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Who Should Police Municipal Markets?

A questionable bond sale in Illinois has left some wondering why there's no one to stop financially troubled governments from borrowing.

Borrowers have long assumed that banks and other traditional lenders will only loan them as much money as they can responsibly afford. Almost a decade ago, the subprime mortgage crisis shattered that belief. But it might still persist in the municipal market.

Take Illinois, whose fiscal woes are no secret. It has the lowest credit rating (BBB+) — by far — of all 50 states, its pensions are among the worst-funded in the country and it's entering its second fiscal year without a budget. Yet earlier this month, Illinois borrowed more than a half-billion dollars from municipal market investors with relative ease.

The state paid a higher interest rate for its troubles. But thanks to the high demand for municipal bonds these days, the rate was actually lower than the one Illinois paid on its last bond issuance in January.

"That's the biggest weakness of the municipal market," said Matt Fabian, managing director for Municipal Market Analytics. "We will help issuers borrow as much as they say they want, whether or not they can afford it."

No one is saying Illinois won't pay back the debt — it gives bondholders a high priority when it comes to repayments and it has a dedicated reserve fund for paying its bonds. Still, before Illinois went to market, a major investor in U.S. municipal debt said the bond sale should be boycotted. Citing the state's budget impasse and poor pension funding, BlackRock's Peter Hayes said investors "should really be penalizing [Illinois] in some way."

Illinois was penalized — to a degree. An analysis by DePaul University policy professor Martin Luby shows that the 3.75 percent interest rate the state was charged on 10-year bonds was about twice as high as that of a AAA-rated state. That difference is called the spread, and in Illinois' case, the spread on its bonds was even wider than it was in January before the state's most recent credit rating downgrade. That widening equates to a roughly $12 million financial condition penalty for the state's credit deterioration between January and June, meaning the state received that much less in proceeds from the sale.

"The financial condition penalty is somewhat obscured [by the fact that] interest rates are so low," added Luby. "But if this were the state of Maryland or Minnesota, they would have borrowed at 2 percent. There's a real cost associated with that."

The question of who, if anyone, should be in charge of fiscal discipline in the municipal market is a relatively new one. Before the 2008 financial crisis, it was incredibly rare for a government to default on debt. In addition, a lot of bonds were insured. Bond insurers are the closest the muni market has ever got to fiscal policing, according to Fabian. That's because before guaranteeing insurance on the debt, insurers have the power to ask a government for changes in the bond deal or

in the government’s own finances.

What’s more, it’s rare for issuers not to pay: Fewer than 1 percent of municipal bonds go into default. But high-profile municipal bankruptcies following the Great Recession in Detroit and Stockton, Calif., where bondholders swallowed significant losses on general obligation bonds, has some investors nervous.

“This is very new to the municipal market because in this cycle you’re getting people who aren’t actually made whole,” said Marc Bushallow, managing director of fixed income at Manning & Napier.

There are no proposals on the table for how to police municipal markets should investors ever demand it. For now, it seems the bar is set relatively high for a government to actually be denied access to the market. Were it not for a lack of interest from investors, for instance, no one would have kept Puerto Rico’s water utility from borrowing hundreds of millions in debt to avoid defaulting on an upcoming payment. This, despite the fact that the island has already defaulted twice on other bond payments and was seeking protection from Congress to restructure its massive $70 billion in debt.

Since investors are more interested in their own bottom lines, they’re unlikely to act to stop troubled governments from borrowing. A good clue as to whether investors even think about credit worthiness lies in who buys government bond debt in the first place. Puerto Rico’s last major bond issue, for example, was mostly bought up by hedge fund firms, known for chasing high yield and often riskier assets.

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