

Ohio Constitutional Modernization Committee – April 14, 2016 Testimony

Chairman Cole and members of the Finance, Taxation, and Economic Development Committee: good morning. Thank you for the opportunity to appear before you on behalf of State Treasurer Josh Mandel. It is an honor to appear before the Committee. I currently serve as the Director of the Office of Debt Management at the Treasurer's office. Deputy Treasurer Seth Metcalf is unable to appear today, but he has asked me to testify on behalf of the office with respect to the recommendations that are currently under consideration.

Before addressing the recommendations, I'd like to briefly discuss what the Office of Debt Management at the Treasurer's office does.

At its core, the Treasurer's office has three primary debt-related functions. The first is to oversee the debt issuance process for all of the programs for which the Treasurer of State serves as the issuer. These programs include the state's general obligation highway debt, the state's GARVEE transportation bonds, the state's lease-appropriation bonds, the state's Federal and State Infrastructure Bank bonds, the Ohio Enterprise Bond Program, and the Community College Intercept Program. The office interfaces with the rating agencies and works to ensure post-issuance compliance. Debt Management also performs certain duties on behalf of the Treasurer of State for the Ohio Public Facilities Commission. The second core function is to ensure the timely payment on the state's approximately \$10.8 billion in outstanding debt. The office acts as paying agent and bond registrar for all general obligation debt and coordinates debt payments via corporate bond trustees for revenue and special obligation debt. Additionally, the office calculates payments on state interest-rate swap agreements and evaluates remarketing agent performance on the state's outstanding variable rate obligations. The office's third core function is to produce several legally-required reports including the Commissioners of the Sinking Fund Semi-Annual Report.

In short, the Treasurer's office is integrally involved on a daily basis with the issues that are the subject of the Committee's recommendations. Given that, I'm hopeful that this testimony will provide the Committee with a helpful perspective on the recommendations.

Unless the Committee members have questions about the Treasurer's office's role in the state's debt issuance and management, I'd like to discuss the recommendations in turn.

Recommendation One: "State Debt"

The first recommendation before the Committee is relatively minor, but it's one that brings the constitution into line with the realities of how state debt is paid today. The recommendation is to strike the reference to the sinking fund in Section 2 of Article VIII and insert the more generic word "state" in its place. Given that there is no longer a true "sinking fund," this recommendation would make the Constitution more accurate; while still retaining in the Constitution the source of where debts will be paid from.

Recommendation Two: “The Sinking Fund and the Sinking Fund Commission”

The second recommendation is to repeal Sections 7 through 11 of Article VIII for the reason that the state no longer utilizes a sinking fund and because the duties of the Sinking Fund Commission are being performed by the Treasurer’s office. From the Treasurer’s office’s perspective, there are two problems with this recommendation: one is philosophical and the other is more practical.

Section 8 of Article VIII currently mandates the involvement of publicly-elected officials in the state’s debt process. Sections 9 and 11 provide for those officials to report to the governor and legislature on debt issuance and payment. Section 10 expressly holds the publicly-elected officials accountable for the payment of the interest and principal on the state’s outstanding debt. These are all important concepts, and ones that rightfully belong in the Ohio Constitution. Nothing in the report and recommendation indicates that those concepts and duties are any less relevant today than they were in 1851. The only thing that has changed is simply that the Commissioners of the Sinking Fund no longer perform those duties. However, instead of taking the approach used in the first recommendation—where the Committee is looking to replace the phrase “sinking fund” with the word “state” to better reflect today’s practices—this recommendation instead discards the concepts in Sections 7 through 11 in their entirety.

The Treasurer’s office believes that to do so would be a mistake not only because these are foundational ideas, but also because they are important to public perception. Accountability for publicly-elected officials for the incurrence of general obligation debt matters. So does entrusting elected executive officials with the necessary and important task of repaying the state’s debt. Just as this Committee has recommended retaining Section 1’s \$750,000 debt limitation because of its importance for public perception—notwithstanding the fact that it has become antiquated—so too should the responsibility for the payment of the state’s debts, the reporting on such debt, and the accountability for such debt by publicly-elected officials be retained in the Ohio Constitution.

If this Committee is to revisit Sections 7 through 11 of Article VIII, rather than remove the delegated duties from the constitution, this is an opportunity for the Committee to reinforce those duties. In particular, as Mr. Metcalf discussed in his last testimony, the Committee should use this as an opportunity to not only modernize those sections but also to reaffirm direct accountability for Ohio taxpayers over elected executive officials for general obligation debt in the Ohio Constitution.

The second problem with this recommendation is that it may create a vacuum with respect to legal responsibility from not only a constitutional perspective, but also from a statutory one. If Sections 7 through 11 are repealed, it will have the effect of rendering a number of related statutes meaningless. Without delegating those responsibilities to the officials who currently perform them, Ohio law would be silent on many of these responsibilities.

Currently, the Treasurer's Office of Debt Management performs the ongoing roles and responsibilities of the Sinking Fund Commission. As far as I am aware, the Treasurer's office does not have independent statutory authorization to perform many of those tasks. When the Treasurer's office is acting in that capacity, it is wearing the hat of the Sinking Fund Commission. For example, when paying debt service on the state's general obligation debt, the members of the Treasurer's office interact with other state agencies as the Commission, and ultimately make the payments from the Commissioners of the Sinking Fund's designated bond service funds. Similarly, when the Treasurer's office does much of its reporting, it does so as a member of the Commission of the Sinking Fund. In fact, the Office of Debt Management's operating expenses are funded through the Commissioners of the Sinking Fund GRF line item in the Treasurer of State's operating budget (ALI 090-401). In other words, while the Commissioners of the Sinking Fund may not be active, the legal framework that is in place provides the requisite authority for the Treasurer's office, as a member of the Commission of the Sinking Fund, to perform those duties.

Accordingly, before the Committee moves forward with this recommendation, a more fulsome analysis of the legal repercussions of repealing Sections 7 through 11 without replacement should be conducted. Based on my review of the recommendation, the Committee is looking to repeal Sections 7 through 11 because the duties of the Sinking Fund Commission are being performed by the Treasurer's office, not because the Committee believes those duties are unnecessary. The Committee should make sure that it doesn't inadvertently remove the authorization for the performance of those duties.

Recommendation Three: "Authorization for Debt Obligations"

The last recommendation before the Committee is a constitutional amendment to increase the purposes for which the State of Ohio can incur general obligation debt. Specifically, proposed Article VIII, Section 2t would permit the State to incur general obligation debt for the purposes for which the State currently issues lease-appropriation debt. The rationale put forward in support of this amendment is that issuing general obligation debt for these purposes—instead of lease-appropriation debt—would allow the state to save money in its borrowing. While the relatively modest savings of this amendment have been discussed before this Committee, the relative costs of the amendment have not.

To understand the relative cost, it's crucial to look at the difference between a general obligation debt and a lease appropriation debt from a legal perspective. In a worst case scenario—and I should preface this with saying that I was formerly a bankruptcy attorney and am viewing the issue from that perspective—if the State were to default on a general obligation bond, bond holders have the ability to bring an action to force the state to increase revenues—whether by taxes, increased fees, or some other means—to pay the outstanding bonds. With lease-appropriation debt, bond holders have no such remedy. It is clearly disclosed that with lease-appropriation debt, the state's obligation to pay bondholders is entirely contingent on the State

legislature, every two years, appropriating the funds needed to pay debt service. If the state legislature doesn't, bond holders have no remedy. They cannot sue the state to force it to increase revenues. The state does not have to increase taxes to pay bondholders.

That's not to say that there wouldn't be consequences. Of course, to not pay on any of the state's debt would significantly hurt the state's credit rating and limit its ability to access the capital markets. And to be clear, I am in no way suggesting that the state should ever not pay its debts, or that the state would ever be in that type of fiscal position. However, general obligation debt is a long-term commitment, and we can't predict the future. If the state were to ever find itself in significant fiscal distress, lease-appropriation debt simply does not saddle Ohio taxpayers with the legal obligation to repay creditors.

To put it in a different context, it's like the difference between borrowing with or without personal liability. For instance, as you know, if you or I are to borrow money from a bank to buy a house, we sign a promissory note that personally obligates us to repay the debt, and we generally give the bank a mortgage on the property as well. In the event we ultimately fail to repay the loan, the bank forecloses on the property, and in the event the value of the house isn't enough to cover the debt, they come after us for the deficiency. Now, if we were able to borrow without personal liability and without having to provide collateral and were to default on the loan, the bank would be without a remedy against us. Now, in that example, without a mortgage or personal liability, a bank would charge a borrower an extremely high interest rate, which makes sense: the bank's risk of not getting repaid has increased tremendously.

For the state of Ohio, that's essentially the difference between general obligation debt and lease-appropriation debt. The biggest difference between the examples, however, is that in the case of the state, Ohio pays only slightly more interest when it borrows on a lease-appropriation basis. Fortunately, investors are very familiar and comfortable with the state's lease-appropriation credit, and are willing to loan money on that basis for a similar rate, even though they lose the ability to force the state to raise revenue to repay the debt.

It really comes down to a cost-benefit analysis. For the small benefit Ohio taxpayers would receive, is it worth the extraordinary commitment of general obligation bonds?

An interesting example of a state that has done such an analysis is one that Former Speaker Davidson discussed with Mr. Metcalf, and that is our neighboring state of Indiana. Indiana has concluded that they will only issue lease-appropriation debt and will not issue general obligation debt. What makes that all the more interesting is that Indiana's credit rating for their lease-appropriation debt is the same as Ohio's credit rating for our general obligation debt. So, if Indiana can get the same credit rating without making the same commitment, why should Ohio taxpayers give up more to get the same thing?

In Director Keen's remarks on October 8th, 2015, he cited the increase cost associated with the lease-appropriation bonds as ranging between 10-30 basis points. To put that type of savings in

perspective: the median sale price for homes in Ohio is \$131,070, and as of this morning, the average 30-year fixed rate mortgage in Ohio is 3.42%. The increased monthly cost of an extra 20 basis points on that average Ohio mortgage translates to \$14 per month—from \$583 to \$597. If you could borrow from a bank to pay for your house without putting your house at risk or assuming any personal liability, would you be willing to pay an additional \$14 per month? Many probably would.

So I hope what the Committee can see is that the case for simply increasing the purposes for which the state can incur general obligation debt is not a clear one. Lease-appropriation debt has become a useful tool for the state, allowing Ohio to borrow at very low-interest rates while not placing a legal burden on taxpayers. If the ultimate goal is to simply decrease the state's borrowing costs, improving our fiscal profile would be a far more meaningful approach. If Indiana can give up less and get the same credit rating, why shouldn't we do that?

Put another way, instead of placing more permanent burdens on taxpayers, as suggested by this amendment, the Committee should explore whether the exact opposite approach would be better: decreasing the state's G.O. tax burden and increasing use of the lease-appropriation credit. Director Keen's testimony indicated that this cost would be small. The Treasurer's office would like to prepare an analysis for the Committee's consideration in conjunction with its review of this recommendation.

Before moving forward with dramatically increasing the purposes for which the State can incur general obligation debt, the Treasurer's office strongly urges the Committee to hold off on voting on this recommendation until it can properly weigh the potential costs.

Jonathan Azoff
Director of Office of Debt Management & Senior Counsel
Ohio Treasurer Josh Mandel