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## Do California Cities' Bankruptcies Signal a Growing Credit Crisis in the Muni Market?

Municipal bankruptcy has been in the business headlines recently. The recent string of California cities filing Chapter 9 municipal bankruptcy protection, or publicly discussing such a filing, has again fueled the discussion of the safety of municipal bonds. Investors and commentators have also begun asking a much bigger question – is there a shifting attitude toward municipal bankruptcy that makes it more acceptable to municipalities today? We continue to believe that Chapter 9 filings will remain relatively rare, and that there are some dynamics specific to California that have triggered the recent uptick in Chapter 9 activity. We also agree with some commentators' observation that the stigma attached to municipal bankruptcy seems to be lessening among some market participants. However, the vast majority of state and local government officials continue to view municipal bankruptcy as a non-starter and will go to extraordinary lengths to ensure that they meet their debt obligations as scheduled.

Bloomberg reports that there have been 42 municipal bankruptcies filed in the U.S. since 1981, an average of less than two per year. Governing magazine reports that while there were a total of 26 municipal bankruptcy filings since 2010, 20 were for local utility authorities, local hospital authorities or special purpose districts. These types of issuers are very different from typical local government issuers, often having high leverage, very limited revenue streams with little financial flexibility, and are often dependent on the successful completion of some economic development or project. The six local governments that have filed for Chapter 9 protection, and the two California cities currently being discussed as likely filers, are outlined in the table below.

| Municipality         | Date Filed                              | Causes   | Chapter 9 Status         |
|----------------------|---|--|--------------------------|
| Central Falls, RI    | 8/1/2011                                | After being placed under a state appointed receiver, the City filed for bankruptcy protection from \$21 million of outstanding debt plus millions more of unmanageable unfunded pension liabilities.   | Ongoing                  |
| Boise County, ID     | 9/8/2011                                | The City lost a legal battle with a developer and was ordered to pay a judgment of \$5.4 million. The County filed for Chapter 9 protection, but the filing was rejected on the basis that the County failed to prove it was insolvent.  | Rejected                 |
| Jefferson County, AL | 11/9/2011                               | The County accumulated more than \$3 billion of debt associated with its sewer system upgrade. The complex financing scheme used to fund the improvements – which have resulted in criminal prosecution of some of the participants – collapsed in 2008 as a result of the financial crisis. The County filed after years of unsuccessful negotiations with creditors and state officials. | Ongoing                  |
| Harrisburg, PA       | 3/10/2012                               | The City guaranteed the debt for a waste-to-energy plant. When the plant failed to perform, the City became obligated to support more than \$300 million of project debt. The City was placed under state Receivership and, though it filed Chapter 9, the filing has been rejected and suspended until late 2012.   | Rejected, status pending |
| Stockton, CA         | 6/28/2012                               | The City filed for Chapter 9 after failing to reach agreement with its creditors and labor unions that would allow it to close a \$26 million budget gap.  | Ongoing                  |
| Mammoth Lakes, CA    | 7/3/2012                                | The City lost a legal battle with a developer and was ordered to pay a judgment of \$43 million. Without the resources to make such a payment, the City sought Chapter 9 protection.   | Ongoing                  |
| San Bernardino, CA   | Filing possible within the next 30 days | The City Council voted to authorize a Chapter 9 filing after being unable to negotiate relief from rising pension costs and budget shortfalls. The City is also subject to an investigation of accounting irregularities.  | Not Yet Filed            |
| Compton, CA          | TBD                                     | On July 17, the City Comptroller disclosed that the City faces a cash emergency after failing to secure short-term cash flow financing and close a \$10 million budget gap. The Mayor has raised the possibility of "fraud, waste, and abuse."   | Not Yet Filed            |

Source: Governing.com; Bloomberg; The Los Angeles Times

In most past cases, bankruptcy has been preceded by an unexpected triggering event (the failure of a project, a legal judgment, etc.) that overwhelmed the municipalities' financial resources. Since the financial crisis hit in 2008, though, many local governments have faced financial pressures unmatched since the Great Depression. A few have been unable to overcome the revenue shocks from severe and sustained declines in tax revenues and simultaneous cuts in state funds transfers. Even so, the vast majority of municipal issuers have successfully balanced shrinking revenues with demands for services and maintained reasonable financial health.

Each Chapter 9 story represents a unique situation in which poor financial management or uncontrollable events created a financial crisis. As we have noted in previous market comments, we continue to believe that municipal bankruptcy will remain a rare event, due to factors including:

1. Municipalities must be allowed to file for Chapter 9 protection under state law and meet other legal criteria. Only 27 states permit municipal bankruptcy, and many of those that do often make filings extremely hard to pursue. States typically do not want their political subdivisions seeking bankruptcy and often work actively to preclude such actions.
2. Municipal bankruptcy can be long and expensive. Unlike corporate Chapter 11 filings, municipal Chapter 9 bankruptcies are often protracted affairs that take many years to conclude. The resulting costs – legal, economic and political – often outweigh what are initially viewed as the benefits of seeking bankruptcy protection.
3. Very few municipalities ever face unmanageable financial obligations. As political subdivisions with taxing power, local governments generally have the financial wherewithal to meet their obligations, even if debts must be renegotiated or restructured to allow an issuer a chance to “grow into them.” It is only truly exceptional cases – typically involving financial or economic speculation, gross mismanagement, or corruption – that will so stress a municipality’s financial structure that it becomes untenable. And, most states have active programs to monitor and assist municipalities in working out of difficult situations before they become acute.

For municipal investors, the important lesson of the uptick in filings by California cities is “know your issuer.” Although we regularly note that general obligation and essential purpose utility revenue bonds as groups are among the most stable and secure investments in the municipal market, it remains critical to examine issues individually. Problems like those of Stockton, San Bernardino and Jefferson County do not arise overnight – such situations take many years to develop, and there are plenty of warning signs along the way for those that would look for them. Careful selection of credit cannot eliminate all possibility of negative credit surprises, but it can ensure that the types of situations that can degenerate into defaults and bankruptcies are identified and moved out of portfolios long before they become headline news.

### **What is Happening in California?**

In our view, the increasing rate of filings by California cities is a strong caution for investors in California local munis, but it does not indicate a general rise in credit risk for the municipal market as a whole. We believe that there are a number of factors unique to California that raise the likelihood that economically challenged municipalities will consider Chapter 9. These include:

- California is one of 27 states that allow municipalities to seek Chapter 9 bankruptcy protection, and in California the path to Chapter 9 is much easier than in most states. Most states actively work to prevent municipalities from seeking Chapter 9, including appointing state receivers and/or oversight boards or managers to fiscally distressed municipalities. While California's Legislature did recently pass AB 506 to create a mediation process that could help local governments avoid bankruptcy, it does not bind local governments in any meaningful way.
- The unique characteristics of the California real estate market and state and local economies make the problems for local municipalities potentially worse than in most other states.
  1. Many California real estate sub-markets – northern Orange County, San Bernardino and Riverside Counties, the East Bay, the Central Valley – were among the fastest growing markets in the nation during the early to mid-2000s. As property values exploded and new real estate development far outpaced the rest of the nation, local government tax rolls grew far more rapidly than in most other areas.
  2. The rapidly increasing revenues fed demand for large annual increases in budget expenditures. One very significant component of growing municipal expenditures was employee benefits, specifically retiree pension and healthcare benefits. These expenses grew very rapidly in many municipalities that were flush with revenue, locking in long-term obligations. When the housing market began collapsing in 2006 and 2007, some of these municipalities saw their tax bases decline by 30% to 40%. These figures are unmatched anywhere except small portions of Nevada and Florida. Many California cities and counties are now faced with a high level of fixed budget costs that must be met with dramatically reduced revenue levels.
  3. The State of California has also been hit harder than most states by the economic downturn. The State has attempted to close its own massive budget gaps through a number of means, including slashing state payments to local municipalities and eliminating a variety of state-level programs that push costs down onto cities and counties.
  4. When the state eliminated local redevelopment agencies (RDAs) earlier this year – a move by the state to capture additional revenues to balance its own budget – it forced the responsibility for outstanding RDA obligations down onto local governments. It also eliminated RDAs as a potential source of inter-fund loans or short-term liquidity providers for local governments. Some cities had become dependent on loans or transfers from their local RDAs to balance budgets or provide short-term cash flow help.

- California municipalities have long been viewed as providing far more lucrative public employee benefits than municipalities in most other states. With recent changes in pension obligation financial reporting and the rapid growth in annual expenses related to employee and retiree benefits, costs related to those benefits are rising very rapidly for many California municipalities. Those issuers that have been the most generous in the past will face the most pressure going forward to reconcile limited revenues with growing fixed employee and retiree costs.
- California seems to be developing an acceptance of municipal bankruptcy in which cities see Chapter 9 as a more effective path than attempting to bargain with employees or creditors. This seems to have grown in part out of the experiences of the federal government, corporations and state governments during the financial crisis, and while not unique to California is certainly seen most strongly there. We do not see this sentiment among most issuers in other states or regions. There is a growing sense in California that Chapter 9 can be a mechanism cities can use to force concessions by employee bargaining groups which could not otherwise be won. There seems to be a growing sentiment that it is unfair to place the entire burden of higher taxes and reduced services on local taxpayers and residents, and that creditors – including bondholders – should share the pain. The extent to which this trend continues will likely depend on whether other municipalities view the costs and outcomes in Vallejo, Stockton and other cities as preferable to what they might be able to achieve through negotiation with employees and creditors.



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