68%         |
| Value Added After Debt Service                                   | \$462 million | \$272 million |

Both bond issues are 30-year bonds and the ultimate value will not be known for many more years, but so far, the pension obligation bonds approved by past Legislatures have been a net positive for the State of Kansas.

I would be pleased to answer any questions the Committee has regarding HB 2405.