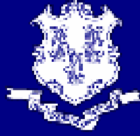

OLR RESEARCH REPORT

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RECENT BONDING REFORMS IN OTHER STATES

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You asked for information about reforms in state bonding and debt management practices enacted in other states within the past five to eight years.

SUMMARY

Extensive internet searches and a call to the National Conference of State Legislatures yielded two states (Illinois and Massachusetts) that have enacted significant bonding reforms since 2004 and two additional states (Washington and Pennsylvania) that have legislation pending to reduce the amount of debt they issue.

Illinois enacted a series of bonding and debt management reforms in 2004 to, among other things, (1) restrict the amount of new debt the state can issue in any given year, (2) limit bond issuance costs, (3) ban the use of capitalized interest in bond issuance, and (4) require detailed disclosures on issuance costs (PA 93-0839). Massachusetts passed a law in 2012 that makes its annual debt affordability analysis a statutory requirement and establishes a new advisory committee to continually review of the size and condition of the state's tax-supported debt and recommend the total amount of new debt to be authorized for the next fiscal year (S. 2342, § 112).

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Washington's legislature adopted a resolution in 2012 to amend the state's constitutional debt limit (SJR 8221). The amendment, which will take effect in 2014 if voters approve it, restricts the amount of debt the state can issue by gradually decreasing the percentage of state revenue that can be used to pay annual debt service costs. A bill pending in the Pennsylvania legislature would similarly restrict the amount of debt the state can issue by lowering, from $4 billion to $1.5 billion, the debt limit for a major state economic development program (House Bill 2175).

For your further information, we attach a copy of Standard and Poor's *2011 State Debt Review: Despite Surge of Issuance, No Debt Crisis for U.S. States*, which discusses current credit trends and future projections in the state debt market and includes brief descriptions of recent developments in each state's debt burden.

ILLINOIS

The Illinois legislature enacted several bonding and debt management reforms in 2004 (PA 93-0839). The changes sought to restrict both the amount of debt the state issues and borrowing practices that produce short-term savings at the expense of increasing overall costs. Information on the act's requirements comes from (1) the Commission on Government Forecasting and Accountability's *Analysis of the FY 2013 Capital Infrastructure Plan for the State of Illinois* and (2) "Reforming State Debt Management Practices: The Case of Illinois, 2004," by Martin J. Luby, *Municipal Finance Journal*, Vol. 30, No. 1, Spring 2009.

Debt Service Limit

Limiting the share of annual revenue that a state may allocate to pay principal and interest ("debt service") on borrowing restricts the amount of new debt the state can issue in any given year. The 2004 Illinois act limits the state's debt service costs on outstanding general obligation (GO) bonds to a maximum of 7% of the aggregate appropriations from its General and Road funds for the prior fiscal year. The limit applies to both long-term and short-term borrowing.

The state comptroller and treasurer may jointly consent, in writing, to waive the limit. Since 2004, $3.466 billion in GO pension obligation notes sold in 2010 and $3.7 billion in GO pension obligation bonds issued in 2011 have been exempted from the limit.

Cost of Issuance Restrictions

Bond issuance costs typically include underwriting fees and other costs associated with rating and marketing state debt. The 2004 act limits Illinois bond issuance costs to 0.5% of the principal amount of the bond offering. The limit applies to professional fees, including underwriting costs, but excludes the cost of bond insurance. These cost-of-issuance limits reduce the amount of bonds outstanding, since bonded amounts typically include issuance costs.

The act also bars payments to anyone who paid a contingency fee to a third party for promoting his or her hiring on a debt transaction. All professionals involved in a bond sale must certify that they paid no contingency fees. Anyone who makes a false certification is barred from participating in state debt transactions for two years.

Capitalized Interest

The 2004 act prohibits the use of capitalized interest in bond issuance. Capitalized interest refers to the practice of borrowing additional money to pay interest costs for an initial period on the bonds being issued. Borrowing to pay interest requires an issuer to sell more bonds and increases both the state's outstanding debt and the overall cost of a bond issue. The Illinois legislature excluded a March 2010 authorization of $1.5 billion in GO refunding bonds from this restriction.

Amortization and Maturity Schedules

The 2004 act requires the repayment of any new or refunding GO bonds issued after its effective date to be structured so an equal ("level") amount of the principal balance is repaid each year over the life of the bonds, with the first principal payment due in the fiscal year after the bonds are sold. These changes eliminate backloaded or balloon repayment schedules and provide a transparent and predictable schedule for repaying principal and interest over the life of the bonds.

The 2004 act also shortened the maximum maturity for state GO bonds from 30 to 25 years, thus reducing debt costs by paying off bonds sooner. As was the case with the capitalized interest restriction, the March 2010 sale of $1.5 billion of refunding bonds was excluded from the level principal payment requirements.

Sale Method

Bonds may be sold through competitive or negotiated bids from underwriters. Competitive sales are more transparent than negotiated sales. But, according to the Government Finance Officers Association, negotiated sales can be more efficient for lower-rated bonds, bonds that feature nonstandard repayment structures such as variable or deferred interest, or when a state wishes to target underwriting fees to a disadvantaged or local business.

The Illinois act limits the use of negotiated bond sales to no more than 75% of all debt sales in any fiscal year. It also requires no more than 75% of the bonds outstanding in any fiscal year to have been sold through negotiated sales. This limit effectively requires the state to sell at least part of its first bond issue each year through a competitive sale. The legislature later excluded GO and "Build Illinois" refunding bonds sold in FYs 09 through 11 and pension obligation bonds sold in 2010 and 2011 from the competitive sale requirement.

Requirements for Refunding Bonds

Refunding bonds are new bonds issued to pay off outstanding bonds and refinance the remaining debt. Under the 2004 act, refunding bonds can be issued only if they yield at least a 3% net present value debt service savings compared to the outstanding bonds. (Net present value is used to compare the value of a dollar today to its value in the future, taking into account inflation and investment returns.)

Refunding bonds must also mature no later than the final maturity date of the original bonds. (GO and Build Illinois refunding bonds sold from FY 09-11 are exempt from these requirements.) Finally, the outstanding principal maturing, and redemption amounts, of the refunding bonds must be no greater than those of the bonds they are refunding. The provisions prevent refunding bonds from extending the term or increasing the principal amount of the original bonds.

Disclosures and Other Requirements

The 2004 act requires the state Office of Management and Budget, which issues Illinois state bonds, to provide detailed summaries of bond issuance costs to the state Commission on Government Forecasting and Accountability. Summaries must include, for each bond issue: (1) the principal and interest payments over the full stated bond term and (2) total principal and interest payments in each fiscal year on all other

outstanding bonds over their full stated terms. The act also requires detailed disclosures on refunding bond savings, issuance costs, and contingency fee certifications.

MASSACHUSETTS

The Massachusetts legislature adopted legislation in 2012 (S. 2342, § 112) that makes the Massachusetts governor's annual debt affordability analysis a statutory requirement and establishes a new independent Capital Debt Affordability Committee to provide an independent estimate of annual debt affordability to guide the governor and the legislature in authorizing new state debt. The new law also establishes criteria for the debt to be included in the affordability analysis and requires the committee to establish and review methods to calculate available revenue to support the new debt.

Debt affordability analysis is a financial planning tool states and local governments use in the capital planning process to evaluate how much debt they can afford. OLR Report 2011-R-0084 provides more information on state debt affordability analyses.

Capital Debt Affordability Committee

The new committee has seven voting and eight nonvoting members. The voting members are the following or their designees:

1. the secretary of finance and administration, who serves as the committee chair;

2. the state treasurer;

3. the comptroller;

4. the transportation secretary;

5. a Massachusetts resident, appointed by the governor, who is an expert in public finance and employed by a public or private higher education institution; and

6. two experts in public finance appointed by the state treasurer, who live in Massachusetts and are not state employees or state contractors.

The nonvoting members are the chairs and ranking members of the legislature's committees on (1) bonding, capital expenditures, and state assets and (2) ways and means.

Types of Debt Covered

The committee must conduct a continuing review of the size and condition of the state's tax-supported debt. The requirement covers all bonds and other forms of debt issued by the state, including state agency capital leases that are wholly or partly supported by state tax revenue. It does not include refunding bonds issued to pay off outstanding bonds at or before maturity.

Report and Estimate of Prudent New Debt

By September 10 annually, the committee must issue an estimate of the total amount of new debt the state may prudently authorize for the next fiscal year. Under the act, the committee's estimate is advisory and not binding on the governor or the legislature.

In making the estimate, the committee must consider and report on:

1. the amount of state bonds that, in the next fiscal year, will be (a) outstanding and (b) authorized but not issued;

2. the state's capital program;

3. capital improvement and school construction needs for the next five fiscal years;

4. projected debt service requirements for the next 10 years;

5. criteria used by bond rating agencies to rate the state's bonds;

6. other factors related to the (a) state's ability to meet debt service requirements for the next five years or (b) marketability of the state's bonds;

7. the effect of new authorizations on the above factors;

8. pertinent debt ratios, such as debt service to General Fund revenue, debt to personal income, debt per capita, and debt to estimated full property value;

9. comparisons of these debt ratios for the five New England states, New York, and five other states the committee identifies as comparable to Massachusetts;

10. the percentage of outstanding GO bonds that have fixed and variable rates and those that have such rates through hedging contacts, with specified information about the hedging contracts (see below); and

11. other classes of state tax-supported debt and debt issued by other state subdivisions and units.

A hedging contract is an agreement between two parties that establishes the predetermined price of an asset or investment, such as a commodity, at a future date. Two parties may also agree to exchange interest rate cash flows, based on a specified notional amount (such as one million) in a particular currency (such as dollars). Exchanges can be from a fixed to a floating rate (or vice versa) or from one floating rate to another. When used as hedges, such contracts are intended to reduce or offset the risk of interest rate fluctuations over time.

For each hedging contract involving Massachusetts state debt, the committee must describe the contract and report its (1) outstanding notional amount, (2) effective and expiration dates, (3) counterparty name and credit rating, and (4) rate or floating index paid by the state and the counterparty. The committee must also summarize how the state's hedging contracts have performed compared to their original objectives.

Governor's Annual Bond Limit Determination

The 2012 legislation also codifies current practice by requiring the governor, by October 15 annually, to determine (1) total new state debt authorizations for the upcoming fiscal year and (2) the preliminary allocation of the debt for capital projects. In making these determinations, it requires the governor to consider the committee's estimate and report.

WASHINGTON

In 2012, Washington's legislature passed Senate Joint Resolution 8221 proposing a constitutional amendment to reduce the state's debt limit. The amendment phases in, from 2014 to 2034, a reduction in the state's maximum annual debt service to 8% of the average general state revenue for the previous six fiscal years, from the current limit of 9% of

the average revenue for the previous three fiscal years. It also expands the definition of general state revenue to include state property taxes deposited in the general fund. It will take effect on July 1, 2014 if voters in the general election approve it.

These changes to the state's constitutional debt limit were based on recommendations by Washington's Commission on State Debt. The commission, created through legislation in 2011, was charged with recommending possible changes to the state's debt policy in order to (1) stabilize its capacity to incur new debt, (2) reduce the growth in annual debt-service payments, and (3) maintain and enhance the state's credit rating.

PENNSYLVANIA

House Bill 2175, pending in Pennsylvania's legislature, would reduce the amount of debt the state issues by decreasing, from $4.05 billion to $1.5 billion, the debt limit for the Redevelopment Assistance Capital Program (RACP). RACP is an economic development program that provides matching grants for significant economic development capital projects. The bill would reduce the program's debt limit by $500 million upon passage and then gradually lower it by $50 million per year from 2012 through 2019 and $150 million per year thereafter, until it reaches $1.5 billion. The bill also modifies the types of projects eligible for RACP grants and requires the Governor's Budget Office to establish new guidelines for administering the program, submit quarterly reports on RACP projects, and post certain information about approved projects on its website.

JL/RP:ro