BRECKINRIDGE CAPITAL ADVISORS

SPECIAL COMMENTARY:
THE ROLE OF STATE CREDIT ENHANCMENT PROGRAMS AFTER *THE GREAT RECESSION*

July 2011

U.S. local governments continue to operate under severe fiscal stress. Local government tax collections are down,[1] and state-aid cuts are up.[2] As we noted in our December commentary, an uptick in local government defaults over the next 12 – 24 months is possible.[3]

Still, local government bond defaults are likely to remain rare.[4] Local governments exhibit low debt levels, modest and predictable servicing costs, and manageable pension obligations.[5] Legal protections for bondholders remain sturdy, and issuers continue to demonstrate a strong willingness to repay lenders.

In this ***Special Commentary***, we discuss another protection for municipal investors: state credit enhancement programs. Many investors are unfamiliar with these programs despite their ubiquity in the municipal market. The programs are rarely utilized, but some may be triggered in the aftermath of the Great Recession.

Purpose

States establish credit enhancement programs to ensure market access for weaker local issuers. Credit enhancement links the state's credit profile to that of its local governments. The result is greater demand for weaker issuers' debt and, subsequently, lower borrowing costs.

Two kinds of issuers benefit most from credit enhancement programs: distressed issuers and small issuers. Distressed borrowers benefit because they often have limited market access without enhancement, e.g. Detroit. Small issuers benefit because enhancement enlarges the market for their bonds. Small-government enhancement programs often apply to many issuers at once, homogenizing the credit profile of a state's small issuers. This creates a more liquid market for each issuer's debt.[6]

Structure

There are at least 34 state credit enhancement programs in 24 states.[7] Most are characterized by two over-arching features: (a) a pledge of state cash to investors upon default and (b) financial incentives to deter default in the first place. (State tax intercept programs are the exception.) The most common structures are discussed below.

State Aid Intercepts

State aid intercept programs typically backstop municipal or school district debt. Under these programs, states pledge to "intercept" state aid owed to a local government if the local government defaults (or nears default). The state then redirects the aid to bondholders. Bondholders are paid until the default is cured or until all of the local government's state aid has been spent.[8] Intercept programs have rarely been triggered. Usually, the mere ***threat*** to intercept aid deters default.

State aid intercept programs are typically created by general legislation that applies to many issuers at once. New York State's school district intercept program applies automatically to each of its 680 school districts.[9] Ohio's program applies to school districts that agree to meet certain minimum benchmarks.[10]

State Tax Intercepts

State tax intercept programs typically create a third party entity to collect the taxes of a distressed local government. Under these programs, the third party entity collects all or a portion of the local government's taxes and uses them to pay the local government's debt service costs. Debt service is generally paid before the taxes flow to the local treasury.

Tax intercept programs are often created by special legislation in response to a fiscal crisis. For example, during New York City's 1975 debt crisis, officials created the Municipal Assistance Corporation to collect the City's tax revenue and remit it to bondholders.[11] Effectively, bondholders were paid prior to operational costs.

State Guarantees

Michigan, Oregon, Utah, and Washington backstop eligible school district debt by guaranteeing timely debt service payments in the event of default.

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Under all four programs, the defaulting borrower must repay the state if the guarantee is triggered.[12] Other states guarantee school district bonds through standing appropriation programs.[13]

State Permanent Funds

Nevada, Texas, and Wyoming operate trust funds to enhance public school debt. These funds are capitalized with the sale of state lands, mineral rights, and land-related royalties.[14] If a school district defaults, fund assets are drawn to pay bondholders. All three states require defaulting school districts to repay the funds.

Evaluating Credit Enhancement Programs

State credit enhancement programs provide varying degrees of security. Outlined below are several determinants that affect the relative strength of a program.

Timing of Payment

Strong enhancement programs ensure that bondholders receive timely debt service payments. The Georgia State Aid Intercept program exemplifies a strong program. There, the state transfers money to bondholders if no payment is received at least 15 days prior to the due date for debt service.[15] Less strong programs direct payment to bondholders only after a default occurs.

State's Legal Obligation to Pay

Strong programs include a contractual pledge by the state to intercept aid on behalf of bondholders. New York's school district intercept program is contractual.[16] A failure by New York to intercept aid would impair bondholders' contract rights. Under weaker programs lawmakers can legally rewrite intercept laws without impairing bondholders' rights.

Nature of the Pledged Revenues

Strong state credit enhancement programs utilize reliable revenue streams to keep bondholders whole. Where an enhancement program is secured by a pledge to intercept state aid, investors seek a high ratio between the amount of aid withheld and the debt service owed. In the case of permanent funds, an over-collateralized fund of treasuries is preferred. When payment is made by a third party, security is generally enhanced. For example, under a Buffalo, NY intercept program, debt service is paid by the state comptroller from county sales taxes and city state aid. The City, itself, obtains the pledged revenues only after bondholders are paid.[17]

State Oversight

Strong programs monitor the fiscal performance of participating local governments. In New Jersey, the Local Finance Board and Department of Education annually review municipal and school district budgets to ensure they are compliant with state laws and debt service obligations.[18] This monitoring system enables the state to act prior to a "debt crisis" so as to avoid triggering the state's intercept program.

Notification by a Third Party

Strong programs often employ a third party to notify state officials of a default. Weaker programs permit notification by the parties to the bond contract. The Roosevelt Union Free School District's (NY) 2005 and 2006 experiences illustrate a weaker program.

The District failed to make timely debt service payments to its bond trustee in December of each year.[19] However, the state of New York was never notified. Instead, the bond trustee paid investors and resolved the situation with the District, directly.[20]

Credit Quality of the State

Strong state finances improve the quality of a state credit enhancement program. A state's financial condition is strongly correlated with the likelihood that it will enforce its credit enhancement pledge and ably monitor its local governments.

Risks

In the wake of the Great Recession, investors should be aware of several ***remote*** risks associated with credit enhancement programs.

First, credit enhancement programs are untested forms of credit protection. Local bond defaults are rare, and enhancement programs have been triggered infrequently (if at all). In a debt crisis, elected officials may not adhere to enhancement pledges. This risk increases where the relevant statute is ambiguously worded or the program's mechanics are subject to interpretation. In an extreme case, officials might amend enhancement statutes to the detriment of bondholders.

Second, credit enhancement protections may fail in bankruptcy court. The recent bankruptcy of Vallejo, CA raised the specter that certain intercept clauses might go unenforced in Chapter 9.[21]

Third, states may not honor credit enhancement pledges where bond insurers provide parallel protection for investors. States have limited incentive to trigger their enhancement provisions upon default if insurers have already pledged to keep bondholders whole.[22] A dispute between a state and an insurer could threaten the security of other insured bonds.

Likely Outcomes

States are likely to maintain and honor their credit enhancement programs in the near- and long-term.

The market would react swiftly and negatively against a state that failed to honor its enhancement pledge. Borrowing costs would increase dramatically for the state's small issuers. This is particularly true given most issuers' manageable debt levels.

A "wave" of defaults within the same state could theoretically overwhelm an enhancement program's mechanics and a state's political will, but that situation seems unlikely.

Even in a Chapter 9 proceeding, most state credit enhancement programs should perform well. Enhancement programs are usually designed to survive a Chapter 9 filing.[23] As a general rule, the bankruptcy code is likely to treat intercepted funds as revenues of the state, not the local government. Ostensibly, this fact removes them from the bankrupt municipality's "estate."[24] Where a third party collects local taxes or withholds local aid, bondholder protections are enhanced for the purposes of the federal bankruptcy code.[25]

The most likely risks to bondholders from enhancement programs are notification delays and downgrades to states' credit ratings. Bondholders may have to wait for principal and interest payments where states are forced to administer intercept programs. Ratings downgrades are likely to devalue bonds enhanced by states' credit.

Breckinridge remains confident in the credit fundamentals of state credit enhancement programs and expects them to function ably, if called upon. We continue to monitor our holdings of enhanced bonds, as well as unenhanced ones, to generate income and preserve value over time.

[1] State Revenue Report, Tax Revenues finished 2010 Strong; Growth Continues in Early 2011, Rockefeller Institute, p. 2. Available at: http://www.rockinst.org/pdf/government_finance/state_revenue_report/2011-04-19-SRR_83%20rev.pdf While state revenues are growing, local revenues continue to fall. Property taxes are down 2% year-over-year and 4.5% from first quarter 2008. See Census of Governments June 28, 2011 report.

[2] See Michael Cooper, "Cities Bleed as States Cut Aid," New York Times, Sunday March 27, 2011.

[3] See BCA's Municipal Misconceptions & 2011 Credit Outlook. See also Sector Outlook for U.S. Local Governments – Toughest Year Yet, Moody's, p. 1, March 17, 2011. Note: Moody's shares this view.

[4] Moody's also shares this view. Ibid.

[5] Nationally, municipal debt levels are falling. Outstanding state and local debt fell to 15% of GDP in Q2 2011. Federal Reserve Flow of Funds, Table L. 211 (June 9, 2011), Monthly Statement of the Public Debt of the United States, May 31, 2011 (state and local government securities), and Q2 GDP per Bureau of Economic Analysis.

[6] In practice, intercept programs homogenize issuers' debt profiles only modestly. Investors continue to demand higher interest rates from small issuers with poor credit metrics even where state intercept programs support the credit.

[7] Standard & Poor's, State Credit Enhancement Programs, Nov. 13, 2008, at 26.

[8] In the latter case, bondholders can theoretically suffer a haircut. However, to date, we know of no instance in which a bondholder has suffered a haircut after investing in a bond supported by a state intercept program

[9] See New York State laws, State Finance Law, art 6, § 99-b.

[10] See Ohio Revised Code, §3317.18 and §3301-8-01 of the Ohio Administrative Code.

[11] In fact, the MAC legislation converted city taxes into state revenues. Then, the state assigned the revenues to MAC which paid bondholders prior to other interested parties. See Roger Dunstan, Overview of New York City's Fiscal Crisis, California Research Bureau, California state Library, CRB Note, Vol. 3., no. 1, March 1, 1995.

[12] See: Michigan State School Bond Loan Fund Program, Section 16 of Article 9 of Michigan's Constitution; Oregon School Bond Guarantee Program, Oregon Laws 1997, Ch. 614; Utah School Bond Guaranty Act, Title 53A, Chapter 28, Sec. 201 – 402; Washington School Bond Guarantee Program, Washington Administrative Code 210-02.

[13] The difference between a "guarantee" and a "standing appropriation" is mostly semantics. Under both programs, the state pledges to keep bondholders whole without triggering legislative action. Examples of standing appropriations programs include: The Minnesota State Standing Appropriation Program, The Texas Higher Education Bond Program, and the West Virginia Municipal Bond Commission Program.

[14] Fund monies may only be used for school purposes and are comprised mostly of U.S. treasuries. Usually, the requirement that fund assets be used only for schools is constitutionally prescribed. For example, Article 11, Section 3 of the Nevada Constitution requires proceeds of the fund to be used only for educational purposes. Nevada's fund holds proceeds from the sale and/or operation of federal lands

[15] See Title 20, Sec. 20-2-480 of the Georgia Code and Standard & Poor's Public Finance Criteria, 2007, p. 90.

[16] See any Official Statement of a New York State School District. The program amounts to "a covenant by the State with the holders" of school district bonds. This particular quote is from a School District of Schenectady deal dated July 22, 2010, CUSIP base #806466.

[17] See any official statement of the Buffalo Fiscal Stability Authority. See "disbursement of revenues."

[18] See NJSA 40A:4-1 and NJSA 18A:22-1.

[19] See Harold Burger , The Handbook of Municipal Bonds, "State Credit Enhancement Programs for School Districts and Municipalities," Ch. 72, p. 1138 (2008).

[20] Under New York law, bondholders are required to notify the state of late payments, not school districts or trustees. See Laws of New York, Consolidated Law, New York State Finance Law, Sec. 99-B, "Withholding of State Aid for Purposes Upon," p. 1.

[21] See Amicus Curaie brief in Support of National Public Finance Guarantee Corporation (September 16, 2010) and City of Vallejo's Response (October 4, 2010), In re: City of Vallejo, Case No. 08-26813, Docket Control #WS-002.

[22] Where an insurer requires the debtor municipality to repay with a high rate of interest, states may act.

[23] Bankruptcy courts are likely to construe state aid and permanent fund monies as the property of the state, not that of the bankrupt municipality. Bankrupt municipalities have no claims to property of the state.

[24] Technically, there is no "estate" in a municipal bankruptcy proceeding. A municipal entity cannot relinquish sovereign control over its property even in a Chapter 9 proceeding. Creditors' claims on the "estate" are really only claims on the municipality's cash flows, not the property of the municipality, itself. Any other interpretation of Chapter 9 permits creditors to unconstitutionally usurp local (and therefore state) powers by liquidating municipal assets or otherwise infringing on local/state fiscal sovereignty.

[25] The Vallejo bankruptcy case supports this conclusion. In that case, California's controller filed a motion to ensure that intercepted funds be used to protect Vallejo's bondholders. See: Randall Jensen, "California Controller Seeks to Protect Use of Intercept Funds," The Bond Buyer, Wednesday, December 29, 2010. Note that despite the Controller's motion, the City of Vallejo argued that it was entitled to intercepted funds earmarked for bondholders. Vallejo's argument relied on a quirk in California local government law that is (likely) inapplicable in other jurisdictions. The City of Vallejo and National Public Finance Guarantee Corporation settled the issue without litigation.

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