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Agreements and Ancillary Arrangements on General Obligation Debt and Operating Notes (Building Commission)

[LFB 2003-05 Budget Summary: Page 90, #7]

CURRENT LAW

The Building Commission has the authority to issue general and revenue obligation debt on behalf of the state. The Commission can enter into certain agreements and ancillary arrangements relating to issuance of state general obligation debt and operating notes.

GOVERNOR

Authorize the Building Commission to determine whether any payments received or paid on agreements or ancillary arrangements relating to public debt would be deposited into, or made from, the bond security redemption fund (BSRF) or the capital improvement fund (CIF). Require that the Commission make this determination when the Commission contracts for any such agreement or ancillary arrangements. Specify that the Commission, in making payment from these funds, would also have the authority to determine the timing of any transfer of funds.

Provide that monies received from the issuance of public debt or payments from any agreement or ancillary arrangement relating to public debt would be deposited in the CIF, except as follows: (a) any monies representing accrued interest or that are for funding or refunding bonds would be credited to the BSRF or the building trust fund; and (b) any monies that represent a premium or that are from an agreement or ancillary arrangement relating to public debt could be credited to the BSRF or the CIF, as determined by the Building Commission. Under current law, monies received from the issuance of public debt are deposited in the CIF, except that any monies representing a premium or accrued interest or that are for funding or refunding bonds are credited to the BSRF or the building trust fund.

Authorize expenditures from the CIF for any payment due under an agreement or ancillary arrangement with respect to public debt and modify current law governing the transfer of the proceeds of public debt to the CIF to pay loans or notes, to also apply to these payments.

Modify current law governing expenditures from the BSRF to add payments due under an agreement or ancillary arrangement as an allowable purpose. Under current law, the BSRF is used to pay principal, interest and premium, if any, on public debt. Related provisions concerning debt service appropriations and the BSRF would be modified to reflect this additional spending purpose.

Delete the current law limitation that an interest exchange agreement is not considered public debt of the state.

Modifications to Operating Note Obligations. Delete current law references that specify that the Building Commission's authority to enter into agreements and ancillary arrangements for public debt applies to operating notes. Instead, create similar authority under the statutes governing operating notes, except specify that the Commission would have that authority at the time of, or in anticipation of, and after issuing operating notes. Delete the Building Commission's specific authority to purchase insurance on operating notes, which, under SB 44, could be purchased as part of an agreement or ancillary arrangement.

In addition, specify that any payment made or received under such agreements or arrangements would be made from, or deposited to, the general fund or the operating note redemption fund, as determined by the Commission.

Specify that all moneys resulting from payments to be received under an agreement or ancillary arrangement regarding operating notes would be credited to the general fund. Authorize the operating note redemption fund to make payments due on an agreement or ancillary arrangement entered into with respect to operating notes. Specify that the payments due under these agreements or arrangements with respect to operating notes would be an allowable purpose for which funds could be transferred from the GPR sum sufficient appropriation for debt service on operating notes to the operating note redemption fund.

DOA Capital Finance officials estimate that the state could receive $4.5 million in 2003-04 associated with these agreements. These amounts would be applied to GPR debt service appropriations, and would be treated as a GPR-Lapse under SB 44.

DISCUSSION POINTS

1. Since 1969, the Building Commission has been authorized to issue state debt, including the refunding of such debt for refinancing purposes. Each bond issue involves a series of bonds with specific rates and maturities. Some of the state's bonds are callable on the part of the state, which means that if the state can borrow at a lower rate than rates on outstanding callable bonds, the state can pay off the outstanding callable bonds and reissue the debt at the lower rates. Other state bond issues cannot be called, which makes refinancing those bonds more difficult.

2. The refinancing or refunding of debt is a debt management tool that can be used to replace an existing stream of debt service payments with an alternative stream of payments. Typically, the new stream of debt service payments is designed to reduce the interest costs on the outstanding debt by taking advantage of lower current interest rates.

3. Generally, in refinancing state debt, the state issues new general obligation bonds (the refunding bonds) and uses the proceeds of that bond issue for payments on outstanding debt (the refunded bonds). This refunding approach generally involves bonds that are callable, which means that the state has the right pay the bonds off prior to their maturity date. An example of this type of refunding could involve the state calling certain bonds issues that carry rates of 5.25%, and issue replacement bonds that carry rates of 4.0%. An analysis that compares the cash flows under this transaction would likely result in interest cost savings to the state. Generally, if the present value of the savings from a potential refunding exceeds 3% of the amount to be refunded, the state will carry out the refunding.

4. Another way the state currently refunds state debt is through advanced refundings, which typically involve non-callable bonds. Under this type of refunding transaction, a separate set of bonds are issued at rates that are lower than the rates on the existing bonds that are being advance refunded. The proceeds of these bonds are placed in investments within an escrow account, from which the principal and interest payments on the existing non-callable bonds are made. The state then repays the lower cost bonds, which results in interest costs savings to the state. However, federal tax law allows only one advanced refunding of tax exempt bond issues.

5. According to DOA Capital Finance officials, the proposed modifications relating to agreements on state debt would allow the state to take advantage of low market interest rates, with respect to state bond issues with higher interest rates that cannot called or advanced refunded at this time. Because such bonds cannot be currently called or directly refinanced, the state cannot take advantage of the potential interest cost savings associated with the lower current market interest rates. DOA Capital Finance officials believe that the financing mechanisms that would be allowed under SB 44 would allow the state to capture such interest rate savings.

6. Interest rate swap and other hedging products are financing mechanisms that involve the exchange of interest payments on a specified principal amount. Often these swaps involve two parties exchanging a fixed rate payment on a specified principal amount with a variable rate payment on that same amount. No principal amounts of debt are exchanged, rather only the interest payments on the specified principal amounts are exchanged. These mechanisms effectively allow issuers to refinance principal amounts to take advantage of potentially lower rates without calling in existing debt and reissuing those amounts at lower rates.

7. The market for swaps, derivatives and hedging products is a relatively new financial market. Its origin dates back to the early 1980's. Since then, it has grown to a significant financial market for both private and public debt issuers. While the use of these mechanisms is widely prevalent among private issuers, governmental units have become involved in the swap market as a method to refinance debt or hedge against changes in interest rates on fixed and variable rate debt.

8. The following example illustrates a potential agreement. Under the example, it is assumed that the state issued $200 million in bonds in 2000, with bonds maturing each year from 2001 through 2020. Of the $200 million issued, it is assumed that the $100 million in bonds due between 2001 and 2010 cannot be called or advance refunded, while the remaining $100 million in bonds due between 2011 and 2020 could be called beginning in 2011, but cannot be advance refunded. In 2003, interest rates on long-term bonds have been significantly below the rates on the outstanding state bonds, which means that there are interest savings available, if the state could refund these bonds. However, under current law, because the bonds due between 2003 and 2010 cannot be called or advance refunded, the state would not be able to refinance the bonds to take advantage of lower rates until 2011, when the bonds maturing beyond that date could be called.

9. Under the proposed modification included in SB 44, the state could enter into an agreement in 2003 and receive an up-front payment from the counterparty to the agreement. In exchange the counterparty receives the future right to compel the state to call the $100 million in callable portion of the $200 million bond issue in 2011. If the counterparty exercises the right, the state would issue refunding bonds in 2011 to pay off the $100 million in bonds that are called. The type of rate on the refunding bonds could be a fixed rate or a variable rate, whichever is indicated in the agreement. For this example, it is assumed that variable rate refunding bonds are issued. The repayment structure on the refunding bonds would mirror the structure on the callable bonds being refunded. The state would pay the principal due each year on the refunding bonds. However, under the agreement, the counterparty would make the variable rate interest payments to holders of state's refunding bonds, which would be lower than the rate on the original bonds. Conversely, the state would make annual interest payments to the counterparty at the higher fixed rates that existed on the callable bonds. The annual amount of the state's interest payment to counterparty would equal the rate that had existed on the original callable bonds times the annual outstanding (notional) principal amounts that would have existed each year on the original callable bonds from 2011-2020.

10. Under this example, because long-term rates fell in 2003 relative to the rates on the state's $200 million bond issue, the state could capture some of the interest costs savings resulting from these lower rates through the payment received under the agreement. In this example, a counterparty, interested in holding a long-term obligation, and hoping to make money on the difference between the fixed rate on the state's bonds and future variable rates, is willing to pay the state for the right receive fixed rate payments in the future (from 2011 through 2020).

11. Typically, the state's debt obligations have been entered into to fund capital projects and other improvements for the state and local governments and to make state land purchases. Under the proposed modifications, the state would be acting as a financial investor by entering into agreement that would be ancillary to the state bond issue in an attempt to make money off the potential differences in market interest rates associated with short, variable and long term debt. This would be a new area of activity for the Building Commission, as it would be given the authority to enter into agreements for the sole purpose of trying to gain financial advantage from differences in market interest rates. In addition, under SB 44, the Commission would be authorized to make expenditures from the state's GPR sum sufficient debt service appropriations for payments required under these agreements. As a result, the proposal in SB 44 would represent a significant expansion of authority for the administration and the Building Commission.

12. The financing mechanisms that would be allowed under the modifications contained in SB 44 would involve various risks. One of the primary risks associated with these agreements would be interest rate risk. Because these agreements are designed to take advantage of interest rate differences, if the assumptions used in entering into an agreement are not sound or if unforeseen changes in interest rates occur, the state could incur additional interest costs or other payments associated with these transactions. For example, if long-term rates fall below the assumed rates that went into pricing the value of an agreement, the state could end up paying higher interest costs under the agreement than would have been paid if the state had retained the right to refund the bond at these lower rates.

13. DOA Capital Finance officials contend that if such mechanisms are not available to the state, the state is forgoing the opportunity to realize savings attributable to its non-callable debt due to lower market interest rates. Further, they indicate that the risk associated with entering into an agreement that may result in the state paying above market rates in the future is no different than the risk the state takes on associated with any non-callable bond issue or refunding issue entered into by the state. Such bonds issues also lock the state into paying a fixed rate in the future that may exceed future market rates.

14. These agreements also carry risk known as termination risk. This risk involves the potential that a party may terminate an agreement prior to its scheduled end date. There is also a risk that early termination of an agreement could result in costs to the various parties of the agreement. Agreements can contain various legal and financial reasons for termination such as bankruptcy or default on the part of one party to the agreement. These agreements may also contain other triggers that could result in the agreement being voluntarily terminated by one party to the agreement who holds a positive position under the agreement. As mentioned earlier, depending on where market rates are compared to rates contained in the agreement, the state could unexpectedly be required to make a lump sum termination payment on these agreements, which could be significant.

15. Other risks include counterparty risk, which is the risk that a counterparty will not honor its obligations as specified in the contract. Such risks can be intertwined with termination risk evaluations. Generally bond rating agencies expect rated borrowers to accept agreements only with counterparties that hold ratings that are at least as high as their own ratings.

16. Under the proposal, agreements, while generally associated with a "notional" principal amounts, would nonetheless be obligations that commit the state to make interest payments based on those amounts. However, unlike the state public debt, which is limited in amount by the Legislature and the State Constitution, the amount of obligations the state could enter into would not be limited under SB 44.

17. The success of the state in generating cost savings under these transactions would largely depend the state's ability to accurately price and establish the terms of these transactions. In doing so, the state would need access to the best information available on the interest markets at the time of the transaction. If the pricing of the transaction or the terms established under the transaction are not sound, the transaction could end up increasing interest costs to the state. While DOA Capital

Finance officials have shown expertise in making pricing decisions on, and in establishing the terms of, state bond issues for capital finance or other improvement projects, such expertise may not automatically transfer to swaps, derivatives and hedging products.

18. DOA Capital Finance officials indicate that they will hire independent firms to conduct a financial risk analysis of each transaction and assist the state in pricing and setting of terms of the agreement. Further, although the Building Commission and DOA Capital Finance would be administering the program, rating agencies would be aware of, and monitor the state's position on these agreements. Rating agency analysts would look at the state's obligations in total, including its overall variable and fixed rate exposure. Any changes in the state's creditworthiness standing associated with these agreements and its exposure to the different type of debt would be reflected in their analysis of the state.

19. To ensure that DOA obtains assistance in making pricing and other market determinations associated with agreements associated with state general obligation debt, the Committee could require such agreements be subject to an independent finding that its terms and conditions reflect a fair market value of such agreement as of the date of its execution.

20. Financial consulting firms specializing in these agreements as well as bond rating agency analyses of parties to such agreements have also noted that such agreements require a high level of monitoring and tracking. They suggest that the state's interest position on such agreements should be constantly measured against the state's interest position on the underlying bond issue that is the basis for the notional principal amount under the agreement. In addition, accounting steps should be taken to ensure that a specific notional principal amount that is the basis of an agreement remains matched to the principal amount on the underlying bond issue, so the state can monitor its interest position on the agreement. The state would want to avoid a situation where it has several outstanding agreements that can no longer be tied to, or measured against, specific bond issues. Similarly, the state would want avoid having to pay on an agreement associated with a bond issue, after the principal on the bonds has been retired.

21. The proposed modifications to state debt obligations included under SB 44 would provide the DOA staff and the Building Commission with broad authority to enter into agreements associated with the state's debt obligations. As mentioned, the state would have certain risks associated with these agreements. Therefore, if the authority to enter into these agreements is provided, the state may want to establish some parameters for the program that could limit the state's risk.

22. Recently the State of New York provided entities that issue bonds in New York the authority to enter into agreements similar to those that would be allowed under SB 44. However, in order to potentially mitigate some of the risks mentioned earlier, the New York Legislature placed certain limitations on such agreements. The following points identify some potential limitations the Committee may want to consider, which are similar in nature to those included in the New York legislation.

23. To place some limits on the size of the program and to the address the issue of

legislative oversight over the amount of such obligations that could be entered into by the state, the Committee could limit the total notional amounts contracted for under such agreements or arrangements to no more than 20% of the state's outstanding general obligation debt, including its commercial paper program, at the time the agreement or arrangement is entered into. Further, to ensure that the State is properly monitoring these transactions, the Committee could require that no agreement would be allowed to have a notional principal amount with a maturity exceeding the maturity of the related general obligation debt and that the authorizing resolution for any agreement be required to identify the underlying general obligation bonds on which the agreement is based. Such provisions would limit the total contractual obligations the state would be exposed to with regard to under these agreement and would help ensure that the maturities on the state's debt obligations and related agreements associated with that debt remain matched.

24. In order to provide further disclosure of the state's position on these agreements to the Legislature, DOA could be required to issue a semi-annual report to the Building Commission and the Co-chairs of the Joint Finance Committee for any year the state continues to be a party to a contract on an agreement, that lists all such contracts. The report could be required to include the following: (a) a description of the contract, including a summary of the terms and conditions, rates, maturity, and the estimated market value of each agreement, and other provisions; (b) any amounts which were required to be paid and received on the contract; (c) any credit enhancement, liquidity facility, or reserves, including an accounting of all such costs and expenses incurred; (d) descriptions of each counterparty; and (e) an assessment of the counterparty risk, the termination risk, and other risks associated with each agreement. Such a report would keep the Legislature apprised of the extent of the use of agreements and of the benefits and risks associated with the program.

25. To address any counterparty risk associated with such agreements, the state could require that any counterparty to such agreement could not have a credit rating from any nationally recognized statistical rating agency that is lower than the state's rating on its general obligation debt at the time of the agreement. In addition, similar to the New York legislation, in the event a counterparty to the state on an agreement is downgraded below the required rating position while the transaction remains active, the Committee could require that the counterparty to the agreement be collateralized with United State Treasury investments. Specifically, the Committee could require that the counterparty be collateralized for the remainder of the agreement, or until the counterparty is upgraded to an allowable rating, in an amount equal to 50% of the net market value of the agreement with the state at the time the downgrade occurs. Any collateral amounts could be deposited with the state, or a trustee of the state.

26. As mentioned earlier, rating agency and industry analysts indicate that developing a debt management system for tracking debt obligations and any ancillary agreements is important. In providing borrowing agencies the authority to enter into agreements, the State of New York required that the issuing authority put in place the guidelines for the program that would include: (a) the conditions under which such contracts can be entered into; (b) the methods by which such contracts are to be solicited and procured; (c) the form and content such contracts shall take; (d) the aspects of risk exposure associated with such contracts; (e) the standards and procedures for counterparty selection; (f) the standards for the procurement of credit enhancement, liquidity

facilities, or the setting aside of reserves in connection with such contracts; (g) provisions for collateralization or other requirements for securing the financial interest in such contracts; (h) the long-term implications associated with entering into such agreements, such as costs of borrowing, historical trends, use of capacity for variable rate bonds and related credit enhancements, and any potential impact on the future ability to call bonds, including opportunities to refund related debt obligations, and similar considerations; (i) the methods to be used to reflect such contracts in the state's financial statements; and (j) a system for financial monitoring and periodic assessment of such contracts. Similarly, the Committee could require the Building Commission to adopt such guidelines prior to authorizing the approval of any contract for any agreement or ancillary arrangement relating to the state's general obligation debt.

27. DOA and the Building Commission would likely develop reporting requirements and safeguards for the proposed program. However, placing specific requirements in statute will provide the Legislature and the public with the assurance that these requirements are in place.

ALTERNATIVES

1. Approve the Governor's recommendation to authorize the Building Commission to determine whether any payments received or paid on agreements or ancillary arrangements relating to public debt would be deposited into, or made from, the bond security redemption fund or the capital improvement fund. Require that the Commission make this determination when the Commission contracts for any such agreement or ancillary arrangements. Specify that the Commission, in making payment from these funds, would also have the authority to determine the timing of any transfer of funds. Provide the Building Commission with the necessary authority included under the Governor's recommendations to carry out these arrangements and agreements related to state general obligation and operating note debt. Estimate lapses from GPR sum sufficient debt service appropriations of $4,500,000 in 2003-04 associated with the sale of these agreements or arrangements.

2. Approve the Governor's recommendation, as modified by the following provisions:

a. Require that any agreement or ancillary arrangement related to state general obligation debt be subject to an independent finding that its terms and conditions reflect a fair market value of such an agreement, as of the date of its execution;

b. Limit the total notional amounts contracted for under such agreements or arrangements to no more than 20% of the state's outstanding general obligation debt, including its commercial paper program, at the time the agreement or arrangement is entered into;

c. Require that no agreement would be allowed to have a notional principal amount with a maturity exceeding the maturity of the related general obligation debt on which that amount is based and that the authorizing resolution for any agreement be required to identify the related general obligation debt on which the agreement is based;

d. Require DOA to issue a semi-annual report to the Building Commission and the Co-

chairs of the Joint Finance Committee, for any year the state continues to be a party to a contract on an agreement or ancillary arrangement related to state debt, that lists all such contracts. Require that the report contain the following: (1) a description of the contract, including a summary of the terms and conditions, rates, maturity, and the estimated market value of each agreement, and other agreement provisions; (2) any amounts which were required to be paid and received on the contract; (3) any credit enhancement, liquidity facility, or reserves, including an accounting of all such costs and expenses incurred; (4) descriptions of each counterparty; and (5) an assessment of the counterparty risk, the termination risk, and other risks associated with each agreement;

e. Require that any counterparty to an agreement or ancillary arrangement related to state debt could not have a credit rating from at least one nationally recognized rating agency that is lower than the state rating on its general obligation debt at the time of the agreement. Specify that in the event a counterparty to the state is downgraded below this required rating position while the agreement remains outstanding, the counterparty would be required to be collateralized with United State Treasury investments for the remainder of the agreement, or until the counterparty is upgraded to an allowable rating, in an amount equal to 50% of the net market value of the contract to state at the time the downgrade occurs. Further specify that any collateral amounts would be deposited with the state, or a trustee of the state; and

f. Require the Building Commission, prior to entering into any agreement or ancillary arrangements related to state debt, to put in place guidelines for such agreements that would include: (1) the conditions under which such contracts can be entered into; (2) the methods by which such contracts are to be solicited and procured; (3) the form and content such contracts shall take; (4) the aspects of risk exposure associated with such contracts; (5) the standards and procedures for counterparty selection; (6) standards for the procurement of credit enhancement, liquidity facilities, or the setting aside of reserves in connection with such contracts; (7) provisions for collateralization or other requirements for securing the financial interest in such contracts; (8) the long-term implications associated with entering into such agreements, such as costs of borrowing, historical trends, use of capacity for variable rate bonds and related credit enhancements, and any potential impact on the future ability to call bonds, including opportunities to refund related debt obligations, and similar considerations; (9) the methods to be used to reflect such contracts in the state's financial statements; and (10) a system for financial monitoring, and periodic assessment, of such contracts.

3. Delete provision.

Alternative 3	GPR-Lapse
2003-05 FUNDING (Change to Bill)	**-** $4,500,000

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