

December 2008

# GOVERNMENT BOND ISSUANCE IN THE STATE OF ALABAMA

## A Case Study of Monitoring Options



## Introduction

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Based on recent events over the issuance of sewer bonds in Jefferson County, government entities in Alabama face a crisis in restoring investor confidence at a national level. As New York Times noted, “Jefferson County is teetering on the brink of bankruptcy after a series of exotic bond deals that the bankers concocted went wrong, and the interest on its debts, rather than shrinking as the bankers had promised, has ballooned like a bad subprime mortgage.”<sup>1</sup> The Mayor of Birmingham and other notable leaders were recently arrested by the Federal Bureau of Investigation in connection to these events. Investor perceptions have also been scarred as the result of the local government bankruptcies of Greene County and the Town of Millport. As a result of these events, government entities in Alabama are finding it more difficult to obtain a favorable bond rating and market their bonds. The bottom line is that higher interest rate for municipal debt issuances, as a result of misguided perceptions, necessitate a higher burden on the State’s taxpayers to repay the debt. From this accord, the happenings of Jefferson County impact other governmental entities within the State of Alabama. As a result, the need to restore confidence remains paramount.

In many respects, the fact that access to the bond market is more restrictive and costly for Alabama governments could not come at a worse time. Local governments are facing huge financial challenges under conditions of soaring health care and pension costs, increases in services to the aging, mandated public safety expenditures, and infrastructure replacement and maintenance. Despite this reality, the State has the potential to create an environment that maintains economic vitality, strong fiscal/debt management, transparency, and accountability to the citizenry and investors, alike. Strengthening state-level financial oversight will result in a favorable outcome within the market.

According to the Securities Industry and Financial Market Association, municipal bond investors are paying greater attention to the underlying ratings of governmental issuers. In assigning a rating, the agencies (Moody’s [Mergent], Standard and Poor’s (S&P), and Fitch ICBA) assess a government’s ability to pay the principal and interest on debt by evaluating its economic base, financial condition and practices, debt factors, governance and planning. A further, and significant, factor is a state’s oversight of local government financial management practices. According to Moody’s, “strong financial management practices in a state may mitigate the [effects of other factors, such as] concentrated economy”.<sup>2</sup> In 1994, the Securities and Exchange Commission issued guidance promoting the use of State Information Depositories, which are non-partisan and non-profit entities<sup>3</sup>. Furthermore, recent research has shown that states have an additional vested interest in their own, as well as their localities’ financial management and performance, since weak local performance (lower bond ratings, municipal bankruptcy, and fiscal stress) can have a negative effect on the state’s overall bond ratings, as well as other localities within the state.<sup>4</sup> From this perspective, central oversight plays a critical role in reducing the cost of debt.

Currently, there is no real financial monitoring statutory oversight in place within Alabama. For example, only the State’s 67 counties and a few local school boards are audited by the Examiners of Public Accounts. The primary exception to limited state-level oversight is the Alabama State Department of Education’s Local Education Agency Financial Assistance division, which was created in response to the 1995 Alabama Education Accountability Act (Act 95-313). This division,

under the direction of the Assistant State Superintendent of Administration and Financial Services, administers the financial monitoring of 130 local boards of education. Annual budgets and audits are reviewed for compliance. Debt issuances are pooled and debt payments are monitored by agency personnel. Given these unfavorable oversight conditions and the current bond market crisis, the Director of ADECA charged Auburn University at Montgomery's Center for Government and Public Affairs to explore exemplary practices within other states.

## Case Study

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The origins of state-level oversight trace back to the New York City financial crisis of 1973, the Advisory Commission on Intergovernmental Relations stated that, at a minimum, a state agency or commission should be designated to have oversight authority in addressing current fiscal practices employed by local governments. Since this time, many states have adopted measures that would increase financial transparency and accountability through the creation of oversight authorities. These organizations may promote a wide range of practices from a uniform chart of accounts, debt management, financial trends monitoring, to implementing corrective actions when an entity receives a qualified or adverse audit opinion. These steps extend beyond traditional practices currently being applied within the State of Alabama, such as adherence to generally accepted accounting principles, adoption an annual budget, or adhering to recommended cash and debt management procedures.

According to the report "State Programs to Assist Distressed Local Governments", conducted by the National Conference of State Legislatures, 87% of the states require that local governments submit their audited financial report to the states and 42% made the submission a condition of receiving state aid.<sup>5</sup> Further over half of these states require public authorities and other entities that issue moral obligation debt to report to the state agency on an annual basis. For example, New York and Tennessee both require any local entity, as established under state law, which issues debt or receives state or federal pass-through funding to file financial reports as a condition of receiving aid. Utah additionally requires non-profit agencies who receive more than 50 percent of their revenues from state governments to report on an annual basis to the State Auditor. State agencies responsible for reviewing Local Government Financial Reports varies widely by State: 24%- rely on State Auditor, 22%- State Finance / Administrative / Treasury Dept., 10%- Department of Revenue / Tax Dept., 8%- Legislative Agency / Auditor, 8%- Dept. of Community Affairs.<sup>6</sup> Financial oversight and governance plays a critical role in the quality of a State's underlying bond rating.

As of February 2008, nine states received Aaa bond ratings from *Moody's*, the rating judged to be the highest quality, with minimal credit risk. These states are Delaware, Georgia, Maryland, Missouri, North Carolina, South Carolina, Utah, Vermont and Virginia. To quantify these bond ratings, *Moody's* (Mergent) municipal bond yield averages on long-term bonds for December 2006 were 3.76 for Aaa; 3.99 for Aa, and 4.14 for A bond ratings.<sup>7</sup> As demonstrated in **Appendix A**, unrated and uninsured bonds, which are prevalent in Alabama, result in even higher-than-average interest rates on debt issuances. In the case of Millport and Greene County this fact held true both prior to the municipal bankruptcy and after the municipal bankruptcy was declared. To demonstrate the costs associated with receiving an unfavorable rating, Table 1 reflects the payback and interests costs associated with a \$50,000,000 standard bond issuance involving biannual payments over a 30 period

(excluding coupon payments and administrative costs). The difference in interest costs between an Aaa rated bond and C rated bond under these assumptions is \$66,482,202.

**Table 1- Payback and Interest Costs on a Hypothetical \$50m Bond Issuance**

| Rating | Payments | Interest | Total Payback | Interest      | Present Value of Payback |
|--------|----------|----------|---------------|---------------|--------------------------|
| Aaa    | 60       | 3.76%    | \$152,864,339 | \$102,864,339 | \$25,946,137             |
| Aa     | 60       | 3.99%    | \$163,569,732 | \$113,569,732 | \$27,763,196             |
| A      | 60       | 4.14%    | \$170,945,192 | \$120,945,192 | \$29,015,056             |
| Baa    | 60       | 4.34%    | \$181,289,899 | \$131,289,899 | \$30,770,895             |
| Ba, B  | 60       | 4.60%    | \$195,662,693 | \$145,662,693 | \$33,210,434             |
| Caa/Ca | 60       | 4.75%    | \$204,458,368 | \$154,458,368 | \$34,703,351             |
| C      | 60       | 4.99%    | \$219,346,541 | \$169,346,541 | \$37,230,366             |

Since the rating agencies have placed heavy emphasis on the fiscal management policies and structures of state and local governments, this study focused on exemplary models of municipal finance oversight utilized in North Carolina, Georgia, and Virginia. All these states receive the highest credit ratings from all three rating agencies and place emphasis on debt management, as well as fiscal policies.

### **North Carolina**

North Carolina’s Local Government Commission (LGC), a division of the State Treasurer’s Office, was created in 1931 to help address the problems in local government finance caused by the depression. The oversight system has two principal components: 1) control over debt issuance and 2) budgetary and fiscal oversight authority. North Carolina’s LGC has been credited with strong credit ratings at both the state and local government levels. Presently, North Carolina is the only state legally responsible for the issuance of all local government debt. The LGC directly issues and approves the sale of both state and local government debt instruments and sells all general obligation bonds competitively. Local governments can privately place enterprise bonds and certificates of participation with an underwriter after the LGC enters into a bond purchase agreement/acceptance contract. The LGC also maintains the bond records, register of bonds, and monitors the debt service payments, as well as issues a newsletter, called *The Bond Reporter*, to the public on a monthly basis.<sup>8</sup>

According to research, approximately 25% of the nation’s AAA rated local governments are found in North Carolina - more than any other state. According to Fitch, “...as a result of the LGC” bonds that would normally receive a BBB typically receive a BB rating under the current LGC oversight structure.<sup>9</sup> Lawrence finds the North Carolina local government interest savings were approximately \$6.75 million in 2005 with \$7.5 billion in outstanding bonds and installment purchases rated.<sup>10</sup>

### **Georgia**

The Georgia Future Communities Commission GFCC was temporarily created for the purpose of “...examining governmental, social, and economic issues confronting local governments; to assess

the future implications for community and economic development if current negative trends in our cities and counties are not corrected.<sup>11</sup> GFCC recommended, to legislature, that financial oversight responsibilities should rest with the State Auditor and Department of Community Affairs (DCA). DCA is charged with collecting and publishing financial and non-financial indicators for communities with annual expenditures greater than \$250,000. These reports include the revenues, expenditures, assets, and debts of all funds and agencies of the local government, and other such information as may be reasonably requested by the Department.<sup>12</sup> Further, each local independent authority is also required to submit an annual report of indebtedness to the DCA.<sup>13</sup> Using the annual reports as well as the related qualitative information, the DCA prepares an annual Report on Local Government Finances for all Georgia local governments as well as a Report on Indebtedness of local independent authorities. These reports are available on the department's website.

GFCC also sought to improve government accountability by making financial information reported by Georgia's local governments more comparable and granting the DCA and the State Auditor requisite authority to develop a uniform chart of accounts for the local governments in cooperation with the Georgia Municipal Association and the Association County Commissioners of Georgia.<sup>14</sup> The Nonprofit and Local Government Audits Division, within the State Auditor's office, is responsible for review of annual audit reports. If the report contains any findings or recommendations, the local government is also required to submit written comments on the findings and recommendations, including a corrective action plan, to the State Auditor for review. Local governments which do not submit acceptable audit reports to the State Auditor are subject to the provisions of state law that "No state agency shall make or transmit any state grant funds to any local government which has failed to provide all the audits required by law within the preceding five years." Another unique aspect to Georgia is that it is one of only three states in the country that expressly prohibits any of its local governments to file for Chapter 9 bankruptcy protection.<sup>15</sup>

### Virginia

Virginia is currently in the process of developing a monitoring infrastructure. For instance, within the Department of the Treasury, the Virginia Public School Authority (VPSA) provides financing to local school districts in Virginia by using the proceeds of its bonds to purchase a "pool" of general obligation bonds from localities and, in turn, each locality uses the proceeds to finance capital projects for public schools. In the event of a default of any Local School Bond, a "State Aid Intercept" provision provides for a diversion to the holder of its local school bonds of all funds appropriated and payable to the Local Issuer by the Commonwealth.<sup>16</sup>

Concerning financial procedures and indicators, the Auditor of Public Accounts, a legislative fiscal agency, compiles data from the audited financial statements of the local governments.<sup>17</sup> All counties and cities must comply with this requirement, as well as all towns with populations of 3,500 or more. The Auditor of Public Accounts prepares and publishes statements showing in detail the total and per capita revenues and expenditures of all localities for the preceding fiscal year. This report, *Comparative Report of Local Government Revenues and Expenditures*, details the debt expenditures of each locality as well as the outstanding debt at the end of the fiscal year. As far as municipal bankruptcy, Virginia does not specifically authorize any municipality to file for Chapter 9 protection; thus, the federal courts interpret the lack of "specific authorization" in state law as prohibiting municipal bankruptcy filings. **Appendix B** provides a summary of differences between these three states and Alabama. **Appendix C** reflects the composition of oversight boards in terms of membership.

## Conclusion and Future Research

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All three of these options provide viable policies that can be further studied to enhance the municipal finance system in Alabama. Leveraging best practices of these model programs, the State of Alabama could implement a two-part program to address the issue and benefit the governments and citizens of the State.

First, the state could organize a working group to explore in greater detail the benefits and limitations of the various models being applied within the states. Based on this research, the State of Alabama could engage in specific action to restore investor confidence. The examples that follow illustrate how the state could implement some of the models discussed in the previous section:

- **North Carolina Model**, a statute is already in place in the Code of Alabama, 1975, §41-4-2 that gives the State Department of Finance general supervision over the finances of the counties, municipal corporations, political subdivisions and local public bodies in the state. By enforcing this statute to create an additional division within the Department of Finance, the department could opt to receive and review annual budgets and annual audits of local governments, contact local officials on audit findings to determine how the deficiencies were handled, approve local government debt issuances, and monitor repayment of debts for likelihood of default. This office could also create and administer a financial indicator system.
- **Georgia Model**, an Alabama Future Communities Commission could be created to study and discuss the various state models in place and determine, both from a local and state management perspective, what accountability practices need to be put into place as well as the best cost-benefit model that would benefit all of Alabama's local governments. This commission should consider municipal finance from the ground-level with a uniform accounting system, a department or commission designated to receive annual audits, appropriate debt disclosure documents and continuing monitoring of the debt issuances, fiscal health monitoring and financial and non-financial indicators, and fiscal stress procedures to follow when a municipality cannot meet certain criteria such as defaulting on debt payments; unable to meet payroll; unable to remit statutory payments to other municipalities and/or the state; and continuous deficit spending.

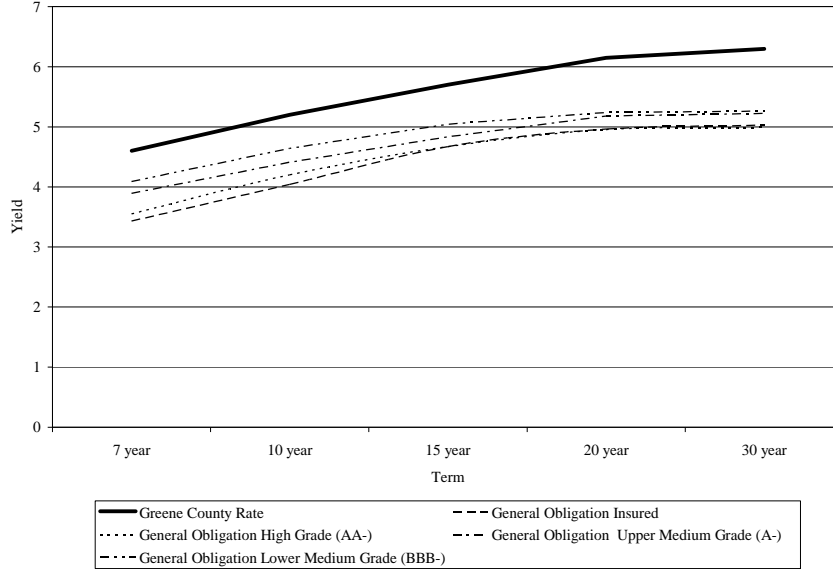
Second, the State could create an administrative office (or alternatively, partner with Universities) to provide research support to the oversight body. Duties of such an entity would be to:

- Collect and publish information relating to bond issuance costs (e.g., attorney fees, bond yields, and other terms and conditions).
- Maintain a central repository of financial data derived from CAFRs that could be used to perform financial trend monitoring assessments of local governments within the State.
- Coordinate stakeholders (e.g., business leaders, municipal leaders, members of professional associations) with an interest in ensuring transparency, debt and fiscal management, as well as accountability for local government finances.

The Center for Government and Public Affairs would welcome the opportunity to play a vital part in this effort by facilitating Commission meetings, gathering needed data to study, assessing other states financial practices, and conducting interviews.

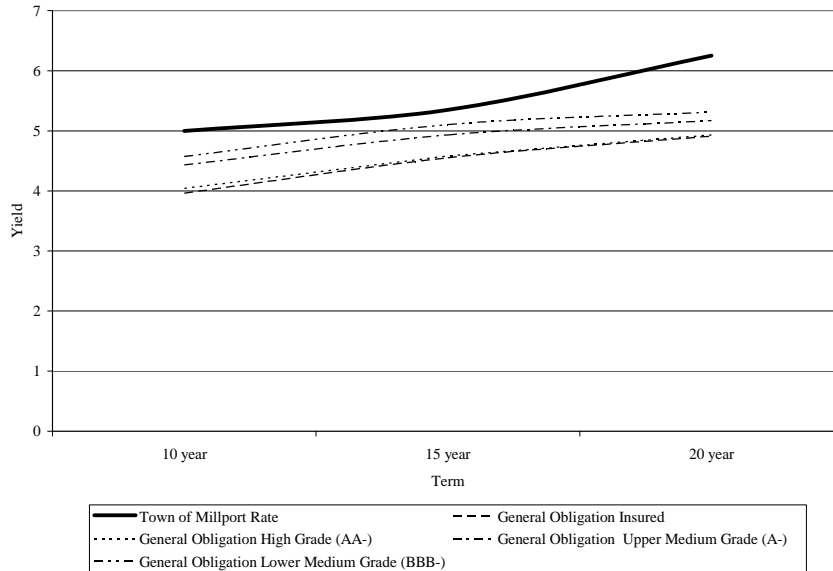
## APPENDIX A

### Greene County 2002 Debt Issuance Interest Yields (Fair Market Yield Curves at 8/1/03)



Source: Bloomberg Investor Services Database, May 2, 2007; Fair Market Yield Curves – Historical Comparison for August 1, 2003.

### Town of Millport Debt Issuance Interest Yields (Fair Market Yield Curves at 7/31/02)



Source: Bloomberg Investor Services Database, May 2, 2007; Fair Market Yield Curves – Historical Comparison for July 31, 2002.

## APPENDIX B- COMPARATIVE ANALYSIS OF MONITORING RESPONSIBILITIES

| State          | Fiscal Condition Monitoring    | Debt Issuance Monitoring       | Authorize Municipal Bankruptcy | Require Annual Audit           | Penalties Imposed / Consequences           | Publish Annual Financial Report    | Publish Bond Information      | Central Data Repository for Benchmarking |
|----------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|--|------------------------------------|-------------------------------|--|
| North Carolina | Yes                            | Yes                            | Yes                            | Yes                            | Yes  | Yes                                | Yes, see <i>Bond Reporter</i> | Yes                                      |
| Georgia        | Yes, if expenses exceed \$250k | Yes                            | No                             | Yes, if expenses exceed \$300k | Yes, withhold State appropriations         | Yes                                | Yes                           | Yes                                      |
| Virginia       | Yes                            | Partial, only school districts | No                             | Yes                            | Yes, State has authority to perform audit. | Yes, see <i>Comparative Report</i> | Yes                           | Yes                                      |
| Alabama        | Partial, only school districts | Partial, only school districts | Yes                            | Partial*                       | No   | Partial*, only counties            | No                            | No                                       |

\* Presently, under the Code of Alabama (1975), other financial practices that are required by the state include a stipulation that the county commission prepare and adopt an annual budget for that county (§11-8-3). Cities and towns are required to have an annual audit with the appointment of an independent, certified public accountant to review and audit the financial reports under Code of Alabama §11-43-85. Cities, towns, and all special authorities are not required to adopt an annual budget, but the Alabama League of Municipalities does encourage this practice. Counties, cities, and towns are required to report to their respective commission or council on their financial status under Alabama law. Counties are required by law to publish financial statements on a semiannual basis (§11-3-21). Cities and towns are directed to present the financial condition of the municipality to the council at least every six months (§11-43-84). Bond and debt statutory guidance is found under §11-81-5 through 11-81-20 and 11-81-22 through 11-81-33 for municipalities and counties, respectively. Currently, there is no reporting requirement by the municipality to the state of bond indebtedness or terms of contract.

**APPENDIX C- TYPE AND MEMBER COMPOSITION OF OVERSIGHT BOARDS**

| State          | Oversight Board Name   | Type of State Agency                       | Board Composition  | # of Administrative Staff   |
|----------------|--|--|--|---|
| North Carolina | NC Local Government Commission   | State Treasurer's Office                   | The Commission (LGC) has a nine-member board that directs its operations. The members are the State Treasurer, State Auditor, Secretary of State, Secretary of Revenue Department, three Governor Appointees, one Appointee by the President of the Senate, and one Appointee by the Speaker of the House. The State Treasurer serves as Chairman and selects the Secretary of the Commission, who oversees administrative personnel.  | Approx. 33 (40% of staff hold "Certified Public Accountant" licenses) |
| Georgia        | GFCC recommended that DCA / Nonprofit and Local Government Audits Division provide oversight | Dept. of Community Affairs / State Auditor | The GFCC was comprised of 35 members: nine private sector members appointed by the Georgia Chamber of Commerce; ten members of the General Assembly, five appointed by the Speaker of the House of Representatives and five appointed by the President of the Senate; five county officials appointed by the Association County Commissioners of Georgia; one county constitutional officer appointed by the County Officers Association of Georgia; and five municipal officials appointed by the Georgia Municipal Association. The chairperson was selected by the Governor from among the nine private sector members. | Not available / Not available   |
| Virginia       | VA Public School Authority (Dept. of Treasury) / No Oversight Board for Local Governments    | Administrative / State Auditor             | The State Treasurer, the State Comptroller, the Superintendent of Public Instruction or his designee, and five additional members appointed by the Governor constitute the VPSA Board. The gubernatorial appointees serve at the pleasure of the Governor for six-year terms (except appointments to fill vacancies are for the unexpired terms). The Governor appoints the Chair of the VPSA.   | Not available / Not available   |

## References

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- <sup>1</sup> New York Times. "High Finance Backfires on Alabama County." March 12, 2008. Accessed on November 27, 2008 at: <http://www.nytimes.com/2008/03/12/business/12bama.html>.
- <sup>2</sup> Moody's (November 2004); Moody's provides ratings coverage and analysis on 90% of public debt issued by state and local governments, hospitals, higher education institutions and other tax-exempt entities in the United States.
- <sup>3</sup> Rule 15c2-12, promulgated by the Securities and Exchange Commission<sup>3</sup> (November 1994) specifies that issuers of municipal securities must file annual information and notice of material events with central information depositories. The new rule introduced the concept of State Information Depositories (SIDS). While the new SEC rule does not require state to establish SIDS, they did indicate that "states can play a significant role in enhancing disclosure in the municipal securities market." The rule requires issuers to provide information to the SID, if one exists in the issuer's state. Although three states (Michigan, Texas, Ohio) have established SIDS- typically non-profit organizations, the SEC is currently considering a proposed rule change regarding the establishment of a continuing disclosure service of the Electronic Municipal Market Access system ("EMMA") (the "proposed rule change"). The proposed rule change consists of expanding EMMA to receive electronic submissions of, and making publicly available on the internet, continuing disclosure documents and related information from issuers, obligated persons and agents pursuant to continuing disclosure undertakings entered into consistent with Exchange Act Rule 15c2-12.
- <sup>4</sup> Advisory Commission on Intergovernmental Relations (ACIR) 1973, 1985; Spiotto, 1995; Baldassare, 1998; Tung, 2002; Honadle, 2003; Kloha, Weissert & Kleine, 2005; Deal and Bowling, 2009
- <sup>5</sup> Legislative Finance Paper #86, Mackey, 1993; Alabama, California, Delaware, Indiana, Mississippi, Nebraska, New Mexico, Oregon and Texas did not respond to the survey.
- <sup>6</sup> Alabama, California, Delaware, Indiana, Mississippi, Nebraska, New Mexico, Oregon and Texas did not respond to the survey.
- <sup>7</sup> Mergent Municipal and Government Manual (2007). A9-19.
- <sup>8</sup> <http://www.nctreasurer.com>; North Carolina General Statute 159-3; Coe (2007); Lawrence (2005)
- <sup>9</sup> Larkin, Schaub (1999) *State of North Carolina Local Government Commission – Credit Enhancement Program Review*, Fitch ICBA.
- <sup>10</sup> Lawrence, *Financing Capital Projects in North Carolina*, 2<sup>nd</sup> edition; Institute of Government UNC
- <sup>11</sup> HR 324; [http://www.legis.state.ga.us/legis/1995\\_96/leg/fulltext/hr324.htm](http://www.legis.state.ga.us/legis/1995_96/leg/fulltext/hr324.htm)
- <sup>12</sup> Georgia Code §36-81-8 (2008)
- <sup>13</sup> [www.dca.state.ga.us](http://www.dca.state.ga.us); <http://www.dca.state.ga.us/development/research/programs/debtIssuance.asp>
- <sup>14</sup> Uniform Chart of Accounts History; [www.dca.state.ga.us](http://www.dca.state.ga.us)
- <sup>15</sup> Georgia Code §36-80-5 (2008)
- <sup>16</sup> Virginia Code §15.2-2659
- <sup>17</sup> Virginia Code §15.2-2510; <http://www.apa.state.va.us>