ADVISOR PERSPECTIVES

Hype and Reality in the Muni Bond Market

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Meredith Whitney's prediction last year of billions of dollars in municipal bond defaults stirred investors' fears. Earlier this summer, bankruptcies in three California cities reignited them, and last week a Federal Reserve study revealed that muni bonds have defaulted at a higher rate than previously reported.

But no crisis has befallen the municipal bond market, and it is highly unlikely that one ever will. Individual, high-quality muni bonds are still the safest investment, after U.S. Treasury and agency bonds, and they offer the best after-tax returns for individual investors.

We'll offer some specific guidelines for today's muni-bond investors, but first let's consider recent muni defaults, with an emphasis on the California situation, to understand why they happened. We'll see that, in fact, recent developments should actually safeguard bondholder interests over the long term.

A problem long in the making

When President Franklin Delano Roosevelt was asked in 1937 whether federal employees should be allowed to unionize, he responded that, although he understood that government employees' desire for adequate wages and working conditions, he could not approve the right of unions to strike, because government requires "orderliness and continuity of conduct" to be effective. In 1962, however, President Kennedy issued an executive order that granted the right to federal employees to unionize and bargain collectively.

The unionization of municipal workers is jointly governed by state and federal laws. However, unions must win the right to organize in each state. Every state has its own labor laws and labor boards. The state of Wisconsin was an early pioneer in establishing union's right to organize. Its pro-union workers almost annually threatened garbage strikes at budget time.[i] To end the strikes, they granted unions the right of collective bargaining in 1959, the first state to do so.[ii]

But it was not until 1963, after a law was passed setting up union election procedures that Wisconsin's unions were firmly entrenched. It was not until 1977, after more strikes by police and firefighters, that binding arbitration was established to eliminate them. It was

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Wisconsin's historic position in the labor history movement that made their now Governor Scott Walker's decision to eliminate collective bargaining this year such a challenge to unions everywhere. National union forces tried to recall him. Their failure to do so, and the elimination of the check off that required everyone to have dues deducted from their paycheck, has resulted in a workers dropping their membership in the American Federation of State, County and Municipal Employees union (AFSCME) by half. The American federation of Teachers (AFT) dropped by a third.[iii]

When the U.S. economy was strong and growing, high compensation and benefits for municipal workers was a manageable cost of doing business. Even if wage increases were modest, unions could count on increased pension and healthcare benefits. In the current climate of economic contraction, however, union benefits are often unsustainable. Union practices such as calling in sick and working extra shifts for overtime need to be eliminated. Labor contracts usually govern pensions, but in some states, such as New York, Alaska, Illinois and Michigan, unions successfully forced the passage of constitutional guarantees, making modifications to benefits very difficult.[iv]

State and local municipalities face problems that in large part result from political decisions to allow municipal unions to bargain collectively and strike. Public-service workers earned much less than those in the private sector before unionization. But the right to bargain collectively gave unions *de facto* monopoly power, which they deployed to great effect. Since municipalities cannot move and face no outside competition, there are few countervailing forces. The only option is for citizens to move away, as they have been doing in Detroit, which has lost more than a quarter of its population in the last decade.[v]

The wages and benefits of union workers now outstrip those of their private-sector counterparts. Although politicians promised pension and health care benefits, they often chose not to fund them, especially the non-monetary benefits. According to a Pew Center report entitled "The Widening Gap," in fiscal 2009 states had set aside 78% of the funds needed for pensions, but only 5% of retiree healthcare and other benefits.[vi]

In addition, governments allowed pension plans to operate under the questionable assumption that they would return 8% to 8.5%, or sometimes even more. When market conditions changed, the politicians could no longer deny reality. To put this in perspective, the California Public employees Retirement System (CalPERs), the largest public-pension system in the country, reported a 1% return on investments for the fiscal year[vii] ending June 2012, while its assumed rate-of-return was 7.5%. In sum, on average other states' investment returns were only slightly better. The overall rate-of-return for state pensions nationwide for fiscal 2012 year was 1.5%.[viii] States are reluctant to accept these real rates of return as the norm. Lower assumed rates-of-return, however, increase the funding gap, requiring states to set aside more funds. That deepens the debt they must recognize.

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States confront the inevitable

This problem was a long time in the making, and it can no longer be ignored.

Due to collapsed housing prices, high unemployment, underfunded pensions, retiree healthcare promises and unfunded federal mandates, state governments have had to confront challenges that they were previously able to put off or conceal. Politicians at every level of government previously found it more convenient to acquiesce to the demands of the municipal unions and get re-elected than to hold the line on pensions and benefits. From the politicians' perspective, why not give in? They would be long out of office before the bill for those pay packages would come due.

There is not much discussion of politician's salaries and benefits packages, because they are fewer in number, unless they convene a 2 A.M. session to pass raises as they did in Pennsylvania in 2005. Many state legislatures, however, are bloated and entrenched, raising the costs of living and doing business in those states.

Now, faltering economic conditions have strained the state and local fiscal resources, forcing hard choices – among them bankruptcy.

Municipal bankruptcies have been most frequent in California, where laws are generally lax in protecting creditors' rights. For example, California law allows homeowners to walk away from the mortgages on their primary residence. Now many politicians in California cities are viewing bankruptcy as a means to achieve pension and health-care reform. Vallejo, CA, was in bankruptcy for three years, but it did not take on those reforms because of constraints imposed by CalPERS. Monmouth Lakes, San Bernadino and Stockton are all in bankruptcy now, with Compton following close behind.

Stockton was the first municipality to ask bondholders to take a significant haircut. The bondholders good fortune is that some of the bonds are backed with insurance that guarantees the timely payment of interest and the return of principal when the bonds come due. The credit enhancement provided by the insurance enabled the city to sell bonds at a lower interest rate than they would have otherwise been able to do. The bond insurers' National Public Finance Guarantee Corporation (a subsidiary of MBIA, Inc.) and Assured Guarantee are challenging Stockton's decision to fully protect its pension agreements in bankruptcy while reducing payments to bondholders. The perspective of the insurance company is that Chapter 9 "was not intended to be used as a sword to prefer one class of similarly situated creditor over another."[ix]

Having mismanaged municipalities for years, politicians today are unwilling to accept the consequences, saying they cannot cut public safety. Though this may sound reasonable on the face of it, in fact the proportion of general fund spending on essential services, such as police and fire protection, is much higher than average in places considering bankruptcy. According to data gleaned from California local government financial

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statements, the average amount of the budget dedicated to public safety spending is 52.7% for cities and counties with populations greater than 100,000 and 56.2% for those with populations between 50,000 and 100,000 people.[x] But Stockton spends 87.33% of its budget on safety. Insofar as there are also outstanding pension and health care obligations for all municipal workers, that percentage is even greater.[xi]

Many municipalities in California pay more than 70% of their budget for public safety, and they claim they are hemmed in by state and local laws dictating wages and other benefits. But many California municipalities have freedom to create their own policies. They can pay above-average salaries to politicians and have binding arbitration decide their labor negotiations, if it is written into their constitutions.   Binding arbitration usually results in looking at what other municipalities have agreed to, without regard to the fiscal health of the municipality in question. In one egregious case reported recently, a Stockton police chief secured a pension of over $200,000 per year after working less than one year for the city, “retiring” at age 52, and taking another police chief job elsewhere. This was not an isolated incident.[xii]

Not all California cities are content with the status quo. San Diego and San Jose voters passed measures rolling back pension benefits by a 2:1 landslide. In San Diego, base pay was frozen for six years, and new employees were offered 401(k) plans instead of a defined-benefit pension plan. In San Jose, union workers will have to pay more toward their pensions, have higher retirement ages, enjoy reduced inflation protection, and subject future retirement changes to voter approval. Unions are challenging those results in court.

Some states take control

Bankruptcy is only one route state and local governments have chosen to achieve fiscal solvency; many have been able balance their budgets without compromising the quality of services they provide.

Some politicians have found that reducing the costs of doing municipal business is good politics, and they have modified contracts with varying success. For example, Rhode Island passed landmark pension reform in November 2011, in the wake of credit downgrades by the rating agencies and municipal bankruptcies. To improve its credit position, Rhode Island’s legislature merged their conventional pension plan with a 401(k)-style plan that affected not only the currently retired, but also those still currently employed, a first in pension reform. They also raised the retirement age for current employees and suspended the cost of living adjustment for retirees.[xiii]

In Wisconsin, Governor Scott Walker suspended collective bargaining rights. In June, the unions made a concerted effort to recall the governor that fell short. Wisconsin is one of the few states with a fully funded pension plan, because if the pension fund returns sag, it is allowed to pay out less money to retirees.

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In 2012 Scranton, PA was facing dire circumstances. There was only $5,000 remaining in the coffers, and the mayor, Chris Doherty, defied a court order and decided that all city-paid employees would receive the minimum wage of $7.25 an hour. The mayor said that the city simply had no funds and could not pay any more. The city also faced an onerous arbitration award. Since then, the state legislature has passed a law that cut the award in half and brought the unions back to the bargaining table.[xiv] The mayor repaid the city workers for their lost wages.

Sandy Springs, a suburb of Atlanta, took a different route,[xv] becoming an independent city in 2005. Aside from public-safety workers, who are required to be municipal employees, the municipal government has only seven workers. The rest of the work is outsourced by competitive bid. Sandy Springs spend about one fifth of its budget on capital projects. City workers have 401(k)s funded by monthly deductions from their paychecks. Other cities in the northern part of Fulton County have followed suit.

An improving regulatory backstop

Regulatory agencies and insurers have taken measures to safeguard bondholder interests.

In June 2012, the SEC recommended that state pension plans comply with corporate-style Generally Accepted Accounting Principles (GAAP). With the implementation of this requirement, states will be forced to disclose and confront their unfunded liability. How they solve their problems remains to be seen. Though municipalities do not have to comply with GAAP, they will not be able to receive an unqualified accounting opinion without it.

Stepping into the breach is a new bond insurance company called Build America Mutual Assurance Company (BAM). It will be rated AA and will insure BBB- and A-rated bonds. Insurance makes buying bonds much simpler, because the investor does not have to evaluate the issuer's credit if he or she has confidence in the insurer's credit. This insurance company will only insure the bonds of its members, who pay 1% or more of the face value of bonds issued. Since BAM will be member-owned, it is less likely to represent an easy fix to municipal financial problems.[xvi]

Moody's Investor Service recently issued proposed changes for analyzing U.S. public-sector pension data and requested comments from issuers. It seeks to treat pension liabilities as a debt obligation of state and local governments. Excessive debt will result in downgrades. It was recently reported that Moody's said that it "does not expect any state ratings to change based on the proposed adjustments alone." [xvii] Moody's action "would nearly triple – to 2.2 trillion, from $766 billion – the unfunded pension liabilities reported by state and local governments in 2010."[xviii]

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What the supposed municipal-bond crisis means to investors

Reading about bankruptcies and municipal problems is very unsettling. Munis are supposed to allow you to sleep at night, but the news can be distressing. Despite high-profile difficulties in states such as California and Illinois, however, most highly rated municipal bonds remain ultra-safe investments.

Here are our guidelines for investing in the current market:

- Read the newspaper. Reward bond issuers that support bondholder rights, and don't buy the bonds of issuers who do not. For example, Jefferson County, Alabama sold general obligation warrants for their sewer system, and those warrants are now in default. Unlike general obligation bonds that are backed by the full faith and credit of the issuer, warrants (which are not bonds) are not backed by any taxing power, and the state will not authorize the raising of taxes to make payments.

- Buy the bonds of larger entities, favoring states over local governments. The federal government pushes debt onto state governments, and state governments push debt to local governments. For example, the state of Illinois is proposing to transfer pension obligations for teachers to the local governments. State-issued general obligation bonds are the safest municipal securities, so investors should choose carefully if buying any other type of muni.

- Buy only high-quality bonds. Though you may pick up more yield on lower-quality bonds, and though you may need more income, it always pays to stick with high-quality bonds in uncertain times. If interest rates rise, then lower quality bond prices will quickly reflect the constriction of credit, and they will thus decline in price more than high-quality bonds. Purchase certain state-issued GOs, AAA-rated county and city bonds, highly rated essential-service bonds, and certain university bonds.

- Use the ratings as a starting point, not a final guide. Ratings are issued when bonds come to market. They may not reflect current conditions. Check the material event reports posted by most issuers to see if they provide any additional information, and check the news outlets if you have cause for concern. If there is a big yield disparity between the bonds you are considering and other similar bonds, you need to ask why. The market is the first to reflect real problems.

- Recognize that high-yield bonds and bond funds that own them contain more risks. Non-investment-grade bonds (rated lower than BBB-) and weak investment-grade bonds yield more because they are more likely to default. If they were to default, any presumed yield advantage would evaporate, along with your principal. Though less than 1% of the bonds rated by Moody's have defaulted, many more unrated bonds will default. According to a Federal Reserve Bank report issued August 15,

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2012, issuers of unrated bonds for nursing homes, healthcare projects, housing and industrial development have a greater frequency of default than might otherwise be expected (and a greater frequency than rated bonds). [xix]

Over the longer term, if state and local governments find ways to improve their fiscal conditions, either through bankruptcy or budgetary measures, bondholders' positions will further improve. In the short term, improved regulation, disclosure and insurance provisions will support the stability and safety of the municipal bond market.

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