

## municipal bonds – keeping it in perspective

**T**he recent economic crisis has impacted all areas of finance, and clearly the municipal bond market has been no exception. Despite long standing views regarding the inherent safety of municipal bonds, they have recently come under scrutiny by investors, analysts, and rating agencies alike. We are all familiar with the events that have triggered this upheaval, but perhaps we also need to be reminded of what precisely has changed and what has not.

### What has changed?

What is it about tax-exempt municipal bonds that now cause uncertainty among investors? It is no secret that states and local governments are navigating through one of the worst financial crises ever. In many cases, the impact of plunging tax receipts has given rise to record budget deficits that are projected to get worse before they get better. However, it is important to understand the nature of state and local government revenues, as well the critical services these revenues fund.

Most states derive roughly 90 percent of their revenue from three primary sources: personal income tax, sales tax, and corporate income tax. Approximately 80 percent of all revenues are spent on education (elementary and secondary combined), health/public services, and transportation. For local governments, the largest revenue source in addition to state aid is ad valorem (property) taxes, with expenditures consisting primarily of education, health, and public safety (police, fire, jail). Prior to the 2007 meltdown, state and local governments enjoyed consecutive years of robust revenue growth, healthy reserves and, for better or worse, a heavy reliance on the capital markets. But the last three years have painted a very different picture for municipalities, as the national recession drastically reduced tax revenues and required tough decisions from government officials to correspondingly increase existing tax rates, implement new taxes, or slash expenditures. Given the historical lag of tax collections following a recession, state revenues are projected to remain suppressed in ensuing fiscal years, requiring states and local governments to continue to find ways to curtail spending or raise taxes.

Unlike most downturns, the all-encompassing domino effect of this economic crisis has been unparalleled. The hous-

ing market crash, diminished home values, and stagnant housing sales have slashed property tax collections, while high unemployment levels, curtailed consumer spending, and declining corporate profitability have reduced income, sales, and corporate tax receipts. In addition, the equity market crash and subsequent volatility has significantly reduced wealth levels and further driven down tax receipts. Lack of employment has exacerbated the housing crisis, and although historically low interest rates should have encouraged spending, the credit crunch has made it difficult for consumers to take advantage of low cost financing.

To further complicate matters, many of the events that resulted in revenue declines simultaneously increased expenditures. High unemployment rates have increased unemployment benefits paid by state and local governments, and have had a contagion effect into the healthcare area as the uninsured and indigent population continues to expand. Additionally, the equity fall-out and low interest rate environment has reduced state and local government investment income and, most notably, caused a spike in unfunded pension liabilities. Pension assets declined in value given their average 60 to 70 percent allocation to equities, while the present value of liabilities increased as interest rates fell. As a result, states and local governments are facing significant pension fund gaps, placing additional pressure on already strained revenues.

While the current financial challenges facing states and municipalities are arguably the most extreme in modern history, some of the perceived severity can be attributed to heightened awareness. Approximately 70 percent of municipal obligations are held by individual or “retail” investors who generally seek high after-tax income and rely on the inherent safety of the asset class itself. Add the double-barreled security that was often provided through bond insurance and letters of credit, the performance of the underlying security was largely overlooked. With daily headlines touting potential municipal defaults, even the most mundane of securities are now being put under a microscope. Such analysis may be justified however, as the current environment of increased financial stress and greater market volatility could potentially give rise to isolated defaults for some of the smaller or more speculative rated issuers.

## municipal bonds – keeping it in perspective

### What has remained the same?

While all this sounds quite disconcerting, it is important to keep things in perspective. Aside from securities issued by the federal government and its agencies and instrumentalities, municipal bonds have historically been considered the next safest asset class. General obligation bonds, or debt secured by a full faith and credit pledge, have long been regarded as the most secure debt issued by municipalities, followed by debt secured solely by a dedicated cash stream, or revenue bonds. Although the underlying revenue source is different among these two bond types, the user base from which repayment is derived is often large, diverse, and stable, providing dependable security for the debt. In addition, issuers typically not only have the autonomous ability to raise additional revenue when necessary, but more notably a legal obligation to do so to ensure timely payment of principal and interest. Given these strong security provisions, default rates on investment grade municipal obligations have been virtually non-existent, with triple-B municipal bonds defaulting less than triple-A rated corporate bonds. The last state-level crisis occurred over 77 years ago in Pennsylvania, further evidencing the remoteness of a state default. The table below provides historical default rates of municipals versus corporate along the rating spectrum.

(In Percent)	Moody's		S&P	
	Muni	Corp	Muni	Corp
Rating category				
Aaa/AAA	0.00	0.52	0.00	0.60
Aa/AA	0.06	0.52	0.00	1.50
A/A	0.03	1.29	0.23	2.91
Baa/BBB	0.13	4.64	0.32	10.29
Ba/BB	2.65	19.12	1.74	29.93
B/B	11.86	43.34	8.48	53.72
Caa-C/CCC-C	16.58	69.18	44.81	69.19
Averages				
Investment grade	0.07	2.09	0.20	4.14
Non-investment grade	4.29	31.37	7.37	42.35
All	0.10	9.70	0.29	12.98

Source: U.S. Municipal Bond Fairness Act, 2008.

Further supporting the low default rate is the level of priority issuers place on the timely payment of debt service. At a modest five to ten percent of total general fund expenditures, issuers have historically spared no effort to ensure

bondholders get paid, even at the expense of other payments or lower priority creditors. California for example, the largest state and issuer of tax-exempt debt, has faced this challenge a number of times in the past. Expenditures have historically represented anywhere from 92 percent of revenues in boom years to 110 percent in bust years, with 2010 levels projected at roughly 106 percent. In 2009, California issued \$2 billion of IOUs to subordinated creditors to guarantee sufficient cash was available for more critical expenditures, including debt service. The IOUs were ultimately paid in full. The governor also implemented furlough Fridays that, while not politically popular, resulted in millions of dollars of savings and unless a 2010-11 state budget is adopted soon, IOUs will likely once again be considered.

In the unlikely event of a default, the ability of municipal bondholders to recover principal and interest payments has historically been significantly higher than corporate recoveries, equating to 66 percent of par value versus 42 percent of par, respectively. This recovery rate, however, can be misleading, as it encompasses all types of municipal debt from state general obligation to the far more risky real estate and not-for-profit sectors. If we assume traditional, plain vanilla municipal securities, (i.e. tax-backed general obligation and essential service revenue bonds), repayment has almost always been satisfied with a full recovery of 100 cents on the dollar. This is especially true for, but not necessarily limited to, state and local general obligation debt, state and local sales tax-backed debt, water/sewer bonds, public power bonds, state/local leases debt (i.e. certificates of participation), and public universities. When assessing the credit risk and recovery rate for these municipal sectors, rating agencies typically assume a 100 percent or near 100 percent recovery.

### Available Solutions

States and local governments are afforded significant powers to tap large and diverse revenue sources, as well as slash programs and services to either permanently or temporarily fill budget gaps. Given the economic hardship many people are facing today, states and local governments have had to make difficult choices regarding raising taxes in a period when citizens can least afford it, and eliminating programs when citizens need them the most. Factor in political pressures and the task becomes even more daunting. To help off-set some of these occurrences, many states and local governments have tapped unreserved

## municipal bonds – keeping it in perspective

fund balances, or rainy day funds, but this is not a permanent solution. Despite all the challenges, states and local governments have been rather proactive in dealing with deficits, demonstrating a willingness to cut expenses, raise taxes, and utilize reserves. For the 2010 fiscal year, approximately 77 percent of states enacted budget cuts, while 56 percent enacted tax and fee increases. In addition, over 75 percent of states implemented further mid-year budget cuts to address strained financial operations.

In addition to raising taxes and cutting expenditures, states and local governments have the ability to make use of non-recurring revenues, such as asset sales or more commonly, short-term cash flow notes. Although opponents argue that the use of non-recurring revenues only serves as a band-aid and will instead push some governmental entities further into the red, the use of non-recurring revenue is a viable alternative to close budget gaps when used prudently.

### Not all Municipal Debt is Created Equally

Keeping in mind the inherent safety of plain vanilla municipal debt, it is important to understand that not all municipal debt is created equally. State and local debt backed by a full faith and credit pledge is generally considered the safest, followed by revenue bonds issued for essential service projects. States are sovereign, cannot file for bankruptcy, and have all powers afforded to them to generate revenue, cut expenditures, and efficiently access the capital markets. From a pure ratings perspective, all but two states are currently rated in the double-A category or better. However, within the realm of general obligation bonds, there are varying degrees of risk depending on whether the bonds have a limited or unlimited tax pledge. Other considerations include the size and diversity of the tax base, growth in assessed valuations, and concentration of taxpayers.

Two of the safest revenue sub-sectors include water and sewer enterprises, as well as public power facilities. Some might argue that in today's economic climate, these credit types offer a stronger level of security than general obligation bonds as people may be more inclined to pay their utility bill before they pay their tax bill. However, what makes these two utility sub-sectors reliable outside such speculation is the issuer's autonomous ability and legal obligation to raise user rates to levels sufficient to cover bond payments, a local monopoly on the service territory, and apparent essentiality of the service provided. Other sub-sectors that are generally considered stable within the

municipal market include sales tax-backed debt, lease/appropriation debt, and public universities. While each of these sub-sectors is secured by relatively predictable cash streams, it is imperative to be aware of the specific risks inherent to each particular credit type.

Despite a low historic default rate on general obligation and essential service revenue bonds, the added attention that is being afforded to municipal debt is nonetheless a healthy wake-up call. In addition to states and municipalities, the ability to issue tax-exempt debt is extended to a variety of governmental entities that promote and foster the development and/or well-being of the general public. However, some different 'municipal' issuers of tax-exempt debt actually have more corporate-like characteristics. These sub-sectors largely include Section 501c-3 financings, such as higher education and health care.

For higher education, the ability of a college or university to continually attract and matriculate students, as well as tuition rates, endowment levels and competition are considered key credit drivers. For health care, understanding a hospital's reliance on Medicaid/Medicare payments, as well as leverage ratios, liquidity levels, competition, and market position are critical determinants of an issuer's ability to service its debt. While hospitals clearly provide an essential service, not all hospitals are essential or maintain viable operations. Services provided by these sub-sectors may be easily substituted for similar services offered by competitors, and providers have very little ability, if any at all, to generate additional revenue on its existing consumer base. These characteristics are unlike those of property tax-backed or true essential service debt, and therein lies the critical distinction. Accordingly, the variance of risk both within these credit types, as well as across each issuer can be broad, requiring a clear understanding of the fundamental credit strengths and weaknesses of each financing.

Other sub-sector markets that are perceived as carrying additional risk include, but are not limited to, housing, transportation (highways, toll roads, airports, etc.), private activity bonds, industrial development bonds, and tax increment financings. As mentioned above, these sub-sectors have less stable revenue bases, limited rate-setting ability and are often open to pure competitive pressures more commonly found in corporate transactions. Hence, the key for analyzing municipal securities is being able to fully understand and differentiate between the type of municipal bond being issued and the underlying credit. Although two

## municipal bonds – keeping it in perspective

municipal issuers may share the same rating, they could have very different levels of payment risk depending on the sector or sub-sector.

One important aspect that is often overlooked when assessing municipal credit risk is financial management. For the handful of municipal credits that have either defaulted or were on the brink of default, the general mismanagement of funds, or outright corruption of government officials was often a common thread.

### Keeping it in Perspective

Although the current economic environment will likely continue to provide a higher degree of volatility, tax-exempt municipal debt should still be considered a prudent, viable investment if properly analyzed. At approximately \$32 trillion, the U.S. bond market is nearly three times larger than the U.S. stock market. Of that amount, nearly ten percent or \$2.8 trillion represents the municipal bond market, which supports the ability of states and governments to finance

themselves and hence provide essential services. Access to the capital markets is not a luxury states and local governments can afford to be without. Additionally, governmental entities may be exposed to cross-default and cross-acceleration provisions, which if exercised by bondholders could significantly impair financial operations.

Bondholders are not the only ones who do not want states or local governments to default on their obligations. The federal government has strong incentive to offer relief programs and viable financing alternatives to issuers. This is most evident through programs such as the American Recovery and Reinvestment Act, which made stabilization funds available to all states, as well the subsidized issuance of Build America Bonds. And while reliance on the federal government should not necessarily be considered a safety net, it would be difficult for the federal government to refuse aid for a state or local government in light of the trillions of dollars it poured into the corporate sector to save companies and banks that were considered “too big to fail.”

## about the author



*Michele A. Palmo*  
*Director, LDI - Liability Management*

*Ms. Palmo joined Cutwater in 2007 and currently oversees the municipal guaranteed investment portfolio as well as the firm’s asset-backed and commercial paper conduit portfolios. Ms. Palmo is also involved in the structuring and marketing of liability driven investment products. Before joining Cutwater, she spent 12 years at Scotia Capital as director of public finance and infrastructure, where she gained extensive knowledge of the municipal finance market. While at Scotia, Ms. Palmo underwrote letters of credit and liquidity facilities in support of municipal variable rate demand obligations, and was responsible for the analysis and syndication of all municipal credits, including general obligation, utilities, transportations, higher education and not-for-profit healthcare. In addition to credit enhancement, she underwrote various facilities supporting Public Private Partnership transactions relating to large infrastructure projects. Ms. Palmo has a bachelor’s degree in accounting and economics from the State University of New York at Brockport and an MBA from the University at Albany.*

**Cutwater Asset Management**  
 113 King Street  
 Armonk, NY 10504  
 800-937-2624  
[www.cutwater.com](http://www.cutwater.com)