

HOUSE FINANCE COMMITTEE  
April 20, 2007  
1:44 p.m.

CALL TO ORDER

Co-Chair Meyer called the House Finance Committee meeting to order at [1:44:38 PM](#).

MEMBERS PRESENT

Representative Mike Chenault, Co-Chair  
Representative Kevin Meyer, Co-Chair  
Representative Harry Crawford  
Representative Les Gara  
Representative Mike Hawker  
Representative Mike Kelly  
Representative Mary Nelson  
Representative Bill Thomas, Jr.

MEMBERS ABSENT

Representative Richard Foster  
Representative Bill Stoltze, Vice-Chair  
Representative Reggie Joule

ALSO PRESENT

Representative Anna Fairclough; Brian Andrews, Deputy Commissioner, Treasury Division, Department of Revenue

PRESENT VIA TELECONFERENCE

Michael O'Leary, CFA, Executive Vice President, Callan Associates; Jason Ellement, FSA, CFA, Callan Associates

SUMMARY

HB 159 "An Act relating to the issuance of a certificate of birth resulting in a stillbirth."

CSHB 159 (JUD) was REPORTED out of Committee with a "do pass" recommendation and with fiscal note #1 by the Department of Health and Social Services.

HB 13 "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."

CSHB 13 (FIN) was REPORTED out of Committee with a "do pass" recommendation and with a new indeterminate fiscal note by the Department of Administration and with zero fiscal note #1 by the Department of Revenue.

HB 215 "An Act relating to the establishment of a task force to review the Council on Domestic Violence and Sexual Assault."

CSHB 215 (HES) was REPORTED out of Committee with a "do pass" recommendation and with zero fiscal note #1 by the Department of Health and Social Services, zero fiscal note #2 by the Department of Law, new zero fiscal note by the Legislature, new fiscal note by the Department of Corrections, and new fiscal note by the Department of Public Safety.

HB 45 "An Act authorizing the Department of Military and Veterans' Affairs to establish and maintain Alaska veterans' cemeteries; and establishing the Alaska veterans' cemetery fund in the general fund."

CSHB 45 (MLV) was scheduled but not heard.

HB 88 "An Act relating to televisions, monitors, portable computers, and similar devices in motor vehicles; and providing for an effective date."

CSHB 88 (JUD) was scheduled but not heard.

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HOUSE BILL NO. 159

"An Act relating to the issuance of a certificate of birth resulting in a stillbirth."

Co-Chair Meyer referred to a letter from Jean Mischel from Legal Services regarding verification of a retroactivity clause in subsection (f) of the bill (copy on file.)

Co-Chair Chenault MOVED to REPORT CSHB 159 (JUD) out of committee with individual recommendations and with the accompanying fiscal note. There being NO OBJECTION, it was so ordered.

CSHB 159 (JUD) was REPORTED out of Committee with a "do pass" recommendation and with fiscal note #1 by the Department of Health and Social Services.

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HOUSE BILL NO. 13

"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."

Co-Chair Chenault MOVED to ADOPT the work draft for HB 13, labeled 25-LS0084\M, Cook, 4/17/07. There being NO OBJECTION, it was so ordered.

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Representative Hawker, sponsor, explained that HB 13 is a solutions bill. It has the potential to patch the \$42 million general fund hole in the budget. The bill provides governmental employers in Alaska with a tool that could save taxpayers money regarding PERS/TRS unfunded liability. He related that the determination as to how to pay off the unfunded liability falls upon the legislature. Representative Hawker described how the bill provides mechanisms to lower the interest rate on the pension obligation liability. It allows for an arbitrage interest

differential and sets up several mechanisms for issuing bonds.

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Representative Hawker reported that the bill allows the Municipal Bond Bank to facilitate transactions on behalf of individual or multiple communities. It empowers the Alaska Housing Finance Corporation to participate in such transactions should it be deemed appropriate, it empowers the state bond committee to utilize these tools, and most significantly, the bill creates a public subsidiary corporation called the Pension Obligation Bond Corporation, which is managed by the Commissioners of Revenue, Commerce, Community, and Regional Affairs and Administration. He termed the bill appropriate and prudent. He emphasized that the greatest risk is in not acting.

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Representative Gara summarized the bill's action: "We issue a bond for a certain amount and the way we make money off of pension obligation bonds is then we invest that same amount of money in the market at a higher rate." Representative Hawker agreed. The state is able to fix the interest cost through a debt instrument that allows the state to fund its obligation to pay. The proceeds from that instrument are placed in an investment trust.

Representative Gara asked how much can be made from this investment. Representative Hawker characterized returns of at least 1.5 percent with a high degree of confidence.

Representative Crawford asked if there is a way to hedge against a loss. Representative Hawker thought the up-coming presentation would answer that question. He offered that time is the best protection against risk and the greatest asset for a pension obligation bond contract. Representative Crawford wondered about guarding against the downside. Representative Hawker thought a hedge mechanism could be addressed later.

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Representative Gara called the bill a double-edged sword, with a scenario where money could be lost. He suggested issuing 10-year bonds and investing for the long term. Representative Hawker replied that it is only one of many tools, therefore there is less risk. The risk is spread over several components. The pension liability probably will be paid off in 60 years. Representative Gara stated support for the bill.

Co-Chair Meyer noted there is risk with any financial tool.

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BRIAN ANDREWS, DEPUTY COMMISSIONER, TREASURY DIVISION, DEPARTMENT OF REVENUE, referred to a handout entitled "Pension Obligation Bonds - April 20, 2007" (copy on file.) Mr. Andrews informed the committee that his presentation would cover three areas: a description of Pension Obligation Bonds (POBs), the reasons to consider POBs, what the risks are, the potential savings achieved, and why POBs are issued as taxable debt.

Mr. Andrews referred to Slide 1 - Pension Obligation Bond objectives. He compared issuing POBs to paying off an ever-increasing credit card debt with the use of a line of credit on a home. POBs are not new to the marketplace, or to Alaska.

Mr. Andrews addressed Slide 2 - three reasons to consider issuing POBS. The three reasons include interest rate savings, a positive earnings arbitrage, and no reduction in the state's credit rating. He pointed out that POBs are not a golden bullet; just a financial tool - Slide 3. He defined Unfunded Actuarial Accrued Liability (UAAL) - a bill of \$8.6 billion that the pension plan is giving to the State of Alaska and to local governments - Slide 4.

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Mr. Andrews spoke to Slide 5 - how the UAAL bill is paid. Option A is to use cash to pay the bill off and Option B is for the pension plans to give a loan of 25 years at 8.25 percent to the state.

Mr. Andrews showed Slide 6 - Interest Rate Savings. He described how a savings of 2.5 percent on interest cost is achieved. A reduced interest rate equals savings of \$272 million.

Slide 7 - Interest Rate History - shows a graph of ten-year treasury yields. One of the key factors is to issue debt at a low interest rate cost.

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Mr. Andrews turned to positive earnings arbitrage. Slide 8 - Historical Investment Returns of State Pension Plans (PERS) - shows the average return over the last 15 years is 9.09 percent.

Slide 9 shows the same type of returns on TRS.

Slide 10 addressed the Long Term Target Asset Allocation, which are reviewed each year by the ARM Board.

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Mr. Andrews turned to credit neutrality and Slide 11 - Credit Rating Consideration. The issuance of POBs has never hurt a state's credit rating. Rating agencies talk about hard and soft dollar liabilities. The unfunded liability is a soft liability and can be ignored. It becomes a hard obligation after pension obligation bonds are issued. He maintained that there is currently a hard obligation to pay the benefits compared to other states. He suggested by being pro-active, the state's credit rating would improve.

Mr. Andrews discussed the risks listed on Slide 2 and Investment Risk Analysis - Slide 13.

Mr. Andrews used the graph in Slide 14 - Investment Risk (PERS) - to show examples of returns if POBs had been issued in any given year. The far right column is the estimated cumulative PERS Net Return to 2006. He speculated what would have happened if the bonds had been issued previously.

Slide 15 depicts similar data on Investment Risk for TRS.

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Mr. Andrews discussed Slide 16 - UAAL vs. POB Financial Success. As long as bond-funded assets earn more than 5.75 percent, the state is better off for having borrowed. If assets earn less than 5.75 percent, POBs are undesirable. If assets earn more than 8.25 percent, the UAAL can increase due to actuarial and/or accounting changes.

Mr. Andrews informed the committee about Monte Carlo simulation scenarios as shown in Slide 17 - Investment Return Forecast - with examples of three portfolios. The conservative portfolio did better.

Mr. Andrews talked about Slide 18 - Political Risk - Key Driver of UAAL. Between 1992 and 2003, increasing liabilities, not poor investment performance, caused the most damage to the PERS/TRS system. Mr. Andrews continued to address Political Risk - Slide 19 and Market Risk - Slide 20.

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Mr. Andrews described the types of POBs as listed on Slide 21: general obligation bonds, obligations imposed by law, and annual appropriation bonds. He noted a restriction in HB 13 that the bonds do not constitute a general obligation of the state.

Mr. Andrews addressed potential savings by issuing POBs. Slide 22 suggests the combination of POBs and cash infusion and Slide 23 depicts four matrices - Case Study (PERS). He compared and contrasted the four matrices.

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Mr. Andrews did a similar analysis on Slide 24 - Case Study (TRS). He described one of the scenarios and how to attain a savings.

Mr. Andrews addressed tax issues on Slide 25 - Taxable Bonds vs. Tax Exempt Bonds and Slide 26 - The Difficulty with Tax Exempt. He preferred not to go through an IRS audit.

Mr. Andrews highlighted four take-aways on Slide 27.

Mr. Andrews concluded that the administration is in favor of HB 13.

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MICHAEL O'LEARY, CFA, EXECUTIVE VICE PRESIDENT, CALLAN ASSOCIATES, referred to a handout, "State of Alaska - POB Issuance Illustrations" (copy on file.) He related the Overview and Description found on Slide 1. Callan was asked to illustrate the range of possible outcomes associated with issuing \$2 billion in Pension Obligation Bonds (POBs), using assumptions of a 5.7 percent interest rate with a mortgage-like repayment pattern over 25 years. Callan's standard capital market projections were used and multiple policies were considered. He cautioned that his objective is to show the order of magnitude and range of possibilities for investing POB proceeds. The results do not consider the effects on annual pension contributions levels or funded status.

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JASON ELLEMENT, FSC, CFA, CALLAN ASSOCIATES, explained that the study looked at four asset allocations as illustrated on Slide 2. The pension fund's target mix is close to the 65/35 mix.

Mr. Ellement addressed Slide 3 - Assumed Debt Schedule. The level annual payments would be \$152 million per year, the total principal repayment would be \$2 billion, and the total interest cost over 25 years would be \$1.8 billion.

Mr. Ellement explained that Slide 4 looks at the Probability of Exceeding 5.70%. There is a 13 percent probability that the 65/35 mix will not exceed 5.7 percent over 25 years. There is not a lot of distinction between the more aggressive portfolios and the 65/35 mix.

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Mr. Ellement addressed POB Savings/Cost on Slide 5. He compared and contrasted the various scenarios. All projections are in today's dollars.

Mr. Ellement discussed Slide 6 - Distribution of One-Year Return, Slide 7 - Years to Recovery First Year Return if it is less than minus 10%, and Slide 8 - Years to Recovery minus 10% less than First Year Return if it is less than minus 5%.

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Mr. O'Leary concluded by summarizing Slides 9 and 10. He pointed out that issuing POBs and investing the proceeds in higher yielding securities is a leveraged investment strategy. Over the long run, a POB program that is prudently implemented has a high probability of success, depending on certain factors. POB programs that have been unsuccessful in the past have used too much leverage and/or issued when interest rates were high.

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Co-Chair Meyer referred to POB programs that have been unsuccessful in the past. He wondered if interest rates would continue to increase or drop down. Mr. O'Leary replied that the expectation is that interest rates are "at a level that is fairly reasonable given our inflationary expectation." He stated he would not be surprised to see the shorter end of the yield curve decline. The expected return on an investment grade bond portfolio over five years is 5.25 percent. He said he does not see interest rates climbing nor declining.

Mr. Andrews added that the environment has been a flat yield curve for some time. He thought it would remain flat for about 6 to 9 months, eventually reverting to a normal curve.

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Representative Hawker emphasized that the legislation empowers the state to pursue such a transaction. The state would not be committed to continue forward.

Co-Chair Meyer questioned the cost to the state and what the incentive was for the investment firms. Mr. Andrews explained that the cost of bond issuance is a half of one percent. A billion dollar transaction would be \$50 million. He observed that Europeans buy a large percentage of the bonds.

Representative Hawker noted that Alaska Housing Finance Corporation is always in the market for such transactions. There is a free market competition. Mr. Andrews noted that the 50 basis points cost is spread out over 25 years. The goal is to earn more than the 5.75 percent. He added that retirement plans earnings are up around 9 percent.

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In response to a question by Representative Crawford, Mr. Andrews explained that a number of factors would be examined to make sure the plan is prudent and well thought out, but that the specifics have not been flushed out. Representative Hawker pointed to AHFC's success. He maintained that competent professionals would be empowered to make the decisions. Oversight for the bonds would be through the creation of a Pension Obligation Bond Corporation, which includes the commissioners of Administration, Revenue, and Commerce, Community, and Economic Development.

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In response to a question by Representative Joule, Representative Hawker maintained that the professionals are in the state already and pointed out that Callan has been a long-time consulting firm with the state. He added that the state's expertise has been demonstrated over time.

Representative Joule stressed that highly specialized areas are being challenged, in terms of retention.

Representative Hawker noted that there are dedicated and competent state workers that could make more as professional investment managers.

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Representative Gara clarified that there would be a 25-year issuance and noted that investment in the early years can be more aggressive. Mr. Andrews stressed that it is important to get positive earnings arbitrage in the first few years by being conservative and low risk. Investment would be more aggressive between years 5 - 10.

Representative Gara questioned if the Callan numbers take into account the conservative/aggressive/conservative approach. Mr. Andrews explained that Callan examined only various portfolio allocation mixes.

Mr. O'Leary noted that more complex asset allocation models can be done. He explained that today's presentation is a reasonable depiction of the worst case for different broad levels of risk.

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Representative Gara questioned what "best estimate" numbers would look like. Mr. O'Leary spoke to the 65/35 mix with an expected return of 7 percent. Mr. Andrews demonstrated that the PERS/TRS expected return is 8 percent. Mr. O'Leary said he expects an 8 percent rate of return. Representative Gara asked if the Callen probability numbers reflect the real world. Mr. O'Leary replied that "they do with the only caveat being provided that those shifts from initial conservatism to more aggressive to final conservatism are moderate in character."

Representative Hawker related that the numbers are fine-tuned by professionals. He summarized that the point of the presentation is that there is a risk in taking a decisive action, but the professionals will react appropriately and mitigate that risk. He emphasized that the costs and risks associated with comfortable inaction far exceed the risks of empowering competent professionals to take a responsible, measured, and calculated entry into the markets.

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Representative Kelly thought that time was a factor with this legislation. He also thought the interest rate was a factor. He maintained that the scrutiny of the issuance is going to be a lot higher than the scrutiny of the bill. He wondered what might cause a loss or risk.

Mr. Andrews used New Jersey as an example of a failure where the proceeds of the bonds were not used to fund the pension obligation.

Representative Hawker addressed the fiscal note by the Department of Revenue. He thought it was essentially an indeterminate note because the bill empowers the state to pursue a transaction. There will be costs associated when the transaction takes place. He suggested that the new fiscal note by the Department of Administration be indeterminate also.

Representative Gara asked about authorizing an expense for an auditor. He referred to previous discussion on Section 1, regarding allowing prepayment of TRS unfunded liability.

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Representative Hawker said the issue was raised in Ways and Means as a concern of Representative Seaton's. The question was answered in the State Affairs Committee. Representative Hawker pointed out that there are mechanisms in place to

deal with that issue. He described a hypothetical satellite account as an example.

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Co-Chair Chenault MOVED to REPORT CSHB 13 (FIN) out of Committee with individual recommendations and with the accompanying fiscal notes.

Representative Kelly asked if indeterminate fiscal notes are appropriate for the bill. Representative Hawker said yes. Should a series of transactions be embarked upon, the Department of Administration could then respond.

Co-Chair Meyer MOVED that the fiscal note from the Department of Administration, dated 3/21/07, be changed to an indeterminate note. There being NO OBJECTION, it was so ordered.

CSHB 13 (FIN) was REPORTED out of Committee with a "do pass" recommendation and with a new indeterminate fiscal note by the Department of Administration and with zero fiscal note #1 by the Department of Revenue.

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HOUSE BILL NO. 215

"An Act relating to the establishment of a task force to review the Council on Domestic Violence and Sexual Assault."

REPRESENTATIVE ANNA FAIRCLOUGH addressed the reasoning behind having a task force to review the Council on Domestic Violence and Sexual Assault. There have been questions about staff turnover, reports on grant management, debate on office location, and questions about appointment to the Council and coordination with other state agencies. A task force would take each of these points on and provide a report back to the legislature.

Representative Fairclough reminded the committee that Alaska ranks number one on many violent issues such as sexual assault. She pointed out that the Council has done a fabulous job in providing financial support to a network of agencies across the state to respond to that issue. She thought it was time to re-look at what the Council is focusing on.

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Representative Fairclough reviewed the sections of the bill. Section 1 talks about the findings of the State of Alaska

and quantifies that we do have an issue. Section 2 establishes the actual task force.

Representative Fairclough reported that she has met with the Council and the Network on Domestic Violence and Sexual Assault who have agreed to move forward with a task force. Section 2 describes the composition of the fifteen members. It includes the legislative body in the process, which is an important part of finding solutions to the problem of sexual assault.

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Representative Fairclough referred to page 3, lines 8-15, which outlines audit notations, a menu that provides the legislature with options to proceed forward with modifications on mandates and prevention strategies.

Co-Chair Meyer referred to the fiscal notes that primarily cover travel for the task force for one year.

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Representative Hawker MOVED to REPORT CSHB 215 (HES) out of committee with individual recommendations and with the accompanying fiscal notes. There being NO OBJECTION, it was so ordered.

CSHB 215 (HES) was REPORTED out of Committee with a "do pass" recommendation and with zero fiscal note #1 by the Department of Health and Social Services, zero fiscal note #2 by the Department of Law, new zero fiscal note by the Legislature, new fiscal note by the Department of Corrections, and new fiscal note by the Department of Public Safety.

#### ADJOURNMENT

The meeting was adjourned at 3:27 PM.