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NYT: Bankruptcy in Alabama County Offers Warning for Other Municipalities.

The bankruptcy of the most populous county in Alabama moved closer to resolution this week with an agreement providing that investors will lose 20 percent of the money they invested in bonds that were rated AAA. The big loser financially is JPMorgan Chase, which underwrote many of the securities — and paid bribes to get the business.

Large municipal bond disasters have been rare, but I suspect there will be more. The Jefferson County bankruptcy may serve as a precedent for forcing bondholders to take losses in bankruptcy. Despite lots of legal protections, loans to municipal governments can be just like loans to people and companies: if the borrower truly can't afford to pay what was promised, it won't be paid.

Jefferson County's problems involve corrupt politicians and bad luck, but they also include a longstanding unwillingness to face facts about the county's sewer system — and a bond market that failed to face the facts about the county and kept lending money long after it was prudent to do so.

The corruption involved was breathtaking. More than 20 people, including politicians, contractors and influence peddlers, have been convicted. JPMorgan escaped criminal charges, but the Securities and Exchange Commission penalized it for paying bribes through local middlemen.

That corruption was important and no doubt raised the financing costs for the county. But the basic financial decisions about the structure of the county's debt were different only in scale from what many other municipalities did.

The disaster provides an example of how derivative securities can be oversold. Not all risks can be hedged, and certainly not at acceptable costs, but that is something Wall Street salesmen tend to overlook when they make their pitches. When such contracts are written, you can be sure that the Wall Street firm will make sure it will come out O.K., even if that increases the risk that the customer will not.

The county's sewer debt used to be long-term, fixed-rate debt. The county would have been better off if that had not changed. But Wall Street persuaded it, and a lot of other municipalities, that such debt was too costly. The county could save some money by issuing what the salesmen called synthetic fixed-rate debt.

And what is that? The county issued long-term variable-rate debt, where the interest payments would fluctuate based on short-term market rates. Just doing that would have left the county at risk if interest rates surged, so JPMorgan also entered into an interest rate swap. That provided that the county would pay a long-term rate to JPMorgan, which would pay a short-term rate to the county.

The net cost of that was a little lower than the cost of fixed-rate debt would have been.

There was an important catch: the swap payments were not based on what the county actually had to pay. They were based instead on indexes that might, or might not, move in the same way that

rates moved on the county's actual debt. It was not really "fixed rate," the title notwithstanding.

Another risk, probably never considered, was that the monoline insurance companies, which routinely guaranteed munis for a fee, would collapse.

Those risks were not necessarily large, and if Jefferson County had not structured 90 percent of its debt that way — rather than the 10 or 20 percent some advisers recommend — they might not have become crucial. But in the credit crisis, a lot happened that had not been expected.

Jefferson County issued two types of variable-rate debt, both of which blew up.

The largest was auction-rate debt. That debt paid rates that were set every week at auctions. The risk to investors was that an auction could fail and they would be stuck with the bonds. If that happened, the county would pay a penalty rate, often twice the London Interbank Offered Rate, known as Libor.

When auctions began to fail, that penalty rate was not enough to attract investors, but it was high enough to raise the financing costs for the county significantly. The interest rate swap did not protect it because it was based on an index, not on the actual cost the county was paying. Suddenly the "fixed rate" went up.

The second type was known as variable rate demand bonds, or V.R.D.O.'s to the cognoscenti. Their rates fluctuated based on an index rate, but the holder had the right to sell them every week. If no one else would buy, there were banks that had promised to buy them.

The catch was that the banks were not in it for the long haul. The V.R.D.O.'s might have 30-year maturities. But if the banks were forced to bail them out and could not find other buyers, the interest rates rose and the debt turned into three-year debt. The banks were protected, but the county was not.

Turning for a moment from finance to the real world, these bonds were financing a sewer system that was managed badly for decades. Wealthier areas found ways to stay out of it. In the late 1990s, the county was forced to take over what a court-appointed receiver later called "municipal systems that had never been properly operated and maintained." But it still could not force some people within its service area to hook up to its system.

Some people used the sewers without paying, and when they were caught, they were not forced to pay what they owed. When a consultant told the county commissioners a decade ago that the county would have to raise rates rapidly, the commissioners simply ignored the report and did not mention it when they borrowed more money.

And the investors were not paying much attention. They were told they did not need to because the bonds were insured by one of three monoline insurance firms, FGIC, XL Capital Associates and FSA, and therefore had AAA ratings.

The records do not show whether those monoline insurers did any real research before they issued the guarantees. If they did, they did not seem to have noticed how poorly the system was run.

The bonds were backed only by sewer system revenue, but there was a covenant in them in which the Jefferson County commissioners promised to keep rates adequate to meet the system's obligations. For many years, they ignored that promise. In 2009, after the bonds defaulted and it was obvious that rates had to be raised substantially if the county was going to meet its obligations, the commissioners did the opposite. They voted to reduce rates. In 2011, the county went into

bankruptcy.

Four people who served on the five-member county commission have since been convicted of taking bribes and sentenced to prison, and a fifth was convicted of obstructing justice by lying about gifts she received from investment bankers. She received probation and testified against her former colleagues.

Under the deal disclosed this week, JPMorgan agrees not to be paid for many of the bonds it holds. Including fines, forgone fees the county owed it and forfeited bonds, this has cost the bank more than $1.5 billion before taxes. A JPMorgan spokesman said that losses had already been accounted for and that the settlement would have no significant financial effect on the bank.

Under the deal, normal investors are to be offered a choice of receiving 80 cents for every dollar of bonds they own, and forfeiting the right to get any more, or 65 cents while retaining the right to sue the monoline insurers, all of which are in financial difficulty. They would probably be better off to take the 80 cents.

There is optimism that those payments can be financed by selling new bonds. Those bonds would almost certainly be rated as junk, but the presumed yields, ranging up to 6.75 percent on some bonds where the interest will not be paid until maturity decades from now, are thought attractive enough to draw in investors. Sewage rates will rise and might have to rise further if market interest rates go up before this can be completed, some months from now. But they will not rise as much as would have been necessary without forcing bondholders to take losses.

There are other municipalities where crises are looming, even without rampant corruption.

Cities and states are legally required to pay pensions to retired workers and to pay bondholders, along with paying for continuing government functions. But if there is not enough money for all of that — and in some cases, where population is shrinking, there almost certainly will not be — don’t bet that the judges and politicians will conclude that the retirees and bondholders should face no losses while basic government operations are devastated.

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