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The Default of Special District Financing: Evidence from California

Anna Racheva-Sarabian,* Dmitry Ryvkin† and Anastasia Semykina‡

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Abstract

In response to a series of legislative measures curbing property tax revenues, special taxation districts emerged as a mechanism of financing public infrastructure by local governments in many U.S. states. Community facilities districts (CFDs) in California are but one example. These districts are financed by issuing a special type of land-secured municipal bonds known as CFD or Mello-Roos bonds, and levying special taxes to service the debt. Using a unique comprehensive data set on California CFD bond issues since the moment of their inception until 2006, we study the default experience of these largely nonrated bonds. Contrary to the general belief that the "dirt" CFD bonds are very risky, we find that their lifetime performance is at least as good as that of Standard and Poor's B to BBB rated municipal bonds. Using duration analysis, we explore the dependence of the likelihood of CFD default on issue characteristics and macroeconomic and industry factors. We find that the state of local economy and construction industry are strong predictors of CFD default. The default is positively linked to the risk premium of the CFD bonds measured as the spread between their interest rate and the AAA rated general obligation municipal bonds yield index. We also find aging effects and relate them to stages of CFD development.

Keywords: Mello-Roos, CFD, municipal bonds, default, duration analysis

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