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Commentary: Why the Municipal Market Is Going to Need Defending.

The next five years are going to be critical for municipal finance, as surely as default follows distress.

All of a sudden, everyone is eager to defend tax exemption and the municipal market. Hundreds of local officials signed a letter drafted by the National Association of State Treasurers advising the federal government to keep its hands off. In Congress, two House members are starting a bipartisan municipal finance caucus to do much the same thing.

This is good news for all those who think states and municipalities are best served by being able to borrow whenever they feel like it, without having to apply to a higher authority for permission.

It's also a good thing because, boy, is municipal finance going to need defending.

Let me boil this down before I boil over. Every time the municipal market has produced an Event, federal regulators and would-be overlords have reacted with astonishment, outrage, scrutiny, and new rules. As they should; their primary mission is to protect investors.

Consider the rise of the Memphis "Bond Daddies" in the late 1960s and the New York City financial crisis of 1975. The result: the creation of the Municipal Securities Rulemaking Board.

Then there was the Washington Public Power Supply System default in 1983 and the Orange County bankruptcy in 1994. Each produced You've Got To Be Kidding Me moments, lengthy analyses, and new rules.

Since then we've had a steady stream of Events: the deliberate mis-pricing of bonds and swaps called "yield-burning," the Jefferson County and Detroit bankruptcies, and the trashing (by certain parties) of the General Obligation pledge.

What is going to differentiate this year from the past is the possibility of multiple events. There's Puerto Rico at $70 billion in bonded debt, as well as pension liabilities. But there's also the Detroit Public Schools, Chicago Public Schools, and even the city of Chicago.

The municipal market has played a role in every case. Sometimes municipalities delayed balancing the budget with the upfront money they got in connection with swaps. Sometimes they sold bonds to cover operating expenses. Other times, as revealed in the Chicago Tribune's 2013 series "Broken Bonds," they used so-called "scoop and toss" refundings—borrowing money to pay debt service and push off repayment for years, even decades.

There's plenty of blame to go around, as Richard Ciccarone, head of Merritt Research Services, pointed out last year on his MuniNetGuide website: "Too often, government officials and politicians have appeased taxpayers by adopting unhealthy fiscal practices by either maintaining expenses they can't afford or by keeping lower taxes than their liabilities warranted," he wrote. "At the same time, investors and rating agencies may be inadvertent enablers if they ignore early signs of imprudent debt policies or other negative credit factors that are developing but not of immediate concern."

Former Kentucky state official and full-time market commentator Kristi Culpepper observed last year, "All of the recent insolvencies in the municipal bond market have combined protracted fiscal mismanagement with a reliance on innovative financial products (e.g. interest rate swaps and pension obligation bonds)."

The mainstream media is interested in politics, not public finance. It treats every financial blowup as a discrete, rather than a related. almost predictable, event. Washington, I suspect, isn't going to make the same mistake. Borrowing larger and larger amounts of money to delay making hard public policy choices isn't an appropriate use of the municipal bond market.

It's going to be very hard for those who would preserve the municipal market to excuse such abuses. I still think states and municipalities should be able to borrow money when they want to. But I won't defend the indefensible.

The next five years are going to be critical for municipal finance, as surely as default follows distress. This market is a victim of its own success: The numbers have gotten too big. Be prepared for the firestorm to come.

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