House Committee on Oversight

38 Studios Moral Obligation Bond Repayment

May 8, 2014

RIPEC

What is RIPEC?

- RIPEC is an independent, nonprofit and nonpartisan public policy research and education organization.

- Organization founded in 1932.

- Primary purpose is to promote more efficient, economical and responsible government.

Agenda

- Methodology
- Scope of evaluation questions
- Context: Examples of default
- Context: Default
- Context: The municipal bond market
- Fundamental considerations
- RIPEC fiscal analysis
- Potential other bond issues
- Capital needs for the state
- Summary

Methodology

- Reviewed the question of payment
  - Weighing the consequences of payment should be separated from how we arrived at this situation
- Reviewed the issues surrounding payment
  - Consequences of payment vs. no payment
  - Quantifiable vs. non-quantifiable
- Examined municipal bond default, current market data, and modeled potential additional costs associated with higher interest rates due to bond rate reductions.
- Reviewed and updated RIPEC’s 2013 report, which examined:
  - RI’s current debt position; and
  - Potential impacts of default.

Scope of Evaluation: Questions

What are the consequences of paying, or not paying?

The following questions allow us to better explore this issue:

- What would be the nature of the default?
- Would the fact that we are able to pay, but unwilling to pay, make a difference?
- What would the response to non-payment be by rating agencies, the market, and other entities?
- What aspects of the potential impact of defaulting are quantifiable, and which are non-quantifiable?
- What would be the potential fiscal impact of the default?
- What are the implications of this decision on other entities in the state such as quasi-state agencies and local governments?

Context: Examples of Default

- Since 1970, of those entities rated by Moody’s Investors, there have been only 80 examples of default.
  - A majority of these defaults were related to special project funding such as housing, or hospitals.

- No examples of a state defaulting have occurred since 1933.

- No examples over the last 100 years of a state defaulting by its choice as opposed to an inability to pay.
  - (See S&P handout)

- The majority of past defaults occurred on very low grade issuers. Rhode Island has an Aa2 (Moody’s), or relatively high grade, rating.

Context: Default

- Non-payment of the debt service triggers default.
- If no appropriation is made, it will trigger action.
- The event of non-payment has to be disclosed, and it will trigger action by the three rating agencies, as well as others.
- All bond issuances of the state, which require a rating level, will have to be examined.
- All bond issuances of related agencies, which require an underlying state rating, will have to be reviewed.
- Those holding Rhode Island debt, which requires a certain rating level, may need to sell.

Context: The Municipal Bond Market

- Market size
  - Large industry
  - Rhode Island’s share is relatively small
- Not issuing state debt would not make a difference to the market. However: non-payment by a state would break new and uncharted terrain.
  - To have a state choose not to pay, as indicated, has not happened
  - This calculus for repayment—of determining whether it is cheaper not to pay then to pay—would challenge the fundamental concept of the market of appropriation-backed debt.
  - Is this the right question to ask?

Context: The Municipal Bond Market

- Non-payment would be creating a condition challenging the belief that moral obligation debt is debt, and will be paid (See S&P’s handout).
- A willful choice to default would challenge a very large industry.
- What reaction would be expected by the rating agencies and the market in general?
- What justification is there to illustrate that the state would not be penalized by the market?
- It is not a question of whether we would be penalized, or punished, but rather, to what extreme?
- We are not a significant issuer of debt to the size of the market, therefore, the market has the best example to punish a state for choosing not to pay.

Context: The Municipal Bond Market

- Will this spillover to other related debt within the state?
- Will, as happened in Michigan, a spillover to other issuers occur?

This is a serious decision that needs to be made and not on the emotional side of how we got here.

Fundamental Considerations

Would the fact that we are able, but unwilling to pay, make a difference?

- There is reason to believe that because of Rhode Island's small issuance of debt in relation to the total market, Rhode Island may be penalized severely by rating agencies, bond insurers, and the market (to discourage others from considering default).

- It would be easy to make Rhode Island the example of what happens when moral obligation commitments are not met—through either higher cost borrowing or a general unwillingness to invest.

What would the response to non-payment be by rating agencies, the market, and other entities?

- No state has defaulted on a bond since the Depression, when Arkansas defaulted on a 1933 payment. This non-payment is still in the literature when you review this issue – many decades later. They paid, but still were penalized.
- In most instances of municipal default, municipalities suffered credit rating downgrades, which, in many cases, were severe (some amounting to over 8 level reductions).
- In some cases these downgrades were for the city's general obligation debt rating, and in others they were only on the individual bonding authority or project.
- In a recent study by Moody's there are few occurrences of municipal defaults versus the private capital market.

What would the response to non-payment be by rating agencies, the market, and other entities?

- Rating agencies have already publicly announced their concern about Rhode Island's consideration of non-payment.
- On Monday, June 17, 2013, Moody's Investors Service warned it could lower RI's Aa2 general obligation rating if lawmakers refused to appropriate payment towards the 38 Studios debt. It also downgraded the 38 Studios debt from A2 to Baa1.
- On April 17, 2014, S&P issued a warning regarding the payment of the 38 Studio debt.
- Lastly, Moody's placed the state's Aa3 related appropriation bond ratings and the Job Creation Guarantee Program, on review for further downgrade.
- Fitch has also mentioned the impact of the 38 studios payment.

What would the response to non-payment be by rating agencies, the market, and other entities?

In the April 2014 publication, Standard and Poor's announced that:

"Consistent with our criteria, if we believe that Rhode Island or any other issuer waivers in its commitment to supporting its debt, we could take negative rating action, potentially lowering GO, appropriation, and moral obligation debt by multiple notches. Furthermore, the possibility of potentially negative credit rating actions could extend beyond the current legislative session"

This reflects the potential outcome for the state.

What would the response to non-payment be by rating agencies, the market, and other entities?

- There is also a recent case study to supplement the examples in RIPEC’s 2013 report.
- In February 2014, a municipality called Lombard, Illinois, lost its investment grade rating for failing to honor its appropriation commitment on $190.0 million in borrowing. S&P downgraded the suburb’s issuer credit rating six notches from BBB to B.
- A review of the fiscal challenges in Detroit has indicated a spillover impact to other communities in Michigan.

What aspects of the potential impact of defaulting are quantifiable, and which are non-quantifiable?

Quantifiable:

- Defaulting would result in a credit downgrade by rating agencies, which would result in an increased cost of borrowing for the state.
  - However, the extent of this downgrade, and the ripple effect into other types of debt, can not be fully determined.

Less-quantifiable impacts include:

- Risk to state credit and reputation across all types of debt (general obligation, appropriation, or moral obligation).
- Risk to other Rhode Island entities' ability to borrow (municipalities and other state-related agencies).
- Risk to portfolios of those holding Rhode Island outstanding debt.
- Risk to demand for investment in the state's debt.

Other consequences

- State's image
  - We will be known as the only state to default since 1933
  - We will be known as the state that willfully decided not to pay its obligations
- State's willingness to pay other obligations will be questioned
- Corporate reaction to non payment?
- What does it say about the state?
  - Willingness
- Low interest rate environment
- Others

What would be the potential fiscal impact of default?

- There is the potential for a credit downgrade by the rating agencies, and, therefore, an increase in the interest rate paid to bondholders.

- This increased cost of borrowing could affect not only the loan guarantees in question—but any debt subject to appropriation or appropriation supported debt offered by issuers including the state, municipal government and others.

- This potential increased cost has been analyzed in two different studies: one conducted by RIPEC in June 2013, and one conducted by the Rhode Island Office of Management and Budget (OMB), also in June 2013. Both reports model costs associated with potential interest rate changes. There is also an upcoming study by SJ Advisors, a private firm hired by the state, to analyze repayment.

- Both models focus on appropriation and general obligation bonds.

What would be the potential fiscal impact of default?

- The OMB conducted a best-case, mid-range, and maximum impact scenario, based on potential differences in basis point changes.
- The best-case scenario suggests the increase in interest costs would be approximately $26.3 million over ten years or $84.7 million over 20 years.
- The mid-range, multi-notch credit downgrade scenario they presented, suggests an estimated cost of $52.7 million over ten years or nearly $170.6 million over 20 years.
- Worst case scenarios could result in a cost of $80.2 million over ten years or nearly $260.4 million over 20 years.

RIPEC Fiscal Analysis

Model Assumptions

- The RIPEC Model included the following assumptions:
  - Bonds issued each year for 10 years
  - Bond amount based on RI average over recent years
  - 20 year bond repayment
  - 2 payments per year
  - Level debt service (each payment is roughly the same)
  - Interest rate increases based on yield spread between different credit ratings
  - Rating downgrades are the same for General Obligation and Appropriation Bonds

Possible Scenarios

- Scenario 1:
  - RI General Obligation Bonds downgraded by 1 notch (interest rate increases by 56 basis points)
  - RI Appropriation Bonds downgraded by 1 notch (interest rate increases by 56 basis points)
- Scenario 2:
  - RI GO Bonds downgraded by 2 notches (interest rate increases by 112 basis points)
  - RI Appropriation Bonds downgraded by 2 notches (interest rate increases 112 basis points)
- Additional Impacts:
  - RI Historic Tax Credit bonds downgraded by 1 notch (interest rate increases by 56 basis points)
  - RI Historic Tax Credit bonds downgraded by 2 notches (interest rate increases 112 basis points)

Scenario 1 - One Notch Downgrade

Option 1 - General Obligation Bonds (1 notch downgrade - 56 basis point increase)

Loan Terms		Loan Costs	
Loan amount	$ 100,000,000	Total Payment	$ 1,058,369,118
Annual interest rate	0.56%	Principal	$ 999,926,116
Loan period in years	20	Total Interest	$ 58,443,003
Number of payments per year	2	Ten Year Cost	$ 26,001,234
Start date of loan	07/01/14	**Total Cumulative Interest (29 years)**	**$ 58,443,003**

Option 1 - Appropriation Bonds (1 notch downgrade - 56 basis point increase)

Loan Terms		Loan Costs	
Loan amount	$ 40,000,000	Total Payment	$ 42,334,765
Annual interest rate	0.56%	Principal	$ 39,997,045
Loan period in years	20	Total Interest	$ 2,337,720
Number of payments per year	2	Ten Year Cost	$ 10,400,494
Start date of loan	07/01/14	**Total Cumulative Interest (29 years)**	**$ 23,377,201**

10 Year Cost: 36,401,728 ; Overall Cost: 81,820,204

Scenario 2 - Two Notch Downgrade

Option 2- General Obligation Bonds (2 notch downgrade - 112 basis point increase)

Loan Terms		Loan Costs	
Loan amount	$ 100,000,000	Total Payment	$ 111,880,782
Annual interest rate	1.12%	Principal	$ 99,984,422
Loan period in years	20	Total Interest	$ 11,896,360
Number of payments per year	2	Ten Year Cost	$ 52,405,274
Start date of loan	07/01/14	**Total Cumulative Interest (29 years)**	**$ 118,963,600**

Option 2- Appropriation Bonds (2 notch downgrade - 112 basis point increase)

Loan Terms		Loan Costs	
Loan amount	$ 40,000,000	Total Payment	$ 44,752,313
Annual interest rate	1.12%	Principal	$ 39,993,769
Loan period in years	20	Total Interest	$ 4,758,544
Number of payments per year	2	Ten Year Cost	$ 20,962,110
Start date of loan	07/01/14	**Total Cumulative Interest (29 years)**	**$ 47,585,440**

10 Year Cost: $73,367,384 ; Overall Cost: $166,549,040

Additional Impacts – Historic Tax Credits

Historic Tax Credit Bonds (1 notch downgrade - 56 basis points)

Loan Terms		Loan Costs	
Loan amount	$ 150,000,000	Total Payment	$ 157,696,999
Annual interest rate	0.56%	Principal	$ 148,988,991
Loan period in years	20	Total Interest	$ 8,708,007
Number of payments per year	2	Ten Year Cost	$ 38,741,839
Start date of loan	07/01/14	**Total Cumulative Interest (29 years)**	**$ 8,708,007**

Historic Tax Credit Bonds (2 notch downgrade - 112 basis points)

Loan Terms		Loan Costs	
Loan amount	$ 150,000,000	Total Payment	$ 166,702,365
Annual interest rate	1.12%	Principal	$ 148,976,788
Loan period in years	20	Total Interest	$ 17,725,576
Number of payments per year	2	Ten Year Cost	$ 78,083,858
Start date of loan	07/01/14	**Total Cumulative Interest (29 years)**	**$ 17,725,576**

Overall Cost: $8,708,007 or 17,725,576

Potential other bond issues

- There are various other debt issuers that could be impacted by a rating reduction for the State:
  - School Construction
    - Reauthorization of state support of school construction with state appropriations pledge
  - Commerce Corporation asset backed loan program
  - Quasi-state agency debt
  - Refunding opportunities
  - Municipal Debt

Capital needs for the state

Governor's Recommended FY 2015 Capital Project Funding by Source ($ Millions)

Expenditures by Source	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	Total
Federal Funds	$ 363.2	$ 278.4	$ 243.6	$ 243.4	$ 217.3	$ 1,345.9
Rhode Island Capital Plan (RICAP)	152.3	125.1	110.0	97.4	88.0	572.8
General Revenue	1.6	1.6	1.0	1.0	1.0	6.3
Restricted Receipts	3.1	8.6	3.4	0.3	0.3	15.8
General Obligation Bonds	102.0	123.7	108.8	112.7	130.7	577.9
Revenue Bonds	39.9	38.9	38.4	37.4	36.9	191.4
Revolved Capitalization Grants	16.6	17.6	18.1	19.2	19.7	91.1
Certificates of Participation	40.2	25.2	15.0	-	-	80.4
RI Health & Educational Building Corp.	12.2	5.9	22.6	37.4	62.2	140.3
Land Sale Revenue	21.3	9.6	8.4	1.0	1.0	41.3
Grant Anticipation Revenue Vehicle (GARVEE)	6.8	4.1	-	-	-	10.8
Private Funding	1.0	0.5	-	0.2	2.5	4.2
Other	115.7	147.6	116.9	114.6	184.9	679.7
Totals	**$ 875.8**	**$ 786.8**	**$ 686.2**	**$ 664.5**	**$ 744.5**	**$ 3,757.8**

SOURCE: State budget documents; RIPEC calculations

Summary

- This is a question of impact to the state and not about how we may have gotten here.
- Image
  - The only state to default based upon willingness
  - Why is that?
- Rating reduction
  - We will receive downgrades of our bond rating
  - To what extent ?
  - S&P said in 2011 it would be no higher than a B
- Cost
  - There will be a cost associated with the non payment
  - We believe that it will exceed the cost of the debt.
- Is this what we want to be known for?

Conclusion

- Questions
  - And would like to be able to respond if anyone has any questions

- Will submit written testimony to the committee after the state’s commissioned study has been submitted and we have had a chance to review.

Appendix

Appendix – Definition of Bonds

Definition of Bonds by Type

Bond Type	Definition	In Event of Default
General Obligation	Bond secured by the full faith and credit of an issuer with taxing power	Bond holders have right to compel a tax levy or legislative appropriation to satisfy issuer's obligation
Moral Obligation	Bond secured by revenues from the financed project, and a non-binding undertaking that any deficiency in pledged revenues will be reported to the state legislature, which may apportion state moneys to make up the shortfall	Legislation authorizing the issuance of moral obligation bonds typically grants the state legislature the authority to apportion money to support the debt service payments, but does not legally obligate the legislature to do so
Appropriation	Broadly, bond relying on an appropriation from the state legislature for security	Depends on the more specific bond type
Revenue	Bond payable from a specific source of revenue, and to which the full faith and credit of an issuer with taxing power is not pledged; generally, no voter approval is required	Depends on source of pledged revenue

SOURCE: Governor's Proposed FY 2015 Capital Budget

Appendix – Credit Ratings Summary

Table 7
Long-Term Credit Ratings by Agency

Moody's	S&P	Fitch	Categorization
Aaa	AAA	AAA	Prime
Aa1	AA+	AA+	High grade
Aa2	**AA**	**AA**	
Aa3	AA-	AA-	
A1	A+	A+	Upper medium grade
A2	A	A	
A3	A-	A-	
Baa1	BBB+	BBB+	Lower medium grade
Baa2	BBB	BBB	
Baa3	BBB-	BBB-	
Ba1	BB+	BB+	Non-investment grade speculative
Ba2	BB	BB	
Ba3	BB-	BB-	
B1	B+	B+	Highly speculative
B2	B	B	
B3	B-	B-	
Caa1	CCC+		Substantial risks
Caa2	CCC+	CCC	Extremely speculative
Caa3	CCC-		Default imminent with little prospect for recovery
	CC		
Ca			
	C		
C		DDD	
-	D	DDD	In default
-		DDD	

Appendix – RI Credit Ratings

Table 8

Rhode Island Credit Ratings - General Obligation Debt

Agency	2009	2010	2011	2012	2013
Moody's	Aa3 (negative)	Aa2 (stable)	Aa2 (stable)	Aa2 (negative)	Aa2 (negative)
Fitch	AA- (negative)	AA (negative)	AA- (stable)	AA (stable)	AA (stable)
Standard and Poor's	AA (stable)	AA (negative)	AA (negative)	AA (stable)	AA (stable)

SOURCE: Office of the Rhode Island General Treasurer