# Bond Case Briefs

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## Municipal Bond Investors Have to Share the Burden in State Bailouts.

When Greece had its government debt crisis a decade ago, it received several rounds for bailout funding from the European Commission, the European Central Bank, and the International Monetary Fund. Key to the negotiations were not only the extent to which Greece would reform its public finances, but also how much the existing owners of its debt would have to suffer losses before the country received the bailout funding. The private investors in Greek bonds ultimately took haircuts that reduced the value of their positions by 59 percent in 2012.

Now in the United States, many voices, including former Federal Reserve Chairman Ben Bernanke, are calling on the federal government to provide massive transfers for bailouts of state and local governments as they face their own debt crisis. House Speaker Nancy Pelosi has also called for an additional $1 trillion. The argument goes that the coronavirus pandemic has slammed state and local revenues, and extensive additional federal support is now necessary to support spending.

Absent among these requests has been any mention of the existing bond holders, the creditors who voluntarily loaned nearly $4 trillion to state and local governments in the municipal bond market. The federal government supports this market through a valuable tax break, as the vast majority of these bonds pay tax free interest to the holders.

Around 30 percent of the municipal bond market are general obligation bonds backed by the general revenue of the issuing state, county or city, as opposed to revenue bonds that are linked to specific revenue streams. The $1 trillion in outstanding general obligation bonds are unsecured, and their holders are not asked to share in the burden.

Proponents of past bailouts in both the United States and the European Union have cited worries that allowing creditors to suffer losses might unleash or worsen a financial crisis. These assertions are in many cases dubious but, even taking this argument at face value, it would be hard to apply to municipal bonds in the current situation.

When the debt crisis in Greece looked like it might be repeated by other countries in the European Union, officials were concerned that the debt crisis might bring down the banking system. Total sovereign exposure by banks to debts of Italy, Spain, Greece, Ireland, and Portugal amounted to 58 percent of tier one bank capital, according to data of the Organisation for Economic Cooperation and Development. But even with this situation, Greece managed to enact haircuts for the bond holders.

By contrast, as of this spring, around 12 percent of municipal bonds were owned by banks. This implies only about $130 billion of total exposure to all general obligation municipal debt by the banking sector, compared to well above $1 trillion of tier one bank capital. Similar amounts of general obligation municipal debt reside on the balance sheets of the insurance companies, where municipal bonds are 7 percent of assets.

The remaining municipal bonds are directly owned by individuals, or in mutual funds and exchange traded funds largely owned by individuals. Municipal bond defaults would primarily affect individual investors, and especially individuals who buy tax exempt municipal debt because they are looking for tax free income. Congress has to therefore condition any further bailout funds on shared losses by municipal bond investors. For instance, the law can mandate that state governments pass legislation that would write off a dollar of municipal bond debt for every dollar of additional grants given to a state or local government.

These actions would face legal challenges, since the contracts clause in the Constitution prohibits state legislation which impairs contracts. But past cases have allowed this legislation when "reasonable and necessary to serve an important public purpose." Nothing in the bankruptcy code prohibits states from imposing debt restructuring laws on themselves. Congress would have to amend the bankruptcy code if it wanted to let states enact restructuring laws for counties and cities.

The federal government offered assistance to state and local governments with over $270 billion for the Cares Act and $500 billion for the municipal liquidity facility of the Federal Reserve. Bernanke and others complain that the conditions on the funding are restrictive. However, states such as New Jersey are already investigating ways to tap the municipal liquidity facility to support contributions to the pension plans for public workers that it has underfunded for years. If that is not flexibility, then what is?

The Cares Act and the municipal liquidity facility should have been more than sufficient for most states. In the cases where they are not, it is time for the investors who willingly took risk and received such tax breaks by investing in these bonds to share the load with debt relief.

THE HILL

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