CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

DEBT LINE Off Prints

California Debt And Investment Advisory Commission
Philip Angelides, Chair

Volume 20, No. 1 **January 2001**

MUNICIPAL FINANCE OUTLOOK FOR 2001

Mark Campbell
CDIAC, Policy Research Unit

At the close of each calendar year, the California Debt and Investment Advisory Commission (CDIAC) has asked a panel of advisors to help it forecast the state of the California municipal finance market. Their responses to this year's survey suggest crossing currents of change and stability for 2001. While the future promises to be different, as a consequence of technology, corporate mergers, economic and population growth, and a redistribution of wealth, it will also maintain some of its old character. The pent up demand for infrastructure and a backlog of approved projects will likely temper a decline in debt issuance in 2001 even though an economic slowdown threatens to roll back public debt financing.

Contributors to this year's survey included financial advisors, local government finance officers, investment consultants, bond counsels, trustees, and representatives from financial institutions. Their most oft-cited projections concerned 1) the effect of the economy on debt issuance; 2) local government issuance decisions; 3) the issuance process; 4) the nature of the municipal finance industry; and 5) public investments.

The Force of Economics

The Bond Market Association's Economic Outlook, subtitled "Soft Landing through 2001," predicts that while the economic expansion will continue, both inflation and unemployment will rise slowly during the coming year. The Gross Domestic Product is expected to drop from the 2000 level of 4.1% to 3.9% in 2001.

A slowing economy in the future foretells lower governmental revenues and either reduced growth or increased debt financing. As the economy slows communities will experience less pressure for development. Those communities that have experienced the greatest growth in the state, particularly those located in the Central Valley, will be able to focus resources on planning rather than project development. Conversely, a falling economy is likely to increase the need for basic services, such as welfare. The rising cost of these services combined with declining tax revenues may constrain cash flows and increase the need for interim financing.

The fortunes of local governments rise and fall with tax revenues. In a report before members of the League of California Cities, the Legislative Analyst's Office (LAO) recognized the state's healthy growth in General Fund revenues for fiscal year 1999-2000. Taxable sales growth rose from approximately 6% to nearly 15% of the state's General Fund revenues between first quarter of 1999 and the first quarter of 2000, but are expected to drop back to 10% by the end of 2000. The LAO projected state General Fund reserves in 2000-01 to be \$6.9 billion and in 2001-2002 to be \$10.3 billion.

Declining tax revenue for local governments threatens their ability to meet prior financial commitments paid from their General Funds. Those communities that underwrote substantial capital growth with debt financing during the "economic upswing" of the past several years may have to tighten their fiscal belts during a "downturn". Future debt issuance may be constrained as these communities wait for the good times to return.

Recent economic trends, including a sizeable "correction" in the equities market, suggest that the Federal Reserve Board may drop interest rates in the future. As an indication of pressures to do so, the equities markets plummeted after the Board failed to take action at its December 19th meeting. In anticipation of a drop in interest rates, issuers are preparing to refund their outstanding debt as a way to reduce debt service payments. Should rates remain constant, however, current rates may still offer many issuers significant refunding opportunities.

Interest rates can affect the timing of a deal, but they do not often influence the decision to issue new debt. Those communities with a backlog of projects may continue to press forward, but it is likely that they will re-examine these deals using new revenue and market projections.

What About Local Government Debt Issuance?

Debt issuance by local governments will remain a function of population growth in 2001. As a result, infrastructure development, including water, sewer, drainage, and roads, will remain leading purposes for the use of debt financing during the coming years. In addition, Proposition 1A and the recently approved Proposition 39 have revived local school construction plans just in time to address the critical need for more classrooms across the state. Proposition 1A, passed in 1998, provided for $9.2 billion in debt financing to upgrade or build classrooms for California colleges through kindergartens. Proposition 39 reduced the voter approval requirements under specified conditions for local school district General Obligation bonds from 66.67 percent to 55 percent.

Indeed, population pressures across the state have lead to greater voter involvement in many areas of local decision making, particularly in local land use. Voter initiatives in many regions of the state have imposed stricter growth limits than those imposed by local government officials. Indications are that the use of initiatives for all local purposes, including debt issuance and land use, will expand over the next several years, causing the Assembly Speaker Robert Hertzberg to focus on the process in the upcoming 2001 Legislative year.

The strong economy during the past 10 years has benefited a few communities with redevelopment districts who have been able to refinance outstanding debt as a result of rising tax increments. Depending on their prior debt issuance, refinancings enabled these communities to lower their rates and increase their investment in redevelopment projects. A slowing economy in the future will result in fewer tax allocation and tax increment bond financings, as the growth in property values and personal income slows.

At the same time, a decline in the economy in the future may reduce the number of industrial development financings that help communities expand their economies. Slower economic growth reduces the numbers of business that may otherwise borrow through industrial development bonds.

A slowing economy in the future also will begin to constrain residential development. As housing construction falls off, assessment and community facilities financings will decline. To lower the risk of future default, local governments will begin to scrutinize the viability of land-secured transactions more closely. Defaults put at risk the network of public services provided to the community since most of these services rely on the flow of payments from property owners. Communities will increasingly look to the services of professionals who can help assess the risk inherent in these transactions.

Demographic patterns may place an unexpected burden on local governments that finance public employee health care. The blip on the demographer's chart known as the "baby boomers" is reaching retirement age and soon the individuals who comprise that demographic set no longer will be contributing to their health care insurance through wage-related payments. As a result, local governments who finance employee health plans may be forced to draw down assets to cover health care services faster than the next generation of employees can contribute to sustain them. The shortfall in revenues for these programs may require local governments to finance retiree health care through debt.

Finally, an anomaly facing city and county government finance officers is the tobacco settlement whose flow of payments was intended to finance health care. As these payments materialize the struggle to define their use is being waged across the state. Most notable is the County of Orange where citizens and elected leaders contest the proportion of payments to be used to service the debt previously issued to extricate the county from its 1994 bankruptcy.

While several cities and counties have considered the benefits of securitizing these payments by issuing bonds serviced by payments from the tobacco companies, only a few have taken steps to do so. Most entities are still considering the settlement as "found money," that is, unexpected, windfall revenues. But, as these payments are built into a city or county's baseline budget year after year, that local government risks placing itself in the awkward position of having to depend upon the smoking habits of its citizens to fund essential services.

Securitization of tobacco settlement payments transfers the risk in the flow of tobacco payments from the local government to the investors. The complexity of the settlements would suggest that investors are more likely to understand the nature of this risk than are public entities. Those cities and counties that do consider securitization should start by answering several questions. First, is it prudent for the city or county to rely on tobacco payments as a source of revenue? What risk is inherent in depending upon this source for certain types of programs? Second, is it appropriate for the city or county to continue to receive a source of revenue that is tied to smoking? Do the citizens of the community have concerns about this source of funding? What limits do these concerns place on the community's fiscal policies? Third, what is the cost of shifting the risk to a third party (investor) versus the benefits of retaining the risk and returns? Expressed another way, this question asks, what is the net present value of having a known amount of cash today versus receiving an uncertain amount through payments received over time?

Of Issuers and Issuance

From an issuer's perspective, 2001 may be characterized more by changes in the process of issuance than by the content and purpose of borrowing. Many public entities have found the ability to integrate general community information with bond documents on the Internet. The facility with which this medium serves to distribute and publicize information has created a storm of controversy over the preliminary and continuing disclosure obligations of public debt issuers. These discussions have, for the most part, centered on interpreting the Securities and Exchange Commission's (SEC) Rule 10b-5 and 15c2-12 in the context of this new technology.

Public entities are also using the Internet to trade their municipal securities. The Internet, they hope, will allow them to secure lower rates and improved liquidity. That very possibility has germinated scores of Internet service providers drawn by the prospect of trading via the Internet the roughly 1.4 million municipal securities in place today.

The uncertainty surrounding the disclosure obligations of issuers who use the Internet in the issuance of their debt, the rate of change among Internet technologies, and the opportunism of Internet entrepreneurs makes it hard to standardize practices. In the absence of consensus, most issuers are taking a cautious approach to the use of the Internet.

The Internet and rising personal wealth have brought municipal securities closer to more Californians. More and more of them are seeking out the security offered by the fixed-income market. As these individuals age and the risks inherent to the equities market becomes less tolerable, the shift to municipals is likely to increase.

A growth in sales to these so-called "retail" investors demands that issuers be more diligent in disclosing the conditions of their deals and their continuing financial status. Issuers must recognize that retail investors may be assuming double-digit returns based upon their prior experiences in the equities markets. The inexperience of these investors with municipal securities exposes them to greater risk and suggests an increased need for investor education such as that offered by CDIAC and the securities industry, itself.

Indications that the economy may slow during 2001 warrant a continued emphasis on issuer disclosure. A slowing economy in the future will likely constrain personal and governmental revenues, limiting debt issuance and tightening debt service margins already built into current and future year budgets. Investors must be made aware of these changing conditions and their effect upon an issuer's debt repayment.

Since the Internet has improved access for many retail investors to the municipal securities markets in the same way it has to the corporate market, public issuers must begin to ask whether their disclosures should more approximate the disclosures made by corporations. The advances made in public financial reporting systems as a consequence of "Y2K-related" expenditures now make it possible for many municipal entities to provide "real-time" financial reports.

Finally, two notes on the status of particular debt issues. With respect to the newly restructured electricity market in California, municipal utilities face rising disaffection in the competitive marketplace because of their access to tax-exempt debt. But even as municipal utilities take steps to strengthen their financial positions prior to entering a competitive energy market, the state's efforts to restructure that market are unraveling. Today, both state and federal officials are re-examining the appropriate mix of regulation and free-market investment needed to create a stable and secure energy future for California.

The second note concerns the increasing interest being paid to variable rate debt in the municipal market. To diversify their balance sheets, many issuers have either introduced or increased their share of variable rate bonds in their portfolios. Historically, variable rate bonds have had lower interest rates than fixed rate bonds, but expose issuers to interest rate risk. If issuers decide to evaluate the use of variable rate bonds, they should consider their asset-liability mix, risk tolerance, and ability to administer these forms of debt.

The People That Make it Possible

Behind the curtain of public finance are the many professionals who provide the services and skills that make nearly all public debt transactions possible. For them, the world will change as a consequence of the Internet, corporate mergers, and the opportunities provided by new types of securities.

The Internet has offered many service providers the chance to expand their services through growth and systems integration. The outcome is expected to be increased efficiency as these organizations begin to provide ancillary services through strategic alliances with other providers. Much like the system used by managed health care, selected providers may become a point of access through which an issuer can receive a full spectrum of technical and advisory services.

As the market becomes more refined, service providers will seek to define themselves better. In many cases this will lead to the acquisition of a competitor who possesses the expertise or relationships needed to specialize.

The contraction of the market as a result of corporate mergers will lead many providers to reassess their commitment to specialty services. Upon consideration, some service providers may decide to focus on a particular type of service only if they possess the technical capacity and expertise needed to perform well. In a relationship-driven industry such as public finance, those without the necessary and sufficient resources needed to offer continuity and performance over time are likely to disappear. Declining numbers of providers is also likely to change the structure of the marketplace. Fewer underwriters, for example, may shift the balance towards negotiated transactions and away from a competitive structure.

Coincidentally, the lines between underwriters and financial advisors are becoming increasingly blurred. In response to such changes, the SEC has taken steps to require individuals giving advice on a security, whether or not the advisor receives payment for services rendered, to be registered with the state or the SEC. According to this approach, an unregistered financial advisor who has maintained a long-term relationship with an issuer would no longer be able to suggest investment options, forcing the issuer to form a second, independent relationship or make the decision in-house.

And Now Investments

The year 2001 also will bring changes for those concerned with public fund investments. As a result of higher than anticipated governmental revenues, the volume of 5-year and shorter term U.S. Treasuries likely will decline. Public entities that have previously invested in U.S. Treasuries may have to seek out alternatives. Doing so will require that they establish a market value for these alternative investments with an eye towards the increased risk these securities may involve.

As the supply of Treasuries decreases, yields will decrease and prices will increase. The technical relationship between Treasuries and other sectors of the market, particularly the use of Treasuries for indexing purposes, will change as a result. This will require investors to rethink the use of the U.S. Treasury as a benchmark and, potentially, to supplant it with another instrument.

One alternative to U.S. Treasuries is federal agency securities, such as Fannie Maes or Federal Home Loan Banks. The level of debt issuance by these agencies has been rising in recent years. But increased issuance has been coupled with a rising concern among federal lawmakers over consumer protection. The pressure to regulate these securities, however, seems to be abating.

Finally, if the market continues to slow and the yields on corporate bonds increase, interest in these securities among public investors may increase in turn. But as the economy slows, the default risk associated with corporate securities rises. Although most public entities do not invest in corporate bonds for this reason, those that do will need to be more concerned with the credit quality of corporate bonds and be more adept at tracking changes in the economy and in corporate performances.

The author and CDIAC take full responsibility for the opinions made here. Both, however, wish to thank the contributors whose insights made this article possible.

This Offprint was previously published in DEBT LINE, a monthly publication of the California Debt and Investment Advisory Commission (CDIAC). CDIAC was created in 1981 to provide information, education, and technical assistance on public debt and investment to state and local public officials and public finance officers. DEBT LINE serves as a vehicle to reach CDIAC's constituents, providing news and information pertaining to the California municipal finance market. In addition to topical articles, DEBT LINE contains a listing of the proposed and final sales of public debt provided to CDIAC pursuant to Section 8855(g) of the California Government Code. Questions concerning the Commission should be directed to CDIAC at (916) 653-3269 or, by e-mail, at cdiac@treasurer.ca.gov. For a full listing of CDIAC publications, please visit our website at http://www.treasurer.ca.gov/stocda.htm.