## MEMORANDUM

To: House Pensions and Benefits Committee

From: Alan D. Conroy, Executive Director

Date: March 11, 2013

Subject: Pension Obligation Bonds

The following comments are offered for your consideration as you evaluate the issuance of pension obligation bonds as one potential approach toward improving the long-term funded status of KPERS.

### Assumptions

- For purposes of this discussion, it is assumed that pension obligation bonds (POBs) are bonds issued by the State of Kansas through KDFA.
  - The net bond sales proceeds are deposited as a contribution to KPERS to finance a portion of the UAL.
  - Debt service (principal and interest) on the bonds are obligations of the State of Kansas., and debt service is paid by the State of Kansas.

### Theory

- In theory, an up-front payment (bond proceeds) to a pension plan's unfunded actuarial liability (UAL) could reduce future UAL payments, thereby permitting the bonds' debt service to be funded to some degree by resources that would have been committed to future UAL payments.
  - If the bond proceeds that are invested can earn 8% or more, then no new UAL will be incurred.
  - If the debt costs less than 8 percent, then a savings is realized if the assets grow at the actuarially assumed 8 percent return.
  - Therefore, POB's can reduce expected total employer contributions via the opportunity to finance an existing obligation at a lower implied rate of interest.

### Risks

By their nature, pension obligation bonds entail risks both for the State of Kansas as the issuer and for KPERS.

**State budget flexibility.**

- While the conversion of a portion of the employer contributions into fixed debt service payments reflects a commitment to devote State resources toward addressing the UAL, it would also reduce the flexibility of the State's budget.
- The issuance of POBs may impact the State's debt capacity and ability to do other borrowing.

**Market timing and investment return risk.**

- The validity of the refinancing concept is predicated on the realization of investment returns over the term of the financing that are in excess of the financing rate.
- While specific proposals have not been presented to KPERS for consideration, bonds of various sizes have been discussed. For example, at the System's current NAV of $14.3 billion, a bond issuance in the amount of $1.5 billion would be approximately 10.5% of total assets. Therefore, a one-time inflow of cash at that level would entail significant market timing risk.
- There is risk that the investment performance achieved may not exceed the borrowing rate on the bonds. Investment returns are volatile, and significant fluctuations in returns are possible, particularly over shorter time periods. The timing of depositing the bond proceeds amplifies the short-term investment risk. The asset allocation mix of the Retirement System's investment portfolio is focused on a very long-term investment time horizon.
- The historically low level of interest rates, which makes issuing POBs seem attractive at this point in time, also has implications for expected total returns from the System's fixed income investments (and, therefore, the achievement of the 8% actuarial return assumption).
- The System's assets are invested in a manner to meet the actuarial assumption (currently, 8 percent) on average over time, and to minimize (as much as possible) the variability of returns over time. Assets are also invested in a manner to reduce, over time, the difference between assets and liabilities. Current asset strategies are designed to offer the best risk/reward tradeoff over the long term.
    - Any effort to reduce short-term variability will serve to reduce the long-term expected return.
    - Any effort to increase short-term returns will contribute to higher overall risk in both returns and asset/liability coordination.
- A substantial deposit in assets will cause investment results to have a greater impact, either positive or negative, to the System's actuarial results.
    - If long-term returns are above the actuarial assumption, the funding status improves.
    - If long-term returns are below the actuarial assumption, then the employer is obligated to make up the shortfall, regardless of the POB.
    - A higher funded ratio means that the impact of investment returns on the System's funded status is heightened.

## Timing and Sizing Considerations

- The amount of pension obligation bonds to be issued should be determined by the degree to which the state wants to reduce the UAL (improve the funded status of the System) and the amount of bonds which can be absorbed by the market at a reasonable cost.
- The Retirement System can manage the investment of any amount of bond proceeds. If the bond proceeds are received in one lump sum, some of the proceeds may be invested in a temporary portfolio (i.e., a series of short-term, fixed income "bullet" portfolios), then re-invested more permanently at maturity, in order to diversify the market timing risk of initial investment.
- If pension obligation bonds are floated in increments, such as a series of $500 million issuances at six-month intervals, then the System would rebalance the investment portfolio toward the long-term target asset mix each time a cash inflow is received.
  - $500 million is approximately 3.5% of the System's current total assets of $14.3 billion.
  - POB proceeds will necessarily be commingled with the rest of the investment portfolio. (They will not be tracked separately.)
- Ideally, the market timing risk of investing a large amount of pension obligation bond proceeds would be diversified over a time period of eighteen months to two years.

KPERS will be available to provide additional information that you may require to evaluate the advisibility of issuing bonds or regarding specific bonding proposals.