Viewpoint

One of a series of opinion columns by bankruptcy professionals

Municipalities Under Financial Distress

By Robert C. Smith and Pearl Mathew

Prior to 2008, states and municipalities enjoyed unrestricted access to the bond market to fund infrastructure projects, build schools and acquire property. The tax-free nature of municipal bonds coupled with the belief that the bonds were default-free made them a popular choice with investors. This thinking was supported by the rating agencies which were quick to give an AAA rating.

According to an article in *Seeking Alpha*, in the mid-1990s, states and cities were retiring as much debt as they were incurring. During the 2000s, municipalities borrowed as much as $150 billion per year in aggregate, peaking at $215 billion in 2007. By that time $2.7 trillion in debt was outstanding, a staggering sum representing more than two years' worth of tax receipts. According to a recent study by the Schwab Center of Financial Research, the market for municipal state and local and public enterprise debt today is nearly $3 trillion in debt outstanding, with more than 50,000 eligible and more than 10,000 active issuers.

The recession and subsequent period of slow economic growth have significantly impacted municipalities. These entities face financial challenges including lower tax revenues, decreased aid from the federal and state governments, unfunded federal mandates, pension funding gaps, collective-bargaining obligations and increased demand for services from citizens.

These dynamics have impacted the municipal bond market and have the potential to do so for quite some time.

An analysis of broad market data would indicate that we are in a period of moderate displacement. State and local budgets are under pressure. As noted below, total debt relative to performance metrics has worsened. The municipal bond market has contracted in recent periods and default rates have inched up but not to the levels that were first projected by some experts.

There are strong opposing viewpoints on the likelihood of widespread state and municipal bond defaults. Some experts argue that state and municipal bonds are no longer the safe, tax-free investments, as once believed, due to the fiscal problems faced by many states and municipalities. Challengers to this viewpoint argue that factors affecting sovereign, state and municipal debt are mistakenly being lumped together by experts, investors and the media.

There are many factors being discussed that could dramatically affect both munis default rates and pricing. A decision could be made to tax bonds to raise revenue for cash strapped states and municipalities. Or, states could deal with their budget deficits by cutting aid to municipalities thereby further exacerbating the fiscal problems of municipalities. Munis holders tend to be wealthy individuals who could react negatively to news of the risk of defaults or a possible loss of the bonds' tax-free status and sell their bond holdings. This could cause a drop in bond prices and a loss of interest in future issuances.

The median state debt as a percentage of personal income rose to 2.5% in 2010 from 2.2% in 2000, a 14% increase, according to Moody's Investors Service. While the increase would seem manageable at first glance, the numbers are distorted by a concentration of borrowing and deficit spending occurring in select states such as California, New York and Illinois.

The credit crisis has caused many bond insurers to close shop, increasing the risk to muni bond investors. Currently, less than 10% of new municipal bond issues are insured, which is down from about 50% in 2008 according to the Municipal Securities Rulemaking Board.

Most municipal bond issuances aren't rated by national firms; thus, keeping track of defaults can be a tedious process. A Bank of AmericaMerrill Lynch report from December 2010 indicated that there was $4.25 billion of municipal debt in default, which represents 0.15% of the entire municipal bond market. In 2010, municipal bond defaults amounted to $2.7 billion or about 0.09% of outstanding issues. Research at Moody's also shows that there should be no state government and only a few local government defaults on Moody's-rated debt in 2011. In 2010, only one tax-exempt healthcare borrower defaulted and there were no defaults by Moody's-rated state or local governments. Note that most defaults occur on unrated securities, typically tied to special purpose facilities.

Muni issuers will continue to face significant fiscal challenges in the upcoming years. The stability of the bond market will be an important enabler in allowing municipal entities flexibility to manage such challenges. In a form of circular logic, the ability of the municipal entities to confront the challenges will also be a key factor to maintaining market stability. The trends, while some negative, would seem to indicate that on the whole municipal bonds continue to perform and that market participants still perceive munis as a relative safe haven.

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The misalignment of municipal revenues with expenditures, the diverse nature of the municipal stakeholder base (politicians, professional administrators, unions, retirees, bondholders and taxpayers), and the resultant impact on municipal securities have created an environment that will require change. Municipalities need to make material changes in the means by which government services are provided. They must confront key stakeholders and constituencies and demand contribution from all. Unions, pensioners and taxpayers must each contribute to the solution. Bondholders will need to restructure obligations in select situations. The parallels to corporate restructurings are eerily similar and provide opportunity for turnaround professionals at multiple levels of the spectrum.

Operational turnaround firms are increasingly being employed by states and larger cities to help governments identify means of delivering services more efficiently. The turnaround firm is uniquely positioned to provide an objective critique of governmental operations, make recommendations as to appropriate cuts, merger of services and sales of infrastructure. In short, third-party advisers can provide municipal managers professional guidance and cover to make and implement the difficult decisions. In fact, the city of Detroit and New York state are but two sizable entities that have availed themselves of such expertise.

Legal advice has been and will continue to be critical to manage the impact of government shortfalls on bondholders and other key stakeholders. Some municipalities may need to take extreme measures, including a restructuring under Chapter 9. While Chapter 9 is rarely utilized and somewhat difficult to implement, such a filing can allow a municipality to deliver services while adjusting or refinancing its debt. To file, municipalities need to prove insolvency, show that previous efforts to renegotiate debts have failed, and display a willingness to pay creditors. Approvals are needed at the state level in order for a municipality to file, and only 24 states allow for such a filing. State governments themselves are precluded from filing. Note that in 2009 only 10 municipalities filed for Chapter 9, and in 2010 only five filed. In general, municipalities should look at Chapter 9 as an option of last resort. Although such filings make it easier for a city to break onerous labor contracts, make other politically tough cost cuts or restructure debt obligations, they can have hidden costs, such as distracting politicians, alienating businesses and making it more difficult for a city to raise cash in the capital markets going forward.

Finally, as municipal entities continue to deal with defaults and debt restructurings, all affected stakeholders should need the services of financial professionals. Financial reporting guidelines for municipal securities are significantly more lax than those for corporate securities. The SEC regulates the sale of initial offerings but does not regulate ongoing reporting, thereby increasing the potential for limited and constrained financial information. Restructuring professionals, utilizing short- and long-term financial modeling skills coupled with communication and negotiating skills, can assist the broad range of stakeholders in any municipal debt scenario.

Opinions expressed are those of the author, not of Dow Jones & Company, Inc.

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