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By Frederick J. Sheehan

## Dark Vision

*The Coming Collapse Of The Municipal Bond Market*

This paper is directed to traditional municipal bondholders, those who hold bonds primarily to receive tax-exempt, steady income. That investor generally holds municipal bonds expecting little change in the price of these securities. That investor welcomes capital gains, but that is a secondary objective.<sup>1</sup>

Such investors do not own municipal bonds as speculative securities. They do not get paid enough to do so. They buy municipal bonds for the income, not for appreciation. Today, no matter what one's reason for owning municipal bonds, these are speculative investments.

### Ignoring the Evidence, Believing the Experts, and Losing 40%

The municipal market will probably repeat the pattern of the sub-prime collapse. Although it is plain to see, the usual experts do not notice. This was true of all of our recent financial bubbles, including subprime mortgages.

The first index of subprime mortgage securities was introduced in January 2007.<sup>2</sup> It immediately dropped like a rock. By February 27, the BBB-rated bond index fell nearly 40%. (It rebounded 1.5% on February 28 after Federal Reserve chairman Ben Bernanke (an expert), told Congress the mortgage market was not "a broad financial concern."<sup>3</sup>) This was a *bond* index, not an emerging market ETF. It was rated BBB, in other words, investment grade. It consisted of mortgages, all of which were sold in 2006 - the year before.

Despite the financial system's enormous exposure to subprime mortgages, this monumental

event went practically unnoticed. Comments by the experts betrayed their ignorance. In March 2007, Federal Reserve Chairman Ben Bernanke stated: "[W]e believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."<sup>4</sup> Bernanke should have known at least two things: 1 - his banking system had never been as leveraged; 2 - over 50% of his banking system's assets were invested in construction loans, land development and mortgages.<sup>5</sup>

The collapse of municipal finance is equally unanticipated. (Note: Unless specifically differentiated, "municipal" refers to state, county, city, town and other tax-exempt entities - colleges, hospitals, highways, etc.) The gradual deterioration of municipal finances, which has been compounding for decades, has quickened over the past several months. Spending is rising and revenue is collapsing.<sup>6</sup> Funding gaps have been disguised by accounting gimmicks.

Over the past decade, the mainstream press reported financial collapses after it was too late for investors. Enron, Citicorp, AIG and Bernie Madoff are examples.

### Section 1: The Mess in Municipal Finance

#### The Current Situation

Recent cost-cutting by states and municipalities is inadequate. This much is probably obvious. What may go unrecognized is that filling these

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gaps using conventional measures is impossible. Parties to suffer from unconventional measures include bondholders.

Some reasons for municipal collapse:

First, losses on investments will require much higher pension contributions. Estimates vary but some states and towns will need to increase their contribution by 50% or even 100% starting in 2010 or 2011.

Second, spending has exploded. In New York City, the average compensation for full-time workers rose from \$65,401 in 2000 to \$106,743 – a 63% increase. Pension benefits consume a growing proportion of the city's budget. They are calculated, as is true for most municipal and state workers, using a formula based on earnings in the final years of employment. Since salaries have risen so steeply, so have pension contributions: New York City's cost to pre-fund pensions rose from \$2,530 per full-time employee in 2000 to \$20,333 in 2008.<sup>7</sup> The number of full-time employees has risen from roughly 24,000 in 2003 to over 31,000 in 2008 (even though school enrollment has fallen 4%; education consumes one-third of the city's budget.)<sup>8</sup>

The reckless expenditures and commitments in New York City were common across the country. The degree of irresponsibility differed but the rationale was generally the same. Many fell into the trap of projecting into the infinite. Between 2000 and 2007, New York City tax revenue rose 41%. In 2006, the top one percent of taxpayers paid nearly 48% of the city's personal income tax compared to 34% two decades ago.<sup>9</sup> This spiral will have to unwind.

Given entrenched interests, many municipalities will resort to bankruptcy court. Bondholders will be among the plaintiffs.

The city of Vallejo, California filed for bankruptcy in 2008. In Vallejo, a police sergeant (on average) earned \$150,000 a year. Those who retired at the age of 50 received a \$135,000 annual pension. This was adjusted for inflation in future years. Vallejo city employees could retire at 55 (after a 30-year career) and receive 80% of their salary. This had recently been increased from 60%.<sup>10</sup> Vallejo officials said such generous salaries were needed to compete with other towns,

which indicates Vallejo will be joined by adjacent towns in the court room.

It is possible to reduce such benefits, but this takes time and involves court and legislative support. (The ability to reduce benefits would be disputed by many. See appendix.) Many municipalities are finding they do not have time. They cannot meet the next payroll. Or, they try to raise property taxes but taxpayers revolt. In court, all contracts, including those of bondholders, are up for renegotiation.

Third, accounting gimmicks are near an end. To meet booming expenses, many municipalities have engaged in questionable practices, such as selling property to meet current expenses. Bonds that pay 7% interest have been sold when the local investment committee assumed its pension fund could earn a higher return on its assets. It is fair to say that those who bought these bonds were as ignorant of their unsuitability as were town officials who took the advice of investment bankers and pension consultants.

Fourth, disclosure to municipal bondholders has been poor. Financial disclosure for municipal financing is not well enforced. Weak municipalities take advantage of this freedom. DPC DATA, a firm that provides information on municipal bonds, conducted a study of transactions in 2008. In its study, half of the distressed bond<sup>11</sup> transactions involved securities for which financial statements had not been filed during the 2007 or 2008 calendar years.<sup>12</sup> DPC DATA looked specifically at sales from dealers to customers. Between September and November 2008, over half of the sales at par or above were after a distress notice was filed by the issuer.<sup>13</sup> Over 40% of the worst trades (sales from dealers to customers) were to retail buyers.<sup>14</sup> It is difficult not to conclude that dealers took advantage of the retail buyer's naiveté.

### How Did We Get Here?

States and municipalities will continue to cut costs. This was inevitable before the recession. Even in the boom years, they spent more money than they received in tax revenues. Many municipalities made straight-line projections of increasing property taxes to build anything and everything, and, to improve employee benefits. Many states did the same, assuming annual gains in income, sales, capital gains

and corporate taxes never flag.

The graphs used by state treasurers, school-district principals and pension-fund consultants showed parallel, rising lines of expenses and tax collections for years to come. (This was especially necessary for the pension fund consultants who suggested increases in union retirement benefits. Any increase today, no matter how small, raises the benefit permanently. A series of annual increases, inconsequential as each may be, significantly boost municipal expenditures for as many years as the youngest, current employee lives.)

### The Growing Gap Between Spending and Revenues

It was common during the borrowing and spending years to extrapolate the upward trend forever. It would be unfair to isolate city managers as singularly short-sighted. Those who cashed out home equity to supplement stagnant income made a similar mistake. They, in turn, were encouraged by the most vocal of the borrow-and-spend cheerleaders, Federal Reserve Chairman Alan Greenspan (a commonly acclaimed expert). He was in a position to urge caution on the part of all parties. Instead he told households they had “restructure[d] and strengthen[ed] balance sheets...Nowhere has this process of balance sheet adjustment been more evident than in the household sector.”

That was in 2003. Of course, the opposite was true. Greenspan was confused, as were municipal managers. In the same speech, Greenspan told households their “net worth” had risen 4.5% during the first half of 2003.<sup>15</sup> The increased “wealth” was mostly the rise in house prices across the country. The Federal Reserve chairman neglected to mention that home mortgage debt rose by 6.5% over the same period, at a time when incomes were not rising.

Like Greenspan, municipalities looked at rosy data such as that in Table 1. They were looking at their own tax receipts, not the national average. But being a national average, this table gives an idea how municipal decisions were made.

Municipalities had been spending more than their income before the revenue boom. But, instead of reducing the debt they had incurred, it grew worse. Table 2 shows the rise in net bond market borrowing over the past decade or

TABLE 1

### State and Local Government Current Receipts (In Billions)

|                             | 2003  | 2007    | Percent Change |
|-----------------------------|-------|---------|----------------|
| <b>Current Tax Receipts</b> | \$979 | \$1,304 | +33%           |
| <b>Categories:</b>          |       |         |                |
| Income Taxes                | \$205 | \$298   | +46%           |
| Sales taxes                 | \$348 | \$437   | +26%           |
| Property Taxes              | \$308 | \$391   | +27%           |
| Corporate Income Taxes      | \$35  | \$61    | +74%           |
| Other                       | \$84  | \$117   | +39%           |

Note: “Current tax receipts” are used rather than the larger category of “total receipts.” The latter includes transfer receipts from the federal government and returns on assets. The reliability of that income is more erratic than cash flows from tax income, so, “current tax receipts” is shown. In 2003, “current receipts” were \$1,494 trillion and in 2007 they were \$1,902 trillion.

Data: Bureau of Economic Analysis National Income and Product Accounts Table 3.3: State and Local government Current Receipts and Expenditures.

so.

Table 2 extends beyond the past decade (a conventional presentation) to show that municipalities were retiring more debt than they were borrowing in 1996. This was also true in 1994 and 1995.

To accommodate the rising desire for municipal borrowing, Wall Street manufactured new securities. The market for these bonds collapsed in 2007. Issuance dropped in 2008. The securities were creative structures, as they had to be, to attract the volume of investor interest that would match the rising borrowing desires of municipalities. As everyone knows, Wall Street overdid it, and the market for these dubious securities foundered. (The municipalities, of course, overdid it too.) Two other related developments sucked life out of the market.

First, municipal insurers collapsed, including MBIA Insurance Corporation and Ambac Financial Group. Sometimes called “monoline insurers,” they guaranteed principal and interest payments of bonds. The insurers were generally rated AAA, as were the bonds they insured. (A BBB-rated city issued AAA-bonds by paying MBIA a fee.) Ambac was downgraded from AAA to AA in January 2008. This triggered a simultaneous downgrade of over 100,000 municipal and institutional bonds valued at over \$500 billion (before the Ambac downgrade). Today, the default of a prominent municipality might unnerve investors holding other municipal issues.

Second, many of the largest banks that underwrote and traded municipal bonds departed the municipal business.

TABLE 2

### State and Municipal Borrowing (in Billions)

|      |        |
|------|--------|
| 1996 | -\$7   |
| 1997 | +\$57  |
| 1998 | +\$84  |
| 1999 | +\$54  |
| 2000 | +\$23  |
| 2001 | +\$122 |
| 2002 | +\$159 |
| 2003 | +\$137 |
| 2004 | +\$130 |
| 2005 | +\$195 |
| 2006 | +\$177 |
| 2007 | +\$215 |
| 2008 | +\$71  |

SOURCE: Federal Reserve Flow of Funds (Z-1), Table F.21

It is doubtful a vibrant (pre-2007) municipal bond market will return anytime soon. Lacking these creative financings and a liquid market for trading municipal securities, it will be impossible to fill the growing fiscal gap by issuing bonds.

The rising volume of outstanding debt by municipalities is also troublesome:  
We can make certain presumptions from the

| Volume of outstanding Municipal Debt in U.S.                          |                |
|---|----------------|
| 1996  | \$1.3 trillion |
| 2003  | \$1.9 trillion |
| 2007  | \$2.7 trillion |
| ***Debt volume rose 42% between 2003 to 2007.                         |                |
| ***Current tax receipts rose 33% between 2003 and 2007. (See table 1) |                |

data:

- 1 - Spending is out of control. States and municipalities have not begun to reduce spending by the magnitude required.
- 2 - *Even if* conditions in the municipal bond market returned to the heady days of 2007, falling tax revenues would require bond issuance on a much greater scale than in 2007.
- 3 - Related to that, current bond issues will need to be rolled over when they mature, since budget gaps are rising. A market of buyers for such large borrowing does not exist. The consequences will be a shock. Lacking the ability to rollover bonds, municipalities will not be able to pay employees, vendors and bondholders. In which order is the question.
- 4 - The federal government is the only option to fill the gap, short of really cutting expenditures. The federal government will certainly do what it can, but that will not be enough and eventually will not work.
- 5 - At that point, decisions will have to be made that should have been addressed 50 years ago. There will be enormous cuts in municipal spending. Possibilities include employee costs (jobs, pensions), refusing to meet federal mandates (health, welfare), and not paying bondholders. The last may be the first choice, since it combines populist sym-

pathies and would defer the wrath of employees, who might live next door to the mayor.

### Municipal Spending Growth that is Difficult to Control

Many would change this title to "Impossible to Control," meaning, these expenses can never be cut. Yet, if there are no means to pay, spending must be cut to match revenue.

The "impossible" to cut expenses are often where spending is most out-of-control. Some follow:

1 - One of the largest municipal expenditures is coupon interest on bond obligations. If the average municipal bond paid 5% interest in 2003 and in 2007, annual payments rose from about \$50 billion a year to \$75 billion a year - a 50% increase.

2 - Federal mandates - the federal government imposes requirements such as the Clean Air Act, the Clean Water Act, the Homeland Security Act, the Individuals with Disabilities Act and the No Child Left Behind Act. The federal government either underfunds or does not fund its impositions.

3 - One federal program is Medicare. The federal government pays a portion but they are left to fund the remainder. The following shows Medicaid spending by the 50 states:

|      |                           |
|------|---------------------------|
| 1970 | \$2 billion               |
| 1980 | \$11 billion              |
| 1990 | \$32 billion              |
| 2000 | \$89 billion              |
| 2008 | \$158 billion (estimated) |

Source: National Association of State Budget Officers

4 - In 1955, slightly more than 4 million Americans worked for state and municipal governments. In 2008, nearly 20 million did.<sup>16</sup> This is not only a much higher cost but also suffers the same problem as social security: the ratio of workers to recipients. Municipal workers are paid by tax flows from non-government workers. Government workers have risen to a substantial proportion of American workers. This places a larger burden on private sector workers to fund municipal salaries and benefits.

The pay structure will most certainly shrink. The average public-sector employee receives 43% more in pay and benefits than the average

private-sector worker.<sup>17</sup> The press is publishing more stories about the discrepancies than it has in the past. Private-sector employees, many of whom have lost their private pensions, their health benefits, and often their jobs, are not pleased.

Does that matter? Below, we will look at court decisions that were made during waves of populist anger, sometimes sweeping away legal history.

### The Time to Sell Has Arrived: Municipal Deficits Have Been Disclosed

Returning to the subprime meltdown, there was plenty of evidence that had been disclosed before the collapse.<sup>18</sup> The popular press preferred to quote Chairman Bernanke or Secretary of the Treasury Hank Paulson (in July 2007: “This is far and away the strongest global economy I’ve seen in my business lifetime.”) or superstar CEO’s such as Ken Lewis at Bank of America (in June 2007, on the housing slump: “We’re seeing the worst of it.”)

Evidence of municipal deficits has also been publicly disclosed, but underreported. California’s difficulties are front-page news, but its problems seem to be isolated in the media’s and public’s minds. Table 3 (below) shows mounting deficits across the country. As always happens, the media and Wall Street will discover the crisis is widespread well after it was time to sell.

A comment on Table 3: these estimates consistently lag. They will continue to do so. The parabolic rises, such as pension contributions and higher unemployment benefits will be recognized when they are impossible to disguise. In the case study below of New York City during the Depression, there was a moment when years and layers of skullduggery were revealed. The “city’s need to borrow escalated by multiples of what was expected even during the month under discussion.”<sup>19</sup> (My underlining.) We will see plenty of the same. Or, have we already? California’s budget deficit estimate increased from \$6 billion (in the fall of 2008) to \$35.5 billion. Were state officials really caught so flat-footed?

### Section 2: Municipal Bonds - Their Characteristics and History in Crisis

There are some assumptions supporting municipal-bond investing that are not valid in times of stress.

First, “general obligation municipal bonds never default.”<sup>20</sup> The definition of general obligation bonds, in the footnote, courtesy of Morningstar.com, does not make this statement. It does, however, give the investor confidence that the issuer is obligated to do everything in its power to make coupon payments.

Second, recent theatrical performances by municipal politicians have led many to assume

TABLE 3

#### ESTIMATED STATE BUDGET GAPS State Budget Gaps of Some Larger States - For FISCAL YEAR 2009

|               | ESTIMATED ON<br>DECEMBER 23, 2008 |                                 | ESTIMATED ON<br>MARCH 13, 2009 |                                 |
|---------------|-----------------------------------|---------------------------------|--------------------------------|---------------------------------|
|               | Size of Gap<br>(in billions)      | As % of FY 2009<br>General Fund | Size of Gap<br>(in billions)   | As % of FY 2009<br>General Fund |
| California    | \$13.8                            | 13.6%                           | \$35.93                        | 5.5%                            |
| Connecticut   | \$0.3                             | 2.3%                            | \$1.9                          | 11.0%                           |
| Florida       | \$2.3                             | 9.0%                            | \$2.3                          | 9.0%                            |
| Georgia       | \$2.5                             | 11.7%                           | \$2.2                          | 11.5%                           |
| Illinois      | \$2.0                             | 7.0%                            | \$6.1                          | 21.4%                           |
| Massachusetts | \$2.1                             | 7.3%                            | \$3.6                          | 12.7%                           |
| Michigan      | \$0.1                             | 0.6%                            | \$0.7                          | 2.9%                            |
| New Jersey    | \$1.2                             | 3.7%                            | \$6.1                          | 18.8%                           |
| New York      | \$1.7                             | 3.0%                            | \$6.6                          | 11.7%                           |
| Ohio          | \$1.2                             | 4.2%                            | \$1.9                          | 6.8%                            |
| Pennsylvania  | \$1.6                             | 5.6%                            | \$2.3                          | 8.1%                            |

Source: Center on Budget and Policy Priorities. The CBPP gathers information from the states. For states that provided a range of estimates the CBPP shows “only the low end of the FY09 gap for these states”.

the federal government will meet payments of insolvent municipalities. Several mayors and governors have made presumptuous statements that Washington will “have to” fund municipal expenses. There is reason for local politicians to believe this. Washington appears to fund any request for a bailout. It is important to understand that whatever the federal government provides or guarantees has a time limit since the federal government’s rising deficit will run out of buyers for its debt. The safety net may last long enough for an investor to hold a municipal bond to maturity, but that is a bet. Municipal bondholders generally do not buy speculative securities.

The federal government (including the Federal Reserve, Treasury Department and FDIC) have committed to over \$12 trillion (note: *trillion*, not billion) in bailouts. The federal government projects a deficit in this fiscal year of 12% of GDP. That does not include the \$8 trillion of bailout commitments that have not yet been drawn down.

Washington’s current largesse ensures the credit of the U.S. government will be downgraded. If not downgraded by the rating agencies (which have lost their own credibility), then by buyers. There will be a point when the Treasury will attempt to issue more bonds and there will be no bids. Or, the Federal Reserve will buy Treasury bonds from the open market at higher rates.

The question then will be whether the federal government will issue Treasury securities at a much higher yield or shrink the debt.<sup>21</sup> In either case, municipalities will have no choice but to shrink themselves: revenues are falling much faster than new taxes can be passed and collected.

## 1 - MUNICIPAL BOND FAILURES

### A - 1970 to the Present

In 2002, Moody’s published a *Special Comment* on municipal bonds.<sup>22</sup> Moody’s wrote in the first page summary: “General Obligation (GO) and essential service municipal bonds have been particularly safe. No Moody’s-rated issuer defaulted on any of these securities during the sample period.”

(Note: revenue bonds (defined in footnote 20)

*are, in general, more susceptible to default than general obligation bonds. That being so, this paper is directed towards general obligation bonds. Revenue bondholders, in general, are taking an additional increment of risk. Specifically, some revenue bonds are safer if they are backed by a predictable source of revenue, such as water bills.)*

Moody’s studied the period between 1970 and 2000. The 1970s was a particularly troubling period for municipal issues. Moody’s has reason to pat itself on the back. There were some large defaults in this period. Cleveland defaulted in 1978.<sup>23</sup>

There were only 18 defaults of Moody’s-rated revenue bonds during this 30-year period. Most of the defaults were hospital and medical related. There were over 1,300 defaults of *unrated* municipal bonds between 1970-2002. Presumably, unrated by anyone, not just by Moody’s.

The Moody’s *Special Comment* states: “Even in the event of default on GO bonds, investors are likely to enjoy a full recovery of principal and interest because municipalities are required to levy additional taxes to repay debt backed by the general obligation pledge.”

There are at least two reasons to doubt municipalities will raise taxes to meet municipal bond obligations.

Americans felt more duty-bound to honor a contract 70 years ago, yet, even in the 1930s, this was not always true. One example hails from the heartland, in Iowa. In 1933, the Iowa Supreme Court ruled the City of Dubuque was required to meet its bond commitments. Kevin A. Kordana, a University of Virginia Law School professor, has written: “[T]axpayers promptly replaced the Iowa Supreme Court justices with ‘judges already committed to their anti-bondholder viewpoint.’”<sup>24</sup> A tangle in the federal courts followed which would require more explanation than it is worth, but a headline from the *New York Times* probably says all one needs to know about human tendencies in time of woe: “Iowa Farmers Abduct Judge From Court; Beat Him and Put Rope Around His Neck.”<sup>25</sup>

Second, to require the municipality to meet its commitments may be impractical. Court deci-

sions regarding the mandate to raise taxes have been mixed, but many favor the municipality over the bondholder. Kordana wrote that compulsory tax increases “led depression era courts to begin to emphasize the discretionary aspect of the remedy.”<sup>26</sup> In duty-bound West Palm Beach, Florida, the property tax rate was raised to 42.5% of assessed value.<sup>27</sup>

Incidentally or maybe not so incidentally given the roots of the current bust, Kordana leans on the research of A.M. Hillhouse. Hillhouse studied the history of municipal bond defaults in the United States and published his findings in a book, *Municipal Bonds* (1936). Hillhouse assessed “the major portion of overbonding by municipalities arises out of real estate booms.” Readers may be familiar with the Florida real estate bubble of the mid-1920s. Hillhouse wrote: “The prize crop of boom bond troubles of all time came with collapse of the Florida real estate speculation in 1926.”<sup>28</sup> Given the current real estate troubles in Florida, problems of the twenties may fade in significance.

## **B - The Great Depression**

There are three topics covered in this section. First, a general background. Second - the most important section - the law. Legal decisions were often arbitrary with little means to predict where one stood. Third, a case study of New York City in which unanticipated developments may find similarities today.

The Great Depression was the last period when municipalities faced insolvency on a wide scale. It was also a time when they ran out of options other than to make large cuts.

Moody’s 2002 statement: “[M]unicipalities are required to levy additional taxes to repay debt backed by the general obligation pledge” has not been honored in the breach. It is probably a less viable assumption today than in the Great Depression. One comparison between the 1930s and today is honor itself - quoting from the *Pittsburgh Business Times* in 2003: “Almost pathologically, fiscal default now seems to be goal of many, rather than to be prevented at all costs.”

Whether one assumes our grandparents possessed a higher standard of conduct or not, defaults were common. In 1935, there were at least 3,252 municipal issues in default.<sup>29</sup> This was the peak, which is interesting since the bottom of the Depression was in 1933.

## **1 - A Chronology of the 1930s:**

Between 1912 and 1932 local government expenses increased 361%; state government spending rose 100%; federal government spending rose 13%.<sup>30</sup> The federal government was in a far better position to advance funds in the 1930s than today. The states were in a far better position to help towns and cities than today.

1931 - Municipal revenues continued to increase through 1931. Municipal bond and note issuance set a record in the first half of 1931. Yet, there were warnings: New York City’s uncollected taxes rose from 0.96% in 1927 to 4.88% in 1930.<sup>31</sup>

By the end of 1931, several problems had arisen: Chicago and South Carolina could not issue notes or bonds at any rate. By December, municipal bond dealers were no longer willing to hold municipal bond inventories.<sup>32</sup>

1932 - More municipalities were unable to sell bonds. Often, the concession required by potential bond buyers was to cut payrolls. After running through all excuses and possible avenues of funding, municipalities conceded and cut salaries: Newark, Westchester County (twice in 1932), Nassau County, the City of Philadelphia (a 22% salary cut).<sup>33</sup>

1933 - New York City nearly defaulted. See case study below.

May 1933 - Yields on some issues became meaningless. All City of Miami bonds (yields ranged from 4-3/4% to 5-1/2%, maturities from 1935 to 1955) were quoted at \$26. It was nearly impossible to get price quotes for a wide range of municipal bonds. Arkansas and Detroit were in default.<sup>34</sup>

By 1933 - across the U.S., every form of municipal expenditure had been cut since 1930 with the exception of relief payments. Welfare had risen from \$100 million in 1929 to almost \$500 million. Grants-in-aid from federal government to municipalities rose from \$500 million in 1933 to \$1.6 billion in 1934.<sup>35</sup>

1933 - General sales taxes were introduced on a significant scale in Illinois, Michigan, New York and North Carolina. (Ability to raise taxes at this time was concentrated in the states rather than cities.)<sup>36</sup>

## 2 - Unexpected Developments in Legislation and the Law

Since 2007, the federal government has taken several actions only possible in times of disaster. The municipal bondholder needs to consider arbitrary legislation as a possibility. Most recently, the “secured creditors” of Chrysler received 29 cents on the dollar on their bonds and discovered they stood in a junior position to the United Auto Workers. (Corporate bonds of other companies in financial trouble were sold off in the aftermath of the Chrysler ukase.)<sup>37</sup>

Following are some actions during the 1930s to which we may see parallel activity today.

February 1933 - Senate bill to remove tax exemption of both U.S. Treasury and municipal bonds was introduced and passed in National Industrial and Recovery Act. (It was removed at request of Roosevelt administration so as not to disrupt Treasury market.)<sup>38</sup>

February 1933 - City of Detroit defaulted on interest payments. The 1933-1934 Detroit budget dedicated 50% of estimated tax revenue to interest payments. Tax delinquencies rose from 36% in 1932-1933 to 80% in 1933-1934. Detroit issued scrip (rather than money) to pay city employees. Scrip was refused by local stores. (Many other cities issued scrip for wages in the Depression.) Detroit was able to negotiate much lower interest payments and longer debt maturities with bondholders. It was able to do so because bondholders knew Detroit was out of money with no ability to borrow.

Please note the parties compromised and did not rely on a court decision. It was approved by bondholders because they knew Detroit had no means to pay its bills, other than a reduction of interest payments. (After the negotiation succeeded, City of Detroit bonds rose \$25.)<sup>39</sup>

April 1933 - House of Representatives bill that would have given the courts the power to delay municipal debt payments up to 10 years. This cleared the House Judiciary Committee. Municipal bond prices fell. Bill was defeated on a House vote.<sup>40</sup>

May 1934 - Municipal Bankruptcy Bill became law. Set a formula under which insolvent municipalities could refinance themselves - at the expense of current creditors - in “[f]ederal courts under their constitutional powers to deal with bankrupts.”<sup>41</sup> In May 1936, the U.S.

Supreme Court ruled the Municipal Bankruptcy Bill was unconstitutional.<sup>42</sup>

January 1940 - House of Representatives proposed to tax income on municipal securities: “There is a wide public sentiment in favor of eliminating the avenue of escape, now available, to people of substantial wealth from their fair share of the tax burden by going into tax-exempt securities. Obviously, inequality exists because of this...”<sup>43</sup>

### A DEPRESSION PERIOD CASE STUDY - NEW YORK CITY

In 1932, New York City needed bank cooperation to sell bonds. (The city even tried hiring 40 ex-bond salesmen to sell issues itself.) The banks demanded the city cut its budget and raise the 5 cent subway fare. City officials consented, made promises, then broke them. This was in private. In public, Mayor Walker condemned bankers for “squeezing” the city and grinding the poor. Walker claimed he could cut no more. Walker resigned September 1932 when corruption charges were imminent.

The new Mayor McKee received no cooperation from City Hall (Tammany Hall). He tried to enforce a 6% pay cut in September. The mayor failed. The banks responded: “There is no market today for New York City bonds.” The political response to banks was predictable, from Al Smith (who would later enter the mayor’s race): “This thing [\$25 million to fund relief measures] is an insurance policy against possible riot and disorder.”<sup>44</sup> This rhetoric goes with the times, as does the badmouthing of lenders.

Despite the populist cant, the banks won. (This seems unlikely today, given the subservient state of the banks to the state.) In December 1932, the city conceded salary cuts, a subway fare hike and a new capital budget. Salary cuts were made when Governor Lehman called a special session of the legislature to remove mandatory wage laws for the city.<sup>45</sup> The cat-and-mouse game would continue through 1933, the city resisting every spending reduction, but in the end, it kept cutting its budget. (The subway fare was not raised.)

During the negotiations, New York City fiscal books were found to be lacking. Massive corruption was discovered on payrolls and in construction contracts; the city booked tax arrears from previous years as anticipated revenue in each succeeding year; there was no credible



data on city's revenues or expenses and overhead costs were put into the capital budget.<sup>46</sup> Once this chicanery was found, "the city's need to borrow *escalated by multiples of what was expected even during the month under discussion.*"<sup>47</sup> [My italics.] We have become acclimated to such dishonesty in recent years. The stock and bond markets gave Enron and Fannie Mae every benefit of the doubt until these companies could no longer raise cash. The municipal bondholder today should expect similar disclosures in the months ahead.

In what may well be true again, Barrie Wigmore, author of *The Crash and its Aftermath*, wrote of 1933: "The turmoil over municipal credits begat a long list of criticisms of municipal practices that had been acceptable in previous, less contentious times. The practical power of local governments to alter their commitments to bondholders was fundamental and quite startling, but besides that, critics claimed that municipal accounting practices were lax, employed shifting standards, lacked audits, and hid obligations that had accrued."<sup>48</sup>

To conclude this section, a bondholder would be wise not to rely on Moody's synopsis of the legal requirements for general obligation bond issuers "to levy additional taxes to repay debt backed by the general obligation pledge." When the ship is sinking, standard procedures are often abandoned.

### 3 - Conclusion

Municipal bondholder can weave a case supporting a personal municipal portfolio or municipal bond fund today. At what gain? At what risk?

The gains are well known. Municipal bonds pay a steady, known income. It is known because municipal bonds are presumed never to default. Municipal bonds pay out yields that may exceed the inflation rate. Even if the yield is short of inflation, it is better than 1-2%, about what one can expect to receive on the most popular safe, fixed-income investment: a money-market fund. There is very little gain by an income-conscious bondholder: Betting against the odds and being right does not pay.

*The central risk is the assumption of safety.* Top rated municipal bonds offer little chance for a capital gain. (The most plausible possibility for gains today is if taxes are raised. The value of a tax-exempt security would rise.) Therefore, the

best case is no negative developments. If municipal bonds default, stop paying coupon obligations or simply delay payments, the premises upon which they are owned are shattered.

Today, the balance between gain and risk is tilted towards risk. The probabilities weigh against the bondholder. Municipal bondholders should satisfy themselves with answers to the following questions:

Will revenues - assessed house values, incomes, personal spending (sales tax) - recover quickly to previous levels?

Will municipalities refuse to pay for federally mandated programs? (There is hope here. Several towns in California have announced they will stop funding federal mandates.)

Will police, teachers, etc., accept lower retirement benefits without going to court?

Will courts force municipalities to "levy taxes sufficient to pay debt."

For a municipality that has no other means to acquire revenue, will the federal government offer a blank check?

If the federal government lends money, will bondholders be paid in full?

## APPENDIX

### Are Public Pension Plan Benefits Immutable?

In *While America Aged* (2008), by Roger Lowenstein, the author writes "how pension debts ruined General Motors, [New York City] subways [and] bankrupted San Diego." Of New York City, the author writes: "any benefit granted to an employee at any time during his employ was forever guaranteed." And: "Governments do not even have the option of escaping the pensions via bankruptcy. Once granted, public pensions are truly immutable."<sup>49</sup>

The state of New York is known for its protection of public employee pensions. Yet, even there, exceptions have been made. The courts found that changes in employment conditions and in regulations may change the pension benefit. (*See Lippman v. Bd. of Educ. of the Sewanhaka Cent. High School Dist.*, 66 N.Y.2d 313 (1985).<sup>50</sup>

Across the country, legislative bodies and courts have been resourceful in reinterpreting such immutable guarantees. All states have legal loopholes such as when the state retirement system is “financially threatened” (Maryland), changes that are a “reasonable and necessary means of affecting an area of important public policy” (known as the “California rule,” which is also the guideline in several other states, including Colorado, Idaho, Kansas, Nebraska, Washington), or in Massachusetts, where, in the court’s opinion, the contract “protects...the core of [the member’s] reasonable expectations.”

It is impossible to know when and how public pension and health benefits will be modified within the different states. For a bondholder, the expectation that courts will eliminate benefits rather than reduce or eliminate coupon payments is a weak reed upon which to invest. As a practical matter, there is no doubt public pension benefits will be a casualty of the municipal collapse.

In 1934, the Supreme Court ruled that moratoriums on home foreclosure already instituted in various states were constitutional. Chief Justice Charles Evan Hughes wrote the Supreme Court’s majority opinion, that “the economic interests of the State may justify the exercise of its continuing and dominant protective power notwithstanding interference with contracts.”

Chief Justice Hughes did not bind himself to immutable contracts. Public pensioners should prepare themselves for such future interpretations.

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## Footnotes:

<sup>1</sup> Though secondary in purpose, price appreciation is presumably welcome. The most likely reasons for capital gains (that is, when the price of the bond rises) are when interest rates, in general, are falling or when the bond, specifically, is considered a safer investment than before. As will be discussed below, if prospective tax increases are passed, the value of municipal bonds will rise.

<sup>2</sup> The ABX.HE BBB 07-01

<sup>3</sup> Jody Shenn, *Bloomberg*, "Subprime Mortgage Perceived Risk decreases." February 28, 2007

<sup>4</sup> Ben S. Bernanke, Testimony before Congressional Joint Economic Committee, March 28, 2007

<sup>5</sup> Federal Deposit and Insurance Commission, Statistics on Depository Institutions Report - issued each quarter.

<sup>6</sup> The Rockefeller Institute found that in the 47 states reporting revenues, first quarter 2009 personal income tax receipts fell 15.8% from the comparative period in 2008. Corporate tax revenue declined 16.2% and total tax revenue fell 12.6%. Rockinst.org, *State Revenue Flash Report*, May 13, 2009

<sup>7</sup> Citizen's Budget Commission, January 2009, "Six-figure Civil Servants," p. 2

<sup>8</sup> Nicole Gelinias, "New York's Next Fiscal Crisis" *City Journal*, Summer 2008,

<sup>9</sup> Nicole Gelinias, "New York's Next Fiscal Crisis" *City Journal*, Summer 2008, the 2006 figure is "even after adjusting for the temporarily higher tax rate."

<sup>10</sup> *Money Magazine*, "Fat Pensions Spell Doom for Many Cities," June 3, 2008. In New York City the 2008 average compensation (pay plus benefits) for firefighters was \$186,464 and \$164,045 for police officers.

Citizen's Budget Commission, January 2009, "Six-figure Civil Servants," p. 2,3

<sup>11</sup> Near bankruptcy

<sup>12</sup> Peter J. Schmitt, DPC DATA, "The Consequences of Poor Disclosure Enforcement in the Municipal Securities Market," 2009, P.5

<sup>13</sup> Peter J. Schmitt, DPC DATA, "The Consequences of Poor Disclosure Enforcement in the Municipal Securities Market," 2009, P. 11,12

<sup>14</sup> Peter J. Schmitt, DPC DATA, "The Consequences of Poor Disclosure Enforcement in the Municipal Securities Market," 2009. "Retail buyer" was defined as transactions of \$50,000 or less.

<sup>15</sup> July 15, 2003, Chairman Alan Greenspan, *Federal Reserve Board's semiannual monetary policy report to the Congress*, Before the Committee on Financial Services, U.S. House of Representatives

<sup>16</sup> A. Gary Shilling, *Insight*, February 2009, P.5, from BLS

<sup>17</sup> Dennis Cauchon, "Benefits Widen Public, Private Pay Gap," *USA Today*, May 8, 2009. Data is from Bureau of Labor Statistics as of December 2008.

<sup>18</sup> The Mortgage Asset Research Institute had published a study of what were known as "liar's loans" in 2006. Those are loans in which the borrower's stated income is not verified by the lender. The Institute found that 60% of those who received such mortgages had overstated their income by at least 50%.

<sup>19</sup> Barrie Wigmore, *The Crash and Its Aftermath: A History of Securities Markets in the United States, 1929-1933*, Greenwood Press, 1985, p. 406

<sup>20</sup> The following definitions are from Morningstar.com:

**General obligation bonds** are debt instruments issued by states and local governments to raise funds for public works. What makes general obligation bonds (or GO bonds for short) unique is that they are backed by the full faith and credit of the issuing municipality. This means that the municipality commits its full resources to paying bondholders, including general taxation and the ability to raise more funds through credit. The ability to back up bond payments with tax funds is what makes GO bonds distinct from revenue bonds.

**Revenue bonds** are repaid using the revenue generated by the specific project the bonds are issued to fund (fees from a public parking garage, for example).

**GO bonds** give municipalities a tool to raise funds for projects that will not provide direct sources of revenue—roads and bridges, parks and equipment, and the like. As a result, **GO bonds** are typically used to fund projects that will serve the entire community; **revenue bonds**, on the other hand, are used to fund projects that will serve specific populations, who provide revenue to repay the debt through user fees and use taxes.

<sup>21</sup> There is no need to discuss other avenues used in the 1970s, such as denominating bonds in other currencies. They will only be chosen when the federal government needs to shrink its commitments. Prior guarantees to the municipal market would not be honored.

<sup>22</sup> Lisa Washburn, "Special Comment: Moody's Municipal Bond Rating Scale"; Moody's Investor Service, Global Credit Research

<sup>23</sup> publicbonds.org. "Municipal Bonds and Defaults"

<sup>24</sup> Kevin A. Kordana, Associate Professor of Law, University of Virginia, "Tax Increases in Municipal Bankruptcies," *Virginia Law Review*, September 1997, Volume 83, Number 6.

<sup>25</sup> *New York Times*, "Iowa Farmers Abduct Judge From Court; Beat Him and Put Rope Around His Neck," April 27, 1933; Another Times headline two days later: "Iowa Troops Rule Farm Riot Areas; Mob Blocks A Sale."

- <sup>26</sup> Kevin A. Kordana, p. 1104
- <sup>27</sup> A.M. Hillhouse, *Municipal Bonds*, Prentice-Hall, 1936, This is quoted in Kordana.
- <sup>28</sup> *Review of Municipal Bonds*, by E.A. Kincaid, in the *Accounting Review*, Volume 12, Number 3, 1937, p. 327-328
- <sup>29</sup> George H. Hempel, *The Postwar Quality of Municipal Bonds*, dissertation, University of Michigan, 1964
- <sup>30</sup> Wigmore, p. 400
- <sup>31</sup> Wigmore, p. 290
- <sup>32</sup> Wigmore, p. 291
- <sup>33</sup> Wigmore, p. 407-408
- <sup>34</sup> Wigmore, P. 512
- <sup>35</sup> Wigmore, p. 513
- <sup>36</sup> Wigmore, p. 513
- <sup>37</sup> Garman Research, "Priority Lost"
- <sup>38</sup> Wigmore, p. 511
- <sup>39</sup> Wigmore, p. 514
- <sup>40</sup> Wigmore, p. 511
- <sup>41</sup> *New York Times*, "Bill Aiding Cities that are Bankrupt is Voted by Senate," May 2, 1934
- <sup>42</sup> *New York Times*, "Law to Help Cities in Distress is Void," May 26, 1936
- <sup>43</sup> *New York Times*, "Municipal Bonds Seen Facing a Tax," January 2, 1940
- <sup>44</sup> Wigmore, p. 401-405
- <sup>45</sup> Wigmore, p. 405-406
- <sup>46</sup> Wigmore, p. 406
- <sup>47</sup> Wigmore, p. 406
- <sup>48</sup> Wigmore, p. 516
- <sup>49</sup> Roger Lowenstein, *While America Aged*, p. 85 (2008)
- <sup>50</sup> Kevin A. Kordana, "Tax Increases in Municipal Bankruptcies," *Virginia Law Review*, Volume 83, Number 6.
- <sup>51</sup> Home Building and Loan Association v. Blaisdell, *Grant's Interest Rate Observer*, March 23, 2007

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