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California Eyes Feds

Banks Unlikely to Help With Record \$13B Note Deal

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By Rich Saskal

SAN FRANCISCO — After selling a year’s worth of general obligation bonds in a month, California officials now face their next market challenge — a record-sized cash-flow borrowing for a state government that is being hammered by the recession.

Currently, the state is projected to need a \$13 billion cash-flow borrowing this summer, according to Department of Finance spokesman H.D. Palmer.

That would be the largest municipal note borrowing on record, and with the recession taking a big bite out of tax revenues, state officials say some sort of federal backstop will be needed to make it happen.

“Obviously we’re going to pursue all avenues, but again the banks have told us, don’t come looking to us for the enhancement that you normally receive,” said Tom Dresslar, spokesman for Treasurer Bill Lockyer. “It’s not going to happen.”

In most years, California is able to issue revenue anticipation notes, which are issued and redeemed within a single fiscal year, without outside enhancement.

But the state has enhanced cash-flow borrowings in the past, such as its \$11 billion issue of revenue anticipation warrants in 2003. Those instruments were supported by forward warrant purchase agreements with seven investment banks that committed to redeem the notes if the state was not able to.

Ultimately, the state redeemed those warrants with a huge deficit bond issue. Raws, unlike Rans, can be issued to bridge fiscal years, or without an enacted budget.

This year, state lawmakers enacted the fiscal 2010 budget in February while adopting a series of tax hikes and spending cuts to close a gaping budget hole.

But since then, California’s revenue picture has weakened to the tune of \$8 billion, according to the state’s legislative budget analyst. At the same time, a special election measure for May 19, a pillar of the fiscal 2010 budget, has been faring poorly in opinion polls. It would authorize \$5 billion in borrowing against the state lottery.

California faces its note challenge after what the treasurer has described as two major successes in the market for long-term general obligation bonds: a \$6.54 billion tax-exempt sale in March, followed this week with \$6.9 billion of taxable bonds, including \$5.2 billion of Build America Bonds. Under the BAB program, the federal government promises to pay the state 35% of debt service on the taxable bonds issued for purposes that qualify for tax-exempt bond status.



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After being forced out of the long-term bond market for nine months while the state battled with budget uncertainties, the treasurer's office, seeing enough demand to upsize both deals substantially, has priced more than \$13 billion in four weeks.

That's enough to restart thousands of bond-financed infrastructure programs that officials put on hold in December after months without market access, Palmer said.

"This means the spigot can be turned back on," Palmer said. "We can meet the cash needs for several thousands of projects that were postponed late last year."

Now the challenge will be to get cash-flow financing to avoid a repeat of the state's liquidity problems from earlier this year, which forced Controller John Chiang to halt billions of dollars in payments that were due to taxpayers, vendors, and local governments.

Palmer said Gov. Arnold Schwarzenegger supports Lockyer's efforts to obtain a federal backstop for the borrowing.

Dresslar said the state's preferred option is for the federal government to provide a standby purchase guarantee to banks that would provide letters of credit to support the cash-flow borrowing.

That administrative approach could be carried out under authority provided by the Troubled Asset Relief Program, Dresslar said. If that doesn't work, Congress could also enact a solution, he said.

Dresslar emphasized that the treasurer's office is not looking for a bailout, and is not seeking to be singled out. What is needed, he said, is a program to support all municipal borrowers.

"We're not asking the federal government for one thin dime," he said. "We're asking them to consider providing some kind of backstop that allows us to conduct the mammoth cash-flow borrowing we're going to need to keep California operating the next fiscal year. And we're not asking them to provide it gratis — we said we'd be willing to pay for the service."

Paul McIntosh, executive director of the California State Association of Counties, said that the impacts of the recession are pushing more of his members into the capital markets to manage their cash-flow needs. Unfortunately, he said, they are finding less access.

"Many California counties and cities had to spend down reserves this year," he said. "Their cash-flow situation is worse next year."

For the past 17 years, CSAC and the League of California Cities have sponsored a pooled tax and revenue anticipation note deal on behalf of their members through the California Statewide Communities Development Authority.

Last year, there were 29 participating agencies in an \$854 million issue. This year, McIntosh said, there is demand from about 60. But a credit squeeze is affecting about 40 of those agencies, which either will be shut out of the deal or downsize their borrowing.

"Historically, we've gone out and purchased bond insurance as a credit enhancement to the pool," he said. This year, they have been forced to obtain a letter of credit, and LOC provider US Bank has imposed "pretty onerous" requirements on pool members, McIntosh said.

CSAC and the League of California Cities have been lobbying Congress for support under TARP.

"The state found out what we were doing and they got interested in it as well on their short-term notes," McIntosh said.

Sacramento-based Capitol Public Finance Group LLC advises many local school districts, governments, and agencies on their cash-flow financing needs.

This year, such note issuers are going to see wider distinctions in spreads and market access, said managing director Jeffrey Small.

“Unlike prior years, I think bond investors are going to be discriminatory as to what kind of issue they buy,” he said.

Issuers with the top short-term credit ratings will have no problems issuing notes at attractive rates, Small said. But spreads, even between issuers with Standard & Poor’s SP1-plus and SP1 ratings, could be wide compared to previously, he said.

Such distinctions could impact popular tax and revenue anticipation note pools, according to Small. “If you have a pool issue, it’s going to be more problematic,” he said.

As for the state government, Small said, federal enhancement will be critical.

“What kind of cash flow can California put together that an institutional investor would say that’s a credible budget?” he said.

California’s long-term GO bonds carry ratings of A from Standard & Poor’s, A2 from Moody’s Investors Service, and A from Fitch Ratings. Its current Rans, which are due to be redeemed before the fiscal year ends June 30, carry ratings of F2 from Fitch, MIG-2 from Moody’s, and SP-2 from Standard & Poor’s.

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