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Municipalities Pushing Out Payments Spur Balloon Debt Resurgence.

U.S. cities and school districts struggling to keep up with expenditures are increasing sales of debt that delays interest until the bonds mature, often resulting in ballooning final payments that are many times the amount originally borrowed.

Issuance of capital-appreciation bonds, known for their balloon payments due at maturity, is on pace to increase 54 percent this year to $2 billion, the largest amount since 2012, according to data compiled by Bloomberg. The surge has come as states including Texas and California, which have the highest volumes of the securities, have passed laws restricting its use because of mushrooming amount of debt and interest that must be paid when the bonds mature.

Use of the debt, also known as zero-coupon bonds, had been declining since coming under fire in recent years for letting officials postpone paying for schools, roads and other capital projects. Texas passed a law this year that limits governments to only having one-fourth of their debt in capital appreciation bonds.

“It allows local governments to borrow and shift the burden to future generations of taxpayers,” said James Quintero, director of local governance at the Texas Public Policy Foundation in Austin, which pushes for restrained taxes and spending.

Higher Payments

The risk with capital-appreciation bonds is that by delaying annual payments for principal and interest they can result in sharply higher payments when the debt matures, forcing government officials to scramble to come up with funds needed to pay bondholders. The $91 million of capital appreciation bonds sold by the Wylie Independent School District near Dallas in February will cost about $268 million when they come due in 2050.

Puerto Rico’s capital appreciation bonds threaten to saddle the commonwealth’s bond insurers, Ambac Financial Group Inc. and MBIA Inc., with much higher liabilities then is reflected in the principal amount borrowed. Once interest is included, Ambac said its Puerto Rico exposure increases to $10.5 billion from $2.4 billion. For MBIA’s National Public Finance Guarantee Corp., it more than doubles to about $10.5 billion.

Most of the increase has come in California, where borrowing through capital-appreciation debt so far has more than doubled to $900 million this year. It’s still well under the $2.1 billion that state’s municipalities borrowed using the debt in 2007. California Governor Jerry Brown signed legislation in 2013 designed to limit use of the debt structure. That was after reports that one district that borrowed $179 million from 2008 to 2011 with capital-appreciation debt would have to repay $1.27 billion of debt service by 2051.

Tax Avoidance

Zero-coupon debt accounts for about $253 billion of the outstanding securities in the $3.7 trillion municipal market, data compiled by Bloomberg show.

The debt is seen as a way around limits on tax rates and debt service that may keep borrowers providing needed capital improvements or services. In Texas, where borrowers are expected to sell about the same $700 million they did last year, a cap on the amount of property tax that can be levied for debt payments has pushed many of the fastest-growing school districts in the state to adopt the structure. It lets them borrow without collecting the property tax until earlier borrowings have been repaid.

The Wylie schools used them in response to a 173 percent increase in the number of people in the city from 2000 to 2010, making it the one of the fastest-growing suburbs in the country, said Michele Trongaard, the chief financial officer. Her district did refinance $20 million of capital-appreciation bonds to achieve a present-value savings of about $4 million in October, she said.

Texas Sales

“I understand the issues people have with it, but when you have the kind growth we did, you really don’t have any choice,” Trongaard said. “We do everything we can to get the most we can for taxpayers’ money, but sometimes you have to let your enrollment catch up with your buildings.”

Companies that rate municipal debt have been expressing concern about the increasing use of the bonds in Texas. In 2012, Fitch Ratings cut the Leander Independent School District’s rating one level to AA-, in part because of the district’s increasing reliance on capital-appreciation bonds, which slow the district’s ability to pay down its debt.

When Texas’s new law took effect, Moody’s Investors Service praised it as a “credit positive because it will deter school districts from issuing debt based on uncertain future taxable value growth projections.”

Besides limiting the amount of capital-appreciation borrowers can issue, the law limited maturities to 20 years, half 40-year terms many school districts previously used, Moody’s said.

In Texas, the Leander school district near Austin refinanced $101 million of the $114 million in capital-appreciation bonds it had outstanding in June, leaving $13 billion of the debt outstanding, said Lucas Janda, chief financial officer.

“It’s for savings for our taxpayers,” said Janda.

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by Darrell Preston

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