Stephen Hopkins Center
for Civil Rights

Use of Grey Market Debt Issues in Rhode Island[1]

Legal and Policy Implications

I. Introduction and Background

This collection of legal and policy considerations for debt associated with state guaranties not approved by state voters was prepared to highlight issues affecting legislative and public financial markets reactions the failure of 38 Studios and to supplement apparent shortcomings in analysis offered by both the state's leading politicians and financial ratings agencies.

It is generally not well understood that -- despite the fanfare with which it was adopted by our elected officials -- the Job Creation Guaranty Program at the Economic Development Corporation, the bulk of which went to back the 38 Studios Company, has nonetheless created no legal obligation for the state.

It is unsurprising, and in fact predictable, that elected officials should prefer policies where they can claim to have created benefits for the citizens and the economy without paying for the costs of those policies. This aspect of political theory was well enough understood by the crafters of the Rhode Island Constitution that the legislature was denied the power to borrow or guaranty more than $50,000 without approval of the state's voters. Thus, subject to that exception for small issues, in Rhode Island, the legislature is generally without the constitutional authority to obligate the state.

Despite this constitutional restriction, a grey market of borrowing, epitomized by the 38 Studios bonds, has developed that violates the spirit of the Rhode Island Constitution, if not the letter. Such borrowing, without voter approval, takes place with endorsement by the legislature that nonetheless is without legal obligation. It is equally no surprise that this confuses the state's citizens, and perhaps some lawmakers.

It ought not, however, confuse the disinterested analysts of public finance. Several factors may be at fault, but our inquiry suggests that Moody's, especially, has contributed to this confusion by the use of loaded terminology that appears to equate failure to provide annual appropriations, where there is no legal obligation to do so, with the failure to service a general obligation bond. Moody's labels such lending as "moral obligation" and characterizes any failure of the public entity involved to appropriate moneys to subsidize deficits in bondholder payments as a "default". By using such loaded terminology, analysts have contributed to all but converting these debts into obligations of the state that subvert constitutional restrictions. Fitch, alternatively, uses the less provocative and more accurate description of "appropriations backed." But the financial industry has tended to standardize around the Moody's rhetorical regime, with journalistic coverage, even by those who consider subsidy of such issues a more open policy question, adopting the "obligation" and "default" characterizations.

Most critically, the failure to carefully and legitimately address the issue of what some have labeled 'contagion' *i.e.*, the effect of failing to subsidize grey market borrowing on the state's general obligation and revenue bond ratings, leaves a gaping hole in the ability of investors and the state to

[1] Prepared by Stephen Hopkins Center Legal Researcher Brian Bishop

assess the impact of the policy choice not to appropriate these funds. The effect is to coerce states into treating grey market borrowing as actual obligations. This interaction to date suggests an economic phenomenon not unlike quantum entanglement in which observation links the observer and the observed state, *i.e.*, Moody's observes the state will subsidize bondholders, but whether the state will subsidize bondholders depends in no small part on Moody's analysis. It does not appear that Moody's analysis even contemplates the possibility that the state would choose not to subsidize the bondholders.

As reported by local reporter Stephen Beale for GolocalProv on June 28th, 2012, a spokesman for Moody's, David Jacobson, said of this alternative: it would have to reassess its recent report, which did not change the original rating of A2 for the 38 Studios bonds, based on the assurances it received from state officials. The spokesman said he did not know if a default would be a factor in any future changes to the state's overall bond rating.

In order to be able to make a rational determination about whether to subsidize this debt, it is time that all involved learn of the true implications of this alternative. In a recent exposition on the subject with WPRI's Ted Nesi and Tim White, Speaker Gordon Fox had a more guarded outlook on this question that begs for this lacking guidance:

> "Fox didn't rule out the possibility that Rhode Island will opt to default on the $75 million moral-obligation bonds the EDC issued for 38 Studios, which are not legal obligations of the state and could require lawmakers to appropriate more than $12 million a year for bondholders through 2020.
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> "That's a discussion that will go forward, because there are implications that if you don't honor the bonds, you'll never be able to sell any more bonds," he said. "All that discussion has to take place, so there's a lot to be discussed. But you're right – it's not per se that we have to pay those bonds, but it's going to be up to appropriation of the future General Assemblies."

These statements are markedly different from the confident assurances of the state's likely subsidy of the 38 Studios Bonds Moody's earlier reported. Notably, the speaker recognizes a concern regarding access to money markets and its cost basis as a potential policy guide in this matter, but we find this relationship does not appear to have been thoroughly explored by anyone in the legislature or executive prior to the assurances reportedly given to Moody's and detailed in its May 24th note. As noted above, we cannot find any serious or comprehensive analysis of the very question that the Speaker suggests should guide lawmakers.

II. The risk that a subsidy will not be appropriated is priced into the bonds.

While the ratings agencies do not work for state policymakers, we would think such treatment is the necessary due diligence that legislators would require in making the decision whether to subsidize the 38 Studios bonds. Further, we think it would be the fundamental job of a ratings agency to examine the likely effects of various paths of conduct legitimately open to the parties to these public finance transactions. Of course we recognized it is possible that ratings firms could be accused in public discourse of extortion on behalf of bondholders by suggesting negative ratings effects, but the current lack of specificity now plays precisely that role. Ultimately the clarity and reasoning of this analysis would support its objectivity and the current circumstance, if anything, undermines the perception of disinterested ratings.

It is clear that the state's policy makers subscribe to an extent to Moody's undertakings. For instance the most recently published report by the Treasurer to the Public Finance Management Board cited a Moody's note dated July 22, 2010 for the proposition that the key drivers of state government credit quality in the near term are:

- Reliability of budgets

- Revenue forecasts
- Risk of double dip recession
- Magnitude of structural imbalance
- Phase-out of federal stimulus (ARRA) funding
- Financial flexibility and availability of reserves Available liquidity
- Extent of long-term liabilities
- Exposure to variable rate debt; and
- Political consensus related to spending and benefit levels

It is notable that this list does not include servicing of appropriations backed, 'moral obligation' debt issues. This is consonant with the fact that Moody's regularly rates such issues independently of state backed issues such as general obligation and revenue bonds with the appropriations backed debt universally displaying lower credit ratings and a higher risk premium for investors. Nonetheless, the notion that 'contagion' might impact a state's overall credit quality despite the general separation in assessment of appropriations backed, 'moral obligation' debt is allowed to persist.

Indeed, Moody's seems critically aware that there is a risk that states will not subsidize appropriations backed, 'moral obligation' issues, or else there would be little explanation for lower ratings and higher yields on this debt as compared to Rhode Island general obligation and revenue backed debt. One must assume that the analysis already conducted in first rating these bonds, as well as in revisiting their current status, must have involved some review of scenarios of non-subsidy and their effect on this and related debt. As Moody's seems quite well aware, the only obligation that the state has in the present matter is a ministerial duty of the governor to notify the legislature in the event that the capital reserve fund falls below target levels. There is no obligation, implied or otherwise, for the legislature to appropriate moneys to replenish such funds. Indeed, the lack of state obligation in this case is so clear that it is disclosed in all capital letters on the first page of the private placement memorandum circulated to potential investors in the deal. It seems inappropriate, intransparent and poor analysis to label financial instruments that explicitly disclaim obligation as nonetheless imposing the same.[2]

Notwithstanding rhetoric to the contrary, the duty of notice amounts to little more than an earlier legislature emphatically informing a later legislature that it has endorsed a certain policy. Certainly, without examining the alternatives to which the sums in question would otherwise be put to use – whether that be a gratuity to state workers, the funding of a public infrastructure construction project, or the elimination of the state sales tax - it makes no claim whatsoever, moral or otherwise, on the wisdom that a future legislature may find in appropriating money for a failed strategy crafted by others.

If it is at least debatable that moneys advanced in support of an endorsed state policy might allow a claim of moral obligation attaches, the use of the term "default" with regard to a state's failure to appropriate moneys in support of such bonds when needed, is even more troubling. No doubt, by filing for bankruptcy, if not by some prior action, 38 Studios triggered a default event. Likewise, an argument, based on a certain construction of the contracts involved, that the EDC may cause a default event if it should fail to subsidize the issue in the event the state chooses not to do so. But, given that the only legal obligation imposed on the state government is that the governor make the appropriations request to the general assembly, provided that request is made, the state cannot truly be said to be in default.

Rather, the state is being asked for a subsidy for bondholders.

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[2]It is a matter of historical interest that this was not Moody's idea, but that of onetime Attorney General John Mitchell. Mitchell is credited during his earlier career as a public finance attorney with originating this vehicle for evading constitutional limits on public borrowing.

This is not to deny that there are reasons that a legislature may consider subsidies in such circumstances. The predominant of those is perhaps the elephant in the kitchen: if a state through its legislature endorses a policy without appropriating the funds to effect it, and fails later to subsidize to any manifestly required extent this endorsed policy, the reliance the market will place on such unfunded endorsements in the future must logically be called into question.

Without adequate guidance from ratings agencies, we can only speculate that this type of grey market borrowing would become more difficult, should the state refuse to subsidize the 38 Studios bonds. While this may have the result of increased expense for this kind of financing, the increased cost must be weighed against the positive impact of deterring wasteful, excessively risky, and constitutionally suspect projects.

Thus it seems clear that Moody's nomenclature with reference to such borrowing contributes to misconceptions that could be understood as intended to influence public policy rather than chart the risk of investments. We believe this deserves immediate correction.

III. Further limiting the use of appropriations-backed, 'moral obligation' bonds does not jeopardize essential public purposes.

As quoted on the Nesi's Notes blog, Moody's Vice President Marcia J. Van Wagner observed that this type of borrowing was " 'used to support debt issued for essential public purposes, such as public hospitals, universities, housing projects, or schools' although they are sometimes issued for economic-development projects such as the 38 Studios relocation deal." While our review does not encompass the public finance practices of other states, our estimation is that this statement is inaccurate with regards to Rhode Island. In Rhode Island, at least, with the glaring exception of corporate welfare like that extended to 38 Studios, essentially all of the other purposes listed are financed with general obligation bonds and/or conduit lending. These programs are carefully distinguished in the annual report of the treasurer to the Public Finance Management Board from the appropriations backed debt that is the subject of this memorandum.

It thus seems that statements conflating the purposes of general obligation or conduit borrowing and grey market public financing in Rhode Island may inappropriately telegraph a threat to essential state services arising from a failure to subsidize the 38 Studios issue. As part of our call for ratings agencies to improve the precision of their analysis of appropriations backed, 'moral obligation' debt, we think it equally important that they improve the accuracy of the umbrella they place over such debt. By the inaccurate implication that essential public purposes, at least those described, would be thwarted by the loss of such grey market access, Moody's inappropriately inserts itself in the Rhode Island policy discourse.

In making this observation we have reviewed Rhode Island's extant borrowing and cannot see the statement as supported in the context of our state's public finance.

Indeed, the only thread upon which Moody's could support this statement is if one took the entire statement, including the specific reference to public hospitals, universities, housing projects, or schools, to make reference to the state backed borrowing for programs to provide mortgages for the purchase by individuals of multi-families homes that the Rhode Island Housing and Mortgage Finance Corporation (RIHMFC) had previously, but no longer, undertaken in the grey market. It is a stretch to suggest that generic lending for multi-family homes represents a "housing project". But even if it could be accepted as a convenience for discussing past practice, it does not describe Rhode Island's present access to public finance markets.

While the most significant overhang in outstanding grey market financing in Rhode Island, according to the 2010 report of the Public Finance Management Board, is composed of bonds that supported lending for multi-family housing, according to RIHMFC Treasurer and acting CFO Richard G. Hartley, those loans are essentially revenue bonds similar to its other conduit debt and RIHMFC no longer finances multi-family debt in the grey market leading to no expectation for rolling of this debt or new issues.

It is further notable that, even the 38 Studios issue might theoretically be treated similar to revenue bonds in the sense that they identified a source of revenue - payments from 38 Studios - as the basis for their retirement. Yet it seems unlikely that a lack of state subsidy for 38 Studios could identically affect even the outstanding RIHMFC grey market debt, given the performance of the underlying loans to date in the face of a challenging real estate environment.

While the RIHMFC debt has performed, the decision to distinguish it with more implicit state endorsement in the first place was related to an understanding of the risk implied by multi-family lending. While Stephen Hopkins Center is unconvinced that government endorsed lending for multi (or single) family housing is anything other than a market dislocation, it is clear that, with regard to risk, the policy can be carried out without implicit government guarantees, as the majority of outstanding RIHMFC debt and all its current lending, including multi-family lending, demonstrate.

Still, this emphasizes that failure to subsidize the 38 Studios bonds might not even altogether end grey market borrowing under legislative authorizations, but that the underlying credit quality and specific state policies would be more rigorously scrutinized. This would likely benefit the market and the polity.

IV. The risks to the range of state policy choices is minimal and in keeping with constitutional limitations on the authority of the General Assembly.

As noted above, the increased costs and difficulty in attracting investors to carry the state's appropriations-backed, 'moral obligation' issues may, as a practical matter, result in a curtailment of grey market access in Rhode Island. Thus it will likely foreclose some policy options, which is to say legislative rather than plebiscite authorized borrowing for unbacked or higher risk endeavors. The state arguably undertook such borrowing a score years ago when it subsidized the rescue of depositors through the Depositor's Economic Protection Corporation (DEPCO) following the failure of the state chartered guarantor of a number of Rhode Island credit unions. Distinctly, however, the sitting legislature recognized a deficiency in funding from the outset and identified a stream of revenue, a 0.6% sales tax on the existing taxable base, that it proposed would support the repayment of these bonds. While the legislature was without constitutional authority to actually commit those revenues in advance by statute, the policy itself might have been analyzed as more sound than 38 Studios and more likely to be credited by future legislatures. The sitting legislature had recognized a cost to taxpayers upfront, thus not taking credit for any positive accomplishments, i.e. rescuing the funds and savings of a significant portion of the state's citizens caught in what constituted a virtual local recession, while pretending to such as a financial miracle without acknowledged cost.

This mechanism highlights a distinction by which the characterization of such bond issues as "appropriations backed" is all the more appropriate. Even here, one can distinguish between the DEPCO bonds where the legislature could not guarantee future appropriations but increased a specific tax aimed at funding the certain call on external support. While this did not constitute a future appropriation of that targeted tax increase, nor guarantee that a future legislature might not reduce the tax to previous levels or direct the proceeds to other programs, it represented a political signal that taxes had to be increased to fund this legislative action -- a critical component of political theory in which the legislature acknowledges that pursuit of its chosen policy was linked to a long term tax increase.

This comports with a degree of political accountability as well as calling on future legislatures to continue the policy given that the funds involved went ***directly*** to a broader array of Rhode Islanders who, as a group, amounted to no particularly privileged cohort (perhaps with the exception of the proportionally reduced but extant payments to a relatively small list of depositors who had more than $100,000 on deposit at any of the closed institutions – most notably, the state, itself, that had $ 9.6 million on deposit. cf., *Kayrous et al v. DEPCO* 593 A. 2d 943 (1991) holding that the DEPCO scheme did not require the 2/3 majority vote constitutionally commanded for “local or private” appropriations, an issue that arguably resolves differently with regard to 38 Studios where the bonds were considered as directed at private purpose and thus were taxable. This DEPCO/Sales Tax linkage did not bind the future legislature, but created legitimate policy incentives for stability in that undertaking that look significantly different than those in place in regards to 38 Studios.

Of course, the Rhode Island Constitution requires fealty to certain explicit limits, and not simply a sense of political accountability. Although there were serious constitutional questions raised about the DEPCO arrangement, the Rhode Island Supreme Court specifically recognized that legislation that provided for no obligation “moral or otherwise,” did not constitute borrowing on behalf of the people of the state despite policy incentives that favored the future commitment of specified tax revenues. Thus there is a reasonable basis to believe that arrangements like the DEPCO undertaking, that more clearly avoided a direct private purpose, and identified a source of funding for likely state subsidy of bonds, would be treated differently by analysts than narrower economic development borrowing for private beneficiaries, even in the event that the state should choose not to subsidize the 38 Studios issue. It is, however, fair to say that such public policy undertakings as DEPCO, unless subject to voter approval, might appropriately be less favorably regarded by markets.

Thus, inquiry into the use of appropriations backed lending in Rhode Island can lead to no simple conclusion that essential public purposes would be placed at risk by the serious consideration of whether or not to subsidize bondholders (or more precisely insurers) of the 38 Studios issue. Indeed, the treatment to date of these subsidies as all but a foregone conclusion of policy would tend to support the notion the early notion that grey market finance carried an implicit guaranty making the bonds tantamount to and rated similarly to general obligation date. But the legal obligations of the state are viewed as all but perfected by the original legislation with virtually no practical option for future legislatures to even debate whether to subsidize shortfalls, then this mechanism is more clealry a workaround intended to violate the Rhode Island Constitution.

As Josh Barros wrote aptly for Bloomberg View on June 28th of last year: “Rhode Island lawmakers owe taxpayers an explanation of why the state issues moral-obligation bonds. If the answer is in order to preserve the option of default, they should provide guidance as to what kind of circumstances would lead the state to consider defaulting -- and how that guidance relates to 38 Studios.” Barros’ contention is exactly right. State officials must have the policy space to seriously discuss practical and constitutional limitations for the range of options open to the legislature. Such open discourse itself ought not to play a significant role in rating such debt unless it unduly delays a state decision in the matter.

We might, and do, add that Moody’s owes the public finance community an explanation of the circumstances under which it may be appropriate for a state to decline to subsidize such issues. In rating these grey market issues as significantly more risky than general obligation and traditional revenue debt, Moody’s is acknowledging the risk of strategic default and essentially endorsing that tactic. If strategic default were never legitimate, it would be inappropriate for Moody’s to enable a market for these instruments and they ought to refuse to rate them.

V. Appropriations-backed, ‘moral obligation’ ‘default’ and pension reform.

The larger question that analysts must now answer is how, in theory and practice, they view the idea of contagion, *i.e.*, that the ratings for legal obligations of the state and/or its revenue backed public finance might be negatively affected by a failure to subsidize, or fully subsidize, debt that provided solely for appropriations requests from future legislatures without obligation to fulfill such requests.

It bears noting that the most recent instance of the state shedding implied promises of future payments, *i.e.*, pension reform, resulted in positive guidance on the state’s debt. Indeed, news reports have Moody’s Vice President Marcia J. Van Wagner personally authoring such a note back in October of 2011. Here is no evidence of contagion – except perhaps inverse –suggesting that the reconsideration and curtailment of appropriations backed regimes would actually improve the state's credit. Of course, such analysis makes a great deal of sense. If the state reduces discretionary expenditures, even those with a long respected statutory pedigree, this frees more resources for the payment of actual obligations.

Certainly, the Hopkins Center respects that bondholders could place some reliance on the recent legislative enlargement of the Job Creation Guaranty Program to facilitate lending of the sort employed for the benefit of 38 Studios, despite the lack of legal obligation. Further, policy arguments can be presented in favor of subsidizing this arrangement, just as they may be advanced for declining to do so. But it is manifestly unhealthy that a legislature that just reconsidered its statutory promises to state workers in the form of unilaterally amending pensions should act as if it is powerless to consider the costs and benefits of subsidizing 38 Studios bondholders.

We do not insist that the results of such analysis should be identical to the outcome of reviewing pension statutes. Indeed, despite their displeasure with changes to pension laws, state workers have not defected *en masse* from state service, nor does the state have difficulty filling open positions. Conversely it is quite clear that failing to subsidize the 38 Studios deal will naturally alienate investors from investing in such grey market economic development. So the state would lose some borrowing capability. The policy question is not, then, how to place bondholders and state workers in perfect parity, but whether the loss of some grey market borrowing ability is enough of a cost to merit some $100 million dollars in subsidy – certainly taken in light of the fact that the state will in all likelihood maintain in its legal case over the pension reform that it does not have the money to pay pensions.

VI. Duties to Investors.

Additional confusion about a contagion effect on the state's credit rating remains because a degree of the state's credit rating may reasonably reflect not its bottom line, but its attitude towards protecting investors. For instance, the state's recent adoption of 2011 Public Law Ch. 269 (and 277) is thought to have signaled a commitment to investors in the event of municipal bankruptcies. That law provides in part:

> Each city, town and district shall annually appropriate a sum sufficient to pay the principal, premium and interest coming due within the year on all its general obligation bonds and notes to the extent that moneys for the general obligation bonds and notes are not otherwise provided. If that sum is not appropriated, it shall nevertheless be added to the annual tax levy. Annual appropriations for payment of financing leases and obligations securing bonds, notes or certificates ("other financing obligations"), shall also have a first lien on ad valorem taxes and general fund revenues commencing on the date of each annual appropriation.

This relatively novel policy, deliberately adopted to effectively collateralize municipal debt, telegraphing a priority in bankruptcy or receivership, has not resulted in specific guidance on Rhode Island municipal debt, given some outstanding legal questions about its retroactive application. But there seems little doubt that, psychologically, the market appropriately credits the state with an attitude for protecting investors. It thus becomes clear that the state, by weighing its policy options in the 38 Studios matter, makes no implication whatsoever in regard to general obligation debt where it has a deserved reputation for coveting the interests of its lenders.

Debate over 38 Studios subsidies may highlight that the state would hold municipalities to a higher standard than the state itself, although careful examination of this recent law shows that local authorities are still provided with appropriating authority where grey market borrowing is concerned even though, in cases of general obligation, the law may as much as delegate the taxing power to investors.

Of course there are reasons to more carefully regulate the service of municipal debt. Municipalities can go bankrupt or be placed in receivership for which there is no state analog. So actual state obligations are not conducive of being discharged or evaded.

It is clear that the state still could still suffer reputationally from denying subsidies to bondholders or insurers in cases such as 38 Studios. It is not our intention, given the acknowledged psychological effects that actions of public debtors can have on the public finance markets, to suggest that such factors are inappropriate to determinations of creditworthiness. Rather we suggest that these are obvious drivers of ratings, but that other obvious drivers are being ignored in public discourse on this issue. Better guidance from credit research firms is essential to policymakers and to protect taxpayers and investors.

VI. Conclusion.

Given the habit of analysts for rating individual issues in public finance, and the broad evidence of Rhode Island's commitment to its ***legal*** obligations to bondholders, there is no basis for contagion theory to outright chill serious policy debates on the limits to the state's finances in providing subsidies for appropriations backed issues. Still, we believe the state polity requires not our assurance, but that of the objective and disinterested analysts of public finance.

Indeed, the circumspect and curtailed discussion of these matters during the previous legislative session and election cycle seems fueled by the equally inappropriate fact that elected officials fear that even a discussion of the merits of subsidizing the 38 Studios bonds would itself trigger 'contagion' like effects on the state's bonds. Because politicians and bureaucrats had apparently felt chilled in raising these questions, we prepared them for submission as a third party so that political actors and investors may obtain better and more thorough analysis -- not only for the purposes of resolving state subsidies to the 38 Studios deal but for instituting better transparency and accountability to similar transactions throughout the public finance economy.

Since our preparation of this analysis and the commencement of the new legislative session, it is apparent that not all legislators feel so constrained from discussing the merits of subsidy for these grey market issues as we had feared in the immediate wake of the bankruptcy of 38 Studios. But we trust this analysis will be of benefit to them as well as to Moody's and other finance analysts in assisting informed public finance decisions by both legislators and investors.