Puerto Rico Shows Perils of Muni Bonds Backed by Empty Promises.

Municipal-bond investors are learning that when cash gets tight, promises are made to be broken.

Puerto Rico's default Monday on bonds sold by its Public Finance Corp. underscored the risks of debt backed only by a legislature's pledge to repay. Two days later, Chicago's Metropolitan Pier and Exposition Authority's rating was cut to near-junk from AAA by Standard & Poor's because Illinois hasn't appropriated the money to pay its bonds amid a stalemate over the budget.

Unlike with general obligations or debt that has a claim to specific revenue, buyers have little recourse if politicians walk away from appropriation bonds, a $197 billion niche of the municipal market. Vadnais Heights, Minnesota, and Menasha, Wisconsin, have already done so. In bankrupt San Bernardino, California, investors may recover one cent on the dollar.

"Appropriation debt is scarier than people want to think it is," said Matt Dalton, chief executive officer of Rye Brook, New York-based Belle Haven Investments, which manages $3 billion of munis. He said his firm tends to avoid the securities.

Legislators "have to come around the table and appropriate each year, and as you can see, if they're not on sound financial footing, you're taking a lot of risk," he said.

Pennies Paid

Detroit's $18 billion bankruptcy illustrated the differing legal protections for investors. Buyers of its certificates of participation, which had neither the city's taxing power nor specific revenue streams behind them, recouped 12 cents on the dollar, according to a report this week from Moody's Investors Service. Holders of its general obligations got six times more.

San Bernardino, which filed for bankruptcy in 2012, has proposed giving investors just 1 cent on the dollar for pension-obligation bonds the city voted to stop funding three years ago.

"It's alarming to see if you're in an unsecured position, really how crammed down you're going to get," said John Flahive, Boston-based director of fixed income at BNY Mellon Wealth Management, which oversees $20 billion of munis. "We've always been cautious toward appropriated debt."

The bonds were the first to take the hit in Puerto Rico, where the government is reeling from $72 billion of obligations. Faced with a growing cash crunch, the legislature didn't provide funds to cover bonds the commonwealth's Finance Corp. sold to help keep the government afloat. When $58 million of interest and principal was due Monday, it paid just $628,000.

Bonds Fall

Finance Corp. securities due in 2031 traded Thursday for 9 cents on the dollar, data compiled by Bloomberg show. They fetched 100 cents as recently as June 2013.

Bonds sold by Chicago's Metropolitan Pier, which operates the biggest U.S. convention center, tumbled Wednesday after S&P cut its rating by seven steps. That came after the authority couldn't make a required deposit into its debt-service fund because the legislature hasn't appropriated the tax money. The agency hasn't missed any interest or principal payments, which aren't due until December.

Its $208 million of 5.25 percent bonds maturing in 2050 traded Wednesday for as little as 96.7 cents on the dollar, down from $1.05 when they'd last traded on July 30. That pushed the yield to 5.5 percent from 4.1 percent.

"Investors are going to want more yield for appropriation debt," said Alan Schankel, a managing director at Janney Montgomery Scott LLC in Philadelphia. Puerto Rico and Chicago's Metropolitan Pier are "part of the procession of anecdotes about appropriation debt that we've been hearing about."

Jersey Jitters

States like New Jersey are drawing bondholders' scrutiny, Schankel said. With the second-lowest credit rating after Illinois, New Jersey has about $30 billion of appropriation-backed debt and related securities, according to Moody's, which rates the securities no higher than four steps above junk.

Investors are demanding a premium to buy the debt. New Jersey bonds due in December 2023, which are funded out of the annual transportation budget, traded Thursday for an average yield of 4 percent, a full percentage point more than general obligations with a similar maturity, data compiled by Bloomberg show.

Kansas will test investors' willingness to purchase bonds with little security when it sells $1 billion of debt next week through its development finance authority. The proceeds will be used to shore up its underfunded workers' retirement system.

The prospectus circulated to potential buyers warns that if Kansas doesn't allocate cash to pay investors, the agency "has no obligation to seek or obtain any source of moneys for deposit to the Revenue Account, other than State appropriations."

Melika Willoughby, a spokeswoman for Governor Sam Brownback, didn't have an immediate comment on the bond sale.

"Anytime there's a political process involved in getting paid, which is what an appropriation is, you have to be concerned," BNY Mellon's Flahive said. "The market will be very critical in the reward versus risk given the events in the appropriated space."

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Brian Chappatta

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