Bond Case Briefs

Municipal Finance Law Since 1971

NYT: Cost of Public Projects Is Rising, and Pain Will Be Felt for Years.

States and cities across the nation are starting to learn what Wall Street already knows: the days of easy money are coming to an end.

Interest rates have been inching up everywhere, sending America's vast market for municipal bonds, a crucial source of financing for roads, bridges, schools and more, into its steepest decline since the dark days of the financial crisis in 2008.

For one state, Illinois, the higher interest rates will add up to $130 million over the next 25 years — and that is for just one new borrowing. All told, the interest burden of states and localities is likely to grow by many billions, sapping tax dollars that otherwise might have been spent on public services.

The same concerns about rising rates that have buffeted the world's stock markets recently have also affected the market for municipal bonds. The muni market, despite a modest rally on Wednesday, is headed for one of its worst months in years.

Much as home mortgage rates are making home buying a bit more costly as they rise, so, too, are the rates at which states and cities borrow money. Public officials — and taxpayers — may feel the effects for years. Perversely, the places with the greatest distress are likely to see their borrowing costs rise most.

Over the last few days Georgia, Philadelphia, the Metropolitan Transportation Authority in New York and others have delayed sales of new bonds, citing the precipitous plunge in prices that is driving up interest rates.

Gov. Pat Quinn of Illinois attributed the extra cost to the state's failure to shore up its finances, particularly its rickety pension system. Illinois has the lowest credit rating of any state, and as interest rates rise they tend to rise fastest for the weakest borrowers.

"Borrowing money when you're already in debt doesn't seem like a good idea to me," said Felicia Hill, a 44-year-old Chicago woman who wondered how the state could bear the rising cost. "I think it could have waited, when we have bigger problems in Illinois."

The sell-off in the municipal bond market has followed the general rout in the overall bond market, which was set off when Ben S. Bernanke, the chairman of the Federal Reserve, indicated that the strength of the economic recovery might allow the central bank to pull back on its $85 billion---month bond-buying program earlier than anticipated.

The Fed was not buying municipal bonds, but the market reacted anyway. Investors expected interest rates to rise, and because prices move in the opposite direction, the values of the municipal bonds they already held dropped.

Investors apparently started selling, not wanting to be the last one out. That caused a flood of bond sales. For the week ended June 19, $3.368 billion flowed out of mutual funds that hold tax-exempt municipal bonds, according to the Investment Company Institute. The outflow for the previous week was $3.236 billion.

Such sell-offs tend to hit the municipal bond market hard because it has many individual investors who buy bonds to hold them, either directly or through mutual funds, rather than financial institutions that trade them quickly.

“The mutual fund’s customer has proven to be fickle in these volatile periods, and you get the sticker-shock effect,” said Chris Mauro, the head of municipal bond strategy at RBC Capital Markets. The trend starts to feed off itself and can last for a long time, he said. “As they liquidate, there’s pressure on the mutual funds to raise cash, which puts more selling pressure onto the market.”

Some analysts thought the sell-off was made worse by the actions of Detroit as it flirted with bankruptcy. The city’s emergency manager, Kevyn Orr, proposed inflicting severe losses on its bondholders earlier this month as he struggled to keep the city from declaring what would be the largest municipal bankruptcy in history. That prompted investors to sell Detroit bonds, and raised questions about whether Detroit’s approach could set an example that other distressed cities would follow.

Some local governments that had planned to issue bonds this week decided to wait and see whether the market improved. But Illinois was among those that could not afford to wait. It had been conserving money by delaying road maintenance and the building of new schools.

Abdon Pallasch, an assistant state budget director, cited in particular the risk of delaying reconstruction of the city’s commuter rail system in hopes of obtaining better rates on the bonds, which have a total value of $1.3 billion. He said service had been halted on the Red Line, Chicago’s oldest, inconveniencing 80,000 commuters a day.

Mr. Pallasch said that state finance officers had calculated the state’s $130 million market penalty by comparing the rate Illinois will pay on these bonds with the rates being paid on similar bonds issued by states with AA ratings. That, he said, was Illinois’s credit rating before the state’s pension problems boiled up.

Illinois has shortchanged its pension system for many years and has now fallen so far behind that it cannot catch up without diverting money away from other programs. Governor Quinn has tried several times without success to push pension overhauls through the legislature. Moody’s Investors Service downgraded the state’s credit to A3 in June, soon after one failed legislative effort, and Fitch went to A-, the equivalent in its ranking system.

Although those ratings are the lowest of any state, they are still several notches above junk grade.

Governor Quinn said that the state was paying an average interest rate on the bonds of 5.042 percent. He called on lawmakers to enact pension changes “by July 9, so we can stop the bleeding, prevent future downgrades and jump-start Illinois’s economy.”

Daniel Berger, senior market strategist for Thomson Reuters Municipal Market Data, said the pension-related downgrades cited by the governor were important factors but not the only ones.

He said that market conditions had driven the interest rate on a typical 10-year municipal bond up by more than one percentage point since the beginning of May. The rate for longer-maturity bonds were more than 1.25 percentage points higher.

“He’s ignoring the adverse market conditions,” Mr. Berger said.

BY MARY WILLIAMS WALSH