

# Bond Case Briefs

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## Troubled Municipal Borrowers Can't Hide From Matt Fabian.

**The Municipal Market Analytics partner built a database to track issuers' difficulties, and says the outlook is bleak.**

The \$3.8 trillion U.S. municipal bond market is home to more than 50,000 individual issuers. That's almost 10 times the number of corporations that sell debt. Yet muni issuers, which range from a tiny California school district to an economic powerhouse such as New York City, aren't beholden to the same reporting requirements that companies must follow. Matt Fabian, a partner at Concord, Mass.-based research firm Municipal Market Analytics Inc., scours their often haphazard filings for signs of troubled borrowers. His database tracks events such as issuers dipping into reserves or skipping payments, informing his weekly reports to clients.

This labor-intensive undertaking has yielded surprising insights into where defaults cluster and may offer investors a road map. Fabian, based in Westport, Conn., joined MMA in 2006 after working at a ratings company, bond insurer, and investment bank. Here, he talks about his process, his bleak outlook for the U.S., and the implications for investors.

**ROMY VARGHESE:** You started your database in 2009, when the Municipal Securities Rulemaking Board rolled out the Electronic Municipal Market Access [EMMA] service for disclosures that could affect the value of bonds. Describe your process.

**MATT FABIAN:** Every two weeks, we look at every event notice that has been posted to EMMA. Usually there are 2,000 to 3,000 event notices. Any notice that's not a bond call or rating change, we'll open and read. To the extent that the PDF file has information about some kind of trouble, we'll enter that into our database. It takes a couple days. It's a serious time commitment. The issuers and their attorneys who do these filings don't necessarily make it easy for you.

We keep one database of unique borrowers that are in trouble and a linked page that has all the Cusips. It's a combination of hand-punched data fields and data fields extracted from Bloomberg that go to either the borrower tab or Cusip tab.

**RV:** How large is the database?

**MF:** We have 2,020 individual borrowers that have filed some sort of trouble since the summer of 2009. There's just over 20,000 Cusips.

**RV:** You recently analyzed the data by county level. Did you uncover any surprising trends?

**MF:** Traditional credit metrics would argue that the weaker the economy in an area, the more likely there will be impairments and defaults. That is true. The thing I didn't expect was that from the traditional debt analysis, you would think there would be more defaults the more debt outstanding there was in an area. But that's not true. At least on the county level, the less debt outstanding, the more likely a large portion of that debt is impaired.

**RV:** You've shown that defaults and impairments tend to cluster in metropolitan areas that are smaller and poorer than average. Why is it that entirely rural counties are home to about 5 percent of impaired bonds and account for just 2 percent of all outstanding debt?

**MF:** To the extent that you're in an urban area or on the coasts or close to a growth area in the country, there should be more investors willing to support a Plan B. But the more rural the area gets, the more the projects reflect the interests of just one party. So when it fails, that takeout interest is harder to come by. If you finance a jail in rural Texas [in an effort to create jobs and support the local economy], and the jail doesn't work, there aren't many other ways to reuse that project. If you're financing a jail in Manhattan, there would be plenty of alternate buyers willing to refinance that debt and take it over.

**RV:** Your analysis found that counties in the Midwest and Southeast are home to about 37 percent and 22 percent, respectively, of outstanding bonds that are in default. Excluding bankrupt Puerto Rico, about \$19 billion of the \$31.8 billion in defaulted and impaired bonds are in those two regions. What does that show?

**MF:** The kinds of munis that default are often the kinds that are financing economic speculation. And areas in the Southeast and in the Midwest have accounted for more disappointment as far as economic speculation than other areas in the country.

Speculative capital attracts more speculative capital. In the Southeast, where there has been growth, governments and borrowers will be more prone to overborrowing.

**RV:** Considering that defaults are rarer than in corporate bonds, why should muni bond investors care where they are clustered?

**MF:** Most muni investors are not looking to profit off of municipal distress, they're looking to avoid it. Investors should underweight areas most prone to defaults. To reduce your portfolio's overall exposure to risk, you should be thinking about its regional exposure, how exposed it is to rural as opposed to urban, or the kinds of economies that underlie the bonds even if the sector isn't explicitly tied to the economy—like a charter school or a senior living project or a hospital. The economic effects from that credit being located in an urban or a rural area are going to be increasingly important in the America of the next few decades.

**RV:** Do you expect more defaults?

**MF:** Because our sector is so lumpy, we have so many tiny credits and so many extremely large credits, it's hard to know. The default data in the database do suggest that the default rates are going to rise in the near term. For the number of bonds coming into the database and staying there, the number of bonds defaulting is too low right now.

**RV:** Why is it important to keep this database going?

**MF:** Things are going to get worse. The credit cycle will turn. As the economy softens, we will see the effects in muni credit in real time and we'll be able to provide context on just how bad it is and where things are likely to go.

**RV:** Why should people other than muni bond investors care about the trends you've unearthed?

**MF:** It's one more reason to rethink how we spend our economic development dollars nationwide. And long term, the level of the concern we have for these communities, where speculative financings tend to fail, are areas that are likely going to need more help going forward. It's part of the long-

term America-in-decline trend.

**RV:** Which is ...?

**MF:** The idea that long-term federal budget deficits combined with slow growth and large legacy spending obligations on the part of the states together mean less money trickling down to the local level. Local governments will be faced with either rolling out increasingly severe austerity in their spending or raising tax rates. Either one will slow the economy further.

**RV:** And income inequality will worsen.

**MF:** As local governments are forced to go their own way as federal and state aid is reduced, affluent communities will increasingly outperform poorer communities. Affluent communities are best able to navigate a future where communities are left on their own. And poorer communities are not.

### **Bloomberg Munis**

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