

Municipal Securities Research

Municipal Commentary

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Broken Bench

It came as no surprise that Jefferson County, Ala., filed for bankruptcy last week. The market did not register the event as significant, and money continued to flow into municipal funds. Despite dire predictions and significant fiscal problems among tax-exempt borrowers, new defaults in 2011 have been 30% lower than 2010. Following the great "sell-off" last winter, the asset class has performed better than others, remains "cheap" relative to Treasuries and, in our view, continues to be a stable, low default sector.

But a few concerns linger. Harrisburg, Pa., and Central Falls, R.I., also currently have active bankruptcy petitions. Vallejo, Calif., recently exited bankruptcy, but it, too, filed in the post financial crisis period.

- First, is Chapter 9 (the U.S. bankruptcy chapter for municipalities) contagious?
- Second, are there systemic problems in the asset class?
- Third, how do we spot these problems ahead of time?

(For those who were on vacation last week and missed the many news stories, we summarize the Jefferson County situation briefly; others may skip this paragraph. In the late 1990s, under mandate from the EPA, the county embarked on a program to bring its sewer system into compliance with environmental regulations. The financing quickly grew to more than \$3 billion bonds and included 18 swaps with roughly a \$5.6 billion notional value. Bribery and corruption has been widely documented, and several bankers, advisors, and politicians have served jail sentences. JP Morgan paid \$75 million in fines and forfeited \$647 million in swap termination payments. There have been many attempts to work out the problem, but at the bottom there is a lack of agreement among the county, the state and creditors. More recently, the county's wage tax was overturned by the state Supreme Court, leaving the county limited resources to meet its obligations. A proposed workout plan in September 2011 came close, but failed. As an aside, Jefferson County sewers have been in default on their debts for some time now.)

Is Chapter 9 Contagious?

In some limited contexts, Chapter 9 may be viewed as a last resort. Two characteristics that we see in Jefferson County and Harrisburg:

- *First, there is an untenable debt structure.* Excessive debt relative to the size of the community is common to Jefferson County and Harrisburg. But extreme levels of debt are not common problems across "Muniland," in our view, neither in California nor even in Illinois. In the case of Harrisburg, the city

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decided to guarantee project financing presumably with the view that the guarantee would never be called. But Jefferson County's sizable interest rate bets went out-of-the-money in 2008 and Harrisburg's incinerator failed to produce sufficient revenues to cover debt.

- *Second, there is a protracted political impasse.* Alabama counties do not have home rule and are at the mercy of the state legislature to grant revenue raising authority. To date, the state has not acted on the county's behalf. Even after the court invalidated the county's wage tax, the state was unwilling to find a substitute solution. A plan hatched over the summer and supported by the governor included a new authority that would issue bonds to restructure the county's debt. This plan, too, failed to gain acceptance, leading to the bankruptcy filing. Some state officials have *wanted* the county to file bankruptcy for several years. In fact, in the summer of 2008, David Bronner, head of the Alabama pension systems, suggested that his pension plan would buy the system but only if it declared bankruptcy. In Harrisburg, the mayor and city council have been at loggerheads, and the council has rejected the state coordinator and mayor's workout plans several times.

What do you do when you have a political impasse and an untenable debt structure? Turning to the federal bankruptcy courts is one way of bringing in an objective, dispassionate authority to help sort out the impasse. In some states, external authorities have been successful in working out public sector fiscal crises outside bankruptcy. We have written elsewhere about state oversight programs that grant authority and rights to a state level "receiver" such as in Michigan, Pennsylvania, and Ohio. State-based control boards have been brought in to solve fiscal problems in New York City, the city of Yonkers, the city of Philadelphia and even Washington, D.C. These workouts have been accomplished without bankruptcy or even default. Elsewhere, there are numerous state-based credit enhancement programs that tie together the finances of troubled local borrowers with their states. We point out that these mechanisms do not exist in Alabama.

Are these bankruptcies symptomatic of a systemic problem?

We think not. Corruption is present in politics at all levels as well as across the corporate spectrum. One would no sooner write-off the entirety of corporate finance in the face of the Enron or WorldCom debacles than one should write-off municipals with Jefferson County. Excessive leverage has led to financial crises throughout history. Perhaps with the exception of the ongoing subprime mortgage mess, markets and borrowers have been able to work out, absorb and shake off major financial miscalculations. The following are a few examples:

Over the past decade, auction rate securities paired with swap transactions (which synthetically created fixed-rate payments) were common in the municipal market, particularly among healthcare, higher education, transit systems and large issuers.

When bond insurance melted down and banks were no longer willing to support auction rate securities, many issuers experienced spiked rates and out-of-the-money swaps. To unwind the structure, issuers were, in many cases (as in Jefferson County), responsible for termination payments to their swap counterparties. But over the past three years many have been able to work out of these structures or absorb the damage — in some measure, reflecting the resilience of markets. From late 2009 through much of 2010, healthcare institutions restructured their debt and financed swap termination payments in returning to more "plain vanilla" structures, thereby improving their overall risk profile. For example, Asante Health System in Oregon completed a significant restructuring in February 2010, moving from a debt structure that was virtually all variable rate (approximately 89%) to a

more conservative post-restructuring debt mix of 76% fixed-rate debt. Along with a fixed-rate refunding of \$102.7 million VRDOs and a fixed-rate conversion of \$69.7 million of ARS, the restructuring included a bond-financed \$29.9 million swap termination payment. This enabled the hospital to unwind all \$257.7 million outstanding swaps. The restructuring modestly increased leverage to 55.9% debt to capitalization from 50.8%, but we believe this was an adequate tradeoff to eliminate variable rate volatility and remove the negative mark-to-market impact of swap exposure on its balance sheet.

Enjoying Dessert Is Not the Same as Binging

Even troubled Detroit has worked through a swap termination without bankruptcy (but not without significant fiscal pain). In 2005, the city sold \$536 million in taxable pension certificates and then sold another \$936 million in 2006. In what seemed like a good idea at the time, the city also entered into two interest rate swap arrangements, which gave counterparties the right to terminate the swap if the of the city's rating was downgraded below investment grade. When the city's credit rating was downgraded, they faced termination payments in the range of \$300 - \$400 million. In exchange for not terminating the swaps, the city agreed to pledge first monies from its casino wagering tax to payment of the swaps.

In the mid-1970s and again in the mid-1980s, numerous government securities firms failed over excessive leverage in the repo market, bringing municipalities down with them. (For example, the demise of Lombard-Wall in 1982 left the New York State Dormitory Authority — DASNY — with \$55 million losses. More than 50 municipal note issuers in New York State faced fiscal crises following the firm's demise.) In the early 1990s, Orange County, Calif., heavily leveraged its investment pool using reverse repurchase agreements and lost big when interest rates turned against them. According to one SEC report, the investment pool's leverage ranged from 158% to 292% during 1993-1994. While Orange County went into bankruptcy, others in these examples did not. Cuyahoga County, Ohio, had borrowed some \$660 million to invest in repurchase agreements and lost \$122 million on \$1.1 billion invested.

How Do We Spot Problems before They Happen?

The excessive leverage in Jefferson County, as well as Harrisburg's choice to guarantee a speculative project, should be visible to the naked eye. While we have illustrated how the municipal market can be resilient even in the face of highly leveraged financing programs, these approaches introduce atypical risk. We believe risk-taking is generally healthy and necessary for society to innovate and progress. However, municipal market investors are typically conservative, low risk-takers. When a borrower has most of its financing in variable-rate debt or guarantees a financing that is outsized relative to its budget, in our opinion, the red flag should go up. Such approaches run counter to the conservative investor.

In our view, a bankruptcy to watch is Central Falls, R.I., which essentially ran out of money to pay its retirees. In addition to 222 state run public pension plans there are more than 3,000 locally run retirement systems like Central Falls. Many are sustainable and others are making changes to bolster their plans' solvency. But there are also some, like Central Falls, that are running out of funds. Municipal audits (even if dated) typically disclose funding levels and the management discussion (as well as annual budgets) will highlight measures to improve funding.

If anything, the debt load that both Jefferson County and Harrisburg face, coupled with their political impasse, have a greater resemblance to our federal government than the rest of the municipal market, which we believe continues to be relatively stable and high-quality.

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Additional information is available on request.

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