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California: The State of Confusion

An Update on California General Obligation Bonds

June 1, 2010

The Problem

California's budget issues are once again likely to be in the news. Some distinction should be made between the State's creditworthiness and its most immediate problem, which is one of liquidity. While the deficit for the 2010-11 fiscal year is currently estimated to be $19.1 Billion, debt service on the State's bonded debt will likely continue to be paid in a timely manner. State cash flows are volatile throughout the year, so intra-year liquidity needs are typically met through the issuance of Revenue Anticipation Notes (RAN's). A budget must be in place before the State can issue the RAN's. This is the second year of budget stress during this recessionary period and it will again provide a confrontational summer in Sacramento, as legislators grapple with raising revenue and cutting expenditures to create a balanced budget. Both note and bond investors will be paying particular attention to budget solutions for assurances that their notes and bonds will continue to be paid in a timely manner.

In January, the Governor is required to submit a preliminary budget for the following year which starts on July 1st. Typically, a budget is revised in May, approved by June 15, with implementation on July 1. Due to the current fiscal stress, this approval process is highly unlikely to be completed in a timely fashion, and discussions may linger on into the summer. For each day's delay, the value of most savings and revenue solutions are reduced, as their productive period is shortened.

As of this date, it does not appear that the parties in Sacramento are close to a solution. The State Controller has sent a letter to the legislative leaders stating that if they do not act soon he will have to begin to conserve cash. The Controller noted that the State appears to have sufficient resources to continue operations through August. Inaction by the Legislature will likely lead to the issuance of IOU's again this summer.

The Governor's Budget Solution

The Governor has proposed the following revised (as of May) budget solutions:

- $12.3B Expenditure reductions (64.6% of shortfall)
- $3.3B Federal funds (17.7% of shortfall)
- $1.2B Alternative funding (6.7% of shortfall)
- $2.1B Fund shifts and other revenue reductions (11% of shortfall)

California's solution will be a political one. Much of this budget solution is on the back of expenditure cuts (64.6%) which were mostly to social services, so getting legislative approval in this current form may be problematic.

Frequently Asked Questions

Q: Could the State default?

A: Yes, but it is unlikely. A default serves the best interests of no one, the least of which would be the State which would be penalized when it needed to access future credit markets. Additionally, a State of California default would likely re-price risk for the entire national municipal market, resulting in higher future interest payments for all municipal issuers. The last state to default was Arkansas during the Great Depression and eventually, those investors were paid in full. Prior to that period, several states defaulted during and prior to Reconstruction.

Q: Is bankruptcy a possibility?

A: Bankruptcy is a legal status that is not available to states.

Q: What is the priority of payment for California General Obligation (GO's) Bonds?
A: GO's are paid out of general fund revenues, which carry the full faith and credit obligation of the State. GO's are second in line only to Prop 98 funding for K-14 education.

Q: What are the structural challenges of the State?
A:
1. The State has less flexibility than other states in its budgetary process. Structural challenges include the requirement to have a super-majority to pass a budget and earmark funding.
2. The State has a highly progressive tax system which leads to revenue volatility during recessionary times.

Q: Are there any positives?
A:
1. The State's debt burden is modest on a per capita basis and low as a portion of total personal income.
2. The debt is structured in a conservative way, with little variable-rate debt that could be exposed to rising interest rates.
3. The State is important on a national level, as it contributes 13% to US GDP. If it were a country, it would be the tenth largest economy in the world.

Q: Is HighMark buying State of California GO's for its managed accounts?
A: No, not at the moment. We are looking for greater clarity on forthcoming budget solutions.

Q: How have other bonds issued within the State been affected?
A: Bonds issued within the State have suffered, as bond buyers across the country have avoided California-issued debt, causing yields to rise and prices to fall.

Q: What tax-exempt bonds within the State are you recommending for clients?
A: GO's (other than those issued by the State) and essential service revenue bonds such as those for water, sewer, and electric system projects, which provide good security, and in the case of essential service revenue bonds, a revenue stream dedicated to paying debt service. Currently these types of bonds are attractively priced compared to similar bonds in other states. Over time, as California's prospects improve, we believe these bonds will likely become more expensive.