STATE DEBT OBLIGATIONS

INFRASTRUCTURE GENERAL GOVERNMENT APPROPRIATIONS SUBCOMMITTEE
STAFF: RICHARD AMON

ISSUE BRIEF

SUMMARY

When a discussion on state debt occurs, the focus of the conversation typically centers on General Obligation debt – debt issued by the state based on the state's "full faith and credit" and ability to raise taxes if needed to pay off obligations. While General Obligation debt is likely the most important type of debt held by the state, there exist many other types of debt obligations incurred by the state and its subdivisions. This Brief attempts to identify and classify the majority of those obligations. The Analyst calculates that approximately $10.3 billion of outstanding state-related debt exists.

CATEGORIES OF STATE DEBT

In order to facilitate discussion of a complicated subject the Analyst classifies debt obligations into three categories:

1. Legal Obligations
2. Credit Obligations
3. Non-State Obligations

Legal obligations require the State of Utah to pay all outstanding debt no matter the circumstance. Credit obligations, while not legally binding to the State, nevertheless may significantly affect the credit of the state because of the perceived responsibility of the State to guarantee payment. Non-state obligations are debt incurred by entities that are both legally separate and do not involve the State's credit.

For legal and credit obligations the Analyst makes a further distinction between direct and indirect state obligations. Direct obligations consist of debt incurred by entities that are directly attributable to the state. Indirect obligations consist of debt obligations that are only loosely related to the state. The table below summarizes these categories. A description of each category and sub-category follows along with examples and numerical data related to each.

	Direct State Obligations	**Indirect State Obligations**
Legal Obligations	General Obligation Debt	Public School Debt Guaranty
Credit Obligations	State Building Ownership Auth.	Higher Education revenue bonds
Non-State Obligations	Housing Authority; Student Loans; Cities, Towns, and Counties	

Table 1

LEGAL OBLIGATIONS

Legal obligations require the state to pay the debt no matter what happens. In the event that the state could not meet a debt service appropriation for a legal debt, the state would have to levy a property tax sufficient to meet the obligation.

Direct – General Obligation Bonds

General Obligation bonds are the most direct debt the State of Utah contracts because the state itself enters into the bond agreement and legally commits the state's tax base to pay those obligations. General Obligation bonds pledge the "full faith, credit and resources of the state" and levy an annual tax on real and personal property sufficient to pay the debt service on the bonds when and if annual appropriations to debt service funds do not cover the obligation (U.C.A. 63B-1a-303). The Utah State Constitution allows the State of Utah to contract debt for "public purposes, including the erection of buildings" as long as the state does not exceed a limitation of one and a half percent of the taxable value of property in the state (Article XIV, Section 1). This authorization and limitation refers to the General Obligation debt of the state.

As of January 1, 2011 the State of Utah owes $3.1 billion of General Obligation bond principal to investors. This does not include an additional Legislative authorization of $1.01 billion for Transportation Investment Fund projects (I-15 Utah County and part of Mountain View Corridor in Salt Lake) which is anticipated to be issued in the next two years. The current Constitutional Debt calculation as of January 2011 resulted in $1.1 billion of additional bonding capacity under the limit.

Each year the state appropriates an amount sufficient to pay principal, interest, and fees related to the issuance of General Obligation bond debt. In FY 2012 the state will pay off $251.1 million of bond principal and pay $125.7 million of interest on general obligation bond debt.

Indirect – School Bond Guaranty

Whereas General Obligations are contracted and paid for directly by the state, another category of legal obligations exist in which an indirect entity pays the debt service, but legally the state guaranties the debt. In 1996 voters passed a referendum recommended by both the Constitutional Review Commission and the Legislature to amend the State Constitution to guarantee the debt of school districts (Article X, Section 5). This change to the Constitution allows school districts to access the credit of the state, receive lower interest rates, and avoid higher bond insurance (especially rural districts). Utah statute further clarifies this guaranty in the Utah School Bond Guaranty Act (U.C.A. 53A-28-201) and pledges the full faith and credit and unlimited taxing power of the state to ensure full payment of eligible public education debt. The Act requires the State Treasurer to determine whether the financial affairs of a particular school district would preclude eligibility in the guaranty program. If eligible, the Treasurer issues the district a certificate of eligibility good for one year. This certificate may be used when issuing the school's bonds to receive the state's credit (currently AAA) and more favorable interest rates (especially in rural districts).

Several built-in mechanisms help mitigate the risk to the state of the guaranty program. A school district desiring to incur debt must first receive authorization from the voters to issue a general obligation bond. Then, the Utah School Bond Guaranty Act requires that each school board with outstanding debt transfer to its paying agent sufficient funds to make debt service payments at least 15 days before the due date. If sufficient funds are not transferred within 10 days before the due date, the Act requires the paying agent to notify the State Treasurer who the Act requires to discharge the obligation. If the Treasurer makes a payment for a school district the Act further requires the Treasurer to intercept any payment from the Uniform School Fund or other state funds to the board and use those funds to reimburse the state for payments made. The Treasurer may also asses a penalty on the board of up to five percent of the amount paid by the state. If the Treasurer is unable to collect sufficient funds through the intercept mechanism within one year of the date of payment, the Act requires the Treasurer to pursue legal action against the school board including the compulsion to levy a property tax to repay the state.

The State Treasurer currently tracks outstanding debt and debt payments by the Utah school districts. In fiscal year 2010 the school districts paid $200 million in principal and $108 million in interest. The total principal outstanding at the end of FY 2010 was $2.6 billion with payments outstanding of $3.4 billion. Total principal outstanding is scheduled to fall to $2.3 billion by the end of FY 2011 with payments outstanding of $3.1 billion. To date all districts are current with their payments and there have been no defaults. Even though the state legally guarantees public education debt, the chance that the state would be called upon to actually pay that debt is extremely small. The built-in mechanisms give an incentive to the school districts to pay their debt.

CREDIT OBLIGATIONS

Unlike legal obligations, credit obligations do not guarantee payment of debt service. A credit obligation lends the credit of the state to an entity without a legal liability to the state. Credit obligations therefore involve state entities, but not the state itself. While limiting legal liability, a credit obligation does create a credit liability to the state. The state's credit rating would be affected by a default on a credit obligation.

Direct – SBOA Lease Revenue

In 1979 the Legislature created the State Building Ownership Authority (SBOA) as a political and corporate entity to finance the construction of facilities through the issuance of lease revenue bonds (U.C.A 63-1-304 and 305). The Authority pays the debt service on outstanding bonds with rental payments received from state agencies. Those state agencies making rental payments to the Authority receive annual appropriations for such by the Legislature. State statute specifically excludes the state from legal liability or general obligations arising from debts issued by the SBOA.

To get the highest bond rating and in order to avoid the requirement of funding a debt service reserve fund to secure the bonds (and unnecessarily tie up cash in restricted accounts), the SBOA cross-collateralizes all of the 68 buildings owned by the Authority. The cross-collateralization gives bond holders "right, title and interest in all the facilities" should any debt service payment not be made. Since the Authority does not have the "full faith and credit" of the state and therefore has no taxing power, the Authority receives a lower credit rating (AA+ as opposed to AAA).

Even though the state does not directly issue SBOA lease revenue bonds the Authority is a creation of the state and the state appropriates funds for lease payments to pay off the bonds. As opposed to moral obligation bonds, credit agencies directly associate the Authority's lease revenue bonds with the state's credit. Any default by the Authority would directly affect the credit rating of the State of Utah.

The State Building Ownership Authority owes approximately $329 million in outstanding principal and is scheduled to pay approximately $15.4 million in principal and $12.2 million in interest in FY 2012.

Indirect – Moral Obligations

Certain entities may issue revenue bonds secured by a pledge that each year a state official will certify to the Governor by December 1 the amounts necessary to restore any shortfall in a debt service reserve fund. This pledge constitutes a moral obligation of the state to fund the debt service even though no legal obligation exists. The Governor is not obligated to budget the debt service in his/her budget nor is the Legislature obligated to appropriate funds to cover the shortfall. The moral obligation allows the entity to receive a higher credit rating based on the state's credit and thereby issue bonds at lower interest rates.

Any bonds issued under the State Financing Consolidation Act (U.C.A. 63B-1b receive the moral obligation pledge of the state. This Act provides bonding authority for revolving loan funds such as water resources. There are currently $65.8 million of revenue bonds outstanding under this authority. Other entities currently authorized by state law to issue revenue bonds as moral obligations include the Utah State Board of Regents (U.C.A. 53B-21-101) and the Utah Communications Network (U.C.A. 63C-7-301 and 304). All of the Utah Communication Network's $4 million revenue bonds outstanding constitute moral obligations.

The State Board of Regents may issue bonds in behalf of Utah institutions of higher education to finance buildings based on revenues pledged from the operation of buildings, student fees, or proprietary activities. The Regents must first receive authorization from the Legislature before they may issue any bonds. Not all of those bonds are secured with the pledge that would make them moral obligation bonds. Of the Regents' current outstanding debt for capital projects of $560.3 million, about $485 million is a moral obligation.

In addition, the Student Loan Purchase Program issues some bonds as moral obligations of the state, while others are issued under its own authority as discussed in the next section. The Student Assistance Program currently has $1.4 billion of moral obligation bonds outstanding. The most recent issuance of student loan bonds received a 'AAA' rating as a result of the moral obligation pledge.

As the state does not directly issue moral obligations debt, like it does for SBOA lease revenue bonds, the credit risk to the state is not as great as SBOA debt. However, credit agencies view a moral obligation as an indication that the state will contribute in the event of a default; hence a higher credit rating. Inaction by the state to stand behind a moral obligation pledge would likely negatively impact the credit rating of the state.

NON-STATE OBLIGATIONS

As discussed previously, general obligations and moral obligations rely on the power of the State of Utah to levy taxes to repay debt as their source of credit. Utah receives excellent credit ratings because of its history of fiscal responsibility and debt management. This final category of debt, non-state obligations, rely on the credit rating of the non-state entity rather than the credit of the State of Utah.

This final category of debt represents minimal credit and legal liability to the State of Utah. Defaults of obligations by these entities would probably not affect the state. The State of Utah created three entities that may issue debt under their own authority, which does not constitute legal or moral obligations of the state: the Utah Housing Authority, student loans of the Board of Regents, and the State Charter School Finance Authority.

Housing and Student Loans (Asset Backed)

Asset backed entities rely on the value of owned assets as a source of collateral and credit. The credit of these entities improves as the assets grow and as the entities pay off obligations.

The Utah Housing Corporation Act (U.C.A. 9-4) created the Utah Housing Corporation to give Utah residents access to affordable housing through mortgage loans funded by the issuance of bonds. When first created, the Corporation may have issued moral obligation bonds using the state's credit; however, the Corporation currently operates independently of the state and is responsible for its own credit. The repayment of mortgage loans to the Corporation acts as collateral for the bonds issued and is the source of credit to the Corporation. The Corporation currently has $1.7 billion of bonds outstanding. However, of that amount $236 million is conduit debt for multi-family construction issued through the Corporation, but paid back and issued under the credit of private builders. Therefore, the total outstanding obligation of the Corporation is approximately $1.5 billion.

Statute authorizes the Utah State Board of Regents (U.C.A. 53B-13-104) as the Utah Higher Education Assistance Authority (U.C.A. 53-12) to issue bonds in order to raise capital to make loans to students attending institutions of higher education in the state. The Authority issues bonds using the state's moral obligation and using its own credit. Unlike the moral obligation bonds described in a previous section, bonds issued using its own credit do not convey any recourse to appropriated funds to cover a default. The Authority alone holds responsibility for the bonds and these bonds are rated based on the credit history, worthiness, and assets of the Authority. The repayment of student loans to the Authority acts as collateral for the bonds issued and is the source of credit to the Authority for these revenue bonds. Of the $2.1 billion of student loan debt currently outstanding, approximately $0.7 billion was issued using the Authority's own credit.

Charter School Finance Authority

The State Charter School Finance Authority Act (U.C.A. 53A-20b-104) authorizes the State Charter School Finance Authority to issue bonds in order to finance charter school facilities. The approximately $104 million of outstanding debt incurred by the Authority does not constitute legal or moral obligations of the state (U.C.A 53-20b-105).

Counties, Cities, Towns

The Utah State Constitution allows counties, cities, towns, school districts, and political subdivisions to issue debt with certain limitations (Article XIV, Sections 3 and 4). The Constitution further stipulates that the state will not assume any part of the debt of these entities except as provided by the School bond Guaranty (Article XIV, Section 6). Even though these entities are subdivisions of the state, the Constitutional provisions limit both the legal and credit risk to the state sufficiently that their obligations have no impact on the state's credit rating.

CONCLUSION

The State of Utah currently holds an "AAA" rating from all three credit rating agencies for its General Obligation bonds. As discussed in the sections above, obligations other than General Obligations may impact this rating. The state currently appropriates sufficient funds to cover all General Obligation and SBOA lease revenue debt service. The State Treasurer actively monitors the Utah School Bond Guaranty program to ensure that school districts meet their outstanding debt payments and statutory controls so that the state assumes a minimal credit risk. Entities that contract moral obligations in the name of the state self-monitor their debt obligations knowing that any default would likely ruin any hope of future debt issuance. Non-state obligations should not affect the state's credit rating and are actively monitored to a much lesser extent. Table 2 below contains an estimate of all outstanding debt, as discussed previously in the brief.

Principal Outstanding (billions)

	Direct State Obligations		Indirect State Obligations	
Legal Obligations	General Obligation Debt	$3.3	Public School Debt Guaranty	$2.6
Credit Obligations	State Building Ownership Auth.	$0.3	Higher Education revenue bonds	$1.9
Non-State Obligations	Housing Authority			$1.5
	Student Loans			$0.7

Total All Bonds	**$10.3**

Table 2