Ideas in Action

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Proposed Tobacco "Securitization" Legislation: Financing Options Should Retain Flexibility

by: Arnold Greenfield, Senior Research Fellow

Legislation is now pending as the Florida Legislative Session nears its end which if enacted, would authorize partial "securitization" of future tobacco settlement payments from certain members of the industry to the State. The author has reviewed this proposed legislation and certain other information made available to the legislative and executive branches of the State, as well as certain financings for this purpose already completed in other jurisdictions.

On the basis of this analysis and the experience of the author in the public, private and academic sectors relating to public finance, comments and recommendations have been developed for consideration in the drafting and implementing of this legislation.

Scope

For the purpose of this analysis, it has been assumed that Legislation in some form probably will be enacted. For the reasons set out below the author has also concluded that State action to "securitize" a portion of the future tobacco payments would be beneficial. Therefore, within the limited space and time available prior to final Legislative action, somewhat greater emphasis has been placed on how best to accomplish this objective, rather than on whether to do so. If the Legislature takes no action prior to adjournment, how to best effectuate the program will become moot.

It should also be noted in the spirit of full disclosure that the author is a retired officer of a major national investment banking firm; however, there has been no communication with my former firm about this subject. All analyses and recommendations within this article are my own, solely in my capacity with Florida TaxWatch, and do not necessarily represent the views of any other organization with which the author has been or is now affiliated.

Summary of Proposed Program

The proposal is for the State to create by Legislative Act a not-for-profit corporation to which the State would transfer an interest in a portion of the stream of revenues to be received under the Florida tobacco settlement. The corporation would sell revenue bonds not backed by the credit or taxing power of the State to be secured by this future strewn of revenues. The State would not be liable or responsible to bondholders for any shortfall of these revenues to provide for interest or principal payments on the bonds or in the event of bankruptcy of the corporation.

A portion of the risk of future non-payment of the revenues from the tobacco companies covered by the settlement agreement would thereby be transferred to the bondholders. The State would have available for current use (for legally authorized purposes) the net proceeds of the bonds paid to the State by the corporation, plus the amounts received from reinvestment of the proceeds (within legally permissible limits). Arrangements of this type are referred to as "securitization" transactions and are not uncommon in the financial world.

In economic terms, the future value of the stream of revenue is discounted to present value at the interest rate paid on the transactions. For this reason, a financing on tax exempt terms would net substantially more present value (cash on closing the bond loan), because such a loan at tax exempt interest rates would be about 200 basis points (2%) less costly than the same loan at taxable rates, and the discount to present value would be correspondingly less.

The State of Florida has done several "custody receipt" transactions which had some common characteristics with the currently proposed plan (Future streams of payments from local governments for pollution control loans were sold to investors.), so this type of arrangement is not radical or unprecedented for the State. Many securitization transactions have also been done in other States, including some involving similar tobacco revenues.

Legal Questions

State bonding transactions involve both Federal and State law questions. Federal law governs the tax treatment of the securities to be issued; that is, whether the interest on the bonds to be issued will be tax exempt or taxable to the bondholders and also the applicable "arbitrage" regulations governing reinvestment of the proceeds of the bonds. Within the limitations of Federal tax law and regulations, State law governs the manner and purpose for issuance of debt obligations in a given State (Federal law also regulates disclosure questions, but this area of law is outside the scope of this article.).

Therefore, Federal law is generally uniform throughout the country, but State law varies within jurisdictions. Each State Legislature has significant latitude regarding the purposes and methods for issuing debt obligations within their jurisdiction. In order to qualify for tax exempt treatment under Federal law, State bonding authorization must be consistent with Federal law; but there is a wide decree of discretion for each State within the Federal tax law limits. A State may also elect to authorize the issuance of bonds on a taxable basis when this course of action is deemed to be beneficial.

One reason to issue taxable bonds may be that the desired purpose is not achievable on a tax exempt basis. Some State and local bonds are also issued on a taxable basis to avoid the arbitrage regulations and permit reinvestment of the proceeds with no yield restrictions.

Under the subject legislation, there is a serious concern that deposit of the bond proceeds in the Lawton Chiles Endowment Fund and reinvestment therein for the purposes of that Fund probably would not qualify the bonds to be issued for tax exempt treatment. This concern is justified, but this use of the proceeds is not the only alternative available to the State.

All three New York tobacco securitization transactions completed to date have been done on a tax exempt basis, which clearly demonstrates that this result is available under certain circumstances.

There may also be a State law question about whether the corporation to be created (presumably to act as an instrumentality of the State) can issue bonds for a purpose that might not be permissible if bonds were issued directly by the State. The State is generally limited to issuing revenue bonds for "fixed capital outlay" purposes, which could be construed to exclude the use of State bond proceeds for deposits into the Endowment Fund. See Article VII, Section 11 (d), Florida Constitution.

Validation of the bonds would settle State law questions. Federal tax law questions would be determined by the opinions of transaction counsel. Based upon research for this article, including interviews with highly sophisticated tax counsel, it is likely that a satisfactory result can be obtained.

Available Alternatives

When bond proceeds are used for capital outlay purposes, the interest on the bonds is usually tax exempt. A portion of the proposed "tobacco bonds" could in all probability be used to fund ongoing State capital outlay projects within the applicable Federal law restrictions. The same result would probably also be available if a portion of such bond proceeds were to be used to provide for the repayment of outstanding debt obligations on a current basis or through "advance refundings." There may also be some other more complex legally permissible alternatives available. Also, the proposed bonds do not have to be all taxable or all tax exempt, depending on the use of the proceeds and other issues.

In this regard, it should be noted that the enabling legislation should not make replacement of the tobacco revenues from other sources for deposit into the Endowment Fund a legal condition for the use of portions of the bond proceeds for other permissible purposes, as this linkage could cause Federal authorities to look through the form of the transaction and deem it to be an artifice or device designed to avoid the restrictions of Federal tax law.

However, money being fungible, the Legislature may in its discretion choose to appropriate funds from various sources for various legally authorized purposes. In the course of research for this article, the author has been assured by highly qualified and nationally recognized bond and tax counsel that, properly structured, at least a major part and possibly all of the proposed bonds could be issued on a tax exempt basis.

There is no apparent "arbitrage" benefit to be derived from a taxable bond issuance in this case, as it is correctly being assumed that under current bond market conditions the reinvestment rate would probably be below the borrowing rate (thus creating a "negative arbitrage" situation). The operative motivation appears to be the proposed use of proceeds. As explained above, other potential legally permissible purposes seem to be available; subject to Legislative action, the net benefits to the Endowment Fund can balance out.

Benefits of Tax Exempt Treatment

(1) Tax exempt interest would obviously reduce the borrowing cost. By reducing the interest cost, the same revenue stream can also produce larger principal amounts available for the desired purposes if the State so elects through Legislative action in future years.

In order to accurately compare the interest cost differential between hypothetical taxable and tax exempt financing plans, it is necessary to make various assumptions as to principal repayment schedules, interest rates to be paid (and, less obviously, possible complex prepayment arrangements prior to scheduled maturity). A wide variety of reasonable assumptions would require voluminous detailed debt retirement schedules. Within the scope of this article, to illustrate this potential interest cost differential, a $3 billion principal financing at 8 percent taxable interest (making certain assumptions) might cost about $5.25 billion in interest to scheduled maturity over a 30 year retirement period. If the interest rate were to be reduced to 6 percent over the scheduled life of the loan (holding the scheduled principal payments constant) the total interest to be paid would be reduced to about $3.94 billion, thus avoiding about $1.31 billion of interest cost. However, it is more realistic to assume that the avoided annual interest costs would be applied to increased principal payments over the scheduled maturities, thereby further reducing the aggregate interest cost.

Even if the interest differential between taxable and tax exempt rates was less than the 200 basis points assumed above, it may readily be seen that the avoided incremental interest cost resulting from tax exempt financing would be very substantial. The total interest cost would be further reduced by shortening the scheduled maturities and by accelerating the payment of the principal, whether the interest to be paid was taxable or tax exempt.

(2) The amount of "negative arbitrage" (loss on reinvestment) would in all likelihood be reduced or possibly eliminated, if bonds are issued on a tax exempt basis.

Conclusion

For the reasons explained above, the enabling legislation should not " paint the State into a corner" by foreclosing the options that could be used to issue some or all of the proposed bonds on a tax exempt basis. After a law is enacted and the Legislature adjourns, it will be too late to explore and implement these options without further legislative action. Flexibility should be retained for structuring and implementing the program within State and Federal legal limits.

Just a few words added to the pending Bill could save enormous amounts of money in avoided interest costs and/or significantly expand the benefits of the proposed program. The Bill should provide that portions of the bond proceeds may be deposited in the Endowment Fund, may be used to pay capital outlay costs for State projects, may be used to provide for retirement of outstanding debt obligations, or for other legally authorized purposes.

As this article is being prepared for publication, there are apparent differences between the Florida Senate and House of Representatives' positions on this subject. The comments in this article are predicated on the assumption that the Legislature is likely to take some action. If some form of "securitization" is chosen and enacted into law, it is hoped that these views and recommendations will be taken into consideration, both to avoid potential legal pitfalls and to implement the program in the most financially beneficial manner.

About the Author

Arnold Greenfield is a member of the Florida Bar and the National Association of Bond Lawyers. He was the first Director of Bond Finance for the state of Florida, a consultant on finance and taxation to the 1978 Florida Constitution Revision Commission and Managing Director of a major national investment bank until his retirement in 1994. He is now a Visiting Professor at the Askew School of Public Administration and Policy, Florida State University, and a Senior Research Fellow with Florida TaxWatch.

For more information on this report, please call:
(850) 222-5052

OR
write Florida TaxWatch at:
P.O. Box 10209
Tallahassee, FL 32302