

ALASKA STATE LEGISLATURE
SENATE COMMUNITY AND REGIONAL AFFAIRS STANDING COMMITTEE

April 28, 2006

1:34 p.m.

MEMBERS PRESENT

Senator Bert Stedman, Chair
Senator Thomas Wagoner

MEMBERS ABSENT

Senator Gary Stevens, Vice Chair
Senator Johnny Ellis
Senator Albert Kookesh

COMMITTEE CALENDAR

CS FOR HOUSE BILL NO. 278(RLS)

"An Act relating to prepayments of accrued actuarial liabilities of government retirement systems; 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, notes, commercial paper, or other obligations 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; authorizing a governmental employer to issue obligations to prepay all or a portion of the governmental employer's shares of the unfunded accrued actuarial liabilities of retirement systems and to enter into a lease or other contractual agreement with a trustee or the Alaska Municipal Bond Bank Authority or a subsidiary of the authority in connection with the issuance of obligations for that purpose, and relating to those obligations; and providing for an effective date."

HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 278

SHORT TITLE: RETIREMENT SYSTEM LIABILITY/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
 01/17/06 (H) Heard & Held
 01/17/06 (H) MINUTE(STA)
 01/19/06 (H) STA AT 8:00 AM CAPITOL 106
 01/19/06 (H) Heard & Held
 01/19/06 (H) MINUTE(STA)
 01/24/06 (H) STA AT 8:00 AM CAPITOL 106
 01/24/06 (H) Heard & Held
 01/24/06 (H) MINUTE(STA)
 01/26/06 (H) STA AT 8:00 AM CAPITOL 106
 01/26/06 (H) Moved Out of Committee
 01/26/06 (H) MINUTE(STA)
 01/27/06 (H) STA RPT 2DP 5NR
 01/27/06 (H) DP: GARDNER, GRUENBERG;
 01/27/06 (H) NR: LYNN, ELKINS, RAMRAS, GATTO, SEATON
 03/08/06 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 03/08/06 (H) Heard & Held
 03/08/06 (H) MINUTE(FIN)
 03/24/06 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 03/24/06 (H) Moved CSHB 278(FIN) Out of Committee
 03/24/06 (H) MINUTE(FIN)
 03/27/06 (H) FIN RPT CS(FIN) NT 4DP 3NR
 03/27/06 (H) DP: HAWKER, WEYHRAUCH, FOSTER, MEYER;
 03/27/06 (H) NR: KELLY, KERTTULA, STOLTZE
 04/13/06 (H) RLS AT 1:30 PM CAPITOL 106
 04/13/06 (H) -- Meeting Canceled --
 04/20/06 (H) RLS AT 9:00 AM CAPITOL 17
 04/20/06 (H) Moved CSHB 278(RLS) Out of Committee
 04/20/06 (H) MINUTE(RLS)
 04/21/06 (H) RLS RPT CS(RLS) NT 2DP 4NR
 04/21/06 (H) DP: MCGUIRE, ROKEBERG;
 04/21/06 (H) NR: GUTTENBERG, COGHILL, HARRIS,
 BERKOWITZ
 04/21/06 (H) TRANSMITTED TO (S)
 04/21/06 (H) VERSION: CSHB 278(RLS)
 04/22/06 (S) READ THE FIRST TIME - REFERRALS
 04/22/06 (S) CRA, FIN
 04/28/06 (S) CRA AT 1:30 PM BELTZ 211

WITNESS REGISTER

Representative Mike Hawker
 Alaska Capitol Building
 Juneau, AK 99801-1182

POSITION STATEMENT: Sponsor of HB 278

Carol Samuels, Vice President
Seattle-Northwest Securities Corporation
1000 Southwest Broadway, Suite 1800
Portland, Oregon 97205

POSITION STATEMENT: Supported HB 278

Larry Semmens, Finance Director
City of Kenai
210 Fidalgo, Suite 200
Kenai, AK 99611

POSITION STATEMENT: Supported HB 278

Gregg Sundberg, Managing Director
Merrill Lynch
Seattle, WA

POSITION STATEMENT: Supported HB 278

Carl Rose, Executive Director
Association of Alaska School Boards
1111 W. 9th Street
Juneau, AK 99801

POSITION STATEMENT: Supported HB 278

Kevin Ritchie, Executive Director
Alaska Municipal League,
217 Second Street, Suite 200
Juneau, AK 99801

POSITION STATEMENT: Supported HB 278

ACTION NARRATIVE

CHAIR BERT STEDMAN called the Senate Community and Regional Affairs Standing Committee meeting to order at [1:34:15 PM](#). Senator Thomas Wagoner and Chair Bert Stedman were present.

CSHB 278(RLS)-RETIREMENT SYSTEM LIABILITY/BONDS

[1:34:26 PM](#)

SENATOR BERT STEDMAN announced HB 278 to be up for consideration. He asked the record to reflect that there was not a quorum, but that Representative Hawker would introduce HB 278 and public testimony would be taken.

REPRESENTATIVE MIKE HAWKER, Sponsor of HB 278, informed members that the bill addresses the issue of the unfunded pension obligation for past service costs. Describing HB 278 as an empowering bill, he said it doesn't authorize transactions it simply grants power to the Municipal Bond Bank to work with municipalities to see if they can structure such transactions. He added that the bill also clarifies that municipalities have the right to conduct such transactions.

A pension obligation bonding transaction is simply an arbitrage transaction. In such a transaction an entity with a pension liability would issue debt the proceeds of which would be invested with the plan assets and would yield a return that is the same as the rest of the plan assets. In the case of the State of Alaska and its government employers that's been demonstrated to be a bit better than 8 percent. Representative Hawker described it as borrowing for cheap, investing for expensive, and benefiting from the differential and suggested that even in today's markets the spread would be better than 5 percent.

REPRESENTATIVE HAWKER outlined the risks and the points of opposition: too much inherent investment risk; constitutional limitations regarding the ability for municipalities to general obligation debt for the purpose of capital projects; issuing such debt transactions could impair the State's or the municipalities' credit ratings; municipalities might refuse to pay after entering into one of these transactions.

He asserted his belief that, "... there are very rational analyses that would lead one to the conclusion that while those risks all do exist, that they are adequately mitigated and protected by the forces within the market - that we would not be subjecting anyone or ourselves assuming too much risk in pursuing one of these transactions.

REPRESENTATIVE HAWKER noted that the packets included comments from Standard and Poor's rating agency and an educational primer from a securities law firm both of which provided supporting comments and information related to POBs. In particular the primer points out that agencies actually endorse these transactions.

With regard to the concern about constitutional limits, he said the key is how the transaction is structured, which is why the vehicles that are used aren't, by definition, general obligation bonds. Although, he opined, if that authority were available a

transaction could be executed at an even lower cost to the borrower.

The issue of investment risk and market timing is legitimate when the window is short, but over time that risk is mitigated. The transactions contemplated here extend from 25 to 28 years and it's been proven time and again that over time, markets perform consistently. For example, in the past ten years the State's PERS and TRS programs have returned more than 8 percent.

To address the concern that relates to municipalities not paying up he pointed out that the Municipal Bond Bank screens and guides municipalities that are entering into these transactions. Language in the bill makes it clear that a community won't be put into debt circumstances beyond its means.

He advised that the bill has been specifically crafted to exempt POBs from any of the debt ceiling limits placed on the Municipal Bond Bank. He asked the committee to give particular attention to that provision and decide whether or not it is appropriate.

[1:45:45 PM](#)

CHAIR STEDMAN asked for a layman's explanation of: how the mechanism would work; why municipalities would borrow; and what municipalities would do with the money.

REPRESENTATIVE HAWKER explained that the Municipal Bond Bank exists to help government employers in the state that may not have the financial standing to enter international capital markets. In this instance, the bill would authorize the Municipal Bond Bank to issue debt on behalf of communities. The municipalities would be the ultimate obligators for repaying the debt and the money that's raised would go to the individual municipalities for the specific purpose of being deposited into the state's retirement investment trust. That money would be invested on behalf of the particular community or group of communities. The bill says that if a community wants to put money into its PERS or TRS account(s) then as the money is invested it is earmarked and accounted for separately so that the benefit of the investment would go to the benefit of the specific community that made the initial deposit.

CHAIR STEDMAN posed the hypothetical situation of a community with a \$25 million liability that wanted to use this mechanism for all of its unfunded liability and asked Representative Hawker to explain that process.

REPRESENTATIVE HAWKER explained that the bond authority, on behalf of the community, would issue \$25 million in debt. In the open market that debt would be payable at somewhere between 5 and 6 percent. When the money goes into the pension plan(s) it would reduce the employer's unfunded past service cost. As a result, when the actuarial valuation is performed on the plan the employer's obligation for past service cost would be reduced. The community would no longer have an unfunded past service cost. Instead of having an obligation to the pension plan, it would be substituting a fixed debt to the capital markets at a little more than 5 percent.

He advised when he first began looking at these vehicles he asked national investment firms to review the state's overall financial picture and its \$6 billion unfunded pension liability. Two firms modeled what would happen if the state were to go to the capital markets and bond out the entire \$6 billion liability and then pay off the debt with a 25 year amortization. Both indicated that the approximate net present value or real dollar savings to the pension plan would be in the range of \$1.5 billion.

REPRESENTATIVE HAWKER acknowledged that the scenario was just a model, but it clarifies that there is the potential for saving the public significant amounts of money in satisfying the pension obligations.

CHAIR STEDMAN asked for assurance that municipalities have this option and it is in no way mandatory.

REPRESENTATIVE HAWKER agreed that the bill is strictly permissive and the decision to pursue such transactions would be made on a community-by-community basis.

CHAIR STEDMAN questioned whether there have been failures.

REPRESENTATIVE HAWKER responded there have been spectacular failures, but if the transactions are approached responsibly and the expectations for returns are realistic this is a reasonable alternative. The permanent fund is a good solid investment benchmark that shows that a long-term average return of 8 percent isn't unreasonable. On the other hand, some states have entered into transactions in order to leverage their pension plans to remove money from the plans and place it in the general fund to meet ongoing governmental obligations. He said he would

argue that that is clearly wrong and that action positioned those states for spectacular failure.

He asserted that it's important to look at successes as well as failures to make certain that, as the bill is crafted, the appropriate sidebars are in place to ensure that the transactions are approached responsibly.

CHAIR STEDMAN referenced the hypothetical instance of an 8 percent return for bonds that are issued and pay between 5 and 6 percent and asked for clarification as to how the money would be generated.

REPRESENTATIVE HAWKER replied the proceeds of the bond issuance would be deposited into the pension retirement trusts and would be invested along with the rest of the pension assets. As has been demonstrated here in Alaska, the return over time would be in excess of 8 percent.

[1:55:35 PM](#)

CHAIR STEDMAN questioned where the risk lay.

REPRESENTATIVE HAWKER replied the investment risk is that the state pensions, under the auspices of the ARM Board, could fail to earn a return that is greater than the cost of the bonds over the life of the bond issue.

CHAIR STEDMAN asked if success or failure is dependent on swings in the financial market.

REPRESENTATIVE HAWKER responded market timing is important, but the value of these transactions is that there is a demonstrated ability to achieve an 8 percent return over time. Also, the bonds are contractual obligations so the rate is fixed over the term of the obligation.

CHAIR STEDMAN noted that he and most others agree that municipalities are responsible for their own liabilities even though the state might have to step in at some point if the liabilities become unmanageable at the local level. He questioned how municipalities might deal with transactions that "turn upside down" and how the state treasury might be obligated.

REPRESENTATIVE HAWKER said he couldn't speak for municipalities, but many are already turned upside down in terms of ability to

meet their current obligations. He said he does agree that the PERS liability is an obligation of the municipalities. HB 278 provides a tool for municipalities to help themselves without increasing risk to the state treasury. Certainly there would be no more risk than there is now since the retirement plans are state sponsored and have constitutionally mandated benefits.

CHAIR STEDMAN asked if there has been discussion about including schools, the university, and the state in addition to municipalities.

REPRESENTATIVE HAWKER acknowledged, for the record, that the current administration does not believe that these transactions are in the state's best interest so it won't be a participant. On the other hand, individual municipalities have asked about participation and that is an individual decision as to whether or not to pursue this in relation to the PERS/TRS liability. The University of Alaska requested specific authority to be included, but at Representative Weyhrauch's request, that authority was removed from the bill in the House Finance Committee.

He reiterated that this is just one tool that has proven to be adequately successful in markets outside Alaska and that it's important to put as many tools as is responsibly possible in municipal employers' hands.

[2:05:27 PM](#)

CHAIR STEDMAN asked if the proceeds from a bond issuance are turned over to the ARM Board for management.

REPRESENTATIVE HAWKER replied yes; the proceeds would be invested under the auspices of the investment managers that are currently managing the state pension investment trusts.

CHAIR STEDMAN asked if the ARM Board would assume increased risk.

REPRESENTATIVE HAWKER said he couldn't speak for the ARM Board, but its current investment management structure would be affected. Simply put, HB 278 would provide additional assets to invest according to current investment guidelines and policies.

CHAIR STEDMAN questioned whether the ARM Board wouldn't be doubling its liability if it were paying the bonds off over 20 to 25 years.

REPRESENTATIVE HAWKER admitted he was a bit confused by the question because the debt to the bond investors would ultimately be an obligation of the government employer and not an obligation of the pension trust.

CHAIR STEDMAN agreed and added that everything flows back to the employer.

REPRESENTATIVE HAWKER said he couldn't see how the obligation to the capital markets from a municipality would affect the operation of the trustee that was investing the proceeds.

CHAIR STEDMAN responded the trustee investing the proceeds would have to deal with asset allocation and the underlying debt service requirements to pay the bonds off.

REPRESENTATIVE HAWKER respectfully pointed out that the money to pay off the bonds wouldn't come from the pension trust. The only cash flow the pension trustees have to manage is the cash flow required to meet the benefits and obligations under the pension plans. A municipality's obligation wouldn't be transferred to anyone; it would remain an obligation of that municipality. The only obligation the pension trust would have would be to meet the benefit payments that are part of the pension and retirement structure.

[2:09:05 PM](#)

CAROL SAMUELS, Vice President with Seattle-Northwest Securities Corporation, testified in support of HB 278 and reported that in Oregon over 130 municipalities have entered the capital markets for the purpose of refinancing pension liability.

Responding to Chair Stedman she clarified that this isn't a new financing; it is a replacement. From a cash flow standpoint, the bond proceeds would be sent to the system and the obligation to the system would be satisfied by those bond proceeds. The municipality would use general fund resources - which it would otherwise use to pay off the obligation to PERS - to pay off the bonds. If everything is successful from a reinvestment point of view, the overall cost to the municipality should go down.

In Oregon the various jurisdictions issued about \$5 billion in POBs over the last four years and the projection is that it will save more than \$1 billion or about 25 percent of the amount that

was borrowed. The projection assumed a reinvestment rate of 8 percent.

She directed attention to page 8 of a PowerPoint presentation and said it indicates the actual experience of the various jurisdictions since 2002. Column 2 shows the true interest cost (TIC) and it indicates that the jurisdictions borrowed from a low of 4.77 percent in late 2005 to a high of 7 percent in 2002. The average is between 5 and 5.5 percent. The column at the far right shows the rate of return for each entity since they deposited the proceeds. She noted that even the highest borrowing rate has earned more than the cost of funds, which is the break even. To the extent that the municipalities earn, on average, more than 7 percent over the 25-year borrowing period they will reduce the amount that they would otherwise pay to PERS.

She summarized that when properly structured POBs can be a useful tool to municipalities that are faced with significant cost increases in order to payoff a liability.

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SENATOR THOMAS WAGONER asked what would keep a municipality from getting into the same difficulty again.

MS. SAMUELS replied Oregon had similar difficulties and in 2003 that Legislature approved a rewrite of the system. Originally the liability was projected to be \$17 billion and now it is projected to be between \$5 billion and \$6 billion. Certainly the strong returns in the last few years have helped, but most of the reduction came through reforms. The system was a defined benefit system and is now a combination of defined benefit and defined contribution.

SENATOR WAGONER said Alaska has taken similar steps with its pension plans, but the real problem is skyrocketing medical costs here in Alaska compared to other states. The problem here in Alaska isn't a lack of money it's a problem of ignoring a solution, he asserted.

[2:16:55 PM](#)

REPRESENTATIVE HAWKER agreed that the greatest challenge to the pension plan, to Medicaid and to workers' compensation is the explosive unsustainable growth in medical costs. He asked that

this be viewed on its own merit as just one of the many tools needed to approach the problem.

LARRY SEMMENS, Finance Director for the City of Kenai, stated support for the work the Legislature has done to address pension issues. He said he would like to go on record as being in personal support of HB 278 because it gives municipalities a tool to deal with an unfunded liability. He emphasized that each municipality would analyze risk before making the decision to enter into these transactions and if the borrowing market is at 7.5 percent it's unlikely that any POBs would be issued because the benefit wouldn't justify the risk.

He said it's unlikely that the moral obligation of the state would be affected if a municipality were to default on the debt. It's more likely, he said, that a struggling municipality wouldn't be able to meet the terms of the issuance in the first place. Looking at it from the reverse he said he wonders if there might be an impact on the state if municipalities began having financial problems due to the dramatic increase in PERS rates. That is likely because if a municipality were to default on its PERS obligation the rest of the system would have to assume that obligation and the State constitutes about two-thirds of the PERS system.

He urged the committee to give municipalities tools to deal with their unfunded pension obligations. This is just one of those tools, he said.

[2:21:12 PM](#)

CHAIR STEDMAN asked him to comment as a member of the ARM Board.

MR. SEMMENS reported that the ARM Board has stated that it would continue to evaluate POBs, but it has not made a recommendation.

CHAIR STEDMAN asked if the ARM Board would return to the Legislature in January 2007 with a list of recommendations.

MR. SEMMENS replied the ARM Board issued its report on April 18 with recommendations that were identified by three priorities. One recommendation is embodied in HB 278 and as far as he is aware, that's the only action the Legislature has taken on those recommendations. SB 141 tasked the ARM Board with managing the assets such that they would meet liabilities. He interprets that to mean that there must be enough assets in the system.

2:24:08 PM

GREGG SUNDBERG, Managing Director with Merrill Lynch, spoke in support of the bill. He reinforced the notion that this is just one important tool and in no way is it a fix for the systemic problem that caused the unfunded liability. Depending on market conditions this tool can be used beneficially to help reduce the cost of the unfunded liability that remains after the systemic problem is addressed.

He cautioned that using POBs would not be appropriate for all entities because the use of bonds exchanges a soft liability for a hard liability and some entities aren't in a position to manage exposure to a hard liability. Clearly some municipalities in Alaska will benefit more than others and it's likely that the larger municipalities will benefit more frequently.

In response to questions about prior use of POBs, he advised that about 160 pension financings have been done in the last three years and virtually all could be viewed as successes retrospectively. One measure of success is how the rating agencies view the risk exposure of these transactions. Generally, he said, the existing ratings are maintained and sometimes the rating agency comment is positive relating to use of POBs. As long as the pension bonds are structured conservatively so the employer savings is about constant over time; and as long as conservative actuarial assumptions are used in the savings calculations; and as long as POBs are just one tool of a larger comprehensive pension plan there is every reason to believe that there would be no impact on ratings.

Identifying the problem, making a systemic fix and implementing a POB program to lower the cost of the remaining liability is often viewed as credit positive, he concluded.

2:27:39 PM

SENATOR WAGONER announced that he had a statement to make and he meant no disrespect to Representative Hawker or others who had testified. He continued to say that:

As long as ANWAR maintains the current status and as long as people in Washington and Oregon continue to be against opening up of ANWAR, I'm going to do everything in my power, legislatively and personally to dissuade anybody in Alaska from doing any business at all with people from Washington, Oregon, and California.

CHAIR STEDMAN remarked Senator Wagoner isn't alone in that sentiment.

REPRESENTATIVE HAWKER said he was not unfamiliar with such comments and he had probably expressed similar opinions in the past. However, a U.S. Senator once counseled him to be cautious in taking that approach.

[2:30:16 PM](#)

CHAIR STEDMAN announced he would like to hear from the Alaska Municipal League.

KEVIN RITCHIE, Executive Director of the Alaska Municipal League (AML), spoke in support of HB 278 and advised that AML passed a resolution supporting the option to use pension obligation bonds as a tool.

He agreed that the larger more sophisticated municipalities would be more likely to use this tool than the smaller municipalities, but a reason for having the bond bank is to help smaller less financially sophisticated municipalities. That's an advantage of the bond bank; it puts packages together for small communities that go to the bond market.

MR. RITCHIE likened the proposal to refinancing a home mortgage. The original loan is paid off, a new loan is taken out, and payments are made to that new debt instrument. The state would be paid off and with the resulting reduction in liability the PERS rate would go down. There would be another obligation, but the idea is that it would be smaller than the obligation to the state.

Before anyone uses this tool it is important to have the entire plan outlined by the state regarding how it can address the issue. The bottom line is that on the local level all citizens are double constituents. They are city and borough constituents as well as state constituents and the goal is for the state and municipalities to work together to get the best deal for constituents. For some communities, he said, this might be part of the solution. Some large communities might not make this choice and some of the smaller communities might have to band together with other small municipalities to evaluate the use of this tool.

CHAIR STEDMAN asked if AML and the ARM Board have had conversations on the unfunded liability issue.

MR. RITCHIE replied they have been working together closely and although the ARM Board hasn't taken a stand on whether POBs are a good idea or not, AML looks forward to continuing the working relationship.

[2:36:20 PM](#)

CARL ROSE, Executive Director of the Association of Alaska School Boards (AASB), stated that AASB is on record as being in support of the option to use pension obligation bonds. He opined that the decision to take advantage of this opportunity or not is a policy call that should be made at the local level. This would be a partnership at the local level with municipalities and with the state as well. We'd like the opportunity to take advantage of this if it serves us well at the local level, he said.

CHAIR STEDMAN asked if AASB believes this would be a good mechanism for dealing with the PERS/TRS liability issue.

MR. ROSE replied it could be in some school districts. Clearly, a school district couldn't act alone; it would be in conjunction with the local municipalities, but it's at the local level that the feasibility discussion should take place.

CHAIR STEDMAN remarked that would be a discussion for another day. because the state shares in the cost of education.

MR. ROSE agreed.

[2:39:24 PM](#)

CHAIR STEDMAN suggested that the issue of greater return on the portfolio would be explored when the bill moved on to the Finance Committee. Everyone should be comfortable with the risk inherent and there should be an action plan in the event that this turns upside down for some municipality.

He told Representative Hawker that he appreciated his comment that the municipal level PERS/TRS liability is a municipal obligation.

REPRESENTATIVE HAWKER said if a municipality should avail itself of this opportunity it would be signing on the line acknowledging that liability.

CHAIR STEDMAN closed public testimony and noted that he didn't have a quorum and so he could not take action on HB 278. He announced that the committee would do so at the next meeting and further discussion could take place in the Finance Committee.

There being no further business to come before the committee, Chair Stedman adjourned the meeting at [2:44:26 PM](#)