Research Brief

OFFICE OF THE NEW YORK STATE COMPTROLLER

DIVISION OF LOCAL GOVERNMENT AND SCHOOL ACCOUNTABILITY

The Credit Crunch:
Implications for Local Government Short–Term Debt

The current global financial market crisis could have serious implications for New York's local governments if access to the credit markets remains constrained. While many long-term implications for local government finances may occur as a result of the broader deterioration in the economy, the credit situation has produced a more immediate impact on liquidity – the ability of local governments to finance their short-term capital operations and cash flow needs. Local governments who are dependent on short-term debt for these purposes could face continued risks.

As a result of the credit crisis, some local governments have had difficulty attracting buyers for their debt, particularly those issuers with low or no credit ratings.[1] Many local governments that do find buyers may be faced with higher interest costs.

While the federal government has initiated a $250 billion Capital Purchase Program to inject liquidity into eligible banks, and discussions on other ways to improve liquidity in the municipal market are ongoing, local governments and school districts must understand that this global crisis may take time to resolve. It is therefore critical that local officials carefully review their cash flow needs and keep abreast of continuously changing market conditions that could affect the timing of any scheduled note sales.

Types of Short Term Debt

Bond Anticipation Note: An obligation issued to finance capital purposes in anticipation of issuing long-term bonds.

Tax Anticipation Note: An obligation issued in anticipation of the collection of future real property taxes and assessments.

Revenue Anticipation Note: An obligation issued in anticipation of certain future revenues, usually state aid.

Budget Note: An obligation issued to finance unforeseeable or other expenditures for which an insufficient provision was made in the annual budget.

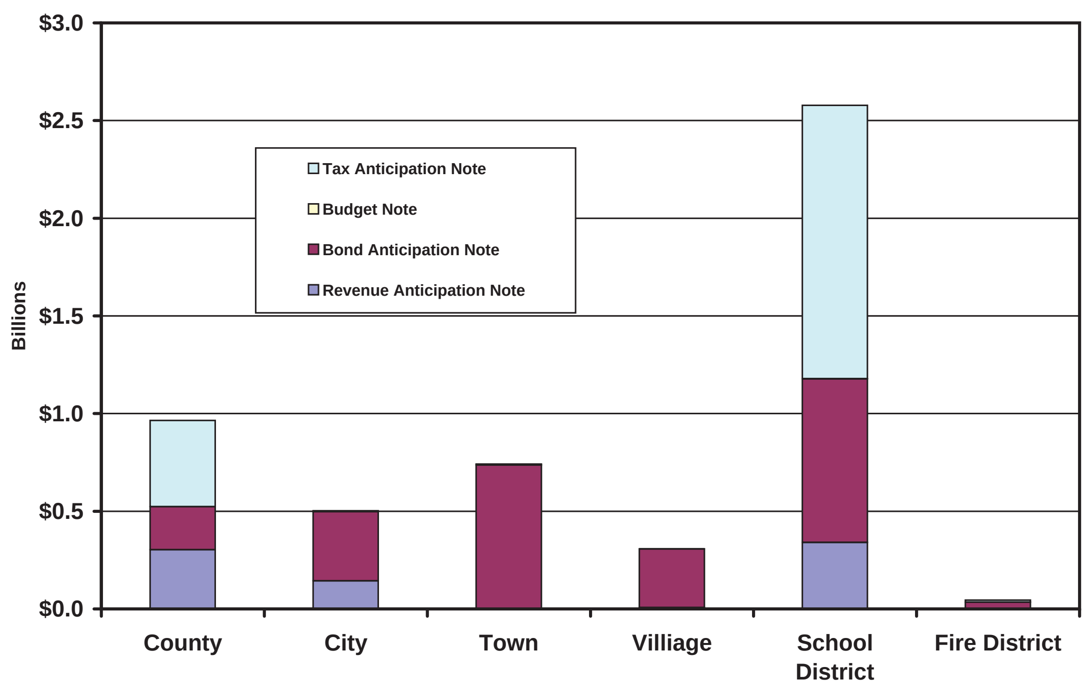
Thomas P. DiNapoli • State Comptroller

Short-Term Debt Issued by New York's Local Governments

Local governments (excluding New York City) issued $5.1 billion in short-term debt in 2007. Over half of this amount was issued by school districts, while counties (19 percent), towns (14 percent), cities (10 percent), villages (6 percent) and fire districts (1 percent) accounted for the remainder. Bond anticipation notes (BANs) represent the largest type of short-term debt issued in 2007, totaling nearly $2.5 billion of the $5.1 billion issued, followed by tax anticipation notes ($1.9 billion) and revenue anticipation notes (nearly $800 million).

The total amount of short-term debt issued has increased by nearly 17 percent between 1998 and 2007, from $4.4 billion to $5.1 billion. While the level of short-term borrowing peaked in 2003 at $7.0 billion, this was largely due to late State budgets that produced delays in school aid and other local assistance payments, and artificially increased the need for short-term borrowing. School district reserve levels also dipped to their lowest level in 2003, the same year short-term borrowing peaked.

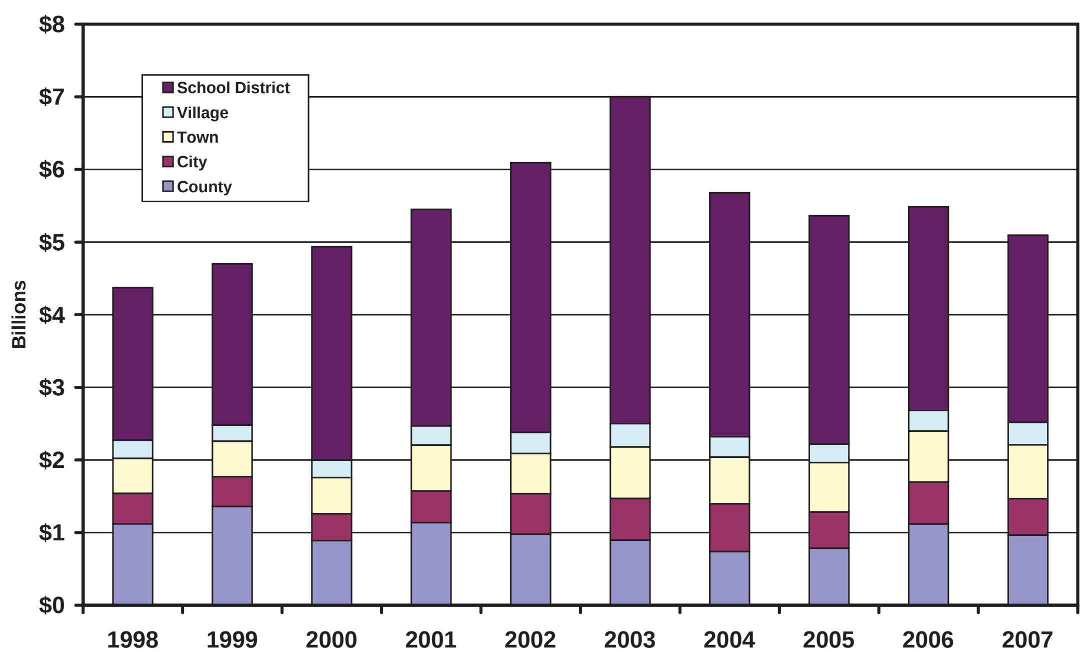
Short–Term Debt for New York Municipalities, by Type and Class, 2007



Since then, short-term borrowing levels have returned to more normal levels, although some of this decline is also attributable to large increases in State aid for schools, enabling districts to increase their reserves and decrease short-term borrowing.

Local governments typically issue TANs or RANs to meet seasonal cash flow needs. These notes are usually required to be redeemed within one year of issuance.[2] When revenues sensitive to economic conditions (e.g., sales taxes) decline, cash flow is impacted and borrowing needs typically increase. Without the ability to borrow, local governments could be faced with a situation where they are potentially unable to meet payroll or other operating expenses.

Short–Term Debt for New York Municipalities, by Class, 1998–2007



Frozen Credit Markets: The Case of Erie County

On September 24 and 25, 2008, the Erie County Fiscal Stability Authority (ECFSA) attempted and failed to sell $84.7 million in BANs and $75 million in RANs. The $84.7 million BAN sale would have funded major capital improvement projects that have been stalled for two years due to an impasse between the ECFSA and the County. The $75 million was essential for the County to finance operations after September 30th.

Faced with a situation where payroll and other expenses might not be met without an immediate infusion of cash, the County borrowed the $75 million in a negotiated transaction with a bank. However, this transaction will cost County taxpayers an additional $1 million because of higher interest rates on the loan.[4]

BANs are issued to finance capital expenditures for up to five years, and are then usually redeemed or replaced with long-term debt.[3] In the current environment, local governments planning to finance capital projects may be forced to delay projects until the market situation improves. These delays can result in increased construction costs and risks associated with deferred maintenance of facilities, roads, bridges, etc. However, for local governments that have already issued BANs and need to either renew their notes or convert them to long-term debt, the current market presents more immediate challenges. The municipality may be forced to issue long-term debt regardless of market conditions (with resulting higher costs), seek to obtain alternative financing or "roll over" the BAN with the current holder of the debt, or pay off the BAN using other resources. If these options can't be utilized, the local government may find itself at risk of default.

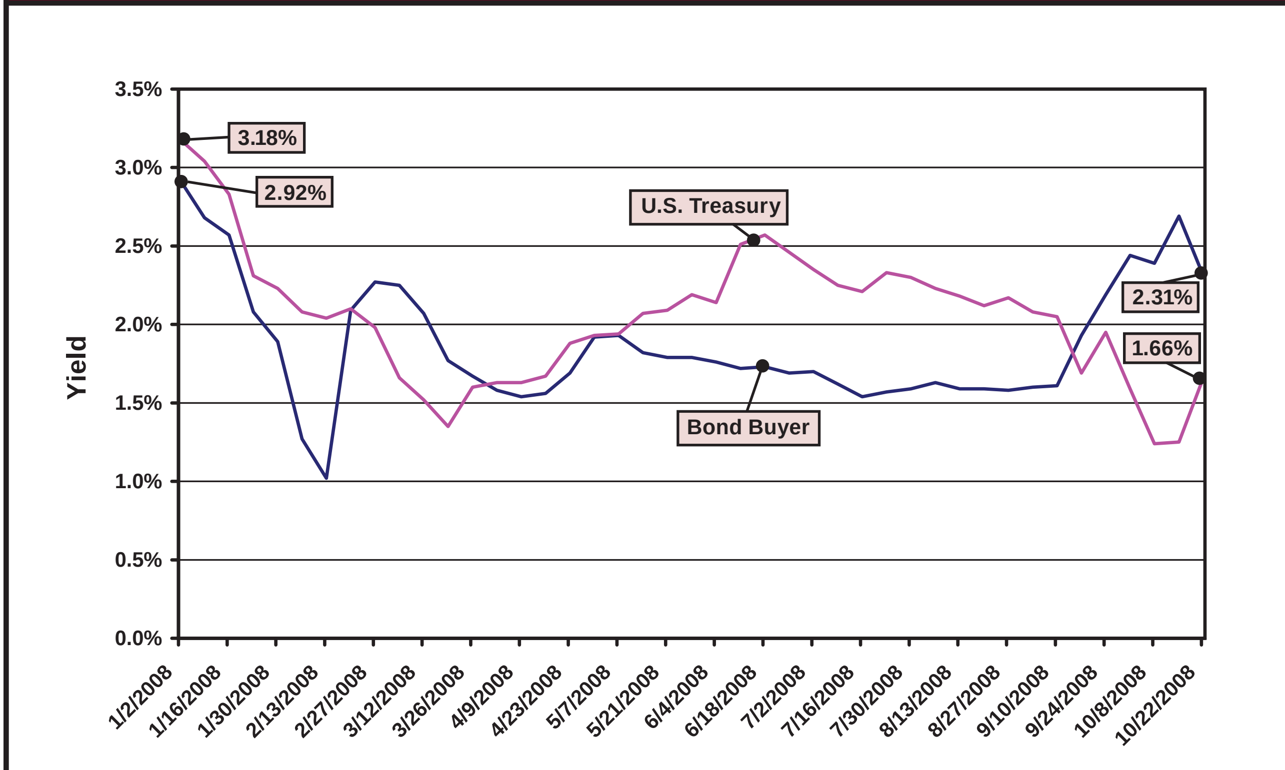
In New York, local governments can issue short-term notes using a competitive or negotiated process. Alternatively, local governments can issue notes through private sales to banks (also known as private placement debt).

Current Market Conditions

Beginning in September 2008, access to the municipal credit markets has been increasingly constrained due to a series of events in the financial sector which have decreased demand for municipal notes by banks and money market funds, and for municipal bonds by institutional investors who have historically been the primary purchasers of municipal debt. Bank and investment house failures, weakened balance sheets, and decreased need for the tax benefits associated with most municipal debt have all been contributing factors to this crisis. As a result, the volume of new municipal bond issues in September 2008 declined by 40 percent nationwide compared to September 2007, and over $11 billion in bond and note sales have been postponed.[5] Market volume has also been impacted by the limited availability of bond insurance,[6] and the weakening fiscal outlook for many state and local governments.

If the credit crunch continues, the market risks to local governments that rely on short-term borrowing will also continue. In a worst case scenario, a local government could be shut out of the market altogether. Those that have market access will likely pay higher interest rates – increasing repayment costs for taxpayers and squeezing already tight budgets.

Yield Trends: Bond Buyer 1–year Note Index vs. U.S. Treasury Constant Maturity Index



Note: Dates in the graph above correspond to the Bond Buyer index. The U.S. Treasury Index is updated weekly but the update occurs two days later. (1/2/08 Bond Buyer Index date corresponds to a 1/4/08 U.S. Treasury Index date)

Recent news articles and market data indicate that New York's local governments have successfully issued short-term debt on a competitive basis, despite the continuing market turmoil, although sales attracted a limited number of bidders and, in several cases, only one bid was received. Data analyzed by OSC point to a decreasing number of bidders, particularly for smaller issuers.[7] Anecdotal evidence indicates that some recent sales failed to attract any bidders.

On October 17, 2008, The Bond Buyer's One-Year Note Index was at 2.69 percent.[8] This represents a tax-exempt yield that was 144 basis points *above* the U.S. Treasury One-Year Constant Maturity Index at 1.25 percent – an indication of the level of market stress.[9] While the spread between these indicies narrowed to 65 basis points on October 22, the one–year note index continues to exceed the treasury index, reflecting the ongoing volatility in the credit markets. The impact of this is that municipalities have to pay an interest rate that increasingly exceeds the rate paid on U.S. Treasury bills (which are considered a safer investment) to coax investors into buying their debt, even though this debt offers a tax-exempt rate. Prior to the recent upheaval in the markets in mid-September, the one-year note yield according to the Bond Buyer index averaged 1.80 percent, or 33 basis points *less* than the Treasury index, which averaged 2.13 percent during this time period. California recently completed a large note sale with yields at upwards of 4.25 percent.[10] Market experts expect that these market conditions could exist for some time.

Recommendations

Until the current credit crisis abates, local governments and school districts should anticipate that access to the market will be more constrained and that issuing short-term debt could be more costly. To the extent possible, municipalities and school districts should review their cash flow needs and develop contingency plans in the event that market conditions delay a note sale. These contingencies should include exploring competitive, negotiated or private placement sale options, temporarily borrowing from other funds (where legally permissible), or restructuring expenditure patterns for cash flow relief. Local officials should also ensure that the revenues in anticipation of which RANs are issued remain adequate, and that an alternative source of repayment is available for BANs maturing in the near future if they can no longer be rolled over. Finally, localities should make sure that debt service costs are budgeted conservatively and budgets are modified to reflect accurately any higher costs.

Comptroller DiNapoli will continue to monitor the activity in the municipal bond and note market and explore potential solutions to assist local governments in an extreme situation where they may be shut out of the market with no alternative means to raise cash. In light of strained economic conditions and the uncertainty of how long access to the capital market will be constrained, New York's local governments and school districts should carefully re-evaluate their capital and cash flow needs in a proactive manner. Given the day-to-day volatility in the current market and the changing financial landscape, local officials should not assume that short-term debt can be issued without unforeseen problems.

Notes

[1] Many New York localities are small issuers who rely on privately placed debt with local or regional banks, and do not have a credit rating.

[2] Notes can be "rolled over" under certain circumstances.

[3] Generally, BANS can be issued or renewed for up to five years.

[4] Spina, Matthew. *Credit Crunch, delay add $1 million to loan cost.* Buffalo News. September 30, 2008.

[5] Philips, Ted. *In New York, Even Top-Rated Issuers Worry About Finding Bidders for Notes.* The Bond Buyer. October 6, 2008. Herman, Jack. *Observers see Possible Muni Boost from Bank Plan. The Bond Buyer.* October 15, 2008.

[6] Issuers can purchase bond insurance to raise the rating of the bonds which may result in interest cost savings. The credit ratings of many major bond insurers have been downgraded due to losses suffered in mortgage-backed securities insured by these firms. As a result, there is little benefit in purchasing bond insurance from these entities.

[7] Phillips. The Bond Buyer. October 6, 2008. OSC analysis of municipal market sales data from July 1, 2008 to present.

[8] This index is based on estimate yields for theoretical new one-year note issues from 10 state and local issuers.

[9] This index is based on the average yield, using the daily yield curve, of a range of Treasury securities, adjusted to the equivalent of a one-year maturity.

[10] Scharchilli, Michael. *Demand Surges for NYC GOs, California RANs.* The Bond Buyer. October 16, 2008.

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