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KENTUCKY'S AFFORDABLE PREPAID TUITION
2002 ANNUAL REPORT
EXECUTIVE SUMMARY

State Treasurer Jonathan Miller
State Capitol Annex
Frankfort, KY 40601

Dear Treasurer Miller:

Kentucky's Affordable Prepaid Tuition (KAPT) Fund is on sound financial ground.

As the investment consultant for the plan, I have reviewed KAPT's investments and investment performance, actuarial analysis, and financial statements. As you know, I am a consultant for several other state prepaid tuition programs, and I base my thoughts below on an in-depth knowledge of the structure and workings of such plans.

2002 was a difficult year for most prepaid tuition programs across the country. Severe tuition hikes and poor stock market performance caused many plans to experience price increases and actuarial deficits at levels not previously encountered.

As demonstrated in the information provided in this report, however, KAPT has weathered the storm of a turbulent economy during its first year of existence and is sound structurally and financially for the short and long terms. During its first two enrollments, over 4,200 families opened KAPT accounts and KAPT assets totaled $25 million at the end of December. Unlike other programs across the country, KAPT did not experience double-digit tuition increases, or significant investment losses or actuarial deficits. There are several reasons for KAPT's unique status, which I will explain as I highlight some of the key points of financial information contained in this annual report:

1. KAPT's Unique Financial Guarantee – the Unclaimed Property Fund

The primary reason why KAPT's financial standing is sound rests in the design of the program itself. When the Kentucky General Assembly created KAPT, it anticipated situations when program deficits could occur due to higher-than-expected tuition increases or lower-than-expected investment returns. Rather than requiring tax increases or general fund expenditures to relieve such deficit situations, KAPT is financially guaranteed by the state's unclaimed property fund. While nine of the country's 19 prepaid programs have some state financial backing, to the best of my knowledge, KAPT is the only prepaid program in the country backed by a specific pool of assets.

Kentucky's unclaimed property fund is administered by the Kentucky State Treasurer's office. If KAPT is ever unable to pay any of its obligations, 75 percent of this fund is available to make up any shortfall. This financial backing is a tremendous source of security.

Currently, the unclaimed property fund has a balance of over $56 million. This includes $48 million in cash and an additional $8-10 million in stocks and bonds. <u>Accordingly, the unclaimed property fund – KAPT's backup fund – is more than twice the size of the KAPT fund itself</u>.

And while KAPT will continue to grow, so will the unclaimed property fund. Over the past 10 years, the unclaimed property fund has grown on average by $6 million a year – that is, every year on average the fund received $6 million more from unclaimed property holders than it returned to rightful owners. Even with the efforts of your administration to return unclaimed property to its owners, the fund has still grown, on net, by over $21 million the past three years.

Accordingly, in the short term and in the long run, the unclaimed property fund provides a substantial financial backing for the KAPT fund.

2. KAPT Investment Deficits – Minor and Insignificant

Another reason for KAPT's sound financial position is its timing in entering the investment market. Although KAPT enrollment began in October 2001, first payments were not due until February 1, 2002, causing KAPT to miss more than two-thirds of the stock market losses that were experienced by other programs.

Because KAPT avoided the significant stock market losses of 2000 and 2001, and also significantly, because of KAPT's balanced portfolio, which includes holdings in safer bond and cash instruments, KAPT's portfolio experienced only a $1.53 million loss during the 2002 calendar year. As of January 15, that deficit was shrunk by about half to approximately $885,000.[1] Compared to other prepaid programs or institutional funds in general, that loss is relatively insignificant.

KAPT's actuarial valuation and audit of financial statements also demonstrate KAPT's sound footing. An actuarial deficit/surplus consists of the long-term projection of assets compared to the long-term projection of liabilities if no further contracts are sold by the program. The actuarial valuation shows that KAPT was 95 percent funded as of June 30, 2002, with a $2.8 million projected actuarial deficit. Further, the cash flow projection presented in Appendix E of the Actuarial Valuation shows that if KAPT never sold another contract – a highly unlikely scenario – KAPT would not experience its first shortfall under these actuarial assumptions until 2022.

KAPT further received an unqualified opinion on its audit of financial statements, performed by an outside auditor, Carpenter, Mountjoy & Bressler, who was hired by State Auditor Ed Hatchett. The audit indicated no problems were found with KAPT's financial reporting and internal controls. As expected given its short life-span, the financial statements show KAPT had a net accounting deficit of $6.4 million as of June 30, 2002.[2] Even in good economic times, such accounting deficits are expected in the infancy of these types of plans due to the nature of the programs, which rely on future investment earnings.

Moreover, according to our calculations, KAPT would not experience a shortfall until 2022 – almost two decades from now. And even then, the balance of the abandoned property fund today is more than nine times greater than the largest projected deficit, suggesting no impact on the state General Fund.

[1] This is an estimated amount, derived by assuming that the stocks in the portfolio increased by approximately the same amount as the S&P 500 (4.36% from 1/1/03-1/15/03) and the bonds in the portfolio declined by approximately the same amount as inflation-indexed bonds (-0.5% from 1/1/03-1/15/03). These rates of return, when applied to the year-end market value and year-end asset allocation of the fund, produces a gain of approximately $647,000.

[2] This number is higher than the actuarially calculated deficit because accounting guidelines require a deduction from the assets of the program as an allowance for uncollectible accounts. The allowance used in KAPT's financial statements for this deduction was $3.5 million. The actuarial calculation does not deduct this amount from assets because, from the actuarial perspective, a reduction in the number of accounts to be collected would also result in a reduction of payout liabilities for the program and, thus, the allowance would be offset.

3. KAPT's Long-Term Financial Future is Bright

The relative size of the unclaimed property fund provides a financial cushion against several more years of potential rising tuition and declining stock markets. Accordingly, unlike with other state programs that do not have financial guarantees, KAPT will not require a taxpayer bailout or significant cuts to the program to survive.

Of course, the unclaimed property fund is not limitless, and there could be a scenario several years from now where investment deficits could approach the size of the unclaimed property cushion.

The good news is that such a scenario can be anticipated many years in advance through the intensive actuarial and financial analyses as seen in this report. If the worst case scenarios materialize in the future, KAPT may need to limit enrollment or charge higher prices to new enrollees. However, people who already signed up for KAPT need not worry – their guarantee is solid; they never will have to pay higher prices than those specified in their contract. Kentucky families already participating in KAPT will never be affected by the uncertain economic times of the future – indeed, by enrolling their children in KAPT, they have made a wise investment decision in tough economic times.

Just as significant, the state will never have to use taxpayer funds to bail out KAPT. While other states are having to make tough decisions about their prepaid tuition programs, the Kentucky General Assembly can be assured that KAPT will never adversely affect the general fund budget bottom line.

Sincerely,

F. Jeffrey Van Orden
Milliman USA