

New England Fiscal Facts

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Securitizing Tobacco Settlements: The Basics, the Benefits, the Risks

By E. Matthew Quigley

In this time of fiscal hardship for American states, governors and legislators across the country are searching for ways to make up for revenue shortfalls. Partly because of the severity of the revenue crisis, innovative and unconventional means of raising cash have begun to surface. One of these approaches, the topic of this article, is the securitization of tobacco settlement revenues.

The Tobacco Settlement

In November 1998, the attorneys general of 46 states, including the six in New England, signed a Master Settlement Agreement (MSA) with companies representing roughly 98 percent of the current tobacco industry. Among other provisions, the MSA provides for a signing bonus that was paid to the states in 1999 and specifies that a share of tobacco company profits is to be paid in perpetuity to the signatory states. In 1999 dollars, this stream of revenues was estimated to be worth roughly

\$306 billion for the first 25 years of the agreement. For the six New England states, Table 1 details the upfront payments, average annual payments in perpetuity, and total value of the tobacco settlement payments, all in 1999 dollars.

States have put these funds to a variety of uses. In New England, Connecticut, Maine, Massachusetts, and Vermont have invested them in trust funds. New Hampshire has used its settlement funds to provide supplemental education funding. Rhode Island, initially treating the money as general fund revenue, has joined a growing number of states that have securitized their settlement revenue streams.

What Is Securitization?

In the case of tobacco settlements, securitization is the process of issuing bonds backed by tobacco settlement revenues. Through the sales of bonds, states pledge their right to collect future revenue streams in exchange for an

upfront lump-sum payment. Although these transactions can take many different forms, states tend to sell or pledge their tobacco revenue streams to a Special Purpose Entity (SPE) established by the state legislature for the express purpose of selling tobacco-revenue-backed bonds and servic-

Table 1

Tobacco Settlement Payments

	Upfront Payments	Average Annual Payments in Perpetuity	Total Value over First 25 Years
Connecticut	\$45 million	\$141 million	\$ 5.7 billion
Maine	18 million	59 million	2.4 billion
Massachusetts	97 million	307 million	12.3 billion
New Hampshire	16 million	51 million	2.0 billion
Rhode Island	17 million	55 million	2.2 billion
Vermont	10 million	31 million	1.3 billion

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State Budget Timetables

Annual Budgets

Massachusetts
Rhode Island
Vermont
FY02: July 1, 2001
to June 30, 2002
FY03: July 1, 2002
to June 30, 2003

Biennial Budgets

Connecticut
Maine
New Hampshire
FY02-03: July 1, 2001
to June 30, 2003

ing the debt. These SPEs are designed to be both bankruptcy proof and legally separate from the state. As a result, the state does not put its own credit rating at risk through the issuance of a tobacco bond.¹ A list of securitizations to date is provided in Table 2.

Structuring Securitizations

Depending upon the intended use of the funds raised through securitization, tobacco bonds can be either taxable or tax-exempt. Generally speaking, if the proceeds from a bond sale will be used for governmental purposes (e.g., funding an infrastructure need), then the bonds are tax-exempt. If, however, the proceeds will be used for a private purpose or will be reinvested (e.g., used to endow a pension fund), then the bonds are taxable. There are costs and benefits to the states associated with either option. States have more flexibility in spending the proceeds of taxable bonds. However, because they carry a higher interest rate than tax-exempt bonds, taxables raise interest costs to the state and, therefore, reduce present value. Conversely, tax-exempt bonds, while more restrictive on uses of proceeds, have lower interest costs.

After choosing between these two options, states face decisions on three main structural issues: amortization structure, the term or final maturity of the debt, and the percentage of tobacco settlement revenues to be securitized. Amortization structures can be residual or turbo. A residual structure allows the bond issuer to receive any tobacco settlement revenues above the planned debt service, so-called "residual payments." In other words, if tobacco settlement revenues are larger than expected in any given year, the issuer retains the difference between the actual revenues received and the planned debt service payment on the tobacco bonds. This structure allows the issuer to retain the upside potential associated with tobacco settlement revenues while at the same time transferring the downside potential (i.e., declines in revenues) to bondholders.

A residual structure also includes so-called "trapping events" that mandate a deposit of all residual payments into a "trapping account." Typical trapping events include an increase in the market share of non-MSA participating manufacturers or a drop in cigarette consumption below certain specified levels. Under these types of circumstances, residuals are accumulated in a trapping account up to a pre-specified level, thereby ensuring an additional level of security to bondholders. Only after trapping requirements are met do residuals flow through to the issuing state.

Under a turbo structure, all available tobacco settlement revenues are used to amortize tobacco bonds before the issuer can receive any residual cash flows. In other words, all revenues are "trapped" and used to amortize the debt as quickly as possible right from the issuance of the bonds. Largely because of this, investors view a "turboized" structure positively. From the state's perspective, a turbo amortization has the advantage of retiring debt more quickly. On the downside, a turbo transfers less long-term tobacco industry risk to bondholders than does a residual structure.

In addition to determining the best amortization structure, states contemplating securitization must also decide which term or maturity date best fits their needs. The nearer the final maturity date of the bond (i.e., the point in time at which final payments are made to bondholders), the less total interest that the state has to pay to bondholders. Thus, a bond with a short maturity period may make sense to a state wanting to amortize its principal quickly. This involves a

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¹ Although the state's credit rating is not directly at risk, some risk remains. If projected tobacco settlement revenues diminish below levels necessary to provide adequate debt service, it is possible, although perhaps not likely, that bondholders could compel the state to repay bondholders. Additionally, coupled with other indicators, the sale of tobacco bonds for deficit financing may adversely affect a state's overall credit rating.

Table 2

Tobacco Securitizations as of November 2002

Seller	Structure of Bonds						Bond Proceeds as a Percent of Fiscal Year Revenues	Use of Bond Proceeds
	Total Amount (\$ millions)	Moody's Rating	S&P Rating	Fitch Rating	Closing Date	Percent of Overall II Settlement Securitized		
Alabama	50.0	Aa1	A	NR	09/21/00	See Note 1	1	Economic development
Alaska	116.0	Aa3	A	A+	10/26/00	40	8	Education; infrastructure
South Carolina	934.5	Aa3/A1	A	A+	03/22/01	100	17	Health care; community development; water infrastructure; tobacco farmer assistance
Alaska II	126.8	Aa3	A	A+	08/15/01	40	11	Education; infrastructure
Arkansas	60.0	Aa2	NR	NR	09/25/01	See Note 1	2	Capital projects
Iowa	644.2	Aa3/A1	A	NR	10/25/01	78	12	Capital projects; health care trust fund endowment
Louisiana	1,202.8	Aa3/A1	A	A+	11/07/01	60	19	Education and health care trust fund endowment; local aid to schools; liquidity reserve
Alabama II	103.8	Aa1	A	NR	12/20/01	See Note 1	2	Economic development
Wisconsin	1,600	A1	A	A+	05/23/02	100	16	Cover deficit
Rhode Island	685.4	A1	A	A+	06/27/02	100	27	Debt defeasance; cover deficit
New Jersey	1,801.5	A1	A	A+	08/28/02	50	8	Unrestricted general fund use
South Dakota	278.0	Aa3/A1	A	NR	09/24/02	100	33	Education
Washington State	517.9	A1	A	NR	11/05/02	29	5	Unrestricted general fund use

Note 1: Because of peculiarities in the manner in which Alabama and Arkansas securitized their receivables, it was not possible to make estimates of this percentage for these two states comparable to estimates made for the other states.

Note 2: Bond proceeds as a percent of fiscal year revenues = (bond proceeds received by the issuing state) ÷ (total revenues received by the issuing state during the year in which the bonds were issued).

Source: Moody's Investors Service, Standard & Poor's, Fitch Ratings.

tradeoff, however. Tobacco revenue streams are more secure in the near term than they are in the long term. Therefore, revenue stream risks borne by the states are further mitigated the longer the term of the bond.

Finally, states can securitize different percentages of their tobacco settlement revenues. Regardless of the amortization structure chosen, securitized revenues are irrevocably dedicated to debt service. Unsecuritized tobacco settlement revenues can be used for whatever purpose the state deems necessary.

Potential Benefits of Securitization

Securitization, as previously mentioned, allows states to receive sizable funds today rather than smaller payments spread out over many years. For states facing immediate fiscal needs, an upfront infusion of cash may have more utility than a future revenue stream. Securitization also transfers risks from the state to the capital markets; such risks include the possibility that the tobacco companies will go bankrupt or move overseas, that consumption patterns will change, or that the settlement will be successfully challenged in court by nonparticipating tobacco firms. States may diversify their risk by investing the bond proceeds in a variety of uses (e.g., endowing health care or pension funds), so that revenues are not overly dependent on one industry. In a similar vein, securitization limits a state's association with the

tobacco industry, an association perceived as undesirable by some elements of the public. Finally, by using securitization proceeds to fund capital projects or defease existing debt, a state can free up general revenue funds for a variety of purposes. It is possible that defeasance of existing debt could positively affect the overall credit rating of a state with a pre-existing heavy debt burden.

Potential Drawbacks of Securitization

Despite the aforementioned benefits of securitization, it also has disadvantages. First, the high discount (in most cases, tobacco settlement bonds have sold for between 50 cents and 54 cents on the dollar) or high interest rate makes the bonds potentially expensive and results in lower net income over the life of the settlement. Second, there may be a limited market for tobacco bonds. Although no evidence of market saturation has yet surfaced, some believe that a saturation point will be reached in the market for tobacco revenue bonds, beyond which states will realize fewer gains with greater costs. Third, if future payment streams diminish to the point where they are insufficient to cover debt service, a state could face pressure to back the bonds with general revenue. Finally, "inappropriate" use of bond proceeds (e.g., using proceeds to close a budget gap without addressing the underlying structural causes) could adversely affect a state's overall credit rating.

Conclusions and Outlook

What would securitization mean for each of the New England states?

Connecticut and Massachusetts, given the enormity of their budget problems and the substantial size of their tobacco settlement revenue streams, stand to enjoy the highest potential benefits from securitization. Maine, New Hampshire, and Vermont are in a situation similar to that of Rhode Island (see box).

Connecticut ended the first year of its biennial budget cycle with a deficit of \$817 million. The legislature reduced the deficit by transferring the \$595 million balance of the state's rainy day fund into the general fund. The remaining deficit of \$222 million was carried over into the current fiscal year and will be closed through the issuance of economic recovery notes. Officials project

that an additional \$415 million shortfall will materialize during the current fiscal year. If the state were to securitize its entire settlement, it could raise approximately \$1.5 billion to \$1.7 billion – more than three times the expected FY2003 shortfall – assuming discount and transaction costs similar to those of states that have already securitized.

For the first three years of the MSA, Massachusetts “banked” 70 percent of its payment into a Medicaid Security Trust Fund and devoted 30 percent to the state's general fund. As fiscal conditions worsened in FY2001/2002, “banking” was abandoned, and 100 percent of tobacco settlement revenues were, and currently are, diverted to general fund expenditures. If Massachusetts were to securitize 100 percent of its tobacco settlement revenues, it could expect to realize a lump-

An Update: The Fiscal Condition of the New England States

New England Economic Indicators, January 2003

The January 2003 issue of *New England Economic Indicators* features an article by E. Matthew Quigley on the fiscal condition of the New England states, based on data available through fall 2002. The article updates an article by Robert Tannenwald on the same topic that appeared in the June 1999 issue of *Indicators*. The current article documents the about-face in state finances that has taken place since the earlier analysis. Charts show changes in revenue collections, patterns in revenues and spending, changes in budget stabilization fund balances, and budget surpluses or deficits in relation to general fund spending.

New England Economic Indicators contains data and analysis on the New England economy and is produced as a resource for researchers and members of the public. The January issue of *New England Economic Indicators* and back issues are available online at:

<http://www.bos.frb.org/economic/need/need.htm>

Subscriptions to *New England Economic Indicators* and copies of the January issue are available without charge. Contact the Boston Fed's Research Library:

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Case Study: Rhode Island

To date, Rhode Island is the only New England state to have securitized its tobacco settlement funds. On June 20, 2002, the state's newly created Tobacco Settlement Financing Corporation sold its right to collect \$1.2 billion in tobacco settlement proceeds over the next 20 years for a lump sum of \$685.4 million (\$649.7 million in tax exempt bonds and \$35.7 million in taxable bonds). The bonds have a 20-year maturity and will be paid back by FY2022 through a full turbo redemption schedule.

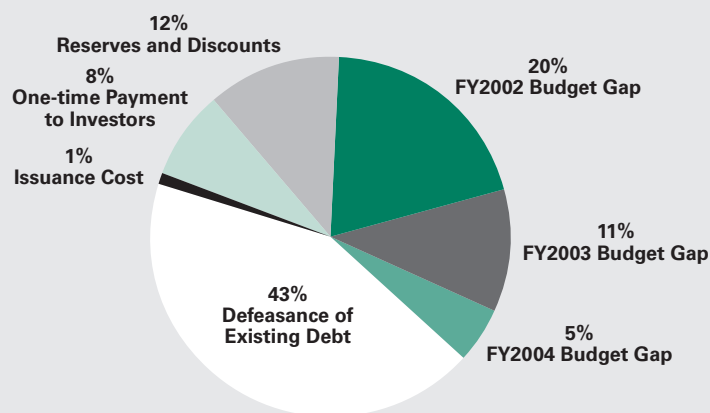
Of the total funds raised, \$142.2 million covered the costs of issuance, reserves, and discounts for the purchasers, including \$55.6 million set aside to finance the first annual payment to bondholders. Part of the bonds' proceeds had

to be used for this purpose because the state had already channeled its most recent tobacco payment into its general fund. The remaining \$487.6 million – 79 percent of total funds raised – is available for general appropriation. The state used \$295.3 million

to buy back existing, noncallable general obligation bonds, thereby freeing itself of \$343.5 million in net debt service payments through FY2012 — \$51.6 million in debt service payments for FY2003 alone. An additional \$135 million was used to close the state's FY2002 budget gap; \$77.3 million was set aside

as a contingency fund for FY2003; and \$35.6 million is to be carried over into FY2004, also to serve as a hedge against possible revenue shortfalls.

Rhode Island's Use of Proceeds from Securitization



sum payment of about \$4 billion, roughly double the size of the expected revenue shortfall for FY2004. If the Commonwealth were to securitize the 30 percent that it had previously earmarked for expenditure, it could realize approximately \$1 billion, or 50 percent of the expected deficit. This second option would allow the Commonwealth to reestablish its guideline of earmarking 70 percent of settlement revenues to shore up Medicaid.

The net present value of Maine's settlement revenue stream is approximately \$1.5 billion. Securitization of the entire amount would yield approximately \$625 million. Subtracting transaction costs of approximately 20 percent, or \$125 million, would yield \$500 million in available funds. This figure is roughly double the size of the

\$243 million revenue shortfall predicted for Maine's FY2002-2003 biennial budget cycle. Although lawmakers have publicly considered the idea, no proposal for securitization has, to date, been introduced.

New Hampshire and Vermont are the states least likely to securitize. Michael Ablowich, commissioner of New Hampshire's Department of the Treasury, is unaware of any pending proposals to securitize, and state finance experts have been skeptical of its utility. Vermont officials are similarly skeptical. In 1999, the Vermont state treasurer recommended against securitization, citing high transaction costs and the relatively small lump-sum payment that it would produce. Currently, no proposals to securitize are under consideration. **FF**