Telling Myth from Reality in MuniLand

BY ROBERT DOTY

Misunderstandings about municipal securities persist, especially regarding the proven safety of the market. It begins with inadequate recognition by some about the substantial diversity among municipal securities and their varying risks. Municipal securities are issued by states, cities, counties, school districts, water agencies, fire districts, road improvement districts, and a host of special districts, agencies, and authorities. Some municipal securities are payable solely by, or are otherwise dependent on the success of, private parties. There are many municipal security credits and a variety of bonds, notes, certificates of participation, warrants, variable-rate securities, commercial paper, lease-purchase obligations, and other forms of instruments. This diversity can make it difficult for issuers, investors, policymakers, pundits, and the public to make sense of the market.

The entire muni sector, including issuers and investors, needs to understand the types of municipal securities and credits, and the risks each one entails. This is especially important because the Securities and Exchange Commission continues to consider new ways of regulating municipal issuers and politicians are proposing a cap on the tax exemption, or eliminating it altogether. The truth is that the vast majority of municipal securities are sound and secure, with extremely low default risks. Traditional municipal securities — tax-supported general obligation bonds and essential purpose revenue bonds — have been using structures that were originated in the 1800s, with few defaults.

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WHY THE MISPERCEPTIONS PERSIST

In 2010 and 2011, a relentless drumbeat of dramatic and at times irresponsible headlines alarmed municipal securities investors with serious and unwarranted exaggerations of market risks. Pundits predicted large-scale municipal securities defaults, of hundreds of billions of dollars, and even bankruptcies. News stories frequently highlighted the occasional valid criticisms of significantly underfunded public pension fund liabilities, unwise financings, and excessive spending in unbalanced budgets. Then, taking gigantic leaps of logic, some of these stories asserted that disastrous consequences overhanging the municipal market portended a municipal securities version of the financial crisis.

Those pundit and media "analyses" show fundamental misconceptions about the strength and enforceability of key municipal general obligation and traditional revenue securities structures. And as for other, less safe securities that are payable from the general funds of general purpose governments (cities, counties) and school districts, pundits seem to have assumed that large numbers of state and local governments would choose to serve their constituencies by defaulting. The choice to default has certainly not been the historical pattern, however, over the long term, during the financial crisis, or afterward.

Moreover, while there are certainly well-publicized defaults and examples of severe financial problems in a few communities, there is no evidence that the overall strength and stability of securities issued for governmental purposes will decline significantly, even in the face of fiscal stress. Issuers that chose such a path would have an extremely difficult time obtaining the funding needed to provide services. Overall, the debt service on municipal securities remains a low proportion of governmental budgets. At state levels, payment of debt service often has a high constitutional or statutory priority. Unlike private corporations, municipal governments must remain in existence and must have access to the market to obtain funds for their long-term projects, and cash flow on a short-term basis.

At the same time, some municipal securities structures and credits entail greater risks — sometimes substantially greater risks — than others. Market observers — including regulators — sometimes overgeneralize, incorrectly, by describing municipal securities merely as general obligation bonds and revenue bonds. This misses the significant distinction between general obligation bonds and general fund securities. It also completely misses more serious risks of default among land-based securities and tax allocation/tax increment securities that are payable from special taxes and special assessments within limited districts for, and dependent upon the success of, new real estate development.

Understanding what is being issued and the associated risks will help issuers further develop appropriate disclosure policies and practices, and it will help investors, regulators, legislators, and the public understand that not all municipal securities are the same. A better understanding would give policymakers, among regulators and in Congress, the wherewithal to address concerns in the muni market with a scalpel rather than a sledgehammer. Market sectors that are more problematic than others could be identified accurately and addressed promptly and effectively.

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DIVERSE STRUCTURES

General Obligation Bonds. Traditional municipal general obligation bonds are quite secure. Pundits and commentators who predict large-scale defaults in this market sector are simply mistaken. Local general obligation bonds are typically secured by pledged taxes and issuer agreements, as needed, to raise taxes, without regard to rate or amount. The pledge is approved, in effect, by voters, or authorized under state law before the bonds are issued, so subsequent voter action would be unnecessary and even improper. In cases where there is a cap on how much the taxes may be raised, the jurisdiction is still obligated to increase taxes up to the cap. Issuers' tax obligations are valid and enforceable under state law and, in some cases, secured by statutory liens.

Unlike local general obligations, state-level general obligation bonds are payable from state general funds, but the states have access to considerably more diverse revenue sources than do local governments. Further, state constitutions and statutes often provide a high priority for payment of debt service.

Local General Fund Securities. When looking at securities of general governments and school districts, general fund securities involve greater risks than do general obligation bonds. Much depends on the management quality and financial practices (e.g., pension and OPEB funding) of the specific issuers, but to the extent that there are general government defaults, this is the sector in which they are most likely to occur. The problem for pundits, however, is that there are not hundreds of billions of dollars of these securities outstanding, nor is there a systemic risk of default with these types of bonds.

Despite the similarity of the name, general fund securities are not general obligation bonds. General fund securities are commonly (but as the recent case of Jefferson County, Alabama, shows, not always) issued in the form of securitized lease-purchase agreements (certificates of participation or lease revenue bonds) that are payable from whatever monies happen to be in an issuer's general fund. Jefferson County called some securities "general obligations," but the securities were not backed by a pledge to raise taxes. The leased property serves as collateral. In Chapter 9 bankruptcy, uncollateralized general fund investors are unsecured creditors. There is no requirement that the issuers of general fund securities raise taxes or revenues to pay the securities. Moreover, in most states, payments on lease securities must be appropriated annually — it is a discretionary act. (In California and Indiana, the leases are generally "abatement" leases, and the issuers are obligated to make payments from their general funds so long as the facilities are available for the issuers' use.) Unlike the general obligation bond sector, the essential nature of the leased projects is a key issue. It is thought that if collateral is essential for governmental use, a government would likely pay the lease rentals, since not doing so would deny the government the use of the leased property.

Obligations payable from general funds include the notes issued by New York City and bank loans taken by the City of Cleveland, Ohio, in the 1970s, and notes issued by Orange County, California, in the 1990s — and they were all paid, eventually. In the cases of New York and Orange County, investors received higher rates of interest as compensation for the delay. (The current-day Vallejo, Stockton, and San Bernardino, California, bankruptcies are not about general obligation bonds or essential purpose revenue bonds.)

For those who emphasize the risks of municipal fiscal stress, the securities to watch are general fund securities, not general obligation bonds. In practice, however, general fund securities have generally been sound investments because the overwhelming majority of issuers are loath to damage their reputations and ease of market access by defaulting.

REVENUE BONDS

Essential Purpose Bonds. Traditional governmental utility revenue bonds are very sound securities that are payable from pledged revenues of established governmental water, wastewater, and similar utility monopolies. Issuers typically agree to raise user fees to generate the revenues to pay these securities, and people will not move out of town simply because they do not like their water rates. They will pay increased user fees because they need the service, and there is no alternative provider.

Issuers' agreements are valid and enforceable under state law. The market is waiting to see how much the Jefferson County bankruptcy court will permit or require the system's revenues to be raised. Yet, even there, the net revenues being generated (after paying operation expenses) are being applied to payment of the securities.

The risks of securities of start-up, rapidly expanding, or substantially modified projects (e.g., the Washington Public Power Supply System and Jefferson County's greatly modified wastewater system), or in tiny special districts (e.g., the Xenia, Iowa, Rural Water District) may be more significant. Jefferson County is a special case, involving significant repeated misbehavior and carelessness by market professionals and county officials. In addition, the Jefferson County situation involves another factor (as did Harrisburg, Pennsylvania, and Orange County in the 1990s, and more recently, five school districts in Wisconsin) — namely, heavy issuer involvement with interest rate swaps or other exotic instruments.

Revenue Bonds for Private Credits. A wide variety of other municipal revenue securities are payable from user fees on what are not considered first-line government services, and they may be issued to help non-profit and for-profit entities that are not part of the government. These types of bonds — industrial development, 501(c)(3), and similar conduit bonds or bonds for projects with private managers or developers — bear diverse degrees of risk, sometimes quite significant, and sometimes not. This sector is more risky than some others, largely because private and non-profit borrowers can have a limited amount of flexibility in increasing user rates, as can certain governmental issuers, in some situations. This type of debt is issued to fund toll roads, telecom systems, waste-to-energy facilities, sports arenas, private prisons, airports (affected by the American Airlines Chapter 11 bankruptcy filing), nursing homes, assisted living and continuing care facilities, multifamily housing projects, and so on.

Special Tax Bonds. In terms of default risk, special tax (and assessment) bonds can be highly risky. The actual risk levels depend on the details of each transaction. These bonds include community development district bonds in Florida and Louisiana, sanitary district bonds in Nebraska, metropolitan district bonds in Colorado, municipal utility district bonds in Texas, Mello-Roos bonds in California, and tax allocation/tax increment or assessment bonds in many states.

Special tax bonds (including special assessment bonds) are a diverse group of municipal securities that often bear substantial risk for both issuers and investors, especially when they are payable from property taxes (or assessments) levied on undeveloped real estate to pay for infrastructure that is intended to serve the property. The risks of land-based special tax bonds vary considerably from state to state, with Florida, Louisiana, and Nebraska experiencing especially heavy defaults during and after the financial crisis. In California and Texas, however, as a result of state action and improvements in market practices, land-based bonds have performed much better.

Tthe Securities and Exchange Commission and the Municipal Securities Rulemaking Board could make substantial improvements if they focused on the right market

sectors, benefitting investors and issuers and minimizing regulatory burdens. These improvements could be accompanied by both carrots and sticks. Targeted regulation could include:

- Providing specific due diligence and disclosure guidance to issuers, conduit borrowers, obligated persons, underwriters, and municipal advisors about their responsibilities and ill-advised practices in the riskier transactions.
- Educating issuers, professionals, and investors about the relative sector risks.
- Bringing financial advisors that help prepare official statements within the purview of SEC Rule 15c2-12's professional review requirement, and bringing other municipal advisors (e.g., feasibility, appraisal, and other experts) within the coverage of the rule, regarding material they provide for official statements.
- Expanding the definition of "final official statement" in Rule 15c2-12 to require information specifically relevant to riskier securities.
- Promoting improvements in practices associated with the expert work products provided to investors and issuers in transactions that are readily identifiable as being riskier (e.g., feasibility analyses, other financial projections, and asset appraisals) through regulation of the experts as municipal advisors.
- Strongly discouraging municipal advisor contingent fees and other conflicts of interest in the riskier transactions.
- Aggressive targeting of enforcement on recognizable abusive transactions and practices.

Similarly, Congress might choose to target securities regulation and action regarding the tax-exemption for troublesome market sectors, rather than traditional bonds.

ESPECIALLY CAREFUL REVIEW NEEDED

As described above, the municipal securities market has many segments, and pundits, as well as regulators and many market participants, have missed the fact that specific municipal sectors have significantly higher risks than others, and that these can be readily identified in advance. In other words, the pundits have been wrong not once, but twice. Instead of focusing on key areas where problems have been proven to exist, the SEC often fails to distinguish among municipal securities, taking a generalized approach to reforms related to municipal disclosure standards that apply broadly to all market sectors.

A better understanding of municipal debt would give policymakers, among regulators and in Congress, the wherewithal to address concerns in the muni market with a scalpel rather than a sledgehammer.

An approach that is more finely focused on the problem market sectors could provide important benefits and protections for investors without significant cost increases or burdens for governmental issuers. Traditional general obligation bonds have defaulted recently at the rate of only 0.01 percent of outstanding general obligation securities;[1] traditional water/wastewater bonds have defaulted at the rate of 0.02 percent; and school districts have a default rate of zero, according to Municipal Market Advisors data.

Meanwhile, in market sectors that depend on the performance of private companies or non-profits, outstanding nursing home bonds defaulted at the rate of 4.21 percent; assisted living bonds, at a rate of 4.86 percent; local multifamily housing bonds, 1.73 percent; and economic/industrial development bonds, 1.02 percent. Real estate developer-dominated community development districts defaulted at the phenomenal rate of 15.21 percent.

In other words, outstanding nursing home bonds defaulted at a rate that was 421 times greater than that of outstanding general obligation bonds, and CDD bonds defaulted at a rate that was 1,521 times the general obligation bond rate. (While the Harrisburg general obligation bond default — which is under challenge — increases the rate for general obligation bond defaults, the overall increased rate remains very low.)

Data published by MMA, Bloomberg, and S&P Indices[2] show that 80 percent or more of municipal securities — especially those that depend primarily on governmental credits — are responsible for 20 percent or less of the defaults in the municipal market. In other words, 20 percent or less of municipal securities — those dependent primarily upon private credits — are respon-

sible for 80 percent or more of the defaults. MMA also found that rated municipal securities have an especially low default rate — only 15 of 25,000 rated issues defaulted in the period from July 1, 2009, through January 2011.[3] Further, Fitch Ratings reported that "municipal bonds have an average recovery rate of 68.33 percent, based on the number of defaults, and a 66.92 percent recovery rate, based on the dollar-weighted average, both of which are higher than public corporate bonds, which have a long-term average rate of approximately 40 percent."[4]

The late, highly respected John Petersen of George Mason University estimated that defaults overall have been very low even going back even to the Depression. Petersen and others found that the recovery rate for defaulted governmental purpose securities was high even during the Depression,[5] and have suggested that Depression defaults were remedied very quickly after the banking system was brought back into service. In other words, the banking system's recovery enabled municipalities to make payments on their securities.

The default analyses and data demonstrate that, historically, municipal securities defaults overall have been a small fraction of 1 percent. Petersen found that, in contrast to the overall municipal default rate, traditional municipal securities have defaulted over the past 40 years at rates as low as 0.03 percent to 0.06 percent, even during and after the financial crisis.

CONCLUSIONS

The municipal securities market is highly diverse. Traditional general obligation securities and revenue securities for essential governmental utilities fare very well in terms of historical default experience and are quite secure. General fund securities pose somewhat greater risks than do general obligation bonds, but historically, even general fund securities have performed very well. But there are indeed riskier municipal securities in the marketplace, and certain categories of municipal securities — especially those that depend on private-sector performance or for real estate or start-up projects — fare less well, sometimes significantly so. The greatest risks are readily identifiable in advance, thus alerting issuers and municipal finance professionals to the need for greater care in due diligence, structuring, and disclosure, and alerting investors that they need to pay attention to the securities they purchase and to the yields the investors accept.

Notes

1. If municipal securities paid by bond insurers or from reserves are included, the default rate increases somewhat, but only to about 0.06 percent. See Kelly Nolan, "On 'General Obligation' Munis, Investors Advise Caution," Wall Street Journal (May 17, 2012), citing data provided by Municipal Market Advisors.
2. Data provided by Municipal Market Advisors, drawing on Fitch Ratings data, Bloomberg LP, and S&P Indices cited in for the *Bloomberg Visual Guide to Municipal Bonds* (John Wiley & Sons and Bloomberg Press, 2012).
3. Testimony of Matt Fabian, Managing Director, Municipal Market Advisors, before the House Judiciary Committee, Subcommittee on Courts, Commercial and Administrative Law at 4-5 (Feb. 14, 2011), as cited in the Bloomberg Visual Guide to Municipal Bonds at 8-10, 24.
4. See Fitch Ratings, "Municipal Default Risk Revisited" (June 23, 2003), and "Default Risk and Recovery Rates on U.S. Municipal Bonds" (January 9, 2007), as discussed in the *Bloomberg Visual Guide to Municipal Bonds*.
5. Data and analysis provided by John E. Petersen in "Municipal Defaults: Eighty Years Does Make a Big Difference" (unpublished paper, 2011), as cited and quoted in the *Bloomberg Visual Guide to Municipal Bonds*. Richard Ciccarone of Merritt has made similar observations.

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