

SENATE FINANCE COMMITTEE
February 18, 2009
9:07 a.m.

9:07:02 AM

CALL TO ORDER

Co-Chair Hoffman called the Senate Finance Committee meeting to order at 9:07 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Charlie Huggins, Vice-Chair
Senator Johnny Ellis
Senator Kim Elton
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Pat Galvin, Commissioner, Department of Revenue; Jerry Burnett, Deputy Commissioner, Division of Treasury, Department of Revenue

PRESENT VIA TELECONFERENCE

None

SUMMARY

#sb95
SB 95

"An Act making supplemental appropriations, capital appropriations, and other appropriations; amending appropriations; making appropriations to capitalize funds; making appropriations under art. IX, sec. 17(c), Constitution of the State of Alaska, from the constitutional budget reserve fund; and providing for an effective date."

SB 95 was POSTPONED.

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^CONSTITUTIONAL BUDGET RESERVE PERFORMANCE REVIEW

Co-Chair Stedman related that the meeting would continue a discussion of the Constitutional Budget Reserve (CBR), which was begun last week. He explained that the CBR is the

state's main savings account. It requires a three-quarter majority vote of the legislature to access the funds. The CBR has two components; the main account and the subaccount, which differs in size and in investment strategies than the main account. He referred to handouts included in the Finance Committee members' packets. A single page from SB 256, the FY08 supplemental bill, shows the CBR intent language, lines 6-9. Alaska Statute 37.10.430 deals with the management of the budget reserve fund.

[9:10:41 AM](#)

PAT GALVIN, COMMISSIONER, DEPARTMENT OF REVENUE, introduced himself.

Co-Chair Stedman referred to the document entitled "Constitutional Budget Reserve Fund - January 31, 2009 Results" (copy on file) and requested an explanation of it.

[9:11:47 AM](#)

JERRY BURNETT, DEPUTY COMMISSIONER, DIVISION OF TREASURY, DEPARTMENT OF REVENUE, explained that the top line shows the balance in the corpus and the subaccount of the CBR as of January 31, 2009, and the total balance of both accounts. The next columns show the performance forecast for both accounts; 4.53 percent for the corpus, and 7.61 percent for the subaccount. He referred to the combined income loss for FY09.

Co-Chair Stedman requested to know when the performance numbers were updated. Mr. Burnett replied that the forecast numbers were done, based on capital market projections, in early 2008. The performance in 2008 did not meet expectations. The forecast did not match expectations for the last three years.

[9:13:55 AM](#)

Co-Chair Hoffman asked if the three-year performance ended January 31, 2009. Mr. Burnett said it did.

Co-Chair Stedman asked if it was net or gross. Mr. Burnett said net.

Co-Chair Hoffman asked what timeframe was anticipated. Mr. Burnett said a 5-year expected performance.

Co-Chair Stedman commented how performance numbers were presented. He wondered about the breadth of the data. Mr. Burnett said it shows actual performance, fiscal year to date. He offered to provide numbers for a five-year schedule. Co-Chair Stedman asked for further explanation of the balance and combined columns. Mr. Burnett clarified

that the combined column shows the corpus at the beginning of the fiscal year, then with additional cash added, net investment results, and the total.

Co-Chair Stedman asked if "gain/loss" should be included. Mr. Burnett further clarified that that was depicted on the right hand side of the column.

[9:16:39 AM](#)

Senator Elton asked when the subaccount was created. Mr. Burnett said in 2000. Senator Elton asked who makes the determination how much money is in the subaccount. Mr. Burnett explained that when the subaccount was created in 2000, there was temporary language in statute that directed the Department of Revenue to deposit \$400 million to the subaccount. There were no other deposits to the subaccount prior to April of 2008. The amount was determined by the commissioner of revenue and the deputy commissioner working together.

Mr. Burnett referred to the second set of numbers; account, balance, asset allocation. They show the breakout of the corpus into broad market fixed income, intermediate-term fixed income, and short-term fixed income. It shows the percentages of asset allocations as of January 1, 2009.

Co-Chair Stedman described the broad market fixed income actual and target amounts. Mr. Burnett continued to explain asset allocation, actual allocation, and year-to-date income of the corpus.

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Mr. Burnett commented on the year-to-date income. A majority of the contributions were made later in the fiscal year. When determining the performance, the income is based on the actual amount that was in there at any time, rather than a beginning or ending total. Looking at the income and comparing it to the total does not yield the same results as a percentage basis. Co-Chair Stedman added that it is a timing issue.

Mr. Burnett explained the asset allocations of the subaccount; domestic equity, international equity, conservative aggregate, emerging income plus fund, and short-term fixed income.

Co-Chair Hoffman asked if they are the original allocations from 2000 for both accounts, or if they had been adjusted. Mr. Burnett thought the only change since 2000 was the addition of the emerging income plus fund - the international fixed income fund - in 2008.

Co-Chair Stedman restated it as "rebalancing". He asked how the portfolio was rebalanced and when it was done.

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Commissioner Galvin explained the timing of the initial allocation and the rebalancing, which occurs continuously, as needed.

Co-Chair Stedman said it looks like the domestic equity asset allocation is done monthly. Commissioner Galvin said it is monitored on a daily basis. Rebalancing is done as needed and rebalancing is done on a regular basis. He suggested asking Gary Bader for a further explanation.

[9:24:59 AM](#)

Senator Thomas asked what the conservative aggregate is. Mr. Burnett said it is a broad market fixed income fund.

Mr. Burnett continued to explain the year-to-date income statement of the subaccount. No additional contributions were made into the subaccount after the first of the year. All were made in April of 2008. There was a loss of income with a balance of about \$3.39 billion as of January 31, 2009.

Co-Chair Stedman maintained that the subaccount was previously a fairly static portfolio. Mr. Burnett said there was only one transaction into the subaccount in 2000. The next transaction was made in April of 2008.

[9:26:51 AM](#)

Mr. Burnett explained the aggregate of fixed income and equity investments to the subaccount. Co-Chair Stedman expressed confusion about the percentage column. Commissioner Galvin corrected that it should be 31 percent, not 72 percent.

Co-Chair Hoffman pointed out a loss of over \$1 billion for 12 months ending January 31, 2009. Mr. Burnett said it was for the fiscal year; for seven months beginning July 1 and ending January 31. Co-Chair Hoffman asked if the performance forecast of 7.6 percent for five years was accurate. Mr. Burnett said it was correct.

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Mr. Burnett continued to explain the major contributions to the CBR from July 2007 to today.

Co-Chair Stedman referred to handouts entitled, "AY10: FY 2009 Proposed CBRF Investment Guidelines - Subaccount" and

AY19: FY 2009 Proposed CBRF Investment Guidelines - Main Account" (copy on file). He wondered if they were updated quarterly. Commissioner Galvin said they were reviewed quarterly and approved annually. Co-Chair Stedman observed that a 1 percent fund was not included on the list, but that it was insignificant.

[9:30:21 AM](#)

Co-Chair Hoffman returned to the contribution list and noted authorization in last year's and this year's budget to deposit \$5.8 billion into the CBR. He asked if the dates listed were the dates that deposits were made to the corpus. Mr. Burnett explained the various deposits by date. Previous to April of 2008, they amounted to tax settlements and after that they were dates when the cash was transferred to the CBR.

Co-Chair Hoffman asked if on April 30, 2008, a transfer was made from the corpus to the subaccount. He wondered if there were subsequent deposits and how the amounts were determined. Commissioner Galvin said there was one transfer and the amount was determined by Deputy Commissioner Andrews and himself, recognizing the intent language in the budget. The transfer was made at that time to recognize that this was the total amount that would come in over the fiscal year.

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Co-Chair Stedman referred to a handout containing intent language of SB 256. He noted a reference on line 3 appropriating \$2.6 billion from the general fund to the CBR. He maintained that there was no reference in the bill for transferring an additional \$1 billion from the corpus to the subaccount. He asked if there were conversations with finance co-chairs regarding that number. Commissioner Galvin explained it was a combination of a broader discussion of the subaccount being for aggressive investments. The account was intended to be a five-year cash flow. Historic use of the fund was also considered.

Co-Chair Stedman questioned if there were conversations with finance committee co-chairs about potential cash flow needs and priorities of the state. Commissioner Galvin said he relied upon Mr. Andrews' discussions with co-chairs of the finance committees. Commissioner Galvin shared information that Mr. Andrews provided.

[9:36:23 AM](#)

Co-Chair Stedman reiterated that he strongly spoke against modifying allocations. Co-Chair Hoffman said he had no

discussions with Mr. Andrews as to how allocations to the subaccount should be made.

Co-Chair Stedman referred to lines 6 - 9 and suggested that the committee decide how that intent language should be modified.

Commissioner Galvin said that was language in the FY 08 supplemental, not the budget.

[9:38:34 AM](#)

Co-Chair Stedman understood that it was supplemental language. He referred to subsection (c) of AS 37.10.430, which contains language about the subaccount of the CBR.

Co-Chair Stedman noted that line 8 of the supplemental says "in a manner of maximizing the long-term earnings of the fund while meeting the minimum liquidity requirements of the state". He commented that he did not understand how "maximizing the long-term liquidity requirements of the state" relates to a savings account. Mr. Galvin commented that the subaccount remains entirely liquid, which is distinguished from the investment period or the amount of risk. The allocation is between equities and fixed income. The equity market that the fund is invested in is completely liquid. He agreed that the language could be understood differently than what the subaccount is currently used for.

[9:40:14 AM](#)

Co-Chair Stedman said the way he reads lines 8 and 9 is, "the liquidity requirements of the state, not the liquidity of the assets held". In other words, "the need to draw on the money to meet our obligations, versus an execution by a portfolio manager to liquidate a particular holding and put it in cash". Commissioner Galvin emphasized that there are two accounts. The subaccount is statutorily designated as the "plus five years". The language says "maximize the long-term earnings", which, given two choices, means "move it into the one that has the maximum return". Liquidity could have multiple meanings. In terms of liquidity of the state, the interpretation "in the context of the existence of the subaccount, and the direction between the main and the sub, I think the language seems fairly clear that the minimum liquidity requirements of the state is a recognition that the subaccount is set up for five-plus years".

[9:42:19 AM](#)

Co-Chair Stedman disagreed. He referred to conversations prior to inclusion of the language, about whether to include it in a bill or in letters from the co-chairs. Commissioner Galvin reported on a request to Mr. Andrews to get direction

from the legislature on the use of the CBR. He said there has to be a conversation as to the process of which funds to access first. Historically, the CBR has been the fund for the last draw. There is currently almost \$10 billion in various reserve funds. The question is when the legislature will go to the CBR, first or last.

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Senator Elton related that he has not thought of the CBR as the last draw. He requested a prioritized list of the rankings of the draws. Commissioner Galvin did not see that as part of his role, but rather as the legislature's role to rank the fund sources. He reiterated that, historically, the CBR has been used when there are no longer reserves. He listed several reserves; the statutory budget reserve, the public education fund, and Alaska Housing Finance funds. When looking at a potential 5-year draw, there was a need to prioritize the draws. It remains an unanswered question about potential draws in the future. It will be a reflection of legislative intent. It is a question of liquidity.

[9:48:36 AM](#)

Co-Chair Stedman returned to the issue of added language in the supplemental bill. He wondered if there would be any restrictions to allocating a heavier concentration of the CBR into the subaccount if the language wasn't in there. Commissioner Galvin did not believe so.

Co-Chair Stedman thought that the language was not needed and it was "cover your butt" language. He maintained that there was not conversation last year with the Senate Finance Committee regarding the fund. Commissioner Galvin replied that it was a conversation between the executive and legislative branches as it relates to the fund. He maintained that the language makes sense in terms of communicating legislative intent. He thought that the language being included in the supplemental was meaningful.

[9:51:27 AM](#)

Co-Chair Stedman recalled conversations with the governor regarding needing capital projects in response to the economic slow down. No one saw the magnitude of the decline, but it was recognized last spring. Those conversations played into a lack of interest in reallocating a heavier concentration of funds in the CBR into aggressive accounts. Now the conversation is about the exposure of a large portion of CBR, the possibility of needing to liquidate, and scaling back on capital spending. It is all related and is a point of agitation. He concluded that

there was an attempt to circumvent the Senate Finance Committee.

[9:53:57 AM](#)

Co-Chair Hoffman stated that it is known that there will be amendments to the FY09 budget and a shortfall of \$1.2 to \$1.6 billion. There is \$6.6 billion in the CBR. He questioned where the state would find the funds to make up for the shortfall and if there would be a reallocation between the corpus and the subaccount of the CBR. He asked Commissioner Galvin how that decision would be made.

[9:56:00 AM](#)

Commissioner Galvin replied that legislative language would determine the source of the funds for the shortfall, either the CBR, the statutory budget reserve, or somewhere else. Co-Chair Hoffman said he was assuming it would come out of the CBR. Commissioner Galvin said it would come from the corpus of the CBR. The subaccount is intended for "five years plus". He addressed the question of a potential reallocation. He would be looking for guidance from the legislature as to expectations about future CBR use. Reallocation is possible, but not absolute. It depends on input from the legislature. He appreciated that individual legislators have a different view regarding the budget; however, he emphasized that this is the budget that was passed. He pointed out that his department has to have legislative direction.

[9:58:57 AM](#)

Co-Chair Stedman reminded the commissioner that line 3, Section 33, of the supplemental bill lists the sum of \$2.6 billion, not \$4.1 billion. Another issue is the amount above \$2.6 billion, which is not reflected anywhere. Commissioner Galvin said that was a helpful clarification.

Senator Elton pointed out that the language "it is the intent of the legislature" is permissive and allows for making deposits to the subaccount, but it also allows for moving money out of the subaccount and back to the corpus. He assumed that both accounts are fairly actively managed. He wondered if Commissioner Galvin considered getting in touch with the co-chairs of both finance committees about reallocating funds back to the corpus. Commissioner Galvin said he did not. He spoke of the expectation that the subaccount is the "plus 5 years" investment. He talked of investment strategies. He said the primary question is, did things change so dramatically that the funds would need to be moved before five years is up. He said a clearer picture of this year's budget cycle is needed.

[10:03:33 AM](#)

Senator Elton observed that now was the time to take a look at reallocating those funds.

Co-Chair Stedman reminded the committee that there was a shortfall of at least \$1.2 for FY09. At \$50 per barrel of oil, the shortfall would be about \$2 billion. He maintained that the conservative side of the CBR would be wiped out by FY10 at that price. Commissioner Galvin noted that part of the difficulty is that the decision making regarding this process is awkward. It requires the legislature to give direction as to which of the funds to access and when they will be needed. The significant driver in the need to reallocate is the change in revenue expectations. The state's reserve needs ought to be examined.

[10:08:12 AM](#)

Senator Elton emphasized that all accounts could be depleted by FY14, which is a five-year forecast. It does not matter which account is drawn from first if all funds will be gone. He thought it better to be conservative when making projections. Commissioner Galvin suggested, when talking of "five years and out" from an investment standpoint, asking what is the expectation for the funds. He spoke of reasonable projections. He maintained that in three months there will be a clearer picture. There was no point in the fall where the decision to reallocate was reached, but there could be a point reached in the near future.

[10:12:15 AM](#)

Co-Chair Stedman clarified that, generally speaking, the last reserve account fallback is the permanent fund, not the CBR. The permanent fund has \$3 million in losses, which makes it not a stop gap. He recalled previous testimony about the earnings reserve. He maintained that there would be a high reluctance to liquidate forward funding in education. He spoke of the SBR account, which requires a simple majority vote to access. After the CBR is liquidated, about \$1 billion remains in the SBR. There are not a lot of options. He addressed the revenue forecast and the CBR at different oil prices. Soon, the legislature will be engaged in a discussion about how long the CBR will last and which assets to liquidate first. He wished to work with the DOR on this in an orderly process. Commissioner Galvin agreed.

[10:16:02 AM](#)

Co-Chair Stedman returned to Co-Chair Hoffman's question about the forecast for earnings projections in the CBR for FY09 and FY10.

Commissioner Galvin explained the way that the budgeting is done. He explained the performance forecast for the CBR and how it is adjusted.

Mr. Burnett spoke of a pending updated forecast for each of the funds. He expected it to be sent to the committee's staff by the afternoon.

Senator Huggins expressed disappointment regarding methods of adding language and the direction the CBR is taking. He wanted the committee to be involved in decisions and asked for future documentation and cooperation from the commissioner.

[10:19:59 AM](#)

Commissioner Galvin assured the committee that he would cooperate. He questioned the effectiveness of the legislature's involvement in the decision making process.

Co-Chair Stedman cautioned not to underestimate the sensitivity of a billion dollar loss in the future interest of the Senate Finance Committee to exercise its authority to protect the treasury.

Senator Thomas spoke of a concern regarding the performance forecast of the CBR and the capital market forecast.

[10:24:04 AM](#)

Commissioner Galvin explained that the performance forecast for the various classes does not meet the near-term historic returns. He restated Senator Thomas's concern "was there a different allocation between equities and fixed that would have returned the same amount without the same amount of risk."

Senator Thomas spoke about the five-year timeframe.

Commissioner Galvin concluded that if there were an asset allocation that would have provided a similar target return with less risk "we would have taken it". This mix is based on forward-projected returns.

[10:27:03 AM](#)

Co-Chair Hoffman recalled when the CBR was discussed and adopted. The concept of that budget was initiated by the legislature, not the administration. It is time to look at the statute and re-evaluate how the two accounts work. One of the goals is to stretch the savings account out as far as possible, and to do so, be cognizant as to how the funds are invested.

Co-Chair Stedman said, "It's more important - return of your money than return on it."

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ADJOURNMENT

The meeting was adjourned at 10:27 AM.