MUNICIPAL BONDS IN 2011: AN UPDATE ON STATE AND LOCAL BORROWING

November 23, 2011

Summary

The state and local government bond markets have held up well throughout the year despite a few high profile municipal defaults or bankruptcies by local governments. The forecasts from some commentators in 2010 and earlier this year predicting a municipal bond crisis have not come to fruition, and a collapse of the municipal debt markets is not likely to arise anytime soon. Certainly states and localities will continue to encounter fiscal strain, but potential defaults or bankruptcies are so few and far between that they are the "exceptions" that prove the "rule". Earlier this year, NASBO and other state and local groups provided information indicating that significant concerns about the municipal markets were overblown. Recent trends indicate that the state and local groups' analyses were correct, that municipal bonds were generally safe.

Bond Issuance Up In Third Quarter 2011

On a dollar value basis, tax-exempt bond issuance is up for the third quarter of calendar year 2011 at $72.2[1] billion , a six percent increase over the second quarter in 2011. State and local municipalities issued $193.6 billion during the first nine months of 2011, which equates to a 35 percent decrease from the record breaking $ 297.6[2] billion issued in the first nine months of 2010. Some bond analysts and municipal market followers have been anticipating decreased debt issuance this year -- or at least the first half of the year -- compared to the prior two calendar years due to the expiration of federally subsidized bond programs under the American Recovery and Reinvestment Act (ARRA). Most notably, this was the expiration of the Build America Bonds Program that encouraged borrowing for infrastructure development by providing a 35 percent interest payment subsidy on behalf of the federal government for qualifying bonds issued by state and local governments.

Now issuance is up in the third quarter of this calendar year after being down significantly in the first half of 2011. There are several possible reasons for this. Increased debt issuance in the third quarter of calendar year 2011 suggests that markets continue to shrug off concerns that ignited worry about municipal borrowers in the beginning of the year. The federal debt ceiling problem resolved in a last minute showdown in August may have caused some pent up demand while government officials delayed issuance. Furthermore, a continued low interest rate environment has encouraged state and local governments to restructure debt maturity schedules and issue new debt carrying historically low borrowing costs. While state revenues were up somewhat at the end of most states' fiscal year (46 states have fiscal years that end on June 30), that seems to be less of a reason than the low interest rate environment. Paying interest for bonds is a long term proposition, and the increase in revenue toward the end of the last state fiscal year is not necessarily a major reason for increased issuance. Lastly, investors continue to seek safe investment vehicles with the strength of the economic recovery uncertain.

Background on Municipal Default and Bankruptcy

With overall debt issuance up and defaults declining, the municipal markets, however, have not been without some notable problems that have received a lot of publicity. A few localities like Central Falls, Rhode Island; Harrisburg, Pennsylvania; and most recently Jefferson County, Alabama[3], have produced big headlines. Again, these are exceptions proving the rule that very few municipal bonds enter default either through bankruptcy or funding shortfall. As analyst Richard Larkin has described the situation,

[1] "Municipal Bond Credit Report: 3rd Quarter 2011", Securities Industry and Financial Markets Association (SIFMA), 2011.
[2] "Municipal Bond Credit Report: 3rd Quarter 2010", Securities Industry and Financial Markets Association (SIFMA), 2010.
[3] Jefferson County first defaulted on its sewer system bonds in 2008 but the municipality didn't enter bankruptcy until late 2011.

"For all of the rhetoric in 2011 about falling revenue, rising expenses, high unfunded pension liabilities, and cutbacks in federal aid, the stories behind these two bankruptcies are about human error by the officials charged with managing Jefferson County's Sewer System, and Harrisburg's Incinerator Project."[4] The municipal markets are treating these public finance blunders as isolated incidences, signaling an understanding that these rare cases are not evidence of an underlying, systemic issue. For the most part, states and localities in spite of very difficult economic and fiscal situations have convinced investors that their bond principle and interest will be paid now and in the future.

States unlike local governments or municipalities are not allowed to declare bankruptcy because individual state governments are considered sovereign entities with taxing authority. However, this did not stop Congress from revisiting the issue of state bankruptcy earlier this year even though the very supposition of changing the law could have adverse effects on state borrowing costs. While state bankruptcy remains a legal fiction, state defaults have precedents, but it has happened only in extremely rare instances in the nation's past – decades ago. During the peak of the Great Depression in 1933, the State of Arkansas defaulted on some of its bonds and required federal funding for the next two years, and following the Panic of 1837, eight states defaulted on infrastructure bonds throughout the 1840's, yet almost all of the states repaid in full. The likelihood of a state default due to the Great Recession is extremely small. In fact, any default arising from a government entity with taxing authority is very rare. Investors in state bonds can take solace in the fact that the last default on general obligation state bonds was in 1933.

Investors in state bonds can take solace in the fact that the last default on general obligation state bonds was in 1933.

Historically, municipal default is a rare occurrence, and even when default does occur, bondholders seldom loose their entire principal. Often times, a default can result when a covenant in the bond agreement is violated. This is known as a "technical default", but there is no payment missed and the bond structure remains the same. A true default is considered to occur in the suspension of a coupon payment or with debt restructuring that results in a loss of principle to investors. The severity of the default and the extent of lost principle or interest payments are contingent upon a number of financial variables most notably current cash flow derived through user fees or taxes.

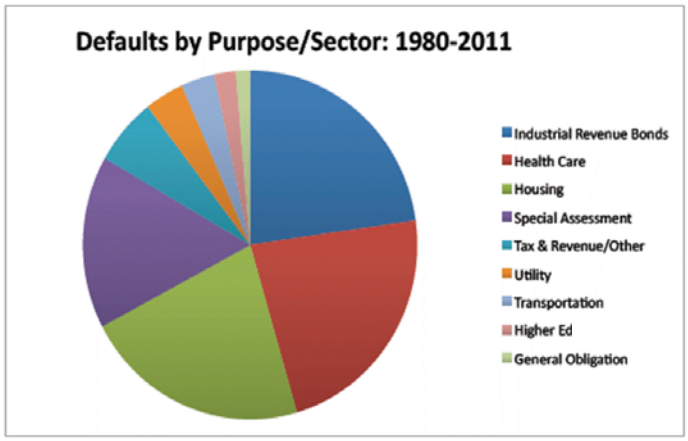
Municipal defaults are more likely to follow down swings in the business cycle and also occur more frequently in high growth areas that borrow heavily to meet expansion needs. However, as in the recent bankruptcy case of Jefferson County, poor financial management by local officials can also lead to default. Default rates have been improving over the past 25 years due to the passage of the Tax Reform Act of 1986, which restricted the tax-exempt status for differing bond types, including risky industrial development bonds that allowed private businesses to benefit from tax-exempt borrowing. There are generally two basic types of municipal bonds. General obligation bonds, which are backed by the full faith and credit of a governmental entity with taxing authority, and revenue bonds, which are bonds backed by a designated revenue stream, such as a user fee or lease payment. Revenue bonds typically carry greater risk because repayment is not paid with taxes but rather is contingent upon the borrower's ability to generate revenue.

Overall, Municipal Defaults Decreasing

During this same time period of increased issuance, municipal defaults continue to be a very small percentage of both the number of issuers and the aggregate dollar value of outstanding tax-exempt debt. There were no defaults on state general obligation bonds and none had been expected. In the first nine months of 2011, there were 42 municipal defaults totaling $949 million, falling from the 79 defaults experienced in 2010, amounting to $2.89 billion[5]. The declining number of issuers defaulting, and the decreasing dollar value of those

[4] "Harrisburg & Jefferson County Bankruptcies Are Old News: Man-Made Disasters in Pennsylvania & Alabama Date Back to 2008 & 2009," Larkin, R., November 10, 2011.
[5] "Alabama's Jefferson County Enters Biggest Muni Bankruptcy as Crisis Victim," Selway, W., Newkirk, M., and Church, S., Bloomberg Nov. 10, 2011.

defaults indicates that local governments and municipalities are better able to meet debt obligations this year than in 2010. The pace of defaults in the third quarter has also slowed resulting in 12 defaults, totaling $126 million[6], from 18 in the third quarter of 2010, and 24 in the same three months of 2009. Relative comparisons aside, the default rates for both 2010 and 2011 are well below 1% and remain a mere fraction of the more than $2.9 trillion of outstanding tax-exempt debt. The chart below[7], from a recent study by Kroll Bond Ratings, highlights the most common types of bonds that experience default. Bonds issued by hospitals, industrial development organizations, and housing development projects comprise the overwhelming majority of defaulted bonds. General debt obligations tied to cities, counties, and states with taxing authority almost never experience default.



[Defaults primarily attributable to revenue bonds not general obligation debt.]

When revenue streams either through taxes or other sources decline, the ability to borrow for appropriate uses becomes even more important. This scenario provides a strong incentive for borrowers to meet debt obligations even when budgets are tight. For this reason, states and localities will likely continue to meet obligations even as the economic recovery remains anemic. Default rates are also low because the municipal markets have a very long memory when it comes to default, and there is a tendency to punish borrowers with higher borrowing costs or a refusal to loan funds. Also, many jurisdictions have statutes or provisions to ensure that debt repayment is given budgetary priority. State and local borrowers realize that it is in their long term financial interest to meet obligations or face adverse consequences for a very lengthy period.

State and local officials will continue to face difficult fiscal times and resource constraints for all of the programs and services requiring funds. These officials will have some very difficult decisions in allocating government resources in the future. This does not imply that municipalities are considering increased borrowing in lieu of tough budgetary choices. Debt issuance and borrowing continue to be effective tools of public management, and officials should not be deterred from isolated instances of financial irresponsibility. When debt financing is implemented with prudence, state and municipal borrowing for capital intensive projects is the only way to assure users pay an equal share throughout the useful life of the asset. Long lasting physical assets produce a future stream of benefits that can be financed accordingly. Bond maturity schedules should equal the useful life of the asset to ensure prior generations are not overburdened by large upfront payments, nor should later generations pay for assets no longer functioning. From this perspective, bond issuance becomes a tool of equity rather than a public burden.

This does not imply that municipalities are considering increased borrowing in lieu of tough budgetary choices.

Trends in the municipal markets suggest state and local governments will continue to have access to capital for years to come. As traditional equity markets remain volatile due to uncertainties in the Euro zone and other economic factors, investors will likely continue to seek traditionally safe harbors like municipal debt. The low default rates of 2011 are demonstrative of the persistent fiscal prudence exhibited by the overwhelming majority of debt issuers and the longstanding sense of obligation to meet debt service requirements pervasive amongst government finance officials, which means that - with very few exceptions - interest on debt will be paid.

If you would like additional information, please contact Scott Pattison (spattison@nasbo.org or 202-624-8804) or Michael Streepey (mstreepey@nasbo.org or 202-624-8433).

[6] "U.S. Municipal Defaults Declined Last Quarter, Distressed Newsletter Says," Vekshin, A., Bloomberg Oct. 20, 2011.
[7] Chart - "An Analysis of Historical Municipal Bond Defaults: Lessons Learned the Past as Prologue." Fons, J., Randazzo, T., Joffe, E., Kroll Bond Ratings, November 14, 2011.