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Impact of COVID-19 on Municipal Finance: Restructurings Inevitable (Part 1): Sheppard Mullin

"Only when the tide goes out do you discover who's been swimming naked" – Warren Buffet

The tide has gone out on the municipal finance market.

While much of the discussion about the financial fall-out of the COVID-19 virus has focused on the massive wealth destruction in stock markets and pressure on corporates around the world, the impact on the largest financial market in the world- the $3 trillion US municipal finance market- cannot be ignored. Simply put, the market is imploding.

In a market primarily driven by mammoth mutual funds and institutional investors, the "flight to cash" is clearly on. Selling pressure this week has pushed muni prices into free-fall, particularly on the short end of the curve. The primary market (where states, cities and other municipal issuers borrow and refinance) is essentially closed.

This is not a short-term correction. The longer-term implications of COVID-19 on the market and municipalities is daunting. Consider:

- many states and cities are dependent on sales and use taxes to fund their budgets. Florida and Nevada for example, depend on these taxes for 60% of their revenues. Curtailment of travel and leisure activities and consumer activity in general will quickly reduce these revenues.
- budgets in states like North Dakota, New Mexico and Oklahoma will be decimated by plunging oil prices
- financings dependent on project revenues will be at risk in numerous sectors such as sports stadiums, airports, toll roads, senior living facilities and student housing, to name a few.

Municipal reserves, where available, will help, but funding pressures will force many states and cities to turn to the Federal Government to maintain essential services. Recently announced Federal stimulus programs, including the expansion of the Federal Reserve's Money Market Mutual Fund Liquidity Facility to include purchases of certain types of municipal securities, may help in the short-term.

But the challenges will be daunting and will reveal themselves only gradually. States and cities with strong reserves, a diversified tax base, well-funded pension and employee benefit plans and low debt will undoubtedly weather the storm. Other municipalities without those virtues will be pressured to adopt debt restructuring strategies, including debt adjustments under Chapter 9 of the Bankruptcy Code, on a scale that could eclipse the wave that followed the "Great Recession" of 2008-09.

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