

**MINUTES OF THE
STATE DEBT POLICY ADVISORY COMMISSION
MEETING OF MAY 14, 2009
STATE CAPITOL, ROOM 350
SALEM, OR 97301**

Members Present: Treasurer Ben Westlund, Chair
Representative Phil Barnhart
Scott Harra, Ex Officio Member
Senator Rick Metsger

Members Absent: Wes Lawrence, Public Member

Staff Present: Laura Lockwood-McCall
Lee Anaya

Attendees Present: Jack Kenny, DAS
Staci Dycus, OST
Darren Bond, OST
Steve Bender, Legislative Fiscal Office
Daron Hill, Legislative Fiscal Office

Treasurer Westlund, Chair, called the meeting of the State Debt Policy Advisory Commission (SDPAC) to order at 5:10 p.m.

Senator Metsger moved to approve the January 20, 2009 minutes, Representative Barnhart seconded the motion, and the minutes were approved by unanimous vote.

Ms. Lockwood-McCall began with a review of the interest rate assumption used in the January 2009 presentation of the State Debt Capacity model. The assumption has historically been based on the 5 year average Bond Buyer's 20 Bond Index, which is an aggregate index of municipal credit ratings from BBB to AAA; the average resulting in about an A-rated credit. Given that the State issues bonds at the AA credit level, the decision to base the model rate on the 20 Bond Index is relatively conservative. Ms. Lockwood-McCall noted, however, that at the time of January 2009 SDPAC meeting, given the unprecedented dislocation of worldwide credit markets, the Commission was unsure whether to continue to rely on this approach to forecasting long-term municipal interest rates. Without a clear sense as to the direction of the capital markets, the Commission elected to continue to use the five year average of the 20 Bond Index but added 100 basis points (or 1%) as a way to account for the potential of higher future interest rates. This resulted in an assumed interest rate of 5.53% being used in the SDPAC model.

Ms. Lockwood-McCall stated that since the January 2009 meeting of the Commission, municipal credit markets have stabilized and various State bonds have been sold well below the 5.53% level, with the highest interest rate on lottery bonds at a 4.74% all-in cost of funds. She stated that the reasons behind this decline in interest rates is related to restored investor confidence and the authorization by the Federal Government of a new direct tax subsidy bond program called "Build America Bonds", which allow state and local governments to receive a 35 percent interest payment subsidy when they sell federally taxable bonds. These taxable bonds are attractive to a wide range of new types of investors; as more municipal bonds are sold in this fashion, less are sold tax-exempt, which has effectively reduced the supply of these types of bonds which in turn has lowered interest rates in the tax exempt credit market. Given this overall stabilization, Ms. Lockwood-McCall recommended that the Commission reconsider its initial interest rate assumption for the State's debt capacity model.

Lockwood-McCall stated that the Build America Bonds program is currently only available for the next two years, while the interest assumption to be made about the model is over a six year period. Ms. Lockwood-

McCall explained that all things being equal, lowering the interest rate in the model increased the state's overall debt capacity.

Representative Barnhart asked for an update on the five year average of the 20 Bond Index. Ms. Lockwood-McCall responded that the average for the past five years was 4.56%, and the current 20 Bond Index stood at 4.62%. She went on to explain that at the height of the credit market crisis back in October 2008, the Index briefly exceeded 6%, and that prior to the launching of the Build America Bond program, the Index was at 4.92%.

Treasurer Westlund suggested the Commission consider lowering the assumed interest rate in the debt capacity model, but also suggested that they maintain a cushion above the 5 year average 20 Bond Buyer Index. Treasurer Westlund expressed concern that the country is entering period of unprecedented large federal budget deficits and noted that inflation could rise significantly in the next few years. Treasurer Westlund stated that he would be comfortable, however, lowering the assumed rate by 50 basis points.

Representative Barnhart outlined two scenarios that he believed to be possible for the economy. In the first scenario, the economy enters a long period of mild deflation, slow economic growth, and low interest rates. Representative Barnhart stated that this would be a very possible scenario. Mr. Barnhart went on to explain a second scenario, where the Federal Reserve pumps large amounts of capital into the economy resulting in a loss of confidence in the dollar, which causes demand for the dollar to decline, and the economy enters a period of rapid inflation. Representative Barnhart states that he believed the assumed rate should be set between 50 and 100 basis points lower than the current assumed rate of 5.53%.

Mr. Harra pointed out that the dollars that the Federal Reserve was injecting into the economy could quickly be withdrawn. Thus his fears of hyperinflation are lower than those of Treasurer Westlund. Mr. Harra contended that last fall was a serious anomaly. He argued that the Federal Reserve is now more attuned to the world economic situation than it was last fall, and that the Federal Reserve would quickly respond to either deflation or hyperinflation. Mr. Harra stated that he preferred to be more aggressive than Treasurer Westlund in terms of reducing the interest rate assumption, but indicated support for a 50 basis point reduction at this time. Mr. Harra also reminded the Commission that the State's Economic and Revenue forecast, to be released on May 15, 2009, would have a large impact on the model as well. Mr. Harra proposed a 75 basis point reduction to the assumed rate of the model. Discussion ensued regarding the turnaround time on updating the model once the State Economic and Revenue forecast is released.

Mr. Steve Bender, analyst for the Legislative Fiscal Office, asked the Commission to consider how the model would be affected by the fact that typically much of the debt issued in a biennium is near the end of that biennium, and thus would be two years away from the current date. Ms. Lockwood-McCall explained that the assumption being decided upon isn't for only the next year or two, but that it is forecast across three biennium, or six years. Given that the Commission reviews the model's assumption regarding long-term interest rates, future revenue levels, and debt issuance activity every year, the State has sufficient time to modify its long-term debt issuance plans accordingly if conditions were to change.

Mr. Darren Bond, Deputy State Treasurer, explained that hyper inflation doesn't have to take place for interest rates to rise significantly. A moderate amount of inflation can have the same effect. A period of easy money, continued for the next six months to one year is significant. He believes that there is a high risk that when any inflation occurs, interest rates will rise significantly. However, the Commission will have the opportunity to reevaluate the model assumption in one year, making the inflation argument a moot point in the long run.

Mr. Harra reiterated his position for a 50 to 75 basis point reduction. Senator Metsger noted that the legislature will make decisions based on the assumptions to the model, but while the model is based on a six year period most legislators will be mostly concerned with the next two. Senator Metsger stated that, because of the uncertainty with the economy, he would advocate for a 50 basis point reduction in the

assumed interest rate for the model at this time. Discussion ensued about the effect of an economic recovery on the model in general.

Treasurer Westlund posed a question regarding Fitch Ratings, Moody's Investor Services, and Standard & Poor's with regard to how those agencies would view any change in the interest rate assumption for the State Debt Capacity model.

Ms. Lockwood-McCall explained that the rating agencies are satisfied with the fact that the State has a process for determining debt capacity, that the process is debated, and that the result is adhered to by the State Legislature. Moody's Investor Services, in particular, is concerned about the total amount of debt issued by the State, as that particular agency tracks the ratio between debt issued by the State as it relates to personal income. Standard & Poor's and Fitch Ratings are content that the State has a process, and again, that this process is adhered to by policy makers.

Treasurer Westlund made a motion to lower the interest rate assumption for the State Debt Capacity model by 53 basis points, to 5.0%. Senator Metsger seconded the motion, and the motion carried unanimously.

With no further business, the meeting adjourned at 5:45 p.m.