Securitization Of Tobacco Settlement Payments To Reduce States’ Conflict Of Interest

Issuing a bond in return for up-front money might uncouple states’ desire for tobacco settlement funds from their wish to reduce smoking.

by Jody Sindelar and Tracy Falba

ABSTRACT: Securitization of the Master Settlement Agreement (MSA) payments from tobacco companies is hotly debated in states and policy circles. Securitization is issuing a bond backed by future payments in return for up-front money. Many public health advocates are strongly against securitization. However, securitization itself does not rob states of tobacco control. Rather, the issue is lack of commitment to tobacco control by states. Further, securitization can mitigate states’ conflict of interest between keeping tobacco companies fiscally healthy to ensure their MSA payments and reducing tobacco sales for health reasons. States should not align with tobacco companies with the common interest of keeping tobacco companies fiscally healthy.

In 1998 attorneys general of forty-six states signed the Master Settlement Agreement (MSA) as part of a resolution of the states’ case against four major tobacco companies to recover smoking-related Medicaid expenses. Four states—Florida, Minnesota, Mississippi, and Texas—settled their cases separately. It was initially reported that $209 billion would be paid to the forty-six states over the first twenty-five years of the agreement, subject to several adjustments contingent on inflation and sales of tobacco. Securitization is the states’ selling of their MSA stream of payments by issuing a bond typically backed by the payments owed to the state from the MSA. Some states are securitizing the settlement funds. The tobacco-control community sees securitization as robbing future tobacco-control programs to pay for states’ current budget reductions and other expenses. Tobacco-control advocates are now fighting to keep current MSA payments allocated to tobacco-control efforts and do not want to see future MSA funds lost to tobacco control by securitization.

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We offer two conceptual points related to securitization that have not previously been highlighted in the literature. One point is that it is not securitization per se that potentially robs future tobacco-control programs, but, rather, states' lack of commitment to use the funds for these purposes. The second point is that securitization may benefit tobacco-control efforts by reducing states' conflict of interest between keeping the tobacco companies fiscally healthy to pay the MSA payments and their desire to reduce sales of tobacco. We contend that states should not be aligned with tobacco companies in the common goal of keeping tobacco companies fiscally healthy to ensure that the MSA payments are made.

Background

**Stream of MSA payments.** Although it has been estimated that the original participating tobacco companies (Philip Morris, RJR Tobacco, Brown and Williamson, and Lorillard) would make payments of $209 billion over the first twenty-five years of the agreement, the actual amount is specified through a formula such that if these four tobacco companies sell tobacco products at a rate higher than the 1997 national rate, they will make higher settlement payments to the states. On the other hand, if sales decline, payments will be reduced. This formula provides favorable public health incentives.

**Securitization.** With securitization, a state sells a bond that is typically backed by the future stream of income that is due to the state through the MSA. The state gets a lump-sum payment when the bond is sold and promises to pay the "loan" back over time. By securitizing, or issuing a bond, the state trades a potentially risky future stream of payments for a certain lump-sum payment. Securitization is similar to issuing revenue bonds that states do relatively routinely, such as revenue anticipation notes. Funds raised by issuing a bond can be spent in current budgets on tobacco control or other uses, used for deficit reduction, placed in a dedicated trust, used for capital expenses, or used otherwise.

**How the market determines the interest rate.** The financial aspects of securitization are best understood as issuing a bond. The price of the bond—that is, the amount of money that the state receives up front—depends on the risk of default, the structure of the bond, and the administrative costs. The cost to the state is the interest rate that it must pay on the "loan." For investors to be willing to buy the bonds, the bonds have to offer a sufficient return to cover the risk that the tobacco companies might default on their future payments. Tobacco companies might default, in part or in full, because of large court case settlements, declining sales because of competition, stricter Food and Drug Administration (FDA) regulation, and other possibilities. These risks are reflected in the bond price that is set in the market for bonds and, in particular, tobacco bonds.

The price is also affected by how the bond is structured. The state picks the term to maturity (such as five- or twenty-five-year maturity), the percentage of the cash flows to securitize, the tax status of the bond (for example, taxable ver-
sus tax-exempt), and so forth.4

**“Cents on the dollar.”** The up-front payment made to the states through securitization will be less than if the expected future payments were simply summed. This is the case because of the discounting that must occur due to inflation, the risk of default, and administrative costs. Some argue that states are raising only “cents on the dollar,” but this always occurs when a bond is issued, and it is the cost of trading a risky stream of future dollars for a sure up-front sum. The up-front money can be reinvested in assets of lower risk. The discounting aspects of this are similar to those of a lottery winner who chooses to take an up-front lump-sum payment and reinvest it instead of receiving nominally higher yearly payments. But in the case of securitization, there is the added concern of default and risks of lower payments.

**Why do states securitize?** States would want to securitize for two primary reasons: (1) the concern that the tobacco companies might default on the promised stream of payments; and (2) the desire to obtain funds now rather than in the future.

The first reason applies because states do not wish to bear the risk of tobacco companies’ defaulting; securitization offers the certainty of receiving a guaranteed sum rather than the riskier stream of payments. In securitization, the risk is transferred from the state to the bondholders; the bondholders are the ones who will ultimately be receiving the risky future stream of payments from the tobacco companies. If the tobacco companies do not pay in full, the bondholders suffer the financial loss, not the state. However, in some recent cases, such as in New York State, the state itself backs the bond and thus does not get the benefit of the transfer of the risk to bondholders.

The second reason pertains to having access to funds now rather than later. Selling the present value of the future stream of payments gives the state up-front funds. The funds can then be used to meet current needs, fund tobacco-control or other programs, or establish an endowed trust for special purposes, such as tobacco control.

**Policy Implications**

**Separation of fund sources and uses.** The decision to move funds to the present through securitization is a decision about how to obtain revenue. For example, a state could raise taxes (income, sales, or tobacco), raise fees (traffic tickets, entrance to parks, and so forth), or issue bonds. Decisions about sources of funds can, in theory, be made separately from the uses of funds.5 On a practical basis, sources and uses of funds can be linked because of politics and other issues, but financially they are separate issues. For example, it may be beneficial politically (the “moral imperative”) to earmark cigarette tax revenues to tobacco control or highway toll fees to highway construction, but financially they need not be linked.

The separation of the uses and sources of funds indicates that it is not the taking of the funds in a current lump sum that jeopardizes the use of funds for tobacco control; rather, it is the lack of commitment to use the funds for tobacco control.
control. For instance, tobacco-control funding need not be (and is not in many cases) substantial in states that have not securitized their settlement revenue. Alternatively, following securitization, an endowed trust fund could be established for tobacco control using the funds from securitization. The interest from the trust could be used to fund tobacco-control programs each year and to pay for health care. In this way, the riskiness of the stream of payments from the tobacco companies would be reduced and the funds could be committed to future tobacco-control programs. It is worth noting, however, that even dollars committed to a trust fund have been used for current expenditures rather than for tobacco control. For example, funds from the trust of Iowa and other states have been used for other purposes. Tracy Falba and colleagues find no systematic differences in tobacco-control efforts by whether or not states securitize. This is attributable in part to the fact that states that do not securitize do not necessarily spend their tobacco payments on tobacco control; often these states have devoted large chunks of this revenue to deficit reduction. However, the decision to securitize may serve as a signal that a state is not committed to tobacco-control efforts.

Further, if a state spends money on tobacco control, it does not matter whether it comes from MSA settlements, tobacco taxes, or general revenues. Expenses paid by the securitization funds may free up other funds to be used for tobacco control. General state funds may be fungible. Using the securitized funds for capital expenses sometimes allows the state to issue a tax-exempt bond, which lowers the interest cost to the state. Thus, issuing a tax-exempt bond is cheaper for the state but may restrict uses of the revenue. Nevertheless, it can free up other unrestricted funds to be used for tobacco control. However, if the freed-up funds are not earmarked for tobacco control, it can be more difficult to get these funds allocated to tobacco control.

Some states seem to securitize largely for the purpose of paying state deficits and capital expenses; nonetheless, states that have not securitized have similarly used their MSA funds. Again, at least in theory, it is not the sources of funds that matter but, rather, the use for and commitment to tobacco control. For example, Rhode Island planned to use most of its funds to close current and future-year budget gaps. Alaska used securitized funds to back school construction, another capital expense, and intended to use a portion for health promotion purposes.

Reducing the potential for conflict. States now rely on the MSA payments to cover many of their expenses, including deficit reduction, tobacco-control programs, educational spending, and health care. Thus, while states sued tobacco companies prior to the MSA in part to reduce tobacco sales, they now are also financially interested in the tobacco companies’ payments to the state. States may be less compelled to reduce smoking through increased cigarette taxes, anti-tobacco advertising, and other mechanisms. Note, however, that a single state could aggressively reduce tobacco use in its state without hurting the national payment much (or at all if it is a small state), but if all states were aggressive, the payments would be reduced.
Evidence of the states’ conflict between these two interests may be starkly seen in the recent response by the states to the Madison County, Illinois, court case. In this class-action suit, the judgment against the tobacco companies initially required a $12 billion bond from Philip Morris to appeal the $10.1 billion settlement in a case about “light” cigarettes and false advertising. Several of the states requested that the $12 billion bond be reduced on the grounds that Philip Morris would not be able to make its MSA payments to the states if it had to pay $12 billion in the court case. The amount was later reduced to a still hefty $6 billion. Interestingly, Missouri passed a bill that went into effect in August 2003 that limits appeal bonds to $50 million for tobacco companies. Other states are considering similar moves.

Thus, securitization backed by MSA funds would have the advantage of uncoupling states’ desire for funds from the MSA and their desire to reduce smoking. The conflict of interest can be reduced greatly by securitization depending on the terms of the bond. For example, a long-term bond backed by all of the MSA payments would transfer much of the risk to the investor and away from the state. On the other hand, only a small percentage of securitization on a short-term bond with the state backing the bond with general revenues would leave most of the risk with the state.

**Concluding Comments**

We close with two conceptual points relevant to the debate about securitization. First, it is not securitization per se that robs states of future tobacco companies’ funding but, rather, states’ lack of commitment to use MSA funds for these purposes. Focus should be on the uses of the funds. Discussions of securitization at the state level may signal the desire to use MSA funds for deficit reduction and a low commitment to tobacco control. Even deficit reduction, however, may save cuts to tobacco-control programs in the short and long run.

Second, securitization backed by the MSA funds reduces states’ conflict of interest between ensuring the financial viability of the tobacco companies and reducing tobacco use. States that securitize in this way could have more interest in controlling tobacco sales and less interest in protecting the fiscal health of the tobacco companies. The reduction in conflict is most fully realized when all of the risk of defaulting on the MSA payments is transferred to the bondholders. Despite the reduction in the conflict, securitization could be harmful for tobacco-control efforts if the funds are earmarked or used primarily for other purposes, such as deficit reduction. Of course, the use of MSA funds for deficit reduction and other expenses also occurs even without securitization. If the sole motivation for securitizing seems to be use of funds for deficit reduction, this could serve as a signal for tobacco-control advocates of lack of commitment to reducing smoking rates. Politically there may be an advantage to fighting the battle each year on the grounds that it gives advocates more years in which to be persuasive and win.
funds for tobacco control, thus securitization could be harmful. However, the reduction in the conflict is an important and sometimes overlooked argument in favor of securitization. States should not align with the tobacco companies in a common interest of keeping tobacco companies fiscally healthy.

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NOTES
3. California and New York issued bonds backed by general revenues of the state.
6. T. Falba, A. Snyder, and J. Sindelar, “The Effects of Securitizing MSA Funds on Tobacco Control Activities by State” (Unpublished manuscript, Yale University, 2004).
9. In a very comprehensive paper, Steven Schroeder notes this potential conflict of interest but does not note that securitization using MSA funds as collateral mitigates the conflict of interest. Schroeder, “Tobacco Control.”