

Securitization – Breaking the Promise

When attorneys general settled their lawsuits with tobacco companies in 1998, the resulting agreement included language promising a dedication to reducing youth smoking and promoting public health. Today, a number of states are breaking that promise - and handing the tobacco industry a profit windfall - by securitizing their tobacco settlement money, affecting both health policy and state budgets. Faced with record deficits, many states are eyeing future payments from tobacco companies. Investment firms are now offering states the chance to sell the rights to those payments in exchange for one lump payment, through a process called securitization.

While the lure of easy money is hard to resist in difficult fiscal times, lawmakers face stiff political opposition to securitization for good reason. Future public health initiatives should not be endangered to overcome one year's budget problem. Jean Ross of the California Budget Project likened California's plan to sell 85% of the state's share of tobacco money to mortgaging the house to buy groceries.¹ The real tragedy is that securitization will only give the states 30 to 40 cents on the dollar. The balance goes to investors and underwriters. This is bad public policy and is simply not an acceptable trade-off when public health hangs in the balance.

Background

The tobacco money at stake resulted from the 1998 Master Settlement Agreement, under which the major tobacco companies make annual payments to the states in an attempt to provide compensation for the devastation caused by cigarettes. Health advocates hoped and expected the money would be used for health care and tobacco prevention.

What is the Master Settlement Agreement?

The Master Settlement Agreement, or MSA, is an out-of-court settlement struck in 1998 between the largest tobacco companies and the attorneys general of 46 states, the District of Columbia and several U.S. territories

(four states – Minnesota, Mississippi, Texas and Florida – settled their cases separately). It ended lawsuits being pursued by the states seeking reimbursement for public expenditures for healthcare for tobacco-related illnesses. In return for a release from past, present and future claims by public entities, the tobacco companies agreed to:

SCHEDULE AND CALCULATION OF PAYMENTS TO STATES - Payments to the states under the MSA are perpetual, in theory. The schedule calls for payments of roughly \$200 billion by 2025. The exact payments were not laid out in advance, however, because of a complex formula used to adjust the base amount paid each year. It is important to understand how the payments are calculated, because the uncertainty associated with the payments is one of the rationales for securitizing the proceeds. The two most important adjustments:

- ***THE INFLATION ADJUSTMENT*** – This works just like it sounds – each year payments increase either by the inflation rate or 3%, whichever is higher.
- ***THE VOLUME ADJUSTMENT*** – This relates to cigarette consumption and market share. In any year that the major cigarette companies' total U.S. sales fall more than 2% below the 1997 baseline, their payments to states are reduced by .98 times the decline.

¹ "Burning the Tobacco Windfall," Dan Morain, *Los Angeles Times*, A1, July 24, 2002.

- Pay substantial sums to the settling states;
- Fund a national foundation devoted to the interests of public health;² and
- Change the way they advertise and market in order to reduce underage smoking.

The MSA is an enforceable agreement, and the attorneys general can take tobacco companies back to court when they feel the MSA is being violated. Time has revealed a number of problems with the MSA. Among the biggest disappointments is the tiny fraction of MSA funds that has been devoted to tobacco prevention efforts, in spite of the fact that the MSA contained clauses espousing the ideals of tobacco control and prevention of youth smoking. Now even the small amount being spent on tobacco prevention is threatened by securitization.

What is Securitization?

Securitization involves selling the rights to an expected revenue stream to investors in return for an immediate influx of cash. Technically, the rights are transferred to a state-created corporate entity for the purpose of issuing bonds backed by the future funds. The up-front lump sum from the bond sale is then given to the state. The revenue stream is then used to pay interest and principle on the bonds.

STATES WINNING THE LOTTERY – Most of us are familiar with the concept behind securitization, even if the word is new. We all know that huge state lottery jackpots are a little misleading – if you win and want the full amount, you must wait for up to 25 years. To have it all at once, you're forced to take a steep discount, usually getting around 40 cents on the dollar instead of full payment over 20 years. Ironically, this is a bigger percentage than some states are receiving for their tobacco bonds.

However, a dollar today is worth more than a dollar tomorrow, so states get only a fraction of the total expected payout. The exact percentage received depends on a number of factors, including the number of years of the payout, prevailing interest rates, the strength of the stock and bond markets, and the perceived risk in collecting the future receivables. Based on these factors, a rating will be assigned to each issue of bonds. The higher the rating, the more investors will be willing to pay for the bonds, and the more cash will flow into state coffers. Of course, there are other costs associated with securitization, particularly the fees charged by brokers, which can amount to millions of dollars in a large deal.

Tobacco Securitization

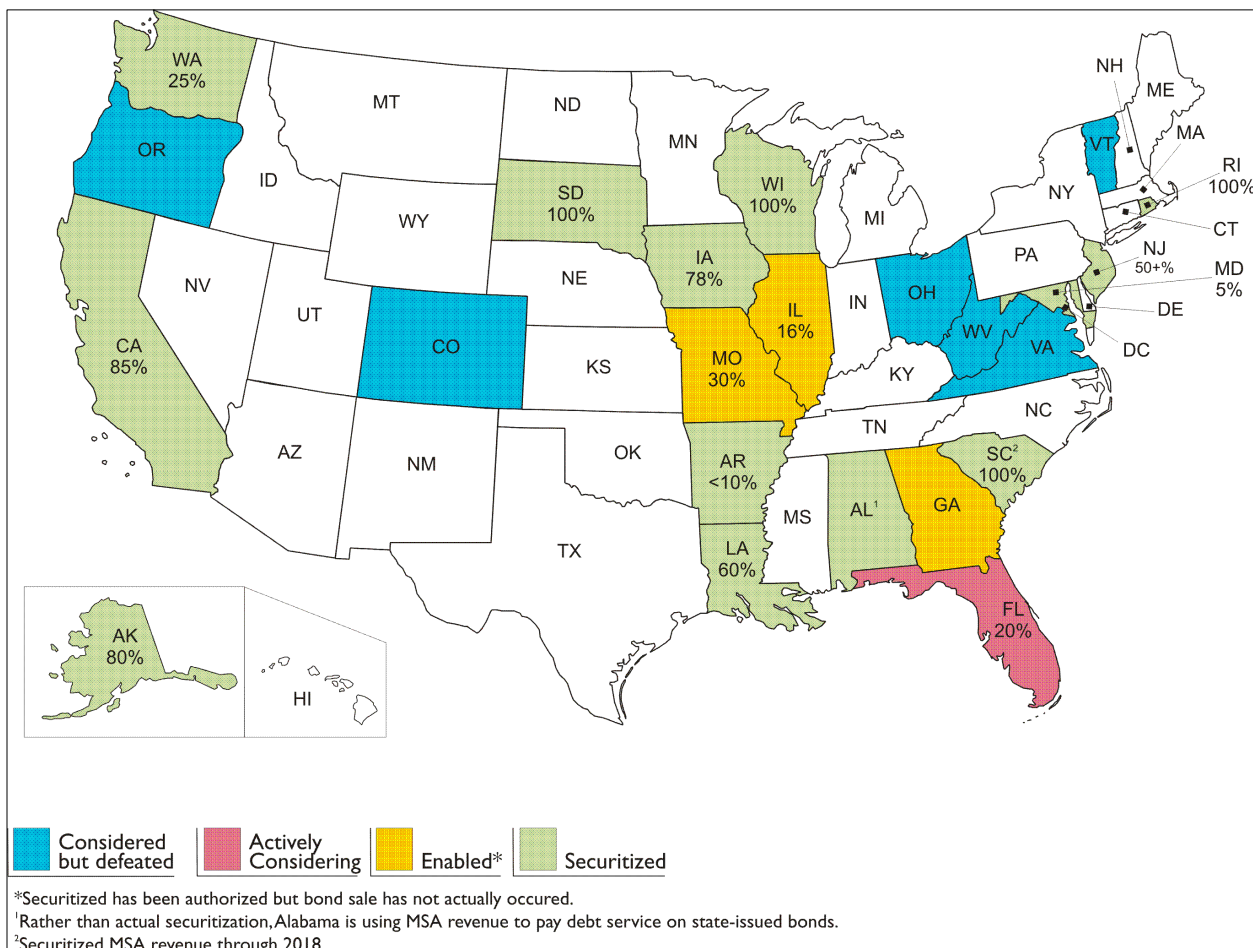
Tobacco securitization means selling the rights to future MSA payments to investors for an up-front payment. Unlike traditional state or municipal bonds, these instruments are not backed directly by the state or municipality. A number of states have already securitized some or all of their expected MSA funds (see map), a few are actively debating it, and nearly all have considered it.

² The American Legacy Foundation was established in 1998 with the mission of reducing tobacco use in the United States through grants, research, marketing and collaboration with other health organizations, including the American Lung Association.

Why are States Securitizing?

Securitization is attractive to cash-strapped politicians. MSA proceeds represent a sizable pot of cash, and the opportunity to balance this year's budget at the expense of future revenue is difficult to resist. There are two main rationales put forward by proponents of securitization.

- **BUDGET GAPS** – During the economic boom of the 90s, many states cut taxes and increased spending. Now that the economy is slowing, approximately 40 states are facing budget crises, many of them of record severity. And unlike the federal government, many state constitutions require a balanced budget. In other words, legislators don't get to go home until spending equals revenue.
- **PERCEIVED RISK AND UNCERTAINTY OF FUTURE MSA PAYMENTS** – State treasurers and brokers say that securitizing is a risk-management tool, protecting the state from falling MSA revenues and the possible bankruptcy of the big tobacco firms.



Who is Profiting from Securitization?

There are benefactors of securitization, but it's not the public or the taxpayer.

- **TOBACCO INDUSTRY** – Big Tobacco does not receive any of the proceeds of the bond sales, and their payments under the MSA are not affected. But since securitization will likely lead to a decrease in spending on tobacco prevention, they can look forward to a larger crop of new smokers in the future.
- **BROKERS** – Brokerage houses have not been silent, uninterested partners in securitization. Instead, they have lobbied state governments³ and marketed to investors,⁴ highlighting the virtues of securitization while ignoring the shortfalls. Brokers stand to make millions from every securitization deal, and their share is the safest bet of all – they get their commission no matter how well the bonds hold their value or how little the state nets in the bargain.
- **THIS YEAR'S BUDGET** – Securitization is perceived as a one-time magic bullet for budget deficits. Legislators facing hard choices can go back to their constituents having balanced the budget without raising taxes or cutting spending, hoping that no one asks what will be done next year. Friends of the tobacco industry can also show that they are earning their campaign contributions. However, politicians should be wary of a voter backlash when the state faces similar budget problems next year, compounded by loss of the annual MSA payment.

WHAT ARE WE TO BELIEVE? – The bond industry tells different stories to different interests.

To state governments: Brokers warn state treasurers that the tobacco industry is in trouble. Securitizing now will protect the state in the event of bankruptcy and therefore makes good fiscal sense.

To investors: Brokers assure investors that their money will be paid back, because the tobacco industry is making record profits and is viewed by Wall Street as a blue-chip stock.

To each other: Yet, after securitizing 100% of its MSA payments, Wisconsin discovered that its overall bond rating had gone down. Apparently, securitizing a known revenue stream to plug a one-year budget gap shows poor fiscal stewardship.

What's the Problem with Securitization?

Securitization is a bad deal for state governments, taxpayers and public health. Citizens should be concerned when public health is compromised by mortgaging a future revenue stream to plug a one-year budget deficit. Three problems plague securitization schemes:

South Dakota voters headed off some of the ill-effects of securitization. In a special election, they voted to place funds from securitization into a tobacco prevention trust fund. Only the interest from the trust can be used unless 75% of the legislature agrees to tap the principle. However, the state would have found itself with much more money in the long run if they had simply placed the annual payments into a trust fund for a few years, without securitizing.

- **FUTURE HEALTH INITIATIVE FUNDING** – Most state tobacco prevention programs are funded with settlement dollars. If future settlement payments disappear into this year's budget gap, the source of future prevention budgets becomes very uncertain. While a few states fund such programs with tobacco tax

³ "No Risk in Tobacco-Bond Sales, Almond Aide Tells House Panel," Katherine Gregg, *Providence Journal*, p. B8, February 7, 2002.

⁴ "Bond Raters Give Thumbs Up to Tobacco Settlement Bonds," Jay H. Abrams, Ph.D., *FMSbonds.com*, visited September 5, 2002.

revenue, the trend is to put tax revenue directly into general funds. In fact, of the 18 states that passed new tobacco taxes in 2002, only two - New Jersey and Utah - dedicated any part of the new revenue to tobacco prevention. At the same time, many states have drastically cut their tobacco prevention programs, in spite of the fact that studies have shown that for every dollar spent on prevention, the state can reap more than three dollars in long-term health care savings.⁵

- **FINANCIAL SACRIFICE** – States that have securitized have only received about 30 to 40 cents for each dollar anticipated under the MSA. In other words, by securitizing states are forgoing the bulk of the money owed to them. And this return may go even lower for future securitizers as the bond market becomes saturated with tobacco bonds and the available capital is stretched thinner. Recently, Governor Hoeven of North Dakota decided against securitization, in spite of a great need for quick cash, because too much future money would have to be given up.⁶

NOT A GOOD COMPROMISE – Securitizing a portion of a state’s MSA payments is not a sensible “middle ground.” Since bond holders will have to be paid first, this tactic assures that the entire risk of lower future MSA payments is borne by the state.

- **“QUICK FIX”** – From a fiscal standpoint, filling a budget gap with tobacco bond proceeds is a mere bandage. By not addressing the underlying reasons for gaps between revenue and spending, states leave themselves open to the same problem next year and in years to come. Not only will there be no more tobacco money to securitize, the annual MSA payment will be going to bond holders, not to the state. The bond market itself seems to recognize the improvidence of securitizing – the plan to spend future MSA proceeds on a budget gap earned Wisconsin a lower overall Moody’s bond rating from AA2 to AA3⁷ (see text box, page 3).

Case Studies

Florida and Massachusetts Just Say “No”

Florida

Florida settled with the tobacco companies prior to the MSA, reaping approximately \$13 billion. It was one of the first states to consider securitization. Growing fears of a collapse in the tobacco industry peaked in 2000 when a jury awarded Florida plaintiffs of a class-action suit punitive damages of over \$145 billion. Governor Bush, stating that he feared that the industry would go bankrupt from such an award, proposed a securitization plan of Florida’s settlement money that would exchange at least half of the \$425 million annual payments over the next 30 years for nearly \$2.4 billion upfront. The plan also would have guaranteed that proceeds were spent on health-related issues.

The same fears created by the verdicts led to hesitation and inaction by the state with regard to securitization. Those analyzing the Florida situation feared that the bond market would not be cooperative or fruitful because any financial hardships that the tobacco companies may incur

⁵ Tobacco Control Section, California Department of Health Services, *California Tobacco Control Update*, April 2000, <http://www.dhs.ca.gov/tobacco>.

⁶ “North Dakota Governor Cool to Idea of Selling Off Tobacco Settlement,” Dale Wetzel, *Associated Press*, September 1, 2002.

⁷ “Another Bond Agency Lowers Wisconsin’s Rating,” AP, *Star Tribune* (Minneapolis/St. Paul), May 25, 2002.

would also affect the long-term payment of the bonds, leading to unfavorable interest rates and potentially creating ill-will among the state's investors.⁸

2000 saw the last major securitization activity in Florida. The legislature approved the creation of a corporation to sell bonds worth up to \$3 billion of the settlement revenues, but mandated that the actual sale of the bonds required further approval. The state Senate demanded this compromise out of fears that Florida would lose \$800-900 million by securitizing the settlement payments over the 30-year period.⁹ For this year, it looks as if the opportunity window for securitization of tobacco settlement payments has closed.¹⁰

"Just because 15 states have done it, does nothing to spruce up the really bad idea of borrowing against future payments of the state's share of the tobacco settlement."---
Editorial, The Boston Herald, 7/9/02.

Massachusetts

Massachusetts receives approximately \$288 million per year as part of its \$4.7 billion share of the MSA. Like many states, Massachusetts originally intended to use the money for future health-care costs and tobacco control and prevention measures. However, also like many states, Massachusetts has been dipping into the fund for other reasons. As budget woes continue to increase, state legislators have proposed using even more of the funds for general budget purposes.

Over the past year, there has also been increasing debate over the possibility of securitizing the state's MSA payments. The plan, which is supported by the governor, would mean cashing in on \$1.4 billion of future MSA payments, reducing annual income by more than \$86 million.

Thus far, state lawmakers have rejected proposals for securitization. One state senator remarked that he was reluctant to agree to a plan that is good for one time only while the future income "goes away forever."¹¹ The Massachusetts Taxpayers Foundation agreed, saying, "You are robbing 30 years of payments to pay for today's operating costs."¹²

Wisconsin and California Sacrifice Tomorrow's Health for Cash Today

Wisconsin

Wisconsin was originally awarded an estimated \$5.2 billion from the MSA. However, faced with a large budget deficit, Wisconsin joined the list of states that have decided to securitize their MSA payments. In 2001, Governor McCallum proposed securitizing Wisconsin's entire 25-year settlement award for an upfront payment of \$1.6 billion (or less than 36 cents on the dollar). Initially, the governor intended to use only \$350 million of that amount to fix the budget deficit and establish an endowment fund with the balance, of which the Wisconsin Tobacco Control Board would receive the first \$25 million per year for prevention and cessation programs.

⁸ "Tobacco task force hasn't met; Group considers how to maintain income from companies in case fortunes change," Randolph Pendleton, *Florida Times-Union*, p B-6, August 6, 2000.

⁹ "Bill would protect tobacco suit funds," Randolph Pendleton, *Florida Union-Times*, p B-3, May 6, 2000.

¹⁰ "Tobacco task force hasn't met; Group considers how to maintain income from companies in case fortunes change," Randolph Pendleton, *Florida Times-Union*, p B-6, August 6, 2000.

¹¹ "Budget talks put everything on the table," editorial, *The Boston Herald*, p. 26, July 9, 2002.

¹² "Smoke and Mirrors," Charles Stein, *Boston Globe*, May 21, 2002.

However, the final version passed by the legislature took \$450 million to plug the deficit, reducing the endowment.

Subsequently, due to an economic downturn and the events of September 11, another deficit was projected and the governor reopened the budget in 2002. At that time, he proposed using all remaining tobacco settlement monies to fix the deficit, leaving no endowment. The bill passed on July 29, 2002.

Furthermore, due to poor tobacco bond market conditions, the state will not receive any residual revenues until the bonds are repaid and the state regains its rights to the annual MSA payments—currently estimated to be the year 2018.

However, Wisconsin will still be feeling the effects of securitization well beyond 2018. Although the bond revenues will provide needed cash for the current budget, estimates suggest that the plan will have a negative impact of as much as \$1.7 billion on the state's general fund by the year 2032.¹³ Said state Representative Frank Urban, "I'm terribly disappointed. Here is a pot of money that was supposed to pay medical costs and spread the message to teenagers that smoking is detrimental to their health, and it's gone."¹⁴

California

California received the largest share of the MSA, totaling \$25 billion. An agreement within the state divided the money between the state government, which received 50% or \$12.5 billion, and county and municipal governments. Several of California's counties and cities, including Sacramento, San Diego and Sonoma, securitized their portions of the MSA. For a while, the state resisted. However, in early September 2002 California agreed to the largest issue of tobacco bonds to date, totaling \$4.5 billion.

Governor Davis initially proposed selling 40 % of the tobacco payments, reaping \$2.4 billion.¹⁵ But as the budget crisis grew into a \$17 billion deficit, the governor's proposed sale increased to approximately 85 %¹⁶ of the payments, or \$4.5 billion in immediate revenue in exchange for future revenue potentially worth \$12.5 billion (36 cents on the dollar).¹⁷ Although the MSA payments were originally intended to fund cancer research, health-care programs and tobacco control measures, the plan reneges on this promise in exchange for a one-time payment to be applied to the 2002-2003 budget. In fact, California cut its state tobacco prevention budget by 45% for FY 2003.

Critics of the plan were upset with the poor financial planning and management of state officials. They repeated the concerns echoed in many other states that a one-time fix that involves trading in a substantial future revenue stream for a much smaller amount up front does not demonstrate sound judgment. An official from the California Budget Project said, "Our opinion is that if you

¹³ Report to the Joint Committee on Finance from Bob Lang, Legislative Fiscal Bureau, February 22, 2002.

¹⁴ "Tobacco money is a quick fix; State's planning called weak," Dennis Chaptman, *Milwaukee Journal Sentinel*, May 5, 2002.

¹⁵ "Banking on Tobacco," David Brown, *The Recorder*, p. 1, June 3, 2002.

¹⁶ Unlike other states which set bond sales by the percentage of expected MSA proceeds, California plans to sell as much as is necessary to raise \$4.5 billion. The final sale could involve anywhere from 75% - 100% of California's MSA share.

¹⁷ "Blowing Smoke; Warning: Gov. Davis' plan to use tobacco lawsuit money to fill a budget gap is dangerous to our financial health," Matt Smith, *SF Weekly*, column, June 26, 2002.

have a revenue problem, you should solve that revenue problem.”¹⁸ Others questioned the motives behind the law firms and investment banks that aggressively proposed the securitization plans to legislators and then bid for the rights to broker them, making millions in the process.¹⁹

Conclusion

The Master Settlement Agreement was certainly not the cure-all for tobacco control that some touted it to be back in 1998. Now securitization threatens to erode even the modest gains made with the MSA. Selling off decades of revenue meant to promote public health in order to plug a one-year budget gap is short-sited and violates the trust voters place in their representatives. Taxpayers should be appalled twice - first because of the irresponsible way some state governments are addressing budget deficits, and second because everyone, even nonsmokers, will have to pay more down the road toward health care for tobacco-related diseases. Tobacco control is a sound investment for the future, one of the surest ways to enhance health and decrease health care costs. This is not a case of a difficult choice between public health and public finance. No matter which lens one looks through - health advocate, attorney general or state comptroller - securitization is a bad idea.

¹⁸ *Id.*

¹⁹ “Banking on Tobacco,” David Brown, *The Recorder*, p. 1, June 3, 2002.