

Municipal Bond Market Update: How Safe Is It?

Arthur A. Micheletti, CFA
Chief Economist and
Investment Strategist

January 2011

Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, CA 94404
T: 650 571 5800
www.bailard.com

In a recent *60 Minutes* interview, Meredith Whitney, a noted Wall Street analyst (who in 2007 warned early and often about the pending banking crisis), pointed to municipal bond defaults as the next major issue likely to hit the financial markets given the fiscal challenges state and localities are currently facing. She argued that a municipal bond default crisis could trigger hundreds of billion dollars of losses for bondholders. However, this view is not generally held by other municipal bond analysts. Joe Mysak of Bloomberg, for example, wrote a commentary saying that such claims are “in the realm of the fabulous”. While he acknowledged that there are likely to be 100 to 200 municipal defaults in 2011, Mysak estimated that they would only generate maybe \$5 to \$10 billion in losses.

To put this loss estimate into perspective, states and municipalities have around \$2.8 trillion in bonds outstanding. The municipal bond market is huge and, for reasons we will explain later, we expect the majority of bonds to continue to make interest and principal payments.

But, to begin at the beginning, we will first discuss the history of municipal bond defaults in the U.S. We will then move on to review the different types of municipal bonds, what

constitutes default, what happens in default, the bankruptcy alternative and the possibility of federal government bailouts, before summarizing the key risks facing the municipal bond markets today.

History of municipal bond defaults:

A. Nineteenth Century Defaults: The Panics of 1837 and 1839 triggered numerous municipal bond defaults, as well as a huge number of bank failures. In addition, in 1842, Pennsylvania defaulted on its debt.

B. Great Depression Defaults: From 1929 to 1937, there were over 4,700 municipal defaults. Bondholders often used the courts to force issuers to increase taxes. Arkansas's default was a particularly interesting case. In 1933, it defaulted on its debt, after the state assumed repayment responsibility for hundreds of road district revenue bonds that were supported by gasoline and automobile taxes. When Arkansas tried to turn these revenue bonds into state general obligation bonds (G.O.s) with lower coupons, bank and insurance company bondholders forced the state into bankruptcy. Ultimately, all of the state issuers that defaulted during the Great Depression repaid their obligations in full.

C. "Modern" Defaults: In February of 2010, Moody's issued a report that catalogued municipal defaults and recoveries on bonds it had rated between 1970 and 2009. The report counted a total of 54 defaults: 21- Housing, 21- Healthcare, 3- Utilities, 1- Higher Education, 1- Recreation, 4- Non-G.O. governments and 3 -G.O.s. One third of these bonds were conduit bonds, corporate and nonprofit borrowings issued in the guise of municipal debt. Another third were projects tied to property assessments. Finally, the report noted that, going back to 1970, no investor took a loss on a state or city's general obligation debt.

In summary, historically, defaults have been rare and investors were typically made whole.

Types of municipal bonds

Municipal bonds are broadly divided into two classes: G.O. and Revenue Bonds.

G.O. bonds are secured by the full faith and credit of the issuer. The borrower is committed to raising taxes and other revenues to cover the amount owed. This type of debt is treated as unsecured for bankruptcy purposes, which allows municipalities to postpone the making of principal and interest payments while they work out their fiscal issues.

Revenue bonds are secured and have a dedicated stream of revenues to meet their debt obligations

Typical examples include utilities, housing, toll roads, etc. Most revenue bonds have provisions to raise rates to increase revenues so that interest and principal payments can be made.

State and local borrowers can also issue "conduit" revenue bonds. Conduit bonds are bonds issued by government entities on behalf of a third party, generally a nonprofit entity such as a hospital, a college or a developer of government subsidized housing projects. Conduit bonds can also be issued for a for-profit entity. (These are known as industrial bonds). Conduit bonds are not government debt; they are private debt secured by the revenues generated by the project being financed. Governments issue conduit bonds because they believe the project will benefit the public in some way. These types of bonds are most vulnerable to default, although they also tend to be secured.

What constitutes default?

There are two types of default, monetary and technical. Usually, when people talk about default, they are referring to a monetary default, where a borrower fails to make a debt service payment in full and on time. Technical defaults are due to a failure to comply with certain debt covenants, such as raising rates when certain debt service coverage ratios are not met or drawing down on reserves. A technical default can also occur if the issuer files for bankruptcy.

What happens in default?

If an issuer of a bond defaults, the bondholders' rights and remedies are defined in the bond documents and state law. A common remedy in the case of a default is that the payment on the debt is accelerated. The principal and accrued interest are due immediately or ahead of schedule. A bondholder could force the sale of assets if the bond is secured. This is harder to do with a government borrower that is unsecured than for a revenue or conduit bond that may have underlying property.

It is usually in the interest of the bondholder to cooperate with the borrower. Bondholders may begin with a forbearance agreement stating they will not declare an event of default while the government and creditors negotiate a settlement. This is most likely to occur when the default is due to something like the timing of cash flows and where the funds are expected to be recovered.

Bondholders may also seek a "writ of mandamus" from a court to compel government officials to take specific actions to cure whatever problem caused

the default. They might have to collect more taxes for G.O. bonds or raise rates for revenue bonds. Issuers can't argue for a permanent default until all revenue sources have been exhausted.

Most government issuers provide bondholders extra protections. State constitutions often give debt service priority over other expenditures. For example, in California, debt service is the second entity paid after schools. That means a lot of spending would be cut before bond servicing would be at risk. In California, while debt service has risen from just above 1% of revenues in 1978 to 5.7% in 2010, it is not that large a part of the budget. Rollovers next year also pose only a small risk, totaling only \$2.9 billion in California (0.4% of state GDP).

In some states, local municipalities can declare bankruptcy and allow the state to take over administrative responsibilities, including negotiating or renegotiating contracts. In some cases this remedy is triggered automatically when a local government's credit rating falls below a certain level.

In other cases, issuers may restructure their debt by exchanging new debt for old with new terms. They may also make a tender offer to bondholders to repurchase debt below par. Bondholders may choose to renegotiate or to take a discount rather than drawing the process out and risk depleting the ability of municipalities to repay, with the possibility of receiving even less in the end.

A closer look at the bankruptcy alternative

Currently, 23 states allow local municipalities to file for bankruptcy. Indiana is pushing legislation to become number 24. To remedy many local municipalities' fiscal issues, bankruptcy may be the only course. We are likely to see more states allow municipal bankruptcy over the next year.

Some commentators argue that all local municipalities would do anything to avoid bankruptcy since they would be banned from the credit markets, effectively preventing them from borrowing additional funds at a cost-effective rate in the future. But this belief failed a key test in 2008 when Vallejo, CA filed for bankruptcy. The city actually embraced bankruptcy as a solution to its difficulties. Although the housing collapse hit property tax revenues hard, Vallejo's real problem was collective bargaining agreements' control of the city's labor costs. Acknowledging its inability to meet future obligations, Vallejo took the bankruptcy route to ask the judge to throw out those agreements and to allow it renegotiate labor contracts. Many municipalities throughout the country are also facing soaring labor costs they can't

afford to pay. Ironically, municipalities that use bankruptcy to reduce future obligations and restore fiscal discipline may actually have an easier time garnering credit in the future.

Although some states have filed for bankruptcy in the past, it is extremely rare and may not be constitutional. The primary constitutional stumbling blocks to state bankruptcy, according to a *Weekly Standard* article by Professor David A. Skeel, are the Tenth Amendment's protection of state sovereignty and the Fifth Amendment's protection of the property interests of creditors.

Professor Skeel argues that the state sovereignty issue could be resolved "so long as a state can't be thrown into bankruptcy against its will and bankruptcy doesn't usurp state lawmaking powers." The Fifth Amendment's "Takings Clause" does protect creditors from being deprived of property without due process. The clause might be violated if the "law allowed a court to ignore the property interests of creditors who had been promised specific state tax revenues or had been given other collateral." However, local municipalities have successfully used Chapter 9 of the bankruptcy code to file for bankruptcy as it provides a mechanism for respecting the rights of creditors. It is possible Congress could pass similar legislation to allow states to declare bankruptcy as well. This would at least raise the possibility that, as unsecured creditors, G.O. bondholders could see a reduction or restructuring of that debt.

Too big to fail? The possibility of a federal bailout

Some bondholders suggest that the federal government regards the biggest debtors as "too big to fail" and thus will be compelled to rescue defaulting states and municipalities. However, the current sentiment for restoring fiscal discipline makes it more difficult for politicians to continue bailing out states and enabling irresponsible fiscal behavior. In addition, given the size and breadth of the problem, it would be difficult to cherry pick which states the federal government would bail out. Once the bailouts began, everyone would be lining up for assistance. Moreover, the federal government has fiscal problems of its own to solve.

We believe municipal issuers will have to work their own way out of their fiscal problems. However, it is possible that Congress might establish some sort of oversight panel for distressed states similar to the Municipal Assistance Corporation created during the 1975 New York City financial crisis. The federal government could then provide financial assistance in return for tight oversight, including putting state

pension plans on a more sustainable course. Finally, the Fed could buy state debt, although new legislation would be needed to allow it to purchase securities with less than a triple-A rating.

In addition, states are sovereign and have the power themselves to change state bankruptcy laws, cut spending and raise taxes. The problem is that many states have spent like drunken sailors. California, New Jersey and Illinois have spent decades spending more than they bring in and overpromising services that they can't deliver. They have the power to change this.

with municipal debt yielding more than comparable maturity U.S. Treasury bonds. The other key risk is that the financial remedies necessary to solve state and local fiscal problems are likely to have a significant impact on economic growth. Higher taxes and spending cuts will probably contribute to slower growth in the short term even if they are necessary for the long-term stability of municipal finances.

Summary of key risks

As mentioned earlier, we believe most municipal bond issuers will continue to make their interest and principal payments. Municipal bond defaults historically have been rare and, in the vast majority of cases, bondholders were eventually made whole. We also believe most state and local municipalities will choose to avoid default and risk cutting themselves off from the credit markets. They can always raise taxes, fees and rates to generate revenue for debt repayment. Thus, there is unlikely to be a massive loss from municipals caused by defaults.

Nevertheless, while defaults are rare and bankruptcy is even rarer, the financial problems of municipalities are arguably more severe today than at any time since the Great Depression. In addition, long-term entitlements make municipalities even more vulnerable. As a result, defaults are likely to increase.

Much of this default risk is already discounted in the current prices of municipal bonds. So we see the real risk in the municipal bond market as, not so much the repayment risk, but the psychological impact on the market of credit downgrades and the headline risk surrounding financial distress. These factors could cause municipal yields to rise as the premium for default risk goes up. This is already happening,

Disclaimer

This white paper has been distributed for informational purposes only and is not a recommendation of, or an offer to sell or solicitation of an offer to buy, any particular security, strategy or investment product. This article does not take into account the particular investment objectives, financial situations or needs of individual clients. Charts and performance information portrayed in this piece are not indicative of the past or future performance of any Bailard product. **Past performance is no indication of future results.** This article contains the current opinions of the author and such opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Bailard will not offer investment advice in any jurisdiction where it is prohibited from doing so.