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Red Storm Rising In The Municipal Market.

We are all concerned with the economic impact of the Covid-19 pandemic and are fed daily platitudes about the coming recovery. Fears of bankruptcy are being realized among listed companies as the Federal government and the Federal Reserve Bank extend themselves in unprecedented ways. The municipal market is another story.

State governments are making appeals to Congress for bailouts and the Fed is likely to intervene in purchasing state debt issues to provide funding for them to supplement the financial holes created by the shutdowns of regional economies. But there is a huge segment of the muni market for which little relief will be forthcoming, the small localities and the private purpose or conduit bonds. The fact that these entities and bond issuers have suffered from the pandemic is a forgone conclusion. How many of them have the financial means to avoid default is something to fear.

The vulnerability of municipal bonds is that they are usually the equity component of the capital structure of an undertaking or project. Yet they differ in that they are generally better secured than actual creditors when it comes to default or bankruptcy because they have first claim on the hard assets of the project or enforceable promises from the governmental entity. For this reason default or bankruptcy recoveries tend to be better than in corporate bonds.

A pandemic changes the dynamics of a muni financed bond project in that revenues suddenly fall off a cliff so that merely defaulting on interest payments or principal maturities does not deal with the fact that there is no cash on hand or lines of credit to fund the ongoing expenses of the entity. One current example of such a desperate strait was a nursing home operator who not only couldn't make the bond payment obligations for debt service, but actually tapped the debt payment reserve for operating cash, with bondholder consent.

A second source of likely defaults this year are in bond issues with high coupon rates that are capable of being refinanced but have no early call provisions. We term these "staged defaults." They were quite common in the 1980s and are likely to see a wide comeback this year. Since such issuers arrange the new financing in advance of the default, it results in no loss of interest or principal by existing bondholders. It is only a loss of the opportunity to replace the investment with another bond with a similar yield. Unfortunately, there was never a legal challenge to this blatant breach of contract so it is likely viewed today as a legitimate remedy. Unfortunately, insured bonds are the most vulnerable here since the insurer can not only reduce their exposure to the viability of the enterprise they insured going forward, but also, they can earn a second up-front insurance fee while also capturing the balance of the accruing up-front fee on the refinanced issue. For bond insurers, it doesn't get any better than this.

There is no way to estimate how serious a problem this represents for the municipal bond market. I do expect, however, that bank trustees will be more alert about reporting new payment failures on a timely basis. Hence, we have started a graph based on the dollar amount of payment defaults and included not just defaults in payments to bondholders, but also, failures to make payment obligations to the bond trustee, i.e. distressed issues. We feel this is a better measure of what the market can expect. The chart below shows that defaults as of early July total 59 defaults on $3.8 billion. This

compares to 16 defaults on $1.7 billion by July of last year and 49 defaults on $4.1 billion for all of 2019.

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by Richard Lehmann

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