Municipal Bond Risk

From a quiet backwater, what’s all this wave action?

By Gary Ellis

Three memorable years—the past two, along with perhaps the next—will provide a generation of financial analysts with its new baseline trove of statistics and war stories about securities markets in duress. The municipal bond market has not been spared a role in this still unfolding drama and that has surprised many investors. During our erstwhile stroll along economic easy street, the term “municipal bond market” usually appeared after modifiers such as: “staid,” “sleepy,” “boring,” or—from diplomats—“ultra-low-risk.” Until mid 2007, high-yield municipal bond funds had enjoyed (and aggressively marketed) four-plus consecutive years of enviably high total returns. In stark contrast, by late 2008, investors in those funds were shocked with sharply negative results. Concurrently, as direct municipal bond investors checked their municipal portfolios, they frequently found jar- ringly diminished market valuations. How did the supposedly low credit risk municipal bond market vanish so quickly? Mostly, it didn’t, the abundance of recent commentary suggesting other-wise notwithstanding.

Some near-term credit deterioration among municipal bond issuers is certain; states and local governments are not recession-immune. Balance sheet slippage among them by now is pervasive. Municipal bond credit duress has increased lately and is likely to continue growing in the near future. Nevertheless, it likely will lead to default only rarely and should not alter the fundamentally low risk profile for the traditional government-purpose munici-pal market. For the most part, credit deterioration among municipal bond issuers was a minor factor in municipal bonds’ year-end 2008 market valuation losses. That is evidenced, in part, by the market’s subsequently recouping most of the previous pricing slippage.

Direct investors in investment-grade, traditional, government-purpose municipal bonds typically do not intend to aggressively trade their securities. Such investors’ primary concern is with default or nonpayment risk, not short-term pricing volatility. However, they may graft concepts rooted in the equity markets to their understanding of municipal securities portfolios. Especially, they may view common stock price movement as a corporate performance/risk measurement report card. That premise does not necessarily transfer to municipal bond credit risk assessment. Within the mainstream high-grade municipal securities arena, market segmentation and securities structuring circumstances, along with a limited universe of buyers, have produced pricing volatility that has been easily misread as an indicator of substantial bedrock credit deterioration. In contrast, high-yield municipal bonds cluster as a distinctly separate group with its own markedly heightened credit risk profile.

The Core Municipal Bond Market

Most municipal bonds link easily to a casual investor’s image of the purposes behind municipal financing—constructing city halls, roads, utilities, airports, or possibly hospitals. Such securities form the municipal market core and undergird its ultra-stable reputation. However, several widely reported commentaries predict difficult financial and budgetary circumstances for states and local governments. Moody’s has placed a “negative outlook” on the entire local government municipal bond sector. Releases from the highly regarded Rockefeller Institute of Government depict significant declines in state and local government tax revenue receipts.

Moody’s Negative Outlook

On April 2, 2009, Moody’s placed the entire local government bond sector on “negative credit outlook.” For the most part, its explanation for that uncharacteristic step points to straightforward consequences of a deep recession. Major non-obvious concerns mentioned are suddenly heightened unfunded pension liabilities and some issuers’ now facing higher-than-budgeted debt-service costs via adversely performing, previously issued, supposedly cost-saving variable-rate debt. Those financing devices lately have been inflicting unanticipated negative consequences on many issuers, especially via failed remarketing and resultant heightened debt-servicing costs.

Unfunded pension liabilities have soared, a casualty of equity market valuation loss. Consider, however, equity price improvements since March 2009; unfunded retirement liabilities already are smaller. Large funding mismatches persisting well into the future are the fundamental concern; attempting to estimate them now with any precision is largely futile. A potentially serious problem may exist for some bond issuers if pension payout renegotiation eventually becomes necessary. Both pension and bond payout requirements generally have enforceable contract backing, which could conflict. If so, small issuers’ appropriation-type financings lacking
clearly dedicated revenues or other security might be most exposed. This will vary by state and place; details will be crucial. Presently, this is mostly speculative and hopefully will remain that way.

Generally, municipal bond credit risk can be viewed in two ways. The first is the risk of ratings downgrade, over which prospect ratings agencies such as Moody’s have substantial control. The second is the risk of nonpayment, which is the core matter for directly investing bondholders. Moody’s negative outlook probably pertains more to the first than the second. Moody’s research shows that default risk for general government municipal bonds has been near zero; its default-rate statistics for corporate and municipal bonds (all sectors), shown in table 1, indicate that the expected default rate for Baa-rated municipal debt is one-quarter that of Aaa corporate bonds. General state/local government debt default statistics have been even lower. Moreover, Moody’s has noted that post-default investment recovery rates have been far higher for municipals than for corporate bonds.

State general-obligation bonds typically carry credit ratings at least in the AA range, although notable exceptions, exemplified by California, have existed recently. Apart from the states’ senior debt, most municipal bonds have been rated within the A category on their own merits, with fewer than 20 percent in the next lower Baa category and very few below that. Moody’s gradually has been moving toward application of an upgraded, corporate-equivalent global scale to its municipal bond ratings practice. Nevertheless, a simple data application is instructive. In the very unlikely event that Moody’s drastically cuts its average outstanding municipal rating to Baa, the implied default risk still would be lower than for Aaa corporate bonds.

Among traditional municipal securities categories the hospital sector carries the most credit risk. It has accounted for the most rated municipal bond defaults, holds significant business enterprise-competitive risks, and has been undergoing a good bit of strategic restructuring. Moreover, it is saddled with a disproportionate share of variable-rate bond offerings gone awry. Still, the average Moody’s hospital bond rating is A, matching the average corporate bond rating.

Rockefeller Institute Reports

Rockefeller Institute reports show that state and local government tax revenue trends recently have fallen off significantly and that the decline rate has been steadily accelerating. So far, the data are more negative for states than for local governments. In major part, that is because states rely heavily on comparatively volatile income and sales taxation. In contrast, local governments depend primarily upon property tax revenues, which are more stable in the short term. A companion study cautions that state and local tax receipt trends generally are lagging indicators, following current macro-economic circumstances. Local governments’ financial health may deteriorate gradually, over an extended time period, because they heavily depend upon assessed-value driven property tax receipts and assessments typically are adjusted downward on a lagged basis. Overall, most state and local government budgets are in for a period of extended travail. However, given the drop in state/local tax receipts, are government entities appropriately cutting expenses and boosting revenues where they can? For the most part, it seems they are so far, though reports paint an uneven picture and California is an especially prominent concern.

Nevertheless, given the significant economic and financial challenges that many municipal governments face, some will seriously consider defaulting on municipal debt obligations. Few likely will. Defaulting is a very expensive, onerous, and frequently crippling task for issuers that assures market-access loss. If attempted, prospects for successful debt repudiation usually are dubious, perhaps partially evidenced by high recovery levels for defaulted municipal bond debt. Municipal bonds typically are secured with carefully worded contracts (indentures, loan agreements, etc.). Debt obligations are not a variant on stock dividends; they are not discretionary and generally are legally enforceable.

Securities Structuring and Market Segmentation Considerations

Municipal bond issuers as a group are dissimilar from far better understood corporate stock or bond issuers. In contrast to the corporate realm’s S&P 500 issuers’ group of highly liquid securities, the municipal bond market’s supply side is fragmented across more than 40,000 mostly obscure issuers. To overcome the market illiquidity resulting from a preponderance of issuers that

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<th>Corporate</th>
<th>Municipal</th>
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<tr>
<td>Caa-C</td>
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lack name recognition, the municipal bond insurance industry grew for three decades until it covered a large share of the municipal market with homogenous, usually AAA, guarantees. These enhancements generally rested atop underlying bonds that already had very low risk credit characteristics. However, those insurance policies were not frivolous. They provided valuable uniformity, hence liquidity, to an otherwise hodgepodge market. Between late 2007 and mid-2008, that bond-insurance-oiled market liquidity largely evaporated. Suddenly most bond insurers faced severe financial challenges and sharp ratings drops resulting from an unduly blithe application of their guarantees to ill-fated structured finance debt. Consequently most insured municipal bonds have suffered significant ratings cuts but little underlying credit quality loss; the underlying bonds already were characteristically solid on their own merits. However, after habitually overrelying on the omnipresence of highly rated financial guarantees, many municipal bond buyers were not well-equipped to navigate a market abruptly lacking credible bond insurance support. Concern about an apparently ensuing bond supply glut was a key factor behind late 2008’s municipal securities price drops.

The Variable-Rate Bonds Problem

Classic municipal bond issuers’ financial structures differ from corporate securities issuers. State and local governments, along with their balance sheets, usually are characterized by a wealth of long-term fixed capital assets but a dearth of cash. Municipal bonds typically finance long-term capital facilities: roads, bridges, hospitals, airports, and the like. Most municipal issuers have very stable, ongoing operations and do not need large cash positions on their balance sheets. For those reasons, the natural structure for a generic municipal bond is long-term fixed rate. In contrast to the corporate debt market, true short-term securities issuance has been a minor portion of annual municipal securities originations, in the 10–15 percent range. As a result, absent restructuring interventions, the municipal bond market would have an overabundance of long-term securities, a dearth of short-term instruments, and a short-term supply vacuum begging to be filled.

Most nominally short-term municipal bonds, in fact, are long-maturity bonds structurally packaged to function as short-term securities. That recharacterization usually has depended upon the presence of periodic “put” features for variable-rate demand bonds (VRDBs) or regularly scheduled remarketing arrangements for (now notorious) auction-rate bonds. Tender option bonds (TOBs) are roughly similar to VRDB securities, but they are structured and assembled in the secondary market. Long-term bond funds frequently have been TOB packagers since that technique can provide them with a de-facto leveraging opportunity. To function properly, most of these actually long-term bonds, reconfigured as short-term instruments have depended upon external supports, including bond insurance. They have relied especially upon ready availability of contingent liquidity backstops in the form of bank-supplied lines or letters of credit. Consequently the viability of these techniques abruptly ended by mid-2008, as previously AAA bond insurance credit ratings plummeted and once cash-flush, liquidity-providing banks nearly drowned in their own toxic assets.

The financial guarantor and liquidity backstop provider implosions had multiple negative consequences for the municipal bond market. Municipal variable-rate securities issuers frequently were shocked to discover that supposedly innovative and inexpensively serviced variable-rate bonds were backfiring and proving to be very costly, unbudgeted burdens. By now, many such arrangements have been unwound and the bonds resold as conventional fixed-rate debt. However, at least once the consequence has been hugely negative. The Jefferson County, AL, sewer bond mega-default resulted in large part from that entity’s insured variable-rate bond financings going disastrously awry. Additionally, TOB manufacturers were forced to de-lever, disassemble their TOB offerings, and dump the underlying long-term fixed-rate bonds into a market already overcrowded with sellers and by then inadequately offset with few buyers. That provided yet another oversupply cause; municipal securities prices plummeted, especially during late 2008, but for the most part this price drop was not related to underlying bond credit deterioration.

High-Yield Municipal Bonds

Compared to mainstream munis, high-yield municipal bonds’ credit risk exposure is far higher, especially during a recessionary period. These bonds commonly are very different from the standard investment-grade, largely government bonds discussed here so far. Frequently high-yield municipals are structured, corporate, or project finance-type securities with issuer and/or structural characteristics that a casual observer reasonably would not expect to find beneath the municipal-bonds umbrella. Key examples include industrial development bonds (essentially, corporate securities assembled as tax-free munis), multifamily housing finance bonds, and the healthcare sector’s low credit quality tail. Real estate or land development related bonds make up a significant fraction of high-yield portfolios. Given the real estate bust, such bonds now may have especially heightened risk characteristics. Tobacco settlement revenue bonds, most of which are still rated BBB-/Baa3, also are prominent quasi-high-yield investments. Their pricing has suffered recently, partly via negative shifts in market consensus about future trends in cigarette use. True high-yield bonds comprise a minor portion of the mu-
municipal bond market and their supply is somewhat inelastic. Supply inflexibility combined with fickle demand patterns can produce choppy pricing patterns.

The major direct buyers of speculative-grade municipal securities are a handful of specialized, high-yield, tax-exempt bond funds and most of the capacity for adequately analyzing these securities resides with those funds’ managers. The final, indirect, demand source for high-yield municipal bonds is, of course, municipal bond fund investors. Their demand, or lack thereof, for high-yield fund shares largely determines such funds’ net investable cash, hence, appetite for additional speculative grade bonds. A typical potential high-yield municipal bond fund investor has scant capacity for developing a solid understanding of the actual bonds in such funds. Many such holdings are arcane and the information necessary for building an adequate understanding of them is not easily available. Investors’ fallback approach can be undue reliance upon these funds’ posted total returns (coupon yields plus or minus securities price changes). The catch: A major force for these securities’ price movements (and hence total returns) is the supply/demand balance for high-yield bonds that those very same fund investors collectively, albeit indirectly, produced by overfocusing on prior returns data. This amounts to group circular reasoning. Recognizing that demystifies high-yield municipal funds’ boom-bust record.

Build America Bonds

Build America Bonds’ (BAB) surprise mid-April emergence has been a major force in stanching the municipal bond supply overhang problem and facilitating municipal bonds’ subsequent resurgence. BAB’s legal birthplace is the 2009 American Recovery and Reinvestment Act (i.e., the Obama stimulus package). BABs are municipal securities issued on a federally taxable basis with interest payments partially subsidized by the U.S. government. Among several authorized variants, the overwhelmingly popular choice involves an issuer receiving ongoing federal subsidies covering 35 percent of interest payments. BAB buyers typically have been tax-exempt entities such as pension funds or designated retirement accounts. The first issuers were obviously well-known entities, such as the University of Virginia, the New Jersey Turnpike, and the state of California, all clearly recognizable to corporate bond investors who are presumed unfamiliar with the municipal market’s byzantine warrens. Subsequently, small issuers have successfully issued BABs. The prospects for eventually reselling such small-issue BABs in the secondary market, could be hindered by their dearth of name recognition and prove more challenging than new issue purchase. Some corporate bond buyers, lulled by their own market’s liquidity and abundant, fast disclosure, may be dismayed later by the lack of both for many small issue municipal bonds. A repricing bump downward may await. Meanwhile, reversed anxieties about nascent shortages of traditional tax-exempt municipal bonds spurred buying, boosted prices, obliterated supply overhang fears, and returned taxable/tax-exempt yield spreads to previous norms.

Conclusion

Commentators frequently underestimate the complexity of municipal finance. When times are flush, high-yield municipal bond risks are brushed off. During a downturn, generalized financial weakening is hyperbolized to worst-case extremes. Municipal bonds as a whole are not risk-free, but the investment-grade, traditional purpose, mainstream market remains a low-risk arena. Other segments of this market harbored heightened risks well before the recession. Those weaknesses remain, notwithstanding recent demand-driven price gains.

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Disclosure: This commentary is for information purposes only and is not intended as a recommendation or solicitation for any financial product or service. Investing in municipal bonds involves risks, including loss of the principal amount invested. The term ‘high yield,’ when applied to bonds, typically implies the presence of a significant element of credit risk, irrespective of whether such bonds actually carry speculative grade (Ba1/BB+ or lower) ratings. Municipal bonds typically offer a lower yield than comparable taxable bonds in consideration of the tax-advantaged status of their interest payments, which are exempt from federal taxes and may be exempt from state and local taxes where they were issued. The alternative minimum tax may apply and can negate these benefits. Capital gains do not share this tax-advantaged status.

Endnotes

2. See the following reports from the Nelson A Rockefeller Institute of Government, Albany, NY: Lucy Dadayan and Donald J. Boyd, The Damage is Just Beginning, State Revenue Report No. 73 (October 2008); State Revenue Declined Sharply in Fourth Quarter, State Revenue Flash Report (March 2009); Sales Tax Decline in Late 2008 Was the Worst in 50 Years, State Revenue Report No. 75 (April 2009); April is the Cruelest Month, State Revenue Flash Report (June 2009).