

Municipal Bonds and Bankruptcy Proceedings

The following is a response by BAM Director of Fixed Income Strategies Harold Walton to a February 18, 2010, article in The Wall Street Journal titled Muni Threat: Cities Weigh Chapter 9.

This article discusses how some municipalities are considering bankruptcy as a method of dealing with their debt loads: “The economic slump, however, is forcing debt-laden cities, towns and smaller taxing districts throughout the U.S. to consider using Chapter 9. As their revenue declines faster than expenses, some public entities are scrambling to keep making payments on municipal bonds. And that is causing experts to worry about the safety of securities traditionally considered low risk.”

While many municipalities are indeed in a tough situation, this article is painting a dire picture with a very broad brush. There are several important things to keep in mind regarding this article, especially as it relates to how we purchase municipal bonds.

First, we screen out nonessential service municipal bonds for portfolios. Most of the situations cited in the article (such as the Harrisburg, Pa., incinerator plant and the Las Vegas monorail) involve bonds that are not general obligation debt, nor essential service revenue bonds. The municipal bonds we buy are either general obligation bonds or essential service revenue bonds (such as water/sewer, highway transportation or university revenue bonds).

Second, states cannot enter Chapter 9 bankruptcy, and 26 states prohibit municipalities from filing for bankruptcy. (It should be noted that two of the states featured in the article — California and Pennsylvania — are not among that list.)

Third, municipal bond ratings (unlike corporate bond ratings) do not typically experience drops of several credit rating levels at a time, such as when Lehman Brothers corporate debt went from a rating of AA to default in the same day. We monitor credit quality so that appropriate action can be taken if there are adverse changes to credit quality.

Fourth, we avoid long-term bonds and generally only purchase municipal bonds with a credit quality of AA or higher, which further minimizes the possibility of default.

Finally, recovery rates for defaulted municipal bonds have historically been much higher than for corporate bonds. Defaults do not necessarily translate into low recovery rates. (For example, the largest municipal default in U.S. history was Orange County, Calif., in 1994, and all bond holders were eventually paid in full.)

Compared with corporate bonds, the track record is even better for the types of bonds we purchase. According to a study by Fitch Ratings on default risk, defaults of tax-backed debt and essential-service debt have typically been followed by recoveries of 100 percent.¹ Also, Moody’s noted that the anticipated recovery rate on defaulted general obligations bonds is nearly 100 percent.²

Though the risk is certainly there for some municipal bond sectors, we take steps to minimize the risks discussed in this article.

¹ David Litvack and Mike McDermott, **Municipal Default Risk Revisited**. *Fitch Ratings*, June 23, 2003.

² **Moody's U.S. Municipal Bond Rating Scale**. *Moody's*, November 2002.

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