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Moody's: Municipal Defaults Up Since Crisis, But Still Low.

May 7 (Reuters) – Moody's Investors Service said on Tuesday that the number of defaults among the U.S. municipal bonds it rates has risen since the financial crisis but still remains low.

The economy has been recovering but many local governments are buckling under a combination of stresses on their budgets, with places such as Stockton, California, in bankruptcy.

"Revenue and spending pressures from the sluggish economic recovery, including soaring pension costs, have intensified credit stress faced by local governments," Moody's said in its annual report on municipal defaults.

In 2012, there were five Moody's-rated defaults and 23 since the beginning of the recession in 2008, with an average of 4.6 defaults per year, up from 1.3 in the 1970-2007 period.

"We expect states and the vast majority of local governments to continue to do the hard work of rebalancing and adjusting their budgets," it said. "Given long-term demographic trends, cuts in federal spending, and substantial underfunding of pensions and other entitlements, this hard work is by no means over, and will need to continue for some time."

During and after the recession, state and local revenues plunged to record lows. At the same time, the financial crisis ravaged the returns on public pension investments, the primary source of funding for most retirement systems. Revenues are now back at pre-recession levels and many pensions have made reforms, but the federal government is embracing spending cuts that threaten both the grants cities and states receive and their revenue in general.

The five defaults among Moody's rated issuers last year included two towns, Stockton and Wenatchee, Washington. KidsPeace, a non-profit in Pennsylvania, and American Opportunity for Housing in Colinas, Texas, along with California's Oakdale Sewer Enterprise, also defaulted.

Particularly, there has been a rise in speculative-grade rated governments and risks remain in healthcare, Moody's said. Multi-family housing bonds are stressed by historically low interest rates, which can hurt housing projects' cash flow and threaten debt repayment, Moody's said.

Last August the Federal Reserve Bank of New York said defaults are more numerous than rating agencies such as Moody's report. Combining data on unrated and rated bonds, researchers at the bank found that from 1970 to 2011, there were 2,521 defaults, compared with just 71 listed by Moody's.

Usually, bonds sod by smaller municipalities or authorities and carrying higher risk of default do not have ratings from Moody's, Standard & Poor's or Fitch Ratings.

Moody's said defaults in 2012 came close to reasonable expectations, but that "over the longer term – and even since the advent of the financial crisis in 2008 – have been so infrequent as to suggest that our rating distribution on the whole may be too low."

Still, it said it has actively lowered ratings in recognition that credit risk has increased.

Analyst Meredith Whitney predicted a large cascade of defaults two and a half years ago. Even though her forecasts did not came true, they cast a pall over demand for bonds. Last month, a Securities and Exchange Commissioner raised the possibility of a municipal "Armageddon" related to recent bankruptcies and the looming rise of interest rates.

Commissioner Dan Gallagher said the bankruptcies could set legal precedents ending the long-held tradition of fully repaying bondholders when a local government goes under.

"Local government defaults are necessarily high-profile events because of their rarity, of course, but also because of their consequent power to set precedents and expectations ranging from loss recovery rates to bankruptcy case law," Moody's said.