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After Disaster Strikes, Munis Often Provide New Capital.

It has been a devastating hurricane season so far, and our hearts go out to the people and places for whom Harvey and Irma will be storms of lasting significance.

The first order of the day is to help meet the immediate needs of those affected, and people from across the United States have helped save lives, shipped necessities, and donated to various agencies that provide assistance. In Texas and other areas hit by Harvey, homeowners and businesses are filing insurance claims, and adjusters are busy assessing damages, a daunting task in the country's fourth-largest city.

Longer-term solutions in Texas, Louisiana, Puerto Rico, the U.S. Virgin Islands, Florida and elsewhere will require significant financing: The federal government has already agreed to provide $15.3 billion in disaster aid and that amount will certainly rise as the damage caused by the hurricanes is fully assessed. According to The New York Times, federal disaster aid related to Hurricane Katrina totaled $110 billion, and the $15.3 billion allocated so far represents "the first installment."

Sources of revenue

States typically supplement federal aid with money that has been set aside in aptly named "rainy day funds" for these types of emergencies. The rainy day fund in Texas is officially known as the Economic Stabilization Fund and will likely be tapped. As of June 30, 2017, its balance totaled nearly $10 billion, according to a recent Bond Buyer article by William Glasgall, the director of state and local programs at the Volcker Alliance in New York. Allocations from this fund – the biggest rainy day fund in any state, according to the state's Office of the Comptroller – can be allocated for hurricane relief by a two-thirds vote of the Texas Legislature.

At some point, depending on the degree to which affected municipalities have to (or choose to) retrofit or replace critical infrastructure, or embark on a master plan to rebuild areas that were largely destroyed, the municipal bond market may eventually become a source of capital as well.

In recent history, various restrictions in the Internal Revenue Code of 1986 have been relaxed to allow for special tax-exempt securities that could "foster economic recovery after natural disasters and other catastrophic events," according to The Fundamentals of Municipal Bonds, a Securities Industry and Financial Markets Association reference book. As a result, the book explains, the U.S. Congress has occasionally authorized disaster recovery bonds: Gulf Opportunity Zone bonds were first sold in 2005 to help Alabama, Louisiana, Mississippi and other areas affected by Hurricane Katrina, and Midwest Disaster Area bonds were issued in 2008 to finance rebuilding efforts after severe storms, tornadoes and flooding occurred in seven Midwest states. A number of Texas and Louisiana counties that were damaged during Hurricane Ike were also eligible for financing from the 2008 issuance.

The relaxation of restrictions in the Internal Revenue Code of 1986 also helped New York City rebuild after 9/11. Non-rated Liberty Bonds were issued in 2005 by the NYC Industrial Development

Agency to finance the completion of 7 World Trade Center, a skyscraper to replace one of the buildings that had been destroyed. By purchasing some of the $475 million in Liberty Bonds, which had coupons ranging from 6.25% to 6.75% and were backed by lease payments on the top 42 floors of 7 WTC, our team delivered shareholder value and something that we believe is equally important—the financing that helped rebuild a city that refused to be shattered by the events of that day.

Liberty Bonds and other bonds issued after natural disasters or catastrophic events, we believe, epitomize the essential character of the municipal bond market.

We believe similar bond structures may be created to help Texas, Louisiana, Puerto Rico, Florida and other areas rebuild, and we are confident that participating in this type of rebuilding will remain highly attractive to many municipal bond investors.

Market impact

Credit rating agencies have already begun to look at the bonds they rate to see if any of their assessments need to be adjusted. These agencies – S&P Global Ratings (S&P), Moody's Investors Service and other Nationally Recognized Statistical Rating Organizations (NRSROs) – are focused on whether the securities issued by hospitals, toll roads and other issuers in the affected geographies still have the same credit quality after the storm as they did before it.

According to S&P, "There's no question the hurricane's devastation of the fourth-largest city in the U.S. could have a negative effect on the credit quality of various local government issuers, but it's too soon to tell."

While some credits may see downgrades if an NRSRO perceives a change in an issuer's likelihood of maintaining its debt-service obligations, Moody's notes that none of the municipal bonds it has rated has defaulted because of a natural disaster. Additionally, the number of credit upgrades issued by Moody's one year after Katrina for bonds issued in the New Orleans region was greater than the number of downgrades issued in the hurricane's wake, according to a report by RSM, which provides audit, tax and consulting services to the financial industry. RSM also reports that no natural-disaster-related defaults have occurred in at least 75 years. Some muni sales were postponed and some bonds experienced brief payment interruptions after Katrina hit, but those events were the result of logistical problems caused by flooding, not by changes in credit quality.

This track record goes a long way toward explaining why the muni market has remained calm amid the storms. Prices in the municipal market and among municipal securities issued in Texas have been rising overall during the third quarter, and Hurricane Harvey had little impact on the trajectory of either the Bloomberg Barclays Municipal Bond Index or its Texas component, Bloomberg Barclays Municipal Bond Texas Exempt Index.1 The end of summer is generally a quiet time for munis, but the market's reaction to Hurricane Sandy, which struck late October 2012, was similarly muted.

The Handbook of Municipal Bonds, often referred to as Fabozzi – an homage to Frank J. Fabozzi, one of its editors – provides an example of an uninsured Bond Anticipation Note (a BAN) that was issued at par in New Orleans in late July 2005. The evaluation for this BAN was just above par on August 29, 2005, when Katrina made landfall in Louisiana. The evaluation was adjusted after the next trade, at $94.40 on September 21, and again on September 22, when it traded at $98.00. The BAN was subsequently traded actively and quoted, in large part thanks to the extra effort of its evaluator to keep the market apprised of the bond's status.

It is too soon to tell what will happen to the prices of muni bonds in areas affected by this year's hurricanes. Analysts at S&P have cautioned that securities backed by property taxes may be at risk. Many school district bonds issued in Texas are guaranteed by the state's Permanent School Fund, which totaled $37.3 billion as of the latest annual report, according to Glasgall's Bond Buyer article. This fund guarantees more than $4 billion in public and charter school debt and provided $1 billion in state aid as of August 31, 2016, Glasgall reports.

Economic impact

Municipalities that have been damaged by a storm or other catastrophe often see an increase in spending as homeowners and businesses start to repair properties and replace goods that had been lost. Spending on household goods and construction materials often drives economic growth, especially if the population remains relatively constant. In the short term, it is likely that tourism will be adversely affected – which could have an impact on bonds backed by hotel taxes – but Americans have often demonstrated a willingness to show their support by showing up once the catastrophized municipality is back on its feet.

Some municipal officials have embarked on ambitious revitalization plans in the aftermath of a natural disaster, according to a 2013 article in Governing Magazine by Liz Farmer.

In Tuscaloosa, Alabama, city leaders used an ample reserve fund to meet immediate needs after a tornado struck in 2011 and, while waiting for federal funds, began to think about ways to revitalize the parts of the city that had been destroyed. Officials approved a high-density master plan for a mixed-use district. The new district surrounds CityWalk, a nearly 6-mile trail that traces the approximate path of the tornado and is scheduled to be completed next year.

Amid a contentious debate among stakeholders, San Francisco's mayor persuaded federal officials that it was economically sensible to replace (not retrofit) the Embarcadero Freeway, which was extensively damaged in the 1989 earthquake. According to the Governing Magazine article, "the waterfront where the Embarcadero once stood is a model of city planning, attracting billions of dollars in reinvestment and new development," including AT&T Park, home to the San Francisco Giants.

And the 1.5-square-mile farming town of Greensburg, Kansas, transformed itself after a tornado destroyed 95% of it, Governing Magazine reports. The small community took advantage of state and federal grants and appropriations, established a property tax incentive program for businesses willing to adhere to green building standards, and even issued bonds to fund projects that turned Greensburg into "a world model for sustainable, environmentally friendly development."

OppenheimerFunds

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