Bond Case Briefs

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Municipal Bonds, Big Squeeze Getting Tighter - Bankruptcy No Longer Rare.

Summary

- Local general obligation bonds can be swept up in bankruptcies necessitated by an inability to pay other contractual obligations.
- Nationally, spending for health insurance has reached $3.2 trillion, or $10,000 per person.
- The negative impact on local governments that provide lifetime private health insurance for retired employees is substantial and growing.

Local taxation is higher than ever. Taxes go up or remain the same, but never go down. Yet, most of our local roads, bridges and other government infrastructure are in poor condition. Municipal bond issuance is not growing in line with capital needs, even though interest rates are still at historic lows. What else is happening that would make sense out of these seemingly contradictory facts?

Contractual financial obligations of municipalities (school districts, villages, towns and counties) include, but are not limited to, bonds and promissory notes issued to investors in exchange for cash. Bond proceeds are, for the most part, used to build and maintain infrastructure.

Another large category of municipal contractual obligations is defined benefit pension plans and the cost of lifetime health insurance for retired employees. Defined pension benefit versus defined contribution plans and lifetime health insurance have been long gone from America's private sector because they became unaffordable.

In nearly every municipal failure since Orange County, CA, in 1994, the entity could not afford to pay the sum of principal and interest, pension fund contributions, and the non-deferrable, ever-rising annual health insurance premiums for retirees. These municipalities used appropriation bonds to fund deficiencies in their pension plans. All the structures failed. In fact, most major losses suffered by bond holders were on appropriation-backed bonds, not general obligation bonds.

For more information on appropriation-backed debt used by many states and localities to circumnavigate constitutional limits on indebtedness, click here.

General obligation principal and interest payments and pensions contributions are fixed or predicable costs, depending on long-term investment performance for the latter. Contractual obligations are unsecured but have the borrower's unconditional promise to pay – the only way to obtain debt relief is in bankruptcy court. However, most of local and state pension plan benefits are granted under statutory laws whose terms can be changed at will by legislative action. It remains to be seen whether that legal distinction would protect unsecured general obligation bonds in a bankruptcy.

Health insurance, on the other hand, is a variable cost that only goes up. This is just as big a problem for states and the federal government who pick up the tab for Medicare and Medicaid for persons over 65 years of age. But that is not the case with many of the largest local and state retired

employee health insurance plans.

Incredibly, these plans have not elected to switch to Medicare insurance from the much more expensive private health insurance. The result is states and the federal government save money, and the local government pays much more than necessary for retired employees' health insurance. Post-retirement benefits, excluding pension payments, are for the most part, agreements that are subject to negotiation and re-negotiation each year, with the employer having the final say. However, there doesn't appear to be any local political will to address the issue except in bankruptcy.

As it is, the current federal budget and structural deficits are the result of current and projected spending on health insurance premiums, which continue to be paid from Treasury borrowing.

In many cases, the cost of health insurance and pension funding can exceed by a wide margin the amount due each year on general obligation bonds. Thus, bankruptcy may be petitioned even when bonded debt is modest but employee benefit funding is unaffordable.

Growth in the cost of health insurance for the public and private sectors is so great (see chart) that it is the chief cause of the shrinking or slow growth in government capital improvement borrowing and a major contributor to local bankruptcies.

Characteristics that you don't want in an issuer of general obligation bonds, of which the presence of any two suggest looking elsewhere, are:

- Population loss of 5%+ in the past five years
- Declining real estate values
- Unemployment greater than or equal to 140% of the national average
- High overall real estate taxation. Total real estate taxes paid as a percent of the current market value of all taxable property yields the overall tax rate, which typically ranges from 1% to 3% of current or fair market value. Stay away from municipalities having overall property taxes greater than 2%, unless it's a high-income jurisdiction. Taxation approaching, equaling, or exceeding 3% is a major indicator of financial distress or inability to increase taxation without further damage to the local tax base.

These characteristics, in my experience, highly correlate to local governments in or heading toward serious financial distress for any number of causes.

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