State of Kansas - Implications for a $5 Billion Pension Obligation Bond Transaction

KDFA Role – Established by KSA 74-8901 *et seq*. as a conduit finance authority to efficiently access the capital markets on behalf of the State and other public and private borrowers. KDFA is a State-wide and multistate, multipurpose issuer, and serves to centralize the function of debt issuance and management, and has streamlined access to long-term capital financing for State agencies, political subdivisions, public and private organizations and businesses. KDFA works with its finance teams to structure efficient bond issues in compliance with State and federal regulatory requirements, and provides significant post-issuance administration and debt management resources to maintain ongoing compliance with State and federal regulatory requirements.

Tax Status of Bonds - Pension obligation bonds are issued on a taxable basis because current federal tax law restricts the investment of the proceeds of tax-exempt bonds in higher-yielding taxable securities (risk arbitrage). Pension Bonds issued for the primary purpose of investing the proceeds in higher yielding securities are characterized as arbitrage bonds, and the 1986 Tax Act essentially ended the issuance of tax exempt bond pension bonds for the purpose of depositing the proceeds into a pension fund for investment, or the for the purpose of purchasing annuities to replace an issuer's responsibilities to its retirees. Bonds issued as tax-exempt obligations, except for certain limited exceptions related primarily to bond proceeds spend down, must submit any investment earnings in excess of the bond yield to the federal government in the form of arbitrage rebate payments.

Security of Repayment for the Bonds – The Kansas Constitution significantly constrains the State from issuing general obligation bonds, but pension obligation bonds are typically structured as fairly simple fixed rate issues, designed to lock in an interest cost with the ultimate goal of attaining a rate of investment return which is materially higher than the bond rate, and are debt serviced from appropriations by the legislature from the State General Fund.

State's Credit Rating – Likely but not certain downgrade of State's current Issuer Credit Rating (ICR) of S&P 'AA+' and Moody's 'Aa1' (negative outlook). Pension bonds are used as an asset-liability management tool, the State's liability profile does not change significantly from the rating agencies perspective, but budget flexibility for expenses does.

Arbitrage – In theory, over the very long term, the KPERS would expect to invest the bond proceeds and earn more in investment returns than the State would pay in debt service on the bonds. However, it is important to note there were two significant periods in 20th Century where equity markets were flat over a long period of time '29 to '54 (25 years) and '66 to '82 (16 years).

Size – $5B is an extremely large transaction for the municipal market which recently has had weekly volume of about $10B. Breaking the transaction into smaller pieces would help reduce timing risk for both the debt issuance and the associated asset purchases and also increase the pricing efficiency of the debt issuance.

Sample Transaction Numbers – Assuming 30 year level debt service; taxable; annual SGF appropriation pledge; 'AA' credit spreads, all in financing would be at about 5% and mean $325M annual debt service starting in fiscal year 2013.