

# **Bond Case Briefs**

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## **Financial Illiteracy: One of Government's Biggest and Least-Discussed Problems.**

Failure to understand financial outcomes is more dangerous to states and localities than ever, and there's a big gap between what public leaders know about finance and what they need to know.

This is part of an ongoing series called Finance 101 that goes back to the basics to help public officials.

In the fall of 2012, the Minneapolis suburb of Vadnais Heights found itself with a credit rating downgraded to junk status. Local leaders in the town of 12,000 were not only insulted, but shocked. Vadnais Heights owed its disgrace to one action it didn't think was that crucial: It had stopped making bond payments on a \$25 million sports complex. The town had expected the complex to meet its borrowing costs through added revenue, but it had fallen short of estimates. So town officials had ceased paying bondholders rather than choosing to bill taxpayers for the unexpected costs.

Mayor Marc Johannsen called the credit downgrade "not fair" and "not reflective of the overall financial condition" of the community. "We've never missed a bond payment in the history of the city," Johannsen said, "and we'll never miss a bond payment that we're obligated to do."

The city was right in claiming that it had done nothing illegal. Lease revenue bonds like the ones issued for the sports facility don't carry a contractual obligation. But Wall Street rating agencies don't make that distinction. To them, a default is a default, and the town had evaded its responsibility.

Vadnais Heights wasn't really guilty of mismanagement; it was guilty of ignorance. It didn't realize the consequences of what it had done. Other communities have found themselves in similar situations. Earlier in 2012, Wenatchee, Wash., got its credit rating reduced below investment grade because it failed to support a regional sports arena that defaulted on nearly \$42 million in debt. For nearly half a year, the city had covered interest payments to bondholders. When it stopped, ratings agencies dinged Wenatchee's overall credit score, even though revenue-based bonds had been issued to pay for the project.

The idea that a city can be penalized only when it breaks the law is a common misperception. "I don't get a sense many local governments understand bond math or securities," says Matt Fabian, managing director at the bond analytics firm Municipal Market Advisors. "They get into leases connected to a project and don't realize that a default on that lease is tantamount to a default on a general obligation bond."

Failure to understand financial outcomes, even when combined with good faith, is more dangerous to states and localities than it has ever been. Tougher ratings standards are part of the picture, but the problem goes far beyond those. Municipal and state leaders face an entirely new regulatory climate with the passage of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act. That law, which is still being implemented, is bringing increased scrutiny of government financial performance on all levels.

The Securities and Exchange Commission (SEC) now has a Municipal Securities and Public Pensions Unit, with a mission to root out misdeeds in public finance. The new rules became painfully evident to Harrisburg, Pa., in May of last year, when the SEC sued the city for securities fraud. One of the documents the SEC cited in its case was then-Mayor Stephen Reed's 2009 State of the City address, which called the debts of the city's waste treatment facility an "issue that can be resolved."

Reed failed to mention that because the troubled facility wasn't meeting its projected revenue, Harrisburg was already being forced to cover its debt payments. At the time of his speech, the city had paid out \$1.8 million; by the time of the SEC action, it held about \$260 million in debt related to the facility. Reed may not have intended to mislead anyone. But these days, fiscal innocence isn't enough to forestall legal trouble.

"It's not that you have to know every single debit and credit," says Kinney Poynter, executive director of the National Association of State Auditors, Comptrollers and Treasurers. "But you have to have an understanding of when something just doesn't sound right."

These are not isolated cases. Elected officials practically everywhere are forced to make difficult financial decisions without the benefit of knowing exactly how the mechanics work. This has always been true to some extent, but the learning curve is much steeper now, due not only to the new regulatory climate but to the use of complex Wall Street trading products and gimmicks.

Most smaller jurisdictions are led by people whose understanding of intricate financial dealings is limited. And yet they have no choice but to engage in those dealings. They don't always know the right questions to ask, and if a decision comes back to haunt them, as it did in Wenatchee and Vadenais Heights, they tend to be genuinely surprised. The biggest cities and states have the manpower and resources to pick their way through the new economy, but they are not immune to bad advice or poorly understood decisions.

Sometimes it is a fine line between fiscal ignorance and willful inattention to the risks of a decision. In 2005, Detroit's then-Mayor Kwame Kilpatrick worked out a deal with Wall Street that sounded terrific. An elaborate \$1.4 billion borrowing transaction that involved a series of credit swaps, it was projected to save Detroit \$277 million over 14 years, while helping with the city's \$1.2 billion unfunded pension liability. Kilpatrick believed it would save a significant number of city jobs.

But when the recession hit a couple of years later, Detroit's gamble didn't pay off. The swaps forced the city to settle its debt at a locked-in 6 percent interest rate even as the market crash made it impossible to earn that large a rate of return. A condition of the swap agreement also caused Detroit to fall even further into the hole when its bond rating was sharply downgraded. "They were basically either not aware of this possibility or ignored it because they were so desperate to get the \$1.4 billion," says Sujit CanagaRetna, senior fiscal analyst at the Council of State Governments. It's now estimated that the deal could cost Detroit \$2.8 billion over the next 22 years. This represents about one-sixth of the \$18 billion in debt the city cited in its bankruptcy filing in 2013.

No one is suggesting that the swap-deal-gone-wrong is the sole reason Detroit filed for bankruptcy. But it was a contributor. Localities all over the country made similar missteps, albeit mostly smaller ones, in the boom years that preceded the Great Recession. The idea that the good times would simply continue created its own set of headaches that officials today are faced with fixing. If this was not outright ignorance, it clearly qualifies as a form of fiscal naiveté.

So does the assumption California lawmakers made in the 1990s that high market returns would continue in perpetuity and pay for generous pension increases for state retirees. During the dot-com boom at the end of that decade, then-Gov. Gray Davis granted significant increases at the urging of

the California Public Employees' Retirement System—while letting the state take a break from actually contributing to the pension fund. After the crash, the promises became a painful legacy the state is still dealing with.

Most elected officials don't like to talk much about these issues. But they know that even at the most basic levels, government finance and accounting are anything but intuitive. Successful candidates often win their jobs on the basis of personal appeal, not on their mastery of policy or management details, and certainly not on their knowledge of Wall Street trading. Once in office, they are forced to learn an entirely new language—if they choose to. "You have people coming in who have absolutely no idea how the appropriations process works," says Connecticut Rep. Diana Urban, who is also a former economics professor. "Oftentimes they don't know what constitutes a fiscal year, and they certainly don't know that you can push something into the next fiscal year to make it work."

Budget documents and balance sheets are obscure papers with arcane difficulties lurking beneath the numbers. For example, the bonds that a locality issues to pay for a project will show up as revenue on a general fund statement. That statement is simply a tally of all operations and activities paid for out of general treasury accounts. But those same bonds will count as a liability on the overall government statement, which accounts for debt service and other special funds. Then there are legacy costs such as pension liabilities, which have their own unique accounting. It can make grasping a government's actual financial status an impossible task for the untrained.

"When you think about it, I'm a retired cop and now I'm chairman of a finance committee of a \$3 billion organization and the 10th largest city in the nation," says San Jose, Calif., Councilman Pete Constant. "Can you imagine a corporation taking someone like that and putting them in charge of it with so little experience?" The same could be said for elected finance officer positions—Nevada Controller Kim Wallin, for example, is the first accountant elected to the job in that state in 50 years.

In many jurisdictions, term limits contribute to the financial literacy problem. "Even assuming a person hits the ground running, they're on such a steep learning curve, by the time they learn anything they are term-limited out," says Houston Controller Ron Green, who ran for his position after hitting his six-year limit on the city council.

LaVonne Griffin-Valade, the city auditor in Portland, Ore., was shocked when she started her job in 2009 and found out that no one had told council members about the burden of retiree health-care costs, otherwise known as Other Post-Employment Benefits. As in most jurisdictions, retiree health care in Portland is not prefunded the way pensions are. It simply shows up without much context as a line item cost in the government budget. After four years, Griffin-Valade isn't sure how much progress her education campaign has made. "I think if I quizzed them individually today," she says, "they still wouldn't necessarily understand the underlying issues. It's just not been on anyone's radar."

Dodd-Frank may help in some regards, but it will complicate the lives of elected officials in other ways. The new law includes rules written to define more precisely who constitutes a financial adviser qualified to work with governments. But, as is characteristic of the new web of regulatory reforms, the rules alone total nearly 800 pages of explanation. Deciphering the full impact has been a daunting task that even financial analysts are still piecing together. This year as well, new accounting guidelines for pension liability reporting will make some governments' liabilities appear to increase dramatically—a change that will cause alarm among those who don't know where it's coming from and one that will surely be used by those with a desire to embarrass those holding office.

The solution to the problem of insufficient expertise is, of course, education. But where will it come

from? At the most direct level, those decision-makers who do have a financial background can help their colleagues who don't. But politics often gets in the way. "I have to be really careful when I am advising other board members who come to me," says Jay Fountain, chair of the Fiscal Committee for Stamford, Conn.'s Board of Representatives and a former long-time researcher for the Governmental Accounting Standards Board. "I know that what I'm saying doesn't count for just my vote."

Still, there are some well-trained officeholders who have made it their business to inform the financially challenged within their governments. In Portland, Griffin-Valade issues regular reports designed to educate the city council about the city's actual financial health. Her 2011 report challenged the council's decisions regarding, among other things, the city's rainy day fund, health-care and pension costs. With her second report in 2013, Portland began looking at a budget surplus and the council voted to use some of it to pay down the city's debt. Portland's new mayor pushed for the move, but the decision was also a clear result of the education effort from the auditor's office.

State financial stewards can provide help to localities, and some are starting to do so. New York Comptroller Thomas DiNapoli has established a Fiscal Stress Monitoring System for the state's cities, designed to stave off drastic measures such as control boards or bankruptcy. In Tennessee, a number of local governments were drowning in debt after the recession because they invested in risky variable rate instruments to finance infrastructure projects. The Tennessee State Funding Board now mandates that local governments taking on debt draft their own debt management policies. These have to follow state-directed principles, including the disclosure of costs and risks.

Professional organizations are also recognizing the need for more education. The Municipal Securities Rulemaking Board (MSRB) has launched an initiative designed to help local governments with everything from the basics of issuing bonds to the ins and outs of the new regulatory climate. "Post-financial crisis and Dodd-Frank, it absolutely is a more complicated world," says MSRB Chair Daniel Heimowitz. "From the regulatory landscape and understanding what your relationship with a dealer is, to what your own obligations are, there's a much more heightened sense and understanding that everybody needs to pay attention."

The National Association of State Budget Officers (NASBO) is launching an online video series designed to help the public and government officials with the basics. The first video explains the state budget process, drilling down to items as rudimentary as explaining what a fiscal year is. "People don't mind the very basics," says NASBO Executive Director Scott Pattison. "So [there's no such thing as] dumbing it down too much."

But the onus is on individuals in government to take up the cause either for themselves or for their colleagues and jurisdiction. The plain truth is, in this era of austerity and increased accountability, decision-makers must own their choices more than ever. Whether government officials like it or not, the public tolerance for unawareness has been whittled down to an unforgiving nub. "If you don't have at least a comfortable understanding of the process, then you're really out of the discussion loop," says Connecticut's Urban. "If we had a better understanding of how all this works, I think we could have more truth in budgeting."

Some elected officials are always going to avoid the hard studying, but a few revel in it. One of the latter is San Jose's Constant. After joining the city council in 2007, he was given a spot on the pension board. He decided to take a few classes to educate himself on his new job. Now he's a Ph.D. candidate writing his dissertation on public pension governance.

"It became apparent to me," he says, "that I was in a decision-making role and not feeling comfortable I had all the tools to make the right decision. You can sit in a room with all these experts

but you have no idea if they are guiding you in the right direction or wrong direction. I at least wanted to know the right questions to ask.”

BY LIZ FARMER | FEBRUARY 2014

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