

SENATE FINANCE COMMITTEE
ANCHORAGE LEGISLATIVE INFORMATION OFFICE
September 29, 2016
2:40 p.m.

[Note: The following meeting convened in the Anchorage Legislative Information Office and was teleconferenced and recorded in Juneau.]

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CALL TO ORDER

Co-Chair Kelly called the Senate Finance Committee meeting to order at 2:40 p.m.

MEMBERS PRESENT

Senator Anna MacKinnon, Co-Chair
Senator Pete Kelly, Co-Chair
Senator Peter Micciche, Vice-Chair
Senator Click Bishop
Senator Mike Dunleavy
Senator Lyman Hoffman
Senator Donny Olson

MEMBERS ABSENT

None

ALSO PRESENT

Jerry Burnett, Deputy Commissioner, Treasury Division, Department of Revenue; Deven Mitchell, Executive Director, Alaska Municipal Bond Bank Authority, Department of Revenue; Steve Kantor, Financial Advisor, Hilltop Securities; Randall Hoffbeck, Commissioner, Department of Revenue; Steve Kantor, Financial Advisor, First Southwest; Financial Advisor, Pension Obligation Bond Corporation; Mark Foster, Fiscal Study Group Member, Commonwealth North; Representative Steve Thompson; Representative Mike Chenault; Representative Dan Saddler; Representative Liz Vasquez.

PRESENT VIA TELECONFERENCE

Stephen Gauthier, Government Finance Officers Association;
Representative Sam Kito.

SUMMARY

DISCUSSION OF PENSION OBLIGATION BONDS

Co-Chair Kelly relayed that the administration had proposed issuing pension obligation bonds, and the committee was gathered to consider the idea.

^DISCUSSION OF PENSION OBLIGATION BONDS

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JERRY BURNETT, DEPUTY COMMISSIONER, TREASURY DIVISION, DEPARTMENT OF REVENUE, relayed that he was acting in the role of Designated Chair of the Alaska Pension Obligation Bond Corporation (APOBC). He stated that the POBC had met the previous Monday to approve the issuance of up to \$3.5 billion worth of pension obligation bonds and delegated the responsibilities for doing the transactions to the staff. He added that staff included Devin Mitchell, Executive Director, Alaska Municipal Bond Bank Authority, Department of Revenue; and the officers of the APOBC, which included himself and the commissioner of the Department of Revenue (DOR). He added that Commissioner Randall Hoffbeck was attending another meeting and would be present later in the meeting.

Mr. Burnett stated that he would go through the reasons why the state should do a pension obligation bond, how the administration would protect and state and the pension system from the problems that had been raised by the Government Finance Officers Association (GFOA). The GFOA had stated in its advisory bulletin that local governments and states should not do pension obligation bonds.

Co-Chair Kelly wondered if there was anyone online. He noted that Representative Kito was online. He asked for a list of members of the APOBC.

Mr. Burnett replied that statute defined the members of APOBC as the commissioners of DOR, the Department of Administration, and the Department of Commerce, Community and Economic Development. He continued that in each case, the commissioners (if not available) had delegated the

authority to a deputy commissioner to include: himself, John Boucher, Senior Economist, Office of Management and Budget, Office of the Governor; and Fred Parady, Deputy Commissioner, Department of Commerce, Community, and Economic Development. He explained that the corporation was established through legislation in 2008 (sponsored by Representative Mike Hawker), at which time up to \$5 billion in bonds was authorized for issuance.

Co-Chair Kelly asked about the year the legislation was passed. Mr. Burnett replied that it was in 2008.

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DEVEN MITCHELL, EXECUTIVE DIRECTOR, ALASKA MUNICIPAL BOND BANK AUTHORITY, DEPARTMENT OF REVENUE, explained that he would provide some background as to why the state had unfunded liabilities and why pension obligation bonds were being discussed. He explained that the state managed a number of retirement systems, the two largest of which were the Public Employees' Retirement System (PERS), and the Teachers' Retirement System (TRS). He continued that the retirement programs had three separate tiers, which were defined benefit programs. He remarked that there was now a retirement program in place that was a defined contribution program. He stressed that there were still employees in the first three tiers that were guaranteed by the constitution and that the system was intended to be prefunded. He remarked that the benefits were estimated through an actuarial analysis in the late 1990s to be fully funded. He stressed that the actuarial analysis was incorrect (after using outdated mortality tables), resulting in an unfunded actuarial liability. He shared that the unfunded liability was currently \$6 billion, which would pay up to \$20 billion of future benefits, due to an 8 percent return assumption in the pension system's actuarial analysis. He remarked that it was critical to look at the future payments, with the exception of the \$6 billion, as growing at 8 percent per year.

Senator Dunleavy asked if Mr. Mitchell was discussing both TRS and PERS.

Mr. Mitchell answered in the affirmative.

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Co-Chair MacKinnon asked if the funding being discussed included healthcare.

Mr. Mitchell answered in the affirmative. He furthered that the Other Postemployment Benefits (OPEB) piece of the retirement system (after deposits in 2015) was near 100 percent funded in PERS, and were slightly over 100 percent funded in TRS as of the last approved actuarial analysis. [Secretaries note: OPEB are benefits (other than pensions) that U.S. state and local governments provide to their retired employees]. He explained that the trust was split apart into four pieces, two in TRS and two in PERS, with one for pension and one for OPEB.

Co-Chair MacKinnon referred to a footnote by a credit rating agency that indicated the state was \$12 billion to \$14 billion in a liability position. She asked how the reference compared to the \$6 billion of unfunded liability.

Mr. Burnett responded that rating agencies applied its own discount rate, and the \$6 billion was based on the 8 percent actuarial assumed rate that the retirement board was using. He continued that rating agencies each applied its own rate, and the rate would result in a larger liability than what was produced with 8 percent.

Senator Bishop remarked that there was historical background offered, which had included a miscalculation of the actuarial assumption. He wanted to know what cash was available for the fund.

Mr. Burnett stated that for purposes of funding, under SB 125 and under the calculation for the employer rate, POBC was using 8 percent. [Secretary's note: In FY 08, SB 125 converted the PERS defined-benefit plan to a cost-share plan, like TRS, and provided for one integrated system of accounting for all employers.]

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Senator Dunleavy asked if the current payoff amount would be \$6 billion.

Mr. Mitchell stated that today it would take \$6 billion to be placed in the fund to earn 8 percent until it was spent in the future to satisfy the expected pension benefits that would materialize.

Senator Dunleavy asked how much it would be if the full amount owed to each individual were calculated and paid immediately.

Mr. Mitchell asked if Senator Dunleavy meant to ask for an amount not assuming any rate of return on the benefits.

Senator Dunleavy answered in the affirmative.

Mr. Mitchell stated that a one percent reduction in the rate of return pushed the amount from \$11 billion to about \$19 billion. He noted that the amount was not in present value, but rather in payments. He discussed calculations and concluded that it would require a significant amount of additional funding if the state were to assume a zero percent rate of return on the trust.

Senator Dunleavy asked if the amount was higher than \$19 billion.

Mr. Mitchell replied that he had used a hypothetical scenario of only a 1 percent differential, and had only considered the cash flow. Later on in the analysis, the payment that was projected with an 8 percent assumption was about \$11 billion. If the rate of return assumption was reduced to 7 percent, the payment amount jumped to \$19.8 billion.

Co-Chair Kelly asked for clarification on the amounts being discussed.

Mr. Burnett stated that the state would have to pay \$11 billion to replace the \$6 billion if it was not paid now.

Mr. Mitchell explained that recognition of the unfunded liability had occurred in the early 2000s. The recognition resulted in a push by the Murkowski administration [former Governor Frank Murkowski] for pension obligation bond authorization, which was approved by the legislature in 2008.

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Mr. Mitchell discussed the PowerPoint, "Department of Revenue; Presentation to Senate Finance Committee; Pension

Obligation Bond Transaction; September 29, 2016" (copy on file).

He read from slide 2, "GFOA Pension Obligation Bond Advisory Bulletin Concerns and POBC Mitigation":

Might Fail to Earn Bond Interest Rate

- Interest rate is the one variable POB Issuers can control
- The lower the rate the higher the expectation of success over the 23 year life
- The PERS and TRS have an assumed rate of return of 8% for the prefunding of the pension trusts
- The bond interest rate is expected to be below 4.0% including all costs of issuance

POBs are Complex Instruments with Considerable Risk

- The POBC has only authorized fixed rate debt, the most simple means of issuing bonds
- No derivatives or variable rate products are allowed

Mr. Mitchell stated that there were many reasons not to use pension obligation bonds, and that bonds had been used in fiscally irresponsible ways. He explicated that it was possible to take greater savings up front and create bigger liability in the future. He stated that there were ways that he considered more and less fiscally responsible to structure a transaction. He thought what was being proposed by the administration was as fiscally responsible as was possible if one were to choose to do pension obligation bonds.

Mr. Mitchell discussed the GFOA concerns outlined on slide 2. He thought the state had solved the systemic issue that was present in tier 1 of the retirement plans. He emphasized that the one thing that was able to be controlled in a pension obligation bond issuance was the cost of capital. He noted that APOBC had approved a resolution that allowed for an interest rate up to 4.5 percent. If the trust did not receive that rate of return, it would make things worse.

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Vice-Chair Micciche asked about Mr. Mitchell's hypothetical scenario that included a 1 percent reduction in the rate of

return which would bring the \$11 billion in liability to \$19 billion. He wondered if the rate comparison had started with 4 percent or 8 percent.

Mr. Mitchell replied that the comparison had been made from an 8 percent to a 7 percent rate of return. He clarified that \$6 billion was the equivalent of the \$11 billion on a present value basis. He continued that for each percent that went down, there was a fairly linear relationship. If the funds were only earning 6 percent, then it would increase the payment amount by \$8.8 billion. He clarified that it would not be impacted by the bonds, which would be paying 4 percent.

Senator Dunleavy wondered how the risk would be rated for Alaska.

Mr. Burnett replied that over the past 30 years that the pension funds had been in play, the funds have earned more than 8 percent. He noted that there would be a chart later in the presentation that would show rolling 20-year averages every year for the previous several years, and would reflect a rate of return that was well above 4 percent. He pointed out that the amount of money in the pension obligation bond issue was very small (with small risk) relative to the rest of the money in the pension funds (with larger risk), as well as the unfunded amount. He referred to the systematic underfunding of the system in the late 1990s and early 2000s, created by miscalculation of certain actuaries.

Senator Dunleavy queried that if the risk was such, why it was not recommended that government be funded through the same approach.

Mr. Burnett replied that the state had a debt that must be paid, and currently the state was paying the debt with an 8 percent interest rate.

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Senator Dunleavy asked if the state was going to incur more debt to pay of its debt. Mr. Burnett replied in the negative, and clarified that the state would be replacing one debt [in pension debt] with another debt.

Senator Dunleavy asked anecdotally if Mr. Burnett would recommend that Alaskans take a mortgage out on their house and play the market.

Mr. Burnett replied in the negative.

Co-Chair MacKinnon stressed that the pension obligation bonds were a bonding mechanism that was affected by the federal interest rate, and not necessarily stocks that were moving up and down in the market. She furthered that bonds could be invested in stocks, but the administration was proposing something more fixed, that was not competing directly with stocks.

Mr. Burnett explained that the proposal was to borrow money at a fixed rate of interest in an international marketplace, which would be sold at a fixed interest rate over a period of 23 years. Proceeds from the bonds would be invested along with the rest of the pension fund, using the same asset allocation as the fund board was currently using to invest.

Co-Chair MacKinnon stressed that the proposal was not the same as purchasing a stock.

Mr. Burnett stated that a common concern was that often times when people proposed use of pension obligation bonds, it was proposed with a variable rate interest rate, with derivatives, etc.; where there was a significant market risk in how much was required to pay for the bonds. He confirmed that the administration was not proposing anything like such an idea, but rather was proposing a simple fixed rate security.

Co-Chair MacKinnon asked about the APOBC resolution that provided the parameters the administration was considering, including the fixed rate and the amount of the pension obligation bonds.

Mr. Burnett agreed to provide the information.

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Vice-Chair Micciche asked about Mr. Burnett's comments pertaining to replacing debt. He wondered if Mr. Burnett had been referring to trading an 8 percent debt with a 4 percent or lower debt.

Mr. Burnett responded in the affirmative.

Vice-Chair Micciche again referred to the concept of replacing debt, and asked if Mr. Burnett had been referring to up to \$3.5 billion versus the \$20 billion or so that was already invested.

Mr. Burnett agreed, and stated that there was already a huge debt on the pension system.

Co-Chair Kelly invited Representative Saddler to ask a question at the table.

Representative Saddler wondered if the \$3.5 billion in pension obligation bond issues would meet 100 percent of the pension obligation, or if there was a risk of overfunding that might result in increased benefits for retirees.

Mr. Mitchell replied that the sizing would depend somewhat on what the market would bear, and it was unknown exactly how much of the potential authority would be sold. He furthered that it would be a range of \$2.3 billion to \$3.3 billion. At the \$2.3 billion mark, the corporation would plan to make a \$980 million deposit into TRS, which would fund it to 90 percent. There would be a smaller deposit of approximately \$1.3 billion to PERS that would fund it to approximately 80 percent. If there was a larger transaction of \$2.3 billion in to PERS, the system would be funded to 90 percent. He continued that at 90 percent, there was an expectation of having some positive years and not being over funded in the short term. He remarked that a primary benefit of the PERS transaction was that if the actuarial assumptions were borne out, it would eliminate the state's payment on behalf of the other employer's payments.

Co-Chair Kelly asked for Vice-Chair Micciche to restate his earlier questions.

Vice-Chair Micciche announced that that the state was already covering the debt at an 8 percent interest rate, and pondered that Mr. Burnett was talking about replacing the debt with another debt at an interest rate of 4 percent or under.

Mr. Burnett replied in the affirmative.

Vice-Chair Micciche reiterated that the state had a similar arrangement with obligation bonds on \$20 billion already invested, versus the proposed bonds (up to \$3.5 billion) on the books.

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Co-Chair MacKinnon challenged that local municipalities had an obligation to pay its debt that had been incurred in the system, while the state would be removing the debt by the investment. She thought the proposal was a policy decision, and that the state would clean up all of the pension liability based on the POB proposal. She agreed that 100 percent of the state's liability rested in the TRS system. She referred to Representative Saddler's question about the possibility of overfunding and expanding benefits, and wondered why the state would put up to \$2.5 billion in the PERS system when the state was not 100 percent responsible for the system.

Co-Chair Kelly invited Representative Thompson to ask a question.

Representative Thompson asked if the state went from funding 90 percent to 100 percent of its obligation, if it meant the municipalities involved in the system would expect rates to go down. Conversely, he wondered if the rates would go up if the following year there was less funding.

Mr. Burnett replied that the APOBC, in structuring the proposal, had been very concerned with going below the 22 percent that municipalities currently paid. He relayed that the group was basing its decisions on a reading of the law, in which the municipalities continued to pay at 22 percent, and therefore continuing to make payments into the system to reduce the unfunded liability. He continued that by funding to the 90 percent, and to an allowable level, the rate would be about 25 percent if the municipalities were paying their share of the current payment (with no payment on behalf).

Mr. Burnett continued, stating that if the pay rate was left at 22 percent, in the early years the municipalities would be paying to help with the unfunded liability and reducing the state's exposure.

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Co-Chair MacKinnon thought there was pressure on legislators through an administrative policy to have the municipalities come to cities asking to lower the contribution rate. She emphasized that the municipalities had played a part in getting the state into the position it was in with unfunded liability. She pointed out that the state had put up \$3 billion in cash to try and help with the problem.

Mr. Burnett agreed, and remarked that the state had done an incredible job relative to the municipalities. He referred to discussions with a variety of city attorneys, finance officers, and managers; and universally they had preferred to leave the 22 percent contribution rate in place rather than a variable rate in the future. He thought the continuity of the rate would make for a more stable system. He commented that the current law would allow for the continuity, but perhaps could be strengthened.

Mr. Mitchell clarified that if the \$2.3 billion was put in the trust the actuarial analysis would produce an employer contribution requirement below 22 percent, and would be closer to 17 percent or 18 percent. The law (as reviewed by the Department of Law, the legislative attorney, and the municipal attorney) stated that a 22 percent contribution rate was not only a floor but a ceiling. Consequently, even though the actuarially determined rate would drop, the municipalities would still pay 22 percent. He explained the possible fluctuation of the rate, and stated that by maintaining the 22 percent rate, it was expected that the rate would never have to go above 22 percent in the future. He summarized that the municipalities would wind up paying a share of the unfunded liability, whereas with a "rate holiday" they would not.

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Co-Chair MacKinnon understood, but stressed that if the administration went forward there would be pressure on the legislature to reduce the cap from 22 percent because some municipalities would argue they were paying more than necessary, even though the state had been paying on behalf for years.

Mr. Mitchell replied that if municipalities started asking for a rate reduction, they would need to be aware that it would create future liability.

Senator Dunleavy referred to previous comments about investing in the market and interest rates. He asked for Mr. Burnett to discuss the investment of proceeds.

Mr. Burnett explained that investment proceeds would be invested by the Alaska Retirement Management (ARM) Board, in exactly the same way that it was investing money for PERS and TRS.

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Senator Dunleavy asked if the board was investing in the stock market.

Mr. Burnett conveyed that the board was investing in the stock market, private equity real estate, other alternative investments, and bonds.

Co-Chair Kelly surmised that if the state went to bonding, the funds went to the ARM board, and were no longer available to the legislature.

Mr. Burnett concurred.

Co-Chair Kelly remarked that there was no way to reap any benefit from the money (beyond paying pension obligation debt) if there was difficult financial times in the future. He discussed the use of potential savings in the period of time that payments to the pension fund went down. He thought bonding would put the state in a more difficult position in the future unless conditions turned out to be favorable.

Mr. Burnett thought Co-Chair Kelly had stated things correctly, but clarified that under current accounting rules on credit analysis, payments to the pension funds were considered like bonds sold to an outside investor. He continued that if the legislature failed to pay a payment of the Unfunded Actuarial Accrued Liability (UAAL) to the pension fund, it would be seen as an extreme credit negative; similar to if the state failed to pay the bond payments. He stated that the pension obligations had to be paid, because it was a contractual item in the

constitution. He clarified (not as a recommendation) that defaulting on an obligation to an outside entity was a better result to the state than not paying the unfunded liability directly to the pension trust.

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Co-Chair Kelly identified that the state had the ability to pay or reduce payments to the state assistance in the hope that it would buy some time. He emphasized that if the debt was turned into a bond payment, the state would no longer have the same flexibility.

Mr. Burnett stated that the bond payment only limited the ability to reduce state assistance, as it would still have an extreme credit negative if not paid.

Co-Chair Kelly clarified that he was referring to the state's ability to pay its bills.

Mr. Burnett expressed understanding. He stated that the administration believed that the savings in cash flow made the transaction worthwhile.

Mr. Mitchell added that Co-Chair Kelly was correct in that the bonds would limit the state's options, but some optionality would be retained. The state would still be paying 22 percent payroll as an employer, over the required amount and thereby retaining some flexibility. The state would retain a payment on behalf of payments in the TRS system, because of the lower floor. He thought Co-Chair Kelly had made a valid point, and agreed that the state would be giving up some flexibility under the bond scenario.

Senator Dunleavy asked about reinvesting proceeds after selling bonds. He asked for an explanation of what would happen if there was a one percent return on investment over the life of the bond.

Mr. Mitchell replied that under the scenario, the state would pay more than it earned.

Mr. Burnett added that the state would also be earning one percent on the rest of the balance in the pension system, so the payments on behalf would go to an unsustainable level and the system would be broken.

Senator Dunleavy asked if the pension obligation bonds were a gamble.

Mr. Burnett stated that it was a gamble to have a funded pension system and assume that it will have enough funding.

Senator Dunleavy asked if it was a gamble to predict what the stock market would do on the following day.

Mr. Burnett answered in the affirmative.

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Co-Chair MacKinnon referred to when the administration was considering restructuring the permanent fund, and relayed that the legislature had reviewed rates of return. She thought 8 percent, prospectively, was too high according to financial markets and credit rating agencies. She thought that there could be a difference of \$8 billion on a 1 percent assumption. She referred to the 20-year rate retrospective that was mentioned earlier, and acknowledged that there had been rates above 8 percent. She referred to Senator Dunleavy's earlier comments about a zero percent interest rate in Japan, and wondered when it would be possible to observe real rates of return.

Mr. Burnett stated that the actuarial assumption was a rolling 20 year experience, and the administration had provided a 7 percent scenario for the committee to consider. He continued that the ARM board reviewed the actuarial rate of return on a four-year basis, and the following year the rate would be reviewed. When the review was done, the rate could be different than 8 percent. He was not sure of the outcome, and recalled that at the last review, the rate was left at 8 percent. The actuary had done a lot of analysis, and the state's financial advisor (Callan Associates) had considered the rate to be within a reasonable range. He thought the average rate for public pensions in the United States was around 7.5 percent.

Mr. Burnett continued, and relayed that he had seen the analysis of the Permanent Fund Protection Act, and thought that rates in the range of 6.9 to 7.25 had been examined. He relayed that Callan Associates had calculated that two-thirds of time, the pension fund would produce somewhere between a minus 4 percent and a 20 percent return in the

next year. He relayed that there was a new asset allocation and analysis every year. He continued that the rate could be less than 8 percent in the future. If the rate was 7 percent, the cash flow under the current plan would equate to another \$8.8 billion over the next 23 years, to amortize the unfunded liability. If the state sold pension bonds, it would reduce the \$8.8 billion by about \$1.5 billion.

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Co-Chair Kelly invited Representative Saddler to ask a question.

Representative Saddler discussed the investment principal of not trying to time the market. He wondered if there was a way to ameliorate the cost by having a slower pace of investment or dollar cost averaging.

Mr. Burnett stated that there were a number of methods to consider, and was not sure what the ARM board would choose to do. He assumed that the ARM board chief investment officer Gary Bader had looked at all possibilities as to the decision to put the funds into the current asset allocation, or to "bleed the funds in" over a period of time. He confirmed that the decision would be made as a policy matter by the ARM board and staff.

Mr. Mitchell furthered that it would take quite a while to put \$3 billion to work, even if one wanted to put it in right away.

Senator Bishop queried as to how many other states had also made a pension obligation bond transaction, and with what results.

STEVE KANTOR, FINANCIAL ADVISOR, HILLTOP SECURITIES, stated that there had been several other states that had completed a similar type of transaction, and the transaction being proposed was "uniquely Alaskan." He opined that the proposal had different aspects to it that made it both more conservative, and also a little bit safer than some of the other transactions. He discussed a recent large transaction done by the State of Kansas; and mentioned that additional similar transactions had taken place in the states of New Jersey, Illinois, and Oregon.

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Co-Chair MacKinnon asked if the state would be penalized if there were lower than expected rates of return in the early year.

Mr. Kantor replied that, evaluating the transaction over the 23-year period, it was less advantageous to have lower interest rates in the beginning than the end. The more the state earned up front, the more it could use to build the fund up. He thought the transaction could withstand lower interest rates in the beginning because the state had the ability to continue to earn rates over time, and it was an average calculation rather than a one-year calculation.

Co-Chair Kelly remarked that he had gleaned from presentations regarding pension unfunded liability that it was almost impossible to recover from failed initial investments. He thought Co-Chair MacKinnon had valid concerns and remarked that some of the impacts on the fund were not repairable.

Senator Dunleavy referred to passage of the bill that authorized pension obligation bonds in 2008, and the amount of time needed to recover from negative financial impacts.

RANDALL HOFFBECK, COMMISSIONER, DEPARTMENT OF REVENUE, noted that the rolling 20-year average incorporated the "meltdown" Senator Dunleavy mentioned, as well as the .dotcom financial crisis, and rates of return were still in the 7 percent range.

Co-Chair Kelly asked for clarification.

Commissioner Hoffbeck repeated that he was discussing a 20 year average of rates of return.

Co-Chair MacKinnon expressed concern with the possibility that the market was currently in a bubble and while it was advantageous to sell, it was not currently advantageous to buy stock.

Mr. Kantor stated that there was a lot of conjecture as to what would happen. He pointed out that there was a point at which the stock market had risen unexpectedly and defied expectations. He mentioned market unpredictability, and emphasized the focus on the long term in the context of the proposed POB transaction.

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Co-Chair Kelly wanted to advance through the slides of the presentation, and asked members to hold questions until later in the meeting.

Commissioner Hoffbeck stated that he wanted to focus on two slides. He thought the first slide addressed many of the concerns that had been expressed about pension obligation bonds, and would discuss why the administration's proposal was different than some of the objections maintained. He conveyed that the last slide would show relevant numbers.

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Mr. Mitchell returned to slide 2, "GFOA Pension Obligation Bond Advisory Bulletin - Concerns and POBC Mitigation":

Potentially Uses Debt Capacity

- With implementation of GASB 68 the portion of the unfunded actuarially assumed pension liability in PERS and TRS annual payment that is funded by the State has been added to the State's balance sheet as a debt
- The concept of soft liability versus hard liability is no longer viable
- The POBC issue will replace the existing liability

POBS may Defer Principal Payment or Extend Repayment

- The POB payments are based on the latest actuarial analysis with no extension of amortization
- Annual payments will be level after a 2-4 year ramp up period, creating budget stability and pushing savings into the future
- All annual payments are tailored to be less than the current actuarial analysis projects

Rating Agencies May View POBs Negatively

- The POBC has structured the bonds as conservatively as possible

- The POBC transaction is expected to be neutral to positive for the State's rating

Mr. Mitchell noted that the administration had tried to mitigate the negative view of pension obligation bonds by avoiding the first four points on the slide. He emphasized that the administration had tried to structure the bond proposal as fiscally responsible as possible to avoid any potential for a negative rating viewpoint. He discussed the viewpoint of rating agencies, which considered unfunded pension liabilities to be the same as any other debt.

Mr. Mitchell turned to slide 7, "Cash Flow Benefit - Rate of Return Sensitivity." He noted that the following two slides would show modelling of the base case scenario as well as the maximum case scenario as a comparison of the potential state payment after a transaction with an 8 percent return. The base case scenario was at \$2.3 billion total principal amortization; and the max case was at \$3.3 billion, which would constitute the full 90 percent of funding in both TRS and PRS.

Mr. Mitchell continued discussing slide 7, and noted that the principal amortization column reflected the payments the state would be making as of today. He pointed out that the potential cash flow benefit at the 8 percent return level on the max case scenario generated just under \$3 billion of cash flow relief. He continued that in FY 18, there would be a \$50 million reduction, in part due to a mismatch between the budgetary expectation and the latest actuarial analysis that had not yet been transferred to the Office of Management and Budget or the Division of Legislative Finance. He continued that in FY 19, the benefit dropped to approximately \$1.6 million and then grew to \$404 million in FY 39. He suggested that the table illustrated budget stabilization rather than a short-term benefit.

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Mr. Mitchell drew attention to the "Potential Cash Flow Benefit - 7 percent Return" column on the far right of slide 7. He noted that the 7 percent return diminished the total budgetary relief to \$1.8 billion. He stated that the administration would pursue the transaction. He reiterated that there were additional slides to provide backup, and

thought comparing slide 8 and slide 9 was particularly useful.

Mr. Mitchell looked at slide 8, "State Payment Breakdown (8 percent Return)." He drew attention to the total of \$11 million at the top of the 'Existing State Assistance Payment' column of the left hand table. He compared it to the \$19 billion total of the '7 percent Return State Assistance Payment' column on slide 9; and compared the 'Cash Flow Benefit' column totals of the two slides. He thought the benefit of the proposed transaction was apparent. He pointed out savings in FY 39.

Co-Chair Kelly asked if Mr. Mitchell had run numbers on a 6 percent return scenario.

Mr. Mitchell answered in the negative. He elaborated that the analyst that had worked on the numbers being presented had indicated that the results were fairly linear, and therefore it was possible to estimate a 6 percent rate of return based on the existing information.

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Vice-Chair Micciche remarked that financial liability was always a risk. He understood that anything above the rate of the issuance of the bond was a benefit to the state.

Mr. Mitchell agreed that there would be a benefit; and it would be the difference between the 4 percent cost of capital (that the state would still be paying), and the 4.15 annualized rate of return that the state would earn on the invested assets.

Vice-Chair Micciche queried the odds that selling bonds would not reduce the existing 8 percent level of liability risk.

Mr. Mitchell stated that historical 20-year rolling averages would indicate a statistically near 100 percent likelihood of success. He added that there was always a risk in historical performance.

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Representative Saddler referred the charts on slide 8 and slide 9, and asked about the state's retirement obligation.

Mr. Mitchell clarified that the numbers in the "Existing State Asst. Payment" column reflected the portion the state paid on behalf of the employers (including the state). He clarified that the figures were not representative of the 22 percent of payroll that the state (and other employers) paid as an employer.

Co-Chair MacKinnon asked if the administration had structured a direct cash payment in order to look at the cost savings.

Mr. Burnett stated that the payment depended upon the source of funds. He continued that the administration was not aware of a source of funds that was not going to be needed for budgetary purposes for other reasons, that was available and not earning more than 4 percent. He thought the only source of funds that was not necessary to use was taking money from the permanent fund earnings reserve beyond what would otherwise be taken out. He thought a cash-to-cash analysis would work if the state had a large balance someplace in a fund that was not invested long term.

Senator Dunleavy pointed out that although the department was moving ahead with its plans and was authorized by law, the legislature was under no obligation to fund the bonds being considered. He wondered if the administration would move forward if there were not enough legislators supportive of appropriating the funding.

Commissioner Hoffbeck hoped the legislature would support the action, and thought it was a good business decision to make. He furthered that the reason the topic had come back up was due to the fact that the cost of debt had dropped so far. He emphasized that the pension obligation was constitutionally required to be paid; and thought the pertinent question was whether the state wanted to pay the debt at 8 percent, or at 4 percent. He opined that there was an opportunity to reduce long-term costs, and the state should take it.

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Senator Dunleavy discussed balancing risk. He discussed a prediction that interest rates would maintain or drop, and wondered if the situation was time sensitive or if the

state could wait to have a larger discussion to include more members. He commented that the transaction involved a large sum of money, there were no guarantees, and there were inherent risks. He reiterated his question to ask if the administration would go forward with the proposal if there was limited support.

Commissioner Hoffbeck expressed concern that without support, failing to move forward with the bonds would raise the cost of the debt. He thought if there was verbal non-support from the legislature (which put concerns in the market on the appropriation), it would increase the cost of the bond issuance and cost the state money. He indicated that the issue of legislative support would be weighed when the administration was making the decision to move forward with the proposal. He stipulated that if the department could not get a good deal for the state, it would not move forward.

Senator Dunleavy communicated that the legislature was under an obligation to ask as many questions as possible. He thought that if the questions raised the rates, it would be the concern of the administration.

Commissioner Hoffbeck clarified that he had stated that in moving forward, the department would need to consider the impact legislative support would have on the cost of the bond issuance.

Co-Chair Kelly thought it was important to state that the committee was on the record, even if it was not acting on legislation at the moment. He recommended that the administration take time to work through the issue with the legislature so that it did not mistakenly say anything on the record that could possibly impact the state's bond record.

Commissioner Hoffbeck shared a concern that when the administration had originally considered the pension obligation bonds over the previous summer, rates had been approximately 3.5 percent; and current rates had risen to 3.8 percent. He thought there was indications that the market was starting to rise.

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Co-Chair Kelly asked about slide 10, "Financing Schedule," and wondered why marketing in the United States was on the schedule after marketing in Asia and Europe. He wondered if there was anything in particular to know about the time frame listed on the slide.

Commissioner Hoffbeck answered in the negative, and relayed that the administration had realized that it was necessary to increase the number of investors that purchased State of Alaska bonds. He continued that the administration's goal was to secure up to 100 new investors. He stated that it was more convenient to go through the United States toward the end of the financing schedule.

Vice-Chair Micciche looked at the principle of \$3.5 billion, and wondered why there was an 8 percent interest rate. He wondered if the administration had investigated a lower fixed interest rate that presented some savings to the state but at a lower level of risk than going out for bonding.

Mr. Mitchell asked if Vice-Chair Micciche had been referring to the actuarial rate of return of 8 percent, and wondering why the administration did not have a lower target rate.

Vice-Chair Micciche answered in the affirmative.

Mr. Mitchell expanded that the actuarial rate had most recently been 8.25 percent and had diminished to 8 percent. He continued that if the actuarial assumption was decreased, it would increase the unfunded liability. He referred back to the differing state assistance payment amounts as reflected on slides 8 and 9, which had changed with a 1 percent reduction in the assumption of a rate of return.

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Vice-Chair Micciche recalled that Mr. Mitchell had stated that the difference was linear, and pondered that a 6 percent rate of return could add another \$8 billion to the state assistance payment.

Commissioner Hoffbeck discussed the risk involved in the proposed transaction; and suggested that if the bonds were sold at a 4 percent return, the state could only achieve a

3.75 percent rate of return over the twenty year period being examined. He asserted that the resultant loss of a quarter of a percent could be considered a rounding error compared the larger issue of funding the pension fund if the state only achieved a 3.75 rate of return.

Co-Chair MacKinnon asked if the aforementioned 23-year time period was an expected plan closure date. She inquired if the administration was engaging in due diligence by providing the credit rating agencies an opportunity to question the administration about the proposal and prevent another downgrade in the state's credit rating.

Mr. Mitchell conveyed that meetings with the credit agencies had already occurred, and the administration expected to have feedback from the agencies the following day or early in the subsequent week.

Co-Chair MacKinnon asked if Mr. Mitchell would be notifying the Finance Committees upon receiving the feedback.

Mr. Mitchell explained that if the credit agencies did not view the proposed transaction as the administration suspected, it would have to reevaluate the proposal. He furthered that the administration expected the proposal was subject to an appropriation pledge; and used the Anchorage jail, the Goose Creek Correctional Center, and the Alaska Native Tribal Health Consortium (ANTHC) housing facility as examples. The facilities listed had all been subject to appropriation commitments of the state; under which the state annually committed to appropriate money.

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Co-Chair MacKinnon clarified that the transactions being considered were taxable.

Mr. Mitchell answered in the affirmative.

Co-Chair MacKinnon mentioned reading about cities that had taken on pension obligation bonds, gone bankrupt, and had later regretted decisions related to pension obligation bonds and poor initial returns.

Co-Chair MacKinnon queried the impacts on the other states, and wondered how the monetary amount of the proposed transaction compared to those in other states. She remarked

that American pension systems were in trouble, and thought it was fascinating that the State of Illinois was issuing pension obligation bonds when it could not make pension payments. She wondered if there were other states or cities that had been successful over a long period of time in the same scenario that was being contemplated by the administration.

STEVE KANTOR, FINANCIAL ADVISOR, FIRST SOUTHWEST; FINANCIAL ADVISOR, PENSION OBLIGATION BOND CORPORATION, communicated that the transaction was sized to be "uniquely Alaskan." He elaborated that there had been pension obligation bonds that had been larger, and pension bonds that had been smaller; and due to the economies of scale, the goal was to maintain 90 percent funding. He was confident that the state could sell more bonds if needed. He thought cities such as Detroit, Michigan; and Stockton, California had structured their bond deals to get all of the potential savings up front in a way that had magnified the problem when things did not go as planned. He thought there was a responsible way to structure the transaction.

Mr. Kantor continued, suggesting that the State of Alaska had taken the opposite approach to that of the aforementioned cities. He reported that a rating agency had expressed that it had never seen a pension bond structured as conservatively. He emphasized that the proposed transaction had been structured to maximize the benefit to the state, while minimizing the risk.

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Co-Chair Kelly invited Representative Saddler to comment.

Representative Saddler mentioned the effect of various financial activities on the state's bond rating. He asked to what extent the issuance of the \$3.5 billion would affect the state's bond rating for general obligation bonds and debt capacity.

Mr. Mitchell explained that there would be some impact on debt capacity, but explained that state already had the obligation on its balance sheet. He considered that it was a matter of the rating agencies following through with rhetoric regarding how the agencies analyzed pension obligations that were on one's balance sheet. He opined that it would be difficult for the agencies to penalize the

state for refinancing an existing obligation in a responsible fashion.

Mr. Mitchell continued, mentioning the size of the transaction and the state's outstanding \$800 million in general obligation debt. He discussed issuing \$3 billion subject to appropriation obligation to the State of Alaska through a public corporation. He explained that the APOBC would have feedback on the subject later in the week, and reiterated that if the group received unexpected feedback it was likely the transaction would have to be put on hold. He discussed different rating levels, and how the state not being downgraded from an "AA" rating category would cause the cost of capital to go up.

Representative Saddler commented that he had attended a meeting with Commonwealth North, at which the Alaska's Liquid Natural Gas (AKLNG) project was discussed. He wondered if there would be any possible advantage to the state to gaining the bond issue with anything else that might have to do with financing of the natural gas pipeline.

Mr. Kantor disclosed that he was also the financial advisor to the state for the AKLNG project for the Department of Revenue. He noted that one potential advantage was introducing the State of Alaska and the appropriation credit to a much broader base of international investors. He pondered that the funding amounts being discussed for the AKLNG project were quite significant, and would require additional investors to be able to invest in the project. He thought that by getting parties comfortable with the state and being able to tell the story of the state's credit, the proposed transaction could smooth the way for going ahead with marketing for the AKLNG project.

Representative Saddler clarified that Mr. Kantor was referring to financing in the context of the state's reputation.

Mr. Kantor answered in the affirmative.

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STEPHEN GAUTHIER, GOVERNMENT FINANCE OFFICERS ASSOCIATION (via teleconference), relayed that he had been asked to explain the policy position that the Government Finance Officers Association (GFOA) had taken. He explained that GFOA was the professional association of finance officers in the United States and Canada, and had about 18,000 members from all states and most local governments. He thought it was understandable why pension obligation bonds were attractive, and acknowledged the opportunity for earnings and budget relief through the transaction. He continued and stated that GFOA had taken a position against pension obligation bonds as an association was that the bonds frequently fail. He furthered that until 2009, most pension obligation bonds failed. He qualified that currently there were more successful such bond ventures than not, although the endeavor was still risky. He added that pension obligation bonds often attracted governments that were in the least position to take such risks.

Mr. Gauthier continued discussing GFOA's position on pension obligation bonds, and highlighted reasons for the advisory bulletin referenced by Mr. Burnett. He discussed borrowing money and reinvesting at a higher rate of interest; and pointed out the long-term nature of bonds. He emphasized that relying on a guarantee of investing at the same rate was problematic over time. He referred to the variable nature of markets. He asserted that there were complications in reinvesting refinancing. He explained that very often it was possible to get monies but there were factors that would affect how it could be reinvested.

Mr. Gauthier relayed that often pension obligation bond financial arrangements involved underlying factors such as swaps and derivatives, which carried more risk than was usually imagined. He discussed complications with debt management, noting that pension obligation bonds lowered legal debt margin by taking accounting liability and turning it into an actual debt obligation. He continued that with taxable bonds there was (unlike regular tax-exempt bonds) often no call provision. He mentioned that sometimes GFOA had observed pension obligation bond arrangements would frequently backload principal payments, and often over a longer period than the amortization would have been for the underlying unfunded obligation.

Mr. Gauthier discussed possible political issues (especially in states with strong unions); and had found that when pensions looked better, people looked for increases in benefits. He used the example of the City of Detroit, which had also used pension obligation bonds. He found it ironic that on the surface pension programs [after pension obligation bonds] looked healthy, because the debt had been moved elsewhere. He concluded that pension bonds did not solve the pension problem for rating agencies, which were fundamentally looking for a comprehensive solution to include funding policies and other details. He mentioned rating agencies' concern about a long-term plan. He summarized that it was possible that the proposed transaction would be successful, but that it was the position of GFOA that the risks of pension obligation bonds typically outweighed the benefits on most occasions.

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Co-Chair MacKinnon wondered if Mr. Gauthier was present when the administration showed a slide that indicated the structure of its proposal was much different than other pension obligation bond transactions; in the sense that the proposal was not taking up-front savings and there was fixed liability.

Mr. Gauthier indicated that he had not heard the comments related to the slide. He stated that theoretically the risk was that money would be lost after not being able to invest at a higher rate than the debt. He was not sure how to guarantee having the appropriate rate of return.

Co-Chair MacKinnon agreed that the state could not guarantee the rate of return, but wanted to know if Mr. Gauthier had considered the administration's position that the state had a closed plan with a fixed liability.

Mr. Gauthier acknowledged that a closed plan did change some things, and could be considered "less of a moving target." He was not sure of the plan details and was hesitant to comment on it.

Co-Chair MacKinnon remarked that from the administration's perspective, the proposed transaction was more comprehensive than other cities or pension plans that had considered pension obligation bonds. She continued that the transaction being considered was fixed for a time frame of

23 years, and although the state had a little more control of variables, the rate of return could not be guaranteed.

Mr. Gauthier summarized that the rate of borrowing was always fixed, but if for any reason the market changed and it was not possible to invest at a higher rate, the state would lose money.

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Vice-Chair Micciche characterized Mr. Gauthier's comments as blunt and not necessarily quantified. He asked if the comments were weighed against the 8 percent that the state was currently paying in interest. He asked about the factors influencing the failure of pension obligation bond endeavors in earlier years.

Mr. Gauthier reiterated that he was not aware of any details pertaining to the proposed transaction, but rather had been asked for a general recommendation from GFOA on the use of pension obligation bonds. He stated that the bonds were only as good as the assurance that the purchaser would not be stuck with a higher interest rate on the bonds. He reminded the committee that the bonds, because they were taxable, were over a longer term than municipal or callable bonds. He thought the question of whether to move forward with the bonds could be reduced to a prudential judgement of whether the state was satisfied with the bond earnings projection.

Vice-Chair Micciche thought there had been factors present in other pension obligation bond transactions that had caused earlier failures. He noted that Mr. Gauthier had stated that the market had improved in recent years. He understood that there was differences in various market factors, but thought Mr. Gauthier's statements had been more based on the risk of the earlier years than current conditions. He inquired as to what conditions that resulted in more failures in earlier years.

Mr. Gauthier referred to dramatic changes in the market in 2008, and referred to a number highs and lows in the market in the years preceding 2008. He reiterated that with pension obligation bonds, the state would be borrowing and reinvesting for a long period of time, and therefore everything was dependent on the market performance. He referred to a quantitative research study from Boston

College. He reiterated that it was not possible to have guarantees for investing at a higher rate over a long term.

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MARK FOSTER, FISCAL STUDY GROUP MEMBER, COMMONWEALTH NORTH, shared that he was retired, and was very interested in the proposed POB transaction. He was formerly the chief financial officer of Anchorage School District, and had a fair amount of exposure to the Governmental Accounting Standards Board (GASB) and pension accounting. He had developed some background information on the proposal for Commonwealth North, and wanted to share information about the returns that had been generated by pension obligation bonds by other states or municipalities.

Mr. Foster discussed pension obligation bonds, noting that other entities had enjoyed good returns for certain periods of time, but that had become negative in other years. He referred to a table entitled "Pension Funding Ratios by State" from the Boston College Center for Retirement Research (copy on file), and highlighted data on pension bonds issued by other states. He referred to data that indicated the bonds began to look like good investments in recent years, where there was increased liquidity that helped to push asset prices up.

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Mr. Foster discussed historical net returns on pension obligation bonds, and a period of time when there was qualitative easing. He cautioned against using the information as a basis for decision making. He encouraged the administration and committee to review economic literature looking at "headwind" in the economy that had the potential to diminish the returns relative to the historic records. Additionally, he cautioned against looking to the past to estimate what future returns would be. He pointed out economic headwinds such as an aging population and the associated costs. He reported that many records suggested low growth and slow growth returns would drop below 5 percent.

Mr. Foster continued, and thought there was clearly anxiety about whether the bonds might have the potential to increase the interest rate and cost of financing beyond just the pension. He considered it could have an impact on

state and local financing for other capital infrastructure. He continued that if it was possible to get a favorable determination, it would be great; but if not, he considered that the bonds could have significant risk to infrastructure going forward.

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Senator Dunleavy asked what Mr. Foster thought of the idea of issuing over \$3 billion in pension obligation bonds.

Mr. Foster stated that if the risk could be diminished, with assurances that there would not be a negative impact on other debt costs (state or local); he thought the bonds were "a decent bet." He relayed that he was conservative in his projections, and thought the earnings should be estimated in the 5 percent range rather than 7 percent or 8 percent.

Senator Dunleavy inquired what would happen if the administration moved forward with the transaction without a guarantee that the legislature would appropriate the funds. He wondered how the appropriation would be structured; whether it would go in the supplemental budget, in the appropriation bill, or as a stand-alone item. He conveyed that he was in the position of needing to be convinced that the proposed transaction was a good idea. He was unsure about the need for quick action, and he was not sure how many good outcomes had come from moving quickly on an item of such magnitude. He expressed skepticism about the proposal.

Senator Kelly invited Representative Vasquez to comment.

Representative Vasquez referred to slide 8 and slide 9 [of the PowerPoint presentation given by Mr. Mitchell], and remarked that the projected scenarios using a 7 percent and 8 percent rate of return did not seem realistic. She would have liked to have seen projections using 6 percent, 5 percent, and even a 4 percent rate of return. She discussed the cost of bond issuance and thought there should be more information on the matter. She noted that there was no historic perspective being presented on the returns the corporation had gained in its investments.

Co-Chair Kelly asked that the administration respond to Representative Vasquez, as well as the Co-Chairs of House Finance, with the information she requested.

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Vice-Chair Micciche thanked Mr. Foster for his testimony, which he thought encapsulated the periods of growth and negative returns from 1992 to 2009. He referred to a document provided by the director of the Legislative Finance Division. The document had shown that in order to have negative returns over a 25 year period, it was necessary to stack the period of negative returns. He referred to discussion and testing of another investment option earlier in the year, which had found that the stacking had never occurred. He requested the administration to respond to the other testifiers in the meeting and consider the presentations that had been made.

Co-Chair Kelly agreed with Senator Micciche and requested that the administration respond to the other presentations. He thought there were some unanswered questions to address.

Co-Chair Thompson asked that responses from the administration be shared with the House Finance Committee.

Co-Chair Kelly agreed.

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ADJOURNMENT

[4:43:25 PM](#)

The meeting was adjourned at 4:43 p.m.