Beware Of The Muni Bond Bubble: States And Cities Can Fail As Well

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Greece and Spain both suffered S&P downgrades this week — Greece to junk — as bondholders realized the obvious. The nations cannot raise taxes and cut spending fast enough to pay their debt without killing off economic recovery.

But nothing has shaken another massive debt market: American municipal bonds.

You might think that investors would pause before pouring money into obligations of muni debt, particularly obligations of California, New York or Illinois. Like mid-2000s homeowners, state and local governments spent boom years using illusory gains to justify ever-higher spending and borrowing.

By 2008, state and local debt rose to $2.2 trillion — 49% higher, after inflation, than in 2000. The biggest partners in profligacy also promised more benefits to public workers in the future.

As the recession's severity became apparent, officials kept borrowing: States have already borrowed another $15 billion for operating costs over the past two years.

Yet gatekeepers consider municipal bonds low-risk. "We do not expect that states will default on general-obligation debt, even under the most stressed economic conditions," analysts at Moody's wrote in a February 2010 report.

Higher Taxes

As for cities and towns, "we expect very few defaults in this sector given the tools that local governments have at their disposal." Standard and Poor's agrees.

The investment advisers and managers who allocate credit assume that states and cities will do anything to avoid default. The assumed incentive, of course, is their desire to borrow more.

The analysts also think that lending to state and local governments isn't risky because they — unlike private firms — have a captive source of funds. State and local governments can always tax their residents and businesses more.

There's further reassurance in the law. State governments can't declare bankruptcy to escape debt. Cities, towns and counties can file for bankruptcy only if their state allows it, and more than half don't.

The analysts take comfort in financial engineering too. The underwriters who help governments raise money have found creative ways to dodge obstacles that theoretically constrain borrowing. States issue debt through structures that depend on taxes for repayment, even as repayment isn't an official state obligation because such a promise would require voter approval.

Another theory is that the federal government regards the biggest debtors "too big to fail."

Finally, observers point to the past. Between 1970 and 2000, no investor took a loss on a state's or a city's general-obligation debt. Even Orange County, Calif., which declared insolvency in 1994 in a one-off meltdown, repaid its lenders with interest.

We've heard it before. Before 2006, conventional wisdom held that if you wanted a risk-free investment, you couldn't do better than buy mortgage-backed securities. Homeowners were willing and able to repay what they owed. Struggling homeowners couldn't turn to bankruptcy. Financial engineering provided another layer of security: Underwriters and raters had designed airtight structures. History proved all this.

Yet investors pumped so much money into that supposedly airtight market that they blew it apart.

To get a glimpse of the possible future of Muniworld, look to Vallejo, Calif., about 30 miles north of San Francisco. Like many municipalities, this city of 120,000 residents found itself hard hit by the housing bust, with property-tax revenues falling by more than a quarter.

So Vallejo did something unprecedented. Seeing that the real problem was that “collective bargaining agreements control the city’s labor costs,” as Vallejo told the court, it petitioned a bankruptcy judge in 2008 to throw out those agreements.

Vallejo violated the first principle of municipal-finance conventional wisdom: that cities and towns will do anything to avoid default. Vallejo was insolvent, true, but its managers could have done what many of their counterparts around the nation have done: try, through structured finance, to borrow more somehow and hope for the best.

But the benefits of paring down contractual obligations outweighed the costs. If the court approves Vallejo’s bankruptcy-exit plan this summer, for example, the city will emerge from bankruptcy with $34 million in health-care obligations to retirees, down from $135 million.

Throughout its bankruptcy, Vallejo has not paid the full amount it owes on its municipal bonds. (The city has one municipal bondholder, the Union Bank of California.) What’s more, it has proposed, in its exit plan, to defer payments on its bonds, investing in infrastructure before paying lenders in full.

Vallejo’s bondholders may get off relatively easily, though, because Vallejo stopped piling up obligations, rather than trying one mad dash to borrow more. Vallejo didn’t follow, say, Illinois’ example: borrowing in the bond markets to fund future obligations to retirees. Vallejo knew that it had to cut future obligations — and even so, it couldn’t do it without affecting bondholders.

It’s easy to imagine some future mayor convincing a bankruptcy judge that it’s only fair for bondholders, along with union members, to take big cuts in a restructuring.

Indeed, heavily indebted governments’ willingness to repay crippling debt will depend on what’s politically expedient. Today, politicians see the advantages of borrowing more. Ten years from now, it may be more practical for a governor to tell the public: We’ve borrowed too much. We did so because clever Wall Street investors convinced our predecessors that it was a good idea, and we shouldn’t have to pay it back.

Investors continue to assume that financial calculations would trump political calculations — that is, that no state or city would default because it would cut off access to credit. But a state or city that did cut down its obligations might have an easier time getting financing, since new bondholders would know that its finances were sustainable.

Lenders Forsaken

As municipal debt grows, the risk mounts that someday it will be politically, economically and financially worthwhile for borrowers to escape it. When that happens, the protections that lenders supposedly enjoy will be meaningless. Lenders shouldn’t take solace in states’ inability to access bankruptcy codes: A state could certainly stop making payments on its debt without going into bankruptcy.

But there’s always Uncle Sam, right? In relying on future bailouts, investors are taking a gamble. When the White House rescued Chrysler and General Motors, it forced bondholders to take bigger losses than union members did. And as Europe’s woes may be showing now, sometimes governments are just too big to bail out.

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