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TOBACCO SETTLEMENT BONDS: THE EFFECT OF SECURITIZATION ON THE CREDIT OF THE STATES USING CAPITAL APPRECIATION BONDS

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ABSTRACT

Tobacco Settlement bonds have been issued by several states to obtain immediate cash from the funds that were awarded to them over time in the Tobacco Master Settlement Agreement (MSA) of 1998. The MSA provides monies in perpetuity to states to settle claims and lawsuits against the tobacco industry. Nine states, Washington, DC and two territories have chosen to cash in on the MSA payments by issuing capital appreciation bonds so that they may receive funds immediately and postpone any type of repayment out to 55 years. This paper critically analyzes how using capital appreciation bonds backed by diminishing future MSA revenue streams will inevitably lead to default and higher borrowing costs for all bonds for these states and municipalities.

Key Words: Tobacco settlement bonds, Capital appreciation bonds, Default, Securitization

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1. INTRODUCTION

This paper explores the looming consequences for nine states and three U.S. territories (Alaska, California, Washington D.C. Guam, Iowa, Michigan, New Jersey, New Your, Ohio, Puerto Rico, Rhode Island and West Virginia; “the 12”) that issued capital appreciation bonds (CABs) as Tobacco-Settlement bonds. The CABs in question all have the following specs: a) their maturity terms range from 29 to 55 years; b) they are frequently held with no insurance or are insured by a troubled company; c) they have no sinking fund; and d) the unusual structure of the CAB allows for compounding of deferred interest until the maturity of the bond. This “perfect storm” has fiduciary consequences for “the 12” as the payback of accumulated interest and principal will range from of 10.41 to more than 1,800 times the amount borrowed. This leads to the inevitable conclusion that many, if not all of the issuers, will default at some point in the future (Quigley, 2003).

While this has serious consequences for “the 12”, additional concern rests with Oppenheimer Rochester Funds which have 25% of their total holdings in these bonds resulting in a concentration in excess of $5 billion in these assets. Oppenheimer is carrying these bonds at cost rather than at their value at maturity. In the case of New York County’s Tobacco Trust V Bond, for example, the bond is carried at $3.845 million in value but matures in 2060 for $70.372 million, representing an increase of 51.9 fold. In addition, there is no disclosure that there is no mandated sinking fund or provision for repayment in the bonds (Estes, J). The Guiliano Law Firm Securities Arbitration Blog, in March 2011, stated that, “Investors suffering losses in the Oppenheimer Rochester Funds may have claims against their stockbrokers or financial advisors for failure to perform due diligence.” This statement followed a loss of 66% of the value in the fund in 2010. The majority of the municipal bonds held in the Oppenheimer Rochester Funds are capital appreciation bonds. This possible legal action is in addition to the current arbitrations against these funds for poor risk management during the 2008 financial crisis, per the securities litigation website.

2. BACKGROUND

In November 1998, after more than a decade of lawsuits and arbitration, the Tobacco Master Settlement Agreement (MSA) was reached between the attorneys general of 46 states and the major tobacco companies, (www.legacyforhealth.org). These tobacco producers, known as the Original Participating Manufacturers (OPM), agreed to settle Medicaid lawsuits and to provide states with money to cover tobacco-related healthcare costs and to promote tobacco prevention and cessation programs. The OPMs agreed to pay a minimum of $206 billion over 25 years. To date, part of the monies collected have been used to fund the American Legacy Foundation, an anti-smoking advocacy group, and to dissolve the tobacco industry’s self-serving and discredited institutions: the Tobacco Institute, the Center for Indoor Air Research, and the Council for Tobacco Research (Brescoli, 1986; Greene, 2000; Sullivan, 1996; *Tribune News Service,* 1998). In return for agreeing to the terms of the MSA, cigarette manufacturers were released from past, present, and future tort liability related to damages caused by smoking. Approximately 40 additional cigarette-related companies have signed the agreement since 1998 (www.legacyforhealth.org).

More recently, however, fewer and fewer states are using the money as it was originally intended, i.e., to promote tobacco prevention and to cover the tobacco related medical expenses that had been borne by the states and was the original basis for the lawsuit. According to the Campaign for Tobacco-Free Kids 2011 report on state tobacco prevention spending vs. state tobacco revenues, of the 12 states that issued capital appreciation bonds, only Alaska currently funds tobacco prevention and cessation programs at the level recommended by the Centers for Disease Control and Prevention (www.tobaccofreekids.org). One explanation for the downturn in support of the intent of the funding is the market crash and recession of 2008. When state revenues dropped precipitously, public officials needed a way to balance budgets, complete capital projects, and keep the state agencies running. In other words, they needed cash, and the 1998 settlement did not preclude states from using the money for purposes other than healthcare and education (Podkul, 2014). This led to the imperfect solution of issuing Tobacco Settlement bonds as CABs to enable the immediate influx of cash while postponing any repayment up to 55 years.

3. TOBACCO SETTLEMENT BONDS

As noted in *The Economist* (September 7, 2013), "Tobacco-settlement bonds are a tribute both to the inventiveness of bankers and the childlike impatience of politicians." With forecasts of extended uncertainty in the economy, several states chose to relinquish their future MSA payments in exchange for an immediate inflow of cash to the states' coffers. To do this, they securitized all of the tobacco proceeds they expected to receive from future settlement revenues, and in return, received a discounted lump-sum payment. Designed by some of the biggest banks and financial institutions in the country, including Barclays, Citigroup, JPMorgan, UBS, Morgan Stanley, Goldman Sachs and the now defunct Bear Stearns, the tobacco settlement CABs are "structured with a bewildering array of maturities, prepayment schedules and other special features that made them easier to sell, but hard for even determined analysts to evaluate and compare" (Walsh, May 4, 2014, *New York Times*). These investment firms made sure to pass on the risk to investors while at the same time securing large fees and commissions.

Capital Appreciation Bonds are municipal securities that do not adhere to long-time fiscal municipal norms and accountability controls (Estes, Fudge, & Van Wart, 2014). Unlike regular municipal bonds, which pay interest on a semiannual basis at the coupon rate over their entire lives and are generally issued for 10 to 30 year maturities, CABs are securities "on which the investment return of an initial principal amount is reinvested at the coupon rate until maturity, at which time the investor receives a single payment representing the face value of the bond and all accrued and compounded interest" (Fudge, 2013). In essence, CABs assign the rights to future income from settlement dollars in return for discounted rights to immediate funds (Estes, 2013; Estes & Sheil, 2015). Since CABs do not pay periodic interest payments like typical municipals bonds, there are neither periodic payments to investors nor sinking fund payments to retire the bonds, and therefore no debt service to report on budgets (Ayala, 2013).

CABs often look attractive to cash-strapped states and municipalities because they are carried on their books at their principal value (the discounted amount at which they are first issued). The purchase price, which is much lower than the ultimate payout, reflects the risk of a bond maturing in up to 55 years, the decreasing revenues supporting the bonds, the lack of sinking fund requirements, and the absence of regular interest payments to the bondholders for the life of the bond (Estes, J). The potential for fiscal disaster comes at the bonds' maturity when the payoff costs and accreted values are factored in; the face value of the bond (not the discounted amount) and all accrued and accumulated interest (Adelmann, 2013; Lusvardi, 2012). With their long delayed paybacks (up to 55 years) and their ability to accrue interest on the interest, CABs go from attractive to fiscally terrifying quickly as the benefit of the money received is dwarfed by the money that must eventually be repaid. CABs are often pejoratively described as "surprise" loans because the amount due can be 10 to more than 100 times the size of the original bond (Adelmann, 2013). In one case the payback is over 1800 times the amount borrowed. By contrast, a normal payback for a municipal bond is 2 to 3 times the amount borrowed by the municipal bond issuer.

CABs are similar in nature to zero coupon bonds in that the bonds are paid off at maturity. The difference, according to the Municipal Securities Rulemaking Board (MSRB), is that the initial amount of funds received by the issuing entity is considered to be the principal amount for a CAB, while the value at maturity is considered to be the principal amount for a zero coupon bond (http://www.msrb.org/Glossary.aspx). Further, in zero coupon bonds there is no expectation of compounded interest in the future, investors earn a return by simply purchasing the zero coupon bond for the discounted value of funds to be received in 30 years. Fortunately, most of the tobacco settlement bonds are not issued as capital appreciation bonds. Only "the 12" have chosen to utilize CABs as an investment vehicle to receive immediate funds from the tobacco settlement. The face amount of the bonds issued is $22,604,520,000 with only $573,180,000 received by the states issuing the bonds after the discount leaving a total amount to be repaid of $67,134,019,000 at maturity. Considering the difference between the funds received and the amount to be repaid at maturity for the total of the outstanding tobacco settlement bonds issued, "the 12" will be forced to repay an average of over 117 times the amount received. While these CABs represent only a small portion (8.3%) of the total tobacco bonds outstanding, the rest are normal municipal bonds, they represent a very significant future liability for "the 12" (Estes, J).

Initially, an investor may believe that the risk for default is mitigated by the insurance on these bonds. Further compounding an already serious problem is the simple fact that this is not true. The selection of the carriers and the problems these carriers are experiencing undermines this assumption. According to the Reuters Data Base eMAXX, of the three insurance providers used by California, the only state to pay for any insurance on their tobacco CABs, one is in Chapter 11 bankruptcy, one is undergoing mandated restructuring by the Maryland Insurance Commissioner, and the other has a credit rating of only AA-. The total insured represents only 10.7% of the bonds issued by California and less than 0.1% of the total outstanding tobacco settlement bonds. When insurance is provided, it is in tiny amounts and is issued by insurance companies with questionable longevity.

Almost all of the bonds (96.8%) have a call provision, but only 57.1% have a provision for a sinking fund (Estes, 2013). Some bonds include a "turbo redemption" feature that requires tobacco settlement payments not used for debt service in any given year be used to accelerate the debt's retirement (Albanese, 2004). However, enticing as this sounds to an investor, the turbo provision also includes a proviso found well toward the end of the offering statement that indicates if the state does not redeem the bonds any failure to make the "required" turbo payments shall not be considered a default on the bond (Podkul, 2014). In addition, many states and counties set up tobacco settlement agencies to act as remote bankruptcy corporations in an attempt to distance themselves from potential lawsuits and other liabilities arising from activist bondholders. At the same time, these agencies are used to transfer funds to state budgetary control. In reality, these faux corporations do not shield the states from liability, but are simply a thinly disguised conduit for states' general funds to receive the small amount of capital from the bond issue.

Since often no money is being set aside to refund or call these bonds, for the maturity values of these bonds to be repaid there will need to be another source of funding sometime in the future. Given the amount of capital required, the percentage needed to support a sinking fund, and the states' budgetary constraints, the likelihood of refunding these speculative investments is questionable, at best. However, while the few individual bondholders have little recourse when it comes to repayment, major institutional players and large investment firms are more than willing to play hardball with the states' credit ratings and integrity. For example, when Niagara County issued CABs in 2005, the county received $6.6 million upfront and agreed to pay back an astonishing $437 million upon maturity in 2060. By 2014, Niagara County determined that it needed to refinance its tobacco bonds at a lower interest rate, but Oppenheimer Funds filed a lawsuit to block the county from receiving any money for refinancing until the county paid off the investment firm's riskiest bonds (Prohaska, 2014). The bonds on Oppenheimer's books were valued at $1,782,960. The negotiated redemption paid to the company was $6,887,568 on an accreted value of $12,651,150 for a difference of $5,763,582. Thus, Oppenheimer was made whole on a very speculative investment. In an article from the *Buffalo News* (October 24, 2014), legislator Clyde L. Burmaster said, "We're going to do everything we can to pay off those people [Oppenheimer Funds] as long as I'm president of this corporation" [the Niagara Tobacco Asset Securitization Corporation].

4. LOOMING DEFAULT

Predictions from Reuters and the Wall Street credit agency, Fitch, indicate that the majority of tobacco bonds issued by U.S. states, counties, and cities will default if cigarette consumption keeps falling at a 3 to 4 percent annual rate (Gralla, 2012). In addition, Moody's Investor Services has placed more than $20 billion of municipal bonds backed by tobacco settlement funds from the MSA under review (January 22, 2013). Moody's analysts list the accelerated decrease in adult U.S. smokers, which is reducing the amount of money the states receive, as a key concern for these bonds. Compounding this fall in revenue is that total sales for vaping are projected to top $3.5 billion in 2015 per Todd Slater in an article in Vaper Authority. Further, he points out that statistics highlight the inverse relationship between vaping and cigarette usage:

> "In 2012, 200,000 packs of disposable electronic cigarettes were purchased in the United States, while 14 billion packs of traditional cigarettes were sold. Two years later, the total sales of electronic cigarettes doubled to 400,000 packs, while tobacco cigarette sales decreased by 1 billion packs over the same period. Top market analysts now forecast tobacco sales to continue to decline by more than 68% over

> the next 10 years, while e-cigarette sales will increase 10 fold over the same period."

Given the increasing use of vaping products and the observed inverse relationship between vaping and traditional cigarettes, increasingly, states are lobbying for the inclusion of vaping under the MSA in order to secure a piece of the increasing vaping revenue to offset the currently rapidly declining traditional tobacco revenue. However, they have been unsuccessful to date so states are turning to vaping industry-wide regulation. According to a recent 2015 online Reuters/Ipsos poll of 5,679 Americans, about 10 percent of U.S. adults now vape. That is almost four times higher than a 2013 U.S. government estimate of e-cigarettes use by 2.6 percent of adults. Thus, the retirement of the securitized tobacco settlement payments will require a growing percentage of tobacco sales revenues, which are on a steep and accelerating decline.

5. FROM SECURITIZATION TO GENERAL OBLIGATIONS

Given the challenges inherent in these bonds, many states have transitioned these tobacco CABs into general obligation bonds. Both Virginia and Ohio have already been forced to move funds from their debt reserves in order to meet interest and serial bond repayments for tobacco CABs. While New Jersey set aside 76% of the tobacco-settlement revenue on a one time basis in 2007 to retire existing tobacco settlement bonds in order to continue to sell new bonds, by 2014 revenues were short and the state could no longer cover the bonds' interest and principal payments (Sloan, 2014). If future tobacco sales continue to decline at this rate, the state of New Jersey will be unable to retire a $673 million bond with a tax-free coupon of 4.75%, until 2055—21 years late (Farrell, 2011). A recent article by Spencer Jakab in the Wall Street Journal stated that Americans consumed an annual average of 4,123 cigarettes 40 years ago, compared to an annual average of 850 cigarettes today.

With the increasing likelihood and perhaps inevitability of default, some of "the 12" are considering moving their newer issue CAB's to general obligation (GO) bonds, placing the states' "good faith and credit" directly behind these bonds. This could lead to serious problems (Fuerbringer, 2002). According to the Federal Reserve Bank of Boston, "Coupled with other indicators, the sale of tobacco bonds for deficit financing may adversely affect a state's overall credit rating," (Quigley, 2003). States like New Jersey are already grappling with this problem. For example, Standard & Poor's downgraded New Jersey's taxpayer-backed debt indicating that the "state's reliance on one-time measures" would add pressure to future budgets (Podkul, 2014). Furthermore, while the state of New Jersey increased its pledge of receipts from the MSA to debt service which helped to improve the credit rating on the revised bond issue to an 'A', at the same time, it drove the state's credit rating down. S&P downgraded New Jersey to a C credit rating which has major implications for the state's ability to borrow money in the future. Moreover, simply delivering basic civil services may be compromised because of the perilous situation in which these states have placed themselves. The ultimate loser, in these cases, are the taxpayers.

New York, Minnesota, and California, all of which have bills pending to allow the conversion and issuance of Tobacco Settlement bonds as GO bonds, have been warned by Moody's that should this occur, they would receive the same credit rating reduction as New Jersey. None the less, California, is proceeding with a bill to allow making new issues of the capital appreciation bonds a general obligation of the state. These issues are further emphasized in a white paper published by the Campaign for Tobacco-Free Kids:

> "States that use securitization funds to address budget deficits may also have their credit or bond ratings downgraded because securitizing eliminates a substantial future state revenue stream in exchange for a one-time budgetary band-aid that does nothing to address underlying state revenue and expenditure problems" (www.tobaccofreekids.org).

States are using tobacco funds for purposes other than prevention and cessation programs. While it is true there is no requirement that the funds be used as intended, it seems only logical that some acknowledgment for the purpose of the money be exercised through clear public disclosure. There are several states that have allocated no funding whatsoever from the billions received to prevention programs. These include the states of New Hampshire, New Jersey, North Carolina, and Ohio. In addition, Washington has elected to cut its tobacco prevention programs by 90% while Maryland has reduced its prevention programs by 75% for 2013. The most blatant example of the misuse of the tobacco settlement funds is North Carolina which gave $42 million of the settlement funds to market tobacco and modernize the tobacco curing process and an additional $200,000 of the settlement funds to the Carolina Horse Park, an equestrian center near Pinehurst, NC (Eucalitto, C., April 15, 2013).

6. A DARK OUTLOOK FOR THE BONDS

The overall rating for the tobacco settlement bonds has been dropping. In California, the bonds are rated BBB+, which is a concern for an upcoming new issuance by the Golden State Tobacco Securitization Corporation (GSTSC). To combat this concern, the state director of finance will request the governor to include an appropriation for the full amount of debt service and operating expenses due in the next fiscal year in the annual state budget. Thus, the rating will be based on the credit quality of the state of California, whose general obligation bonds are rated 'A-' with a positive outlook by Fitch. This will effectively convert the tobacco settlement bonds to a general obligation bond and insure that their rating will track with the State of California's A- rating with a positive outlook. With revenue from bonds continuing to decline, "the 12" are looking for ways to maintain their credit rating on existing bonds in order to allow for the refinancing of the existing bonds with new issues. Issuing any new CAB's as General Obligation bonds would place the full faith and taxing ability of the state of California behind the new CABs negating the revenue generated from the MSA as the source of payback. While it is difficult to assess the impact of California's eight-year term limits or of the simple fact that few of the legislators making the decision to convert the CABs to general obligation status will be alive in 55 years (at maturity), it does bear consideration. This lack of accountability, in the opinion of the authors, is definitely a factor in the decision to obtain more cash now from a higher rated bond issue backed by the general obligation of the state at the expense of future taxpayers.

According to HJ Sims Company, a nationwide broker-dealer, Moody's downgraded $3.5 million of long term tobacco bonds from Baa3 to a range of B1 through Caa1. This dramatic change in long term bonds could lead to a series of lawsuits against firms like Oppenheimer Rochester Funds whose tobacco bonds lost 66% of their value in 2010 (Guiliano, 2011). It is not unthinkable that stockbrokers and financial advisors might be sued for failure to perform due diligence. The majority of the municipal bonds held in the Oppenheimer Rochester Funds are capital appreciation bonds, and the fall in their value reflects the rating downgrades, revised settlement agreements, and resulting values. Compounding the challenge of sustainable tobacco cash flows is the proposal by President Obama to increase the tax on cigarettes from $1.01 to $1.95 per pack. The result, according to Kenneth Shea, a senior tobacco analyst at Bloomberg, would cut consumption by 12%. When this is added to the already downward slope of cigarette sales it clearly does not bode well for any continuous sustainability of tobacco cash flow.

The impact of duration, a measure of the sensitivity of the price of the bond to a change in interest rates expressed in years, on these mutual funds in the event of an increase in interest rates can be calculated by multiplying the duration by the increase in interest rates. This number will approximate the percentage fall in the retail value of the bond. Since a major factor in duration are the periodic payments received on the bond and since these bonds have no payments for the life of the bond, the effect of any increase in interest rates would be catastrophic on the two Oppenheimer Mutual Funds holding the majority of these bonds.

For example, if a bond has 40 years until maturity and the interest rates increase by 2%, the fall in the value would be approximately 80% from the current market value which is less than 15 cents on the dollar. This would reduce the value of the bonds to the neighborhood of $30 per bond, well below the issue value and force Oppenheimer to mark the bond to its market value. The authors believe that this could have serious legal and regulatory ramifications for Oppenheimer and those states and territories issuing the bonds, forcing full disclosures of the process and consequences of having taken this path to raise capital.

7. DISCUSSION

Is it any wonder that tobacco settlement bonds issued as CABs are sold at deep discounts and carried on the books of the investment banks at their discounted principal values? There is an inherent and obvious risk for both the state and the investor when assumptions are not calculated correctly. For years after the MSA was signed, it was assumed and generally accepted that cigarette volume would decline slowly, at a rate of less than 2.0% annually. Based on this assumption, California issued $4.1 billion in tobacco bonds in 2007 and assured investors and the legislature that the debt would be retired on time in 2047. Two years later, cigarette sales in California had dropped 9.3% due in part to both stricter antismoking laws and higher taxes. As cigarette sales plummeted, so did tobacco settlement payments, by 16.4%, netting the state $1.7 billion less than expected (Farrell, 2011).

By November 2010, rapidly falling demand for cigarettes pushed Standard & Poor's to downgrade 51 tobacco bonds in 16 states to junk status. The chief analyst at Herbert J. Sims & Company, has predicted that if tobacco payments continue to decline by 4 percent per year, full-blown defaults will begin in 2024, when Ohio will be about $350 million short on $1.1 billion of tobacco bonds scheduled to mature (Larkin, 2014).

8. CONCLUSION

CABs are not, and never will be, a good idea for states, municipalities and investors. They are fundamentally very risky financial instruments that seduce public officials into gambling away future revenues for an immediate influx of small amounts of cash to state coffers with no accountability for those decisions in the future. Nowhere in the review of public documents is there any indication or recognition of the oxymoronic assumption of expecting a certain level of tobacco settlement payouts for decades to come, while at the same time, initiating anti-smoking measures to effectively reduce smoking.

With the lump sum netted from the tobacco settlement bonds, "the 12" examined in this paper were able to, in some cases, retire debt, and fulfill a wish list of projects, but at a huge cost to current and future taxpayers. New Jersey and New York have had to dig into special tobacco-bond reserves to pay bondholders. Many analysts consider this to be a "technical default because it effectively means the bondholders are being paid with their own money" (Walsh, 2012).

Not only are the tobacco settlement bonds in danger of default, perhaps as early as 2024, as suggested by bond analyst, Richard Larkin, but several states are actually discussing the possibility of making these tobacco settlement bonds general obligation bonds. This would put taxpayers and the states on the hook for the total value of the bonds while giving a huge boost to those entities holding the bulk of the CABs, such as Oppenheimer Funds. The consequence of this decision is the removal of additional monies from the general fund thereby reducing the money available to meet existing state obligations. Why would states do this?

In discussions with Governors and States' Attorney Generals, Pro Publica found that none of them wanted a bond default "during their watch" (Podkul, 2014). Reasons cited varied from the effect on future borrowing ability and increased interest costs to damaged relationships with the bond underwriters and bond brokers who handle their new bond issues. Regardless of the logic or reasons given, the probability of a default without some version of a state backed guarantee is high and any type of guarantee would involve taxpayer funds. Left unattended, these festering CABs will have a detrimental effect on the states' credit ratings and will likely necessitate a tax increase to pay the costs of a new bond issue to refund the outstanding tobacco settlement bonds.

Herbert Simon (1916 – 2001), the Nobel prize-winning economist, in his seminal research on organizations, coined the term "satisficing" to describe a decision making process that a group undertakes to solve an organizational problem (Simon, 1956). As soon as the group finds an available alternative to the problem that meets a low-level threshold of acceptability, the group stops searching. The group thereby gives up the possibility for the optimal solution and settles for the expedient solution. It is not a far stretch to say "the 12" that issued Tobacco Settlement bonds as CABs thought they had found the optimal solution to their states' needs. Instead, they capitulated to a "satisficed" alternative based on expediency, too-good-to-be-true packaging by investment firms, and poorly analyzed assumptions, which will eventually lead to default, and possibly, malfeasance by public officials if alternative solutions are not found.

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