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Response to Headline News

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Today's New York Times article titled "A Path Is Sought for States to Escape Their Debt Burdens", inflamed the anxiety level once again for investors in the $2.8 trillion municipal bond market. Addressing the idea of a new path to bankruptcy for state governments that would allow them to restructure their obligations raises some immediate thoughts, concerns and further questions regarding the impact on the municipal market.

As the current municipal bankruptcy code, Chapter 9, exists, states are not allowed to file for bankruptcy protection. State governments are sovereign, on-going entities that provide essential services to their populations. Some local governments are allowed to file for bankruptcy protection under Chapter 9, but only half the states allow their municipalities to file, and those that do, have restrictions including solvency and other tests to be met prior to an entity using the bankruptcy route. In fact, the trend with states has been moving to make Chapter 9 less accessible to their municipalities. Some states have stepped in, through various oversight measures, to avert a locality from filing for bankruptcy due to the market penalty that could be assessed on other localities in the state or the state itself on future debt issuances. Historically, we have seen only a small number of bankruptcies in the municipal bond market for reasons that include; the solvency test, the market penalty and perceived risk that could be felt across the state, the time and cost to work through a bankruptcy, and the unknown outcome of bankruptcy protection.

- We currently do not see any state seeking an avenue to bankruptcy restructuring, or in a fiscally strained condition to be considered insolvent. As the recent New York Times article states, "no state is actually known to want to declare bankruptcy." The state bankruptcy discussion has been raised by certain members of Congress and academics that are under the misconception that this is a resolution to the state's fiscal problems.

  California State Treasurer Bill Lockyer responded to the article with this statement:
  "To the folks in Congress cooking this baloney: Don't bother. States didn't ask for it. We don't want it. We don't need it. Bankruptcy would devastate states' ability to recover from the recession and make the infrastructure investments that create good jobs. It would inflict severe injury on taxpayers. Advocates of this preposterous idea want one thing above all - to see government go up in flames and, with it, the lives of a certain class of working people they don't like."
  "The people making this dangerous suggestion - and those who lend it credibility it doesn't deserve – confuse states' near-term budget deficits with long-term funding obligations. The latter, including pension obligations, are serious problems. We are dealing with them by reducing benefits and increasing employees' contributions, among other moves. With respect to our budget shortfalls, we have the tools to fix them without taking a wrecking ball to our economies and taxpayers. Thanks, but we'll pass on the Gingrich Kool-Aid."

- We currently put a low probability on the likelihood of a broad restructuring of the bankruptcy code to include state governments. The prospect of this raises more questions and volatility in the market. It would raise the cost of borrowing for state and local governments already struggling with revenue and expenditure imbalances, instill further uncertainty and potential disruption in the market and asks states that are financially sound to be penalized for the mismanagement of their peers. Could this also potentially exert "peer pressure" by those that are fiscally sound, onto those who are not, to get their fiscal houses in order?

- It is important to separate "default" from "bankruptcy" as the two are mutually exclusive. Historically, we have seen municipalities in bankruptcy continue to pay their debt obligations. In fact, in the few high profile bankruptcies that have involved general obligation bondholders, bondholders have been made whole. In the case of Orange County, CA, a premium was paid to extend maturities slightly.

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- State municipal debt service payments are currently a small portion of overall expenditures, on average 4% of expenditures and in all instances within 10% of total expenditures. We do not see state general obligation debt as being the culprit of state expenditures being out-of-control. To impact capital market access, drastically change a well-imbedded and thought-out bankruptcy code, and risk perception in the market, placing price pressure on municipal bonds, would be short sighted.

- We do like the idea of an oversight panel structured such as the Municipal Assistance Corporation (MAC) that was initiated during New York City's financial troubles in the 1970's. This could be a good way to address the restructuring of state and local governments' burgeoning pension and healthcare liabilities and existing union contracts while maintaining market stability.

To raise the idea of instituting a new path for states to file bankruptcy, and the prospect that a state could file for bankruptcy, all in an effort to facilitate union negotiation of collective bargaining agreements, in our opinion is reckless, not constructive, and counterproductive. The states should be focusing on their immediate challenge of taking the necessary legislative action to balance budgets for this and next fiscal year while beginning to institute constructive changes in pension funding that will produce longer term, sustainable expenditure reductions.

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