

ALASKA STATE LEGISLATURE
HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS

February 14, 2007

3:42 p.m.

MEMBERS PRESENT

Representative Mike Hawker, Chair
Representative Anna Fairclough, Vice Chair
Representative Bob Roses
Representative Paul Seaton
Representative Sharon Cissna
Representative Max Gruenberg

MEMBERS ABSENT

Representative Peggy Wilson

COMMITTEE CALENDAR

HOUSE BILL NO. 125

"An Act relating to budget planning and a long-range fiscal plan for the State of Alaska."

- HEARD AND HELD

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."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 125

SHORT TITLE: LONG-RANGE FISCAL PLAN

SPONSOR(s): WAYS & MEANS

02/08/07 (H) READ THE FIRST TIME - REFERRALS
02/08/07 (H) W&M, FIN
02/14/07 (H) W&M AT 3:30 PM HOUSE FINANCE 519

BILL: HB 13

SHORT TITLE: RETIREMENT SYSTEM LIABILITY/BONDS

SPONSOR(s): REPRESENTATIVE(s) HAWKER

01/16/07 (H) PREFILE RELEASED 1/5/07
01/16/07 (H) READ THE FIRST TIME - REFERRALS
01/16/07 (H) W&M, STA, FIN
02/14/07 (H) W&M AT 3:30 PM HOUSE FINANCE 519

WITNESS REGISTER

FRANK J. INGRASSIA, Chairman
Municipal Finance and Infrastructure Group
Goldman, Sachs & Co.
New York, New York

POSITION STATEMENT: During hearing of HB 13, presented information on pension obligation bonds.

RICHARD A. SCHOBBER, JR., Vice-President
Municipal Finance
Goldman, Sachs & Co.
Seattle, Washington

POSITION STATEMENT: During hearing of HB 13, explained portions of pension fund debt calculations.

CAROL SAMUELS, Vice-President
Seattle-Northwest Securities
Portland, Oregon

POSITION STATEMENT: During hearing of HB 13, presented information on pension obligation bonds and described Oregon's experience with pension obligation bonds.

PAUL BLOOM, Director, & Regional Manager
Pacific Northwest Public Finance Group
Merrill Lynch
(No address provided)

POSITION STATEMENT: During hearing of HB 13, presented information on pension obligation bonds.

ACTION NARRATIVE

CHAIR MIKE HAWKER called the House Special Committee on Ways and Means meeting to order at [3:42:43 PM](#). Present at the call to order were Representatives Hawker, Gruenberg, Roses, Seaton, Fairclough, and Cissna.

HB 125-LONG-RANGE FISCAL PLAN

[3:43:44 PM](#)

[Contains discussion of HOUSE BILL NO. 68.]

Chair Hawker announced that the first order of business would be HOUSE BILL NO. 125, "An Act relating to budget planning and a long-range fiscal plan for the State of Alaska." He stated that the committee considered amending HB 68, but by consensus agreed instead to go with a proposed committee substitute.

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REPRESENTATIVE FAIRCLOUGH moved to adopt the proposed committee substitute (CS) for HB 125, Version 25-LS0546\C, Cook, 2/8/07. There being no objection, Version C was before the committee.

[HB 125 was held over.]

HB 13-RETIREMENT SYSTEM LIABILITY/BONDS

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CHAIR HAWKER announced that the next order of business would be 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."

CHAIR HAWKER, sponsor of HB 13, explained that HB 13 empowers the Alaska Municipal Bond Bank Authority (municipal bond bank) to utilize its credit enhancement services for political subdivisions that may wish to structure a pension finance transaction to help meet the costs of unfunded pension liabilities. He noted that HB 13 provides the state another method to resolve the various state employers' unfunded pension liabilities. Chair Hawker observed that there are various methods to reduce pension fund debt, such as early payment, refinancing at a lower cost, or reducing operating costs. The bill contains concepts that allow the state to refinance its unfunded pension plan debt at a lower rate of interest. Although a similar bill, House Bill 278, was considered in last year's legislative session, HB 13 has been expanded to empower the executive branch to pursue such transactions that it might deem appropriate to help resolve the state's obligations under the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS). He emphasized that this bill does not execute, direct, or authorize transactions; rather it empowers the decision makers to bring forward proposals for transactions they may deem appropriate. He opined that HB 13 takes a more innovative and contemporary view of the state's ability to use structured financing.

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FRANK J. INGRASSIA, Chairman, Municipal Finance and Infrastructure Group, Goldman Sachs & Co., referred to a PowerPoint presentation titled, "Pension Obligation Bonds - Overview of Structure and Current Market Opportunities" which was also provided to the committee. He informed the committee that since 2000, a number of factors have caused steady growth in unfunded pension and other post employment benefit costs. He explained that nationwide, funding ratios for public pension funds grew from about 80 percent in 1990 to over 100 percent in 2001. Due to the successful economy at the time, many states negotiated more generous benefit contracts with their employees. Unfortunately, shortly after that "the bubble burst" and pension funding ratios started to fall significantly. As a result, by 2005, there was a nationwide pension funding deficit (not including medical benefits) of over \$340 billion. The problem

of unfunded liability has grown exponentially as other costs, such as medical costs, continue to grow. Unfunded pension fund liability considered a debt of the state by Standard and Poor's financial rating service, he said.

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MR. INGRASSIA referred to page 2 of the handout and said that in 1999 the funding ratios for PERS/TRS were 106 percent and 103 percent, respectively. Since then the unfunded actuarial accrued liability (UAAL) has increased dramatically and the cumulative funding ratio for PERS/TRS combined has decreased from 67.6 percent in 2004 to 64.1 percent in 2005. The funding ratio might be even lower if one were to examine the figures from 2006, he said.

CHAIR HAWKER observed that today's presentation does not require the most recent data on the PERS/TRS liability; rather the financing opportunities that are being discussed today apply regardless of the details of the data.

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MR. INGRASSIA explained that an 80 percent funding ratio is the minimum level required for a pension fund to be self-sustaining based on the earnings that it generates. If a pension fund has a ratio below 80 percent, the pension authority should take some action to fix it; pensions funded at 80 percent or above are probably in pretty good shape, he opined.

MR. INGRASSIA described the UAAL as the difference between assets currently in the pension fund and the present value of the required payments to the existing plan participants over time. Each year a state's pension system reviews the assumptions in the pension fund actuarial report to determine the required payment stream and compare it to the earnings potential of the assets on hand. The pro-forma annual shortfall is then discounted at the assumed interest rate, which in Alaska is 8.25 percent, to determine the present value of the shortfall. The UAAL is essentially a debt which carries an interest rate of 8.25 percent. In Alaska, this debt obligation is constitutionally protected by Article XII, Section 7 of the Alaska State Constitution, he noted.

MR. INGRASSIA described pension obligation bonds (POBs) as a method to refinance pension fund debt in order to lower the cost of the existing debt to plan participants. He observed that

this is an ideal time to look at POBs because interest rates are at a 30-40 year low, as is shown by the chart on page 4 of the handout. He said that the state could issue POBs in today's market at about a 5.56 percent interest rate, which is an attractive refinancing possibility when compared to the 8.25 percent interest accruing on the UAAL. The potential savings to the state from refinancing are significant, he noted.

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REPRESENTATIVE SEATON observed that an 80 percent funding ratio leaves 20 percent unfunded, therefore the state is relying on the interest to pay some percent of the benefits. He questioned whether the 80 percent target is sufficient to allow for the state to make the payments it is scheduled to make.

MR. INGRASSIA related that his research in the pension field indicates that at 80 percent, there is an earnings potential to get to 100 percent funding. A fund could target a higher funding ratio, he noted, but at 80 percent the earnings potential is sufficient to allow the fund to grow to 100 percent. Although a study by the state's actuary, Buck Consultants, used an 85 percent target for one fund and a 90 percent target for another, the Municipal Finance and Infrastructure Group used 80 percent to keep the numbers manageable. It is the state's decision to determine at what level to fund its pension plans, he noted.

REPRESENTATIVE SEATON asked whether the choice to fund at 80 percent requires the state to make 20 percent more to fund its future liability.

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MR. INGRASSIA said another component to consider is that of employer contributions, which can also be higher than the ongoing "run rate" of the requirements. The aforementioned is what has been happening. The higher employer contribution rates are much higher than the ongoing run rate to try and make up the unfunded liability. He indicated that earnings, employer contributions, and other outside contributions are all taken into consideration.

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REPRESENTATIVE SEATON followed up by clarifying that under the scenario presented today, the 80 percent funding might require

an employer contribution rate increase to make up the additional 20 percent.

MR. INGRASSIA noted his agreement with Representative Seaton's clarification, and noted that the state could have a higher target number than 80 percent.

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CHAIR HAWKER said that in planning the presentation, 80 percent seemed like a good number for discussion purposes and he pointed out that with market possibilities, funding at 100 percent could be overaggressive and result in an over-funded program. He reminded the committee that the determination of what constitutes full funding and other alternatives, is a policy call. He said that other alternatives which may be discussed include making ongoing additional contributions to the pension funds.

MR. INGRASSIA noted that the 80 percent funding ratio is considered the minimum funding level. He referred to page 4 of the committee handout and described as significant the potential savings to the state in refinancing from 8.25 percent interest to 5.56 percent interest. For example, the issuance of \$2.1 billion in bonds for PERS could result in a savings of \$626 million in present value savings, while issuance of \$1.3 billion in bonds could save \$384 million in present value savings for TRS. He clarified that to fund at 80 percent meant funding enough to get to an 80 percent funding ratio; not funding 80 percent of the unfunded liability.

MR. INGRASSIA emphasized that there are numerous factors to consider and that all the numbers are based on assumptions. Factors which affect the size of the UAAL include: actuarial assumptions such as life expectancy and demographics, assumed rate of return, actual investment returns, changes in contractual benefits, and benefit cost assumptions compared to actual experience. Due to these variables, the size of the UAAL is constantly shifting, which is one reason to avoid a 100 percent ratio. He identified three possible options for funding Alaska's UAAL: upfront cash contributions by the state or employers from any surplus funds, increased employer contributions, or pre-fund with POB proceeds at 5.56 percent interest. Pension fund managers can reach their funding goals by mixing and matching these alternatives, he informed the committee. He said that due to growth in unfunded liabilities, a number of states have issued POBs over the last few years.

MR. INGRASSIA informed Representative Gruenberg that Goldman, Sachs & Co. has done underwriting with the state in the past and hopes to continue to do business with the state, noting that his company earns fees as a bond underwriter.

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REPRESENTATIVE ROSES expressed concern that the interest rate available to the state will not be as attractive if too many states issue these bonds at the same time, thereby flooding the bond market.

MR. INGRASSIA explained that the assumption is that these pension bonds will be taxable bonds, and since most bonds are non-taxable, the market for taxable bonds is almost unlimited. As an example, the state of Illinois issued \$10 billion in taxable pension bonds in 2003, and the primary buyers were European banks which would not normally consider buying municipal debt. There is a saying in the taxable market that "size opens eyes," meaning big taxable programs are more liquid and more attractive to big pension funds and banks, he said. He offered that "we do not really see any constraint in terms of the market for taxable pension bonds."

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MR. INGRASSIA, in response to a question about whether bonds are always profitable to the issuers, directed the committee's attention to the table on page 6 of the handout which shows that some states sold bonds "right as the bubble was bursting" and were not profitable by 2004. However, if one looks at a time progression, the bonds generally catch up. As of 2004, 84 percent of POBs were profitable, 7 percent were at a break-even point, and 9 percent had lost money, he said.

CHAIR HAWKER indicated that risk assessment and examination of other state's experiences with pension bonds would need to be considered by the committee prior to moving HB 13.

REPRESENTATIVE GRUENBERG asked whether the state could use the permanent fund as a funding source instead of selling bonds on the open market.

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CHAIR HAWKER replied that although that concept could not be considered today, perhaps representatives from the permanent fund could address this at a future time.

MR. INGRASSIA reminded the committee that an issue to consider is how the various financial rating agencies view pension liabilities. He explained that the rating agencies have slightly different views, but they all tend to view unfunded liability as a debt of the state. Furthermore, if the debt is not being solved, it is viewed as a problem. Despite the different ways that rating agencies view pension fund debt, the bottom line is that implementation of a plan to address and fund the existing UAAL and a funding plan for future obligations could be considered a credit positive.

MR. INGRASSIA said the total annual employer contribution for pension liabilities has the following two components: the normal pension contribution amount required to meet the annual pension expenses and the UAAL component. The UAAL is sized to help amortize the unfunded liabilities over time. The UAAL has been receiving a lot of attention in this state, he observed. To achieve an 80 percent funding ratio, the states' employers would have to contribute \$2.1 billion for PERS and \$1.3 billion for TRS, he said. However, he cautioned that these figure are based on information from 2005 and would be considerably higher if today's numbers were used. He told the committee that although some states have sold bonds to make one year's payment to their funds, he does not recommend that approach.

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MR. INGRASSIA stressed that recognizing and managing risks is one of the keys to POB issuance success. He said that the broad range of investments utilized by pension funds generally result in returns substantially higher than today's debt rates. If the actual returns are above the assumed actuarial investment return, the savings from the issuance of pension bonds can be even higher than predicted. Conversely, earnings of less than the current 8.25 percent, but more than 5.56 percent of the bonds would still result in savings, although less than projected. The issuer only goes negative if the earnings rate on the pension assets is less than the 5.56 percent predicted, he said. Pension obligation bonds can help improve relations with local governments by providing more security and a higher funding ratio and can permit more stable budget planning for all pension fund participants.

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CHAIR HAWKER advised that in later meetings the pension asset managers would present information on the state's past track record for past returns.

MR. INGRASSIA explained that potential risks include negative returns if the returns are below the bond interest rate. Furthermore, bond issuance converts "soft" obligations to "hard" obligations. Last, POBs result in a lump-sum payment to a pension fund, which concentrates rather than spreads market risk. There are ways to manage this market risk, he assured the committee. He clarified that a "soft" obligation is one in which the debt is owed, but the details of when and how it will be paid are not set. However, once bonds are sold there is a fixed amortization schedule, which must be paid in a timely fashion or default is risked. Therefore, it has a "hard" schedule.

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RICHARD A. SCHOBBER, JR., Vice-President, Municipal Finance, Goldman, Sachs & Co., reminded the committee that for the past two years there has been an established cap in Alaska [which has now been repealed] on the annual amount by which employer pension obligations can increase. As a result, the contributions have been low. When the actuaries have recalculated what is needed to fund the UAAL, the state has seen gigantic increases in the required employer contribution rate. Although the state does not have to pay the UAAL right away, it will have to pay someday and the cost of making the payment in the future will dramatically increase.

MR. INGRASSIA reminded the committee that since the Alaska State Constitution limits the issuance of general obligation debt to capital improvements, state issuance of POBs will require new legislative authority, including the probability that debt service payment on POBs will require an annual appropriation. He summarized that assuming an 80 percent funding ratio, if the state were to issue \$1.3 billion in bonds for the TRS program at 5.56 percent, the total gross savings over 25 years is estimated to be \$720 million, which equates to present value savings of about \$384 million. For the PERS program, issuance of \$2.1 billion in bonds would result in a savings of about \$1.1 billion, which equates to present value savings of \$626 million. If a higher savings rate is chosen, the savings rate would be proportionally higher, he noted.

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MR. INGRASSIA referred to the matrix on page 12 of the handout and explained that it provides a reference point by which the fund managers can mix and match policies to achieve a target funding ratio of 80 percent by 2032. If no bonds are issued and no cash contribution is made, the average employer contribution rate for TRS over the next 10 years would be 44.96 percent. The matrix shows how the employer contribution rate can change depending on whether POBs are issued and whether any cash contributions are made to the UAAL. A 5 percent decrease in the employer contribution rate equates to an annual savings of \$32 million, he said. He suggested this type of payment could be done over a period of a few years, to ease the effect on the general fund.

MR. INGRASSIA indicated that the aforementioned calculations regarding TRS are based on the wage base of both defined-benefits employees [Tiers 1-3] and defined-contribution employees [Tier IV].

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MR. INGRASSIA emphasized that the matrix scenarios shown on pages 12-13 of the handout provide a useful, powerful tool for policymakers to use in considering how to approach pension fund debt. He told the committee that for the PERS plan, a decrease of 5 percent in the employer contribution rate equates to an annual savings of \$94.8 million. He noted that Chair Hawker had requested a review of past earnings using an actual earnings rate of 8.1 percent, rather than the expected 8.25 percent. Page 14 of the handout shows the results of that review, and indicates that the lowered earning rate increases the projected employer contribution rate by approximately 1 percent annually, so the employer contribution rate is not as sensitive to earnings rates as one might think, he said.

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MR. INGRASSIA posed the possibility that the state could consider ways to optimize use of available cash. For example, capital construction needs are typically funded from ongoing revenues, and it may be possible to finance the state's capital construction requirements with tax-exempt bonds, and use general fund revenues to contribute to the UAAL. The examples on page 17 of the handout show the predicted results using different

funding options. This may be a way to achieve the desired policy goals of funding capital needs and reducing the UAAL by issuance of tax-exempt bonds, which have a lower interest rate, and therefore may be less of a burden on the state general fund.

CHAIR HAWKER observed that the scenarios shown on the matrix could assist the policymakers to look at the state's finances in a more contemporary manner than has been done in the past.

REPRESENTATIVE ROSES expressed concern that if a lot of states issue tax-exempt bonds at the same time, it could have a negative effect on the bond market, and thus on the expected rate of return.

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MR. INGRASSIA agreed that there could be a marginal impact on the bond markets if many states issued tax-exempt bonds at the same time. However, he reminded the committee, very few states have the magnitude of cash available for capital expenditures that Alaska has, so their ability to access the tax-exempt market would be limited. The possibility mentioned by Representative Roses does in theory exist, but Mr. Ingrassia stated he does not think it would be a realistic problem for Alaska.

CHAIR HAWKER reminded the committee that there are many resources available to the committee on this complex subject and that he can provide direct contact information for the committee members.

REPRESENTATIVE SEATON observed that it would be a policy change to target funding the pension plans at 80 percent, since past policy has been to target funding at 100 percent.

CHAIR HAWKER said that consideration of a target funding ratio for the pension fund liabilities would be an excellent topic to discuss with the Department of Revenue.

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CAROL SAMUELS, Vice-President, Seattle-Northwest Securities, told the committee that the pension benefits situation in Oregon was very similar to Alaska's situation. She provided the committee with copies of a PowerPoint presentation titled, "Pension Obligation Bonds, The Oregon Story," dated February 14, 2007. Referring to the page titled, "Oregon vs. Alaska Pension

System," she described the Oregon pension system as about four times the size of Alaska's, with an asset base of about \$53 billion. It is a single system with multiple tiers and covers around 325,000 employees. The current post-reform average employer contribution rate is 15 percent, compared to a pre-reform employer contribution rate of around 30 percent. The current funded ratio is about 91 percent, and the unfunded liability as of December 31, 2005, is \$4.6 billion, down from a high of \$17 billion prior to 2003.

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MS. SAMUELS described bonding as a popular tool across the country for financing pension fund liabilities. In Oregon, local governments and school districts have statutory authority to issue debt separately for what are termed "full faith and credit obligations." In general, the issuance authority is more flexible in Oregon than in Alaska, and does not require yearly appropriation, she noted. Smaller entities could use "intercept agreements" with the state to secure the pledge of additional operating funds so as to achieve a "state" credit rating. In 2003, the Oregon voters approved a constitutional amendment authorizing the state itself to issue general obligation bonds, she said. She informed the committee that if Alaska wanted to take a similar route and enact constitutional and/or statutory reforms to allow it to issue bonds, it could bring the available interest rate down further because "that is considered to be the safest form of security out there." She cautioned that if bonds are sold, it is critical to consider "housekeeping" issues carefully to assure that the participating employers receive the credit due them.

MS. SAMUELS stated that HB 13 incorporates many of the provisions Oregon found useful, such as intercept agreements and lump-sum accounts. In Oregon, over 175 employers have issued approximately \$5.4 billion in POBs. Using an 8 percent expected rate of return, the savings are estimated to be around \$1.3 billion. However, the actual returns have been substantially higher than the projected 8 percent she said, referring to the chart titled, "Recent Returns - Lump Sum Accounts." These returns, which reflect the True Interest Cost (TIC), support the prior observation that size matters and larger issuances receive more favorable interest rates. Ms. Samuels emphasized that timing is really key, and that bond issuance transactions should not be considered a guaranteed savings, although Oregon has had a positive experience thus far.

MS. SAMUELS pointed out that it is important not to over promise results, and for people to understand there is no guarantee of savings and that unfunded liabilities can continue to fluctuate. Furthermore, she emphasized that accounting and crediting decisions should be worked out as carefully as possible in advance of any bond issuance.

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MS. SAMUELS acknowledged that the funding scenarios on the handout page titled, "Oregon vs. Alaska: Potential Savings," is based on an assumed bond interest rate of 6 percent and the assumption that the entire unfunded liability is funded. These numbers are chosen for the sake of illustration, and she said her firm would likely not recommend funding the entire unfunded liability.

CHAIR HAWKER reminded the committee that there is no transaction on the table nor is any commitment to any firm being made at this point. The investment banking community is providing information for further consideration of these issues by the committee, he said.

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PAUL BLOOM, Director & Regional Manager, Pacific Northwest Public Finance Group, Merrill Lynch, told the committee his firm has been very involved in state public finance matters and helped draft and analyze last year's House Bill 278. He noted that it may be in the state's best interest to have the option to issue POBs as part of its "tool kit" to address pension funding challenges. Today's low interest rates make this a particularly attractive option at this time, he said. Depending on the funding ratio scenario chosen, Alaska could potentially capture hundreds of millions of dollars in present value savings. He opined that it is critical to understand that POBs are only one of a number of tools that could be used to address the pension fund liability issues. There are a number of factors to consider when addressing this issue. He suggested that a proactive approach to asset management includes exploration of ways to protect the state's investment returns from changes in inflation and downturns in the equity market. He offered that the passage of HB 13 would be a positive step for Alaska to take.

REPRESENTATIVE SEATON asked how current equity market performance affects risks in the bond market.

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MR. BLOOM replied that is why his firm recommends being proactive in looking at ways to protect investments against market downturns, noting that there are things an investor can do to protect itself from changes in the equity market. He said that the returns in the fixed income market are not generally as high as those in the equity markets, but that fixed income investments may help stabilize the funding ratio of the state's pension funds. Some employers may be willing to have a higher employer contribution rate if it would result in a more predictable and stable system, he said. He noted that the current allocation of assets in Alaska's system is about 60-70 percent in equities. In general a mix of 75 percent in equity and 25 percent in fixed income is a fairly common asset mix for pension systems. There are adjustments that can be made to an asset mix to help protect it and lock in gains, he advised.

CHAIR HAWKER said that future consideration of HB 13 would likely include discussions with the state's asset managers about the pension fund portfolio past performance and possible future direction.

[HB 13 was held over.]

ADJOURNMENT

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at 5:08:18 PM.