THE BOND BUYER
THE DAILY NEWSPAPER OF PUBLIC FINANCE

DEAL IN FOCUS

New N.Y. Credit Inspired By Workers' Comp Reform

Monday, October 26, 2009

By Ted Phillips

The 2007 reform of New York State's workers' compensation laws was intended to reduce costs to employers. The policy change also began the gestation of a new credit that is expected to come due in the second week of November.

Next month, the Dormitory Authority of the State of New York plans to sell the first piece of what could total $4.55 billion of taxable and-or tax-exempt bonds to partially fund liabilities to the state's special disability fund, which will close to new claims on July 1.

The deal size had not been set last week, but DASNY will consider a resolution at its board meeting this week to sell up to

$1 billion of bonds with expected maximum maturities of 30 years.

The new bonds, called pledged assessment revenue bonds, will be backed by annual assessments made on workers' compensation insurers and self-insured employers in the state. Nearly all New York employers must carry workers' compensation insurance for the nearly eight million workers in the state.

"We haven't seen many like this," said Moody's Investors Service analyst Emily Raimes. "These have this annual assessment feature, which I think we consider pretty strong."

"It's a new credit so it has value from a diversification perspective," said Joe Darcy, senior portfolio manager at Dreyfus Corp. "The financing structure in terms of the source of revenue securing the deals appears to be very tight so it takes it out of the general appropriated malaise that some of New York's debt falls into."

Goldman, Sachs & Co. and Siebert Brandford Shank & Co. are underwriters on the deal. Hawkins Delafield & Wood LLP is bond counsel.

The state created the special disability fund — also called the second injury fund — in 1916 to remove a disincentive to employers to hire workers, such as war veterans, who had a prior injury.

The fund reduced liabilities to employers and insurers who might have otherwise incurred greater costs if a worker became permanently disabled from the combination of an old injury and a new injury. An injury that on its own might not cause disability could be materially worse when combined with a previous injury.

With the establishment of the fund, the employer or insurer of the disabled worker in these cases would pay the claim and then be reimbursed.

The fund has operated on a pay-as-you go basis. Under the current system, the Workers' Compensation Board each year sets an assessment on insurers and self-insured employers by multiplying the previous year's disbursements by 150% and then reducing it by the current balance in the fund.

In 2008, the fund's disbursements totaled $498 million and the fund ended the year with a balance of $246 million. Multiplying the 2008 disbursements by 150% and subtracting the balance put this year's assessment at $501 million.

Annual disbursements weren't always this large. In 1983, disbursement were closer to $30 million, but changes to the law increased the scope of eligible injuries and assessments rose.

"Workers' comp has long been one of the most onerous burdens that businesses faced in New York," said Elizabeth Lynam, deputy research director at the Citizens Budget Commission, a fiscal watchdog organization. "It was a significant barrier for businesses, and definitely a problem with our competitiveness. Compared to other states, our system was very costly."

The situation has improved over the past two years, according to Lynam.

The 2007 reform act implemented several changes to reduce costs to insurers and employers. Among those changes was the upcoming closure of the fund to new claims and the authorization of DASNY to sell bonds to finance to 25% of the second injury fund's liabilities as of June 30, 2007 when they totaled $18.2 billion.

Although the fund won't close to new claims until next year, injuries must have occurred before July 1, 2007, to be eligible. The bond proceeds will be used to fund up-front lump settlements on claims, fund the cost of transferring liabilities to insurers, and fund anticipated liabilities.

"This is designed to take some cost out of the system," said Finer Hampton, deputy superintendent and chief economist of the New York State Insurance Department. The fund's reimbursements didn't give insurers much reason to try to reduce claims, he said.

The fund "really isn't a great incentive for the insurer to try to strike settlements or do other deals, or try to avoid the claim in the first place if they're confident that it's a second injury, because they basically get to shift [the cost] out to the industry," he said.

Under the 2007 reform, the special disability fund's annual levy will continue to be based on the old formula but with the addition of a separate assessment to meet debt service and other funding requirements related to the debt.

The law also requires that assessments meet a 1.1 times debt service coverage ratio. DASNY expects assessments to fall over the life of the bonds as liabilities are paid off, reducing debt service coverage but not below the covenanted 1.1 times coverage.

Assessments will be paid to the state commissioner of taxation and finance and be held in a segregated fund. The bonds will also have a debt service reserve fund equal to six months' debt service.

Historical collection rates for the assessments have been at nearly 100% and the state attorney general has the authority to enforce the assessments, according to DASNY documents.

The annual assessment feature, which is not subject to appropriation, gives the bonds a level of security that revenue bonds typically don't have, Raimes said.

With gas tax bonds, for example, "if revenues go down because there's an economic downturn or people find some other way of traveling other than by using gas, there's really nothing you can do about that," Raimes said. "Whereas with this structure, if for some reason you set the assessment one year to give you enough money to cover debt service and if for some reason collections come in low ... then the next year you can make that up and you can change the assessment. And that's kind of a strong feature for this type of credit, but different from most of the revenue bonds that we look at."

Moody's rates the bonds Aa3 with stable outlook. The rating is the same as the state's general obligation rating, but Raimes said that is a coincidence.

"It's not linked to the state in the sense that the state's rating could go up and down and we wouldn't expect these ratings would go up and down," she said. "They're rated separately because there's legal separation and good separation between the revenue stream and the state general fund."

Fitch Ratings and Standard & Poor's assign AA ratings with stable outlooks to the bonds.

Darcy said that the credit's legal structure is an attractive feature, given the current options for investing in other New York credits.

"The New York economy and New York State's revenues continue to be affected by the downturn that occurred in the financial services industry," Darcy said. "The likelihood of continued budget shortfalls for the foreseeable future would appear to be fairly high. To the extent that you have sources of revenue [for the new credit] that have demonstrated on a historical basis adequate flows that are securely pledged in support of specific debt ... you have a better credit structure and therefore better performance potential for the debt."

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