



SECURITIZING STATE TOBACCO SETTLEMENT PAYMENTS MYTHS vs. FACTS

Investment firms and banks are urging many states to “securitize” their tobacco settlement payments by selling the investment firms the right to receive future state settlement proceeds in exchange for a lump-sum payment to the states now – with the investment firms subsequently selling the future income streams from the tobacco settlements to investors through issuing “settlement bonds.” State budget deficits or other state needs for immediate new revenue may make these securitization deals appear attractive. But it is absolutely certain, using simple math, that securitizing a state’s tobacco settlement payments will bring a state less money, overall, than it would otherwise obtain through continuing to receive its scheduled settlement payments. States that use securitization funds to address budget deficits may also have their credit or bond ratings downgraded because securitizing eliminates a substantial future state revenue stream in exchange for a one-time budgetary band-aid that does nothing to address underlying state revenue and expenditure problems.

Some supporters still claim that securitizing is worthwhile because they say it will protect a state against possible future declines in its settlement payments caused by declines in U.S. smoking levels or even the bankruptcy of one or more of the major cigarette companies that are making the settlement payments. But these risks have been greatly exaggerated and securitization actually does not provide as much protection as commonly expected. Indeed, the amount any state can get today in exchange for selling off future settlement payments already reflects any likely future declines in those payments (and is further reduced to ensure adequate profits for the financial firms managing the deal).

Even if securitization were a good deal for the states, it is likely to be a bad deal for state efforts to prevent and reduce tobacco use. While securitization does not necessarily have any direct link to how much funding a state invests in tobacco prevention efforts, it eliminates a future stream of state tobacco settlement payments that should provide funding for state efforts to reduce its tobacco-caused harms and costs. Moreover, states that have securitized their tobacco-settlement payments have often done so without allocating any of the funds for tobacco-prevention. Even in those cases where the states have used some of the securitization receipts to fund tobacco-prevention efforts (and other public health programs), the states usually end up raiding those funds to get money for other state purposes.

Myth: *Securitizing state tobacco settlement payments is neither good nor bad for tobacco-prevention or public health efforts.*

Fact: **States that have securitized settlement payments have eliminated or diminished a stream of future state revenue that could otherwise provide funds for state tobacco-prevention or public health efforts, and have typically failed to allocate any of the securitization revenues to public health tobacco prevention. Even when special public health or tobacco-prevention funds have been established using settlement or securitization payments, the funds often end up being raided for other purposes.**

Because of securitization done to raise funds for other purposes, large amounts of tobacco-settlement payments are no longer available to prevent and reduce tobacco use in a growing number of states and counties. This loss of future state settlement payments contradicts the basic purpose of the state tobacco settlements and the underlying lawsuits against the major cigarette companies: to compensate the states for smoking-caused harms and costs and to provide funds to support new state efforts to prevent and reduce smoking-caused harms and costs within their borders. By severely reducing the pool of revenues available in future years for ongoing state programs, securitization also puts additional pressures on existing funding for state tobacco-prevention efforts. In Iowa, for example, a raid on its securitization funds has reallocated the funds for other, unrelated purposes. This kind of tobacco control funding is also at risk in other states and counties that have initially used their securitization proceeds to create new funds to support tobacco prevention or other public health programs. In other states that have securitized – including Wisconsin and South Carolina – tobacco-prevention programs supported by non-securitization funds have also come under attack.

These actions do not make sense from either a public health or a fiscal perspective. State investments in comprehensive, effective efforts to prevent and reduce tobacco use not only save lives and reduce smoking-caused disease and suffering but also reduce the enormous smoking-caused costs that burden state Medicaid programs and other government programs.

To evaluate securitization efforts exclusively from a tobacco prevention perspective requires a careful analysis of the amount of funding the state is likely to direct to state tobacco prevention efforts, over time, with or without securitization. Key considerations include: a) whether the securitization proposal blocks funding of non-capital projects, such as tobacco prevention initiatives; b) the overall amount of funding formally dedicated to tobacco prevention; c) the timing of the funding (how much is available now versus later); d) the maximum and minimum amounts that might be available each year; e) the structure of the tobacco-prevention funding (is it placed in a trust fund dedicated to tobacco-prevention purposes or must the legislature make separate allocations each year); f) how protected the tobacco-prevention funding is from possible shifts to other purposes in future years; and g) what types of tobacco-prevention efforts the funding will support. Ideally, securitizing states would dedicate adequate amounts of the new funding to support a comprehensive range of effective tobacco-prevention strategies and initiatives on a sustained, multi-year basis, with any reallocation of the funds to other purposes possible only by super-majority votes of the state legislature. But whether such a structure would end up benefiting efforts to prevent and reduce tobacco use in a state more than not securitizing the funds would still be difficult to predict.

Myth: *State funding losses under securitization will be minimal.*

Fact: **States will receive only pennies for every future dollar of settlement revenues they securitize, and investors, investment firms, and bond lawyers will end up getting a big chunk of the securitization proceeds.**

The investment firms and bond lawyers that want to securitize the states settlement payments are motivated by a desire for profits – and any money they make can only come right out of the securitizing states' pockets. In addition, securitization, by definition, is the exchange of more money in the future for less money right now. According to the September 2, 1999, *Columbus Newswire*, for example, Governor Bob Taft of Ohio “opposes securitization because about \$1.9 billion of the \$9.9 billion payment to Ohio [through 2025] would be paid to investors and bond firms.” Similarly, the New York State counties that have securitized are reportedly receiving, on average, only about 40 cents on the dollar through 2025 (with one getting only 32 cents). In Washington State, projections used by the proponents of the securitization proposal that passed there showed that the state will, *at best*, get less than 38 cents on the dollar – with returns of only 25 to 30 cents per dollar more likely according to the state’s director of financial management.

Current returns may be even lower now that Washington, California, and other new states have securitized large portions of their settlement revenues, thereby glutting a market already well-supplied with tobacco settlement bonds. Even before California’s massive securitization was initiated, a Merrill Lynch & Co. report stated that the market for tobacco bonds in California “has begun to back off [prior to new country securitization bonds being offered for sale in June 2002] . . . and a skittish retail audience remains a major hurdle for deals coming to market.” For example, some large investors have been avoiding them, because of their links with tobacco, despite the fact that they pay higher interest rates than comparable municipal or general obligation bonds. And other institutional investors that have purchased tobacco settlement bonds do not want to increase their tobacco-related holdings. In fact, a March 2002 report in the *Bond Buyer* trade journal noted that municipal bond funds, which are major buyers of tobacco-settlement bonds, may have already reached their exposure limits. Underwriters have also suggested that the saturation point for securitization bonds is about \$16 to \$20 billion, an amount which is now close to being reached if it has not already. That means the financial world is likely to pay even fewer pennies for every dollar they securitize for the states, and to require other increasingly less favorable conditions in their securitization agreements with the states.

To avoid unpleasant surprises, state securitization legislation should clearly and precisely identify the minimum amount or percentage that the state would receive from selling off the specified portion of its future settlement proceeds, but the securitization legislation proposed to date typically have not

included any such protections. Calculating how much securitization will actually cost a state depends on accurately estimating future state tobacco settlement payments after all adjustments have been made. In many cases, states discount future payments by assuming excessive downward volume adjustments (from reduced national cigarette sales) or exaggerating the risk of future bankruptcy or financial difficulties among the cigarette companies. When trying to make securitization look as attractive as possible, some presentations even fail to take into account the automatic, upward, compounded inflation adjustment of three percent per year (or the actual rate of inflation, whichever is higher) which greatly increases the value of future settlement payments.

In contrast, investment firms that are pushing securitization have carefully considered and estimated all future adjustments or threats to the state settlement payments – and have concluded that the payments are secure and will be substantial. In fact, one investment firm forecast concludes that the future income stream through the state settlement payments is secure and lucrative (thanks to the upward inflation adjustment), even if the federal tobacco lawsuit (or some other event) forced the cigarette companies to make additional annual payments larger than those the companies are already making to the states. The securitization bonds that have already been issued have received top rankings by Moody's and Standard and Poor's (the major financial institutions that rate bonds), based on careful evaluations of the financial health of the cigarette companies over the next 20 or more years and their projections of the reliability and size of future tobacco settlement payments.

Myth: *Securitizing state settlement payments will strengthen the state's economic health.*

Fact: **When done to address budget deficits, securitization can prompt reductions to the state's bond and credit ratings, which can increase its costs and reduce its ability to raise funds through issuing other bonds.**

Accordingly to a November 29, 2002 *New York Times* article, five states that have securitized to obtain funds to address budget deficits have had their credit ratings lowered by the three main credit agencies or have been placed on alert. New Jersey, for example, had its credit rating downgraded by one notch, from AA+ to AA soon after it announced that it would be securitizing about half of the settlement revenues the state would have received over the next 25 years. This lowering of state credit ratings happens because Standard & Poor's, Moody's and other bond rating services see securitizing to get funds to address budget shortfalls as quick fixes that eliminate a solid stream of future revenues while doing nothing to correct the underlying imbalances between state revenues and expenditures. For example, Wisconsin's bond and credit ratings were both reduced in part because of the state's decision to securitize. Such reductions to a state's bond and credit ratings could force the state to pay higher interest rates on borrowed money, including bond proceeds, and make it harder for the state to raise money through either borrowing or issuing other types of bonds. As the *New York Times* article stated, "rating agency officials and underwriters of municipal bonds said that a cut [in government credit ratings] of one notch could raise the interest rates on a new bond by as much as 10 basis points, or hundredths of a percentage point. For a big state issuing a lot of debt, it could amount to millions of dollars of extra interest payments."

Myth: *Securitizing state tobacco settlement payments will transfer the risk of future settlement payment reductions away from the state.*

Fact: **As typically structured, securitizing actually concentrates the risks on the state, making the state even more vulnerable to any changes in settlement payments related to downturns in the tobacco industry.**

Investment banks have not been willing to purchase any states' entire settlement proceeds. For example, in Colorado a securitization proposal worked out with the investment firms called for the state to sell or securitize 75 percent of its settlement payments and retain the riskiest 25 percent. Following the securitization arrangement (which the state has, so far, rejected), any future declines in the annual payments to the state would have been taken out of the state's 25 percent share. In any given year, the investment firms' 75 percent share would be at risk only after any future payment reductions had used up the entire 25 percent share retained by the state. In other cases, the securitization arrangement would make a lump-sum purchase of only the next eight or 10 years of a state's

settlement payments – providing the state with no protection for possible reductions to its scheduled payments after that time.

Myth: *Securitizing state settlement proceeds eliminates the unseemly link between state settlement revenues and the economic health of the cigarette companies and the size of their U.S. cigarette sales.*

Fact: **In most cases, securitization would make the states' remaining settlement payments even more dependent on the prosperity of the cigarette companies.**

As noted above, securitization would concentrate all of the risk of future settlement payment reductions in that portion of a state's scheduled settlement payments that the securitization arrangements would not cover. All future reductions to the state's scheduled settlement payments would be taken out of those settlement payments still retained by the state before going after any of the settlement payments transferred to others through securitization.

Myth: *States that securitize will have no obligation to those who buy the settlement bonds produced by the securitization process if the settlement bonds substantially lose value.*

Fact: **Even in those cases where the securitization arrangement expressly eliminates any legal obligation of the state to compensate those who purchase settlement bonds, the expectation is that the state will protect bond holders anyway.**

In the securitization process, the financial firms that purchase rights to future state settlement payments will then sell shares of the future payments to investors through settlement bonds. Securitization agreements typically say that the state will not have any obligation to protect investors who buy the bonds. In fact, most settlement arrangements include significant discounts in the amount paid to the states to cover the transfer of legal responsibility for backing the bonds from the state to the financial institutions. But the investment community believes that political pressure would force the securitizing states to bail out those who purchase the settlement bonds (such as pension funds for retired persons) if the bonds drop sharply in value or simply stop providing positive returns. Investment advisors have even stated that the moral or political obligation of states to protect settlement bond investors makes the bonds more attractive than various other bonds issued by corporations or investment companies. As the Wisconsin Legislative Fiscal Bureau puts it "Even if the state would have no legal responsibility, having bonds in default that are effectively tied to the state's rights to tobacco settlement payments could be perceived as harmful to the state's financial reputation."

Myth: *Securitizing state settlement proceeds has no effect on how state legislatures choose to spend the proceeds.*

Fact: **Depending on how it is done, securitization agreements could block state legislatures from using any of the lump-sum securitization proceeds to address health care, tobacco prevention, or any other state needs except for capital construction, such as projects to create more prisons, roads, and buildings.**

The way to securitize that provides a state with the largest lump-sum payment is on a special tax-exempt basis that prohibits the state from spending the lump-sum for anything other than debt refinancing or capital construction projects. On the other hand, a state might still be able to use all or part of the lump-sum from such a tax-exempt securitization to establish an interest-bearing trust, with the interest from the lump-sum placed in the trust available for any purpose chosen by the state legislature. Securitizing to put funds in general revenues to reduce budget deficits cannot be done on a tax-free basis, and thereby obtains smaller lump-sum amounts.

Myth: *Future state settlement payments will drop sharply because of the "volume adjustment," which reduces the cigarette companies' payments to the states when their U.S. cigarette sales decline.*

Fact: **Over time, the various adjustments to the state settlement payments called for by the settlement agreements could actually increase rather than decrease the tobacco payments to each state.**

While the settlement agreements call for reductions in the cigarette companies' payments to the states if their U.S. cigarette sales decline, any such reductions in future years should be quite gradual (especially since the large one-time consumption drop in 1999 caused by the cigarette companies' enormous settlement-related price hikes is now over). In addition, the settlement agreements also call for automatic upward payment adjustments to account for inflation of at least three percent per year, compounded, which will off-set the downward volume adjustments. According to current predictions of U.S. cigarette sales over the next decade, the inflation adjustment should begin to increase state settlement proceeds by more than the volume adjustment will reduce them starting in about 2008.

Myth: *Future state settlement payments are likely to decline or even disappear because the large damages awards in various anti-tobacco lawsuits will force the cigarette companies into bankruptcy.*

Fact: **It is unlikely that any of the major U.S. cigarette companies will declare bankruptcy in the foreseeable future, and safeguards are already in place to protect the states if any bankruptcies do occur.**

Most of the talk about cigarette company bankruptcies was initially prompted by the fear that the appeal bond requirement in the *Engle* class action lawsuit in Florida (the amount the companies would have to post as security in order to appeal the rulings and damage awards against them) would be more than the companies could possibly afford. But Florida and several other states have passed new tobacco-industry-protection laws setting a \$100 million cap on appeal bond amounts, which has completely eliminated any *Engle*-related bankruptcy threat for years to come. Moreover, Florida law (and the law in many other states) prohibits punitive damage awards against corporate defendants – such as the cigarette companies – that would force them into bankruptcy or put them out of business. Even if a large judgement is ultimately made against the cigarette companies in *Engle* or some other big lawsuit, the ruling and damages award will be tied up in appeals proceedings for decades and the final judgement could ultimately be overruled or reduced.

In addition, the cigarette companies have enormous amounts of assets and extremely large cash flows and assets to finance payment of any damages (for example, Wall Street tobacco analysts say they could readily afford a \$10 to \$20 billion appeal bond). In addition, the cigarette companies also have a unique ability to obtain additional future revenue by raising the prices of their addictive products. In fact, the companies' "settlement-related" price hikes have increased their annual revenues by roughly \$18 billion per year, providing them with about \$9 billion per year more than they need to pay off all of their future settlement-related costs. Similar price increases would enable the companies to pay, over time, virtually any possible damage awards or settlements in the *Engle* lawsuit or any other lawsuits.

On the other side of the equation, winning plaintiffs and their attorneys in the *Engle* case and other tobacco lawsuits would have a direct interest in keeping the cigarette companies solvent so that they would receive their damage payments and legal fees. In addition, they could easily arrange workable payment schedules for any damage awards that would spread the payments out over time, thereby eliminating any risk that the damage payments would force any of the companies into bankruptcy or threaten their ability to keep operating (and keep making their state settlement payments).

Moreover, bankruptcy proceedings are designed to provide special protections to those owed legal damages awards from companies that declare bankruptcy; and the tobacco settlement agreements also include specific procedures for handling cigarette company bankruptcies. More broadly, if any of the settling cigarette companies actually did go out of business, any company that purchased its brands would have to make settlement payments based on the brands' future sales, and to the extent any other settling cigarette companies took over any part of the defaulting company's U.S. market share their own settlement payment obligations would increase proportionately.

Myth: *Securitizing the proceeds is the fiscally conservative approach.*

Fact: **The steady flow of annual settlement proceeds into a state trust should provide the state with more funding, overall.**

While securitization offers a big chunk of money more-or-less immediately, sticking with the annual settlement payments offers the states substantially more real earnings both in the out-years and overall (unless there are major cigarette company bankruptcies). In fact, under the current securitization proposals, states could accumulate a fund as large as the lump-sum from securitization simply by collecting their annual settlement payments (as adjusted for declines in U.S. cigarette sales and for inflation) for six to 10 years – and would still retain their full rights to all future settlement payments, as well.

In Colorado, for example, the Colorado Auditor Office's independent review of revenue options showed that the continued flow of annual settlement payments into a state trust was more lucrative and efficient under both optimistic and pessimistic scenarios. After adjusting for national inflation and projected changes in domestic tobacco sales, the Colorado Legislative Council similarly found that directing the states settlement payments to a trust fund would produce more interest income for the state, over time, than placing the securitization lump-sum into a trust fund.

Securitization to Date

More than a dozen states have already securitized a portion of their settlement payments or are in the process, including Alabama, Alaska, California, Iowa, Louisiana, Maryland, Missouri, New Jersey, Oregon, Rhode Island, South Carolina, South Dakota, Washington, Wisconsin, and the District of Columbia and Puerto Rico. New York city and some New York counties have also securitized some of their shares of New York State's tobacco settlement payments, as have some California counties.

A number of states have considered securitization and rejected it, including Illinois, Nevada, Vermont, Virginia, West Virginia, and Colorado (which has rejected it twice). But budget difficulties have prompted some to reconsider, with Oregon's policymakers actually changing their minds and securitizing some of the state's settlement proceeds after initially rejecting it. Many other states, including some of those that have previously rejected securitization, are currently considering securitization to address ongoing budget shortfalls.

Campaign for Tobacco-Free Kids, December 12, 2002

More Information on Securitization

Campaign for Tobacco-Free Kids factsheet, *Problems with Securitizing State Tobacco Settlement Payments*, <http://www.tobaccofreekids.org/research/factsheets/pdf/0217.pdf>.

Campaign for Tobacco-Free Kids factsheet, *MSA Calls for States to Invest Tobacco Settlement Funds to Prevent and Reduce Tobacco Use*, <http://tobaccofreekids.org/research/factsheets/pdf/0203.pdf>.

Fuerbringer, J, "Tobacco Money Could Harm Credit Rating of Some States," *New York Times*, November 29, 2002.

Other analyses of state securitization proposals:

- California: http://www.lao.ca.gov/analysis_2002/health_ss/healthss_04_CC_TSF_anl02.htm