

**ALASKA STATE LEGISLATURE
HOUSE STATE AFFAIRS STANDING COMMITTEE**

January 17, 2006
8:04 a.m.

MEMBERS PRESENT

Representative Paul Seaton, Chair
Representative Carl Gatto, Vice Chair
Representative Jim Elkins
Representative Bob Lynn
Representative Berta Gardner
Representative Max Gruenberg

MEMBERS ABSENT

Representative Jay Ramras

OTHER MEMBERS PRESENT

Representative Mike Hawker

COMMITTEE CALENDAR

HOUSE BILL NO. 278

"An Act relating to the Alaska Municipal Bond Bank Authority; permitting the Alaska Municipal Bond Bank Authority or a subsidiary of the authority to assist state and municipal governmental employers by issuing bonds and other commercial paper to enable the governmental employers to prepay all or a portion of the governmental employers' shares of the unfunded accrued actuarial liabilities of retirement systems and authorizing governmental employers to contract with and to issue bonds, notes, or commercial paper to the authority or its subsidiary corporation for that purpose; and providing for an effective date."

- HEARD AND HELD

HOUSE BILL NO. 273

"An Act relating to the dividends of individuals claiming allowable absences; and providing for an effective date."

- HEARD AND HELD

HOUSE BILL NO. 23

"An Act relating to construction of a legislative hall."

- BILL HEARING CANCELED

PREVIOUS COMMITTEE ACTION

BILL: HB 278

SHORT TITLE: RETIREMENT SYSTEM BONDS

SPONSOR(S): REPRESENTATIVE(S) HAWKER

04/19/05	(H)	READ THE FIRST TIME - REFERRALS
04/19/05	(H)	STA, FIN
01/12/06	(H)	STA AT 8:00 AM CAPITOL 106
01/12/06	(H)	Heard & Held
01/12/06	(H)	MINUTE(STA)
01/17/06	(H)	STA AT 8:00 AM CAPITOL 106

BILL: HB 273

SHORT TITLE: PFD: DELAY PAYMENT FOR ALLOWABLE ABSENCES

SPONSOR(S): REPRESENTATIVE(S) WEYHRAUCH

04/18/05	(H)	READ THE FIRST TIME - REFERRALS
04/18/05	(H)	STA, FIN
05/05/05	(H)	STA AT 8:00 AM CAPITOL 106
05/05/05	(H)	Heard & Held
05/05/05	(H)	MINUTE(STA)
01/12/06	(H)	STA AT 8:00 AM CAPITOL 106
01/12/06	(H)	Scheduled But Not Heard
01/17/06	(H)	STA AT 8:00 AM CAPITOL 106

WITNESS REGISTER

CAROL SAMUELS, Vice President
Seattle Northwest Securities
Portland, Oregon

POSITION STATEMENT: Described the use of the Pension Obligation Bond (POB).

GARY BADER, Chief Investment Officer
Treasury Division
Department of Revenue
Juneau, Alaska

POSITION STATEMENT: Provided information on Pension Obligation Bonds.

TOM BOUTIN, Deputy Commissioner
Treasure Division
Department of Revenue

Juneau, Alaska

POSITION STATEMENT: Testified regarding Pension Obligation Bonds.

DEVEN MITCHELL, Executive Director
Alaska Municipal Bond Bank Authority
and Debt Manager for the State of Alaska
Juneau, Alaska

POSITION STATEMENT: Answered questions regarding the use of bonds in Alaska communities.

JEFFREY SINZ, Chief Fiscal Officer
Municipality of Anchorage
Anchorage, Alaska

POSITION STATEMENT: Testified in support of HB 278.

TERRY HARVEY, Staff
to Representative Bruce Weyhrauch
Alaska State Legislature

POSITION STATEMENT: Presented HB 273 on behalf of Representative Weyhrauch, sponsor.

ACTION NARRATIVE

CHAIR PAUL SEATON called the House State Affairs Standing Committee meeting to order at [8:04:47 AM](#). Representatives Gatto, Elkins, Gardner, and Seaton were present at the call to order. Representatives Lynn and Gruenberg arrived as the meeting was in progress.

HB 278-RETIREMENT SYSTEM BONDS

[8:05:27 AM](#)

CHAIR SEATON announced that the first order of business was HOUSE BILL NO. 278, "An Act relating to the Alaska Municipal Bond Bank Authority; permitting the Alaska Municipal Bond Bank Authority or a subsidiary of the authority to assist state and municipal governmental employers by issuing bonds and other commercial paper to enable the governmental employers to prepay all or a portion of the governmental employers' shares of the unfunded accrued actuarial liabilities of retirement systems and authorizing governmental employers to contract with and to issue bonds, notes, or commercial paper to the authority or its subsidiary corporation for that purpose; and providing for an effective date."

CHAIR SEATON said the meeting will focus on the Pension Obligation Bond (POB) because using POBs is one of the methods that is being considered in addressing the under-funded Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS).

8:07:04 AM

CAROL SAMUELS, Vice President, Seattle Northwest Securities, Oregon, said POBs offer a potential tool that can be very flexible and useful to local and state jurisdictions. Seattle Northwest Securities has been involved in over \$3 billion of "these types of obligations" in Oregon. Referring to her presentation, Ms. Samuels defined a POB as a replacement obligation for a jurisdiction's already existing obligation to the pension system. She continued as follows:

It can help defray some of the costs that are already on the books. Pension systems essentially measure assets on one hand, in other words, the securities they own in their portfolio, against a calculation of future liabilities over the long term, which they translate into present value dollars, or dollars that are meaningful today. They compare the two of them, and if liabilities are greater than assets, again, measured on a present value basis, then you have an unfunded actuarial accrued liability, which ... everybody abbreviates ... to UAAL or UAL. This is not an uncommon problem. In fact it's rare to find a pension system, either in the private sector or in the public sector, that does not have a significant unfunded liability. [This is] largely because investment returns in the early years of this decade lagged expectations.

8:10:15 AM

MS. SAMUELS further explained:

In Alaska, repayment of this debt - this UAAL - is amortized just like any other bond or loan that you might have on your mortgage, for example. It's amortized over a fixed period and it's built into existing payroll rates. So, a fairly significant component of payroll rates is devoted to repaying the debt. The debt is amortized in Alaska at an interest rate of 8.25 percent. Now, I often get questions

about the differences in percents - why is it one percent of payroll and another percent that isn't equal to 8.25 - and it's important to keep in mind that they're different. One is a percent of payroll, so you take a given payroll of a jurisdiction, you figure out the dollars that are necessary to repay the debt at an interest rate of 8.25 percent, and then you divide by the payroll of the jurisdiction to get the payroll rate. So they're both percentage terms, but they're measuring different things.

Therefore, the retirement system is essentially the banker, and when I say it's a replacement obligation to issue a pension obligation bond, that's exactly why. There is an obligation; it is an unconditional obligation of the jurisdiction. They have to repay it, and it's being amortized at 8.25 percent. Many jurisdictions have looked to the marketplace to see whether or not they can get a better deal. Again, it's not a new obligation, it's not like borrowing money to build a new sewer system where you have to come up with additional revenue. If this works as you hope it will, this should lower your overall costs because you will only enter into this if you believe you can save money on an obligation you have already.

Moving to page three, being more specific to your situation, why might this be something you'd want to consider granting authority to jurisdictions to pursue? Well, according to the most recently released valuation, which is from 2004, PERS rates...are expected to rise to 32 percent of payroll, beginning in 2011, and they don't go down again until 2029. Paying a third of your payroll in pension costs is obviously a pretty significant bite for jurisdictions to take on, and they're not paying anywhere close to that right now, so you can expect that over time the amount of money that's devoted to paying pension and related healthcare costs is going to eat up their ability to do the other things that citizens expect, from cities, boroughs, school districts...

TRS rates are even expected to go higher. They are expected to go to 50 percent of payroll in 2011, and they will continue increasing to 56 percent by 2028 before they then decline. So it's a long way to go with pretty extreme rates relative to what we've seen

elsewhere. Properly structured pension bonds - and I underscore properly structured, there are lots of ways to structure these that would not be, in our opinion, prudent for a jurisdiction - can be an effective tool to bring these payroll rates down immediately, and more importantly, to produce long term savings for these jurisdictions. In Oregon, as I mentioned, we've been pretty heavily involved in assisting jurisdictions with obligations of this type. In fact, jurisdictions overall have sold more than \$5 billion, and we project that, at the rates of return that the Oregon actuary uses, which is 8 percent (not 8.25), that savings are going to be over \$1.3 billion, or close to 25 percent of the total.

[8:14:37 AM](#)

REPRESENTATIVE GARDNER asked what the normal life of a pension bond is, regarding PERS and TRS.

[8:15:00 AM](#)

MS. SAMUELS said she recommends a structure that matches the amortization period of the loan Alaska is receiving from the system. She added that it is tempting to lengthen that period to reduce costs, but it is not financially prudent because it is borrowing against the borrowing.

[8:16:30 AM](#)

CHAIR SEATON said the present dollar value of the pension obligation system is based on a schedule of payments over the next 20 years, and those scheduled payments have to take place. He asked if the POBs have anything to do with the structured payment schedule or only with the present dollar value.

[8:17:35 AM](#)

MS. SAMUELS said she thinks her presentation will answer his question. She said there may not be a direct match between what the debt service is and the annual saving, because in many cases, these are not like typical bonds with guaranteed payments. She said payments are based on rates of returns that are earned on the bond proceeds, how quickly the payroll grows, and on other demographic variables. She added that it is very complicated, and needs to be considered carefully before moving

ahead. It is not as predictable as refinancing a mortgage, she noted.

REPRESENTATIVE GRUENBERG asked if there was a way to make it more predictable.

8:19:25 AM

MS. SAMUELS said, "Not exactly," and requested that she continue her presentation. Referring to page 4 of her presentation, she said:

PERS is basically twice the size as TRS, in terms of the asset base. The number of covered employees is 70,000, versus approximately 21,000. The average employer rates that are currently being paid, and these are in contrast to the ones I cited earlier...are approximately 16.8 percent and 21 percent. Please note the footnote: these are collared rates, meaning they are, in a way, artificially reduced in order to keep within a 5 percent band. The actuary actually calculated that for PERS the rate should have been about 25.6 percent, where as for TRS it should have been closer to 39 percent. So you can already see the steady increase...and the longer you take to pay it back...the more interest accrues. It's like you're not making a payment, so the debt just keeps increasing, which is one of the reasons that rates are projected to rise so high. Funded ratios for PERS and TRS are approximately 72 percent and 64 percent, and when you translate the debt, the shortfall in 2004 in present value terms is approximately \$5.7 billion combined.

MS. SAMUELS continued, referring to page 5:

Obviously saving somewhere between 20 and 25 percent of your debt sounds pretty good, and reducing payroll rates sounds even better...but the thing that people need to understand and be comfortable with is that...this is basically...an arbitrage play. Now usually when you use the words "arbitrage play," you say that in sort of a whisper with a giggle because it's illegal under federal tax laws. The reason that

we say it proudly in this case, is because federal tax law does not rule over this type of issue. Why? Because you would have to sell these bonds on a taxable basis. In other words, unlike a bond issue that Juneau might sell for a new sewer facility, the interest on which would be tax-exempt under federal tax law...these bonds would have to be sold on a taxable basis. Interest earned on the bonds is subject to federal tax. The reason the federal government makes these taxable, which makes the interest rate higher (right now we're projecting an interest rate for an obligation of this type to be 5.5 to 6.0 percent), is they reserve the tax exempt privilege for capital projects. This is considered to be an operating project.

The good news of the federal government not being involved in this is they have absolutely nothing to say about whether or not you earn arbitrage. Arbitrage is borrowing at one rate and turning around and re-investing at another. That is essentially the main issue when it comes to pension bonds. Can you borrow at, say, 6 percent..., and turn around and invest it at the PERS system at 8.25? If that's the case, that 2.25 percent difference, that's what we call the arbitrage, allows municipalities to reduce their overall cost of the pension system...

In this example, the breakeven is your rate of borrowing. In other words, if you borrow at 6 percent, as long as you earn more than 6 percent, you will end up costing your jurisdictions less than if they continue to make their loan repayments to the PERS system. On the other hand, and if you earn 8.25 percent, you will meet the savings that I am going to show you later in the presentation. If you earn somewhere between 6 and 8.25, you will still save money, but you won't save as much. If you earn more than 8.25 percent, which historically the system has, you'll save even more than I'm going to show you, but then, of course, if you earn less than 6 percent, you will end up costing your jurisdictions more.

So, the real question that a municipal official needs to ask themselves before going ahead and entering into a POB, is do I believe over the next 22 years, in this

case, that I can earn more than my current borrowing rate which is somewhere between 5.5 and 6.0 percent. If you think that that's a good bet, and again we use the word bet because that is what it is, it is a guestimate, it's a gamble, but in this case it could work very heavily to your advantage. If you think that that's a good gamble, then it's something that you should do.

Of course, you are kind of gambling either way, because if you don't make this choice, and you could've earned a higher rate of return on these proceeds, you could put your jurisdiction in worse shape by not pursuing a POB.

8:26:00 AM

Moving on to page 6, we have a snapshot of rates of return, since 1992, in the pension system. As you can see, in most periods it's in excess of 8.25 percent. I do not have statistics that date back as far as I do in Oregon, but under the theory that the Oregon investment system is equivalent to the Alaska investment system, I can tell you that Oregon has statistics that over the past 50 years, they have earned more than 10 percent return. That doesn't mean they're going to earn 10 percent return every year; it doesn't mean they're going to earn 8 percent every year, which is the benchmark for the Oregon system. There are going to be some years where you have a 1994, or worse, you have a 2001. But if, on average, the system earns more than 8.25 percent, you're ahead of the game.

8:27:10 AM

CHAIR SEATON asked if the 2004-2005 numbers are available.

8:27:24 AM

MS. SAMUELS answered no, and that other testifiers will have that. Referring to page 7, she said 133 jurisdictions in Oregon, including the state, have used POBs. In Oregon they use a full-phasing credit obligation, which means "you can borrow funds and repay them on an unconditional basis without receiving a vote." School districts and counties use that technique, she

said. She said the state chose to go to the voters to change the constitution to allow the process, which ended up being easily passed. It was a general obligation bond, and for public perception reasons, Oregon chose to say that property taxes could not be used to repay that debt, she noted. Oregon has never levied a property tax, she added. Alaska could do it that way.

[8:29:38 AM](#)

REPRESENTATIVE GRUENBERG said Alaska's constitution prohibits general obligation bonds, so "all we can do is moral obligation bonds."

[8:29:42 AM](#)

MS. SAMUELS said Alaska could pursue a constitutional amendment, because the interest cost will be lower with a general obligation bond than with a moral obligation bond. She said the state would need to consider how long that authority change would take, because interest rates may go up during that time. The interest rate for a moral obligation bond would probably be half a percentage point higher, she surmised, and over a 22-year period that can really add up. She continued:

The key lesson we learned in Oregon is that it is important to make sure you protect the borrowing side, and you create a security structure that is saleable, but it's probably more important that you figure out the housekeeping issues...of what happens to the proceeds when they're delivered to the system. If the system were about to receive about \$5 billion that they weren't counting on, you'd want to make sure that that money was protected, and that those jurisdictions that had actually borrowed the funds, would end up getting the credit for the amount they borrowed. The process in Oregon is that there is a lump sum account - and this is built into statute - that had a little black box around it. The jurisdiction that funded that black box is the only jurisdiction that gets the credit for the funds that are in there. It is kind of like a prepayment account. As money accumulated through interest earnings, those funds are used to buy down the payroll rate. So in the TRS example, if you had a 50 percent payroll rate and you created a lump sum account, funds would be drawn out of that account on an annual basis and used to reduce that 50 percent

to something lower than that - say, 20 or 30 percent. If the fund earns greater interest, over time, then the 8.25 percent (which is assumed), then the payroll rate buy-down will be even more significant...if it earns less the payroll rate buy-down will be lower than what's estimated. That gets back to the question...about the predictability. There are savings, but they may not come in your...standard savings report where you're going to save \$1 million a year. You may save \$2 million one year and \$500,000 the next. It really depends on what happens to that account.

[8:33:26 AM](#)

CHAIR SEATON referred to Table 6, and asked if payments are strictly amortized, so that the employer is not seeing an increase in the percent of payroll for retirement during low return years.

[8:34:27 AM](#)

MS. SAMUELS said if there was "a series of [low] periods that look like 2001, 2002, and 2003, you could see a situation where payroll rates were higher than what would otherwise be the case." Referring to page 9, which shows the rates of return that affected Oregon, she said that because things "snapped back" after 2003, actual earnings were over 60 percent, translating to a 19 percent return. She said Alaska needs to try and predict future rates, and then do a "gut check."

[8:36:22 AM](#)

CHAIR SEATON said that in spite of the snapping back, table 6 shows figures well below 5 percent in 2003.

[8:36:42 AM](#)

MS. SAMUELS said she doesn't know where that 2003 figure came from, and she is skeptical because the system in Oregon earned about 26 percent that year. She said the comparable months might be different. Referring to page 9, she said that the rates of return for 2002 have been well in excess of the borrowing rate. Page 10 refers to the legislative process to begin to use POBs. She said she is often asked if the obligation can be paid off, and she said probably not, because the system assumes an 8.25 percent return, and if there is a

period when it doesn't earn close to that, the employer will need to provide the cash. If the fund earns double digits, for example, it must benefit the jurisdiction only. These are housekeeping issues, she said. Arbitrage risk remains the same. She noted that the structure of the financing is important; it is not appropriate to use unrealistic assumptions about rates of returns. New Jersey did that, she stated. She said she would not go into a borrowing at an interest rate of over 7 percent, which is why the window for Alaska is narrow. Long-term interest rates are expected to go up, and they are between 5.5 and 6.0 now. She doesn't think it is prudent to re-amortize over a longer period of time or back weight it by taking all of the savings up front. New Jersey and Illinois tried to balance their budgets in that manner. She referred to page 11 and said that statutes and administrative rules must be made to make sure the money is handled properly.

[8:41:21 AM](#)

MS. SAMUELS said the bonds are not likely to be subject to early redemption. The bonds are taxable and sold predominately overseas to international banks, and Alaska's competition would not be with other municipalities. If there is a redemption provision it will cost half a percent, and she said that is too high of a price to pay at the current low interest rates. "Once you go down this road, your chances of getting back out of it are pretty minimal," she warned.

MS. SAMUELS stated that rating agencies would know that Alaska has a shortfall, and in their opinion translating that shortfall into a bond is no different, in fact it might be a plus because Alaska is doing all it can to bring down its cost structure. She added it is less flexible to use a bond issue than to continue to use PERS as a banker.

[8:43:38 AM](#)

CHAIR SEATON said Alaska's contribution rates are only going up 5 percent per year, "even though actuarially we should be at the 25 and 38 percent...and structurally we have just limited the payments. Under the bond system...are we going to be paying at an actuary rate or would we soft-structure it the same way so that our payments...accrue slowly at first." He ask if it would immediately increase the employers' payments per year.

[8:44:31 AM](#)

MS. SAMUELS said yes, a 5 percent collar is essentially the meaning of a soft liability. She said it is taking advantage of the softness of the obligation, but by doing that, the costs will be significantly steeper down the road. Secondly, she said, bonds are fixed, with a promise to repay a certain amount of principle every year at a certain interest rate. There are variable-rate structures, but it would still be a fixed obligation, she noted. "The hardness of the structure means you're taking care of your business now," and not waiting for payroll growth. The bond is a more conservative financial structure because, "you're making your payment as you owe them."

[8:46:53 AM](#)

REPRESENTATIVE GRUENBERG questioned if markets would look at Alaska differently than Oregon because the state is so dependent on the volatile oil resource for its revenues.

[8:47:28 AM](#)

MS. SAMUELS said Oregon can offer a different security structure to the market. Alaska has a strong reputation in the bond market, she noted, but a moral obligation pledge is worth a lot less to investors. Alaska needs to evaluate "meaningful" access, and she guessed that Alaska is well positioned under any circumstance to enter the market. Some small cities may not be able to enter the market. She said that getting an obligation approved by the voters that would allow the state to not have it subject to the appropriation process would grant much broader and less expensive access to all municipalities in the state. She continued:

Approaching the [Alaskan] voters is pretty tough hill to get over. Our sense is that there are ways in ... Point 2 to expand access with additional security structures, such as the intercept. The intercept is pretty important, and in our opinion HB 278, if you pursue that, should be expanded to include things like allowing an intercept for schools. ... Since schools get such a wide proportion of their funding from the state, effectively you've got a state credit, and that is exactly the way we did it in Oregon. In Oregon school districts ... get about 70 percent of their operating cash from the state; they entered into an intercept agreement with the state, whereby the state

paid the debt service directly, right off the top of their appropriation, and they ended up with a credit rating that was just one small notch below the state's rating We would recommend that you pursue something similar in Alaska to the extent there's a way to get there under your current constraints.

[8:51:19 AM](#)

MS. SAMUELS said allowing bond reserves to be set up and accessing bond insurance is important. Referring to HB 278, she said the one significant issue she suggests is that the nature of the obligation between the local entities and the Bond Bank needs to be further defined. She said it wasn't clear that HB 278 granted authority for the Bond Bank to sell bonds for this purpose, and the bill does not grant clear authority to the local governments to sell bonds to the Bond Bank for this purpose, she warned. She said the bill should be expanded to contain an intercept agreement for schools. This could help expand the amount of dollars for schools. She said the bill should have additional flexibility, so that jurisdictions can pool together outside of the Bond Bank and have their own authority.

[8:53:42 AM](#)

MS. SAMUELS gave an example of the City and Borough of Juneau. Juneau owes about \$75 million to the PERS system. Assuming bonds were sold in March and the borrowing rate would be [indecipherable], which is about .25 percent too high, and the fund earned 8.25 percent, Juneau's total savings would be over \$23 million, which is an annual savings of \$1 million per year - real money for a community the size of Juneau. She said another way to look at it is a 20 percent savings, and she noted that Oregon has a minimum requirement of saving 3 percent, so by that definition, "this is a terrific refinancing."

[8:55:23 AM](#)

REPRESENTATIVE GATTO indicated that it sounds bad to say we are going to solve money problems by borrowing money. He said that in the late 1800s, there was the gay '90s, and that was followed by the great depression. We are fighting a major war, he said, and he asked if we could "find ourselves in such a hole that we get sued by the bond holders" and lose Alaska's permanent fund.

[8:57:26 AM](#)

MS. SAMUELS agreed that the state would be borrowing, but she said the state has already borrowed that money and would just be changing its banker. "This is a debt you have already," she said. She said POBs are a bad choice if there is an economic depression. She noted that Oregon has a 56-year history of investment returns, and it is over 10 percent through boom and bust cycles. Alaska has an actuary to give an estimate of returns, and the 8.25 percent is not the upper end, she said, it is supposed to be the average. It is not a guarantee, she said, but it could also turn out badly if Alaska doesn't do a POB.

9:00:06 AM

REPRESENTATIVE GRUENBERG said if these are moral obligation bonds, then the permanent fund would be protected.

9:00:59 AM

MS. SAMUELS said she does not know about the laws restricting the use of the permanent fund, but generically a moral obligation is one in which investors have only a moral promise to make payments.

9:02:18 AM

CHAIR SEATON asked if POBs were issued on an amortized repayment schedule, would the individual municipalities issuing these bonds see the employee wage base percentages jump to the actuarial listed amounts. He noted the 5 percent collar now, and wants to know if that would change.

9:04:15 AM

MS. SAMUELS said that is a housekeeping issue that needs some attention. She added that there needs to be a structure that memorialize how the rate reductions would be applied against payroll rates. She doesn't think that has been set up, but it could be done in the legislation or by administrative rule.

9:05:40 AM

CHAIR SEATON said the PERS and TRS actuarial rates are 25 and 38 percent, and "we're paying 14 percent because of the soft cap." There is a collar of 5 percent, and he asked if that collar would go away with a POB.

[9:06:30 AM](#)

MS. SAMUELS said it depends on how the system structures it, and it is her understanding that the 5 percent collar is going away anyway. She indicated that the following would work best:

Let's assume that PERS calculates that based upon your \$20 million payment, you're going to get an 8 percent reduction in your payroll from now until 2028 when the debt is retired. That's at the assumed rate of 8.25 percent. ... If the system itself projects that the rate is going to go from this year's 16.77 to next year at 21.77, you would still get that 8 percent [reduction], it would just be against a higher number.

[9:07:50 AM](#)

CHAIR SEATON said an Alaska Retirement Management Board (ARMB) presentation said a payroll reduction would be around 2.6 to 3.1. He asked if the 8 percent was a guess.

[9:08:18 AM](#)

MS. SAMUELS said she was pulling that number out of the air, but she could probably calculate what the payroll rate reduction would be.

[9:08:37 AM](#)

CHAIR SEATON said that would be helpful.

[9:08:48 AM](#)

MS. SAMUELS said:

Part of what makes a large rate reduction is if you are making a payment in advance of when it's recognized in the rates. So, if you pay the full amount of your unfunded liabilities when you're only being charged for, say, 60 percent of it - which is basically what's happening now [because] they're not building into your rates exactly what you owe - you're going to get a bigger rate reduction if it's fully recognized. ... There are quite a few municipalities in Oregon who are paying nothing on PERS I would not be surprised to see a pretty significant reduction

in rates because you are paying before it's recognized in your rate structure.

CHAIR SEATON requested estimates from Ms. Samuels.

[9:10:59 AM](#)

GARY BADER, Chief Investment Officer, Treasury Division, Department of Revenue (DOR), said DOR is staff to the Alaska Retirement Management Board (ARMB). He noted that the board was established in October and recently heard its first presentation on POBs. He said the board learned that without POBs the [PERS and TRS] system is significantly underfunded and future contributions will be the way to cover those balances. POBs lever the contribution risk - if the fund achieves greater than the actuarial discount rate, the contributors to the fund benefit, if it does not, they are at a disadvantage. He said the leverage cuts two ways. If such bonds had been issued five years ago, the total returns to the system would be less than the cost of issuing the bonds. "We would be disappointed with the experience," he said, and if the bonds had been issued three years ago, we all would have been happy with the outcome. He added that POBs impose a market timing decision on the ARMB. "While it may make sense to invest all the assets immediately, politics may require some sort of dollar averaging," he said. "Imagine if we had invested all of the proceeds in mid-2000, just about the peak of the stock market, today we would be very dissatisfied with the results." The real test is what happens over the life of the bonds, he noted.

[9:14:29 AM](#)

MR. BADER said several asset categories that the pension funds invest in are not accessible immediately, like real estate. If an infusion of \$1-2 billion were available to the ARMB immediately, it is doubtful that they could immediately adopt the same asset allocations that they have now, and may need to look more at public markets to invest the funds, he stated. He told the committee that the state financial advisor, Chester Johnson, recommended that "the bond rating agencies take a harder look at general obligation bonds...and consider that a hard liability, versus a promise to have to increase the contribution rate as a soft liability." Regarding the cost of issuing POBs, Mr. Johnson told him it depends on the amount of bonds that are issued, but estimated that one to two percent - or \$10-20 million - of that which was underwritten might be used up. He said ARMB heard four presentations on POBs and explored

the concept, but they did not come to any conclusions, and so have no position on HB 278. Regarding page 6 of Ms. Samuels report regarding investment returns, the FY04 rate of return was 14.7 percent, and in FY05, it was 8.95 percent for PERS.

[9:17:24 AM](#)

CHAIR SEATON asked if the asset allocation of the Alaska State Pension Investment Board (ASPIB) was 60 percent in equities and 40 percent in bonds, and what that means regarding the POBs.

[9:19:17 AM](#)

MR. BADER said, "It's likely if you sell taxable bonds at 6 percent and you invest it in bonds, trying to mimic the Lehman [Brothers Aggregate Index], you would get close to the same return, and so it would be hard to make a case for that just on the basis of looking at returns. However, when the board does its asset allocation, it looks not only at investment returns, but looks at the variability of returns and how they match with other investments. For example, in 2002, when the stock market peaked, equity returns...fell a lot. At the same time interest rates were coming down, so fixed income returns were kind of helping the portfolio, and keeping it from suffering the ten, fifteen, twenty percent losses in equity returns. So a portfolio is structured to try and have investments where some are doing well and others are not in favor. That would be one of the arguments for keeping an investment in bonds." He said selling a POB and put it all in equities would be an even riskier proposition than the way the board currently invests its funds. He added that he can't give an answer.

[9:21:19 AM](#)

CHAIR SEATON said he would like the board to carefully address that.

[9:23:15 AM](#)

MR. BADER said, "If you sell a bond today for 6 percent, and the market happens to be 6 percent, well we look at that and say, 'What's the point?'" If interest rates go down, you will make money on the investment. It isn't a given that you break even or lose money.

[9:23:53 AM](#)

CHAIR SEATON said the POBs would probably not be redeemable, "so is the difference than that the bonds that you might be buying, you could...I guess you could resell them."

[9:24:29 AM](#)

MR. BADER said, "We do resell the bonds, and if interest rates go down, we sell them at a profit."

[9:24:37 AM](#)

CHAIR SEATON asked about the structure of POBs and if they are re-sellable.

[9:24:55 AM](#)

MR. BADER said the comments from the state financial advisor indicate that the premium would be too high to make POBs callable.

[9:25:10 AM](#)

REPRESENTATIVE GRUENBERG said he is confused, and the only reason he heard on why POBs are taxable is because they are not for capital construction projects. He said he would like something in writing analyzing what kinds of bonds are taxable and what are not. He also wants to know how they can be structured to be tax-free.

[9:26:54 AM](#)

TOM BOUTIN, Deputy Commissioner, Treasure Division, Department of Revenue, said the department generally opposes POBs, so far. He noted that six to eight banking firms have made presentations to the department, and Mr. Boutin said he has read reports on the topic. He told the committee that he has been involved in Alaska public finance for about 20 years, and he sits on a number of boards that issue state debt. He said real estate investments can make sense, but "issuing long term taxable bonds in the hope to invest in a higher yield is not something that the Department of Revenue would recommend to state government." He said that HB 278 brings up unanswered questions. If a lease structure is contemplated for HB 278, then he said he would worry about extending the state moral obligation to lease debt. He said that has implications for ongoing debt, and he added that there is about \$1.3 billion of state moral obligation debt now. If the state moral obligation is not explicitly tacked on

the POBs, he said, there is a significant chance that a large amount of this kind of debt would still be counted in a moral obligation way.

[9:30:33 AM](#)

MR. BOUTIN said the state has a finite limit to a moral obligation debt at the current rating levels, and HB 278 could use up that debt capacity. He added that most Alaska municipalities are too small to use the Bond Bank, and so the HB 278 structure would not be available to them.

[9:31:37 AM](#)

CHAIR SEATON asked Mr. Boutin to explain further about the size of communities and their access to the Bond Bank.

[9:32:01 AM](#)

MR. BOUTIN answered that a number of Alaska municipalities are rated the same as, or higher than, the state moral obligation credit rating, so it doesn't make sense for them to use the Bond Bank. Anchorage used the Bond Bank last year for replacing the roof on their performing arts center. It made sense because in that case part of the ticket receipts were used to make the debt service for the roof. But if Anchorage went out and did that structure on its own, the credit quality of having a ticket surcharge wouldn't be a very good credit structure, he said. When Anchorage came to the Bond Bank then all of the money, including school foundation money, was pledged with a senior lien to the Bond Bank. But typically, Anchorage won't come to the Bond Bank. Juneau doesn't normally come to the Bond Bank, but did so a year or two ago for hospital revenue bonds, because health care bonds are well liked now. The Northwest Arctic Borough is 25 percent of the Bond Bank's portfolio, he noted, so "there's a typical community that gains an advantage from the Bond Bank." That borough doesn't have a credit rating, doesn't have property taxes, and so has used the Bond Bank more than other communities.

[9:35:20 AM](#)

CHAIR SEATON said he thought Mr. Boutin said some smaller communities don't have access to the Bond Bank.

[9:35:41 AM](#)

MR. BOUTIN said absolutely. He said Ms. Samuels mentioned Hyder, and he said he would be skeptical if Hyder could come to the Bond Bank and access the credit markets. "Likewise, Hydaburg would be on the edge." He said communities that are too small and don't have predictable revenue normally would not have access to the Bond Bank. He said Kaktovik did a small deal through the Bond Bank, but that was an anomaly.

[9:36:59 AM](#)

CHAIR SEATON said there were 155 different PERS employers around the state and the legislature is trying to figure out if POBs could be useful. He asked if Mr. Boutin was saying that the 30 smallest employers could not use POBs.

[9:37:51 AM](#)

MR. BOUTIN said that would have to be assessed community by community, but it's a safe bet that there is a significant number of municipalities that could not access the credit markets through the Bond Bank under HB 278.

[9:38:28 AM](#)

CHAIR SEATON said he wants an estimation of the employers that could not participate, and if there is a structural change that could fix that, because the attempt is to design this for everyone.

[9:39:18 AM](#)

REPRESENTATIVE GATTO asked if Oregon has an AA credit rating.

[9:39:27 AM](#)

MR. BOUTIN said he did not know. He said Alaska's general obligation rating is AA with all three credit rating agencies. The moral obligation rating is usually a full notch below, so he expects an A rating for that.

[9:40:15 AM](#)

REPRESENTATIVE GATTO asked if the state's credit rating will change by taking on the debt.

[9:40:30 AM](#)

MR. BOUTIN said he does not know what the moral obligation debt capacity is, but it is far less than \$6 billion. He said Alaska depends upon a volatile single source of income, unlike Oregon, and that is a concern of the credit raters. He said he didn't think Oregon would be switching to a defined contribution plan, but Alaska will be on July 1.

[9:42:10 AM](#)

REPRESENTATIVE GRUENBERG said he would like the same answers for TRS. He asked if Rural Education Attendance [Areas] (REAA) would have the same problems because they have no tax base.

[9:42:45 AM](#)

MR. BOUTIN said he doesn't know what structure would allow a REAA to issue debt.

[9:43:15 AM](#)

CHAIR SEATON asked if the school districts have the ability to issue debt.

[9:43:26 AM](#)

MR. BOUTIN said many municipalities issue school debt now to build schools.

[9:44:00 AM](#)

REPRESENTATIVE GRUENBERG said it is the municipality that issues debt, not the schools. He noted that Alaska differs from other states in its dependency on the federal government.

[9:44:21 AM](#)

REPRESENTATIVE GARDNER asked about the state already having \$1.3 billion in outstanding moral obligation.

[9:44:48 AM](#)

MR. BOUTIN said that is debt for the Alaska Student Loan Corporation, the Alaska Municipal Bond Bank Authority ("Bond Bank"), the Alaska Energy Authority, and perhaps for the Alaska Industrial Development and Export Authority. State moral obligation is a device used across the country as a credit enhancement. "It's language of art that you stick in the

enabling legislation for an authority, and then you repeat it in the bond documents that state that there will be a reserve fund, and if that reserve fund is used to pay debt service, then the executive director or commissioner is pledged to go to the legislature and ask that the reserve fund be replenished." He said if a state failed to meet that moral obligation, even to the extent of not replenishing the reserve fund, then it would not have access to the debt markets.

[9:47:28 AM](#)

CHAIR SEATON asked about a limit on the moral obligation.

[9:47:39 AM](#)

MR. BOUTIN said there is a limit, and it is less than \$6 billion, but the state hasn't tried to test the limit.

[9:49:04 AM](#)

REPRESENTATIVE GRUENBERG said he is interested in pursuing whether a constitutional amendment would be needed for POBs to be used. He said general obligation bonds are easier to sell and carry a lower interest.

[9:49:47 AM](#)

MR. BOUTIN said under most circumstances that's correct.

[9:50:00 AM](#)

REPRESENTATIVE GRUENBERG noted that Mr. Boutin said that two other entities would benefit by having the ability to issue general obligation bonds, including the student loan program.

[9:50:26 AM](#)

REPRESENTATIVE SEATON said a constitutional amendment is not part of the bill.

[9:51:20 AM](#)

MR. BOUTIN declared that market timing of POBs is key, and the state wouldn't issue POBs if it knew interest rates were about to go down.

[9:53:35 AM](#)

REPRESENTATIVE GRUENBERG asked if timing is the issue with the issuance of any bond.

[9:53:51 AM](#)

MR. BOUTIN answered no, a state debt is for a particular product or a particular need, so "it's not timing for the market, you're accessing the credit markets as cost effectively as you can to make those student loans or to build that school or that road, and so, no, it's only in this case where you're trying to do arbitrage that it's a market timing issue."

[9:54:31 AM](#)

DEVEN MITCHELL, Executive Director, Alaska Municipal Bond Bank Authority, and Debt Manager for the State of Alaska, said he could discuss the annual report or answer questions. Referring to the question of why POBs can't be taxed, he said that without a project the federal tax code requires that it be taxed. The state could possibly access a tax-exempt market if it had another project that it was going to pay cash for and instead used tax-exempt bonds and used that cash for "this contribution."

[9:56:23 AM](#)

CHAIR SEATON said, "That would be a substitute for POBs. You would take state money that we were going to put into whatever project...we were going to put cash in, and we would infuse that cash into the system. But we wouldn't be issuing bonds for that case; that would be an alternative. Is that correct?"

[9:56:38 AM](#)

MR. MITCHELL said that's correct. He said the intercept provision is already in statute, "and that when the Bond Bank makes loans there is a contract that is entered into with that municipality that provides the Bond Bank - not to take money from the municipality, but to take it from the state before it gets to the municipality - and that is the intercept provision that helps garner the ratings the Bond Bank achieves in addition to the moral obligation."

MR. MITCHELL said the ability of municipalities to issue bonds is already defined. After speaking with attorneys, he said, "some appropriation-backed bond would be possible, meaning that

it would be a subject-to-appropriation pledge of a local jurisdiction," which is a fairly weak pledge. He noted that in this case there is no building that might be taken, so the only penalty might be the loss of market access, which would not be a big threat to a small community. Mr. Mitchell said the Bond Bank has to have sufficient ability to encourage the repayment of the loan, and "there has not been a case of default in this program." There have been about 34 communities in Alaska that "have accessed the Bond Bank - and one authority - and in all of those cases, but the authority, we have the ability to intercept state aid, which is a huge hammer to that community." He said some small communities have an infrastructure and other assets like taxes and federal timber receipts, "and so you have a mechanism for gathering that money for the repayment of your obligation, where there really just isn't any ability to provide that type of security in a large number of smaller communities in the state of Alaska."

[10:00:24 AM](#)

CHAIR SEATON asked, "But with the intercept, you've been able to finesse that lack of credit?"

[10:00:43 AM](#)

MR. MITCHELL answered that in some incidences that's correct. He said those communities were also pledging a general obligation of that community. He added that there was "a lot of hand-wringing" regarding the Kaktovik loan, because it is a very small community and doesn't have a lot of financial resources. But he said the community found the project important enough that it was willing to make a commitment with a general obligation pledge "where they have put up their full faith and credit of the community taxing authority," which he said carries more weight than a local legislative body saying it is willing to promise to pay annually. The intercept provision has limitations, for example, without a school district "it wouldn't be sufficient to cover debt service." He added that with the foundation formula there's another set of issues to address.

[10:02:21 AM](#)

CHAIR SEATON asked if the five communities that have dissolved have been involved with the Bond Bank.

[10:02:49 AM](#)

MR. MITCHELL answered no.

CHAIR SEATON asked him to provide information on the communities with PERS liabilities that may not have the credit worthiness to access the Bond Bank, and how that might be remedied.

MR. MITCHELL said it would be difficult. He will provide a list of communities that "might" or "definitely will" be able to.

REPRESENTATIVE GARDNER asked the down side of borrowing money to help fix the unfunded liability. She called it a "shell game of taking money from existing capital projects and applying that against the unfunded liability and then getting bonds for the capital projects, which would have a lower interest rate and would be tax-exempt."

[10:04:47 AM](#)

MR. MITCHELL said that is a theoretical possibility, but it would be very difficult to implement, because the United States Treasury has an interest in limiting tax-exempt bond authority. He continued, "If there were maybe one large project that otherwise was going to be—or one large group of projects—that could otherwise have been funded with general obligation debt or some other mechanism that the state had available...there are other credit ramifications."

MR. MITCHELL said, as the debt manager, he has been discussing the state's ability to access capital markets that would be paid from the general fund, but "we've been operating on a little bit of thin ice." He noted that Alaska's revenue forecast is a "dire picture in the mid to long term" because its expenditures are not going to match revenues. "We're going to have a shortfall," he stated. The state has been reluctant to borrow a lot of long-term obligations prior to a fiscal fix, he said. He stated that it isn't just the issue before the committee, but the state as a whole. "I don't think that there would be a good alternative is the bottom line at this point." he said. He agreed that it is theoretically possible but it's not without other costs.

[10:07:50 AM](#)

REPRESENTATIVE GRUENBERG asked about the state paying back over time and cutting out the middleman entirely, "rather than going through this whole POB thing."

[10:08:29 AM](#)

MR. MITCHELL said that's one of the options.

[10:08:44 AM](#)

CHAIR SEATON clarified that the debt is structured to be paid off by the employers that have the debt. The mechanism to pay that debt is from individual contributions based on each employee's wage base. Those are "the contributions that go up to the 25 and 38 percent—depending on the figures. The problem is that when a third of the salary base is charged for PERS, and in TRS, almost 50 percent of the salary wage base must be charged, it's a large burden on the employers." The POB would be an attempt to pay off that debt up front, "so that we do not collect that from the individual employers or the teachers' salary, and so that we lower that amount and then the funds that are available to those communities, those employers, or the school district could be used for other things." He said there could be other mechanisms for paying off that debt besides a percentage of employee wage base, and POBs are one mechanism.

[10:11:15 AM](#)

The committee took an at-ease from 10:11 a.m. to 10:12 a.m.

[10:12:29 AM](#)

JEFFREY SINZ, Chief Fiscal Officer, Municipality of Anchorage, asked if the committee had copies of his previous presentation entitled, "Pension Obligation Bonds: One Employer's Perspective." He said pension obligation debt is an important tool, and there are very few tools available. "We have not made any decision about the appropriateness of their use at this point, but we strongly advocate for the preservation of pension obligation debt as one tool that may become appropriate at some point in the future."

MR. SINZ noted three basic issues to be overcome before considering using POBs: access to the market place for small communities; access to financial expertise during decision-making, and; uncertainty and unanswered questions. He put forth the following questions: What does the system do if it receives a large inflow of cash from an employer? Who issues the debt? How is it invested? What happens if investments are highly successful or not? How are rates adjusted?

[10:17:01 AM](#)

MR. SINZ said the challenge is the large unfunded accrued actuarial liability, and one answer is SB 141, "which is really a long term change," and the effects would be seen sometime in the future. He said rapidly increasing employer contribution rates are limited by the five percent statutory limitation. "The opportunity that seems to exist here is the opportunity to substitute pension obligation debt for all or a portion of the unfunded liability." He said he used analysis from Merrill Lynch for a statewide perspective and from Seattle Northwest Securities for specific information for Anchorage. Statewide PERS unfunded actuarial liability, as of June 2004, was \$3.41 billion, and by substituting pension obligation debt for that liability, "it is possible to generate a significant savings. The assumption Merrill Lynch used was that the entire unfunded liability would be substituted with POBs." The cost of debt would be 5.8 percent, "and PERS would earn the actuarially 8.25 percent rate on those monies, and by doing this the future value of payments made by all of the employers participating in the system would be reduced by \$2.5 billion," which would be realized over a 25-year period of the debt. He said the present value of that savings is \$1.2 billion.

[10:19:55 AM](#)

MR. SINZ said, "The effective reduction for participating employers is 3.85 percent in the effective contribution rate we would be paying." He noted that both normal and past service cost rates are now being paid to the PERS in the form of an employer contribution. "With a pension obligation debt alternative, we would be paying the normal cost rate to PERS, but we would be paying a debt service payment rather than that past service contribution." Looking only at Anchorage as a specific employer, its share of the current liability is \$462 million. Using data from Seattle Northwest Securities, "we can come up with a different set of savings assumptions. The future value of savings they calculate—the potential future savings—is \$212.9 million for Anchorage with a present value of \$113 million." He said that analysis assumed a cost of debt of 6 percent.

[10:22:19 AM](#)

CHAIR SEATON said Seattle Northwest Securities spoke of an 8 percent reduction. He asked about going from 28 percent to 25 percent.

[10:23:08 AM](#)

MR. SINZ said over a 25-year period there will be an annual savings of about \$6 million a year, which grows over the life of the debt because of growth in the assumed payroll.

[10:23:50 AM](#)

CHAIR SEATON asked if he looked at "this being an amortized, hard number...instead of increasing at the 5 percent per year in the year that this is issued, you would then immediately jump to the 25 percent...individual rate for those 25 years, instead of having the soft increase of 5 percent."

[10:24:19 AM](#)

MR. SINZ said the analysis used the assumption of selling bonds soon - within the next year.

[10:24:37 AM](#)

CHAIR SEATON said the state has been providing money to offset the increases in the system. If the municipality would issue bonds for this debt, "my understanding from the testimony is," that the contribution rate would immediately jump from 14.7 percent to 25 percent. "You would immediately jump to a hard number basically equal to 25 percent of employee salary, and that would stay fixed for the entire length of the debt since it can't be recalled." Chair Seaton asked if that has been a consideration that Mr. Sinz looked at in his analysis.

[10:26:11 AM](#)

MR. SINZ said it was not. He said his analysis does not factor in debt-design structural issues. He said there are many things that would need to be considered before a decision was made.

[10:26:37 AM](#)

CHAIR SEATON stated his concern that municipalities would not like an increase in this amount, and POBs will cause a dramatic increase in the contributions of employers for the short term. He asked Mr. Sinz to look into that.

[10:27:40 AM](#)

REPRESENTATIVE GARDNER said the shift from the collared rate of increase is not really before the committee; it is an authorization to explore the POB option, and then each employer can make the decision to participate.

[10:28:07 AM](#)

CHAIR SEATON said "the biggest cry we have heard from municipalities is the increasing rate." Authorizing a structure that will dramatically increase these contribution rates is a critical factor to consider, he point out.

[10:29:40 AM](#)

REPRESENTATIVE GARDNER said the bill will authorize the tool "should they choose to use it."

[10:29:53 AM](#)

MR. SINZ added that such an increase is not an unavoidable consequence of POBs; there are ways to mitigate that effect. He said HB 278 in its current form is not a perfect solution, nor is it a decision to issue POBs in itself, but it is a step in the right direction. He stated his support of the bill.

[10:31:25 AM](#)

CHAIR SEATON announced that HB 278 was heard and held.

HB 273-PFD: DELAY PAYMENT FOR ALLOWABLE ABSENCES

[10:32:12 AM](#)

CHAIR SEATON announced that the last order of business was HOUSE BILL NO. 273, "An Act relating to the dividends of individuals claiming allowable absences; and providing for an effective date."

[10:32:22 AM](#)

TERRY HARVEY, Staff to Representative Bruce Weyhrauch, Alaska State Legislature, introduced HB 273 on behalf of Representative Weyhrauch, sponsor. He said HB 273 is timely because of the latest statistics from the Permanent Fund Dividend division. The bill will require the state to hold dividends of any person who is out of the state with an allowable absence until that person returns to the state.

10:33:46 AM

CHAIR SEATON said there is an update in the committee packet regarding the amount of money that is leaving Alaska. He said the committee will take up HB 273 on Thursday in more detail.

ADJOURNMENT

There being no further business before the committee, the House State Affairs Standing Committee meeting was adjourned at 10:34:44 AM.