State Debt in a Time of Turmoil

By
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States and municipalities borrow hundreds of billions of dollars every year through the bond market. In 2008-09, upheaval in U.S. financial markets changed the way governments could borrow money to finance infrastructure building and other activities. State treasurers and other officials responded by changing how they market and package their bonds in order to keep funds flowing to vital projects.

The recession that began in December 2007 led to a number of financial problems for state governments. In many states, officials had to address large budget shortfalls while trying to provide services for unemployed workers and distressed homeowners. In addition to these well-publicized challenges, states were also caught in the turmoil of U.S. financial markets.

State governments are major participants in investment and debt markets. For instance, as custodians of public employee pension funds, states invest hundreds of billions of dollars in equities, real estate, bonds and other assets. As builders of infrastructure projects like roads and universities, states also borrow large sums. The economic downturn led to serious problems for both functions.

State treasurers, as custodians of public funds, were at the forefront of the financial crisis. Forty treasurers are involved in the issuance or maintenance of public debt. In many states, they are joined in this task by other officials and authorities that share responsibility for various types of debt issuance. Once lawmakers approve projects and grant authority to borrow funds, state treasurers and others responsible for debt management must obtain the required money.

Since the sums involved are too large to be financed through simple bank loans, states must borrow money from investors through the debt markets. They accomplish this by issuing bonds, which are financial agreements between borrowers and lenders with specified interest rates and repayment schedules. Tax-exempt municipal bonds are the basic tool used by state and local governments to fund capital projects such as utilities, roads and bridges, airports, health care facilities, education buildings, housing and environmental remediation programs.
State governments have traditionally had good access to capital because of their broad taxing authority and strong history of repayment. But the recession brought disruption to bond markets in 2008 and 2009, forcing states to delay or cancel some bond sales.

**Changing Conditions**

The market for state debt is subject to the same fluctuations and forces as other financial exchanges. Following the start of the recession and the failure of major financial institutions in 2008, uncertainty led many investors to withdraw from debt markets or move rapidly to U.S. Treasury bonds. Although the markets thawed as investor unease subsided somewhat, overall sales of municipal securities fell 9 percent in 2008 to $389.6 billion. In 2009, sales rose to $409 billion, nearly the same amount seen in 2005 and 4.6 percent below peak levels in 2007.\(^1\) (See Figure A [6] for a breakdown of municipal bond issues in the last two years.)

Investors’ nervousness about almost everything besides Treasury bonds showed up in prices for municipal bonds. An index published by industry newspaper *The Bond Buyer* showed that, “By December 2008, yields on 20-year general obligation bonds reached an astounding 175 percent of similar-maturity Treasuries; that same spread averaged just 89 percent between 1994 and 2007.”\(^2\) In other words, relative to U.S. Treasuries, municipal borrowers such as states had to pay much higher interest rates on the bonds in late 2008 than they traditionally had. Higher interest costs on debt mean that public projects are more expensive to complete.

Fortunately for states, the markets settled down in 2009 as investors returned to buying municipal bonds. In fact, bonds with high ratings came with historically low interest rates, coinciding with low interest rates in the overall U.S. financial markets.

The players in the debt markets also changed. States and other municipal issuers work with financial advisers and banks that serve as underwriters, preparing bonds for sale and finding buyers for them. Well-known bond underwriters such as Merrill Lynch and UBS merged or left the field in 2008. This change left states with fewer options for underwriting services and may have contributed to higher borrowing costs for issuers.\(^3\)

Issuers also felt the loss of major bond insurers. The interest a state pays on bonds is partly determined by buyers’ assessments of the state’s credit rating. Some states are highly rated and can find favorable interest terms based on this standing. Other states, and many local entities, traditionally looked for so-called credit enhancements to improve the marketability of their bonds. Bond insurers make debt more attractive by promising to make bond payments in the event the issuer cannot.

During the credit crisis, many bond insurance companies became entangled in problems related to mortgage-backed securities. As a result, their credit ratings and ability to insure new bond offerings declined. Municipal issuers’ use of insurance for their bonds also declined. “Only 10.5 percent of all new issues carried bond insurance in (2009) through September, roughly half of the 20.4 percent carrying insurance in the same year-earlier period,” according to the Securities Industry and Financial Markets Association.\(^4\) The significant point from this trend is that governments accustomed to selling bonds with an enhancement from insurance companies must now sell their bonds without this guarantee. This often means they receive lower ratings than with insurance and must offer higher interest rates to compensate investors.

Another change in the municipal market came in the type of investor who bought state and local debt in 2008 and 2009. Individuals who buy bonds or bond funds are known as retail investors, while organizations such as pension funds or corporations that buy bonds are called institutional investors.
In a reversal from the recent past, retail investors became the dominant buyers of municipal bonds in the last two years. The two classes of investors have different reasons for buying bonds, so states shifted their marketing strategies in order to meet growing demand from individuals.

California, the largest municipal debt issuer in 2009, employed several tools to market state bonds to investors in the last two years. Recognizing demand from institutional investors alone would not be enough to obtain necessary financing, State Treasurer Bill Lockyer developed a Web site, www.buycaliforniabonds.com, to explain state bonds to potential investors. The site informs visitors about the steps they can take to purchase municipal bonds, including setting up a brokerage account and researching specific bond offerings. The site also offers information about upcoming bond sales.

To raise awareness of the Web site, and by extension state bonds, the state ran radio advertisements featuring Gov. Arnold Schwarzenegger. The successful marketing and education efforts helped the state fill out several bond offerings in 2008 with 40 percent to nearly 80 percent of sales coming from retail buyers. By adapting to changing market conditions, the state was able to obtain financing at a difficult time.

**Federal Assistance**

States received significant financial assistance from the federal government in 2009 in the American Recovery and Reinvestment Act. The stimulus package included a new debt tool for states and local entities in which the federal government pays a portion of the interest. The program, named Build America Bonds, made an immediate impact on the municipal market.

The stimulus legislation was designed by Congress to bolster the economy, and so, too, the Build America Bonds program was designed to encourage economic growth and job creation. Build America Bonds must be used for new projects, such as road or school construction, as opposed to refinancing existing debt. Bonds issued in 2009 came with an interest subsidy of 35 percent, paid by the federal government to the issuing state or local entity. In contrast to many other municipal bonds, Build America Bonds are taxable, which means interest earned on the bonds by investors is subject to federal income taxation.

Since Build America Bonds lack the tax exemption that makes other bonds attractive to buyers, states must generally pay higher interest rates on them. The federal subsidy covers a portion or all of the additional cost, depending on the precise details of a given bond offering. Other programs authorized by the stimulus legislation include Recovery Zone and Qualified School Construction Bonds. Together with Build America Bonds, these programs provided significant aid to state borrowing efforts last year.

In the program’s first year, $64 billion in Build America Bonds were issued, according to the U.S. Department of the Treasury. The program began in April 2009, so the first-year figure only includes nine months. At more than 15 percent of the entire municipal market last year, Build America Bonds quickly took hold with investors and issuers. From April to November, 42 states and Washington, D.C. issued Build America Bonds. Figure B shows the states (including localities within those states) that issued $1 billion or more in the new bonds as of Nov. 30, 2009.

The new bonds have been successful for a number of reasons. For one, they brought new investors into the market for state debt. Typical buyers of traditional tax-exempt bonds have an interest in both the income the bonds produce and the tax benefits they convey. The tax exemption is most
valuable to bondholders in higher income tax brackets. Taxable bonds, such as Build America Bonds, generally must pay higher interest rates to compensate for the lack of tax exemptions. The creation of the Build America Bonds program inserted a new type of taxable debt instrument, backed by subsidies from the federal government, into the market. Buyers of the bonds have included foreign investors and pension funds that are not affected by U.S. federal income taxes, and thus have not been interested in tax-exempt bonds in the past.

The Build America Bonds program also helped states by lowering the effective interest rate they must pay on new bonds. As some borrowing has shifted from traditional tax-exempt bonds to Build America Bonds, the supply of tax-exempt bonds has fallen, and with it the interest states must pay on those bonds. At the beginning of March 2009, 99 percent of municipal bonds issued year to date were tax-exempt. By the beginning of December 2009, 21 percent of issues in the year were taxable bonds. Build America Bonds changed the composition of the market in a remarkable way.

Transparency in the Market for State Debt

The Internet and electronic communications are transforming the way buyers and sellers of public debt interact. States provide information to investors about their financial conditions and debt in a number of ways. They post online information about their budgets and revenue collection on a regular basis. They also publish consolidated annual financial reports, with details about assets, liabilities, income and expenditures. When preparing bond offerings, states also work with underwriters to prepare official statements for investors.

Recently, the regulatory body set up by Congress to oversee the municipal market—the Municipal Securities Rulemaking Board—established an online repository of disclosure information for investors. The Electronic Municipal Market Access System is replacing an older system of paper records with a Web site investors can use to access information about thousands of state and local government bonds. The National Association of State Treasurers and other organizations support this initiative as a way to make the municipal market more transparent for investors.

The system brings changes to the market by giving investors access to information free of charge for the first time and allowing investors to easily compare the disclosure practices of different issuers. In 2009, the U.S. Securities and Exchange Commission approved the Electronic Municipal Market Access System as a central repository of documents related to state and local bonds.

Turmoil and Stability

Amidst the economic upheaval of the last two years, states adapted to evolving conditions to find funding for public works. Their own efforts to market bond offerings toward investors’ current needs helped produce this result. So, too, did assistance from the federal government in the form of a new, subsidized bond program. As always, state and local governments also worked with private sector financial experts to assess market conditions and craft appropriate borrowing strategies.

At the start of 2010, market experts anticipated growth in the municipal market, particularly with regard to taxable issues like Build America Bonds. With the program scheduled to expire at the end of the year, however, Congress would have to pass new legislation to give Build America Bonds life beyond the short term. The President’s proposed budget for fiscal year 2011 includes a provision making the program permanent, although with a lower interest subsidy of 28 percent. State treasurers and other officials have stated that regardless of the specific parameters associated with Build America Bonds, tax-exempt bonds should remain a primary tool available to municipal issuers.
Notes


7. Katie Carroll, Presentation to the National Association of State Treasurers, Dec. 9, 2008 in Addison, Texas.

8. Several other states have undertaken similar efforts aimed at retail buyers. For example, see www.buyoregonbonds.com [15] and buydcbonds.com.


10. Ibid.


http://www.sifma.org/uploadedFiles/Research/ResearchReports/2009/Municip... [19].

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