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WSJ: Borrowing Maneuver Catches Flak.

‘Scoop and Toss’ Involves Selling New Debt to Pay Off Existing Bonds

A budget-stretching tactic employed by strapped local governments from California to Puerto Rico is coming under market scrutiny, amid fears that Detroit’s record bankruptcy filing could presage further pain for municipal-bond investors.

The maneuver, called “scoop and toss,” involves selling new long-term debt to raise funds to pay off maturing bonds, effectively extending the timetable for retiring municipal borrowings. Refinancings that aim to reduce interest rates typically keep the same maturity schedule.

The practice, which has been around for decades, helps cities, states and other local entities to stay current on their obligations as they try to claw out of one of the deepest economic downturns since the Great Depression.

The debt sales often offer above-market interest rates that appeal to many bond buyers at a time of slow economic growth, easy Federal Reserve policy and low rates on relatively safe investments such as U.S. Treasury securities and bank accounts.

But some observers warn that scoop-and-toss refinancings add to interest costs while allowing civic managers to overlook structural economic difficulties. Investors purchasing the debt take on the risk that the securities will lose value, as they did in Detroit’s $18 billion Chapter 9 bankruptcy case.

“It’s never a good sign to see this,” said John Loffredo, portfolio manager of the MainStay Tax Free Bond Fund. Mr. Loffredo said his firm recently started buying Puerto Rico bonds that carried third-party insurance guaranteeing repayment, citing the high yields.

Among the chief practitioners of scoop and toss is Puerto Rico, which since 2006 has relied on new bond sales and loans to help balance its budget and pay off old bonds coming due. The island commonwealth has restructured about $4 billion in debt from its main operating budget since then. About $70 billion of Puerto Rico debt is outstanding.

Yields on Puerto Rico’s bonds have risen sharply this year, making it much more expensive to sell debt to investors, following rating-company downgrades. Puerto Rico bond prices are down about 16% in 2013.

In 2011, Puerto Rico sold $356 million of bonds that begin maturing in 2024. Some of the proceeds were used to pay off a bond from 1989 that was maturing in 2011—in effect turning a 22-year bond into a 35-year one.

Lyle Fitterer, head of tax-exempt investments at Wells Capital Management, which oversees about $33 billion in municipal-debt investments, said he would like to see cheaper bond prices or a sustainable economic recovery plan before he boosts his firm’s small Puerto Rico holdings.

“The scoop-and-toss strategy might be a good strategy for a short-term solution, if you have a temporary economic recession," he said. "But obviously, the longer it goes on, the more difficult it is to argue that it's a good long-term solution."

Officials in the U.S. territory are seeking to put the island on stronger fiscal footing through tax increases and entitlement reform, and seek to end scoop and toss by 2015. "In the past, it had been restructuring after restructuring," Puerto Rico Treasury Secretary Melba Acosta said recently in an interview. "We are moving away from that."

Puerto Rico officials have said they can make it through this fiscal year without borrowing, and have been drawing down a line of credit from the Government Development Bank, according to Fitch Ratings.

U.S. companies frequently issue new bonds to pay off old debt. But investors typically worry less about corporate-debt issuers because the money can be used to expand the business, which can benefit bond buyers.

"If a corporation started going into decline, you aren't going to see the debt rolling over and being refinanced," said Stan Garstka, accounting professor at the Yale School of Management.

To be sure, there are signs of progress for municipalities. Over the summer, Moody's Investors Service raised its outlook for U.S. states to stable from negative, saying "the slowly improving U.S. economy continues supporting state revenues and reserves."

Other municipal entities have employed scoop-and-toss strategies recently. Suffolk County, N.Y., which recently declared a fiscal emergency, last year sold through an authority about $38 million in bonds backed by tobacco revenues to help cover other debt payments that were due in 2012 and 2013.

In California, the Foothill/Eastern Transportation Corridor Agency, which operates toll roads in Orange County, is looking into a scoop and toss that would pay off bonds from 1999 and extend the maturity of the debt by 13 years to 2053. The bonds are backed primarily by revenues from tolls, but traffic on the roads has grown slower than expected.

Fitch said the plan makes it easier for the authority to pay off its bonds. In 2040, the year the authority will have to pay the most, payments fall to $243 million from $297 million under the new plan. Without scoop and toss, Fitch said it would likely downgrade the outstanding bonds to junk status.

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