

## Austerity Age Fades as Road Work Pushes Atlanta to Borrow.

For the first time since 2001, Atlanta is seeking voter approval to sell bonds for infrastructure. For years, black nets underneath downtown Atlanta's 106-year-old Courtland Street bridge kept broken concrete from hitting cars and pedestrians below — and regularly snagged on the roofs of trucks.

Now, for the first time since 2001, Atlanta is seeking voter approval to sell bonds for infrastructure, including a replacement for the derelict span. If approved on March 17, officials say the \$250 million would begin addressing \$1 billion of needed improvements to roads, traffic signals and other public works.

"We have maintenance that's been put off for years and years and years," said Richard Mendoza, commissioner of the Public Works Department. "The \$250 million is what we are able to afford without raising property taxes."

Atlanta's decision is part of a shift for American states and cities as the economy expands at the fastest pace in over a decade: They're using the taxpayer credit card again. After a budget-cutting push led governments to pay off debt by the most on record, the \$3.6 trillion municipal-bond market may grow this year for the first time since 2010 because of borrowing for construction projects.

### **Critical Stage**

State and local governments are expected to sell \$357.5 billion in debt this year, an increase of \$9.4 billion from 2014, according to a survey of 14 investment banks released last month by the Securities Industry and Financial Markets Association, a New York-based group that represents Wall Street.

"The infrastructure in this country is reaching a critical stage in its degree of performance," said Phil Fischer, head of municipal-bond research for Bank of America Merrill Lynch in New York. At a certain point, he said, "infrastructure is not optional."

America's governments would need to spend about \$3.6 trillion through 2020 to put everything from roads and water to sewers and electricity networks into adequate shape, according to a 2013 report by the Reston, Virginia-based American Society of Civil Engineers.

Atlanta may seize on interest rates close to a 50-year low to chip away at projects put on hold as the housing-market crash and recession led it to raise taxes and cut spending.

### **Rating Raised**

Its finances are now on the mend. Standard & Poor's in June raised Atlanta's rating three steps to AA, its third-highest rank. In October, Moody's Investors Service changed its outlook on the city to positive, indicating it may lift the grade from Aa2, also the third-highest rating.

When the city of 448,000 last sold bonds in October, 10-year securities yielded 2.3 percent, about 0.2 percentage point more than benchmark debt, according to data compiled by Bloomberg.

“Atlanta was hit hard by the recession and by foreclosures, but we believe they have rebounded nicely,” said Dan Close, a senior vice president at Nuveen Asset Management in Chicago, which manages two Georgia municipal bond funds with a combined \$388 million in assets.

The Atlanta real-estate market has revived since 2012, when it had the nation’s second-highest rate of foreclosures. Home repossessions are now back to pre-recession levels, which has lifted property-tax rolls.

## **Falling Concrete**

Atlanta’s backlog of infrastructure work includes replacing the Courtland bridge, which spans city streets, alleys and parking lots near Georgia State University.

The city took the nets beneath it down more than a year ago and began patching the underside instead. The temporary fix will need to be repeated in three or four years if the bridge isn’t replaced, said Michael Ayo, bridge engineer for the city.

The draft list of projects also includes a new indoor swimming complex to replace one that was closed in 2012 because the 90-year-old warehouse it was built upon was in danger of collapsing.

“We’re not untypical of major cities,” said Mendoza, the public works commissioner. “We have not kept pace with the investment needed in infrastructure.”

The city plans meetings over the next two months to pitch its plan to the public.

Residents may be an easy sell. Voters already signed off on many of the proposed projects when they voted two years ago in favor of a one-cent-per-dollar sales-tax increase to pay for them. The measure, which was metropolitan Atlanta’s first attempt to deal with its infrastructure needs as a region, failed because city voters were outnumbered by suburbanites who opposed it. The bond sale doesn’t face that hurdle.

Atlanta Mayor Kasim Reed began talking about selling bonds after the sales tax failed. If successful, it could become the first of a series, said Mendoza.

“This bond is intended to be the first down payment to address the backlog,” he said. “Maybe we’ll do another \$250 million in five years.”

Bloomberg

By Margaret Newkirk

Jan 22, 2015

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## **GASB Adds External Investment Pools to Its Technical Agenda.**

**Project Description:** The objective of this project is to improve financial reporting by external investment pools and pool participants that report positions in investment pools. Improvement will be achieved by addressing recognition, measurement, of investment pools and their disclosures.

### EXTERNAL INVESTMENT POOLS—PROJECT PLAN

**Background:** In order to qualify for amortized cost reporting, current GASB literature in Statement 31 links local government investment pools to Securities and Exchange Commission (SEC) Rule 2a7, requiring that pool sponsors follow specific 2a7 criteria. In 2014, the SEC significantly revised its rules affecting money market funds. The pre-agenda research indicated that those rules will affect investment pools to such an extent that few governments will be in a position to adopt the 2014 amendments. Those effects include the inability of pool participants to transact at a floating net asset value per share and the potential imposition of liquidity fees or redemption gates. Pre-agenda research indicated that some local government investment pools differ from many SEC-registered money market funds. For example, pool sponsors may have a more complete understanding about cash flow and liquidity needs of pool participants, pool participation may be involuntary, and alternative investment vehicles may be limited.

The pre-agenda research results suggested that some investment pools are assuming significant interest rate risk. In the event of an increase in interest rates, pool investments could suffer fair value losses. The extent of those losses, if any, will depend in part on the maturities of a pool's investments. The longer an investment's term-to-maturity, the greater an investment's exposure to fair value losses arising from interest rate risk. To portray accurately the financial position and economic condition of a pool, the proposed project would examine the interest rate risk of and structures of different investment pools in order to determine the appropriate measurement criteria and disclosure requirements.

### **Accounting and Financial Reporting Issues: The project will consider the following issues:**

- If a cost-based measurement for investment pools is developed, what criteria or defining characteristics describe such pools
- For all investment pools, what additional note disclosures are essential information for financial statement users?
- For pool participants, what additional note disclosures are essential information for financial statement users.

### **History:**

Pre-agenda research proposed: August 2014

Proposed for addition to the current technical agenda: December 2014

### **Status:**

Added to Research Agenda: August 2014

Added to Current Agenda: December 2014

### **Project staff:**

Deborah Beams

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**Board Meetings Topics to be considered:**

January 2015: Measurement of investment pool assets and net asset value per share. Criteria for cost-based investment pools.

March 2014: Continuation of cost-based criteria.

April 2015: Investment pool and participant disclosures.

May 2015 (T/C): Review draft standards section of an Exposure Draft.

June 2015: Review preballot draft of an Exposure Draft.

June 2015 (T/C): Review ballot draft and issue Exposure Draft.

July-August 2015: Comment Period (60 days).

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**[WSJ: Detroit's Lawyers and Advisers Defend Billing.](#)**

The lawyers and advisers who guided the city of Detroit through the largest municipal bankruptcy in U.S. history are now defending their work's multimillion-dollar price tag.

In court papers, lead law firm Jones Day and others that helped Detroit navigate its historic debt restructuring made a case—at the request of U.S. Bankruptcy Judge Steven Rhodes—for why their hourly billing rates and final tab are reasonable.

Officials at Jones Day, who pointed out they had already cut \$17.7 million from their tab, defended the \$53.7 million in fees charged for roughly 17 months' work.

"Nothing in the Chapter 9 case suggests that Jones Day's fees and expenses were irrational or overreaching," firm officials said in court papers.

The firm's defense raises a novel issue in a municipal bankruptcy cases: the rules laid out in the U.S. Bankruptcy Code for Chapter 11 cases related to how professionals can bill clients don't apply to Chapter 9—the type of bankruptcy used by struggling cities and counties.

Shortly after Detroit filed for bankruptcy in July 2013, Judge Rhodes made it clear that its lawyers shouldn't be charging the struggling city for first-class flights, alcoholic beverages or movies in hotel rooms. His instructions are the most detailed legal-fee instructions given to a city or county in a modern municipal bankruptcy case.

In Detroit's case, some firms said they refrained from making unnecessary or overly aggressive moves that would have run up the bill for the 680,000-resident city. Lawyers at Dentons U.S. LLP who spoke for the city's 23,500 retirees said that they also cut their bill by \$3.4 million. The firm charged \$14.6 million for helping explain the claims and voting process to retirees who were unfamiliar and "largely hostile" to the bankruptcy, firm officials said in court papers.

The Clark Hill PLC law firm, which charged \$6.3 million for work in representing the city's retirement systems, said its final bill is "eminently reasonable relative to the complexity of the matters addressed, the resources demanded by the case, and the interests at stake." Investment banker Miller Buckfire & Co. LLC which helped the city negotiate bond reductions, reorganize the

city's water and sewer department and find \$120 million in bankruptcy financing argued that city officials knew early on how much that work would cost.

Bankruptcy judges have less power over the fees charged to cities and counties that file for Chapter 9 protection because federal courts give states and the municipalities more latitude to govern. Specifically, the Code says that "the court may not by any stay, order, or decree, in the case or otherwise, interfere with...any of the property or revenues of the [municipality in bankruptcy]."

Even with taxpayers footing the bill, the watchdog in typical Chapter 11 corporate bankruptcy cases—the U.S. trustee's office—doesn't monitor the financial operations in municipal bankruptcy cases.

Other judges have used a hands-off approach in municipal bankruptcy cases, including Stockton, Calif.'s bankruptcy judge who decided that he doesn't need to approve settlements struck by city officials that, in a Chapter 11 corporate case, would normally need court clearance.

Detroit emerged from bankruptcy in December after cutting \$7 billion in debt owed to Wall Street firms, city retirees and others.

Throughout the city's bankruptcy, Detroit leaders fought pressure from some Wall Street creditors and others to sell the city's valuable art collection to repay a greater portion of the city's debt. Federal mediators helped negotiate a deal to use more than \$800 million from private foundations and the state of Michigan to avoid that sale and make the cuts to city's worker pensions less severe.

City leaders who blamed tax revenue that fell after the real-estate crash and the city's population decline are now planning to spend \$1.7 billion to revitalize the city by removing blighted buildings and boosting police and fire services in the city.

THE WALL STREET JOURNAL

By KATY STECH

Jan. 20, 2015 3:57 p.m. ET

(Dow Jones Daily Bankruptcy Review covers news about distressed companies and those under bankruptcy protection. Go to <http://dbr.dowjones.com>)

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## **[Obama Proposes Tapping Private Investors to Fund Infrastructure Projects.](#)**

WASHINGTON — The White House unveiled a tax proposal and administrative actions on Friday that are aimed at promoting private investment in roads, bridges, water systems and broadband networks.

The plans are an attempt to find ways to finance the vast backlog of American infrastructure projects without using any new federal money.

President Obama has repeatedly said that a broad effort to address the nation's infrastructure needs is a potential area of agreement between his administration and the Republican Congress, although deep divisions remain on how to handle such projects.

Vice President Joseph R. Biden Jr. is scheduled to discuss the plans here on Friday afternoon at the construction site of the Anacostia River Tunnel, which would handle the two billion to three billion gallons of contaminated sewage water that pour into the river each year.

One proposal that could draw bipartisan backing would create so-called qualified public infrastructure bonds that could be issued to finance airports; roads; mass transit, water and sewer systems; and other projects. They would be the first type of municipal bonds available for public-private partnerships and would be exempt from the alternative minimum tax.

The White House did not detail the cost of Mr. Obama's bond proposal, which officials said would be included in his budget, or how it would be paid for.

The Environmental Protection Agency and the Agriculture Department will also use existing federal funds to encourage private investors to finance infrastructure projects, including drinking-water and wastewater systems and rural energy and broadband projects, White House officials said.

On top of those public-private initiatives, Mr. Obama's advisers said the president still wanted Congress to increase federal financing for highways, bridges and transit projects along the lines of legislation he proposed last year that would authorize \$300 billion for the work over four years.

"Private capital is not a substitute for public investment," the White House said in a fact sheet outlining the plan. "But in the absence of Congress acting on this common-sense proposal, the president will continue to do whatever he can through his own authority to promote American economic growth where there is need or opportunity. And right now, there is a real opportunity to put private capital to work in revitalizing U.S. infrastructure."

The announcements come at the end of a week during which Mr. Obama has previewed a number of domestic proposals that will be featured in his State of the Union address on Tuesday. They include new policies on paid family leave, broadband access and cybersecurity. Last week, he outlined a plan to make community college tuition-free.

THE NEW YORK TIMES

By JULIE HIRSCHFELD DAVIS

JAN. 16, 2015

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## **[White House Proposal Would Encourage Public-Private Infrastructure Projects.](#)**

WASHINGTON—The White House will propose new policies designed to make it easier for the private sector to work with governments on infrastructure projects such as roads, ports, public transportation and utility networks.

As part of a series of policy rollouts in advance of next week's State of the Union address, the Obama administration is proposing the creation of a new kind of municipal bond to help finance projects that are jointly managed or financed by both government and the private sector.

The proposed new securities, called Qualified Public Infrastructure Bonds, wouldn't expire and would offer new tax advantages over current options for public-private municipal partnerships. The

administration says the proposed new bonds would help lower the cost of borrowing for cities and towns. The bond proposal would require a vote from Congress.

The Obama administration has also launched a new initiative at the Environmental Protection Agency to help attract more private-sector investment in drinking water and wastewater systems, as well as one through the Department of Agriculture that would find new opportunities for private-sector investment in rural water, energy and broadband projects.

Vice President Joe Biden will discuss the administration's proposals at a stop in southeast Washington, D.C. on Friday, appearing with EPA administrator Gina McCarthy, Secretary of Agriculture Tom Vilsack, and Washington, D.C. Mayor Muriel Bowser.

President Barack Obama has repeatedly stressed the need for greater investment in infrastructure, and has identified the topic as one potential area of compromise with congressional Republicans during his final two years in office.

In his State of the Union, he is expected to call on Congress to vote on a separate four-year, \$300 billion transportation proposal.

THE WALL STREET JOURNAL

By BYRON TAU

Jan. 16, 2015 9:53 a.m. ET

—John D. McKinnon contributed to this article.

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## **[The Other Debt Bomb in Public-Employee Benefits.](#)**

Underfunded health-care obligations may be close to \$1 trillion. Many cities and states are in for big trouble.

Public-pension funds have garnered attention in recent years for being underfunded, but a more precarious situation has received much less notice: health-care obligations for public retirees.

Unlike pension plans, governments are not required to contribute to separate trusts to support health-care promises. As a result, only 11 states have funded more than 10% of retiree health-care liabilities, according to a November 2013 report from the credit-rating agency Standard & Poor's. For example, New Jersey has almost no assets backing one of the largest retiree health-care liabilities of any state—\$63.8 billion.

Only eight out of the 30 largest U.S. cities have funded more than 5% of their retiree health-care obligations, according to a [study](#) released last March by the Pew Charitable Trust. New York City tops the list with \$22,857 of unfunded liabilities per household.

What exactly are retiree health-care obligations? State and local governments typically pay most of the insurance premiums for employees who retire before they are eligible for Medicare at age 65. That can be a long commitment, as many workers retire as early as 50. Many governments also pay a percentage of Medicare premiums once retired workers turn 65.

Total U.S. unfunded health-care liabilities exceeded \$530 billion in 2009, the Government

Accountability Office estimated, but the current number may be closer to \$1 trillion, according to a 2014 comprehensive study released by the National Bureau of Economic Research.

Governments usually finance health-care spending with current revenues from property taxes and other sources. They'll need to reverse this spending growth to have enough revenue to pay for essential services such as schools and police.

For years, state and local governments could promise more health-care benefits without much accountability. To provide more transparency, the Government Accounting Standards Board since 2006 has required governments to disclose retiree health-care benefits in their financial reports.

In 2014 the GASB proposed major improvements to the disclosure requirements. Perhaps most important, the new rules would require state and local governments to include these liabilities on their balance sheets, rather than in financial footnotes.

The GASB also proposed that all governments use the same discount rate—equal to the interest rate on AA-rated municipal bonds. Governments use an assumed investment yield when figuring out the amount of current assets needed to finance future benefits. Many governments have assumed unrealistically high yields to understate the current funding shortfall.

At the same time, some state and local governments are attempting to reduce their health-care obligations. This is much easier legally than reforming pension benefits, which often are protected expressly by state constitutions. But reductions in retiree health-care obligations are still subject to collective bargaining and sometimes litigation.

Since 2010 more than 15 states have passed laws to reduce health-care cost-of-living adjustments—automatic benefit increases linked to the consumer-price index. Courts in eight states upheld these reductions on grounds that cost-of-living adjustments should not be considered a contractual right. Only Washington's law was struck down in 2011, and the case is now on appeal.

Some state and local governments—Nevada and West Virginia, for example—have increased deductibles and scaled back premium subsidies. Others like Ohio and Maine have reduced the health-care benefits provided to retirees.

Several years ago Pennsylvania changed early retirement eligibility to 20 years of service from 15. In Massachusetts, however, public employees with 10 years of part-time service still qualify for retiree health care.

In a few jurisdictions, public retirees now must purchase health insurance through Affordable Care Act exchanges, rather than directly from a private insurance company. This allows retirees to receive premium subsidies from the federal government, reducing the burden on state and local governments. Of course, this does not change the actual costs of retiree health care.

The GASB should adopt its recent proposals despite significant resistance from governmental groups and officials like Ohio Auditor Dave Yost, who testified against the rule, arguing that health-care benefits should not be considered liabilities since they are not legally binding like pensions.

Taxpayers could use the new information to examine the trajectory of their city and state's retiree health-care obligations, and consider reform. One possible approach: Tie the level of health-care subsidies to the number of years in public employment above a reasonable minimum. Another idea: Apply the reductions in health-care benefits mainly to new or younger workers, while maintaining the benefits of retired employees.

In any event, states and cities should set up separate trusts with enough investment assets to support over time whatever health-care benefits they have promised. Then these commitments will have more credibility with public employees, and governments can avoid a time bomb that could explode on future budgets.

THE WALL STREET JOURNAL

By ROBERT C. POZEN

Jan. 15, 2015 7:10 p.m. ET

Mr. Pozen, a senior lecturer at Harvard Business School and a senior fellow at the Brookings Institution, is the author of "Extreme Productivity: Boost Your Results, Reduce Your Hours" (HarperBusiness, 2012).

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### **[Fitch: More US Defense Budget Cuts May Raise Housing Bond Risk.](#)**

Fitch Ratings-New York-15 January 2015: The cuts to the growth in Basic Allowance for Housing (BAH) rates are unlikely to have an immediate impact on taxable military housing bonds at their current levels. However, if the US Department of Defense (DoD) continues cuts in coming years, Fitch Ratings expects that changes in the demand dynamics for privatized military housing transactions could potentially affect those projects' bottom lines and their debt-service coverage levels over time. This was the first time BAH rates have been sized at less than 100% of market rates since 2005.

The bonds or certificates that were issued to finance privatized military housing are commonly secured by a first lien on all receipts from privatized housing on military bases, which can be made up of one or multiple projects and/or bases. The 2015 BAH aggregate rates for military housing rose by 0.5%. Because some of the bases and rank levels were positively impacted and some were negative, the net change for most Fitch-rated transactions will be small. The BAH in higher rent areas, such as California, received sizeable increases, while more rural areas declined.

How the cut is implemented for those residing in on-base privatized housing will play a role in how great an impact there will be on individual project's bottom lines. Service members who receive the BAH are subject to internal rate protection as new BAH rates do not take effect unless the military service member has a change of station and is assigned to another base in 2015. The current BAH rate is grandfathered at the higher level until the service member is sent for permanent duty at another location or moves. Tenant turnover has been estimated at 30% per year.

The potential for further cuts to the BAH through future defense budgets is uncertain, as are annual changes to BAH rates. The DoD has indicated it needs to reduce personnel spending to meet budgetary goals. While the DoD originally intended to cut the BAH by 5%, the current National Defense Authorization Act only cut the BAH by 1% and set rates to cover 99% of the estimated cost of local housing. Personnel costs are more than one-third of the DoD's non-war 2015 budget. In February 2015, the Military Compensation and Retirement Modernization Commissions will deliver their recommendations to Congress, which may include additional cuts.

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## **[Obama Proposes New Muni Bonds for Public-Private Investments.](#)**

President Barack Obama is proposing a new class of municipal bonds to spur private investment in U.S. infrastructure projects.

The program, called Qualified Public Infrastructure Bonds, wouldn't expire, and there'd be no cap on issuance, the administration said in a statement Friday. The debt also wouldn't be subject to the Alternative Minimum Tax, which limits the tax benefits and exemptions that high-earning individuals can claim.

"QPIBs will extend the benefits of municipal bonds to public private partnerships, like partnerships that involve long-term leasing and management contracts, lowering the cost of borrowing and attracting new capital," the administration said in the statement. The bonds will serve "as a permanent lower cost financing tool to increase private participation in building our nation's public infrastructure."

The proposal for a new type of security in the \$3.6 trillion municipal market is part of a broader White House plan calling for more investment in roads, bridges and other infrastructure in advance of the administration's budget proposal that will be released Feb. 2.

### **Building Block**

The market contracted in 2014 for an unprecedented fourth straight year as local officials refrained from borrowing even as tax-exempt interest rates were close to generational lows.

The last time the market expanded was in 2010, the final year of the federal Build America Bonds program. The initiative, popular with local officials and Wall Street investors, gave municipalities a subsidy on interest costs for issuing taxable debt to finance infrastructure work.

The new type of debt for public-private partnerships, or P3s, would build upon the \$10 billion private-activity bond market by including funding for airports, ports, mass transit, water and sewer initiatives. There's a \$15 billion limit to issuance of private-activity bonds. The proposed bonds can't be used to privatize public systems or finance privately owned facilities.

America's federal, state and local governments need to spend \$3.6 trillion through 2020 to put the nation's critical systems in adequate shape, according to a 2013 report from the American Society of

Civil Engineers. Without higher spending, the group projects the costs of travel delays, power and water outages will reach \$1.8 trillion by 2020.

## **Alternative Appeal**

“The interest in P3s has clearly been growing, and we’ve seen states in particular launch a lot of these projects,” said Robin Prunty, who oversees state credit ratings at Standard & Poor’s in New York, said in an interview. “The availability of an attractive alternative with cost-effective financing, certainly from a strict muni perspective that’s a positive.”

Obama has made previous calls for increased infrastructure investment since the end of Build America Bonds, which were part of his 2009 stimulus plan. He asked Congress in 2013 to create a national infrastructure bank and recommended a program called America Fast Forward Bonds. He sought the same initiatives last year after they failed to advance in Congress.

Because the new munis would require legislative approval, it’s unlikely they’ll become reality, said Matt Posner at Municipal Market Analytics.

“MMA suggests clients put the reality of these bonds ever entering the marketplace at a very low probability,” Posner, a managing director at the Concord, Massachusetts-based research firm, wrote in a note today.

## **Tax Threats**

The president has also recommended altering the century-old policy of giving a tax exemption to interest on muni bonds. He’s recommended a 28 percent cap on income-tax deductions for the wealthiest households since 2011.

The tax break also has faced challenges in Congress amid a push to curb the federal deficit, including from Oregon Senator Ron Wyden, the top-ranked Democrat on the Finance Committee. No proposals have advanced.

While it’s unclear how much of Obama’s latest initiative may be implemented, the plan for the new bonds is welcome, said Robert Poole, director of transportation policy at the Reason Foundation, a nonprofit in Los Angeles that advocates free markets.

Many people who track public-private partnership deals are concerned that the cap on private-activity bonds will be reached in the next few years, he said.

“Eliminating that cap — mainstreaming level playing-field financing for P3 projects — is huge,” Poole said by e-mail.

Bloomberg

By Brian Chappatta

Jan 16, 2015

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## **Municipal Issuer Brief - What Should Be on Issuers' Radar.**

Municipal Market Advisors | Jan. 13

[Read the Brief.](#)

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### **Long Beach Civic Center P3 Hybrid to Plenary.**

The City Council of Long Beach, Calif., this month unanimously chose a DBFOM team led by Plenary Group to negotiate terms of a complicated real estate/P3 deal for developing a new downtown civic center, new port headquarters and related private development. To help meet the city's affordability cap, Plenary proposes to fund the civic center, comprising a new city hall, library and park, with tax-exempt debt. The spread risk on those bonds remains with the Plenary consortium until financial close, which could occur in mid-to-late 2015, Plenary's target, or mid-2017, the deadline set in the RFP.

The \$12.6-million (FY 2014) annual affordability cap set in the RFP is the amount the city now spends on its existing facilities, deemed seismically unsafe. The city's actual lease payment under the cap will be negotiated as scope changes are considered in Plenary's proposed design. The final amount, subject to deductions for under-performance, will be indexed to inflation, capped at 6 percent a year over the 40-year term of the agreement.

Plenary's tax-exempt structure involves City debt issuance through a non-profit corporation, a contract for development services to Plenary's project company, and Plenary purchased subdebt to backstop effective risk transfer.

"We believe we've found an innovative way to marry tax-exempt structure with the long-term risk transfer objectives of a P3," says Stuart Marks, senior vice president at Plenary. "This option is open due to the unique features of this project and the procurement methodology selected by the city," says Marks. "They kept an open mind and encouraged innovative proposals."

(Marks leads Plenary's U.S. origination activities, including directing bidding consortia across all aspects of project development and overseeing project financing, structuring and commercial activities.)

Both senior and subordinated debt would be issued by the non-profit to fund the civic center projects, estimated to cost \$180 million, and to defease \$20 million in city debt. The higher-risk subordinated debt would be purchased by Plenary and held as long-term "quasi equity" in the deal.

(Plenary does not invest for a traditional captive fund. It pursues long-term P3 opportunities with its own equity, part of which is sourced at a Plenary corporate level from strategic institutional investors.)

Plenary believes this allows for greater flexibility in the types of investments it pursues, such as subordinated debt, although some equity funds also can also hold those bonds.

This also leaves Plenary fully in control of its equity without concern for 3rd party restrictions, interference or differing investment views or horizons.)

The City of Long Beach believed it could finance a new city hall, library and park using funds already budgeted to operate and maintain those city assets. Proceeds from the sale of excess property around the new civic center to the selected developer would subsidize the civic elements of the project. Consolidation efficiencies would reduce operating costs. Building a new headquarters in the complex for the Port of Long Beach, a city department, was included as an option that would produce scale economies in design and construction.

Long Beach issued an RFI in April 2013 as a market test, got seven responses, then hired Arup Financial Services in December 2013 to develop a procurement strategy and draft an RFP. Three teams were shortlisted in June 2014 and one, real estate developer, Related California, dropped out. That left a DBFOM team led by Macquarie as the sole competitor against Plenary.

Arup had devised a competition where teams would offer “soft bids”—without committed financing or a committed price—that, after stress testing, were deemed most likely to meet the \$12.6-million (FY 2014) annual affordability cap set by the city to pay the capital and operating costs of the new civic center.

That approach provided flexibility but it leaves the city without a fixed-price bid. “The City has now put themselves in a position of finalizing pricing, financing, specs etc. without the benefit of competitive pressure and the innovation that brings,” says a P3 developer that declined to compete in Long Beach.

Much remains to be negotiated between the city and Plenary’s team. “Our selection is the beginning of the partnership,” says Dale Bonner, Executive Chairman of Plenary Concessions. “We’ve still got a lot of work ahead of us” to further define the City’s goals and requirements for the project.

Extensive public outreach was added to gain the support of the city’s new mayor and council, who were seated in July. In addition, the city auditor will monitor contract terms as the negotiations proceed, says Bonner, so that there will be no surprises at the end.

Plenary’s team includes 20% partner Edgemoor Infrastructure & Real Estate. Clark Construction, Edgemoor’s parent, and architect SOM will design and construct the civic center and 11-story port headquarters, estimated to cost \$179-million. Johnson Controls Inc. (JCI) will provide facility management services for the civic center components and, potentially, subject to further discussions with the Port, the Port’s new headquarters building.

To firm up its bid price and financing details, the Plenary team now must:

- Conduct extensive public hearings on its civic center design and master plan for revitalizing the city’s downtown area;
- Obtain all environmental permits and other entitlements to the five-acre site;
- Negotiate specifications and scope;
- Confirm its authorizing legislation; (The proposed DBFOM structure is authorized by general law in California, but the City is also considering pursuing project-specific authorization at the state level.) and
- Arrange financing, which would include defeasing about \$20 million in city debt.

Plenary and Edgemoor would put in about \$30 million cash at financial close, its agreed purchase price for around three acres of city land near the civic center.

If Plenary meets its obligations during the exclusive negotiation period to get to financial close and Long Beach doesn’t, the city has agreed to pay the developers a termination fee of up to \$3.5-

million.

Including that contingency, the city has budgeted \$9.2 million for legal and financial advisors to negotiate the final agreement. Arup and law firm Sheppard Mullin Richter & Hampton LLC will represent the city. The port is expected to pay half of the consulting fees. Its advisory team, if any, was not noted in the public presentations.

The city's timeline would require consulting services through mid-2017. Plenary, which has a staff of 80 P3 specialists in North America, believes it can complete California Environmental Quality Act clearance in around six months, then finance and begin work before the end of 2015.

### **Sources**

- City funds available for payment to the Project Company (affordability limit): \$12.6 million (FY 2014) per year, with annual inflation increases capped at 6%.
- Plenary purchase of city land: \$30 million at financial close.

### **Uses**

- Fund Civic Center (City Hall, Library, Lincoln Park) capital costs: \$180 million
- Defeasement city debt: \$20 million
- Pay debt service and operating costs, including facility management costs, SPV costs, lifecycle costs, energy costs (a material component) and management fees for the tax-exempt structure. The city estimates that cost will be \$7.6 million per year, though it is subject to adjustment.

### **P3 Real Estate/Tax-Exempt Model - A Market Test**

"The market is still trying to figure out what a social infrastructure P3 is," says Orion Fulton, Senior Manager with Arup Transaction Advice. The Canadian fixed-price concession model with private finance worked well for the Long Beach Courthouse P3 and will be tested in a few months for a new Judicial Complex in Indianapolis.

But that model didn't fit the Long Beach Civic Center project. Combining real estate development, urban revitalization and DBFOM delivery of large public buildings under an affordability cap using a P3 model requires great flexibility, he says.

Fulton admits that the hybrid real estate/P3 project in Long Beach isn't what pure P3 developers want. But "it's the cold hard reality of where the public sponsors are now," he says. "The P3 purists back away as soon as they see tax-exempt financing and real estate. Well, good luck in trying to get deals done," he says.

Long Beach transaction details won't be set for months, maybe years. "It's not a victory yet," says Ignacio Barandiaran, who heads Arup's transaction advisory group in North America. "It's an opportunity to set a precedent."

By Editor January 16, 2015

By William Reinhardt, editor, Public Works Financing

Public Works Financing is a monthly newsletter covering P3s in all infrastructure markets, since 1988. It is widely read and cited in the media, academic research, federal reports and congressional testimony.

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## **Indy Justice Center Draws Big Guns to U.S. P3 Market.**

The U.S. P3 market reached a milestone recently when the winning bidder for a large social infrastructure project submitted a financial proposal that featured a committed-price private placement financing drawn down at the start of construction. This is the first time large insurers and pension funds have been willing to fund construction of a large U.S. DBFOM project with a fixed credit spread that was competitive with other sources of funds and, in this case, that allowed the winning team to meet the city's strict affordability limit.

WMB Heartland Justice Partners, led by Meridiam Infrastructure, was selected on Dec. 12 from three finalists to negotiate a 35-year availability-payment contract for DBFOM delivery of the Marion County Justice Center in downtown Indianapolis. WMB's low capital cost, \$408 million, won the day.

That and other details will be confirmed over the next few months as the P3 agreement is finalized and submitted to the City-County Council.

WBM marketing efforts last fall led to commitments for about \$525 million in senior debt by U.S. and Canadian institutions. They agreed to take the credit-spread risk from selection to financial close, now set for March 31, 2015. The total financing, including 10% equity, is \$583 million.

Meridiam has experience in the private placement market. It refinanced its Long Beach Courthouse P3 project with a private placement of \$520 million in 5.88% senior secured notes in November 2013. The credit spread started at 275 bps and steps up to 375 bps at maturity in 2047.

There is some cross-over between the participants in the two financings, but most of the Marion County Justice Center lenders assembled by Barclays Private Placement are new to the P3 market.

"This is a great milestone," says Joe Aiello, Meridiam's Director of Business Development North America. "It's an additional source of reasonably priced debt from extraordinarily high-quality institutions." Moreover, the borrowed funds can be taken down immediately at financial close to support construction.

Indianapolis was a good jumping-off point. The city is a strong credit with a history of supporting long-term P3s. Mayor Greg Ballard's recent decision not to run for a third term reduces the risk of politics in the final vote by the City-County council in March. The private participants in the WMB Heartland Justice Partners consortium have world-class credentials. And the P3 contracts are well structured:

- The city agreed to acquire the 46-acre brownfield site and to provide all land entitlements prior to financial close. It will assume all environmental risk at the former industrial site, and pay for pollution liability insurance. The developer will secure a local land-use permit.
- There is no real estate component to the revenue calculation in the affordability cap. Prospective revenues from selling excess downtown property after the existing jails and courthouse are vacated in three years are not counted.
- The city is focused on affordability and is not seeking to win architectural awards.

The \$58.3 million in equity is shared between three experienced developers: Meridiam (70%), Walsh Investors, LLC (15%), and Balfour Beatty Investments, Inc. (15%).

A world-class joint venture of Walsh Construction and Heery International will undertake the three-year design-build work. Skidmore, Owings & Merrill, Dewberry Architects, and Parsons Brinckerhoff

will support their effort. Walsh has a major presence in Indiana as an investor and builder, including a DBFOM contract for the \$1.1-billion East End Crossing of the Ohio River.

Cofely Services, based in Belgium, is a subsidiary of French giant GDF Suez. Cofely will operate and maintain the jails and courtrooms in Indianapolis for the 35-year operating period, starting in July 2018. Its site manager, Albert French, brings prison management expertise from British Columbia.

### **Justice Center Advisors Praised**

Adam Collins, Indianapolis Deputy Mayor of Economic Development, gives high praise to the city's consulting team, which helped speed the Justice Center procurement to completion in under 18 months. "If we hadn't hired these consultants, we wouldn't have issued an RFP by now," he says. "The number one reason we got value-for-money is we brought consultants in early."

Advising the Indianapolis Mayor's Office, the Marion County Sheriff Office and the Marion County Circuit Court are:

- KPMG LLP—has a division that is solely focused on helping cities find efficiency savings; insisted on a 5% design in the bid documents, encouraging innovation, says Collins.
- Nossaman LLP —brought national experience in P3 procurements, bid documents, contract negotiation, says Collins.
- Hellmuth, Obata & Kassabaum, Inc. (technical)—brought national best practices to master planning and urban design, Collins says.

Advising WMB Heartland Justice Partners are:

- Barclays Capital (private placement agent)
- The Bank of Nova Scotia (financial advisor)
- Norton Rose Fulbright (lead legal counsel)
- Ice Miller (local counsel)

Advising the institutional lenders are:

- Mayer Brown (legal counsel)
- Greenberg Traurig (legal counsel private placement)
- BTY Consultancy Group (technical advisor)

### **Affordability Depends On Efficiency Savings**

The winning proposal by WMB Heartland Justice Partners required the lowest annual payment from the City/County while also meeting the rigorous technical specifications established for the project. The new justice complex will feature 37 criminal court/hearing rooms, offices for the Marion County Sheriff's Office, a 3,000-bed detention facility with on-site medical and mental health units, a 960-bed community corrections facility, and surface parking facilities.

Key financial aspects of WMB Heartland Justice Partners' proposal include:

- An annual service fee payment by the City/County of \$46.8 million (2019 dollars)
- This annual service fee is \$3.3 million a year less than the City's affordability limit
- The construction cost of the campus and the facilities will be \$408 million, well below estimates of \$500 million to \$700 million.

The present value of the service fee payments the City will make to WMB Heartland Justice Partners

over the 35-year term of the agreement is \$717.7 million. This covers the construction costs and facility management.

Marion County expects to fund the project from the reallocation of budget dollars from expiring contracts and leases, including savings of \$19 million per year from closing a jail, as well as from reduced operational costs and future revenue sources such as \$50 per diem for holding federal arrestees.

The new center will significantly reduce the Sheriff's costs for transporting arrestees among multiple detention and court buildings and save taxpayers' dollars through the use of centralized security, food preparation, medical, laundry, maintenance and other shared services. The new facility will not require an increase in taxes.

The City will begin final negotiations with WMB Heartland Justice Partners on a project agreement in mid-December. Once that agreement has been finalized, proposals from the two non-selected P3 teams will be released. They are:

- Indy Justice Partners: Fengate Capital Management/ AECOM Global Fund I LP/ Shiel Sexton Company, Inc.
- Plenary Edgemoor Justice Partners: Plenary Group USA Ltd./Edgemoor Infrastructure & Real Estate LLC, with Clark Construction/HDR.

The final project agreement and the proposals submitted by Fengate and Plenary will be made public prior to a vote by the City-County Council by the end of March. If approved, construction could begin in June 2015 and open in 2018.

January 16, 2015

By William G. Reinhardt, editor, Public Works Financing

Public Works Financing is a monthly newsletter covering P3s in all infrastructure markets, since 1988. It is widely read and cited in the media, academic research, federal reports and congressional testimony.

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## **[L.A. Stadium Developers Expect Public Paybacks.](#)**

LOS ANGELES — The developers behind a sprawling sports and housing complex in the Los Angeles suburbs — whose centerpiece stadium could become home for an NFL team — expect to recoup up to \$100 million in local tax dollars in the first five years of operation, an Associated Press review has found.

When the proposal was unveiled last week, Christopher Meany, a senior executive with the joint venture designing and financing the project, emphasized that “there will be no public dollars, no taxpayer dollars, used for this project.”

While the plan does not include any upfront tax money to build the 298-acre community of homes, offices and entertainment venues, a 187-page outline released by developers includes provisions for multimillion-dollar public paybacks to them over time from tax dollars generated by the project, which would cover costs ranging from installing street lights and fire hydrants to running shuttle buses and providing police security on game days.

The documents submitted to officials in Inglewood, where the stadium would be built, say that if annual tax revenue to the city from the completed project exceeds \$25 million as expected, the developers, including a company controlled by the owner of the St. Louis Rams, would be entitled to reimbursements for funds they invested in streets, sewers, parks and other projects deemed dedicated to the public.

Chicago-based sports finance consultant Marc Ganis said claiming no tax money would be used in the project is “hyper-spin” and could damage the project’s credibility. “It’s not an outright lie ... but there will be people who think it is,” Ganis said. “They might be prospective tax dollars, and it might make sense for Inglewood to contribute them to the project, but they are tax dollars.”

Inglewood officials are reviewing the proposal, but Mayor James Butts said the deal appears favorable because the city isn’t required to invest hundreds of millions of dollars into the development. The city about 10 miles from downtown Los Angeles could end up with a steady source of tax income and a vibrant entertainment mecca, he said.

“We get revenue that we didn’t have to make a financial investment for. That is unheard of in a project of this magnitude,” Butts said.

The proposal envisions a domed, 80,000-seat stadium rising on the site of a defunct horse track and would also include a 6,000-seat performance venue and parking. It’s the latest in a string of stadium proposals in the Los Angeles area since the Rams and the Oakland Raiders abandoned Southern California after the 1994 season.

According to the plan, developers could be reimbursed an estimated \$50 million to \$60 million for building the structural backbone of the site: sidewalks and road work, landscaping, water mains and utility lines. Meany said in a statement that those costs are expected to be paid back within the first few years from tax revenue generated by the project, and they represent a fraction of the overall investment.

Additionally, the records say developers can be reimbursed by the city for costs on event days for police, emergency medical crews and shuttle bus services from off-site parking. They estimate that could tally \$8 million annually, or \$40 million for a five-year period.

The records were submitted to the city as part of developers’ plans to place a ballot question before Inglewood voters later this year, which must be approved before stadium construction could move forward. They first must gather thousands of petition signatures to qualify the question. The alliance behind the plan, the Hollywood Park Land Co., includes The Kroenke Group, controlled by Rams owner Stan Kroenke, and Stockbridge Capital Group, which had been developing a 238-acre tract of homes, parks and office space at the former Hollywood Park track. Kroenke’s company owns an adjacent 60 acres, which would be merged into the overall development.

By the developers’ estimate, in its first 25 years, the project will produce more than \$1 billion in local taxes — on property, tickets, parking, utilities and other sources. The first \$25 million each year would be guaranteed for Inglewood, and once developers are reimbursed for eligible costs, any surplus would stay with the city.

West Virginia University economist Brad Humphreys said that the cost of infrastructure in stadium deals is typically absorbed by government, even in developments described as privately financed, as with the Washington Redskins’ new stadium. He noted that research has found taxpayers often end up paying more than forecast in sports stadium and arena projects, once infrastructure and other

costs are considered.

Victor Matheson, a specialist in sports economics who teaches at the College of the Holy Cross in Massachusetts, said the reimbursements for the Inglewood project amounted to “essentially giving tax breaks.”

“The project isn’t quite subsidy-free, but it is also a far cry from the direct building subsidies that averaged about two-thirds of total stadium costs in the building boom” of the 1990s and early 2000s, he said.

By: The Associated Press

January 12, 2015

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## **Oil Price Decline Mostly Positive for Municipals... At Least for Now.**

### Summary

- Most states and local governments should benefit from higher tax receipts as more consumer discretionary income leads to a pick-up in spending.
- Negative effects will be localized around energy producing areas, especially if oil prices stay low for an extended period.
- Longer-term implications could be negative for credit quality if weaker economic conditions in other parts of the world create a drag on U.S. growth.

The dramatic move lower in crude oil prices over the last six months is good news for consumers at the pump. Since most gas tax revenues are collected on a per gallon basis, money formerly spent on gas should net most governments higher tax receipts if consumers spend the newfound money.

Of course, those states with economies heavily concentrated in energy production, namely Alaska, Wyoming and North Dakota, are likely to experience job losses and lower overall tax revenues. There will also be localized pain in cities and towns in other parts of the country involved directly in production or upstream vendors heavily tied to the energy industry. Cutbacks in production are already occurring and are likely to pick up, especially if crude oil prices stay lower for an extended period.

Fortunately, many governments understand their strong connection to the energy industry and conservatively set aside above average levels of reserves knowing that prices may one day fall, especially since they have done so in the past - crude oil has fallen by more than 50% five times since the mid-1980s. Of course, there will be outliers that experience financial distress and all governments directly connected to the industry are likely to run near-term deficits as they right size budgets to match lower tax receipts. Fortunately, many of those affected are starting from a very strong position, so we don’t expect to see many, if any, municipal defaults as a result of the large decline in crude oil prices.

Toll roads are one transportation sector likely to benefit as lower gasoline prices lead to more travel and congestion, making toll roads an attractive alternative. Airports should also strengthen as their major tenants, the airlines, take advantage of lower costs and possible increases in travel. The decline in gasoline prices may also make increasing the Federal gas tax a more palatable solution to funding the Highway Trust Fund. More members of the new Congress, previously committed to not

increasing taxes, have indicated that additional taxes on gasoline could be part of the solution for funding infrastructure.

Of course, oil price declines at least partly reflect economic weakening in other parts of the world. The U.S. economy has thus far stayed the course of slow, but positive growth. However, the economic malaise in other parts of the world could eventually slow growth in the U.S. and reverse some of the short-term benefits most municipal credits are currently experiencing.

Income from tax-exempt municipal bonds or municipal bond funds may be subject to state and local taxes, and a portion of income may be subject to the federal and/or state alternative minimum tax for certain investors. Federal income tax rules will apply to any capital gains.

*There are risks associated with an investment in bond investments, including the impact of interest rates, credit and inflation. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.*

Seeking Alpha

By Chad Farrington, CFA

Jan. 12, 2015 3:15 PM ET

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### **[BlackRock Likes Barbell Approach for Munis.](#)**

BlackRock's municipal-bond team of Peter Hayes, James Schwartz, and Sean Carney today points out that the muni market had a "perfectly positive" year in 2014, posting a net gain in each of the years' 12 calendar months, while muni mutual funds were nearly perfect on a weekly basis, posting net inflows in 50 out of 52 weeks. For 2015, BlackRock says investors should adopt a barbell strategy focusing on short-dated bonds maturing in two years or less and long-dated bonds maturing in 15 to 20 years. From BlackRock:

"Ratios remain attractive (at year-end, 30-year munis were outyielding 30-year Treasuries before tax, making their yields even more attractive after tax). Munis are built for income, and investor appetite for income is insatiable. To wit, demand remains very strong and we foresee another year of net negative supply—a scenario that is good for pricing. Our strategy heading into 2015 is to maintain a barbell approach, holding very short maturities for liquidity and longer maturities for yield pick-up and to benefit from a flattening yield curve. We see greatest value in lower-rated investment-grade securities. Overall, munis are a momentum-driven market. With 2014 momentum well intact, we see little reason for big changes as the calendar turns the page."

Sector-wise, BlackRock likes state tax-backed and essential-service bonds, particularly in Texas, Virginia and the Plains States, as well as school-district bonds and dedicated-tax bonds. BlackRock is underweight land-secured bonds, senior-living bonds and pre-refunded bonds, as well as Puerto Rico bonds.

Barron's

January 12, 2015, 3:23 P.M. ET

By Michael Aneiro

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## **Muni Bond Manager's Journal: Biting Into the Credit Donut.**

My team and I were finalizing a presentation to investors and trying to come up with a way to express the credit-driven nature of the municipal bond investment process. The continuous circle seemed like the best way, since the seven components were interdependent—what happened with one affected another.

I like to call it the “Circle of Credit,” reinterpreted loosely from *The Lion King*, but one wag thought it looked more like the brightly colored donut that Homer Simpson enjoys on his nearly eponymous show. No shock to anyone: the donut nickname stuck. Circle or donut, however, the point remains the same: every part of the analytic methodology is connected.

The process starts with the “Top 5” essential financial performance measures: debt service coverage, debt burden, debt-to-capitalization, days of cash on hand, and operating margin.

The exact calculation and components of each may vary depending on whether the borrower is a municipality issuing general obligation bonds or an authority issuing on behalf of a hospital, college or public utility.

After vetting the financials, we examine the covenants, liens and other documents that set out the legal protections for the bondholder should something go wrong.

For the longest time, a general obligation bond, which is backed by the unlimited taxation power of the issuer, was viewed as the strongest security for bondholders. However, as recent defaults in Detroit and Stockton, CA have shown, even “unlimited” tax pledges have limits.

A first mortgage lien or a first lien on dedicated tax revenues is now viewed as preferable, and bondholders are demanding greater yield for subordinate lien bonds, bonds with general revenue pledges, or bonds funded by annual budget appropriations. As these recent events also demonstrate, having a security protection is one thing, being able to enforce it is another.

Competition must also be considered. Municipalities compete for residents in both subtle and not-s-subtle ways. For example, property-tax rates, along with the quality of schools and other municipal services affect whether or not prospective homebuyers will move into a community. With deregulation of utilities in some areas, electricity customers can choose their power providers. Hospitals have to consider what a cross-town facility offers to attract patients.

We also pay attention to overall sector economics, the factors that shape the forces of supply and demand in the sector. For example, public utilities buy coal or gas to generate energy, and examining their supply chain and pricing are important considerations.

Along with the broad sector view, we see how general demographics affect the credits. A growing community may bode well for increasing a municipality’s tax base. There would also be increased demand on the utility grid, which would mean understanding if the existing infrastructure can handle the load or needs upgrading. It may also mean schools will need to borrow to upgrade and expand. An aging population influences the case mix and capital needs of the local hospital.

Legislative, regulatory and political events are important considerations in the public policy-driven world of municipal bonds. From tax exempt interest to changing rules on disclosure, there are policy issues affecting this market.

However, all politics is local—voters have their say on new bond issues in their community every election day, whether it is to build new schools, improve roads or replace municipal buildings. Local councils vote regularly on fees and charges, property tax increases, new housing developments and a host of other issues which may directly affect the creditworthiness of outstanding or to-be-issued bonds.

National macroeconomic trends get very credit specific quickly, as the 2008-2009 recession powerfully demonstrated. In communities across the country, the rising unemployment rate meant property values declined along with sales tax revenues, two key components of municipal budgets.

No sector was spared: toll roads saw revenues decline, hospitals saw uninsured care costs rise and so on down the credit line. Correspondingly, the numbers reported on the balance sheets, income statements and annual reports of municipal issuers across the country all reflected the decline.

Now we are seeing the influence of the recovery in the economy. Applying the “Top 5” financial performance measures to the financial statements, we see an improving trend in every sector, from housing to healthcare.

We’ve come full circle.

Forbes

1/14/15

Barnet Sherman, Contributor

Barnet Sherman is a director and portfolio manager at TIAA-CREF, a national financial services organization.

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## **[Puerto Rico Facing Debt Risk Beyond Power Utility: Muni Credit.](#)**

Governor Alejandro Garcia Padilla’s strategy to bolster the Government Development Bank, which lends to the junk-rated commonwealth and its localities, hinges on a planned \$2.9 billion bond sale backed by increased petroleum-tax revenue. Lawmakers intend to amend the deal this month to make it more attractive to investors. Without the borrowing, the GDB’s cash would drop by almost half by March 31, according to Moody’s Investors Service, crimping its ability to serve as a financing backstop.

Puerto Rico and its agencies are staggering under \$73 billion of debt, which would rank the territory third among U.S. states. The island needs to meet revenue targets and get its economy to grow to enable it to provide services to its 3.5 million residents and also repay investors, said Municipal Market Analytics Inc.’s Bob Donahue.

“The challenges that are coming down the pike here are greater than they’ve ever been,” said Donahue, managing director of the Concord, Massachusetts-based research firm. There’s concern that the commonwealth has to pay short-term bills “at the same time as public-safety responsibilities must be met.”

**Record Overhaul**

The Electric Power Authority, called Prepa, is working on a plan to restructure \$8.6 billion of liabilities this year, and commonwealth officials have warned that bondholders may take a loss. The move, which would be the largest restructuring ever in the \$3.6 trillion municipal market, became feasible after lawmakers in June passed a measure allowing some public corporations to restructure debt.

“The GDB and the Puerto Rican government continue to execute their plan to strengthen the island’s fiscal health and support its economic growth,” Melba Acosta, president of the bank, said in an e-mail. “We passed the Recovery Act last year in order to ring-fence our general-obligation debt from that of Puerto Rico’s public corporations, which are making progress in resolving their financial difficulties.”

## **Repayment Order**

Puerto Rico’s borrowings include \$13 billion of general-obligation debt, most of which is tax-exempt nationwide and held by individuals, mutual funds and hedge funds. About 54 percent of muni mutual funds own Puerto Rico securities, according to Morningstar Inc.

Debt of other agencies and even general obligations — which the commonwealth’s constitution stipulates must be repaid before other bills — may face an overhaul as well unless the economy gains momentum and residents stop leaving, said Bart Mosley, co-president of Trident Municipal Research in New York. The population has dropped each year since 2005, shrinking 7 percent, according to U.S. Census data.

In a bid to balance budgets, lawmakers have raised taxes and boosted utility and transportation fees while also cutting payrolls, raising the retirement age and requiring public workers to contribute more to pensions.

If legislators ask for more changes to retirement benefits and tax increases, residents may push officials to trim the island’s debt by negotiating with investors, Mosley said.

## **Debt Choice**

“It would be very hard to assume that they don’t choose to go down something that looks like a sovereign-debt restructuring at some point with the general-obligation debt,” Mosley said.

Rating companies cut Puerto Rico to junk in February 2014. Moody’s scores it five levels below investment grade at B2, while Standard & Poor’s assigns a BB, three steps higher.

Financial pressures may intensify if the Infrastructure Financing Authority, called Prifa, is unable to sell the debt repaid with petroleum taxes. A law passed in December capped the average coupon at 8.5 percent, and set a minimum price of 93 cents on the dollar. Legislators plan to change those guidelines this month.

General obligations sold in March 2014 and maturing in July 2035 traded today with an average yield of 9.45 percent, or 87 cents on the dollar, data compiled by Bloomberg show.

## **Cash Need**

The Development Bank needs the sale as proceeds would allow the Highways & Transportation Authority to repay \$2.2 billion it owes the bank. That amounts to 21 percent of GDB loans. The bank said it had about \$1.5 billion of net liquidity as of Nov. 30. That would drop to \$819 million by March 31 if Prifa fails to issue the bonds, Moody’s said in October.

"It's very precarious," Donahue said of the bank's liquidity. "A determination by the auditors that it's insolvent almost certainly puts an end to their ability to assist and leaves the commonwealth and the agencies on their own."

The general fund also faces challenges. Revenue collections through November were \$32.5 million below projections for this fiscal year, according to the Treasury Department. Principal and interest payments — which consume about 15 percent of the budget — are set to increase by \$287 million in the year beginning July 1, according to S&P.

The commonwealth doesn't anticipate another agency debt restructuring beyond Prepa, and the \$2.9 billion borrowing plan allows the highways authority to avoid such a move, Natalia Guzman, senior vice president at the GDB, told investors in an October presentation.

### **'Fixing Prepa'**

"Our resolve to do what is right and necessary to preserve our credit and grow the island economy is now stronger than ever," Garcia Padilla said in a July conference call with investors, about three weeks after signing the restructuring measure.

Officials project that reducing the power agency's \$1.75 billion of tardy customer bills and shrinking its debt will reduce electricity costs and spark the economy. Residents and businesses pay about twice as much as mainland consumers for power, according to Moody's.

Strengthening Prepa may not shield other agencies or the general obligations, said Philip Fischer, head of muni research at Bank of America Merrill Lynch in New York.

"We certainly would hope that fixing Prepa will fix the economy, Fischer said. "But it strikes us as unlikely. Prepa is just one of the problems."

### **'Unsustainable' Finances**

Puerto Rico and its agencies have a history of selling bonds to balance budgets and repay short-term debt. Now that practice comes at a steeper cost as hedge funds and other alternative investors, who target riskier securities for their relatively high yields, have largely replaced traditional muni buyers.

The GDB on Oct. 9 sold tax-exempt notes maturing in June 2015 and priced to yield 7.75 percent. That compared with 0.14 percent on benchmark one-year munis, Bloomberg data show.

"Growing debt and a contracting economy is an unsustainable condition," Alan Schankel, a managing director at Janney Montgomery Scott LLC in Philadelphia, wrote in a Dec. 16 report. "It seems very unlikely that Prepa will be the last case of restructuring for Puerto Rico issuers."

The fiscal 2015 budget assumes economic growth of 0.2 percent, according to S&P. The company has said that isn't enough to deal with rising debt costs and a retirement system that was 3 percent funded as of June 2013, lower than any U.S. state.

The restructuring bill allows Prepa, the aqueduct and sewer authority and other public corporations to ask investors to take a loss. General obligations, Prifa debt, sales-tax bonds and GDB debt are exempt from the law. Without economic growth, Garcia Padilla may have to expand the measure, Donahue said.

"If the governor finds that he has no option, it's something that everyone who is involved in Puerto

Rico should consider," he said.

Bloomberg Muni Credit

By Michelle Kaske Jan 14, 2015 8:44 AM PT

To contact the reporter on this story: Michelle Kaske in New York at mkaske@bloomberg.net

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Mark Tannenbaum, Alan Goldstein

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## **[Refunding Pushes U.S. Municipal Bond Sales to \\$8.77 bln Next Week.](#)**

Jan 16 (Reuters) - The U.S. municipal bond refunding renaissance will be in full bloom next week, with nearly half the \$8.77 billion in scheduled debt sales from issuers eager to refinance at the market's current lowest interest rates, Thomson Reuters data shows.

Out of the \$6.64 billion negotiated sales expected, \$3.35 billion will be refunding, and the Texas Transportation Commission's \$1.75 billion refinancing of turnpike debt will be the largest negotiated deal of the week.

The Texas bonds coming to market on Thursday, with Barclays Capital as lead underwriter, will refund \$686 million toll revenue bonds as well as retire a \$1.1 billion federal Transportation Infrastructure Finance and Innovation (TIFIA) loan.

"The reason we're doing this is simply to obtain debt service savings given current market conditions," said Benjamin Asher, the department's debt management officer during the sale's road show.

The TIFIA loan carries a 5.51 percent interest rate and yields on most U.S. municipal bonds are currently well below that level in the secondary market, even for lower-rated credits.

On Friday, the yield on a top-rated 30-year bond was 2.54 percent, the lowest since December 2012, according to Municipal Market Data, a unit of Thomson Reuters. The yield on a highly rated 10-year was 1.75 percent, the lowest since May 2013.

The state's transportation department has been seeking to lower its debt load for the last year, and it used some of the proceeds from a \$1.6 billion deal in November to refinance outstanding bonds, as well.

In the middle of 2014 municipal bond interest rates began falling, and reversed a sharp decline in the borrowing of states, cities, and other governments. Issuance in the \$3.6 trillion market totaled more than \$314 billion last year and came in slightly ahead of the previous year's sales - something no one would have predicted on Jan. 1, 2014.

"After posting gains in December, the municipal bond market was able to claim a perfectly positive year. Issuance was very strong in December, as was demand, both defying typical patterns and pointing to continued strong momentum heading into 2015," wrote the BlackRock Municipals Group in a note earlier this week.

Refunding has plumped the sales. Out of the \$2.14 billion in competitive sales expected for next

week, 40 percent will be refinancing. The biggest sale on the competitive calendar is a \$460.2 million general obligation refunding deal from the state of Washington.

(Reporting by Lisa Lambert; Editing by Diane Craft)

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## **Tips for Talking Munis with Clients as Rate Hike Looms.**

(Reuters) – Municipal bonds remain a favorite of financial advisers and tax-conscious clients, even though they could be vulnerable to interest rate hikes later this year.

Munis – notes issued by states, cities, and counties to finance infrastructure and other projects – can offer a near-guaranteed return to clients, with slightly higher yields than treasuries, investment advisers say. They also offer federal, and potentially state and city, tax benefits.

Kevin Ashworth, an adviser and investment director at EP Wealth Advisors in Torrance, California, helps to generate tax-free income for clients through federally tax-exempt municipal bond mutual funds, or local general obligation bonds.

Many clients are now eager to sell fixed-income investments before rates increase, Ashworth said.

But he tells them they “can’t abandon fixed income altogether,” and stresses the benefits of munis. “We view municipals as the safe asset for clients.”

Ron Weiner, president and founder of RDM Financial Group in Westport, Conn., says advisers who recommend muni bonds shouldn’t shortcut the calculations needed to see whether an individual client will reap worthy after-tax returns.

“You have to do the math of the individual tax bracket,” he said, noting that clients sometimes end up with a higher after-tax yield if they forgo muni tax breaks and pay income taxes on corporate bond interest.

Even when owning an individual municipal bond makes sense, it can be challenging for a client to find the right vehicle, given strong demand and relatively few issues, advisers say.

### **NOT SEEKING THE ‘HOME RUNS’**

Mutual funds can offer a wider mix of muni bonds, said Jay Sommariva, senior portfolio manager of fixed income at Fort Pitt Capital Group in Pittsburgh.

But he recommends mostly high-grade bonds with good track records issued by local cities and school districts, that offer the greatest tax benefits for area clients.

“We’re not looking for the home runs,” Sommariva said. He focuses, instead, on quality and a nominal coupon that provides a reasonable spread over Treasuries, and a return.

Clients may expect more of a return from municipal bonds than they perhaps should, after a year in which the securities did particularly well. The Standard & Poor’s Municipal Bond Index, for example, returned over 9 percent in 2014, as the risk of defaults in Detroit and other cities faded and interest rates and yields were low.

Advisers must help clients realize that outsized returns are not the point of municipals, or any fixed-

income investment.

A fixed-income portfolio is supposed to produce reliable income, said Brian Battle, analytics group director at Performance Trust Capital Partners in Chicago.

Battle believes strongly in the tax and near-guaranteed returns offered by municipals. He tells clients the municipal sector is a high quality one, and “unique to the U.S.”

Educating clients about the purpose of fixed-income and municipals can be difficult right now, but it must be done, said Weiner of RDM Financial Group.

“We’re settling clients into the idea that bonds are for safety,” he said.

BY HILARY JOHNSON

Fri Jan 16, 2015 8:33am EST

(The author is a Reuters columnist. The opinions expressed are her own.)

(Editing by Linda Stern, Suzanne Barlyn and Bernadette Baum)

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## **[Deloitte: Power & Utilities Accounting, Financial Reporting, and Tax Update.](#)**

We are pleased to announce release of the Power & Utilities Accounting, Financial Reporting, and Tax Update. The publication includes the latest information on accounting, tax, and regulatory matters, including SEC, FASB, IFRS, and tax updates, and focuses on specialized industry accounting matters frequently seen by rate-regulated entities. The annual update also includes a section on accounting and reporting matters specific to renewable energy.

New sections in the January 2015 edition include:

- Accounting and reporting considerations related to carve-out financial statements
- The new revenue recognition standard

Additionally, to address potential challenges in accounting and reporting of financial instruments, leases, and a host of other topics as a result of issued FASB exposure drafts, we have included a section about Board proposals and have highlighted nuances that might affect our industry.

[View the publication.](#)

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## **[Cash-Flow Crunch Wanes as Note Sales Set Record Low: Muni Credit.](#)**

U.S. states and localities issued the fewest short-term notes in at least a decade in 2014, the latest sign that municipal budgets nationwide are strengthening.

Sales of the securities, which mature in less than 18 months, fell to \$40.3 billion last year, the least in Bloomberg data dating back to 2003. Volume is down from a 2010 peak of \$78.5 billion and may sink further: Supply will drop 0.7 percent in 2015, according to a Securities Industry and Financial

Markets Association survey.

The largest note issuers, Texas and California, whittled their offerings in 2014 to the lowest since before the recession that ended in 2009, even with interest rates close to the lowest since the 1960s. Demand for notes, used to bridge cash shortfalls, is dimming as the National Association of State Budget Officers forecasts revenue growth will probably accelerate in fiscal 2015.

“The immediacy of having to issue debt on the short end has decreased significantly,” said Steven Shachat, who oversees \$1.2 billion of munis, including a money-market fund, at Alpine Woods Capital Investors in Purchase, New York. “States and municipalities are really starting to instill some fiscal responsibility.”

## **Bridge Tool**

Municipalities typically sell notes to raise money before tax revenue flows in, or to begin funding projects before selling longer-dated securities. Now there’s less need to go that route. More finance officers are reporting improved fiscal conditions than any time in the 29-year history of a survey conducted by the Washington-based National League of Cities.

The decline in shorter-maturity issuance is part of a borrowing slowdown in an era of local-government austerity. The municipal market contracted for an unprecedented fourth straight year in 2014 as refinancings and maturing bonds exceeded the amount sold, data compiled by Bloomberg show.

While the broad municipal market has outperformed corporate debt in the past year, shorter-dated local securities have trailed. Munis due in one to two years have gained 0.6 percent in the past 12 months, while comparable company obligations have earned 0.8 percent, Bank of America Merrill Lynch data show.

In California, the most-indebted state, long-term sales fell 8.3 percent from 2013, to \$42.4 billion last year. The state also borrowed the least since 2006 for cash-flow needs.

California issued \$2.8 billion in revenue-anticipation notes in September to pay bills during the slowest period for tax receipts, down from \$5.5 billion in 2013 and \$10 billion in 2012.

## **California Reversal**

California’s credit standing has improved more than any state’s since the recession, winning it the highest Moody’s Investors Service rank in 13 years. Governor Jerry Brown has limited borrowing even as taxes on income and corporate earnings have eclipsed estimates.

“By reversing some of the more egregious cash strategies adopted in recent years, the governor improves our ability to weather cash shortfalls in the future,” California Controller Betty Yee said in a statement this month. “The governor, legislature and voters deserve much credit for bringing revenues and expenditures into alignment.”

Texas is also reducing reliance on short-term debt. The second most-populous state in August offered its smallest note sale since 2007. At \$5.4 billion, it was down from \$7.2 billion the prior year, though still the largest short-term borrowing nationwide in 2014.

## **‘Budget-Busters’**

“Coming out of the Great Recession, states have had to very much live within their means, because

there was little cushion for additional expenditures or unexpected growth in programs,” said Arturo Perez, a fiscal analyst at the National Conference of State Legislatures in Denver. “There’s not much in regards to budget-busters that states are reporting.”

Municipalities have mended their finances since fiscal 2010, when states faced a combined \$191 billion of budget gaps, according to data from the Henry J. Kaiser Family Foundation. The improvement has helped push interest rates close to zero on notes, with AAA munis maturing in one year yielding 0.22 percent, compared with a five-year average of 0.31 percent, Bloomberg data show.

States and cities may seize on low borrowing costs to issue longer-dated debt in 2015, while cutting back on note sales. Short-term offerings will probably fall to \$42.5 billion this year from \$42.8 billion in 2014, although total supply will climb 2.7 percent to \$357.5 billion, according to a Sifma survey last month.

“Issuing debt in the very short end of the market means issuing at almost zero — that’s somewhat of a hard opportunity to pass up,” said Shachat at Alpine Woods. “It really is an ideal time to be issuing debt to finance any type of infrastructure needs.”

Bloomberg Muni Credit

By Brian Chappatta

Jan 12, 2015

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Mark Tannenbaum, Alan Goldstein

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## **[S&P's Public Finance Podcast \(Outlooks For Higher Education And Public Power\).](#)**

In this week’s [Extra Credit](#), Senior Director Jessica Matsumori and Director Jeff Panger discuss our 2015 outlook for the higher education and public power sectors, respectively.

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## **[White House Fact Sheet: Increasing Investment in U.S. Roads, Ports and Drinking Water Systems Through Innovative Financing.](#)**

Building a 21st-century infrastructure is a critical component of the Administration’s efforts to accelerate economic growth, expand opportunity, create jobs and improve the competitiveness of the American economy. As part of this effort, President Obama launched the Initiative in July 2014, calling on federal agencies to find new ways to increase investment in ports, roads, bridges, broadband networks, drinking water and sewer systems and other projects by facilitating partnerships between federal, state and local governments and private sector investors.

Today, the Obama Administration is announcing new steps that federal agencies are taking to bring

private sector capital and expertise to bear on improving our nation's roads, bridges, and broadband networks. First, the Administration is launching a new Water Finance Center at the Environmental Protection Agency and highlighting the progress of the Rural Opportunity Investment Initiative at the Department of Agriculture. These efforts will help local and state governments access federal loan and grant programs to get more projects off the ground. The Administration is also announcing a new set of infrastructure tax proposals that will level the playing field for projects that combine public and private investment so that local and state governments can more easily work with the private sector to advance the public interest.

At an event at the Anacostia River Tunnel Project Site in Washington, DC later today, the Vice President — joined by Environmental Protection Agency Administrator Gina McCarthy and USDA Secretary Tom Vilsack — will stress the importance of these critical investments. Today's event is part of the Vice President's ongoing work to highlight the importance of doing more to invest in our nation's infrastructure to create jobs, help American businesses, and grow our economy.

Additional information about the new Build America initiatives is provided below:

**Investing in Drinking Water and Wastewater Systems through a new Center at EPA.** To help address more than \$600 billion in needs for drinking water and wastewater management over the next 20 years, today the Administration is launching a new Water Finance Center at EPA. The Center will work closely with municipal and state governments, utilities and private sector partners to use federal grants to attract more private capital into projects and promote models of public private collaboration that can address the real needs of cities and towns to provide safe water, rebuild sewer systems and keep streams and rivers clean.

**Driving Investment to Rural America via a New USDA Rural Opportunity Investment Initiative.** The Administration is announcing the Rural Opportunity Investment Initiative at the U.S. Department of Agriculture, which will identify opportunities for investment in promising rural water, energy, and broadband projects, reduce barriers to investment and connect projects with investors.

**Leveling the Playing Field for Public-Private Partnerships.** Today the Administration is leveling the playing field for municipalities seeking public private partnerships by proposing the creation of an innovative new kind of municipal bond, Qualified Public Infrastructure Bonds (QPIB).

In addition, the Administration is advancing major highway and port projects through the Transportation Investment Center at the Department of Transportation, working with local and state governments to improve project planning, and attracting investors for U.S. projects from around the world through the SelectUSA Program.

### **Investing in a 21st-Century American Infrastructure**

Investing in a 21st-century American infrastructure is an important part of the Obama Administration's plan to build on the progress our economy is making by creating jobs and expanding opportunity for all hardworking Americans. Infrastructure like roads, bridges, ports, water purification plants and reservoirs provide critical services to consumers and businesses while protecting public health and the environment.

The construction project in Anacostia is an example of the benefits of investment in water management. Each year, 2 to 3 billion gallons of contaminated sewage water pour into the Anacostia River. The new tunnel will control this run-off, improving public health, protecting the environment,

and giving a major boost to economic development on the Anacostia River's banks.

But the current level of infrastructure investment in the U.S. is far too low and too many worthwhile projects go unfunded. The system of water pipes that bring drinking water to homes and businesses, for example, is rapidly aging. An estimated 237,600 water mains break every year. We also lose more than 46 billion gallons of water per day through leaking pipes — enough water to supply the 10 largest American cities for almost two weeks. And the costs for maintenance are only increasing. Over the next fifteen years, utilities will have to spend three times as much on pipe replacement as the current system continues to decline.

The Administration's activities through the Build America Investment Initiative will help interested local and state governments build more of these projects by bringing together the public and private sector to identify challenges and explore creative financing strategies — not only in water but in transportation, energy and broadband.

Private capital is not a substitute for public investment. That's why the President has repeatedly called on Congress to increase public funding for our highways, bridges, and transit system. Last spring, the Administration proposed the GROW AMERICA Act, a 4-year, \$302 billion surface transportation reauthorization proposal. But in the absence of Congress acting on this commonsense proposal, the President will continue to do whatever he can through his own authority to promote American economic growth where there is need or opportunity. And right now, there is a real opportunity to put private capital to work in revitalizing U.S. infrastructure.

That's why today the Administration is announcing efforts across government including new executive actions and a new tax proposal to encourage investment across infrastructure sectors and in regions around the country.

### **Investing in Drinking Water and Wastewater Infrastructure through a new Center at EPA**

The U.S. needs at least \$600 billion in investments in water infrastructure over the next 20 years to keep our taps flowing and our rivers and lakes clean. Today, the Administration is launching a new interagency center at the Environmental Protection Agency to increase innovative financing support for water systems across the country. The Water Finance Center will:

Stimulate private investment and make federal dollars go further: Around the country, towns, cities and states are exploring how to bring innovative financial tools such as public private partnerships to the water sector to get more projects off the ground. The new Center will help interested local and state governments to bring private sector investment and expertise into water system construction and management. Among other roles, the center will bring together investors and project sponsors; highlight promising deals; provide peer-to-peer learning and workshops; and develop case studies and toolkits. The Center will work with states to maximize the benefits of more than \$3 billion in annual federal water investments.

Help attract investment to small communities. Many rural communities are served by small water utilities that lack the resources to explore financing alternatives, engage the private sector and attract investment. The new Water Center will work with on-the-ground partners to provide financial training and technical assistance to small communities and rural water systems.

### **Driving Investment to Rural America via a new USDA Rural Opportunity Investment Initiative**

Investments in rural water, energy, broadband infrastructure can create jobs and accelerate

economic growth. To help rural projects attract more investment, the Administration is announcing the Rural Opportunity Investment (ROI) Initiative at USDA. In close collaboration with both public and private partners, the ROI Initiative will:

Connect projects to investors: The ROI Initiative will facilitate and catalyze rural investment opportunities for the public and private sectors. The Initiative will look to generate and facilitate rural investment through USDA field staff across the country and strengthen relationships with the private sector. Public-private collaborations launched by USDA earlier this year — like the \$10 billion CoBank rural infrastructure fund between CoBank and Capital Peak Asset Management and a \$150 million Rural Business Investment Company — are the type of innovative financing mechanisms that the Initiative will continue to incubate in an effort to develop and finance infrastructure projects.

Improve access to USDA credit programs: The Initiative will also focus on opportunities to leverage private sector financing against the over \$30 billion in existing USDA programs and resources to provide funding to vital rural infrastructure projects; including water and wastewater systems, energy efficiency improvements, broadband networks, and other rural infrastructure needs.

### **Leveling the Playing Field for Public Private Partnership**

The Administration is proposing the creation of an innovative new municipal bond, Qualified Public Infrastructure Bond (QPIB). Today, public private partnerships that combine public ownership with private sector management and operations expertise cannot take advantage of the benefits of municipal bonds. QPIBs will extend the benefits of municipal bonds to public private partnerships, like partnerships that involve long-term leasing and management contracts, lowering the cost of borrowing and attracting new capital.

A similar existing program, Private Activity Bond (PABs), has already been used to support financing of over \$10 billion of roads, tunnels, and bridges. QPIBs will expand the scope of PABs to include financing for airports, ports, mass transit, solid waste disposal, sewer, and water, as well as for more surface transportation projects. Unlike PABs, the QPIB bond program will have no expiration date, no issuance caps, and interest on these bonds will not be subject to the alternative minimum tax. These modifications will increase QPIB's impact as a permanent lower cost financing tool to increase private participation in building our nation's public infrastructure. QPIBs would not be available for privately-owned facilities or privatizations of public facilities.

More details on QPIBs will be available in the upcoming Budget.

### **Growing Investment in Transportation Infrastructure through the DOT Transportation Investment Center**

In July, the President announced the launch of a new center at the Department of Transportation to catalyze private investments in our transportation system. Since the launch of the Center, DOT has taken important steps forward, including:

Facilitating access to hundreds of millions of dollars in credit assistance for vital transportation projects: In Fiscal Year 2014, DOT loaned a record \$7.5 billion to 13 projects through the TIFIA program, leveraging more than \$25 billion in infrastructure investments. Since the launch of the Center, DOT has accelerated high-impact projects like Portsmouth Bypass, a 16-mile, 4-lane highway in Scioto County, Ohio.

Expediting Project Financing and Delivery: To help get highway, port, bridge, tunnel and transit

projects moving faster, the Center is providing hands-on technical assistance and facilitating efficient project delivery to projects, including adding additional projects to the Administration's successful permitting dashboard. The Center is also providing targeted technical assistance to support project planning for projects like the Essex County-Port Newark Container Terminal (PNCT) P3 Project — a recent TIGER grant recipient.

**New Tools:** The Center will be releasing new products, including supplemental provisions for toll concession model contracts and a new guide on incorporating Federal-aid funding into P3s. These products build on tools released over the past several months. In addition, DOT is developing model contracts that show how transportation projects can advance "high-road" labor practices that create good, middle-class jobs and benefit current and aspiring workers alike. These will be an example for other federal agencies as they work to support public private partnerships moving forward.

### **Breaking Ground on more Roads, Bridges and other Infrastructure Projects**

Today, the President is signing a Presidential Memorandum to improve the early phases of infrastructure project planning and design by aligning federal funding for planning and predevelopment at the Departments of Commerce, Transportation, Homeland Security, Housing and Urban Development and Agriculture. These agencies and others will be working closely with local and state governments and other stakeholders over the coming months to ensure that the federal government is doing all it can to support critical predevelopment activities. Private foundations are also doing their part to support innovation in planning and predevelopment activities, with The John D. and Catherine T. MacArthur Foundation, Ford Foundation, and The Rockefeller Foundation announcing support for new projects around the country.

### **Promoting Investment in U.S. Highways and Ports**

For the first time, the Administration is hosting a global event with a clear US infrastructure track at the March 2015 SelectUSA Investment Summit. This Summit will bring together over 2500 leading investors and executives from around the world and connect them with US business opportunities.

A high profile session focused on infrastructure to highlight the growth and diversity of the US P3 market and present day opportunities in the USA for global companies

A roundtable to promote the development of relationships between global investors and American partners to jointly explore US infrastructure investments.

These actions and announcements are the first steps that the Administration is taking as part of the Build America Investment Initiative's two-year action plan, as outlined in a recommendations to the President.

January 16, 2015

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### **[Muni Market Participants Applaud QPIB, Water Proposals.](#)**

WASHINGTON - Municipal market participants applauded President Obama's proposal on Friday to create a new type of tax-exempt municipal bond that could be used to help finance public-private infrastructure projects, but one questioned whether it will pass muster with Congress.

The president also included several other proposals, such the creation of a new Water Finance

Center to help state and local governments leverage federal grants to attract private investors in water and sewer projects, in a package of infrastructure initiatives announced on Friday.

The initiatives were described by the White House in a fact sheet and by Vice President Joe Biden during at the dedication of the Anacostia River Tunnel Project site here. "We want to see private capital moving off the sidelines because we want to put it to work," Biden said. "This isn't privatization, this is collaboration."

Obama is expected to talk about the proposals in his State of the Union speech on Tuesday and will detail them in his budget, which is to be released on Feb. 2.

The initiatives stem from recommendations made in a 19-page report from the Build America Investment Initiative Interagency Working Group, chaired by Treasury and Transportation Secretaries Jack Lew and Anthony Foxx. That report was sent to the White House late last year.

The new Qualified Public Infrastructure Bonds are a centerpiece of the proposals. They would be a hybrid between governmental bonds and private-activity bonds with fewer restrictions than PABs. In contrast to PABs, QPIBs would not have issuance caps and would not be subject to the alternative minimum tax.

They also would not have the private business use test that is currently are used to determine if bonds are governmental bonds or PABs. Under current law, bonds are PABs and not government bonds if more than 10% of the project is used by private parties and more than 10% of the debt service is paid for, or secured by, private parties. But to be tax-exempt, a PAB has to be used to finance projects that fall within several categories, including airports and sewer facilities.

QPIBs could be used to finance airport, port, mass transit, solid waste, sewer, water and surface transportation projects, but only if they are governmentally-owned. QPIBs could not be used for privately-owned projects or privatizations of public facilities.

As a result, they would be particularly beneficial for governmentally-owned projects that have long-term leases or concessions with private parties.

The modifications to the PAB rules for QPIBs "will increase [their] impact as a permanent lower cost financing tool to increase private participation in building our nation's public infrastructure," the White House said in its fact sheet.

The QPIBs drew positive response.

"We think this could be a low-cost approach to stimulating much-needed infrastructure investment," said Standard & Poor's managing director and analyst Robin Prunty in New York. "But there is a cost associated with it, and as a result extensive deliberation in Congress is likely."

"Interest in the public-private 'P3' approach is growing, and many states are developing programs that combine public ownership with private sector management and operations expertise," Prunty said. "But the financing structures can be complex and generally have not benefited from tax exemption. States and other municipal market issuers have found them to be an attractive alternative to deliver large-scale infrastructure projects." "If the financing becomes more cost-effective, we expect that interest could grow. Currently, 33 states have authorized P3s and many projects have been financed or are in the planning stages," Prunty said. "The U.S. projects have primarily focused on transportation, such as roads, toll lanes, and transit projects. However, the Long Beach Courthouse in California is an example of a social infrastructure P3 project, and other states with active transportation P3 projects are also considering approving legislation allowing

social infrastructure P3s. We have also started to see interest at the local level.”

Susan Collet, president of H Street Capitol Strategies, said, “I think [QPIBs take] some significant steps forward in making the private-activity bond model more robust.” She also said they would be “helpful to a lot of issuers.”

Collet said the proposal seems to be consistent with the America Fast Forward bond proposal in that the Obama administration wants new models for bonds to enhance infrastructure. AFF bonds, proposed by Obama in 2013, would be taxable, direct-pay bonds that could be used to finance infrastructure financing.

If Congress wants to include infrastructure financing as part of tax reform, QPIBs could be something considered, Collet said, adding, “I do think it’s going to be a starting point for discussion.” But the tax committees may scrutinize PABs as part of tax reform to make sure their purposes are worthy of tax exemption, she said.

Michael Decker, Securities Industry and Financial Markets Association managing director and co-head of municipal securities, said, “It’s a welcome proposal.”

The proposal will make it easier to use tax-exempt financing when more than a de minimis amount of private involvement in projects, he said, adding, the bonds would “hopefully open the door for new financing structures” and more infrastructure.

Decker noted that tax reform is on the agenda and the Senate Finance Committee just set up working groups, including one on infrastructure. “I think this idea should be in the mix for those discussions.”

If Congress wants to amend the tax code to make it more efficient and promote investment, “this certainly fits the bill,” he said. The QPIBs are in contrast with proposals like the 28% cap on the valuation of tax-exemption, he added. The President has proposed the 28% cap in his last several budget proposals.

Mike Nicholas, chief executive officer of the Bond Dealers of America, said, “The BDA is favorable to this proposal under the guise it would provide municipal issuers of all shapes and sizes the ability to work together with private enterprise to expand opportunities for tax-exempt financing.”

“However, the new QPIBs or any other component of the infrastructure financing proposal can’t lead to changes to the tax-exemption for muni bonds or to structural change to municipal bond issuance which has worked efficiently to the benefit of issuers and taxpayers for 100 years,” he said.

The U.S. Chamber of Commerce likes what it sees in the president’s P3 initiative at this point but the detail will be important, said Janet Kavinsky, the Chamber’s executive director for transportation and infrastructure.

“Although P3s are not a substitute for public investment, as the president’s announcement clearly states, they can bring innovation, cost discipline and time savings, and enable projects to go forward that cannot do so under conventional procurement methods,” she said. “The Chamber will take a close look as the proposals are revealed in detail in the budget and continue working with the administration on this important initiative.”

Sen. Ron Wyden, D-Ore., ranking minority member of the Senate Finance Committee, is on board with the proposal. “We were glad to see many of our Finance Committee suggestions incorporated into these proposals and support their efforts to pursue new opportunities for public-private

partnerships,” said a spokesperson for him.

The new Water Finance Center would be created within the Environmental Protection Agency. “The Center will increase innovative financing support for communities to sustain their water, wastewater and stormwater infrastructure. This Center is part of the President’s Build America Investment Initiative – a government-wide effort to increase infrastructure investment and promote economic growth by creating opportunities for state and local governments and the private sector to collaborate, expand public-private partnerships, and increase the use of federal credit programs,” said Kenneth Kopocis, deputy assistant administrator in EPA’s Office of Water.

Michael Deane, executive director of the National Association of Water Companies, said the Water Finance Center and QPIBs would provide “an excellent opportunity” for the federal government to help communities that are interested in P3s.

NAWC still wants the volume caps to be lifted for regular water and sewer PABs and is also working with the Treasury to get it to clarify the remedial action rules so that governments can ensure the bonds they used to finance water facilities remain tax exempt if they enter into P3s.

The President also signed a memorandum Friday to align federal funding by several federal agencies for planning and predevelopment for the early phases of infrastructure projects.

Obama will also urge Congress to increase funding for transportation infrastructure along the lines of the four-year, \$302 billion Grow America Act the administration proposed in 2014.

“Private capital is not a substitute for public investment,” the White House statement said in its fact sheet.

THE BOND BUYER

BY JIM WATTS and NAOMI JAGODA

JAN 16, 2015 1:03pm ET

Kyle Glazier contributed to this story

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## **[Fitch Revised Criteria for Rating U.S. Public Finance Short-Term Debt.](#)**

On January 7, Fitch revised its criteria for rating U.S. Public Finance Short-Term Debt.

The revised criteria can be found [here](#). (Registration required.)

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## **[U.S. Muni Bond Supply to Spike to \\$7.27 bln Next Week.](#)**

Jan 9 (Reuters) – Debt-hungry investors will get a hefty serving of U.S. municipal bond debt next week, with supply rising to about \$7.27 billion from an estimated \$4.24 billion this week, according to Thomson Reuters estimates on Friday.

Investors in debt sold by states, cities, schools and other issuers in the U.S. municipal bond market

have been ravenous for tax-free bonds as supply dried up over the Christmas and New Year's holidays.

U.S. municipal bond funds reported \$1.33 billion of net inflows in the week ended Jan. 7, the biggest weekly inflows since January 2013, according to Lipper data on Thursday.

A week ago, the yield on top-rated 10-year bonds was 2.01 percent, while the 30-year yield was 2.83 percent on Municipal Market Data's benchmark scale. Price gains over the first full trading week of 2015 pushed the 10-year yield down to 1.91 percent and the 30-year yield to 2.71 percent as of Thursday's market close.

Next week, the New York City Transitional Finance Authority will sell \$750 million of building aid revenue bonds through Ramirez & Co, with retail presale periods on Monday and Tuesday and formal pricing on Wednesday. The deal's structure includes serial bonds due in 2016 through 2044, according to the preliminary official statement.

New York's Metropolitan Transportation Authority will sell \$400 million of fixed-rate revenue bonds and \$100 million of floating rate tender notes through J.P. Morgan, which has slated pricing for Thursday.

In the healthcare sector, Chicago's Rush University Medical Center will issue \$502 million of revenue bonds through the Illinois Finance Authority. Goldman, Sachs & Co is scheduled to price the debt on Thursday.

Topping the week's competitive calendar is a \$131 million wastewater refunding revenue bond issue for California's Orange County Sanitation District. The AAA-rated bonds are slated to price on Tuesday.

(Reporting By Karen Pierog; Editing by Chris Reese)

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## **[New Tool May Aid California Cities in Filling State's Infrastructure Gap.](#)**

The devil is in the details when it comes to California paying to fill an estimated \$59-billion-a-year, infrastructure deficit that's leaving roads to deteriorate. The good news for cities is they just received a shiny new tool this year in their financing toolbox that could help pay for road repair, transit projects and even affordable housing.

It's been a bit of a marquee week for those following transportation news, with Governor Brown literally signing off on California's high-speed rail groundbreaking and the state's infrastructure financing deficit getting a mention in the State of the State and Governor's Inauguration speech, and the proposed state budget for the next fiscal year being released.

Unfortunately, the dollar amounts and detailed proposals for filling in that deficit were not included in Brown's proposed outline of state spending today. But the Governor said they are identifying the problem and have a team working on the issue.

As the Summit and others have noted, however, the state can't solely rely on general obligation bonds to fill in gaps in infrastructure. That method adds to long-term debt and aren't permanent funding sources. Plus, federal funds for infrastructure have been unreliable and reducing in size. Also, as Gov. Brown acknowledged, lowering gas usage lowers the amount collected from gas taxes,

meaning new ways of funding have to be found.

Something that could help with the situation for local governments, a bill Governor Brown approved last year handed cities a robust, revamped finance tool called Enhanced Infrastructure Financing Districts (EIFD) designed to boost local infrastructure and economic development projects. One of the big benefits of these EIFD's is that they put local governments in a better position to be able to leverage state resources and get even more money for projects, say financing experts.

"The state doesn't just hand out money for infrastructure projects," said Fred Silva, senior fiscal analyst at California Forward and presenter for the EIFD webinar. "It has policy preferences and asks for some local contributions through growth in the local economy. The EIFD public finance authority gives cities the power to better leverage state funds for infrastructure projects."

Those interested in EIFD's are invited to attend a [free, public webinar](#) hosted by Meeting of the Minds next week on Tuesday at 10:00am PST when a financing expert panel will take attendees through the new authorities available.

The comments from Gov. Brown regarding the funding gap are definitely a welcome statement. But, depending on the budget's proposals for boosting maintenance of California's transportation system, communities might see varying degrees of benefits, including upgrades of the highways running through them. That's why innovative funding tools like EIFD's will likely enter the conversation more in the next several years.

The webinar next Tuesday will explore the tools available under the EIFD mechanism, such as property tax increment authority, benefit assessments, fees and the ability to enter into public-private partnerships.

The tax increment financing authority, for example, lets cities "invest selected new property tax dollars into the neighborhood instead of into the city's General Fund."

Last year, the Summit produced a [how-to guide](#) on how local and regional agencies could use the new EIFD authority to invest in everything from sidewalk repair and water infrastructure, to the implementation of sustainable communities plans.

We'll also be taking a look through the Governor's budget plan for alignment in Summit Action Team work on infrastructure financing and report back here. And on Monday look out for the Summit's Roadmap to Prosperity, which will layout three big priorities for 2015 and beyond, including building up the state's infrastructure and sustainable communities.

JANUARY 08, 2015

BY JOHN GUENTHER

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### **[Moody's Request for Comment - Tax Increment Debt.](#)**

This Request for Comment describes our proposed methodology for rating tax increment bonds in the US. The approach described in this methodology applies to bonds secured by incremental property tax revenues only.

The proposed methodology includes a scorecard that assigns weights and values to the factors we

consider consistently most important in tax increment bond analysis. We currently rate the debt of 65 redevelopment or economic development agencies, relating to over 110 unique tax increment financing (TIF) project areas. Tax increment bonds issued in California, known also as tax allocation bonds (TABs), comprise 80% of the rated credits. If the proposed methodology is adopted, we expect that approximately one-half of our California Tax Allocation Bond (TABs) ratings could be upgraded, while approximately 10% of our nonCalifornia tax increment ratings could be downgraded. See section titled, "California Tax Allocation Bonds" for additional information on California TABs.

[Read the full Request for Comment.](#)

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## **[How to Use Impact Bonds to Finance Social Good.](#)**

In four short years, social-impact bonds—complex fixed-income instruments aimed at financing social good—have grown from an obscure experiment in the U.K. to a rising market force in the U.S. and abroad. Insiders say that the business will more than quintuple within a year and that the next innovative wave of impact bonds, sometimes called "pay for success bonds," will likely come from local U.S. governments. Currently in the pipeline: A \$7 million bond in Salt Lake City, Utah, aimed at boosting early education; a \$17 million instrument to improve pre-kindergarten literacy in Chicago; and a \$4 million deal tackling homelessness in Cuyahoga County, Ohio.

But let's back up. Social-impact bonds are a collaborative effort between philanthropically minded investors, nonprofits, and governments intent on solving social ills, while paying investors a return. Private investors provide project financing for nonprofits working to cut future public-sector costs by doing things such as reducing repeat youth incarcerations by 10%. When benchmarks are hit, investors get a return, based on what the government saved by not keeping such individuals in jail.

For all their 21st century ethos and excitement, social-impact bonds are still a tiny business; there are just seven in the U.S. According to the Rockefeller Foundation, there are about \$80 million in impact bonds in the country but it expects the domestic market to grow to \$500 million by year's end. President Obama's 2015 budget called for \$300 million to build out the social-impact bond industry. Outside the U.S., Australia, Canada, Germany, Columbia, India, and Israel are either already in or in the process of joining the social-impact bond business. (See Penta's Jan. 13, 2014, ["Pay for Success Bonds Drum Up Interest"](#) at Barrons.com.)

The largest U.S. deal to date is in Massachusetts, with \$28 million in funding going to local nonprofit Roca, which tackles youth recidivism in the state's prisons. Roca literally takes ex-felons off the street and transports them in vans to its programs in Boston, Chelsea, and Springfield, where a dogged combination of therapy and work-training programs prepare them for life outside prison. Over the bond's seven-year maturity period, which started last January, Roca will support 929 at-risk males, 17 to 24 years old.

Investors in the Roca deal include Goldman Sachs and the Kresge family's foundation. If Roca hits its target—to trim the number of days ex-offenders are imprisoned by at least 40%—investors will be paid a 2% to 5% return annually, with lower incarceration rates triggering higher payouts. That relatively low return appeals only to the philanthropically minded investor, of course, but it's a great deal for Massachusetts, which could save as much as \$7 million, even after paying off investors, if Roca hits its most ambitious target. But social-impact deals like this remain stunningly complex. "There's no blueprint here and we're working with four branches of government and across eight institutions with all different kinds of money," says Roca CEO Molly Baldwin. "Would we have

wanted it to be smoother? The answer is yes.”

Critics question social-impact bonds’ viability. In August, the world’s first such bond – in Peterborough, U.K., and also dealing with recidivism—missed its initial 10% reduction target, which would have triggered an immediate repayment of investor principal. Still, the reading came in at a respectable 8.4%; if the reduction in repeat imprisonments stays above 7.5%, the U.K. Ministry of Justice will return money to investors. “The performance of the first group indicates that investors are on track to receive positive returns in 2016,” says one investor, the Rockefeller Foundation.

Meanwhile, the Laura and John Arnold Foundation, a family foundation in Houston, has made grants and loans worth \$14.4 million to help develop the social-impact bond industry, and has invested directly in three impact bonds, including the Roca deal.

Josh McGee, a vice president of the Arnold foundation, says that, as currently structured, the deals take too long to complete. “There is a real question in the space right now about the best way to organize deals,” he says. He’s focusing on locally sourced social-impact bonds, such as the \$4 million Cuyahoga County bond, structured around homelessness. McGee thinks local governments will ultimately prove more nimble than the lumbering states at structuring deals. In short, the nascent social-impact bond industry is ratcheting its way up the learning curve.

Barron’s

January 2, 2015, 2:15 P.M. ET

By Robert Milburn

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## **[S&P U.S. Public Power 2015 Outlook: Despite Several Looming Issues, Credit Quality Should Remain Stable.](#)**

Although the U.S. public power sector is likely to hit some bumps in 2015, Standard & Poor’s Ratings Services believes credit quality overall will remain solid and ratings will stay stable for the sector. Despite some exceptions — such as the Puerto Rico Electric Power Authority in 2014 — we believe public power’s general rate-setting autonomy and a lack of competition for retail customers will underpin the sector’s credit quality. Our outlook incorporates the following expectations:

- Fuel prices, particularly for natural gas, will remain at low levels.
- The economy will expand manageably, enabling utilities to absorb growth without creating undue capital and operational burdens.
- Public power utilities will continue to effectively respond to regulatory measures the U.S. Environmental Protection Agency (EPA) has imposed in the past five years.

Despite this stable outlook, challenges remain. Some of these are broad and more long-term, affecting many utilities. They include the following:

- New EPA regulations targeting carbon emissions at existing power plants will likely weigh more heavily on carbon-intensive utilities than previous measures, and they could affect grid reliability.
- We expect fuel diversification to continue declining, exposing the industry to fuel price volatility.
- Aggressive budgeting of revenue from surplus energy sales might return, weakening financial metrics stressing retail rates if margins fail to materialize.

[Continue reading.](#)

09-Jan-2015

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## **Worst-Funded U.S. Pension Shows Kentucky's Neglect: Muni Credit.**

Kentucky's worker retirement plan, the nation's worst-funded state pension, is losing ground even after a three-year rally in stocks, underscoring the fiscal peril of forgoing payments into the pools.

A 15.5 percent return in fiscal 2014 wasn't enough to bolster the Kentucky Employees Retirement System, which serves 119,735 workers and retirees. Officials shortchanged the plan for more than a decade. They diverted the cash elsewhere, leaving KERS with 21 percent of the funds needed to pay promised benefits in 2014 as distributions exceeded revenue. No single U.S. state plan has a lower ratio, according to the Center for Retirement Research at Boston College.

KERS is one of five pensions in the Kentucky system, which the legislature restructured in 2013 to cut costs and ensure full funding. Its deficit shows that investment returns aren't enough to turn around struggling pensions. Forty-eight states have enacted changes to their plans since 2009 to lower expenses and provide adequate contributions, according to the National Conference of State Legislatures.

"We won't run out of money" as long as KERS gets full funding from the state and meets projected investment returns, said William Thielen, executive director of Kentucky Retirement Systems, which oversees the five pensions pools from Frankfort. "If we fail to meet those assumptions it will threaten our solvency."

### **Rebound Ripple**

U.S. stocks have rebounded from the depths of the recession, pushing the Standard & Poor's 500 Index to three straight annual gains of more than 10 percent for the first time since the 1990s. States that fully funded their plans saw greater benefit from the rally.

Public pension assets have grown about 37 percent since 2009 on average, according to the National Association of State Retirement Administrators. While some plans grew by as much as 66 percent, states that didn't fully fund pensions — Kentucky, New Jersey and Pennsylvania — gained 22 percent or less.

"The funds that increased at the fastest rate had been getting a higher percentage of their required contribution," said Keith Brainard, the Georgetown, Texas-based research director for the association. "Fund returns aren't enough if you have more money going out than you take in."

### **Cash Diverted**

As municipalities mended their finances following the recession, some used pension cash to plug budget deficits. New Jersey, after overhauling and pledging to fund its pensions, skipped \$2.5 billion of promised contributions as revenue missed projections.

Partly because of inadequate contributions, the average funding level of state and local pensions has deteriorated even though investment returns have improved, according to a report last year from Moody's Investors Service on the 25 largest public plans. While returns averaged 7.5 percent from

2004 to 2013, unfunded liabilities tripled to almost \$2 trillion.

Kentucky's pensions haven't been fully funded since fiscal 2002, Thielen said. The state has confronted budget deficits in the wake of the recession.

The KERS plan for workers in nonhazardous jobs shrank in the fiscal year that ended June 30. It paid out about \$914 million of benefits and expenses, or \$182 million more than it received from investments and contributions from workers and the state. The state made about \$300 million of the \$520 million contribution that actuaries had determined was needed to keep pace with outlays.

### **Benefit Switch**

In 2013, lawmakers passed steps designed to cut the expense of Kentucky's plans by moving future workers into a type of plan that doesn't promise specific benefits. They also limited cost-of-living adjustments.

In fiscal 2015 and beyond, the state also committed to make full payments. If Kentucky receives that money and earns its 7.5 percent estimated rate of return, its funding ratio may still shrink to as low as 15 percent in coming years, though it will climb back to 100 percent over 30 years, Thielen said.

The strategy "will work — if we don't neglect it or negate it," Democratic Governor Steve Beshear said in his State of the Commonwealth address Jan. 7.

A proposal for extra funding beyond the actuarially required contributions may come up in the legislative session that started this week, Thielen said.

"We need some additional funding over and above" that payment, he said.

### **Political Risk**

The risk is that a future legislature rolls back the steps passed in 2013 and uses the money for other expenses, Thielen said.

"Politics has a way of being sporadic," he said. "If we have a down year, that has a significant impact on our unfunded liabilities."

The system's precarious balance worries workers who depend on it for income later in life, said Jim Carroll, a retiree and co-founder of Kentucky Government Retirees, which advocates for state workers.

"The reform is doing nothing to help the state pension plan because we have such a deep hole," Carroll, 62, a former public information officer for the state, said in a phone interview. "We're deeply concerned about the financial status of the plan."

Bloomberg Muni Credit

By Darrell Preston

Jan 8, 2015 5:00 PM PT

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Mark Tannenbaum, William Selway

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## **Bondholder Sues Bankrupt San Bernardino for Favoring Calpers.**

(Reuters) - A corporation that holds \$50 million of San Bernardino's pension bonds sued the city on Wednesday for giving preferential treatment to California's public pension system as San Bernardino navigates a third year in bankruptcy.

Luxembourg-based Erste Europäische Pfandbrief-und Kommunalkreditbank AG (EERP), which filed the lawsuit in federal bankruptcy court in Riverside, California, is suing San Bernardino for agreeing to pay in full its debt to the California Public Employees' Retirement System (Calpers), while not yet treating the bondholder equally.

Ambac Assurance Corp., which insures a portion of the pension obligation bond debt, joined EERP in suing San Bernardino. Both claim equal status with Calpers as creditors. They did not sue Calpers, America's biggest public pension fund with assets of \$300 billion.

The lawsuit signals a newly aggressive stance by San Bernardino's capital market creditors after the city made public last year an agreement with Calpers to pay the fund in full when it produces a bankruptcy exit plan. The city has been ordered to produce a bankruptcy blueprint by May.

EERP's suit speaks to the wider fight between Wall Street and pension funds over how they are treated in municipal bankruptcies.

In two other recent municipal bankruptcies, in Detroit Michigan, and Stockton, California, pensioners have fared much better than capital market creditors, although the judges in both cases said that debt to pension funds is not necessarily inviolate in a Chapter 9 bankruptcy.

The deal with Calpers alarmed San Bernardino's other creditors, who fear they will be forced to bear the brunt of the city's debt restructuring if Calpers is left untouched. They also worry about precedent that could be set if Calpers is left whole.

San Bernardino, a city of 205,000, 65 miles east of Los Angeles, declared bankruptcy in July 2012 with a \$45 million deficit. It is one of a handful of municipal bankruptcies that has been closely watched by the \$3.6 trillion U.S. municipal bond market.

Bondholders and public employees want to understand how distressed cities handle their debts to Wall Street, compared with other creditors such as Calpers.

EERP and Ambac said in their filing: "The bondholder pension obligation portion must be treated in all respects equivalently to the Calpers pension obligation portion."

A Calpers spokesman said the fund was still reviewing the filing. Gary Saenz, San Bernardino's city attorney, said Calpers must be treated differently, because stable pensions were vital for the city.

By REUTERS

JAN. 8, 2015, 6:57 P.M. E.S.T.

(Reporting by Tim Reid; editing by Gunna Dickson)

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## **Munis Face 2015 Headwind as Record Market Contraction Set to End.**

After the biggest annual gain since 2011, municipal debt faces a headwind in 2015 as the \$3.6 trillion market is projected to expand for the first time in five years.

An era of austerity that swept through local government may be subsiding more than five years after the recession. Bond sales will swell 15 percent to \$354 billion this year, which would exceed the amount flowing back to investors from debt payments and refinancings by \$46 billion, according to Michael Zezas, chief muni strategist in New York at Morgan Stanley.

That would halt an unprecedented four-year market contraction and ease the scarcity that helped munis outperform Treasuries and corporate debt in 2014. Bank of America Merrill Lynch, Janney Montgomery Scott, Loop Capital Markets and Morgan Stanley project that returns in 2015 will fall from last year's 9.8 percent gain.

Positive net supply "removes something that was a clear support for the market," Zezas said in a telephone interview. "It's hard to forecast the demand side of the equation getting more supportive than it already is."

### **Ownership Sway**

Individuals own the majority of the municipal market either through specific bonds or mutual funds, giving them outsize sway over the asset class's performance. Last year, they poured \$21 billion into muni funds, according to Lipper US Fund Flows data, and state and local debt returned the most since an 11.2 percent gain in 2011. In 2013, they yanked about \$63 billion amid a 2.9 percent loss, the worst since 2008.

Throughout both periods, new issuance failed to catch up to the wave of cash bondholders got back from refinancing and debt payments. That dynamic, known as net negative supply, creates demand for munis, assuming investors want to roll the money back into state and local debt.

From 2011 through 2014, bondholders got more money back from their debt than the amount of new deals from states and cities, causing the market to shrink by about 4 percent as of Sept. 30, according to Federal Reserve data.

Munis' advance last year compared with 7.5 percent for investment-grade corporate bonds and 6 percent for Treasuries, according to Bank of America data.

In his 2015 outlook, published last month, Zezas estimated munis will earn 1.14 percent.

### **2015 Maturities**

In 2015, the amount of maturing debt is set to drop to \$176 billion from \$282 billion, curbing that source of payment to investors, data compiled by Bloomberg show.

States and cities have hesitated to borrow since the 18-month recession ended in June 2009, avoiding the added cost of paying back bondholders. The decline in principal payments in 2015 is a reprieve for municipal budgets because they require more cash than interest does.

The easing debt expenses, combined with strengthening budgets and interest rates close to generational lows may spur lawmakers to borrow before yields rise, said Chris Mier, chief municipal strategist at Loop Capital in Chicago.

“You could see a modest increase in volume from issuers that assume the era of very low rates might be coming to an end and therefore it’s time to begin some new infrastructure projects,” Mier said via telephone.

## **Project Demand**

The median forecast for 10-year Treasury yields at year-end is about 3 percent, almost 1 percentage point higher than now, according to a Bloomberg survey of 74 analysts.

Benchmark 10-year muni yields fell below 2 percent today for the first time since October, Bloomberg data show. They ended last year at 2.11 percent.

In a sign of the pent-up demand among lawmakers for new projects, U.S. states and localities asked voters in November to approve \$44 billion of bonds for schools, water systems, hospitals and roads, more than twice what they sought in 2010.

Voters approved more than \$37 billion of the measures, according to Ipreo, a New York-based financial-market data provider.

“If the muni market does not grow, then this country is in trouble,” said Phil Fischer, head of muni research at Bank of America in New York. “You don’t just add paint to a bridge — if you don’t replace the metal, it will fall down.”

Bloomberg

By Brian Chappatta

Jan 6, 2015 8:32 AM PT

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Mark Tannenbaum, Alan Goldstein

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## **[House Bill Would It More Difficult for Municipalities to File Chapter 9.](#)**

Rep. John Conyers (D-MI) has introduced legislation that would require municipalities to negotiate “in good faith” with creditors before being allowed to file for Chapter 9, clarifying the term to have the same meaning as it does with respect to the National Labor Relations Act. If enacted, a municipality would have to show “clear and convincing evidence” that it met requirements to file under the new law.

The legislation would also require the permission of beneficiaries before any readjustment plans could cut municipal employee or pension benefits.

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## **[Cheap Gas Should Boost Airport, Toll Road Bonds - Wells Fargo.](#)**

With oil sliding below \$50 a barrel today, Wells Fargo looks at the infrastructure implications of low

energy prices and says the ongoing drop in gasoline prices will boost coffers for a variety of municipal bond sectors like airports and toll roads. From Randy Gerardes, senior muni analyst at Wells Fargo Securities:

“We expect persistent lower gasoline prices to have a greater positive effect on airport traffic than automobile traffic. Therefore, we expect modest growth in vehicle miles traveled (VMT) in 2015. However, the increased discretionary income associated with lower fuel prices should offer an accommodative environment for toll operators to increase toll rates, which should support stronger toll revenue growth. We continue to be bullish on airports, specifically large international gateway airports with significant cargo operations. Speaking of cargo, we see the potential for the greatest cargo growth at East Coast and Midwestern ports with strong intermodal connections and infrastructure that can accommodate larger ships. Turning to energy, we expect electricity rates to become increasingly correlated to natural gas prices as electric utilities continue to deemphasize coal-fired generation. Finally, lower primary market issuance will likely drive cash toward higher-yielding infrastructure sectors, such as toll roads, which we saw in 2014.”

Here’s more from Wells on commodity prices and their impact on electricity rates and utilities:

“In 2015, we expect electric utilities to continue to move toward natural gas fired generation in response to environmental regulation. Consequently, we believe natural gas prices will be a bigger driver of electricity rates. Furthermore, we think environmental regulations will be the biggest driver of issuance for generation particularly in light of slowing load growth. In our view, the U.S. natural gas and oil markets are as interconnected as ever. Prices and behavior in one market can have an effect on the other. To date, the price of natural gas has not followed the slide in oil prices. However, low crude oil prices reduces returns for drillers and, in turn, may lead to reduction in drilling assets deployed and ultimately a slowing of U.S. crude production. While lower crude prices may make natural gas drilling more attractive in the short term, we believe producers seek a balance whereby oil production supports gas production and vice versa. The result, in our view, is upward pressure on natural gas prices. As producers curtail production of crude oil, this should, in turn, slow the growth in natural gas production as well.”

Barron’s

By Michael Aneiro

January 5, 2015, 1:58 P.M. ET

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## **[Municipal Bond Maturities to Decline 38% After Market Contracts.](#)**

State and local government costs to repay maturing debt will fall 38 percent in 2015 after a year when the municipal bond market contracted.

Maturities are poised to drop to \$175.98 billion from \$281.87 billion in 2014, according to data compiled by Bloomberg. Issuers from California, New York, Texas, New Jersey, Massachusetts and Florida owe 50 percent of this year’s amount.

The combination of last year’s maturing debt and \$226.54 billion of early redemptions exceeded new securities sales of \$361.62 billion, Bloomberg data show. The municipal bond market shrank 4 percent in 2014 to a total of \$3.5 trillion.

Lower costs for debt coming due lessens fiscal stress on cities and counties emerging from the sluggish growth that followed the financial crisis. The shrinking market, together with the improving U.S. economy, help explain last year's 9.8 percent return for municipal bonds, according to a Bank of America Merrill Lynch index. By comparison, investment grade corporate bonds earned 7.5 percent and Treasuries returned 6 percent.

### **Most Due**

In the coming year, issuers from California have the most debt due, with \$23.3 billion, followed by New York at \$22.1 billion, Texas with \$16.3 billion and New Jersey's \$11.5 billion. Massachusetts and Florida both have \$7.3 billion maturing. New York City, with \$2.59 billion, and Los Angeles, at \$1.59 billion, are the local governments with the largest repayments.

Municipal bond sales in the U.S. are set to increase in the next month while the amount of redemptions and maturing debt falls.

States and localities plan to sell \$8.6 billion of bonds over the next 30 days, Bloomberg data shows. A week ago, the calendar showed \$6.4 billion planned for the coming month. Supply figures exclude derivatives and variable-rate debt. Some municipalities set their deals less than a month before borrowing.

New York State Dormitory Authority plans to sell \$1 billion of bonds, Texas A&M University has scheduled \$377 million, Miami-Dade County will offer \$372 million and Broward County, Florida, School Board will bring \$273 million to market.

### **Illinois Debt**

Municipalities have announced \$12.1 billion of redemptions and an additional \$8.5 billion of debt matures in the next 30 days, compared with the \$26.1 billion total that was scheduled a week ago.

Issuers from Illinois have the most debt coming due with \$2.27 billion, followed by New York at \$1.01 billion and Indiana with \$801 million. The state of Illinois has the biggest amount of securities maturing, with \$944 million.

The municipal market contracted by \$4.1 billion last month. Sales of \$46.1 billion compared with redemptions and maturing debt that totaled \$50.2 billion.

Investors added \$329 million to mutual funds that target municipal securities in the week ended Dec. 24, compared with \$950 million in the previous period and the one-year average of \$439 million, according to Investment Company Institute data compiled by Bloomberg.

### **Michigan Yields**

State and local debt maturing in 10 years now yields 97.3 percent of Treasuries, Bloomberg data show. Since 2000, the gap has averaged 93.7 percent.

Bonds of Michigan and California had the best performance over the past year compared with the average yield of AAA rated 10-year securities, the data show. Yields on Michigan's notes narrowed 23 basis points to 2.32 percent while California's declined 13 basis points to 2.30 percent.

Puerto Rico and New Jersey handed investors the worst results. The yield gap on Puerto Rico notes widened 52 basis points to 9.49 percent and New Jersey's rose 10 basis points to 2.62 percent.

Bloomberg

By Ken Kohn

Jan 5, 2015 4:23 AM PT

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## **[Muni Bonds: Calm Ahead for 2015?](#)**

At times over the past few years, municipal bonds seemed to stray from their traditional role as staid income generators and morph into momentum investments, with performance driven by herds of investors alternately piling into munis or abandoning them, based on a variety of largely external forces.

Heading into 2015, the market hopes that fundamentals will re-emerge as the main performance drivers. For that to happen, munis must stare down two key risks: that rising rates cause greater volatility, and that Congress meddles with muni bonds' longstanding tax-exempt status.

THE MUNI MARKET SAILED through 2014, posting an 8.9% return, per S&P Dow Jones Indices, aided by the tail wind of an unexpected decline in interest rates. Longer-dated munis led the way, gaining 15.5%, while a popular exchange-traded fund, iShares National AMT-Free Muni Bond (ticker: MUB), gained 6.2%. That strong showing marked a rebound from an awful 2013, in which munis lost 2.6% and the same ETF fell by 3.3% after rates rose.

In its latest fixed-income strategy report, U.S. Trust attributes much of the market's 2014 performance to technical factors, namely robust demand and an unusually low supply of new bonds. Many bonds issued in recent years were simply used to refinance older higher-rate debt, while the overall supply of muni bonds shrank as maturing debt exceeded new supply.

U.S. Trust says that more new bonds are now being issued, and that supply "will continue to pick up as improving fiscal conditions at the state and local government levels allow for greater issuance of municipal bonds to satisfy pent-up infrastructure needs." U.S. Trust adds that muni-bond demand could fall this year for a few reasons, including rising Treasury rates, "as well as renewed discussions of federal tax reform and increasing credit risks from certain large issuers with lagging economies, structurally unbalanced budgets, and growing unfunded pension obligations."

Tax reform and pension underfunding are seemingly perennial low-level threats to the muni market. So far, there are few signs that the incoming Republican Congress will pick on munis as a possible source of new tax revenue. As for pension obligations, a five-year stock market bull run has helped make that seem like less of an imminent crisis, and problems remain isolated for now.

The constant through the past several years has been a low default rate, despite a handful of high-profile problems like Detroit's bankruptcy filing and Puerto Rico's continuing struggles. In fact, every year since 2010 has shown a decline in muni defaults, according to Matt Fabian of Municipal Market Analytics, who says "there may be still fewer defaults ahead for 2015, although we expect defaults are approaching a minimum or baseline level that will persist, regardless of economic

conditions.”

SHORTER-DATED BOND YIELDS have been rising amid expectations that the Fed will lift its policy rate this year. JPMorgan forecasts “strong but volatile” muni performance, as the yield curve flattens further, meaning short-dated yields rise more than long-dated ones. JPMorgan sees the best total return this year once again coming from longer-dated muni bonds, specifically those maturing in 21 to 25 years.

Shorter-dated bonds could see further price declines if short-term rates continue to rise. If yields do climb, however, they should become more tempting to investors who use laddering strategies that buy individual bonds of varying, staggered maturities.

“The pricing of earlier maturities has put significant incremental yield (and valuation) into bond prices inside of 10 years, and in particular inside of five years,” MMA’s Fabian wrote in late December. “This is perhaps the best opportunity in years for retail holders looking to repopulate [the] front end [of] income ladders.”

BARRON’S

By MICHAEL ANEIRO

January 3, 2015

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## **[Do Credit Ratings Matter Anymore?](#)**

Jan. 01—Chicago’s finances aren’t in great shape. And they’ve been getting worse in recent years. The city’s pension debt has ballooned to eight times its operating revenue. Between 2002 and 2012, Chicago tripled its debt load. During that time, the city’s population — its tax base — fell. As a result of all those factors, the credit market has reacted harshly. Fitch Ratings has downgraded the city’s debt rating two notches, to A-, just since 2010. Meanwhile, Moody’s Investors Service downgraded Chicago three notches over that time, to Baa1. That’s just three steps away from junk bond status.

But then there’s Standard & Poor’s. Over the same period of time in which the other two ratings agencies have been gutting Chicago’s score, S&P has kept its rating for Chicago locked at A+. These aren’t minor differences. In fact, Chicago’s three credit ratings are now spread across four of the 10 possible rating levels for investment grade bonds.

So what gives? How could three agencies look at the same set of numbers and come up with such disparate results? And how could two groups see a financial decline when a third sees economic stability? “We’re talking about very dramatic differences,” says Matt Fabian, managing director of Municipal Market Advisors (MMA). “When the rating agencies are so divergent, what guidance are investors left with?”

It wasn’t very long ago that most governments could just buy a top-grade AAA rating no matter what their actual financial health was. Thanks to the bond insurance business, a government issuing bonds could just pay for an insurer to wrap the bonds with a AAA rating. Lower-rated bonds mean governments have to pay higher interest rates to investors. So in most cases it was still a better deal to pay a little extra for bond insurance upfront rather than higher interest rates down the road. The system worked — as long as the insurance companies could offer a AAA rating. But as those companies became more aggressive with their own investments, they too became victims of the

financial market collapse in 2008. Those companies were downgraded, and a business that had once insured nearly half of all municipal bonds dropped practically out of existence. It changed everything.

Without the cloak of bond insurance, governments had to rely on their credit quality alone for the first time in decades. It was an unfamiliar practice, and not just for those issuing the bonds. Municipal market investors were, for the first time, required to look under the hood. What they found was often confusing. For one thing, the muni bond market is vastly different from the corporate market. And governments vary significantly from one another in terms of their level of disclosures and financial savviness. Complicating things further was the fact that credit ratings themselves increasingly began to vary. More and more, two different agencies would issue two different ratings for the same bond.

As a result, credit ratings — which were once essentially the only thing that mattered to investors — are today just one of the myriad things investors look at. A rating is an important starting point, but it doesn't have to dictate the kind of reception a government will actually get in the municipal market. Investors want to look at a whole host of factors to assess a city's fiscal health, and government finance officials are today much more likely to work directly with investors. Against that backdrop, the ratings agencies' wildly divergent opinions on the overall health of the municipal market has led to increased skepticism about their own credibility.

In other words, if investors don't care about ratings as much as they used to, and if ratings agencies can't even agree on which way the muni market is trending, then what purpose do they serve?

Since the market crash, credit rating agencies' image as a whole has suffered greatly. They were blamed for helping to precipitate the crisis in the first place, by giving overly generous ratings to mortgage-backed securities that later turned sour. In February 2013, the Department of Justice even sued Standard & Poor's for \$5 billion, claiming that it knowingly issued unduly high ratings. (S&P says the lawsuit is simply a retaliation for the agency's high-profile downgrade of the nation's credit rating in 2011.)

When it comes to the municipal market, some observers see credit rating agencies in the middle of an alarming shift. Increasingly, two agencies will issue a different rating for the same municipal credit. In fact, today about 40 percent of municipalities that have ratings from different agencies have what's called a split rating, according to data from MMA. From the agencies' perspective, the variance is simply a result of their different approaches. And those differences help inform the market, says Bob Kurtter, Moody's managing director of U.S. public finance. "For the most part we see things similarly, and in some cases we don't," he says. "Investors are looking for a range in opinions and, for the most part, I think that's a good thing."

But to those on the outside looking in, the divergence is sending a different message to investors, says MMA's Fabian. "It does undermine the agencies' credibility," he says. "In theory, independent views should generally align with one another. So when they don't, it underscores a degree of subjectivity."

Exactly which agency's creditability has suffered more is, well, subjective. Last summer, municipal credit analyst Tom Kozlik released a scathing report that called into question the revamped ratings methodology that S&P had been applying over the prior year to reassess its local government ratings. The new criteria score municipalities in seven categories: management, economy, budgetary flexibility, institutional framework (governance), budgetary performance, liquidity and debt/liabilities. As a result of the new criteria, S&P has issued about 10 times as many upgrades as it has downgrades over the past year (although most of its ratings did stay the same). S&P

acknowledges that the number of upgrades was higher than its analysts initially expected. But the agency attributes that to the unexpectedly positive results from the qualitative portion of its analyses of governments. In other words, the more subjective measures — particularly government management — were looking pretty good.

Meanwhile, Moody's — which has done a smaller revamp of its criteria, applying stricter standards to governments' pension liabilities — has been issuing about twice as many downgrades as upgrades.

All of this has led governments to pick and choose the agency they think will give them the best rating, according to Kozlik's report. More governments today are issuing just one rating when they go to market, he says — and their rating of choice is S&P. All three agencies have lost market share since their business boomed following the collapse of bond insurers, but S&P has held on to a greater share than either Moody's or Fitch. Even larger issuers, which traditionally have always needed to obtain more than one rating on new bond issues, are finding that they can get by with just one. Last year, Cook County, Ill., issued \$90 million in sales tax bonds and only used an S&P rating. "Years ago we would have done all three agencies," says county Chief Financial Officer Ivan Samstein. "But we thought that we could go with just one rating, and we chose to use S&P."

So who's getting it right? S&P's sunnier outlook or the more negative viewpoint of Moody's and Fitch? Unsurprisingly, that depends on whom you ask. Samstein says the mere fact that he was able to sell \$90 billion in bonds with just one rating, from S&P, means the muni market as a whole is more in line with S&P's more optimistic assumptions. And CFOs also have a duty to get the best price for taxpayers — after all, he says, a lower rating would have increased the county's borrowing costs. Still, adds Samstein, who previously worked as a public finance credit analyst at Moody's: "Most of the market knows, if you're a sophisticated institutional investor, you shouldn't really trust the ratings by themselves."

Governments these days are selling their product to a much more knowledgeable investor. After the collapse of the bond insurance industry, financial firms had to get smart — quickly — about municipal bonds. Analyst desks began opening up or expanding at major financial firms across the country. The Securities and Exchange Commission even established a new Office of Municipal Securities to keep watch over the market. It's no longer a cut-and-dried picture, says Washington, D.C., CFO Jeff DeWitt. The difference now, he says, is that cities and states must market themselves to investors. "The bonds aren't going to get sold as well if you don't get involved."

In fact the District of Columbia is looking to join the growing number of major municipalities that hold investor conferences, a convenient way for issuers in a particular region to connect directly with potential buyers. States like California and Massachusetts have well-established investor relations programs dating back several years. Last March, Massachusetts began selling bonds directly to investors, opening up a two-week period each month in which people can buy general obligation bonds directly from the state. The goal with MassDirect and all these types of programs is to create more competition for bonds, thus lowering the overall borrowing cost for governments.

The blossoming relationship between governments and investors means, among other things, that bond ratings don't carry the same weight as they used to. Of course, no CFO can schmooze his way out of an unfavorable financial status. A bad credit is a bad credit. But in the growing number of cases where municipalities receive two different ratings, finance officers can explain to investors why they believe the higher rating is more accurate and what the lower rating might not be taking into account.

A government's credit rating will always matter. An upgrade or a downgrade on a credit, especially a

general obligation bond, still makes headlines. And ratings give everyone a rough idea of what kind of borrowing costs to expect.

But government finance officers are increasingly finding that a credit rating doesn't have to keep them from getting the deal they want — if they're willing to work for it. "Before 2007, I rarely talked to an investor," says DeWitt. "They'd call occasionally to ask a few questions. But after 2007, I talk to them all the time."

Liz Farmer | Governing

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## **Municipal Defaulters Decline Amid Improving Economy: Muni Credit.**

Municipal issuers are defaulting at the slowest pace since at least 2010 as a strengthening economy boosts local-government finances.

With the U.S. economy expanding the most in more than a decade, improved balance sheets for cities and counties are easing concerns of widespread failures and supporting an unprecedented rally in their debt.

Fifty-seven issuers defaulted for the first time this year as of Dec. 30, compared with 69 in 2013 and 140 in 2010, according to Municipal Market Advisors, a Concord, Massachusetts-based research firm. The number will probably remain in a similar range in 2015 as cost-cutting municipalities in the \$3.6 trillion municipal market have proven resilient, said Chad Farrington, head of muni research in Boston at Columbia Management Investment Advisers.

"For the vast majority of the credits, even a slow recovery is good enough," said Farrington, whose company oversees about \$30 billion in local debt. "It's impressive how well they weathered the downturn. We're not seeing major cracks on the horizon."

Outliers include Detroit, which emerged from a record \$18 billion bankruptcy this year, and Puerto Rico, whose electric utility is expected to restructure its debt, Farrington said. Most defaults are occurring in bonds issued for projects sensitive to the housing bust and recession, such as land deals and retirement homes, he said.

### **Hitting Bottom**

The municipal market may be nearing a "baseline level of defaults" as issuers skip payments thanks to intrinsically flawed projects rather than the economy, said Matt Fabian, a managing director at Municipal Market Advisors.

The U.S. gross domestic product grew at a 5 percent annual rate from July through September, the biggest advance since the third quarter of 2003, according to revised figures from the Commerce Department released Dec. 23.

Banking analyst Meredith Whitney's prediction in December 2010 of "hundreds of billions of dollars" of municipal failures created angst in the market that has dissipated, said Neil Klein, a senior managing director and principal at Carret Asset Management LLC in New York.

## **Breathing Out**

“In 2013, we were still worried about what Meredith Whitney said. In 2014, it started to fall back to the wayside,” said Klein, who helps manage about \$750 million of local securities. “Municipalities are standing on their own and trying to do the best they can, fiscally speaking.”

Detroit filed its bankruptcy in July 2013. Investors pulled a record \$63 billion from muni mutual funds that year.

Since Detroit, no city, town, village or county has filed for protection, said James Spiotto, a bankruptcy specialist and managing director at Chicago’s Chapman Strategic Advisors LLC, which advises on financial restructuring.

This year, individuals have poured about \$21 billion back into muni mutual funds, Lipper US Fund Flows data show. With the influx came an unprecedented rally, with munis posting gains each month for the first time since at least 1989, according to Bank of America Merrill Lynch data. The year’s 9.7 percent return is the most since 2011.

## **Choosing Wisely**

Municipal issuers also took advantage of rates close to generational lows to refinance and improve their balance sheets, Klein said. They slowed borrowing for capital expenses except for “only the most important projects,” Klein said. As a result, the U.S. municipal-bond market shrank by \$30.3 billion during the third quarter, cutting debt to the least in five years, according to the Federal Reserve Board.

While the U.S. economy has improved, municipalities still must adjust costs to account for lower revenue, Janney Capital Markets said in a Dec. 16 report.

The analysts recommended that investors pick “high quality municipal issuers that understand the new financial reality and have made or are making budget adjustments.”

Tax receipts collected by state and local governments as a percentage of gross domestic product won’t return to the high reached in 2007 until 2058, projected the U.S. Government Accountability Office.

Localities “would need to make substantial policy changes to avoid fiscal imbalances,” said the office’s Dec. 17 report.

## **Pathetic Debt**

Most issuers skipping debt payments for the first time this year weren’t governments, but agencies and districts. They were “tiny, unrated, and unloved” credits, Fabian said.

About 82 percent of the defaulters carried no ratings at the time of sale, he said.

Summit Park District, which runs recreational facilities for a village near Chicago and receives funding through property taxes, fees and grants, defaulted on \$2.1 million of unrated general-obligation debt certificates due Dec. 1.

It fell short of principal and interest payments because “due to construction and project delays, the grants were not received in full,” the district said in a Dec. 11 posting on the Municipal Securities Rulemaking Board’s website.

Ross Bruni, the district's executive director, said in an e-mail that additional debt was issued to pay the balance, about \$541,000, according to the notice. A state payment will retire that, he said.

About 20,000 municipal credits carry grades by the ratings companies, and only about 40 are listed as defaulted in the MMA database, Fabian said.

"The data implies that as an investor, if you are only worried about default risk, you can buy anything rated," he said.

(An earlier version of this story didn't include that the GAO projection of tax receipts was as a percentage of gross domestic product.)

Bloomberg Muni Credit

By Romy Varghese Dec 31, 2014

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## **[Charter Schools Find Smarter Way to Borrow.](#)**

An extended rally in municipal bonds is helping Gloria Bonilla-Santiago grow the Camden, N.J., charter-school network she founded in 1997.

Although charter schools are among the riskiest municipal borrowers, and the city of Camden struggles with poverty and crime, Dr. Bonilla-Santiago was able to raise \$10 million in a September bond sale. The money will enable her LEAP Academy University Charter School to expand its campus into the Wilson Building, a 12-story downtown landmark, adding a new cafeteria, fitness center, science labs and a health clinic.

"It's a big responsibility, but there was an opportunity in the market to be able to sell bonds at a good rate," Dr. Bonilla-Santiago said.

The school is paying a rate of 6.3% on longer-term debt. Comparable borrowing costs in 2009 were about 7.6%, according to the Local Initiatives Support Corp., which advises charter schools on finances.

Bonds issued by U.S. cities and states have rallied this year, posting their longest string of monthly gains in more than two decades while outpacing gains in corporate and U.S. Treasury debt. Municipal bonds have returned 8.71% through Dec. 26, according to Barclays PLC. Total return includes price increases and interest payments.

The rally in the \$3.6 trillion market is pushing down borrowing costs for scores of municipalities, including issuers of lower-rated debt. Puerto Rico, which is rated below investment grade due to its heavy debt burden, sold \$3.5 billion of bonds in March. In October, the operator of a struggling toll road in California issued \$1.4 billion.

Investors' rising appetite for muni bonds is a boost for charters, which are typically nonprofit, publicly funded and run independently from local school districts. Charter schools, which educate

about 2.6 million students in the U.S., issued about \$1.64 billion of debt this year through Oct. 5, more than the record volumes from all of last year and the year before, according to a report by Charter School Advisors and the LISC.

The ramp-up in charter schools' debt sales comes as mainstay municipal issuers cut back amid postrecession belt-tightening by public officials. They are attracting yield-hungry investors who have pushed into riskier debt in search of better returns amid low interest rates.

Investors consider charter-school bonds to be riskier than conventional school-district debt because charter schools' primary funding is per-student payments from the state rather than local property taxes. That makes it hard for charters to finance buildings or renovations without tapping outside sources like donors or the bond market.

Charter-school bonds are the seventh-most likely sector to miss debt payments, out of 33, according to data from Municipal Market Advisors, a research firm based in Concord, Mass. About 1.37% of outstanding charter bonds, including both rated and unrated debt, have defaulted. That compares with an average of .03% for all rated bonds over the past five years, according to a report by Moody's Investors Service. Charter schools have issued more than \$10 billion in bonds since 1998.

John Miller, co-head of fixed income at Nuveen Asset Management LLC, said he has been "pretty aggressive" about adding charter-school bonds, and now holds about \$1.4 billion, the majority of which are in the Nuveen High Yield Municipal Bond Fund, which has returned more than 18% this year. Safely investing in the sector requires analysis and legwork, even visiting the schools, he said. That means the market doesn't necessarily price the bonds efficiently, creating an opportunity to find bargains.

"I've heard people say 'I can't get my arms around the idiosyncratic risk here,'" Mr. Miller said. "But there are returns to be had for actually doing that."

Other factors are driving charter-school bond sales.

Life School, near Dallas, was stuck paying relatively high rates until this year, when Texas agreed to guarantee its bonds—and those of other investment-grade charters—through the \$37.7 billion Permanent School Fund, the nation's largest education endowment. Created with a \$2 million grant in 1854, the fund backs about \$55.2 billion of Texas school debt with money from investments such as state land, providing districts with the equivalent of a triple-A rating and access to lower-cost borrowing.

Scott Fuller, Life School's chief of staff, said that guarantee saved about \$13 million on building a new high school in Waxahachie.

"To put \$13 million back into the classroom for us—it's a game changer," he said.

Six Texas charter-school operators have now accessed the guarantee to back about \$273 million in debt, according to the Texas Charter Schools Association.

"Finding and providing facilities is always challenge No. 1 throughout the state, so being included in the Permanent School Fund and having the full faith and credit of the state of Texas and the triple-A rating to back those bonds has been a huge boon to charter schools," said David Dunn, executive director of the group.

Meanwhile, the growth of charters poses an increasing risk for public school systems in cities such as Philadelphia, Cleveland and St. Louis that compete with them for students and state money,

according to a report by Moody's.

Students' flight to charters has helped reduce the Philadelphia district's underlying credit rating to junk, which is defined as below BBB- or the equivalent, though investors are protected by a state program that can withhold district funds for bondholders, Moody's said.

In Camden, workers are renovating the Wilson Building, which is scheduled to open this summer.

The school hasn't always had an easy path financially, according to Dr. Bonilla-Santiago, who is also a professor at Rutgers University. LEAP lost its tax-exempt status in 2010 after the school got bad advice on its paperwork-filing requirements, she said. The Internal Revenue Service restored the exemption after an appeal. The recent bond sale was rated BB- by Standard & Poor's Ratings Services.

The process of accessing the bond market, such as receiving a credit rating, helped the school improve its financial management, Dr. Bonilla-Santiago said. And as LEAP has grown, its buildings and students have helped breathe new life in the neighborhood around Camden's Cooper Street, she said.

"The school has to be run like a business," she said. "It has to be accountable. You have to have yearly audits. You have to build credit and you have to have the right kind of reputation. And that takes time."

THE WALL STREET JOURNAL

By AARON KURILOFF

Dec. 28, 2014 9:40 p.m. ET

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## **[Market Close: 2014 - What's Not To Like?](#)**

### A VERY GOOD YEAR

For many municipal market participations, this year turned out to be a good year in the end, although that's not the way it looked in January.

"There was a lot to like about 2014," says James Colby, senior municipal strategist and portfolio manager at Van Eck Global, summing up the way he views the year. "It was surprising in terms of the returns we have seen in the muni space."

He said that at beginning of the year the municipal community - the sales people, traders and portfolio managers - didn't expect to see anything more in the way of returns than the average coupon.

"What the Federal Reserve would do tempered our expectations - and then that didn't happen."

He says the weakened supply landscape was overtaken by basic demand. "All that reinvestment money found its way back into the asset class."

And he cites March as the turning point for the muni market.

“It was the inflection point. March was a strong signal for a move forward. The big Puerto Rico bond issue came to market then – and the deal was effectively placed. And those Puerto Rico bonds then traded up afterwards in a meaningful way.”

Puerto Rico issued \$3.5 billion of general obligation bonds on March 11. The junk-rated bonds were priced with an 8% coupon to yield 8.727% in 2035 and saw strong demand from investors.

Other things broke right for munis amid all the uncertainty about the Fed’s intentions, he said.

“On the heels of a terrible 2013, when \$60 billion in assets left the muni space in all categories and sectors. Even with 8% returns in 2014 we didn’t recover all of those assets that left in 2013. This suggests that the rest may come back in 2015 if all goes well.”

He sees no change in the supply/demand picture for 2015. “The same story is in place.”

“The thing that could work against munis is the economy – the GDP,” he asserts. “If the economy really is as strong as 5%, then expect equities and corporates to surge and if Treasury yields rise, then munis would underperform.”

Oil could be a market factor in 2015. If crude prices stay in the \$50-a-barrel range “more people will drive and they will feel better about things and that could cause a pickup in consumption and economic performance.”

That has both good and bad consequences for munis.

“It’s a two-edged sword – it’s good news for some issuers like toll roads and airlines and industrial, but if rates rise sooner rather than later it would likely put a damper on overall muni performance,” he says.

As for the rest of 2015, the scenario is still unclear.

“It’s like a two-act play with an uncertain ending,” Colby says. “My guess is that investors will take a cautious approach as to when and where they will place their bets in the muni space. But credit quality is a plus and it will remain strong.”

#### A CHRISTMAS PRESENT FOR A.C.

Elsewhere, New Jersey is giving Atlantic City a \$40 million short-term loan so the city won’t have to sell notes in the municipal market, according to a published report.

The city had originally planned a \$140 million bond sale for November, then scaled it back to a smaller note sale, which was delayed because of concerns about the city’s finances in the wake of the casino closures.

The city must repay the 0.75% interest loan by March 31, according to an agreement signed by the city and the state, Reuters reported.

#### PRIMARY MARKET

No bond issues are scheduled for negotiated or competitive sale until after the start of the new year.

Looking ahead to January, Miami-Dade County, Fla., will put out for bid on Jan. 6 three separate

competitive sales of general obligation bonds totaling about \$372 million. Proceeds from the sales will be used for parks, public health and its "Building Better Communities" program.

## SECONDARY MARKET

High-grade municipal bond prices were lower on Wednesday. The yield on the benchmark 10-year general obligation scale rose one basis point to 2.10% from 2.09% on Tuesday, while the yield on 30-year GOs was up one basis point to 2.95% from 2.94% on Tuesday, according to the final read of Municipal Market Data's triple-A scale.

Treasury prices were lower, with the two-year note yield rising to 0.74% on Wednesday from 0.73% on Tuesday. The 10-year yield increased to 2.27% from 2.25% while the 30-year rose to 2.85%, from 2.83% on Tuesday.

The 10-year muni-to-Treasury ratio was calculated at 92.5% on Tuesday versus 92.5% on Tuesday; the 30-year muni to Treasury ratio was at 104.2%, compared with 103.1% on Tuesday.

"Heavier than anticipated year-end new issue volume contributed to elevated municipal to Treasury ratios in recent weeks," Alan Schankel, managing director at Janney Capital Markets, wrote in a research report. "A strong burst of new issuance in early December may be responsible for the higher municipal to Treasury ratios we've experienced in recent weeks."

But over the longer term, Janney sees ratios as heading down.

## THE BOND BUYER

BY CHIP BARNETT

DEC 24, 2014 2:12pm ET

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## **[U.S. Stellar Municipal Bond Returns Set to Dim in 2015.](#)**

(Reuters) - U.S. municipal bonds' stellar 9 percent performance so far this year may not continue in 2015 as interest rates are set to rise and dampen returns, analysts and fund managers said.

Munis bounced back from a negative return in 2013, when investors fled the asset class partly on concerns about high-risk situations in Detroit and Puerto Rico. This year, high-yield funds and long-duration munis clocked among the highest returns.

For 2015, investors are anticipating higher interest rates, which could bring the rally to a halt. Bond prices typically move inversely to interest rates, and the U.S. Federal Reserve has signaled it will raise rates in 2015.

"An unanticipated jump in interest rates has the potential to reintroduce households, who are the biggest holders of municipals, to interest-rate risk," said Chris Mauro, head of U.S. municipals strategy at RBC Capital Markets. "This could cause a negative, herd response on the part of these investors, temporarily dislocating the municipal market."

The S&P Municipal Bond Index returned 9.25 percent as of Dec. 17. That beat both its Treasury Bond Index, which has returns of 3.83 percent, and its investment-grade corporate bond index, with returns of 7.28 percent. This year's returns for the S&P Muni index are on track to be the highest

since 2011.

“We’ve had a very good year in the muni market,” said Jeffrey Lipton, Managing Director, Municipal Research, at Oppenheimer & Co, pointing to positive flows into intermediate, long-term and high yield funds.

Interest rates on long-term bonds this year have taken the biggest plunge in a decade. According to Municipal Market Data, a unit of Thomson Reuters, the yield on top-rated debt maturing in 20 years and beyond has fallen the most since 2004 on its benchmark scale, meaning the prices spiked during that time.

That’s unlikely to be repeated in 2015.

“We’re expecting the on-paper returns will end the year (2015) looking somewhat boring but the path to get there will be anything but boring,” said Morgan Stanley analyst Michael Zezas. “There is plenty of risk in the market that has the potential to create a fair amount of volatility along the way.”

Municipal bond performance could remain positive at the beginning of the year, but overall in 2015 the range could be somewhere between a negative return of 2 percent to a positive return of 5 percent for 2015, said Richard Ciccarone, head of Iowa-based Merritt Research Services.

Constricting supply pushed up returns this year. The amount of outstanding debt, \$3.63 trillion, is the smallest in five years.

Issuance so far this year through Wednesday is \$312 billion, according to Thomson Reuters data, level with 2013’s figure for the year as a whole. Many expect next year’s supply to be higher, boosted by bond ballot measures in November’s elections and continued demand to improve creaking infrastructure.

“We’ve gone through a period of time when America has been holding back,” said Ciccarone. “Physical structures can only take that for so long.”

According to a survey of banks released earlier this month by the Securities Industry and Financial Markets Association, sales of all municipal bonds will likely rise to \$357.5 billion in 2015 from \$348.1 billion estimated this year.

Inflows into bond funds are also expected to continue. With two weeks remaining in the year, municipal bond funds have received total net inflows of \$23.3 billion, compared to record net outflows of \$64.2 billion in 2013, according to Lipper.

Thu Dec 18, 2014 1:34pm EST

(Reporting by Megan Davies, Lisa Lambert, Hilary Russ, Robin Respaut, Karen Pierog, Ed Krudy; writing by Lisa Lambert and Megan Davies; Editing by Cynthia Osterman)

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## **[NABL Files Amicus in Jefferson County Case.](#)**

NABL filed today an amicus brief with the 11th Circuit Court of Appeals in support of Jefferson County’s request that the court take an interlocutory appeal from a ruling of the District Court in Jefferson County v. Bennett, et al. Certain Jefferson County water and sewer ratepayers brought a

case in the District Court to appeal the plan of adjustment confirmed by the Bankruptcy Court in Jefferson County's bankruptcy case. Jefferson County sought to have the District Court dismiss the case as moot because the bankruptcy confirmation order had been substantially consummated when the county sold \$1.8 billion of warrants on December 3, 2013. Although the doctrine of equitable mootness has been established in other chapters of the Bankruptcy Code, this is a case of first impression with respect to Chapter 9. The District Court denied Jefferson County's motion to dismiss but did certify the question for an interlocutory appeal to the 11th Circuit.

NABL supports the 11th Circuit taking the interlocutory appeal because doing so would materially advance the disposition of the case and provide needed guidance to the municipal bond market regarding the finality of substantially consummated Chapter 9 plans of adjustment. NABL's amicus brief is available [here](#).

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### **[NABL, SIFMA: Ratepayers' JeffCo Appeal Undermines Market.](#)**

WASHINGTON - Municipal bond groups are seeking federal appeals court guidance in a ratepayer appeal of part of Jefferson County, Ala.'s Chapter 9 bankruptcy plan, saying the district court decision allowing a challenge of the plan threatens to undermine market stability.

The National Association of Bond Lawyers and Securities Industry and Financial Markets Association filed friend of the court briefs Thursday with the Eleventh Circuit Court of Appeals in Atlanta, Ga., asking it to provide guidance to municipal issuers by taking up the question of whether the ratepayers' appeal of the bankruptcy plan is moot because the plan is largely consummated.

The issue before the court is whether bankruptcy courts confirming a Chapter 9 plan of adjustment, can be the final determiner of issues that involve certain rights of citizens and state powers over utilities rates if the plan is not stayed on appeal and implemented.

A federal district court judge ruled earlier this month that the county's sewer ratepayers' appeal of the bankruptcy court's decision on the confirmation order wasn't moot, even though the plan is largely implemented, but decided to allow the county to appeal to the Eleventh Circuit before the district court has fully considered the merits of the ratepayers' case. At issue in the district court is the plan's provision to grant sewer rate-setting powers to the bankruptcy court.

NABL's brief, penned by Richard Carmody and Aaron McLeod of Adams and Reese in Birmingham, Ala., said the appeals court should hear the case because it raises serious questions for other municipalities that may contemplate Chapter 9 proceedings and could make a difference in the marketability of the new sewer warrants the county has issued to settle existing debts as part of the plan.

"Because no circuit court of appeals has ruled on the mootness of appeals from a substantially consummated Chapter 9 plan, resolution of these issues by the Eleventh Circuit would help settle the secondary market for the new sewer warrants," NABL said.

NABL president Tony Martini of Edwards Wildman in Boston said NABL tried to be neutral on the merits of the appeal, but feels strongly the appeals court should hear it.

"We recognize that this is a very important question," Martini said.

SIFMA's brief, written by Jayna Lamar and Kasdin Miller of Maynard, Cooper & Gale in Birmingham

as well as SIFMA attorneys Ira Hammerman, Kevin Carroll, and Leslie Norwood, told the Eleventh Circuit it should act now because the district court's order allowing the ratepayers' appeal threatens to undermine market stability.

"The disruption created by the order for all issuers must be resolved now," SIFMA said. "The market cost of awaiting full district court proceedings is simply too high."

THE BOND BUYER

BY KYLE GLAZIER

DEC 19, 2014 2:10pm ET

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## **Munis Approach Cheapest Level of 2014 Relative to Treasury Debt.**

Prices in the \$3.6 trillion municipal bond market are close to the cheapest relative to Treasuries this year as investors snap up U.S. government debt as a haven from financial turmoil.

Benchmark 10-year munis yield 2.1 percent, about the same rate as the start of the week, compared with 2.05 percent on similar-maturity Treasuries, data compiled by Bloomberg show. The ratio of the interest rates is a measure of relative value between the asset classes. At about 102 percent, it's close to the highest in a year, signaling that tax-free bonds have weakened relative to their federal counterparts.

Ten-year Treasury yields plunged 0.07 percentage point today as falling crude oil prices damp inflation and growing financial turmoil in Russia fuels demand for haven assets from Germany to Japan. Russia's ruble tumbled even as the central bank increased its key rate to 17 percent from 10.5 percent.

"Geopolitical events like we're seeing today don't always affect munis as strongly as they do Treasuries, and this would be a case in point," said David Manges, muni trading manager at BNY Mellon Capital Markets LLC in Pittsburgh. "Treasury riptides have their own dynamic."

Munis have earned 0.5 percent this month through Dec. 15, on pace for an unprecedented 12 straight months of gains in 2014, Bank of America Merrill Lynch data show.

Individuals added \$695 million to muni mutual funds last week, the most in two months, Lipper US Fund Flows data show. The increased demand coincides with dwindling supply: States and cities have set \$5.4 billion of sales for this week, down from \$14 billion in the prior two periods, Bloomberg data show.

Bloomberg

By Brian Chappatta Dec 16, 2014 7:35 AM PT

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Mark Schoifet, Mark Tannenbaum

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## **Municipal Issuer Brief - Important Issues in 2014**

[Read the Brief.](#)

Municipal Market Advisors | Dec. 22

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### **A 5-Part Test for Public-Private Partnerships.**

Like it or not, public-private partnerships (P3s) for infrastructure are here to stay in the United States. The recent openings of two Florida projects, the I-595 Express highway and the PortMiami Tunnel, as well as Texas' North Tarrant Express highway — projects with a total cost of \$4.9 billion — are high-profile success stories that provide a demonstrable proof-of-concept boost for the U.S. P3 market.

But P3s have not fared well in some places. The Philadelphia City Council, for example recently refused to vote on Mayor Michael Nutter's proposal to sell the antiquated Philadelphia Gas Works to UIL, a publicly traded company, for \$1.86 billion. The failure of that transaction and earlier P3 proposals such as those involving the Pennsylvania Turnpike and Chicago's Midway Airport raise a fundamental question. What does it take for a P3 to succeed and reach the public-policy finish line?

Whether one is an official aspiring for the best deal for the taxpayers or a vendor trying to decide whether to invest millions of dollars in a P3 bid, there are principles that can provide guideposts. We suggest the following five conditions as a recipe for success:

**1. Political will:** Fundamental to any successful P3 initiative is broad-based, senior-level support within a government. If a jurisdiction is divided on partisan or other lines as to whether a P3 is the correct approach, it reduces both the chances of success and the vendor's appetite to present a financially attractive proposal. Without a real consensus at the outset, the risk of a P3 being thwarted or mischaracterized by opponents is simply too high. Dealing with the politics at the beginning of the process, not the end (as happened in Philadelphia), ensures that a government does not waste bidders' time or its own.

**2. A belief in private-sector value creation:** Philosophically, there has to be an embrace of the idea that the private sector can create value that government cannot achieve on its own. In advising a major U.S. city, a senior official once stated that "a contractor is nothing more than someone trying to get money out of the government's wallet." With any variant of this attitude — viewing a P3 partner in an adversarial way before even entering into a transaction — an initiative cannot succeed. In places as varied as Indiana and Florida, the public sector has embraced P3s because there is an underlying belief that, properly structured, they can create more value than traditional procurement approaches.

**3. The underlying quality of assets:** The assets involved in the P3 transaction must be of commercial interest to the private sector. This may seem basic, but there have been a number of situations where bid processes were launched involving distressed assets. A proposed lease of the Port of Chicago, which had operated at a loss for 10 years and had not seen significant investment since the 1980s, failed to gain traction in the market, for example. The takeaway: Clever public marketing can rarely overcome a difficult or unattractive business proposition.

**4. Commercially reasonable contract terms:** Negotiating a concession agreement or other project documents is always a balancing act. On the one hand, the public interest must be comprehensively protected. On the other, it is not uncommon to have a situation where all of the bidders object to a contract term proposed by the government, only to have their feedback ignored. When companies indicate that a contract term would prevent them from bidding, it is prudent to listen. A contract that allows multiple companies to submit final bids is critical. In its Ohio River bridges contract, Indiana got the risk allocation and other terms correct.

**5. A willingness to pay transaction costs:** Hiring experienced financial, legal and technical advisers is good public policy, but bringing these experts on board during the P3 process involves costs that can encounter political resistance. However, transaction costs effectively amount to a rounding error on large projects. In this regard, perhaps it wise to follow some age-old advice and avoid being penny wise and pound foolish.

Overall, it is expected that the United States will become the world's largest P3 market over the next decade. For that to happen, many successes will be needed. We believe the five-part test outlined here can be a useful filtering and decision tool for public officials evaluating P3 projects.

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BY STEPHEN GOLDSMITH & ANDREW DEYE | DECEMBER 17, 2014

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## [Even with Stock Market's Rise, Many Pensions Haven't Recovered from Recession.](#)

Almost 40 percent of pension plans examined, even those that have been well-funded, have yet to reach their pre-recession peaks.

This fall, Jim Carroll appeared before the Kentucky legislature's Public Pension Oversight Board and testified about the state of the nation's worst-funded retirement plan. Over the last three years, said the co-founder of Kentucky Government Retirees, the Kentucky Employees Retirement System has exceeded its assumed rate of return — yet it lost more than half a billion dollars in that time.

In fact, the plan has been in a virtual freefall for years. At the end of the 2013 fiscal year, the plan had \$3.3 billion in net assets — that's roughly half of its peak value just before the Great Recession. The gap makes it the pension system that has the farthest to go to recover the assets it lost in the stock market crash, according to a Governing analysis of 146 larger pension plans across the country.

It's not for lack of performance — Kentucky has had some big returns in recent years. This summer, it reported a 15.5 percent rate of return on the fiscal year that ended June 30. The year before that, it earned a 12.7 percent return on investments. But for all that great performance, Kentucky Retirement Systems has continued to bleed money. It now has just one quarter of the assets it needs to cover its more than \$12 billion in estimated liabilities and its dependents worry it will run out of money in the next decade.

"We are not going to invest our way out of this," Carroll said.

Kentucky is not alone. Overall, 57 pension systems (39 percent) have not recovered their assets prior to the recession and 18 of those plans are still more than 10 percent below their peaks. Meanwhile,

89 systems have now regained their losses. Most plans' peak year was 2007, followed by losses the following two years that added up to a one-quarter drop in average value across the plans.

Most plans began their recovery in the 2010 fiscal year although many did face varying losses again in 2012. Governing's analysis, which used data from the Boston College Center for Retirement Research (CRR), looked at the larger pension plans across the country with available data regarding plans' net market assets — the actual amount in the funds at year-end. That figure is a different from a plans' actuarial value, which projects earnings over time and incorporates other assumptions about the retiree population.

Collectively, the asset values of the 146 systems has recovered from the recession and now total \$2.84 trillion, up about 1 percent from 2007. This value, however, does not account for inflation. If adjusted, the aggregate total would not yet have recovered from the recession's losses.

The recovery level of plans, however, is varied. Some have surpassed their pre-recession peaks by more than 50 percent. On the other end, Kentucky's state employee plan has the farthest to go, followed by other pension funds that commonly make headlines. Those are: Chicago's police, city and teachers' funds, Pennsylvania state and teachers plans and New Jersey Teachers' plan — all which are more or less one-quarter short of their pre-recession peaks.

Among these plans, underfunding is a recurring theme. All of the plans in the chart above were not being fully funded by their governments when the recession hit and they continued to be underfunded through the market recovery period. This meant that these pension plans were unable to fully capitalize on the big gains of the stock market in recent years. Meanwhile, noted CRR Assistant Director of State and Local Research Jean-Pierre Aubry, it's not as if liabilities stood still since the recession. "For the plan to improve its funded ratio, its assets have to grow faster than its liabilities, he said. "So when you've had the losses we've had in 2008 and 2009, they really need to have monumental gains to improve their funded ratio. If you already have huge numbers in liabilities, you can't just be plodding along if you want to make up that ground."

That also means that even plans that have been well funded by their governments have generally not been able to catch up to their funded status before the recession. They do, however, tend to be far healthier than the plans that have not caught up.

Texas' county and district pension plan, for example, was almost fully funded in 2007 when its assets suffered a 29 percent drop the next year. The contributing governments kept funding the plan, making slightly more than the recommended contribution each year. By 2010, the plan had recovered its losses. By 2013, the plan's net assets were 37 percent higher than in 2007. Yet its funded status was 88 percent — healthy by actuarial standards, which indicate plans should be at least 80 percent funded. But as the plan's liabilities grew, thanks to more employees retiring and living longer, the gains were not enough to get back to the 94 percent funded status it enjoyed before the recession.

Meanwhile, plans that don't have a history of consistent funding from their governments went from marginally healthy to ailing in a matter of years. Kentucky's state employee plan was actually overfunded in 2002, with 110 percent of the assets needed to cover liabilities. Since then, its actuarial liabilities have doubled while its assets have been more than cut in half. Over that same period of time, Kentucky has not made its full actuarial contribution. Even before the recession, Kentucky's funded status had taken a hit — in 2007, it was 58 percent funded. As it continued to lose money post-recession, its funded status slid further to 25 percent.

Another example: New Jersey had not been putting any money into its state teachers' plan since at

least 2001 (as far back as the CRR data goes) because at the time, the system was fully funded. But even when it dipped below fully funded after 2003, it took a few years for the state to start making any contributions at all. And those contributions have been a small fraction of the amount the state should be paying. (In fact, last week, the state's three largest pension funds sued Gov. Chris Christie for cutting \$2.4 billion in pension fund payments he promised to pay as part of 2011 pension reform.) New Jersey's teachers plan in 2007 had 75 percent of the assets it needed to cover promised payments to retirees; as of 2013, it had just 57 percent.

So, while a plan's investment recovery is not the only factor in its overall health, it plays a substantial role. Plans that have recovered their investment losses tend to be healthier than plans that have not. Just about everybody lost out when the stock market crashed. But the cut went a lot deeper for the pension plans that weren't getting enough money from their governments in the first place. In fact, three of these seven highlighted plans were healthy by actuarial standards before the recession. Today, none of them are.

"It illustrates the peril of becoming severely underfunded," said Keith Brainard, research director for the National Association of State Retirement Administrators. "Being severely underfunded combined with a strong market decline can really create fiscal distress for employers."

In Kentucky, that severity is reaching a breaking point. Since 2011, the plan has lost an average of \$260 million per year while its payouts to retirees have averaged about \$900 million per year. The state passed pension reform in 2013 that will effectively end cost of living pay increases to retirees. The reform also included a requirement that the state fully fund the plan, and for 2014, it has made its full actuarial contribution. But the retirees association's Carroll worries that won't be enough. He asserted that the state must also make up for at least some of its missed payments over the last decade.

"This deep hole has been dug with a shovel and it's being filled using a hand trowel," he said. "In several years I have to hope the situation will ease and I have to hope the stock market doesn't decline during that time."

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BY LIZ FARMER | DECEMBER 17, 2014

Data Editor Mike Maciag contributed to this story.

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## [\*\*The Week in Public Finance: Traffic Cam Drama, Retiree Healthcare and Another D.C. Shoutout A Roundup of Money \(and other\) News Governments Can Use.\*\*](#)

### **Putting on the brakes**

Are red light and speeding cameras that mail tickets to violators intended to be revenue generators or traffic calming measures? It's a debate that rages among communities that have the cameras but according to one credit ratings agency, the answer is clear. It's all about the money.

That's why Moody's Investors Service is raising the caution flag for New Jersey and Nassau County, N.Y. for failing to renew their red light camera and speed camera programs, respectively. Calling New Jersey's red light cameras a "a revenue generator" for local governments, Moody's on Dec. 19

said nixing the programs in both states will “further constrain governments’ ability to implement new revenue streams at a time when these governments are facing property tax limits, uneven sales tax growth and anti-tax sentiment.” Nassau’s program, which installed speed cameras around schools, had only been implemented in July of this year and netted \$21 million for the county. New Jersey’s has been around since 2008 in 25 municipalities and typically accounted for between 1 and 2 percent of towns’ revenues. Both programs faced public resistance and problems with their contracted operators that resulted in tens of thousands of violations being dismissed.

## **Costly promises**

States’ obligations to paying for retiree healthcare vary so incredibly that the gap between the most and least burdensome obligation is a whopping \$67 billion. Of the states that directly offer retiree health care, Oklahoma has approximately \$4 million in unfunded liabilities while New York has upwards of \$67.7 billion, according to a [new brief](#) by the National Association of State Retirement Administrators (NASRA) and the Center for State and Local Government Excellence (SLGE). The assessment is an update to last year’s brief that only looked at general state employees. The information now includes public safety officers, university employees, and legislators, among others for the 2013 fiscal year.

Some of the brief’s findings include: more than three-quarters of the total state retiree healthcare unfunded liability is held by just 10 states and as of 2013, 33 states are setting aside assets to prefund these liabilities. That’s up from 18 in 2011. Although many states believe that, legally speaking, retiree healthcare promises are more easily broken than pension promises, more government are paying attention to the mounting debts.

To be sure, these debts are now likely even higher than the brief suggests - also this week California State Controller John Chiang released his own [report](#) showing the state’s unfunded liability for retiree healthcare as of 2014 totaled \$71.8 billion. The change represents a staggering \$7.2 billion jump from the \$64.6 billion obligation identified last year. In his statement, Chiang urged adopting a policy of pre-funding retiree healthcare (as pensions are pre-funded), noting that such a move could reduce California’s unfunded liability by \$25 billion (or 35 percent) to \$46.8 billion.

## **Farewell, Mayor Gray**

The mayor of the nation’s capital city steps down this month after losing his re-election bid. But Washington, D.C. Mayor Vincent Gray certainly made the most of his farewell address this week, which one local news outlet joked “ran nearly as long as his term in office.” Still, you may be asking, what does that have to do with public finance? In his nearly 9,400-word speech, Gray championed his fiscal responsibility measures over the last four years, including restoring Washington’s rainy day fund and seeing the city’s credit rating rise to AA - it’s highest ever. But most appreciated by yours truly was this little quip that sums up the importance of knowing the role of numbers in public service.

“Now, fiscal responsibility may not sound glamorous - but it is the foundation for everything a government does,” Gray said. “Even the most well-intentioned plans fail if you can’t pay for them.”

Ain’t that the truth.

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BY LIZ FARMER | DECEMBER 19, 2014

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## **Environmental Risks Becoming Part of Bond Assessments.**

Municipal bond investors have started asking governments to disclose their area's environmental hazards, but a lot of the information they want is not yet known.

Each spring the city of Orting, Wash., is the final stop on the Daffodil Festival Parade. Against the expansive backdrop of Mount Rainier, this town of 7,000 puts on a wonderful show that earned it the nickname "Small Town, Big View."

In all this bucolic delight, it's easy to forget that at any moment Orting could be wiped off the map. Mount Rainier is an active volcano. When it erupts, the resulting crush of lava, mud and glacial ice will bring disastrous problems for Orting and every town nearby.

This is no secret. In fact, in a recent bond offering document, Orting quoted the U.S. Geological Survey's (USGS) assessment that "over the past 10,000 years Mount Rainier has been the source of numerous volcanic debris flows that buried now densely populated areas as far as 100 km from the volcano." USGS also says it's not possible to predict the next eruption. So for now, folks in Orting will focus on the daffodils.

A statement about volcanoes might seem out of place in a financial report. But, in fact, this statement and many others like it are a direct response to specific questions posed by bond investors and other financial stakeholders. They use this information to measure and "price in" the potential for volcanoes, hurricanes, earthquakes and other discrete, catastrophic events. Their analysis matters a lot. For example, some academic papers have shown that, when they sell bonds, communities in California most vulnerable to earthquakes pay up to millions of dollars more in extra borrowing costs.

More recently these financial stakeholders have started to push the boundary for what we can reasonably include in a government financial statement. They have started to call for a new type of information about other environmental risks that are far more abstract and systematic. For state and local governments, these new demands present some big and immediate challenges.

Climate change is a prime example. At a recent industry conference, a panel of municipal bond investors and credit ratings experts outlined a sort of wish list of information that states and municipalities ought to share about the financial implications of future climate change. These investors are especially interested in the deleterious effects of rising water levels. Sewer systems, after all, run on gravity. If water levels rise, less water flows downhill, and that can render an entire sewer system useless. It makes sense that water and sewer bond investors would want to know if climate change might cripple their investment.

It doesn't stop with too much water. These same stakeholders have publicly called for better disclosures about the financial implications of prolonged droughts. Others want cities to speculate on how a massive conversion to solar energy might fundamentally alter urban infrastructure needs.

This appetite for information is more than understandable, but it also presents several problems for state and local governments. First, a lot of this information is unknowable. Scientists mostly agree about the likelihood and eventual effects of one-off catastrophic events like volcanoes and earthquakes. But at the moment they don't really agree on how, when and where climate change will happen, and how it will ultimately shift weather patterns, raise sea levels and melt glaciers. The science gets better every day, but for now these sorts of massive changes are difficult to understand and predict.

Moreover, if a government wants to disclose these risks it must exercise proper internal controls on how it carries out that risk assessment. These controls require a clear procedure to separate the “relevant” risks from the “nonrelevant” ones. Of course, this is difficult to do when the risk assessment is based on mathematical models that can reach qualitatively different conclusions if the assumptions change. Once a government discloses this information, citizens naturally start to wonder why their state or city isn’t doing more to prepare for the eventual problems and other systemic threats related to climate change.

The beauty of budgets and financial statements is that they make abstract things real. But for that to work, those abstract events must be grounded in at least a little bit of empirical reality. Right now, there’s no such reality for the information investors want the most.

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BY JUSTIN MARLOWE | DECEMBER 2014

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## **[Falling Oil Prices Help Consumers, Hurt States.](#)**

The price of oil has dropped by 40 percent over the past few months. Most oil states have money saved in permanent funds, but the drop in revenues is causing shortfalls already.

It’s been nice for drivers to fill up their tanks at the lowest cost in years. But a 40 percent decline in oil prices over the last half of the year is bad news for energy-producing states.

In New Mexico, for example, every dollar drop in the price of a barrel of oil means \$7.5 million less for the state’s general fund. “It adds up pretty quick,” said David Abbey, who directs the Legislative Finance Committee. “When prices are falling like a brick, we can’t lower our estimates fast enough.”

Abbey notes that his state – along with other oil and gas states such as North Dakota and Texas – devotes most of its oil revenues to permanent funds, which have billions of dollars in reserves. Capital outlays may be delayed and there could be less money for education or debt service, but money socked away when things were flush will keep those states from having to impose deep cuts right away. “They can weather these short term swings easily,” said Norton Francis, a state tax policy expert at the Urban Institute. “The problem comes when this price stays low for a long time.”

Some state officials are hopeful that the drop in gas prices – coming just in time for the holiday shopping season – will put more money in consumers’ pockets and thus give a boost to sales tax revenues. Greg Albrecht, the chief economist for Louisiana’s Legislative Fiscal Office, noted that mineral taxes account for a much smaller share of state revenues than sales taxes, which have run ahead of forecasts this year. Mineral taxes account for 13 percent of Louisiana’s general fund revenues, compared with 29 percent from sales taxes.

Still, each dollar-per-barrel drop in oil cuts state revenue by \$12 million. Declining oil revenues are the cause of more than half of Louisiana’s \$171 billion budget shortfall, which has already led to spending freezes and the elimination of state jobs. The situation is worse in Alaska. The state depends on oil for more than 90 percent of its general fund revenues and forecast the highest oil prices of any state when it set its budget. Oil revenues were already going to drop due to a tax cut, but the steep fall in prices has saddled the state with a \$3.5 billion shortfall.

The situation is nowhere near as dire in other states, but oil dropping below \$60 per barrel doesn’t

help states' bottom lines. Aside from a decline in severance taxes and royalty payments, low prices hurt oil state economies. Production is already being cut, with field workers being laid off. And the few states that link their gas taxes to the prices of oil, such as Kentucky and Pennsylvania, can count on a drop in fuel tax collections, noted Michael Streepey of the National Association of State Budget Officers. Kentucky, for example, can count on \$129 million less in gas and diesel tax collections in 2015.

Diminished oil revenues are thus compounding budget problems that persist in many states, despite the overall economic recovery. Kansas is projecting \$1 billion in shortfalls during the current fiscal year and next. "In Kansas, that's another \$5 million that they don't have," said Francis, referring to the state's losses with every dollar drop in oil prices.

He said states like Kansas might ultimately be hurt the most. The major oil states such as Texas have been socking away billions in permanent or rainy day funds for years, if not generations. (Alaska had \$14.7 billion in its reserve funds at the end of November.) They can ride out the price drop, which is expected to persist through 2015. It's the states that get a little extra help from oil that haven't saved as much and therefore are going to miss the money that's not coming in that much more. "Swings make them more vulnerable," Francis said. "If they're already in a precarious position like Kansas, even a small swing in oil money causes problems."

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BY ALAN GREENBLATT | DECEMBER 24, 2014

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## [The 2014 Takeaways from State and Local Finance.](#)

A look back at four of this year's trends in public finance.

### **Some threats really are empty.**

Remember the threat of the taper? When former Federal Reserve Chair Ben Bernanke hinted at slowing down the Fed's practice of quantitative easing (buying municipal bonds with newly printed money), it prompted a major sell-off in the market and spiked interest rates in the summer of 2013. Then, newly minted Chair Janet Yellen, actually did it after she took over in February of this year. So what happened? The municipal market prepared itself for higher rates, witnessed the successive tapering process, and then was taken by surprise as global weakness and declining inflation drove interest rates lower, noted Loop Capital Markets Strategist Chris Mier in his look back at 2014. Calling the falling interest rates "one of the most durable trends of the year," he said rates fell steadily from 4.75 percent to 3.83 percent, "with barely a glance in the rear-view mirror."

The fear of rising interest rates did have one notable result, however. That prospect, combined with government's reticence to increase debt loads, resulted in a slower municipal market in 2014. Total bond issuance declined nearly 10 percent from 2013.

### **Pensions aren't sacred. But retirees still have sway.**

First Detroit's bankruptcy judge ruled that pensions could take a haircut alongside bondholders in municipal bankruptcies. Then Stockton, Calif.'s judge ruled similarly this year. Both rulings sent shockwaves through the municipal community but the end result was far less dramatic. Stockton, citing cuts already made to retiree healthcare, didn't cut pensions and exited bankruptcy in late

October. Detroit did cut pensions — but far less than the cuts to what it owed bondholders. The Motor City exited bankruptcy in November.

Both cities' final plans caused concern among the credit community — up until this year, the General Obligation bond was pretty much sacrosanct. And it was just a few years ago that the Rhode Island town of Central Falls exited bankruptcy keeping bondholders whole while dealing major cuts to pensions. So what's the trend now? Investors are a little unsure and, not surprisingly, the credit ratings agencies have slightly different views. Moody's Investors Service said last month in a credit analysis, "pensions are likely to enjoy better treatment than general government debt in Michigan and California Chapter 9 cases, and potentially in bankruptcies filed in other states. [This has] negative credit implications for local government bond investors in Michigan and California, and the U.S. as a whole."

Meanwhile, Standard & Poor's said in a presentation this week to investors that city bankruptcies were still too unique to start drawing conclusions that a new trend is emerging. "Despite months of headlines and court battles, ultimately the outcomes of these bankruptcies will not impact our view on GO bond ratings," said Horacio Aldrete, managing director for S&P's U.S. Public Finance-State & Local Government Group.

### **Management matters. A lot.**

Aldrete also noted that investors say a government's financial management is of the biggest difference-makers in S&P's rating assessments. Of the governments that S&P rates AAA (the top rating), 90 percent have either a strong or very strong management score. Conversely, the majority of credits rated BBB or lower got a weak or very weak management score. An analysis this week by the Municipal Market Advisors takes and puts some faces, er, stats, to that story.

At the end of the financial crisis that began in 2008, New Jersey and California were both grabbing headlines for monstrous budget woes. Today, one state is reforming its ways while the other keeps trying to fix problems with the same old tools. California ended a decade of budget deficits in 2013 and took that momentum into this year with a budget surplus. Gov. Jerry Brown throughout his tenure has been keenly focused on reducing the state's debt load and "exuberance over CA's fiscal and rating improvements led the state's securities to outperform the market for a second year," notes MMA's Matt Fabian. (In other words, California got good deals on its bond sales.)

Of particular note, the state's voters this fall approved new legislation that will double the size of the state's General Fund reserve, require deposits from capital gains windfalls to address revenue volatility issues and protect the funds from withdrawal. "These are authentic, structural improvements in the state's budget that should not be underappreciated," Fabian wrote. S&P agreed. The agency upgraded California's credit rating one notch to A one day after the voter approval.

Meanwhile, New Jersey has faced multiple bond rating downgrades under Gov. Chris Christie and this year it continued to use one-time fixes to plug its massive budget deficits. Fabian notes the state's lagging economic performance, overly optimistic budget projections and failure to consistently fund pensions, retiree healthcare and transportation has led to a persistent structural imbalance and a deteriorating fiscal position. "The lack of a Rainy Day Fund and thin General Fund balance — less than 1% of the budget — limits flexibility and cushion to address any unforeseen circumstances," he added.

### **This might be as good as it gets.**

Two state and local governmental organizations recently released annual reports on government financial health. They both essentially came to the same conclusion: Many governments are past the immediate pains of the recession but are now feeling the duller aches of the slow-growth economy. [The National League of Cities' City Fiscal Conditions Survey](#) found that cities made some key gains in fiscal year 2014 although many still can't claim a full recovery from the recession. Mainly, they have started to make up for areas where there were spending cutbacks during the downturn and they are increasing their reserve funds. And the overall positive figures are widespread — 80 percent of city finance officers reported improved fiscal conditions this year, the highest such number in the 29-year history of the survey.

The National Association of State Budget Officers also released its [year-end report](#) on the health of state finances. That analysis found state spending is increasing for the fifth straight year but growth continues to be minimal and the competition for limited dollars remains fierce. That's because much of the projected 3.1 percent spending increase will be gobbled up by rising costs in education and Medicaid, leaving little money available for spending in other areas. Additionally, in no year since the recession has spending growth matched the nearly four-decade average of 5.5 percent. Even more alarming: This year's total general fund spending of \$748 billion is still 2 percent below the pre-recession peak, after accounting for inflation. "If we continue to see this for another two to three fiscal years," said Scott Pattison at the report's release, "we have to assume we are in a new economic era...this 'new normal' that economists talk about."

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BY LIZ FARMER | DECEMBER 19, 2014

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## [Public Finance Predictions for 2015.](#)

Tight budgets, declining oil prices and pension scares are some key finance topics that state and local governments will face in 2015.

Here are some key public finance topics that state and local governments will face in 2015.

### **More belt tightening**

The general consensus on 2015's economy is that state and local revenues will continue to inch along, basically growing a little more than the cost of inflation. That leaves little room for increased spending in areas that saw funding drops during the recession. This is particularly true for cities, which have the least taxing power yet fund a lot of essential daily services. Throw in the fact that most citizens aren't keen on higher taxes, and Jeff Winter, partner-in-charge of RubinBrown's Public Sector Services Group, said that means governments will need to keep a tight lid on their expenses. "We're seeing steady growth but at a slower rate than we were in 2012," he said. "And cities that are sales-tax-dependent are not going to have huge increases in revenue sources in the future. There still needs to be attention paid to personnel costs and capital projects may have to be put on hold or financed in another way."

However, economies will vary widely. Standard & Poor's Gabriel Petek predicted that economic growth in the West and Southwest will likely outpace the other regions in 2015, particularly in new housing growth. Income and wealth, however, will remain starkly higher on the coasts than in the South and Midwest.

## **Muni market activity will pick up (slightly)**

Many analysts are predicting an uptick in municipal market activity for the first time in three years. The general consensus is that total offerings by governments, which include new bond sales and refinances, will increase in volume to about \$335 billion, compared to an estimated \$328 billion this year. Wells Fargo Senior Analyst Natalie Cohen predicts a slightly higher total (\$340 billion) with a little more than half of that due to new bond issuance. "The higher new money issuance reflects economic improvement and a desire in many communities to 'get on with it' despite the chronic lack of action in Washington," Cohen wrote in her analysis this month. "Voters gave this positive signal at the ballot box, by approving significantly more bond issues than last year (\$13 billion compared with \$7 billion)."

Tom Kozlik, municipal credit analyst for Janney Montgomery Scott, offers up a dissenting view. He predicts that volume will decrease for a fourth straight year to no more than \$275 billion total (and in fact, it won't pick up again until 2018). He attributes the dip to an expected increase in interest rates in 2015.

## **Here comes Kroll**

As credit ratings agencies have increasingly disagreed with each other about the health of state and local governments, Loop Capital Markets' Chief Strategist Chris Mier pointed out in a year-end analysis that agitation has caused "a number of high-profile issuers to change their line-up, tossing out one firm and substituting another." (More specifically, Kozlik in a report this summer noted that has commonly meant that municipalities have favored using their ratings from S&P.) Mier also said in his assessment that "the increasing presence of Kroll Ratings" was contributing to that trend. Started in 2009, the agency named for its founder is small but growing fast, with revenue doubling every year, notes Forbes. Its biggest gains have come in the U.S. commercial and residential mortgage backed securities markets. This year it also expanded its public finance team and became a listed rating agency in EMMA, the online database where governments file municipal market disclosures. Look for Kroll to continue to elbow its way into rating the municipal market in 2015.

## **GASB stirring the pot**

The Government Accounting Standards Board's (GASB) new rules on pension accounting will become visible for the first time on government balance sheets. Analysts have said the stricter view of unfunded liabilities are likely to encourage talks of reform in states- Namely, New Jersey, Illinois, Pennsylvania, Kentucky, Connecticut and Rhode Island-that are struggling to fund their pensions. New Jersey recently disclosed in its official statement that as a result of the more conservative GASB approach to calculating pension funding, its funded level decreased to 30 percent from 50 percent and its liabilities to \$50 billion from \$37 billion. "Stronger reporting standards alone won't solve or even address the challenge of pension funding," wrote Janney Montgomery Scott's Alan Schankel in a December analysis. "But they may draw closer attention to the most underfunded systems, pressuring political leadership to consider often needed reforms."

GASB is also likely to create some budgeting angst if it succeeds in its quest to require governments to report as lost income the tax incentives they award to companies. The new disclosures could shed light on a previously murky area of government finance and provide hard data on information that has often been assembled piecemeal, if at all. Some government finance organizations will likely push back on the proposal and argue that reporting tax abatements isn't an accounting issue - that policymakers think of these decisions as investments, rather than a drain on finances. Stakeholders have until Jan. 30 to comment but the debate will likely play out through the year.

## **Oil prices will impact state budgets**

The recent decline in oil prices will give way to some mid-year budget scrambling as oil-dependent states revise their revenue expectations for fiscal 2015. But not all energy-based economies are equal. Alaska has been repeatedly cited by observers as particularly vulnerable. However, notes S&P's Petek, its extraordinarily high budget reserve levels buy the state time to develop a response. Alaska's fiscal 2015 budget originally assumed oil prices would average \$105.06 per barrel, which would mean about 495,900 barrels per day of production on Alaska's North Slope, according to S&P. Based on more recent price and production information, the state has revised its estimates to \$76 per barrel and 509,500 barrels per day for fiscal 2015.

Alaska is hugely dependent on oil - those revenues made up 88 percent of its estimated revenue for the 2014 fiscal year. With the updated figures, the state's budget gap has widened to \$3.5 billion - equal to 57 percent of general fund expenditures. But Alaska's extraordinarily large budget reserves (which total more than three times its general fund expenses) are saving the state from a budgeting crisis at the moment. However if lower oil prices persist through 2015, the economies and finances of other energy producing states — Texas, Louisiana, Alaska, Wyoming, New Mexico, Oklahoma, and North Dakota - will also be put to the test.

For non oil-producing states and cities, look for some easing in costs (particularly in transportation) and a potential bump up in sales tax revenues as consumers saving money on gas are likely to spend that elsewhere.

## **An answer in Illinois**

After a circuit court struck down Illinois' pension reform legislation, the state's Supreme Court is now weighing the constitutionality of provisions that reduce cost of living raises for retirees, cap eligible earnings and delay the retirement age for certain employees. An unfavorable ruling for the state could have "financial and societal consequences," predicted Municipal Market Advisors' Matt Fabian in his 2015 outlook, "including lower government employment, higher taxes, reduced social services, lower education spending, constrained investment in infrastructure, etc." However a ruling that the state was justified in its legislation, "would likely lead to healthier negotiations centered on obtaining the best sustainable compromise," Fabian said.

## **More clarity on the SEC's definition of a no-no.**

In 2014, the SEC ran its Municipalities Continuing Disclosure Cooperation Initiative. The program allowed municipalities to look for and submit any additional information (like a credit rating change) they should have filed as a financial update to any bond sales completed in the last five years. Governments must continue to update investors with relevant information for as long as the bonds are outstanding. The Securities and Exchange Commission indicated it would offer "favorable" settlement agreements with those who fessed up but has been pretty mum on what kinds of omissions it would levy a more severe sentence.

The coming year should help clear that up as the SEC begins announcing its so-called enforcement actions against governments that have been lax with their disclosures. LeeAnn Gaunt, chief of the SEC enforcement division's municipal securities and public pensions unit, recently told a group of government finance officers the initiative showed that "many" official statements released in the past five years have incorrectly stated that issuers were in full disclosure. She declined to reveal just how many or what the worst cases were, reported the Bond Buyer. But thankfully, that wait should soon be over.

## **Build America 21% Outperforms Local-Government ETFs: Muni Credit.**

Four years after the last Build America Bonds were issued, the taxable debt is delivering the biggest gains among exchange-traded funds focused on municipal securities.

The SPDR Nuveen Barclays Build America Bond ETF (BABS) proved the best choice during a record-setting year for muni exchange-traded funds. Its 20.6 percent gain through Dec. 23 was highest among the 26 muni ETFs tracked by Bloomberg.

Build Americas benefited this year from their longer maturities, which are luring buyers seeking to pad returns with yields close to generational lows. The average maturity of the \$113 million SPDR Nuveen ETF is about 25 years, according to its website. Munis due in 22 or more years have earned 14.9 percent in 2014, beating shorter maturities, according to Barclays Plc data.

“The market’s been willing to trade the Build America Bond sector as a long maturity, a long-duration asset class, and that’s helped drive the returns,” said Bart Mosley, co-president of Trident Municipal Research in New York.

### **Leaping Assets**

With the \$3.6 trillion municipal-debt market earning 8.7 percent this year, the most since 2011, exchange-traded funds have emerged as a popular way to tap the rally. Muni ETFs had \$13.4 billion of assets as of Sept. 30, the most ever and up from \$7.8 billion three years earlier, according to Federal Reserve data.

ETFs are similar to mutual funds that track indexes of equities, bonds, commodities or geographic concentrations. They can be bought and sold during the trading day, allowing investors to jump on market moves more quickly than with mutual funds. U.S. ETFs have about \$1.7 trillion in assets, Bloomberg data show.

Build America obligations were created under President Barack Obama’s 2009 economic stimulus, and municipalities nationwide sold \$188 billion of the debt before the program expired at the end of 2010, data compiled by Bloomberg show.

States and localities used the bonds to pay for infrastructure work, and received a 35 percent federal subsidy on interest payments. Congress reduced that support by 7.2 percent last fiscal year and 7.3 percent this year as part of federal budget cuts, according to the Internal Revenue Service.

### **Treasuries Tailwind**

A rally in Treasuries has helped propel gains in Build America Bonds, said Dan Close, senior vice president at Nuveen Asset Management in Chicago and manager of the Build America ETF. Yields on 30-year federal debt have fallen by about 1.1 percentage points this year to 2.83 percent, the first annual decline since 2011, data compiled by Bloomberg show.

The ETF benefited from “a generally declining interest-rate environment and, to some extent, some spread narrowing,” Close said.

The performance of Build Americas sold by California underscores the rally in the securities.

Build America Bonds that mature in November 2030 traded Dec. 24 with an average yield of 2.96 percent, or about 1.1 percentage points more than Treasuries, Bloomberg data show. That gap has shrunk by more than half this year. Tax-exempt munis with a similar maturity yield about 2.46 percent.

The higher interest rates are a draw for investors, said Thomas Boccellari, an ETF analyst at Morningstar Inc. in Chicago. Improving state and local budgets also give bondholders confidence that municipalities will repay their obligations, he said.

### **Fiscal Confidence**

“Not only was the fund getting a nice yield relative to other municipal bonds, but it was also getting that same increased price return from the underlying fundamentals of the municipal bonds,” Boccellari said.

State tax collections last quarter rose 4 percent from a year earlier, according to a report from the Nelson A. Rockefeller Institute of Government in Albany, New York. It was the biggest quarterly increase in a year.

Build Americas have maintained their value in part because a finite amount of the debt exists, Mosley and Boccellari said. Investors also face a limited universe of long-term corporate debt, they said.

“Not only are taxable munis attractive credits in and of themselves, but if you want to buy 20- or 30-year taxable bonds, you don’t have a lot of options,” Mosely said.

The prospect of higher interest rates next year as the economy grows may hinder the ETF’s performance, said Mosley.

Yields on 30-year Treasuries, a benchmark for borrowing rates, will climb about 0.9 percentage point to 3.7 percent a year from now, according to the median forecast of 53 analysts in a Bloomberg survey.

Even in that scenario, the extra yield on Build America Bonds will provide a cushion, Boccellari said.

“Even if rates go up, demand for BABs should continue in 2015 for their relative yield,” Boccellari said.

Bloomberg Muni Credit

By Michelle Kaske

Dec 25, 2014 5:00 PM PT

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## **WSJ: U.S. Muni-Bond Market Is on a Tear.**

The Tax-Favored Debt Has Outperformed Corporate Bonds, Treasuries in 2014

The debt issued by U.S. cities, states and local entities such as sewer systems has posted its longest string of monthly gains in more than two decades in 2014, outpacing gains in corporate bonds and U.S. government debt, according to data from Barclays PLC.

Investors are flocking to the \$3.6 trillion municipal-bond market at a time of low interest rates, uneven global growth and concern that the nearly uninterrupted rise in many stocks and bonds since the financial crisis will come to an end. The debt is especially attractive because interest payments typically don't generate federal taxes and, in some cases, aren't subject to state taxes.

That foundation, along with forecasts for relatively flat issuance of new bonds, is expected to support the rally in 2015 despite concerns about the impact of an increase in short-term interest rates by the Federal Reserve, which many economists and investors expect in the middle of next year. The fiscal woes of state and local governments are also a lingering worry.

"The U.S. muni market lurches between extended periods of tranquility and abrupt interludes of instability," said Thomas McLoughlin, co-head of fundamental research at UBS Wealth Management Americas. "And the story of 2014 is this has been an extended period of relative tranquility."

The gains in every month of 2014 have more than reversed the sector's pullback last year, amid Detroit's record bankruptcy, Puerto Rico's financial straits and concerns about higher interest rates. Some observers warned that municipal bonds were vulnerable to an investor exodus, echoing a sentiment that pervaded the market after the 2008 financial crisis.

Instead, municipal bonds have returned 8.71% this year through Friday, including price gains and interest payments, according to Barclays. That compares with a total return of 15.3% for the S&P 500, 6.97% for highly rated corporate debt and 4.6% for U.S. Treasury debt.

The broad debt-market rally that upended Wall Street bets on rising interest rates in 2014 also fueled a surge of investor funds into municipal bonds, many of which are considered as safe as Treasuries because they are backed by tax revenue. Yields on municipal bonds fell to a two-year low of 1.94% in mid-October, according to Barclays data. Yields fall when prices rise.

Investors, led by individuals purchasing the debt through mutual funds, have poured \$23.9 billion into municipal-bond funds through mid-December, according to Lipper. They withdrew \$63.5 billion last year.

Low overall borrowing by belt-tightening public officials in cities and states through the first three quarters of the year reduced the supply of new bonds, while higher tax rates increased the relative attractiveness of tax-exempt debt, said Daniel Solender, director of municipal-bond management at Lord Abbett & Co., which oversees about \$16 billion.

Despite a late-year increase in bond issuance and the prospect of the Fed raising rates, yields on municipal debt still look attractive, he said.

In the first quarter of the year, cities and states borrowed about one-quarter less than they did in the same period of 2013, according to data from the Securities Industry and Financial Markets Association. Municipal-bond issuance totaled \$295.8 billion through November, about 4% less than

in the same period last year.

“When you look at supply, which picked up for us in the fourth quarter, there are still more bonds being called out of the market than being issued, so that creates some demand,” Mr. Solender said.

The supply of bonds isn’t likely to surge in 2015. A SIFMA survey of municipal-bond underwriters and dealers this month predicted issuance will reach \$357.5 billion, compared with a total of \$348.1 billion forecast for 2014.

At the same time, demand from individual investors, mutual funds and banks and insurance companies has remained robust, said Ashton Goodfield, co-head of the municipal-bond department at Deutsche Asset & Wealth Management, a unit of Deutsche Bank AG . That has helped investors overcome last year’s fears about losses from Detroit or Puerto Rico. The U.S. commonwealth passed a law in June allowing some public agencies to restructure their finances.

“I think people are understanding that there’s not going to be a rash of bankruptcies in the market,” Ms. Goodfield said. “It’s a confirmation that municipal credits are generally solid.”

Some analysts said hedge funds and other distressed-debt investors have assumed much of the risk from Puerto Rico, which has about \$73 billion in total debt. Hedge funds were the primary buyers in a March \$3.5 billion bond sale. Puerto Rico’s cash-strapped electric-power authority owes about \$9 billion and appointed a chief restructuring officer in September.

Investor concerns over municipal pension obligations, however, may become more apparent in the new year, leading some to avoid states with large funding gaps such as Illinois, said Tim McGregor, director of municipal fixed income at Northern Trust in Chicago, which manages about \$30 billion.

“Many places have done good work on pension reform, but those that are lagging will continue to be under the microscope,” Mr. McGregor said. “I expect the market will begin differentiating a little more.”

An unexpected jump in interest rates could also slow the rally in 2015, said Chris Mauro, head of U.S. municipal strategy at RBC Capital Markets. A new Congress could also take up tax reform, introducing unforeseen changes to the municipal sector, breaking through a widespread perception of Washington gridlock.

“As we learned in 1986, large-scale tax reform is extremely unpredictable,” he said.

THE WALL STREET JOURNAL

By AARON KURILOFF

Dec. 28, 2014 4:32 p.m. ET

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## [\*\*S&P Places Radian Asset Assurance on CreditWatch Negative Following Assured Guaranty Deal.\*\*](#)

Standard & Poor’s Ratings Services said today that it placed its ratings on Radian Asset Assurance Inc. (Radian Asset), including its ‘B+’ long-term counterparty and financial strength ratings, on CreditWatch Positive. We are also affirming our ‘AA’ financial strength and enhancement ratings on

Assured Guaranty Municipal Corp., Assured Guaranty Corp. (AGC), Assured Guaranty Re Ltd., and Municipal Assurance Corp. (collectively, Assured).

Assured will purchase Radian Asset through AGC for \$810 million in cash. As of Sept. 30, 2014, Radian Asset had statutory capital of \$1.3 billion (\$1 billion of surplus and \$287 million of contingency reserves), remaining unearned premium reserves of \$176 million, and present value of installment premiums of \$66 million. Assured's purchase of Radian Asset will have an immaterial effect on Assured's capital adequacy. We expect the company to maintain on a pro-forma basis more than \$1.3 billion capital cushion at the current rating level following the close of the acquisition.

As of Sept. 30, 2014, Radian Asset's insured par totaled approximately \$19 billion, comprised of \$11 billion in public-finance transactions and \$8 billion of structured-finance transactions (\$6.1 billion of corporate collateralized debt obligation exposures will mature by 2017). The proposed purchase does not materially increase the theoretical losses of Assured's insured portfolio or materially reduce the pro-forma capital position upon the transaction close.

The stable outlook on Assured reflects its strong competitive profile and very strong capital adequacy even with the proposed acquisition.

We could lower our rating on Assured below the 'AA' category if the current interest-yield and credit-spread compression environment persists beyond the next 12 months and Assured's public finance risk-adjusted pricing ratio remains at or less than 4%. We could also lower the rating if the company exhibits significant volatility from earnings or capital adequacy. Based on our view of the new-issue U.S. public finance and financial guarantee markets, we do not believe the business or financial risk profiles of the company will change dramatically and therefore do not expect to raise the ratings.

The complete list of ratings affected by this action will be available in the coming days. When available, the list can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com). Our analysis of these ratings actions is ongoing; we will post any additional rating changes at the same location.

The CreditWatch Positive on Radian Asset is based on our expectation that the company's insured obligations will become obligations of AGC. We also expect that upon close of the transaction, Radian Asset will be folded into AGC and dissolved. We would maintain the rating on Radian Asset at the current level if the transaction fails to occur.

December 23, 2014 11:26 AM EST

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## **Public Pensions Are America's Greece.**

Bruce Rauner, a Republican, liked to talk tough about unions and public-sector pensions when he was campaigning for governor in Illinois.

"The system is full of fraud and self-dealing and abuses, such as folks who have a pay rise in the last years of their career [so their pension is higher] or folks who moved in and out of certain jobs, so they could get a pension," he said in August 2013.

With two or three pensions, some are making as much as half a million dollars in retirement pay, he claimed. This, he thundered, is a rip-off of taxpayers and other workers.

But as soon as Mr Rauner was elected last month, the self-made millionaire toned down the rhetoric. The size and complexity of the public-pension mess suddenly hit him, and, aware that he had to bring together Democrats, unions and creditors, he began to backtrack. He declares now that it is most important to “protect what is done—don’t change history. Don’t modify or reduce anybody’s pension who has retired, or has paid into a system and they’ve accrued benefits.”

Illinois is like Greece in one obvious way: it overpromised and underdelivered on pensions and has little appetite for dealing with the problem, says Hal Weitzman of the University of Chicago Booth School of Business. This large Midwestern state, with a population of 13m (Greece has 11m, though a far smaller GDP than Illinois), has the most underfunded retirement system of any state and the largest pension burden relative to state revenue.

It also has the highest number of public-pension funds close to insolvency, such as the one looking after Chicago’s police and firemen. According to the Civic Federation, a budget watchdog, Illinois has piled up a whopping \$111 billion in unfunded pension liabilities, in addition to \$56 billion in debt for health benefits for pensioners. The state devotes one in four of its tax dollars to pensions, which is more than it spends on primary and secondary education.

Mainly as a result of this gargantuan pension debt, Illinois’s bond rating is the lowest of all the states, which means dramatically higher borrowing costs. When the state government failed to address pension underfunding in its budget for 2014, two credit-rating agencies, Fitch and Moody’s, cut the state’s bond rating, which in Moody’s case put Illinois on a par with Botswana. (An incensed editorial in the Chicago Tribune asked what Botswana had done to be so insulted.)

The main reason for the pension debacle is decades of underfunding. “Everything was always done with a short-term view,” says Laurence Msall, head of the Civic Federation. “Unique to Illinois is the idea that you don’t have to pay for pensions and you don’t have to follow actuarial recommendations.”

Whereas most other states follow the rules set by the Governmental Accounting Standards Board (GASB), which, however imperfect, require some budget discipline, Illinois has mostly ignored them. In 2013 the state paid \$2.8 billion into its pension fund for teachers, one of its five pension funds, but GASB rules would have required a contribution of \$3.6 billion, says Joshua Rauh, a professor of finance at Stanford University.

According to Mr Rauh’s calculations, Illinois’s true unfunded pension liability is \$250 billion. All the other calculations, he says, are based on over-optimistic assumptions. For example, the state assumes an average annual return on its investments of 7.75% over 30 years. But according to Mr Rauh it has only a 25% chance of achieving gains of that order.

After the public-relations disaster of the credit downgrades, Pat Quinn, the outgoing governor belatedly pushed for pension reform. In December 2013 the legislature approved a bill that reduces annual increases in pension payments, increases the retirement age and caps pensionable salaries. Some have welcomed it as Illinois’s first actuarially sound pension-funding scheme, designed to get the five plans fully funded in 30 years. Mr Rauh, however, thinks that the reform “does not even come close to addressing the problem”.

Mr Quinn’s changes were supposed to become law in June, but were held up by legal challenges and ultimately rejected by Judge John Belz of the Sangamon County circuit court for violating the state constitution, which makes existing pension contracts virtually untouchable. (Only New York and Arizona have similar safeguards in their constitutions.) Lisa Madigan, the state attorney-general, has appealed against the ruling to the Illinois Supreme Court, which is looking at the case.

James Spiotto, a lawyer at Chapman Strategic Advisors, argues that if a state is unable rather than unwilling to pay its pensions, then the well-being of its citizens overrides any constitutional protections. The Supreme Court has consistently ruled that states cannot abdicate their responsibility to provide essential services and infrastructure. And if Illinois cuts public services yet further the state will lose more taxpayers, resulting in “a death spiral”, says Mr Spiotto.

Union representatives disagree with this scenario. Dan Montgomery, the president of the Illinois Federation of Teachers, believes Mr Quinn’s reform is illegal and that the state must find ways to pay up, for instance by extending the repayment schedule of its debt and increasing tax revenue by closing loopholes and expanding a sales tax on services.

Mr Rauner was elected on a promise that he would not make his predecessor’s temporary increase of income and corporate tax permanent. But he has not explained how Illinois will cope with the loss of more than \$7 billion in annual revenue. Nor has he laid out any broader plans for fixing the pensions mess. For a start he might look to Washington and the budget deal hashed out in Congress. This allows some distressed private-sector pension plans to cut the benefits of retirees. In Illinois, though, more inventive measures may be needed.

In 2015 Illinois will either sink further into a Greek-style morass of debt or start its long-delayed rehabilitation. Mr Rauner has warned of a rough 24 months ahead. “I ain’t going to be Mr Popularity for a while,” he says. Voters may not mind, if he is able to sort this disaster out.

THE ECONOMIST

DEC. 20, 2014, 1:02 PM

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### **[Kansas Pension-Bond Plan Revived Amid Budget Strain: Muni Credit.](#)**

Governor Sam Brownback’s plan to divert pension cash to plug a budget deficit has Kansas Treasurer Ron Estes recommending a fiscal tool the state hasn’t used in a decade — selling bonds to fund its retirement plan.

Brownback, a Republican who starts his second term in January, last week proposed shortchanging the state’s pension contributions by \$58 million to close a \$280 million budget hole caused in part by tax cuts the governor championed. Kansas, with the fifth-weakest pension system among U.S. states, had its issuer ratings downgraded by Standard & Poor’s and Moody’s Investors Service this year.

To close a \$7.35 billion funding shortfall, the state needs to keep commitments that were part of a 2012 pension overhaul, said Estes, a Republican who also won re-election last month. The plan called for more funding from the state, including revenue from casinos it owns, and raised the amount employees pay.

“We need to keep working on our pension reforms passed two years ago or we’ll fall further behind,” Estes said in an interview from Topeka.

#### **2004 Example**

Kansas can take advantage of interest rates close to five-decade lows to raise cash, increase the funding level and create fixed payments, Estes said. The state issued \$500 million of pension bonds in 2004; a proposal to sell another round stalled in the legislature last year.

The 2004 bonds were sold through the Kansas Development Finance Authority. The debt, which is insured, has traded this month at an average yield of 4.5 percent for a May 2034 maturity, Bloomberg data show. That's about 1.9 percentage points above Treasuries.

Because of investment losses from the recession and insufficient contributions, public retirement plans nationwide are at least \$1.3 trillion short of the assets needed to pay about \$5 trillion of projected benefits, Federal Reserve data show. Since 2005, every state but Idaho has passed laws to boost pension funding, according to the National Conference of State Legislatures.

Kansas is among states and localities that have turned to debt to bolster their plans. Led by California's Orange County, municipalities have issued a combined \$356 million of revenue-backed pension bonds this year, compared with \$424 million in 2013, according to data compiled by Bloomberg. In 2003, Illinois sold \$10 billion of bonds for its pensions.

### **Backfire Risk**

The debt, which is typically taxable, carries risk. The strategy is to invest the proceeds, usually in stocks, and earn more than it costs to repay bond investors. The approach can backfire if issuers borrow when equities are at historic highs, said Jean-Pierre Aubry, assistant director of state and local research at the Center for Retirement Research at Boston College. The S&P 500 Index this week posted its best two-day gain in more than three years.

"There are instances where they can work, but they can be risky financial tools for cash-strapped borrowers," Aubry said in a phone interview. "They're gambling on the market and should be undertaken by those with the appetite for the risk and the ability to absorb the risk."

Kansas, which was charged by the U.S. Securities and Exchange Commission in August with failing to disclose its pension liability to municipal-bond investors, passed legislation in 2012 to bolster its retirement plans. The state's pensions were 56.4 percent funded as of 2013, higher than only four states, according to data compiled by Bloomberg. The ratio would reach 100 percent by 2033 if Kansas sticks to the changes laid out in 2012, Estes said.

### **Paying Up**

Starting next month, workers' contributions to the Kansas Public Employees Retirement System will increase to 6 percent of their salaries from 5 percent. About 281,000 people pay into the system, which has \$14 billion of assets.

The system supports issuing bonds or any measure that boosts its funding, said Kristen Basso, a spokeswoman.

"Pension bonds would reduce our unfunded liability and improve our funded ratio," she said in an e-mail.

Brownback's plan would reduce the pension payment by almost 12 percent. He can make general-fund budget cuts on his own, without the legislature's approval, according to Ashley Murdie, a spokeswoman for Estes.

"I can't go into details right now, but the governor will address the long-term sustainability of KPERS," said Eileen Hawley, the governor's communications director. "It is one of his top priorities."

The budget deficit for the state of 2.9 million arose when a committee that estimates revenue met

this month and lowered its projection. After tax reductions approved by the legislature in 2012, the state took in about \$340 million less than forecast during the year through June.

Debt from Kansas has earned 8.4 percent this year, compared with 8.8 percent for the entire municipal market, Barclays Plc data show.

In August, S&P cut the state to AA, the third-highest level. It assigned a negative outlook, citing budget pressure as scheduled income-tax cuts are phased in. Moody's in April dropped it to an equivalent Aa2.

"There could be a threat of a downgrade if this situation goes on for several years," said Estes.

Bloomberg Muni Credit

By Darrell Preston Dec 19, 2014 8:24 AM PT

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## **[Green Bonds Sell Big in 2014 as Finance Bids to Help Climate.](#)**

(Reuters) - A "green" bond market has taken root this year, with municipalities and corporations issuing new environmentally-focused bonds and money managers jumping in to buy them.

But it's too soon to tell whether all the new activity - less than a sliver of the \$91 trillion worldwide bond market - will send much new money to projects like efficient buildings and better water systems.

Instead, the new bonds reflect the complexities of using finance to address issues like climate change. While the sale of notes termed green bonds tripled to \$35 billion worldwide in 2014, many are bonds that might have been sold anyway without the label, and which trade at terms comparable to non-green bonds.

Nor is it clear the new bonds are "green" in the environmental sense that investors may expect, and issuers face only voluntary standards so far.

Participants say that to avoid the impression that green bonds are just a marketing ploy, they still need to show more corporate treasurers and investors the bonds can make it easier to fund projects, a corner they have not yet turned.

"If people think this is just to raise the flag, it's not going to last long," said Christopher Flensburg, Head of Sustainable Products and Product Development for Skandinaviska Enskilda Banken AB, the Swedish bank that's the world's largest underwriter of green bonds.

Still, the spike in new activity shows some success to date, with new issuers and new buyers. Green bonds used to come exclusively from AAA-rated organizations like the World Bank; the last year has seen rising issues of green bonds from municipal issuers as well as some from corporations that are rated junk.

On the buy side, State Street Corp has filed a registration with the U.S. Securities and Exchange Commission to run what could be the first green bond index fund. Also, since July Bank of America Corp, Standard & Poor's and Barclays MSCI each have launched new green bond indexes that may form the basis of future mutual funds and exchange traded funds.

Corporate and municipal issuers started issuing bonds they labeled as "green" in earnest last year, when they realized that they could pull in some new buyers who wanted to invest environmentally.

"We thought the worst thing that happens is we get more people interested in our bonds" said Alan Westenskow, a Zions Bank vice president who works with municipal issuers. He advised the Utah Associated Municipal Power Systems on a \$21 million offer this month to pay for systems to turn waste heat to electricity. The offering, made in several sections, pays a coupon ranging from 3 percent to 5 percent.

Spanish clean energy company Abengoa Greenfield, a unit of Abengoa SA issued its first high-yield green bonds in September - a 500-million-euro issue in all. A representative said "90 percent of our projects qualify as green projects, so why not issue a Green Bond?"

Still unclear is how much extra demand the green label creates. The Abengoa representative said the company didn't have information on the extra demand. A spokesman for Bank of America, which underwrote the Utah bonds, said executives there would not comment on demand.

## JUNK GREEN BONDS

In August 2014, the first wave of corporate junk green bonds entered the mix, when an affiliate of Princeton, New Jersey, power producer NRG Energy Inc sold \$500 million of senior notes to pay for the purchase of the Alta Wind Energy Center, a wind farm in California. Abengoa followed suit, bringing the green high yield market to \$1 billion.

Corporate issues now make up 14 of the 51 green bonds tracked in Bank of America's green bond index, and have driven down its average rating to AA2 from AAA, according to a BofA Merrill Lynch research report.

At \$1.98 billion, green muni bonds themselves are just a fraction the "green" market, possibly because many muni issues have traditionally backed environmental projects and find investors even without the green label.

"At the end of the day, a bond is still a bond whether it's dubbed as 'green' or not," Eva Rippeteau, associate director at Fitch Ratings, said in an emailed analysis sent after the Metropolitan Water Reclamation District of Greater Chicago came to market this week with a \$300 million green bond, with a coupon ranging from 2 percent to 5 percent. "In many cases, these bonds are funding the same projects that a regular bond would."

Orders for a recent \$350 million green bond sale by Massachusetts exceeded \$1 billion, like many other over-subscribed municipal offerings. One buyer, Charles Hill, portfolio manager of T. Rowe Price's \$3.9 billion Summit Municipal Intermediate Fund, said he has never had client requests for green bonds specifically, but bought the Massachusetts bonds because he liked them for traditional criteria like their intermediate duration, and their 5 percent coupon, comparable to that of similar non-green bonds.

## GREEN CONSCIOUS

To be sure, the entire movement isn't about labeling. A spokeswoman for NRG Energy said it used

the term “to be able to target an incremental universe of investors who are more green conscious and to differentiate ourselves from other issuers.”

Steve Liberatore, a TIAA-CREF fund manager who oversees \$6 billion in bond products that use social or environmental criteria to pick investments for clients concerned about the use of their money, said he skipped the NRG bond because the company also has natural gas operations. He aims to avoid fossil fuels.

“What we’re seeing is a shift in the ability of the investor to link up directly with the projects” focused on sustainability, he said.

Interested investors and issuers are willing to give it time to grow, and to improve their standards. The Climate Bonds Initiative, a London nonprofit that promotes investments to reduce carbon emissions, estimates 39 percent of green bonds sold since 2013 were issued without an independent review of how green they are. Many institutional buyers do have internal standards for what kinds of projects green bonds can back.

Catherine Roy, Calvert Investments’ chief investment officer for fixed income, said she expects no slowdown. “There are still trillions of dollars of capital needed to address a wide range of global environmental challenges,” Roy said.

Reuters

By Ross Kerber and Hilary Russ

December 18, 2014 1:05 AM

(Reporting by Ross Kerber in Boston and Hilary Russ in New York. Additional reporting by Francesca Landini in Milan and Jose Elias Rodriguez in Madrid. Editing by Linda Stern and John Pickering)

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## **[U.S. Stellar Municipal Bond Returns Set to Dim in 2015.](#)**

Dec 18 (Reuters) - U.S. municipal bonds’ stellar 9 percent performance so far this year may not continue in 2015 as interest rates are set to rise and dampen returns, analysts and fund managers said.

Munis bounced back from a negative return in 2013, when investors fled the asset class partly on concerns about high-risk situations in Detroit and Puerto Rico. This year, high-yield funds and long-duration munis clocked among the highest returns.

For 2015, investors are anticipating higher interest rates, which could bring the rally to a halt. Bond prices typically move inversely to interest rates, and the U.S. Federal Reserve has signaled it will raise rates in 2015.

“An unanticipated jump in interest rates has the potential to reintroduce households, who are the biggest holders of municipals, to interest-rate risk,” said Chris Mauro, head of U.S. municipals strategy at RBC Capital Markets. “This could cause a negative, herd response on the part of these investors, temporarily dislocating the municipal market.”

The S&P Municipal Bond Index returned 9.25 percent as of Dec. 17. That beat both its Treasury Bond Index, which has returns of 3.83 percent, and its investment-grade corporate bond index, with

returns of 7.28 percent. This year's returns for the S&P Muni index are on track to be the highest since 2011.

"We've had a very good year in the muni market," said Jeffrey Lipton, Managing Director, Municipal Research, at Oppenheimer & Co, pointing to positive flows into intermediate, long-term and high yield funds.

Interest rates on long-term bonds this year have taken the biggest plunge in a decade. According to Municipal Market Data, a unit of Thomson Reuters, the yield on top-rated debt maturing in 20 years and beyond has fallen the most since 2004 on its benchmark scale, meaning the prices spiked during that time.

That's unlikely to be repeated in 2015.

"We're expecting the on-paper returns will end the year (2015) looking somewhat boring but the path to get there will be anything but boring," said Morgan Stanley analyst Michael Zexas. "There is plenty of risk in the market that has the potential to create a fair amount of volatility along the way."

Municipal bond performance could remain positive at the beginning of the year, but overall in 2015 the range could be somewhere between a negative return of 2 percent to a positive return of 5 percent for 2015, said Richard Ciccarone, head of Iowa-based Merritt Research Services.

Constricting supply pushed up returns this year. The amount of outstanding debt, \$3.63 trillion, is the smallest in five years.

Issuance so far this year through Wednesday is \$312 billion, according to Thomson Reuters data, level with 2013's figure for the year as a whole. Many expect next year's supply to be higher, boosted by bond ballot measures in November's elections and continued demand to improve creaking infrastructure.

"We've gone through a period of time when America has been holding back," said Ciccarone. "Physical structures can only take that for so long."

According to a survey of banks released earlier this month by the Securities Industry and Financial Markets Association, sales of all municipal bonds will likely rise to \$357.5 billion in 2015 from \$348.1 billion estimated this year.

Inflows into bond funds are also expected to continue. With two weeks remaining in the year, municipal bond funds have received total net inflows of \$23.3 billion, compared to record net outflows of \$64.2 billion in 2013, according to Lipper.

Reuters

Thu Dec 18, 2014 1:29pm EST

(Reporting by Megan Davies, Lisa Lambert, Hilary Russ, Robin Respaut, Karen Pierog, Ed Krudy; writing by Lisa Lambert and Megan Davies; Editing by Cynthia Osterman)

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## **[Pension Time Bomb Ticks as Disclosure Rules Toughen: Muni Credit.](#)**

Jersey, like other municipal governments, used an accounting sleight-of-hand for years to boost

pension-funding levels. New rules are putting an end to the practice.

Last month, the state became the first to disclose weaker funding ratios under the revamped approach, according to Fitch Ratings. Under the new regime, which officials nationwide have phased in starting in 2013, governments must determine when their pensions will run out of money and reflect that projected investment returns will taper off after that date.

New Jersey's experience shows how funding ratios can plummet as a result. In documents for a bond sale last month, the Garden State said its plans will start running out of cash in 2021. Based on that calculation, it had 32.6 percent of assets to pay promised retirement benefits, down from 54.2 percent in 2013. By making pensions look worse off, the new rules may jolt localities into action, said Matt Fabian at Municipal Market Advisors.

"We're optimistic that the new accounting treatment will generate a stronger policy response," said Fabian, a managing director at the Concord, Massachusetts-based research firm.

U.S. state and local retirement plans are short at least \$1.3 trillion because of investment losses triggered by the recession and insufficient contributions, according to Federal Reserve data. The deficit strains government finances, forcing officials to balance payments into pension plans with money for schools and roads.

### **GASB Says**

The Norwalk, Connecticut-based Governmental Accounting Standards Board, which makes accounting rules for states and localities, released the rule in August 2012 to improve pension disclosure. The change transforms how governments report the cost in financial statements, in current dollars, of benefits that won't be paid for decades. The overhaul followed criticism from investors in the \$3.6 trillion municipal-bond market that governments were underestimating the expense.

Dallas said in documents for a bond sale this month that the shift could have a "significant" impact on its financial statements and unfunded pension liability of about \$1.8 billion. The city won't have more specifics until it gets data from its retirement plans later this year, Jeanne Chipperfield, Dallas's chief financial officer, said in an e-mail. Its two largest pension funds were at least 78 percent funded, according to fiscal 2013 financial statements.

### **Prairie Headwinds**

California is among states that anticipated the shift and passed laws to increase funding or curb benefits, said Keith Brainard, the Georgetown, Texas-based research director for the National Association of State Retirement Administrators. Since 2009, almost every state, including New Jersey, has enacted such changes, according to Brainard's group.

Efforts to reduce pension deficits face headwinds in states grappling with financial strains. In Kansas, Governor Sam Brownback may deepen the retirement liability by diverting money from the plans to balance the budget.

New Jersey, after overhauling and pledging to fund its pensions, skipped \$2.5 billion of promised contributions for fiscal 2014 and 2015 as revenue missed projections.

"The problem New Jersey faces is much worse than it was," said Douglas Offerman, senior director with Fitch. "The cost becomes higher as the state tries to catch up with its underfunding."

The accounting change “does not materially impact New Jersey’s fiscal position or the system’s current assets of approximately \$40 billion,” Christopher Santarelli, spokesman for Treasurer Andrew Sidamon-Eristoff, said in an e-mail.

## **Decision Time**

Illinois, which had the weakest funding ratios among U.S. states in 2013, at 39.3 percent, won’t report under the new rules until the end of this fiscal year, said Abdon Pallasch, the state’s assistant budget director. Last month, a ruling by a circuit court judge struck down a 2013 law that raised the retirement age. Illinois’s attorney general appealed the decision to the state Supreme Court.

“If the court upholds pension reform it means we will be reporting better numbers,” said Pallasch.

In most cases, retirement systems getting the required payments won’t deplete their assets, so they wouldn’t see funding ratios drop under the new approach, Brainard said.

Kentucky, with the second worst-funded state plans for 2013, with 44 percent of promised assets, overhauled its system last year and officials pledged to keep up with funding.

“Our actuaries say if we meet our assumptions we won’t run out of money,” said William Thielen, executive director of Kentucky Retirement Systems. “It may drop a bit more in the near-term, but in the long run it will come back.”

## **Scrimpers’ Remorse**

Governments are supposed to set aside money every year to invest to pay promised pension benefits. Municipalities that scrimp on the payments and funnel the money toward services or to fill budget holes have to catch up as workers approach retirement age.

“If you are not investing assets in a manner to achieve a long-term rate, you generally are not going to earn a long-term rate,” said Scott Reeser, project manager for GASB.

Under GASB’s overhaul, governments calculating pension costs for the period after the depletion date must use lower assumed rates of return. Instead of projected annual earnings of about 8 percent, as is typical for many systems, they have to use a return based on 20-year general-obligation bonds rated at least AA, the third-highest level, said Reeser. The bonds yielded 3.19 percent as of Dec. 12, Moody’s Investors Service data show.

“That rate is generally lower than most governments use as a long-term expected rate of return,” Reeser said. “The lower the discount rate used, the higher the liability.”

Bloomberg Muni Credit

By Darrell Preston

Dec 17, 2014 8:50 AM PT

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## **[GFOA: City of Houston's New Financial Policies Promote Fiscal Responsibility, Transparency.](#)**

Strengthened financial reserves, increased transparency, and an expanded focus on long-term planning are among the highlights of new financial policies approved this week by Houston City Council.

“These policies are to serve as a guide for improved financial management and heightened accountability, with more focus on making sure today’s decisions are sustainable in the future,” Mayor Annise Parker said of the policies, last updated more than a decade ago. “City staff did an outstanding job of researching and developing these policies, using lessons learned in other communities to craft a document that suits Houston as we work to strengthen our City’s financial future.”

The policies were drafted over the past year by City finance staff in coordination with the office of City Councilmember Stephen Costello, who chairs Council’s Budget and Fiscal Affairs Committee. Reflecting best practices from the Government Finance Officers Association and cities across the United States, the policies address topics ranging from debt management to internal financial controls to evaluation of proposals for City investment in economic development.

“Approval of these new policies is just a first step,” said Parker. “Adherence to them is essential to the City’s long-term financial health, especially in light of financial challenges ahead.

The new policies include the following:

- An increase in the City’s minimum financial reserves to hedge against risk;
- Clearer communication to councilmembers and the public regarding decisions on budgeting and spending public funds; and
- Greater emphasis on long-term planning and forecasting to identify and anticipate budgetary challenges before they become unwieldy.

The new 13-page document also requires the City to report in its annual budget whether it is in compliance with each component of the policies. “The requirement for public reporting on our adherence to the new policies is an important one,” according to Kelly Dowe, the City’s chief business officer. “While the policies codify our current practices in many regards, they also set a high standard for us not just in how we manage and utilize public resources, but how we inform citizens and their elected representatives as to our progress.”

The [full text of the policies](#) as adopted can be found at the City’s website.

Friday, December 5, 2014

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## **[NASACT Responds to GASB Exposure Draft: The Hierarchy of Generally Accepted Accounting Principles for State Governments.](#)**

Read the National Association of State Auditors, Comptrollers and Treasurers’ response the

## **[Exiting Municipal Bankruptcy Only a Step in Road to Recovery.](#)**

Many cities that declare bankruptcy ultimately emerge from it in a year or two. But regaining the trust of their citizens is a long-term proposition.

A short walk down Weber Avenue, the main downtown street in Stockton, Calif., offers an unmistakable reminder of the ambition the city used to possess, and the reality that confronts it now.

At the head of the avenue, city hall, a Renaissance Revival building that was part of the City Beautiful movement, is a monument to public service. Above its frieze are words that proclaim the local government's purpose: "To inspire a nobler civic life; to fulfill justice; to serve the people." Those words were written nearly a century ago. Today, the roof leaks, the paint is peeling off the two-story columns and a digital sign out front reminds citizens of the upcoming Fridays the city government is closed.

Similar signs of distress present themselves throughout the commercial district. Private security guards stand on the street corners outside a downtown school because there aren't enough city cops to staff the high-crime area to the satisfaction of property owners. Look to the left or right off Weber Avenue, and there are more boarded-up buildings — beautiful relics from the city's early 20th-century heyday — than there are open ones.

Stockton has been in bankruptcy since the summer of 2012, the largest American city to declare that status other than Detroit. To get out, its leaders have done the things other distressed cities around the country have done. They have renegotiated debt and tried to fix overly generous compensation packages for retirees and employees that were loading down city budgets. This has shown some positive results. The city's water bond rating, for example, was upgraded this year. There are signs of life even in the beleaguered downtown, including rehab work on some of the landmark buildings and construction of a new 13-story courthouse for the county of San Joaquin. But more important, after nearly two and a half years, the city this October was released from the burdens of its restructuring by the referee in charge of its case, U.S. Bankruptcy Judge Christopher Klein.

City officials seem confident that their plan will not only keep Stockton solvent but also put it in a position to prosper. But they also know that exiting bankruptcy won't change anything overnight. The real challenge lies in the years — and decades — ahead. The crucial question is whether future politicians and citizens will have the patience to stick with the game plan.

There is no one reason for Stockton's fiscal demise; as in other cities, there was a whole series of flawed decisions, driven primarily by well-meaning but overzealous officials who lacked the ability to take any kind of financial long view. "Everybody wants a villain," says Councilmember Kathy Miller. "And there isn't one."

Stockton started on the road to trouble in the late 1990s, when the government of California and cities all over the state began increasing pension benefits for their employees. Stockton, with a population of just under 300,000, doesn't have the lure of the major metro centers in Northern California when it comes to attracting public employees. But it's close enough geographically that it draws from the same labor pool. In competing with bigger cities, Stockton upped the ante by giving its employees and retirees full health-care coverage for life. That coverage meant no premiums and

unlimited benefits for dependents.

It was the cushiest benefit package in the state. But at the time, few people raised even the slightest objection. As in most California cities, there was an assumption that the money to pay for the benefits would always be there. The pension increases were far from the only lavish spending commitment the city undertook in its healthy years. Gripped by the idea that big projects downtown would spur development and attract more residents, Stockton in the 2000s invested heavily in waterfront revitalization. Along the water, it financed \$135 million in bonds to build a 10,000-seat indoor arena and a minor league ballpark, on the notion that the projects would either break even or make money on an annual basis. But they turned out to need subsidies, and both stand today as symbols of the city's attempt to grow too big too fast.

When the arena opened in 2005, Stockton paid a million dollars to have Neil Diamond sing at the opening party. In 2008, after shelling out \$2.7 million to build a restaurant at the renovated Hotel Stockton, the city gave the space rent free to a chic Sacramento restaurateur. (The restaurant proved too pricey for Stockton and failed after one year.) A 650-space parking garage, a 66-slip marina and the purchase of an eight-story downtown office building for a new city hall capped the buying binge.

Altogether, between 2003 and 2009, the city of Stockton issued nearly \$320 million in debt tied to its general fund, roughly twice as much as the city spent from that fund last year. The annual debt service for the fund increased by 600 percent between the start of the recession and 2012, thanks to a back-loaded interest payment schedule.

Meanwhile, pension and health-care costs kept rising. To deal with these costs, Stockton purchased \$125 million in pension obligation bonds — and purchased them at precisely the wrong time. The bonds, which are used to shore up unfunded pension liabilities, were acquired in 2007 at the height of the market. When the market crashed, the city saw its investment drop almost immediately by nearly a quarter. Housing values plummeted by 70 percent, crushing revenues just when debt liabilities were ballooning.

In 2012, the Stockton City Council voted to enter mediation, a state condition prior to filing for bankruptcy. By that time, the city had been in a declared state of fiscal emergency for two years — services had been cut, along with \$90 million in annual expenses; nearly half of non-safety city employees were laid off; and wages were reduced by as much as 23 percent. Even with those drastic measures, Stockton still didn't have the funds to keep running.

By the fall of 2012, the initial shock of bankruptcy had worn off. Residents understood that their water would stay on and the streetlights would still work. Post-bankruptcy life in Stockton went on. But that life was one of closed libraries, closed public parks and most alarmingly, increased crime, as the city's police force lost a quarter of its personnel in just three years. In 2012, Forbes named Stockton the eighth most dangerous city in the nation. A record 71 people were killed in the city that year and robberies and burglaries became more frequent as well.

"It's taken a toll," says Dari Sylvester, a professor at the University of the Pacific in Stockton, who was instructed to fill out a police report online when she called to report that her car had been broken into. "Everybody knows someone who's been the victim of a crime and the few cops we have are going to focus on violent crime." Indeed, homicides fell significantly last year to 32, thanks in part to neighborhood watch group activity and increased use of street cameras to ward off crimes. But the first 10 months of this year saw 45 homicides, including a string of shootings on one weekend in October that left five people dead.

Crime has driven key decisions in the bankruptcy period. In the run-up to filing for Chapter 9 bankruptcy protection, the council voted to phase out the city's health-care plan (an unfunded liability of more than \$500 million for retirees' health care alone) and replace it with a traditional HMO in order to avoid more police layoffs. It was a move that still weighs on those who made it. "It was heart-wrenching," says former City Manager Bob Deis, the driving force behind the decision. "But the alternative was to cut more police officers and I just couldn't put the city at risk."

Police pensions have been another politically treacherous issue. Police officers in California are trained by the state and their pensions are managed by CalPERS, the state retirement system. This means officers can easily transfer from one jurisdiction to another and maintain their benefits. Klein, Stockton's bankruptcy judge, ruled on Oct. 1 that California cities could cut ties with CalPERS in bankruptcy and reduce their pension liabilities, but Stockton has not been interested in cutting the roughly \$30 million a year it pays to CalPERS. City officials have been fearful that cutting pension benefits would lead to an exodus of cops looking to keep their retirement plans with another city.

In November 2013, in a further effort to deal with the public safety problem, Stockton's leaders proposed a three-quarter-cent sales tax — Measure A — to raise an extra \$28 million a year to help fund the hiring of more police officers. Despite a 16.6 percent unemployment rate in the city at the time, voters approved the tax, a clear signal that residents were sick of feeling unsafe. But thanks to the particulars of the plan, Stockton had to reach minimum staffing levels (365 cops) before so-called Measure A officers could be hired. As the bankruptcy has dragged on this year, police have resigned from the force in numbers significant enough to keep staff levels below the Measure A threshold. In September, the first few Measure A officers were hired, five months after the tax went into effect.

Employee compensation has been crucial to Stockton's bankruptcy in still another way. One creditor, Franklin Templeton Investments, held up approval of Stockton's bankruptcy exit plan, which the city submitted to the court more than a year ago. Stockton offered Franklin Templeton \$350,000 — only 1 percent of the money it owed the firm on a \$35 million unsecured loan that paid for fire stations, a police station, bridges, street improvements and parks. The firm pushed back, arguing that it was being treated unfairly when Stockton did not cut its employees' pensions at all. The city, however, reasoned that its health-care cuts — worth roughly \$23,000 a year per person in lost benefits — impaired its employees and retirees enough. The issue forced a lengthy trial this spring and twice led Klein to delay issuing a decision on Stockton's overall plan to emerge from bankruptcy.

One of the few positive things about bankruptcy is that it forces a city to face its past. Deis, the now-retired city manager, likens it to a 12-step program in which city officials admit defeat, tally up the wrongs of the past, try to set them right and then move on. Indeed, there is an emotional cost to bankruptcy that can't immediately be squared away on paper in the same way the city has renegotiated much of its debt. Filing for bankruptcy embarrassed Stockton residents. They weren't prepared for the national and global attention. "Nothing but horrible things they wrote about us — how screwed up we were, how awful Stockton was," says Councilmember Miller, still visibly rattled about it more than two years after the fact. "It was so demoralizing for the people in this community [to see Stockton] be held up as the poster child of the municipal screwup of the century."

But for all the work officials have done trying to plan out the next 35 years of Stockton's financial future, the remaining steps and the inevitable delays in returning to real solvency will test an already impatient citizenry. "The public is feeling beset upon," says downtown developer Dan Cort, who is active in rehabbing downtown buildings. "Businesses are losing credibility because of the bankruptcy."

Keeping those emotions in check will be one of the city's biggest challenges in the years ahead. Deis worries that future public officials, voted in by distrustful residents, won't stick to the exit plan and its elements of fiscal austerity. The public is skeptical for good reason — they've been misled before by politicians whose financial and policy decisions turned Stockton into a sinking ship. They point to the nearby city of Vallejo and note that it is still plagued by budget deficits and crime problems three years after emerging from bankruptcy. What residents of both cities need to remember, says Chris McKenzie of the League of California Cities, is that three years is not enough time for a complete fiscal recovery. In McKenzie's view, Stockton is better prepared to face the next decade than most cities because it's had to devote so much attention to its financial future. "These are people," he says, "who are not wearing rose-colored glasses anymore."

GOVERNING.COM

BY LIZ FARMER | DECEMBER 2014

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## **[Municipal Issuer Brief - Alternatives to Traditional Financing.](#)**

Municipal Issuer Brief - Alternatives to Traditional Financing

Municipal Market Advisors | Dec. 8

[Read the Brief.](#)

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## **[S&P: A Year After the Local Government GO Criteria Update, California City Ratings Remain Strong.](#)**

Two years ago, Standard & Poor's Ratings Services took stock of California city governments in the wake of the Great Recession and found that the significant economic and budgetary pressure did not ultimately alter their overall credit quality. (See "Diving Under The Surface Of California City Credit Quality Reveals A Diverse Picture," published Dec. 19, 2012, on RatingsDirect.) The application of our revised local government general obligation (GO) criteria during the past year provided an opportunity to take another look at how our ratings on California cities have fared as the state and its local economies continue to recover. The increased transparency and comparability of ratings under the revised criteria (see "U.S. Local Governments General Obligation Ratings: Methodology And Assumptions," published Sept. 12, 2013) also allow us to better compare cities with their peers both within and outside the state, as well as highlight patterns and trends that distinguish California credits from those in the rest of the country.

On the whole, we find that California's cities are recovering well, with a few exceptions. However, the economy has not recovered with the same vigor across the state's diverse regions: As in previous recoveries, the urban coastal regions have regained jobs and economic activity more swiftly than their inland and rural counterparts have. The lack of a uniform economic recovery makes generalizing about credit trends difficult even at the state level. As we discuss in detail below, cities in the Central Valley, the far north, and the Inland Empire may continue to face challenges as they seek to balance spending pressure with slower revenue growth.

**Overview**

- California cities as a whole are recovering well, with regional differences.
- Their rating distribution remains bifurcated, with relatively more highly rated issuers than other states and also more distressed credits than other states.
- Management remains a key determinant of credit performance, particularly in light of the uneven economic recovery.
- Climbing pension and other postemployment benefit burdens haven't had a broad impact on cities' credit quality but in some cases pose a long-term challenge for budgets and balance sheets.
- We anticipate that the rating distribution of California cities will remain stable as a result of a strong state economy overall.

[Continue reading.](#)

11-Dec-2014

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### **[S&P Request for Comment: U.S. Public Finance Waterworks, Sanitary Sewer, and Drainage Utility Systems: Methodology and Assumptions.](#)**

1. Standard & Poor's Ratings Services is requesting comments on the proposed changes to its methodology for assigning issue credit ratings, issuer credit ratings (ICRs) ratings derived from stand-alone credit profiles (SACPs), based on waterworks, sanitary sewer, and drainage utility revenue pledges of local and regional governments (LRGs) in the U.S. If adopted, these proposed criteria would supersede the following articles published Sept. 15, 2008:

"Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds" and "Key Water And Sewer Utility Credit Ratio Ranges".

2. This article is related to our criteria article "Principles Of Credit Ratings", published on Feb. 16, 2011.

3. This request for comment (RFC) proposes changes that are intended to provide additional transparency and comparability to help market participants better understand our approach in assigning ratings to U.S. public finance waterworks, sanitary sewer and drainage utility systems, to enhance the forward-looking nature of these ratings, and to enhance the global comparability of our ratings through a clear, comprehensive, and globally consistent criteria framework.

[Continue reading.](#)

10-Dec-2014

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### **[Standard & Poor's Reclassifies 157 U.S. Public Universities; They are No Longer Government-Related Entities.](#)**

NEW YORK (Standard & Poor's) Dec. 5, 2014—Standard & Poor's Ratings Services has reviewed all rated entities in the U.S. public finance higher education sector it had previously classified as a government-related entity (GRE). Pursuant to our methodology, "Rating Government-Related Entities: Methodology And Assumptions," published Dec. 9, 2010, on RatingsDirect, GREs could receive extraordinary government intervention during periods of stress. We have reexamined the

link between the government and the U.S. public universities we rate and have concluded the majority of these universities will not benefit from timely extraordinary government support, nor do we expect them to be subject to negative intervention by the related government, in that the state will not redirect funds away from it or take other action to impair the university.

As a result of this review, we will no longer apply the GRE criteria to 157 public universities in the following states: Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington, West Virginia, and Wyoming. This also applies to public universities in the District of Columbia.

We do not expect this to have a significant impact on our ratings. The long-term rating on 155 institutions are unaffected by this change because the long-term rating and the stand-alone credit profiles (SACPs) on them are the same. However, as a result of this action, we have lowered the ratings on two public universities to the level of their SACP. We have downgraded Alabama State University to 'BBB+' from 'A-'; the outlook is negative. As well, we lowered the rating on the University of Northern Iowa to 'A' from 'A+'; the outlook is stable. These two institutions had previously benefited from a one-notch rating uplift for government support, as a result of the application of the GRE criteria. In conjunction with this review, we also raised the SACP on two universities. We raised our SACP on Iowa State University of Science and Technology to 'aa-' from 'aa-' based on our assessment of strong enrollment growth, consistently strong operating performance, and financial resources that are consistent with the rating. In addition, we raised our SACP on the University of North Dakota to 'aa-' from 'a+' based on what we view as its strong demand profile, manageable debt, and financial resources that are comparable to those of other 'aa-' public universities. In both cases, the revised SACP equals the previous long-term rating. Therefore, although there is no longer a one-notch uplift from the SACP for government support, there is no change in the long-term rating.

We first applied GRE criteria to the sector in 2009. Since then, the Great Recession and the performance of U.S. states and public universities have informed our expectations that most public universities operate independently and do not benefit from timely extraordinary support. Universities in the U.S. have demonstrated a proven ability to withstand declining revenue sources, variability in endowment values, changing demographics, and various competitive pressures in a range of economic cycles. Universities in the U.S. are autonomous entities. They have operated without any direct negative government intervention and retain full authority to implement any adjustments to respond to changing economic climates. These institutions operate separately from the state or federal government. U.S. states provide ongoing operating and capital support for public universities. However, we have seen that in times of fiscal stress, states have responded by cutting back ongoing operating and capital appropriations to these institutions. We have also seen that universities usually had full autonomy to raise tuition and other fees charged, as well as cut back on their operating expenses.

Although there is little history of public universities requiring extraordinary entity-specific support related to their fiscal stress, we also believe that U.S. states are less willing to provide this support. In most cases, there is also a lack of a government framework to predictably respond in a timely manner. This is because for most public universities, extraordinary support can only be given through the acceleration of funds annually appropriated. For some states, this can be done as an administrative action; others would require legislative action. In either case, the usefulness of the ability to accelerate already appropriated funds depends on the point in the year that the university

would need liquidity, so the benefit is hard to predict. In addition, for most states, the requirement for legislative approval for any other support, in our view, affects both the predictability and the timeliness of support. We believe the same holds true for both Howard University and Gallaudet University, which receive annual appropriations from the federal government. The criteria focus on government intervention that enables timely repayment of a GRE's debt, reducing the likelihood of default.

We will continue to consider the remaining 14 public universities as GREs; for these, we either expect timely extraordinary government support or see a material risk of negative intervention from the related government. The GRE criteria apply to public universities in Hawaii, New York, Ohio, Tennessee, and the Commonwealth of Puerto Rico. No ratings are affected. We believe that Hawaii, New York, Ohio and Tennessee either have a legislative or administrative framework in place to provide timely extraordinary support.

For Hawaii, although there has been no need for extraordinary support, should an extraordinary event require state assistance, the director of finance and governor are statutorily authorized to provide temporary loans to the University of Hawaii (and other state departments and agencies) to meet their obligations. This does not require legislative action.

Similarly, New York considers both of its public universities to be state agencies. In addition, the state has an established history of helping distressed public entities and each year there is a substantial contingency appropriation that it could use with any other debt service appropriation. We consider these resources as sufficient to provide timely extraordinary support for either State University of New York or City University of New York, given that state appropriations already back most of the debt that each of these universities issues.

Ohio has a history of providing extraordinary support dating to the 1970s and as recent as the mid-1990s, including for debt service payments. Currently, state legislation requires that the state monitor the finances of the universities to ensure all payroll and debt service payments are made. Universities attest quarterly that they have made these payments. Officials use annual audited data to develop a score and place a university on fiscal watch. The state monitors debt to resources and operating surpluses as well as fund balances. This allows for timely extraordinary support for the universities in the state. The GRE criteria affect the nine public universities in Ohio.

In Tennessee, the Tennessee State School Bond Authority (TSSBA), a component unit of the state, issues debt for public universities. The TBSSA issues debt for revenue-supported projects for the University of Tennessee (UT) board of trustees, which oversees the UT system (composed of four universities and three institutes), and the Tennessee board of regents, the governing body for six state universities, 13 community colleges, and 27 technology centers. The bonds benefit from a strong state appropriation-intercept mechanism, if fees and charges are insufficient to pay debt service. A statutory intercept of state revenues to the university secures the bonds. The state commissioner of finance and administration will, within one business day, intercept any operating and maintenance appropriations to the publicly funded institutions with projects under the resolution if the TSSBA notifies the commissioner that funds on hand are insufficient to pay debt service. We understand that the commissioner has never used the provision and the program has a 47-year history of no debt service shortfalls or defaults.

We continue to classify the University of Puerto Rico as a GRE. However, we have revised our view of the likelihood of extraordinary support to "low" from "high." The change does not affect the rating on the university because the rating does not include any uplift from government support. Our SACP on the university is the same as our rating on the Commonwealth of Puerto Rico (BB/Negative). The revision reflects our expectation, that given Puerto Rico's current fiscal condition, its ability to

provide extraordinary support for the university is diminished. In addition, the university still relies on the Government Development Bank of Puerto Rico as its fiscal agent. We believe the liquidity pressures that face the commonwealth and GDB create the potential for negative intervention.

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## **S&P: Renewables Start to Shape U.S. Utility Decisions; Stable Outlook for Utilities, but More Changes to Generation Portfolios are Expected.**

Last week offered two announcements in the power industry that provide concrete evidence of the small toehold that distributed generation—especially photovoltaic solar—is starting to gain competitive ground in the future energy landscape of some electricity markets. First out of the gate, Germany’s largest utility, E.ON, announced Dec. 1 a radical shift in its business strategy. The utility, which has one of the largest market capitalizations of major utility companies globally (currently about \$37 billion) intends to divest about 51 gigawatts (GW) of conventional generation, spinning off these assets into a new, independent company. It will keep its renewable generation (about 4.4 GW), along with its distribution networks, and customer solution businesses. E.ON’s CEO cited a few key reasons:

- Innovation in renewable energy and customer technology expectations has changed and mandates a change in how E.ON is organized to focus on opportunities.
- E.ON’s existing structure can’t adequately address the simultaneous challenges to conventional generation and tap into the renewable energy opportunities. The company characterized its existing conventional power plants that it will divest as a “safeguard security of supply for the transformation.”
- Two companies are needed to address both the medium to near-term needs for central station generation, which E.ON expects could be increasingly supplanted by renewables over time.

[Continue reading.](#)

10-Dec-2014

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## **Alaska, North Dakota, Wyoming Munis at Risk from Falling Oil.**

Falling energy prices are benefiting some municipal bond sectors, like toll-road bonds and airport bonds. But states that lean heavily on the oil industry face growing financial risks as the price of oil keeps heading lower. Bank of America Merrill Lynch reports today that while 10 states account for nearly 78% of U.S. oil production, “the relative impact of declining prices differs widely” among these states. More from BofA strategists Philip Fischer, Yingchen Li, and Celena Chan:

“Alaska, North Dakota and Wyoming will feel the pinch much more acutely than states like Texas, California or Oklahoma, because tax revenues from oil production in the former states makes up disparately large proportions of total revenue collections. Texas has been through the ups and downs of crude prices and has, accordingly, developed a vibrant and diversified economy away from oil. Alaska is the most heavily reliant on oil revenues, where 78% of the states total revenues are attributed to oil. Each of these states, though, is a strongly rated credit.”

BofA says the pain will extend to many local governments too:

“In some states, like North Dakota, large portions of the severance taxes that the state collects on oil are passed down to the local governments. Thus, local governments, which themselves budgeted for large remittances from the state, might face budget shortfalls. In states that do not pass down those revenues, local governments rely heavily on sales and use taxes. As oil production grew, so too did the labor force, which then participated in the local economy.... However, as production becomes less and less economical at lower and lower prices, producers may scale back production or altogether cease production....”

“As production is cut and new wells are left undrilled, jobs and individuals’ discretionary income will likely fall in tandem. Local governments may be forced to find alternative sources of funds to pay for government services that were otherwise funded with revenues associated with that oil production. This will likely be felt in cities and counties where oil production is the dominant, if not only, industry. As these revenue streams begin to decline, issuers’ often-competing responsibility between essential government services and debt service becomes that much more strained.”

On the other hand, Puerto Rico - which is in desperate need of some good economic news - may see benefits to its public utility. BofA again:

“One beneficiary is Puerto Rico’s Electric Power Authority (PREPA), which relies heavily on oil for its power generation. Seven out of 10 plants rely solely on oil, while an eighth plant uses a mix of oil and natural gas. Oil-produced energy accounts for 70% of PREPA’s costs.”

Barron’s

December 12, 2014, 3:50 P.M. ET

By Michael Aneiro

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## **[Why Muni-Bond Investors are Wondering what Illinois is Going to Do.](#)**

Municipal debt investors are watching the appeals process that will decide whether or not Illinois’ pension reform bill ends up in the wastebasket, a decision that would send the Land of Lincoln back to square one in its attempts to battle its pension funding crisis.

“There’s so much uncertainty there,” Daniel Solender, the lead portfolio manager for municipal bonds at investment manager Lord Abbett & Co., said by phone Wednesday. “It’s hard to know what the right valuation is [for the state’s bonds].”

So far, investors are waiting and watching. Solender noted that there hasn’t been much trading in Illinois’ bonds in response to a Nov. 21 Circuit Court decision that said the reform bill was unconstitutional. If the Illinois Supreme Court upholds that decision, Solender expects a negative effect on the state’s bond values.

“For investors to get comfortable, there has to be some idea of a plan [for pension reform], and there doesn’t seem to be one [now],” he said.

Still, he is confident that Illinois has time to work out its pension issues one way or another.

Solender and other sources are looking optimistically to Governor-elect Bruce Rauner, a Republican, to address the issue. Rauner will replace Pat Quinn, a Democrat, on Jan. 12.

Illinois' unfunded pension liability has ballooned to \$111.2 billion, according to a November report by the Illinois Commission on Government Forecasting and Accountability. The Teachers' Retirement System accounts for about half of that at \$61.6 billion, the report said.

A June 24 report by Standard & Poor's revealed that Illinois has, by far, the lowest level of pension funding in the country at 40.4% funded, followed by Connecticut (49.1%).

As part of a Dec. 1 panel in New York City that discussed municipal debt restructuring, William A. Brandt Jr., president and CEO of Development Specialists Inc., said that Illinois holds 43% of the public pensions in the U.S. According to Brandt, who is also the chair of the Illinois Finance Authority, those amount to some 652 public pensions.

"Illinois is your problem state," he warned.

The pension reform bill, which was approved in December 2013 with the support of Quinn, aimed to address the pension funding gap by raising minimum retirement ages, lowering cost-of-living adjustments, and putting a cap on the base salary that serves to determine pension payments.

However, Judge John W. Belz of the Circuit Court for the Seventh Judicial Circuit in Sangamon County, Ill., ruled on Nov. 21 that the bill violated the state constitution.

The plaintiffs in the case had argued that the bill violated the Pension Protection Clause in the Illinois state constitution, which prohibits impairing or diminishing pensions. The defendants countered that Illinois could enact the pension reform bill using the sovereign powers or police powers granted to U.S. states.

Belz ruled in the plaintiffs' favor, concluding, "The Illinois legislature could not have been more clear that any attempt to diminish or impair pension rights is unconstitutional."

According to Michael Comes, a portfolio manager and vice president of research at Cumberland Advisors Inc., the most palatable pension reforms are ones that affect brand-new city employees. Pension reforms that have been popular among other states recently include raising the retirement age, changing the formula for cost-of-living increases, raising employee contributions to their pensions, or switching employees over to 401(k) plans, Comes said by phone.

Moody's Investors Service Inc. expressed skepticism that the state Supreme Court would reverse the circuit court ruling.

"While a lower-court ruling can, of course, be reversed, this summer the Illinois Supreme Court indicated in a separate case on retiree health benefits that it will adhere strictly to the pension protection clause, a legal barrier that for many years has impeded political consensus on reforms affecting current Illinois pension participants," the ratings agency said in a Nov. 24 report.

Illinois' credit rating of A3 is the lowest among U.S. states, five notches below the median, Moody's said.

The ratings agency added that Illinois' ratio of adjusted net pension liability to revenue was 268% in 2013, well above the 60% median for all states.

In a Nov. 11 report, Moody's Analytics referred to Illinois as "the country's most financially troubled state."

S&P singled out Illinois alongside Kentucky, New Jersey, and Pennsylvania as states with credit

quality harmed by pension funding issues.

According to an April 8 report by the Pew Charitable Trust, state-run retirement systems had a shortfall of \$915 billion during fiscal 2012, a number that ballooned to more than \$1 trillion when local government obligations were considered, as well. That number is up from \$452 billion in fiscal 2008.

If the state of Illinois and its municipalities struggle under their load of obligations, they won't have access to municipal bankruptcy protection. States are prohibited from filing for Chapter 9 under the federal bankruptcy code, and Illinois doesn't have a mechanism that would allow its municipalities to file under that section.

Brandt noted that major Chapter 9 filings such as those of the City of Detroit, Mich., and Jefferson County, Ala., aren't your "customary" bankruptcy filings — they are "event-driven."

He notes that for some struggling municipalities, they are "corporate entities that may or may not need to exist any more."

The Street

By Lisa Allen | 12/11/14 - 09:25 AM EST|

— Kelsey Butler contributed to this report

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## **[Oil Dive Propels Toll-Road Bonds to Biggest Rally: Muni Credit.](#)**

Bonds for tollways are en route to beating the municipal market by the most in nine years as cheaper oil and a growing economy lead more Americans to hit the road.

Debt backed by toll and turnpike revenue has earned 12.1 percent this year, compared with 9.5 percent for all munis, Bank of America Merrill Lynch data show. The outperformance is the most since the data began in 2005 as investors bet that Americans will drive more as the price of oil plunges to the lowest level since 2009.

About 46.3 million people in the U.S. were set to travel more than 49 miles (79 kilometers) during the Thanksgiving holiday period, the most since 2007, according to a projection from AAA. The trend signals a buying opportunity in toll bonds, which offer above-average yields as municipal interest rates remain close to generational lows, according to American Century Investments and Morgan Stanley.

"The toll-road sector is currently attractive and should do well as gas prices stay low and there's more driving, while the overall economy remains strong," said Steven Permut, who oversees \$6.5 billion as head of munis at American Century in Mountain View, California.

### **Avoiding Congestion**

Traffic will grow as much as 2 percent next year on average for tollways rated by Moody's Investors Service, while revenue will jump 5 percent, the company said in a report last month. As free roads get busier, tolled routes may lure drivers, according to Moody's, which gives the segment a stable outlook.

Investors should buy more transportation-revenue bonds than benchmarks suggest, according to Michael Zezas, head of muni research at Morgan Stanley. He recommends putting more cash into tollway and airport debt than into any of the other parts of the market listed in a Dec. 8 report.

Crude-oil futures on the New York Mercantile Exchange have plummeted as the U.S. shale boom boosts production while growth in global demand slows. The price fell below \$62 per barrel today, the lowest since July 2009.

Average retail gasoline prices have slumped to a four-year low of about \$2.64 a gallon, according to AAA. An Oklahoma City station sold gasoline for \$1.99 a gallon Dec. 3, becoming the first in the U.S. to drop below \$2 since July 2010, according to GasBuddy.

### **Biggest Borrowers**

Municipal issuers have \$118 billion of debt tied to toll roads, bridges and tunnels, data compiled by Bloomberg show. The biggest borrowers are the New Jersey State Turnpike Authority, the Bay Area Toll Authority, which runs the San Francisco-Oakland Bay Bridge, and the North Texas Tollway Authority.

The Texas agency issued \$457 million of debt Nov. 5. Bonds rated A2 by Moody's, the sixth-highest level, and maturing in January 2025 priced to yield 2.89 percent, Bloomberg data show. That was more than the 2.66 percent yield on an index of munis with a similar grade and maturity.

Last week, the Pennsylvania Turnpike Commission issued \$294 million of revenue bonds rated A1 by Moody's, one level higher than the Texas debt. Securities due in December 2024 priced to yield 2.71 percent, compared with about 2.6 percent on an index of similarly-ranked revenue bonds.

### **Yield Lure**

The extra yield means that toll bonds have room to extend the rally, said Dan Solender at Lord Abbett & Co.

"Some of the transportation-type sectors seem to have a little more spread and room to tighten," said Solender, who oversees \$16 billion as director of munis for Lord Abbett in Jersey City, New Jersey.

The outlook for travel next year may be even better as people adjust to cheaper prices, said Michael Green, a spokesman for Heathrow, Florida-based AAA.

"If gas prices remain less expensive well into 2015, we could see people change their driving habits as a result," said Green, who's based in Washington.

Less costly gasoline may benefit most of the \$3.7 trillion municipal market by increasing discretionary income and tax revenue, said Chad Farrington, head of muni research in Boston at Columbia Management Investment Advisers, which oversees about \$30 billion in local debt.

### **Pinched Parties**

Yet energy-producing states may be pinched as tax revenue tied to energy declines, he said. North Dakota, with the lowest unemployment rate nationwide at 2.8 percent, may see its production boom falter if current oil levels persist, Farrington said.

Moody's in October also cited Texas, Alaska, Oklahoma and New Mexico as states where collections

are at risk. Louisiana froze spending last month to prepare for reduced oil revenue.

The decline may be offset in some states by increased hiring, with the U.S. jobless rate at a six-year low of 5.8 percent.

“The domestic economy remains solid and that along with lower oil prices will be very beneficial to the transportation sector,” said Permut at American Century. “We’re going to continue to see strength there.”

Bloomberg MuniCredit

By Brian Chappatta and Elizabeth Campbell

Dec 10, 2014 7:29 AM PT

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Mark Tannenbaum, Pete Young

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## **[Muni Sales Poised to Decelerate While Redemptions Rise.](#)**

Municipal bond sales in the U.S. are set to decrease in the next month while the amount of redemptions and maturing debt rises.

States and localities plan to sell \$14.6 billion of bonds over the next 30 days, according to data compiled by Bloomberg. A week ago, the calendar showed \$20.8 billion planned for the coming month. Supply figures exclude derivatives and variable-rate debt. Some municipalities set their deals less than a month before borrowing.

In the coming weeks, Los Angeles Community College District plans to sell \$1.33 billion of bonds, Dallas has scheduled \$529 million, the Bay Area Toll Authority in California will offer \$536 million and Harris County/Houston Sports Authority will bring \$458 million to market.

Municipalities have announced \$15.2 billion of redemptions and an additional \$12.7 billion of debt matures in the next 30 days, compared with the \$27.5 billion total that was scheduled a week ago.

Issuers from Illinois have the most debt coming due with \$2.55 billion, followed by New Jersey at \$1.33 billion and New York with \$1.13 billion. The state of Illinois has the biggest amount of securities maturing, with \$952 million.

The \$3.5 trillion municipal market contracted by \$641 million last month. Sales of \$34.8 billion compared with redemptions and maturing debt that totaled \$35.5 billion.

Bloomberg News

By Ken Kohn Dec 8, 2014 4:16 AM PT

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Stacie Sherman, Mark Tannenbaum

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## **[Standard & Poor's: Diverging Trends Keep U.S. States' OPEB Liabilities Relatively Stable.](#)**

From Standard & Poor's CreditMatters TV:

[Diverging Trends Keep U.S. States' OPEB Liabilities Relatively Stable.](#)

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## **[SIFMA Survey: Total Muni Issuance to Edge up 2.7% to \\$357.5B in 2015.](#)**

WASHINGTON - Total tax-exempt and taxable municipal bond issuance in 2015 is expected to edge up to \$357.5 billion, an increase of more than 2.7% from the \$348.1 billion forecast for this year, according to respondents of an industry survey.

The 2015 estimated level would be a 17.3% drop from peak muni issuance, which was \$433 billion in 2010, according to Thomson Reuters data.

Issuance would rise slightly to \$315.0 billion from \$305.3 billion this year for long-term munis, while it would remain almost unchanged at \$42.5 billion from 42.8 billion for short-term munis, according to median estimates from the 14 bank and broker-dealers firms that responded to the Securities Industry and Financial Markets Association's annual survey. They made their projections between Nov. 7 and Nov. 21.

Issuance of long-term tax-exempt munis not subject to the alternative minimum tax is expected to be up only slightly in 2015 to \$275 billion from \$273.5 billion this year, according to survey respondents.

"I think of that as essentially flat issuance for next year," said Michael Decker, a managing director of SIFMA and co-head of its muni division. "Bank lending is continuing to draw from public issuance. Many issuers are able to get very attractive terms from banks for short- and medium-term borrowings. That's a driving factor of continued weak issuance."

Bank borrowings include both loans and private placements, he said.

In addition, state and local governments are still not borrowing to the extent they were prior to the Great Recession, Decker said.

The survey respondents estimated bank lending would fall to an estimated \$35 billion, or 9.8% of issuance of long-term munis, from \$45 billion this year.

But Decker stressed that these are just estimates. "We don't really know what the total of bank lending is," he said. "I'm not aware of a good data source."

Refundings are projected to remain mostly unchanged in 2015 at 45% of issuance of long-term munis, compared to 46% this year.

But survey respondents projected the issuance of taxable munis and munis subject to the AMT to rise. They estimated 2015 issuance of taxables will increase to \$30 billion, a 29.3% increase over this year, and that issuance of AMT munis would rise to \$10.0 billion, a 16.7% gain.

They also projected issuance of variable rate demand obligations to increase to \$9.0 billion in 2015, from a record low of \$6.6 billion in 2014.

Decker said the survey found that, "from a credit perspective, the market is sound."

"We're not going to see any systemic credit issue in 2015, but we may see some isolated credit events," he said, explaining when asked that these could range from technical defaults to distressed financials for issuers, or even bankruptcy filings.

Asked what could have the greatest impact on the muni market in 2015, most respondents put curtailment of tax exemption for munis at the top of the list.

President Obama, in his budget requests, has proposed capping the value of tax exemption to 28%. The tax reform draft offered by House Ways and Means Committee chairman Dave Camp, R. Mich., which could form the basis for future plans, proposed what would amount to a 25% cap on the value of tax-exemption, as well as the elimination of tax exemption for private-activity bonds issued after 2014.

Survey respondents were also concerned about the underfunded pensions of many state and local governments, as well as general economic weakness and the tendency of some issuers to defer maintenance or improvements of capital projects.

THE BOND BUYER

BY LYNN HUME

DEC 4, 2014 12:00am ET

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## **[MassDirect Notes Win Deal of the Year.](#)**

Modeled in part on the U.S. Treasury's TreasuryDirect, the innovative new program makes highly-rated Massachusetts general obligation bonds available to retail investors on a nearly continuous basis through a retail rolling offering. In 2014, Massachusetts sold on average more than \$6 million a day and sold out the full \$250 million program one month ahead of schedule.

The MassDirect program is "a window into the future of the municipal bond market," said Michael Scarchilli, editor in chief of The Bond Buyer, when presenting the award at a ceremony held at the Waldorf Astoria hotel in New York City. "It democratizes primary market distribution for retail investors and takes a critical step toward pre-price transparency."

The deal also won the Deal of the Year award for Non-Traditional Financing, marking the first time that category, which debuted in 2006, has yielded an overall winner. It's the second Deal of the Year win for the Commonwealth of Massachusetts, however, as its billion-dollar Accelerated Bridge Program bond package won the national honors from the Northeast position in 2011.

MassDirect bonds are sold by the state's underwriter, Citi, through TMC Bonds, an open

architecture electronic trading platform which already carries over 30% of all interdealer secondary trades in the muni market. And now, Massachusetts new-issue bonds reach hundreds of independent brokers and thousands of retail investors who never had access to new-issue bonds in the past.

For the fourth year, the Deal of the Year gala included the presentation of the Freda Johnson Award for Trailblazing Women in Public Finance. This year, the organization honored two public finance professionals; one from the public sector and one from the private. The 2014 honorees were Chicago's Chief Financial Officer Lois Scott, and veteran New York-based banker Kym Arnone, the Municipal Securities Rulemaking Board Chair.

The night also featured a video tribute to muni market legend Jim Lebenthal, who passed away in November. His daughter Alexandra Lebenthal followed the tribute with a rousing speech for which she received a standing ovation.

For more than a decade, the editors of The Bond Buyer have selected outstanding municipal bond transactions for special recognition. The 2014 awards, which considered deals that closed between Oct. 1, 2013 and Sept. 30, 2014, drew nominations that represent the full diversity of the communities and public purposes that are served by the municipal finance market.

Issuers were honored in eight categories, revealed online Nov. 3-7 through separate video announcements at BondBuyer.com.

The other finalists were:

### **Northeast Region**

The \$350 million century-bond offering from the District of Columbia Water & Sewer Authority, which may set a precedent for municipalities across the nation with pressing long-term environmental infrastructure needs. DC Water's innovative deal not only helps meet national water quality standards, it marks the first sale of a century bond by a water and sewer utility and the first independently certified green bond sold in the United States.

### **Southwest Region**

The Colorado Regional Transportation District's \$441 million offering of certificates of participation, which marked the first time that any issuer had used a proposed rail line as the leased property in a COP deal. The transaction was the second largest tax-exempt issuance of COPs in the past five years and the largest issuance in the transportation sector in the past decade.

### **Midwest Region**

The Karegnondi Water Authority's \$220.5 million financing to fund a 63-mile pipeline to Lake Huron, which completed Michigan's Flint and Genesee County's breakaway from their dependence on the Detroit water system. Entering a market where local governments across Michigan have faced heightened penalties, the authority sold the bonds to more than 30 investors and achieved an all-in borrowing cost below projections.

### **Southeast Region**

The Louisiana State Bond Commission's \$112 million financing of unclaimed property special revenue bonds, on behalf of the State of Louisiana, which needed to finance a portion of the state's 200-mile-long Interstate 49 project. The state solved the problem with a unique and unconventional approach: securitizing unclaimed property receipts. To strengthen the credit, the state added an

appropriation-backed promise to replenish the debt service reserve.

## **Far West Region**

The County of Los Angeles Redevelopment Refunding Authority's \$53 million refunding of tax allocation bonds, removing them from a post-California redevelopment agency dissolution limbo. The offering was the first to be issued through a countywide program that enables its public finance staff to put together refundings for cities in the county, and the first to use a pooled structure that combined individual successor agencies into a single refunding series.

## **Healthcare Financing**

The \$1.04 billion Health and Educational Facilities Authority of the State of Missouri revenue bond transaction, which financed a complex debt restructuring and management structure reevaluation for St. Louis-based SSM Health Care. The transaction decreased the weighted average cost of debt for SSM Health to 3.1% from 4.6% and lowered the maximum annual debt service by nearly 10 percent, resulting in a savings of about \$3 million per year.

## **Small Issuer Financing**

The Village of Oakwood in Cuyahoga County, Ohio's \$2.69 million of various purpose notes, the first transaction financed through the Ohio Market Access Program. The unique credit enhancement program created by the Ohio Treasurer's office helped Oakwood carry top short-term credit marks, expanded its universe of buyers and lowered the village's borrowing cost by about 50%. The program offers a model that can be replicated nationwide.

THE BOND BUYER

DEC 4, 2014 9:00pm ET

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## **[Firefighters Lose Bid to Sue Bankrupt San Bernardino in State Court.](#)**

Calif Dec 3 (Reuters) - Firefighters in bankrupt San Bernardino cannot sue the city in a California state court over lost wages and benefits, the U.S. Bankruptcy Court judge overseeing the case ruled on Wednesday.

"Starting to allow parties to argue their claims in another forum isn't a precedent I want to set," U.S. Bankruptcy Judge Meredith Jury said.

The city's firefighters union had sought to escape the automatic block on suing a city under Chapter 9 bankruptcy protection. Firefighters want a state court, not the federal bankruptcy court, to hear their arguments that the city has illegally cut wages and benefits since declaring bankruptcy in August 2012.

Jury said she would not approve any city bankruptcy plan that breaks state law when it comes to firefighter compensation.

San Bernardino, a city of 205,000 people 65 miles east of Los Angeles, filed for bankruptcy in August 2012 with a budget deficit of \$45 million.

The city is one of a handful of municipal bankruptcies, including Detroit, Michigan and Stockton,

California, being closely watched by the \$3.7 trillion U.S. municipal bond market. Bondholders, public employees and other state and local governments are keen to understand how financially distressed cities under Chapter 9 protection handle debts to Wall Street, large pension funds and other creditors.

Last month, San Bernardino revealed it was not going to challenge its largest creditor, the California Public Employees' Retirement System (Calpers), in any bankruptcy plan.

In a deal struck during private mediation sessions with Calpers over the past year, San Bernardino has agreed not to reduce future payments to the giant fund, America's biggest public pension system with assets of \$300 billion. The city has also begun repaying about \$13 million in arrears to the fund.

That leaves open the prospect of the city cutting what it owes to other creditors, including Wall Street bondholders and insurers.

These include Ambac Assurance Corp, insurer of \$50 million of pension obligation bonds issued to the city in 2005, Erste Europäische Pfandbrief-und Kommunalkreditbank AG, holder of the bonds, and Wells Fargo Bank, the bond trustee and the flagship bank of Wells Fargo & Co.

BY TIM REID

RIVERSIDE Wed Dec 3, 2014 6:40pm EST

(Reporting by Tim Reid; Editing by David Gregorio)

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## **[Municipal Rush to Borrow May Repeat: Chart of the Day.](#)**

The biggest calendar of proposed municipal-bond offerings in more than five years may be more than a one-time event, according to John Mousseau, Cumberland Advisors Inc.'s director of fixed income.

As the [CHART OF THE DAY](#) illustrates, state and local governments planned as of yesterday to raise \$18.7 billion through debt sales in the next 30 days, according to data compiled by the Bond Buyer. The previous day's \$19.1 billion total was the highest since June 2009 and more than double this year's average of \$7.9 billion.

Much of the borrowing will be done to refinance bonds that were sold a decade ago, when yields were higher, Mousseau wrote three days ago in a post on Cumberland's website. The average yield on 20-year municipal securities was 3.54 percent last week, down from 4.60 percent at the end of November 2005, according to Moody's Investors Service.

Similar surges in sales may happen during the next two years, especially "at the junctures of large maturities of bonds — that is, January and July," the Sarasota, Florida-based investor wrote. "This is a tried-and-true method for issuers to manage and lower their overall debt-service costs."

The current increase in what the Bond Buyer calls 30-day visible supply may send municipals lower, Mousseau wrote. As he put it: "The sheer size of the calendar should allow for some softening of prices."

Longer-term municipals may be available for purchase at yields 35 percent to 40 percent more than

those on comparable Treasury securities, according to Mousseau, an executive vice president whose firm manages \$2.2 billion of assets.

BLOOMBERG NEWS

By David Wilson Dec 4, 2014 10:19 AM PT

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## **[U.S. Municipal Bond Issuance to Flatline in 2015 - SIFMA.](#)**

Dec 4 (Reuters) - New borrowing by U.S. states, cities and other parts of the public sector will nearly flatline next year, with issuance of tax-exempt debt likely rising to \$275 billion from around \$273.5 billion this year, according to a trade group's survey released on Thursday.

The growing practice of issuers borrowing directly from banks, instead of tapping the \$3.7 trillion municipal bond market, will contribute to the stasis, the Securities Industry and Financial Markets Association (SIFMA) found in its annual survey.

Over the last few years the public sector has looked more to bank loans, which have less oversight and fewer disclosure requirements, for financing needs.

"We expect municipal issuance to remain mostly flat to up slightly in 2015, with bank lending continuing to provide borrowers with an alternative to public bond issuance," said Michael Decker, one of the heads of SIFMA's municipal securities group, in a statement. "Short- and long-term yields will likely creep up, in part as a response to changing monetary policy."

Still, the survey of banks and underwriters found direct placements of bonds to banks could drop to \$35 billion in 2015 from \$45 billion this year.

Total issuance, which includes taxable debt, will reach \$357.5 billion in 2015, up from \$348.1 billion estimated this year, SIFMA said.

Any rise will come from long-term debt. In 2015, SIFMA expects \$315 billion in long-term bonds, compared to \$305.3 billion in 2014.

Debt sales this year are catching up to last year's levels after plunging at the beginning of 2014. Rising interest rates dried up refinancing at the end of 2013 and beginning of 2014. By July this year, issuance was running 15.4 percent below 2013, exclusively due to a drop in refundings, Thomson Reuters data showed.

Then interest rates dropped, and as of November sales were just 3.3 percent less than last year.

On Municipal Market Data's benchmark scale, the yield on a top-rated 10-year bond on the first trading day of this year was 2.79 percent and on a highly rated 30-year was 4.20 percent. As of Wednesday, the yield on the 10-year bond was 2.08 percent and on the 30-year 3.02 percent, according to MMD, a Thomson Reuters company.

Nonetheless, SIFMA said 2015 will see the same level of refundings as this year.

WASHINGTON Thu Dec 4, 2014 11:32am EST

(Reporting By Lisa Lambert; Editing by Meredith Mazzilli)

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## **[Municipal Issuer Brief - Pros/Cons for Upcoming Deal Slate.](#)**

[Download the Brief.](#)

Municipal Market Advisors | Dec. 2

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### **[Fitch: Ratings Reflect Issuers' Resiliency to Hazardous Events.](#)**

NEW YORK-(BUSINESS WIRE)-Fitch's ratings incorporate an assessment of an entity's credit characteristics which speak to overall resiliency to manage unexpected events, according to a Fitch Ratings report.

Under a disaster scenario, those issuers which possess revenue diversity as well as an ample supply of reserves and liquid assets are afforded the ability to quickly restore operating capabilities, as well as finance the clean-up and recovery effort, until private insurance and state and/or federal disaster reimbursement funds are received, according to Fitch's report.

Issuers with small geographies, limited liquid financial resources or limited assets, such as some higher education institutions or health care facilities and utilities, may be more vulnerable to credit deterioration following an event.

The diversity of state revenues and large geographic service areas position state ratings favorably with regard to event risk. Fitch does not see event risk rise to the level of a key rating driver in any of its state general obligation ratings. Similar to states, most local government issuers demonstrate a level of revenue and geographic diversity that limits Fitch's concerns regarding the impact to bondholders from event risk.

Event risk for electric utilities is a limited concern, primarily for utilities with very small service areas in regions prone to natural disasters or those with single generation asset risk. As a result of the essentiality of the service provided, electric utilities have emergency response plans in place and perform periodic drills to test the plans and response times as a standard industry practice.

Water utilities are less likely than electric utilities to experience single event weather-related destruction of their distribution pipelines, given their underground nature. The damage to underground pipelines has more to do with aging infrastructure and the lack of routine repair and replacement programs.

Healthcare issuers are also typically not prone to hazard risk but there are limited cases where the issue rises to a level of credit consideration in Fitch's ratings. Healthcare issuers can be more vulnerable to event risk in instances where there are significant levels of single asset risk and concentrated revenues.

Higher education obligors can be vulnerable to event risk due to their concentrated asset base and high level of tuition dependence. The likely frequency of recurrence of any natural event may be tied

to its location, making them more vulnerable to such events.

Housing agencies across the 50 states have built up large reserves over their 30 to 40 year history and therefore are capable of handling many unknown risks. Mortgage insurance, property insurance and Federal Emergency Management Agency for flood insurance and catastrophic losses tend to make this sector rather stable.

For more information, a special report titled 'Event Risk and Overall Credit Resiliency' is available on the Fitch Ratings web site at [www.fitchratings.com](http://www.fitchratings.com).

December 02, 2014 05:15 PM Eastern Standard Time

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## **[Moody's: Outlooks for US States and Local Governments Remain Stable on Stronger Revenues.](#)**

The 2015 outlooks for states and local governments are stable as a strengthening US economy supports state revenue growth and property tax revenues slowly recover, supporting the local governments. State tax revenue growth in 2015 will rise faster than in 2014, but remain within a 5% - 6% range, moderate by historical standards for the sector, while property taxes will grow at 2%-3% for the next several years...

[Purchase the Report.](#)

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## **[WSJ: Most States are Good Credit Risks.](#)**

Even when hefty pension obligations and unfunded employee health-care liabilities are taken into account, state credit quality generally is strong.

The \$518 billion of state general-obligation bonds and other state-supported debt are probably the best slice of the \$3.7 trillion municipal-bond market. General-obligation bonds are backed by states' full faith and credit.

This [table](#) shows the yield premium, measured in hundredths of a percentage point, of 10-year state general-obligation debt above a triple-A benchmark, now about 2.15%. (Ratings for some states are more indicative than real, because they have little or no debt outstanding.)

Barron's has looked at state financial health for the past three years using data compiled by Eaton Vance. This year's tally differs from last year's because it offers a more comprehensive picture, based on about 10 measures that factor in assets, liabilities and other gauges of economic health.

THE WALL STREET JOURNAL

By ANDREW BARY

Nov. 29, 2014 8:11 p.m. ET

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## **Houston Stadium Debt Backfire Spurs Restructuring: Muni Credit.**

The agency that financed stadiums for three of Houston's professional sports teams is selling debt to extricate itself from municipal-bond deals that backfired with the financial crisis.

The Harris County-Houston Sports Authority plans to borrow about \$689 million starting this week to restructure some of its \$1 billion of obligations. The debt, mostly backed by tourism-related taxes, was sold to pay for facilities in the fourth-most-populous U.S. city for Major League Baseball's Astros, the National Basketball Association's Rockets and the National Football League's Texans.

Localities are still dealing with financing structures sold by Wall Street banks more than a decade ago with the promise of cutting borrowing costs. For the Harris County agency, the recession triggered events that caused the deal to unravel: The debt's insurer was downgraded, leading the authority to repay \$117 million of bonds 16 years earlier than scheduled while also ending swap contracts at a cost of \$25 million.

"We've struggled, but this deal will put all of this behind us," J. Kent Friedman, a Houston attorney who is chairman of the authority, said in a phone interview. "We're aggressively trying to get this done by the end of the year."

### **Debt Trap**

This week's offering shows how municipal borrowers trapped in misfiring deals don't have to follow Detroit, where bankruptcy left bondholders with a fraction of their original investment. Investors may also take a loss in Puerto Rico, where the island's electric agency is set to release a plan in March to restructure its \$8.6 billion of debt.

The sports authority's approach resembles an October deal from the San Joaquin Hills Transportation Corridor Agency in California, in extending maturities to match expected revenue, said Alan Schankel, managing director of Janney Montgomery Scott LLC in Philadelphia. The revamp will spread the stadium agency's repayment over 12 extra years.

"There's things issuers can do, short of bankruptcy, that move the projects forward," said Schankel. "It's a credit-positive for investors, but its good for the issuer too."

### **Tourism Cash**

The authority, created by the county and the city of 2.2 million people in 1997 to fund sports venues, sold bonds in 1998 for Minute Maid baseball park, and in 2001 for the NRG football stadium and the Toyota Center basketball arena. The agency also built BBVA Compass Stadium for the Dynamo Major League Soccer franchise without borrowing. That venue opened in 2012.

Backing for the bonds came from income such as a 2 percent tax on hotel and motel stays and a 5 percent car-rental levy. The debt also included variable-rate bonds with interest-rate swaps designed to control borrowing costs.

MBIA Insurance Corp., which guaranteed the variable-rate debt and swaps, was stripped of its last top rating in June 2008 after losses on mortgage-backed securities it insured. JPMorgan Chase & Co., the buyer of last resort for the variable-rate debt, repurchased those bonds, which in 2009 triggered a provision requiring the authority to pay off the securities in five years rather than the scheduled 21.

### **Wrong-Way Bet**

The authority paid to end the swaps in 2011, and this year repaid the accelerated debt using reserves, according to Friedman. The agency had company in paying to exit swaps, which proved wrong-way bets for many localities after the Federal Reserve drove its benchmark interest rate close to zero. Municipal borrowers in the \$3.7 trillion market have paid at least \$5 billion to banks to end interest-rate swaps, data compiled by Bloomberg show.

The agency met its obligations without missing payments to investors, according to Friedman. Moody's Investors Service had warned in 2010 that the agency might not make its payments.

By pushing the maturity out to 2053, the new structure will create flat payments that align with expected revenue. Previously, the payments escalated through 2041, which would have required the revenue backing the debt to increase.

"We're making it more comfortable for the authority to make debt-service payments," said Friedman. "We're making it less complicated."

### **Rodeo Bonds**

On top of selling \$569 million of new senior and junior-lien debt backed by the car and hotel taxes, the authority wants to issue about \$120 million of bonds this month backed mainly by payments from the Texans NFL team and a livestock show and rodeo, said Friedman.

The new structure will also provide dedicated reserves and remove the risk that a failure in one part of the structure could trigger defaults of other parts, according to Moody's. Surplus revenue would go toward reserves to repay debt early.

The changes may lead rating companies to raise the authority's ratings. Moody's assigned an A2, its sixth-highest grade, to the new senior-level bonds. That's still seven levels higher than the Ba3 mark of the current senior debt, which Moody's put on review for an upgrade once the restructuring is done. Standard & Poor's gives an A- rating, its seventh-highest, to the new senior debt, and put some existing senior debt on positive credit watch, meaning ratings may rise.

As the authority sells, its finances are improving. Pledged revenue, including lodging and car-rental taxes, are up 36 percent from 2010 to 2013 after falling 12.7 percent from 2008 to 2010, according to S&P. The restructuring also saves \$60 million and frees up revenue of \$24.5 million in 2014, according to S&P.

"It all worked out and everyone got paid," said John Medina, an analyst with Moody's in New York.

Bloomberg Muni Credit

By Darrell Preston

Dec 1, 2014 5:00 PM PT

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Mark Tannenbaum, Alan Goldstein

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## **New Jersey Bond Costs Swell Fivefold in Stress Sign: Muni Credit.**

New Jersey's relative borrowing costs grew fivefold in its first general-obligation sale in 19 months, signaling that underfunded pensions and revenue shortfalls are rattling municipal-bond investors.

The state issued \$525 million of general-obligation debt yesterday in a competitive offer won by Bank of America Merrill Lynch, which beat out seven banks. Bonds maturing in June 2025 priced to yield 2.75 percent, or about 0.5 percentage point more than benchmark munis, data compiled by Bloomberg show. In comparison, the yield spread was 0.09 percentage point for 10-year debt in the state's last long-term general-obligation sale, for \$350 million in May 2013, the data show.

Investors are rendering their verdict on policy moves by Republican Governor Chris Christie, 52, who plugged a revenue shortfall in June by cutting \$2.5 billion in promised pension payments for this fiscal year and last year. That maneuver, plus three straight years of overestimated revenue and a lackluster recovery from the recession, led the three biggest rating companies to downgrade the state a combined eight times under the governor, the most for a chief executive of the state.

"The spreads should have been much wider based on the deterioration of New Jersey's credit quality," Tom Metzold, co-director of munis in Boston at Eaton Vance Management, which oversees \$27 billion of local debt, said in a telephone interview. He anticipates the yield gap will widen to as much as one percentage point within the next year.

### **Timing, Size**

The state treasurer's office calculates that the yield spread rose from 0.23 percentage point in the May 2013 transaction. The increase amounts to \$1.4 million a year in additional debt-service costs, and resulted in part from the different time of year and the larger size, according to Christopher Santarelli, a spokesman for Treasurer Andrew Sidamon-Eristoff.

"We would emphasize the market met our GO bonds enthusiastically today with the top eight firms bidding for the entire offering," Santarelli said in an e-mail.

Christie, in his second term, plans to announce next year whether he'll seek the nomination for president in 2016. He's in Canada through Dec. 5 to discuss energy, an issue that will be central to the Republican contest. He visited Mexico in September to press for expanded North American energy ties.

### **Building Classrooms**

Back home, Christie has struggled with New Jersey's budget as revenue falls short of projections and pension, benefit and debt costs eat up more of annual spending.

The bonds sold yesterday include \$450 million to build college classrooms and labs for science, technology, engineering and math programs. The balance is for environmental projects.

Christie campaigned for the \$750 million Building Our Future Bond Act, as did Senate President Steve Sweeney, a Democrat. They've said college projects would create construction jobs and attract students, a boost for a state that trails the U.S. and its neighbors in recovering from the 18-month recession that ended in June 2009.

New Jersey's unemployment rate, at 6.6 percent in October, compared with 5.8 percent nationally, 6 percent in New York and 5.4 percent in Pennsylvania.

## Casino Faith

Christie's faith in another promised revenue generator, the gambling destination Atlantic City, hasn't paid off, as four of 12 casinos stopped operations this year while a fifth, Trump Taj Mahal, plans to close this month. He has yet to identify a permanent funding source for the Transportation Trust Fund, the highway repair and construction account that will run dry next fiscal year, and hasn't said how he plans to resolve the shortfall in pensions and retiree health benefits.

New Jersey's retirement system had enough assets to cover 32.6 percent of projected liabilities as of June 30, according to a bond-offering supplement released Nov. 25. That compared with 54.2 percent a year earlier.

The lower ratio is because of new Governmental Accounting Standards Board rules that change how states must calculate underfunding. New Jersey was the first to disclose the numbers under the new requirement, Fitch Ratings said in a Nov. 25 report.

New Jersey in 2013 made 28 percent of the required pension payment, the worst among U.S. states, according to Loop Capital Markets, a bond underwriter in Chicago.

### 'No Signs'

Tom Kozlik, a municipal-bond analyst for Janney Montgomery Scott LLC in Philadelphia, said the funding is the biggest cause for concern that New Jersey debt will grow riskier.

"There are currently no signs that a significant amount of reform will occur to New Jersey's spending or budgeting habits," Kozlik said by e-mail after the bond sale. "Balance requires a significant amount of political will, but the longer state political actors wait, the more politically and financially difficult changes become."

New Jersey requires voter approval to issue general-obligation bonds, which are backed by the state's taxing power. The state had about \$35 billion of bonds as of June 2013, including \$2.4 billion of general obligations, according to its most recent debt report.

The general obligations are rated A1 by Moody's Investors Service, the fifth-highest investment grade, and A, one step lower, by Standard & Poor's and Fitch. Only Illinois has lower rankings among U.S. states.

Zia Ahmed, a spokesman for Charlotte, North Carolina-based Bank of America, didn't have a comment on the sale.

Bloomberg

By Elise Young and Michelle Kaske

Dec 3, 2014 5:00 PM PT

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Mark Tannenbaum, Alan Goldstein

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## **Slowing Cigarette Sales Could put Virginia Tobacco Bond Payments at Risk.**

The company that funded Virginia's tobacco commission is spending more money than it takes in, which could leave some big investors feeling burned because they bet people wouldn't quit smoking as fast as they have.

But the Virginia Tobacco Settlement Financing Corp.'s red ink isn't likely to be a headache for the state or its tobacco commission. When Virginia sold investors a half-interest in the annual payments tobacco companies promised it under their multibillion-dollar settlement with states, the paperwork very carefully said the state would not be on the hook if that flow of funds wasn't as big as people expected.

And it hasn't been.

The Settlement Financial Corp. paid Virginia more than \$1 billion in return for half the tobacco companies' annual payments to the state. To finance that payment, the Settlement Financial Corp. sold bonds - it raised about \$1.2 billion in 2007 by selling bonds with a face value of just over \$2 billion, but marketing them at a deep discount to that face value. That translated to a return to investors of nearly 9 percent on its tax-exempt bonds - about twice the rate on U.S. Treasury bonds - and nearly 11.7 percent on its taxable bonds, assuming they are repaid in full in 2047.

That's not looking too likely these days, said Evelyn R. Whitley, the state's director of debt management, who oversees the financing corporation's operations.

Virginia's not alone. In a recent report, Moody's Investor Services estimated that 80 percent of the \$97 billion that states raised by selling similar bonds won't be repaid in full if cigarette sales slow even more.

The big cigarette companies have been making smaller payments to states than most experts had forecast when the settlement was negotiated in 1998.

The reason is that smokers have been quitting or shifting to discount brands that aren't participating in the agreement in larger numbers than expected. The participating tobacco companies' payments are based on sales. Last year saw a particularly steep dip. A decline that had averaged about 3 percent a year since 2000 amounted to nearly 5 percent in 2013, in large part because of the rapid growth of e-cigarettes according to municipal bond analysts at UBS Financial Services.

That means revenue from the financial corporation's share of the state payments has been running as much as \$20 million a year below the interest payments it makes on its bonds in recent years.

The corporation got a bit of breathing room in July, when it negotiated a settlement of claims from the bankrupt investment bank Lehman Brothers. That brought in a \$13.6 million payment in October, and should mean additional payments in the future, Whitley said.

But shortfalls are likely to continue as more and more smokers quit, and it won't take many years to run through the corporation's \$85 million reserve fund, which it taps when its revenue falls short of the interest it has to pay on its bonds, Whitley said.

When that happens, she said, the state has three choices:

- It can let the corporation pull the plug on itself and go into default.

- It can see if the investors who bought the bonds - mostly hedge funds and other investment pools specializing in high risk securities - might be interested in refinancing them, basically by agreeing to accept less than the face value of the bonds.
- The General Assembly could consider giving the corporation a larger share of the state's tobacco settlement revenue.

New Jersey took that third step in March, pledging to pay investors in its tobacco bonds the remaining \$60 million a year in tobacco settlement funds that it had been using for other state spending, such as the health programs the settlement was originally designed to fund.

"Investors understood the risks," Whitely said. And with the hefty interest they've received since buying the bonds, "they've been pretty well hedged against the risk."

The Daily Press

Dec 1, 2014

By Dave Ress

dress@dailypress.com

Ress can be reached by phone at 757-247-4535.

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## **Municipal Bond Volume Rises 15.3% in November.**

NEW YORK - Long-term municipal bond issuance rose for the fourth month in a row as volume increased 15.3% in November, according to Thomson Reuters data.

### **Monthly Data**

New issue supply rose to \$28.330 billion in November as 922 new deals came to market, up from the \$24.563 billion in 841 deals that were priced in November of 2013, according to the final report.

November's supply, however, was lower than October's total of \$34 billion in issuance.

Tax-exempt volume increased 18.9% in November to \$25.684 billion in 842 deals, compared to \$21.599 billion in 746 deals in the same period last year. Taxable sales rose 65.4% to \$2.138 billion in 69 deals from \$1.293 billion in 77 sales in November 2013.

Negotiated sales rose 9.8% to \$20.381 billion in 580 deals from \$18.556 billion in 468 deals last year. Competitive sales jumped 73.8% to \$7.474 billion from \$4.300 billion in the same period last year. Private placements plunged 72.2% to \$474 million in eight deals from \$1.707 billion in 65 deals in November 2013.

While the string of new issue gains has been unbroken for several months, some analysts and traders are predicting a decline in volume over the near- and long-term.

Alan Schankel, a managing director at Janney Capital Markets says his firm forecasts falling issuance through 2017.

Some of the factors Janney sees as keeping issuance low include higher interest rates, which would

result in lower refunding amounts and austerity measures instituted by issuers.

But not all had a down outlook for municipals in the short-term.

James Colby, senior municipal strategist and portfolio manager at Van Eck Global, said that November was a good month for the market overall.

"This was a better month for underwriters, issues and all those who wanted to see a bit of variety on the calendar," Colby said.

Colby said there had been a recent deficit of muni supply versus muni demand.

"The supply and demand gap narrowed in November," he said. "It was a strong month in terms of supply."

Data from Siebert Brandford Shank show that municipal bond new issue supply was \$264 billion while demand, meaning money from bond calls, maturing bonds and coupon payments, totaled \$351 billion as of Oct. 31, according to Van Eck.

Refundings surged 92% in November to \$12.075 billion in 401 issues, from 6.291 billion in 257 issues in the same period last year. However, new money issues totaled \$11.996 billion in November in 468 deals, down 5.2% compared with \$12.653 billion in 513 issues last year. Combined new money and refunding issues totaled \$4.259 billion, down 24.2% from \$5.619 billion in November 2013.

General obligation bond sales increased 49.9% in November to \$12.248 billion in 584 issues from \$8.169 billion; revenue bond issuance slipped 1.9% to 16.082 billion in 338 issues from \$16.391 billion in 334 issues a year earlier.

Electric power issues showed the biggest gain of the month, rising 228.9% to \$724.6 million in 13 issues from \$220.3 million in 13 issues last year. Also logging big gains were public facilities bonds, which rose 132.1% to \$1.086 billion in 47 issues from \$468.1 billion in 52 issues in the same period last year. The biggest losers were development bonds which dropped 58.5% to \$454.9 million in 20 issues from \$1.095 billion in 39 issues last November; and housing bonds which fell 24.3% to \$792.2 million in 36 issues from \$1.047 billion in 38 issues in November 2013.

Bond insurance gained in November, rising 16.7% to cover \$1.795 billion in 145 issues compared to \$1.538 billion in 91 issues in the same period last year. Insured mortgages rose 1,462% to \$40.6 million in November in one issue from \$2.6 million in a single issue last year.

Meanwhile, municipalities continued to waver in their sales of municipal bonds in November.

State governments issued 14.1% more bonds in November, with the total rising to \$3.828 billion in 17 issues from \$3.357 billion in 30 issues in the same period last year. But offerings at state agencies declined by 21.5% to \$6.308 billion in 88 issues from \$8.038 billion in 108 issues last year.

Issuance by counties and parishes dropped 40.2% to \$1.818 billion in 51 issues from \$3.042 billion in 72 issues last year while issuance in cities and towns rose 17.5% to \$2.937 billion in 245 issues from \$2.499 billion in 229 issues in the same month last year.

Districts issued \$73.5% more bonds at \$5.714 billion in 375 deals, up from \$3.293 billion in 293 deals last year; local authorities sold \$6.950 billion in 131 issues, up 88.8% from \$3.680 billion in 2013.

For the year to date, California ranked as the No. 1 state in new municipal issuance with sales of \$41.549 billion, down 8.7% from \$45.532 billion last year. Texas ranked second, with \$34.745 billion in bond sales, up 11.2% from the same 11 month period last year.

THE BOND BUYER

BY CHIP BARNETT

NOV 26, 2014 1:13pm ET

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## [\*\*Are Muni Bonds Being Replaced by Direct Loans?\*\*](#)

Municipalities and banks are getting friendlier, and it's starting to irk credit rating agencies.

Earlier this year, Wisconsin pulled off a fancy financing maneuver designed to avoid an expected increase in interest rates. Rather than waiting until next year to go to the municipal market and refinance a certain set of bonds, the state got a \$278 million loan secured directly from a bank. In doing so, Wisconsin locked in 2014's lower interest rates and can pay off bondholders next year with the proceeds.

This particular refinancing tool, called a delayed draw term loan, is complex and likely only to be used by more sophisticated issuers like large municipalities or states that are very accustomed to selling bonds. But it's one of many examples in recent years where a government has skipped issuing debt in the municipal market and just borrowed the cash instead.

Sometimes, said Cook County, Ill., CFO Ivan Samstein, the best deal is through a bank. "It's the ability to do a lower-cost transaction because of lower fees and a cost of capital," he said. "I think that's what driving issuers to work directly with banks." In recent years, Cook County has refinanced most of its floating rate bonds through banks instead of the market, moving from about \$130 million a few years ago to \$370 million with banks today.

In fact, over the last five years, banks in general have nearly doubled their municipal holdings to \$425 billion in securities and loans, up from \$225 billion at the end of 2009, according to a recent Moody's Investors Service report. The practice is becoming so prevalent that muni analysts say it's contributed to the slower pace of new bond issuance over that same five-year period.

The increased borrowing by municipalities has irked credit ratings agencies, leading Moody's and Standard & Poor's to call for better uniform disclosures of bank loans to governments. S&P even warned issuers that a delay in providing the information could have "negative rating implications."

Obviously people secure bank loans all the time, so why the fuss when governments do it? The main reason has to do with transparency — like credit analysts and investors who are assessing a government's risk exposure need to know where that government's money is going. Large issuers like Wisconsin have already made a habit of notifying the public of any private financings. But as direct loans and other private structures have become more prevalent among smaller, less frequent issuers, credit analysts are often learning about them from year-end audits rather than from the borrower at the time of the loan. That means that, thanks to the lag time in issuing these reports, the full details of a bank deal may not be publicly known until a year after the fact.

And that's a problem. Ratings agencies aren't just looking at governments' comprehensive debt

positions but also at the terms associated with these deals, said S&P analyst Henry Henderson. “That’s probably our biggest concern with the direct purchase sector,” he said. “If there are different terms [than a typical loan agreement], we feel that it’s important that’s disclosed to the public.”

Rating agencies are not alone. Like Wisconsin, Cook County is one of the experienced issuers that voluntarily reports its bank deals with the Municipal Securities Rulemaking Board, the body that sets rules for the municipal market and its users. The board doesn’t require governments to disclose bank deals, but two years ago it published guidance on doing so. And starting next year, California is requiring higher standards for disclosing these types of direct loans. The law speeds up the deadline to file loan disclosures to 21 days. (It requires alternative forms of financing be included in existing bank loan transparency regulations.)

It could be a game changer. Not only will it make for a more informed market, Municipal Market Advisors’ Matt Posner points out it could actually reduce California’s borrowing costs because of this more complete picture for investors. And if that happens, other states will likely follow.

GOVERNING.COM

BY LIZ FARMER | NOVEMBER 26, 2014

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## **[GASB Issues Preliminary Views on Lease Accounting for State and Local Governments.](#)**

Norwalk, CT, November 20, 2014—The Governmental Accounting Standards Board (GASB) today issued for public comment a [Preliminary Views, Leases](#), which includes proposals to improve the accounting and financial reporting for leases for state and local governments from both a lessee and lessor perspective.

Many governments use leasing to finance certain necessary items—including vehicles, heavy equipment, and buildings—without having to actually purchase them. Some governments also serve in a lessor capacity by leasing assets to other entities.

The purpose of the Preliminary Views is to obtain comments from stakeholders on the Board’s views before developing more detailed proposals for changes to existing accounting and financial reporting standards. The Preliminary Views presents the Board’s current thinking on the issues associated with accounting for leases—which are based on the foundational principle that all leases are financings of the right to use an underlying asset.

The document includes proposals on how leases would be presented in the financial statements and essential information related to leases that governments would disclose in the notes.

Under the proposal, lessee governments would report the following in their financial statements for all leases except short-term leases (12 months or less):

- An intangible asset that represents the government’s right to use the leased asset
- A corresponding liability for lease payments
- Amortization expense related to the lease asset (recognizing the asset amount as an expense over the term of the lease)
- Interest expense related to the lease liability

Government lessors would report the following in their financial statements for all leases except short-term leases:

- A receivable for the right to receive payments
- A corresponding deferred inflow of resources to reflect resources related to future periods
- Lease revenue (and a corresponding reduction in the deferred inflow) systematically over the term of the lease
- Interest revenue related to the receivable

“The Preliminary Views more closely aligns the accounting and financial reporting for leases with the economic substance of those transactions,” said GASB Chair David A. Vaudt. “The Board has an opportunity to make changes to the current guidance on leases that would result in greater transparency, reduced complexity in application, and more meaningful information for financial statements users.”

The Preliminary Views is available on the GASB website, [www.gasb.org](http://www.gasb.org). Stakeholders are encouraged to review the proposals and provide comments by March 6, 2015.

The GASB will host public hearings on the Preliminary Views on April 8, 9, and 10, 2015. Locations and other details, including instructions for registering to participate, are highlighted in the document.

#### About the Governmental Accounting Standards Board

The GASB is the independent, not-for-profit organization formed in 1984 that establishes and improves financial accounting and reporting standards for state and local governments. Its seven members are drawn from the Board’s diverse range of stakeholders, including preparers and auditors of government financial statements, users of those statements, and members of the academic community. More information about the GASB can be found at its website, [www.gasb.org](http://www.gasb.org).

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## **[GASB Issues Preliminary Views on Reporting Governments’ Fiduciary Responsibilities.](#)**

Norwalk, CT, November 20, 2014—The Governmental Accounting Standards Board (GASB) today issued for public comment a [Preliminary Views, Financial Reporting for Fiduciary Responsibilities.](#)

The Preliminary Views presents the Board’s current thinking on fundamental issues associated with the reporting of activities in which a government has a fiduciary responsibility. In this context, fiduciary responsibility generally relates to a government controlling assets belonging to others in a trustee or custodial capacity.

The Board’s primary objective in this project is to enhance the consistency and comparability of when and how governments report their fiduciary activities in basic financial statements. The purpose of the document is to obtain comments from stakeholders before developing more detailed proposals for changes to existing financial reporting standards.

“The current state and local government accounting and financial reporting literature does not adequately define what constitutes a fiduciary responsibility,” said GASB Chair David A. Vaudt. “The changes the Board is proposing would give governments and their auditors clearer guidance for determining which activities should be reported in fiduciary funds and in which type of fiduciary

fund the activities should be reported.”

The Preliminary Views proposed by the Board, if approved as a final Statement, would enhance reporting of fiduciary activities by:

- Defining when a government has a fiduciary responsibility and, therefore, is required to present fiduciary fund financial statements
- Clarifying financial reporting requirements for fiduciary responsibilities, including a requirement for business-type activities that serve in a fiduciary capacity
- Introducing the use of a financial statement that reports the inflows and outflows of resources for all fiduciary fund types

“This proposal would provide financial statement users with needed information regarding both general and special-purpose governments, including business-type activities such as public universities, hospitals, and utilities, which generally have not reported their fiduciary activities in the past,” said Mr. Vaudt.

The Board’s views presented in the document were informed based on extensive outreach with stakeholders during the pre-agenda research phase.

The Preliminary Views is available on the GASB website, [www.gasb.org](http://www.gasb.org). Stakeholders are encouraged to review the proposals and provide comments by March 6, 2015.

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### **[S&P: U.S. State OPEB Liability is Stabilizing, But Funding Remains Low, Report Says.](#)**

NEW YORK (Standard & Poor’s) Nov. 17, 2014–Total unfunded state other postemployment benefit (OPEB) liabilities are stable from last year, although funding ratios remain low for the nation’s combined \$529.8 billion in liabilities, said a report published today by Standard & Poor’s Ratings Services.

The report entitled, “Diverging Trends Underlie Overall Stable U.S. State OPEB Liability,” highlights states that have done the most to reduce absolute OPEB liabilities, led by North Carolina, Michigan, and Hawaii, as well as those for which liabilities have actually increased, including Texas, New Jersey, and Alaska. The report also notes that proposed changes to the Governmental Accounting Standards Board (GASB) to make future OPEB reporting align with new

standards for pension reporting could improve the ability to compare OPEB liability across states.

A companion to this OPEB report, "Proposed GASB Changes To OPEB Reporting Could Enhance Comparability But Reduce Information On Funding Progress," also published today, outlines proposed GASB changes and the effect they could have on how states report OPEB liabilities. If implemented, the new rules could improve OPEB comparability but obscure information on a state.

Standard & Poor's annual survey of U.S. states OPEB liabilities shows only a 0.1% decline from last year's report, showing some states' practical measures to address rising health care costs and the largely unfunded status of OPEB trusts, taking into account divergence among states.

"We believe states' efforts to address OPEB liabilities have slowed the growth in total unfunded liabilities in the past several years," said Standard & Poor's credit analyst Sussan Corson.

"Funding ratios have also improved slightly for most states that have established OPEB trusts, and changes to certain states' OPEB plan design or eligibility requirements have also led to declines," Ms. Corson continued. "Conversely, some states continue to report rising OPEB liabilities that could eventually pressure budgets and credit unless addressed," Ms. Corson concluded.

Despite the overall stability of state OPEB funding, several states have reported large changes in their actuarial unfunded liability since our last survey. The largest absolute decline in unfunded OPEB liabilities based on updated OPEB valuations in the past year occurred in Michigan, North Carolina, and Hawaii.

The OPEB report also notes the effect of the Patient Protection And Affordable Care Act on long-term health care costs that will continue to affect states and could provide both opportunities and costs.

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## **[Pensions Case Study: North Riverside.](#)**

Illinois' municipal pension shortfall, excluding Chicago, has spiked to more than \$12 billion from \$1 billion just a decade ago. Municipalities are suffering the consequences. They're cutting core services, raising taxes and adding new fees to pay for their increasing government-worker pension costs.

The problem is local governments have their hands tied when it comes to pension reform. The Illinois state legislature sets municipal pension laws with no regard to whether the local budget and taxpayers can afford them.

But the village of North Riverside found a way to get around the General Assembly's road block to pension reform. North Riverside plans to move its entire fire department to a private provider of fire protection services - a private provider with a 401(k)-style retirement plan. The village plans to transfer its 12 firefighters and four lieutenants - and their full salaries - to the same private company that's been providing the village's ambulance service for nearly 30 years.

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ILLINOIS POLICY

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NOVEMBER 11, 2014

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## **[Pay-for-Success Is Gaining Momentum, Study Finds.](#)**

The inaugural round of grants from the federally funded pay-for-success program is already spurring growth of performance-based contracting nationwide, according to a recently published report.

"It is a little like throwing a match on some dry kindling," said Patrick Lester, director of the Social Innovation Research Center and the report's author.

In October, the program, administered by the Corporation for National and Community Service, announced \$12-million for eight grant recipients. They included the Harvard Kennedy School Social Impact Bond Technical Assistance Lab, Third Sector Capital Partners, and the Corporation for Supportive Housing. The grantees play a critical intermediary role in performance-based contracting, identifying communities in need and making subgrants to government agencies and direct service providers.

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The Chronicle of Philanthropy

By Megan O'Neil

November 17, 2014

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## **[Jones Day: Nine Lessons From Detroit's Chapter 9 Case.](#)**

On November 7, 2014, Judge Steven Rhodes, the judge presiding over the City of Detroit's bankruptcy case, announced that he would confirm the City's proposed Plan of Adjustment (the "Plan"), including the creditor settlements contained within that Plan. A more detailed written opinion will follow, but the opinion read from the bench on November 7, together with an earlier opinion in this case, are among the most important precedents in U.S. municipal bankruptcy law. Indeed, the City's bankruptcy proceedings more generally—the significant reduction of both bond and pension and retiree health debt, the speed with which the City emerged from bankruptcy, and the largely consensual nature of the Plan—make clear that municipal bankruptcy law can be successfully used to restructure debt and provide a fresh start to cities, counties, towns, school districts, and other general-purpose municipalities.

The Plan that Judge Rhodes confirmed is itself noteworthy. It eliminates more than \$7 billion of Detroit's debt and other legacy liabilities and defers repayment of the principal of most of the remaining unsecured debt for at least nine years. Apart from reducing the City's debt load, the plan makes about \$1.7 billion available over the next 10 years for restructuring and reinvestment initiatives to address blight, restore the City's infrastructure, and enable the City to improve the services it delivers to residents, especially those promoting public safety. That a Plan of Adjustment with these features was even proposed is a radical departure from what has been the norm in municipal restructurings. Most of the time, municipal restructurings involve modest, if any, adjustments to debt, with austerity measures imposed on the debtor municipality after years of chapter 9 litigation. Here, the City's Plan of Adjustment was proposed, ultimately accepted by almost all classes of creditors, and judicially approved in less than 17 months from the date of the City's chapter 9 filing. That is nothing short of remarkable.

The agreements embodied in the City's Plan of Adjustment, as well as Judge Rhodes's rulings, thus provide several important lessons for investors, municipal and state leaders, and public-sector labor unions.

**1. Unsecured creditors have more limited rights against governmental borrowers than against corporate ones.** For example, municipal unsecured creditors usually cannot attach, levy against, or otherwise compel the sale of assets of a municipality, whether such assets are characterized as core or not. Frequently, municipal unsecured creditors can collect only out of the municipality's excess cash (unlikely to be available when a municipality is in distress) or the proceeds of increased taxes (if taxes can be increased without further damaging the municipality's ability to retain residents and businesses). Judge Rhodes determined that the commencement of a chapter 9 case does not expand these rights.

**2. General obligation ("GO") bonds, usually regarded as the safest type of municipal bonds, are not immune from impairment in a chapter 9 bankruptcy.** While GO bonds often are said to be "secured" or backed by a "pledge" of the taxing power of the municipality, these bonds are not necessarily actually secured by collateral. Instead, in municipal finance, these terms may mean only that the issuer has promised to pay the bonds out of a specified revenue stream and that it will raise taxes to do so if necessary. Judge Rhodes noted that the question of whether one type of GO bond

represented a secured claim that is enforceable in bankruptcy was a “coin toss.” As to a second type of GO bond, his opinion suggests that there was an approximately 75 percent probability that it would be regarded as unsecured and that the settlement that resulted in a 41 percent distribution to holders of such bonds was at the high end of the range of reasonableness.

**3. Where a municipality cannot provide essential services, the municipality’s need to do so may well come before the interests of GO bondholders and other creditors.** If there are real constraints on raising taxes—for example, if tax delinquency rates are already high or the municipality will suffer further decline by raising taxes—bankruptcy courts will not require the municipality to increase taxes. In other words, all creditors, including GO bondholders, are exposed to risk if the municipality cannot provide adequate services to its residents and its tax base is stressed.

**4. Municipal bonds often do not include certain protections that are becoming standard in corporate debt instruments, subjecting municipal bondholders to avoidable risks.** In Detroit, holders and insurers of municipal bonds secured by special revenues were seemingly surprised to learn that bankruptcy courts may well have the power to reset bond interest rates if the rates are above market levels when a plan is considered for confirmation. This has been the law in corporate bankruptcy for at least 35 years, and corporate debt documents have evolved to include “make whole” provisions that, when properly drafted, may substantially protect bond holders from interest rate reductions. Not one of the City’s debt documents included these provisions. Few municipal bonds do.

**5. State-law limits on a municipality’s ability to issue and collateralize debt are important, and the legality of debt instruments designed to circumvent such limits is highly questionable.** In Detroit, some lenders had accepted obligations that were structured to avoid the City’s debt limits. Ordinarily, legal opinions protect investors from this kind of risk, but in appropriate cases, the opinions can successfully be challenged. As a result, holders of some obligations face the real possibility that their claims might not be enforceable at all.

**6. State constitutional protections for accrued pensions, like protections against the impairment of contracts more generally, give way to federal bankruptcy power.** As a result, accrued but unfunded pensions are likely not immune from impairment by a federal bankruptcy judge. In perhaps the most widely reported decision in the City’s case, Judge Rhodes held that the Michigan Constitution’s Pensions Clause, which provides that accrued pension benefits are “contractual obligations” that cannot be “diminished or impaired” by the state or its political subdivisions, stood as no obstacle to the impairment of pension claims in chapter 9. That Clause, Judge Rhodes held, merely conferred contractual status on pension claims, and the bankruptcy court’s power to impair municipal contracts is well-established—indeed, municipal bankruptcy would be worthless without it. In Stockton’s bankruptcy case, Judge Klein recently reached the same conclusion with respect to similar protections under California law.

**7. In the face of unsustainable pension obligations, the emotional, hot-button issue of pension cuts can be consensually resolved with shared sacrifice.** Struggling municipalities often are confronted with large pension obligations. Faced with shrinking tax bases and increasing life expectancies, not to mention cost-of-living adjustments and other promises that may have been unrealistic even when made, many municipalities face unfunded pension obligations that cannot be satisfied. The decisions by Judge Rhodes make clear that these obligations can be reduced to realistically fundable levels and that these reductions can be achieved through agreement with retiree interest groups. In Detroit, the agreements also established hybrid pension plans to deliver future pensions for active employees. Such arrangements combined elements of defined benefit and defined contribution programs, and they may be a blueprint for pension reform in other distressed

municipalities.

**8. Customary funding assumptions for public pension plans may well be unrealistic.** As the City's pension expert testified, U.S. public pension plans historically have had "a policy that essentially believes that investment gains [are] permanent and losses [are] temporary." Government and labor leaders, and their pension trustee appointees, need to eschew these "bet on the come" assumptions in favor of more conservative funding and investment approaches. Indeed, in his oral opinion, Judge Rhodes expressly embraced the importance of labor leadership bargaining for appropriate funding of pension benefits, and he admonished labor unions, the City of Detroit, and the State to employ more "honest and realistic accounting and actuarial" assumptions for both pension funding and liability disclosure. Negotiating for ever-increasing pension benefits and assuming that they will ultimately be funded may no longer be an appropriate bargaining strategy.

**9. Differences in treatment of unsecured creditors does not necessarily lead to a finding of "unfair discrimination."** As Judge Rhodes saw it, the recovery for a class of unsecured pension claims was estimated at as much as 60 percent while the recovery for another class of unsecured creditors was estimated at 13 percent. To Judge Rhodes, this was not unfair discrimination for several reasons: the City had a "strong interest in preserving its relationships with its employees and in enhancing their motivation, consistent with its financial resources," the discrimination was related to the City's mission of providing adequate services to residents, and more favorable treatment of pension claims was consistent with the reasonable expectations of creditors given the Pensions Clause in the Michigan Constitution. This determination will be surprising to many municipal bond market observers who have noted that in many prior cases, claims of bondholders have received greater recoveries than the claims of municipal employees.

To be sure, and fortunately, chapter 9 bankruptcy cases and even municipal defaults are likely to remain rare. Indeed, municipal bonds will likely remain relatively safe investments, and many municipalities have strong tax bases, carry reasonable amounts of debt, and can provide services that are sufficient to retain or even attract residents and businesses. Nevertheless, when evaluating debt of issuers with weaker tax bases and higher debt loads, or extraordinary and unsustainable legacy liabilities, the Detroit case provides important lessons for all municipal stakeholders. And for municipalities that are inexorably headed to insolvency, the Detroit chapter 9 case provides a playbook for the swift and successful application of chapter 9.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Last Updated: November 21 2014

Article by Bruce Bennett, Evan Miller, Beth Heifetz, Heather Lennox, Corinne Ball and David G. Heiman

Jones Day

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## **[S&P: Detroit's Bankruptcy Plan Outcome Will Not Lead to a Reevaluation of Recovery Assumptions for Bond Insurers.](#)**

The approval of Detroit's plan of adjustment will require the legacy bond insurers to continue to make claim payments related to the city's unlimited tax General Obligation (GO) bonds. When

considering the claims the bond insurers have already paid and those they will pay in the future, the ultimate loss given default for bond insurers' insured exposures in the aggregate is approximately 26% of debt service. The claims that Assured Guaranty Ltd. (Assured) and National Public Finance Guarantee Corp. (National) will make on future debt service for their unlimited tax GO insured exposure are much less than 26%, with Detroit responsible for the balance of the payments. For Assured and National, the capital adequacy analysis Standard & Poor's Ratings Services...

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Report Published 2014/11/20

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## **States' Finances Are Now on Solid Ground: Barron's.**

U.S. states represent one of the most secure areas of the global bond market, typically benefiting from low debt levels relative to the size of their economies, and the ability to cut spending and raise taxes during tough times.

Even when hefty pension obligations and unfunded employee health-care liabilities are taken into account, state credit quality generally is strong. The \$518 billion of state general-obligation bonds and other state-supported debt are probably the best slice of the \$3.7 trillion municipal-bond market. General-obligation bonds are backed by the issuer's full faith and credit.

"The most important factor about state credit quality is that states are sovereign entities that have the ability to raise revenues or cut spending as needed," says Tom Kozlik, a municipal analyst at Janney Capital Markets in Philadelphia. There hasn't been a state-government default since the Depression.

Reflecting all of this, both Moody's Investors Service and rival Standard & Poor's give a triple-A rating to 15 states. Only Illinois and New Jersey have a Moody's rating below double-A. In contrast, just three U.S. companies, ExxonMobil (ticker: XOM), Microsoft (MSFT), and Johnson & Johnson (JNJ) have triple-A ratings from both rating agencies. Even the U.S. government lost its triple-A rating from S&P in a controversial 2011 action, and mighty Apple (AAPL), with its \$120 billion of net cash and \$40 billion of annual income, merits only a double-A1 rating from Moody's and a AA+ from S&P, a notch below triple-A.

"While most state credits are stable and have improved in the past three years, a few have struggled. Illinois, New Jersey, and Connecticut aren't fully funding their pension obligations, have thin financial reserves, are structurally imbalanced, and are using one-time revenue sources to balance budgets," says Jim Evans, a portfolio manager at Eaton Vance, an investment manager with a specialty in municipal bonds.

Atop the list are North Dakota, Wyoming, and Utah, which boast modest liabilities, ample cash, and strong economies.

New Jersey's fiscal woes, which stem largely from a lackluster economy and persistent underfunding of its pension program, could have political implications if Republican Gov. Chris Christie enters the 2016 presidential race.

Fiscal trends generally have been positive. Nearly every state has enacted some pension reform since 2009 that either reduces benefits or increases employee contributions, and debt issuance has

been light in the past two years. And laggards New York and California have shown improving finances and garnered rating upgrades.

There are some negatives. State tax revenue fell 1.2% in the second quarter, marking the first quarterly drop since 2009, Rockefeller Institute data show. And many states continue to underfund their pension plans. Most have set aside no reserves to finance postretirement health-care benefits for employees. These expenses are paid annually out of the state budget. In that regard, some investors are worried about the Detroit precedent. Bondholders fared worse than pensioners in the city's bankruptcy settlement, and that treatment could be repeated if a state gets into financial distress. The situation is the same in troubled Puerto Rico. Island politicians are putting local interests and constituents ahead of bondholders.

**STATE GENERAL-OBLIGATION**, or GO, debt has rallied this year in a strong muni-bond market. Total returns (income plus capital appreciation) so far in 2014 on long-term munis are about 13%. When Barron's looked at the states a year ago ("Munis on the Mend," Cover Story, Oct. 14), most state GO debt with maturities of 30 years carried yields in the 4.2% to 4.7% range, with the only outlier being Illinois, whose debt yielded about 5.75%. The 30-year Treasury stood at 3.75%. We argued then that state GOs were a "good play for risk-averse investors."

It's harder now to get excited about state GOs—and other munis—with many long-term state GOs offering yields in the 3.2% to 3.6% range. Illinois remains an exception, with a 4%-plus yield. California's 30-year debt is about 3.45%, and Connecticut's, 3.6%, while top-rated states like Virginia and Minnesota are closer to 3.2%.

New Jersey long-term general-obligation debt yields about 3.75%, but it trades lightly because only about \$2 billion is outstanding. The more actively traded bonds are the state's \$32 billion of debt supported by legislative appropriation, such as the New Jersey Transportation Trust Fund Authority. These carry a slightly lower rating than Jersey GOs and can yield 4.25% or more.

Yields on state general-obligation paper compare favorably with the 30-year Treasury's 3%, especially on an after-tax basis. Yet, absolute yields aren't high and provide little cushion above inflation, and investors could suffer sizable losses if rates do rise and they sell their bonds before maturity.

The [table](#) on this page shows the yield premium, measured in hundreds of a percentage point, of 10-year state general-obligation debt above a triple-A benchmark, now 2.15%. Reflecting strong state credit quality, most 10-year GOs trade close to the triple-A benchmark. It should be said that ratings and spreads for some states are more indicative than real, because they have little or no GO or state-supported debt outstanding. These include Nebraska, Wyoming, and North and South Dakota.

Barron's has looked at state financial health for the past three years using data compiled by Eaton Vance. This year's tally differs from last year's because it offers a more comprehensive picture, based on about 10 measures that factor in assets, liabilities, and other gauges of economic health. The 2013 rankings were based only on the states' debt and pension liabilities relative to their economic output. That approach had merit because it highlighted the growing pension burden in many states—an issue to which many investors have paid little attention.

The broader approach taken by Eaton Vance this year offers a holistic look at state finances beyond debt and pension liabilities. The firm has added other post-employment-benefit, or OPEB, liabilities, which is dominated by unfunded health-care obligations to get a more complete snapshot of state liabilities. The total of those three figures, relative to each state's economic output, is shown in the table on page 24.

**PENSION AND HEALTH-CARE** liabilities matter because they dwarf outstanding state debt and aren't easily extinguished, thanks to legal protections. Eaton Vance puts unfunded state pension and health-care costs nationwide at \$1.6 trillion, or three times the amount of state debt. The firm estimates health-care liabilities because states don't provide much information on which portion is their responsibility and which portion is the obligation of local governments. Eaton Vance assigns the full health-care burden to the state, meaning the liability could be overstated. Whether overstated or not, unfunded postretirement employee health-care liabilities are a major problem for state and local governments. In the Detroit bankruptcy, one of the city's largest obligations was unfunded health-care costs.

Other factors that figure in Eaton Vance's proprietary analysis include the funding status of state pension plans and whether states are making the actuarially mandated contribution to their pension fund each year.

Some states, such as New York, have made ample annual contributions, while others, including New Jersey, Pennsylvania, and Illinois, have not. To balance their budgets, these states have skimmed on their pension contributions in recent years, but that simply defers the ultimate payment and has contributed to their weakening credit quality.

To evaluate debt-payment ability, Eaton Vance incorporates the asset side of states' balance sheets by looking at cash and investment levels. It also focuses on several economic indicators, including the jobless rate, the state's gross-domestic-product growth, wealth, tax burden, and population gains. The firm assigns different weights to each of the measures to come up with an overall state ranking.

"To get a true measure of state rating, you have to look at liquidity reserves and the health of the state economy and the state's ability to raise taxes," says Bill Delahunty, director of municipal research at Eaton Vance.

**THE TOP THREE STATES** aren't necessarily tops in the two categories shown in the table. In fact, North Dakota is 14th nationally in the debt, pension, and health-care measure.

Delahunty says that North Dakota is a prime example of why it's important to look beyond the debt, pension, and health-care total. The state has the lowest unemployment rate in the country, 2.7%, thanks to an energy boom, and it has had the highest economic-growth rate of any state over the past three years. North Dakota also has a large cash pile—enough to fully fund its pension plan and still have ample liquidity left over.

Wyoming has a healthy economy, minimal debt, the lowest tax burden of any state, and a large cash hoard, sufficient to support its budget for four years. And, Delahunty says, the state could fully fund its pension plan with a modest contribution from its rainy-day fund.

Wyoming Gov. Matt Mead emphasizes the importance of pension funding. "If I were a company moving to a state, I would want to know how those pension plans are doing because I wouldn't want to make a 20-year commitment to a state that's going to raise taxes because they're underwater on their pension plans," he tells Barron's.

With no state income tax, Wyoming is an anti-California—and it plans to stay that way. "I think it's very tempting sometimes to raise taxes if you want to raise revenue. But when I've seen the economic development we've had in the past 3½ years, I'm telling you, it's a huge deal to have the lowest taxes in the country," Mead adds.

Utah has little debt and makes ample annual contributions to its pension plan. The state also has one of the lowest jobless rates in the country and the second-highest median household income, adjusted for the cost of living, behind Virginia.

Despite Utah's sterling credit quality, Gov. Gary Herbert argues that there's room for improvement, such as cutting the state's modest debt of \$2.6 billion. "It's just a little bit high. Either way, we're one of only nine states with a triple-A bond rating [from all three main rating agencies]. So we're in pretty good shape. I just want to make sure we don't jeopardize that."

Alaska had the country's largest pool of cash and investments, totaling \$69.6 billion at the end of its fiscal 2013, stemming largely from energy taxes. That money is sufficient to fund the northernmost state's annual budget for five years, and Alaska is contributing money from that fund to shore up its pension plan.

The worst-ranked states, Illinois and New Jersey, do poorly when gauged by most key metrics. Illinois has the worst-funded pension plan among the 50 states—just 30%—based on Moody's analysis. Its total unfunded pension liability of \$168 billion also is the second worst in the country behind California, says Moody's. And Illinois has one of the highest rates of unemployment, at 8.4%.

In addition, Illinois' finances could get pressured because temporary income-tax surcharges start to expire on Jan. 1, 2015. "Illinois is underfunding its pension plan, and it's getting more and more difficult to climb out of that hole," Delahunty observes.

**PERSISTENT PENSION** underfunding in the administration of Gov. Chris Christie and his predecessors is plaguing New Jersey, which has one of the lowest funding ratios of any state and the worst average annual pension contribution over the past three years, relative to actuarially required levels. The worsened outlook has come despite the pension reforms that Christie pushed through in 2011.

"New Jersey continues to struggle with structural imbalance, and the governor's decision to reduce pension contributions in fiscal 2014 and 2015 highlights the fact that the state lacks the revenues to comply with its own agreed-on contribution to the pension system," S&P wrote in explaining its downgrade of New Jersey general-obligation paper to A from A+ in September. The rating agency added that the state is closing its budget gap by employing "one-time measures, such as legal settlements, debt restructurings, and pension-payment deferrals."

Big, scheduled, annual increases in the New Jersey pension contributions, to \$4.8 billion in fiscal 2018 from \$2.25 billion in the current year, threaten to crowd out other state expenditures. And with the nation's second-highest combined state and local tax burden behind New York, the Garden State has little room to hike taxes.

Pennsylvania, ranked No. 47, has been hurt by a weak economy and a growing pension liability. These factored into a Moody's downgrade in July, when the state's credit rating fell to Aa3 from Aa2. Tax-revenue growth has been sluggish since the recession, despite the state's energy boom tied to hydraulic fracturing in the vast Marcellus shale deposit.

Pennsylvania has a low, flat income tax rate of 3.1%—below the top rates of almost 9% in neighboring New Jersey and New York—but a tax increase looks unlikely.

Janney's Kozlik regularly is asked by investors about Pennsylvania's relatively low income tax. "Try running for governor in Pennsylvania and telling residents that you're going to raise their taxes because people in New York and New Jersey are paying more," he says. The combined state and

local tax bite in Pennsylvania, however, is in the top quartile in the country, according to data from [taxfoundation.org](http://taxfoundation.org).

A sluggish economy and weak pension funding are weighing on Connecticut. The state also has lost some of its appeal as a tax haven for New Yorkers because its top income-tax rate has risen to almost 7%.

**NEW YORK** is a bright spot in the fiscally challenged Northeast, thanks to the strength of the New York City economy, spending restraint, and conservative financial management, including strong pension funding. The state's unfunded pension liability is just over half of smaller Connecticut's. The Empire State continues to rely too heavily, however, on the superwealthy, including hedge fund managers and private-equity chieftains, who pay a large chunk of the state's income taxes. And the volatile income tax kicks in 60% of state revenue, about twice the national average.

California so far is defying supply siders who argued that a 2012 tax increase that lifted the top income-tax rate to 13%—for those earning more than \$1 million—would drive the affluent out of the state. It has the highest top tax rate in the country and doesn't offer a preferential rate on capital gains, which has meant that those cashing in options and restricted stock at highflying technology companies like Facebook (FB) and Twitter (TWTR) face a stiff combined federal and state capital-gains tax bite. California got a Moody's upgrade to AA3 from A1 in June, and the rating agency recently cited the state's "rapidly improving financial position." California has gone from having huge budget gaps after the 2008 recession to boasting a surplus in the latest fiscal year.

Like New York, California is heavily dependent on its income tax, which similarly kicks in 60% of revenue and is paid disproportionately by its ultra-rich. Structural impediments also are a problem in tough times because it takes a vote of two-thirds of the legislature to raise taxes.

**PUERTO RICO REMAINS** in a class by itself, with far higher yields than those of any state and a poor economic and financial situation. The commonwealth's benchmark 8% bond due in 2035 that was sold in a \$3.5 billion deal in March now trades at 87 cents on the dollar for a 9.4% yield. That's equivalent to a 15% on a fully taxable bond for someone in the top federal tax bracket. Few dollar-denominated bonds from any country yield so much, even before the tax benefit.

The issue for investors is whether that yield compensates for the risk, especially after Puerto Rico enacted legislation that is expected to lead to the restructuring of certain public utilities, including the island's electric and highway authorities. Reflecting this, the long-term debt of the public authorities trades around 50 cents on the dollar. The commonwealth's strategy is to wall off its GO debt and tax-supported Cofina bonds—the name comes from the Spanish words for Puerto Rico Sales Tax Financing Corp.—from the troubled authorities.

There's little evidence that the depressed Puerto Rican economy is turning around, and the island remains burdened by a badly underfunded pension plan. Eaton Vance analysts cite other negatives, including high electricity costs, population loss, and a looming budget gap in the current fiscal year, despite major initiatives to finally achieve balance. The commonwealth is considering a \$2.5 billion bond issue in the coming months that would offer a fresh test of investor demand.

Aside from Puerto Rico and a handful of states, credit quality is strong at the state level, making municipal bonds an attractive option for income investors. Too bad muni yields are so low.

BARRON'S

By ANDREW BARY

November 22, 2014

Additional reporting by Alexander Eule.

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## **[Wall Street's Taxpayer Scam: How Local Governments Get Fleeced — and So Do You.](#)**

A trick Wall Street uses with municipal finance is to make it seem complex. It isn't — here's what you should know

The news was buried somewhat by all the hubbub over President Obama's executive orders and the (manufactured) scandal over Jonathan Gruber (aka, History's Greatest Monster) but earlier this week, a movement to rein in Wall Street took a step activists hope is just the first of many. Galvanized in part by a recent blockbuster investigation on the damage done by a series of loans taken from Wall Street by Chicago Public Schools — which have not panned out and which Mayor Rahm Emanuel is trying to disown — opponents of Wall Street's "predatory loans" demanded action, using a new report from the Roosevelt Institute as a guide.

Titled "[Dirty Deals: How Wall Street's Predatory Deals Hurt Taxpayers and What We Can Do About It.](#)" the report is an in-depth look at one of Wall Street's most insidious but overlooked practices that also tackles how government officials can fight back — assuming, of course, that they're interested. Earlier this week, Salon called Roosevelt Institute fellow Saqib Bhatti to discuss his findings and recommendations for what those concerned about Wall Street malfeasance can do next. Our conversation is below and has been lightly edited for clarity and length.

**Could you explain to me what the relationship is like between Wall Street and municipal governments? Or is it too varied to say there's any single dynamic?**

There are, of course, some nuances from place to place, but in general there are some broad trends. The relationship between municipalities and Wall Street is largely broken because there's a very strong imbalance of power that exists or, at least, is perceived to exist. Banks typically set the rules of the game. They make recommendations for different types of deals municipalities should be doing, they pitch deals to them. Typically, municipalities may bargain around the margins but largely accept the rules as they're set by Wall Street.

When I say there's a perception of imbalance of power I use that word because, in reality, municipalities could have a lot more power if they chose to wield it. If they actually chose to play hardball or question some of the underlying assumptions that Wall Street brings into various municipal finance deals, they could potentially fight to get a better deal or to question the entire framework around how some fees are structured and so forth.

**And why is it that municipal governments even go down this road, dealing with banks? What makes this so irresistible?**

The reality is that there really is a revenue crisis in our country that's really affecting city and local governments. Over the course of the last 35 years it's been very hard to raise revenue, and so there are real budget problems that exist. Typically, what this means is that cities and states regularly have to borrow money and often the pitch from banks is, "Here's a way you can borrow for less!" or

“Here’s a way you can save some money!” That’s typically how it’s framed, as an exciting new product that can save you money. But what often isn’t factored in there is that new product could have a lot of risks built-in, and those risks actually have a dollar value and a real cost.

**And those would be the “predatory deals” you refer to in the report’s title. How are you defining a “predatory” deal?**

I think a predatory deal is one that really takes advantage of the vulnerabilities in the customer. I’d say they are typically characterized by high costs, high risks, high levels of complexity, and they’re often designed to fail or designed in a way where the bank is not concerned if they do fail.

**Do officials tend to know that these deals are structured in such a disadvantageous way? Do they think that for whatever reason they’ll make it work or outsmart the banks? Or do they often not know what they’re getting into?**

One of the big problems is that often the banks really downplay the risks or misrepresent the likelihood of the risks occurring. Often, government officials are really not aware that the risks could actually materialize. One of the things that’s featured prominently in the report is interest rate swaps. With interest rate swaps, in particular, one of the big problems was that there’s all sorts of risks that were embedded in the deals, and in the paperwork there’s all these disclosures that say these risks exist, but when the banks actually pitched the deals the pitch said not to worry about those risks. Or they would make projections of all the money the city could save but those projections were all based on none of those risks materializing.

Especially with products that are relatively new, that are not widely understood and where, frankly, in many cases they haven’t been around long enough to really understand what all the risks are, there is this huge problem that exists. The risks just are not disclosed on a level that they should be and in reality, that’s not just unethical, it’s also illegal and violates the Fair Dealing Standards of the Municipal Securities Ruling Board.

**So to take this more into the here-and-now, can you tell me a bit about a recent news story or event that involves this issue?**

There was a great Chicago Tribune investigation last week that looked at financial schemes that Chicago public schools (CPS) got into. CPS took out a series of auction rate securities, which they then linked together with interest rate swaps, and the idea was, it was pitched to CPS as a way to get a cheaper interest rate than taking out a traditional fixed-rate bond. A hypothetical example would be that if you were to take out a fixed-rate bond it might cost you 8 percent and the banks were basically saying that if you do this complicated scheme that involves all these auction rate securities and interest rate swaps and a few other things, you can essentially lock in a synthetic fixed rate of 6 percent, which is cheaper than 8 percent, and so you can save some money.

The problem was that there were a lot of risks associated with this. For instance, the 6 percent was not really a 6 percent. The synthetic fixed was actually not fixed because there were other variables in there that made it so that you weren’t really getting a fixed rate. There are traditional costs that were not properly represented to CPS. One of the other problems that existed in particular was that when the banks projected cost savings, they compared the deal to a more expensive one that CPS wouldn’t have gotten, so in this case it’s as though they made a cost-saving projection that was predicated on the idea that CPS would pay 9 percent otherwise, when, in reality, CPS would have paid 8 percent. They inflated the cost of the alternative to make it seem like a better deal.

There are a number of similar things that went on. One of the problems that eventually surfaced in

those deals was that the auction rate securities market completely froze up. When that happened, the variable interest rate on the underlying bonds actually skyrocketed. At the moment at which Bank of America in 2007 underwrote some of these auction rate securities deals, Bank of America officials were already aware of the fact that the market was headed for a meltdown — that’s an exact quote from the Tribune, “headed for a market meltdown” — and did actually still underwrite the deal for CPS to get these auction rate securities and didn’t warn CPS of this fact. That risk was not actually disclosed to CPS.

In reality, the bigger thing is that — and this is the part that’s often lost on public officials, unfortunately — when Wall Street banks are pitching deals their No. 1 goal is not to save money for taxpayers. Their No. 1 goal is to maximize profits for themselves. In this hypothetical situation where a bank says, “You can get a fixed rate for 8 percent or a synthetic fixed for 6 percent,” the reason they’re steering you towards the 6 percent deal is that they get to charge more fees because that deal is more complex. In a traditional fixed-rate bond, if the interest rate is 8 percent the banks get to charge some fees upfront for underwriting the bond but that interest, over time, is going to the bondholders and not back to the banks. In a synthetic fixed-rate structure, the interest that’s going to go to bondholders is much, much lower and the rest of the money is actually going to the banks.

The reason why they push you into these structures that have more complex transactions and more individual deals built into them is that with each of these deals, banks get to charge fees and collect more of that money for themselves instead of it going to bondholders or anywhere else. That’s the piece that’s often lost on public officials, is that no, the bank is not looking to do you a favor. They’re looking to maximize their own profits and, ultimately, those profits are coming at the expense of taxpayers.

**OK, so how do people end up experiencing this in their everyday lives? Obviously no one wants to see their tax dollars wasted, but that’s a somewhat abstract transaction — a few numbers on your monthly check or what have you. How does it become more tangible, the downside?**

I think it has a huge impact. For example, the Detroit Water Department in 2012 had to pay \$547 million in penalties to terminate interest rate swaps. Now more than 40 percent of the water bill that people pay in Detroit actually goes towards paying off that termination fee, and it’s hit the Water Department hard so now the Water Department is actually shutting off the water of Detroiters who have missed just a couple of payments on their bill. In the meantime, they’re actually paying out \$547 million in fees to banks on these deals.

There is strong reason to believe that if the Detroit Water Department pursued legal claims against the deals that they could have recovered some of that money, but instead of trying to recover the \$547 million they’re turning off the water on low-income, working-class people of color who are already struggling to get by.

In Chicago we’ve seen the impact of these finance deals in school closings. In Chicago we had the largest school closing in the history of the country when 50 schools were closed last year, presumably to save money. Based on CPS’ own estimates, each school closing would have saved up to about \$800,000, and in the meantime the school system is paying out \$36 million a year on its interest rate swaps. The Tribune estimated that this complex financing structure with auction rate securities is going to end up costing the school system \$100 million more than if it had chosen a fixed-rate traditional bond, and that’s actually a conservative estimate because it only looks at a small number of the deals that CPS has.

**You mentioned before that municipal officials have more control over this situation than**

## **they either think or want us to believe. What are some of the tools they could be using?**

There's a couple. There are some legal angles here, which is that for many of the deals that have taken place there have been a clear law-breaking risk. That's a case with things like the illegal manipulation of the LIBOR interest rates, that's happened with the way a lot of these auction rate securities and interest rate swaps were pitched and the risks misrepresented. There are some clear legal angles there, you can file for an arbitration with the Financial Industry Regulatory Authority under the Fair Dealing Standards of the Municipal Securities Ruling Board. You can also sue for state-based claims for breach of contract and fraud, where applicable.

Beyond that, there's some bigger stuff overall, which is just not done very often. Cities and states could actually play hardball with Wall Street. In reality, there are a lot of different fee structures, deal structures, that exist only because they're not really pushed back on, ever. For example, bond underwriting fees are typically a percentage of the total amount that's being issued, but in reality it's not any more work for a bank to underwrite a \$200 million bond than it is to underwrite a \$100 million bond and they get to make twice as much money. There's no reason why that's the case; there's no reason why it's a percentage, but if any one city were to try to buck that trend, they would say, "That's just not how it works."

The reality is that the market is not preordained. Right now, Wall Street sets the terms of the market and cities and states negotiate around the margins. What we need is to turn that on its head. If we actually had cities and states saying, "Here are the rules that we're going to operate by because this is what works for taxpayers," and Wall Street can take it or leave it, if they actually stand by that they can move the market. American taxpayer dollars are still one of the largest pools of capital that exist in the country, in the world.

The city of Los Angeles currently has a campaign where they're trying to reduce their fees. The city of Los Angeles is the second-largest city in the country. It also has a huge pension fund and many different agencies that it controls. If you actually have the city of Los Angeles take a hard line that says, "We won't do business with any banks that don't abide by this set of rules or that don't put the interests of taxpayers first," then they can actually change the way Wall Street deals with them. If you have enough cities getting together and saying they'll do that, that can have an impact.

In 2012 the Oakland city council managed to pass a resolution to boycott Goldman Sachs because they wouldn't renegotiate an interest rate swap. The city of Oakland by itself is relatively small, but if you had Oakland, Los Angeles, Chicago, Chicago Public Schools, New York, the New York Metropolitan Transportation Authority, all of these different bodies with interest swaps, if they were to pass similar resolutions they could renegotiate these interest rate swaps in a heartbeat. There's this power of numbers and we need cities and states to more effectively use their leverage as customers of Wall Street to renegotiate our relationship.

## **The report has a few recommendations for how government officials and citizens can address this problem. What are they?**

One is that we need greater transparency around the financial health of our cities; we need to know how much money we're paying out every year on financial years, and we need greater transparency in terms of the deals that we've entered into and the risks that are contained within them.

Secondly, we need accountability ... [if] we learn that the banks have broken the law, we need to actually litigate against them and get back the money they've taken from us. We need to hold them accountable, and then even where there is not illegal behavior, but there is unethical behavior, we need to use our leverage as customers of Wall Street to hold them accountable and try to get a

better deal.

Thirdly, we need to try to reduce fees, again using our leverage as customers of Wall Street.

The fourth recommendation is something I call “collective bargaining with Wall Street,” which is the idea of having cities and states across the country band together and try to change the conditions and terms that Wall Street operates under to better reflect the interests of taxpayers.

Fifth is creating more public options for financial services. There are many types of financial services like investment management or debt management that cities and states could do themselves for cheaper and they need to start thinking about developing those capacities.

Finally, the last recommendation of the report is to create publicly owned banks. We currently have one of these in the U.S., which is the Bank of North Dakota, and we need to look at the option of creating more publicly owned banks either at the city, state or county levels.

**Say you’re a voter who cares about this issue but isn’t really so wonky and numerically inclined. What are some red flags or good signs, in terms of rhetoric, that people should be paying attention to when they’re deciding whom to support in local government?**

Any politician who says, “All of our deals are fine” — that should be a red flag. Anyone who says, “We’re sophisticated and we know what we’re doing” — that should be a red flag. Anyone who tries to obscure what’s going on by muddling it in complexity, to make it hard to understand — that should be a red flag. What we should be looking for is people who can actually talk about this in a way that makes sense.

One of the tricks Wall Street has when it comes to municipal finance and when it comes to finance more generally is to make things seem overly complex, so complex that people stop caring and believe they can’t possibly understand it. That’s not actually the case. In reality, most of these things can be understood and can be talked about in plain English, and what we really need is more elected leaders who are willing to break these things down and talk to voters about them in a way that they can understand and that can offer real, common-sense solutions that don’t take a finance degree to understand. At the end of the day, this stuff does not need to be so complicated. Anyone who’s promising another complicated financing scheme as a solution is probably not actually going to be able to deliver on that because the more complex you get, the more heavily weighted things are in the banks’ favor.

The key words we should be looking for from politicians is that we shouldn’t need key words. They should just be able to talk about solutions that actually make sense to the average person and make it clear that they’re actually going to hold banks accountable for these deals they’ve already gotten into and make sure we’re having good, plain, vanilla banking going forward that will make sure we get the best deals.

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## **Stockton Highlights Nationwide Risk of Conflict Between Muni Investors And Public Sector Unions.**

Fixed-income investors are now on notice that their rights could be trumped by public-sector union bosses, following a court ruling granting Franklin Templeton Investments just pennies on the dollar for its muni bonds from bankrupt Stockton, California. And the case is only one of many across the country. (There's no word yet on whether Templeton will appeal.)

The ruling, while distressing, should not be surprising. In part, because investors are subject to an unfair information asymmetry at the hands of state and local governments. It's well-documented that government pensions tend to understate their pension and other obligations to workers and retirees, potentially hiding some risk from bondholders.

Yet, it's not all bad news for investors. While this most recent ruling clearly favored public employees over investors, in an earlier ruling the same judge made history in the Golden State by designating pensions as impairable—subject to a haircut in the event of bankruptcy. Pensions may still get favorable treatment, but no longer in automatic fashion.

Stockton is not alone. A new report from Moody's Investors Service shows just how widespread the risk runs as investors weigh whether to put their trust in municipal officials. The question is whether Stockton could be a wake-up call for city managers and union leaders across the country to tighten their belts and lower the temperature at the negotiating table.

"When municipal credit deteriorates to the point of service insolvency and results in bankruptcy or receivership, bondholders can find themselves in fierce competition with pensioners and current employees over resources and priority of payment," wrote my former colleague Al Medioli, vice president and senior credit officer at Moody's.

In my former life as municipal bond analyst with Moody's (I rated hospitals that behave like businesses in many ways but receive the tax benefits of a not-for-profit and thus fall under the muni umbrella), one of the factors we considered was whether a debt-issuing entity was unionized, a status that was inherently viewed as a "credit negative" due to unions' ability to disrupt operations. When we observed a history of obstreperous union leadership, we noted this to investors.

"Despite this decision to confirm Stockton's plan leaving pensions intact, local governments will now have more negotiating leverage with labor unions, who cannot count on pensions as ironclad obligations, even in bankruptcy," Moody's wrote in another report after the ruling.

This will also help cities better with Other Post-Employment Benefits (OPEBs), which typically include life insurance, health care benefits, and deferred-compensation. In the Stockton bankruptcy, only 1 percent of OPEBs were recovered. During restructurings, OPEBs are often used as a bargaining chip to cash in favor of pension protections. And as with pension obligations; oftentimes the OPEB obligations are obscured. The sheer irregularity of such an arrangement and the politicization of these benefits will no doubt be red flags to potential bondholders as they choose where to invest in the future.

Medioli's report examined the seven substantial municipal restructurings that have occurred since 2008. Of the seven, just one (Central Falls, Rhode Island, where bonded debt made up a small fraction of liabilities) took a haircut on pensions while making investors whole. The other five (San Bernadino, California, is still pending) favored pensions: four paid 100 percent to their pension funds

while skimming from investors. Detroit was ordered to pay 82 percent for pensioners and only 25 percent to investors.

Such thumb-on-the-scale restructurings in favor of union leaders creates economic moral hazard: City stewards are less likely to enact urgently needed pension reforms if they know accountability is unlikely. Workers and retirees put their hard-earned money into pension systems and are understandably anxious to enjoy the fruit of their labors. Yet cities that make unsustainable defined benefit promises do a disservice to their workers. Some muni bond issuers have shifted to a hybrid model with features of a 401(k)-type defined contribution structure with some guaranteed contributions. This is more sustainable for both taxpayers and workers.

“Reality is not negotiable,” former Utah state Sen. Dan Liljenquist, a Republican who helped push a hybrid model in his state, told The Wall Street Journal. “The fact is somebody bears the risk. Ultimately, the state is bearing more risk than it can.”

Forbes.com

Carrie Sheffield | Contributor

11/17/2014 @ 10:11PM

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## **[GASB: On the Horizon.](#)**

### **Accounting for Leases**

After completing the initial phase of project deliberations, the GASB is preparing to issue a Preliminary Views for its [Leases project](#) in November. A Preliminary Views is a document the GASB issues to gather public input on a topic prior to proposing new standards. This document will lay out the Board’s initial thinking on how to improve the GASB’s current accounting and financial reporting guidance on leasing.

The existing GASB guidance on lease accounting is based on Financial Accounting Standards Board’s (FASB) guidance issued through 1989. The GASB routinely evaluates its standards to ensure that they continue to properly capture the transactions they address and to result in information needed to make decisions and assess accountability. Because the FASB has an active lease accounting project underway, it was an opportune time for the GASB to look at its existing lease accounting standards and leverage off of the FASB’s efforts, while considering the government environment.

The GASB’s forthcoming proposal is intended to provide essential information to financial statement users and to reduce complexity for preparers, thereby enhancing the overall effectiveness of the Board’s guidance on leases.

The Preliminary Views document will address how leases are presented in the financial statements and the basic information that lessee and lessor governments should disclose in the notes. In addition, the due process document will address topics including:

- The definition of a lease
- Separating components of contracts that contain lease and service provisions
- Lessee accounting, including note disclosures

- Lessor accounting, including note disclosures
- Short-term leases
- Sale-leasebacks
- Intra-entity leases.

[View an article](#) on the Leases project from a previous issue of the GASB Outlook.

## **Fiduciary Responsibilities**

The GASB is finalizing a Preliminary Views for its Fiduciary Responsibilities project. The document is expected to be issued in November.

The GASB is planning to propose guidance addressing when a government would have a fiduciary responsibility. Fiduciary responsibility generally relates to acting as a guardian or trustee of assets belonging to others. The Board's primary objective is to enhance the consistency and comparability of when and how governments report their fiduciary activities in audited financial reports. To meet this objective, the document will:

- Define when a government has a fiduciary responsibility and, therefore, is required to present fiduciary fund financial statements
- Define the types of fiduciary funds
- Clarify financial reporting requirements for business-type activities that have fiduciary responsibilities
- Introduce the use of a financial statement that reports the inflows and outflows of resources for all fiduciary fund types.

[View an article](#) on the Fiduciary Activities project from a previous issue of the GASB Outlook.

## **Other Postemployment Benefits**

In November, the GASB is scheduled to begin redeliberations on the [two Exposure Drafts issued in connection with the Other Postemployment Benefits \(OPEB\) project and the related Exposure Draft on pensions](#), in light of the public response to the proposals.

The GASB received written [comments](#) from 76 individuals and organizations in response to Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions. Thirty individuals and organizations [commented](#) on Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans, and 26 [commented](#) on the Exposure Draft addressing pension-related issues.

More than three dozen stakeholders provided the Board with additional input and feedback in a series of public hearings held in September in New York, Chicago, and San Francisco. The Board also reviewed results of field testing of the proposed OPEB standards at various state and local governments.

[View an article](#) on the OPEB project from a previous issue of the GASB Outlook.

## **External Investment Pools**

The GASB recently commenced pre-agenda research on [external investment pools](#) that function, for governments, much like money market funds do in the private sector. The GASB will study what effects, if any, changes recently adopted by the Securities and Exchange Commission (SEC) will have on external investment pools operated by governments.

The research will provide the GASB with the information it needs to determine whether a project should be added to the current technical agenda to consider revising existing standards on external investment pools. Initial research will explore the degree to which government investment pools conform to or diverge from the current and new SEC rules.

The staff is scheduled to provide an educational memo with research findings to the Board before the end of 2014.

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## **[Detroit Bankruptcy 'All Negative' For Muni Investors - MMA.](#)**

I spent my [Current Yield column this week](#) discussing how the outcomes of the Detroit and Stockton bankruptcies are pretty uniformly bad for muni bond investors, since both of those cases upended the preferential treatment bondholders have traditionally received in Chapter 9 cases compared with other creditors. Instead, bondholders got the short end of the repayment stick in both cases, as public employees and pensions recovered a lot more of what each city owed them than bondholders did.

The outcome of the Detroit case was so bad that it prompted Matt Fabian of Municipal Market Advisors today to label the situation “all negative” for muni investors, particularly in the state of Michigan, adding that “takeaways for the municipal market from Detroit’s bankruptcy are uniformly negative.”

Fabian offers his own version of Bank of America Merrill Lynch’s seven lessons for investors from Detroit’s bankruptcy. Here’s a brief version:

- **Pensions > Bonds:** “In the absence of legal precedents to the contrary, local unsecured GO bondholders, particularly those in MI, have to assume their position in the capital structure is subordinate to pensioners and indeed that of almost any other politically connected creditor,” Fabian writes. That’s some serious food for thought if you own muni bonds in Michigan.
- **OPEBs = Bonds:** Fabian points out that unsecured bondholders weren’t treated better than OPEBs, which he calls “a complete change in thinking” for the muni market.
- **Secured credits got impaired too:** Fabian says Detroit represented “the largest municipal payment default in recent history” for secured creditors, despite the allegedly superior investor protections afforded secured creditors.
- **Bondholders can be bullied:** After this case, Fabian sees “no reason why future debtor advisors would not similarly be able to harass municipal creditors into large losses.”
- **State as adversary, not partner:** Fabian says Michigan “played a key role in steering losses onto” bondholders, and that lower-rated government bonds in Michigan “may no longer be suitable for traditional retail investors.”
- **Investor ambivalence:** Fabian says investors have continued to buy Michigan bonds, and underwriters have continued to issue them, with little negative consequence to the state despite the unfavorable treatment of Detroit bondholders.

Fabian adds that Detroit still needs revenue growth to make its bankruptcy-exit plan work, and he calls the court case “undeniably a success for Detroit’s restructuring advisors, who followed a corporate-style, adversarial strategy that set creditor losses as its highest priority” and in doing so set a precedent for future municipal bankruptcy cases. He says the outcome may even prompt more federal scrutiny of profligate municipal governments, saying it even incrementally increases the risk that the federal government might revoke the tax-exempt status of municipal bonds.

As for Stockton, Fabian says the unfavorable treatment of certificates of participation in that case “should incrementally reduce the value and liquidity of [California] COPs.” He adds that COPs have been an important financing structure for California local governments, which are “likely to see their borrowing costs rise as a result.”

November 10, 2014, 2:58 P.M. ET

By Michael Aneiro

Barron's

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## **[S&P's Public Finance Podcast \(California's Proposition 2, Stockton, And Detroit\).](#)**

From Standard & Poor's CreditMatters TV:

Extra Credit: S&P's Public Finance Podcast (California's Proposition 2, Stockton, And Detroit)

[Watch here.](#)

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## **[State Pension Funds' Combined Underfunding Rises to \\$4.7 Trillion – Report.](#)**

State employee retirement systems are underfunded by a total of \$4.7 trillion for a funding ratio of 36%, said a report from State Budget Solutions, a non-profit organization advocating state budget reform.

The report, “Promises Made, Promises Broken 2014” uses data from fiscal year 2013 comprehensive annual financial reports and actuarial valuations from individual plans. In its 2013 report, the group estimated underfunding at \$4.1 trillion, or a 39% funding ratio.

The report measured state public pension liabilities by market valuation instead of discount rates based on investment return assumptions because “the discount rates that plans use are just far too high,” said Joe Luppino-Esposito, State Budget Solutions general counsel and the report's author, in an interview. A risk-free rate based on a 15-year Treasury bond rate works better when states fail to make annual contributions and address unfunded liabilities, Mr. Luppino-Esposito said. “Even if you are on target, it doesn't work. The bottom line is that on paper nothing beats a government pension. But in reality, the money isn't there,” Mr. Luppino-Esposito said.

The overall actuarial assets of state pension funds in the 50 states, according to the report, total \$2.68 trillion, while liabilities total \$7.42 trillion.

Using the states' own assumptions, unfunded liabilities are just over \$1 trillion, the report said.

The state with the lowest funding ratio is Illinois at 22%, the report said. The state's public employee pension funds have \$95 billion in assets and \$426.6 billion in liabilities, according to the report.

PENSIONS & INVESTMENTS

## **[S&P: U.S. Public Finance Rating Improvement Cools in the Third Quarter After the Local Government Criteria Implementation Period.](#)**

U.S. public finance (USPF) upgrades again outnumbered downgrades during the third quarter, but the upgrade-to-downgrade ratio continues to decline. The slower pace of upgrades reflected, in part, Standard & Poor's Ratings Services completing its implementation of its revised local government general obligation (GO) bond rating criteria during the third quarter. The revised criteria resulted in upward revisions of approximately 41% of our local government ratings. Through the 12-month criteria implementation period, our upgrade ratio reflected this transition to a higher local government ratings distribution.

As the criteria implementation began to wind down, the upgrade-to-downgrade ratio declined in step with the decrease in criteria-related rating actions. The 2.18 to one upgrade to downgrade ratio during the third quarter was lower than in any other period since the second quarter of 2013 — just before the introduction of our revised local government criteria.

[Continue Reading.](#)

10-Nov-2014

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## **[MMA Municipal Issuer Brief - Green Bonds.](#)**

[Municipal Market Advisors Municipal Issuer Brief - November 11, 2014](#)

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## **[Why Pay for Success Matters.](#)**

For too long, public funding has been extended toward programs that show little efficacy or impact in areas they target. And yet, year after year, these programs continue to get funded.

But there are some encouraging developments as new models have begun to take shape in communities across our nation and around the world that offer the promise of delivering more effective and efficient services to citizens at a reduced cost by government. One approach that has gained increasing traction is known as Pay for Success - programs that rely on defining real outcomes and using data and evidence to measure progress.

This model has appeal to taxpayers, governments, philanthropy and the private sector because it represents a unique partnership model that infuses private sector resources to fund evidence-based interventions in areas ranging from education to healthcare to unemployment. Funding takes place at the front end of program delivery and requires government to pay for services only when outcomes are delivered. If outcomes aren't achieved, the government can pay nothing; if outcomes are achieved above a certain threshold, private sector investors don't just get their money back, they

may see a return on top of the amount originally invested.

### **Emphasis on best practices and evidence-based programs**

While the idea of evidence or outcomes-based funding shouldn't seem radical, the reality is that in too many publicly funded programs, there is little or no data to determine if investments are yielding intended results. By introducing a model for funding that can infuse new private sector capital at the outset, a much more rigorous measurement process is put in place and the government only pays when outcomes are achieved. These new models hold the potential to illuminate what works and what doesn't, and to optimize both delivery of service and tax dollars.

### **The blended approach**

Another attractive feature of pay for success models is the "blended" approach the funding mechanisms can represent. While private capital is put up at the front end of a program by means of a bond as an investment tool, often philanthropy will underwrite any "first losses" - in other words, limiting potential investor losses, should the program not show desired outcomes. This dramatically reduces the risk for private sector investors, while maintaining the potential upside for investors should the program yield results.

Why would philanthropy cover potential losses? In philanthropy, most giving represents 100% permanent loss of capital - you write a check for a donation and funds are expended and taken off the books. With pay for performance, these underwriting "guarantees" are only called if the program fails to achieve targets. So philanthropists may never need to actually expend funds if the program is successful. Additionally, this "catalyst" style of potential funding unleashes and infuses new private capital into social programs, augmenting and scaling what philanthropy and governments typically fund. Taxpayer dollars are made most efficient since the model only requires government expenditures for successful outcomes, thus eliminating waste.

The Pay for Success model is not without its critics - some say it's simply too good to be true, some believe that it's impossible to put this model into practice, and others say that we simply don't have enough evidence to show that this approach works. But others believe it could well represent a new way forward as the needs of our communities grow and government resources continue to come under pressure.

Like any innovation, Pay for Success will likely have both victories and failures. We're certainly encouraged by reports like this week's from the Beeck Center for Social Impact and Innovation at Georgetown University and Monitor Deloitte, which provides case studies and success stories from around the world to help policy makers design programs that achieve real impact.

We are also pleased to see policymakers like U.S. Representatives John Delaney and Todd Young taking the lead on bipartisan legislation like the Social Impact Bond Act, which would foster the creation of programs that incentivize results, not just activities. We're also watching state and local officials like Mayor Ben McAdams of Salt Lake County, who is financing quality early childhood education through a Pay for Success initiative in partnership with Goldman Sachs.

It's early days for pay for success models, but these and other innovative approaches to funding needs in our nation and around the world hold promise for an improved "invest in what works" approach that delivers better practices and outcomes for those being served.

FORBES

Jean Case Contributor

## **California's New Tax Increment Financing Law Could Unlock Billions of Dollars.**

When California Gov. Jerry Brown signed a new law on Sept. 29 to facilitate infrastructure financing, he gave hope to people in the Golden State and beyond that local governments would pick up where constrained state and federal budgets have failed to meet enormous needs for road, transit, water, sewer and many other projects.

The law, S.B. 628, is expected to revitalize the practice of tax-increment financing in California—a means of generating revenue based on projections of higher property values and taxes arising from long-term property development following in the wake of infrastructure construction. It lowers voter-approval thresholds and expands the range of infrastructure projects eligible for support. If communities embrace the new statute, billions of dollars in new financing will become available.

Last year, the American Society of Civil Engineers estimated U.S. infrastructure funding needs of \$3.6 trillion through the end of the decade, with funding streams expected to produce only \$2 trillion. Another study, just released by the International Monetary Fund reports that infrastructure quality in the United States has been declining since 2006, and now ranks behind that of other major countries: Germany, France, Japan, Canada and the United Kingdom. The study asserts that the time is right for a major infrastructure push.

In this country, “the national consensus on infrastructure has broken and a new framework, and new institutional arrangements, are needed,” says Mark Pisano, a professor of the practice of public administration at the University of Southern California and a force behind the new state law.

Congress has not seen fit to increase the 18.4 cents-per-gallon gas tax that's been on the books for year, instead funding the national highway “trust fund” with stop-gap gimmicks that expire in May. Water, sewer and other infrastructure needs are also underfunded, according to the civil engineers.

The prospect that California's new law may have the breadth to address many local infrastructure needs is seen in West Sacramento, just across the river from the state's capital city. It is one of just two or three jurisdictions in the state that is on the road, albeit under an older statute, to successful use of forward-looking tax increment financing, or TIF.

This, as a Las Vegas craps player might say, involves betting on the come: counting on revenues that will accrue from private investment that follows development of high-quality infrastructure in new or redeveloped areas. Tax increment bonding under the new law allows jurisdictions to look out 45 years as they project new building and consequent new property tax revenues.

West Sacramento's Bridge District, once a crumbling, decrepit industrial area, is now benefitting from rapid revitalization thanks to such financing techniques. A major boost to the area came in 2000, when a new ballpark, Raley Field opened as home to the Sacramento River Cats, Triple-A affiliate of baseball's World Series champion San Francisco Giants. After much work to deindustrialize the rest of the Bridge District, housing and retail are coming on line.

### **Financing Techniques Evolve**

The heyday of California tax-increment financing came during the first decade of this century, when

state law allowed cities to create “urban redevelopment zones.” To fund investment in blighted areas, the zones could collect part (an “increment”) of assumed property tax growth. This, of course, deprived the cities themselves of revenues they might need to finance their operations, and the broad law also allowed increments to be collected against other municipal entities, notably school districts and community colleges.

West Sacramento’s redevelopment zone covered 45 percent of the city and generated \$60 million, or about \$5 million a year, to fund infrastructure from 2000 to 2012. But then the state government rescinded redevelopment zone authority. In a wrenching state budget crisis, the governor and legislature decided they could ill afford to continue backfilling school budgets for the revenues they’d lost to the redevelopment zones.

West Sacramento acted to ensure that remaining redevelopment tax funds would remain available. The Bridge District was already deep into its revitalization program. Highways had been torn down, rail lines removed, and blighted areas cleaned. Apartment complexes were under construction. But much more infrastructure was needed to achieve the vision of a dynamic community, with parks, public spaces and a reclaimed riverfront.

So the city and its economic development manager, Aaron Laurel, decided to employ another legislative authority to create Increment Financing Districts, or IFDs. This law, which has now been replaced by S.B. 628, required a two-thirds vote of property owners in the district, both to create the district and then, in another vote, to authorize issuance of bonds. These were high hurdles and West Sacramento’s was one of few significant initiatives that met them.

The other, in San Francisco’s Rincon Hill, is clearing blight and creating new living opportunities near the base of the San Francisco-Oakland Bay Bridge and not far from AT&T Park and the Embarcadero.

With most renewal projects stalled, urban infrastructure experts began a drive to enact the new TIF law that would be easier for communities to use. California Forward, a foundation-supported government reform organization whose board has included many prominent citizens, was among leaders of the effort.

Pisano, who served as the executive director of the Southern California Association of Governments for 31 years before his professorship at USC’s Price School of Public Policy (pictured here), worked with California Forward fiscal policy expert Fred Silva, in drafting language and later writing a guide to using the new authorities.

The new law includes major departures from past practice:

- Communities can now establish “enhanced” IFDs without a vote.
- A vote is still required to create bonding authority but now just 55 percent of ownership approval is needed, down from 67 percent.
- IFDs can now look out as far as 45 years when calculating increases in property values, allowing much larger valuations than under the present 30-year limit.
- Unlike bonding under the old redevelopment authority, funds can be used both inside and outside the financing district—for example to build two new bridges and a streetcar line running across an existing bridge between West Sacramento to downtown Sacramento.

In addition the new law will allow a broader range of infrastructure needs—roads, transit, bridges, water, sewer and other underground utilities, cleaning of brownfields, parks and more.

The 45-year term “is a really big deal,” says Laurel, observing that adding 15 years of assumed development will allow substantially larger bonding authority—likely more than offsetting the loss of authority to include school district revenues in the increment financing plan. Parks in the Bridge District are high on his priority list.

As his bill, S.B. 628, was approved by the legislature, State Sen. Jim Beall, a Democrat from San Jose, says it would “help local jurisdictions finance transportation projects and transit-oriented development.” He noted the large funding gaps local leaders face as they try to make investments in everything from aging water mains and crumbling local roads to next-generation transit stations. In Los Angeles alone, for example, the nation’s second-largest city is estimated to have a backlog of \$8.1 billion in deferred infrastructure maintenance—a figure as large as the city’s entire annual budget, reports California Forward staffer Justin Ewers.

Pisano, during a recent meeting of a National Academy of Public Administration infrastructure task force he chairs, observed that billions of dollars in private funds are “looking for a place to land” in financing infrastructure projects. Private highways and bridges are showing the way, but additional novel institutional arrangements are needed to boost further progress.

California’s new law should encourage more public-private partnerships, Pisano says, and in this and other regards may contribute to a new vision for building infrastructure and revitalizing the U.S. economy.

Government Executive

By Timothy B. Clark

November 11, 2014

Timothy B. Clark is editor-at-large at Government Executive.

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## **[A Green Bond for Public Pensions.](#)**

Pension plans want to support environmental projects, but there is one thing holding them back.

Green investments are the current darling of Wall Street. The market for them is expected to exceed \$40 billion this year, according to Bloomberg. But there’s one huge institutional player who’s being left out: state and local pension plans.

“There has been a lot of buzz about infrastructure finance in the public pension community,” said Girard Miller, chief investment officer of the Orange County Employees Retirement System (OCERS) and a former *Governing* columnist. He noted that many pension plans are interested in investments that can boost funding for new infrastructure, especially when those projects are environmentally friendly. The problem, Miller said, is that pension investment officials “don’t want tax-exempt paper in their portfolios.”

Why? Since pension plans are already tax exempt, they can’t claim the tax exemption. That leaves, he says, “a mismatch between available pension capital and the public sector’s infrastructure financing needs, especially for projects that lack a revenue source.”

Is there a fix? Miller talked about one in a recent interview, which has been edited for clarity and

length.

**Let's start at the beginning. There are so many definitions of green bonds out there. How are you defining it?**

These are bonds issued to finance environmentally friendly capital projects. One use of the concept applies very narrowly to tax-exempt bonds for what are called brownfields development. Then there is also an international working group promoting "climate bonds," which are sometimes called green bonds. CalSTRS, the large state teachers pension fund here in California, is part of that working group. The central idea is to reduce the carbon footprint globally through infrastructure projects that can be funded through big bond issues. I use the term green bonds very broadly to include essential environmental projects that might be funded by states and localities through bond financing. Beyond carbon reduction and water conservation in drought areas, I'll leave it to the policy geeks and public finance guys to haggle over the definition. It's a big tent.

**When Connecticut issued a green bond this past October, State Treasurer Denise Nappier said they were developing the bonds "to meet the needs of the growing group of investors who have mandates to invest in sustainable projects that will help preserve our environment for future generations." Where do pension plans fall within this "mandate"?**

In OCERS there isn't a mandate, no social objective. The traditional goal is to seek out the best returns. There are other, bigger funds that take a broader view of their responsibility. The word that strikes me as interesting was coined by John Rogers, the past president of the Chartered Financial Analyst Institute: super fiduciaries. These are big funds — like CalPERS or CalSTRS — that take large positions so that they own a chunk of the economy. For them, terms like sustainability mean something because if society at large fails — especially in terms of environmental concerns — then their overall investments are not going to do well. They feel they have a higher calling than squeezing out the best profit. That's where some of the pension plan interest in green bonds comes.

The problem is that pension plans don't want tax-exempt income. We're not the only ones. Sovereign investment funds from abroad, such as those in China and the Middle East, and endowment funds don't care about taxes either.

**What would attract them?**

What we need is a taxable option to be approved by Congress and limited to green bonds, not to every conceivable capital project, which is typically what happens when politics gets involved. A taxable bond option (TBO) is a concept that has been kicking around in public finance circles for four decades. As far back as the 1970s, economists like John Petersen were saying there is a smarter way to do this stuff. Build America Bonds, which were authorized in 2009-2010 at the bottom of the Great Recession, were a taxable option. A TBO allows, but does not require, a muni bond issuer to elect to pay taxable interest and receive a direct interest-cost reimbursement from the U.S. Treasury rather than the indirect subsidy of tax exemption. In most cases, that would mean a lower borrowing cost — net-net — than issuing tax-exempt bonds. For pension plans, a TBO-yield will compare favorably with corporate credit and foreign sovereign bonds, plus the bonds would be a diversifier for our bond portfolios. Foreign investors and endowment funds, as well as ordinary investors with incomes below \$200,000, would prefer taxable municipals.

**What's the objection to them?**

Some leaders in the public finance community believe that it's a slippery slope, that if the federal government starts down this path they will someday want to eliminate tax exemption for municipal

bonds. Secondly, there has been a fear in some circles that someday the feds will run out of money and renege on their promise to pay the interest reimbursement. In theory, it's harder to renege on tax exemption.

### **What's the track record with Build America Bonds? Did the federal government keep its commitment? Did the bonds sell well?**

Build America Bonds were successful. No one disputes that. It was limited in term, and the bonds got scarfed up and are sitting in people's portfolios. Uncle Sam is paying its share and there's no sign of doing anything otherwise.

### **What's the U.S. government's interest in a taxable muni?**

It costs the Treasury less to pay a direct subsidy to the muni bond issuer than to give a tax exemption to the typically wealthy investors whose effective marginal income tax rates are usually 28 to 40 percent. For state governments, the taxable option could help their revenues as well. It works as long as the reimbursement rate of the direct subsidy is lower than the effective average tax rate on that issuer's muni bonds.

### **So what's the next step?**

The public finance community, the public pension funds and their lobbyists on Capitol Hill have to step up to make this happen.

GOVERNING.COM

BY PENELOPE LEMOV | NOVEMBER 13, 2014

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## **[Market Rates of Return for Effective Financial Management.](#)**

The Pioneer Institute [released a report](#) this week that provided more evidence to conservative groups who say that U.S. pensions are over-valued. Most pension funds calculate their assets and unfunded liabilities using an assumed rate of investment return between 7 and 8 percent. The Pioneer Institute advocated using a market rate. Its report outlined how to create a rate of return for each individual plan based on the historical returns of each investment asset type. For example, for a portfolio with a mix of investments ranging from stocks, which historically average an 8.3 percent return rate, to real estate assets, which average a 3.4 percent rate of return, Pioneer would assume a rate of return around 6.6 percent.

With pension accounting changes being rolled out everywhere this year, the institute's paper provided a glimpse into what changes may be in store for many plans. In one of the starkest examples, the unfunded liability of the Illinois State Teachers Retirement fund, which assumes an 8 percent investment return, would increase by more than one-third to nearly \$79 billion, according to the Pioneer Institute. (The institute's formula yielded a 6.3 percent investment return for the teachers' fund.)

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## **Moody's: More Than Half of Largest US Cities Maintained or Improved Credit Quality Since the Recession.**

New York, November 13, 2014 — Since the onset of the Great Recession, the credit quality of 34 of the 50 largest US cities was either maintained or improved, says Moody's Investors Service. In the report "Anatomy of Successful US Cities," Moody's attributes the resiliency of these cities to their inherent strengths and robust financial management.

"By no means were these successful cities immune to the downturn, but the impact was much less severe, especially with the support of healthy tax base growth," says Jennifer Dierksen, a Moody's Analyst. "Other supporting factors were tax base diversity, a significant institutional presence, and their status as regional economic centers."

Despite the challenges of the downturn, the tax bases of the 34 successful cities increased by 6.6% on since 2008, compared with a median decline of 3.6% for all US cities with populations over 100,000.

Furthermore, the successful cities have very diverse tax bases, reducing the exposure of governments to one particular industry or large taxpayer. In addition, the stable presence of large institutions, such as federal government agencies, universities, and hospitals, benefits these cities by offsetting negative credit forces.

With healthy tax base growth, the successful cities effectively balanced their budgets, increasing revenues by 7.7% and expenditures by 7.0% between 2008 and 2013. In contrast, other US cities with populations over 100,000 saw average revenue growth of 2.0% and expenditure growth of 2.8% over the same period. The successful cities ultimately improved their reserves, which averaged 18.6% of operating revenues in fiscal 2013.

Furthermore, while these successful cities had above-average debt burdens, they were often the result of addressing the capital needs of large city infrastructure. Fixed costs, including debt service, pensions and OPEB, still remained manageable, providing these cities with budgetary flexibility.

Thirty of the 34 successful cities maintained their ratings throughout the recession, while four experienced rating upgrades. Overall, the successful cities maintain a median rating of Aa1, two notches above the sector median of Aa3.

Moody's subscribers can access this report [here](#).

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## **Moody's: Most US State Retiree Health Care Costs Becoming More Affordable.**

New York, November 10, 2014 — Many states have largely stabilized their retiree health care expenses through a combination of benefit changes and moderating health insurance costs, but these liabilities remain high for some states — particularly those that fully pay for teacher benefits. Retiree health care, also known as other post-employment benefits (OPEB), for states is fully explored in the new Moody's Investors Service report, "States Controlling Retiree Health Costs, but

## Teacher Benefits Are Costly for Some.”

Thirty-one states have been able to lower or maintain OPEB costs relative to revenue since 2011 by adjusting healthcare benefits and aided by low price inflation. Overall, the majority of states are seeing stable to improving OPEB affordability, with median OPEB costs under 1% of revenues from fiscal years 2011 to 2013. Most states pay for retiree health costs on a pay-as-you-go basis, rather than putting money aside now for the benefits that current employees will receive when they retire.

“Unlike pension benefits, OPEB liabilities are not contractually protected in most states,” says Marcia Van Wagner, a Moody’s Vice President and Senior Analyst. “This allows government employers to control costs by adjusting health benefits and employee or retiree contribution requirements.”

Changes to benefits and other factors also have reduced total state OPEB liabilities, which measures in present value terms all the retiree health benefits that current employees and retirees would receive given plan benefits. OPEB liabilities fell 7.5% from 2011 to 2013. Some states were able to reduce OPEB liabilities by a much greater amount. Ohio, whose costs declined the most, changed eligibility provisions for covering spouses, children, and benefits for Medicare-eligible retirees. Kentucky raised the level of contributions required of active employees toward their retiree health benefits. Some states also changed the vesting periods for eligibility for retiree health insurance.

Provisions in the Affordable Care Act (ACA) have also allowed states to change the way they account for future OPEB liabilities. The ACA has allowed states to shift pharmacy costs to Medicare and raise drug subsidy discount rates, thereby pre-funding a portion of future liabilities.

Furthermore, average insurance premiums and total national health expenditures have moderated along with medical care inflation, allowing states to lower cost trend assumptions in their OPEB valuations.

However, states that fully or partially pay for teacher retiree health benefits continue to have greater OPEB debt burdens. Five states with the highest OPEB liabilities — Connecticut, New Jersey, Illinois, Hawaii, and Delaware — fall into this category. Many of these states also have high debt and pension costs for the same reason.

Containing costs will be more difficult for states with less flexibility to adjust OPEB benefits as the aging state workforce retires. The small number of states whose laws protect OPEB benefits will be most challenged, but states that pre-fund liabilities will face budgetary pressure during periods of low-to-moderate revenue growth.

Moody’s subscribers can access this report [here](#).

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## **[Muni Supply Set to Shrink as Redemptions Exceed Sales.](#)**

The U.S. municipal bond market is poised to contract in the next month as redemptions and maturing debt exceed sales of new securities.

The gap between redemptions and new debt, a signal of supply and demand in the \$3.5 trillion municipal market, will reach \$27.3 billion over the next 30 days, compared with a contraction of \$4.74 billion last month, according to data compiled by Bloomberg.

States and localities have scheduled \$10.2 billion of sales in the next 30 days, compared with \$10.9 billion on the previous trading day, the data show. Supply figures exclude derivatives and variable-rate debt. Some municipalities set their deals less than a month before borrowing.

Municipalities have announced \$21.6 billion of redemptions and an additional \$15.9 billion of debt matures in the next month.

Posey County, Indiana Economic Development for Midwest Fertilizer Co., Arizona Transportation Board and Dallas Area Rapid Transit have scheduled sales in coming weeks, the data show. Houston Independent School District and Rhode Island Tobacco Settlement Finance Corp. are also on the calendar.

BLOOMBERG

By Ken Kohn | Nov 17, 2014 4:46 AM PT

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## **[NAST-NASACT Workgroup Issues Letter Regarding Changes to SEC Rule 2a-7 and the Impacts on Local Government Investment Pools.](#)**

The National Association of State Treasurers (NAST) and the National Association of State Auditors, Comptrollers and Treasurers (NASACT) has created a work group to examine the amendments to Rule 2a-7 impacting money market mutual funds (MMFs) that were approved by the Securities and Exchange Commission (SEC) on July 23, 2014. Among other things, the amendments will require institutional prime MMFs to adopt a floating net asset value (NAV) instead of the traditional stable NAV.

The work group is focusing primarily on the impact the amendments will have on local government investment pools (LGIPs), which in many cases are operated by state governments.

The work group has sent a letter to the Governmental Accounting Standards Board (GASB) requesting that GASB (1) add this issue to its technical agenda and (2) consider options that will allow LGIPs to continue using amortized cost (stable NAV).

[View the letter.](#)

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## **[S&P: Why Detroit's Bankruptcy Plan Outcome Doesn't Affect U.S. Municipal General Obligation Ratings.](#)**

Since June 2013, when Detroit's Emergency Manager announced the city would not make upcoming debt service payments and was poised to file Chapter 9 bankruptcy should settlements with creditors not be reached quickly, Detroit's lawsuits and court battles have been in the headlines. During this time, the treatment of debt and pension/other postemployment benefit (OPEB)

obligations has attracted attention from market participants, including Standard & Poor's Ratings Services.

Standard & Poor's has followed the proceedings over the past 17 months and has carefully considered the bankruptcy's potential impact on general obligation (GO) and similarly supported ratings. In the end, despite months of headlines and court battles, ultimately the outcome of the Detroit bankruptcy will not have an impact on our GO ratings. This view is based on our feeling that there was no precedent set that is widely applicable to GO debt, and that the forward-looking nature of our U.S. local government criteria gives us opportunities to identify and take into account such weaknesses before issuers reach the point of deciding who to pay and not pay, either via bankruptcy or default.

[Continue Reading.](#)

07-Nov-2014

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## **California's GO Debt Upgraded To 'A+' From 'A' On Strengthened Budget Stabilization Account; Outlook Stable.**

NEW YORK (Standard & Poor's) Nov. 5, 2014—Standard & Poor's Ratings Services has raised its rating on the State of California's general obligation (GO) debt to 'A+' from 'A', and raised its rating on the state's general fund annual appropriation-secured debt to 'A' from 'A-'. The outlook on both ratings is stable.

"The upgrades follow voter approval on Nov. 4, 2014, of a strengthened budget stabilization account under Proposition 2," said Standard & Poor's credit analyst David Hitchcock. "In our view, the new state constitutional provision will partially mitigate California's volatile revenue structure by setting aside windfall revenue for use during periods when state tax revenue could fall materially short of forecast," Mr. Hitchcock added.

The enacted provisions have become part of the state constitution and, as such, cannot be overridden during the annual budgetary process. California has had a history of leaving its budget stabilization account (BSA) unfunded until the current budget year.

The upgrade on California's general fund appropriation-secured debt follows the upgrade on the state GO debt. This rating is below the GO rating due to pledged revenues subject to annual state appropriation.

Other key factors supporting the 'A+' GO rating include our view of California's:

Diverse economy of 38.3 million people, or 12% of the total U.S. population;

Recent commitment to aligning recurring revenues and expenses, while simultaneously paying down budgetary debts, and an improved cash position;

Timely enactment of budgets following a constitutional amendment

requiring only majority legislative consent to approve budgets, which has reduced exposure to liquidity shortfalls; and Moderately high bonded debt.

Somewhat offsetting these strengths are what we consider the state's: Volatile revenue base, which is linked to difficult-to-forecast financial market performance because of a highly progressive income tax structure, and still relatively modest reserves as a percent of expenditures; Potential for current structural budget balance to erode when voter-approved tax hikes fully expire in 2018, or sooner if the legislature were to significantly increase ongoing spending; and Large retirement benefit and budgetary liabilities. The state's general fund serves as the source of all GO bond repayment, to which California has pledged its full faith and credit.

The stable outlook reflects our view that California will build a material BSA fund balance in the coming years under recently passed Proposition 2, and that it will continue to pay down deferred liabilities and debt in advance of the 2018 expiration of a temporary income tax surcharge. The outlook also reflects a state financial position at the end of fiscal 2014 that was its strongest position of the past decade. The paydown of budgetary deferrals could accelerate if revenues come in ahead of budget, and trigger certain provisions in the budget. However, reserves are expected to remain slim in relation to budgeted expenses, while waiting for Proposition 2 to go into effect. Potential developments that could lead to a positive outlook or upgrade would include an improved budget process, with a midyear budget review and an institutional framework for timely midyear corrective budget actions; or a reduction in the state's very significant pension, other postemployment benefits (OPEB), and debt liabilities. A downgrade could occur if significant structural budgetary imbalances reappeared, potentially due to a sharp decline in budgeted revenues, or if the state developed cash flow problems. Although California has recently addressed its teacher pension underfunding, the state continues to carry a large unfunded OPEB that could prove troublesome if not eventually addressed.

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## **[MMA Municipal Issuer Brief - What A GOP-Controlled Congress Could Mean.](#)**

[Read the Brief.](#)

November 3, 2014

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## **[California Credit Rating Raised After Voters Pass Reserve.](#)**

California's credit rating was raised by Standard & Poor's one day after voters in the most indebted U.S. state agreed to bolster a rainy-day fund for fiscal emergencies.

S&P boosted its rating one step to A+, fifth-ranked, the highest since February 2009. Only New Jersey and Illinois have lower ratings.

"This is the fourth upgrade for California by a rating agency in the past two years and it rewards the state for the immense strides it has taken toward fiscal discipline and budget stability since the Great Recession," Treasurer Bill Lockyer said yesterday in a statement.

Credit-rating companies have criticized California for its failure to set aside money when the economy is booming and for relying on volatile capital-gains taxes tied to the performance of the stock market, to finance the general fund, which pays for most core operations.

Proposition 2, championed by Democratic Governor Jerry Brown, sets aside 1.5 percent of general-fund revenue each year into a rainy-day fund, as well as capital-gains taxes that exceed 8 percent of the general fund.

Brown has steered the state to a projected surplus five years after it logged a record deficit. Temporary tax increases and a resurgent economy have fueled the turnaround.

### **Sixth-Highest**

Standard & Poor's last boosted the state's rating in January 2013 to A, its sixth-highest grade and the best since January 2010. Fitch Ratings in August 2013 increased the state's grade to A, also sixth-highest.

Moody's Investors Service raised California's credit in June by one step to Aa3, the fourth-highest level, the state's highest mark with the company since 2001.

Investors demanded as little as 0.25 percentage point of extra yield yesterday to buy 10-year California obligations instead of top-rated municipal bonds, according to data compiled by Bloomberg. The spread was as high as 1.7 percentage points in 2009, when the state resorted to IOUs to pay bills.

Bloomberg

By Michael B. Marois Nov 5, 2014 9:01 PM PT

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Jeffrey Taylor, Pete Young

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## **[SIFMA US Municipal Credit Report, Third Quarter 2014.](#)**

The municipal bond credit report is a quarterly report on the trends and statistics of U.S. municipal bond market, both taxable and tax-exempt. Issuance volumes, outstanding, credit spreads, highlights and commentary are included.

### **Summary**

According to Thomson Reuters, long-term public municipal issuance volume totaled \$71.8 billion in the third quarter of 2014, a decline of 13.6 percent from the prior quarter (\$83.2 billion) but an increase of 5.2 percent year-over-year (y-o-y) (\$68.3 billion). Year to date ending September, issuance figures reached \$215.4 billion, well below the 10-year average of \$277.3 billion. Including private placements (\$2.1 billion), long-term municipal issuance for 3Q'14 was \$73.9 billion.

Tax-exempt issuance totaled \$64.7 billion in 3Q'14, a decline of 12.7 percent but an increase of 6.7 percent q-o-q and y-o-y, respectively. Taxable issuance totaled \$4.9 billion in 3Q'14, a decline of 20.8 percent and 10.9 percent, respectively, q-o-q and y o y. AMT issuance was \$2.2 billion, a decline of 22.6 percent q-o-q but an increase of 2.9 percent y-o-y.

By use of proceeds, general purpose led issuance totals in 3Q'14 (\$21.7 billion), followed by primary & secondary education (\$12.1 billion), and water & sewer facilities (\$8.7 billion), identical rankings as the prior quarter.

Refunding volumes as a percentage of issuance rose slightly from the prior quarter, with 58.2 percent of issuance refunded compared to 53.8 percent in 2Q'14.

[View the Report.](#)

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## **Municipal Trading Volume Dips in Third Quarter 2014.**

Alexandria, VA - The Municipal Securities Rulemaking Board (MSRB) today released municipal market statistics that show a 25.4 percent decline in the number of municipal bond trades for the quarter ending September 30, 2014 compared to the same quarter a year ago, among other findings. The MSRB's quarterly statistics published today include data on trading patterns, interest rate resets and continuing disclosure filings for the \$3.7 trillion municipal bond market. The MSRB, which regulates the municipal market, is an independent source of market data and operates the Electronic Municipal Market Access (EMMA®) website to disseminate trading and disclosure documents and data.

Among the third quarter 2014 highlights:

- The total number of municipal trades in the third quarter of 2014 fell to 2.19 million, down 25.4 percent from the third quarter of 2013.
- Par amount of municipal securities traded in the third quarter of 2014 totaled \$671.8 billion, down 18.6 percent from the \$825.4 billion traded in the same period one year ago.
- Compared to the second quarter of 2014, par amount traded decreased 9.1 percent and the number of trades decreased 2.3 percent.
- Trading of fixed rate municipal securities decreased to \$371.2 billion in the third quarter compared to the \$493.2 billion traded in same period last year, a 24.7 percent decline.
- The number of variable rate demand obligations rate resets continued to decline in the third quarter to 155,170, down from 171,539 rate resets in the same period one year ago.

The MSRB's quarterly statistical summaries include aggregate market information for different types of municipal issues and trades, and the number of interest rate resets for variable rate demand obligations and auction rate securities. The data also include statistics pertaining to continuing disclosure documents received through the MSRB's EMMA website. Daily and historical summaries of trade data based on security type, size, sector, maturity, source of repayment and coupon type are displayed in EMMA's Market Statistics section.

The EMMA website is a centralized online database operated by the MSRB that provides free public access to official disclosure documents and trade data associated with municipal bonds. In addition to current credit rating information, the EMMA website also makes available real-time trade data and primary market and continuing disclosure documents for over one million outstanding municipal bonds, as well as current interest rate information, liquidity documents and other information for

most variable rate municipal securities.

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## **Likely Default of Puerto Rican Utility Haunts Brokers, Muni Fund Managers.**

The widely expected default of a Puerto Rican utility continues to weigh on some investment managers.

One in four U.S. municipal bond funds hold some exposure to the debt of the utility, the Puerto Rico Electric Power Authority or Prepa, a self-funded utility that provides electricity to nearly 1.5 million households and businesses on the island.

The approximately \$1.7 billion in Prepa bonds held by mutual funds is a drop in the bucket for the \$553 billion U.S. muni bond fund industry. And the exposures generally account for less than 1% of the total portfolio.

But 39 mostly single-state and high-yield funds have weightings around or above 2%, according to an InvestmentNews analysis of data from Morningstar Inc., including funds from OppenheimerFunds and Franklin Templeton Investments. Those funds account for about \$33 billion in assets.

“Yields are not that high in fixed income,” said Morningstar analyst Kiran Lalani. “It’s a yield boost to add some of these bonds.”

For single-state funds, managers are also limited in the number of securities they can buy and tend to fill out the rest of portfolios such as the Oppenheimer Rochester Maryland Municipal Fund (ORMDX) or Franklin New Jersey Tax-Free Income (FRNJX) with more Puerto Rican debt, according to Ms. Lalani.

The commonwealth said in an Oct. 30 report that the island’s power utility may use its authority under a law passed by local lawmakers in June that would allow it to ask bondholders to take a loss.

Franklin Templeton Investments and OppenheimerFunds have both filed lawsuits in federal court alleging the debt-restructuring law is illegal.

Puerto Rico’s debt-laden woes seem to have weighed on fund companies, too.

Oppenheimer’s \$26 billion muni operation saw nearly \$5.3 billion in investor redemptions in the 12 months ended Sept. 30, according to Morningstar, while Franklin’s \$68 billion muni business saw nearly \$4.9 billion in outflows over that time period.

Spokespeople for both firms declined to comment.

The Prepa securities are also a central subject in ongoing arbitration cases against brokers at firms including a UBS AG affiliate by investors who say they were sold Prepa bonds that subsequently lost value, according to Lawrence L. Klayman, a lawyer representing some investors in those cases.

A UBS spokesman did not respond to a request for comment.

Ms. Lalani, the Morningstar analyst, said that most fund managers have taken a cautious approach to the territory and reduced their exposures.

John V. Miller, the co-head of fixed income at Nuveen Asset Management, said in August that his

firm had “reevaluated” its use of Puerto Rican securities in fixed income portfolios.

“At a minimum it’s a high-yield play, if not a distressed-debt play, therefore it would only be a good fit in certain portfolios,” he told InvestmentNews.

He said the firm had declined to participate in a lawsuit against the legality of Prepa’s debt restructuring.

“It’s a little bit academic in nature,” said Mr. Miller. “Let’s say it is unconstitutional, where’s the money going to come from to pay the debt back?”

InvestmentNews

By Trevor Hunnicutt

Nov 6, 2014 @ 4:13 pm

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## **[Detroit Bankruptcy Taught Muni Investors Painful Lessons.](#)**

No matter what a federal judge decides today about approving Detroit’s \$18 billion bankruptcy plan, the record-setting case has already taught municipal bond investors some painful lessons.

Above all, pensions trump bonds, and when local politicians are forced to choose sides, Wall Street will be left out.

“It’s pretty easy to stick it to the bondholders,” said Lee Bogdanoff, a bankruptcy attorney who helped the second-largest U.S. municipality to suffer financial implosion, Jefferson County, Alabama, fight off demands by creditors holding billions of dollars in bonds.

U.S. Bankruptcy Judge Steven Rhodes is set to announce this afternoon whether he’ll approve Detroit’s proposal to eliminate \$7 billion of debt, including some bonds backed by taxes. Rhodes must determine whether the plan is fair and feasible and whether to accept or overrule the objections of a handful of retirees who still oppose it.

During a two-month trial, Rhodes focused many of his questions on whether the plan was workable, repeatedly telling city officials he wouldn’t allow them to enter into any more bad debt deals. He showed less concern about whether the plan was fair to bondholders and other financial creditors, like debt insurers.

### **Investor Education**

“Hopefully this will educate not only investors, but also political leaders,” said Richard Ciccarone, a municipal debt analyst and president of Merritt Research Services in Chicago. “You can’t treat municipal debt as a risk-free investment.”

Detroit filed for bankruptcy in July 2013, listing \$18 billion in liabilities. After decades of population decline and the disappearance of manufacturing jobs in the U.S. automotive capital, it could no longer meet financial obligations while providing essential services.

The city plans to spend about \$1.7 billion to rebuild by removing blight and improving everything from police and fire protection to public transportation.

The case broke new ground in several areas, said James Spiotto, a bankruptcy specialist and managing director at Chicago's Chapman Strategic Advisors LLC, which counsels on financial restructuring.

### **Sewer Sacrifices**

Detroit pushed water and sewer bondholders to make sacrifices, even though their debt was guaranteed by the city's utility, which wasn't in bankruptcy and had been paying its debt on time. Eventually, the city refinanced some of those bonds at lower cost and left the rest unchanged.

The city also succeeded in forcing bondholders who held debt tied to property taxes to agree to take less than they were owed, something that municipal investors had assumed a bankruptcy court wouldn't allow. Since those so-called general obligation bondholders were covered by insurance, any losses were passed on to the insurers, according to Spiotto.

"That was a gift of the bond insurers to the city," he said.

The most important legal precedent to come out of the Detroit bankruptcy involved the protections state lawmakers had given to public-worker pensions. In a ruling that was later echoed in a case of Stockton, California, Rhodes found that when a city files for bankruptcy, those protections don't apply because federal law trumps state law.

### **No Priority**

That ruling should be a win for municipal debt investors because it means that from a legal perspective, retirees shouldn't get priority over unsecured bondholders, said Bogdanoff, co-managing partner at Klee Tuchin Bogdanoff & Stern LLP, who's not currently involved in the Detroit case. The debt should be considered equivalent, so each side would normally have to take about the same cuts.

In Detroit and in Stockton, however, local leaders predictably pushed plans that favored public workers over investors. So while the Detroit case gives investors a legal victory to leverage in future fights, it also teaches that, unlike corporate reorganizations, municipal bankruptcies are a very political animal.

"The more politically powerful group, the more sympathetic groups wound up doing better," Bogdanoff said. "The Wall Street creditors really took it on the chin."

Under the plan proposed by Detroit Emergency Manager Kevyn Orr and his team of legal and financial advisers, agreements were hashed out with the city's large creditors, including retired workers who accepted modest pension cuts; hedge funds that held pension-related debt; and nearby counties that objected to how the bankruptcy would affect the water and sewer services they receive from the city.

### **Art Protection**

The settlements include an \$816 million deal to bolster pensions in return for protecting city-owned art from liquidation; Detroit's agreement to pay \$85 million to end interest-rate swaps valued at \$288 million; and the pension debt settlements.

Before they settled, pension debt creditors, including hedge fund managers Aurelius Capital Management LP and BlueMountain Capital Management LLC, had argued that because they are being paid far less than retired city workers, the plan is unfair. As part of the settlements, those

objections have been withdrawn.

“Until we get clarification from federal appellate courts, we have to conclude a municipality’s general fund obligations are structurally subordinated to their pension liabilities,” said Tom McLoughlin, head of municipal fixed-income at UBS Wealth Management Americas in New York. Under the bankruptcy code, a municipality “has more latitude to treat creditors in a disparate fashion than you’d see in a typical corporate reorganization,” he added.

The case is *In re City of Detroit*, 13-bk-53846, U.S. Bankruptcy Court, Eastern District of Michigan (Detroit).

By Steven Church

November 07, 2014

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## **[How the Tribune Analyzed CPS' Bond Deals.](#)**

When Chicago Public Schools officials embraced auction-rate borrowing over traditional fixed-rate bonds, their goal was to save money for the financially strapped district.

From 2003 through 2007, the district issued auction-rate bonds four times, racking up a total of \$1 billion in auction-rate debt, most of it paired with interest-rate swaps. The district refinanced the bonds in 2008, keeping similar maturity dates.

To assess the long-term success of this strategy, the Tribune conducted its own analysis of the deals and their future trajectory.

First, reporters calculated the total amount the district paid out on these deals, since CPS did not have that information. Reporters then estimated the future payments CPS will make on the refinanced deals.

As a comparison, the reporters estimated how much the district would have paid if it had opted to borrow the same sum through traditional fixed-rate bonds with the same payment schedules.

Because such an analysis requires a variety of nuanced decisions that affect the final numbers, reporters consulted with academics and leading municipal bond experts to ensure that the Tribune’s methodology was sound. One was Andrew Kalotay Associates, a debt management advisory firm that advised the city of Chicago on a recent bond issue. Another prominent firm, Municipal Market Advisors, also supported the Tribune’s methods.

In the end, the Tribune analysis found that the district could end up paying \$100 million more in today’s dollars over the life of the deals than if it had stuck with safer borrowing methods.

The most complex part of the analysis involved constructing the hypothetical fixed-rate alternative to CPS’ auction-rate deals. Here are more details about those calculations, as well as the objections

raised by CPS officials and the district's longtime financial adviser.

### **The fixed-rate alternative**

To estimate the costs for CPS if it had issued fixed-rate bonds instead of auction-rate securities, Tribune reporters relied on market data provided by Thomson Reuters MMD.

MMD rates are published every business day and are used in the municipal bond market as a benchmark for the return, or yield, that investors will receive.

That data gave the Tribune an idea of what yield investors would have demanded from CPS if the school district had issued fixed-rate bonds. From that information, reporters could construct hypothetical fixed-rate bonds and calculate the interest costs for CPS.

The term "bond" is used colloquially — and throughout the Tribune series — to refer to an issuance of several hundred million dollars in debt, whether auction-rate or fixed-rate. In fact, each of these bond issues is made up of a series of smaller bonds, with each one coming due in a different year. Investors buy shares of one or more of these bonds in exchange for payments of interest and — when the bond comes due — principal.

The MMD yield curves apply to premium fixed-rate bonds with an interest rate of 5 percent. Borrowers pay 5 percent on the entire bond issue even though the market would accept lower rates, especially for bonds that come due during the early years. In exchange, investors pay more upfront than the face value of a bond.

If CPS had issued premium fixed-rate bonds that delivered the same amount of project money that the district got from the auction-rate bonds, those fixed-rate bonds would have had a lower face value and a lower principal payment than the auction-rate bonds.

The Tribune calculated the lower face value of each of these bonds as follows:

For the four dates on which CPS issued auction-rate bonds, the Tribune obtained MMD yields for each year in which a bond was due.

Reporters used a Microsoft Excel function to convert those yields into prices. The price is the amount, stated as a percentage of the face value, that investors pay to buy shares of a bond on day one.

Reporters divided the face value of each of the auction-rate bonds by the corresponding prices to create smaller fixed-rate bonds — bonds with a lower face value than the auction-rate bonds — that delivered the same project money.

Reporters then calculated the amount of interest CPS would pay on these smaller fixed-rate bonds at an interest rate of 5 percent. This enabled the Tribune to estimate how much CPS would have paid had it used traditional fixed-rate borrowing to bring in the amount of project money that the district obtained using auction-rate bonds.

### **Adjusting for refinancing**

The MMD curves assume that the borrower will reserve the right to refinance the bond at par value — to pay back the principal amount of the old bond using money from a new bond issued at new rates — after 10 or more years.

This is typically part of the contract for fixed-rate bonds, including most fixed-rate bonds issued by CPS, as district officials acknowledged in interviews.

Because refinancing fixed-rate bonds can result in massive savings if rates drop, the right to refinance — or call — bonds has a lasting value. Few municipalities are willing to forgo that right, which is sometimes referred to as the call option.

Pairing auction-rate bonds with interest-rate swaps made it extremely unlikely that CPS could save money by taking advantage of that option, as swaps are costly to terminate when rates drop. But the school district likely would have been able to save money by refinancing if it had issued fixed-rate bonds instead.

Of CPS' four auction-rate bonds, three were issued in 2003 or 2004. If CPS had opted for fixed-rate bonds, the district could have refinanced them at par value in 2013 and 2014, when rates were significantly lower. (The fourth bond was issued in 2007.)

For its analysis, the Tribune assumed that had CPS issued fixed-rate bonds in 2003 and 2004, the district would have exercised its 10-year call option, as was common for municipalities across the country. Reporters used 2013 and 2014 MMD yield curves to create new premium fixed-rate refinancing bonds, then calculated the estimated interest payments from 2013 or 2014 until the final maturity date.

The Tribune did not attempt to determine how much could be saved by refinancing the 2007 bond. However, reporters did another kind of refinancing adjustment when they calculated the fixed-rate alternative for the 2007 auction-rate bond.

The 2007 auction-rate bond was itself a refinancing of a 1997 fixed-rate bond. The terms of the contract for that particular bond said it could be refinanced at par value in 2009. To refinance in 2007, CPS paid a \$5 million premium; CPS opted to do that in order to enter into swap deals that provided \$43 million in upfront cash.

The Tribune's hypothetical fixed-rate scenario assumes CPS would have avoided the premium for refinancing and waited until 2009 to refinance the bonds. Therefore, when totaling the cost of the fixed-rate equivalent, the Tribune calculated the interest on the 1997 bond from 2007 (when the auction-rate bond was issued) until the 2009 call date. Reporters then assumed the bond was refinanced and calculated the new interest payments using 2009 MMD yields.

Rates were particularly low in 2013-14, when three of the hypothetical fixed-rate bonds could have been refinanced. That significantly increased the cost difference between the fixed-rate and auction-rate options.

After reporters adjusted figures for the present value of future dollars, the cost difference between the two borrowing methods amounted to about \$100 million. If reporters had assumed the school district would choose not to refinance the 2003 and 2004 bonds, the estimated savings would have been less: about \$70 million.

The Tribune worked with Andrew Kalotay and others at New York City-based Kalotay Associates to develop its method of calculating the cost of CPS' hypothetical fixed-rate bonds. Concord, Mass.-based Municipal Market Advisors also reviewed the method and found it to be reasonable. Charles Jones, a professor at Columbia Business School, said the Tribune's methodology "makes perfect sense."

## **Choosing yield curves**

Because CPS bought insurance on its auction-rate bonds and on most fixed-rate bond issues during the 2003-09 time period, reporters chose the MMD curves published for insured bonds, which assume the municipality buying the insurance has a rating of A. CPS at the time had slightly better ratings of A+ or AA-.

CPS officials later provided their own estimated yield-to-call values for that time period. For some bonds, those values were nearly identical to the MMD insured yields that the Tribune used.

The Tribune's decision to use MMD yield curves was partly a result of conversations with CPS and with Adela Cepeda of A.C. Advisory, a financial advisory firm that advised the school district on the bond deals.

But CPS officials and Cepeda both questioned the Tribune's use of insured yields. They argued that MMD insured yield curves are lower than what CPS would pay and thus underestimate what the district would have paid for fixed-rate debt.

"The MMDs are just indexes and they provide guidance, but they are not absolute indicators of where a deal should price," Cepeda said.

So the Tribune did a separate analysis to test the difference between the MMD yields it chose and the yields on CPS bonds issued around the same time as the district's auction-rate securities. In nearly every case, the Tribune found that the MMD yields were higher than yields on CPS bonds with the same maturities. This suggests that the Tribune's analysis underestimates the district's losses on auction-rate securities.

In constructing the three refinancing bonds that would have been issued in 2013 and 2014, the Tribune used a slightly more expensive yield curve. That is because CPS, like many municipalities, has backed away from the use of bond insurance in recent years. So the Tribune opted to use the MMD values for municipalities rated A. CPS had a rating of A+ in 2013, according to its annual financial report.

### **Calculating costs**

When the Tribune calculated the district's costs on the auction-rate deals, reporters included interest payments on the bonds as well as net payments on the interest-rate swaps. To make those calculations, reporters used information from the swap confirmation documents and data compiled by Bloomberg and the Federal Reserve Bank of St. Louis, then spot-checked the results against paper records from CPS.

Much of the same data went into calculating past and future costs on the debt the district used to refinance the auction-rate bonds after the auction-rate market collapsed in 2008. Two bonds were refinanced with fixed-rate debt, so future costs were simple to determine.

The remaining two were refinanced with variable-rate bonds pegged to the floating London Interbank Offered Rate, or Libor. To calculate future costs to CPS, the Tribune used estimated future rates provided by Andrew Kalotay Associates and derived from the Bloomberg U.S. dollar swap curve.

Reporters also used spot rates provided by Kalotay (also based on the Bloomberg U.S. dollar swap curve) to calculate the present value of future dollars by discounting the cash flows on an annual basis.

This was done for payments from 2014 onward on both the refinancing bonds and the hypothetical

fixed-rate alternatives. The Tribune did not adjust the cost of past payments made since the first deal closed in 2003. But based on conversations with experts, reporters believe doing so would have had a minimal effect on the estimated cost difference.

The Tribune's analysis omitted some minimal costs that would have been incurred both on the hypothetical fixed-rate bonds and on the auction-rate bonds.

One was the cost of insurance on the initial bond issues. Documents showed that insurance costs were slightly higher when CPS issued auction-rate bonds than when it issued fixed-rate bonds; so to the extent that the omission of this cost affected the comparison, it made the auction-rate bond option look slightly better than it otherwise would have.

The Tribune also left out the issuance costs on both the initial bonds and any refinancing bonds. With one exception, all the bonds — whether fixed- or auction-rate — would have been refinanced once, so it was assumed the costs on both sides would be roughly equal.

The 2007 bond issue incurred two sets of issuance costs in the auction-rate scenario but only one set in the fixed-rate scenario, so again the omission would have made the auction-rate option look better.

### **Challenges, objections**

In response to the Tribune's questions, both Chicago Public Schools and A.C. Advisory did analyses that compared the cost of the four auction-rate bond deals with what the school district would have paid for fixed-rate debt.

CPS' analysis covered a different time period than the Tribune's. While Tribune reporters looked at the cost of the deals through the final maturity dates, from 2030 to 2034, the school district's analysis ended at the present day.

For that 11-year period, CPS found, the costs associated with the auction-rate bonds were \$30 million less than what fixed-rate bonds would have cost during the same period.

Several key factors helped determine that finding. One is that during the past 11 years, the school district has received or paid out several lump sums associated with its auction-rate deals. As mentioned above, the interest-rate swaps associated with the 2007 bond delivered a \$43 million upfront payment to CPS.

The district also paid about \$20 million in swap termination payments in 2008 when it refinanced its auction-rate bonds after the market collapse. Together, these one-time payments provided a net benefit to the district of about \$23 million.

CPS applied that benefit in its entirety to the initial 11-year period of the deals — even though the terms of the deals dictate that the school district will be paying the higher rates associated with the \$43 million gain until 2030.

Another important factor in CPS' \$30 million finding is that its analysis captures all the low payments the district made on its auction-rate deals from 2003 to 2007, before the deals blew up. But the analysis captures less than seven years of the much longer period the district will spend paying the higher rates it agreed to when it refinanced the deals in 2008.

CPS declined to address the question of whether auction-rate bonds or fixed-rate bonds would cost more over the life of the deals.

“We only looked at it through current day because we think that’s the appropriate approach,” said CPS Treasurer Jennie Huang Bennett.

If CPS wanted to end the deals today, however, it would have to pay \$126.5 million to extricate itself from swap deals, according to valuations of the swaps in the district’s 2013 annual financial report.

A.C. Advisory, which advised CPS on the auction-rate deals, chose — like the Tribune — to analyze the costs of the deals through maturity.

The company hired a New York City-based firm, Stanley P. Stone & Associates, which provides support services to municipal advisers and underwriters, to compare the cost of the school district’s auction-rate deals with what fixed-rate bonds would have cost.

The firm’s findings omitted one of the four deals, the one in 2007 that involved a refinancing of older debt. Cepeda said a comparison was inappropriate in that case because the school district “believed it could not” refinance those bonds at a fixed rate under terms of a 1997 intergovernmental agreement.

Cepeda later acknowledged that the district “may have been technically able” to issue fixed-rate debt but chose not to.

On the other three deals, Stone & Associates found that the school district had saved \$64 million by issuing auction-rate debt rather than fixed-rate debt.

But the firm’s analysis showed different costs for the auction-rate bonds than the payment amounts calculated by CPS or by the Tribune. In the case of one bond, Stone’s cost-to-date was \$20 million less than what the school district reported.

The firm’s estimate of what CPS would have paid for fixed-rate debt, meanwhile, was much higher than the Tribune’s estimate.

Stone’s analysis assumed that if CPS had issued fixed-rate bonds in 2003 and 2004, it would not have chosen to take advantage of historically low interest rates by refinancing 10 years later. This increased the firm’s estimated fixed-rate costs significantly.

CPS made the same assumption, showing no refinancings in 2013, though it had little effect on an analysis that ended in 2014.

Kalotay said any analysis “should have used the call option. Why would you disregard it?”

Matt Fabian of Municipal Market Advisors also said that assuming the bonds would be refinanced — as the Tribune did in its analysis — was the correct approach.

“That’s exactly what you should do,” he said. “That’s what would happen.”

The Chicago Tribune

November 7, 2014

By Heather Gillers and Jason Grotto

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## **Elections Season Could Shake Up Muni ETFs.**

The municipal bond market, along with related exchange traded funds, have been steadily strengthening as austerity across local governments keeps supply low, but midterm elections could affect the munis market ahead.

For instance, in Illinois, the state income tax is a key factor to watch, according to Peter Hayes, Managing Director, head of BlackRock's Municipal Bonds Group.

Specifically, the temporary tax increase to 5% is set to expire at year-end and will move back down to 3.75%. The Democratic incumbent governor wants to extend the tax increase while the Republican challenger is fine with letting it expire. If the Democrats have their way, the higher state tax rate would entice more Illinois investors to hold onto munis and benefit from the state tax exemption on Illinois-issued debt.

Additionally, in Pennsylvania, "pension reform will be a critical point on how the state is viewed by credit ratings agencies and broader municipal market," Hayes added.

Muni ETF investors have a number of options to gain exposure to these state bonds. For example, the iShares National AMT-Free Muni Bond ETF (NYSEArca: MUB) includes a 5.3% tilt toward Illinois and 3.0% in Pennsylvania. The Market Vectors Intermediate Municipal Index ETF (NYSEArca: ITM) allocates Illinois 4.0% and Pennsylvania 2.2%. Additionally, the PIMCO Intermediate Municipal Bond ETF (NYSEArca: MUNI) holds 6.1% in Illinois-issued debt and 4.9% in Pennsylvania debt.

MUB has a 6.41 year duration and a 1.58% 30-day SEC yield or a 2.79% taxable equivalent yield for those in the highest income bracket. ITM has a 7.17 year duration and a 2.46% 30-day SEC yield or a 3.39% taxable equivalent yield. MUNI has a 4.65 year duration and a 1.15% 30-day SEC yield.

Moreover, there are just a few bond initiatives for this election season. For example, California's Proposition 2, or the so-called Rainy Day Budget Stabilization Act, will help provide a greater cushion for the state government in case of another financial crisis or emergency.

The proposition "has the potential to significantly improve the state's financial flexibility and credit rating going forward," Hayes said.

California accounts for a large portion of the broad muni bond ETFs, including 22.7% in MUB, 15.1% in ITM and 11.7% in MUNI. Alternatively, investors can specifically target California muni bonds through the iShares California AMT-Free Muni Bond ETF (NYSEArca: CMF), SPDR Nuveen Barclays California Municipal Bond ETF (NYSEArca: CXA) and PowerShares Insured California Municipal Bond Portfolio (NYSEArca: PWZ).

October 28th at 8:20am by Tom Lydon

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## **Act 47: Pennsylvania Says Enough Is Enough. Or Is It? Ballard Spahr.**

Pennsylvania Governor Tom Corbett today signed House Bill 1773 (HB 1773) into law, significantly overhauling the Municipalities Financial Recovery Act, known as Act 47. Enacted in the 1980s to provide assistance to municipalities that were suffering from collapsed tax bases following the closure of many western Pennsylvania steel mills, Act 47 was intended to help distressed municipalities control their expenses (particularly labor arbitration awards), enhance revenue through additional taxing authority, and qualify for certain Commonwealth grants and no-interest loans on a priority basis.

Twenty-eight municipalities across the Commonwealth have been officially declared financially distressed under Act 47—with others contemplating such a determination, and undoubtedly even more able to qualify under the law if they wished to do so. Unfortunately, only nine have had their determinations lifted. It is noteworthy that 14 municipalities have been in the Act 47 program more than 10 years, some more than 20 years. Given the apparent difficulty of overcoming municipal financial distress (or the reluctance of municipal officials to make difficult choices required to alleviate it), and with the hindsight of an apparently successfully negotiated resolution to the City of Harrisburg's defaults and insolvency, the General Assembly determined to amend the law.

### **A New Timetable To Manage Distress**

While Act 47 recovery plans are typically written with a five-year shelf life, after which an updated plan is typically put in place, the new amendments impose a five-year time limit for municipalities to exit Act 47. At the same time, the amended law permits the recovery plan coordinator to ask the local Court of Common Pleas for a one-time, three-year extension. For municipalities already in Act 47 and operating under a recovery plan, the termination date for their distressed status will be five years from the effective date of the most recent recovery plan or amendment. If their current plan is scheduled to expire within one year or less of the effective date of the Act 47 amendments, the municipality is subject to an automatic extension of three years from the termination date of the current recovery plan or plan amendment.

By adding this time limit, the Commonwealth is emphasizing the need for municipal officials to take a hard look at their underlying financial structure, including collective bargaining agreements. The question is whether the maximum of eight years under Act 47 will be enough time to implement significant and successful financial structural changes. Labor costs are one of the most significant contributing factors to a municipality's fiscally distressed status. Collective bargaining agreements, however, typically last four or more years. Under Act 47's new time limits, it is likely that a municipality will have at most only one opportunity to reduce its labor costs through collective bargaining during an Act 47 designation. The practical effect of the new amendments must be warmly welcomed by municipal employees.

Since the expiration provisions may not provide sufficient time for a municipality to solve its labor cost issues, it is essential that a municipality times its entry into Act 47 when its collective bargaining agreements are scheduled to expire and that it uses the Act 47 tools effectively and fully when it has the opportunity to do so. While a time limit might be a reasonable idea, an arbitrary limit may be too short to permit meaningful change to alleviate long-term municipal fiscal distress. It is questionable whether five or eight years is enough time for a municipality to significantly reverse the other causes of fiscal distress, such as a declining population and eroding business tax base, deteriorating infrastructure, and declining investment, that in many cases have been declining for years. The main focus of a successful state oversight regime should be providing the tools that municipalities need to regain their footing; whether the new time limit and other amendments do so remains to be seen.

## **Four Exit Scenarios**

In the fifth year of a municipality's Act 47 status, the recovery plan coordinator must complete a report setting forth the financial condition of the municipality and make one of the following findings:

- The conditions within the municipality warrant a termination of distressed status.
- The conditions warrant a three-year extension and exit plan.
- The conditions justify a request by the Secretary of the Department of Community and Economic Development (Secretary) for a determination of fiscal emergency.
- The conditions warrant disincorporation of the municipality.

After public notice, a comment period and a public hearing, the Secretary will issue an administrative determination of termination status and the reasons for such determination. Factors considered in the Secretary's determination include elimination of operating deficits, projected balanced budgets, projected revenues, stable debt obligations, and resolution of all financially adverse claims or judgments against the municipality. This determination is subject to appeal by specific parties identified in the new law, including a collective bargaining representative

## **Receivership: Doubling Down on the Harrisburg Approach**

The mismanagement and crisis of inaction that resulted in the installation of a state-appointed receiver for the City of Harrisburg ended in 2013 with the adoption of the "Harrisburg Strong Plan"—the innovative financial recovery plan that allowed Harrisburg to avoid municipal bankruptcy and reposition itself for long-term renewal. The Harrisburg Strong Plan received national recognition, and the strategies implemented in it have been viewed as a potential "blueprint" for restructuring municipal obligations for distressed cities that is both cheaper and faster than a Chapter 9 bankruptcy filing. A number of the lessons learned from Harrisburg appear to have informed some of the Act 47 amendments.

Chapters 6 and 7 of Act 47 govern the fiscal emergency and receiver provisions. Upon the Secretary's request, the Governor may determine that a fiscal emergency exists if the distressed municipality is insolvent (or projected to be insolvent in the next six months), and the municipality either (1) is unable to continue providing vital and necessary services; or (2) has failed to approve the coordinator's plan or an alternative plan that had been approved by the Secretary. Upon determination of a fiscal emergency, the Governor may then formally declare the municipality to be in a state of fiscal emergency, and direct the Secretary to develop an emergency action plan to ensure the maintenance of vital and necessary services. During a state of fiscal emergency, the Governor may exercise the authority of the municipality's elected or appointed officials and may assume any of their powers, including the powers to, among other things, collect funds, obtain emergency financial aid, and enter into contracts and agreements on behalf of the municipality for vital and necessary services. The elected and appointed officials may continue acting in their respective offices and capacities, as long as no action or decision conflicts with the emergency action plan, order, or exercise of power by the Governor.

Shortly after the declaration of fiscal emergency, the municipality's governing body must negotiate a consent agreement with creditors and any other interested parties. The consent agreement must incorporate a plan setting forth measures designed to provide long-term financial stability to the municipality and maintain vital and necessary services. Once a consent agreement is negotiated, the Secretary will decide whether to approve it. If the consent agreement is approved, the municipality's governing body must enact an ordinance adopting it. The status of fiscal emergency will end when the Secretary determines that the municipality is solvent and is not projected to be insolvent within

180 days or less, and is able to maintain vital and necessary services after the termination of fiscal emergency.

If the consent agreement is not approved, or the municipality fails to enact an ordinance adopting it, the Governor may appoint a receiver for the municipality. The receiver will then develop a recovery plan for the municipality. Such a plan is expected to ensure that vital and necessary services continue, the municipality's lawful financial obligations are paid, and required pension fund payments are deposited in a timely manner. The plan will also authorize a number of other actions, including the sale and conveyance of municipal property; approval, modification, or termination of contracts; and any other decisions the receiver deems appropriate.

The recovery plan must be confirmed by the Court of Common Pleas unless it finds clear and convincing evidence that the plan is arbitrary, capricious, or wholly inadequate to alleviate the fiscal emergency. Confirmation of a recovery plan requires the elected and appointed officials to undertake the acts set forth in the plan and suspends their authority to exercise power on behalf of the distressed municipality under law, charter, ordinance, rule, or regulation to the extent that such power would interfere with the powers granted to the receiver or the recovery plan's goals.

The receiver's term will end two years after appointment, with the option for one or more extensions of up to two years as approved by the court. The receivership also terminates automatically upon certification from the Secretary that the fiscal emergency has ended and the Governor rescinds the declaration. If the municipality remains financially distressed upon the expiration of the receivership period as determined by the Secretary, the recovery plan shall remain in effect and the Secretary will appoint (or re-appoint) a coordinator to administer the recovery plan in accordance with the timeline and requirements of Act 47.

Unlike some other states' receivership laws, notably Michigan's Act 436, the Commonwealth's receivership provisions under these amendments do not expressly allow a receiver to reject, modify, or terminate existing collective bargaining agreements. This difference is critical because high labor costs are usually the largest contributor to a municipality's fiscal distress. The new receivership provisions do, however, put labor leaders on notice that absent their willingness to negotiate contracts based on a municipality's reasonable capacity to pay for labor, the contracts may end up being impaired to a greater extent under a Chapter 9 bankruptcy proceeding.

### **Disincorporation - A Radical Approach**

The original Act 47 anticipated that some municipalities may, in fact, be "nonviable" due to the long-term loss of their tax bases. In practice, the lack of interest in municipal consolidation on the part of more financially balanced adjoining communities has prevented determinations of nonviability. The new amendments provide that a municipality unable to exit Act 47 could legally be deemed nonviable, resulting in "disincorporation." For purposes of this section of the law, a "municipality" is defined as a "county, city, borough, incorporated town, township and home rule municipality that does not provide a police service or fire service through its employees." The City of Philadelphia is not included in this definition, however.

The disincorporation provisions of the Act 47 amendments seem to be the clearest "warning shot" from the General Assembly to municipal leaders that their inability, or reluctance, to overcome perpetual financial distress will no longer be tolerated. While the reality of disincorporation may at first seem to position the distressed community for an easier path toward consolidation with skeptical neighbors, in practice, the disincorporation option may be of limited value if it does not apply to large numbers of municipalities with police and fire employees. Under the disincorporation provisions, if the Secretary determines that disincorporation is warranted, the Secretary must

provide notice to the municipality's governing body and recommend disincorporation. Within 45 days of this determination, the governing body may enact an ordinance initiating the disincorporation, or, if the governing body fails to do so, a petition signed by a majority of registered electors of the municipality (those voting in the last gubernatorial election) may be submitted to the Court of Common Pleas. After another round of notice and hearing, the court will then issue a decree approving the ordinance's validity or granting the petition unless it finds by clear and convincing evidence that the municipality should remain incorporated because of a reasonable expectation that the municipality is viable.

If the court were to take the extraordinary step of issuing a disincorporation decree, a service district administrator would be appointed by the Secretary to establish an essential service plan. The service district administrator will enjoy broad powers, including the ability to sell or convey the municipality's assets; repay debts, bonds, and other obligations; seek a writ of mandamus against the municipality's governing body to carry out the disincorporation; approve, negotiate, or terminate contracts for services; identify essential services; apply for grants and loans; establish fees; and contract for professional services for the municipality. After the decree but before implementation of disincorporation, the municipality must enact a budget providing for the payment of every current obligation before the date of disincorporation and provide for the transfer and administration of any municipal pension assets to a private or public pension fund. The municipality's governing body may adopt recommended governing standards to be included in the essential service plan. Once the plan has been filed, there will be another round of notice, public meeting and comment, as well as an opportunity to appeal the final plan, before final filing of the plan.

On the date of disincorporation, the terms of all elected officials of the municipality automatically terminate and no person shall be elected or appointed, all ordinances of the municipality are nullified, all corporate powers granted to the municipality under its charter or the municipal code terminate, and the municipality shall be deemed an unincorporated service district.

## **Revenue Enhancement**

The Act 47 amendments also set forth a number of changes to what municipalities operating under the program can do. These include expressly conditioning the increase in the earned income tax upon equal imposition on both residents and commuters. They also allow a municipality to triple the usual \$52 maximum local services tax rate. It is important to note that municipalities will retain the ability to maintain this higher local services tax after exiting Act 47.

Municipalities in Act 47 will still not be allowed to change labor contracts already in place. They will, however, be able to pursue changes to labor contracts through the applicable collective bargaining process and Act 111 interest arbitration procedures. The existing provisions of Act 47 mandate that the collective bargaining agreement that results from those procedures must comply with the Act 47 recovery plan that is in place at that time (with very limited exceptions).

The amendments also remove a provision allowing municipalities with distressed municipal pension plans to use added revenue from the higher local services tax to pay pension debt. Certain provisions are specific to Pittsburgh, which entered Act 47 in 2003. Unlike other Act 47 municipalities, Pittsburgh would not have an opportunity to increase its local services tax in lieu of an earned income tax. Act 47 does not apply to the City of Philadelphia.

Although the Act 47 amendments passed the General Assembly easily, these changes address Act 47 procedures and levels of state oversight; they do little to alleviate the underlying financial, demographic, or structural problems causing the financial distress. If nothing else, the amendments should serve notice to Pennsylvania municipal leaders and voters that the General Assembly expects

municipalities to make meaningful and politically difficult decisions to address their fiscal situation in a timely manner, or risk losing local control of their municipalities. The legislative intent is clear: the days of perpetual Act 47 status and “treading water” financially are numbered. The question is whether the General Assembly has provided adequate tools to enable municipalities to achieve that result on schedule, or at all.

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October 31, 2014

by William C. Rhodes, John P. McLaughlin, Patrick J. Harvey, Christopher R. Sullivan, and Kimberly D. Magrini

Attorneys in Ballard Spahr’s Municipal Recovery Initiative have hands-on experience representing governments in matters of public finance; public-private partnerships; bankruptcy, restructuring, and capital recovery; labor and employment; tax; land use; and intergovernmental relations. Our attorneys have a track record of success helping financially distressed municipalities with issues such as accessing capital markets, negotiating and arbitrating labor contracts, and monetizing assets.

The firm’s Public Sector Labor and Employment practice is a multidisciplinary labor and employment law practice that represents cities and municipalities in all aspects of Act 47, including the development of early intervention programs and financial recovery plans, pension and post-retirement health care issues, collective bargaining and grievance and interest arbitration under Act 195 and Act 111, and all other employment, labor, and personnel issues.

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**[Ballard Spahr: Regulators Decline to Exempt TOBs from Risk Retention Rule but Add Helpful Revisions and Clarifications.](#)**

Although regulators have rebuffed industry efforts to have tender option bonds (TOBs) exempted

from the final [credit risk retention rule](#) (the CRRR), they have nevertheless provided some helpful changes and clarifications that may offset any disappointment with this decision. The rule implements Section 15G of the Securities Exchange Act of 1934, which was enacted as part of the Dodd-Frank legislation.

The CRRR governs risk retention with respect to asset-backed securities (ABS), some of which (like qualified residential mortgage loans) are exempt from the requirement. No exemption from the 5 percent risk retention requirement is provided, however, for sponsors of issuing entities concerning TOBs, a secondary market municipal bond financing technique, as many commenters had requested. It is worth noting that TOBs did not play any part in the financial crisis that led to Section 15G's enactment.

Our recent [alert](#) summarized key aspects of the CRRR, which was issued more than three years after it was originally proposed by the three prudential bank regulators, the Securities Exchange Commission, and the housing finance regulators (collectively, the Agencies). We noted that the CRRR largely tracked the version of the rule that was re-proposed in September 2013 (the Re-proposed Rule). With respect to TOBs, the final rule and accompanying release, in addition to providing certain technical changes and clarifications, also raise several issues that may merit further clarification.

A TOB involves the deposit of one or more highly rated (typically tax-exempt) municipal bonds (munis) into a trust and issuance by the trust of two classes of securities: floating rate, puttable securities (floaters) and an inverse floating rate (residual) security. TOBs provide municipalities with access to a diverse investor base and a more liquid market. The CRRR definition of TOB focuses on those features entitling the holders to tender such bonds to the issuing entity for purchase at any time upon no more than 397 days' notice, for a purchase price equal to the approximate amortized cost of the security, plus accrued interest (if any) at the time of tendering.

A key TOB-related concept in the CRRR is the newly created term "qualified tender option bond entity" (QTOBE), which is defined as a TOB issuer that:

- Issues no securities other than a single class of TOBs with a preferred variable return payable out of capital that itself meets the risk retention requirements
- Holds only tax-exempt munis as assets and issues only securities, the income from which is tax-exempt to investors
- Is collateralized solely by servicing assets and munis that are not subject to substitution and that have the same municipal issuer and the same underlying obligor or source of payment (without regard to any third-party credit enhancement)
- Has a legally binding commitment from a regulated liquidity provider to provide a 100 percent guaranty or liquidity coverage with respect to all outstanding TOBs

The following discussion highlights the noteworthy changes and clarifications contained in the final rule, as compared with the Re-proposed Rule.

### **The CRRR's Definitions of TOB and QTOBE**

- Deletion of any requirement that a TOB qualify for purchase by money market funds in accordance with Rule 2a-7 under the Investment Company Act of 1940
- Extension from 30 days to 397 days of the maximum notice period for tender by a TOB holder
- The clarification that the determination of same source of payment on the municipal securities is made without regard to any third-party credit enhancement
- The clarification that a QTOBE may hold a pass-through pro rata beneficial interest in an

underlying tax-exempt municipal security

In addition, although the CRRR requires that a QTOBE have a binding commitment from a regulated liquidity provider to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding TOBs, the release recognizes that such liquidity coverage may not be enforceable against the regulated liquidity provider upon the occurrence of a tender option termination event (TOTE). (TOTE typically result from a bankruptcy, default, downgrade below investment grade, or event of taxability relating to the underlying bond(s) and other principal credit sources).

No changes were made to the Re-proposed Rule's requirements that the munis be tax-exempt or that they have the same municipal issuer or source of payment. Accordingly, QTOBEs may not hold taxable munis or pool bonds from different underlying obligors or credit sources.

### **Compliance by the Sponsor**

The sponsor of a QTOBE is solely responsible for satisfying the risk retention requirements. The release contains two helpful clarifications regarding sponsor identification:

- Recognition that more than one party could meet the definition of sponsor for purposes of the rule, in which case the transaction parties may designate which party is the sponsor with responsibility for satisfying the risk retention rule
- Explicit comfort that designation of a party as the "sponsor" for purposes of the final rule bears no relationship to whether or not such party is the "sponsor" for other purposes, such as Rule 2a-7 under the Investment Company Act or the Volcker Rule

### **Risk Retention Methods**

No changes were made regarding satisfaction of the risk retention requirements by a sponsor (a) by retaining an eligible vertical interest (at least 5 percent of each class of ABS issued) and/or an eligible horizontal interest (generally a first-loss interest in an amount equal to at least 5 percent of the par value of all ABS interests issued), (b) by retaining an interest that upon issuance meets the requirements of an eligible horizontal interest, but upon the occurrence of a TOTE will meet the requirements of an eligible vertical interest, and/or (c) by holding munis from the same issuance of, and with a face value equal to, 5 percent of the face value of the munis deposited in the QTOBE.

In the rulemaking, concerns were raised about how a TOB sponsor could retain:

- An eligible horizontal interest in the context of the TOB structure (which generally requires the sponsor to bear the first loss) without jeopardizing the tax rules for pass-through of the tax-exempt interest
- An eligible vertical interest (i.e., two classes of ABS interests with the holders of residual interests typically not also being holders of TOB interests)

To address these concerns, the Agencies specify that a residual interest in a QTOBE would meet the requirements of an eligible horizontal interest before, and an eligible vertical interest after, the occurrence of a TOTE under the following circumstances:

- Prior to the occurrence of a TOTE, the residual holder bears all market risk associated with the underlying tax-exempt municipal security
- After the occurrence of a TOTE, any credit losses are shared pro rata between the TOBs and the residual interest

Therefore, a first-loss residual interest is not required to satisfy the requirements for an eligible horizontal interest before a TOTE; and it is not necessary for the sponsor to hold both floater and residual interests to satisfy the requirements for an eligible vertical interest after a TOTE.

The final rule requires the sponsor to calculate the fair value of all ABS interests issued upon an issuance of TOBs that increases the face amount of TOBs then outstanding. Calculation of such fair value is thus required upon initial issuance of the TOBs, without any obligation to recalculate unless the face value of the TOBs outstanding exceeds the face value of the TOBs initially issued. If the face value of TOBs outstanding is increased—e.g., in connection with an additional deposit of munis, an increase in leverage, or the issuance of more TOBs to reflect the amount of accreted interest on zero coupon bonds—the fair value of the ABS interests would need to be recalculated to ensure that the risk retention percentage is satisfied.

## **Hedging**

In response to questions regarding prohibited hedging of the required retained risks, the Agencies also clarified that, consistent with the treatment of other credit risk retention options in the final rule, the holder of retained credit risk may not hedge its exposure to the requisite retained 5 percent, but it may hedge any ABS interests or municipal securities in excess of the minimum requirement.

## **Disclosure**

The CRRR requires the sponsor to provide certain mandatory disclosures to potential investors within a reasonable time before the sale of the ABS and, upon request, to the SEC or the appropriate federal banking agency. The final rule tailors the disclosure requirements as follows:

- Sponsors that retain munis outside the QTOBE must clearly disclose the identities of the TOB entity and the municipal issuer and specify the face amount of munis deposited in the TOB entity and the face amount retained outside the TOB entity and subject to the hedging prohibition.
- Sponsors that hold a residual interest meeting the requirements of an eligible vertical interest before a TOTE and an eligible horizontal interest after a TOTE must make the requisite disclosures required for both interests.

## **Effective Date**

For TOBs, the rule is effective beginning two years after date of publication in the Federal Register. There will be no grandfathering of TOB entities formed before the effective date.

## **Some Open Issues**

Several questions to be considered in applying the new rule include:

- The release provides that the holder of risk retention may divide the ABS interests or munis required to be retained among its majority-owned affiliates, but may not do so among unrelated entities that are managed by the sponsor or by an affiliate of the sponsor. May the residual interest be divided among related entities that are not majority-owned affiliates, such as multiple mutual funds in a fund complex? If so, may such entities designate a single residual holder entity as the “sponsor” with responsibility for satisfying the risk retention requirements?
- Does the prohibition on transfer of a retained interest prohibit pledging as security for a liquidity facility or credit enhancement the portion of a residual interest that is required to be retained?
- Can taxable munis be financed in a TOB-like structure and still satisfy the CRRR?

Ballard Spahr's Bank Supervision and Regulation practice and Public Finance Department include experienced lawyers who, among other things, counsel a variety of financial services industry clients and their boards of directors and senior management on a variety of transactional and compliance issues. Over the past several years, they have provided advice and counsel on, and transactional assistance in connection with, the myriad rules issued under Dodd-Frank.

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by Keith R. Fisher and Joyce J. Gorman

October 31, 2014

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## **[MMA Municipal Issuer Brief - Jobs, Housing & Local Governments.](#)**

[Read the Brief.](#)

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## **[New Bridges Between Louisville and Indiana May Set Standard for Financing Future Highway Projects.](#)**

LOUISVILLE —The concrete piers of two new bridges are rising out of the Ohio River between Louisville and Southern Indiana, as crews blast limestone and move earth to build the roads and tunnels that will soon connect the twin spans to nearby interstate highways.

For more than two decades, the project languished. Business and political leaders on both sides of the river couldn't agree on how to relieve snarled traffic, improve safety and spur development that was bypassing the region for Indianapolis and Nashville.

The Ohio River Bridges project is an American anomaly that has the potential to become a model while lack of money and political will are allowing many of the nation's roads and bridges to crumble. Along the shores of the Ohio, Democrat-led Kentucky and Republican-run Indiana have forged a partnership to rebuild U.S. infrastructure at a time of partisan gridlock and untapped trillions in private dollars.

"It's an enduring irony that the U.S., allegedly the home of innovation, is absolutely block-headed and backwards in this one respect," former Indiana Gov. Mitch Daniels, now the president of Purdue University in West Lafayette, Ind., said in an interview. "America needs the upgrade and modernization of our infrastructure, and I don't think you'll get there if you keep excluding, or at least discouraging, private capital."

The Obama administration, which had resisted private financing of public works, is starting a new

center to serve as a one-stop shop for bringing capital into government projects. During a Sept. 9 infrastructure conference with investors, U.S. Treasury Secretary Jack Lew said that while direct federal spending is indispensable in such cases, tight budgets demand creative ways for unlocking private money.

His cabinet colleague, Transportation Secretary Anthony Foxx, put it more bluntly when he announced the Build America Investment Initiative in July.

“There will always be a substantial role for public investment,” Foxx said. “But the reality is we have trillions of dollars internationally on the sidelines that are not being put to work.”

Fixing those roads and bridges also boosts employment. Every \$1 billion in new infrastructure investment creates about 18,000 jobs, according to a 2009 report by economists at the University of Massachusetts’ Political Economy Research Institute.

An Indiana economic-impact study estimated that the Ohio River Bridges project alone will generate an average of 15,500 jobs annually through 2042. Planners also promise a safety dividend as well: The river’s juncture is a national crossroads of truck traffic that has seen higher accident and injury rates than U.S. averages, according to a crash study.

For Indiana’s share of the \$2.3 billion project, the state is using WVB East End Partners to finance, design, build and maintain for 35 years a new bridge and highway approaches. The group consists of Walsh Investors of Chicago; Vinci Concessions, based in Rueil-Malmaison, France; and Bilfinger Project Investments North America, a division of the German builder Bilfinger.

While Kentucky lacks the legal authority for such a deal and is using more traditional public financing for its portion, Democratic Gov. Steve Beshear is pushing for legislation to allow Kentucky to use public-private partnerships for transportation work. The old model of relying on federal funding is no longer viable, he said.

“The practical facts are that if we are going to have any large infrastructure projects in the foreseeable future, it’s going to have to involve the private sector,” Beshear said. “That’s where the money is, and that’s where people are willing to put money up in order to get these projects built.”

Institutional investors such as Montreal-based Caisse de Depot et Placement du Quebec have capital and want to invest in U.S. infrastructure because it meets their long-term objectives, said Macky Tall, Caisse’s vice president of private equity and infrastructure. The Caisse is Canada’s second-biggest pension-fund manager, with \$190.7 billion in net assets as of June 30.

There hasn’t been more investment because the U.S. is behind other countries in tapping private capital, Tall said, and there’s been a lack of expertise, legal authority or receptivity to it in some parts of the country.

“We as the investors keep it very simple: We only go and invest where that capital is desired and considered helpful,” he said. “We really only make these investments where there is appetite for that capital.”

Tall said states are becoming more comfortable with private investment, in part because there are more examples of successful projects and fewer alternatives to pay for mounting infrastructure needs.

The United States has used mostly fuel taxes and public financing for such projects. And the federal gasoline tax hasn’t been raised since President Bill Clinton was in office. A divided Congress only

managed a short-term measure in July to prevent the Highway Trust Fund from becoming insolvent.

California passed the first legislation allowing public-private partnerships for transportation projects in 1989. Today, 33 states and Puerto Rico have such authority, according to the National Conference of State Legislatures.

After years of debating the Ohio River bridges, Daniels and Beshear got on the phone late in 2011 and agreed to split the work, paying for each share separately.

Kentucky's portion includes a new six-lane downtown bridge for northbound Interstate 65 from Louisville and a reconfigured "Spaghetti Junction" where I-65 meets Interstates 64 and 71. The existing Kennedy Bridge will be rebuilt and will handle southbound I-65.

Indiana is building a new bridge eight miles upstream connecting Louisville's east end with Southern Indiana while also expanding highways and building twin tunnels under historically protected property in eastern Jefferson County.

The east-end bridge will connect Interstate 265 in Kentucky, also known as the Gene Snyder Freeway, with I-265 in Indiana, creating a bypass around Louisville.

(For example, travelers from Lexington to Indianapolis or Chicago could take the I-265 loop and avoid downtown Louisville.)

Indiana's financing approach won "project of the year" recognition last year from groups including the Washington-based American Road & Transportation Builders Association, which called it "a prime example of the ingenuity" of public-private partnerships. The tools had been used before, though rarely on a project of such scale involving two state governments, the association said.

Kentucky is using more traditional financing that includes bonds backed by toll revenue, a low-interest federal loan and Grant Anticipation Revenue Vehicles bonds, or Garvees.

The failure to craft more innovative approaches has left an unmet U.S. infrastructure need that the American Society of Civil Engineers estimates will reach \$3.6 trillion by the end of the decade. The list of stalled projects includes a replacement for the Interstate 5 bridge connecting Portland, Ore., and Vancouver, Wash., and a new Brent Spence Bridge on Interstates 75 and 71 between Northern Kentucky and Cincinnati.

Officials in those states have been unable to agree on the scope or funding as Kentucky and Indiana have with the Ohio River Bridges. Beshear said he'd like private financing as an option for the Brent Spence Bridge, just as public-private partnerships have been used for the Denver FasTracks rail project and the replacement of the Goethals Bridge between New York City and New Jersey.

Institutional investors say they would like to invest more in public infrastructure — if only there were more suitable projects willing to take their money. If there were, it would mean an additional \$2.5 trillion in investment globally through 2030, according to a 2013 study by the McKinsey Global Institute. The U.S. has the potential to be the largest public-private partnership market in the world because of the size of its infrastructure and urban populations, Moody's Investors Service said in a Sept. 8 report.

The swift financial closing of the Ohio River Bridges project — fewer than nine months — suggests the U.S. is ready for more public-private partnerships, said Xavier Huillard, Vinci's chief executive officer.

One remaining barrier to private investment is that projects generally require a dedicated funding stream such as tolls, which some Americans oppose on top of paying taxes, said Robert Palter, director of McKinsey's infrastructure practice in Toronto.

While residents in Louisville and Southern Indiana aren't happy about tolls for the new Ohio River bridges, the work has been needed for decades, said Rebecca Bethard, who bought a house with her husband that overlooks the bridge work in Indiana. It will cut her 40-minute commute to Louisville in half, and the value of their home should only increase, she said.

"Tolls are a fair trade-off for getting it done," Bethard, an attorney, said in an interview. "The benefits outweigh the costs."

The unreliability of conducting business in the region was significant, said Kerry Stemler, chairman of the Louisville area's chamber of commerce, who helped lead a bi-state bridges authority. U.S. military convoys have even diverted around Louisville because of the congestion, he said.

"Not to move forward with this project basically was saying to this city and this part of the country that we're not going to be participating in the future growth of the country, and that's not acceptable," Louisville Mayor Greg Fischer said in an interview.

BY MARK NIQUETTE

Bloomberg News

October 27, 2014

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## **New Challenges for Keeping Public Money Safe.**

Governments across the country face a significant fiscal dilemma: sacrifice yield on their bank deposits or assume more risk.

Still reeling from the financial turmoil over the last few years, banks have recently told governments of all sizes that, because of changing regulatory requirements and business practices, the financial institutions may no longer be in a position to provide the mandatory amount of collateral to protect public deposits. This creates concerns about alternative ways to secure collateral as well as the need to develop new standards to protect taxpayer funds.

The yield on many depository accounts is stuck at record lows, yet the cost to financial institutions of collateralizing or otherwise securing these accounts continues to increase. Many governments are struggling to find depository accounts that meet their legal requirements and risk-tolerance levels. This is forcing officials to evaluate policies for mitigating risk without sacrificing yields on the deposits.

The Federal Deposit Insurance Corporation (FDIC) provides federal depository insurance up to certain thresholds for accounts maintained in FDIC-insured banks and savings associations. The standard insurance amount totals \$250,000 per depositor, per insured bank, for each account ownership category. But what about bank balances of deposit accounts in excess of federal depository insurance?

Unfortunately, many governments' investment policies only address FDIC insurance and not other forms of depository insurance that may be available. Modifying investment policies would address this issue, barring statutory restrictions on accepting other forms of depository insurance.

To mitigate some of the risk of uninsured and uncollateralized deposits, some states allow use of single- or multiple-financial-institution collateral pools. In a single-institution pool, an institution pledges a group of securities against all of its public deposits. In a multiple-institution pool, various institutions pledge a group of securities to provide common collateral for their deposits of public funds. In this scenario, the assets of the pool and the power to make additional assessments against its members ensure that no loss of public funds occurs due to the default of a member.

Therefore, a multiple-institution collateral pool is considered depository insurance, while a single institution collateral pool is considered collateral. Many government investment policies don't address the use of either type of pool, which may limit a government's ability to improve the yield on its depository accounts. A change in a government's investment policy could address this issue for a single-institution collateral pool, but the creation of a multiple-institution pool may require a change in state laws.

Alternatives to collateral pools have surfaced to assist governments in improving yield without sacrificing risk. One example is Insured Cash Sweep services (ICS), where governments can access multimillion-dollar FDIC insurance on public funds placed into demand deposit accounts, money-market deposit accounts, or both, in increments below the \$250,000 FDIC limit. The use of ICS services may require a change in state statutes — it's currently approved in 42 states — and a change in a government's investment policy.

Another alternative is public unit deposit letters of credit (LOCs), which offer a less-expensive alternative to collateral. A Federal Home Loan Bank issues the LOCs to pledging banks and assists them in mitigating risk for collateral pledged to local-government deposits. Using a LOC also may require a change in state statute or a local-government investment policy.

Governments often rely on yields on their deposits to fill budgetary holes, and this new era of collateralizing public deposits threatens a government's ability to make ends meet. Governments cannot afford to stand back and watch. It's time to be proactive, investigate alternatives and implement investment policies that align with the reality of today's banking sector.

GOVERNING.COM

BY FREDERICK G. LANTZ | OCTOBER 30, 2014

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## **[New Rule Could Require Governments to Report Tax Incentives as Lost Income.](#)**

Corporate tax incentives have become an increasingly popular way for state and local governments to try to attract new businesses. Now those subsidies could begin affecting governments' budgetary bottom lines, under an accounting change being considered that would require reporting those incentives as lost income in annual financial reports.

On Friday, the Governmental Accounting Standards Board (GASB) issued for public comment [proposed rules](#) for requiring state and local governments for the first time to disclose information about property and other tax abatement agreements. If approved, the new disclosures could shed light on a previously murky area of government finance and provide hard data on information that has often been assembled piecemeal, if at all. Stakeholders have until Jan. 30, 2015 to comment.

"This is huge," said Greg LeRoy, executive director of Good Jobs First, a policy center that advocates

for transparency in economic subsidies. “If you care about school finance or smart growth or regionalism or land use in general, this data will enable you to figure things out that were unthinkable before.”

Many state and local governments currently have tax abatement programs in place, and the impact of those abatements can be substantial. But there’s no way to know the magnitude or the nature of those programs just by looking at government financial statements. Efforts to track such data in the past have been initiated by third-party organizations like Good Jobs First or by media outlets. In 2012, The New York Times reported that state, county and city incentives total some \$80.4 billion every year. Texas led the nation in incentives, according to the Times, offering around \$19 billion annually.

“Tax abatements can significantly reduce the amount of revenue a government receives,” said GASB Chair David A. Vaudt in a statement. “But in many cases, little is known publicly about their total size or their terms and conditions. What the Board has proposed would make the financial impact of these transactions much more transparent.”

The proposed tax abatement disclosure requirements would include:

- The tax being abated
- Criteria that must be met for the taxpayer to be eligible for the abatement
- Provisions for recapturing abated taxes
- The types of commitments made by tax abatement recipients
- Number of tax abatement agreements
- Dollar amount of taxes abated
- Other commitments made by a government, such as to build infrastructure assets.

LeRoy said that data could have the biggest implications for school districts, which in most cases are funded by property taxes. Under the proposed disclosure requirements, part of property tax abatements would show up as lost income for districts. Good Jobs First has [released its own analysis](#) of the requirement’s implications.

“Schools are obviously the biggest losers when councils grant property tax abatements and tax increment financing agreements,” LeRoy said. “Typically about half of that money would have gone to school districts.”

Also of note is the provision requiring governments to report the criteria that businesses must meet for the abatement and how governments will get that money back if the goals aren’t achieved, commonly referred to as clawback provisions. That requirement “puts this on the forefront of disclosures,” said Justin Marlowe, a Governing contributor and a public finance professor at the University of Washington’s Evans School. “The fact that they’re going to make entities disclose whether they’ve ever done a clawback is really big and will reveal something about that jurisdiction from a policy standpoint that might not otherwise be clear.”

A change of this magnitude is sure to meet resistance. GASB, established in 1984, has a history of stirring the pot with its proposed accounting standards — so much so that it was the subject of a 2009 Journal of Financial Management article that outlined the board’s increasingly tumultuous role

in government accountability in accounting. And in 2007, the Government Finance Officers Association went so far as to try and abolish GASB and transfer the board's responsibilities to the organization that sets accounting standards for the private sector.

Marlowe predicts strong pushback from those who would argue that reporting tax abatements isn't an accounting issue - that policymakers think of these decisions as investments, rather than a drain on finances. "But I think what GASB is saying is that state governments and others have had plenty of chances now to put this out there," Marlowe said. "A lot of what the GASB has done recently is say, 'Look, no one else is stepping up. If we have to be the ones, than that's what has to be done.'"

GOVERNING.COM

BY LIZ FARMER | OCTOBER 31, 2014

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## **Stockton's Costly Bankruptcy May Not Tempt Other Cities.**

Stockton, California, is emerging from bankruptcy saddled with legal bills and a damaged reputation that will deter other U.S. cities from seeking a path through court to cut their debts.

"The leaders of distressed U.S. municipalities will continue to pursue other options before setting in motion the long and costly process that bankruptcy implies," Chris Morgan, director in the San Francisco office of Standard & Poor's, said yesterday in a statement after a judge approved the city's debt-adjustment plan. "We believe that the implications of Stockton's exit from bankruptcy will be modest."

Stockton, a city of 298,000 about 80 miles (130 kilometers) east of San Francisco, filed for bankruptcy in June 2012 after the housing market collapsed, retiree health-care costs mounted and tax revenue eroded. It was one of three California cities to file for bankruptcy that year.

U.S. Bankruptcy Judge Christopher Klein in Sacramento, California, yesterday approved Stockton's plan to exit court protection by paying bond investors pennies on the dollar while shielding public pensions. In doing so, he warned other cities about the costs of municipal bankruptcy and said it "shouldn't be entered into lightly."

As of May, the city had paid lawyers and other advisers almost \$14 million, according to court filings.

The bankruptcy filing was unavoidable, Connie Cochran, a Stockton spokeswoman, said in a phone interview.

### **'Insolvent' City**

"We were insolvent both from a service perspective and fiscally," she said. "We recognize that we need to live within our means and follow the plan that we've developed."

Stockton will begin to exit bankruptcy once the judge sets a date, possibly by the end of the year, Cochran said.

The plan calls for a \$5.1 million contribution for canceling retiree health benefits. Also, Stockton voters last year approved a proposal to increase the city's sales tax to 9 percent to generate about

\$28 million annually, which would go toward exiting bankruptcy, restoring city services and paying for law enforcement.

The police department is having trouble keeping employees, who are leaving because of low pay, said Kathryn Nance, president of the Stockton Police Officers' Association, which represents about 360 officers.

"It's still going to be a very long road just to get back to where we were before," Nance said in a phone interview. "We are the lowest-paid police force in the county and with the compensation packages and benefits, people are leaving to go to other agencies."

### **'Doesn't Change'**

The bankruptcy exit "doesn't change the difficult economic environment" in the city, said S&P's Morgan. In assessing its creditworthiness, "the main thing we're going to be looking at is a willingness to meet their obligations and their overall financial health," he said in a phone interview.

The city passed on an option presented by Klein to end its contract with the California Public Employees' Retirement System, the biggest U.S. public pension fund. Doing so would have reduced pensions by 60 percent and caused many employees to leave, Marc Levinson, Stockton's lead bankruptcy attorney, had warned.

Still, Klein's ruling could set up future challenges from California cities burdened by retiree obligations.

"Local governments will now have more negotiating leverage with labor unions, who cannot count on pensions as ironclad obligations, even in bankruptcy," Gregory Lipitz, a vice president and senior credit officer at Moody's Investors Service, said in a research note yesterday.

### **Detroit Plan**

Stockton's bankruptcy was dwarfed by Detroit's. The city of about 700,000 filed a record \$18 billion municipal bankruptcy last year, saying decades of decline left it unable to provide basic services while still meeting financial obligations. Its plan to trim about \$7 billion in debt by reducing some bond recoveries and cutting retiree benefits goes up for court approval next week.

"Ultimately, the decision in Stockton highlights a unique and unfortunate situation brought on by the financial collapse of 2008, and thankfully not a situation that the overwhelming majority of municipalities have to face," Teague Paterson, a pension attorney at Beeson, Tayer & Bodine, said in a statement.

The case is *In re Stockton*, 12-bk-32118, U.S. Bankruptcy Court, Eastern District of California (Sacramento).

By Alison Vekshin and Michael Bathon

Oct 30, 2014 9:01 PM PT

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## **[New York City Pension Funds Slow Growth of Wall Street Fees.](#)**

New York's five pension funds paid Wall Street investment managers \$530.2 million in the most recent fiscal year, an 8.5 percent increase, according to the city's [annual financial report](#) released today.

The rate of growth in the year through June slowed compared with the previous period, when expenses paid to the city's almost 250 managers rose 28 percent.

New York City Comptroller Scott Stringer, who serves as chief investment adviser to the pensions, has vowed to reduce fees and increase internal management. Fees erode returns crucial to funding benefits for New York's more than 237,000 retirees and future payments to 344,000 employees.

Pension assets for police officers, firefighters, teachers, school administrators and civilian employees rose about 17 percent to \$160.6 billion in the 12 months ended June 30, according to the report.

Eric Sumberg, a spokesman for Stringer, didn't immediately respond to a request for comment.

By Martin Z. Braun

Oct 31, 2014 11:49 AM PT

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## **[Record Rally Reaches 10th Month as Volatility Rises: Muni Credit.](#)**

The \$3.7 trillion municipal market is set to gain in October, weathering the highest volatility since January to extend a record rally.

State and local debt has earned 0.7 percent through Oct. 30, according to Bank of America Merrill Lynch data. The 10th straight month of gains in 2014 marks an unprecedented stretch to start a year since the data begin in 1989. The highest top tax bracket since 2000 is helping fuel demand. Yields on benchmark 10-year munis have dropped 0.1 percentage point this month to 2.12 percent, data compiled by Bloomberg show.

Global financial markets gyrated in October as investors fretted that global growth was slowing. For munis, the 30-day volatility on benchmark 10-year yields reached the steepest since Jan. 14. During a 30-day rollercoaster, interest rates plunged along with Treasuries and then climbed by the most in 16 months as investor demand waned.

"When you look at year-to-date total returns, it's been pretty impressive," said John Flahive, Boston-based director of fixed income at BNY Mellon Wealth Management, which oversees about \$20 billion in munis. "It just seems we have much more sensitivity, given how low in rates we are, to following the volatility of the Treasury marketplace."

Until the current rally, the longest win streak to start a year was five months in 1991, Bank of

America data show. The 9 percent return for munis in 2014 has defied forecasts of analysts and investors, who predicted a second year of losses after a selloff in 2013.

Instead of rising, yields have dropped, luring states and cities to borrow. Municipalities are on pace to issue \$36 billion of long-term, fixed-rate bonds in October, the highest monthly total since March 2013.

Investor appetite weakened after benchmark 10-year yields touched 1.94 percent Oct. 16, the lowest since May 2013. Individuals added \$37 million to muni mutual funds this week, down from \$444 million two weeks ago and the lowest since August, Lipper US Fund Flows data show.

BlackRock Inc. (BLK), the world's largest money manager, sold some local debt as yields declined, according to Peter Hayes, who oversees \$122 billion as head of munis at the New York-based company.

Ten-year yields then surged 0.16 percentage point to 2.14 percent in the week through Oct. 24, the biggest jump since July 2013, as buyers balked at the lower rates.

### **Ride's End**

"The mid-month volatility for munis was extraordinary," said James Dearborn, head of munis in Boston at Columbia Management Investment Advisers, which oversees about \$30 billion in local debt. "At the end of the ride, which to some people probably felt unpleasant, we're at a better, more justifiable level than where we started."

Muni volatility also rose relative to that on Treasuries. Because individuals own about 60 percent of the municipal market and most debt doesn't trade on a daily basis, state and local bonds have historically been less volatile than their federal counterparts. Yet on Oct. 27, the 30-day muni yield volatility reached the closest to the measure for Treasuries in three months.

### **'Better Place'**

As munis swung in value, the market cheapened compared with federal obligations. The ratio of yields on 10-year munis to those on similar-maturity Treasuries rose to 94 percent on Oct. 24, the highest since July. A rising figure signals that state and local debt is increasingly cheap. The measure is still below the five-year average of 98 percent.

"Volatility never feels good, but if we cheapened a little bit to Treasuries, that puts us in a better place going forward," Dearborn said.

October's issuance glut may not carry over into the next two months, re-establishing the 2014 trend of slowing supply. States and cities have scheduled \$8.3 billion of bond sales in the next 30 days, down from \$13.7 billion on Oct. 15, Bloomberg data show. Issuance in 2014 is about 6 percent below the 2013 pace.

The gains in the face of higher volatility may give investors confidence that state and local debt will retain value even if interest rates rise next year, as projected in a Bloomberg survey of more than 70 analysts.

"It all happened so fast," said Blake Miller, who helps oversee \$10 billion of munis at Neuberger Berman Group LLC in New York. "But after going over that speed bump, we ended the month in pretty good fashion, with yields down across the board."

By Brian Chappatta

Oct 31, 2014 8:05 AM PT

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## **[Judge Approves California City's Bankruptcy-Exit Plan.](#)**

The federal judge overseeing the two-year-long bankruptcy of Stockton, Calif., ruled Thursday that the distressed city can exit court protection without deeper cuts to its pension obligations.

U.S. Bankruptcy Judge Christopher Klein called the city's reorganization plan, which raises taxes and slashes payments to bondholders, "the best that can be done" during a hearing in Sacramento.

The decision is a victory for public-pension advocates who worried the judge would reject the plan because the city didn't cut obligations to California Public Employees' Retirement System, which controls city workers' retirement money. The same judge about a month ago said the city had the power to sever its ties with the retirement system, known as Calpers. The judge overseeing Detroit's bankruptcy case has also ruled that payments into pension funds can be reduced while a city is insolvent.

The resolution of the Stockton case is "unlikely" to lead other U.S. cities to view bankruptcy "as an attractive option for resolving serious financial challenges," said Standard & Poor's Ratings Services in a statement.

Calpers, the largest public pension in the U.S., said in a statement, "The judge recognized that the city's employees and retirees have already made significant concessions" and "that further impairing pensions would harm them even more."

Judge Klein approved the city's reorganization plan over protests from two Franklin Templeton Investments-managed funds, which underwrote the bonds for Stockton's fire stations and parks. The funds argued that the city could afford to repay more than its \$4 million offer.

Critics of the exit plan have said the city will continue to struggle to afford the state-mandated payments to Calpers.

"We are disappointed," Franklin Templeton lawyer James Johnston said after the ruling.

Meanwhile, many pension fund lawyers applauded the judge's decision. Harvey Leiderman, a partner at Reed Smith LLP who represents public-employee pension funds, said the confirmation of Stockton's plan "threw cold water on anyone who thinks there is an easy exit off ramp for resolving your fiscal issues" through a municipal bankruptcy. Calpers is a client of Mr. Leiderman's, but he didn't represent the system in the Stockton case.

"The outcome in Stockton is more evidence that bankruptcy is not an appropriate tool to jettison pension debt," said Teague Paterson, a lawyer at Beeson, Tayer & Bodine, who also represents pension funds and who filed a brief in the Stockton case.

City leaders put Stockton, a city of 300,000 people located about 80 miles inland from San Francisco, into bankruptcy in June 2012, after it was hit hard by the housing crash. Judge Klein also blamed the city's financial woes on former leaders who offered overly generous pay to city workers and took on debt for new projects that the city couldn't afford.

It was the second-largest financial failure by a U.S. city and one of several California cities—San Bernardino, Vallejo and Mammoth Lakes—to seek bankruptcy protection in recent years. It needed a judge to approve its plan to repay creditors before it could exit from bankruptcy.

Instead of cutting payments to Calpers, the city chose to raise taxes. Last year, voters approved a 3/4-cent sales tax to pay for more police officers. More than 1,000 workers and retirees who had \$538 million in claims against the city also agreed to accept one-time payments worth \$5.1 million instead.

The judge on Thursday highlighted how much the city spent during its two years in bankruptcy, saying that legal fees amounted to \$13.8 million. "It's impossible" to go through a municipal bankruptcy, he said, "without spending an eight-digit number."

THE WALL STREET JOURNAL

By KATY STECH and DAN FITZPATRICK

Updated Oct. 30, 2014 5:00 p.m. ET

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## **[Governments Would Disclose Information on Tax Abatements Under GASB Proposal.](#)**

Norwalk, CT, October 31, 2014—The Governmental Accounting Standards Board (GASB) issued for public comment an [Exposure Draft](#) of a proposed Statement, Tax Abatement Disclosures, which would require state and local governments for the first time to disclose information about property and other tax abatement agreements.

Governments generally agree to abate or reduce the taxes of businesses and other taxpayers to promote economic development, job growth, redevelopment of blighted or underdeveloped areas, and other actions that are beneficial to the government or its citizens. Many state and local governments currently have tax abatement programs in place and the effects of tax abatements on their financial health and ability to raise revenue can be substantial. However, it is difficult to discern the magnitude and nature of those effects from financial statements at present.

The disclosure requirements proposed by the GASB are designed to provide financial statement users with essential information about these programs. Specifically, the proposed tax abatement disclosure requirements would include:

General descriptive information, such as:

- The tax being abated
- Criteria that must be met for the taxpayer to be eligible for the abatement
- Provisions for recapturing abated taxes

- The types of commitments made by tax abatement recipients
- Number of tax abatement agreements
- Dollar amount of taxes abated
- Other commitments made by a government, such as to build infrastructure assets.

“Tax abatements can significantly reduce the amount of revenue a government receives,” said GASB Chair David A. Vaudt. “But in many cases, little is known publicly about their total size or their terms and conditions. What the Board has proposed would make the financial impact of these transactions much more transparent.”

The proposed guidance addresses tax abatements resulting from agreements entered into by the reporting government, as well as those initiated by other governments that reduce the reporting government’s tax revenues.

The Exposure Draft is available on the GASB website, [www.gasb.org](http://www.gasb.org). Stakeholders are encouraged to review the proposals and provide comments by January 30, 2015.

[Visit the Tax Abatement Disclosure Webpage.](#)

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## **[GFOA: Talking Points Address Accusations against Pension Plans.](#)**

Citing an “urgent goal of saving public pensions amid persistent low funded levels and a burgeoning movement to disassemble them, Callan Investments Institute issued talking points “to move the discussion forward around the importance of DB plans.”

The research paper cites seven points of discussion, and follows with research, data, and actuarial considerations to back each one.

The points include the following: DB plans serve many purposes beyond providing constituents with retirement income; DB plans are proven to be extremely cost effective and reliable in delivering basic retirement income security - when the rules of DB finance are followed; and DB plan funding surpluses and deficits occur as part of the normal cycle of investment market returns.

[Read the research paper.](#)

Thursday, October 30, 2014

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## **[GFOA: Pensions Help Recruit and Retain High-Quality Workers, Research Finds.](#)**

Cutbacks in public pensions could hurt worker quality, as research shows that pensions help recruit and retain high-quality workers, according to a brief from the Center for Retirement Research at Boston College. One indicator of quality is the wage that a worker can earn in the private sector, and by this measure, states and localities consistently have a “quality gap” - the workers they lose have a higher private-sector wage than those they gain, the center’s research found. The analysis shows that jurisdictions with relatively generous pensions have smaller quality gaps, meaning they can better maintain a high-quality workforce. Thus, the bottom line, according to the brief, is that states

and localities should be cautious about scaling pensions back too far.

[Read the brief.](#)

Thursday, October 30, 2014

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## **Looking Under the Hood of Alternative Bond Funds.**

Different funds have radically different strategies and management arrangements

The nontraditional bond fund sector continues to attract inflows and new products.

These funds had net flows of almost \$25 billion through Aug. 31, according to Morningstar.

Plus, the category is getting more crowded, with 22 new entrants in 2013 and 20 or more additional arrivals projected for 2014, the research group estimates.

A key reason for the appeal of many of these funds is the fact that their flexible portfolios may offer more protection and steadier total returns in a rising interest rate environment than traditional bond funds.

That benefit hasn't been strenuously tested yet, though, as bond yield increases, which were widely expected for 2014, are still on hold. The 10-year Treasury, for instance, dropped to 2% in mid-October.

Surging market volatility is making regulators increasingly concerned that bond funds have loaded up on hard-to-sell assets.

Some funds in this category focus on narrow niches and provide unique strategies, experts point out.

The Forward Credit Analysis Long/Short Fund (FLSIX) focuses on municipal bonds, which accounted for close to 80% of the portfolio as of Sept. 30. Short-term securities (13%) and corporate bonds (7.4%) comprise the balance, with a fraction of 1% in futures contracts.

What makes this fund unique is that it can use strategies to replicate short positions in municipal bonds. According to the fund's materials: "A substantial portion of assets may be invested in derivatives to seek to achieve returns and for hedging." Additionally, "The fund may engage in borrowing for investment purposes in order to increase its holdings of portfolio securities and/or to collateralize short sale positions, as well as for cash management, and short positions may equal up to 100% of the fund's net asset value."

The hedges are indirect due to the fund's inability to directly short tax-exempt municipals, according to Jim O'Donnell, Forward's chief investment officer.

Portfolio managers can work with Treasury bond futures and the Markit MCDX synthetic municipal-credit index to get around that limitation.

PIMCO is the fund's subadvisor. However, that firm's recent management shake-up doesn't concern O'Donnell, because it hasn't affected PIMCO's municipal-bond managers, who are led by Joe Deane in New York, he says.

The fund uses two benchmarks for comparison: the Barclays U.S. Municipal Bond Index and the Barclays U.S. Corporate High Yield Bond Index.

The returns on institutional shares, from 2009 through 2013, fell between the performance of two indexes, although its 1-, 3- and 5- year performance lagged both benchmarks.

#### Other Strategies

The Pioneer Absolute Return Bond Fund (ABRDX) takes a different approach that incorporates two strategies.

The portfolio's core component is managed to track the fund's benchmark, the Bank of America Merrill Lynch 3-month U.S. Treasury Index. The fund then uses multiple uncorrelated alpha-generation strategies through selective use of derivatives to seek performance above the core strategy and deliver absolute returns.

These strategies include spread duration, sovereign exposure, interest rates, currency selection and inflation, among others.

The fund takes team-based portfolio management to a new level, according to Pioneer, by utilizing over a dozen analysts and managers with investment responsibility for a particular alpha generator.

For example, one manager handles inflation and Nordic yield curves; another handles volatility, and so on.

The idea behind this approach is to take small amounts of risk across many uncorrelated positions with the goal of adding incremental gains over time. It's a complex management strategy, but a team of portfolio construction-specialists monitors drawdowns and risk levels to avoid extreme positions, says the fund group.

This is the third inception of the strategy for Pioneer, which launched the euro version in December 2010, the British-pound version in December 2013 and the U.S. dollar fund in January 2014.

According to Morningstar, the fund has just under \$20 million of assets, and its return has slightly trailed that of the Non-Traditional Bond index.

By Ed McCarthy, CFP

ThinkAdvisor

October 24, 2014

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### **[S&P: Ebola Adds Costs For Health Care Sector; No Rating Impact Yet.](#)**

NEW YORK (Standard & Poor's) Oct. 22, 2014- Standard & Poor's Ratings Services does not currently expect any near-term rating actions in the health care sector as a result of the Ebola situation. However, we recognize that preparedness will be an added financial expense for many providers and it is already affecting senior management time and energy.

The current progression of Ebola could take one of at least two tracks, in our

view. One, the current spread of the disease could be contained, and the health care sector—and the nation as a whole—could come to terms with the U.S. being exposed to this disease. We currently believe that the financial and credit impact would likely be modest and incremental in this case. Two, the Ebola outbreak could continue to spread, in which case we believe the sector will likely respond in ways not yet determined. The financial effects and resulting credit impact, if any, under the second scenario cannot be known at present. However, we believe that the following issues would be relevant credit considerations if the issue were to progress along the second track:

- What additional costs will be required in equipment, training and protocols for patients who present with Ebola or suspected Ebola? Will hazardous waste disposal problems emerge? Who pays for it? Is the cost borne by each individual hospital, the local government, or will federal dollars be available?
- Will hospitals face a stigma from treating patients, potentially driving other patients away from the facility?
- Similarly, will an Ebola stigma create personnel shortages of nurses and other health care professionals if they choose not to be present if Ebola patients show up at their facility?
- If providers are forced, or choose, to forego business as they manage this disease, will business interruption insurance cover these costs? Will there be lawsuits for deaths and the potential spread of the disease? Will malpractice costs go up?

While the Ebola situation is dominating the headlines, there are many other public health issues, such as the flu, that we believe already have a bigger impact on overall morbidity and mortality in the U.S. Indeed, annual fluctuations in flu severity impact reported hospital patient volume trends with possible implications for profitability.

Standard & Poor's will continue to monitor Texas Health, where to date two health workers contracted the disease, as well as other health care providers and other health-related for-profit entities for any immediate financial impact, both positive or negative. For example, a handful of selected health-related suppliers in the for-profit space could experience a spike in demand, especially those that provide protective gear. However, we expect the incremental costs related to Ebola preparedness will be but one more cost pressure on U.S. providers, and one more factor contributing to our view on the credit quality of health-care providers.

Standard & Poor's Ratings Services, part of McGraw Hill Financial (NYSE: MHFI), is the world's leading provider of independent credit risk research and benchmarks. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 23 countries, and more than 150 years' experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information and independent benchmarks that help to support the growth of transparent, liquid debt markets worldwide.

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## **[MMA Municipal Issuer Brief - October 20, 2014 - Local Pensions as Problematic.](#)**

[Read the Brief.](#)

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## **[Does “Pay for Success” Actually Pay Off? The ROI of Social Impact Bonds.](#)**

The concept of Social Impact Bonds is so popular in many circles that politicians believe that they can score points when they make SIBs part of their campaign platforms. Winnipeg mayoral candidate Paula Havixbeck pitched SIBs as “a new tool that other countries have had tremendous success with.” The press report didn’t identify which SIBs Havixbeck might have cited as tremendous successes, given that none of the handful of SIB demonstrations has reached any point of financial or program success, though some may in the end do so.

Established politicians have latched on to the concept, too. In Chicago, Mayor Rahm Emanuel announced an ambitious program of social impact bond financing to enroll more children in pre-K classes. The program, to be launched next month, would get 2,600 children into half-day preschool classes over four years. The SIB targets would be met with payments for each pupil who, after pre-K, does not get placed in a special education program (\$9,100 per pupil), is deemed ready for kindergarten after pre-K (\$2,900), and scores above the national average for third-grade reading (\$750).

SIBs are also the cloak of respectability sought by some wealthy investors, or so some SIB pitchers believe. In the Huffington Post’s “Impact” page of contributed articles, Sharon Foulston, who describes herself as “founding a Social Impact Bond to finance a home for single mothers,” a “Business Angel for many years mentoring and investing in entrepreneurs,” and interested in “the mystical world of Tarot,” offers a creative pitch to moneyed people. Pitching her SIB idea to “the second generation of wealth owners, the inheritors of a period of industry and sustained economic growth,” Foulston describes those inheritors of wealth as having reached “a higher level of social conscience, seeking rewards far beyond that which mere money can bring.”

In a way, it's easy to see the attraction of Social Impact Bonds. At a time when government seems to be doing many things ineptly, from the Department of Veterans Affairs' management of VA hospitals to the Centers for Disease Control's mercurially unreliable protocols and actions against a stateside outbreak of Ebola, SIBs radiate the glow of a public/private panacea that might cure the dysfunction of government—even without evidence that they can do so. Preferring the nomenclature of “pay for success” over the “boring” language of Social Impact Bond, the respected McClatchy-Tribune op-ed columnist Jay Ambrose exudes that these products of “our high-energy, imaginative, entrepreneurial, can-do spirit and charitable impulses” could materially contribute to the possibility that “we will help people out of desperate circumstances, that we will become a society with less disadvantage, less crime, less unemployment.”

Why are Social Impact Bonds so popular when their track record is next to nonexistent? The combination of Ambrose, Foulston, and multiple politicians gives the answer. The American populace sees government and politicians as stymied by party divides, but the SIB/PFS concept has garnered the support of politicians across the ideological spectrum, including endorsement from think tanks of the left (the Center for American Progress) and the right (the American Enterprise Institute), with the appearance that these projects risk the moneys of investors rather than taxpayers, and if successful, will save money in virtually any area of public endeavor.

As Ambrose explained the protean potential applicability of SIBs, “A government agency identifies some social dread it wants fixed and then strikes a deal with a non-governmental organization to fix it...[which] will then find investors to fund managers who put together ways to tackle the problem.” As an example, the G8 Social Impact Investment Task Force report, released just last month, suggested that social impact bonds, renamed “development impact bonds” for their application in developing nations, could be, if properly structured and targeted, “an innovative way of tackling the social and environmental issues that constrain private sector development and economic growth: tackling issues in education such as literacy and drop-out rates; in health such as sleeping sickness, malaria and other chronic debilitating diseases; and in employment such as training unemployed youth for available jobs.”

### **Looking at Costs**

The investors behind the highly touted but still unproven Peterborough Prison social impact bond, aimed at reducing recidivism of short-term male prisoners released from incarceration, were not profit-minded investors, but 17 foundations and charitable trusts that committed £5 million. In the U.S., the investors behind the Rikers Island project to reduce recidivism are not the “second generation of wealth owners” who had stumbled into “a higher level of social conscience” that Foulston described, but Goldman Sachs and Bank of America Merrill Lynch, banks that most Americans might not characterize in Foulston's words, and in the case of Goldman Sachs, would receive a financial reward from the project if it worked as planned of over 20 percent, but with a guarantee from Bloomberg Philanthropies, boosted to well north of 80 percent.

The role of philanthropy is critical in the U.S. SIB experiments, and not only with Bloomberg's unusual risk guarantee. Even in Chicago's new pre-K SIB, philanthropy plays a important investment and financing role, with the J.B. and M.K. Pritzker Family Foundation taking a subordinate position behind the Goldman Sachs Social Impact Fund and the Northern Trust taking senior roles—meaning that if the project were not to fully pay out, Goldman and Northern get paid first, and if there were anything left, Pritzker might get it. If the project does succeed, it's probably true that the senior loans get paid at a higher interest rate than the subordinate ones. That is similar to the financial structure that Goldman and Pritzker used for a pre-K SIB in Utah.

One gets the sense of foundations in SIBs playing roles that they have long performed through their

program-related investments, providing guarantees for private investors such as banks that “risky” construction or permanent financing for various kinds of projects, though those loan guarantees typically supported capital projects such as affordable housing and facility development as opposed to the costs of social programs.

Examples of foundations that have made loan guarantees through program-related investments in recent years include the Rasmuson Foundation, which in 2010 provided credit enhancement through a first loss guarantee for new facility and housing development loans originated in Alaska by nonprofits; the John R. Oishei Foundation’s loan guarantee for Buffalo River Fest Park; and the Meyer Memorial Trust’s combined grant and loan guarantee for the Freshwater Trust’s stream and river restoration efforts in Oregon. In a more recent guarantee, the Kresge Foundation in 2013 gave the Calvert Foundation a \$1.25 million loan guarantee toward Calvert’s participation in the Woodward Corridor Investment Fund in Detroit, a \$30 million effort to finance mixed-income, mixed-use projects in walking distance of the city’s downtown core.

Loan guarantees like these PRI investments or Bloomberg’s for the Rikers project don’t usually involve a cash outlay, but they do put that amount of the foundation’s balance sheet at risk should the deal go sour. Somehow, the notion of Meyer Memorial risking tax-exempt foundation resources on the Freshwater Trust or even the Kresge Foundation for the Calvert Foundation’s investment in Detroit feels a little more philanthropically authentic than providing guarantees for Wall Street investment banks that have more capital than these philanthropic institutions might ever hope to see.

There may well be types of investments in which social impact bond-like structures might be significant boosts toward testing and financing high-risk solutions to social problems. If the likes of Wall Street were to invest really high-risk money in nonprofit projects like planning money and predevelopment financing, much as many community development intermediaries and some foundations do in the form of “recoverable grants,” that would significantly propel nonprofits to do things that they otherwise cannot, given limitations in governmental funding. However, at least at the outset of the SIB social experiment, the projects in the first wave of SIBs seem to be occurring in areas where the techniques for success have been well demonstrated without SIBs. In reading the information on sites such as the Federal Reserve Bank of San Francisco’s “What Works for America’s Communities,” the U.S. Department of Education’s What Works Clearinghouse, and the Urban Institute’s What Works Collaborative, as well as Lisbeth Schorr’s groundbreaking 1988 book *Within Our Reach*, much of what is needed in our society is known and available—the obstacle is the lack of sufficient political will to put public capital behind these strategies and projects that really can make breakthrough changes in social conditions. The evidence that paying private investors such as Goldman Sachs a premium in the form of a SIB will lead to that missing public will is not yet visible.

The prospect of private sector pump-priming capital investment plus the promise of governmental savings add up to a strategy that SIB supporters hope might break the logjam of public sector inaction. However, the pump-priming process at this stage of the nation’s understanding of social impact bonds is a bit topsy-turvy. Rather than having Goldman Sachs and other private investors take high-risk positions to demonstrate the concept, the private investors and various SIB financial packagers are looking for government to put money behind incipient SIB efforts to demonstrate “proof of concept.”

The various recent public investments geared to pay for consultants and other costs associated with structuring SIB/PFS show multiple funding sources. For example, the Salt Lake County Council just voted to give Third Sector Capital Partners \$150,000 from its regional development budget to figure out its next pay-for-success project. In this instance, however, it isn’t that Salt Lake knows what it

wants to do as its next SIB following its experience with its first, a pre-K project, but it is taking the money for Third Sector from its regional development budget to figure out what social problem to take on next.

Social Impact Bonds are not actual bonds, but a financing mechanism in which private capital finances the implementation of a program, repaid if the program reaches predetermined achievement goals. In Richmond, California, to finance housing rehabilitation efforts, the city is issuing actual long-term municipal bonds paying low interest rates (in contrast to the return on investment anticipated by SIB investors such as Goldman Sachs). The bond will be underwritten by RBC Capital Markets, the Canadian investment bank, and will probably be issued at the city's AA-credit rating. Wells Fargo and Bank of America have been identified as potentially interested investors in the bond. It isn't quite clear how a municipality's decision to issue housing bonds is all that new, given the long history of states and cities issuing mortgage revenue bonds and multifamily housing bonds.

Legislation in front of Congress right now, H.R. 4885, the Social Impact Bond Act co-sponsored by Indiana Republican congressman Todd Young and Maryland Democrat John Delaney, would provide \$10 million for states toward the cost of Social Impact Bond feasibility studies and additional federal moneys toward the costs of third-party SIB evaluations. With an array of other federal legislators who have subsequently endorsed the bill, ranging from Jared Polis (D-CO) and Joseph Kennedy (D-MA) to Dennis Ross (R-FL) and Aaron Schock (R-IL), the Social Impact Bond Act exemplifies the bipartisan nature of support that SIBs attract, even with calls for increased funding. But when it comes to the technical assistance and evaluation costs that would typically be wrapped into the overall PFS/SIB financing structure, this legislation puts government into the position of paying for and subsidizing the costs that the SIB structure should in theory cover.

Although conservatives have been highly critical of many of President Obama's social program initiatives, there was no noticeable Republican criticism when, on October 1st, the Social Innovation Fund in the Corporation for National and Community Service announced eight grants for a total of \$12 million to launch pay for success initiatives. Each of the grantees will receive between \$200,000 and \$1.8 million a year over three years, with a dollar-for-dollar match. Grant recipients include entities that will structure and provide technical assistance to SIB/PFS projects, such as the Nonprofit Finance Fund (\$3.6 million), the Harvard Kennedy School Social Impact Bond Lab (\$1.93 million), and the aforementioned Third Sector Capital Partners (\$1.9 million). It is striking that the SIF program theory is that federal front-end predevelopment financing is needed for programs with strong evidence-based track records, such as the projects often selected for SIB/PFS efforts in the U.S., and for major investment groups with substantial histories of project financing. This kind of front-end planning and development money is much less available to smaller, community-based nonprofits testing unproven program models rather than large, powerful nonprofits with major private financial partners along the lines of the typical SIF/SIB/PFS grantee.

Whatever the specific SIB structure, government is always on the hook to pay for "successful" SIBs, in that the government take-out for the project having reached predetermined goals is key—except that it involves government take-out plus a solid return on investment. It means that government has to appropriate in advance the funds that will pay the investors the costs of their working capital plus their anticipated rate of return, else investors might wonder whether a future legislative body might actually appropriate the funds promised by a previous legislature. For example, Massachusetts has had to allocate up to \$27 million for its anti-recidivism SIB. Private investors (banks and foundations) have put \$18 million into the project, but anticipate payments of five percent for senior loans and two percent for junior loans if the project is successful. Ostensibly, long-term costs to government are reduced by the savings from avoiding re-incarceration, but government does have to

pay at some point. Programs that could and perhaps should be paid for by government without the necessity of a SIB to attract private investors, such as Utah's pre-K SIB, defy logic. Why should government appropriate funds up front to pay investors' costs when the concept of pre-K is proven, desirable, and broadly supported by voters and legislators?

These social programs are rarely so discrete that they can be separately financed by private investors without government playing a role at the very beginning as well as at the end. For example, the Chicago pre-K SIB requires not only upfront private investment, but \$4.5 million in state grants and \$10 million in city capital funds. The capital expenditure is necessary, we would guess, because there currently aren't enough pre-K spaces in Chicago for the desired SIB pre-K population. A Goldman Sachs representative, Andrea Phillips, said, "Innovative models like social impact bonds and Pay for Success programs allow the private sector to provide the capital needed to expand successful initiatives in our cities and communities, shifting the risk of achieving targeted outcomes away from the taxpayer and enabling governments to pay only for what works," but the reality is that the success of SIBs depends on government investment prior to the SIB project, during the SIB to pay for costs that the investors can't or won't, and after the SIB project once government has to ante up a payment for program costs plus a return on investment.

The public hears about private capital investment, senses governmental dysfunction as of late, and quickly finds the Social Impact Bond concept alluring even while few people know what it really is or whether it will truly save money. Voters might be surprised to learn that government has to be prepared to pay—and pay handsomely in some cases—for having allowed private investors to invest money in projects and concepts that are already well known to work. Why wouldn't the public invest in pre-K, supportive housing, and anti-recidivism projects on their own merits? Do voters need the validation that comes from having Wall Street bankers bless the projects? We suspect that few people understand the levels of government appropriations that might be needed to support PFS/SIB projects both during their implementation and after they are completed and deemed successful—or that government might be needed to provide some up-front SIB project costs.

The queue of potential intermediaries offering their services in structuring and assisting SIBs is out there, is increasing, their motivations probably a mix of commitment to the social issues to be addressed by SIBs—at least we hope so—plus a large dollop of financial expectations for their own bottom lines. For some SIB adherents, their interest in PFS/SIBs is embellished by a strong sentiment that government is unaccountable, uninterested in results, allergic to evaluation and feedback, and largely unproductive. Their ideological predisposition against government seeps out in various settings when they declare, perhaps with unintentional honesty, that half of government programs have never succeeded with measurable results in any social program endeavor—ever. Some people may even imagine that social investors are somehow more enlightened human beings than the public servants who do the public's work in city, state, and federal agencies. Among a segment of social entrepreneurs of late, there is a growing antipathy toward government—even as they seek out government subsidy.

There are, however, people who truly believe in the efficacy of social impact bonds, even while they acknowledge that there is much to be done to hone the concept to make it practical. Representative Joseph Kennedy III, a co-sponsor of the Young/Delaney legislation, wrote what seems a heartfelt plea for support for the legislation and for SIB models such as the Massachusetts anti-recidivism project being carried out by the Chelsea-based nonprofit Roca. But even Kennedy falls prey to the idea of barriers between the public and private sectors that SIBs can overcome. A team of Brookings Institution researchers recently concluded, "While there is still much to learn in designing and implementing social and development impact bonds, early experiences are somewhat promising in that, at the very least, they have gotten the bureaucrats, the investors and the providers of services

to the same table and with aligned interests at that.” It is sort of an imaginary world view, in which these observers imagine government as somehow immune from doing the bidding of private sector interests, as opposed to the typical role of politicians feeding tax subsidy upon tax subsidy to private corporations and succumbing to the political process dominated by direct and indirect corporate campaign contributions.

There are important roles for private capital to leverage—or be leveraged by—public funding, especially if the corporate funding boosts the capacity and access to working capital of nonprofits tackling issues that don’t come with ready-made, proven solutions and truly need high-risk capital. But if the programs are known to work, as many have been demonstrated to do before the concepts of “pay for success” or “social impact bonds” ever entered the public policy lexicon, it seems so much more logical for government simply to pay for the programs to get them done and not add returns of 7, 10, 20, or 80 percent to attract Wall Street investors. And if the challenge now is to devote government money to the front-end costs of putting together investor-financed SIBs, as Salt Lake County, state governments, and the Social Innovation Fund are now doing, the process is headed in the wrong direction. The nonprofit sector needs feasibility, planning, and predevelopment financing, not big Wall Street investors or the financial intermediaries that anticipate solid paydays from the PFS/SIB concept.

WRITTEN BY RICK COHEN FRIDAY, 17 OCTOBER 2014 14:05

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## **When Public Employees Won't Budge on Their Benefits.**

Philadelphia and its teachers are at war over health-insurance costs. Tens of millions of dollars the schools want are at stake.

How bad can a school system’s finances get? Probably not much worse than Philadelphia’s, whose near-perpetual fiscal crisis almost prevented the city’s schools from opening on time in each of the last two years. Now a nasty fight over health-insurance costs between the commission that oversees the schools and the city’s teachers’ union is writing the latest chapter in the nationwide effort to rein in exorbitant public-employee benefits.

The Philadelphia schools’ financial problems are longstanding. The state took over the system in 2001, and it is currently governed by a School Reform Commission (SRC), three of whose five members are appointed by the governor and two by the mayor.

Nearly all the stakeholders have pitched in to help address the district’s financial shortfalls. The city added a percentage point to its sales tax and \$2 to the price of a pack of cigarettes to help the schools, and some of the school district’s unions granted concessions.

The one exception is the Philadelphia Federation of Teachers (PFT). Earlier this month, the SRC voted to cancel its contract with the union and force its members to contribute to the cost of their health insurance. The PFT sued, and this week a state judge granted a preliminary injunction to stay all changes to the health plans. The district plans to appeal the injunction and fight another day on the question of whether the SRC acted within its rights when it canceled the contract and imposed new conditions.

PFT members currently contribute nothing to the cost of their health insurance. Under the SRC plan, members earning less than \$25,000 annually would pay 5 percent of their health-insurance premium, those making between \$25,000 and \$55,000 would pay 10 percent and those who earn

over \$55,000 would contribute 13 percent. The average Philadelphia teacher, who earns \$72,000, would pay \$932 per year.

In 2013, the opening of school was threatened when the school district faced a \$50 million shortfall even after laying off thousands of employees. (The district ultimately borrowed the money and reversed some of the layoffs.) This year the funding gap was \$81 million. In each case, the shortfall would have been largely or completely eliminated by the health-insurance contributions, which are estimated to save between \$60 million and \$100 million annually — resources that are desperately needed in the city's classrooms.

No one can lay the blame for Philadelphia's school-finance crisis at the feet of the PFT. It is a far bigger problem that will require fundamental structural changes in how the city and the state fund schools. But the days of public employees — or anyone, for that matter — paying nothing toward their health-insurance costs are numbered, and rightly so. State and local taxpayers shouldn't be asked to subsidize a public-employee perk that they themselves can only dream of.

GOVERNING.COM

BY CHARLES CHIEPPO | OCTOBER 24, 2014

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## **Seattle Adopts an Old Way to Pay for New Parks.**

Seattle produces some of the finest brewed coffee in the country, and some of the top software. Even its long mild winters are among the best in the world. But if you ask Seattleites what gives them the greatest civic pride, many will point to their world-class city parks. Seattle's leaders often use parks in the same sentence with words like "community identity," "bridging generations" and "social justice."

That's why it's so encouraging that Seattle voters recently reconceived how they'll pay for them. Like Amazon with online retailing or Costco with big-box stores, Seattle might be out ahead with yet another disruptive trend for its citizens.

Let me start with some basics. "General" and "essential" are synonyms in the traditional lexicon of local public finance. Essential local services like police, fire, libraries and parks are funded with general property and sales taxes. These services are so important that everyone pays, regardless of how much or little they use them. The revenues flow into the city's general fund, where local elected officials decide how to spend them. Essential services are, by definition, high priorities in the general fund budget.

Of course, there are exceptions. In rural areas, for instance, it's often cheaper to spread the costs of fire protection over a wide geographic area. In that case, it's appropriate to levy a special property tax that covers multiple cities. The opposite is also true. Essential infrastructure that mostly benefits a particular group of properties is a good candidate for a special assessment where only the owners of the affected properties pay the tax. In these cases, it makes sense to pay for essential services with special revenues rather than general revenues.

Seattle has turned this logic inside out. In a recent election, voters approved the creation of a new metropolitan parks district. There's nothing special about this district or its services. Its geographic boundaries match the city of Seattle's. The city council will serve as the district's governing body. The only difference — and it's a crucial one — is that the taxes it collects will bypass the general

fund and go directly to parks. Cities such as Chicago, Washington, D.C., and even nearby Tacoma have funded parks this way for decades. Seattle voters seem to think this throwback model is the only way to protect this essential service from the political machinations of the general fund.

Some parks advocates have called this a huge win. No more cutting maintenance on parks facilities during recessions. No more choosing between parks and police. New parks that have lived on the drawing board for years can now come to life. Property owners can literally see what they get for part of their property tax dollar. These are all good things.

Other things aren't so positive. When money comes from the general fund, taxpayers can take their concerns directly to the city council. If they don't like the council's answer, they can vote to replace a member. When the money comes from a special levy, like the one that now funds part of Seattle's parks, residents can vote to end that levy. In the special district model, the lines of accountability aren't so clear. Voters' only direct recourse may be to dissolve or restructure the district with a separate future ballot initiative.

The biggest concern is that under this new model, access to stable revenues might be controlled not by policymakers, but by the ability to organize a get-out-the-vote initiative. Some worry this could leave many citizens, especially the poor, out of the mix. So far that's not the case, but critics worry about the possibilities.

It's easy to see why advocates for parks — and other essential services — might want to pursue this model. As general fund resources become harder to find, why not take the case for essential services directly to the voters? If Seattle is a bellwether for things to come, we'll need to fundamentally rethink much of what we know about local public finance.

GOVERNING.COM

BY JUSTIN GERDES | OCTOBER 2014

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## **[World Trade Center Tower Rides a Muni-Bond Revival.](#)**

Developer to Sell \$1.6 Billion of Tax-Exempt Bonds

After more than a year of uncertainty, a third tower at the World Trade Center site appears poised to rise thanks to an unlikely catalyst: a turnaround in the market for municipal bonds.

Developer Larry Silverstein is planning to sell \$1.6 billion of tax-exempt bonds to finance 3 World Trade Center as soon as next week, a move that would give the 1,170-foot tall New York tower the funding to move forward.

If the sale proves successful, the 2.5 million square-foot tower would be the latest byproduct of investors' hunt for yield. With Treasury yields pushing lower, investors have been searching for investments that generate better returns, even if the risks are greater, benefiting everything from Silicon Valley startups to toll roads.

Executives involved with the tower began looking for money last year and determined there wasn't enough investor demand. But a rally in the muni-bond market has given them confidence the bonds will sell and the tower can rise on the 16-acre site.

The improvement in the muni market “has created real optimism about this transaction,” said Janno Lieber, who oversees World Trade Center development for Silverstein Properties Inc.

Limited muni-bond supply due to reduced borrowing by cities and states helped push muni-bond rates to a 2014 low of 2.19% last week, from 3.3% in January, according to the S&P Municipal Bond Index. Bond yields move in the opposite direction of prices.

The 3 World Trade Center bonds would be at a higher rate—expected to be between 5% and 6%—but still below what traditional lenders charge for construction debt. Adding to their appeal: The tower’s bonds are tax-exempt because of congressional action related to the site’s rebuilding.

Still, the bonds aren’t without risk. The 3 World Trade property, nearly the size of the Empire State Building, is just 20% leased, leaving a large space to be filled in an office market that is only gradually improving.

“Rates are so low that people are stretching for yield, which often means going down the credit scale,” said Howard Cure, head of municipal research at Evercore Wealth Management LLC, which oversees about \$5.4 billion.

Silverstein has been planning the tower for years, although construction was halted at eight stories until the developer locked in a tenant and financing, based on the terms of a 2010 government-aid agreement.

The developer secured its tenant last year when advertising firm GroupM, a division of WPP, agreed to take 515,000 square feet in the base of the building.

But when Silverstein looked at its options for financing, it saw that the interest payments on municipal debt would be too high. Meanwhile, banks weren’t willing to make a loan for a building with so much vacancy. Lenders have remained relatively conservative since the downturn, and typically lend only for buildings with significant leasing agreements in place.

“The banks are not in a position to take that risk yet,” Christopher Haynes, president of loan-advisory firm Broadacre Financial Corp., said of construction loans for office towers without tenants. “I just don’t think the market’s there.”

Silverstein initially went to the Port Authority of New York and New Jersey—which owns the 16-acre site—and asked the agency to back most of the debt. While agency officials were supportive, its board rejected the request in the early summer, leading Mr. Silverstein to turn back to the bond market.

The result was encouraging. Silverstein’s bankers at Goldman Sachs Group Inc. and other advisers told the developer the deal might be able to work based on the terms of the 2010 aid package, in which the Port Authority would cover the first \$210 million of shortfalls to investors.

Aided further by a noticeable uptick in the lower-Manhattan leasing market, Silverstein put in \$50 million of equity and the bankers began to seek investors.

In recent weeks, bond managers have toured the site, walking through the under-construction concourse below the tower while strolling by 4 World Trade Center, the recently completed tower that also was built by Silverstein, and 7 World Trade Center, Silverstein’s fully leased tower built in 2006.

For the investors, the risk lies largely with the state of the Manhattan office market. While a number

of companies like Time Inc. recently have been opting to move from Midtown to lower Manhattan, any slowdown in the economy could quickly put a halt to pricey moves and cause companies to stay in place.

It isn't clear how much time Silverstein believes the building will take to lease up fully. But an independent appraisal provided to bond investors projects the tower will be leased by 2021, three years after it is completed, assuming it secures financing this fall.

THE WALL STREET JOURNAL

By ELIOT BROWN And AARON KURILOFF

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## **[BlackRock Sales in October Rally Signal Its Limits.](#)**

The municipal-bond market's rally this year has confounded Wall Street expectations, culminating in the best October performance since 2001 and drawing the most cash in two years. BlackRock Inc. (BLK) has had enough.

After an unprecedented nine straight months of muni gains, the world's biggest money manager said it sold some of the debt as benchmark yields sank to a 16-month low. Vanguard Group Inc. also says the market is vulnerable to losses at current levels.

Munis have earned 1.2 percent this month, on pace for the biggest October gain since a 1.4 percent return in 2001, according to Bank of America Merrill Lynch data. While municipal issuers may welcome diving borrowing costs, investors are growing wary of buying as yields approach generational lows.

"We've taken a little bit off the table in the last few days," Peter Hayes, who oversees \$122 billion as head of munis at New York-based BlackRock, said in an Oct. 16 interview. "Nobody really expects rates to rally significantly from here. In fact, I think everybody is waiting for a little bit of a pullback. That's what we'll wait for."

### **Outlier Rally**

Benchmark 10-year muni yields have increased 0.03 percentage point since touching 1.94 percent on Oct. 16, the lowest level since May 2013, Bloomberg data show. They started 2014 at 3 percent.

This year's return for munis has defied forecasts of analysts and investors in the \$3.7 trillion market. Morgan Stanley's main scenario for 2014 was for losses of at least 1.7 percent, while Barclays Plc estimated a 1.45 percent drop. In April, Citigroup Inc. joined the chorus of those advocating sales.

Instead, munis have rallied in each of the first nine months of 2014, a feat that hasn't been seen in the past 25 years, according to Bank of America data.

States and cities across the U.S. are taking advantage of lower rates to finance projects or refund

higher-cost debt.

New York won the lowest borrowing costs in at least half a century last week when it issued 30-year sales-tax bonds at a yield of 2.87 percent, according to the state budget office. It added \$150 million of debt to the deal because of the reduced rates.

### **Carolina 'Jackpot'**

South Carolina's public-service authority, known as Santee Cooper, borrowed an extra \$186 million amid the falling interest rates, said Chief Financial Officer Jeff Armfield.

In Florida, Miami-Dade County Public Schools "hit the jackpot," said Treasurer Leo Fernandez. The district's refinancing will save almost \$24 million, compared with the projected \$14 million, he said in a telephone interview.

Municipalities across the country have scheduled about \$10.5 billion of sales during the next 30 days, the most in four weeks, Bloomberg data show. State and cities have issued \$219 billion of fixed-rate, long-term debt this year, 8 percent below last year's pace, helping stoke the rally.

"Munis are fully valued, overbought and potentially exposed to a backup, particularly if we get heavy supply over the remainder of the year," said Chris Alwine, who oversees \$140 billion of state and local debt as head of munis at Vanguard in Valley Forge, Pennsylvania.

### **2012 Echo**

While Vanguard isn't selling bonds to raise cash, it's looking for debt that will retain value better in declines, Alwine said. He said current yield levels echo the end of 2012, when interest rates fell to the lowest since the 1960s before rising amid the worst yearly losses since 2008.

Morgan Stanley, which predicted 2013's decline, is again projecting losses. The bank's main scenario is for the market to lose 0.88 percent in the next 12 months, Michael Zexas, its chief municipal strategist, wrote in an Oct. 6 report.

The consensus on Wall Street is for yields to rise as the economy strengthens. Ten-year Treasury yields will reach about 3.2 percent in the third quarter of 2015, about a percentage point above current levels, according to the median forecast of 76 analysts in a Bloomberg survey.

Tim McGregor at Northern Trust and Jamie Pagliocco, director of bond managers in Merrimack, New Hampshire, at Fidelity Investments, aren't so quick to call an end to the rally as individuals have added to muni mutual funds for 14 straight weeks. It's the longest stretch since October 2012, Lipper US Fund Flows data show.

### **Cash Influx**

The influx may absorb new deals for the remainder of the year and keep yields near current levels, the asset managers say.

"We've got four to five solid weeks of supply ahead, but it seems like there's cash to make it through that without too much adjustment," said McGregor, who oversees \$30 billion as head of munis at Northern Trust in Chicago. "I would still count on a lot of volatility along the way."

Relative value may stand in the way of a sustained muni rally: The debt has outperformed some major fixed-income counterparts this year. While state and city bonds have gained 9.7 percent,

Treasuries have earned 5.5 percent and investment-grade company securities have returned 7.6 percent, Bank of America data show.

As a result, the ratio of 10-year muni yields to similar-maturity Treasuries has dropped to 90 percent, compared with a five-year average of 98 percent, Bloomberg data show. The lower the figure, the costlier state and local debt is in comparison with federal obligations.

For BlackRock, which said in an outlook in December that munis entered 2014 “reasonably valued,” that’s no longer the case.

“I’m not sure the municipal market is priced right,” Hayes said. “You can use strength like we’ve seen to sell into it, put cash on the sidelines and wait for better opportunities down the road.”

Bloomberg

By Brian Chappatta

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## **[Pimco Sees Returns Ebbing After Best Gain Since '11: Muni Credit.](#)**

With the \$3.7 trillion municipal market poised for its biggest annual gain since 2011, this year is going to be a tough act to beat, say Pacific Investment Management Co. and Morgan Stanley.

Returns in 2015 may be less than half of the 8.7 percent logged in 2014 as interest rates have probably bottomed out close to generational lows, according to Pimco, the \$2 trillion fixed-income manager, and Morgan Stanley, owner of the world’s largest brokerage.

Gains are probably set to diminish as the Federal Reserve wraps up its bond-buying program and prepares to raise interest rates, said Michael Zetas, chief municipal strategist at Morgan Stanley in New York. The prospect of skimpier earnings for investors has significance for municipalities as well: Demand from buyers chasing this year’s rally has helped push borrowing costs toward generational lows for officials financing schools, roads and water systems.

“You’ve already run it fairly far,” said Joe Deane, New York-based head of munis for Pimco, whose co-founder Bill Gross departed on Sept. 26. “From these levels, to have this kind of a return, you would have to take interest rates down to some dramatic levels. I don’t see that being in the cards.”

### **2015 Call**

State and local debt will earn about 3 percent in 2015, said Deane, whose company manages \$50 billion of munis.

While that would still mark a second straight year of gains, it may temper the appetite of individual investors, who have poured cash into U.S. muni mutual funds for 13 straight weeks. That’s the longest stretch since 2012, according to Lipper US Fund Flows data.

The demand pushed yields on benchmark 10-year munis to 2.05 percent, the lowest since May 2013, after the interest rate fell for three straight quarters. Yields may reverse course in 2015 if investors pull back from local obligations in anticipation that the Fed will raise its benchmark lending rate, Zezas said.

The central bank will lift its target, which has been near zero since 2008, starting in the third quarter of 2015, according to the median forecast of 82 analysts surveyed by Bloomberg. Morgan Stanley expects the Fed boosts to start in the first quarter of 2016.

### **Base Case**

“We expect rates to gradually move higher and volatility to pick up as we get closer to a Fed exit,” Zezas said. “Those are things that are a risk in muni performance.”

Morgan Stanley’s main scenario is for munis to lose 0.88 percent in the next 12 months, Zezas wrote in an Oct. 6 report.

“We more or less expect flat returns as a base case,” Zezas said by phone. “But the skew of potential return outcomes is certainly meaningfully lower than what we’ve experienced over the last 12 months.”

Yields on 10-year Treasuries will reach 3.25 percent in the third quarter of 2015, about a percentage point above current levels, according to the median forecast of 75 analysts in a Bloomberg survey.

State and city debt has defied Zezas’s year-end 2013 forecast. At the time, he laid out a base-case scenario for this year in which munis would lose at least 1.7 percent.

### **Rebound Year**

The return this year follows a loss of 2.6 percent in 2013, S&P Dow Jones Indices show. The assets are on track for their best performance since 2011, when they gained 10.6 percent.

Daniel Ivascyn succeeded Gross as Pimco’s chief investment officer. Gross helped its Total Return Fund (PTTRX) become the world’s biggest bond mutual fund, with about \$202 billion of assets, of which 4.2 percent was in munis as of June 30.

After the shakeup, shifts in muni allocations will come from market developments and not Gross’s departure, Deane said.

“They look to all of these specialist desks — do you like your market, do you not like your market? What’s valuable and what’s really rich?,” Deane said. “I don’t think that is going to change.”

Deane and Zezas also have a similar view on where investors should look in terms of credit quality, focusing on higher-rated assets instead of the riskier obligations that have outperformed this year as benchmark yields dove.

Munis in the bottom three levels of investment grade have earned 12.9 percent this year, compared with 6.1 percent for top-rated debt, Barclays Plc data show.

Investors should take the opportunity now to trade out of munis rated one to four steps above junk and purchase higher-grade debt, Zezas said.

Pimco focuses on munis in the single-A range, or four to six steps below top-rated securities, and

bonds maturing in seven to 20 years, Deane said.

“With the rally that we’ve had, it just makes us a little more conservative,” Deane said. “If we’re going to put money to work, it’s going to be higher-grade stuff and it’s going to be shorter.”

Bloomberg

By Michelle Kaske Oct 14, 2014 8:31 AM PT

10/15/2014

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Mark Tannenbaum, William Selway

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## **[S&P U.S. State and Local Government Credit Conditions Forecast: Economic Growth is Tinged by Questions of Sustainability.](#)**

U.S. regions have been growing during the past year at a faster pace than we expected. The U.S. Commerce Department’s Bureau of Economic Analysis’ revised estimate of second-quarter real GDP growth of 4.6% surpassed our expectation of a 4.2% annualized growth rate for the quarter. More generally, the updated official growth estimate confirmed our view that the U.S. economy is gaining momentum. Even before the GDP revision, we had modestly raised our forecast of 2014 real GDP growth to 2.2% from 2.1%. Shortly thereafter, a strong September jobs report followed; thus, several recent indicators offer accumulating evidence that the economy could outperform even our somewhat improved outlook. Welcome as they are, however, indications of faster-paced economic growth create something of a dilemma for state and local government budget officials. Almost across the board, governments have restrained their staffing levels, programmatic funding, and infrastructure investment.

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## **[Striking the Right Note on Public-Private Partnerships.](#)**

Despite some discord, properly managed public-private partnerships can find harmony

Public-private partnerships (PPPs or P3s) have been getting a bad rap lately, causing municipal governments to wonder whether such partnerships really serve public interest — especially as fiscal resources are rebounding following the recession. In a four-part series on PPPs, the Pittsburgh Post-Gazette recently highlighted the pitfalls of making poorly structured financing deals with the private sector to fund infrastructure projects.

Meanwhile, Chicago has been crucified by the public and press for using a P3 to manage 36,000 city parking meters. The private investor, Morgan Stanley Infrastructure Partners, generated \$43.6 million in profit by raising parking rates. Morgan Stanley also billed Chicago for \$61 million for reimbursement, claiming that, when the city closed streets for construction or street festivals, created bike and bus lanes to reduce traffic or allowed someone else to build a competing parking garage, Morgan Stanley lost revenue.

Despite the criticism, interest in P3s is growing. Proponents say partnerships are worth exploring because they often result in creative solutions to delivering and funding public services and infrastructure projects.

“It’s safe to say governments at all levels are faced with budget constraints and there is inherent budget scrutiny,” says Todd Herberghs, executive director for the National Council for Public-Private Partnerships (NCP3P). “As officials are reluctant to increase revenues through taxes, but government still has to deliver the same services, P3s are a great avenue to explore for funding.”

Nationwide, more communities are implementing legislation to facilitate and expand the use of PPPs to improve service and control costs through competition and reduced overhead, says Richard Norment, an independent consultant for PPPs and NCP3P senior fellow. “The number of states that have passed new partnership transportation legislation has plateaued at 34, but what has expanded rapidly is legislation for social infrastructure — water systems, schools, libraries, parking lots. [Such legislation] has eclipsed the transportation number, with 49 states having statutes for such projects,” he says.

Given the facts, “We encourage P3s as an option for local governments, but we don’t encourage rushing into them to get something paid for. That can lead to bad deals,” Herberghs cautions. Instead, he suggests communities take time to examine what they are trying to accomplish, do a complete value analysis and determine the true lifecycle costs. “It’s not just free money,” he says.

Broad communication is key to the success of a PPP, Herberghs adds. “Some projects may have felt rushed through or face public opposition because the process was not as open as the public would have hoped,” he says. “It’s important to be as methodical and transparent as possible.”

Colorado recently took steps in this direction, by amending its legislation so that PPPs are more open to public comment.

“I would argue that the ‘soft elements’ in a partnership are at least as important as the financial aspects,” says David Swindell, associate professor of public affairs and director of the Center for Urban Innovation at Arizona State University (ASU). He notes the importance of two-way communication in the relationship. “It’s not just a cost-benefit in terms of dollar and cents. It also includes efficiencies, effectiveness, whether citizens are satisfied, whether city council politics are going to impact the project, etc.” If politics or poor communication is going to hinder a partnership, then a city council should be gun-shy about entering into these types of partnerships, he says.

Susan Mays, vice president of marketing and strategic initiatives for CH2M Hill’s Operations Management Services group, characterizes successful PPPs as partnerships that provide “collaborative service delivery,” rather than involve a community “contracting out a service.” She notes the importance of creating partnership agreements that allow for flexibility, should issues arise that aren’t specifically spelled out in the contract. She says one agreement her company has with a city says nothing about being a good corporate citizen, but her staff knows the mayor expects the company to participate and be part of the community. “When you look at signing a contract for 10, 20, 30 years, what’s in the contract isn’t going to make the project successful. It’s the skills on both sides of the table that build on a collaborative arrangement.”

“‘Contracting out’ frequently involves a community contract out service X for given price at X quantity. That’s nothing more than city paying a vendor for a service — a contractual relationship. I don’t consider that sort of privatization a partnership,” Swindell says. “A partnership is when both parties are involved — collaborative service delivery” — and both parties benefit.

To help communities determine whether their projects are ripe for partnership with the private sector, ASU has developed a tool to evaluate the chance of success. “We’ve been working on a tool to help communities decide whether they should be doing it in first place. Given the service and given the context of the community, is collaborating the right thing, or should the project remain in-house?” Swindell says.

The success of a P3 hinges on more than just the financial viability of the project and partner. Some services are more amenable to collaboration with public or private sector delivery. Is the leadership stable or is there a lot of turnover? “Would you want to have a partner that can’t keep its leadership in place and might change its mind on the value of partnership? One of the characteristics of success is leadership stability and talent of the partners — do they have a track record of being competent in these types of partnerships?” he asks.

In the ‘90s and early 2000s, there was a push for PPPs, then states, cities and counties moved away from these arrangements because public entities didn’t feel like they were getting what they wanted out of the partnership, and often they weren’t really designed as a partnership, Swindell says. A successful partnership clearly spells out the goals, what each partner’s responsibilities are, and the benefits.

“The private sector needs to profit, and the public sector needs the service. How you specify the agreement and note what each party is contributing to the process and derives from the process isn’t always equal in dollars... We’re now seeing private-sector companies that better understand what the public needs to get out of this and a lot more sophisticated city managers that are savvy to what they need to specify in arrangements so the relationships all work the way parties want them to work,” he says.

John Danielson, city manager for Centennial, Colo., likens a PPP to a marriage. “If both folks want to work on the relationship, it will work to the best of circumstances,” he says. His city of approximately 100,000 residents works with the private sector to provide service delivery for all of its public works, from snow plowing to surveying. This has allowed the city to operate with only 50 employees, while benefitting from the expertise of private professionals. “I get the benefits of super, high-quality work for only the time that I need it,” he says.

However, he recognizes that his city’s P3s are successful because his staff doesn’t operate with a superior-subordinate relationship. He says his staff checks in with major partners every Monday, not to go over every aspect of the contract, but to monitor progress, whether they have the right people and equipment in place, and whether they’ve communicated everything to the public about what they will be doing to meet expectations. “It’s similar to in-house staff meetings, and difficult to tell the difference between city employees and private contractors when they’re physically together in the same room,” he says.

“The group works as a team, keeping in mind the basis of the contract is I win, you win,” Danielson adds. “There has to be a reason for us to be together and for this to work out. I get goods and services on a level that meets my and the residents’ needs. You’re on the other side of it and provide a service and generate a profit, keep people working and keep shareholders happy.”

When the public and private sector works in sync, it can yield innovative and impressive results, Mays says. “Financing is really one of the triggers [for P3s,]” she says. “However, communities also can benefit from P3s in other ways. Perhaps the private sector has technical expertise or the technology to do something more efficiently or effectively. Or, perhaps it’s better to partner with the private sector to help transfer some of the risk.”

The community of Sandy Springs, Ga., is so sold on the benefits of PPPs that Mayor Rusty Paul says he's "double-downed" on them after outsourcing all city services except police, fire and 911.

In 2005, the city of nearly 90,000 residents signed a comprehensive PPP contract for all major city functions, including administrative services and nearly all public works functions. Today, Paul says he rebids the contracts every three years to make sure contractors are fulfilling their obligations on service delivery, and he has a backup contractor lined up in case the primary contractor fails to meet expectations.

Paul says his city's commitment to the privatization model has improved customer satisfaction and helped contractors feel like they are part of the fabric of the community. "Private sector partners know their number one job is to focus on service to earn a paycheck," Paul says. "We foster a teamwork environment and our private sector partners play an essential role and are partners in delivery services to the public."

The bonus, he says, is that by contracting out services to the private sector, his city has price predictability in providing services for several years, which frees up the budget to provide additional city services. Because of PPPs, 25 percent of the city's budget can now be used for capital projects and improvements like repairing streets and creating new parks and public art.

Another example involves Fairfax County, Va., which is building its Metro line. David Birtwistle, CEO of the Virginia Transportation Alliance, said at the end of the first phase of the Metro line expansion in Reston, Va., the county needed a parking facility to accommodate ridership. Knowing that such a project would be expensive, it sought a private partner to provide the parking structure.

When it solicited bids, Fairfax received a bid from Comstock Partners that wanted to charge double what it would be to build 2,300 parking spaces. The bid seemed strange at first, consultant Norment says, but it turns out the developer proposed the project with an additional 3,000 parking spots for no charge so that it could put a mixed-use residential/commercial facility on top of the parking spaces and pay the county for the air rights of the structure. In addition to the parking spaces, the project now includes a commuter park-and-ride facility, transit bus depot, 1.3 million square-foot, mixed-use center that will include 900 luxury apartments, a 200-plus-room hotel, restaurants and office and retail space.

"It created very positive cash flow for the county," Norment says, noting more innovative projects like these are cropping up, with more wrinkles than in years past. "The adage goes, 'if you've seen one PPP, you've seen one PPP.'"

P3s may not be the best solution for governments that are reluctant to raise taxes to fund infrastructure projects, but they are worth considering, Sandy Springs' Paul and Centennial's Danielson say.

"You don't have to roil the whole city and throw out every department to private sector [management] at once," Paul says. Yet, if you give PPPs a chance, "you may be pleasantly surprised by the enthusiasm and innovation you get out of the process."

Danielson suggests communities start with areas that are the least or most poorly served — areas in which you struggle to operate. "If things are not going well, it might be a great place to start looking at a partnership to see if there is a different service model that doesn't cost you any more money. Find someone who has a good partnership and spend a few days to find out what works and doesn't, and what things that might fit in your organization," he says.

Even if resources aren't as tight as they used to be, "when state and local governments look for ways to meet public need, P3s very much belong as part of the evaluation process," Birtwistle says. "The pitfall is that [P3s] were looked at as financing mechanisms, and as revenues increase, [there] may be less of a reliance or interest in such partnerships.

However, partnerships can bring more than just financial resources to the table. They can bring new ideas and more efficient solutions that the public sector may not otherwise have had opportunities to. It would be unfortunate if the public sector didn't continue to look at P3s as an option to a project. It's not the solution in all cases — but in many cases it can be advantageous," Birtwistle says.

By Patricia-Anne Tom | American City and County

Sept. 24, 2014

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## **[Virginia to Debate New P3 Guidelines for Roads.](#)**

Virginia's transportation board and other officials could face new responsibility to conduct risk assessment and communicate their findings to legislators and the public for P3s. That is a recommendation included in [draft guidelines](#) released by state transportation officials Oct. 14.

The state solicited new guidelines following concerns over the U.S. 460 project pursued by former Virginia Gov. Bob McDonald (R). Current Gov. Terry McAuliffe (D) suspended work on the highway in March after learning the project had spent close to \$500 million without a groundbreaking. An inspector general's review found the commonwealth's hasty pursuit of the project allowed it to move forward with little oversight.

Under the guidelines, a new decision matrix would require the Commonwealth Transportation Board to review and approve action before:

- a project enters the development stages and the commonwealth begins to spend money;
- the procurement process begins; and
- a final contract is signed.

"With guidelines like this in place, we would have never gotten to the point we did and spend the money we did on the Route 460 P3 project," Aubrey Layne Jr., Virginia's Secretary of Transportation, told the Richmond Times-Dispatch.

The proposal would expand Virginia's P3 steering committee to include members of the transportation board, chairmen of the House and Senate transportation committees, and an independent financial expert from within the government.

Meetings of the steering committee would require 30 days' notice, briefings for relevant committees at the state legislature, and increased public engagement.

"We fully understand the need for more accountability and transparency in the process," Layne said, "and we believe it should be a more competitive process, too."

For projects over \$100 million or those with complex environmental approval processes, the commonwealth would be required to develop risk-mitigation plans, and the risks would be disclosed

to lawmakers before procurement started.

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## **[S&P's Public Finance Podcast \(State Debt and the Rating Action on Pennsylvania\).](#)**

On this week's segment of Extra Credit, Standard & Poor's Director Henry Henderson discusses our commentary on state debt and Senior Director John Sugden explains our rating action on Pennsylvania.

[Listen to the podcast.](#)

Oct 17, 2014

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## **[MMA Municipal Issuer Brief - October 20, 2014.](#)**

The Municipal Market Advisors warned this week that investors looking at local governments with any hint of distress had better take a hard look at pension debt load. Developments in the bankruptcies of Stockton, Calif., and Detroit have "jeopardized the repayment of capital market creditors," MMA said, and ultimately pensioners are making out better than bondholders when a city is forced to restructure its debts. The firm advised that local governments' investment worthiness be viewed "holistically," meaning that "the costs associated with repaying public debt plus pensions plus OPEBs (retiree healthcare) plus direct loans and other important contractual relationships should be considered when modeling payment capacity."

[Read the Brief.](#)

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## **[Munis Poised for Biggest October Gain Since 2000 Amid Bond Rally.](#)**

The \$3.7 trillion municipal market is poised for its biggest October rally in 14 years, pushing yields to 16-month lows in defiance of historical trading patterns for the month.

State and local debt has earned 1.45 percent this month, on pace for the best October performance since a 1.5 percent gain in 2000, according to Bank of America Merrill Lynch data. Yields on benchmark 10-year munis have dropped 0.28 percentage point this month, the most since January, to 1.95 percent, data compiled by Bloomberg show.

The move contrasts with the past five years. Yields have jumped an average of 0.19 percentage point in October since 2009, more than all periods except June. The municipal market has joined a volatile October for financial markets: Stocks worldwide lost about \$3.3 trillion in market value during the month through yesterday and 10-year Treasury yields dipped below 2 percent for the first time since June 2013.

"The market is going against investors' expectations of higher rates — we've gone nothing but down," said Peter Hayes, head of munis at New York-based BlackRock Inc. (BLK), which oversees \$122 billion in local debt. "Rates are certainly getting close to their all-time lows again."

For state and local bonds, the gains extend a streak in 2014 of no monthly losses, an unprecedented feat over the past 25 years. Fueling the advance, individuals have added to muni mutual funds for 14 straight weeks, the longest stretch since October 2012, Lipper US Fund Flows data show.

Munis' 9.9 percent return this year compares with 5.7 percent for Treasuries, Bank of America data show. That's pushed the ratio of 10-year muni yields to similar-maturity Treasuries to 88 percent, close to the lowest this year, Bloomberg data show. A lower figure signals state and local debt is growing costlier relative to federal debt.

BLOOMBERG

By Brian Chappatta Oct 17, 2014 8:07 AM PT

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Mark Tannenbaum, Alan Goldstein

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## **[Moody's: Advantages of Century Bonds to Finance Infrastructure Come at a Cost.](#)**

New York, October 08, 2014 — Bonds with very long maturities of up to a 100 years—century bonds—can have an appeal for infrastructure bond issuers, says Moody's Investors Service, because they are able to match the long-term service lives of the assets they are financing to the long-term maturities of the debt, deferring rate increases and capital cost recovery for generations. However, these advantages carry some credit risks.

"The issuance of ultra long-dated debt such as century bonds by infrastructure issuers defers rate increases or cost reductions in the near- to medium-term, which runs counter to a key credit strength of infrastructure enterprises: the ability and willingness to raise rates to recover costs of operating and investing in the system," says Moody's Vice President Nick Samuels in the new report, "Century Bonds Create Opportunities and Challenges for US Public Infrastructure Issuers."

Century bonds have become a topic of discussion among infrastructure debt issuers and investors after District of Columbia Water and Sewer Authority (DC Water) sold a \$350 million century bond this summer to help finance a part of a \$2.6 billion consent decree mandated Clean Rivers Project.

From an operating perspective, a century bond issuer gains flexibility by deferring debt service costs far into the future. However, adding century bonds to a debt portfolio can lessen long-term financial flexibility and raise long-run costs.

Compared to a traditional 30-35 year amortization for an infrastructure issuer, a 100-year structure more than triples the total debt service costs.

The water tunnels DC Water was financing are designed to have a useful life of at least 100 years. The authority sought to capitalize on this span and reduce its near-term financing costs by issuing the century bonds, which pay interest only for 90 years and then sinking fund deposits in the final 10 years. Ample investor demand allowed DC Water to both increase the deal's size from the planned \$300 million and reduce the bonds' yield from its original assumptions.

This had been the first century bond deal in infrastructure since Port Authority of New York and New Jersey in 1994.

Recently, the Cleveland Clinic Health System issued a \$400 million century bond, a first in the not-for-profit healthcare sector. Several higher education institutions with strong national reputations have also issued century bonds, and they have also been issued by several corporate issuers.

For more information, Moody's research subscribers can access the report at

[http://www.moody.com/viewresearchdoc.aspx?docid=PBM\\_PBM176188](http://www.moody.com/viewresearchdoc.aspx?docid=PBM_PBM176188).

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## **[State Economic Monitor: October 2014.](#)**

Most states ended the summer of 2014 on a positive economic note. Up from 14 states a year earlier, 25 states reported August unemployment rates below 6 percent. Every state but Alaska added jobs within the last year. But some troubling signs remain. Inflation-adjusted average weekly wages declined or did not change in 26 states. The latest issue of the State Economic Monitor describes economic and fiscal trends at the state level, highlighting particular differences across the states in employment, state government finances, and housing conditions. This issue also includes a special section on state minimum wages.

[Read the complete document.](#)

Richard C. Auxier  
October 16, 2014

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## **[Squeeze on US Muni Sales Boosts Prices.](#)**

US states and cities have cut borrowing by 6 per cent so far this year as they rein in spending and tap other sources of funding for infrastructure projects and the maintenance of public services.

New issuance of "muni" bonds has been slowing in the past couple of years in the aftermath of the financial crisis, which ripped holes in municipal budgets.

In addition to fiscal austerity, a growing number of states and city governments in the US have been turning to partnerships with private entities - known as P3s - or tapping into direct credit lines with banks to meet their funding needs, analysts said.

"States and municipalities are generally doing a better job controlling their spending, and are not willing to embark on large projects while the economic outlook is still a bit uncertain," said Rob Taylor, head of municipal finance at Barclays.

"That, combined with the fact that there's been other sources of funding, such as direct bank lending, points to a drop in new issuance in 2014."

Sales of muni debt fell to \$202.3bn through the end of September, down from \$215.1bn in the same period of 2013, according to data from Thomson Reuters MMD.

Most of the sales' proceeds, or \$57.2bn, was earmarked for general purposes, with funding related to education close behind, at \$56.6bn. The state of California was the largest issuer of general obligation bonds, at \$4.8bn, followed by the commonwealth of Puerto Rico, with \$3.5bn.

For investors, the drop in supply has helped boost muni bond prices, which in turn has increased the total return on the securities.

Muni bonds have been one of the best performing assets so far this year, with average total returns on the debt at 8.1 per cent, according to Barclays indices. That compares with a total return of 4 per cent for US Treasuries and 7 per cent for investment grade corporate debt.

"There's no question about how the imbalance between the supply of new issues and demand has created a very favourable landscape for positive returns," said Jim Colby, chief municipal strategist at Van Eck Global.

"It's a compelling backdrop for many investors, specially when you also factor in some of the tax incentives attached to the securities."

As an incentive to invest in public projects and to keep borrowing costs low, interest income from munis is exempt from federal taxes. Many munis can also be exempt from state taxes and from local taxes too.

The allure of generous tax breaks is clear. An investor in a 35 per cent tax bracket would have to find a fully taxable security, such as a corporate bond, that yields more than 8 per cent to earn the same amount of income.

The strong performance in munis also comes after the worst year for the \$4tn market in almost two decades and just one year after Detroit filed the biggest municipal bankruptcy case in US history.

The Financial Times

By Vivianne Rodrigues in New York

October 10, 2014

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## **[Monoline Insurers 'Could Reach 10%' of Muni Market Again - Citi.](#)**

Like bison on the Great Plains, monoline insurers used to roam in great numbers across the muni-bond landscape. Then the financial crisis hit and monolines nearly went extinct. But now they're on the rebound, and though far less abundant than they were a decade ago, they soon could climb back to relevance in the muni market.

Or not. Citi today says that monolines' share of wrapped new muni bonds "could reach 10% in the future" but acknowledges that "the vast majority of investors continue to largely ignore monoline wraps."

At their peak, monolines - financial institutions with pools of capital and triple-A credit ratings - would insure, or "wrap," bonds by lending their credit ratings (for a fee) to any lower-rated municipality looking to issue bonds. The monolines earned their fees, the issuers achieved lower borrowing costs, and investors could sleep better knowing their bonds were insured, without

conducting in-depth credit research of every little municipality out there. At their peak, monolines insured over half the muni market, before most died out after insuring mortgage bonds that defaulted during the financial crisis. From Citi:

“Nowadays monoline insurers play a smaller role, but their market penetration has been growing over the last several years, helped by higher market volatility, as well as, several high profile credit events, and by the growing realization that a handful of insurers provided a solid credit backing for many new issuers. Consequently, monoline share of new issue supply increased from a low level of 4% in 2012 to 6% in 2014 year-to-date, and, in our view, could reach 8-10% over the next several years.”

Currently, there are three active monolines: Assured (AGM and MAC) - the most active insurer; BAM - was created just several years ago, but already became a formidable competitor to Assured; and National (was carved out of MBIA), which has started wrapping new deals in 2014.

Citi points out that S&P recently upgraded Assured and National closer to triple-A, while monoline credit spreads have tightened, mirroring their credit quality improvement. Citi says the vast majority of investors continue to underestimate or undervalue the extent of its credit improvement, calling it a “mistake” for investors to ignoring monoline wraps when buying municipal bonds. Citi also sees a difference in value between the two main monolines today:

“With National getting into business again, an interesting question is whether there should be a substantial difference between bonds wrapped by Assured and National. Prior to 2014 this spread differential was as high as 100bp for some stressed credits; currently, it is on the order of only 25-50 bps for the majority of low-rated names, Given that both insurers are moving in the positive direction, have somewhat similar claims-paying resources and Caribbean exposures, in our view, this differential should be tighter. Assured’s wraps are more valuable, in our view, but this differential for similar credits and maturities may be worth as little as 10-15 bp.”

October 6, 2014, 5:34 P.M. ET  
By Michael Aneiro

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## **[S&P's Public Finance Podcast \(Stockton's Bankruptcy Case And Our Local Government General Obligation Criteria\).](#)**

In this week’s Extra Credit segment, Standard & Poor’s Director Chris Morgan discusses the recent ruling in the Stockton bankruptcy case regarding the city’s pension contributions, and Director Lisa Schroeer explains the impact of our updated local government general obligation criteria one year after its application.

[Listen to the Podcast.](#)

9 October 2014

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## **[S&P: U.S. Not-For-Profit Senior-Living Sector Remains Stable Despite Mixed Financial Results.](#)**

Median ratios for the U.S. not-for-profit senior-living sector were mixed in 2013, with weaker operating and excess margins offset by balance sheet improvements, particularly liquidity.

We expect the trend of weaker margins to wane over the next several years, as providers continue to leverage improvements in the U.S. economy and housing sector and focus on achieving stronger revenue growth. However, Standard & Poor's believes meaningful revenue growth will be difficult without occupancy levels in excess of 90%. While occupancy levels have certainly improved from the post-recession lows, they have hovered in the mid to upper 80% range, though the latest data suggests some facilities approaching 90% or higher. The sector's other challenges include general expense pressures; changes in consumer preferences and care delivery models (for example home health services; remote monitoring or assisted living green house model); and the need for capital investment to reposition dated communities or provide the necessary services and amenities to attract today's senior population.

We noted last year that it might be difficult for senior-living providers to find the next level of savings to improve operating results. This concern was validated as the operations for providers continued to decline. While the overall median revenue was up in fiscal 2013, the growth rate did not keep pace with the increase in expenses, causing a further decline in the overall median operating margin. We believe expense pressures will persist, as some of the drivers revolve around finding ways to improve occupancy, such as increased sales and marketing expenses. While many organizations experienced some degree of success with their more extensive marketing initiatives, these actions have come at a cost and weakened, in our view, some organizations' operating performance, though we understand these are often short-term solutions to shore up occupancy.

On the positive side, liquidity metrics for most organizations offset these operating pressures, with strong year over year gains, enabling the sector to remain stable. Standard & Poor's believes that, despite some near-term operating pressure, the senior-living sector demonstrates general credit stability, evidenced by the vast majority of sector ratings being affirmed. While we anticipate that there will be continued pockets of operating stress through 2015 and possibly beyond, demand should become more robust as the U.S. economic outlook improves (including the housing sector), baby boomers age, and providers introduce new care delivery models and technologies that can provide higher quality care and reduce cost. Furthermore, many of our rated senior-living providers have experienced management teams and are located in markets with strong demand and limited direct competition.

[Continue Reading.](#)

06-Oct-2014

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## **[GASB Summary of Technical Plan for the Final Third of 2014.](#)**

This [high-level summary](#) of the GASB's technical plan for the final third of 2014 includes information on the projects on Asset Retirement Obligations and Blending Requirements for Certain Business-Type Activities that the Board voted to add to the Current Technical Agenda. Information also is included on the pre-agenda research initiated on 2a-7-like External Investment Pools.

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## **GASB Board Meeting Highlights.**

The GASB held public meetings August 20–22 and September 8 (by teleconference), 2014, to discuss issues associated with its projects on Leases, Fiduciary Responsibilities, Tax Abatement Disclosures, and Irrevocable Charitable Trusts. The Board also reviewed and approved the Technical Plan for the final third of 2014. (See the accompanying article on the Technical Plan.) This article addresses key tentative decisions made by the Board during its deliberations on these topics. (For complete minutes of the Board meeting, visit the [project pages](#) devoted to each project on the GASB website.)

### **Leases**

The Board's deliberations in August on potential revisions to the standards on lease accounting included recognition and disclosure issues related to lease terminations, lease modifications, and multiple lease components. The September deliberations considered sale-leaseback transactions and included a review of draft chapters of a Preliminary Views.

#### *Lease Terminations*

The Board began deliberations by discussing additional potential disclosures. The Board tentatively decided to propose that a lessor government should disclose the existence, and terms and conditions, of options by the lessee to terminate a lease if the lessor government has issued debt for which the principal and interest payments are secured by the lease payments. The Board tentatively decided to propose that for the termination of a lease (other than a transaction associated with the lessee's purchase of the underlying asset), the lessee would remove the lease asset and obligation from its financial statements, and recognize the difference as a gain or loss. The Board also tentatively decided to propose that for a lease termination that is associated with the lessee's purchase of the underlying asset, the lessee would record the difference between the purchase price and carrying amount of the lease liability as an adjustment to the carrying amount of the underlying asset. The Board tentatively decided to propose that for a lease termination, the lessor would remove the lease receivable and related deferred inflow of resources, and recognize any difference as a gain or loss.

#### *Lease Modifications*

The Board considered how to account for and report modifications to leases relating to several potential changes in a lease's terms and conditions. The initial measurement of the assets, liabilities, and deferred inflows of resources related to a lease is based on the specific features of the lease. If those features change during the period of the lease, the measurements need to be adjusted accordingly.

The Board tentatively decided to propose a general approach to be used for lease modifications: A change in the lease contract would be considered a modification of the original lease if the lessee keeps the same right of use. On the other hand, a change would be considered a new lease (and the original lease terminated) if the lessee loses part of its right of use.

Changes in Consideration. The Board tentatively decided to propose that for a lease modification resulting from a change in consideration, the lessee would remeasure the lease liability on the effective date of modification and assess the need for an updated discount rate. The lessee also would adjust the right-of-use asset (the intangible asset it would recognize, related to its right to use the asset being leased) by the difference between the modified liability and the liability immediately before the modification, recognizing neither a gain nor loss. For the lessor, the Board tentatively decided to propose that it remeasure the lease receivable on the effective date of modification and

assess the need for an updated discount rate. The lessor also would adjust the deferred inflow of resources by the difference between the modified receivable and the receivable immediately before the modification, recognizing neither a gain nor loss. (Under the Board's tentative decisions, a lessor would recognize a deferred inflow of resources equal to the present value of payments under the lease, and then recognize lease revenue rationally and systematically over the period of the lease.)

Changes in Scope. The Board tentatively decided to propose that for a lease modification resulting from an increase in scope, the lessee would remeasure the lease liability on the effective date of modification and assess the need for an updated discount rate. The lessee also would adjust the right-of-use asset by the difference between the modified liability and the liability immediately before the modification, recognizing neither a gain nor loss. On the lessor side, the Board also tentatively decided to propose that the lessor remeasure the lease receivable on the effective date of modification and assess the need for an updated discount rate. The lessor also would adjust the deferred inflow of resources by the difference between the modified receivable and the receivable immediately before the modification, recognizing neither a gain nor loss.

The Board then discussed lease modifications related to a decrease in scope. The Board tentatively decided to propose that the lessee would remeasure the lease liability on the effective date of modification and assess the need for an updated discount rate. The lessee also would adjust the right-of-use asset for the portion of the lease that is terminated and recognize a gain or loss for the difference. The lessor would remeasure the lease receivable on the effective date of modification and assess the need for an updated discount rate. The lessor also would adjust the deferred inflow of resources proportionally with the receivable adjustment and recognize a gain or loss on the difference.

#### *Multiple Lease Components and Contract Combinations*

The Board tentatively decided to propose that, in addition to separation of multiple lease components that have different lease terms, lessee governments would be required to separate multiple lease components in a contract if the underlying assets belong to different major classes. However, lessor governments would not be required to do so. A lessor already would have underlying assets recognized separately. The separation of components in a contract for lessors only would affect the lease receivable and deferred inflow of resources and neither of those items would require disclosure of separate information based on major class of underlying asset. Otherwise, lessors would separate lease and nonlease components or multiple lease components on the same basis as lessees.

The Board tentatively decided to propose that governments presume that contracts entered into at or near the same time with the same counterparty are not part of one arrangement, unless there is evidence to the contrary. The Board also tentatively decided to propose that contract combinations be required if one or both of the following criteria are met: (a) the contracts are negotiated as a package with a single objective or (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract.

#### *Sale-Leasebacks*

The Board began the September 8 teleconference meeting by discussing the general approach for the accounting and reporting of sale-leaseback transactions. The Board tentatively decided to propose that, as a general principle, a transaction should include a qualifying sale (as provided by Codification Section R30, "Real Estate," if applicable) in order to be accounted for using sale-leaseback guidance. The presence of an obligation or option for the lessee to repurchase the asset, however, would preclude the use of sale-leaseback accounting.

Gains and Losses. The Board tentatively decided to propose that any gain or loss in a sale-leaseback transaction would be deferred, regardless of how much use of the asset is retained by the seller-lessee. The entire gain in a sale-leaseback transaction would be treated as a deferred inflow of resources, rather than a reduction of the lease asset. If the leaseback is a short-term lease, any gain or loss would be recognized at the date of the sale, rather than deferred. The Board also tentatively decided to propose that the existing exception that recognizes a loss immediately for the difference between the fair value and undepreciated cost of the asset would not be retained.

Off-Market Terms. The Board tentatively decided to propose that an adjustment would be made for the off-market terms in sale-leaseback transactions. A government would be allowed to determine whether any off-market terms exist in a sale-leaseback transaction on the basis of the difference between either of the following, whichever is more readily determinable: (1) the sale price and the fair value of the underlying asset or (2) the present value of the contractual lease payments and the present value of the market rate lease payments. The Board also tentatively decided to propose that governments account for the off-market terms in the following manner: (a) treat any deficiency in the same manner as a prepayment of the lease, and (b) treat any excess as additional financing provided by the buyer-lessor to the seller-lessee.

Accounting for Sale-Leasebacks. The Board tentatively decided to propose that the seller-lessee account for the leaseback under the same guidance to be proposed for lessees of leases that are not part of a sale-leaseback. If the transaction does not qualify for sale-leaseback accounting, the Board tentatively decided to propose that the seller-lessee (transferor) and the buyer-lessor (transferee) would both account for the transaction as a financing. The Board also tentatively decided to propose that the buyer-lessor would follow the applicable guidance for a capital asset purchase and the same guidance provided for lessors of leases that are not part of a sale-leaseback, as if the transactions were separate.

Note Disclosures. The Board tentatively decided to propose that seller-lessees would disclose the terms and conditions of the sale-leaseback transaction, but would not be required to disclose any gain or loss on the sale portion of the transaction separately from gains or losses on other capital asset disposals. Regarding failed sale-leaseback transactions, the Board tentatively decided to propose eliminating the guidance in paragraph 256 of Statement No. 62, Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements, in which transferors disclose the minimum sublease rentals to be received in the future under noncancelable subleases.

Lease-Leaseback Transactions. The Board tentatively decided to propose special guidance for lease-leasebacks such that each party would recognize a net receivable and deferred inflow of resources or a net payable and lease asset. The Board also tentatively decided to propose that governments disclose the gross components of a net lease receivable or payable when there is a lease-leaseback transaction.

## **Fiduciary Responsibilities**

The Board's deliberations on the Fiduciary Responsibilities project included a review of initial draft chapters of a Preliminary Views and a discussion of the organization of the description of a fiduciary that will be proposed in that due process document.

Deliberation of new issues focused on the reporting of fiduciary component units that have fiduciary component units of their own. At present, there is confusion as to the circumstances under which a component unit's own component units that are fiduciary in nature should be included in the financial statements of the primary government.

The Board tentatively decided to propose that when a primary government reports a fiduciary component unit in the fiduciary fund financial statements, the fiduciary component unit would be combined with its own fiduciary component unit and reported as a single fiduciary fund.

## **Tax Abatement Disclosures**

The Board's discussion focused primarily on a first draft of the standards section of an Exposure Draft, Tax Abatement Disclosures. The discussion addressed transition provisions and effective date, as well as cost-benefit considerations.

### *Transition Provisions and Effective Date*

The Board tentatively decided to propose that note disclosures would be required for the current and all prior periods presented. There would be an exception, however, if disclosure of the required information for those periods is not practical. In such circumstances, a government would explain why it was not practical to apply the Statement to those periods. The Board tentatively decided that the proposed standards would be effective for periods beginning after December 15, 2015, and would encourage earlier implementation.

### *Cost-Benefit Considerations*

In addition to considering the costs and benefits associated with the individual decisions made during deliberations on proposed standards, the Board also reviews the expected costs and benefits of the proposed standards as a whole when a draft of a due process document or final pronouncement is first reviewed. The Board tentatively agreed that the benefits of the disclosures about tax abatements that will be proposed in the Exposure Draft would outweigh their perceived costs.

## **Irrevocable Charitable Trusts**

The Board's deliberations on the Irrevocable Charitable Trusts project focused on recognition issues related to three scenarios: (1) direct donations to a government, (2) donations to a component unit of a government, and (3) donations to a third party that is outside the reporting entity for the benefit of a government. The Board also discussed issues specifically related to component units.

### *Direct Donations to a Government or a Component Unit*

The Board discussed split-interest agreements in which a government or a component unit of the government holds and administers the resources—scenarios (1) and (2), respectively. The Board tentatively decided that these resources meet the definition of an asset in Concepts Statement No. 4, Elements of Financial Statements—resources with present service capacity that the government presently controls.

### *Donations to a Third Party outside the Reporting Entity*

Next, the Board discussed split-interest agreements in which a third party outside the reporting entity holds and administers the resources and whether a government's beneficial interests in these split-interest agreements meet the asset definition. The Board discussed the elements of control and present service capacity that are required for those donated resources to be accounted for as assets of the government.

The Board tentatively decided to propose that donated resources held and administered by a third party (intermediary) outside the reporting entity are placed beyond the control of the donor,

granting the government control over beneficial interests, when all the following criteria are met:

- The government (or a component unit of the government) is specified by name as beneficiary in the legal document underlying the donation.
- The government has a vested beneficial interest.
- The donation agreement is irrevocable.
- The donor has not granted variance power to the intermediary.
- The intermediary is not under the control of the donor (in the case of agency relationships).

The Board discussed a government's ability to monetize beneficial interests via assignment as a means to establish the present service capacity of such beneficial interests. The Board tentatively decided to propose that a government controls the present service capacity of beneficial interests if both of the following are true:

- The ability to assign beneficial interests is not subject to approval of the trustee or prohibited by law.
- An actual attempt to assign beneficial interests does not invalidate the government's beneficial interests and therefore terminate the trust.

### *Revenue Recognition*

The Board discussed whether to recognize revenue for beneficial interests. Even if the resources meet the definition of an asset of the government, the inflow of those resources is related to a future period, not to the period in which the donation agreement is finalized. Therefore, the Board tentatively decided to propose that the beneficial interests would be recognized as a deferred inflow of resources rather than revenue.

### *Component Unit Issues*

The Board tentatively decided to propose that, in the case in which the component unit is the specified beneficiary of a split-interest agreement, the component unit would recognize an asset and a deferred inflow of resources, consistent with scenarios in which a government is the specified beneficiary. In the case in which a component unit holds and administers the resources of a split-interest agreement for the primary government, the component unit would recognize the donated resources and liabilities to both the nongovernmental beneficiary and the primary government. Consistent with prior tentative Board decisions, the Board tentatively decided to propose that the primary government would recognize an asset and a deferred inflow for its beneficial interests in the split-interest agreement in which the component unit holds and administers the resources.

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## **[MMA Municipal Issuer Brief - Private Dollars and Politics.](#)**

[Read the Brief.](#)

Municipal Market Advisors | Oct. 7, 2014 |

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## **[S&P Defends Higher Municipal Credit Ratings.](#)**

Over the last year, the credit agency upgraded 41 percent of local governments' ratings, drawing skepticism from some.

As rating agencies, following the financial crisis, have sought to maintain their credibility, the divergence between the ratings that those agencies have doled out to governments has increased. Over the last year the number of issuers that have one rating from Moody's Investors Service and a different one from Standard & Poor's (so-called split ratings) has increased to nearly half, or 46 percent of all investment-grade rated municipal bonds.

Much of the focus has been on S&P, which over the past year has upgraded about 1,600 local governments' ratings as it has applied its new scoring criteria. An upgrade means those governments will likely get a more favorable interest rate on their bond sales than they did in the past, ultimately helping that government save money on borrowing costs. S&P's shift toward higher ratings have drawn skepticism from some observers. But the agency's analysts this week said the higher level of upgrades are simply because after they took a peek under the hood, the local government sector is doing better than analysts initially thought.

Of the roughly 4,000 local governments S&P re-evaluated over the past year, 41 percent received a ratings upgrade, 55 percent received the same rating and 4 percent received a downgrade. S&P initially predicted a more negative picture before it started its reviews - analysts figured only one out of every three governments would get an upgrade while 10 percent would be downgraded. The unpredicted level of upgrades was largely due to the fact that initial predictions were based on old financial and economic data and didn't include any of the more subjective components of S&P's scoring criteria, said analyst Chris Krahe.

"Management is a key piece," Krahe said in a webcast presentation regarding the conclusion of the ratings re-evaluations. "We had conversations with management teams and those discussions bring about insights about plans they have, expectations for future years, [and so on]. That's a very key part of the qualitative analysis we took into account...that was not part of the initial predictions."

Better information also played a role, he added. Many of the unpredicted upgrades were due to things like getting new audited information or updated economic figures.

The ratings criteria had been tested and went through a public comment period in the year before S&P began using it to re-evaluate its government ratings. The new criteria scores municipalities in seven categories: management, economy, budgetary flexibility, institutional framework (governance), budgetary performance, liquidity and debt/liabilities. The score for economy counts for 30 percent of the total score; all other categories are given a 10 percent weight. Key changes in the scoring criteria included giving more weight to the local economy score and adding more factors to the management score to take into account performance under financial stress.

Meanwhile, counterpart Moody's is issuing more downgrades than upgrades and it's leading some to question S&P's tack. In July, a Janney Montgomery Scott issued a fiery note that wondered whether the divergence in ratings would lead to governments only publishing their best rating, a practice known as ratings shopping.

"I do not remember a time when I saw so many credits with not just a one-or-so-notch difference here and there, but multiple-notch differences in some cases," Tom Kozlik, the analyst who wrote the note, told *Governing* at the time. "This is not part of the typical ratings cycle, where sometimes one rating agency is a little higher and vice versa."

Struggling governments have certainly grabbed the headlines but S&P this week reiterated its view

that the local government sector as a whole is “strong and stable” with a historically low default rate. Therefore, the agency’s ratings reflect that strength. The ratings upgrades generally resulted in a percentage shift from government credits that S&P had previously rated in the single-A category moving up into the double-A category. (The triple-A category, the highest rating, also saw an increase in the number of governments that S&P qualified for that tier.) The portion of governments S&P rated at triple-B or lower (junk status) stayed the same.

“We don’t want to appear unaware that there are pockets of stress that could occur, said analyst Lisa Schroeder. “But we wanted this framework to be written in a way that doesn’t penalize the entire sector.”

Others agree. “As an asset class, municipals have an extremely low default experience, higher ratings are better supported by the data,” said the Aug. 25 issue of Municipal Market Advisors’ weekly research brief (emphasis included). The brief added that S&P’s approach to scoring governments’ credit is more forward-looking than Moody’s, which accounts for some of the divergence between the two.

Now that S&P has reevaluated its local credits, it plans on using the new data it has to issue more reports that look at broader themes and trends in local government.

GOVERNING.COM

BY LIZ FARMER | OCTOBER 9, 2014

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## **[Muni Yields Plunge to 16-Month Low on Strongest Demand Since May.](#)**

The \$3.7 trillion municipal market is rallying for the fourth straight week, pushing yields to the lowest since May 2013 amid the strongest demand in five months.

Yields on benchmark 10-year munis have fallen 0.05 percentage point this week to 2.11 percent, data compiled by Bloomberg show. Top-rated 30-year bonds yield 2.97 percent, a 17-month low.

Investors added \$762 million to muni mutual funds in the week through Oct. 8, the largest inflow since May 7, Lipper US Fund Flows data show. Tax-exempt debt is following gains across fixed-income assets as concern mounts that global growth is slowing. Ten-year Treasury yields are set for the biggest weekly drop in six months.

“Individuals like munis more than ever,” Alan Schankel, a managing director at Janney Montgomery Scott in Philadelphia, said by telephone. “The flows are going to continue.”

Munis have earned about 9 percent this year, outpacing a 4.7 percent gain in Treasuries, Bank of America Merrill Lynch data show.

The rally has been most pronounced in longer-maturity munis, with yields on benchmark 30-year debt sinking 0.17 percentage point in the past two weeks. The difference in interest rates between two- and 30-year bonds is 2.63 percentage points, the least in 17 months.

The drop in borrowing costs will benefit issuers from Rhode Island to Washington that are set to

offer \$6.7 billion in debt next week, Bloomberg data show. States and cities issued \$6.1 billion this week. Bond markets are closed Oct. 13 for the U.S. Columbus Day holiday.

As the local-debt market rallied, the \$3.8 billion iShares National AMT-Free Muni Bond exchange-traded fund rose to \$110.32, the highest since May 2013.

BLOOMBERG

By Brian Chappatta Oct 10, 2014 9:01 AM PT

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### **[WSJ: Puerto Rico to Sell \\$1.2 Billion in Notes on Unusual Terms.](#)**

Puerto Rico is expected to sell up to \$1.2 billion of short-term notes this week to large banks that have agreed to hold the debt until it matures in June, forestalling the heavy selling that followed a bond sale in March.

Lenders including J.P. Morgan Chase & Co., Bank of America Corp. and Morgan Stanley have said they won't sell the debt, which is often sold by purchasing banks to bond funds and other buyers, according to people familiar with Puerto Rico's financing plans. The sale of short-term notes, rated below investment grade, is expected to be arranged by J.P. Morgan, the people said. The \$3.5 billion of bonds in March were purchased largely by hedge funds.

The unusual requirement tied to the proposed sale of tax- and revenue-anticipation notes reflects the financially strapped territory's efforts to broaden its funding base and to avoid the market unrest that followed the March deal, some of the people said. Banks don't usually agree to such lockups because regulators have increased capital charges for holding debt rated below investment grade, a bid to discourage lenders from holding risky assets.

The debt matures in June and will pay 7.75% annual interest, according to a notice posted on the website of Electronic Municipal Market Access, known as EMMA. The relatively high interest rate reflects investor fears that the island's economy won't turn a corner before the government runs out of cash.

The sale would mark the first time Puerto Rico has raised money in public markets since passing a law in June that allowed agencies such as the island's power, water and highway authorities to restructure their debts. Those three agencies have almost \$20 billion in outstanding debt, according to Barclays PLC. The law doesn't apply to Puerto Rico's general obligation or sales tax debt.

Representatives for J.P. Morgan, Morgan Stanley and Bank of America declined to comment.

Puerto Rico has about \$73 billion in total debt, which is widely held by mutual funds, hedge funds and individuals, and the island needs market access to cover expenses, including more than \$1.2 billion in debt service due this year.

By selling new bonds, Puerto Rico buys itself time to try to restart the economy, plug its budget

deficit and to restructure the Puerto Rico Electric Power Authority, which owes about \$9 billion.

The previous sale was billed as crucial to give the new administration of Gov. Alejandro Garcia Padilla breathing room. The sale came after major credit-rating firms downgraded Puerto Rico to junk status.

By issuing debt only to banks, Puerto Rico is broadening its pool of investors, as it plans to sell longer-term bonds in coming months and may need hedge funds and mutual funds to buy that debt, said Robert Donahue, managing director at research firm Municipal Market Advisors. The commonwealth also may have wanted to keep the bonds from trading immediately to avoid the risk that falling prices might undermine investor confidence, he said.

Hedge funds like Och-Ziff Capital Management LLC, Fir Tree Partners and Perry Capital LLC bought most of Puerto Rico's bonds in March. Some still own the debt, but many sold out within weeks. The bond traded 2,539 times in its first month after issue, declining in value by about 8% in that period, according to data from EMMA.

In comparison, a California bond sale in March traded 717 times in its first month, according to EMMA.

Banks buying the new notes, which include Barclays and Banco Popular, are willing to put the risky debt on their balance sheets because it pays an unusually high rate for short-term debt. A bond backing bankrupt Detroit's development authority that matures in July traded in recent days at a yield of about 4.25%, according to EMMA.

Agreeing to buy debt now could also win the banks business underwriting billions of dollars in future bond sales Puerto Rico hopes to sell to fund managers in the next 12 months, analysts said.

A representative of Barclays declined to comment. Representatives for Banco Popular didn't immediately return requests for comment.

THE WALL STREET JOURNAL

By MATT WIRZ And AARON KURILOFF

Updated Oct. 7, 2014 6:12 p.m. ET

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## **[WSJ: A Calpers Comeuppance.](#)**

A judge says the giant public pension isn't above bankruptcy law.

A major political battle line these days is between public-union pension funds and taxpayers who pay the bills. Taxpayers won a major victory late last week when federal judge Christopher Klein ruled that the California Public Employees' Retirement System (Calpers) isn't protected from cuts in the city of Stockton's bankruptcy trial.

This is big and hopeful news because pension costs are partly responsible for driving Stockton broke. Pensions equal nearly 40% of the city payroll and are growing. The San Joaquin Valley city will spend \$28 million next year on pensions—twice as much as in 2012 when it declared bankruptcy—and \$36 million by 2020. That's one in every five tax dollars.

Yet everyone is taking a hit in bankruptcy except Calpers. The city last year raised its sales tax by 0.75% to cover rising labor costs and hire more police. Creditors are taking big haircuts. Assured Guaranty, which insures about \$121 million in pension obligation bonds, will recover about 50%. Franklin Templeton Investments has been offered a penny on the dollar for \$35 million in bonds for public works.

Calpers has nonetheless threatened to foreclose on Stockton if it isn't paid in full. When municipalities default on their pension bills, state law lets Calpers freeze worker benefits and charge a "termination fee" to cover their unfunded liability. The law also gives Calpers a lien on municipal assets. Lo, Calpers is demanding a \$1.6 billion termination fee if Stockton breaks its pension contract. Yes, billion.

In 2011 Calpers adopted a policy of discounting the termination fee at a rate tied to 10- and 30-year Treasuries in lieu of the 7.5% rate it ordinarily uses to calculate unfunded liabilities. This sleight-of-hand blows Stockton's \$212 million unfunded pension liability up to \$1.6 billion. Welcome to the Hotel Calpers. You can check out anytime you want, but you can never leave.

Judge Klein called Calpers's extortionist ploy a "golden handcuff," adding that "the city's contract with CalPERS could be rejected" and the "lien can be avoided." Once California lets a municipality file for Chapter 9, federal bankruptcy law under the U.S. Constitution's Supremacy Clause overrides state statutes. Otherwise, the judge noted, "the California Legislature can edit the federal law."

Alas, Stockton appears to prefer being handcuffed. City attorneys argue that severing ties with Calpers or reducing pension benefits would cause a "mass exodus" of workers and "irreparably damage" its ability to recruit. But despite cutting pensions for future workers, Stockton in 2012 reported a record number of police recruits—1,300 for 17 positions.

The truth is that city politicians are handcuffed by the public unions that control Calpers, and bankruptcy does not void the city's requirement under state law to collectively bargain with the unions. Calpers quickly dismissed the judge's ruling as "not legally binding" in Stockton or precedential "in any other bankruptcy proceeding." Translation: Forget you, Klein. We own the politicians.

Yet other bankruptcy judges will likely reach the same conclusions. And later this month Judge Klein must still determine whether Stockton's bankruptcy plan is "fair and equitable." How is it fair for Stockton to pay Calpers 100 cents on the dollar while scalping Franklin and slashing payments to bondholders who financed the city's pensions?

Calpers warns that workers will be at risk if insolvent cities can use bankruptcy to impair pensions, but the bigger danger is if politicians are allowed to use Chapter 9 to protect unions while shorting other creditors. Judge Klein has it right.

THE WALL STREET JOURNAL

Updated Oct. 7, 2014 6:19 p.m. ET

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## **[Bank of America Top U.S. Muni Underwriter So Far in 2014.](#)**

Oct 1 (Reuters) - Bank of America Merrill Lynch remained the top senior underwriter of U.S. municipal debt in the first nine months of 2014, with 262 deals totaling \$28.77 billion, Thomson

Reuters data released on Wednesday showed.

That represented more than 13 percent of sales in a year in which issuance has shrunk. Bank of America, which was also top underwriter in 2013, was followed by Citi, which had 264 deals totaling \$24.35 billion in the first nine months of 2014.

California issued the most debt in the first three quarters of the year, \$5.04 billion spread across eight deals, according to the data, followed by Puerto Rico's single March sale of junk bonds totaling \$3.5 billion. California is typically the largest borrower in the municipal market, and its sales in the first nine months of this year represented a 2.3 percent market share.

The big sales, though, were not enough to lift issuance of municipal bonds from their doldrums, as total issuance was down 9.8 percent from the same period in 2013.

Assured Guaranty insured the most municipal bonds, backing \$7.4 billion debt in the first nine months of the year, the data showed.

After the financial crisis, when many insurers lost their AAA ratings, the number of guaranteed bonds dwindled. Recently, though, interest in insurance has ticked up. Insurers backed a total of \$12.78 billion in deals, 56.3 percent more than they guaranteed in the first nine months of 2013.

Bank of China Ltd made a large entry into the business of providing letters of credit to municipal issuers, taking the top spot for the first nine months after providing no letters of credit through all of 2013. It gave the facilities to only two deals, totaling \$459 million, but that represented nearly one-fifth of the amount of debt backed by letters of credit.

Wells Fargo Bank, which had been the top provider in 2013, slipped to second, backing \$225.1 million in five deals.

Altogether, \$2.37 billion in deals carried letters of credit, a 47.5 percent increase from the same period of 2013.

Wed Oct 1, 2014 4:47pm EDT

By Lisa Lambert

(Reporting by Lisa Lambert, editing by G Crosse and Dan Grebler)

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## **[The U.S. Army Corps of Engineers Explores the Use of P3s on Water Infrastructure Projects.](#)**

Earlier this year, the U.S. Army Corps of Engineers (the "Corps") expressed an interest in utilizing public-private partnerships for improving the nation's water infrastructure. This would be a new means to finance and manage projects for the Corps, which has not historically entered into these arrangements.

A public-private partnership, or "P3," is a contract between the public sector and private entities that results in greater private sector participation in the delivery and/or funding of a public project. In effect, P3s allow for more private investment and involvement in public contracts.

This arrangement is favorable to the public sector, as the private partner will often bear the burden of financing the project. The private partner is then repaid, over time, through a specified mechanism. Often, the project itself creates a new revenue source. For example, a highway project may involve the addition of new tolls. The revenue from the tolls would be used to pay the private partner over many years (sometimes decades) after project completion.

States and municipalities have found success in implementing P3s for various project types, including facilities and transportation work. Recognizing the need for additional funding to support an overhaul of the nation's waterways and ports, the Corps is now interested in exploring the use of P3s as well. Private investment in public infrastructure would allow the Corps to address funding gaps and deliver projects at a faster rate.

To this end, the Water Resources Reform & Development Act of 2014 establishes a P3 pilot program - allowing private entities to participate in the financing, design, and/or construction of the Corps' water infrastructure projects. The Corps is now examining how to best attract private partners to participate in these projects, and what delivery models would yield the most effective and efficient results.

Over the years, the Corps will be required to report on its progress in utilizing the P3 pilot program. The Corps' success may encourage the use of P3s on other large federal projects, revolutionizing the way that these projects are financed and managed.

Last Updated: September 26 2014  
Article by Sonia Tabriz  
Fox Rothschild LLP

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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## **[S&P: Stockton Judge's Pension Comment to Have Modest Influence on U.S. Municipal Bankruptcy Filings.](#)**

SAN FRANCISCO (Standard & Poor's) Oct. 2, 2014--U.S. Bankruptcy Judge Christopher Klein's statement on Oct. 1 that a final plan of adjustment for Stockton, Calif. to exit bankruptcy protection can include reduced payments to the California Public Employees Retirement System (CalPERS) could increase the appeal of bankruptcy for some distressed municipalities, but Standard & Poor's Ratings Services expects overall municipal bankruptcy filings to remain rare.

More pertinently, will the theoretical ability to reduce pension costs (with many legal uncertainties to be navigated and litigated) induce a significantly larger number of local governments to enter bankruptcy? In short, we believe the answer is no. However, the statement by Judge Klein, of U.S. Bankruptcy Court for the Eastern District of California, could prove meaningful for a very small portion of distressed municipalities nationwide as they contemplate potential avenues to address mounting budget and liquidity pressures with little room to navigate.

Judge Klein's decision also highlights the uncertainties that municipalities

and their stakeholders face in the interaction between state and federal laws in bankruptcy. Our observation is that many Chapter 9 municipal bankruptcy cases are settled without creating legal precedent. Judge Klein has not ruled yet on Stockton's proposed plan of adjustment. However, we believe that he signaled that the city could propose (although to date, it has not) as part of its future exit from bankruptcy cuts to pension contributions with unclear effects on what benefits retirees would receive. This could prove meaningful for some municipalities considering bankruptcy. The implicit outcome, however uncertain it may be, could help frame their negotiations with employees on potential changes to retirement benefits as partial solution to mounting budgetary pressures.

In practice, however, we believe any material benefits to a municipality's credit quality from Judge Klein's statement are likely to be quite muted. There are several reasons for this.

First a bankruptcy filing is necessary but not sufficient for a municipality to abrogate its employee contracts under the judge's statement. Second, we believe the bankruptcy process is the start of a negative campaign that once underway puts the municipality in question immediately and substantially in a distant place from its peers in regard to popular perception, market access, and viability of long-term provision of services.

In our view, municipal bankruptcy continues to carry a substantial stigma because it signals that management has abdicated its role as a steward of a community's financial resources and sets in motion what is often a long and costly process. Moreover, the likely negative effects of bankruptcy on a community's long-term economic growth prospects can further impair the municipality's ability to recover financially. Standard & Poor's laid out these negative effects in more detail in the article, "Detroit's Bankruptcy Filing Is Becoming A Long And Costly Row To Hoe," published Dec. 3, 2013. We continue to believe that very few obligors would seriously consider bankruptcy as an option in a large and broad municipal market.

Although we have witnessed three California cities, including Stockton, file for bankruptcy protection in the past five years, we believe that credit quality in the state is stable overall, with most California cities having shown the ability to make difficult budget adjustments during the Great Recession to bring expenditures in line with revenues.

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## **[S&P: The Updated General Obligation Criteria Reflect the U.S. Local Government Sector's Strength and the Importance of Qualitative Analysis.](#)**

In the past year, Standard & Poor's Ratings Services applied its general obligation (GO) local government criteria to more than 4,000 U.S. local government issuer credit ratings and ratings on GO bonds issued by municipal governments that are not special purpose districts. We included cities, counties, towns, villages, townships, and boroughs. Of those local government ratings, 55% did not change. We raised 41% of our ratings and lowered 4%. Most of the ratings changes (69%) were by one notch (see chart 1), which closely matches our expectations from when we released our criteria on Sept. 12, 2013. However, overall rating actions do differ slightly from our estimates we gave when we released the criteria (60% unchanged, 30% upgraded, and 10% downgraded). We attribute the difference to qualitative analysis and updated information

When we first envisioned the criteria update, we had three key goals in mind. First, we wanted to facilitate greater comparability of ratings across geographies and sectors by recognizing and incorporating the overall strength and stability that the local government sector has demonstrated. Second, we sought to enhance the transparency of our ratings methodology, including a clear explanation of qualitative adjustments — which go beyond the numbers and can have a significant impact on an issuer's creditworthiness. Finally, we wanted to formalize and make explicit the forward-looking components of our analysis.

[Continue reading.](#)

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## **[MMA Municipal Issuer Brief - September 29, 2014](#)**

[Read the Brief.](#)

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## **[Insurers Build Market Share as Detroit Shows Value: Muni Credit.](#)**

Municipal bond insurers are capturing the most market share since 2009 as Detroit's bankruptcy and Puerto Rico's struggles underscore the value of the coverage to investors in the \$3.7 trillion market.

About 5.2 percent of the \$248 billion in munis issued this year through September carried insurance, up from 3.2 percent in 2013 and the highest in five years, data compiled by Bloomberg show. Before the financial crisis cost insurers their top ratings amid losses on guarantees of subprime-mortgage debt, more than half the market had the backing.

The coverage has proven its worth in the past year as insured bonds from Detroit and Puerto Rico issuers retained their value while uninsured debt sank. In a sign of the revival, MBIA Inc. (MBI) said yesterday that it hired muni analyst Tom Weyl from Barclays Plc.

"Detroit and Puerto Rico have both shown the marketplace that there's value in solid bond insurers," said Rick Taormina, head of muni strategies in New York at J.P. Morgan Asset Management, which oversees \$53 billion in local debt. "You could start to see a movement towards 10 to 15 percent of

bonds insured over an economic cycle.”

## **Weyl Hire**

Weyl, formerly director of muni research at Barclays in New York, will start by year-end as managing director and head of new business development at National Public Finance Guarantee Corp., MBIA's muni-bond insurance unit in Purchase, New York.

He's the latest muni analyst to bet on an insurance revival. John Hallacy last year joined Assured Guaranty Ltd. (AGO) as managing director of public finance after stepping down as Bank of America Merrill Lynch's head of muni research.

Weyl didn't respond to a voicemail left at his Barclays office number. Mark Lane, a spokesman at Barclays in New York, declined to comment.

In August, National backed its first new bond offering since 2008, according to Bloomberg data. It guaranteed portions of a \$1.8 billion deal from the Michigan Finance Authority on behalf of the Detroit Water and Sewerage Department. Assured Guaranty Municipal Corp. also backed some of the debt.

## **National Benefit**

National's backing drove down yields on the Detroit bonds. A portion due in July 2017 with National insurance priced to yield 1.24 percent, while uninsured debt with the same maturity yielded 1.49 percent.

Investors expected National to back new bonds after Standard & Poor's raised its rating in March to AA-, fourth-highest and one level below units of Assured and Build America Mutual Assurance Co., the market's primary insurers.

“Events over the past year have helped to refocus the market on some of the important benefits of Assured Guaranty bond insurance,” Robert Tucker, head of communications and investor relations in New York, said by e-mail. “Those benefits include greater price stability and improved market liquidity, along with the certainty of timely payment of debt service and our ability to work with an issuer to resolve its difficulties.”

In one example, Puerto Rico general obligations with Assured's protection and due in July 2024 traded this week at 100 cents on the dollar, while debt with the same maturity that doesn't have insurance traded Sept. 26 at 73 cents on the dollar.

## **Storytellers Sought**

S&P said in March that insurers may double their market share to 8 percent of issuance this year. Municipal Market Advisors, a Concord, Massachusetts-based research firm, said in the same month that 5 percent was a probable target.

As soon as next week, Stockton, California's public-financing authority plans to issue \$71 million of wastewater revenue debt with insurance from Build America Mutual, offering documents show.

The city, which sought bankruptcy protection in 2012, has treated enterprise securities such as the water debt as unimpaired, meaning investors will get paid in full, bond documents show. S&P rates the underlying bonds A-, seventh-highest, while the Build America backing boosts the grade to AA, third-best.

National will probably guarantee more new bond sales, and the competition among three companies instead of just two will further boost insured volume, said Alan Schankel, a managing director at Janney Montgomery Scott LLC in Philadelphia.

“When National attracts somebody like Tom Weyl, much like Assured brought in John Hallacy, that’s part of an overall effort to get out and tell their story,” he said. “For insurers, their challenge is marketing now. They have a good story: Stockton, Detroit and other distressed situations have seen investors benefit from having insurance.”

Bloomberg

By Brian Chappatta Oct 2, 2014 5:00 PM PT

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## **[Fitch: Stockton Bankruptcy Ruling Opens Door to Pension Cuts.](#)**

Fitch Ratings-New York-02 October 2014: A federal judge’s verbal ruling yesterday that Stockton’s payments to the California Public Employees’ Retirement System (CalPERS) may be impaired is consistent with our view of pension liabilities in the bankruptcy of a municipality, Fitch Ratings says. Payments to pensions may be protected by anti-impairment language in state law, but in a federal bankruptcy proceeding they are at risk for impairment like any other liability. The ability to impair otherwise protected obligations to reset a debtor’s financial profile is a key premise of municipal bankruptcy law. Bankruptcy protection provided to special revenue obligations and the preservation of statutory liens under the federal law are not affected by this outcome.

If established as a precedent, the Stockton ruling may increase incentives for distressed municipalities to seek pension cuts in bankruptcy court. However, Fitch believes those seeking bankruptcy protection will do so whether or not they can be certain of their ability to impair pensions. More likely in Fitch’s view is that the ruling may encourage labor and management to negotiate pension cuts to avoid the uncertainties of bankruptcy court.

Our basic approach to ratings is therefore unaffected. The ruling supports our view that unfunded pension liabilities and high and increasing pension contributions are a risk that must be accounted for in any credit evaluation.

The impact of the ruling for Stockton’s employees may be minimal, as the city has proposed no pension benefit reductions for CalPERS members. Local officials contend that previously enacted reductions to employee and retiree health benefits have already been substantial, and that further retirement benefit cuts would hurt Stockton’s ability to attract and retain employees. In contrast, Detroit has proposed to reduce benefit payments to pension system members although to a lesser extent than for general government debt holders. The Stockton ruling might raise the bar for bankruptcy plan confirmation as the court must determine it is fair and equitable without pension impairment despite other creditor objection.

The Stockton ruling follows several attempts by well-functioning California municipalities with large long-term liabilities to reduce pension costs. Efforts to impose pension cuts through voter initiatives

in San Jose and San Diego have been delayed by litigation and the legality of such reductions outside of bankruptcy under California and other state constitutions remains unclear.

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The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article, which may include hyperlinks to companies and current ratings, can be accessed at [www.fitchratings.com](http://www.fitchratings.com). All opinions expressed are those of Fitch Ratings.

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## **[Judge Says Cities in Bankruptcy May Reject Pension Contracts.](#)**

The federal judge overseeing the bankruptcy of Stockton, Calif., ruled that the city has the power to cut its pension obligations, a landmark decision that has implications for workers, investors and troubled municipalities across the country.

U.S. Bankruptcy Judge Christopher Klein ruled Wednesday bankruptcy laws give Stockton the power

to cut ties with California Public Employees' Retirement System, or Calpers, which controls city workers' retirement money as the country's largest public pension fund. Judge Klein said that the section of the U.S. Bankruptcy Code that allows distressed cities and companies to break contracts is one of bankruptcy law's core powers.

"Pensions could be adjusted," Judge Klein said from his Sacramento courtroom.

Payments into pension funds are usually considered sacrosanct, but Judge Klein is the second judge to rule recently that they may be cut. In December, the judge overseeing Detroit's bankruptcy case ruled that such obligations aren't entitled to "extraordinary protection" despite state constitutional safeguards against benefit cuts.

"These rulings are going to carry a lot of weight," said Patrick O'Keefe, a Bloomfield Hills, Mich.-based financial consultant who has worked on municipal turnarounds but isn't involved in Stockton's case. If judges decide that bankrupt cities in Michigan and California can reduce their pension obligations, "what stops Chicago or Los Angeles from doing the same thing?"

The decision is a blow to the state's retirement system, which has argued pension payments are guaranteed by California law and can't be cut. Stockton contributes roughly \$30 million a year to Calpers, which controls retirement money for municipal workers across California and has assets of roughly \$294 billion.

In a statement, Calpers officials said they disagree with Judge Klein's ruling on pension impairment.

"This ruling is not legally binding on any of the parties in the Stockton case or as precedent in any other bankruptcy proceeding," the statement said.

Judge Klein didn't say Wednesday whether Stockton, which has 300,000 residents, can leave bankruptcy with a plan that doesn't cut the city's pension contributions. He said he would read his decision at an Oct. 30 hearing.

Stockton's bankruptcy lawyers said that Judge Klein should approve the plan, arguing after Wednesday's ruling that city workers have sacrificed enough.

The city cut its workforce by 30% before filing for bankruptcy in June 2012. Through a major deal on health care cuts, more than 1,000 workers and retirees who had \$538 million in claims against the city agreed to accept one-time payments worth \$5.1 million instead.

Throughout the city's bankruptcy, Stockton lawyers fought off pressure to make pension cuts to free up money to repay a bondholder's \$37 million claim. Two funds managed by Franklin Templeton Investments, which extended the bonds for the city's fire stations and parks, argued that the city's long-term projections show that it could afford to repay more than the city's \$4 million offer.

City lawyers argued that the Stockton would have to pay a \$1.6 billion termination fee and that city workers would quickly find other jobs once the pension contract ends.

"The city cannot impair pensions and continue to function as a city," Marc Levinson, the city's bankruptcy lawyer, said at Wednesday's hearing.

During Wednesday's hearing, Judge Klein said Stockton has the option to leave the Calpers pension system and find a potentially cheaper option with another municipality or the private sector.

"The whole world is out there for a California municipality in terms of how it wants to handle its

pensions," Judge Klein said.

Stockton filed for bankruptcy protection in June 2012 after losing tax revenue during the real-estate downturn—Judge Klein called the city “ground zero” for the subprime-mortgage crisis—and after borrowing money for new projects that it couldn’t afford. Judge Klein also said that former leaders at the city, located about 80 miles inland from San Francisco, also offered overly generous pay to city workers.

Stockton’s bankruptcy marked the second-largest financial failure by a U.S. city and one of several California cities, including San Bernardino and Vallejo, to seek Chapter 9 protection in recent years due to mounting pension obligations and the fallout from the financial crisis.

THE WALL STREET JOURNAL

By KATY STECH and DAN FITZPATRICK

Updated Oct. 1, 2014 8:04 p.m. ET

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## **[MSRB Makes Kroll Bond Ratings Available to the Public through its EMMA Website.](#)**

The Municipal Securities Rulemaking Board (MSRB) announced today that its Electronic Municipal Market Access (EMMA®) website now provides free public access to public finance ratings from Kroll Bond Rating Agency (KBRA).

[View the full press release.](#)

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## **[Moody’s Sees Continued Public Pension Funding Gaps.](#)**

Despite strong investment returns and reform measures, public pension funds are losing ground in dealing with unfunded liabilities, Moody’s Investors Service said in a report issued Thursday.

Between 2004 and 2012, Moody’s calculated that the pension systems’ unfunded liabilities tripled to an estimated \$1.99 trillion, with a compound annual growth rate of 17.7% for the period, in part because of inadequate sponsor contributions.

The contribution shortage will continue to grow as public plan sponsors shift to a new pension accounting and disclosure regime from the Governmental Accounting Standards Board, Moody’s warned. Since it emphasizes investment returns over annual contributions, “the resulting funding disincentive is at the core of the public-sector pension asset-liability gap,” said Al Medioli, senior credit officer, in a statement about the report.

Another factor, Mr. Medioli said, “is that it is inherently difficult to recover an overall asset position after the double-digit losses seen during the recession. Annual returns may be strong, but incremental gain is small relative to pre-downturn levels because the investment base is so much smaller.” Liabilities also face pressure from shifts to riskier asset allocations and an aging population, Moody’s said in the report.

Keith Brainard, research director of the National Association of State Retirement Administrators, questioned Moody's choice of time frame to analyze. "It seems selective and not updated," Mr. Brainard said in an interview. "A better time frame would be one that begins to reflect two important variables: improving investment markets and the effect of the pension reforms that virtually every state has enacted."

"We are on the verge of improving pension funding levels. That improvement we expect to be sharp," Mr. Brainard said.

BY HAZEL BRADFORD | SEPTEMBER 25, 2014 3:51 PM | UPDATED 3:55 PM

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## **Real Estate Munis Coveted in Riskless Return Chase.**

Debt backed by real estate is the best-performing part of the \$3.7 trillion municipal market this year when factoring in price swings as housing foreclosures ebb.

Land-backed munis, known as dirt bonds, earned 10.3 percent this year through Sept. 23, beating the 7.7 percent advance for all munis, according to S&P Dow Jones Indices. After accounting for volatility using Bloomberg's risk-adjusted return calculator, the real-estate securities have gained 7.5 percent, exceeding the 5 percent advance for the whole market.

Debt repaid from land districts, mostly in Florida and California, is profiting as the housing market strengthens amid a recovering economy, said John Miller, co-head of fixed-income at Nuveen Asset Management LLC in Chicago. Foreclosure filings have averaged about 111,000 the past three months, down from a peak of 367,000 in 2010, according to RealtyTrac Inc.

"You have a more stable and steady improvement in the demand for new homes that are constructed today within these districts," said Miller, who helps manage \$94 billion of munis, including \$4.9 billion of dirt bonds. "There's good income coming from the bonds with relatively low volatility."

### **Fee Backing**

Munis backed by real-estate projects are issued to help finance construction and are repaid with assessment fees charged to homeowners.

The housing crisis that deepened during the recession caused some developments financed with munis to fall into payment default. Of the 448 active municipal defaults as of Sept. 10, in which issuers hadn't made full payments, about half were for land-secured debt, according to Municipal Market Advisors, a research firm based in Concord, Massachusetts.

The bulk of distressed land-backed munis came to market from 2005 to 2007 for home developments in Florida called community development districts, Miller said. Many of the securities have reworked payment schedules to revive construction, he said.

"The bonds were restructured in some way," Miller said. "The development restarted and it's no longer as much distressed."

The entire housing market is on the upswing. New homes sold in August at the fastest clip since

2008, Commerce Department figures showed yesterday.

## **Backyard Buyer**

For Jason Diefenthaler at Wasmer, Schroeder & Co. Inc. in Naples, Florida, the development districts are often a car-ride away. The firm oversees \$3.5 billion of munis. Its \$63 million High Yield Municipal Fund, has 7.5 percent of assets in land-backed debt, Diefenthaler said.

“We have a lot of these deals in our backyard,” Diefenthaler said. “We have the ability to hop in our car, call the developer, go over get a site visit and talk to the finance team to see where sales are going.”

Land-backed securities are gaining as investors seek riskier debt for higher yields compared with top-rated munis, Diefenthaler said. Yields on benchmark 10-year munis maturing in 10 years, at 2.25 percent yesterday, fell to the lowest since May 2013 this month, data compiled by Bloomberg show.

High-yield munis, a category including land-backed debt, have gained 13.2 percent this year, S&P data show.

## **Roll Tide**

“What we’ve had is really a rising-tide scenario,” for high-yield munis, Diefenthaler said.

Wasmer Schroeder prefers developments in wealthier areas along Florida’s coasts, he said. The state’s community development districts fold assessment fees into property-tax bills, making it more likely that homeowners will make full payments, he said.

“Your repayment mechanism is really very tax-like,” Diefenthaler said.

Wasmer Schroeder in April bought dirt bonds sold by the Midtown Miami Community Development District, he said. The district sold \$91.8 million of unrated, tax-exempt bonds to refinance debt it sold in 2004 to help fund parks, roadways and parking facilities, according to bond documents.

Nuveen held about \$42 million of the bonds as of Aug. 31, Bloomberg data show.

The performance of the bonds since their sale five months ago underscores the demand for the category. Debt maturing in May 2037 traded with an average yield of 4.88 percent on May 21, down from 5.25 percent when it was sold April 22.

“That was tremendously oversubscribed,” Diefenthaler said of the deal. “We got a fraction of the bid that we put in.”

Bloomberg

By Michelle Kaske Sep 24, 2014 5:00 PM PT

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Mark Tannenbaum, Alan Goldstein

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## **Toll Road Bankruptcy Reflects Growing Pains of P3 Sector, S&P Says.**

WASHINGTON D.C. (Standard & Poor's) Sept. 23, 2014--The bankruptcy filing of the Indiana Toll Road on Sept. 22, 2014, may be the result of an overaggressive capital structure that shifted too much risk to private investors, according to analysts from Standard & Poor's Ratings Services. The Indiana Toll Road, which Standard & Poor' did not rate, was an early-stage public private partnership (P3) transaction in the U.S. We do not believe this bankruptcy will slow the growth of current-generation transportation P3 projects, which have different risk characteristics.

The Indiana Toll Road is one of several "brownfield," or existing, road transactions that relied on overly optimistic traffic volume projections to support an aggressive capital structure. A consortium of investors bought the right to operate the road in 2006, while the Indiana Finance Authority retained physical ownership. Similar projects were more common before the economic downturn and some analogous projects have had difficulty achieving their projected traffic forecasts in recent years.

"These types of deals, which feature an accreting debt structure, are not seen in the marketplace today, but were commonplace in the first generation of these toll-risk projects--what you might call 'Version 1.0' of public-private partnerships," said Steve Dreyer, managing director of the U.S. Utilities & Infrastructure Ratings practice at Standard & Poor's. "Investors and project sponsors have addressed risks differently in more recent transactions, which itself was a driving force behind our newly updated project finance rating methodology. This evolution is both expected and natural, and in our view will ultimately help bridge the substantial financing gap between government resources and public infrastructure needs."

Standard & Poor's will host a discussion on the risks associated with financing public-private roadways like the Indiana Toll Road at its 55 Water Street offices on Thursday, Sept. 25. The discussion, entitled "Traffic and Revenue Forecasting: Is This Risk Too Much For The Private Sector To Bear," is held in conjunction with the International Project Finance Association. Members of the media are invited to attend by [registering through the association's website](#).

Analysts from the Utilities & Infrastructure practice will be available to discuss the sector with reporters in attendance.

Forecasting traffic demand remains the key risk for P3 toll road and managed lane projects. Standard & Poor's newly released project finance criteria focus in detail on these major risks for volume-exposed P3s. Projects with well-established demand, few competing routes, and reasonable toll rates supporting sustainable traffic and revenue growth have been able to achieve investment-grade ratings.

Standard & Poor's publicly rates eight P3 road transportation projects in the U.S., of which half (Elizabeth River Crossings Opco LLC, 95 Express Lanes LLC, and NTE Mobility Partners Segments 3 LLC, and Autopistas Metropolitanas de

Puerto Rico LLC) rely on toll revenues. The rest are availability projects where the project is not exposed to volume risk. Under an availability P3, the project does not take volume risk. Instead, a typically high-rated state agency awards the right to a project to build and operate the road and the project receives regular government payments if it meets key performance targets. Recent examples of rated availability transactions include I-4 Mobility Partners Opco LLC, and I-69 Development Partners LLC. For volume and availability transport P3s, the U.S. lags other regions around the globe, where we have assigned about 45 ratings to privately owned transportation projects.

The number of U.S. P3 projects has been growing in recent years. Notably, Virginia, Texas, Florida, Indiana, and Colorado are deploying P3 projects, including investor-owned toll roads, and 33 states and Puerto Rico have enabled P3 legislation.

Under Standard & Poor's policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.

Standard & Poor's Ratings Services, part of McGraw Hill Financial (NYSE: MHFI), is the world's leading provider of independent credit risk research and benchmarks. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 23 countries, and more than 150 years' experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information and independent benchmarks that help to support the growth of transparent, liquid debt markets worldwide.

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## [MMA Municipal Issuer Brief - September 22, 2014](#)

[Read the Brief.](#)

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### [Why Don't More Cities Sell Air Rights?](#)

Vertically inclined cities could make a lot of money allowing private developers to build high-rise apartments or business spaces above libraries, city halls and schools.

Public works projects often come at heavy expense. Whether it's building new schools, municipal halls or other facilities, such projects produce not only upfront costs, but depending on their magnitude, long-term debts. There is, however, a way to mitigate costs, or even make a project more profitable: Sell off the air rights.

This is an idea that, while holding vast economic potential, is used sparingly in America. Nowadays whenever cities build a central library, to name one example, they usually construct a single-use facility that is only a few stories tall, if that. But what if, before such libraries were built, the air rights — the undeveloped space above the roofline — were deregulated and sold off? In expensive and vertically inclined U.S. cities, private developers would pay governments enormous sums for the right to build a high-rise apartment complex or business space above public projects. This would lead to the broad maximization of public land values, and thus to enormous cash windfalls for local governments.

So why don't more cities sell air rights? It's a good question in these fiscally challenging times. Since the 1980s, the Massachusetts Bay Transportation Authority has granted development rights above its facilities in Boston. For instance, it has sold the air rights above the North Station transit terminal for \$20 million plus the cost of extensive repairs to the station. Now, a new deal above the Back Bay Station is being negotiated. Other major cities have also allowed vertical development over transportation infrastructure, most famously in New York City, when the Pan Am Building went up above Grand Central Terminal.

Generally, though, U.S. cities do not maximize their use of public properties. Walk through any city and you'll find countless examples of where modestly sized government buildings have been plopped down onto prime real estate. In Seattle, for example, substantial public money has recently gone toward a new library, City Hall and renovated convention center, none of which exceed a dozen stories in an otherwise vertical downtown.

It is in compact cities such as Seattle — along with Boston, Chicago, New York City, San Francisco and Washington, D.C. — where utilizing air rights would make the most sense. The returns would be substantial in such hot real estate markets, and besides, compact cities are best equipped to handle added density. After all, if proposed three-story schools, libraries and recreation centers could instead sit inside 50-story mixed-use towers, this would increase the supply of affordable housing and office space, further compelling people to locate centrally.

Of course, barriers now exist to making the sale of air rights a common practice. Zoning regulations — along with neighborhood opposition — often prevent public buildings from mixing with private purposes or becoming too large. But the true barrier may be a philosophical one within governments themselves. For too long, many officials have not viewed public properties as crucial assets that should be used efficiently. Selling air rights would be a step in the right direction.

Scott Beyer | Contributor  
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## **[GASB User Survey on the Effectiveness of Statement 34.](#)**

Feedback from those who need financial information about state and local government financial statements is vital to Governmental Accounting Standards Board's (GASB') efforts to improve financial accounting and reporting. The GASB is currently conducting pre-agenda research to inform its assessment of the effectiveness of Statement No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments, and related standards. The objective of this research is to gather feedback on these broad questions:

- What Statement 34 requirements related to management's discussion and analysis, government-wide financial statements, fund financial statements, and budgetary comparison information are effective or ineffective in providing information that is essential for decision-making and that enhances the ability to assess a government's accountability?
- What concerns exist regarding the application of the standards?
- How do the costs of applying the standards compare with the perceptions of the benefits of the resulting information?

Statement 34 has a pervasive influence over the effectiveness of financial reporting by state and local governments and the ability of that reporting to achieve the objectives of financial reporting. As a result, the GASB decided that it was important, as part of its commitment to maintaining the effectiveness of its standards, to reexamine the current financial reporting model now that it has been in place for a sufficient length of time. This survey is one effort in the planned pre-agenda research to be conducted by the GASB staff.

The GASB has developed an online survey to gather feedback from users of governmental financial information. The GASB would greatly appreciate you taking the time to complete the survey, which can be accessed by following [this link](#).

It is anticipated that the survey will take longer than a typical GASB survey, given the magnitude of the requirements of Statement 34. It is vital, however, that the GASB receive your feedback in order to assess whether Statement 34 has resulted in you receiving the information you need. To make it easier to complete the survey, it is possible for you to download a copy of the survey in its entirety to consider the questions before entering your responses into the online version. Additionally, you do not have to complete the online survey in a single session. You can save your responses and will be provided an individualized link to return to your survey at a later date to complete it.

You are asked to complete the survey by Friday, October, 10, 2014.

Your input is essential to the GASB's standards-setting process. If you have any questions, please feel free to contact Roberta Reese (rereese@gasb.org) or Lisa Parker (lrparker@gasb.org).

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## **GFOA Executive Board Approves Four Best Practices.**

The GFOA's Executive Board approved three new best practices and one revised best practice on September 22, 2014. These documents provide recommendations to government finance officers in the areas of accounting, retirement benefits administration, and debt issuance.

**Coordinating the Work of Multiple Auditors.** This new best practice provides recommendations to facilitate the effective, efficient, and timely performance of group audits - when a portion of a government's financial report is audited by other auditors. Appropriately coordinating auditing functions ensures that there won't be delays in the delivery of financial statements, which is important because delays could result in additional costs or modified opinions.

**Enhancing Reliability of Actuarial Valuations for Pension Plans.** Actuarial information directly affects the funded level and sustainability of pension plans, and this new best practice urges pension plan fiduciaries to ensure that all the information provided to the actuary is accurate and up to date. The document also provides guidance on engaging actuaries and information about additional services that finance officers should consider having the actuary perform.

**Investment Fee Policies for Retirement Systems.** The GFOA developed this best practice to help pension funds minimize the impact of investment management fees on portfolio returns. It recommends that retirement systems, especially those that use alternative investment strategies, adopt an investment management fee policy that will provide for negotiating the lowest competitive fee possible while looking out for the system's long-term earning potential. The best practice also recommends strategies for reducing investment fees.

**Investment of Bond Proceeds.** The GFOA updated this best practice to alert governments to the Security and Exchange Commission's classification of brokers as Municipal Advisors under the SEC Municipal Advisor Rule (MA Rule), in certain instances. The MA Rule, which went into effect in July 2014, permits brokers to provide general information without being considered MAs; however, broker-dealers will be deemed to have provided "advice" when they recommend that their government clients buy a particular security. The updated best practice provides recommendations on how to engage brokers for investing bond proceeds, in light of the new rule.

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## **Century of Debt Suiting Ohio State at These Rates.**

Ohio State University is joining issuers going into hock for 100 years as dwindling borrowing costs kindle the appeal of locking in interest rates for a century.

The school, with its main campus in Columbus, may sell \$150 million in taxable century bonds as soon as this week. It will issue as the relative cost of borrowing for longer periods is shrinking: Thirty-year debt yielded as little as 0.83 percentage point more than 10-year bonds last week, the smallest gap since 2012, data compiled by Bloomberg show.

Even with the advantageous rates, century bonds are rare because they rely on confidence that the issuer will be around in 100 years. While top-rated universities have been the primary users of the securities, interest rates close to generational lows have brought more deals to market. Last week, the Cleveland Clinic became the first not-for-profit health-care system to borrow for a century. In July, the first U.S. public utility sold the securities.

"Century bonds give the ultimate flexibility when it comes to having cost of capital set for a very

long period of time,” said Michael Papadakis, treasurer of Ohio State, which was established in 1870. “As a public university, we don’t have equity, so this is the longest capital you can get.”

## **Century Club**

This would be Ohio State’s second century offer. In 2011, it became the first public school to issue 100-year taxable debt when it sold \$500 million. In earlier issues, Walt Disney Co. (DIS) sold centuries in 1993 and the Port Authority of New York and New Jersey followed a year later. Yale University and the Massachusetts Institute of Technology have sold centuries into the corporate market. So has railroad Norfolk Southern Corp.

Ohio State is determining whether to issue taxable bonds due in 2114 or tax-free securities due in 30 years, Papadakis said. The Cleveland Clinic borrowed Sept. 11 via the corporate market at an interest rate of 4.86 percent for a century, data compiled by Bloomberg show.

While historically low yields are luring issuers, some investors are balking at longer debt.

BlackRock Inc., the world’s largest asset manager, is shifting to 10- to 15-year bonds from longer maturities, Peter Hayes, the company’s head of municipal debt, said in a Sept. 10 report. Fidelity Investments is also focusing on intermediate debt, said Kevin Ramundo, a money manager who helps oversee its \$28.6 billion of state and local securities.

## **Matching Liabilities**

Loews Corp. (L), the holding company run by New York’s Tisch family, is still interested in 30-year debt, though not centuries, said Mark Muller, a money manager who helps oversee \$13 billion of munis in New York. Demand from philanthropies and insurers looking for assets to match indefinite liabilities dwarfs the supply of 100-year bonds, which means more borrowers may emerge, he said.

“It has been more about supply in century bonds than it has been about demand — demand is always there,” Muller said in an interview. “We will go through so many interest-rate cycles by the time these bonds ultimately mature” that investors will have the opportunity to buy higher-yielding debt in the future, he said.

Ohio State’s 2011 centuries reflect the appetite. The debt, rated Aa1 by Moody’s Investors Service, traded last week at a 4.54 percent yield, the lowest since May 2013, Bloomberg data show.

## **‘Permanent Capital’**

The Cleveland Clinic, which opened in 1921, sold \$400 million of debt last week.

“We looked at it as an opportunity for the clinic to raise the closest thing to permanent capital that a not-for-profit organization can have,” said Steven Glass, chief financial officer of the institution, the 12th-biggest Moody’s-rated U.S. health-care system by revenue and the largest employer the city has ever had.

“There’s a very unique group of organizations that could access the market to do 100-year bonds,” he said. “The investors feel like this is an organization that, with all the changes in health care, is going to be one of those that’s here to stay.”

Buyers had a similar stance toward about the District of Columbia Water & Sewer Authority, which serves the White House. It issued \$350 million of taxable 100-year debt in July, with proceeds going toward a \$2.6 billion project to curb sewer overflows.

## Cancer Center

Ohio State's sale, which will also include \$150 million of variable-rate debt, will complete a capital plan that began in 2010, Papadakis said. The bonds will help fund a \$1.1 billion medical-center expansion, he said. They will also finance other infrastructure projects for the school, which enrolls about 63,000 students.

Though munis and Treasuries have slumped the past two weeks, longer bonds have still outperformed their shorter-term counterparts.

Benchmark 30-year munis yield 3.15 percent, compared with 2.29 percent for 10-year maturities. The difference has shrunk from 1.3 percentage points to start the year. Longer-maturity bonds typically have higher yields to compensate for the added risk of the lengthier holding period.

Bonds maturing in longer than 22 years have earned the most in the \$3.7 trillion municipal market this year. Their 12 percent gain compares with the broad market's 7 percent rally, Barclays Plc data show.

"This is a historically great opportunity to lock in low-yielding long-term debt," said Muller at Loews.

BLOOMBERG

By Brian Chappatta Sep 15, 2014 5:00 PM PT

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## **[Mintz Levin: Court Rules on Applicability of Make-Whole Premiums Upon Debt Acceleration.](#)**

The linked [Mintz Levin client advisory](#), which discusses a recent bankruptcy court ruling regarding the applicability of a make-whole premium upon a refinancing of corporate debt following such debt's automatic acceleration upon bankruptcy under the terms of the governing documents, may also be of interest to holders of municipal bonds with call protection and/or early redemption premiums.

In the context of make-whole premiums, court decisions suggest that the applicability of the premium upon a refinancing in bankruptcy will be governed by the wording of the debt documents, and that if an automatic acceleration is triggered by the documents and the documents do not expressly provide for a prepayment premium in such circumstances, no prepayment premium will be payable by the issuer.

Municipal bonds typically feature fixed percentage optional redemption premiums rather than make-whole premiums, but courts may also be inclined to apply to municipal bonds the principle that such early redemption premiums are inapplicable upon an acceleration absent express contract language applying the premium in that context (or, as some courts have suggested, absent evidence that the issuer deliberately defaulted for the purpose of circumventing the call protection provisions.)

9/19/2014

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## **[House P3 Panel Calls for Supporting Greater Use of P3s.](#)**

The House Transportation and Infrastructure's special Panel on Public-Private Partnerships on Wednesday recommended improving public sector capacity to undertake P3s, lowering barriers the federal government to entering P3s agreements and ensuring transparency and accountability when the government and the private sector partner on infrastructure projects.

The panel's [final report](#) called for creating a Transportation Procurement Office in the Department of Transportation to implement P3 procurement best practices, including [P3 model contracts](#), and continuing the Transportation Infrastructure Finance and Innovation Act (TIFIA) program.

"Billions of dollars of infrastructure needs in the U.S. are in search of funding, and well-executed public-private partnerships can enhance the delivery and management of infrastructure," Rep. John Duncan (R-Tenn), chairman of the P3 panel, said. "P3s cannot provide the sole solution to all of the Nation's infrastructure needs, but they can offer significant benefits, particularly for high-cost, technically complex projects that otherwise may risk dying on the vine."

Echoing Duncan's statement, Rep. Peter DeFazio (D-Ore.), told reporters the even under optimal conditions, only 10 to 12 percent of infrastructure would be funded through P3s.

"We are still going to need a very significant and robust federal investment to solve these problems," DeFazio said at a press conference.

In addition to proposals to streamline the P3 process for government, the report proposes improvements to traditional procurement processes.

Over the past six months, the panel held roundtables, hearings and meetings in an effort to understand the role P3s play in development and delivery of transportation and infrastructure projects. In March, NCPPP President Sandra Sullivan testified before the panel, discussing the importance of P3s in water infrastructure.

NCPPP

By Editor September 17, 2014

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## **[Social Impact Bonds are Going Mainstream: Forbes.](#)**

Now making waves in public finance circles are social impact bonds (SIBs). The bipartisan funding concept is a type of "Pay For Success" model where private investors invest capital and manage public projects, usually aimed at improving social outcomes for at-risk individuals, with the goal of reducing government spending in the long-term. Some social impact bonds seek to reduce the prison population through funding rehabilitation and employment programs for first-time offenders with the ultimate goal of reducing recidivism rates. Other SIBs seek to reduce the number of children in foster care. The catch is that private investors front all the costs and will be paid back a financial

return by the government if and only if social outcomes are improved based on some standard measurement. The profit-motivating component comes from the fact that some of the savings from reduced costs for the government can be used to pay back the investor contingent upon their success. Now, Congress is considering the bipartisan Social Impact Bond Act, legislation that will enable the U.S. federal government to allocate \$300 million to SIBs. A House Committee on Ways and Means hearing discussing the merits of social impact bonds led by the two co-sponsors of the bill, Rep. Todd Young (R-IN) and Rep. John Delaney (D-MD), was held last week.

[Continue Reading.](#)

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## **Duane Morris: Has P3 Reached a Tipping Point in The United States?**

Malcom Gladwell's 2000 best-seller *The Tipping Point: How Little Things Can Make a Big Difference* posits that most social shifts (or epidemics, as Gladwell refers to them in his book) share common characteristics, including what he refers to as (1) the law of the few, (2) the stickiness factor, and (3) the power of context. Gladwell asserts that a few influential innovators, whether purposefully or unintentionally, influence society to change, that the changing force has an "it" factor that captures our imaginations and that societal context can speed up change in a way that seems epidemic. These three factors come together and form a phenomenon Gladwell refers to as a Tipping Point, where an idea can go from small to big in a real hurry.

Though not stated with the exact paradigm used in Gladwell's book, this is essentially what Moody's Investors Services Managing Director Chee Mee Hu says is happening for Public Private Partnerships (P3s) in the United States. He states:

More US states and governments around the world are using P3s to develop and maintain public infrastructure . . . Two inter-related trends are at work that could cause P3 activity to expand: the need to upgrade, replace or build out essential infrastructure assets and the inability of governments to finance these current and future infrastructure investments entirely on their balance sheets.

A solution to an infrastructure problem is taking hold in this country, as a result of its adoption by influencers, and the timing and context are perfect for that idea to become really big. The Moody's press release is available [here](#) and refers to Moody's recently released "Global P3 Landscape" report.

P3s have long been touted as a solution to infrastructure funding shortfalls, and, slowly, this concept is taking root across the country. The Moody's article cites to a number of P3 transportation projects already underway, but the reality is that P3 is also being used for downtown city planning in San Antonio and even for scientific cancer research. Furthermore, P3s are also being considered for all manner of infrastructure projects, including schools, ports, tunnels, bridges, and water treatment plants, to name but a few.

Moody's states that P3 models have been steadily increasing over the last five years and that "given the sheer size of its infrastructure and growing urban population, the US has the potential of becoming the largest market for public-private partnerships (P3s) in the world."

Last Updated: September 12 2014

Article by Antony L Sanacory and William W. Fagan III

Duane Morris LLP

Disclaimer: This Alert has been prepared and published for informational purposes only and is not offered, nor should be construed, as legal advice. For more information, please see the firm's full disclaimer.

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## **[FT: Century Bond Surge Defies Rate Fears.](#)**

Investors are seizing the chance to lend money to US companies and municipalities for up to 100 years in exchange for a chance to capture higher yields for longer.

Sales of the so-called ultra long bonds, those maturing in 50 years or longer, have exploded this year despite expectations of higher US bond yields, which may hit long-dated corporate and municipal debt.

Cleveland Clinic, the Ohio-based medical and research centre giant, became on Thursday the first not-for-profit healthcare company to sell 100-year bonds.

Strong demand from institutional investors, such as large pension funds and insurers, has boosted total returns on the bonds with investors leaving aside concerns about duration – a measure of the sensitivity of bond prices to changes in interest rates – in their bond portfolios.

Longer dated bonds have higher duration, meaning they are more vulnerable to interest rate increases.

“It is a special market, for investors who are comfortable managing a higher exposure to duration risks in exchange to adding great names to their portfolios and the possibility of earning higher yields,” said Jay Sterns, director of public finance at Barclays.

Some large corporate borrowers, including Caterpillar and EDF, and not-for-profit organisations, such as the Massachusetts Institute of Technology, have tapped the ultra-long market this year.

Total sales of the securities are running at \$14.3bn, a jump of almost 60 per cent from the same period in 2013, according to Dealogic.

Long-term corporate debt has generated a total return of 11.5 per cent so far in 2014 compared with a 3.6 per cent return on corporate bonds maturing in 10 years or less, according to Barclays.

The strong performance on long-term debt has been welcomed by pension funds and insurers, which have been traditionally the biggest buyers of this type of bond.

They use high-grade, longer-dated securities to match their underlying liabilities.

But a broader pool of buyers and borrowers has been increasingly attracted to the ultra-long corner of the market.

The Cleveland Clinic deal follows the sale of \$350m worth of “century” bonds from the District of Columbia Water and Sewer Authority in July.

Cleveland Clinic completed the sale of \$400m in securities maturing in 2114, with yields of about 4.85 per cent, compared with 3.27 per cent for the US 30-year note, according to people familiar with the sale.

Cleveland Clinic's century bonds received an investment-grade rating of Aa2 from Fitch Ratings, and

will account for about 12 per cent of the company's total debt portfolio, according to Fitch Ratings.

Barclays and JPMorgan managed the offer.

Mr Sterns said there are at least another 15-20 tax-exempt healthcare companies with the right profile to sell century bonds.

"We saw the 100-year funding option as a very good opportunity for us given the combination of low borrowing costs and investor interest," said Steve Glass, chief financial officer of Cleveland Clinic.

The Financial Times

September 11, 2014 6:20 pm

By Vivianne Rodrigues in New York

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## **[Municipal Market Advisors Municipal Issuers Brief - September 15, 2014.](#)**

[Read the Brief.](#)

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## **[Bank Buying Spree Undiminished by Liquidity Rules: Muni Credit.](#)**

Banks added to a record bet on the \$3.7 trillion municipal market last quarter as an unprecedented rally overshadowed regulations that will remove an incentive for the companies to own the securities.

U.S. lenders boosted holdings of state and city debt by \$4.7 billion from March through June to \$430 billion, the most since Federal Reserve data begin in 1945. The purchases extended a more than four-year spree that swelled banks' ownership by \$206 billion, exceeding all other types of investors, according to Fed data released yesterday.

The institutions' appetite helped propel the local-debt market to eight straight months of gains to start the year, the first time that has happened in Bank of America Merrill Lynch data going back to 1989. The banks are buying even as a pending rule change will exclude local debt from the easy-to-sell assets banks can hold to weather a credit crisis. Their demand is helping munis outpace corporate bonds and Treasuries.

"Munis are attractive," said Vikram Rai, a Citigroup Inc. municipal analyst in New York. "There's a global scarcity of high-quality, liquid assets."

### **Keeping Company**

Banks aren't the only buyers this year. Individuals, who own at least 40 percent of the market as of June, have added \$8.3 billion to muni mutual funds in 2014, Lipper US Fund Flows data show. Meanwhile, issuance is about 13 percent below last year's pace as the lingering strains of the recession that ended in 2009 leave officials wary of taking on new projects, data compiled by Bloomberg show.

Munis have earned about 8 percent this year, on pace for the biggest annual gain since 2011, according to Bank of America indexes. That compares with returns of 3 percent for Treasuries and 5.5 for corporate debt.

The rally has pushed muni borrowing costs toward generational lows. Benchmark 10-year munis yield about 2.28 percent. For buyers in the top federal income bracket, that's equivalent to a taxable rate of 3.8 percent. In comparison, similar-maturity Treasuries yield about 2.6 percent.

"Munis have been outperforming other asset classes," said Robert Donahue, a managing director at Concord, Massachusetts-based research firm Municipal Market Advisors. "Banks have really been buying for the yield."

### **Expanded Role**

Since the credit crisis, banks have expanded their role in the municipal market as demand for other types of loans dimmed while the economy recovered.

They increased munis holdings every quarter since late 2009, even as the broader market began to shrink in 2011, Fed data show. By the end of June, they held 12 percent of the market, twice their share at the end of 2009.

State and local officials, including California Treasurer Bill Lockyer, have expressed concern that the new regulations will drive banks away from the market.

The rules, first released in 2013, were approved by the Fed and other regulators this month. While banks won't be able to use munis to satisfy the liquidity requirement, the Fed said it may tweak the rules to allow the most easily traded munis to be included.

### **Assets Aplenty**

Most banks have enough assets on hand so that they don't need to use munis to meet the standards, which take effect starting in January, said Bank of America muni analyst Philip Fischer. The rules may cause banks to sell munis during times of financial stress, he said.

"We don't expect that to be a near-term effect, but it introduces one more risk to the market," said Fischer, who's based in New York.

Banks buy munis primarily for investment reasons, procuring money at short-term rates and plowing it into higher-yielding, long-term bonds, he said.

Munis maturing in 25 or more years are the biggest draw, said Citigroup's Rai.

As the market has rallied this year, long-dated securities have fared the best. Bonds maturing in more than 22 years have returned about 12 percent, according to Barclays Plc data. That compares with the 6.7 percent return on 10-year debt.

"We expect these buying patterns to continue," he said. "It's been a strong source of support."

BLOOMBERG

By William Selway Sep 19, 2014 9:31 AM PT

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Mark Tannenbaum, Pete Young

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## **[WSJ MoneyBeat: Municipal-Bond Issuers Find It's Easy Being 'Green.'](#)**

Massachusetts, a pioneer in selling so-called green bonds for environmental projects, is going greener.

The state this week is selling \$350 million of the bonds, more than triple the size of last year's sale, as more municipalities tap into investor demand for environmentally friendly investments.

Case in point: California is prepping its first green-bond sale ever and plans to start selling \$200 million in the debt Friday. Earlier this year, the New York State Environmental Facilities Corp. and the District of Columbia Water and Sewer Authority sold green bonds, with the latter selling a bond that matures in a whopping 100 years.

Investors who buy green bonds are paid interest and principal from the same revenues as other municipal bonds. The difference is that municipalities pledge to use the proceeds of a green-bond sale for projects that are environmentally friendly.

Massachusetts will use this week's green bond to help pay for a marine terminal in New Bedford, Mass., that will be designed to support the construction of offshore wind projects. The state will also use proceeds for clean-water, energy-efficiency, river-revitalization and open-space-protection efforts, according to the prospectus.

As of late Wednesday morning, the state had received more than \$250 million in orders for the green bonds from individual investors. A 10-year bond, rated double-A-plus, was offered to yield 2.45%. The sale is to be completed Thursday after orders from larger institutional investors.

"There are an increasing number of investors, both individual and institutional investors, who want legitimately green, energy-efficient projects in which they can invest," said Massachusetts Treasurer Steven Grossman. "I would think it is overwhelmingly likely that we will do this again in the future and that it will be a regular part and fixture of our bond offerings."

The growth in green bonds this year "is partially due to the success of the bonds that were issued last year," said Kevin Lehman, a credit analyst at Breckinridge Capital Advisors, which oversees about \$20 billion and has bought green municipal bonds in the past.

"We invest in projects that are essential to a community, and typically these environmentally related bonds are essential projects that support the community in critical ways, whether it's through clean water or whatever it might be," he said.

California didn't indicate a specific project that would be funded with its green-bond proceeds but provided a list of similar categories to which the money could be allocated.

California has experience on the other side of green-bond transactions—on Wednesday, it announced it agreed to buy \$250 million in two-year green bonds issued by the World Bank for the state's pooled investment account. California has been buying World Bank green bonds since 2009.

"It's a way to provide investors an opportunity to buy bonds that they know will be used exclusively

to finance projects that strengthen and protect the environment,” said Tom Dresslar, a spokesman for California Treasurer Bill Lockyer. “We finally reached the point where we were comfortable going down this road.”

There are no immediate plans for a second green-bond sale, but Mr. Dresslar said, “we hope it becomes a permanent part of our bond-sale program.”

Not all investors are enthusiastic. Marilyn Cohen, president at Envision Capital Management in California, which oversees \$320 million, said she wouldn’t be opposed to buying green bonds as long as they are backed by the state’s taxing authority, like other California state bonds. But she said she would skip the coming sale because her clients are already fully invested in California state debt.

The green-bond label is a marketing tool to “entice the retail public,” she said. “I, for one, find it a big yawn.”

THE WALL STREET JOURNAL

By MIKE CHERNEY

Sept. 17, 2014 7:01 p.m. ET

Write to Mike Cherney at [mike.cherney@wsj.com](mailto:mike.cherney@wsj.com)

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## **[CUSIP: Municipal Bond Issuance Indicator Showing Improvement.](#)**

“Though we’ve seen some noteworthy declines in requests for new corporate bond issues in the US and international markets in August, it could be attributable to a seasonal blip,” said Richard Peterson, Director, Global Markets Intelligence, S&P Capital IQ. “However, with major monetary policy decisions looming at the Fed and European Central Bank, we will have to watch the CUSIP indicator closely over the next several months for signs of a changing tide in new capital creation.”

[Read Press Release.](#)

September 15, 2014

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## **[MMA Municipal Issuer Brief - Sept. 8, 2014](#)**

This week’s [Municipal Market Advisors issuer brief](#) takes a look at which of the seven bigger budget states that have reported their annual earnings actually made their revenue projections for the 2014 fiscal year that ended on June 30. The report found that California, Massachusetts and Ohio reported actual revenues above their projections while New Jersey, Pennsylvania, Connecticut and Florida revenues came in below forecasts (even though these states still outperformed the previous fiscal year’s actual performance). “The takeaway here,” said MMA, “is that the estimates in these states were overly aggressive, possibly to use revenue to ‘balance’ the budget while spending more in the interim.”

Whether a state makes its revenue target is important to investors and credit analysts. But it also sends a crucial signal to localities within a state. “Revenue performance can indicate whether shortfalls (or surpluses) are in the future, possibly meaning painful budget cuts and even rating

downgrades," MMA said.

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## **Scranton Stalked by Bankruptcy Mulls Selling Sewers: Muni Credit.**

Scranton, with the weakest pension plan among Pennsylvania's cities, is trying to prop up its retirement funds to avoid becoming the first U.S. municipality since Detroit to file for bankruptcy.

The former manufacturing community will tax commuters starting next month and may sell its sewer system to buttress its retirement funds. The city has 23 cents for every dollar in retiree obligations, down from 47 cents in 2009, according to state data. Without a fix, Scranton may go bankrupt in less than five years, said Pennsylvania Auditor General Eugene DePasquale.

Cities and towns nationwide are coping with paying for pension benefits agreed to in more robust fiscal times. Pennsylvania ranks among the states of most concern since it has allowed municipalities to underfund mounting obligations, said Tamara Lowin, director of research at White Plains, New York-based Belle Haven Investments, which manages about \$2 billion of municipal bonds.

"Without union cooperation, it would be incredibly difficult for them to resolve their liability problem outside of bankruptcy," she said.

### **National Deficit**

Localities in Pennsylvania face at least \$6.7 billion in unfunded pension liabilities, DePasquale said. The state, home to more than a quarter of U.S. public-employee plans, should consolidate systems and limit the local pension costs that it reimburses, he said.

Across the country, municipal officials have altered pensions, from Washington's repeal of some workers' cost-of-living adjustments, upheld by its Supreme Court this year, to Rhode Island's hike in retirement ages in 2011. States and local governments had about \$1.4 trillion less than they needed as of the end of March to pay for promised benefits, according to the Federal Reserve Board.

Scranton, about 125 miles (201 kilometers) northwest of New York, is considering changes to its plans, said David Bulzoni, the business administrator.

"We would like to be in a position to try to solve as many problems that we can, with assistance from the commonwealth, without having to look at that option," he said of bankruptcy.

### **Distressed Program**

The city has been in Pennsylvania's program for fiscally distressed municipalities, called Act 47, since 1992. At the time, it was racking up budget deficits and had lost 21 percent of its population over two decades, according to the state's Community and Economic Development Department.

Dwindling coal and railroad industries took a toll, said Jason Shrive, the city's lawyer. The community is still shrinking: its population fell 0.4 percent from 2010 to 2013, to about 76,000 residents, even as Pennsylvania's grew 0.6 percent, Census data show. About 21 percent of Scranton residents live in poverty, compared with 13 percent statewide.

The city, with an annual budget of about \$130 million, has about \$99 million of debt, financial filings show. None of the three biggest ratings companies grade the bonds.

Scranton general obligations maturing in September 2028 and insured by Ambac traded Sept. 5 at an average yield of 6 percent, or 3.5 percentage points above benchmark munis, data compiled by Bloomberg show.

### **Three Funds**

The city runs three pension funds, one each for police officers, firefighters and non-uniformed personnel. The police and fire plans have fewer active employees than retirees, according to the auditor general's report. Combined, the funding status is 23 percent, weakest among Pennsylvania cities, data from the state's Public Employee Retirement Commission show.

The funds for fire personnel and municipal workers will run out of money in about three years and for the police, in about five, DePasquale's report said.

Scranton "will be facing bankruptcy within five years, potentially sooner without a fix to this," he said by telephone.

Municipal bankruptcies are rare, with 291 since 1980 and no filing by a community since Detroit's record case in July 2013, said James Spiotto, a bankruptcy specialist and managing director at Chicago's Chapman Strategic Advisors LLC, which advises on financial restructuring.

### **Wake Up**

"Detroit has been a wake-up call for others to address their problems," he said. "Chapter 9 is a process, not a solution. It is time-consuming and uncertain, and you may wind up in a place where you may not want to be."

Scranton's pension costs are rising. The city's contribution next year will reach \$15.8 million, from \$3.4 million in 2008, data from the city and the auditor general show. Pension expenses will take up 16 percent of the budget in 2018, from 9 percent in 2006, according to a July presentation by Hackensack, New Jersey-based financial consultant HJA Strategies LLC.

The seat of Lackawanna County, Scranton passed a 0.75 percent income tax on nonresident commuters effective Oct. 1. The measure would generate at least \$5 million annually, based on county data on tax collections, and the funds would go toward pensions, Bulzoni said.

Besides the local and federal governments, top employers include health-care centers, a bond document shows. Opponents have sued to prevent the levy, which they consider illegal.

### **Sewer Sale**

Another option is to sell the sewer authority, which has started a review of the proposal, Bulzoni said. In addition, municipal officials this month met with union representatives to discuss contract features that are depleting pension assets, Bulzoni said. He declined to elaborate because he said some solutions will involve bargaining.

"There has to be some collective agreement to help shore up the plan's solvency," he said.

John J. Judge IV, president of the International Association of Fire Fighters Local 60, said he's optimistic officials will solve the fiscal crisis.

"It's going to take a little bit of time to turn it around," Judge said.

By Romy Varghese Sep 14, 2014 5:00 PM PT

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## **Chicago Water Bonds Seen Shielded From Pension Woes: Muni Credit.**

Chicago, bearing the biggest pension burden among the nation's most-indebted localities, is selling water bonds for the first time since 2012. Investors say the deal's strengths outweigh the city's fiscal woes.

Tomorrow's planned sale of about \$372 million of debt will pay for work on pumping stations and the replacement of water mains, some of which are more than a century old, according to bond documents and the city. Mayor Rahm Emanuel in 2011 set in motion an almost doubling of water and sewer rates over four years. The move has bolstered the system's finances, earning the debt a AA- grade, Standard & Poor's fourth-highest level.

While Emanuel pushed through higher rates, he has failed to contain the swelling pension costs that led Moody's Investors Service to cut Chicago's general-obligation rating to the lowest among the 90 most-populous U.S. cities, excluding Detroit. Paul Mansour of Conning and Patrick Morrissey of Great Lakes Advisors LLC are considering buying the water bonds, in part with the expectation that the association with Chicago will boost yields on an otherwise healthy issuer.

"The water enterprise bonds are among the best that Chicago can offer," said Richard Ciccarone, the Chicago-based chief executive officer of Merritt Research Services LLC, which analyzes municipal finance. "Even though Chicago has been in the news and has some fiscal challenges, the enterprise itself has been well-supported."

Chicago faced heightened scrutiny in the \$3.7 trillion municipal market after Moody's in July 2013 lowered the city's grade three levels the same week that Detroit filed for bankruptcy. The New York-based company dropped Chicago again in March, to Baa1, three steps above junk.

The park district, board of education and transit authority also had their ratings cut by Moody's. The same goes for the water and sewer system: its A3 mark for second-lien bonds, the fourth-lowest investment grade, is down three levels from 14 months ago.

Moody's may be too punitive, said Morrissey, who helps oversee \$3.8 billion of fixed income at Great Lakes Advisors in Chicago. S&P ranks the second-lien water and sewer bonds three levels higher than Moody's.

### **Payoff Time**

S&P's rating shows that "Chicago's efforts are paying off with respect to increased service coverage and better financial oversight of our utilities," Emanuel, a 54-year-old Democrat who is up for re-election next year, said in a Sept. 2 statement. S&P also rates the city's general obligations three steps higher than Moody's.

The water system's finances have improved. Revenue is projected to double by 2016 from 2009 after

the rate increases, while cash reserves are expected to hold at three months of operating expenses through fiscal 2016, bond documents show.

While Chicago's rates rose 25 percent in 2012, with planned increases of 15 percent in each of the following three years, residents in New York, Los Angeles and San Francisco face higher charges, bond documents show. A family's cost per 7,500 gallons of water in Chicago was below \$30 in 2013, compared with more than \$50 in San Francisco, according to the documents.

Chicago's system, whose source is Lake Michigan, supplies and treats water for about 5.4 million people in Chicago and its environs. Suburban customers made up about 47 percent of net sales in 2013, bond documents show.

## **880 Miles**

The 10-year project that Emanuel introduced in 2011 will improve pumping stations, replace 880 miles (1,416 kilometers) of water main and install 204,000 meters.

This is the first sale of water debt for the city since May 2012, according to data compiled by Bloomberg. The bonds are federally tax-exempt though subject to state levies.

Among the most-traded Chicago water and sewer bonds in the past week have been wastewater securities callable in January 2017, Bloomberg data show. A customer bought the debt Sept. 2 with a 1.57 percent yield, or about 1.2 percentage points above benchmark debt, the narrowest gap since July.

Chicago also plans to sell \$301 million of second-lien wastewater bonds next week to fund sewer improvements, according to deal documents and Bloomberg data.

While the water system's customer base and the city's control over rates buoy the bonds, investors have to consider Chicago's risk of fiscal distress, said Mansour, head of muni research in Hartford, Connecticut, at Conning, which oversees about \$11 billion of local debt.

## **Association Eyed**

"There has to be some premium associated with this credit because of the outside chance the city of Chicago's ratings could fall again, and this credit could go along with it," he said by telephone.

Chicago's pension liabilities represented 678 percent of revenue in fiscal 2011, according to a Moody's study released in September 2013. The city found a partial solution in June to address the \$19.2 billion shortfall across its four retirement funds. Illinois lawmakers restructured two of the systems, which had a combined \$9.4 billion in unfunded liabilities for about 60,000 municipal workers and retirees.

The water system pays into the pension fix, showing it's not immune to the city's financial pressures. The measures increase the system's yearly pension contributions, which were \$13 million in fiscal 2013, by an average of 25 percent a year until fiscal 2019, bond documents show. The additional revenue from rate boosts is projected to "more than offset increases in retirement costs," the documents say.

"The water and wastewater credits are largely insulated from the city's general finances," Libby Langsdorf, a city spokeswoman, said in an e-mail.

Any yield premium on the water bonds may make the debt more attractive, said Ciccarone.

“The most important takeaway is they’re revenue-based,” Morrissey of Great Lakes Advisors said of the bonds. “There’s so much less risk of people not paying their water bills here, and the revenue increases have already been put in place.”

By Elizabeth Campbell and Brian Chappatta Sep 8, 2014 5:00 PM PT

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## **[Send Letters to Congress Supporting the Modernizing American Manufacturing Bonds Act.](#)**

Call to Action:

CDFA has begun a targeted letter-writing campaign. We ask that industry stakeholders send letters to the House and Senate members to support CDFA’s Modernizing American Manufacturing Bonds Act and the suggested reforms to modernize and revolutionize Qualified Small Issue Manufacturing Bonds. To make this process easier, we have created sample letters for your use.

Download the sample letters provided below and modify them to fit your letterhead. Email and fax letters to your representatives ASAP. Please also copy CDFA on any correspondence, and we will follow-up with the appropriate office holder.

The following letters should be used to help CDFA’s legislative efforts:

### **[Sample House Letter](#)**

When sending letters please follow these instructions:

- Use this sample text to craft your letter.
- Letters should be tailored to reflect your state/city and placed on your organization’s letterhead.
- For full Congressional office contact information go to [www.house.gov](http://www.house.gov) or [www.senate.gov](http://www.senate.gov).
- Letters should be faxed to your Congressional first.
- Mail letters AFTER you fax them. They will take several days to reach the Capitol office.
- For assistance with crating your letters, do not hesitate to contact CDFA.
- Send a copy of your letter to CDFA @ [kwhite@cdfa.net](mailto:kwhite@cdfa.net).
- Be sure to remove this header from your letters.

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## **[Feds Step Up Quest for Private Infrastructure Financing.](#)**

The Obama administration is pushing ahead with its campaign to draw more private dollars to narrow the huge U.S. infrastructure-finance gap, announcing on Sept. 9 a flurry of project-funding actions.

Officials made the announcements at a Washington, D.C., “summit,” at which Cabinet secretaries

heard ideas from public and private officials on further ways to spark increased private investment in highways, bridges and other infrastructure.

Transportation Secretary Anthony Foxx told attendees at the meeting that his department had approved a \$950-million Transportation Infrastructure Finance and Innovation Act loan for the Interstate 4 project in Orlando, Fla. The loan is the largest to a public-private-partnership project in the TIFIA program's 16-year-history.

Foxx also said DOT had approved a \$1.2-billion allocation of federal private-activity bonds to the Pennsylvania Dept. of Transportation for its ambitious program to replace 600 bridges in 42 months, using a single public-private partnership (P3).

Moreover, he said DOT is providing \$20 million for a new transit-oriented-development pilot program.

Other agencies are taking infrastructure-related action, too. Treasury Secretary Jacob Lew said his department will commission an independent report to identify planned transportation and water infrastructure projects that are judged to have the greatest economic impact.

The White House said that the Agriculture Dept. had approved \$518 million in loans for rural electricity projects.

In the nongovernment sector, the California State Teachers' Retirement System is forming a consortium with other pension funds to invest in U.S. infrastructure, Christopher Ailman, chief investment officer, said at the summit, which was held at Treasury's headquarters.

The White House also said the Ford and Rockefeller foundations are teaming up on a new effort to stimulate innovation in infrastructure projects.

As part of President Obama's "Build America Investment Initiative," announced on July 17, he directed Lew and Foxx to lead an interagency infrastructure-finance working group to identify ways to overcome hurdles to private financing and to speed projects to completion.

They are to produce recommendations by Nov. 14. The summit, part of the two secretaries' search for suggestions, drew more than 100 top infrastructure-finance officials from the public and private sectors.

Much of the discussion at the public portion of the meeting centered on the transportation sector, which has had more P3 and related types of private participation than other markets.

Infrastructure's financial needs are immense. Lew said the U.S. faces a \$1-trillion infrastructure-funding gap by 2020, counting all major sectors.

Commerce Secretary Penny Pritzker, who also addressed the gathering, said the stock of all public infrastructure was valued at nearly \$10.8 trillion in 2012, according to Commerce's Bureau of Economic Analysis. It will take \$360 billion per year just to maintain that infrastructure's current condition, she added.

Lew said that "while direct federal spending on infrastructure is indispensable, we recognize the reality that budget limitations at every level of government make it all the more important to come up with fresh, innovative ways to unlock capital and get more projects under way."

Summit participants gave the meeting positive reviews. Ananth Prasad, secretary of the Florida

DOT—a leader in transportation P3s—told ENR that the summit was helpful in hearing what private investors are looking for from owners. Those factors, he said, include creating a marketplace for P3-type projects and agreeing on “some sort of standardization” in that sector.

Private investors don’t view all projects as good prospects, Prasad notes. “So project selection is key, engaging the industry...and early, and trying to have a predictability is the bottom line of success,” he says.

Some panel members at the conference outlined projects on which they had worked. Jim Tymon, American Association of State Highway and Transportation Officials director of management and program finance, says it was beneficial to hear about individual projects that went well. But moving forward, he says, “Let’s find ways to take those successes and replicate them nationwide.”

Jane Garvey, North American fund chairman of Meridiam, New York City, says that the meeting elicited “some very concrete suggestions, specific ideas.”

Garvey, former chief of the Federal Aviation Administration and acting head of the Federal Highway Administration, adds that the next step is “translating that into action items...many of which can be acted on administratively,” rather than through a probably lengthy legislative process.

Former U.S. DOT Secretary Rodney Slater, now a partner with law firm Squire Patton Boggs LLP, says that after the meeting, “I think that you’re probably going to see something happen on the private side, where they say, ‘Look, with all this effort on the public side, what can we do to match that energy?’”

Tyler Duvall, a principal in McKinsey & Co.’s Washington office, says he thinks the Lew-Fox report will include recommendations on project prioritization and projects’ pre-development phases.

Duvall, a former top U.S. DOT policy official, sees the main challenges for innovative financing center on management, process, and politics.

“I don’t think we need 50 new financing tools,” he adds. “I think we’ve got a good set of tools today. And we’ve got a lot of people who want to invest in this country.”

ENGINEERING NEWS-RECORD

09/09/2014

By Tom Ichniowski

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## **[Moody's Predicts Huge Potential for Public-Private Partnerships.](#)**

Public-private partnerships are still relatively new for most U.S. states, but analysts anticipate they will become more common.

The United States could soon become the biggest market for public-private partnerships in the world, analysts from Moody’s Investors Service said in a [recent analysis](#) of trends around the globe.

Thirty-three states now permit the partnerships for transportation projects, the credit rating agency noted, and many of those states adopted those laws within the last five years.

The way those partnerships are structured is also shifting. Many high-profile partnerships, such as the Indiana Toll Road, allow investors to make money based on the how well their asset performs. If a lot of people use a toll road, the investors make a handsome profit. But if traffic doesn't meet expectations, the investors could lose money instead.

Increasingly, though, U.S. governments are using an arrangement that is more common in Britain and Canada, where P3s are more common than in the U.S. Under the arrangement, governments regularly pay operators fees, called availability payments. That makes the arrangement less risky for investors but more risky for the government.

Nine deals in the U.S. using that arrangement have been inked. Three of them — the Long Beach courthouse in California, Miami's port tunnel and the I-595 managed lanes in south Florida — are operational. Another nine projects are expected to close in the next 18 months, according to Moody's.

Moody's analysts predicted that public-private partnerships would become more common for "social infrastructure," like schools and courthouses and, eventually for water-related projects. The ratings agency also noted that private investors are developing more expertise on public-private partnerships, which they use when interacting with state finance and transportation agencies.

GOVERNING.COM

BY DANIEL C. VOCK | SEPTEMBER 9, 2014

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## **[A Better Way to Manage Government's Underutilized Property.](#)**

A startup emerging from academia wants to help cities get more value from publicly owned land.

Government owns 10 to 30 percent of the footprint of most cities, and the public sector is the nation's largest property owner. But property management is hardly a core function of government, so it's not surprising that many jurisdictions don't even have an accurate inventory of their own property. The data is often scattered across the various agencies in charge of different parcels.

Much public land is underutilized and expensive for taxpayers. The Office of Management and Budget estimates, for example, that it costs about \$1.7 billion per year to maintain and secure underutilized federal properties. For municipal governments, there's also foregone property tax revenue and wasted opportunities to use the land to support local economic development.

A Boston-based start-up is looking to change all that. [OpportunitySpace](#) has its roots in the master's thesis of two Harvard Kennedy School students. It is a data hub and information platform that offers both municipalities and citizens consolidated, standardized data on government-owned land. Parcels are mapped geographically. By clicking on one, users can learn its square footage and assessed value.

The company has completed a pilot project with four Rhode Island municipalities including Providence, where the city's 1,363 publicly owned parcels are now posted online. OpportunitySpace is also operating in Louisville, Ky.

In addition to cutting municipal costs and boosting local tax revenues, the company hopes to increase transparency and the amount of creativity that surrounds development issues. In most cases, a sign in the ground is the only way to know a city is looking to sell a piece of property. At best, the property might be posted somewhere deep within a municipal website. OpportunitySpace hopes to make the information available to those who don't know their way around city hall or tax-assessor databases—to “democratize the sale of government-owned property,” in the words of co-founder Cristina Garamendia.

As the fledgling company nears the end of its incubation period at the Harvard Innovation Lab, it expects to begin charging municipal clients a manageable subscription fee. The plan is for more of its revenue to be generated by selling sophisticated information to the private sector.

OpportunitySpace is working on adding information to its database, such as how to connect with experts and gain a better understanding of potential funding sources and redevelopment incentives. It also is adding zoning maps and information about where public investments, subsidies and tax abatements are focused.

OpportunitySpace has received a couple of boosts recently. Last month it was the subject of a New York Times article. This month it is one of the ideas recognized in the annual Better Government Competition sponsored by the Pioneer Institute, a Boston-based public-policy think tank. (I am affiliated with Pioneer as a senior fellow but was not involved with the competition).

It grabs people's attention when they can pay a highway toll electronically without slowing down. But technology is also enhancing government operations in ways that are less visible, though just as important. If it succeeds, OpportunitySpace will be a prime example of that, helping reduce municipal costs, hike revenues and broaden the marketplace of development ideas.

GOVERNING.COM

BY CHARLES CHIEPPO | SEPTEMBER 11, 2014

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## **[Pensions' Unfunded Liabilities Still Going Up.](#)**

A new survey finds that pension funding levels across all states and major cities inched downward in 2013 and that cities are bearing a greater burden in their budgets than states.

A new survey has found that pensions' unfunded liabilities across all states and major cities inched up in 2013 and that cities are bearing a greater financial burden than states.

State pensions averaged a funded level of 73.1 percent in 2013, down from 73.5 percent in 2012, a Loop Capital Markets report released this week found. In cities, that ratio of the value of money in the pension fund compared to the cost of benefits already promised to retirees was 65.3 percent, down from 65.6 percent in 2012. (Actuaries tend to rate anything above 80 percent funded as an acceptable level.)

Additionally, cities face about three times the pension burden in their budgets that states do, Managing Director Chris Meir said during a conference call with investors Wednesday. On average, annual pension payments make up 4 percent of state budgets and 12 percent of city budgets, the

report found. The budget strain doesn't correlate with how well a pension is funded. Cities like Philadelphia, Jacksonville and Phoenix all spend more than 20 percent of their budgets on pensions while Memphis and Little Rock spend 3 percent or less. All five of those cities have plans that are less than 75 percent funded.

Meir cautioned that a plan can appear healthy on paper but still be in trouble. For example, before filing for bankruptcy, Detroit had pension funds that were 91 percent funded and its pension payments accounted for 7 percent of the city budget. But Detroit had also assumed huge debt in 2006 to sell bonds that went directly into the city's pensions as a way to eliminate its then-unfunded liability. In essence, the city transferred its debt from one part of its books to another.

"Management skill and a culture of debt avoidance also very important factors," Meir said.

On the state level, funded ratios for 19 states improved in fiscal 2013, up from five states in 2012 and 14 states in 2011. Those that showed the biggest improvement (at least a 7 percentage point jump in funded levels) were Montana, Oregon, South Dakota and Ohio. The report found some similar attributes between these and other states that showed bigger improvements last year, including having a generally smaller population or one with lower union concentration (Ohio is an exception). "Right-to-work" states, in particular, tend to avoid such pension problems.

The report found fewer similar attributes between the 26 states that saw their funded levels decrease in 2013. But Meir said there are still some generalities among the states that saw the biggest declines. New Jersey pensions declined the most in 2013, dropping 7 percentage points in the average funded level. The next-biggest drops were in Massachusetts, New York and Virginia, which all dropped by 5 percentage points. Except for New York, states with funded ratios that have deteriorated the most in fiscal 2013 were weak pension performing states to begin with. And, the report noted, these are mostly "older" states in the Northeast and mid-Atlantic. More established states tend to have older — and therefore more expensive to maintain — infrastructure, which adds to their burden.

The conference call ended on an optimistic note. Meir noted that pension reforms have helped eat away at unfunded liabilities in many states and localities, albeit slowly. Thanks to each state's particular legal and economic structure, he said, the reform process has been a "state-by-state skirmish," thus dragging out the process.

"Therefore, we do not believe is a systemic problem," he said. "It is a state-by-state problem with a state-by-state solution."

GOVERNING.COM

BY LIZ FARMER | SEPTEMBER 12, 2014

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## [\*\*Puerto Rico Utility Bond Agreement Limits Disclosure, MMA Says.\*\*](#)

An agreement between Puerto Rico's junk-rated power utility and investors holding the bulk of its debt gives the agency time to mend its finances. It also offers some bondholders non-public information, says Municipal Market Advisors' Bob Donahue.

The Puerto Rico Electric Power Authority, called Prepa, the main supplier of electricity on the island, last month entered into an agreement with investors who collectively hold more than 60 percent of the utility's \$8.3 billion of debt. For signing on to the contract, those bondholders will receive monthly cash statements and financing plans, according to the document for the deal, known as a forbearance agreement.

Such an arrangement is typical in the \$3.7 trillion municipal-bond market, yet the amount of Prepa's obligations makes the situation unique, said Donahue, managing director at Concord, Massachusetts-based MMA. If the utility restructures its debt, it would be the biggest ever in the municipal market.

"The many disclosures that they will receive, that will create a real asymmetry in the market between those in the agreement and those outside," he said.

Lawmakers in June approved a law that would allow certain public corporations, including Prepa, to ask bondholders to take a loss. The commonwealth and its agencies have \$73 billion of debt. The island's economy has struggled to expand since 2006, fueling speculation that Puerto Rico will be unable to repay all of its obligations on time and in full.

### **Restructuring Chief**

Prepa last week picked Lisa Donahue, managing director at New York-based turnaround firm AlixPartners LLP, as chief restructuring officer to cut expenses and improve its finances. As part of its agreement with creditors, Prepa must release a five-year business strategy by Dec. 15 and create a debt-restructuring plan by March 2.

Members of the forbearance group can sell only to other bondholders in the group or to investors who agree to join it, according to the agreement.

Being privy to detail on Prepa's finances gives investors insight into other Puerto Rico credits, said Daniel Solender, who helps manage \$15.5 billion of munis at Lord Abbett & Co. in Jersey City, New Jersey.

"It makes it a strange way to approach it, given how many different types of bonds are outstanding," Solender said. "If you have privileged information on Prepa, it affects the trading of all Puerto Rico bonds."

### **Prepa Rally**

Lord Abbett held Prepa debt as of July 31, Solender said. He declined to say if the firm is part of the forbearance group.

Prepa has rallied since Donahue's appointment. The bonds are gaining in part because the universe of investors who can trade the securities has become limited by the agreement, MMA's Donahue said.

Prepa bonds maturing in July 2040 traded yesterday at an average price of 57.03 cents on the dollar, the highest since June 18, data compiled by Bloomberg show.

With Prepa's debt load and its financial challenges, the utility should disclose information to all investors at the same time through the Electronic Municipal Market Access website, known as EMMA, MMA's Donahue said.

“Given the high stakes and the difficulty that Prepa’s facing, transparency would be the best antidote,” he said.

David Millar, a New York-based spokesman for Puerto Rico’s Government Development Bank, which handles commonwealth debt sales, didn’t immediately respond to an e-mail and phone message. Abimael Lisboa Felix, a spokesman for Prepa in San Juan, didn’t immediately respond to an e-mail and phone message.

By Michelle Kaske Sep 12, 2014 10:39 AM PT

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Mark Tannenbaum, Mark Schoifet

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## **[Chicago at Brink of Swaps Fee as Bond Ratings Fall: Muni Credit.](#)**

Chicago’s deteriorating credit quality has pushed taxpayers to the brink of paying almost \$400 million to Wall Street banks on derivatives contracts that are backfiring.

The city and Chicago Public Schools, both at risk of rating reductions as pension obligations mount, agreed to interest-rate swaps with companies including Bank of America Corp., Goldman Sachs Group Inc. (GS) and Loop Capital Markets LLC last decade as part of debt sales. The accords were designed to cap expenses in case interest rates rose. The deals went awry as the Federal Reserve cut borrowing costs during the recession.

The issuers’ combined bill to exit the deals has reached about \$400 million, almost two-thirds more than the metropolis spent on streets and sanitation in 2013. The contracts on the derivatives stipulate that the banks can demand payment when the issuers’ credit rating falls to a specified level. For the city, that trigger is one level away on most contracts after Moody’s Investors Service cut it to three steps above junk.

“These governments are in a precarious position,” said Laurence Msall, president of the Civic Federation, a Chicago watchdog on government finance. “Hundreds of millions of dollars are at stake.”

### **Derivatives Trail**

States and cities in the \$3.7 trillion municipal market have paid at least \$5 billion to banks to end interest-rate swaps, data compiled by Bloomberg show. The contracts contributed to the bankruptcies of Detroit and Jefferson County, Alabama.

In Chicago this week, Alderman Roderick Sawyer introduced a resolution in the city council calling for Mayor Rahm Emanuel to file an arbitration claim with the Financial Industry Regulatory Authority to recover payments the city and school district have made on swaps. That could generate more than \$600 million and eliminate the need for termination payments, said Jackson Potter, an official with the Chicago Teachers Union.

“The mayor has made a commitment that the city will not enter into any new debt swaps of this kind and has enacted measures to modify and reduce risk to protect the taxpayers of Chicago,” Carl

Gutierrez, spokesman for the city's budget office, said in an e-mailed statement.

"We monitor our swap liability carefully and are in continuing conversations with our swap counterparties to manage the risks of our derivative portfolio," Bill McCaffrey, a schools spokesman, said via e-mail.

### **March Cut**

The city had its general-obligation rating lowered to Baa1 in March by Moody's, which cited "massive" pension liabilities. The company also assigned a negative outlook, meaning more cuts are possible. A credit grade one level lower could trigger swaps termination fees of about \$173 million, according to documents for a March bond sale.

The school system, the nation's third-largest, has more breathing room. It needs two rating companies to reach a predetermined rating level for a possible payment of about \$224 million. It's Moody's rating is two levels from that point.

The potential payments increase pressure on state lawmakers, Governor Pat Quinn and Emanuel to reduce pension obligations, said Richard Ciccarone, Chicago-based president of Merritt Research Services. As the city and school system use reserves to balance budgets, they may have to look for new tax revenue, he said.

"There's not a lot of room for comfort at the schools or the city," Ciccarone said. "The parties need to work together to resolve a very pressing issue. Politics will just make it more difficult."

### **Illinois Bill**

Quinn, a Democrat seeking re-election this year, signed a bill in June that partially addresses Chicago's \$19.2 billion pension shortfall. The law, which cuts benefits and makes employees pay more for retirement, restructures two of the city's plans, for about 60,000 municipal workers and retirees. The law doesn't affect the police or firefighter obligations or lower retirement costs for the schools.

While those changes haven't faced legal challenges, a state judge halted the implementation in May of an overhaul of the state retirement system after unions questioned its constitutionality.

### **'Political Mess'**

The political calendar may complicate matters.

Emanuel, a first-term Democrat, faces a potential challenge in February elections from Karen Lewis, president of the teachers union. Emanuel closed 49 underperforming elementary schools last year, hurting his approval rating, according to a Chicago Tribune poll released last month. That signals the difficulty he may face in addressing the district's budget and pension issues.

Duane McAllister, who helps oversee about \$5 billion of munis at BMO Asset Management Corp. in Milwaukee, said the pressures are keeping his company from buying.

"Chicago is sort of still mired in the political mess that seems to be Illinois politics," said McAllister.

Some city debt is gaining in the face of the stress. Bonds maturing in January 2040 traded yesterday at an average yield of 4.72 percent, compared with an average of about 5 percent since March, according to data compiled by Bloomberg. Yesterday's yield was about 2.6 percentage points above

benchmark debt.

Moody's in August warned of the "narrow distance to rating triggers" for the school system's swaps. The district has 10 fixed-rate swaps with potential triggers if two of the three biggest rating companies cut the debt to the equivalent of Baa3, which is one step above junk, or lower.

### **Triggers Below**

Moody's grades it Baa1, two levels above the trigger. Fitch Ratings is at A-, three levels above the trigger, and Standard & Poor's is at A+, which is five levels above. Moody's and Fitch both have negative outlooks.

"There will be formidable pressure going forward," said Mark Lazarus, a Moody's analyst in Chicago. "It's something you factor into future ratings."

Hitting the trigger levels wouldn't automatically mean the city or school district would have to pay to end the swaps; the banks would have the option to force payment. The companies could also take steps such as having the issuers put up collateral to secure the payments, as banks did to Detroit with taxes on its casinos.

Goldman Sachs declined to comment on the contracts, said Michael DuVally, a spokesman in New York. William Halldin at Charlotte-based Bank of America also declined to comment. James Reynolds, chief executive officer at Chicago-based Loop, didn't respond to e-mails and a phone call seeking comment.

### **Reserve Stash**

For Chicago, a termination payment would be manageable, said Ty Schoback, a senior analyst in Minneapolis at Columbia Management Advisors, which oversees \$30 billion of munis.

"Chicago has got quite a bit of reserves stashed away," Schoback said.

The city has reserves of about \$625 million from leasing a tollway and parking system, according to a February S&P report.

Chicago's payments for pensions are set to reach \$1.1 billion in 2015 from about \$478 million in 2014, according to financial documents.

The "aggregate amounts are not catastrophic," said Arlene Bohner, a senior director at Fitch. Though "it is of concern given the other spending pressures they're under."

### **School Burden**

For the school system, a termination payment would be "far more burdensome," Schoback said.

The district, with about 400,000 students, has tapped reserves to balance its budget as pension costs rose. Swaps payments of \$224 million would exceed the \$216 million it has in debt-service reserves, according to Moody's. The system is using about \$862 million of budgetary reserves in its fiscal 2015 budget, leaving it with about \$300 million, projections show.

Its pension contributions in fiscal 2014 and 2015 tally more than \$600 million each year, up from about \$200 million the previous three years, according to budget documents.

The city has modified some swaps, according to Bohner and its 2013 financial report, released in

June. In March, it reduced the rating at which two of its 11 general-obligation swaps could be triggered, by one level to Baa3, according to the disclosure statement.

The efforts are a “work in progress,” said Fitch’s Bohner. “It’s definitely on their radar screen.”

By Darrell Preston and Elizabeth Campbell

Sep 11, 2014 5:00 PM PT

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Mark Tannenbaum, Mark Schoifet

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## **[Reinventing Democracy through Participatory Budgeting.](#)**

For all the hype surrounding democracy as a concept, in practice it has fallen short of expectations. Americans are proud of the strength and resilience of their democratic institutions, and yet they are deeply distrustful of their elected officials and turning out to vote at ever lower rates. But the lofty goal of reinventing democracy appears infinitely more achievable when we have a mechanism for doing so. Participatory budgeting is coming to the fore as one of the most promising ways to change the relationship between citizens and government, as part of a wave of new democratic innovations.

Participatory budgeting offers a fundamentally different interpretation of democracy than what we have become accustomed to. What if instead of voting to give officials the right to make decisions on our behalf, there were forums that put decision-making authority directly into the hands of citizens? Participatory budgeting, or PB, is a process that allows ordinary people to decide how part of a public budget should be spent.

A PB process begins with community meetings where residents are invited to come together and share their ideas. Next, volunteers take on the task of refining those ideas to develop project proposals. Finally, residents vote for the projects that they most wish to see funded. The results of the vote are binding, making PB a significant departure from forums that involve consultation but not action.

[The Participatory Budgeting Project](#) (PBP) has supported processes that have allocated over \$45 million from public purses across the U.S. Those funds have brought to life more than 250 individual projects, designed by residents and chosen by over 50,000 voters.

Born in the Brazilian city of Porto Alegre in 1989, PB is now practiced in over 1500 cities around the world, and in over 40 communities across the US. In Chicago, where the US experience of PB began in 2009, more than 250,000 residents now have the opportunity to decide the allocation of \$5 million.

In New York City, PB started in 2011 with the discretionary capital works budgets of four inspired city council members. It has since grown to include nearly half of the city’s council districts. A city-wide youth PB process has been launched in Boston, giving young Bostonians aged 12–25 the opportunity to decide how to spend \$1 million.

But PB is more than raw numbers: it matters who participates. Partnerships with local community organizations and targeted outreach have been crucial to ensuring that PB does not merely attract the “usual suspects” – residents who are white, middle to upper class, and highly educated. Instead, PB aims to give real decision-making power to all members of the community.

Furthermore, the process itself is as meaningful as the outcomes it generates. PB provides neighbours with the opportunity to learn from one another. It ignites discussions around whose interests are being served, and whose aren't. It provides a platform for residents to develop leadership skills that can be taken and applied in new contexts. Research in the U.S. to date suggests that these experience have powerful impacts on many PB participants, including those who don't typically get involved in political processes.

PB processes are growing across the U.S. Since we first worked with Chicago Alderman Joe Moore in Chicago in 2009, we have partnered with dozens of other elected officials to launch PB in their community. Last fall, the White House began promoting PB as a best practice of civic engagement, and we have worked with the U.S. Department of Housing and Urban Development to [share PB resource on their website](#).

At the Participatory Budgeting Project, we are proud to continue to partner with national and local organizations to develop new tools, launch new PB processes, and improve existing PB processes, because we believe that transparent and engaged democracy makes our communities stronger. Join us in Austin to learn how to bring this exciting innovation in democracy to your communities, to engage constituents in making real decisions about real money.

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By Josh Lerner and Madeleine Pape

Josh Lerner will serve as a presenter and facilitator for the interactive NLC University Seminar, “Participatory Budgeting – How to Build Deep Community Engagement in Real Budget Decisions (201)” at the Congress of Cities and Exposition on November 19th in Austin, Texas.

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## **[NYT: Detroit's Bankruptcy Deal Hinges on 2 Banks.](#)**

The future of Detroit's pensioners may depend on an insurer's resolution of a dispute with Bank of America and UBS.

Syncora Guarantee, Detroit's most vociferous adversary in bankruptcy, is close to a breakthrough settlement with the city, but before it can close the deal it must resolve a related dispute with two big banks, Bank of America and UBS.

The bankruptcy judge, Steven Rhodes, has adjourned a trial in the case until Monday. If Syncora cannot reach an agreement with the banks by then, it will face a breakdown of its whole deal with Detroit, which would give it a stake in vehicle tolls from the tunnel that runs between Detroit and Windsor, Ontario, as well as some nearby land.

Syncora's dispute with the banks goes back to a \$1.4 billion borrowing by Detroit in 2005. The city was already in dire financial straits and did not have enough to make its required pension contributions. After city unions sued, Detroit decided to borrow the money, and UBS and a precursor to Bank of America underwrote the deal. Syncora insured it along with another bond insurer, the Financial Guaranty Insurance Company.

The \$1.4 billion did not solve Detroit's problems, though — it merely bought the city some time and labor peace. Ultimately, it increased the amount of debt Detroit now has to deal with in its historic Chapter 9 bankruptcy case. In the bankruptcy framework, the borrowing has turned out to be so messy and intractable for the municipal bond market that it almost seems to stand as an example of why it is a bad idea to fund public pensions with borrowed money. Such deals continue to be done in many places, however.

In bankruptcy, Detroit's approach to the 2005 debt has been to argue that the whole borrowing was illegal from the start because the city had reached its debt ceiling. It contends the deal should be voided, which would result in hundreds of millions of dollars in losses for both Syncora and Financial Guaranty.

In fact, until Syncora's announcement on Tuesday that it had an agreement in principle with Detroit, both insurers stood to receive one of the lowest recoveries of the bankruptcy. That outcome would have significant negative implications for the municipal bond industry because it would leave Detroit's pensioners higher on the creditors' pecking order than the investors who bought Detroit's debt in 2005.

The investors had no idea Detroit would later call the borrowing illegal, because the underwriters obtained legal opinions from both the state and independent bond counsel that the debt was valid, binding and enforceable.

It would be highly unusual for a government to repudiate debt marketed with such assurances. Municipal bond analysts have been warning that if Detroit prevails, it will cast a shadow over every other city bringing debt to market in the future.

Complicating matters, when Detroit borrowed in 2005, it tried to hold down the cost by issuing variable-rate debt, then hedging it with a type of derivative called interest-rate swaps. The swaps were intended to protect Detroit if interest rates rose — but if they fell, the city would have to pay the swap counterparties, which happened to be Bank of America and UBS.

The two insurers wrote guarantees for both the debt instruments, called certificates of participation, and for the interest-rate swaps. That protected the investors who bought the certificates and Bank of America and UBS from any missed payments on the swaps.

The borrowing was considered so innovative in 2005 that it won a Deal of the Year award from The Bond Buyer, a trade publication, and was said to have solved Detroit's pension problem once and for all. But by 2009, interest rates had plunged, and Detroit's mandatory swap payments to the two banks ballooned beyond anybody's expectations.

With cash flying out the door, the city's fiscal problems grew bad enough to activate provisions requiring it to terminate the swaps — but that required Detroit to buy out the two banks at the full present value of all the swap payments it would otherwise have to make for the life of the certificates. Once again, it did not have the money.

Detroit bought some time by restructuring the swaps and backstopped its obligations to the banks by pledging the cash it receives from a tax on casinos, an important source of revenue for the city.

After that, Detroit kept right on paying the swaps, even after declaring bankruptcy last year, when it estimated the cost of terminating its swaps at about \$345 million. The city and the banks did reach a proposed settlement of \$165 million, but the judge rejected it.

"It's just too much money," Judge Rhodes said at the time, and he ordered both sides to negotiate a

lower deal. A few weeks later, the banks accepted \$85 million.

Syncora's lawyers saw that the banks planned on turning their losses on the swaps into insurance claims that it and Financial Guaranty would be expected to pay.

That is what Syncora and the two banks will be thrashing out in their closed-door sessions this week. Financial Guaranty is not participating in those talks but has been in touch with Detroit about other possible settlements.

Both insurers say that if the 2005 borrowing was in fact illegal, as the city says, then they were fraudulently induced to insure it. If so, then their policies are also void, they say, and they do not owe the banks any money.

No one wants to touch the third rail underlying all this: If the 2005 borrowing was truly illegal, and must therefore be voided, then the city pension system should be required to give the investors back the \$1.4 billion they provided back in 2005. That would sink Detroit's hard-won exit strategy.

THE NEW YORK TIMES

By MARY WILLIAMS WALSH

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