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So, Just What Are Appropriation Backed Municipal Bonds?

Summary

- Appropriation backed municipal bondholders do not have the right to seek repayment in court.
- Investors are willing to buy appropriation bonds because they understand that failure to make an appropriation for P&I would have a large negative impact on creditworthiness of the appropriating entity.
- Appropriation bonds are issued by localities to fund delinquent retirement contributions. They have played a leading role in precipitating almost every municipal bankruptcy going back to and including the Orange.

The description, versus the definition of appropriation bonds is a contradiction in terms. In a financial context, bonds imply the existence of debt. There are lenders and a borrower who is legally obligated to repay the debt under terms of a contract. If violated, bondholders have the right to seek repayment in court.

Appropriation backed municipal bondholders do not have the right to seek repayment in court. The entity that is the source of the appropriation for P&I has no legal obligation to make that appropriation resulting in near immediate monetary default.

Appropriation bonds are issued by a large number of state corporations of the most populous states. Those states have authorized many local governments to issue them as well. All to circumnavigate limits and restrictions on the issuance of legally enforceable debt.

Ironically, it is precisely the voluntary non-mandatory nature of the P&I appropriation that makes their issuance legal – the bonds do not constitute debt within the meaning of constitutional law or statute.

To the uninitiated, the above facts might seem hard to believe, but there is a rational for their large presence since first being introduced in the early 1980's by the New York State Municipal Assistance Corporation. Originally, they were referred to as "moral obligation" bonds.

Investors are willing to buy appropriation bonds because they understand that failure to make an appropriation for P&I would have a large negative impact on creditworthiness of the appropriating entity

This is undoubtedly true, as long as the appropriating entity, most are states, does not fall on hard times or mismanage its debt or both. In either case, appropriation bonds are the first to go unpaid because the issuer has no legal obligation to repay them.

The U.S. municipal bond market is the only debt market where appropriation backed bonds exist. They account for approximately 20% of the $3.5 outstanding, or $700 billion.

States and municipalities that partake in appropriation financings aren't the issuers of this kind of "debt". Instead, they are the appropriating entities that support P&I, not the bond issuers.

Governments create state and municipal corporations to be the issuers of all outstanding appropriation backed bonds.

There is simply no legal authorization for any state or municipality to directly issue appropriation backed bonds.

Unfortunately, standard nomenclature to identify appropriation risk does not exist. Not all state corporations issue appropriation bonds. Many constitute government sponsored essential service enterprises. Their bonds are secured by user charges and fees, not by appropriation or general taxation.

To determine whether the bond has appropriation risk, look for phrasing like the following on the cover page of the issue's official statement.

"The obligation of the State to make financing agreement payments is subject to the State Legislature making annual appropriations for such purpose and such obligation does not constitute or create a debt of the State, and the State has no continuing legal or moral obligation to appropriate money due under any financing agreement."

Disclosure may instead refer to pledged revenue under a lease or other form of payment agreement. Currently, certificates of participation and pension funding obligations are descriptions commonly used by localities issuing appropriation bonds.

The description of appropriation bonds can be very misleading. The above referenced disclosure quote was taken from an issue of Dormitory Authority of the State of New York Sales Tax Revenue Bonds Series 2015B. There is a high likelihood that bondholders think their investment is secured by a continuing claim on the State's sales tax. But in fact, payment of P&I rest on voluntary annual appropriations

Appropriation bonds are issued by localities to fund delinquent retirement contributions. They have played a leading role in precipitating almost every municipal bankruptcy going back to and including the Orange County, California default in the 1980's.

Detroit's $1.5 billion appropriation pension funding bonds were settled under Chapter 9 at 14 cents on the dollar.

The bonds had a security interest in additionally gaming taxes that generated 14% of P&I. Had it not been for the fact the bonds had a real security interest in other revenues, a recovery value of zero cents on the dollar can be seen. I cannot see why appropriation bondholders even deserve standing in Chapter 9 proceedings. It may evolve to that.

The presence of these non-debt debts is largely the result of constitutional constraints on the issuance of enforceable state and local debt. Unlike enforceable bonds, they can be issued for any purpose and in any amount the issuer chooses and the market will accept. There is potential for misuse.

All but a handful of U.S. states are limited to the issuance of general obligation bonds by their constitutions. GO authorization requires voter approval which is not always forthcoming. That leaves appropriation bonds as the only alternative source of capital improvement funding.

From the investor point of view, I see two solutions, constitutional amendments giving states more flexibility to issue enforceable debt, or providing investors with significantly higher rates on appropriation debt to compensate for the additional risk. Personally, I would stay away from a locally issued appropriation bonds.

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Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

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