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General Obligation – The Mayhem In Municipal Bonds.

Karen Shaw Petrou memorandum to Federal Financial Analytics Clients on the mayhem in municipal bonds.

TO: Federal Financial Analytics Clients

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Transfixed as we are by the Greek tragedy, it's easy to miss another deadly drama in the financial arena. The other looming systemic risk is right here at home: municipal bonds. Let me quickly say that the hazard here isn't the solvency one doomsayers wrongly prophesized a few years ago. With a few, large exceptions, muni issuers are good for it. Rather, what alarms me—a lot—is the potential for a repeat cliff-effect scenario sparked by rating downgrades. Much here is an eerie repeat of the 2008 crisis that almost took down muni-bond insurers and, with them, everyone else. Ironically, changes since the crisis have made the muni market even more vulnerable to a systemic spiral; so much for all our "we learned our lesson" talk.

A very short bit of background: municipal bonds in the U.S. come in two flavors-general-obligation (GO) ones backed by the full-faith-and-credit of the issuing locality, and state and revenue bonds, backed by the proceeds of stadiums, water projects, and the like. The total muni market is $3.2 trillion and defaults across it—$9 billion last year—are miniscule. In most cases, GO bonds are backed not only by the strong word of an issuer, but also by constitutional or other commitments that force repayment, a solvency promise further strengthened by the clear understanding that any locality that doesn't honor its commitments faces years of financial starvation at great cost to its citizenry.

The problem in the muni market thus isn't traditional credit risk, especially for GOs. Rather, it's opacity. By definition, most muni issuers—especially in the revenue-bond category—are small in terms of the global capital market. Their finances are also often ill-stated, if not even flat-out misstated. Here's where the systemic-risk sparkplug comes in: municipal-bond insurance.

Muni-bond insurers slap their own guarantee atop many issuances so that investors—many of whom are retail ones either on their own or through mutual funds—need not worry their little heads. If a GO or revenue bond is AAA, it's not necessarily that the issuer is gilt-edged—far from it in most cases. Rather, it's that the insurer's guarantee got the rating agency's gold star.

This structure makes ratings critical not only to insurers, but also to the marketplace, and here's where the potential repeat of 2008 gets scary. In 2008, most bond insurers were AAA-rated even as almost all of them played faster than fast and looser than loose with their risk profiles. Muni-bond insurance is, as I said, very low risk. It's also, thus, low-margin. In the heady days leading to the crisis, bond-insurance management wanted to fly like the big boys so they doubled down and put their imprimatur also on a wide array of wild structured-financial instruments with strongly correlated risk across their balance sheets. Oops.

The first thing that happens when a rating agency wakes up is that it cuts ratings. Blithely ignorant of everything beneath the surface at the bond insurers when the crisis broke, each of the agencies sharply downgraded the companies often just days before bankruptcy or restructuring. As ratings went down, a cliff-effect scenario unwound.

The name explains the scenario: something suddenly changes market expectations and investors fall off a cliff. When this happens, investors required to hold only high-rated paper (mutual and pension funds, for example) try to unload their munis even as potential buyers-banks, for example-either can't pick them up due to their own woes or won't because they fear another cliff effect. In the end, there were huge jumps in unrealized losses as muni-bond prices plummeted because of the rating downgrades.

Fast forward to right now. The muni market is still an island of solvency strength, pension woes in Illinois and New Jersey notwithstanding. Puerto Rico is, of course, a huge dark cloud on this horizon, but this isn't so much because its $70 billion in outstanding debt is all that much compared to the total muni market, but rather because of what's happened since 2008 to bond-insurance companies.

Several of them didn't make it out the other end of the financial crisis, leaving a far smaller and considerably more concentrated industry. One company-Assured Guaranty-now holds 57 percent of the business all on its own. Combine that number with another bond-insurer holding a lot of Puerto Rico's direct and indirect debt, NPFG, and one comes up to a very concentrated industry dependent on two companies that could well lose their AA ratings in short order. Since these insurers are keeping one large Puerto Rico issuer afloat by not just insuring, but also buying, its debt, think not just exposure, but also correlation risk and be afraid.

If these companies are downgraded, the cliff-effect scenario could well start all over again in a financial system already on edge due to Greece. It also happens at a time when fixed-income market liquidity is very scarce and the ability of custody banks to husband liquidity reserves for investment companies-e.g. retail-bond mutual funds-is unduly constrained. In short, it's a perfect storm.

Maybe these clouds will pass-I surely hope so. They are, though, a critical and urgent reminder that it's not good to regulate the biggest banks within an inch of their lives. The fundamental mechanics of the 2008 crisis remain largely untouched outside the central-bank circumference-big banks and a couple of very large non-banking companies that drew unflattering attention the last time around. Outside this select sphere, though, there are massive pockets of potential market risk and illiquidity, some reverberating of course now through the sovereign-bond market but others to come in our own little muni-bond market here at home.