

US municipal debt: Muni market double-dip worries build

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Concern grows for munis; Will Chapter 9s increase?

Concerns about the ability of US states and municipalities to meet their debt obligations are resurfacing as the threat of a double-dip recession heightens. After the 2008 crash and subsequent US economic recession, state and city revenues came under increasing pressure, leading some analysts to predict defaults on debt. However, although states and cities have struggled with budget shortfalls and have had to implement cost-cutting strategies and tax increases, those concerns seemed exaggerated.

Three years later, however, with a second recession looking increasingly likely, concerns have returned. Lisa Washburn, managing director at municipal bond research firm Municipal Market Advisors Research in Concord, Massachusetts, says many municipalities have not had a chance to recover. "We were just beginning to see a rebound in state revenues earlier in the year, and many states factored improving income and sales taxes into their 2012 budgets," she says. "If those come off projections, then there will be some pressure." Washburn says there also has not been enough time for local municipalities to fully recover and that, unlike in 2008, this time they do not have the cushion that preceded the first recession. "The housing market is still severely depressed and local governments get about 75% of their tax revenues from property taxes," she says. "That revenue has been stressed and municipalities have less of a cushion than when they started the last recession. There is also the question of whether the federal government would have the willingness or capacity to provide the help that it did in the last recession such as through the Build America Bonds programme or Medicaid support." Washburn says pension liabilities are still a concern. "Many states have taken action to curtail the trajectory of pension liabilities but those are still growing." Pension funds invest partly in equity markets and project annual returns of around 8%. So far this year, the Dow Jones has been flat.

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Srinivas Thiruvadhanthai, director of research at The Levy Forecasting Center, says municipalities "dodged a bullet" but that if a second recession hits the crisis is still ahead. "The multi-year expansions in between recessions that we have witnessed in the last couple of decades are not going to recur. That gives little time for those municipalities under stress to get prepared. The past three recessions have brought some munis to the brink. Can they dodge the bullet again if we have a recession next year?"

Washburn, however, is not expecting state debt defaults. Other market participants agree, pointing out that there are protections in place to prevent defaulting on debt: state governments simply have to organize the budget to meet their obligations. Smaller municipalities, however, which have less leeway on changing legislation to meet their budget requirements, are at risk. Lynnette Kelly Hotchkiss, executive director of the Municipal Securities Rulemaking Board (MSRB) says investors simply need to monitor the credits they are exposed to. "There are approximately 50,000 issuers of municipal securities in differing economic positions, so investors just need to keep informed." In 2008, the MSRB established the Electronic Municipal Market Access (Emma) system, which provides investors with access to data and disclosure documents on municipal debt.

But lawyers and analysts suggest that they will be given permission by their overseeing states to restructure so that general obligation bondholders get paid. In the case of Central Falls, Rhode Island, which faces a \$4.8 million budget gap for 2012, there has been state legislation to allow the municipality to file for Chapter 9 bankruptcy and put its debt obligations above its pensions obligations. "It will no doubt be challenged by pension holders, but this case is one to watch. If the law is upheld it could end up being a model for others," says Washburn.

Dan McElhinney, managing director of corporate restructuring at Epiq Systems, says there is a growing interest in Chapter 9 as a means for small municipalities to meet their obligations. "There is limited practical expertise or knowledge about Chapter 9 as it has been so infrequently used but we are seeing lawyers and financial professionals focus more in this area as it appears municipalities might view Chapter 9 as a viable – albeit last – option," says McElhinney. He says that Chapter 9 gives local governments the exclusive right to propose a plan to resolve its obligations. In contrast, a corporate chapter 11 debtor enjoys such exclusivity for only 18 months. "Chapter 9 enables municipalities if agreed by a judge to get out of collective-bargaining agreements. And in circumstances like the Central Falls cases in Rhode Island, where state law conveyed a lien converting holders of general obligation bonds from unsecured to secured creditors, the municipality can pay such obligations in full while unsecured creditors receive only a percentage of what they are owed."

While McElhinney says he is expecting Chapter 9 to be considered within muni-financing options down the line, the reputational damage and potential contagion impact on neighbouring local governments does act as a deterrent. He points out, however, that ratings downgrades for municipalities might exacerbate the filings for Chapter 9. "If you are a local government which has had its credit downgraded, then accessing the capital markets is more difficult and expensive for you," he says. "So filing for Chapter 9, which will damage your ability to raise capital in the short term, becomes less of an issue. In this context, municipalities might look past the negatives associated with Chapter 9 in favour of the upside, which is to bring the municipality back to a manageable, solvent position. If done efficiently and quickly, the sooner the municipality might be able to return to the capital markets."

"There are concerns whether the munis have had enough time to recover before having tax revenues slammed once again"

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