
Are Governments 'Paying for Failure' With Social Impact Bonds?

A social policy experiment is spreading across the country as a new way to finance, deliver, and improve public services and problems. But its merits are so far unproven.

Three years ago, New York City launched an ambitious and unprecedented social policy experiment at its jail on Rikers Island. Thousands of teenage inmates began receiving group therapy aimed at improving their moral reasoning by addressing their beliefs and thought processes in a step-by-step treatment. The goal was to reduce the number of repeat offenses once the inmates were released. Academic studies using the method, known as moral reconation therapy, had reported success in reducing recidivism. Still, no one had ever scaled up these studies to accommodate anything like the 9,240 inmates the four-year Rikers Island program aimed to serve. This month, the program is coming to an abrupt end.

The reason for the progam's demise has to do with another feature of the experiment: It was financed entirely with a $9.6 million loan from Goldman Sachs. New York City was to pay the investment firm back if the repeat offense rate went down by at least 10 percent over four years. In June, a preliminary report showed the program not only was missing its recidivism target, it had no impact on the rate altogether. Goldman Sachs moved swiftly and took a contract option to cancel the program one year early. The first social impact bond program in the United States has officially failed.

"Everyone went into this understanding what they were getting into," says David Butler, a senior adviser at MDRC, a nonprofit social policy research organization that managed the treatment program at Rikers. "These things are risks. Just because something works in one environment doesn't mean it will work somewhere else."

Unpredictable as they are, programs like the one at Rikers are not going away. In fact, these attempts to link altruistic policy goals with the pursuit of private profit have been gaining steam as the latest promising innovation in public finance. The mere announcement of the Rikers project back in 2012 was a catalyst for action in dozens of other jurisdictions. Cash-strapped governments quickly became sold on the concept that they can use private money from investors for preventive social programs — money the government will have to pay back only if the programs produce the desired measurable outcomes. In 2013 alone, 28 state and local governments applied to the Rockefeller Foundation and Harvard's Social Impact Bond Technical Assistance Lab to receive help in developing such programs.

Media outlets have often touted the innovative financing tool with few notes about the complicated nature of the projects. Last year on Capitol Hill, where bipartisan support is famously elusive these days, a $300 million proposal pushed by President Obama to allocate federal funds for social impact bond projects in the states managed to attract proponents on both sides of the aisle.

But as the enthusiasm for social impact bonds has grown, so has skepticism about the concept of partnering with the private sector to accomplish social goals. Last spring, a congressional hearing on the subject ended on a negative note as critics questioned the complicated structure of program contracts between governments, investors and the various private operators involved. “I don’t get this at all,” said Maine independent Sen. Angus King, squinting with disbelief. “I think this is an admission that government isn’t doing what it’s supposed to do. This strikes me as a fancy way of contracting out.”

That hearing was followed by a report last summer that the world’s first social impact program, located in the United Kingdom, had not reached its target goal required to trigger early payments to investors. That development and the news from the Rikers project underscore the fact that the merits of social impact bond programs are entirely unproven. The programs are so new, in fact, that people are still arguing about what to call them. Some say that referring to them as bond investments is misleading because they are not like actual government bonds that are bought and sold on a public market. That’s why many proponents prefer to call them “pay for success” programs. But what does “pay for success” imply, asks Indiana University Public Affairs professor Craig L. Johnson. “That right now we’re paying for failure?”

The bond programs may or may not save governments money in the long run. Even though the Rikers project didn’t work, Goldman Sachs said last month that its three other social impact bond investments had shown “encouraging progress.” Still, it’s much too early to tell if any of these endeavors will actually bring about the kind of change that social scientists and governments are hoping for.

Social impact bonds got their start five years ago in the U.K., at a prison in Peterborough, a city of about 190,000 people situated 100 miles north of London. Investors and social services professionals formed a group called Social Finance and made Peterborough their first investment. For a cost of about $8 million over six years, the provider, One Service, is giving comprehensive assistance to offenders who have served short sentences, in an effort to help them become self-supporting when they are released. Caseworkers help get ex-cons ID cards, set them up with doctors, encourage them to take classes and help them find counseling.

The argument for doing something at Peterborough was compelling. In Britain, 60 percent of those who serve short-term sentences land back in jail within a year. The Peterborough program, which will conclude next year, aims to reduce recidivism by 7.5 percent. The buzz about it and its new financing method via private investors led to the flurry of experiments at the state and local level in the United States. In December 2013, New York became the first state to try social impact bonds, launching a program aimed at reducing recidivism and increasing employment among 2,000 ex-offenders. All told, more than two dozen states and localities have now taken up or considered a social impact bond project.

These bond deals are being used to address all sorts of social problems, including early childhood education, homelessness, health and criminal justice. No two projects are the same. Each must draw up its own contract with service providers and with the project evaluators who track the outcomes. None of the new projects can be modeled after an existing one; each is its own social experiment and must be built from the ground up. For example, the Massachusetts juvenile justice bond program is financed with $18 million from six organizations, including nonprofits. The state is setting aside money every year for a separate fund to pay back investors if the seven-year project meets its goals. The Rikers Island project, on the other hand, was financed entirely by Goldman Sachs, with Bloomberg Philanthropies insuring three-quarters of the money.

The stated goals vary considerably. While the goal at Rikers was to reduce recidivism by at least 10 percent, Massachusetts is targeting a 40 percent reduction in jail days over seven years for the nearly 1,000 offenders in the study. The state estimates this reduction would result in a $22 million savings, and that is the amount it will pay back investors if the goal is reached. If the program exceeds that goal, Massachusetts estimates it could save as much as $45 million; however, it would only have to pay out a maximum of $27 million. Other programs have similarly structured payouts. Goldman Sachs stood to receive as much as $11.7 million if the Rikers program significantly exceeded its goal, while New York City estimates it would have recouped a net savings of up to $20.5 million.

These are complicated agreements — the Massachusetts bond contract is more than 200 pages long — and their very complexity is often cited by their critics as a weakness. Maryland investigated the possibility of using social impact bonds, but the state's Department of Legislative Services concluded in 2013 that the startup cost of designing a program and negotiating a contract would likely exceed the projected savings of a pilot serving several hundred people. That report essentially killed the issue of social impact bonds in Maryland, at least for now.

Indeed, the Rikers experience seems to illustrate that concern. A report on lessons learned prepared last year by MDRC lamented the jail program's "high transaction costs" that weren't covered in the Goldman Sachs loan. And for all the effort, the city's greatest potential for cost savings would have amounted to less than half of a percent of the $1 billion it costs annually to run the jail.

But whatever the critics may say, it seems likely that governments will be increasingly attracted to these experiments. At a minimum, practitioners argue, they will get the benefits of knowing more about what doesn't work, and can cut their losses. In that sense, says MDRC's Butler, the Rikers program was a success. "This is not the recipe for reducing recidivism for these kids at Rikers," he says. "Learning that was really important."

Still, the task of attracting investors is tricky. Even the philanthropically minded investors drawn to social impact bond projects aren't going to put up money for a program that looks like it was constructed on a wing and a prayer.

Goldman Sachs was reticent to enter the Rikers deal in 2012 until it saw results from previous academic studies that showed moral reconation therapy could reduce recidivism by up to 25 percent in those participating. And even then, it took insurance from Bloomberg Philanthropies to seal the deal. (As a result, the firm lost $1.2 million instead of its full investment.) "We're trying to find that sweet spot of allowing every stakeholder to win," says Tracy Palandjian, CEO of Social Finance US, which is a sister company to the U.K. group and is managing the New York state, as well as developing ones in Connecticut, Massachusetts, Michigan and South Carolina. "So even when the state pays back the investors with returns, that still should be smaller than what you gain overall as a state."

But that's where the argument ends, at least for now. Until the social impact projects currently running hit their end dates, no one will know how the numbers play out. And on the social services side, some question whether designing projects focused on short-term behavioral change is the best way to intervene. "It is hard to recreate the kind of concrete turnaround you get in pay for success across a whole lifespan," says Anne Stone, who runs a child development program in Washington state. "I'm not in any way suggesting it's not worthy to move those dials, but is there a way we can be thinking about this in a two-generation approach?"

The fact is, social impact bonds may have started out life as an innovative financing tool. But many who are now taking part in them are finding that the real experiment is in developing a new model for delivering government services. In that sense, supporters hope the projects' immediate impact will be in encouraging more social policy geared toward preventive measures, even if the intangible savings are impossible to quantify. They are hopeful that when a project ends and appears to be working, the government will be willing to pay the full cost of its extension, without any private backers.

Sometimes even the hint of private investment can spur a commitment from government. The Utah Legislature recently agreed to assume some of the costs of a Salt Lake County social impact bond program after Goldman Sachs committed to financing for one. Harvard's Jeffrey Liebman had a similar experience working with a state budget director to find a social impact project for that state. Among the ideas Liebman proposed was a health-care program that would place caseworkers in senior centers to save on Medicaid costs. Instead of going for the financing project, the budget director just opted to include the cost for the caseworkers in the state's budget. "If social impact bonds cause that to happen, that's just as good," Liebman said at last year's Senate hearing.

Still, for Indiana University's Johnson, any kind of mass social impact brought about by these kinds of projects is decades away. "We need a lot more cases to see what works and what doesn't," he says. "The problem I see now is, if you just have a few experiments going, that's not going to tell us how to change. Until people have put up [collectively] hundreds of millions of dollars, we're not going to know if this works."

GOVERNING.COM

BY LIZ FARMER | AUGUST 2015

How to Conserve Water Without Bankrupting Water Utilities.

The more water people save, the more money utilities lose. But new pricing models could change that.

Californians are getting very good at conserving water. Since Gov. Jerry Brown ordered a 25 percent reduction in urban water use this April, Golden State residents have surpassed that mandate. Water use for the months of May and June decreased 28.9 percent and 27.3 percent respectively, according to the State Water Resources Control Board. But if Californians were hoping their conservation efforts would lead to a little extra change in the pocketbook, they'll be disappointed.

Water departments across the state are looking to raise rates — in some cases by double digits. That's because as customers use less water, revenues are plummeting. It's a catch-22: Water utilities want and need customers to conserve water, but when that happens, utilities lose much-needed funds to upgrade and repair critical infrastructure. (Governing recently covered the dilemma in-depth.)

This isn't just a California issue. Increasing weather events and a growing population is putting pressure on water resources in every state. So how do water utilities reduce water use and stay in business? They price water differently.

Indeed, Brown's executive order in California explicitly demands that water utilities develop new "rate structures and other pricing mechanisms" to save water. This is also the subject of a new report from Western Resource Advocates, Ceres and the University of North Carolina's Environmental Finance Center. Released in August, the report looks at water connection fees — the one-time fees that most water utilities charge to connect new users and developments to the water system.

While there’s been plenty of research on how utilities price the volume of water being sold to encourage conservation, there’s been very little of it on water connection charges and how they might lead to water-saving practices. “It’s one area that hasn’t been looked at,” says Peyton Fleming, communications director for Ceres, a nonprofit organization that advocates for sustainability practices. “We wanted to know, can these water connection charges that are being used all across the country be done a little bit differently and in ways that might be helpful to water utilities and consumers?”

To answer that question, report authors surveyed more than 800 water connection fee structures used by communities in Arizona, Colorado, Georgia, North Carolina and Utah. They found that overall most utilities’ water connection charges — about 90 percent of the 800 local water utilities surveyed — didn’t take into account the types of factors that affect a home’s water footprint. In other words, most users pay the same fee regardless of the size of their lot and house, the type of landscaping they have, and the efficiency of their fixtures, among other things. But the report also found that when financial water-saving incentives are included in water connection fees, many customers make conservation changes to cut their costs. That, as a result, also helps utilities in the long run because less water usage means less infrastructure upgrades and repairs.

Aurora, Colo., is one place that employs such a water connection fee. Back in 2002, it was experiencing one of the worst droughts in its history. Municipal reservoirs only had enough water to last nine months. In response, the city began implementing a number of conservation programs, including a redesigned water connection fee. The utility wanted to develop a structure that would better align fees with water utility costs and provide an incentive to builders to construct more water-efficient developments. So it started offering lower fees to customers with landscaping that requires low water usage and charges no fee at all if the new development requires no water after it’s established. Since it started in 2014, five of six new developments used “zero-water” landscaping in order to get a full refund on their connection charges.

In addition to Aurora, the report also feature three other case studies. “Well-designed connection charges that incentivize water-efficient development show enormous potential to help utilities reduce overall water demand and avoid costly new infrastructure projects,” Sharlene Leurig, director of Ceres’ sustainable water infrastructure program and a co-author of the report, said in a statement. “Unfortunately, very few of the 800-plus communities we evaluated are taking advantage of this valuable tool for encouraging water-efficient growth.”

GOVERNING.COM

BY ELIZABETH DAIGNEAU | AUGUST 12, 2015

Kansas $1 Billion Bond Sale Bolsters Pensions Eyeing Hedge Funds.

Kansas Governor Sam Brownback is borrowing $1 billion to let it ride in financial markets as U.S. stocks hold close to record highs.

The state issued bonds Wednesday with a top yield of about 4.93 percent to inject cash into its underfunded workers’ retirement system. Officials expect to gain by plowing the money into stocks, bonds and hedge funds, anticipating that they can make more on the investments than the cost to borrow.

The tactic has been popular with states and cities, which have sold $105 billion of bonds to make up for years of failing to save enough for benefits promised to public employees, according to the Center for Retirement Research at Boston College. It can aid those that borrow ahead of a stock-market rally, or push them deeper in the hole if they're caught by a crash.

The ability to come out ahead "is a crapshoot a lot of times," said Michael Johnson, managing partner at Gurtin Fixed Income Management, which oversees $9.5 billion of munis in Solana Beach, California. "Longer-term, that tends to be true, but you can't tell for sure all the time. It's fairly easy for this to go the other way."

Brownback, a Republican, proposed the bond sale as a way to reduce annual pension contributions after the state's revenue declined because of tax cuts. Kansas struggled to balance budgets when the economy didn't grow fast enough to make up for the lost revenue.

Riskier Strategy

Moody's Investors Service and Standard & Poor's both cut Kansas's credit rating last year because of the budget shortfalls. By 2013, its retirement system was the fifth-worst-funded among states, with about 56 percent of the assets needed to cover the pension checks due as workers retire, according to data compiled by Bloomberg.

The bonds will ease pressure on the budget but do little to fix the retirement system, Moody's said in a report Monday.

While the borrowing is part of a plan to fully fund the pensions by 2033, "adding $1 billion of debt to do it represents a riskier strategy than the simpler alternative of making larger annual pension contributions," the credit-rating company said.

Melika Willoughby, a spokeswoman for Brownback, didn't return a voicemail or e-mail seeking comment.

Returns Slide

Kansas's sale comes as the investment earnings of state and local pensions slipped to 3.4 percent during the year ended in June, the worst performance since 2012, according to Wilshire Associates Inc. The funds expect to make about twice that to keep up with their obligations.

State lawmakers stipulated that the taxable bonds can only be sold if the interest rate is 5 percent or less. The 30-year debt, the longest-maturity securities, priced to yield 4.927 percent, data compiled by Bloomberg show.

With the Standard & Poor's 500 Index close to the record reached in May, the Kansas Public Employees Retirement System wants to pare its domestic-equity holdings and put more into hedge funds, state Treasurer Ron Estes said.

Hedge Funds

"We are looking at hedge funds more as something to add to the mix," said Estes, who is on the pension's board of trustees. "We just have to continue making good investment choices. If we beat 5 percent, we're better off than we were."

As of June 30, 2014, the plans allocated 2.9 percent to alternatives like private-equity funds, including those from Apollo Global Management, Pine Brook Capital Partners and Warburg Pincus, according to the pension's annual report.

Over the past 10 years, alternatives have gained 13.2 percent for the Kansas pension plan, beating all other assets. The system assumes 8 percent annual returns.

With bond proceeds, the 281,000-member retirement system will have 73 percent of assets needed to meet projected obligations by 2020, rather than 66 percent, according to estimates in offering documents.

Some governments that have borrowed for their pensions haven't reaped benefits. Those that did so at the end of the 1990s technology bubble and before the 2007 stock-market peak paid more to borrow than they made, according to a study last year by the Center for Retirement Research.

Kansas has fared better. It issued $500 million of pension bonds in 2004 with a top yield of 5.5 percent.

While those securities looked like a losing bet after the credit-market crisis caused stocks to plummet, the state appears to have come out ahead as markets rebounded, according to the center's study.

"I'd rather my local government not bet on the direction of the stock market," said Hugh McGuirk, Baltimore-based head of municipal investments at T. Rowe Price Group Inc., which oversees $22 billion of local debt.
"It's a way to delay facing up to some of the difficult decisions they're going to have to make, and it might put them even deeper in the hole."

Bloomberg

by Brian Chappatta

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Want a Bike Path? Pay for It Yourself.

Crowdfunding is one way to get a local project done. But wait a minute—what do you pay taxes for?

Your friends ask you to fund their marathon training, their home renovations, even their potato salad. Why not crowdfund something you'd actually use, such as a bike path or a public park?

That's what a growing number of startups are helping people do, as communities with a goal look for sources of financing outside the municipal bond market.

"More and more, people are seeing this as a great alternative avenue … to going through your tax dollars or local public servant," says Slava Rubin, the chief executive officer of Indiegogo, a crowdfunding platform. Rubin says he started seeing public works projects on the site in 2011, with campaigns funding such small-scale infrastructure projects as a $1,000 dog park in Chicago, and that he expects interest only to increase.

"Government is a very slow-moving industry, and it's quite bureaucratic. … Indiegogo, and anybody who creates a campaign, is able to move much more nimbly," Rubin says.

The pickup in crowdfunded infrastructure projects comes at a time of waning city budgets and interest in funding projects, says Erin Barnes, a founder of Ioby, a startup that helps neighborhood residents kick-start public works development. Brooklyn-based Ioby has helped individual contributors fund about $2 million in projects, such as bike lanes, gardens, and park landscaping.

Taking on the Muni Market

Federal and state governments are spending less on public works projects than in recent years, despite historically low interest rates, with transportation and water infrastructure spending in the U.S. declining about 9 percent from 2003 to 2014, according to a Congressional Budget Office report. Tracy Gordon, a senior fellow at the Urban Institute's State & Local Finance Initiative, says public-private partnerships are starting to fill the void.

"What I hear a lot is that debt is a four-letter word," she says. "There's a strong anti-debt, anti-tax sentiment out there. Politicians are very concerned that voters won't approve a municipality selling bonds … to fund a project." When municipalities do sell or refinance bonds, it's more likely to pay for a large-scale project with a lot of community visibility, such as a school or a stadium. Crowdsourcing allows communities to target projects with smaller price tags that might otherwise get overlooked.

"They might not rise to the top in some other government processes in financing public projects," Barnes says of the kinds of projects funded on Ioby's platform. "When neighbors fund something in their community, it sends a signal [to city organizations] that there is significant buy-in."

The Downtown Denver Partnership used Ioby to raise $36,085 for a protected bike lane expected to open this fall, says Aylene McCallum, the director of the partnership's downtown environment division. She says the project garnered significant interest and the selection, design, and construction of the project will take one year compared with three or four years for other buffered or protected bike lanes in the area.

Critics of the project say the city should have funded the project with the tax dollars residents are already paying for such projects, McCallum says. "It was important to explain that we didn't see this as an ongoing funding approach to fund infrastructure," she says. "We saw it as an opportunity to kick-start, if you will, a specific project in downtown Denver to demonstrate to the city that there was broad support for it."

The Urban Institute's Gordon points to another potential problem with the model. "A lot of the things we've talked about seem like amenities for affluent areas," she says. "You have to wonder about that desperately needed capital improvement across town, where perhaps the neighbors aren't as well mobilized."

How the Golden Gate Bridge Got There

Many community-interest projects are still funded by traditional sources. When they are, startups such as Neighborly are helping individuals play a role. The company, which says on its website it is "democratizing the $3.8T municipal securities market," aims to allow users to buy portions of a municipal bond rather than the whole thing.

"Most people don't think to go, 'Hey, I'm going to go buy a municipal bond,'" says Jase Wilson, the chief executive officer of Neighborly. "It's about breaking down the minimum denomination on one side so there's more of a democratic access. It's about demystifying it."

Wilson says Neighborly seeks to sell municipal securities through its registered broker-dealer and tries to make it easy for investors to understand where their money is going. He says he hopes the company will help rekindle local involvement in the municipal market, which once created such projects as the Golden Gate Bridge. At the moment, the bond market that millennials' grandparents invested in is gone, he says.

“They would go buy bonds in their own community for a project they support,” Wilson says. “They would put [the bond certificate] under their bed and clip the coupon, and they would just get some ice cream. It was super local, super hands on, super regenerative.”

Mitchell Moss, an urban planning professor at New York University, says crowdfunding municipal bonds would be a breakthrough for issuers, underwriters, and investors.

“It’s a terrific way to access capital very inexpensively,” Moss says. “We could have a revolution in the municipal bond market by making it as easy to use as an ATM.”

The Shakeout

Jouko Ahvenainen, the executive chairman of Grow VC Group, which works on crowdfunding investment models, says bringing municipal bonds to digital investing services will make the market more efficient. Still, Ahvenainen says, the market is fragmented, and it’s too early to tell how the nascent sector will shake out.

“There will be consolidation and companies with models that disappear,” says Ahvenainen, whose company works on crowd-based investment models.

It will depend on how well technology can get investors to provide the capital the issuer needs, says Thomas Doe, the president of the research firm Municipal Market Analytics. Although the impact of companies such as Neighborly won’t be seen until more deals are done, the tax-exempt status of municipal bonds is piquing investors’ interest, he says.

“People are intrigued. They’re engaged by the passion and excitement displayed by a couple of these firms,” he says. “It may happen in smaller communities first.”

Gordon, of the Urban Institute, says increased access to household investors doesn’t necessarily mean governments will start issuing more debt.

“It doesn’t replace large-scale infrastructure projects or maintenance,” she says. “I don’t see these firms displacing governments.”

Bloomberg

by Amanda Albright

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[Making U.S. Pensions Honest About Returns Means Bigger Deficits.]

Oregon taxpayers and retired public employees will have to dig a little deeper to pay for the state pension’s decision to be more honest about investment returns.

The Oregon Public Employee Retirement System on July 31 reduced its forecast for how much it expects to earn next year to 7.5 percent from 7.75 percent, increasing the hole to be filled by taxpayers and state workers by $1.7 billion to $73.4 billion, according to state data.

States and cities have been shortchanging pensions for decades, as high return assumptions lowered the amount of tax money needed each year to finance the plans. The funds, already $1.4 trillion short, according to the Federal Reserve, face scrutiny for too-optimistic assumptions as markets have become more volatile since the 2008 global financial crisis.

An “assumed rate of return” is used to predict how much a pension has set aside to pay retirees. Too high a rate leads to a false impression of a pension’s ability to pay. The average assumed return in the U.S. is 7.68 percent, according to the National Association of State Retirement Administrators.

“The use of such high assumptions is deceptive because it keeps the funded level looking higher than it should be,” said David Crane, public policy lecturer at Stanford University who worked as an adviser to former California Governor Arnold Schwarzenegger. “Too high a return is dishonest.”

Decades Old

State worker pensions from New York to California are considering or have cut targets. Since 2008 more than half the 126 pensions tracked by the retirement administrators’ association have cut assumptions at least once.

Pensions projection returns are based on estimates in place since the 1980s, said Matthew Smith, state actuary for Washington, who has been working with lawmakers to gradually lower the assumed rate of return from 8 percent to 7.8 percent and more in coming years. The rate of inflation has slowed and fixed-income yields have hovered near record lows since the Fed began providing unprecedented monetary stimulus during the recession that ended in 2009. Public pensions earned 3.4 percent during the past year, the weakest since 2012.

“Conditions that led to large market returns in the 1980s and 1990s no longer exist,” said Smith. “It is not reasonable to look at 30 or 40 years of returns and assume they will continue.”

Biggest Funds

The California Public Employees’ Retirement System and New York State Common Retirement Fund, two of the largest public pensions in the U.S., are considering whether to cut forecasts for returns. Texas Municipal Retirement System cut its forecast to 6.75 percent from 7 percent in July.

Calpers, at $300 billion the largest public pension in the U.S., reported in July that it earned 2.4 percent in its last fiscal year, less than one-third its 7.5 percent target. The fund’s board may consider slowly cutting its rate to 6.5 percent as part of a plan to reduce risk, according to fund documents.

The expected rate doesn’t affect how much is owed to retirees, and missing a target one year doesn’t mean a pension won’t be able to pay benefits, but consistently performing worse than expected increases funding pressure. That adds to stress of governments that recently saw tax revenue restored to levels not seen since before the recession.

“A lower rate of return can force issuers to face up to their funding commitments,” said Tom Aaron, vice president with Moody’s Investors Service.

Contribution Adjustment

Governments that fail to meet assumed returns face a rising unfunded liability unless they make up the difference with higher contributions or reduced benefits.

That can put pressure on other budget items, such as debt services. Pensioners fared better than bondholders in Detroit's 2013 bankruptcy.

"Lower return assumptions mean the issuer has to put more cash into the pension, to the detriment of other expenditures, like debt service," said Matt Fabian, partner at Concord, Massachusetts-based Municipal Market Analytics, a municipal bond research firm.

Dallas's fire and police pension saw its shortfall more than triple to $4.7 billion, Moody's said in July after the city cut its estimate, putting the pension in a position of needing more money.

"Pensions will have to line up for money for debt and operations when you cut estimated returns," said Richard Ciccarone, president and chief executive officer of Chicago-based municipal finance analysts Merritt Research Services.

Bloomberg

by Darrell Preston

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Berkshire's Negative S&P Watch Hits Almost 1,000 Muni Bonds.

Municipal bonds from California to Puerto Rico may lose their second-best credit rating from Standard & Poor's after the company put Berkshire Hathaway Inc. and its core insurance units on a negative watch.

Berkshire Hathaway Assurance Corp. had the outlook on its AA+ rating cut Tuesday, and S&P began dropping its view of the 966 muni securities the insurer backs on Wednesday, according to data compiled by Bloomberg. Berkshire Chairman Warren Buffett got into the muni-bond insurance business in 2008, after the subprime mortgage market began to implode.

Bond insurance has been thrust into the spotlight in the $3.6 trillion municipal market as Puerto Rico's fiscal crisis worsens. Berkshire, for its part, backs just 15 commonwealth securities, and as a secondary guarantor, meaning Buffett is on the hook only if the primary insurer can't pay, data compiled by Bloomberg show.

Berkshire's muni-bond unit has mostly shunned the market since 2009, when Buffett warned about swelling local pension liabilities and compared backing states and cities to insuring natural catastrophes.

"In both cases, a string of loss-free years can be followed by a devastating experience that more than wipes out all earlier profits," Buffett wrote in a letter as part of the 2008 annual report. "We will try, therefore, to proceed carefully in this business, eschewing many classes of bonds that other monolines regularly embrace."

Insurance Offer

In the same letter, Buffett said Berkshire offered to take over insuring the $822 billion of bonds backed by the three largest guarantors, but was turned down. About three-fourths of its secondary-market business instead came by standing behind bonds that were already insured.

Other issuers that have outstanding bonds with a layer of insurance in addition to Berkshire include California, Chicago, Detroit's water system and New Jersey's transportation trust fund authority, data compiled by Bloomberg show.

Berkshire's muni unit is one of the insurers on some debt from Puerto Rico's electric power authority, highway agency and infrastructure financing borrower, Bloomberg data show. It also backs sales-tax bonds, known as Cofina. Some of the securities it guarantees traded this week at 118 cents on the dollar.

Buffett's parent company was put on CreditWatch Negative because of uncertainty around how it will fund its acquisition of Precision Castparts Corp. for about $37.2 billion, S&P said Tuesday in a report.

Omaha, Nebraska-based Berkshire "is likely to use some of the capital resources available at its insurance companies," the credit rater said.

Berkshire Hathaway Assurance's AA+ rating is the highest of any bond insurer, with units of Assured Guaranty Ltd. and Build America Mutual Assurance Co. ranked one step lower.

Bloomberg

by Brian Chappatta

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Bloomberg Brief Weekly Video - 08/13/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Kate Smith about this week's municipal market news.

Watch the video.

August 13, 2015

Moody's: Detroit's Income Tax Revenue Bonds Offer Better Credit Quality than City's GO Pledge.

New York, August 12, 2015 — The City of Detroit's (B2 positive) $245 million in income tax revenue bonds will be publicly reoffered by Barclays and now include structural enhancements that make them stronger than the city's general obligation rating, but are not guaranteed to eliminate bondholder risk in any future economic downturn or bankruptcy, Moody's Investors Service says in "Detroit's New Income Tax Revenue Bonds Provide Greater Credit Protection Than the City's General Obligation."

The income tax revenue bonds are not rated by Moody's, but we believe the bonds would be rated in the low Baa to high Ba range. This is due to the meaningful, but untested, bondholder protection and Detroit's ongoing fiscal and credit challenges.

“Default risk with these income tax bonds is much lower than the city’s general obligation debt, which carries no special statutory protections and was significantly impaired during the city’s recent bankruptcy,” author of the report and Moody’s VP — Senior Credit Officer Hetty Chang says.

However, Moody’s says no guarantee can be made that pledged revenue would not be subject to an automatic stay during bankruptcy proceedings, which raises the possibility of technical or payment default in that scenario.

The income tax bonds share some of the same protection qualities as the city’s distributable state aid (DSA) bonds. The state makes DSA payments directly to the DSA bond trustee, who is responsible for allocating funds for debt servicing. The DSA bonds were not included in Detroit’s recent Chapter 9 proceedings. But Moody’s notes there are differences in bondholder securities between these bonds.

“We perceive greater security for DSA bondholders because distributable state aid is a state revenue appropriated for local government purposes. The state levies and collects sales tax revenue and has issued bonds for Detroit secured by a lien on that revenue. The DSA’s higher degree of state control protects bondholders and warrants the higher rating,” Chang says.

Moody’s also says Detroit’s credit quality continues to be weighed by persistent economic challenges, which directly impact income tax collections. Recent improvements in income tax collections have not recovered to historical levels. Employment remains below pre-recession levels, and population is not rebounding.

Although the risk of default or bankruptcy has lessened for Detroit, the potential for another economic downturn continues to be reflected in the B2 issuer rating. Another recession would elevate financial pressure on the city.

The report is available to Moody’s subscribers here.

Fitch: Pension Obligation Bonds Won't Fix U.S. Public Pensions.

Fitch Ratings-New York-13 August 2015: Pension obligation bonds (POBs) will not correct unsustainable benefit and contribution practices and are not a form of pension reform, Fitch Ratings says. Issuing POBs is neutral for some governments’ credit quality and negative for others. In our view, credit quality is tied to whether governments implement reforms to make their underlying pension obligations sustainable over time.

The Kansas Development Finance Authority’s $1 billion POB issuance this week is the latest issuance of a financing tool often considered by governments with low pension funded ratios. The underlying question is whether they are sustainable without additional reforms to benefits and funding practices.

In the optimal scenario, POBs put cash into a troubled pension system, increasing its potential investment returns (at the assumed discount rate) and decreasing the size of annual contributions. However, this is typically neutral for credit quality because the decline in pension contributions is generally offset by higher debt service and the unfunded pension liability is replaced by bonded debt. At worst, governments using POB proceeds to cover annual contributions that normally would be paid by annual budgetary resources are engaging in deficit financing and creating a higher annual fixed-cost burden and higher liabilities. This is typically negative for credit quality. In all cases, POBs raise timing and investment risks as they are betting that investment returns will exceed the cost of debt service.

According to Thomson Reuters, governments sold $670 million of POBs in the first half of the year, compared with $300 million in all of 2014. The growth of these bonds was motivated by the increase in unfunded pension liabilities, which rose sharply since the significant market losses of 2008-2009.

However, those market losses are not the only cause of weakened pensions. The majority of plans lowered benefits and/or raised contributions in response. Fitch expects slow improvements in funded ratios for most plans as reduced benefits usually apply only to new workers and stronger contribution practices accrue in the form of larger pension investment portfolios. A handful of governments have been unwilling or slow to change benefits or to correct historically inadequate contribution practices that now require much higher contributions. For those pension plans, any gains from issuing POBs will be temporary in the absence of more fundamental reforms.

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The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article, which may include hyperlinks to companies and current ratings, can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.

The Risk in Appropriation Bonds.

Not all municipal bonds are created equal. That principle was reinforced this past week, when Puerto Rico failed to fully pay principal and interest on what market participants call “appropriation bonds.”

This type of bond is repaid only if a state legislature or city council earmarks, or appropriates, payments in the budget. Thus, it lacks the stronger legal protections of other municipal bonds. The missed payment occurred after Puerto Rico’s legislature failed to set aside the money.

In the wake of the drama, some investors say they will think twice before buying this form of debt, which is commonly sold by municipalities on the U.S. mainland, too. The bonds are enticing to some public officials because they can be sold without voter approvals needed for other debt. New Jersey, for example, has $30 billion of these securities outstanding, according to Moody’s Investors Service.

“We don’t see the bonds as offering proper compensation in terms of yield, relative to other options in the market,” says Bill Bonawitz, director of municipal research at PNC Capital Advisors, which oversees $6.5 billion in munis and has generally been avoiding appropriation bonds. “You may be at greater risk than you realize.”

Not all Puerto Rico bondholders are getting stiffed. On July 1, Puerto Rico paid in full what was due on its general-obligation bonds. These bonds, which make up much of the $3.7 trillion muni bond market, are considered to be backed by a municipality’s “full faith and credit” pledge—a promise to pay investors with available revenues, and potentially raise taxes or cut expenditures if there’s a shortfall.

Appropriation bonds do not carry the same pledge. In a prospectus for the Puerto Rico bonds, sold by the Puerto Rico Public Finance Corp., investors were warned in boldface type that the legislature is “not legally bound to appropriate” enough money to pay bondholders.

For individuals buying bonds on their own, highly rated general-obligation bonds are the way to go, says Michael Johnson, head of research at Gurtin Fixed Income Management, which oversees $9.5 billion. He also suggests paper tied to essential services, such as water and sewer systems, which have dependable revenue streams, regardless of economic conditions. “That gives you less things to worry about,” he observes.

Johnson says his firm is comfortable buying appropriation bonds, but that it consistently reviews municipalities for signs of trouble. The bonds can still have some advantages. They can be used to finance new fire stations, city halls, or other important assets that a municipality could lose if it defaulted. In those situations, keeping current on payments might be a top priority for municipal officials, making a default less likely.

However, Puerto Rico’s governor has said the island’s debt is unaffordable, and it remains to be seen whether its general-obligation bonds also suffer losses.

THERE’S TROUBLE WITH appropriation bonds outside Puerto Rico, too.

Take the Metropolitan Pier and Exposition Authority in Illinois, which sold bonds to finance improvements to Chicago convention center McCormick Place. It said this past week that it couldn’t make its monthly deposit to the bond trustee for a coming debt payment. Illinois, which is facing fiscal challenges of its own, hadn’t passed a budget for the fiscal year, so lawmakers never made the appropriation to allow the authority to make the deposit.

It’s still unlikely the authority will default on actual payments to investors. Lawmakers have time to pass a budget before principal and interest is due in December. The bonds are backed by various taxes, including state sales levies, and there’s enough money in the bank for the monthly deposit. But the situation prompted Standard & Poor’s Ratings Services to slap the bonds with a massive downgrade, from triple-A to triple-B-plus, a move that could hurt the bonds’ market value.

BARRON’S

By MIKE CHERNEY

Aug. 8, 2015 1:41 a.m. ET

MSRB: Muni Trading Up 14%, Puerto Rico Bonds Among Most Traded.

WASHINGTON — Trading activity in the municipal market for the second quarter of this year was 14% higher than the previous quarter as well as the second quarter last year, with several Puerto Rico bonds among the most traded, according to the Municipal Securities Rulemaking Board.

These were among the MSRB's findings in its muni market statistics report for the second quarter of 2015, which was released Wednesday.

The MSRB said there were 2.56 million trades from April through June of this year, up 14% from 2.24 million the year before. The last time trading was that high was in the fourth quarter of 2013, when there were about 2.58 million trades.

The total par amount traded in the muni market also rose in the second quarter to $742 billion compared to $739 billion in the second quarter last year. Fixed-rate securities made up 58% of the $742 billion traded and general obligation bonds issued by the Commonwealth of Puerto Rico in 2014 topped the fixed rate list as the highest traded by par amount. These bonds were the third most traded by par amount overall.

Matt Fabian, managing director at Municipal Market Analytics, said those Puerto Rico bonds "were built to be well traded" by having characteristics like one large term and limited call abilities.

"I would have been surprised if they weren't at the top of the list," Fabian said. He added Puerto Rico bonds shifted from long-term to short-term investors as the bonds got riskier and that the consistent "heavy trading" in the bonds drew hedge funds interested in making money with the liquid holdings.

Michael Decker, managing director and co-head of municipal securities at the Securities Industry and Financial Markets Association, said the GO bonds may have been trading more actively because they are seen as less risky than bonds from Puerto Rico's public corporations.

In total, seven bonds from the troubled commonwealth and its authorities made the MSRB's lists of the Top 50 traded bonds based on par amount and number of trades. The bonds included three issues of COFINA revenue bonds reliant on sales tax collections for repayment, as well as general obligation bonds and taxable Government Development Bank bonds.

The MSRB quarterly data also showed that on the consumer level, buying increased to an average daily par amount of $5.97 billion in the second quarter, compared to $5.81 billion a year before, and total consumer purchases were up to an average of 17,009 per day compared to 15,327 the previous year.

The number of variable-rate demand obligation rate resets grew to 135,556 from the first quarter's 133,989, but 2015 data still shows a continuing decline in VRDO rate resets from previous years, the MSRB said.

The self-regulator also received fewer continuing disclosure documents in the second quarter than the year before, with 42,543 in 2015 compared to 43,667 in 2014's second quarter. Twenty-five percent of all the disclosures were bond call notices, the MSRB said.

THE BOND BUYER

BY JACK CASEY

AUG 5, 2015 4:05pm ET

Japanese Investors May Add U.S. Munis to Portfolios.

Japanese investors are about to acquire a taste for U.S. municipal bonds, some U.S.-based money managers contend.

Executives with managers such as Neuberger Berman LLC, Eaton Vance (EV) Management (EV) and Invesco (IVZ) Ltd. say the size, safety and diversification benefits of the $4.4 trillion muni market are poised to win that segment of the fixed-income universe a chunk of the Japanese money that's been flowing into U.S. investment-grade corporates in recent years.

Gatekeepers are skeptical.

That prediction says more about the dreams of money managers than the needs of clients such as Japanese pension funds, said Taro Ogai, Tokyo-based managing director of investment consulting giant Towers Watson & Co.'s business in Japan. "I've never heard of a Japanese pension fund who is interested in U.S. muni bonds," he said.

Some pension clients not overly concerned about eventual rate increases could be attracted to munis because of their relative stability in "flight-to-quality" situations, but they should prove to be the exception rather than the rule, said Konosuke Kita, Tokyo-based director, consulting, with Russell Investments.

Meanwhile, a number of executives of corporate defined benefit plans in Japan said they are looking now to invest in multiasset or unconstrained bond strategies, not munis.

But one pension executive conceded that a lack of familiarity may be at issue, saying he's never considered U.S municipal bonds because "I don't have enough knowledge and information" about that market.

Managers with muni bond businesses such as Neuberger, Eaton Vance and Invesco, say they're working now to address that learning curve, confident that for Japanese investors, to know munis will be to love them.

A confluence of circumstances is setting the stage for potential demand from Japanese investors, said Cynthia Clemson, co-director of municipal investments with Boston-based Eaton Vance Management, in an Aug. 4 interview. Rock-bottom yields for domestic bonds in Japan have pushed investors into U.S. credits, which carry risks that U.S. munis can effectively diversify, she said.

With the 10-year Japanese government bond offering an annual yield of roughly 40 basis points, munis can provide an attractive pickup for Japanese investors even without the tax advantages that endear those bonds to U.S. retail and high-net-worth investors, managers said.

An investment consultant from Mercer's Tokyo office, who declined to be named, said over the past year munis have garnered more attention from institutional and retail investors alike in Japan as a fresh and sizable market following years of considerable allocations to other "spread" instruments, including high grade U.S. corporate and high yield bonds.

Japanese investors have focused on U.S. high-grade corporate bonds in their moves out of domestic bonds, which should magnify the diversification benefits offered by munis, said Ryo Ohira, managing director and head of Neuberger Berman's Tokyo business.

About 10 months ago, Neuberger began including munis in its discussions with clients about credit as a source of "good diversification" for high grade corporates, high yield bonds, bank loans and private debt, he said.

The yield for high grade, AA paper with duration of 5 to 6 years is roughly the same for U.S. corporates and munis at about 2.5%, but cash flows for the latter are steadier than the cyclical flows of the former, said Mr. Ohira. Meanwhile, different investor bases make munis more resilient in times of volatility – like the global financial crisis of 2008, where their drawdown was less than half that of investment-grade corporates, he said.

With "extremely low" default rates compared with corporates, munis allow investors with heavy exposure to high-grade U.S. corporates to diversify their credit risk, agreed Craig Brandon, Ms. Clemson's co-director of municipal investments at Eaton Vance.

However, defaults by Puerto Rico this month and by Detroit in 2013 may cloud that selling point.

In an e-mail, a credit officer at a large Japanese institutional investor, who declined to be identified, said default rates historically lower than those of U.S. corporate bonds make U.S. municipal bonds a market segment Japanese institutional investors can consider to diversify their credit risk, but Puerto Rico's recent default could prove a hurdle to doing so for now.

Managers concede the recent headline risk but say those high-profile defaults shouldn't undermine the long-term story of relative safety.

While munis remain unfamiliar ground for many Japanese pension funds, compared to multisector and unconstrained bond strategies, that could be set to change, predicted Mr. Ohira.

For example, Neuberger Berman hosted a seminar in Tokyo on munis last month attended by 160 executives from pension funds and intermediaries, and the arguments the firm's executives made regarding diversification struck a chord, he said.

Some pension fund clients already are dipping their toes in the muni waters, but it's still early days, said Mr. Ohira. He declined to name the firm's clients.

Robert White, Singapore-based president of Eaton Vance Management International (Asia) Pte. Ltd., said he's likewise seeing signs of growing interest in munis now in the number of appointments Tokyo-based gatekeepers for institutional and retail clients are making with his team.

As a high-grade, safe asset class, munis are getting the most attention now from banks with considerable holdings of Japanese government bonds and U.S. treasuries on their balance sheets, although intermediaries are also beginning to show interest, said Mr. Ohira. Pension funds could follow, especially as the prospect of rate hikes in the U.S. focuses attention on the resulting capital losses on sovereign bonds, he said.

In an e-mail, Alex Sato, Tokyo-based CEO of Invesco Japan, said his firm has been pitching munis for more than a year now, with retail investors responding more aggressively than institutional investors thus far.

More institutional clients are looking into it now as well, led by financial institutions, said Mr. Sato.

“It’s the regional banks showing interest right now,” with distributors anticipating retail investors and pension funds will follow, agreed Eaton Vance’s Mr. White. That, meanwhile, was the “growth trajectory” for bank loans, another asset segment embraced by a growing number of pension funds in Japan in recent years, he noted.

PENSIONS & INVESTMENTS

BY DOUGLAS APPELL | AUGUST 10, 2015

— Contact Douglas Appell at dappell@pionline.com | @Appell_PI
REPRINTS PRINT

U.S. Municipal Bond Insurers Set to Withstand Puerto Rico Default.

U.S. municipal bond insurers will likely weather any potential losses as a result of Puerto Rico’s debt crisis but a downgrade to their ratings or a loss of investor confidence longer-term could pose a serious challenge to their post-crisis recovery.

Bond insurers insure about $13 billion of Puerto Rico’s $72 billion debt load, substantially more than they did in Detroit which centered on a few hundred million dollars of city debt, meaning that losses for the insurers could be much higher.

“We’re monitoring it closely because we don’t know what any type of settlement or restructuring will be,” said David Veno, who analyzes bond insurers for Standard & Poor’s.

Bond insurers such as MBIA and Assured Guaranty were hit during the financial crisis after they ventured into mortgage-backed securities in the years before 2007. Ratings agencies slashed their AAA ratings to junk or withdrew them altogether. That meant bond issuers no longer benefited from their coverage.

Bond insurers essentially lend their rating to municipalities who use insurance to lower their borrowing costs.

For example, Puerto Rico’s insured bonds are trading at hefty premiums compared to uninsured bonds. Insured debt of the Puerto Rico power authority, which is currently in restructuring talks with creditors, recently sold for around 96 cents on the dollar, while uninsured debt is selling for around 54 cents.

Before the crisis, around half of all new municipal bonds had insurance from nine insurers, with nearly 60 percent covered in 2005. By 2012, that had fallen to just 3.6 percent, although it has climbed steadily to 6.6 percent in the first quarter of this year, Thomson Reuters data shows.

Although insurers have slowly recovered since then, Puerto Rico could be their first major test in terms of losses.

Puerto Rico’s Governor Alejandro Garcia Padilla said in June that the U.S. Territory could not afford to pay its debts, adding that all Puerto Rico’s bonds were now negotiable. That shocked many investors who believed the problem was contained in Puerto Rico’s public corporations.

Puerto Rico actually defaulted on Aug. 1 by paying only a fraction of what was due on its Public

Finance Corp (PFC) bonds. None of those bonds were insured,

Crucially, S&P's Veno reaffirmed the ratings on Puerto Rico's two biggest insurers, MBIA – through its National Public Finance Guarantee subsidiary – and Assured Guaranty, after the governor's comments. But a downgrade in response to bigger-than-expected losses could limit their ability to get new business from municipalities that borrow based on their credit ratings.

Key to the health of the insurers will be whether they can maintain the momentum in writing new business or whether bond investors can go without insurance or diversify into firms with little or no Puerto Rico exposure such as Build America Mutual (BAM).

Many stock investors have not stuck around to find out. Shares in both MBIA and Assured plummeted after the governor's statement. MBIA's shares fell to their lowest level since 2010 although they have since recovered some of their losses.

Both companies said in statements they can handle pessimistic scenarios in Puerto Rico. MBIA pointed to the "extremely strong" capital position of its National Public Finance Guarantee subsidiary. Assured said it had the "resources and loss mitigation expertise" to handle its exposure to Puerto Rico.

Assured has $4.9 billion of net exposure to Puerto Rico and $12 billion in claims paying resources. It also generates $400 million from its investments portfolio. Given that municipal claims are paid out over the life of the bond and not all at once means that it is more than adequately capitalized to honor any claims made by investors on Puerto Rico debt.

Assured says a 20 percent loss to the $773 million of power authority bonds it insures would result in annual claims of just $13 million. But losses could be substantially higher in the event of a wider and deeper default.

Assured is also rated 'AA' compared to MBIA's 'AA-', giving it an extra buffer in the event of a downgrade.

MBIA's gross exposure of $4.3 billion to Puerto Rico is lower than Assured' s but is closer to claims paying resources of $4.9 billion at its National Public Finance Guarantee Corp unit. However, MBIA said it has seen business volumes growing since Padilla's speech.

Its lower AA- rating also means a potential downgrade could have a more profound impact.

Still, muni bond investors continue to buy the insurers' products, seeing value in insurance even if they may be distinguishing between the firms.

"Bond insurance will surprise to the upside," said John Loffredo, a fund manager with MacKay Municipal Managers, who says the firm's retail clients have been asking for it more frequently since Puerto Rico hit the headlines in 2013.

Loffredo says 26 percent of the firms $13 billion in municipal bonds is insured. That number is as high as 35 percent in the firms $1.4 billion MainStay tax free fund, which Loffredo co-manages.

REUTERS

NEW YORK, AUGUST 5 | BY EDWARD KRUDY

(Reporting by Edward Krudy; Editing by Diane Craft)

S&P's Public Finance Podcast: (Rating Trends, Atlantic City, And Puerto Rico)

In this week's Extra Credit, Senior Directors Larry Witte and Dave Hitchcock discuss rating trends over the past 30 years and our recent action regarding Puerto Rico's bond payment default, respectively, and Associate Tim Little explains our rating action on Atlantic City.

Listen to the podcast.

August 7, 2015

S&P: The U.S. EPA Finalizes Its Clean Power Plan, But Questions Still Remain.

The cornerstone of the Obama Administration's environmental program was in the news again on Aug. 3, 2015, when the U.S. Environmental Protection Agency (EPA) issued its final Clean Power Plan rules for reducing power plants' carbon emissions. The final rules add several meaningful modifications to the EPA's June 2014 proposal. Some of the revisions add to the proposed rule's stringencies, such as moderately increasing emissions reduction targets to a 32% emissions reduction by 2030 compared to the 2014 proposal's 30%. Other revisions modestly relax the implementation timelines by a year or two (see table 1). The extensions address some of the concerns cited in the more than four million comments submitted to the EPA in an effort to allay certain concerns surrounding reliability and feasibility, but it also prompts some new questions, and will almost certainly face a high level of scrutiny and, potentially, judicial challenges.

Continue reading.

06-Aug-2015

After a Few Years Afloat, Pension Plans Start Sinking Again.

Public pension plans across the country are missing their annual investment targets by wide margins this year, a trend that could put continued pressure on their governance and benefits.

In fiscal year 2015, which ended June 30, no plan so far has hit its annual return assumption, and major plans are reporting returns as low as 2 percent — well below the annual average target between 7 and 8 percent.

But what's shaping up to be a poor year for pension plans could provide ammunition to those who want to change them. That's because last year, new accounting changes took effect that now take investment returns into account when calculating pension plans' funded status. In fiscal 2014, stocks and bonds soared and many pension plans reported big improvements in their funded ratios. But with low returns this year, some plans could look less healthy than they did a year ago. Plans will publish their new funded status in their annual financial reports, which come out later this year.

"This is going to further call attention to the fragility of these underfunded [plans]," said Peter Kiernan, a public finance lawyer at Schiff Hardin. "States and cities are saying they're restoring their plans to health and that they've made it through the Great Recession [but] they're being proven wrong."

The nation's two largest public pension plans — the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System — reported annual returns of 2.4 percent and 4.8 percent, respectively. The funds, which combine for nearly $500 billion in assets, have a target annual investment return of 7.5 percent.

Other major state plans are reporting similarly low returns: the Maryland State Retirement and Pension System earned 2.7 percent, the Virginia Retirement System earned 4.6 percent and the Rhode Island State Employees' Retirement plan earned 2.2 percent. New Jersey will likely miss its mark too as the state employee plan has so far earned 4.6 percent on its investments through the first 11 months of its fiscal year. The state plans' targets range from 7 percent in Virginia to 7.9 percent in New Jersey.

At the municipal level, Philadelphia's public employees plan appears headed for an abysmal year as results through February show a mere 0.5 percent return; Los Angeles' investment return for fiscal 2015 was 2.8 percent; and in New York City, four of the five plans posted an investment return of less than 5 percent with one month to go in the fiscal year, while the city's police plan earned 5.4 percent over the same time period.

The poor performance comes after two years of double-digit returns for many plans. Most plans attribute the slump this year to turmoil in the international market, primarily caused by the financial crisis in Greece. Global stocks and bonds, which account for a significant portion of pension plan portfolios, took a big hit this year. In Maryland and Rhode Island for example, global and international equities are about one-quarter of plan investments.

Another big culprit is the bond market with its continued low interest rates, said Keith Brainard, director of research at the National Association of State Retirement Administrators. Indeed, mutual funds indexed to the bond market returned less than 2 percent this past year. Fixed-income bonds tend to account for a smaller percentage of plan assets compared with global equities, but together, these two poorly performing assets can account for around 40 percent of plan portfolios.

Still, one poor year is no indication that pension plan returns will start sinking into the red like they did in 2008 and 2009 after the stock market crash. Many plans also had a poor year in 2012 only to be followed by double-digit returns again.

"As we say with regard to investment returns," said Brainard, "it's a marathon, not a sprint. One year of returns is less important than the longer term trends."

Some plans also released their three- and five-year investment return averages, and even with 2015's low numbers, they're well above the 7 to 8 percent needed for long-term stability because they include the stock market rebound. CalPERS, for example, earned 10.7 percent over each of the last five years. But plans did not release information on their new 10-year average investment return, which would include the stock market crash in 2008-2009. Using last year's information, which doesn't incorporate 2015's low returns, the 10-year investment return average for many of these plans was around 7 or 8 percent.

Even so, politicians and other stakeholders seeking cuts in pension benefits will likely use the bad year for plans to argue their case. In California, ex-San Jose Mayor Chuck Reed is pushing for a ballot initiative that would amend the state's constitution to let localities make changes to their pension benefits for existing workers. And in New Jersey, Republican presidential candidate and

Gov. Chris Christie has underfunded his pension system and wants to reduce the state's financial commitments to retirees.

"Taxpayer advocacy groups will seize on this," said Kiernan. "Any sitting governor that has a problem like this could be affected."

GOVERNING.COM

BY LIZ FARMER | AUGUST 4, 2015

California Guards Muni Buyers From Bankruptcy With Dibs on Taxes.

San Diego Unified School District didn't think it was fair that rating companies cut its bond grades amid California's fiscal woes four years ago.

So school officials cultivated support among other California districts for legislation boosting protection for investors. Their efforts bore fruit last month, when Governor Jerry Brown signed into law a measure clarifying that tax revenue backs the general obligations of schools, cities and other local issuers. San Diego's system, the state's second-largest after Los Angeles, wants the step to boost its credit rank and lower debt costs.

While rating companies haven't acted on the law, investors have taken notice. The extra yield that buyers demand on some San Diego school debt has shrunk to the lowest in more than three months. Bonds of the Los Angeles Unified School District have also gained. Even though the issuers are solidly investment grade, bondholders welcome the added security after Detroit's record bankruptcy and as Puerto Rico moves toward a historic restructuring.

"It eliminates a lot of uncertainty in the market," said Frances Lewis, director of research in Princeton, New Jersey, at MacKay Municipal Managers, which oversees $13 billion.

Lien In

The law, which takes effect in January, specifies that voter-approved general obligations of school districts and municipalities are backed by a lien on property-tax revenue. While California statutes could be read as having that protection, it wasn't explicitly stated. This would "solidify" prioritizing holders of the bonds, Michael Zezas, chief municipal strategist at Morgan Stanley in New York, said in a July 27 research note.

General obligations from California issuers excluding the state total around $131 billion, according to data compiled by Bloomberg that includes the full value of zero-coupon bonds at maturity.

The San Diego district has about $2.3 billion of general obligations, according to bond documents. In 2011, amid talk of state funding cuts, Moody's and Standard & Poor's lowered the district one step. It's now graded Aa3 and AA-, fourth-highest, respectively.

The downgrade "wasn't warranted" since property-tax revenue goes directly to debt payments, said Jenny Salkeld, chief financial officer for the system, which educates about 132,000 students.

Holy Upheaval

School officials began a push to clarify protections for investors, which gained importance after

Detroit's 2013 bankruptcy upended a pledge once held sacrosanct: that communities would make good on debt backed by their full faith and credit.

Amid Detroit's debt negotiations, investors demanded higher yields on some securities from Michigan. Even in California, some districts saw annual interest rates rise as much as a percentage point, said James Spiotto, managing director in Chicago at Chapman Strategic Advisors LLC, which advises on financial restructuring.

For Mark Wuensch at Principal Global Investors, the new law provides limited comfort: It may not matter how secure investors' standing is when a community is struggling. Cash-strapped Puerto Rico temporarily halted monthly transfers into a fund that pays down $13 billion of general-obligation debt, it said in a regulatory filing late Monday.

"The ability to pay is a lot more important than what the law is," said Wuensch, senior fixed-income analyst in New York at Principal, which manages $4.8 billion in munis. "You can only tax people so much."

Ratings Shrug

Credit raters say they don't expect the law to result in many upgrades. It won't guarantee timely debt payments or prevent defaults for issuers in economic distress, the companies said.

The district's advisers said the companies have been too hasty. Mary Collins, a partner at Orrick, Herrington & Sutcliffe LLP, said she plans to explain the law's significance to analysts and that they should give it a "lot more credence."

For San Diego's schools, an upgrade to the top rank could save 0.20 percentage point, or as much as $30 million for the $525 million borrowings planned next year, said Mark Young, managing director at KNN Public Finance, which advises the district.

Bond Bounty

San Diego school obligations due in July 2029 traded July 27 at an average yield of about 3.2 percent, or 0.41 percentage point above benchmark munis, data compiled by Bloomberg show. That's the narrowest spread since their sale in April.

Los Angeles Unified general obligations due in July 2026 traded Tuesday with an average yield spread of 0.24 percentage point, below the 0.37 percentage point average since February. Moody's grades the district Aa2, third-highest.

A clear definition of investor protections has also benefited Detroit. The city garnered an investment grade from S&P for a bond sale planned for this month, its first since exiting court protection in December, partly because of a specified first-lien pledge on income-tax collections.

Michigan and Nebraska are also working on laws establishing a statutory lien on general obligations, Spiotto said.

"The municipal market has needed more clarification on this since previously there hadn't been that many bankruptcies," said Lewis at MacKay. "It became much more important to look at what the definitions are."

Bloomberg

Romy Varghese

August 4, 2015 — 9:01 PM PDT Updated on August 5, 2015 — 6:27 AM PDT

Puerto Rico Shows Perils of Muni Bonds Backed by Empty Promises.

Municipal-bond investors are learning that when cash gets tight, promises are made to be broken.

Puerto Rico's default Monday on bonds sold by its Public Finance Corp. underscored the risks of debt backed only by a legislature's pledge to repay. Two days later, Chicago's Metropolitan Pier and Exposition Authority's rating was cut to near-junk from AAA by Standard & Poor's because Illinois hasn't appropriated the money to pay its bonds amid a stalemate over the budget.

Unlike with general obligations or debt that has a claim to specific revenue, buyers have little recourse if politicians walk away from appropriation bonds, a $197 billion niche of the municipal market. Vadnais Heights, Minnesota, and Menasha, Wisconsin, have already done so. In bankrupt San Bernardino, California, investors may recover one cent on the dollar.

"Appropriation debt is scarier than people want to think it is," said Matt Dalton, chief executive officer of Rye Brook, New York-based Belle Haven Investments, which manages $3 billion of munis. He said his firm tends to avoid the securities.

Legislators "have to come around the table and appropriate each year, and as you can see, if they're not on sound financial footing, you're taking a lot of risk," he said.

Pennies Paid

Detroit's $18 billion bankruptcy illustrated the differing legal protections for investors. Buyers of its certificates of participation, which had neither the city's taxing power nor specific revenue streams behind them, recouped 12 cents on the dollar, according to a report this week from Moody's Investors Service. Holders of its general obligations got six times more.

San Bernardino, which filed for bankruptcy in 2012, has proposed giving investors just 1 cent on the dollar for pension-obligation bonds the city voted to stop funding three years ago.

"It's alarming to see if you're in an unsecured position, really how crammed down you're going to get," said John Flahive, Boston-based director of fixed income at BNY Mellon Wealth Management, which oversees $20 billion of munis. "We've always been cautious toward appropriated debt."

The bonds were the first to take the hit in Puerto Rico, where the government is reeling from $72 billion of obligations. Faced with a growing cash crunch, the legislature didn't provide funds to cover bonds the commonwealth's Finance Corp. sold to help keep the government afloat. When $58 million of interest and principal was due Monday, it paid just $628,000.

Bonds Fall

Finance Corp. securities due in 2031 traded Thursday for 9 cents on the dollar, data compiled by Bloomberg show. They fetched 100 cents as recently as June 2013.

Bonds sold by Chicago's Metropolitan Pier, which operates the biggest U.S. convention center, tumbled Wednesday after S&P cut its rating by seven steps. That came after the authority couldn't make a required deposit into its debt-service fund because the legislature hasn't appropriated the tax money. The agency hasn't missed any interest or principal payments, which aren't due until December.

Its $208 million of 5.25 percent bonds maturing in 2050 traded Wednesday for as little as 96.7 cents on the dollar, down from $1.05 when they'd last traded on July 30. That pushed the yield to 5.5 percent from 4.1 percent.

"Investors are going to want more yield for appropriation debt," said Alan Schankel, a managing director at Janney Montgomery Scott LLC in Philadelphia. Puerto Rico and Chicago's Metropolitan Pier are "part of the procession of anecdotes about appropriation debt that we've been hearing about."

Jersey Jitters

States like New Jersey are drawing bondholders' scrutiny, Schankel said. With the second-lowest credit rating after Illinois, New Jersey has about $30 billion of appropriation-backed debt and related securities, according to Moody's, which rates the securities no higher than four steps above junk.

Investors are demanding a premium to buy the debt. New Jersey bonds due in December 2023, which are funded out of the annual transportation budget, traded Thursday for an average yield of 4 percent, a full percentage point more than general obligations with a similar maturity, data compiled by Bloomberg show.

Kansas will test investors' willingness to purchase bonds with little security when it sells $1 billion of debt next week through its development finance authority. The proceeds will be used to shore up its underfunded workers' retirement system.

The prospectus circulated to potential buyers warns that if Kansas doesn't allocate cash to pay investors, the agency "has no obligation to seek or obtain any source of moneys for deposit to the Revenue Account, other than State appropriations."

Melika Willoughby, a spokeswoman for Governor Sam Brownback, didn't have an immediate comment on the bond sale.

"Anytime there's a political process involved in getting paid, which is what an appropriation is, you have to be concerned," BNY Mellon's Flahive said. "The market will be very critical in the reward versus risk given the events in the appropriated space."

Bloomberg

Brian Chappatta

August 6, 2015

Bloomberg Brief Weekly Video - 08/06/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

August 6, 2015

[Moody's: Taboo Against Municipal Bankruptcies Has Weakened.]

New York, August 06, 2015 — Municipal bankruptcy, while still a rarity, has become a less unthinkable way for distressed local governments to reduce their debt and pension liabilities, says Moody’s Investors Service in a new report, “Municipal Bankruptcy Still Rare, but No Longer Taboo.”

Moody’s notes that our median municipal rating is Aa3, and less than 0.5% of all its rated cities, counties and school districts have speculative grade credit ratings. Any growing willingness to pursue bankruptcy among the lowest-rated issuers in this group would have no impact on the overall distribution of Moody’s municipal ratings.

Municipal bankruptcies, however, may be more widely considered as the bankruptcies of Jefferson County, AL, Stockton, CA, and Detroit lay out a potential blueprint other distressed municipalities could follow, with Detroit restructuring and emerging in 16 months.

In general, the risks to bondholders and, as a result, the severity of rating downgrades generally accelerate when bankruptcy is seriously considered as an option, says Moody’s.

“Emergence from bankruptcy can restore credit quality going forward, but the process itself is radical and often unpredictable,” says Moody’s Senior Vice President Al Medioli.

Moody’s notes that recent municipal bankruptcies have protected pension liabilities at the expense of bondholders.

“There appears to be a dynamic at play that elevates retirees as a group above other creditors, and that further places pensions on a higher plane above all other liabilities, regardless of bond security or legal revenue pledge,” says Moody’s Medioli.

“The willingness to consider bankruptcy often means the interest of issuers and creditors have become diametrically opposed, which must be reflected in the rating,” explains Medioli.

The number of public local government bankruptcies has remained low following the recession, but there has been a noted recent increase against the backdrop of their extreme infrequency since World War II. Moody’s points to the slow economic recovery and the rise in government fixed costs, particularly pension costs, as the causes of the rise.

“A more frequent use of bankruptcy by distressed credits does not in and of itself alter our overall stable outlook on the state and local government sectors, but it does underscore how the recent recession has left in its wake significant pockets of financial pressure and a tighter budgetary ‘new normal’ that is less resistant to new shocks,” says Medioli.

For more information, Moody’s research subscribers can access this report here.

[Fitch: Medicaid Poses Increasing Risk to U.S. State Budgets.]

Fitch Ratings-New York-07 August 2015: A rebound in healthcare spending and a shift in federal support will put more pressure on U.S. states' long-term budgets, Fitch Ratings says. We expect most states to manage this increase by accelerating their efforts to slow Medicaid spending and taking other budgetary actions. If they do not, they will face long-term budget imbalances.

Last week, the Centers for Medicare and Medicaid Services (CMS) forecast that state and local Medicaid spending growth will average 6.3% annually from 2014 to 2024. The increase is partially due to normalization after recession era rates bottomed at 5.2% in 2007, as well as the statutory downshift in federal funding for the Medicaid expansion that will begin in 2016. Despite the acceleration, spending growth will remain below historical trends. Between 1990 and 2007, state and local Medicaid spending averaged 9.3% annual growth – this is 3% higher than CMS' projection for average annual growth between 2014 and 2024. Fitch attributes part of the comparative improvement to states' ongoing focus on Medicaid cost control.

Fitch believes states have had some success in controlling growth in Medicaid spending, though the challenge remains substantial. One key initiative for a number of states has been implementation of managed care. Between 2001 and 2013, Medicaid managed care spending increased at nearly double the rate of total Medicaid spending. Fitch anticipates this shift toward managed care will likely continue given states' fiscal pressures. While state and local Medicaid spending growth will remain below historical levels, Fitch believes it will still outpace revenue growth and force states to make challenging budgetary decisions.

CMS' projections also reflect the scheduled partial shift of costs for expansion under ACA to states from the federal government. Federal coverage for newly eligible individuals in expansion states will begin a multi-year ramp-down in October 2016 from the current 100% to 90% in federal fiscal 2020 and thereafter. States will need to backfill the federal declines.

Fitch notes that several states have reported net budgetary gains from ACA expansion that could fully or partially offset those increased costs. Currently, 28 states and the District of Columbia have expanded under ACA, and three are actively considering it. Nineteen have rejected it but may expand at any time under current law.

CMS projects overall health spending growth will accelerate to 5.8% annually through 2024, up from 4% in 2007. The recession and its aftermath played a key role in suppressing growth of this metric in recent years as well. CMS also attributes the anticipated rebound (in part) to accelerating economic growth. Prescription drug prices are a key factor as well, with spending set to double between 2013 and 2024.

The Cost of Water Is Rising – Financing Tools And Strategies To Help Communities Pay: Butler Snow

Across America, the cost of water is rising. Getting clean drinking water is not as easy as turning on the faucet. Not only is access to safe water a growing issue across America — it is an expensive one too. Local elected officials throughout the United States, whether in small towns or the country's largest cities, are facing the difficulties of expanding, repairing and bringing into compliance with federal and state regulations their aging drinking water and wastewater systems. In older jurisdictions, pipes installed as long as a century ago will have to be replaced. Repairing and replacing these age old pipes comes with the ever-pervasive task of filling and smoothing the potholes that can result from the repair of these antiquated and dilapidated water and wastewater systems. Additionally, several cities are going to have to make major upgrades to their systems as a result of federal and state enforcement actions and undertake complicated analysis when considering the feasibility of sending their wastewater to a regional system juxtaposed to operating their own wastewater treatment facilities.

It could cost more than $2 trillion over the next 25 years to replace and expand drinking water and wastewater systems nationally.1 Both federal and state solutions are being proposed to address this enormous cost that involves innovative financing and in some instances private parties. However, some cities and towns will find it necessary to utilize current tools (perhaps in unorthodox ways) to construct and repair systems because the need is so great. Regardless, the cost is vast and the need is abundant.

National Solutions

WIFIA – Public works officials around the country are advocating for the use of the Water Infrastructure Financing and Innovation Act ("WIFIA"), a program modeled after the Transportation Infrastructure Financing and Innovation Act ("TIFIA"). WIFIA is an Environmental Protection Agency ("EPA") program that will hopefully spur private sector investment in water infrastructure by providing innovative financing mechanisms for water-related infrastructure projects of national or regional significance.2 The program attempts to fill in gaps left open by State Revolving Fund ("SRF") programs by providing subsidized financing for large dollar-value projects. Once Congress provides funding, WIFIA could provide low interest rate loan financing for the construction of drinking water and wastewater infrastructure.

AFF Bonds – the America Fast Forward ("AFF") bond program is a President Obama backed proposal similar to the Build America Bond program that would be an alternative to traditional tax-exempt bonds. AFF Bonds would be taxable bonds issued by State and local governments in which the treasury would make direct payments to state and local governmental issuers (through refundable tax credits). The AFF bond program would allow the treasury to make direct payments to state and local governmental issuers in an amount equal to 28 % of the coupon interest on the bonds. The goal of the AFF bond program is to facilitate greater efficiency, more investors, and lower costs for state and local governmental debt.

QPIBs – the catalyst for Qualified Public Infrastructure Bonds ("QPIBs") is the push for the public and private sector to work together to build infrastructure projects. QPIBs will extend the benefits of municipal bonds to public private partnerships ("P3s") or like partnerships that involve long-term leasing and management contracts, lowering the cost of borrowing and attracting new capital. If approved by Congress, the QPIB bond program would provide financing for airports, ports, mass transit, solid waste disposal, sewer, and water, as well as for other types of surface transportation projects.

Local Solutions

Tax-exempt municipal bonds – The oldest and most frequently used program to finance infrastructure projects is the use of tax exempt government bonds. There is no federal cap on the amount of tax-exempt debt a local can issue (although there may be state or local caps) and each year the federal government forgoes about $30 billion in revenue through this tax exempt subsidy.

SRF – In the 1970s and 1980s, the federal government provided generous grants to localities to improve their water and wastewater systems.3 Today, the federal government has assisted communities across the nation by providing appropriations to state revolving loan funds through its SRF program, which states, in turn, can loan out to local projects or to help refinance local debt. Over the last two and half decades, SRFs have provided over $100 billion, funding more than 33,320 low-interest loans.

Footnotes

1 Tom Curtis, Water Infrastructure: The last and next 100 Years, Journal AWWA, August 2014 http://www.awwa.org/publications/journal-awwa/table-of-contents/articleid/46499415/issueid/46498556.aspx?getfile=/documents/dcdfiles/46499415/jaw201408curtis.pdf (accessed July 10, 2015).

2 WIFIA was signed into law on June 10, 2014, as Public Law 113-121.

3 Ryan Holeywell, Financing Water Infrastructure Like Transportation, Governing May 2012 http://www.governing.com/topics/finance/gov-financing-water-infrastructure-like-transportation.html (accessed July 10, 2015).

Article by J. Troy Johnston and Tray Hairston

Butler Snow LLP

Last Updated: July 29 2015

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Hawkins Advisory (Annual Qualified Mortgage Information)

This Hawkins Advisory is of interest to single-family housing bond issuers.

Read the Advisory.

7/28/2015

Municipal Issuer Brief: Positive Dynamics Remain in Place.

Read the Brief.

Municipal Market Analytics | Jul. 27

In Post-Detroit Bankruptcy Era, California Protects Investors Before Pensioners.

Before Detroit, many thought general obligation bonds were ironclad. Now they know better.

Starting next year, anyone who buys a general obligation bond from a California locality will stand first in line as a creditor should anything ever happen to cause that locality to restructure its debt. If the law seems redundant to a few people, that’s because general obligation debt is supposed to be backed by the full faith and taxing power of the government selling them. In other words, many thought that meant such bonds were unbreakable. So why does California feel the need to clarify that?

The reason goes back to 2013 when Detroit filed for bankruptcy. The city proposed — and eventually pushed through — a restructuring plan that placed general obligation (GO) bondholders behind the city's pensioners when it came to who would recover the most of what they were owed. While pensioners averaged a roughly 90 percent recovery rate, GO bondholders recovered about 80 cents on the dollar. "Everything is different after Detroit," said Robert Christmas, a financial restructuring expert at Nixon Peabody. "There were challenges to things that I think people believed were sacrosanct or hadn't thought about."

California, which has had three cities enter Chapter 9 bankruptcy in the last seven years (San Bernardino is the only one still litigating its case), wants to be clear that its local GO bondholders won't be treated the same way. The new law, Senate Bill 222, places a lien on future property taxes to ensure investors will be repaid. By clarifying that the lien created with each GO bond issuance is a statutory one, it "should reduce the ultimate bankruptcy risk of nonrecovery on local GO bonds, and thus potentially improve ratings, interest rates and bond costs," Christmas said.

These liens don't provide total immunity to bondholders. A statutory lien, noted Matt Fabian in an analysis for Municipal Market Analytics, does not preclude a disruption in payment or ensure that the collateral, in this case tax revenue, will be sufficient for full payment. Still, with California accounting for about 20 percent of all bankruptcies since 2000 and almost 30 percent of all city or county bankruptcies since 2007, Fabian predicts "even small reductions in future California bankruptcies can have a market-wide benefit."

Indeed, Moody's Investor's Service has called the new law a credit positive for California localities. Fitch Ratings, however, has said statutory lien laws have no effect on its credit ratings. California isn't the first state to pass a statutory lien for GO debt, although it is the first to do so in the post-Detroit bankruptcy era. Louisiana and Rhode Island already have laws on the books. Nebraska has been considering one.

Rhode Island provides a good, if somewhat sobering, example of how a statutory lien can play out in a bankruptcy case. When Central Falls filed for bankruptcy in 2011, the state enacted an emergency statute that placed a lien on property taxes and pledged them to GO bondholders. There were lots of positives from Wall Street's perspective. During the bankruptcy no creditor challenged the lien, and GO bondholders received full and uninterrupted payment of debt service. The judge in that case highlighted the tactic as one he hoped other cities would follow. Central Falls was in and out of bankruptcy in just 13 months, and so its credit rating also began to recover almost immediately. Its rating was moved out of junk status within a month of exiting bankruptcy.

Still, someone has to take a cut. If not GO bondholders, then who? In Central Falls case, it was retirees who settled for roughly half the pensions they were promised. Labor advocates say the move placed a back-breaking burden on retirees who are now living paycheck to paycheck. In California's bankruptcies, GO bondholders and pensioners have been treated fairly equally. But if ever a locality is forced to choose, the new law makes it clear where the favor now lies.

GOVERNING.COM

BY LIZ FARMER | JULY 30, 2015

Municipal Bankruptcy's New Rulemakers.

Neither Congress nor the Obama administration had a response — or even words of support — when two large U.S. cities lurched into bankruptcy two years ago. And there still isn't a response now as Puerto Rico, a U.S. territory, heads in that direction.

Well, that's not entirely true. As Congress completed its 2016 budget resolution in May, it included for the first time in U.S. history a provision of singular discrimination. It barred so-called "bailouts" to municipal corporations, cities and counties — none of which have ever been "bailed out" — while leaving unchanged support for federal bailouts of nongovernmental corporations, such as major Wall Street banks and automobile companies.

Local governments are facing heightened, long-term credit challenges at a time of profound changes in federalism. In the wake of the Great Recession, the oft-forgotten third branch of the federal government, the judiciary, has assumed the most critical role and responsibility for municipal and urban policy. It is increasingly displacing legislative and executive branches in addressing the long-term solvency of some of the nation's oldest cities — assessing, analyzing and examining the extent to which these cities and counties can achieve a sustainable future.

U.S. bankruptcy judges like Steven Rhodes in Detroit and Christopher Klein in Stockton, Calif., have devoted nearly three years to shepherding the two cities through extraordinary trials on their way to solvency. Moreover, unlike the federal bailouts to Detroit's major, iconic private corporations, these federal judges acted without access to solutions often provided private corporations, such as allowing them to shift the liabilities for pension obligations to the federal Pension Benefit Guaranty Corp.

When Congress adopted the municipal bankruptcy amendments in 1988, the country's experience had been that municipal bankruptcies affected small districts. Therefore, Congress acted to ensure that these small jurisdictions would continue to operate and provide essential public services. Indeed, from 1980 to 2013, the vast majority of Chapter 9 filings were by municipal utilities and special districts, as well as hospital and health-care facilities. In the last decade, however, we have experienced bankruptcies of large localities, from Jefferson County, Ala., to Vallejo, Calif., to Harrisburg, Pa., to name a few. These more recent, significant urban bankruptcies affect millions of Americans, disproportionately impacting low-income and minority Americans.

In an unprecedented session hosted by the New York Federal Reserve in April, bankruptcy judges involved in the largest municipal bankruptcies spoke of the lessons learned. Judge Thomas Bennett, who oversaw the Jefferson County bankruptcy, addressed the importance of "long-term municipal sustainability" as a key outcome to any successful municipal distress proceeding — in addition to an effective restructuring of a city or county's debt. Rhodes spoke of the uncertain future of this generation of cities and counties that emerge from municipal bankruptcy given the lack of a federal role in achieving "long-term sustainability," that is, a plan that entails a structuring of a pensions and debt service.

Rhodes said that he devoted much of Detroit's bankruptcy proceedings to ensuring any proposed plan of debt adjustment be feasible, implementable by the city and enduring. "I did not want to become known as the judge on Detroit's first bankruptcy case," he said. As an example, he noted his decision to preserve the artwork housed at the Detroit Institute of Arts. "To sell the art," he said, "would be to forfeit Detroit's future."

The events of these past few years suggest a fundamental alteration in the federalism created half a century ago under former President Richard Nixon, a federalism that included congressional and administrative support for a general revenue sharing program. Even under Nixon's predecessor, Congress created the Advisory Commission on Intergovernmental Relations (ACIR), intending it as the nation's foremost repository of experience and information on intergovernmental structure, finance, process and practice. The ACIR also acted as a critical forum to identify emerging issues, trends and turning points, and as a way to promote stronger intergovernmental communication, cooperation and coordination. Today, that forum is no longer funded.

GOVERNING.COM

BY FRANK SHAFROTH | JULY 2015

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How One Mississippi County Played Wall Street's Fiddle.

All signs pointed to a Mississippi county's bet with Wall Street going south.

Officials in Hinds County, where one in four residents live in poverty, didn't know what they were getting into, according to an independent audit. They couldn't explain the mechanics of the interest-rate swaps they negotiated with Rice Financial Products Co., a New York derivatives dealer. They couldn't say how semi-annual payments on the leveraged bets were determined.

Yet, in the decade since the contracts were first signed, Hinds County netted $6.7 million on the deal due to collapsing short-term rates in the municipal bond market. That bucks the trend of cities, states and localities exiting interest-rate swaps on much less favorable terms.

"It's like walking out of the casino with $6 million," said Robert Brooks, a finance professor at the University of Alabama's Culverhouse College of Commerce in Tuscaloosa. "It could've gone the other way."

It's gone the other way for so many others. Since the 2008 financial crisis, municipalities have paid at least $9 billion to cancel the swaps, according to data compiled by Bloomberg. The contracts were supposed to reduce borrowing costs and protect them against rising payments on floating-rate bonds.

Perhaps the best-known of the interest-rate disasters was Jefferson County, Alabama, about 250 miles northeast of Hinds County. The swaps it bought in 2003, tied to a $3 billion sewer-debt refinancing with JPMorgan Chase & Co., helped push it eight years later into the largest municipal bankruptcy in history. Only Detroit's, a year later, is bigger.

Three Deals

Hinds County includes Jackson, the state capital. It has 245,000 residents over 870 square miles and its median household income is $37,626, about $14,000 less than the U.S. median, according to the Census Bureau.
At least three municipalities profited from swaps with Rice. Durham County, North Carolina, home to Duke University, has netted $18 million since it executed a swap with Rice in 2004. Miami-Dade County, Florida, has received $160 million.

Donald Rice, founder and chief executive officer of Rice Financial, didn't return calls seeking comment.
Porter Bingham of Malachi Financial Products Inc. takes issue with the notion that county officials didn't understand the terms of the swaps and their risks. Malachi was paid about $400,000 to advise on the swaps between 2006 and 2012, according to county records.

"They understood perfectly what they were getting into," Bingham said. The swaps "were assessed and studied."

Complicated Wager

County officials couldn't tell an auditor how the swaps worked. It's little wonder. The terms were a bit complicated.

In floating-rate to floating-rate "basis" swaps, local governments typically pay a bank a short-term tax-exempt rate. In return, they receive 65 percent of the taxable one-month London Interbank Offered Rate, or Libor, plus a set percentage. As long as the federal government doesn't cut tax rates or eliminate the exemption of tax-exempt bonds, the swaps make money for municipalities.

If, however, the government curtails or eliminates the tax exemption, the yield on short-term tax-exempt rates rises and municipalities lose money.

The terms of the deal included this: "If the difference obtained by subtracting USD-LIBOR-BBA from the product of 86 percent multiplied by USD-ISDA-Swap Rate is greater than .005 percent, then sum of USD-LIBOR-BBA, .005 percent, and Constant 1 all multiplied by Factor 1."

Got That?

That was enough to baffle Richard Ryffel, a senior lecturer in finance at Washington University's Olin Business School in St. Louis and a former public-finance banker at Bank of America Corp.

"It seems needlessly complex," Ryffel said. "At some point you get so complicated, and you're speculating anyway, that there's no benefit to it."

The basis swaps that Rice sold to Hinds County, as well as Durham County and Miami-Dade County, did better than typical basis swaps because the terms of the deal were multiplied, juicing returns. Usually swaps are based on a corresponding amount of bonds. But one of the Hinds-Rice deals was leveraged 19 times, with the county basing a $29.8 million swap on $1.6 million of bonds.

Hinds County officials "could not explain how the swap was supposed to benefit the county nor did management demonstrate an understanding of the extent, multitude and nature of the various risks inherent in a swap," according to the independent audit.

Nevertheless, for most of the swaps' life, rates moved in the county's favor. Hinds netted $6.7 million, using the money to pay for projects such as road resurfacing and renovating the county jail.

In March, Hinds County officials decided to quit while they were ahead and terminated the swaps.

"We've enjoyed those payments, but the pendulum, we thought, was about to swing the other way," said Tony Greer, a member of Hinds County's board of supervisors, elected in 2013. "It was just too risky for us to be in."

Bloomberg

by Martin Z Braun

July 27, 2015 — 4:00 PM PDT Updated on July 28, 2015 — 7:08 AM PDT

Bloomberg Brief Weekly Video - 07/30/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

July 30, 2015

Bloomberg Brief Municipal Market Expert Series.

Taylor Riggs, an editor at Bloomberg Brief Municipal Market, spoke with Justin Land, head of tax-exempt management at Wasmer, Schroeder & Co., about Florida's housing market and community development districts.

Watch the video.

July 30, 2015

OppenheimerFunds Chases Distress in Puerto Rico, Long Island.

OppenheimerFunds Inc., which owns more Puerto Rico bonds than any other mutual-fund company, may be among the hardest hit if the island lapses into a record-setting default on some of its $72 billion of debt.
The New York-based company, which manages $24 billion in state and local-government debt, also has a stake in another noteworthy, if smaller scale, case of municipal-market distress.

OppenheimerFunds holds about $21 million, or 46 percent, of the debt sold by Dowling College in Oakdale, New York. The 2,000-student school is the first municipal borrower rated by Moody's Investors Service to default since 2013, ending the longest stretch without such a lapse in almost two decades.

The dual risk illustrates company's long-held strategy of plowing cash into the most precarious corners of the $3.6 trillion municipal market to capture higher yields. Over the years, its funds have invested in airline-backed debt, tobacco bonds and real-estate development deals roiled by the housing-market crash.

"The basic high-yield strategy is built to survive a handful of defaults," said Matt Fabian, partner at Municipal Market Analytics, a Concord, Massachusetts-based research firm. "In return, they're compensated by a much higher stream of income."

Tactic Succeeds

The tactic has delivered annualized returns of almost 5 percent over the last five years to the firm's AMT-Free New York Municipal Fund, outperforming 96 percent of its peers, Bloomberg data show. It's the fund with the largest stake in Dowling. Ray Pellecchia, an OppenheimerFunds spokesman, declined to comment on the company's investment in the college.

Yet such high-yield bonds, especially those from Puerto Rico, have made the funds prone to short-term swings.

Over the past month, the New York fund has trailed 97 percent of peers, Bloomberg data show. That came after Puerto Rico Governor Alejandro Garcia Padilla said he'd seek to restructure the island's debt, which caused bond prices to tumble. OppenheimerFunds owns more than $4 billion of uninsured island securities, Bloomberg data show.

The stakes are lower with Dowling College. Like Puerto Rico, its strains are years in the making. Moody's has rated the school below investment grade since 1997. In March 2014, as enrollment fell by almost half in five years, Moody's dropped the college to Ca, the second-worst rank, citing a "higher probability of default."

Default Triggered

Dowling didn't have the money needed to make bond payments due on June 1, according to disclosure filings. Bondholders agreed to give the school until June 30, 2016, to sort out its finances without going after it for the money they're owed. Pellecchia, the OppenheimerFunds spokesman, said the firm is part of the creditors group.

The college doesn't expect to pay bondholders as long as the agreement is in place, according to the filing.
OppenheimerFunds owns municipal debt the school issued in 1996, 2002 and 2006 through agencies of Suffolk County, New York, and Brookhaven, a town within the county.

Some of the 1996 bonds, which are uninsured and mature in five years, changed hands July 16 at 82 cents on the dollar for an 11 percent yield. The 2006 securities are insured against default by ACA Financial Guaranty Corp.

In connection with the agreement with Dowling, some bondholders bought $6.7 million of taxable debt to provide the college with needed cash, according to the disclosure filings.

The pact may be a good thing for OppenheimerFunds and other investors. Moody's said the the odds of recouping losses are now "modestly improved" because the school has breathing room to implement its strategic plan.

Ralph Cerullo, the college's chief financial officer, didn't return a voicemail left at his office seeking comment.

Bloomberg

by Brian Chappatta

July 27, 2015 — 7:58 AM PDT Updated on July 27, 2015 — 11:43 AM PDT

[Pimco Drawn to Tobacco Bonds for Yield Fix as Puerto Rico Twists.]

As Puerto Rico veers toward a historic default, investors who need a high-yield fix are turning to tobacco instead.

Pacific Investment Management Co. and AllianceBernstein Holding LP, which shed all holdings of the commonwealth's debt, have been buying securities backed by the cash states get from the 1998 legal settlement with tobacco makers. While Moody's Investors Service predicts 80 percent of the bonds may default as a drop in smoking cuts those payouts, the firms say the endgame is predictable, unlike the Caribbean island's: The interest would keeping coming until the debt is paid.

Tobacco bonds have returned 2.4 percent in July as prices rallied, more than triple the municipal market's gain, Barclays Plc data show. Some still yield more than 7 percent, a level rarely found on tax-exempt bonds outside of Puerto Rico.

"In a world where everyone wants income, 7 percent looks OK and tobacco's risks are known," said Guy Davidson, who oversees $32 billion as director of municipal fixed income at AllianceBernstein in New York. Four of the top 10 holdings in the company's high-yield muni fund are tobacco securities, including those sold by Ohio.

Ohio tobacco bonds due in June 2047 traded Wednesday at 80 cents on the dollar, close to the highest since June 17, to yield about 7.5 percent.

Shifting Risk

The $34 billion in tobacco securities outstanding are financed with payments companies make under the legal settlement, which are based on how many cigarettes they sell. State and local governments issued the debt to get the cash upfront, shifting the risk to investors if the payments fall short of expectations.

They've been a mainstay of the high-yield muni funds that have poured money into Puerto Rico. That's fostered speculation tobacco bonds could tumble if a default by the commonwealth on some of its $72 billion of debt leads investors to pull their money from the funds, which would force managers to sell investments to meet withdrawals.

So far, tobacco bonds have weathered the crisis. While individuals yanked money from high-yield funds in the days after Governor Alejandro Garcia Padilla said the island can't afford its debt, the outflows have abated. High-yield funds pulled in $11 million in the past two weeks, Lipper US Fund Flows data show.

Opportunity Ahead?

Peter Hayes, who helps oversee $116 billion as head of municipal debt at New York-based BlackRock Inc., the world's biggest money manager, said that doesn't mean the risk has subsided. The commonwealth may miss a payment on Public Finance Corp. bonds due Aug. 1 and is scheduled to propose a debt-restructuring plan a month later.

"That could be a catalyst for another leg down on some of the Puerto Rico bonds — and if we see some additional selling, we might see spillover into the high-yield muni market, like tobacco," Hayes said. "There might be other buying opportunities ahead."

The yields on tobacco bonds reflect the risk. The earliest securities didn't anticipate how quickly smoking rates would fall. In the seven years through 2006, shipments dropped an average of 1.7 percent a year, according to data from the National Association of Attorneys General. The pace of decline almost tripled in the next seven years.

Default Risk

That's left four out of five bonds prone to default, according to Moody's.

That prospect doesn't bother David Hammer, a money manager at Pimco. Though the bonds may not make full principal payments when they're due, investors will be paid back eventually as long as cigarette shipments don't vanish entirely, he said.

By comparison, Moody's estimates that some owners of Puerto Rico securities may receive as little as 35 percent of what they're owed.

"The difference in tobacco is because you have a claim on those revenues in perpetuity, you're talking about the extension of the payment schedule as opposed to an actual principal haircut," said Hammer, who helps oversee $40 billion of munis for Pimco in New York.

The yields have so far been sufficient to draw buyers, said Davidson of AllianceBernstein.

"While we're all very cautious about the Puerto Rico contagion effect and having a run on muni high-yield, at these levels there seems to be support," he said. "For tobacco, it's steady as she goes, it offers a nice yield, and the contagion to Puerto Rico seems to be pretty modest."

Bloomberg

by Brian Chappatta

July 28, 2015 — 9:01 PM PDT Updated on July 29, 2015 — 5:59 AM PDT

Chicago Mulls Borrowing That Puerto Rico Rejected as Risky.

Chicago may allow the use of a type of debt that's fallen out of favor in other municipalities because it saddles taxpayers with higher costs by delaying payments.

Mayor Rahm Emanuel proposed issuing $500 million of bonds this week in an ordinance that would permit the use of capital appreciation bonds, where borrowers postpone interest and principal payments into one sum at the end of the term. Emanuel's pitch also allows for the more common current interest bonds, which the city said it expects to use.

"We have no intention of issuing CABs," said Chicago Chief Financial Officer Carole Brown, who noted that language has been included in past ordinances. "We do that so we have maximum flexibility. If there is some off chance that there is an investor that wants us to issue bonds with a certain structure, we have flexibility."

Chicago is struggling to plug its deficit and $20 billion of unfunded pension liabilities. The proposal would give the third-most-populous city a means of borrowing without having to face the costs right away.
"Given where Chicago is at, it does seem like it's a way to kind of push off debt payments out longer,

which from a credit standpoint is not favorable," said Michael Johnson, managing partner at Gurtin Fixed Income Management, which oversees $9.5 billion of munis in Solana Beach, California. "It's probably not the best idea for them right now."

Texas restricted the use of CABs in June and California has limited them since 2013. The Puerto Rico Electric Power Authority dismissed a bondholder plan last week to restructure its debt using capital appreciation bonds, citing the disproportionate risks.

Abusive Debt

Chicago hasn't issued capital appreciation bonds since 2009, Molly Poppe, a city spokeswoman, said in an e-mail.

Use of capital appreciation bonds have come under fire in Texas and California, where lawmakers have passed legislation to limit their use. Former California Treasurer William Lockyer called the debt "abusive" because it passes on large payments to future generations.

"They increase the total cost and lower flexibility going into the future," said Steve Murray, a senior director at Fitch Ratings. "They can limit future borrowing ability."

Emanuel also proposed selling $125 million of wastewater revenue bonds to fund swap termination payments, Poppe said. A separate ordinance would authorize $2 billion in bonds for O'Hare International Airport, including $1.7 billion of refunding for savings, and about $300 million of new money for capital projects and interest, according to Poppe.

Bloomberg

by Elizabeth Campbell and Darrell Preston

July 31, 2015 — 10:26 AM PDT Updated on July 31, 2015 — 12:25 PM PDT

Fitch: US Public Pension Contributions May Rise as Returns Lag.

Fitch Ratings-New York-27 July 2015: Investment returns below public pension plans' benchmarks mean that future contributions from participating state and local governments will have to rise in order to recover lost ground, Fitch Ratings says. On Monday CalPERS reported that its assets gained 2.4% in the fiscal year ended June 30, well below its investment return assumption of 7.5%. The slower investment return performance in fiscal 2015 follows several years of above-benchmark returns for CalPERS and other plans.

CalPERS' returns in fiscal 2015 are likely to be similar to those of numerous large state and local pension plans, the majority of which have June 30 fiscal year-ends. Most plans assume their asset portfolios will grow between 7.5% and 8% annually. The need to hit this target every year means that even in years with low-single digit positive returns, like 2015, plans fall behind in their effort to fully advance-fund their pension benefit obligations.

Most large plans have diverse investment portfolios driven by the need to generate annual returns at or above their investment return assumptions. Over time, investment returns are intended to cover the vast majority of pension benefits owed to retirees, with contributions from employers and employees covering the balance. Ultimately, employers must cover whatever benefits are not covered by investment returns and employee contributions.

Contribution pressures on governments have risen rapidly in recent years, the result of investment losses during the last recession, benefit increases in the decade before that, rising retirements and flat or declining public workforce levels. Another factor has been governments' unwillingness to fully fund their actuarially-calculated annual required contributions, which over time leaves asset levels depleted and puts upward pressure on future contribution requirements. Fitch found that, in fiscal 2014, only about 40% of plans received their full annual required contributions.

Most public plans had a series of strong annual returns through fiscal 2014, with investment gains well above investment return assumptions. These returns helped to offset asset losses suffered in the 2008-2009 recession, cushioning the upward momentum in annual required contributions.

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The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article, which may include hyperlinks to companies and current ratings, can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.

[U.S. Municipal Bond Investors Stash Cash Ahead of Expected Rate Rise.]

Investors in U.S. municipal bonds are sitting on more cash than they have in years, in part because they're wary of the $3.7 trillion market at a time when interest rates are expected to rise.

Levels of cash in some portfolios are higher than they have been for at least the past few years, according to interviews with managers from 10 different firms of varying sizes.

And cash has grown to record levels over the last decade in the open-end muni mutual funds tracked by investment research firm Morningstar, according to data the firm provided to Reuters.

Between March 2014 and March 2015, cash rose by $6.2 billion to $31.9 billion, the biggest such jump in at least 10 years. In 2005, it was at only $8.9 billion. Cash is now at 5.5 percent of holdings, almost double the 3 percent 10 years ago. The data do not include closed-end funds.

The Federal Reserve is expected on Wednesday to point to a growing U.S. economy and stronger job market as it sets the stage for a possible interest rate hike in September.

"A lot of my investors who've been with me for a long time know that it can be very painful when rates go higher," said Michael Pepe at JHS Capital Advisors, who focuses on municipal investments. "They'd rather earn nothing than lose 10, 20, 30 percent."

Feeding the flows of cash are seasonally strong summer bond calls, coupon payments and maturities. Some investors are not reinvesting, whether by choice or because there is not enough supply to meet demand.

Bond investors are especially sensitive to the risk of rising interest rates, as prices of bonds they already own generally fall when rates rise. Investors on the sidelines say they are ready to jump back in but they will wait until bond prices decline.

CREDIT SHOCKS

Several factors have led investors to hesitate. They do not know how far or how fast yields on longer-term bonds could rise in response to a Fed hike of short-term rates. They have also had credit shocks with negative headlines out of Puerto Rico and Chicago. And global factors, including China's stock market slump, have triggered global markets' volatility that has even spooked investors in some safe-haven securities.

At BlackRock, portfolios are at 5 or 6 percent cash, compared with 2 percent on average normally, said Peter Hayes, head of BlackRock's municipal bond group.

"Our time horizon on that cash isn't very long. We don't advocate for sitting on cash for a long period of time," Hayes said.

In June alone, investors received $56.6 billion through current and advanced refundings and maturing bonds and notes, according to Interactive Data's MuniView.

JHS Capital Advisors' clients are usually almost fully invested, Pepe said. But currently, they have on average 30 percent allocated to cash and some are as high as 40 percent, the highest levels ever.

Muni investors are not alone in increasing their cash levels. According to a July Bank of America Merrill Lynch survey of global fund managers for all asset classes, cash levels have soared to 5.5 percent, the most since December 2008.

Some muni investors are reluctant to jump back in. Burt Mulford of Eagle Asset Management said June didn't see as much reinvestment as usual.

"The challenge for the retail investor … is finding the bond to replace the bond that just got called," he said, because yields are now so low.

Eagle has about 5 percent cash currently – down slightly from a month ago but much higher than its average 1 percent cash position, Mulford said. The last time it was as high was the summer of 2013, during the so-called "taper tantrum," when bonds sold off, driving up yields, after the Fed began curtailing its bond buying.

The hefty cash levels are just one indicator that the muni market is in the doldrums. Returns so far this year have been tepid at 0.69 percent, according to the S&P National AMT-Free Municipal Index, and investors have pulled money out of municipal bond funds for 11 of the past 12 weeks.

Though the cash buildup is prompted partly by fear, it also positions the market for a lift because investors will be liquid enough to jump back in when valuations improve.

"If you do get some of that scare, a dislocation in the market, we have the dry powder to redeploy," said Julio Bonilla, portfolio manager at Schroders. "Every portfolio manager out there right now is very focused on maintaining some form of liquidity."

That could mean a better second half of 2015 for munis.

"We are definitely more optimistic for the second half of 2015," said Eagle's Mulford. "The trend is gradually turning around."

Dawn Daggy-Mangerson, director of McDonnell Investment Management's municipal portfolio team, said the firm had studied muni performance every time the Fed began a cycle of interest rate rises in the past 25 years. In all four instances – 1994, 1997, 1999 and 2004 – munis showed positive returns of about 5 percent or more annualized for two years after the hikes.

"It's expensive to sit in cash," she said. "And people have been wrong about rising rates for the last couple of years. The longer you're wrong, the more it's going to hurt you."

REUTERS

NEW YORK, JULY 29 | BY HILARY RUSS

(Reporting by Hilary Russ; Additional reporting by Jennifer Ablan; Editing by Megan Davies and Martin Howell)

[City Upside Down: How Houston Lost Control of its Wallet.]

One of the world's biggest economic hubs is on the brink of a financial crisis, experts say. It's spending far more cash than it's bringing in. Revenue is growing, but not nearly as fast as expenses are. City worker pension costs are through the roof, and there aren't any long-term solutions on the table. Despite all this, many residents think everything is great. After all, it ranks at the top of some global "best of" lists nearly every day, and it's become known throughout the nation as the No. 1 place to work, shop, live, raise a family and make a name for yourself.

But the truth is, Houston is in trouble. It's billions of dollars in debt, and the trouble's been brewing in your backyard for years.

"Cities create the platform for the stage upon which all business is done," said Jim Noteware, a Houston-based real estate developer and former director of Houston's Department of Housing and Community Development. "Cities create the roads, sewers and waterlines, but they also create human infrastructure, and all of those in Houston — like across many cities in the country — are breaking down. It's been happening in front of all of our eyes, and nobody's paying attention."

While Noteware has been a critic for quite some time, new data from the Greater Houston Partnership's Municipal Finance Task Force reveals the staggering extent of Houston's financial turmoil. The GHP has been combing through the city of Houston's finances in cooperation with city officials since June 2014. The Houston Business Journal received exclusive access to the report before it was released to the public, and it reveals serious issues that could have a significant impact on Houston businesses. City officials did not immediately return calls for comment.

Problem 1: Revenue is growing, but not as fast as expenses

In 2011, the city reported $1.84 billion in general fund revenue and $1.9 billion in expenses. That $60 million gap is the steepest difference reported in recent years. But, between 2017 and 2020, the city predicts a cumulative deficit of $484.6 million, according to a presentation to the city's budget and fiscal affairs committee.

The city's general fund is what it sounds like – — it finances some of the city's most critical services: Houston Police Department, Houston Fire Department and other local government employees. Since these services don't generate money, the fund relies heavily on property and sales taxes to pay for them – about 80 percent of the general fund's revenue comes from those two sources.

The fund is vital for a city to keep its pulse. Without it, you'd have a pothole-ridden city in shambles, with no established unit tasked with preventing crime and a defunct governmental core. A city in that shape can't effectively attract new business, retain existing ones or lure professional talent. Ask Detroit.

"(The city of Houston is) following an unsustainable budget path, so we're already getting bad services for our taxes," said Steven Craig, interim dean of the College of Liberal Arts and Social Sciences and economics professor at the University of Houston. "Do you want your car to get fixed once a year or once a decade? That's a real expense."

In large part, the leech on the city's wallet is legacy payments — specifically, $3.3 billion worth of unfunded pension payments.

What's it mean for businesses:

An extreme degradation of day-to-day service deliveries. At its most fundamental level, that means people will see fewer police officers and firefighters. Road and infrastructure repairs have already slowed down, so if you're an employer in Houston, it might get tougher to sell new talent on Houston.

"Businesses are very concerned about their ability to attract talent," GHP President Bob Harvey said. "As we know, talent is all about quality of life. Quality of life is impacted by the quality of city services. The huge progress that we've made in recent years to improve our quality of life and our reputation in the country is being impacted by our roads, I can promise you that."

That same challenge applies to the GHP's primary task of selling employers on headquartering in Houston. When the city's aesthetics gather too much dust, cracks and damage, the partnership has a hard sell to make, and that's not even counting issues beneath the city's surface.

"Frankly, looking at the city's municipal facilities right now, it's beyond embarrassing," said Harvey.

Problem 2: The city's bloated with $12.9 billion in debt

Houston is buried under a colossal $12.9 billion outstanding debt in short- and long-term debt obligations. Of that $12.9 billion, $9.6 billion is part of the city's enterprise fund, which is made up of systems that generate their own revenue and have additional taxes dedicated to funding them. The Houston Airport System, the Convention and Entertainment District and the city's water and sewage systems are part of that enterprise fund. So, there's an established plan to reduce that debt, but the debt is still there.

The remaining $3.3 billion is Houston's general obligation debt, which was borrowed for capital expenditures like facilities and construction projects. The city's debt payments on that $3.3 billion shortfall are spread through 2043, but the lion's share of the payments will happen before 2021. The debt payments peak in 2018, when Houston will have to shell over $360 million; by 2030, debt payments are either just above or well-below $100 million.

So until 2020, the city's wallet is going to be historically pinched, and that's for a plan that solves only one of the two $3.3 billion debt chunks.

The bigger problem lies in the city worker's unfunded pension fund. Houston hasn't put enough money into its pension fund, and it's past the point of no return. To date, the city hasn't funded $3.3 billion in employee pensions. There's no plan on the table for funding those pensions — that's what makes it more toxic than Houston's $12.9 billion debt.

In all likelihood, the pensions will have to be paid from the city's general fund, the GHP report said. That spells a further downgrade in city services.

"Everybody blames pensions as the big issue, and it is," Noteware said. "These (municipal) workers think they made a deal with the city, but the city is not a credit-worthy borrower."

In 2014, Houston paid 25.5 percent of the Houston Police Department's payroll toward its pension fund – basically, if a police officer was hypothetically paid a $100 salary, the city took $25.50 of its own (or borrowed) money and put it toward the pension fund. That's an exorbitant contribution; the average pension payment should hover around 11 percent to 13 percent per payroll in a healthy municipality, GHP officials said.

A big catch of pension payout is that the city isn't getting anything in return. It's an investment that yields nothing, and the debt it's causing could potentially ransack the city's credit rating.

"The city is going to be paying tax money now for … services that were delivered five, 10 and 50 years ago," Craig said. "As a taxpayer, that means that I'm going to be paying money and getting nothing back. On average, nobody likes to do that. The city is calling me up on the phone and saying, 'Please, send me $100; I'm not going to give you anything for it.'"

What's it mean for businesses:

Houston's residents aren't getting any return on a large sum of their taxes. For businesses in a competitive environment, any investment that doesn't yield a return is almost always unjustifiable.

Companies usually respond faster than residents when it comes to tax code changes, so that means that more companies will relocate their headquarters outside the city's taxable boundaries, Craig said.

"Business leaders outside of Houston are saying, 'Well, as long as those silly competitors are in Houston, I have a cost advantage over them,'" Craig said. "If you're a business leader in Houston, you're thinking about looking to get your firm out of the city."

It's harder to sell a business on staying in the city limits, Harvey said. Instead, businesses can move their headquarters to one of the numerous counties with gentler tax codes less than 20 miles away. When business moves outside the city, experts largely agree that its workers do, too.

"Two years ago, I spoke with an (executive at Ernst & Young), and he was recruiting and trying to bring companies into Houston," Noteware said. "In 2013, the company recruited 20 very large, new employers in the Houston region. None of t hem are located in Harris County. They all went to Brazoria County, Montgomery County, Lawler County and other counties. We're not building our own job base."

Problem 3: Taxes are already high, and raising them isn't a sustainable solution

Property tax is Houston's largest single revenue source. Between 2012 and 2014, the city earned a collective $2.7 billion in property taxes. During fiscal year 2015, the city of Houston estimates it will scoop up over $1 billion in property tax. Houston, like all Texas cities, doesn't have an income tax, so our relatively high property tax rate is a fair trade-off for businesses that come to Houston, experts say.

Despite the city's record-high revenues, Houston is in record-high debt. In a scenario where businesses relocate out of Houston at a faster rate, experts agree that those businesses' workforces will follow them into the suburbs. That's when the city might be pressured to hike up the already high property tax.

Another challenge that Houston faces is its credit rating. On July 2, New York-based Moody's Investors Service gave Houston a "negative" outlook. It didn't officially downgrade the credit rating, Harvey said, but it showed that a lower credit score isn't a foreign possibility for the city if it fails to rein in its expenses.

"If the next thing that Moody's does is a downgrade, then immediately, all of our debt is more expensive. So, that's more pressure on your budget. Will there be huge pressure to raise taxes? Absolutely," Harvey said. "It's a very common path for cities to take. They take that path until their business community revolts. At that point, forget business attraction — what you'll see is business exits."

What's it mean for businesses:

If Houston even mentioned the possibility of a property tax hike, companies could begin the exodus out of Houston's city limits, said Harvey.

"The worst thing we can do right now is signal that the city is going to raise its taxes to deal with this issue and basically tell businesses that it's going to be less and less favorable to do business in the city limits," Harvey said.

Noteware said he's spoken to a number of Houston commercial property tenants, and they're already "buckling" under the weight of Houston's high property taxes. The two basic solutions for a colossal debt are to either lower expenses or raise revenue, and the city's one malleable tool that raises revenue is taxes. But, even that likely wouldn't be enough.

"It is mathematically impossible for the city to fulfill all of its obligations. It's not just that the existing day-to-day operations are unsustainable," Noteware said. "But, when you look at the total debt that has been accumulated …, it's in excess of $10 billion. The city's general fund is only $2.2 billion. The city could collect taxes for the next few years and pay nothing out. I mean, (it could) just turn out the lights and stop."

Now what?

The first step of solving a problem is acknowledging its existence. If the people holding the city accountable are aware of its short fallings, that puts Houston in a critical position of control. Now, it's leadership's responsibility to pull Houston out of the depths.

"Right now, public attention is the most important thing," Noteware said. "Public awareness and public attention."

Politically, the timing of the data's release is significant. With Mayor Annise Parker relinquishing her role as Houston mayor in January, there will likely be a slew of hopeful successors preaching fiscal reform. To date, there's around half a dozen of those hopefuls gearing up for campaign season, including Rep. Sylvester Turner (D-TX) and Ben Hall, who lost the mayoral election to Parker in 2013.

In bringing this information to light, the GHP faced a unique challenge. For an organization the job of which is to recruit businesses to Houston, detailing the city's fiscal floundering is going to make that mission harder to achieve.

"That's one of the issues we face as a partnership — bringing this issue forward. We think it's critical that the city address these issues now and that we don't continue to defer this issue," Harvey said. "But, by bringing this issue forward, it's going to get more local and national publicity, and it's going to be more of a requirement that we act. You can't raise this issue and not act, because the whole country's going to be saying, 'What did they do?'"

Houston Business Journal

Cara Smith
Editorial intern

Jul 24, 2015, 5:00am CDT

[Illinois Conduit's Program Offers Boost to Smaller Hospitals.]

CHICAGO — The Illinois Finance Authority is rolling out a new financing program this summer to help smaller hospitals purchase equipment and meet federal healthcare record-keeping mandates.

The authority also has in the pipeline a series of deals totaling more than $1 billion that received board approval this month for the University of Chicago, a large healthcare system, and two downtown Chicago-cultural institutions.

The MedCap Program offers medium-term capital for various medical projects. The program is "aimed at small-to-medium sized hospitals, of which there are many in the state, to help them meet their mandates for electronic medical and healthcare record keeping," said Pamela Lenane, a vice president who focuses on the healthcare sector for the IFA.

"It could also help them with upgrade technology assets" and other equipment needs," she said.

The state has 52 hospitals that carry a critical access designation. The IFA is initially marketing the program to smaller, independent hospitals that lack the same access to low-cost capital as larger systems, and it could eventually expand the program to also help continuing care and retirement facilities.

The authority has been looking to expand its programming and Lenane said it saw a need on the equipment/IT/medical records front. It's distributing marketing materials to hospitals and financial advisors and sharing information on the program at various hospital meetings over the summer.

The program offers tax-exempt financing with terms of up to 10 years, step up payments, and a draw down option, with fixed authority and bond counsel fees. The benefits include reduced issuance costs and fees, a simplified process, and standard documentation. For transactions under $20 million, the borrower would pay an issuer's fee of between $5,000 and $12,000. Interest rates on a tax-exempt loan could range from a low of 1.69% to 2.82% on terms between two and 10 years.

The debt would be securitized by collateral via a Uniform Commercial Code filing with no revenue pledge required and could be structured outside of a hospital's master trust indenture. Lenane said those are significant benefits because security and collateral issues for short-lived projects like IT and other equipment pose a challenge.

The bonds would be directly purchased by a lender. The IFA is in discussion with various lenders and has a commitment from Bank of America Merrill Lynch.

The board gave preliminary approval for an up to $585 million new money and refunding of 2007 bonds for the University of Chicago. The sale is tentatively expected to include nearly $350 million of new money and up to $250 million of refunding bonds. The sizing could be cut if the university decides to go with a taxable structure. Those securities would be issued by the university and not the IFA.

The university is working with lead manager Barclays Capital Inc. The co-managers include Wells Fargo Securities, Loop Capital Markets LLC, and William Blair & Co. Its advisor is Prager & Co. LLC and bond counsel is Chapman.

The university carries ratings of Aa2 from Moody's Investors Service, AA from Standard & Poor's, and AA-plus from Fitch Ratings. Standard & Poor's assigns a negative outlook. The school has been adding to its debt load to finance campus wide projects. Moody's last year dropped its rating by one level.

"Indications are that the university's investment in strategic priorities is yielding favorable results that will position it well in the future," Moody's said in downgrading the elite school. "However, risk is elevated over the next several years until the university is able to translate its strategic successes into strengthened cash flow to absorb growing debt service."

Standard & Poor's said its negative outlook reflects worse-than-anticipated fiscal 2013 financial performance combined with the university's strategic financial plan that anticipates deliberate deficits through fiscal 2018 and $300 million to $500 million in additional debt from fiscal 2015 to

2018.

The university has a total of $3 billion of outstanding bonds.

The university's strengths include its "global prominence as an elite research university, with exceptionally strong student demand at both the undergraduate and graduate level, demonstrated fundraising prowess for strategic initiatives, and growing unrestricted liquidity," Moody's said. The IFA board also approved an up to $500 million new money and refunding for OSF Healthcare system. The sale also allows the hospital system to refinance a taxable loan that helped finance its acquisitions of Kewanee Hospital and St. Anthony's and finance a new tower at one of its facilities. New money accounts for $105 million of the deal.

Barclays and Jefferies are underwriting the issue and independent advisor Anne Donahoe is working with OSF, which carries single-A ratings from Fitch and Standard & Poor's and an A3 from Moody's.

OSF is headquartered in Peoria. Ten of the corporation's hospitals are in Illinois. One hospital is in Michigan.

The authority board also gave final approval to the Field Museum of Natural History's plans to convert $89 million of floating-rate debt now backed by a letter of credit. The museum will directly place the debt with Northern Trust, JPMorgan Chase Bank subsidiary DNT Asset Trust, and Wintrust Bank. A general pledge from the museum will continue to secure the debt which will not be rated.

The museum carries ratings of A2 from Moody's and A from Standard & Poor's.

"The rating reflects our view of the Field's consistent operating performance, adequate balance sheet measures for the rating, good fundraising, and progress against its long-range financial planning model," said Standard & Poor's analyst Jessica Matsumori in a report last year. "The aforementioned strengths somewhat offsets some of the credit risks regarding the size and repayment structure of the museum's overall debt profile."

The refunding would reduce letter of credit pricing risk and to reduce variable interest rate risk on the existing series of bonds to be refunded, IFA documents said.

The museum is working with counsel Quarles & Brady LLP, bond counsel Chapman and Cutler LLP.

The Field Museum is one of the world's largest natural history museums, providing collection-based research, exhibits, and public education with a focus on diversity in the world's physical environments and cultures. Its collections are composed of over 25 million professionally maintained natural objects and man-made artifacts. The museum and its collections originated and were an outgrowth from the World's Columbian Exposition held in Chicago in 1893.

The board also signed off on the Shedd Aquarium Society's proposed $23 million refunding of insured debt that will also be directly placed with a bank – JPMorgan Chase Bank's DNT subsidiary.

Shedd carries an A1 rating and stable outlook from Moody's which was last affirmed in 2013. The refunding bonds will be secured by a pledge from the aquarium and not assets. "The proposed refunding will reduce annual debt service expense thereby providing surplus cash flow for program costs," IFA documents said.

The Shedd is working with Chapman and Cutler as bond counsel.

The Shedd Aquarium Society was established in 1924 to construct, maintain and establish the John

G. Shedd Aquarium for educational and scientific purposes, for the collection, care, study, and exhibition of fish and other aquatic animals and plant life, and the education of the public. The aquarium offers one of the largest collections of aquatic life in the world.

The Bond Buyer

by Yvette Shields

JUL 21, 2015 2:31pm ET

[S&P: Court Rejects Chicago's Pension Reform; City Needs New Plan to Address Its Ongoing Structural Imbalance.]

CHICAGO (Standard & Poor's) July 24, 2015–A Cook County circuit court judge today ruled against Chicago's statutory pension reform for its municipal and laborers plans, determining it is not allowable under the state's constitution. The case was brought by unions and retirees that challenged Chicago's pension reform. Standard & Poor's Ratings Services expects the city to appeal the decision to the Illinois Supreme Court.

In the short term, the amount of the city's contributions would decrease, likely reverting to the previous statutory formula. Despite a temporary budgetary reprieve, the increase in the city's pension liability is a significant credit risk, and the limitations placed on the city to fund those liabilities increases the liability's growth. The long-term impact of drawing down pension assets is not quantified at this time, and the magnitude of the financial and legal implications for the city if the municipal and laborers pension plans become insolvent are uncertain. Ultimately, the loss of this case means more hurdles for the city in its attempt to address its growing pension liabilities. We will likely lower our GO rating within the next six months if the city fails to incorporate pension contributions in a structurally balanced manner.

Pension reform has been one of the city's ongoing challenges. In our most recent outlook on the city's general obligation rating, we noted that, during the following six months, Chicago would need to address both its current structural imbalance, as well as the looming pension pressures to maintain its rating. For more information, please see the analysis published July 8, 2015 on RatingsDirect. Despite a likely appeal, which would delay a final decision, the loss at the circuit court level should spur the city to consider alternatives. In our view, the ruling forces the city to identify a solution that does not rely on pension reform to manage the budget demands of its pension liabilities in the long-run — a particular challenge given Illinois' state statutes governing pensions.

We expect that the next six months will show how serious the city is about implementing both immediate and far-reaching plans to address the structural cracks in its budget, including creating its own pension solution. Given the uncertainties surrounding an appeal, however, we expect city management to consider contingency plans for addressing its liability regardless of the ultimate outcome. Without long-term structural fixes, the rating on the city' debt will continue to be pressured.

Under Standard & Poor's policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or

Rating Outlook.

Standard & Poor's Ratings Services, part of McGraw Hill Financial (NYSE: MHFI), is the world's leading provider of independent credit risk research and benchmarks. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 26 countries, and more than 150 years' experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information and independent benchmarks that help to support the growth of transparent, liquid debt markets worldwide.

Eight Things We Learned from the Detroit Bankruptcy: Thompson Coburn

Detroit's historic trip through Bankruptcy Court ended in December 2014 with the confirmation of the City's Plan of Adjustment, which trimmed $7 billion in debt from the city's balance sheet and promised improved resident services. At the beginning of the case, no one predicted that the city would emerge from bankruptcy so quickly — only about 18 months — or that the final Plan of Adjustment would enjoy such widespread support among creditors and politicians. What can we learn from the largest municipal bankruptcy ever?

1. Not all municipalities can take advantage of Chapter 9. Detroit's very first battle after it filed for bankruptcy was whether it was even eligible to do so. This dispute underscored a little known fact: Most U.S. municipalities are unable to file for Chapter 9 bankruptcy. A Chapter 9 filing must be "specifically authorized" by the law of the state where the city is located. So, in the case of municipal bankruptcies, the states themselves control access to the bankruptcy courts. About one-half of the states do not say anything at all about Chapter 9, so the municipalities in those states lack the "specific authority" to file bankruptcy. Other states, such as Michigan, have very rigorous prerequisites that must be satisfied before filing. Missouri law specifically permits most municipalities to file Chapter 9. Incidentally, the term "municipality" is much broader than "city." Other political subdivisions, such as water, school or levy districts, are also included within the definition of "municipality." States cannot themselves file bankruptcy, so Illinois will have to find another way to solve its financial problems. Even if a municipality can file bankruptcy, however, there is another very important threshold question.

2. Can public pension obligations be modified in Chapter 9 cases? Private industry long ago mostly moved from defined benefit pension plans to defined contribution plans. But defined benefit plans are still popular for government employees, including many municipal employees. Many states, including Michigan, have special protections for public pensions in their statutes or even their state constitutions. For instance, Michigan's state constitution says: "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby." Therefore, when Detroit filed its case, there was a legitimate question about whether the public pensions could be modified in the Chapter 9 case.

Michigan's Attorney General argued that Michigan's constitution absolutely prohibited any restructuring of vested pension benefits. Not surprisingly, various retiree groups also opposed the city's efforts to reduce pension benefits. The bankruptcy judge ultimately determined, however, that pension benefits were not entitled to any more protections than any other contractual benefits and permitted Detroit to propose a plan that reduced vested benefits. The judge in the Stockton, California, Chapter 9 case ruled the same way a few months later. Public retirees can no longer assume that their vested benefits are sacrosanct. A definitive trend is developing in the law that a federal bankruptcy court can modify those kinds of benefits, even though state or local law suggests that they cannot be modified.

3. Bondholders and pensioners vs. residents. The Detroit case was mind-numbingly complex; one observer called it the Olympics of Restructuring. But in its simplest terms, the case was all about balancing the interests of three groups:

- Bondholders who held billions of dollars of debt issued by Detroit or its city agencies and for whom the prospect of a massive municipal default was utterly unthinkable.
- Retirees who had worked for the city for decades at below-market wages but who looked forward to a stable pension in their retirement.
- And the city's residents, who had seen city services deteriorate to a level not often seen in this country; indeed, one Forbes columnist called Detroit "America's first Third World city."

Each of the three groups had strong legal and equitable arguments that they claimed should be favored at the expense of the others. The bondholders argued that the entire municipal finance market was predicated on a municipality's solemn promise to pay the bonds, no matter what, and that the cost of municipal credit would increase all across the country if Detroit were permitted to default. The retirees argued that their pensions were not overly generous (the pensions generally ranged from $1,500 to $3,000 per month) and pointed out that many of the former employees were ineligible for Social Security because they did not have sufficient service time in the private sector. The residents pointed to Detroit's dramatic population decline, from 1.8 million in 1950 to less than 700,000 in 2013, as evidence that its residents were "voting with their feet" by leaving the City whenever they were able.

Of course, there were also many differences within the three major groups. Some of the bonds (but not all) were insured by large insurance companies, but the exposure of the bond insurers was so large that their own existence was threatened if they had to pay out. Some bonds were secured by income streams from specific projects, but others were not. Even the pension obligations were complicated. The police and firefighters had a separate pension plan from the other retirees, and it was in considerably better financial shape than the general plan. Moreover, the former city employees were entitled to other post-employment benefits (called "OPEB" in pension parlance) in the form of health and life insurance benefits that were not pre-funded at all. When everything was totaled up, Detroit had a staggering $18 billion or so in liabilities.

4. It really helps to own a $1 billion art collection. Along with its 78,000 abandoned buildings and 70 Superfund sites, Detroit also happened to own a world class art collection that included Van Gogh's "Self-Portrait," Rembrandt's "The Visitation," and Matisse's "The Window." Detroit's involvement in the art world dated back to 1919, when the City bailed out its then-bankrupt local art. In the 1920s, when Detroit was riding particularly high, the museum went on a buying spree and accumulated a collection that was the envy of museums in much larger cities. By 2013 when Detroit filed Chapter 9, the art collection was probably the city's most valuable asset, and the bondholders and retirees, who could agree on almost nothing else, both argued that it would be unfair for Detroit to keep its valuable artwork while asking for creditors to take deep discounts. After months of legal wrangling and public sniping, with estimates of the art collection's value ranging from $350 million to $2 billion, the parties reached the so-called "Grand Bargain."

This agreement, forged in dozens of court-ordered mediation sessions, formed the cornerstone of Detroit's bankruptcy plan. The deal called for the transfer of the art collection to a charitable trust in exchange for $816 million contributed from the State of Michigan, private donors, and several large charitable foundations, including the Ford Foundation, which donated $125 million itself. The retirees had to agree to accept relatively modest reductions in their monthly pensions (less than 5%) but future cost of living adjustments were eliminated. Also, almost all of the other post-employment benefits, such as retiree health care and life insurance, were slashed or eliminated.

5. Retirees fared much better than bondholders. The consensus is that the retirees fared much better than the bondholders in Detroit's case, and that the disparity in treatment was as more because of political concerns than legal distinctions. For instance, the funders of the Grand Bargain insisted that their contributions go toward shoring up the pension plans — not into the pockets of the bondholders. As the case progressed, the judge, the court-ordered mediators, and the other parties began clearly discounting the bondholders' arguments that the entire U.S. municipal bond market would be harmed if Detroit did not pay back its bond debt in full. The city reached agreements with its other creditor groups before turning its attention to the bondholders (or more precisely, the companies that insured the bonds against a default). Faced with the prospect of being the only remaining major hold-out, the bondholders began a frantic round of last-minute deal making.

For instance, Detroit and Syncora (one of the largest bond insurers) reached a deal that will set the creativity bar very high for future settlements in other cases. Syncora just happened to own the company that operates the Detroit-Windsor tunnel, having acquired that company when it filed bankruptcy several years ago. The lease on the tunnel was set to expire in 2020. As part of its settlement with Syncora, the City of Detroit agreed to extend the tunnel lease through 2040, and to give a Syncora a long term lease on a city-owned parking lot, conditioned on Syncora's commitment to make $13 million in improvements on the garage. The city also gave Syncora credits to purchase additional city-owned property in the future, including the old Joe Louis Arena. Similarly creative arrangements were reached with the other major bond insurer.

6. Not all bonds are alike. The bondholders were treated very differently, depending on the types of bonds they held. Some of the bonds that were well secured by project revenues will actually receive payment in full. Other bonds, which were secured by little or no collateral, will receive as little as 15% of their claims. This result turned the municipal bond market on its head. Historically, the bond market has considered so-called "general obligation" bonds as the safest debt that a municipality can issue because the municipality can always raise taxes to make bond payments. Special revenue bonds, on the other hand, have historically been viewed as more risky because the bond payments could come only from the collateral securing them. In the Detroit case, however, "general obligation" bonds were considered unsecured claims that are typically among the last to receive any payment in a bankruptcy case. To-date, however, the gloom and doom predictions about the future of the municipal bond market have been unfounded.

7. Municipal reorganizations are expensive. The total bill for Detroit's bankruptcy professionals was around $170 million, or about $10 million per month. Jones Day, the city's lead bankruptcy counsel, is set to collect over $51 million in fees, which it claims equates to about $17 million in discounts from its normal billing rates. Dentons, the lead bankruptcy counsel for the official retirees committee, made over $14 million. Dozens of other law firms and consultants also worked on the case. A law firm was even appointed to review and monitor the other professionals' bills, and that firm has been paid over $500,000.

8. City services should improve. Residents and visitors to Detroit have long endured abysmal city services. The average response time for a Detroit police call in 2013 was 58 minutes, compared to 11 minutes nationwide. Forty percent of the city's street lights were burned out in 2013. As part of the bankruptcy restructuring, Detroit plans to spend $1.7 billion over 10 years in so-called reinvestment and restricting initiatives, including $400 million to demolish the 78,000 or so blighted or abandoned buildings, $91 million to replace police vehicles — more than half of which are over 10 years old — and $152 million in IT expenditures — about 80% of the city's computers still run Windows XP.

Thankfully, Detroit is sui generis. No one expects a flood of municipal bankruptcies based on the relative success (at least insofar as we can tell at this point) of Detroit's restructuring. Missouri's large cities, however, are not immune from some of the same pressures and problems that contributed to Detroit's financial melt-down.

Thompson Coburn LLP

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

S&P Analysts Address Questions on U.S. Higher Education Challenges, Credit Trends, and Sector Outlook.

NEW YORK (Standard & Poor's) July 20, 2015–Standard & Poor's Ratings Services U.S. public finance analysts hosted an interactive webcast on July 13, 2015, to discuss credit trends and the outlook for the higher education sector. The webcast, which was held in conjunction with the publication of our annual median ratios reports on public and private institutions, featured discussion of hot-button topics such as how U.S.-based public and private colleges and universities are balancing their budgets and addressing increased competition, as well as trends in bond issuance, state appropriations, capital spending, and student demographic shifts.

More than 400 attendees including investors, issuers, and university and college administrators participated in the hour-long discussion. Here is a summary of the key takeaways from the Q&A portion of the webcast.

General trends in fiscal 2014 medians: Our analysis shows flat to slightly decreasing operating margins over the previous year, strong investment returns, improvement of balance sheet ratios, and a growing gap between rating categories.

State appropriations outlook: Most public universities have seen state appropriation reductions in recent years. While we have seen some stabilization in state appropriations in fiscal 2014, we do not expect appropriations to rebound to pre-Great Recession levels in the near term due to the slow economic recovery in many states and competing state budgetary priorities.

Balancing budgets: In an environment of stagnant margins, public and private universities have generally focused on "low hanging fruit" initiatives in terms of cost controls for the past several years, though cost-cutting efforts have increased for many in recent years. Many rated institutions cited a number of efforts including creating efficiencies by restructuring internal computer systems and responsibilities of staff, leaving staff vacancies open, prioritizing maintenance related to safety and holding off on other projects, limiting staff travel, and closely monitoring budgets.

Competition for students: Colleges and universities across the nation are facing increased competition for students, not just in areas with declining college student populations, but even in areas where the demographic trends are favorable. Students are applying to more schools, in part due to the ease of application submissions process, and also to broaden their program and financing options. This increased competition, and universities' heightened sensitivity to affordability, has led to a number of recruitment strategies to entice students, including: new or modified financial aid packages; increased student services; flat or declining tuition rates; adjusted class or degree offerings or requirements for a degree; or expanded recruitment into new national or international markets.

Debt issuance trends: In the first half of calendar 2015, Standard & Poor's saw increased activity in refundings as well as new money issuances, particularly in the higher rated categories for institutions with additional debt capacity. After several years of delayed capital projects or keeping themselves on a "debt diet," many issuers have come to market to take advantage of a favorable interest rate environment and move forward with decisions on strategic projects. We expect to see the effect of these issuances in the fiscal 2015 ratios.

Pension issues: We expect GASB 68 to impact public university balance sheets since several public universities we rate participate in large defined benefit pension plans administered by their respective states and several state pension plans are unfunded. This liability recognition will, in our view, likely reduce the size of university unrestricted net assets (which is an equity-based measure) for fiscal 2015 and future years. While we have received estimates from several universities for their share of these unfunded liabilities, ultimately, this is a reporting requirement and there is no requirement to cash fund these liabilities. At this time, we do not anticipate any rating changes due to this reporting requirement, as the ultimate responsibility for these pension liabilities is not expected to change.

Standard & Poor's private college and university median ratios report covers 263 universities from small regional colleges to large, national or international research universities. The public university median ratios report covers 163 institutions and includes standalone flagship and regional universities as well as several large systems.

Our reports reflect fiscal 2014 figures, which is the most recently available audited financial data and corresponding fall 2013 enrollment information. During the webcast, we provided an interpretation of those numbers while also projecting our expectations for this past year, fiscal 2015, based on historical trends, preliminary and draft financials, and multi-year budgets as well as what we have learned from management meetings.

P3s: Managing Risks And Rewards - Thompson Coburn

Successful P3s—Public-Private Partnerships—can be blessings for state and local governments searching for new ways to finance many types of critical "infrastructure"—roads, schools, prisons, and more—and control operating costs. In typical government contracting arrangements, the governmental entity designs and bids an infrastructure project and the successful private bidder only builds it for governmental operation. In contrast, a typical P3 involves a "design-build" or "design-build-operate" arrangement where the government cedes control of an initiative's design, construction and/or operation to a private contractor—albeit with specified performance parameters—in exchange for reduction in construction cost, operating cost, or financing risk.

Some P3s—e.g., the Indiana toll road contract—allow the private contractor to retain revenues from an existing project over a multi-year period in exchange for a hefty up-front payment and maintenance and operational covenants. Others, like the Chatcomm arrangement spearheaded by Sandy Springs, Georgia, use private expertise primarily to provide services like emergency dispatch while the government and the private contractor share both revenue and capital costs, and the parties collaborate to expand the market for the services.

Interest in P3s is growing as governments search for ways to access expertise, deflect risk, speed up project completion, lower capital and operating costs, avoid public votes and increased taxes, and keep what might otherwise be counted against public debt limits "off the books."

This tool is worth a hard look for any capital-strapped governmental entity in need of new infrastructure. But public officials must approach potential P3 arrangements with eyes wide open and a clear understanding of both prospective benefits and prospective risks.

Similarly, P3s can be a source of profit and accolades for private partners in a P3 venture. But private partners, too, must carefully evaluate potential benefits against a variety of risks: If a private entity accepts responsibility for long-term situations it cannot control or pledges too much of its capital and borrowing power to a single project, then the entity places its overall future at risk.

These arrangements must be carefully structured from both sides of the partnership to create the desired "win-win." Without well-informed attention to detail and more than a modicum of foresight, a P3 can cause significant damage to both public and private reputations and balance sheets.

P3 Types and Considerations: A Very Wide Range

Structuring a P3 is very challenging because P3s come in an almost unlimited variety of flavors, depending on the public entity's goals.

Some types are familiar, like the federal low-income housing tax credit, or LIHTC. That program was intended in part to shift responsibility for providing affordable housing for the nation's working class families from traditional "housing authorities" to the private sector. The LIHTC program shifts cost, operating, and financing risks to the private developer. It accomplishes its goal of providing affordable residential rental units by subsidizing annual debt service and operating costs with federal tax credits and limiting the rent the private developer can charge. Because this specific type of P3 has a sufficiently long history and is appropriately targeted to one particular purpose, most of the potential "bugs" have been worked out of the structure, and the program is generally considered a success.

At the other end of the spectrum, some P3s are essentially "one offs"—that is, there is no universally accepted and time-tested model for the contract arrangement. Those P3s present greater uncertainties and risks for public and private partners alike. For example, in certain P3 structures, a private company can theoretically guarantee completion. But, if the company lacks sufficient capital to cover its mistakes or has other costly commitments that eat up its capital cushion, the private company could become insolvent during construction and force the public sector to either assume responsibility (and cost!) for construction completion or face the specter of a half-completed highly visible eyesore while the default is litigated in court. Similarly, if a company charged with a project's long-term operation experiences financial difficulty or insolvency, the public sector could be forced to assume the project's maintenance and operational responsibility at a cost potentially far greater than what it would have paid the private company.

Conversely, a new mayor or governor may unfairly seek to void a P3 arrangement before the private partner has recouped its costs and made a reasonable return. If the public partner cannot or will not be fair and businesslike in administering its side of the arrangement, the private partner may ultimately win the legal battle but lose the war because legal fees have eaten up all its spare capital and its public adversary is effectively “judgment proof.”

P3 Risk Management: A Framework

The risk that both sides may lose in a P3 deal can increase if the deal is “too good” for either side. An important key to successful P3s is responsible management of risks and benefits—that is, an allocation that is fair to both parties.

In a P3 whose structure is relatively “simple”—for example, the public sector seeks to shift only construction cost and possibly operating cost risk to the private sector—associated public sector risks can be mitigated to a significant extent by careful up front due diligence and by incorporating protections like net worth maintenance requirements or letters of credit into the construction and operating documents. Associated private sector risks can be mitigated by including clear parameters for design and construction outcomes, sharing arrangements for mitigation of unforeseen circumstances, and fair, carefully drafted cost-escalation provisions in the agreements. In long-term arrangements, both partners must recognize that the future is uncertain and that innovation or public policy changes may impact the validity of demand or cost projections.

In P3s that rely on the private sector to generate all of the income required to pay project-related debt, due diligence becomes much more complex. Both public and private sector risks grow exponentially. Future market considerations enter prominently into risk calculi. The failure of a public-private team to accurately predict the future—a nearly impossible task—or appropriately acknowledge and assign or share uncertain long-term risk can crater a project or strangle new related initiatives at any stage of the project’s development or operations. For example, few would have predicted the sustainability movement’s popularity twenty or even ten years ago. Today, sustainability-related initiatives have a conspicuous impact on both private demand and public sector appetite for parking and highway construction on the one hand and mass transit and recycling on the other.

Equally important, both private and governmental entities moving down the path toward a P3 partnership must have the courage to pull off the road when a collision of interests is imminent. That can be very hard when a company or a government has invested significant amounts of time and money in documenting a deal that has been essentially “promised” to shareholders or constituents. Deal momentum snowballs in the rush to schedule the groundbreaking, fill a gaping budget hole, or announce a big contract to shareholders and deal documentation can easily pick up unintentional debris in the dash to the finish line. If obstacles to a successful relationship seem insurmountable or the deal presents risks that have not or cannot be reasonably allocated or shared in a manner that adequately protects each party’s interests, it may be time to put on the brakes regardless of how near the finish line may seem.

But civic progress and private-sector profits cannot be forged without a willingness to take risks—only large quantities of guts can lead to glory. Less publicized P3 successes match or overshadow highly publicized P3 failures. Success or failure depends on how well each partner plans ahead and how realistic each partner can be.

Important P3 Precepts

While public and private sector motivations vary in each P3, in all P3s the government partner attempts to tap private sector expertise and financial resources while the private partner hopes to make a profit. Successful and unsuccessful partnerships of the past offer valuable lessons and can help both private and public partners considering P3s negotiate deals that make sense for both.

Long-term implications

Government officials and private decision-makers must carefully consider the long-term public policy implications of the deal under consideration. Will it unacceptably limit the government's ability to monitor and refine long-term strategies to address changing needs? If an agreement prohibits the development of new roads in an area served by a P3 toll road, citizens may be forced to endure unacceptable traffic congestion for the term of an agreement which may last many decades. If an agreement prohibits expansion of a region's mass transit system to preserve demand for a toll road, that region's sustainability efforts may be intolerably hampered—and the only remedy may be for the public sector to "buy back" the project at significant cost and re-assume the operating and maintenance burden when the public sector's primary interest in the agreement in the first place was to shed that burden. If an agreement requires a private company to operate and pay for operating a facility when that private entity cannot control the market for the facility's "outputs," the company's assets can be decimated even to the point of bankruptcy.

As a corollary point, if the P3 contractor will be expected to generate the revenue that will pay for the project, both government and private-sector officials must each assess the long-term "market" for the improvement as accurately as possible. The operating pro forma must make sense for each party and the P3 agreement must allow for changes in that pro forma as new situations develop. It is impossible to make market predictions for two, three, or four decades into the future. New technologies are coming on the market every day and public polices change over time. Such issues can be addressed by reasonable partners: for example, instead of inking a 75-year "all or nothing" term, the partners can agree to 5-year or 10-year agreement increments where each partner may decline to renew the agreement at the end of the incremental term but once the agreement is renewed neither can terminate during the renewal period. That arrangement strikes a balance between predictability and inability to foresee what tomorrow will bring: either party can completely bow out when the agreement comes up for renewal but, if the working relationship has been a good one, it is more likely that each party will view the renewal as an opportunity to tweak the agreement and work out bugs.

Risk allocation

Public officials must think carefully and be reasonable about risk allocation. Each partner must understand, empathize with, and fairly respond to the legitimate concerns of its counterpart. Risk allocation imbalance is dangerous for both sides. If the government unreasonably over-allocates risk to the private sector partner, either no one will respond to the request for proposals or those who do respond will be more likely to fail because they have little experience in evaluating and quantifying P3 types of risks. If the private partner loads too much risk on the public partner, the government will be criticized by its constituents. Appropriately balanced risk is the hallmark of a win-win deal.

A corollary here is that the private sector partner must always remember that all of the terms of a P3 deal are public. Virtually all governments are subject to some type of "Sunshine law" that enables reporters and others to access virtually all of the final documents involved in any deal. Each P3 deal must withstand public scrutiny—if a big or even medium-sized deal cannot pass a "smell test," it is likely that some reporter will discover the deal's flaws by poring through the public record.

Non-compete provisions

Each party should think hard before it agrees to overt or "disguised" non-compete provisions. For example, a trash-to-energy arrangement may require the public sector to deliver a minimum volume of trash each month to a privately owned incinerator at a set price for a multi-decade term. Prospectively, that may look like a reasonable private sector “ask” but, in hindsight, such a provision could prevent the government from competing with the private incinerator by diverting part of its waste stream to a recycling facility. As discussed above, consider building flexibility into long-term agreements so that deal terms can change as the future changes. The public sector can be willing to pay more (or receive less on the front end) for future flexibility, or the agreement could include provisions for renegotiation if the public sector wishes to address new policy goals that impact the P3 contractor’s reasonable expectations.

Picking partners

Both parties must choose their partners carefully. A government with an unstable political climate will be a bad partner for an established private company because political battles can lead to capricious reconsideration of decisions and generate bad publicity for the company as political opponents seek to discredit each other. A government with an unfriendly business climate may, wittingly or unwittingly, hamper the project’s success. A private partner with little experience and a thin balance sheet may not be able to adequately evaluate risk or fulfill its commitments without significant insolvency concerns. Careful due diligence on both sides of the partnership is essential for P3 success: mistakes are inevitable and each partner must be able to responsibly and successfully shoulder its negotiated share of responsibility for those mistakes.

Quality assets

Both parties must also look carefully at the quality of the public sector “assets” upon which the deal is predicated. Is there a market for the asset or service? Is that market likely to grow or decline? Will the government partner support or thwart private efforts to sustain and grow the market? Can and will the private partner invest sufficiently in the asset to fulfill the government partner’s goals? What happens if the market assessment was “off”?

No time to experiment

Each party should approach untested technologies with a large grain of salt. P3s should not be viewed by either party as opportunities to experiment: risks associated with experiments are difficult if not impossible to allocate and a failed experiment will inevitably generate bad press.

Unrealistic burdens

Beware of projects that attempt to address too many goals by placing unrealistic burdens on the private partner. If a project is overburdened with requirements that do not relate directly to the core purpose of the project—e.g., excessive minority participation, local training, and workforce requirements—the cost of the project will escalate. The private contractor may understandably pad its budget because it lacks experience in addressing such requirements. The public sector may be accused of overpaying—or accused of failing to insist that the contractor fulfill unreasonable ancillary requirements.

Knowing when to fold

To reiterate: both private and governmental entities moving down the path towards a P3 partnership must have the courage to pull the plug when goals are irreconcilable. If it becomes apparent that obstacles to a successful relationship present risks that cannot be reasonably allocated or shared in a manner that adequately protects each party’s interests and gives each party a reasonable chance of success, it may be time for everyone to cut losses—or at the very least ensure that a “no fault” termination option exists at an early stage of a potentially long-term relationship.

Legal authorization

Each party should make sure that federal, state and local law permit the type of P3 arrangement contemplated. While local government charters and other organizational documents are often flexible as to the types of contracts permitted, a local P3 will almost certainly require passage of a specific law that authorizes the particular P3 agreement. On the federal and state levels, special legislation empowering agencies to enter into P3 types of arrangements is almost always required, although many states and the federal government have recently enacted legislation authorizing some types of P3s. On a related note, if federal or state funding is used even in what is essentially a local project, special federal and state requirements will likely apply. Failure to understand those requirements can significantly dampen the victory of an otherwise successful project: federal inspectors general can demand that improperly spent funds be repaid and state auditors can chastise, to the embarrassment of everyone involved.

Seek professional help

Each party must be willing to invest in good professional help in structuring the P3 agreement—and must be willing to pay for that help, even if it ultimately decides to crater the prospective deal. Private parties unused to dealing with prevailing wage, public bidding, and local benefit concerns may find themselves saddled with unanticipated costs and negative media coverage. Public parties unused to negotiating with sophisticated businesspeople may lose on key points if they cannot benefit from equally sophisticated help.

A good investment in quality front-end services from professionals experienced in P3 deals can help public and private partners avoid the pitfalls and achieve the benefits that potential P3 arrangements present.

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Article by Barbara A. Geisman

Thompson Coburn LLP

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

S&P U.S. State and Local Government Credit Conditions Forecast: Financial Management Stands Out In an Age of Economic Limitations.

With little fanfare, the current U.S. economic expansion marked its sixth anniversary in June. Any cause for more celebration was dampened by weaker-than-expected performance in the first quarter, when real GDP contracted by 0.2%. The dip–owing mostly to temporary factors–means state and local governments once again will likely have to settle for a year of subdued economic growth. In Standard & Poor’s Ratings Services’ view, the persistence of a slow recovery has increased the relative importance of financial management in terms of the strength of state and local government credit profiles. The overall positive tilt we continue to see in the balance of our rating changes, therefore, reflects that the sector as a whole has continued to embrace a certain amount of fiscal austerity. Nowhere is this more apparent than in state and local government payrolls. Whereas, by May 2014, the overall U.S. economy had recovered all 8.7 million jobs lost during the Great Recession, even as of June 2015 the state and local government sector still had replaced only 17% of the 758,000 jobs it shed.

Absent the stronger revenue trends that would likely accompany a more robust economic expansion, we've observed that many state and local governments have maintained leaner operations. Those that have done so have been able to hold the line financially and, in many cases, maintain or rebuild their reserves. But it's not universal. We've found that credit deterioration is most likely to occur where pockets of either acute or sustained economic distress couple with imprudent financial management. Recent events in Puerto Rico illustrate, albeit as a more exaggerated example, how protracted economic contraction and weak financial management practices can undermine credit quality.

Overview

- Continued slow GDP growth will require state and local government financial managers to maintain and follow prudent policies.
- The aging of society, including governmental workforces, and higher pension costs are a source of fiscal pressure for some governments.
- We project that growth will accelerate somewhat in most regions in 2016.
- Growth will likely be highest in the Mountain region in 2015 and in the South Atlantic in 2016 and lowest in East South Central in 2015 and in New England in 2016.

Continue reading.

22-Jul-2015

Chicago's Pension Law Struck Down.

A Cook County judge on Friday overturned the city's changes to two pension funds, declaring them "unconstitutional and void."

In her ruling, Judge Rita Novak dismissed city arguments that the changes to the two pension funds amounted to a "net benefit" for retired workers because the city was guaranteeing the funds would be there.

The state constitution, she wrote in her 35-page opinion, "removed diminishing benefits as a means of attaining pension stability." The city, under the state constitution, already is obligated to ensure pension funding because pension promises are "a contractual relationship between the employer and employee," the judge said.

Novak also rejected the city's contention that because at least 27 of 31 affected unions agreed to the changes, it was a "bargained-for" change.

"There is no evidence that, in reaching an agreement with the city, the union officials followed union rules and bylaws in such a way as to bind their members," she wrote. "Nor is there evidence that the membership voted on the agreement. … Additionally, there is no showing that the unions could have acted as agents of retired members while at the same time acting as representatives of active employees."

The ruling represents a setback for Mayor Rahm Emanuel and could end up costing city taxpayers hundreds of millions of dollars more because government employees would get their full benefits restored in two retirement funds and have to pay less toward their retirement.

At issue is a 2014 state law Emanuel pushed through the legislature that aimed at shoring up the financially imperiled pension funds by reducing cost-of-living increases and requiring workers to kick in more money. The city also would pay more into the retirement funds, and Emanuel came up with some of that money by raising 911 phone fees by $1.40 a month.

The worker and laborer funds are short about $9.5 billion of what's needed to meet future obligations and are at risk of going broke within 13 years.

Retired workers and unions sued, citing a clause in the Illinois Constitution that holds that government pension membership "shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."

In May, the Illinois Supreme Court pointed to that clause in unanimously overturning similar changes made to four state pension funds.

Anders Lindall, spokesman for the American Federation of State, County and Municipal Employees Council 31, one of the unions that sued to overturn the law, called on the city not to appeal Friday's ruling.

"We can know, as Chicagoans, that the highest law of our state, the constitution, has meaning, and its integrity has been upheld today — that a pension is a promise, that the life savings of public service workers will not be diminished," he said.

"We would urge the city not to waste further time and taxpayer dollars on an appeal," he said. "Judge Novak was very clear and unequivocal today, and the Supreme Court was just as unequivocal in the spring, that the constitution means exactly what it says and is without exception."

Instead, the city should come up with the money to pay full benefits, he said.

"The problem with pensions is a funding problem, it's not a benefit problem," Lindall said, adding that the average annual pension payment for a city worker is $32,000. "City employees have always paid their share."

But city officials made it clear they intend to appeal to the state Supreme Court.

"We have always recognized that this matter will ultimately be resolved by the Illinois Supreme Court," Corporation Counsel Stephen Patton, the top city attorney, said in a statement. "We now look forward to having our arguments heard there.

"We continue to strongly believe that the City's pension reform legislation, unlike the State legislation held unconstitutional this past spring, does not diminish or impair pension benefits, but rather preserves and protects them. This law not only rescues the municipal and laborer pension funds from certain insolvency, but ensures that, over time, they will be fully funded and the 61,000 affected City workers and retirees will receive the pensions they were promised," Patton said.

While Emanuel is defending the laborers and city workers case, he's already acknowledged the new legal landscape created by the state Supreme Court ruling in his proposed fix for the police and fire pension funds. His plan would not diminish benefits for police officers and firefighters. Instead, the city would stretch out the payment schedule so that initial increases in taxpayer contributions would be reduced. Police and fire pension funds are short about $10 billion and stand to go broke in less than a decade.

The approach also would provide the mayor with some short-term budget relief as the city considers new pension funding sources that could include a significant property tax increase. Lawmakers approved the city pension bill May 31 but have yet to send it to Republican Gov. Bruce Rauner amid the state government stalemate.

The stakes are high in all of this: The city's overall financial woes led one debt rating agency to downgrade the city's creditworthiness to junk status.

"It is essential that the city officials develop a comprehensive plan, both in the short term and in the long term, for the city's finances, regardless of the circuit ruling, because the city faces an over $1 billion budget deficit, the worst credit rating in the United States and the risk of further downgrade if they don't develop a comprehensive plan for stabilizing finances," said Laurence Msall, president of the Civic Federation, a nonpartisan budget watchdog group that supports the pension changes.

The court loss Friday on the laborers and municipal workers pension case actually gives Emanuel a small bit of budget breathing room heading into 2016. The city would no longer have to increase its payments into those two pension funds. That means the $50 million freed up by the 911 phone fee hike could be spent elsewhere.

In addition, Emanuel no longer would have to find an extra $50 million a year in each of the next four years for the two pension funds. But that would be kicking the can down the road, as the pension shortfalls would continue to grow and it would become far more costly in the long run to restore their financial health.

With the law overturned, workers and laborers, meanwhile, could see a savings. As part of the changes, city workers and laborers this year began making increased contributions to the funds — money they could be due back with the judge's decision.

For that reason, unions sought to block the law from being enacted pending the outcome of the case, but they were unsuccessful. "That's why we sought to have the law enjoined, so if it were overturned, it would not be so hard to unscramble the egg," Lindall said before Friday's ruling.

In closing arguments two weeks ago, Patton, the city's top attorney, contended that instead of diminishing or impairing benefits, the changes made to the worker and laborer funds ensure for the first time that the funds won't go bust. That's because the law guarantees adequate city funding, something that wasn't in the previous law, he said.

"Quite the opposite of diminishing or impairing benefits, it preserves and protects them," Patton told Novak in his closing arguments.

Patton also said at least 27 of 31 affected city unions backed the new law, showing that it was a bargained-for exchange that would abide by contract law under the theory of "consideration" that was cited by the Supreme Court in a footnote in its ruling. "There would be nothing that would justify throwing out this statute that saves these pension funds from insolvency," he said.

Clint Krislov, a lawyer challenging the law on behalf of the retired city workers, dismissed the city's contention that the new law was a “net benefit” to workers and retirees because it saved the funds. “This is the Chicken Little defense,” Krislov said. “It says the sky is falling, so we’re going to do what we’re going to do.”

BY TRIBUNE NEWS SERVICE | JULY 24, 2015

By Hal Dardick

Pennsylvania May Sue Firms Over Ex-Harrisburg Mayor’s Bond Deals.

Pennsylvania may sue the financial advisers and law firms that worked with former Harrisburg Mayor Stephen Reed as he allegedly misused proceeds from bond deals that pushed the capital city into insolvency.

The state on Monday requested proposals from lawyers interested in mounting a case, less than a week after state Attorney General Kathleen Kane charged Reed for his role in debt deals that led the city into a state receivership in 2011. Kane said Reed used bond money to buy Western memorabilia and pay those who supported his interests. Reed said he will fight the charges.

“The city of Harrisburg is experiencing financial troubles and they’re experiencing these because of past indiscretions by advisers to the city,” Jeffrey Sheridan, a spokesman for Governor Tom Wolf, said by telephone. Pursuing claims “is the right thing to do.”

Harrisburg, a city of about 50,000, was placed under a state-appointed receiver after struggling with debt payments from a costly incinerator project. It exited receivership last year after selling the plant, leasing its parking system and raising income taxes to settle with creditors owed about $362.5 million.

The recovery plan for the city said that state officials overseeing Harrisburg could seek “redress” from those responsible for decisions on the incinerator project. Any recoveries could go to creditors and the city.

Aggressive Litigation

Sheridan wouldn’t name the potential targets of the state’s action. He said officials unsuccessfully tried to recoup funds from them before deciding to turn to lawyers.

The law firms hired by the state “will be expected to implement an aggressive litigation program that includes identification of any and all causes of action surrounding the legal, financial and other professional services rendered in support of the Harrisburg incinerator retrofit,” according to the state’s solicitation.

Reed, who as mayor for 28 years oversaw the city’s growing debt burden, was the “mastermind” of a pattern of public corruption, Kane said during a briefing last week.

Reed misused money from municipal debt sold for projects including the incinerator, she said. A 2012 forensic audit cited in the state’s request for attorneys said Harrisburg officials and advisers ignored financial risks posed by the project.

Advisers Named

The report referred to RBC Capital Markets, Public Financial Management Inc., Investment Management Advisory Group and Milt Lopus & Associates Inc. for their financial analysis on the deals.

Elisa Barsotti, a New York spokeswoman for RBC Capital Markets, didn't immediately return a phone call and e-mail seeking comment. Sandra Sosinski, a spokeswoman for Philadelphia-based Public Financial Management Inc., had no immediate comment. A message left at Investment Management Advisory Group's Pottstown, Pennsylvania, wasn't immediately returned.

Bruce Barnes, who was president of Harrisburg-based Milt Lopus & Associates Inc., said by telephone that he didn't know about the state action and couldn't comment.

Amanda Ritchie, a spokeswoman for Pittsburgh-based Eckert Seamans Cherin & Mellott, LLC, declined to comment. The audit said the firm's attorneys were involved in several of the incinerator's financings.

Bloomberg

by Romy Varghese

July 21, 2015 — 10:26 AM PDT

Puerto Rico Fallout Seen Contained as Muni Defaults Prove Rare.

The good news for investors in the $3.6 trillion municipal market: only one bond issuer rated by Moody's Investors Service defaulted during the past two years, the first time that's happened since the late 1990s.

The bad news: Puerto Rico is almost certain to miss payments on some of its $72 billion of debt, which may leave investors recovering as little as 35 cents on the dollar, the New York-based credit rater said.

The stability beyond Puerto Rico helps explain why there's been few market ripples as the island careens toward a potentially record-setting default. Munis are poised for their biggest monthly returns since January, according to Bank of America Merrill Lynch data, as investors shrug off the long-building crisis brought about by the commonwealth's unique financial strains.

"Munis went through a lot of stress in the Great Recession and a lot of them did really hard work to rebalance," said Al Medioli, a Moody's analyst who worked on the annual default report the company released Friday. "This is still a very stable, high-quality sector."

States and cities that raise money in the municipal market have been steadily mending from the worst recession since the 1930s, which forced them to cut spending when tax collections tumbled. Speculation about widespread defaults, which caused investors to flee the market in 2011, were proven off base, even as a few cities, including Detroit, stumbled into bankruptcy.

Market Rarity

Defaults by borrowers rated by Moody's are rare, according to its study. Just 95 did so from 1970 to

2014. Only eight of those were general-obligation bonds, which are backed by a government's pledge to use its taxing power to repay investors.

Last year, not one of the approximately 15,400 munis that Moody's rates missed a payment, the first year without such a lapse since 1997.

This month, Dowling College in Oakdale, New York, became the first in 2015 that Moody's deemed in default. The school had seen enrollment plunge 53 percent over the past four years.

The drop in defaults may be short lived. Some localities will be forced to renege on their obligations in the years ahead as retirement costs swell and the long U.S. recovery left "more governments with less margin and weaker positions from which to weather another sharp recession," Moody's said.

"The absence of defaults in 2014 is not really a harbinger of good times; we expect defaults to occur in years to come," it said. "We see no sign that the forces pressuring the public sector have abated."

Junk Cities

The share of junk-rated local governments doubled since 2011 to 0.6 percent by the end of last year, Moody's said. Atlantic City, New Jersey, Chicago and Wayne County, Michigan, are among those with speculative grades.

Puerto Rico is also on the list. Last month, Governor Alejandro Garcia Padilla said the island can't afford to repay all that it owes as the economy struggles and residents leave for the U.S. mainland. Its Public Finance Corp. may miss an Aug. 1 debt payment because the legislature didn't appropriate funds.

The median rating for an issuer the year before it defaults is Ba3, Moody's said. Puerto Rico's general-obligation bonds, its highest-rated securities, are ranked Caa3, six steps below that.

The chances of the commonwealth defaulting "is approaching 100 percent," Moody's said in a report Wednesday.

Guessing Game

What sort of losses that would spell has been a matter of speculation. Moody's estimates that buyers of securities with weaker protections may get as little as 35 cents on the dollar. The recovery rate on others, such as general-obligation debt and senior sales-tax bonds, may be as much as 80 percent.

Medioli, the Moody's analyst, said such a default won't come as a shock. Puerto Rico bonds have plunged 9 percent this year, compared with a 0.5 percent gain for munis as a whole, S&P Dow Jones Indices data show.

"People were watching Puerto Rico all of last year" to see if it would miss a payment, he said. "They keep pulling rabbits out of a hat. They're able to do something to defer what increasingly seems like an inevitable situation."

Bloomberg

by Brian Chappatta

July 23, 2015 — 9:01 PM PDT Updated on July 24, 2015 — 6:05 AM PDT

Bloomberg Brief Weekly Video - 7/22/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

July 22, 2015

Moody's: No U.S. Municipal Defaults in 2014, But Credit Quality Erodes for Some Public Finance Credits.

New York, July 24, 2015 — There were no Moody's-rated US municipal defaults in 2014, but a deterioration in credit quality shifted a small but growing number of public finance credits deeply into speculative grade last year, according to the latest annual default study by Moody's Investors Service.

Despite the absence of municipal defaults, pressures already identified in prior Moody's default studies continue to weigh on public finance amid the expectation defaults will materialize in the future, as detailed in the report, "US Municipal Bond Defaults and Recoveries, 1970-2014."

Despite ongoing headwinds driven by long-term demographic changes and increasing balance sheet leverage from pensions and retiree health care, Moody's believes the municipal market will continue to see few defaults or bankruptcies in the near future. The median rating for all Moody's-rated public finance credits remains Aa3 and only 1.6% of Moody's 8,500 municipal credits were below investment grade at the end of 2014.

While still a low overall percentage, the number of speculative-grade local government cities and counties has more than doubled since 2011. This includes downgrades of Atlantic City (NJ), Perry County (KY) and Kankakee County (IL), and sharp downgrades of more than four notches among several credits in Puerto Rico and two school districts last year.

"Trends affecting public finance include a slow recovery and weak labor participation rate; aging demographics that affect consumer spending; and the continued growth of pension and health care entitlements that increase local government leverage and can crowd out other budgetary demands," author of the study and Moody's SVP Alfred Medioli says. Reflecting the deterioration in credit quality and as leverage increases, a very small but growing number of severely distressed municipalities are using municipal bankruptcy to adjust their liabilities.

"Municipal bankruptcy, though still rare, is becoming a more commonly considered tool to adjust liabilities in the public sector in situations of extreme stress. Jefferson County (AL), Harrisburg (PA), and Detroit all emerged from bankruptcy or receivership," Medioli says.

Moody's has also noted the growing trend of pensions being better protected in bankruptcy at the expense of debt liabilities and retiree health care benefits. This could mean larger losses to bondholders than pensioners are increasingly likely in any future Chapter 9 filings.

The study is available to Moody's subscribers here.

U.S. Charter School Default Rate Up, but Sector Sound: Report.

NEW YORK — U.S. charter schools are defaulting on bonds at a rate of 3.3 percent, a level higher than that recorded three years ago but still not one which should concern investors, according to the co-publisher of a report made available on Tuesday.

Charter schools, held in a number of municipal bond funds, are public schools that operate independently and are an alternative to schools run by local school districts. They are publicly funded but use private-sector lenders to fund buildings.

Of the $10.4 billion issued by charter schools, $346.9 million, or 3.3 percent, has defaulted, according to the report by community financing organization the Local Initiatives Support Corporation (LISC) and Charter School Advisors. That compares to 2.7 percent recorded in a 2012 LISC report by the same author, CSA managing director Wendy Berry.

“I don’t think it should be concerning to investors if they’re looking at schools in the right way,” said Reena Abraham, LISC’s vice president of education programs.

“There is tons of growth in this sector. I think they should be asking the same questions that we have been asking around academic performance. A good school will not fail you.”

The data also showed an uptick in the default rate on the basis of the number of schools issuing bonds – with 5 percent of the 818 schools defaulting according to the 2015 report versus 3.8 percent of 583 recorded in 2012.

The schools defaulted mainly because the authorizer of the school did not renew their charter due to sub-par academic performance, the report said.

Michigan’s default rate of 12 percent was the highest amongst all states. Michigan was particularly active in issuing charter school bonds in the early years of charter school bond issuance – which began in 1998 – according to the report, when underwriting criteria had not evolved, it said.

The high default rate is also due to the state having mostly small, stand-alone schools that were less able to weather Michigan’s economic downturn and the associated effects of reduced education funding, the report said.

The study also said that some state programs were improving charter schools’ access to the bond market with state officials in Colorado, Utah and Texas developing programs to allow charter operators to get enhanced credit ratings.

By REUTERS

JULY 21, 2015, 6:58 P.M. E.D.T.

(Reporting by Megan Davies; Editing by Andrew Hay)

Getting Tested Again: Municipal Bond Funds Face More Stress.

NEW YORK — Here we go again.

One worry after another has hit the municipal bond market in recent years, from a high-profile 2010 prediction for a wave of defaults to Detroit's 2013 bankruptcy filing, the largest in U.S. history.

The latest concern is actually an old one: The governor of Puerto Rico said last month that the island, whose economy and population have been shrinking for years, may not be able to repay its $72 billion in debt. That's significant because half of all muni-bond funds have some Puerto Rican bonds.

The market for bonds issued by local governments, water utilities and school districts is a notoriously emotional one, dominated by individual investors who have been quick to sell when anxious. That can amplify price drops, and investors have been pulling out of muni-bond funds in recent weeks.

But as with each recent challenge, managers of muni-bond funds expect the market to power through. Even though most funds own Puerto Rican bonds, the average amount is 3.4 percent of total assets, among funds with any at all. For half of those funds, it's 1.4 percent or less, according to data from Morningstar.

It's a separate worry, which is still looming, that may lead to bigger difficulties: rising interest rates.

"Puerto Rico is a problem in and of itself," says Lyle Fitterer, who helps oversee $39 billion in muni-bond investments at Wells Fargo Advantage Funds. "It's not going to have a spillover effect on the broader municipal market."

PUERTO RICO PORTIONS

One of the main draws for municipal bonds is that their income is free from federal income taxes.

Puerto Rico is a special case because income from most of its bonds is also free from state and local taxes for people living California, New York and other states far from the Caribbean. Nineteen municipal-bond funds have 10 percent or more of their assets in Puerto Rican bonds, mostly ones that focus on single states or high-yield bonds.

Worries about Puerto Rico, along with other factors, drove investors to pull $1.6 billion out of muni funds in May and June. It marked the first monthly withdrawals since 2013. Even so, muni funds have drawn $29.7 billion in net investment over the 12 months through June, according to Morningstar.

Analysts pay close attention to these numbers because individual investors drive the market. After the much-publicized 2010 predictions for a coming wave of defaults, for example, nervous investors dumped their muni funds. Their pullout forced managers to sell bonds to raise cash to return to investors, which pushed prices lower and spurred even more investors to head for the exits.

LITTLE SPILLOVER

But the troubles for Puerto Rico have not hurt prices of other municipal bonds much.

Even though some areas of the country are also under financial pressure, such as Chicago, tax revenues for local governments are generally improving.

"It's amazing how the market has shrugged off these problems, but there is a thirst for fixed income that seems insatiable," says Josh Gonze, portfolio manager at Thornburg Investments, which manages about $10 billion in municipal bonds. "The market is saying, 'We'll pass on Puerto Rico and the Detroits and Chicagos, but we'll buy everything else.'"

The average intermediate-term, national municipal bond fund is down 0.4 percent over the last three months.

RATE EFFECT

The reason for the price drops during the spring may not be what investors expect.

Although many blame the problems in Puerto Rico, Chicago and other hot spots, "it's really because interest rates are moving higher," Fitterer says.

Higher rates pull down existing bonds' prices, because their yields are suddenly less attractive than those of newly issued bonds. And muni yields are higher than at the start of the year, following the lead of Treasurys. Many economists expect the Federal Reserve to begin raising short-term rates later this year.

Warnings have been circulating for years that bond prices could be in for a sharp slide, once rates rise. Even if it shouldn't happen, muni fund managers acknowledge that some investors may react to a Fed hike by immediately selling in hopes of avoiding losses.

Some fund managers have increased the cash in their portfolios, which would enable them to take advantage and buy low during a sell-off. Gonze's Thornburg Intermediate Municipal fund has 18 percent in cash, up from about 5 percent two years ago, for example.

If a sell-off occurs, managers say it could be short and shallow. Joe Baxter, head of the municipal bond group at Delaware Investments, points to 2004, the last time the Fed began a series of rate hikes. The funds he oversees all rose in the ensuing year.

"You can sit there, waiting for an event," Baxter says, "but then you're missing a chance to keep earning income in a market that's 95 percent good."

Just don't expect the returns to be very big. Yields are low – close to 2.25 percent for a 10-year municipal bond – which means returns will likely be too.

By THE ASSOCIATED PRESS

JULY 23, 2015, 5:11 P.M. E.D.T.

Municipal Bonds Still Considered Safe, Despite Some Ailing Governments.

Puerto Rico is drowning in $72 billion of debt it admittedly cannot pay back. Several states — Illinois, Pennsylvania, New Jersey and Kentucky among them — are facing mounting financial problems of their own, mainly because of pension promises that are not properly funded.

Those government travails come just two years after Detroit's historic bankruptcy, the largest municipal default ever.

Since individuals hold most of the $3.7 trillion invested in municipal bonds — or about 70 percent, either directly or through mutual funds — it raises the question: Should investors be worried? After all, municipal bonds have traditionally been viewed as safe investments.

“There is more stress in the muni market today than there was 10 years ago because there are higher fixed costs like pensions and retiree health care costs, increased debt costs and more modest revenue increases,” said Lisa Washburn, a managing director for Municipal Market Analytics, a research firm based in Concord, Mass. “I am more worried about credit deterioration in states with significant pension issues, but I am not at this point concerned about any risk of default at the state level.”

Overall default levels remain exceedingly low and are not expected to rise meaningfully. The default rate of the S&P Municipal Bond Index, which tracks 84,000 bonds from more than 22,000 issuers, was 0.17 percent in 2014, compared with about 0.11 in 2013.

“We expect to see a small increase from the past in terms of bankruptcy or restructuring, but we have to put this in perspective,” said Christopher W. Alwine, head of Vanguard’s municipal bond group. “It’s a few isolated events in a very large market.”

Still, the pension problem isn’t going away anytime soon. Cities, counties and states will continue their struggle to find the most politically palatable and financially feasible ways to shore up their finances. In some cases, governments have issued more bonds to fill in the pension shortfall, which feels a bit like resorting to a credit card to cover the daily bills.

A recent analysis by the Pew Charitable Trusts found that state and local pensions had a funding gap of $1 trillion.The Illinois pension system, for example, was only 39 percent funded in 2013, according to the report, and the Kentucky system was just 44 percent funded.

“Some states have big pension problems, but they also have a lot of power to manage expenses and raise revenue,” said Al Medioli, head of credit policy for the public finance group at Moody’s Investors Service. “Some local governments are having a harder time.”

The ability to raise taxes has played a large part in keeping overall municipal bond default rates so low — and has contributed to the perception that muni bonds are generally solid investments. General obligation bonds were issued by municipal governments and backed by their “full faith, credit and taxing power,” and investors in such bonds had the legal standing to seek a court-ordered tax increase if that is what it would take to prevent a default. Even in the extremely rare case when a municipality filed for bankruptcy, general obligation bondholders typically recovered most or all of their money, bond analysts said.

But in Detroit’s bankruptcy, that didn’t happen. General obligation bondholders recovered at most only 74 cents on the dollar and in some cases less, while many so-called revenue bondholders were not hurt. Revenue bonds, like those issued by a sewer authority for a new treatment plant, are repaid with a dedicated stream of revenue generated by that authority. As result, some bond managers and investors, both large and small, are shunning general obligation issues in favor of revenue bonds.

“This is the flip of what was taught in Bonds 101,” said Marilyn Cohen, president of Envision Capital Management in El Segundo, Calif., who manages bond portfolios. “Everything we have been taught about general obligation bonds, that the issuers have the unlimited ability to tax the people and pay the bonds, we learned that is false.”

Peter Hayes, head of BlackRock’s municipal bond group, called it the emergence of a dangerous precedent. “If you look at Detroit, it was really more about politics than the law,” he added.

In the bankruptcy of Detroit, as well as with those of Stockton and San Bernardino, Calif., pensioners were widely seen as faring better than bondholders since they received smaller reductions to their benefits, though many retirees did make concessions.

Investors are often drawn to municipal bonds, which help pay for public projects, because of their favorable tax treatment: Individuals generally don't pay federal income tax on the interest they receive. And if you live in the state where the bond was issued, the interest may be exempt from state and local income taxes as well.

Given the tax advantages, munis are often associated with investors in the highest tax brackets, but financial advisers said they often made sense for people in upper-middle tax brackets as well, say, 28 percent or higher.

Wherever you fall on the tax hierarchy, however, what has emerged from the financial crises in Puerto Rico and elsewhere are some basic lessons that bear repeating: Invest only in a diversified portfolio of municipal bonds, and know what you own. Financial advisers said it might be hard to assemble a diversified portfolio of individual bonds without $500,000 to $750,000, though some said it could be done with as little as $250,000.

Many mutual funds offer far more diversification: In Vanguard's national municipal bond funds, for instance, most issuers account for less than 1 percent of a fund's overall holdings.

But that doesn't mean fund investors are fully protected, either. Puerto Rican debt, for example, shows up in about 52 percent of municipal bond mutual funds, according to Morningstar. Exposures range from less than 1 percent of the fund's assets to nearly half.

Consider the collection of municipal bond funds offered by Oppenheimer Funds that are named after individual states, which are particularly attractive to people living in those states because they do not pay tax on bond income at three levels: federal, state and local.

The Rochester Maryland Municipal Fund, for example, had about 52 percent of its holdings in Maryland bonds as of June 30, while about 48 percent was in Puerto Rico. And the Virginia fund had nearly 40 percent of its holdings in Puerto Rican bonds, according to Oppenheimer's website.

So how does a fund named after one state invest an overwhelming chunk of its assets in another locale?

It is perfectly legal, according to the Securities and Exchange Commission rules about what companies can name their investments. Yes, single-state municipal funds must invest 80 percent of their assets in investments of the named state. But an out-of-state security can be placed in the 80 percent basket if it pays interest exempt from both federal income tax and the tax of the named state — a bar that is cleared by United States territories like Puerto Rico, Guam and the Virgin Islands.

With Puerto Rico, "because of the high yield and because of its triple-exempt tax status, it made it particularly attractive to some firms and managers that run single-state muni funds," said Beth Foos, a senior analyst at Morningstar, who also noted that the single-state fund's investment universe was limited.

Puerto Rico is an unusual case. But that the small island shows up in so many portfolios should serve as a reminder to all municipal investors. "You need to know where your money is going," said Ann Rutledge, a co-founder of the ratings firm R&R Consulting, "and how you are going to get it back."

THE NEW YORK TIMES

By TARA SIEGEL BERNA

JULY 24, 2015

Chicago Public Worker Pension Reform Plan Found Illegal.

A plan to ease Chicago's $20 billion public-worker pension deficit is illegal, an Illinois judge ruled, leaving the city vulnerable to another credit downgrade.

Immediately after the ruling, Standard & Poor's said it would probably lower the city's rating again if a solution isn't found. S&P already cut Chicago's rating earlier this month to BBB+, or three levels above junk.

The Illinois Constitution bars the diminishing of public pensions, state court judge Rita Novak ruled Friday. The Illinois Supreme Court in May killed similar changes to the state's pension funds for the same reason.

Rejection of the state plan led within a week to a downgrade of Chicago credit to junk status. Chicago's pensions will be broke in about 10 years without the plan, city lawyers argued before the ruling.

The city's pension plan and the one covering state workers both envisioned cuts in future cost-o--living increases. Chicago argued that its plan was different from the state's because it increased city funding of pension funds and the Illinois measure only reduced benefits.

Novak rejected the city's arguments.

General Assembly

The state constitution "affords the participant protection against" cuts in benefits even if the general assembly changes the pension code, the judge wrote in her 35-page ruling.

The city will appeal to the state supreme court, Chicago's lawyer said after the ruling.

"We continue to strongly believe that the city's pension reform legislation, unlike the state legislation held unconstitutional this past spring, does not diminish or impair pension benefits, but rather preserves and protects them," Stephen Patton, a lawyer for the city, said in an e-mailed statement.

The American Federation of State, County and Municipal Employees Council 31, one of the plaintiffs in the suit, urged the city in an e-mailed statement "not to take up further time and expend additional taxpayer dollars on an appeal of today's decision."

Job Cuts

The court fight over pension reform comes as the city and state face increasing financial pressure. Chicago's public school system is eliminating 1,400 jobs. Illinois' retirement fund has a $111 billion shortfall. And the state is operating without a budget because of stalemate between Republican Governor Bruce Rauner and the Legislature's Democratic leadership.

The pension system in Chicago is $20 billion short and is only 36 percent funded, compared with 61 percent in 2005.

Chicago’s measure, signed into law last year, restructured the pensions of laborers and municipal workers, requiring employees and the city to pay more into the plan while benefits are reduced. The pension plans for fire and police retirees weren’t affected.

The city reform was developed in negotiations with 28 of 31 affected unions, Mayor Rahm Emanuel said in May. The employees had a “full funding guarantee,” the city said. Union-backed beneficiaries sued on behalf of retirees and employees to block the reform.

Truck Driver

The plan didn’t have the support of pensioners, Charles Lomanto, a retired truck driver for the city of Chicago, told reporters outside Novak’s courtroom Friday.

Under the plan, which took effect Jan. 1, pensioners lost all but .85 percent of an expected 3 percent increase in benefits, Lomanto said. Meanwhile, Lomanto said, his health insurance premium costs rose to $1,300 a month from $740.

“Rahm never came to retirees and said, ‘Hey, can we talk?’’ Lomanto said. ‘‘Unions can’t negotiate on behalf of retirees.’’

The rejection leaves Chicago with no viable plan to solve the pension deficit, said Sarah Wetmore, vice president and research director at the Civic Federation, a Chicago nonprofit that tracks municipal finance.

‘‘Without these reforms, the city reverts back to an inadequate funding formula that has resulted in such severe underfunding that actuaries expect the Municipal and Laborers Funds will run out of money within the next decade -– an unthinkable prospect,’’ she said.

‘Credit Neutral’

Moody’s Investors Service called the ruling ‘‘credit neutral’’ for Chicago because of the expected appeal to the state supreme court.

‘‘The ruling is one step forward in the process of resolving outstanding questions on the constitutionality of the 2014 legislation,’’ Matt Butler, assistant vice president and Moody’s lead analyst for Chicago, said in an e-mailed statement.

Chicago’s financial woes and credit downgrades have burdened the city with higher borrowing costs as investors demand larger yields, relative to top-rated bonds, to buy its securities.

Yields on some Chicago bonds are close to the highs reached when Moody’s Investors Service cut the city’s rating to below investment grade in May after the Illinois Supreme Court struck down the state’s pension overhaul.

The price of a taxable Chicago bond maturing in 2042, the most actively traded city security Friday, was little changed at 99.2 cents on the dollar. The securities yield 7.8 percent, almost 5 percentage points above benchmark Treasuries, according data compiled by Bloomberg.

Supreme Court

‘‘Barring a reversal at the supreme court, this puts us back to square one on pension reform in

Chicago," said Richard Ciccarone, Chicago-based chief executive of Merritt Research Services LLC, which analyzes municipal finances. "Now the pressure on the city to come up with a solution here that won't unduly burden taxpayers, and at the same time achieve some level of reform is going to be challenging."

The case is Jones v. Municipal Employees Annuity and Benefit Fund of Chicago, 2014CH20027, Circuit Court, Cook County, Illinois, Chancery Division (Chicago).

Bloomberg

by Margaret Cronin Fisk

July 24, 2015 — 8:34 AM PDT Updated on July 24, 2015 — 11:42 AM PDT

Fitch: Statutory Liens Do Not Boost U.S. Municipal Debt Ratings.

Despite its growing use in U.S. municipal debt, the presence of a statutory lien will not enhance a municipality's debt rating, according to Fitch Ratings in a new report.

The role that statutory liens play when a municipality files for bankruptcy protection has been a topic of increased attention. Perhaps the most notable example of late is California's new law (Senate Bill 222) which automatically attaches a statutory lien to all future general obligation (GO) debt issued by cities, counties, school districts and community college districts. 'While the presence of the statutory lien will enhance a creditor's post-default recovery prospects, it doesn't avoid the interruption of payment upon a bankruptcy filing by a municipality,' said Managing Director Thomas McCormick. 'The simple reason is that in a bankruptcy scenario, the pledged tax revenue could be subject to interruption and default would be likely.'

While statutory liens do not protect a creditor from payment interruption in the event of a bankruptcy, a security defined as 'special revenue' under Chapter 9 of the U.S. bankruptcy code does. The definition of special revenues in the code includes enterprise revenues and such revenues are exempt from the automatic stay in the event of bankruptcy. Fitch's ratings for Detroit's credits reflect the distinction between general and special revenues. Fitch rated Detroit's water and sewer debt distinct from the city and as high as 'BBB+' following Detroit's July 2013 bankruptcy filing despite a 'C' rating on Detroit's unsecured GO debt. Another notable example is the City of Stockton, CA's water bonds, which Fitch rated distinct from the city and as high as 'BBB' during Stockton's bankruptcy notwithstanding defaults on other bond debt by the municipality.

As a result, Fitch caps the ratings on bonds supported by non-special revenues at the unsecured GO debt rating of the municipality. A recent example of the rating cap is the City of Chicago. Like the City's GO debt, Fitch rates Chicago's sales tax bonds 'BBB+' with a Negative Outlook despite high coverage of maximum annual debt service at over 15 times. 'The revenue flows from Chicago's sales tax bonds could be subject to interruption if Chicago were to file for bankruptcy,' said McCormick. 'Additionally, because there is no statutory lien, the lien interest would end with respect to future general sales tax revenues upon a bankruptcy filing by the city and recovery prospects could be no higher than general credit quality recovery.'

July 20, 2015 10:33 AM

New California Law Would Secure Local GO Holders in Bankruptcies.

PHOENIX — California Gov. Jerry Brown has signed a new law securing revenues for general obligation bonds issued by local governments — a move designed to protect bondholders in a bankruptcy proceeding. But rating agencies have mixed feelings about whether it will be of much benefit to holders of local GOs in the nation's most populous state.

The law, known as SB 222, is designed to preserve bondholder rights to the tax revenues used to back bonds, which are received by a municipality after it enters bankruptcy proceedings. The bankruptcy code defines statutory liens like those mandated under SB 222 as created by force of law, as opposed to typical consensual liens that are created by an agreement. "Secured" creditors of a bankrupt municipality are supposed to be first in line to recover their money, but California law was previously silent on whether local GOs were "secured" for that purpose. The new law removes that ambiguity.

"Many have argued that the taxes levied to pay California GO bonds are 'special revenues' under the bankruptcy code, but this analysis has never been certain," said Orrick, Herrington & Sutcliffe attorney John Palmer, who drafted SB 222. "This is the first time we have been able to say that GO bondholders are secured creditors in a municipal bankruptcy. Being a secured creditor in bankruptcy dramatically decreases the risk of nonpayment. This newfound certainty should permit investors and rating agencies to focus more narrowly on the tax-base as the credit for California GO bonds, and less heavily on issuers' general funds."

State Sen. Mary Block, D-San Diego, introduced the bill earlier this year. It passed through both the Assembly and the Senate with strong support last month. The new law, which becomes effective on Jan. 1, is very similar to legislation enacted in Rhode Island in 2011 after Central Falls filed for Chapter 9 protection. California has been home to some high-profile bankruptcy proceedings, including the cities of Stockton, which emerged from Chapter 9 earlier this year, and San Bernardino, which has not yet completed the process.

Moody's Investors Service was upbeat about the implications for holders of bonds sold by California issuers.

"Generally speaking, the security for California local government GO bonds is a dedicated, unlimited, voter-approved property tax levy, the proceeds of which cannot be used for any purpose other than the bonds authorized by voters," Moody's analysts wrote. "The California Constitution makes the debt service levy separate from the property tax levied for operating purposes. State statute is nonetheless silent on whether GO investors would be secured in the event of a local government's bankruptcy filing, and case law on this matter is also very limited. The new law is positive for GO investors because it clearly establishes their secured status."

Although Moody's views the bill as a credit positive, the agency said it would not likely have a "material effect" on the ratings of California local GOs.

Fitch Ratings analysts had a conservative take on the law.

"Revenues supported by a statutory lien are not free from the automatic stay of a municipality's general revenues once bankruptcy proceedings begin," Fitch said. "Rather, the statutory lien prevents the municipality in a bankruptcy from generally diverting the revenues subject to the statutory lien. The statutory lien does not prevent use of the revenues in the bankruptcy process as long as adequate protection for recovery is offered to bondholders benefiting from the statutory lien.

These protections will not guarantee full or timely repayment, only potentially higher recovery."

Palmer said that agencies no longer having to look as closely at general funds due to the assurance of a statutory lien on revenues could be a big positive for issuers paying too much because of general fund weaknesses.

"This would potentially save taxpayers billions of dollars over the time," he said.

THE BOND BUYER

BY KYLE GLAZIER

JUL 17, 2015 3:24pm ET

Social Impact Bonds: A Better Way to Combat Blight.

Like many less affluent cities, Richmond, California, has been dealing with a rash of blighted properties since the real estate meltdown. Although market prices in many areas have returned to their post-crash highs, some homes remain either abandoned or very poorly maintained by owners unable to meet mortgage payments – and thus facing foreclosure. After an unsuccessful attempt to deal with the problem through eminent domain, the city is now turning to social impact bonds to rehabilitate these homes.

In 2013, city leaders proposed an innovative but controversial initiative to attack blight: Investors in private label residential mortgage backed securities (RMBS) would be asked to sell some of their underwater mortgages to the city at a discount to the principal balance. If the investors were unwilling to sell (as they ultimately were), the city would work with a private company, Mortgage Resolution Partners (MRP), to take over the mortgages through the power of eminent domain and then refinance home owners into FHA loans with lower balances.

The plan, called Richmond CARES, met with widespread criticism, as well as litigation from banks and RMBS investors. One issue was the program's poor targeting: Mortgages eligible for Richmond CARES had to be in RMBS pools and had to be either performing or only slightly delinquent. This universe included a lot of high-end properties near San Francisco Bay, but missed many of the most distressed homes in poorer neighborhoods. These highly distressed properties may have had government-backed mortgages or their private mortgages couldn't be refinanced with FHA loans while, at the same time, leaving enough equity to cover the city's costs and pay MRP's $4,500 per-home fee.

Aside from being poorly targeted, the plan also had undesirable side effects, such as undermining the private mortgage market – since lenders would potentially have to price eminent domain risk in addition to default and prepayment risk. Although the City Council has not officially cancelled Richmond CARES, the initiative has not advanced for two years and MRP's website is no longer active.

But now the city – in partnership with the not-for-profit Richmond Community Foundation – is pursuing a more promising strategy. Richmond is planning to issue $3 million of social impact bonds to purchase, rehabilitate and sell blighted properties. During a four-year revolving period, sale proceeds will mostly go to purchasing new properties; during the final year of the bonds' five-year life, proceeds will be devoted to repaying principal and interest.

The purchase and rehabilitation program will be run by the Foundation. Initial targeted properties will include some of the 250 abandoned homes that have been taken over by the city – typically due to failure to pay property taxes. Local contractors will be hired to perform the rehabilitations – keeping the money in the community.

The rehabilitated homes will be offered to graduates of the Richmond SparkPoint Center. SparkPoint, an initiative of the United Way, helps area individuals and families dealing with financial crises. Center advisors help clients get out of debt, increase their income and build savings. Program graduates have a FICO score of 680, making them eligible for FHA mortgages.

Properties will be sold at market rate to avoid depressing nearby property values. But, as Joshua Genser, one of the program's architects, pointed out to me, "market rate" in a poor area of Richmond is very affordable by the standards of the Bay Area. Single-family homes are likely to sell for around $250,000 – a small fraction of what one would expect to pay in nearby communities.

Although the bonds are issued by Richmond, they are not secured by city revenues. The sole source of funds for debt service will be proceeds from the sale of the rehabilitated properties. The bonds are intended for social impact investors less concerned with maximizing risk-adjusted returns than in using their capital for public benefit. The Richmond bonds are most likely to be sold via a private placement to a local bank endeavoring to meet its obligations under the Community Reinvestment Act.

If all goes well, the bonds will be fully repaid with up to 10 percent interest. Any extra proceeds will be retained by the Foundation. Due to the novelty of the program and the fact that it requires effective execution to be profitable, bond investors are taking on a significant risk of principal loss. Although the city has no legal responsibility to make investors whole, a default could affect investor attitudes toward other city debt – a major concern at the moment due to the recent downgrade of Richmond's debt by Moody's. For this reason, it may be better for future social impact bonds to be issued by joint powers authorities or other special purpose entities that do not have similar concerns over reputational risk.

But this is a minor concern over an idea that promises major social benefits. By targeting the most blighted properties, the bond program will improve quality of life and support property values in the neighborhoods that most desperately need this sort of help. The program also promises to improve the city's budget picture by reducing code enforcement costs and eliminating property tax delinquencies.

It is also impressive to see a non-profit partnering with the city as well as private law firms and financial institutions – which have structured the transaction on a pro bono basis – to implement such an innovative concept. The Richmond bond is a great example of a fourth sector initiative, in which private for-profit companies, governments and non-profits team up to tackle stubborn social problems.

BY MARC JOFFE

JULY 13, 2015

Marc Joffe is principal consultant of Public Sector Credit Solutions, an organization that produces data and analytics relevant to government bonds. Previously, Marc was a senior director at Moody's Analytics.

S&P's Public Finance Podcast: (Median Ratio Reports on Public and Private Universities and Colleges).

In this week's Extra Credit, Associate Director Shivani Singh discusses our median ratio reports on public and private universities and colleges.

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Jul 17, 2015

Senators Unveil Puerto Rico Bankruptcy Bill.

WASHINGTON — Sens. Chuck Schumer, D-N.Y., and Richard Blumenthal, D-Conn., unveiled a bill on Wednesday that would allow Puerto Rico municipalities and public corporations to seek protection under Chapter 9 bankruptcy.

The bill, a companion piece of legislation to H.R. 870, a substantially similar bill, has Democratic support but no Republican sponsors. Puerto Rico's non-voting member of Congress, Pedro Pierluisi, introduced H.R. 870 in February and that bill is pending before a subcommittee of the House Judiciary Committee. Rep. Bob Goodlatte, R-Va., the committee chair, said recently that Republicans are not interested in moving that bill.

The push in Congress to consider giving the troubled island entities access to Chapter 9 powers became more urgent after Puerto Rico Gov. Alejandro García Padilla said that the commonwealth will not be able to pay its creditors unless its approximate $72 billion of public debt is restructured. Creditors that hold Puerto Rico debt have lobbied against bankruptcy powers, saying they would prefer the receivership model that would result from a default.

Blumenthal defended the bankruptcy bill, saying Puerto Rico and creditors deserve a "fair, orderly" process.

"The purpose of this bill is to avoid disaster and prevent Puerto Rico from going over a fiscal cliff that is entirely preventable," he said during the press conference. "This disaster would be a self-inflicted wound that can and should be avoided."

Schumer, who said the amount of debt is "staggering," added that he, Blumenthal and the 10 other Democrats sponsoring the bill are committed to helping Puerto Rico fight the "catastrophe head-on and in the right way."

Extending bankruptcy powers to the island has been a generally popular proposal among Democrats, both lawmakers and presidential candidates, but has received little support from Republicans. However, Schumer and Blumenthal said they are hopeful it will become a bipartisan bill. Both said they have had productive talks with their Republican colleagues and Schumer said a number of them "seem to be genuinely interested."

"In the coming weeks, we're going to urge our Republican colleagues to get on board to do what's prudent and fair, to get this bill across the finish line," Schumer said.

Sens. John Cornyn, R-Tex., and Orrin Hatch, R-Utah, have been open to considering granting bankruptcy rights in Puerto Rico. Both senators sit on the Senate Judiciary Committee where the bill is expected to be referred.

Sen. Chuck Grassley, an Iowa Republican and the committee's chair, has previously said he would like to see Puerto Rico's government develop a financial plan before considering granting island entities bankruptcy powers.

García Padilla, who has taken steps to develop a financial plan, has been lobbying members of Congress that have the power to weigh in on both the Senate and House versions of the bill. He reportedly had a one-on-one meeting with Grassley and recently wrapped up a trip to Washington where he met with Republicans on the House Judiciary Committee, including Mimi Walters from California, Ron DeSantis from Florida, Jason Chaffetz of Utah and Ken Buck of Colorado.

"I'm hopeful that the debate in Congress will propel this bill to passage with bipartisan support," García Padilla said in a statement released after Blumenthal and Schumer's press conference. "Chapter 9 is an option that all states have at their disposal for their municipalities and public corporations and there is no reason why Puerto Rico, its creditors and its citizens should not be afforded the same protections."

While Blumenthal did not have an exact timeline for the bill, he said the goal is to operate under the assumption of "the sooner the better."

"Time is not on our side," he said. "The longer uncertainty persists, the more unstable the result."

THE BOND BUYER

BY JACK CASEY

JUL 15, 2015 4:06pm ET

University of Kentucky's Housing P3 Continues to Break New Ground.

The University of Kentucky (UK) Board of Trustees has approved the fifth phase of a massive student housing revitalization plan that will raise the number of beds on campus to 6,504. The $74 million University Flats project, a seven-story building that will contain 771 beds in 312 apartments, is scheduled to open in fall 2017, reported Student Housing Business.

Memphis-based campus housing developer Education Realty Trust (EdR), will finance, build, maintain and manage the project in addition to 12 other residence halls it has built or is constructing for UK. The company, which is responsible for $422 million for the overall project, will have a 75-year lease on all of its buildings and will collect rent, paying some of it to the university once agreed-upon profit thresholds have been met, according to the Lexington Herald-Leader. Specifically, after receiving a 9 percent rate of return from rental payments, in addition to a 2 percent fee for managing the buildings, the company will give UK 25 percent of the net income. Because UK owns the buildings, EdR will not have to pay state property taxes.

This partnership, which was negotiated in 2011, represents the largest on-campus housing development at a U.S. public university. Many other schools are using P3s to add to or replace their student housing stock.

NCPPP

By Editor July 16, 2015

Recovery Best Seen in California and Texas as Debt Sales Shrivel.

Texas and California are so flush with cash they're enjoying a rare boom-times perk: The states don't have to borrow in the $3.6 trillion municipal-debt market to pay bills until tax collections flood in.

Texas is skipping its annual note sale for the first time in three decades because of a surplus left from a surging economy, which grew more than twice as fast as the U.S. last year. California, which was so broke after the recession that it took to issuing IOUs, isn't seeking a short-term loan for the first time since it was held aloft by the 1990s Internet bubble.

The two illustrate the fiscal revival among some states as the economic expansion enters its seventh year. As a result, the sale of notes is poised to fall for a fifth year to less than half the $78 billion peak in 2010, when governments were reeling from the recession, according to data compiled by Bloomberg.

"We're seeing a big decrease in issuance because their fiscal situations have improved significantly," said Doug McGinley, a money manager for Fidelity Investments. "We're seeing less supply because of the improving health of states and their fiscal situations."

While investors have focused on the persistent fiscal strain on borrowers including Puerto Rico, Illinois and New Jersey, finances in most state capitals have been steadily on the mend. A report by the National Association of State Budget Officers last month said revenue collections have stabilized, with growth of 3 percent projected for the current fiscal year.

Rising Rates

The dwindling supply of notes, which typically mature in a year or less, is forcing firms such as Fidelity to find other short-term investments for money-market funds, said McGinley. That's helped ease the pressure on the note market, where prices have slipped this year amid speculation that the Federal Reserve will raise interest rates for the first time in 9 years.

State and local government securities maturing in six to 12 months returned 0.16 percent this year, compared with 0.18 percent for the municipal market overall, according to Bank of America Merrill Lynch indexes.

"The supply of short-term paper will be more constrained," said Burt Mulford, who helps manage $34 billion at Eagle Asset Management in St. Petersburg, Florida.

1980s Phenomena

This year will be the first since 1985 that Texas hasn't sold notes to pay its bills until the bulk of its tax collections arrive. It borrowed $5.4 billion last year.

While the oil-price slide has exerted a drag on Texas's growth, the government has a surplus after its economy expanded by 5.2 percent last year, faster than any other state but North Dakota.

It has $8.5 billion in its rainy day fund, said Chris Bryan, a spokesman for Texas Comptroller Glenn

Hegar. When lawmakers approved their annual budget this year, they left $6 billion of projected revenue unspent, he said.

“We probably have the best balance sheet of any state in the nation,” Texas Governor Greg Abbott said during an interview Tuesday in Bloomberg’s offices in New York.

California Treasurer John Chiang said the strong economy and steps to eliminate the state’s budget deficit are allowing it to avoid short-term borrowing for the first time since the 2001 budget year. That was when California was still enjoying a tax windfall from the soaring stocks of dot-com companies, a good fortune that disappeared when the bubble collapsed.

On July 2, Standard & Poor’s raised California’s rating one step to AA-, it’s highest grade from the company in 14 years.

“It says a lot about the stronger economy in these states,” said Peter Hayes, head of munis at New York-based BlackRock Inc., which oversees about $116 billion of the securities. “There is less need to borrow.”

Bloomberg

by Darrell Preston

July 14, 2015 — 9:01 PM PDT Updated on July 15, 2015 — 6:34 AM PDT

Bloomberg Brief Weekly Video - 07/16/15

Bloomberg’s Michelle Kaske talks with Joe Mysak about this week’s municipal market news.

Watch the video.

1:50 PM PDT
July 16, 2015

Pension Funds Burn Cities as $1 Trillion Shortfall Set to Grow.

The cost to American cities for their cash-strapped pension funds is starting to look a lot worse, and it’s not because the stock-market rally may be losing steam.

Houston was warned by Moody’s Investors Service this month that it may be downgraded because of mounting retirement bills, the latest municipality put on notice as the company ignores bookkeeping gimmicks that let cities mask the size of their debt for years. The approach foreshadows accounting rules for even top-rated issuers that are poised to cause pension shortfalls to swell as new financial reports are released.

“If you’re AAA or AA rated and you’ve got significant and visible unfunded pension obligations, you’ve only got one direction to go in terms of rating, and that’s potentially down,” said Jeff Lipton, head of municipal research in New York at Oppenheimer & Co. “It’s the presentation on the balance sheet that is now going to drive urgency.”

Cities that shortchanged pensions for years are under growing pressure to boost their contributions, even after windfalls from a stock market that's tripled since early 2009. Janney Montgomery Scott has said growing retirement costs are "the largest cloud overhanging" the $3.6 trillion municipal-bond market, where investors are demanding higher yields from borrowers under the greatest strain.

Chicago Pays

That was on display this week for Chicago, whose credit rating was cut to junk by Moody's in May because of a $20 billion pension shortfall. The city was forced to pay yields of almost 8 percent on taxable bonds maturing in 2042, about twice what some homeowners can get on a 30-year mortgage.

Estimates of the pension-fund deficits facing states and cities vary, depending on the assumptions used to calculate the cost of bills due over the next several decades. According to Federal Reserve figures, they have $1.4 trillion less than needed to cover promised benefits.

Officials have been able to lower the size of the liability by counting on investment earnings of more than 7 percent a year, even after they expect to run out of cash. New rules from the Governmental Accounting Standards Board require a lower rate to be used after retirement plans go broke. Many reported shortfalls will grow as a result.

More Coming

Moody's, which in 2013 began using a lower rate than governments do to calculate future liabilities, has estimated that the 25 largest U.S. public pensions alone have $2 trillion less than they need. Cincinnati and Minneapolis are among cities Moody's has since downgraded.

The credit-rating company said in a report Friday that the shortfall in Dallas's police and firefighters' pension system will more than triple to $4.7 billion because of the accounting-rule shift.

"You'll probably start to see a lot more negative outlooks," said David Ashley, who helps oversee $10 billion of munis at Thornburg Investment Management in Santa Fe, New Mexico. "That's on the horizon."

The new reporting requirements are taking full effect just as stock and bond markets sputter as the Federal Reserve prepares to raise interest rates for the first time in nine years.

The California Public Employees' Retirement System, the largest U.S. pension, this week said it earned just 2.4 percent last fiscal year, one-third of the annual return it projects. The California State Teachers' Retirement System, the second-biggest fund, gained 4.5 percent, compared with its 7.5 percent goal.

Gains Slow

The Standard & Poor's 500 Index has climbed 3.2 percent this year, following double-digit gains for each of the last three years.

Pension systems have been a particular strain for local governments, which have less ability than states to raise taxes.

Like other cities, Houston's revenue is limited by property-tax caps. Its three pension plans have combined unfunded liability of about $3.4 billion, according to documents for a debt sale last month.

On July 2, Moody's lowered Houston's outlook to negative, citing the "challenges the city faces from growing pension costs and liabilities." The Aa2 rating is the third-highest investment grade.

Prophecy Fulfilled

Any downward rating moves could hinder efforts of states and localities that are working their way out of the problem by increasing borrowing costs, further straining budgets, said Vikram Rai, head of muni strategy in New York at Citigroup Inc.

Downgrades "could become a self-fulfilling prophecy and exacerbate the fiscal distress," Rai said. It could also drag down prices in the municipal market, he said in a July 8 report.

On the other hand, the new accounting rules and pressure from credit-rating companies may spur action by officials.

"Any time you have clarity around pension funding versus the provision of essential services versus tax levels, it helps generate good policy," said Shawn O'Leary, senior research analyst at Nuveen Asset Management, which oversees about $100 billion in munis. "The market is really paying attention to these issues. The rating agencies are just catching up."

Bloomberg

by Brian Chappatta

July 16, 2015 — 9:01 PM PDT Updated on July 17, 2015 — 11:55 AM PDT

Ratings Value Questioned as More Municipal Borrowers Go Without.

Bond investors don't seem to mind Tallahassee, Florida's decision to provide them with one fewer opinion on the state capital's finances.

The city sold $95 million of revenue bonds last month at yields equal to comparable securities even after it decided to get one less credit rating than it has traditionally done for such debt sales. And city officials expect to save $20,000 a year on fees to boot.

Tallahassee isn't alone in questioning the value of the analysis from Standard & Poor's, Moody's Investors Service and Fitch Ratings, which were blamed for contributing to the credit crisis. The percentage of municipal deals with one rating has climbed this year to the highest since the 2008 market collapse, while the number with three ratings is the lowest, according to data compiled by Bloomberg.

"We're not hearing pushback from investors that one rating isn't enough," said Jay Wenger, managing director at Susquehanna Group Advisors Inc., a Harrisburg, Pennsylvania-based financial adviser.

The decline in the use of multiple municipal ratings doesn't appear to be doing much damage now to the bottom line of the three biggest providers, with revenue up among record sales of corporate securities.

Rising Revenue

“Moody’s credit ratings and research continue to be widely sought by investors because they have proven to be a trusted and reliable source of information on credit risk,” said David Jacobson, a spokesman for the New York-based firm.

McGraw Hill Financial Inc., of which S&P is part, saw 10 percent annual revenue growth from 2010 to 2014, and Moody’s has notched 13 percent annual increase in the same period, according to reports by Bloomberg Intelligence analyst Joshua Yatskowitz. Bloomberg LP, the parent company of Bloomberg News, competes with McGraw Hill in providing financial information.

“Trends in the municipal market such as the one suggested here could be attributed to a number of factors, given the amount of change in this space over the last 12 months,” April Kabahar, a spokeswoman at S&P, said by e-mail.

Institutional investors have bulked up their research departments after top-rated securities tumbled to below investment grade, or junk, during the financial crisis.

Credit Work

“In this day and age, most of the sophisticated investors have to do their own individual credit work, and they will apply their own internal ratings,” said Jaime Durando, head of municipal syndication at RBC Capital Markets in New York.

So far this year, 47 percent of new muni deals have had a single rating, compared with 32 percent in 2008, data compiled by Bloomberg show. The share of triple-rated deals stands at 7 percent, compared with 9 percent in 2008.

“Muni issues larger than $50 million mostly utilize two or three ratings, while those below $50 million typically use just one,” Dan Noonan, a spokesman for Fitch said in an e-mail. “That trend is not new, although the volume of rated deals continues to grow for one, two and three- rated deals.”

Jim Cooke, Tallahassee’s treasurer-clerk, said analysts from S&P, Moody’s and Fitch were calling more frequently on the different securities issued by the municipality, which entailed city employees providing repetitive information. “It just didn’t feel efficient,” he said.

Rating Fees

Tallahassee’s energy revenue bonds were rated AA, third-highest, by S&P, and a step lower at Aa3 by Moody’s. The 10-year maturity was priced in June to yield 2.64 percent, in line with AA revenue bonds, data compiled by Bloomberg show.

The city paid $50,000 to Moody’s and $43,000 to S&P for an aggregate fee that represented 26 percent of the cost of issuance, Cooke said. Tallahassee decided against a rating from Fitch.

In the energy system’s last sale in 2010 with all three grades, Moody’s charged $47,000 and S&P and Fitch each charged $31,000, which totaled 28 percent of the deal’s expenses, he said.

In addition to the $20,000 annual savings from cutting a rating, the city expects to save about $45,000 for each new debt issue that’s sized around $95 million, Cooke said.

While municipalities generally had similar grades from three main raters before the credit crisis, shifting methodologies are now driving more cases of “multi-notch differences in opinion,” said Chad Farrington, head of muni research in Boston at Columbia Threadneedle Investments that manages about $30 billion in local debt.

Issuers are examining the criteria more closely, given the experience of the raters in the credit crisis and with more transparency of their methods under the Dodd-Frank Act, said David Moore, director of Public Financial Management Inc.'s Southern region financial advisory practice.

"Typically, the end result of that analysis is they can pick two of the three and get the same reception in the market or materially the same," Moore said.

Bloomberg

by Romy Varghese

July 19, 2015 — 9:00 PM PDT Updated on July 20, 2015 — 6:46 AM PDT

Is Water a Rising Tide for Investors?

Drought, floods and insatiable thirst for irrigation: the water sector is suddenly simmering.

But, like climate change, the water sector is a long-term play, analysts say. Here's how to size up potential opportunities in both municipal bonds and equities, based on the reasonable assumption that water is an ever-more-valuable commodity.

At first glance, drought in the western U.S. might seem to compromise municipalities' abilities to repay bonds based on water income. After all, they can't charge for water that's not flowing, right?

Not so fast, says Dick Larkin, director of credit analysis with HJ Sims & Co., an investment banking firm in Boca Raton, Florida.

Municipalities can charge more for water, ensuring cash flow and offsetting the lower volume of water. And it's standard, he adds, for bonds to have a one-year reserve of payments for precisely these types of situations.

The bigger opportunity is how municipalities and whole regions must start replacing aging water infrastructure, Larkin says. Reservoirs, dams, pipelines and treatment plants that were built in the mid-20th century are starting to spring leaks. With increased public awareness of water conservation and increased expectations of stewardship, water agencies may well reinvent how water is sourced, stored and purified – instead of just plugging leaks.

It's the discussion about climate change, more than the actual current climate, that is shaping the investing environment, Larkin says. "If the water isn't coming down, we have to figure out how to reuse the water we're using today," he says. "I believe that eventually it will result in a crisis unless leaders start planning for it. There's a great need for municipal bonds to build [water infrastructure], but we won't see that for at least 10 years. This crisis needs to season a little bit."

"It's a slower moving trend, but it won't go away," agrees David Parker, senior utility analyst with Baird, a Milwaukee-based investment management firm. Drought and unusual weather patterns – which may or may not evolve into genuine climate change – are injecting urgency into water agencies' decisions. "When you have a crisis, that's when stakeholders and policymakers think, 'Maybe we should do something and not just hope it will rain tomorrow,'" he says.

Equity analysts agree that the main opportunities in water are in measuring, controlling and purifying it. Technical innovation is slow and steady, mainly because it keeps pace with market demand: Water agencies must merge new technologies with existing infrastructure, and that means a constantly evolving patchwork. “It is a long-term play. There’s no silver bullet technology. There’s no Uber for water industry, no killer app. The rate of adoption of new technology is slow,” says Matthew Dickerson, managing director of Summit Global Management, a San Diego-based investment management firm.

That also translates, they say, to unglamorous but consistently performing companies whose gear are embedded in wells, distribution systems and plants. As pressure rises for better water management, utilities are likely to accelerate their adoption of new technologies, analysts say, especially in developing nations.

Water equities, however, are rarely a pure play because most companies that produce water gauges, meters, pipes and systems do the same for gas, oil and other aspects of infrastructure, says David Brigham, co-portfolio manager of Piper Hill Partners, a research firm in Weston, Vermont.

Badger Meter Inc. (ticker: BMI), in Milwaukee, is one of the few, Brigham says. It is an analyst favorite due to its constant drizzle of innovations. Another up-and-comer is Artesian Resources Corp. (ARTNA), which provides large-scale consulting, engineering and project management. Northwest Pipe Co. (NWPX) has even figured out how to generate electricity as a byproduct of water flowing through its new line of wired pipes. “Water is a mid-cap universe,” Brigham says.

Utilities and agencies are most likely to invest in efficiency and recapture technologies, Dickerson says. Ultraviolet treatment for purifying water has been available for more than two decades and finally might be worth its cost. Smart metering, leak detection, cost-effective desalination and monitoring software are all technologies poised for rapid adoption, he says.

Meanwhile, well-run utilities are starting to anticipate changes in water sourcing, demand and use, and that means demand for innovations that will improve efficiency and lower waste. “The system has assumed that you could use as much as you like, but now it’s starting to be focused on sustainability,” Parker says.

Baird gives positive marks to proactive utilities including American Water Works Co. (AWK), Aqua America Inc. (WTR) and The York Water Co (YORW).

“Water is misunderstood because people take it for granted until they run out of it,” says Marc H. Robert, a partner with Water Asset Management LLC in New York. Utilities and agencies will likely find that they can raise the temperature on prices a bit to support innovations and infrastructure improvement. “Water is relatively inexpensive for what it provides, and is underpriced relative to its full cost of delivery. It’s similar to other infrastructure – but you can’t live without water,” Robert says.

U.S. News & World Report

By Joanne Cleaver

July 16, 2015 | 9:00 a.m. EDT + More

New Player Seeks to Revive VRDO Market.

Clarity Bidrate Alternative Trading System, a division of Arbor Research & Trading, LLC, is signing up investors and lining up potential issuers for an attempt to "revolutionize and rejuvenate" the variable rate demand obligation market.

"Our goals include deepening and broadening the market, a high degree of transparency, centralizing the market and using competitive pricing," Clarity's chief executive officer and president, Robert Novembre, said in an interview last month. The trading system "will give us a healthier, more honest market, with increased liquidity, much greater pre-trading/ execution information and transparency."

VRDOs are long term municipal bonds with floating interest rates that are reset periodically, typically weekly. Along with auction rate securities, the securities were attractive to municipal issuers because they allowed for the sale of long-term obligations using lower short-term interest rates. They offered investors a better return than traditional money market investments.

In 2008, however, the collapse of Lehman Brothers triggered a run on the securities. The average VRDO rate shot up to almost 8% from under 3%, as investors worried about whether banking institutions that provided liquidity facilities to back the securities would be able to meet their obligations, according to a June research report from the Federal Reserve Bank of Atlanta. .

Issuance of VRDOs has fallen to about $11 billion in 2014 from nearly $120 billion in 2008, according to the Municipal Securities Rulemaking Board. The par value of VRDOs outstanding has slipped to $207 billion from $222 billion in March 2014.

"The market has incredibly low yields [and it] doesn't look like an industry that needs more buyers," said Matt Fabian, partner at Municipal Market Analytics. "I think it is likely to continue to shrink for the foreseeable future."

According to Novembre, Clarity is built around the lessons learned from the financial crisis. The system promotes transparency, offering real-time empirical data not available in today's market, pre-trade/execution information and competitive pricing, he said. The system seeks to level the playing field, promoting a deeper and wider investor base. By providing easy access and a place where investors and issuers can meet directly in an unbiased market not influenced by a middleman, the system should increase the potential for new issuance, Novembre said.

Clarity's goal is two-pronged: one, to offer better security structures and two, to offer an efficient marketplace, where all parties can benefit with Clarity's success, Novembre said.

The system is intended to help liquidity providers assess risk and market depth better, and allow issuers to price in a deeper, broader, competitive market and, ultimately, give investors more product to buy.

"This market place has been the same for the last 30 years while everything else in the world has changed, in many ways due to technology," Novembre said. "The time is now. This market is begging for technological advancement, centralization of the marketplace and from a market perspective, it's becoming a matter of when, not if short rates go up, making the Clarity model ever more meaningful to issuers and investors."

"This was a multi-year process, and not an easy one, but we ultimately want to be the go-to place for variable rate debt," said Novembre. "In our view, we created more efficient structures and much needed and improved marketplace, leveling the playing field and augmenting the depth of investors and issuer base."

Michael Decker, a senior managing director of research and public policy at SIFMA, said some issuers' experiences using VRDO products during the crisis made them more wary of the risks.

"However, an even bigger factor is that banks are offering direct loan products or accepting placements as an alternative to public VRDO products," said Decker.

Another problem facing the VRDO market is that it is so compressed, according to Fabian.

"There are only so many buyers and that puts a downward pressure on supply due to the Volker rule and you have incredibly low yields," he said, referencing the SIFMA Municipal Swap Index, which was at .02 for the first fourteen weeks of the year . It reached as high as 0.11 on May 20, but, as of July 8, it was down to 0.04. The Volcker rule places limits on certain speculative investments by banks.

According to the MSRB, the number of interest rate resets on municipal variable-rate demand obligations also hit a new low of 133,896 in the first quarter of 2015, the lowest quarterly number since the MSRB began collecting the information in April 2009, the board said. Previous MSRB reports have noted a decline in the VRDO market since 2009.

Novembre said Clarity isn't hanging its hat on biddable VRDOs, as it also has a platform for biddable tender option bonds, biddable market liquidity variable rate securities, and biddable floating rate notes. The former two require liquidity facilities and the latter two don't.

"We are introducing competitive pricing to all of these markets, with centralization of the market place, which we believe will centralize liquidity," he said. "We designed Clarity to be extremely user friendly, easily accessible and highly transparent. Clarity is designed to be an ATS where issuers and investors meet directly, so there is no middle man that could cloud up the market, using their own balance sheet."

THE BOND BUYER

BY AARON WEITZMAN

JUL 13, 2015 2:43pm ET

S&P's Public Finance Podcast (Puerto Rico And California's Tax Increment Ratings)

In this week's Extra Credit, Senior Director Dave Hitchcock explains our recent rating action on Puerto Rico and Senior Director Michael Stock discusses tax increment ratings after the California Redevelopment Agency dissolution.

Listen to the Podcast.

Jul 09, 2015

Moody's: Fiscal 2014 Medians Show Easing Pressures at Public and Private

Universities.

New York, July 06, 2015 — Fiscal year 2014 medians for public and private universities show much of the higher education sector stabilizing into balanced operations, increased liquidity, and slowly strengthening balance sheets, Moody's Investors Service says in two new reports. Nonetheless, approximately 20% of universities continue to confront material revenue growth pressures.

For private colleges and universities, revenue growth outpaced expense growth for the first time in four years, with median revenue growth at 3.4% while expense growth was 2.9%.

"Double-digit investment returns, robust philanthropic support and limited borrowing led to continued strengthening of private university balance sheets. Strongly correlated with investment returns, total gift revenue grew 7.3% in FY 2014, and larger, wealthier institutions continue to benefit the most," Moody's AVP-Analyst Michael Osborn says in "Signs of Moderating Stress in Private University FY 2014 Medians."

Median growth in net tuition revenue, typically a private university's largest revenue source, stabilized in the 3% range for FY 2013 and 2014. This is much lower than the 7% range from 2005-2008 but equivalent to inflation.

For the public college and university sector, a majority of schools have increased liquidity, balanced operations and grown financial resources, although revenue growth remains pressured for some regional universities. Net tuition revenue growth remains low for many, however, forcing continued expense management.

"Weak demographics combined with the national focus on affordability have thwarted previously strong annual net tuition increases. Regional universities suffered the most, with over half having net tuition revenue growth below an inflationary 3%," Moody's AVP — Analyst Erin Ortiz says in "Public University FY 2014 Medians Highlight Sector Differentiation."

Even as net tuition revenue growth has slowed for the public sector, aggregate state funding modestly increased for the first time in over a decade, which modestly narrowed the gap between state appropriations and revenue from tuition and student fees. State appropriations comprised 24.3% of operating revenue in FY 2014 compared to 23.9% in FY 2013.

The private university report is available to Moody's subscribers here.

The public university report is available to Moody's subscribers here.

Putting Evidence First: Learning From the Rikers Island Social Impact Bond.

Results from the first generation of social impact bonds (also known as pay for success deals) are starting to come in. Last week, the field learned the results of the evaluation of the first social impact bond transaction in the United States.

The investment by Goldman Sachs and Bloomberg Philanthropies in a program to serve young men at the Rikers Island jail—the main processing and housing facility in New York City—did not show a sufficiently positive effect to warrant the continuation of this intervention. The program will terminate at the end of August.

The results seem to be a defeat for this approach. We see them as a partial victory for this disruptive innovation. Here's why:

The social impact bond transaction worked exactly as intended.

The goal of pay for success deals is to encourage private investors to fund proven social programs by providing upfront support to programs that seek to improve long-term outcomes for those in need. If the programs are successful, governments pay the investors back; if they are not, then the investors absorb the cost, and governments pay nothing.

In this case, the program has been found to have no impact –program participants did not spend fewer days in jail than a comparison group – and so the program will end. This alone represents a significant departure from status quo. Under typical government contracts, the program likely would have continued.

Further, the rigorous process of constructing the social impact bond required a new type of program management and pushed New York City government toward more outcomes-based decisionmaking. The process forced public leaders to have conversations with parties inside and outside of government and likely helped create new capacity and infrastructure that can continue to benefit citizens, even though this particular intervention did not reach its goals.

All of these changes will help policymakers as they start to develop the next important innovation—at no loss to taxpayers.

The Rikers program shows why monitoring outcomes is essential to understanding the real-world impact of our social investments.

Though the Rikers program was grounded in Moral Reconation Therapy (MRT), an evidence-based approach with a fairly strong track record of affecting recidivism outcomes for older youth, the program itself hadn't been tested before. When you innovate to apply evidence-based practices in a new program, sometimes you create something that is effective and efficient. Sometimes it does not work.

It is better to know something is not working; that enables you to make a decision either to change program delivery or end the program altogether. That in turn saves taxpayer dollars for more promising approaches. The only way to make such informed decisions is through rigorous testing of our social program investments.

Implementation and context matters. A lot.

Rikers Island is a remarkably disruptive—and potentially damaging—setting to rehabilitate juvenile delinquents. The challenge of serving a youth population in a huge jail setting like Rikers is enormous.

According to the Vera Institute, 87 percent of adolescents who were at Rikers for more than seven days participated in at least one program session. Of those youth, "44 percent reached a programmatic milestone found in prior studies to be associated with positive outcomes." While Vera did not report the completion rate of adolescents in the program, MRT is typically a three-month intervention at minimum.

If juveniles at Rikers were not receiving the full "dose" of the intervention or the intervention was not delivered in the right way, of course they would be less likely to achieve intended outcomes. Recent lessons from the burgeoning field of implementation science have taught us that the setting of an implementation, and the extent to which it mirrors best practice, is critical.

In sum, disruptive innovation is inherently combustible. There will be big wins and big losses on the way to making government more evidence based, more creative, and more receptive to new ideas that better align our spending with the outcomes we want for our society.

The close of the Rikers Island transaction may be a first step along a long road toward more effective innovation. At the end of the road is better, more effective government.

The Urban Institute

July 6, 2015

Justin Milner, Erika C. Poethig, John Roman, and Kelly Walsh

As an organization, the Urban Institute does not take positions on issues. Scholars are independent and empowered to share their evidence-based views and recommendations shaped by research.

Putting the Public Back in Public Finance.

It all came down to the penguins.

Jase Wilson and Patrick Hosty, two self-described urban enthusiasts, were having breakfast in a coffee shop in Kansas City, Mo., one morning in 2012. They were discussing a $500 million general obligation bond issue before voters that would pay for critical improvements in the city’s sewer system as well as a host of smaller projects, including a new penguin exhibit at the zoo.

An acquaintance who overheard the conversation declared that she opposed the bond issue. “Why should I pay for penguins?” she demanded.

Mr. Wilson and Mr. Hosty asked if she had ever bought a municipal bond. She hadn’t. Nor did she quite know what a bond was. And never mind that just a tiny fraction of the funds was earmarked for the zoo.

“We realized right there that our generation — and in fact most people — do not understand how public finance works, or that it finances projects for the public good,” said Mr. Hosty, a bond broker in Kansas City. “Lots of people talk about taxes without understanding how the process works.”

For Mr. Wilson, an entrepreneur who had founded Luminopolis, a company that creates open-source software systems for towns and cities, the penguins represented an opportunity to rethink municipal finance. Could you break that $500 million bond offering into smaller, discrete projects that citizens — whether penguin lovers or more pragmatic sewer proponents — might want to back? And could you give them the opportunity to invest directly in the bond, the way they might back a project on the crowdfunding site Kickstarter?

Those musings prompted Mr. Wilson and Mr. Hosty to create Neighborly, a start-up that aims to connect citizens more directly to public finance. The idea is to use some of the practices of crowdfunding, which has begun to streamline financial markets from commercial real estate to student and consumer loans to small-business capitalization. Neighborly is setting its sights on a market that, though hardly sexy, may surpass them all in size and complexity: the $3.7 trillion municipal bond market.

In many ways, municipal bonds — loans that finance public works like schools, roads, water treatment plants and other projects, often paying tax-exempt interest — are ripe for innovation. Compared with the stock market, the vast market for municipal bonds is opaque and relatively untouched by technological change, leading to higher prices for retail investors.

Although individuals hold 75 percent of municipal bonds, either directly or through mutual funds, they are typically at the end of a long supply chain, starting with bank underwriters that buy securities from municipalities and resell them to brokers and big institutions. A bond may change hands several times before it reaches an end investor. Each time it does, the price may be marked up — in ways that are not always clear. (Unlike stockbrokers, who must disclose fees, bond dealers are not required to reveal their markups.)

A 2012 report by the Government Accountability Office concluded that smaller investors were likely to pay higher prices to buy, and receive lower returns when they sell. The Securities Litigation and Consulting Group, a consulting firm, estimates the cost of excessive markups to small investors at $1 billion a year.

For the 50,000 or so municipalities and agencies that issue roughly $350 billion in bonds annually, the current muni market offers many benefits. Capital costs are typically low for issuers. Because the bonds are usually exempt from federal and state taxes, and sometimes local taxes, investors are willing to accept lower yields than for taxable bonds. And the fees that issuers pay Wall Street bankers have dropped steeply since 2008, when many municipalities took big losses because of ill-advised derivative deals.

Municipal governments in the bond market face challenges, though. Some banks have exited the market, put off by the thin margins that come with originating muni bonds. Structural and regulatory changes have also made the bonds less attractive to banks.

Yet as America’s infrastructure ages, the need for state and local spending on road, bridge and building repairs is mounting. As a result, some states and cities have begun experimenting with new ways of pulling in capital, including green bonds for environmental projects; mini-bonds in lower denominations that ordinary investors can more easily afford; and more direct sales to individual investors.

“We want to create a more intimate link between issuers and investors — not just the large investor,” said Steven Grossman, former state treasurer of Massachusetts, which sold the country’s first green bonds and started an online ordering system that gives individual investors direct access to new bonds.

Muni bonds are historically a safe asset class, but some are looking more risky lately as many cities struggle with underfunded pension obligations.

“You want to make sure that people understand the risks that they are getting into,” said Tom Kozlik, a municipal credit analyst at Janney Montgomery Scott. “There’s a lot of stuff you need to be paying attention to, especially in this market.”

Mr. Kozlik does not see a big need for crowdfunding in municipal finance. For one thing, he said, the market is pretty efficient as it is. He also worries that municipal bonds could be difficult for unsophisticated investors to assess. In addition to underfunded city pension obligations, he points to high-yielding bonds for charter schools as an area of risk.

Mr. Wilson remains undaunted. “Part of the challenge and opportunity is to turn one of the least understood investment classes in the world into what could and should be one of the easiest and most accessible,” he said.

For a glimpse of one possible municipal finance future, look at Denver. Last August, the city made waves when it crowdfunded $12 million worth of mini-bonds. The bond offering, the last phase of a $550 million voter-approved bond program to upgrade roads and civic buildings, was available only to Colorado residents. The bonds were priced in affordable denominations of $500, versus the typical $5,000 minimum for municipal bonds. Orders were limited to $20,000 per person. Had the bonds been offered in the usual way through Wall Street, the average purchase would most likely have been in the $500,000 to $1 million range, said Cary Kennedy, deputy mayor of Denver.

Denver had offered mini-bonds for five years, but this was the first time it did so online. They went on sale at 8 a.m. on a Monday, and orders swamped the city’s website. By 8:16 the bonds were gone; officials had to make refunds to 375 people who placed orders after the bonds sold out.

The bonds were unusual. Investors could buy either a nine- or 14-year zero-coupon bond — which does not pay interest until maturity — with a yield from 4.38 percent to 4.89 percent, higher than that for many municipal bonds at the time. The interest was exempt from city, state and federal taxes. But there was a catch: The Denver bonds could not be easily resold. And while Denver has a triple-A bond rating, these bonds were not rated.

“This was an opportunity for the people of Colorado to invest back into their hometown, in a very safe way,” Ms. Kennedy said.

Denver worked with a local bank, Vectra Bank, to handle the online sales, and did not use a bank underwriter. “We had to start from scratch,” Ms. Kennedy said.

That is where a service like Neighborly’s could come in. Though the company has yet to help any municipality issue a bond, Mr. Wilson said it aspired to be “Denver in a box for all cities.”

Neighborly is testing an online marketplace that offers conventionally issued and rated municipal bonds. Mr. Wilson said it could one day replace some fee-collecting middlemen with an automated system that tracked prices and transactions more efficiently. He also hopes to give municipalities a way to directly issue bonds that would still be rated by outside agencies. Neighborly is exploring block chain technology — a kind of distributed ledger system used by the virtual currency Bitcoin — as a way to accomplish some of that.

It is still settling on a revenue model, and is considering taking a small cut of transactions or licensing its technology to issuers.

It hasn’t been a straight path for the three-year-old company. After their penguin epiphany in 2012, Mr. Wilson and Mr. Hosty began by starting an online platform that made it easier to donate money to civic projects like community gardens, dog parks and bike lanes.

In its first two years, Neighborly helped raise $3 million for around 60 projects. Over that period, Mr. Wilson was accepted into three programs aimed at accelerating the start-up process: Points of Light, in Washington; Tumml, in San Francisco; and 500 Startups, in Silicon Valley. (Mr. Hosty has participated in Neighborly while continuing with his job at a bond firm.)

In the fall of 2014, Mr. Wilson began to tackle the municipal bond market. By this fall he expects to deploy a system that enables municipalities to market bonds directly to investors. The company has lined up seed funding from Structure Capital; the actor and investor Ashton Kutcher; and the venture capital firm Formation 8, which has invested in other civic innovation start-ups, including OpenGov.com.

Eliminating some of the layers in the municipal bond process would “put more money into the project rather than the hands of middlemen,” said Adam Blowers, the comptroller for Geneva, N.Y.

Patrick Sabol, a senior researcher with the Brookings Institution’s Metropolitan Policy Program, said the civic implications of the idea appealed to him. “The interest behind this is less about accessing low-cost capital and more about community involvement and engagement,” he said. “That has kind of been lost in the U.S. in many ways.”

In the building that serves as Neighborly’s San Francisco headquarters hangs a framed municipal bond certificate from the 1930s. The Golden Gate Bridge and Highway District issued it to finance the bridge. For Mr. Wilson, the certificate is a reminder of the vital role municipal finance should play, especially in smaller cities and towns, where many projects were once funded without the need for Wall Street banks.

For decades, though, municipal finance has grown increasingly complex. Under the guidance of Wall Street underwriters, bond deals grew larger and more intricate, combining many projects into single megabonds. A typical muni bond today bundles together all sorts of public financing needs. Sewage plant improvements are combined with zoo projects, making it difficult for ordinary people to comprehend funding that flows both to penguins and vital infrastructure. It has become hard for people to track how money is being spent.

“Muni bonds fell out of favor with people because they became decoupled from people’s civic lives,” Mr. Wilson said. Today, munis are often esoteric instruments bought mostly by high-net-worth investors looking to reduce their tax bills.

Is it possible, or even wise, to rewind municipal finance back to a simpler time?

Some industry professionals argue that the American municipal finance market works extremely well, and in fact is the envy of the world.

And while interesting in theory, crowdfunding may be ill-equipped for the challenges of municipal finance. “Crowdfunding is terrific at raising money,” said Sean W. McCarthy, chief executive of Build America Mutual, a municipal bond insurer, “but making a market around it is more difficult.” That includes tracking the performance of thousands of municipal issuers over time and providing a ready market when investors need to sell. In that sense, he added, “the market is served well now by established players” like national and regional underwriting banks.

The federal government effectively subsidizes municipal bonds by granting them an exemption from taxes, which allows municipalities to offer lower yields and also adds a layer of regulatory oversight. An army of advisers, specialists and bankers are typically required for a bond sale as a result, making it costly to sell bonds in small denominations. “There are 10 different participants to facilitate your $5,000 loan,” said Thomas G. Doe, president of Municipal Market Analytics, an independent research firm based in Concord, Mass.

Abolishing this tax-exempt status is a perennial discussion in Washington, but for now that status makes the bonds most suitable to people in high tax brackets, said Tom Lockard, a former muni bond banker and now a vice president at the real estate crowdfunding site Fundrise. “It’s a bit of a slippery slope,” he said, to promote such bonds to people for whom the tax break is less important.

Fundrise used its crowdfunding platform in January to offer $5,000 chunks of $100,000 bonds with 5 percent tax-free yields issued by the New York Liberty Development Corporation to finance 3 World Trade Center. The catch was that investors had to be wealthy or, technically, “accredited.” “We know the difficulties” of offering muni bonds on a broader scale, Mr. Lockard said. “We continue to study it.”

Mr. Doe of Municipal Market Analytics said crowdfunding offered a direct connection between issuers and their constituents. “Is there a better way to attract capital to public projects in this new era of social media?”

It’s possible, he said, that crowdfunded bonds could play an important role, but they would need to meet large infrastructure needs while surmounting the regulatory hurdles that come with tax-exempt municipal finance. Important details need to be worked out, he said, but this much is certain: “We need new ways of doing this.”

THE NEW YORK TIMES

By AMY CORTESE

JULY 10, 2015

Municipal Issuer Brief: July Historically Pro-Issuer.

Read the Brief.

Municipal Market Analytics | Jul. 6

A Tale of Two States: Comparing PPPs in North Carolina and Ohio.

As states struggle to build and renew their infrastructure assets, they are increasingly turning to the private sector for solutions. States like Virginia have used these so-called public-private partnerships (PPPs) for decades to collaborate with private firms to design, build, finance, operate, and maintain certain public infrastructure facilities.

This procurement model was recently taken up for the first time by Ohio and North Carolina, with differing degrees of success.

Charlotte has outpaced the nation in job creation and is one of the top 20 metros for post-recession economic growth. Concurrently, traffic along I-77, a key regional arterial, increased by 20 percent over the last five years. To alleviate traffic along this corridor, the state requested proposals to add a new high-occupancy toll lane (HOT lane) that will give drivers the option to pay to use a congestion-free route.

Cintra, a multinational transportation company, agreed to design, build, finance, operate, and maintain the HOT lane for 20 years, in exchange for the right to collect tolls. While the state has to compensate the company if revenue falls below a certain threshold, Cintra is covering 85 percent of the projected $650 million in construction costs and is assuming most of the risks associated with the construction and operation of the road—including maintenance on the non-tolled lanes.

The story in Ohio, unfortunately, has fewer potential upsides for the state. The Southern Ohio Veterans Memorial Highway project will create a 16-mile bypass across a primarily rural corridor that has seen decreasing population and declining vehicle miles traveled for years. The most optimistic projections indicate that using the bypass to skirt the city of Portsmouth will save drivers 16 minutes. According to the state, the primary benefits of the PPP are an accelerated construction timeline and economic growth, but the projections are vague and, according to critics, the improvements to regional connectivity will be limited

Beyond the weak rationale for adding new highway capacity, perhaps most disturbing is that the deal puts most of the risks on the state. While the concessionaire, Portsmouth Gateway Group, bears the financial and construction risk at the outset of the project, the state is required to cover all operation and maintenance costs over the 35-year contract term. In total, the road will cost the state $1.2 billion—much more than the originally published $429 million that included only construction costs. Finally, the deal is structured as an "availability payment," which means that the concessionaire gets paid regardless of how many drivers use the road.

A well-executed PPP aligns the interests of the public and private sector to deliver projects on time with better value for taxpayers. Examples like the Long Beach Courthouse in California, the I-495 express lanes in Northern Virginia, and the PortMiami Tunnel in Florida demonstrate the potential of this procurement model.

By balancing the risks between the public and private sectors, North Carolina's I-77 HOT lanes have a good chance of becoming one of these success stories. While it is too early to tell if Ohio's Veterans Memorial Highway will deliver on its vague promise of economic stimulus, it is clear that the structure of the PPP fails to shield taxpayers from many of the potential downsides of a project that delivers limited transportation benefits to the region.

Brookings

Patrick Sabol and Robert Puentes | June 30, 2015 12:30pm

Sen. Hoeven Wants to Help States with Infrastructure Needs.

WASHINGTON — John Hoeven, a Republican senator and former governor of North Dakota, is keeping states' needs in mind with his bill to create Move America Bonds.

"States have real infrastructure needs, so we're trying to actually find ways to help them," said Hoeven, who recently spoke to The Bond Buyer as part of a series of profiles of members of Congress who are focused on municipal bonds.

He said he wants to help states not only with funding from the federal government "but also by enabling them to borrow at a lower cost … and to bring the private sector into the mix in terms of building the infrastructure they need."

Hoeven, 58, was first elected to the Senate in 2010. Prior to that, he was North Dakota's governor for 10 years and held executive positions at banks in North Dakota for many years.

In May, Hoeven and Sen. Ron Wyden, D-Ore., introduced the Move America Act of 2015. The bill would create Move America Bonds, tax-exempt, private-activity bonds that could finance projects that are privately owned and would not be subject to the alternative minimum tax. They would be subject to new, separate state volume caps that would be equal to 50% of the state volume caps for PABs and could be converted to allocations for a new type of tax credit called Move America Credits.

This is not the first time Wyden and Hoeven have worked together on an infrastructure bond bill. When Congress worked on a multiyear surface transportation bill several years ago, the senators co-sponsored a bill that would have created taxable, tax-credit bonds for infrastructure called Transportation and Regional Infrastructure Project (TRIP) bonds. The senators were unable to get those bonds in the transportation law, Moving Ahead for Progress in the 21st Century Act, enacted in 2012. They introduced a similar bill in 2013, but that failed to gain traction.

Now, as Congress wants to pass a six-year highway bill and states continue to have a lot of infrastructure needs, "we decided to give it another swing," Hoeven said.

Unlike TRIP bonds, Move America Bonds would be tax exempt. Hoeven said they chose to propose tax-exempt bonds this time because they thought that approach would increase the chance the legislation would pass and "be of more benefit to the states."

Hoeven said the best legislative vehicle for the concepts in the Move America Act would be a long-term highway bill. He said he would make sure the proposal would be paid for if it is included in the highway bill so that it doesn't add to the federal deficit.

Hoeven thinks the odds of passage are good since Wyden is the top Democrat on the Senate Finance Committee, which will handle the financing component of the transportation bill. Also, he said he thinks there's a good shot Move America Act provisions will pass because "there are just so many things that we need in terms of infrastructure. It's not just highways. It's everything from bridges to ports to any kind of infrastructure you can think of."

The bill "gives states some flexibility to really put some dollars where they need it, and different states have unique needs," he said. Move America Bonds could be used to finance airports, docks and wharves, mass commuting facilities, railroads, highways and freight transfer facilities, flood diversion projects and inland waterway improvements.

Mike Nicholas, chief executive officer of the Bond Dealers of America, praised Hoeven for making infrastructure one of his priorities.

"Senator Hoeven has consistently demonstrated an interest in rebuilding our country's transportation infrastructure," Nicholas said. "His experience as Governor of North Dakota provides a unique perspective to this debate and a keen understanding of the importance of maintaining local governments' low-cost access to capital, which we believe should include the use of tax-exempt bonds."

Highway Trust Fund

The current short-term transportation authorization law expires July 31. In addition to possibly including bonds, a long-term highway bill will have to include funding for the Highway Trust Fund, which is nearing insolvency. The HTF reimburses states for surface transportation projects and is primarily stocked with revenues from motor fuel taxes. But those revenues haven't been sufficient enough in recent years for the HTF to meet all of its obligations.

Hoeven would like to get a six-year highway bill passed by the end of July, but acknowledges that there could be another short-term measure if a funding agreement can't be reached before then.

The Senator does not support raising the federal gas tax to add revenues to the HTF. He is not opposed to using tax revenue from the repatriation of foreign earnings, but thinks it is unlikely Congress could enact such a proposal by July 31, if it is tied to tax reform. "I think there's an opportunity to use repatriation as part of funding a highway bill, but if you also tie that up into tax reform, then I'm concerned that could slow it down," Hoeven said.

A challenge with tax reform is that President Obama wants it to raise revenue and congressional Republicans want it to be revenue neutral.

"That's a real sticking point," Hoeven said.

Also, it's challenging to figure out exactly what changes are going to be made to the tax code as part of a reform, he said.

Some members of Congress have suggested that tax reform that's just limited to the international taxation could be done along with a highway bill. Hoeven suggested that could be a possibility. At the end of the day, he wants to pass a long-term highway bill promptly.

"What I'd like to do is see it get going. I'm a little worried that people keep kind of dragging their heels. So I'm pushing to get something done," he said.

A Former Governor

Hoeven, who served as North Dakota's governor from 2000 to 2010, said that decade has influenced him in Congress.

"I think it's really good background to understand what the states' needs are, and that the country was set up where the states are the laboratories of democracy and that the federal government shouldn't be trying to do everything," Hoeven said. "There are certain things the federal government has to do, like defense of the nation for example, but we really need to do whatever we can to give people in the states more control in trying to reduce some of the size and scope and cost to the federal government."

Infrastructure was important to Hoeven while he was governor, said Shane Goettle, commissioner of North Dakota's commerce department from 2005 to 2010. The governor-turned-Senator understands the importance of infrastructure for job creation, Goettle said.

One of the promises Hoeven made during his first gubernatorial campaign was to widen a highway from Minot to Williston, taking that section of the road in the western part of the state from a two-lane to four-lane highway. He delivered on that promise in 2008. "That is now a key artery for the oil and gas industry in North Dakota," Goettle said.

Hoeven put a lot of emphasis on jobs as governor and worked to keep those raised in North Dakota living there as adults by fostering an environment that would attract business.

"He understands finance and he's always been about jobs and economic development," Goettle said.

While Hoeven was governor of North Dakota, the state's credit rating from Standard and Poor's went from AA-minus to AA-plus, and its rating from Moody's Investors Service went from Aa3 to Aa1 (with the upgrade from Aa2 to Aa1 due to a recalibration). In 2013, S&P gave the state a triple-A rating.

North Dakota has had no general obligation bonds outstanding since fiscal 1998, though some of its authorities have outstanding debt, according to the state's comprehensive annual financial report for fiscal 2014. The state has a low debt burden and tends to fund capital projects on a pay-as-you-go basis, S&P said in reports this year.

Hoeven touted the North Dakota's vast reserves. In 2010, voters approved the creation of a state permanent reserve fund called the Legacy Fund, which receives 30% of oil and gas tax revenue. The fund's principal and earnings can't be spent until after June 30, 2017, with expenditures of principal after that time requiring a two-thirds vote in each house of the state legislature.

Hoeven said the Legacy Fund is helping to put the state in a strong financial position.

"We're bringing a lot of oil revenue and it was to make sure the state was financially strong for generations to come," he said.

Before serving as governor, Hoeven worked in banking. He was executive vice president of First Western Bank in Minot from 1986 to 1993 and then served as president and chief executive officer of the Bank of North Dakota from 1993 to 2000.

The Bank of North Dakota is the only state-owned bank in the United States. State tax collections flow into the bank, and the bank also participates in economic development activities. BND works with private banks to provide financing for economic development in the state and generally makes loans in partnership with private financial institutions. The bank also provides student loans.

Eric Hardmeyer, the bank's current president and CEO, said Hoeven took BND in some new directions that continue to be followed.

When Hoeven was president of the bank, he had it join the Federal Home Loan Bank system. BND buys mortgages from private banks in the state, holds them, and then funds the mortgages by borrowing from the Federal Home Loan Bank at lower interest rates.

"It's nice to have someone in Congress who understands the banking world," Hardmeyer said.

Hoeven said that the principles he picked up while working in banking and finance carry through with him now that he's a senator.

"My background's finance and accounting, and I think that's very important because we have to make sure government is financially responsible and financially sound," he said.

THE BOND BUYER

BY NAOMI JAGODA

JUL 7, 2015 1:18pm ET

A Better Way to Set Public Pay.

Too few local governments are taking advantage of a valuable tool: benchmarking compensation among their public- and private-sector peers.

Fair pay is paramount for public agencies. Pay too little and good employees go elsewhere. Pay too much and budgets and taxpayers suffer, impacting the provision of effective and efficient government services.

Most importantly, the level of salaries paid to public employees also can impact public perception and trust. Whether government employees are compensated more or less generously than their private-sector counterparts with similar responsibilities increasingly is on the minds of the media and citizens alike.

One practice that can have value in navigating fair wages and benefits is benchmarking — collecting data on compensation for comparable jobs in other organizations (public and private) to establish a reasonable market rate. This means paying high-enough salaries so organizations can easily recruit and retain quality staff while not paying more than necessary.

So how are local governments approaching pay and benefits among their competitive peers? Not, unfortunately, through extensive and comprehensive benchmarking.

In a national survey of human-services professionals for large cities and counties, Michael Thom of the University of Southern California's Price School of Public Policy and I found that only slightly more than half the respondents had conducted a benchmarking study within the past decade.

Among those who did conduct a study, less than half report including both the public and private sectors in their evaluations. Instead, the majority evaluated only local governments. Less than 10 percent used their benchmarking results either before or during collective bargaining with their employees. And relatively few examined benefits, focusing only on wages.

In fairness, it can be difficult to obtain comparability data across individuals and jobs, especially when the comparison is with the private sector. Many public-sector jobs have no private-sector equivalent, particularly when it comes to public -safety positions. Further, it can be difficult to compare benefits. Health-insurance costs, for example, vary geographically, and pension plans differ by occupation, jurisdiction and even hire date.

But these limitations are not good reasons not to benchmark. If local governments choose not to benchmark what others are paying for similar occupations, how can they establish proper levels of compensation and monitor competiveness? Relying simply on existing salary and benefit structures leads to compensation "drift," resulting in governments under- or overpaying some employees or broader classifications of workers relative to their competitive peers. And in collective bargaining, failure to seek information on comparable wages and benefits may also place one or both parties at a disadvantage if one party has done its own benchmarking study while the other has not.

So what's the best approach to benchmarking? While annual studies are not necessary, once every 10 years is not frequent enough. The most advisable frequency is two to five years or whatever period coincides with the jurisdiction's collective-bargaining cycle.

Local governments must establish how benchmarking will be integrated into collective bargaining and how they will respond when it is determined that individuals or groups or either under- or overpaid.

Further, benchmarking studies must incorporate all aspects of public-sector compensation: salaries, retirement benefits, paid and sick leave, and other forms of pay and deferred compensation.

Finally, results from benchmarking studies should be publically disclosed and discussed during public meetings. This is essential for transparency and accountability and establishes the practice as a fair and reasonable approach to compensation.

GOVERNING.COM

BY THOM REILLY | JUNE 29, 2015

How Public Pensions Are Getting Smart About Infrastructure.

While American politicians talk about changing public policy to increase investment in U.S. infrastructure, America's public pension funds are investing their money in infrastructure overseas.

The largest U.S. public pension fund, the California Public Employees' Retirement System (CalPERS), recently announced a $1 billion deal with Queensland Investment Corp. (QIC), an Australian pension fund, to invest in Australian and Asian Pacific infrastructure.

At first glance, this would seem to be bad news, especially when you consider that 11 other U.S. public pension funds have deployed an additional $5 billion to overseas infrastructure investments over the past five years while collectively investing less than $800 million in domestic infrastructure.

It is bad news that other countries have figured out how to make infrastructure investing attractive to pension funds while, clearly, the United States has not. But looking closer, CalPERS may be leading a new way to finance American infrastructure while earning a rate of return consistent with other competing investments.

What's remarkable about the CalPERS deal is that instead of hiring expensive middlemen to make infrastructure investments with its money — as was done with the previously deployed $5 billion and is done regularly with the bulk of the $5.3 trillion of U.S. public pension capital — CalPERS is acquiring the capacity make such investments on its own. That reflects a trend among cost-conscious pension plans around the world that have eschewed the intermediary approach.

Pension funds in Australia and Canada did so long ago. Today, they are forceful market players instead of captive customers. Once they bypassed the intermediaries to harness the influence of the large pools of capital they control, they leveraged that power to form pension-owned infrastructure investment platforms such as Australia's Industry Funds Management and Canada's Borealis. These platforms have collectively deployed more than $50 billion of pension capital into infrastructure investments around the world, and they have realized returns above the 7 percent that U.S. pension funds need to fund future liabilities.

The United Kingdom and Switzerland have now followed their lead. The British government launched policy initiatives in 2011 that led to eight U.K. pension funds pooling their capital for the purpose of making direct in-country infrastructure investments. To date, they have deployed a half-billion dollars of capital. And nine Swiss pension funds came together last May, also for the purpose of making direct investments in local infrastructure. They now are structuring their third such investment.

CalPERS' deal with QIC will enable the California fund to tap into the Australian pension fund's experience in developing internal skill to manage assets as owners. This capacity was best demonstrated last year when QIC made a profit of several billion dollars on the sale of the Queensland Motorways, a broken-down highway, bridge and tunnel network that the Queensland state government conveyed to QIC in 2011 to satisfy pension liabilities.

And CalPERS isn't the only U.S. public pension fund — or even the only one in California — tapping into overseas expertise relating to infrastructure financing. This spring, the California State Teachers Retirement System (CalSTRS) announced an investment partnership with a Dutch pension fund, Stichting Pensioenfonds ABP, that will allow CalSTRS to benefit from ABP's skill in negotiating with government project sponsors. This was evident in the 2012 N33 transportation project, which the Dutch government structured expressly to secure equity and debt financing from ABP and Holland's largest pension fund, PGGM.

It's great news that our two largest public pension funds have begun to take steps to acquire the capacity to invest their own money and to end an impoverishing reliance on intermediaries. What's more, they're doing this by forming partnerships with international peers who know how to make money in infrastructure.

Even the most sophisticated pension-fund investors, however, have not figured out how to make money in U.S. infrastructure, given the competition from low-cost capital through the municipal-bond market. It just doesn't seem to make sense for infrastructure-project sponsors to pay pension funds (or any other institutional investors) more for capital than they pay the muni-bond market, currently about 4 percent.

But while capital at 4 percent appears cheap, borrowing costs are only the starting point in public infrastructure projects. Other costs, such as for operations and maintenance, ought to be considered — and too frequently aren't — when taking on projects that might stretch out over 30 years. Governments and taxpayers would get far more value from investors willing and able to finance total lifecycle costs than they do from a simple bond issuance.

As the level of new municipal financings continues to decline, the U.S. will increasingly need investors, such as public pension funds, that can add value beyond what is currently available from the capital markets. Infrastructure project sponsors could realize additional value for taxpayers by raising the kind of patient public pension equity capital that is more interested in long-term dividends than up-front fees for advisory and/or construction services.

By working directly with state and local governments to structure pension-right, public-right infrastructure projects, U.S. public pensions could open the most coveted infrastructure market in the world to the global community of institutional investors. This would result in a win for public pension funds, state and local governments and, most importantly, taxpayers and retirees.

GOVERNING.COM

BY JILL EICHER | JULY 10, 2015

Bloomberg Brief Weekly Video - 07/09/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

Public-Private Partnerships Offer Alternative Model for Water Infrastructure Projects.

In February 2012, the Commonwealth of Massachusetts completed a study of the state's drinking, wastewater, and stormwater infrastructure needs that identified a funding gap of at least $39 billion over the next 20 years. The Water Infrastructure Finance Commission, which prepared the report, concluded that funding from traditional government sources is likely to decline over the same period. This scenario of rising infrastructure needs coupled with declining government resources is playing out in cities and towns across the country. As part of the solution to this funding gap, states and municipalities have been looking to public-private partnerships, or P3s, as an alternative to traditional methods of financing and delivering public infrastructure projects, including projects in the water sector.

In Massachusetts, cities and towns enjoy express authority to use alternative project delivery methods, although this authority is limited. Chapter 149A of the General Laws expressly gives municipal entities authority to procure public building and public works projects using "construction management-at-risk" and "design-build" methods, respectively, in lieu of the traditional design-bi--build procurement method. In order to qualify for Chapter 149A, the project must have an estimated construction cost of $5 million or greater, and the municipality must receive approval from the Inspector General. To date, numerous school building projects have been approved and constructed using this express authority, but only one municipal public works project has used design-build procurement under Chapter 149A. For many cities and towns, the project cost threshold is a barrier to using Chapter 149A for water and wastewater projects, and Chapter 149A does not permit the use of private equity or debt financing to fund such projects. As such, Massachusetts municipalities must seek legislative approval to use alternative delivery methods that include a greater role for private partners and involve long-term contract operations, such as design-build, design-build-operate, and design-build-operate-finance delivery structures.

The Massachusetts Legislature has routinely granted authority for the use of such project structures in cities and towns, particularly for water and wastewater treatment works. This authorization has been granted by special acts to more than a dozen cities and towns, including Lawrence, Lee, Provincetown and Springfield. These special acts typically include authority to enter into a contract "for the lease, operation and maintenance, repair or replacement, financing, design, construction and installation of new facilities or systems and modifications to existing facilities, necessary to ensure adequate services." These special session laws authorize key elements of P3 deal structures and exempt the project from otherwise applicable public bidding and procurement laws (such as M.G.L. Ch. 7C, Secs. 44-57; Ch. 149, Secs. 44A-J; Ch. 149A; and Ch. 30, Sec. 39) and prescribe the selection process and certain contract conditions. This special act process, the only viable solution for most municipal awarding authorities, requires the submission of a Home Rule petition and a vote by the Legislature, thereby introducing uncertainty and possible delays into the public procurement process.

CONSIDERATIONS FOR STRUCTURING P3 AGREEMENTS

A broad spectrum of projects and deal structures may be classified as public-private partnerships, so there is no single, generally accepted definition. In general, the P3 concept involves a transaction based on contractual agreements between a public agency (typically a state or local entity) and a private sector partner that enables the particular skills and assets of each participant (public and private) to be shared in delivering a service or facility for the use of the general public, while also appropriately allocating risks and rewards. In all cases, P3 project structures allow for greater private sector participation in the financing and delivery of projects and typically offer incentives for efficiency and innovation in project finance and delivery.

What are the considerations for municipal stakeholders in public-private partnerships? There are policy concerns stemming from the impacts of P3s on labor and the public's hesitancy to privatize aspects of infrastructure that have traditionally been owned and operated by public entities. These complex issues require strong leadership to overcome. P3s that involve the use of public funds and relate to public assets clearly must be undertaken pursuant to a broad array of federal, state and local laws and regulations. Public-private partnerships require a legal and regulatory framework that protects the private partner's financial investment and property rights while enabling commercial contracts to be legally enforced. Clarity regarding the types of P3s that are authorized, the types of projects that may be delivered using the P3 model, the method of selecting private partners, the scope of ancillary state laws and regulations that will apply (e.g., public bidding requirements, prevailing wages laws, bonding requirements, etc.) is critical to a successful process, as are the audit and oversight requirements that will be applicable to the private partner.

Legal challenges to the public-private partnership model can also be a significant risk to any project and should be thoroughly evaluated early in the project development process. Legal challenges have the potential to delay a project, impose mitigation requirements, or alter other fundamental aspects of a project. Such outcomes become more significant in a public-private partnership context because of their impact on project financing arrangements with multiple debt and equity parties. Legal challenges to P3 projects may include challenges based on public interest grounds, challenges to the procurement of the project and its compliance with the jurisdiction's P3 enabling statute, or challenges relating to the environmental impacts of the project.

A significant headwind to the deployment of P3s is the complexity of the transactions, in particular the financial and legal agreements. The unique and custom nature of these transactions—no two are exactly the same with respect to the facility to be constructed, the financing schemes or the allocated risks—makes it challenging for project sponsors to realize economies of scale that are achieved with projects using traditional delivery methods that have standardized the full spectrum of project activities.

Consideration must be given to seven broad categories of risk common to P3 projects:

- Design/development risk
- Construction risk
- Revenue risk
- Financial risk
- Unexpected event risk (including political/ regulatory risk)
- Performance risk
- Environmental risk

A well-drafted set of legal documents that details the allocation of these risks and other contractual obligations among the parties in a clear and precise fashion is critical for the success of a public-private partnership. A P3 agreement must govern a relationship that may last over a period of decades and must contemplate numerous variables and details, so the partnership agreement must have clear provisions that establish a framework for dealing with a full spectrum of risks and disputes in a cost-efficient and equitable manner.

On the private side, P3s are costly and time consuming endeavors that require careful project development and market positioning efforts. Developers must also contend with each state's unique P3 enabling acts and regulatory frameworks that govern public-private partnerships as well as other laws and regulations that apply to construction, labor, real estate, and corporate matters, just to name a few. Because of these considerations, the P3 delivery model becomes more viable if used for a pipeline of projects, or smaller projects bundled into a single P3 transaction, so that the impact of transaction costs is minimized to the extent practicable.

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Article by Anatoly M. Darov, P.E. and Matthew G. Feher

Burns & Levinson LLP

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Taking on the Ratings Triopoly.

Jules Kroll sensed opportunity. In the wake of the 2008 financial collapse, the reputations of the Big Three credit-rating companies lay in tatters. Standard & Poor’s, Moody’s Investors Service, and Fitch Ratings had all blessed various mortgage-backed securities with their highest ratings, despite the often shaky subprime loans underlying the securities. Kroll, who made his mark as a financial crimes private investigator, with offices in more than 15 countries, reckoned he could come up with a better way.

“There was enormous disappointment in the country about the way the rating agencies had behaved,” Kroll says. “They really let the country down.”

This story appears in the July/August special Rivalry Issue of Bloomberg Markets magazine.

A man with a nose for ferreting out corruption, Kroll, 74, pocketed more than $100 million when he sold his corporate detective firm, Kroll Associates, to Marsh & McLennan for $1.9 billion in 2004. He’d hunted down billions of dollars of assets concealed by Saddam Hussein, Ferdinand Marcos, Jean-Claude Duvalier, and other dictators. With the ratings business, Kroll thought he recognized a lucrative Act 2. He launched Kroll Bond Rating Agency in 2010.

What he didn’t bank on was the entrenched power of the Big Three and the unwillingness of investors, even burned investors, to embrace something new.

Bond raters accredited by the U.S. Securities and Exchange Commission bring in more than $5 billion a year. They had been doing business in more or less the same way since the early 1970s, charging corporations and municipalities billions of dollars a year to have their creditworthiness assessed.

Those companies and governments, in turn, held out the hope of receiving ratings as high as AAA. Payment to the rating companies on some subprime debt deals ran as high as $850,000.

Then came the housing-market collapse and the bond-rating scandal that soon followed. The Big Three came under intense criticism for their role as “key enablers,” as a government commission would later report, of the financial meltdown.

Kroll teamed up with Jerome Fons, who had quit his job as managing director of credit policy at Moody's in August 2007, just as the financial system—and Moody's reputation—was teetering on the brink of collapse. A year later, Fons testified to a congressional hearing about what he thought was wrong with the ratings industry. "A large part of the blame can be placed on the inherent conflicts of interest found in the issuer-pays model," he said.

Fons, now Kroll's executive vice president, helped design a rating agency with a completely different model.

Rather than have the issuers pay for a rating, Kroll and Fons figured they could charge the bond buyers, since those folks should be willing to pay for information critical to making a wise investment. The strategy flopped even before it began. Investors made it clear they wouldn't pony up for a service they had long received for free. The service was never launched.

"We all wanted to avoid the conflicts that are inherent in the issuer-paid model," says Fons. "The economics just don't work. Investors don't want to pay." The issuer-paid model is still in place across the industry.

Kroll was only starting to find out what it would take to compete. In 2010, he joined the exclusive rating-agency club by purchasing a tiny company called Lace Financial and picking up its credential. The Big Three received theirs from the SEC back in 1975, when they were designated Nationally Recognized Statistical Rating Organizations. There are now a total of 10 NRSRO firms, including Kroll. The Big Three accounted for 94.5 percent of the industry's $5.4 billion in revenue in 2013, according to the SEC. Kroll now ranks No. 5, behind Toronto-based DBRS, in ratings issued.

The path forward is steep. Many institutions still require their money managers to recognize ratings from only the Big Three, despite their well-publicized failures. Earlier this year, S&P agreed to pay $125 million to the California Public Employees' Retirement System, or Calpers, the largest public pension fund in the U.S., after Calpers alleged the firm had improperly rated three packages of mortgage-backed securities that collapsed in 2007 and 2008. Calpers was one of those institutions whose rating guidelines recognized only the Big Three. It still is one.

"Rating-agency credit assessments are just one input into our investment process," says Calpers spokesman Joe DeAnda, who declined to address why Calpers doesn't recognize ratings by other firms.

After the investor-paid plan didn't pan out, Kroll and Fons figured they'd compete by offering more in-depth analysis, helping investors who do their own independent research. Jim Nadler, president of Kroll Bond Rating, says investors are getting what they need, noting that 25 percent of Kroll's ratings have been issued for securities not rated by any other firm.

Still, it's just a toehold in an immensely lucrative business. Moody's, the only free-standing public company among the Big Three, had a pretax profit margin last year of 43.8 percent, higher than Google or Apple.

"The margins are extraordinary, unlike any industry I've ever been in before," says Kroll, who ran a family printing business before building his global corporate gumshoe practice. Kroll Bond Rating, as a privately held company, doesn't disclose its financial results.

In July 2011, Kroll issued its first rating, for a commercial mortgage-backed security. It was the right place to start. Later that month, Standard & Poor's CMBS business took a huge hit. Investors complained S&P's AAA rating on a portion of an offering was inflated. S&P stunned the CMBS market by abruptly pulling its ratings on a $1.5 billion offering by Goldman Sachs and Citigroup, saying it had discovered flaws in its methodology. Morgan Stanley issued a research note to clients blasting the world's largest rating company.

"The manner in which S&P took its action has severely eroded investor and issuer confidence in its ratings," Morgan Stanley said. S&P's CMBS rating business was thrown into a tailspin from which it hasn't recovered.

S&P's loss was Kroll's gain. In 2011, Standard & Poor's ranked third in the number of CMBS ratings, as compiled by Commercial Mortgage Alert, and Kroll ranked a distant sixth. By 2014, S&P had fallen to the fifth spot while Kroll had ascended to No. 2, rating 65 CMBS deals that raised $53.8 billion from investors last year. Moody's remained No. 1.

Kroll has continued to chip away, and not just in the niche area of CMBSs. One way it has made inroads is with rock-bottom pricing. In March 2012, Connecticut became the first state in the U.S. to hire Kroll to grade and provide analysis for its general obligation bonds. To win the state's business, Kroll offered a discount: an annual introductory rate for three years of just $50,000. That was 91 percent less than Moody's price of $542,525 for fiscal 2014.

Previously, Connecticut did business exclusively with the Big Three. State Treasurer Denise L. Nappier says Kroll was added as a fourth rating company "in the interest of fostering competition." Kroll is banking on other states and corporations following suit.

"It's not a bad business strategy to get people comfortable with your ratings," says Andra Ghent, a professor at Arizona State University who studies the rating business. "It's almost like a loss leader."

More business, of course, brings more scrutiny—no less so when you got your start decrying the model you're now using. On March 17, Kroll reeled in the city of Chicago as a client for its general obligation bonds, assigning a rating of A- and a stable outlook. Less than two months later, Moody's slashed Chicago's rating two notches to junk level (Ba1) after the Illinois Supreme Court rejected a plan to overhaul the state's pension system.

Fitch and Standard & Poor's cut their ratings within three days, and each member of the Big Three set the future outlook as negative. Only Kroll had left its rating untouched, at A- and stable, as of July 2.

Kroll declined to comment on its Chicago decision.

Are those higher ratings justified? "Kroll will say, 'We're better,'" says Lawrence White, a professor at New York University's Leonard N. Stern School of Business. "That may be so, or they may be giving in to make the issuer happy. We won't know until five years from now."

Bloomberg

by David Evans

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BAML Stays on Top of Underwriter Rankings; PFM Leads FAs.

Bank of America Merrill Lynch maintained its position atop the ranks of municipal underwriters in the first half, as rivals closed the gap in an increasingly competitive market.

Quarterly League Tables

According to data from Thomson Reuters, all of the top 11 firms underwrote more in the first half of this year than in the same period of 2014. The 11 firms earned a total of $214.44 billion in 6,816 versus $143.31 billion in 4,913 deals amid a surge in issuance as issuers took advantage of near-record low interest and refunded debt.

BAML finished the half with a par amount of $27.53 billion in 255 deals, good for 12.8% of the market. The bank's par amount rose from $19.42 billion and 182 deals increase, but its market share decreased from 13.6% in 2014.

Citi underwrote $25.60 billion in 273 deals, to garner a 11.9% market share, improving from $14.95 billion in 172 deals and 10.4% of the market in the first half of 2014. Citi moved up one spot from last year, claiming second place this year.

JPMorgan, which finished third with $24.77 billion in 242 deals for and 11.6% market share, after placing second in the first half of last year with $16.01 billion in 151 deals, for 11.2% of the market.

"Compared to the first half of last year, the market is up almost 50% in total volume. When you look at the first two quarters of 2015, they were pretty similar," said Jamison Feheley, managing director and head of public finance banking for JPMorgan. "Strong issuance volume in the first quarter continued into the second, largely driven by refundings."

Feheley also said that the firm has had no change in its business strategy, as it continued to focus on our clients and execute solutions that provide optimal results in the current market environment.

"We expect a solid pipeline of business to continue through the summer and through the third quarter," he said. "Visibility into the fourth quarter is more challenging and it remains to be seen what impact any potential rate increases by the Fed this year will have on refunding volume and overall new issuance."

Morgan Stanley ranked fourth with $18.03 billion in 251 issues and the same market share as a year earlier, 8.4%. Morgan Stanley did improve from $12.08 billion in volume and 141 deals in the same period of time last year.

RBC Capital Markets jumped from seventh place last year to fifth place, Its $13.13 billion in 421 issues or 6.1% of market share, compared with $8.09 billion in 272 issues or 5.7% of market a year ago.

"With a year-over-year rankings uptick of two notches, we are appreciative to our clients for their confidence in our banking expertise and capital markets execution," said Chris Hamel, managing director and head of the municipal finance group at RBC Capital Markets. "An increase in market share in a high volume year demonstrates that our plans for deepening RBC's involvement in the municipal sector are being realized."

The biggest move inside of the top 11 was Stifel Nicolaus and Co., which improved by three spots to No. 7, with $10.65 billion in 486 transactions or 5% of market share. Last year when Stifel finished tenth, it had $5.122 billion in 283 transactions or 3.6% of the market. Stifel again worked on the most deals.

PFM Increases Market Share

Public Financial Management Inc., increased its market share to 19.9% with a par amount of $35.21 billion in 542 transactions. That compares with 17.5% of market share in the first half of last year, with $20.86 billion in 367 issues.

“PFM has great clients and we work in close cooperation with them in preparing to access the debt markets when their funding needs require and when the markets provide good opportunities to refund or restructure prior obligations,” said John Bonow, managing director and chief executive officer of the PFM Group. “We have many strategic locations around the country that help us serve our clients well with both local resources and sector specialists who are supported by a dedicated capital markets pricing group – this combination helps us understand each unique governmental and non-profit credit and their appropriate cost of capital for a given debt structure.”

Bonow said the companies in the PFM Group have experts across all areas of governmental and non-profit finance, beyond debt advisory work, including budgeting and strategic forecasting, workforce, post-employment obligations, structured products, post-issuance compliance and investment management. This breadth of services provides the context required to offer appropriate advice in both cooperative and challenging economic environments, he said.

“As our clients’ needs develop and markets evolve, we add the resources necessary to continue to be the trusted advisor with comprehensive services and subject matter expertise that our clients have come to expect,” Bonow said.

Bonow expects that refunding volume will continue to be strong, even if the Fed takes rate action in the third quarter.

“We also think there is pent-up need to address deferred infrastructure renewal and replacement needs, and assuming economic conditions remain stable, new money bond volume should continue to increase,” he said. “Moreover, the uncertainty at the federal level means that sectors such as transportation will continue to look for expanded and innovative local funding alternatives to tackle the substantial amount of capital funding needed for our nation to remain competitive and for local jurisdictions to pursue greater economic growth. Finally, underfunded pension and OPEB obligations will continue to get even more well-deserved attention, as the challenges of such funding responsibilities increasingly strain many governmental and non-profit budgets and impact credit ratings.”

FirstSouthwest finished with $17.98 billion in 440 deals or 10.1% of the market, up from $12.53 billion in 321 deals last year.

“We have been building a national FA presence over the past 15 years starting to come into place,” said Jack Addams, vice chairman and head of public finance for FirstSouthwest. “We have great bankers all across the county, good people and a good market, it all came together. The firm is proud of our policy, which is that the client comes first and we are there to do what the client needs to get done. The clients realize the quality of the service that they get with us. It’s a team effort and it reflects the quality of the team we have here.”

Public Resources Advisory Group finished a close third with $15.83 billion, up from the $12.14 billion in par amount from the same period last year. Piper Jaffray came in fourth place and RBC rounds out the top five. Piper moved up from seventh last year, while RBC leaped up from 13th place. The biggest mover on the list however was Kaufman Hall & Associates Inc., which went from 27th place last year to seventh place this year as they saw their par amount balloon to $3.73 billion from $974 million.

Negotiated Underwriting

JPMorgan claimed the top spot for underwriting negotiated deals, after finishing in third place in this category a year ago. The firm finished the first half of 2015 with a par amount in negotiated deals of $19.52 billion, up from the $10.08 billion during the same period of last year. Citi stayed in the number two spot with $19.37 billion, up from $10.40 billion the year prior. BAML dropped to the third spot with $17.46 billion, after finishing first this time last year with $12.11 billion. Morgan Stanley finished fourth with $12.89 billion and RBC came in fifth with $12.42 billion.

Competitive Underwriting

BAML finished the first half of 2015 as the top competitive underwriter, just as it did during the first half last year. The par amount in competitive deals rose to $10.07 billion from $7.32 billion. Citi and JP Morgan flip-flopped positions year over year, as Citi finished in second with $6.23 billion and JP Morgan third with $5.25 billion. Morgan Stanley remained in the fourth spot with $5.14 billion and Robert W Baird moved up one spot from last year, coming in fifth with $3.95 billion.

The biggest mover was Barclays, which rocketed to the ninth spot this year from the 26th spot in the first half of 2014. Barclays' par amount increased to $1.24 billion from $122 million.

Top Issuers

Three of the top six issuers so far this year hail from the Empire State, including two from the city that never sleeps. Topping the list is the New York State Dormitory Authority with a par amount of $4.67 billion in 24 issues. Last year at this time DASNY ranked fifth with $2.36 billion. The Regents of the University of California finished second with $3.35 billion, the New York City Transitional Finance Authority is third with $3.33 billion, the state of California is fourth with $3.04 billion, the Texas Transportation Commission is fifth with $2.39 billion and New York City is sixth with $2.32 billion.

THE BOND BUYER

BY AARON WEITZMAN

JUL 6, 2015 3:58pm ET

Bad Math and a Coming Public Pension Crisis.

When Jim Palermo was serving as a trustee of the village of La Grange, Ill., he noticed something peculiar about the local police officers and firefighters. They were not going to live as long as might be expected, at least according to pension tables.

After Mr. Palermo dug into the numbers, he found that the actuary — the person who advises pension plan trustees about how much money to set aside — was using a mortality table from 1971 that showed La Grange's roughly 100 police officers and firefighters were expected to die, on average, before reaching 75, compared with 79 under a more recent table.

The four years are significant beyond any interest in macabre statistics. When actuaries calculate the numbers for a pension plan, mortality rates are a powerful hidden factor. If an actuary predicts the workers will live to an old age, it means they will be drawing their pensions for more years. That, in turn, means the employer should set aside more money up front, to keep from running out later.

Assuming shorter life spans reduces annual contributions and frees up money for other things, like bigger current paychecks. And if the plan bases pensions on pay, as those in most American cities do, shortening the workers' life spans on paper could lead to both fatter paychecks now and bigger pensions in the future. In La Grange's case, those four years meant tens or hundreds of thousands of dollars to each retiree.

But if more workers are retiring and not dying on schedule, it can be a recipe for financial disaster.

The recommendations made by pension actuaries, like which mortality table to use, are largely hidden from public view, but each decision ripples across decades and can have an outsize effect. More and more actuaries are now worried that their profession will be blamed for its role in steering states and cities into what is looking like a trillion-dollar quagmire.

On Thursday, a panel of senior actuaries will consider whether to update, or elaborate on, the existing actuarial standards for public pensions. The dueling mortality tables will be among the evidence, and Mr. Palermo is among the parties who have submitted written testimony.

It is only the second time in recent memory that the Actuarial Standards Board has held a public hearing, an indication of the gravity of the nation's pension woes. State and local governments have promised several trillion dollars' worth of benefits to retirees — the exact amount is in dispute. Now, with large numbers of public workers retiring, the money set aside is turning out to be at least a trillion dollars short.

Retirees are counting on the money promised to them. Taxpayers are in no mood to bail out troubled pension funds. Some are looking for scapegoats.

"Actuaries make a juicy target," said Mary Pat Campbell, an actuary who responded to the board's call for comments.

She expressed concern that elected officials were using actuaries to lend respectability to "questionable behavior" like funding pensions with borrowed money, picking risky investments and "enacting benefit improvements based on lowballed costs."

Other commentators have focused on the opacity of actuaries' calculations and reports to the boards of trustees that govern public pension plans.

Trustees need clear and honest projections and do not receive them, a former pension trustee from Kentucky, Christopher Tobe, wrote.

He recalled seeing an assumption for future investment returns jump to 7.75 percent from 4.5 percent, with no explanation. The change lowered the state's pension obligations by more than a billion dollars, which in turn meant smaller contributions.

Another commentator, Mark Glennon, told the board that actuaries were churning out reports that no one but other actuaries could understand, providing cover for elected officials who were letting problems spin out of control.

"Chicago represents the most glaring example," wrote Mr. Glennon, the founder of an online news service, WirePoints, which covers the fiscal morass in Illinois. "An actuary could have looked only briefly at some of its pension reports from years ago and seen the calamity to come. Reporters, political leadership and most pension trustees could not. Those who could understand were able to remain silent."

In La Grange, Mr. Palermo, who was elected in 2007, thought the pension funds were being shortchanged. More and more police officers and firefighters were retiring, and they were not dying according to the mortality table used by the actuary. Between them, the two pension funds had less than half the money they should. If this continued, he said, the money would eventually run short, and people would get hurt.

And not just in La Grange. The actuary, Timothy W. Sharpe, had the biggest market share of police and fire pension business in Illinois.

"I think it's a moral hazard," Mr. Palermo said.

Mr. Palermo, who works in financial services, determined Mr. Sharpe was using a table from 1971, which tracked a group of people born from 1914 to 1918, who retired from 1964 to 1968. It is seldom used these days. A table from 2000 is considered more accurate, and in 2014 the Society of Actuaries issued an even newer one.

Mr. Palermo researched mortality rates in the American work force and found no evidence that police and firefighters die younger than other public workers. Finally, he sent a confidential complaint to the Actuarial Board for Counseling and Discipline, which deals with actuaries who stray from the profession's standards of practice.

A few months later, his complaint was written up in a village manager's report and distributed at a public meeting. Mr. Palermo had accused Mr. Sharpe of making statements that were "frequently erroneous and incomplete," it said. He had accused Mr. Sharpe of misleading the village board and persuading it to incorporate the wrong mortality assumptions into the local tax levy.

The news media pounced.

The village manager's report strongly suggested that Mr. Palermo was a troublemaker with few allies in the local government. It said he had acted on his own and that most of the village board was on Mr. Sharpe's side.

It also said that Mr. Sharpe had refused to supply any numbers until the complaint was resolved, so the village had no numbers on which to base the coming year's tax levy. It was about to miss a state deadline.

Mr. Sharpe sent a letter to The Doings, La Grange's newspaper, saying that he had the unanimous support of the police and fire trustees. "I will not be intimidated," he wrote.

In a phone interview, Mr. Sharpe said that he had been instructed to use the 1971 mortality table by the Illinois Insurance Department. Even though it was old, he said, he considered it more realistic because it projected death rates out to age 110. The table from 2000 uses a different population sample and projects death rates out to age 120.

If La Grange projected life spans the way Mr. Palermo wanted, he added, it would "be collecting taxes to pay for pensions to people assumed to live to age 120," a needless expense.

Mr. Sharpe said those additional 10 years were particularly troubling.

"In Illinois, our pensions start very early, at age 50 for police and fire," he said. "There's a 3 percent compounded cost-of-living increase that goes on for life. So the pensions at the later ages of life — I'm talking about after 100, for instance — get very, very large. The person who gets a $50,000 pension at age 50 would get a $250,000 pension by age 100."

He provided data on public workers' death rates from the Illinois Insurance Department, which showed that no one in the state ever lived that long. That is why he said the more recent mortality table could lead to needless tax increases.

In a separate interview, Mr. Palermo said he could not discuss his complaint, which has been resolved, but said that by focusing on the oldest years of the mortality tables, Mr. Sharpe was diverting attention from the much more relevant middle years, where the probability of death was much greater in the 1971 table. For 50-year-olds, for example, the risk of death was seen as more than double in 1971 than what is expected in the later table.

Neither man disclosed how the complaint was resolved. But their battle appears to have no clear-cut victor. Mr. Sharpe, who now uses the newer mortality table, no longer consults for La Grange's police and fire pension trustees. Mr. Palermo did not seek re-election and stepped down in May.

As for the pension system, Mr. Sharpe's successor changed the mortality projections, and La Grange's required minimum pension contribution increased by 20 percent. More increases are coming, but the city has tax caps and cannot catch up quickly without cutting other services.

Mr. Palermo fears it's too late. "It's probably beyond repair," he said. "We're at the point where we're just managing the decline.

THE NEW YORK TIMES

By MARY WILLIAMS WALSH

JULY 8, 2015

GASB Issues Proposed Guidance on External Investment Pools and Component Units.

Norwalk, CT, June 30, 2015 — The Governmental Accounting Standards Board (GASB) today issued two Exposure Drafts proposing accounting and financial reporting guidance related to external investment pools and how certain component units should be presented in a governmental reporting entity's financial statements.

The Exposure Draft, *Accounting and Financial Reporting for Certain External Investment Pools*, would permit qualifying external investment pools to measure pool investments at amortized cost for financial reporting purposes. Reporting under the amortized cost basis reflects investment cost and adjustments made for premiums or discounts associated with the purchase price of the underlying investments in the pool.

The Exposure Draft, *Blending Requirements for Certain Component Units*, would enhance existing guidance regarding the presentation of the financial reporting entity in governmental financial statements. The proposed Statement would establish an additional blending criterion for financial statement presentation of component units of state and local governments.

"These two proposals come in response to requests by stakeholders to resolve important practice issues," said GASB Chairman David Vaudt. "The Exposure Draft on external investment pools should help avoid confusion ahead of forthcoming regulatory rule changes. The Exposure Draft on blending requirements will clarify reporting entity presentation of certain component units incorporated as not-for-profit corporations."

External Investment Pools

For governments, external investment pools function much like money market mutual funds do in the private sector. Government investment funds pool the resources of participating governments and invest in various securities permitted under state law. By pooling their cash together, governments can benefit in a variety of ways, including from economies of scale and professional fund management.

Existing standards provide that external investment pools may measure their investments at amortized cost for financial reporting purposes if they follow substantially all of the provisions of the U.S. Securities and Exchange Commission's Rule 2a7 for money market funds. Likewise, participants in those pools are able to report their position in the pool at amortized cost per share.

The proposal would replace the reference in GASB literature to Rule 2a7 with the GASB's own set of criteria. This is being done in response to major changes to Rule 2a7 that take effect in 2016. Under the rule changes, many government pools would expect to no longer qualify for amortized cost reporting. This would represent a significant change from current practice for both the pools and their participants.

The proposed Statement also would establish additional note disclosure requirements for external investment pools that measure all of their investments at amortized cost for financial reporting purposes and for governments that participate in those pools. These disclosures would include information about limitations or restrictions on participant withdrawals.

Blending Requirements

This Exposure Draft addresses diversity in practice regarding the presentation of not-for-profit corporations in which the primary government is the sole corporate member. The GASB has proposed treating these component units as if they were activities of a primary government through a financial presentation method referred to as blending. The Board believes the proposed approach would enhance consistency of application among governments reporting these types of component units—which would result in increased comparability across governments.

The Exposure Drafts are available on the GASB website, www.gasb.org. Stakeholders are encouraged to review and provide comments on the Exposure Draft, Accounting and Financial Reporting for Certain External Investment Pools, by August 31, 2015. Stakeholders are encouraged to review and provide comments on the Exposure Draft, Blending Requirements for Certain Component Units, by October 2, 2015.

About the Governmental Accounting Standards Board

Established in 1984, the GASB is the independent, private-sector organization based in Norwalk, Connecticut, that establishes accounting and financial reporting standards for U.S. state and local governments that follow Generally Accepted Accounting Principles (GAAP). These standards are recognized as authoritative by state and local governments, state Boards of Accountancy, and the American Institute of CPAs (AICPA). The GASB develops and issues accounting standards through a transparent and inclusive process intended to promote financial reporting that provides useful information to taxpayers, public officials, investors, and others who use financial reports. The Financial Accounting Foundation (FAF) supports and oversees the GASB. For more information, visit www.gasb.org.

GASB Simplifies GAAP Hierarchy for State and Local Governments.

Norwalk, CT, June 29, 2015 — The Governmental Accounting Standards Board (GASB) today issued a final Statement that simplifies the structure of the hierarchy of Generally Accepted Accounting Principles (GAAP)—or "GAAP hierarchy." The GAAP hierarchy identifies the sources of guidance that state and local governments follow when preparing financial statements in conformity with GAAP and lists the order of priority for pronouncements to which a government should look for guidance.

GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, reduces the GAAP hierarchy to two categories of authoritative GAAP from the four categories under GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments.* The first category of authoritative GAAP consists of GASB Statements of Governmental Accounting Standards. The second category comprises GASB Technical Bulletins and Implementation Guides, as well as guidance from the American Institute of Certified Public Accountants that is cleared by the GASB.

The Statement also addresses the use of authoritative and nonauthoritative literature in the event that the accounting treatment for a transaction or other event is not specified within a source of authoritative GAAP.

These changes are intended to improve financial reporting for governments by establishing a framework for the evaluation of accounting guidance that will result in governments applying that guidance with less variation. That will improve the usefulness of financial statement information for making decisions and assessing accountability and enhance the comparability of financial statement information among governments. The Statement also improves implementation guidance by elevating its authoritative status to a level that requires it be exposed for a period of broad public comment prior to issuance, as is done for other GASB pronouncements.

"Applying accounting standards can sometimes be complex, but identifying the right standards to apply should be straightforward," said GASB Chairman David A. Vaudt. "Statement 76 goes a long way toward making that a reality."

In connection with Statement 76, the GASB also recently cleared Implementation Guide No. 2015-1, which incorporates changes resulting from feedback received during the public exposure of all of implementation guidance previously issued.

The requirements of the new pronouncements are effective for reporting periods beginning after June 15, 2015.

Statement 76 is available and the new Implementation Guide soon will be available free of charge on the GASB website. Printed copies of the Statement will be available for purchase in the coming weeks.

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GASB Publishes New Standards for Reporting Health Insurance and Other Retiree Benefits.

Norwalk, CT, June 29, 2015 — The Governmental Accounting Standards Board (GASB) today published two Statements that intend to improve the accounting and financial reporting by state and local governments for postemployment benefits other than pensions (OPEB), primarily retiree health insurance. The GASB also issued a third Statement establishing accounting and financial reporting requirements for pensions and pension plans that were outside the scope of the pension standards the GASB released in 2012.

To help familiarize stakeholders with the Statements, the GASB is offering the following resources on its website:

- A "GASB in Focus" fact sheet answering frequently-asked questions
- A Video discussing key principles of the OPEB Statements
- The full text of the Statements.

The OPEB Statements

GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, addresses reporting by OPEB plans that administer benefits on behalf of governments. GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, addresses reporting by governments that provide OPEB to their employees and for governments that finance OPEB for employees of other governments.

The new OPEB standards parallel the pension standards issued in 2012—GASB Statement No. 67, *Financial Reporting for Pension Plans*, and GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*.

"These newly published OPEB standards will give financial statement users a much more complete picture of how much state and local governments have promised in retiree benefits—and how much those promises actually cost," said GASB Chairman David A. Vaudt. "Together with the Board's recent pension standards, these standards will provide consistent and comprehensive guidance for the full suite of postemployment benefits that governments provide to their employees."

Statement 75

Statement 75 replaces the requirements of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. Statement 75 requires governments to report a liability on the face of the financial statements for the OPEB that they provide.

- Governments that are responsible only for OPEB liabilities related to their own employees and that provide OPEB through a defined benefit OPEB plan administered through a trust that meets specified criteria will report a net OPEB liability—the difference between the total OPEB liability and assets accumulated in the trust and restricted to making benefit payments.
- Governments that participate in a cost-sharing OPEB plan that is administered through a trust that meets the specified criteria will report a liability equal to their proportionate share of the collective OPEB liability for all entities participating in the cost-sharing plan.
- Governments that do not provide OPEB through a trust that meets specified criteria will report the total OPEB liability related to their employees.

Statement 75 carries forward from Statement 45 the option to use a specified alternative measurement method in place of an actuarial valuation for purposes of determining the total OPEB liability for benefits provided through OPEB plans in which there are fewer than 100 plan members (active and inactive). This option was retained in order to reduce costs for smaller governments.

Statement 75 requires governments in all types of OPEB plans to present more extensive note disclosures and required supplementary information (RSI) about their OPEB liabilities. Among the new note disclosures is a description of the effect on the reported OPEB liability of using a discount rate and a healthcare cost trend rate that are one percentage point higher and one percentage point lower than assumed by the government. The new RSI includes a schedule showing the causes of increases and decreases in the OPEB liability and a schedule comparing a government's actual OPEB contributions to its contribution requirements.

Some governments are legally responsible to make contributions directly to an OPEB plan or make benefit payments directly as OPEB comes due for employees of other governments. In certain circumstances—called special funding situations—Statement 75 requires these governments to recognize in their financial statements a share of the other government's net OPEB liability.

Statement 74

Statement 74 replaces GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. Statement 74 addresses the financial reports of defined benefit OPEB plans that are administered through trusts that meet specified criteria. The Statement follows the framework for financial reporting of defined benefit OPEB plans in Statement 45 by requiring a statement of fiduciary net position and a statement of changes in fiduciary net position. The Statement requires more extensive note disclosures and RSI related to the measurement of the OPEB liabilities for which assets have been accumulated, including information about the annual money-weighted rates of return on plan investments. Statement 74 also sets forth note disclosure requirements for defined contribution OPEB plans.

The Pension Statement

GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, completes the suite of pension standards. Statement 73 establishes requirements for those pensions and pension plans that are not administered through a trust meeting specified criteria (in other words, those not covered by Statements 67 and 68). The requirements in Statement 73 for reporting pensions generally are the same as in Statement 68. However, the lack of a pension plan that is administered through a trust that meets specified criteria is reflected in the measurements.

Effective Dates and Availability of Statements

The provisions in Statement 73 are effective for fiscal years beginning after June 15, 2015—except those provisions that address employers and governmental nonemployer contributing entities for pensions that are not within the scope of Statement 68, which are effective for fiscal years beginning after June 15, 2016. The provisions in Statement 74 are effective for fiscal years beginning after June 15, 2016. The provisions in Statement 75 are effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged. Printed copies of the Statements will be available for purchase in the coming weeks.

About the Governmental Accounting Standards Board

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Modernizing American Manufacturing Bonds Act Reintroduced.

Congressman Randy Hultgren (R-IL) and Congressman Richard Neal (D-MA) have reintroduced the Modernizing American Manufacturing Bonds Act of 2015, H.R. 2890.

Read the Press Release.

S&P’s Public Finance Podcast (The Quarterly Ratings Roundup And Allen Park, MI)

In this edition of Extra Credit, Senior Director Larry Witte discusses the key takeaways from our quarterly ratings roundup, and Director Caroline West explains what’s behind our ratings on Allen Park, MI., including how a distressed exchange could affect the entity.

Listen to the podcast.

Jul 02, 2015

Municipal Issuer Brief: Issuers Using One Rating with More Frequency.

Read the Brief.

Municipal Market Analytics | Jun. 29

Georgia Supreme Court Upholds SunTrust Park Bond Financing.

The Georgia Supreme Court Monday upheld a lower court ruling authorizing up to $397 million in bond financing for the Atlanta Braves' new SunTrust Park.

Three Cobb County residents challenged the county commission's decision last year to help finance the 41,500-seat stadium at interstates 75 and 285 through a public-private partnership with an estimated cost of $622 million.

The plaintiffs argued the authorization of the bonds required a public vote, that the intergovernmental agreement to issue the bonds was a violation of the debt and gratuity clauses of the Georgia Constitution and that the project is an improper use of public money for a private facility.

But in Monday's unanimous ruling, Justice David Nahmias upheld the bond financing as legally valid. "It is evident that the lawyers and officials for Cobb County, the Cobb-Marietta Coliseum and Exhibit Hall Authority and the Braves parties relied on prior decisions of this court … when structuring the financing for the new Braves stadium project," Nahmias wrote.

While the court took note of the plaintiffs' concerns about the wisdom of the project's reliance on public financing for a private project, the justices argued those were issues of public policy best left up to Cobb elected officials.

Construction on SunTrust Park is well underway, with the stadium set to open in April 2017.

Jun 29, 2015, 10:36am EDT

Dave Williams

Atlanta Business Chronicle

No Success Like Failure: N.Y. Sees Social Impact Bond Pluses.

A New York City program aimed at cutting recidivism rates among Rikers Island adolescent prison inmates failed to meet its desired goal.

As a result, the city paid nothing for it.

That made the nation's first social impact bond a success, according to city officials and others involved with the program. Under the pay-for-performance vehicle – bond is a misnomer in the traditional muni bond sense, though supporters find the buzzword catchy – the city is not on the hook.

The program, which began in 2012, was originally pegged for four years but reduced after a predetermined three-year checkpoint. Its structure enabled city officials to experiment without risk to taxpayers, according to First Deputy Mayor Tony Shorris.

"This social impact bond allowed the city to test a notion that did not prove successful within the climate we inherited on Rikers," he said. "We will continue to use innovative tools, both on Rikers and elsewhere."

Vera Institute of Justice, a nonprofit, was the independent evaluator of the program, called Adolescent Behavioral Learning Experience, or ABLE. The benchmark was whether the program reduced recidivism among 16-to-18 year-olds who entered Rikers in 2013 by 10% or more. Intervention focused on social skills, personal responsibility and decision-making.

"The program did not reduce recidivism and therefore did not meet the pre-defined threshold of success," Vera said in a statement.

The program will end on Aug. 31.

Goldman Sachs provided a $7.2 million loan to nonprofit MDRC, which oversaw the project. Bloomberg Philanthropies, the personal charity of former Mayor Michael Bloomberg, provided a $6 million loan guarantee. Goldman thus loses $1.2 million. Had the program gone the full four years, Goldman's investment would have been $9.6 million, with Bloomberg Philanthropies' backstop at $7.2 million.

Though modeled after a prison program in Peterborough, U.K., New York's is the first anywhere involving a major financial institution.

"This can unlock new pieces of funding, private capital especially," said Jim Anderson, who leads the government innovation program at Bloomberg Philanthropies. "It also brings a laser-like focus to measurable data. Everyone has an incentive. We're not doing this to feel good. We want positive results.

"Even though we didn't get the result with the program that we all wanted and hoped for, we now know that definitively, thanks to the social impact bond structure that we put in place."

Goldman is involved with three other such programs under its impact investing umbrella. Two involve early childhood education in Salt Lake City and Chicago, with kindergarten preparedness the yardsticks, while the other is criminal justice-oriented in Chelsea, Mass., outside Boston, for which Massachusetts earmarked up to $27 million.

"We're proud to have been part of this public-private partnership that used a new financing model to tackle a difficult issue in a time of government budget constraints," said Andrea Phillips, vice president in Goldman's urban investment group.

"Social impact bonds can fill a gap and are designed to align government, service providers and investors around outcomes at no cost to taxpayers if targets are not met. While we certainly hoped for greater impact in this case, we learned a great deal along the way and remain committed to investing in projects that support important public initiatives."

Working with New York City Mayor Bill de Blasio's office and the city Department of Correction, social justice organization MDRC contracted with the Osborne Association, which ran the program in conjunction with Friends of Island Academy.

"The social impact bond let us test the program without taxpayer expense," said Kristin Misner-Gutierrez, director of social services for the city's deputy mayor for health and human services and former chief of staff in that office under Mayor Michael Bloomberg's administration.

City officials say the program, while missing its benchmarks, generated significant buy-in from Rikers management, uniformed and nonuniformed staff and school personnel, and that the experience of implementing it may plant a seed for further innovation in criminal-justice related programs.

“This administration is committed to a number of reforms at Rikers Island,” said Misner-Gutierrez.

The social bond concept is gathering momentum against a backdrop of tight government spending.

Many states are adapting or considering pilot programs. For instance, in Pennsylvania, where a battle between Gov. Tom Wolf and the legislature over the proposed $30 billion budget has extended past the fiscal-year deadline, Wolf’s administration issued a request for information related to a pay-for-success proposal.

“It’s a trending activity,” said Anderson. “How do we help local governments better influence decision-making.? One way is to shift more to a pay-for-success performance bond.”

THE BOND BUYER

BY PAUL BURTON

JUL 2, 2015 9:00am ET

No Easy Pass for North Carolina’s First Privately Run Toll Lanes.

North Carolina signed contracts and sold $100 million of municipal bonds, workers are surveying the land, and the state’s first private toll lanes are set to open on Interstate 77 in 2018.

Not if Kurt Naas has anything to say about it. Naas and a group of fellow Charlotte-area residents have filed suit to stop the $648 million plan for the state’s first highway project with a private operator, a subsidiary of Madrid-based Ferrovial SA. The residents have spurred a chorus of opposition that includes local business leaders and the government of Mecklenburg County, where the stretch of highway is located.

“We’re siphoning money out of our local economy and we’re sending it to a foreign company,” said Naas, 53, an engineer and resident of Cornelius. “Giving the public right of way and using public dollars to build private lanes is bad public policy.”

The push for such public-private partnerships — or P3s — is expanding across the nation, from North Carolina to Colorado and Texas, as localities face dwindling federal dollars to fix crumbling roads through the almost-broke Highway Trust Fund.

Critical Infrastructure

“The Highway Trust Fund is just going from deadline to deadline, without long-term certainty regarding funds,” said Dan Close, a money manager in Chicago at Nuveen Asset Management, which oversees about $100 billion of munis, including the North Carolina securities. “When you need critical infrastructure completed, P3 projects are offering a little bit more certainty.”

Private financing of public works is common in Europe and Canada, with companies handling the work on the assets while governments retain ownership. It’s less so in the U.S., where the Highway Trust Fund was established in 1956 to support the new Interstate Highway System.

But the fund is almost out of money, supported by a federal gasoline tax that hasn't been raised since 1993 and with lawmakers bickering over how to fill the gap.

So, governments are turning to other sources of financing.

In North Carolina, a venture called I-77 Mobility Partners LLC, led by Ferrovial subsidiary Cintra Infraestructuras and Aberdeen Global Infrastructure II LLP, will design, build, operate and maintain the I-77 project for 50 years.

Above Junk

The company, which is investing $248 million, will collect revenue from the new toll lanes on a 26-mile (42-kilometer) stretch of the highway north from Charlotte.

The state Department of Transportation sold the municipal bonds in May. The sale included securities maturing in June 2026 yielding 3.72 percent, or about 1.4 percentage points over benchmark munis, according to data compiled by Bloomberg. An index of 10-year BBB revenue-backed munis yielded 3.27 percent that day, Bloomberg data show.

Fitch Ratings graded the bonds BBB-, one step above junk, citing the project's vulnerability to less traffic during economic downturns and the area's "limited familiarity with tolling." DBRS Ltd. graded the securities BBB, one step higher.

Levies will change based on demand, and travelers can either use those lanes and pay, or drive on the free lanes. Vehicles with more than three occupants can ride on the new lanes without charge. The state is paying about $95 million toward the cost, and a federal loan to the company provides $189 million.

'Economic Vitality'

The project will create "8,000 direct, indirect and induced jobs" with as many as 100 local companies expected in the construction, said Jean Leier, a spokeswoman for I-77 Mobility Partners.

"This long-term traffic solution will generate economic development and continued economic vitality to this important corridor," she said in an e-mail.

Partnering with a private operator speeds up a project needed to cope with the congestion in a fast-growing area, said Mike Charbonneau, a spokesman for the state Department of Transportation in Raleigh.

Charlotte, the state's most-populous city, is home to Bank of America Corp. and Duke Energy Corp., the biggest U.S. electric utility. Surrounding Mecklenburg and Iredell counties make up 16 percent of the state's employment, according to Fitch.

"While P3s are new to our state, they are an important strategy moving forward to help meet growing demands and to stay ahead of rapid growth," Charbonneau said by e-mail.

'Wild Card'

Representatives of local businesses see the project as worsening traffic and are traveling to Raleigh on June 30 to meet with legislators to persuade them to cancel the transaction, said organizer John McAlpine. He said drivers would eschew tolls, while operators of trucks with more than three axles — which can't use the paid lanes — would throng the free ones.

Mecklenburg County also wants to curb the project. Its board of commissioners voted 7-2 on June 16 on a resolution asking state leaders to cancel it and come up with an alternative without tolls.

The transportation department filed a motion this month in Mecklenburg County Superior Court asking that the suit by Naas's group be dismissed.

With no solution in sight for long-term federal funding of roads, more localities are considering P3 projects, testing American acceptance of tolls, said Jonathan Gifford, director of the Center for Transportation Public-Private Partnership Policy at George Mason University in Arlington, Virginia.

"That's a bit of a wild card," Gifford said. "There's a widening appreciation for the fact that the public acceptance of using tolls to finance the projects is pretty variable."

Bloomberg

by Romy Varghese

June 28, 2015 — 9:00 PM PDT Updated on June 29, 2015 — 6:14 AM PDT

Puerto Rico at Precipice Piles on Muni Market Hampered by Crises.

Illinois and New Jersey have dragged down the municipal-bond market this year as the states wrestled with growing pension-fund bills. Puerto Rico is depressing it even more.

Even before Puerto Rico Governor Alejandro Garcia Padilla said this week that the junk-rated island can't afford to pay its debts, municipal bonds had returned about nothing in 2015 as investors dumped securities of the cash-strapped states and the Federal Reserve moved toward raising interest rates for the first time in nine years.

The pressure on the $3.6 trillion market is building as Puerto Rico seeks to restructure its $72 billion debt load, raising the specter of a record-setting default. With about half of municipal mutual funds holding Puerto Rico bonds, that may fuel selling by investors who've been pulling money from the market for the past two months.

"There seems to be a confluence of events," said Vikram Rai, head of muni strategy in New York at Citigroup Inc.

"Puerto Rico is a one-off case, but it's a debt restructuring which is coming at the wrong time," he said. "That's what worries me — that it could end up impacting everything."

Pulling Funds

The municipal market is dominated by individual investors, who moved money elsewhere after the recession amid speculation that defaults would rise and in 2013, when Detroit filed for bankruptcy. Another exodus has been building: They had already taken $1.9 billion from muni mutual funds for the past eight straight weeks, the longest stretch in 18 months, Lipper US Fund Flows data show.

The price of Puerto Rico's most frequently traded securities tumbled this week, hitting record lows, after Garcia Padilla said the teetering island can't afford to make good on all of its debts. He said officials want to negotiate with investors to postpone debt payments and will propose a restructuring plan by the end of August.

Commonwealth securities pared their losses Wednesday after the Puerto Rico Electric Power Authority avoided defaulting on a $415 million bond payment and reached an agreement to continue negotiations with creditors out of court.

Greek Buffer

There was no immediate fallout in the broader municipal market from Puerto Rico's push to restructure its debts, with yields little changed this week as investors snapped up the safest assets amid Greece's escalating debt crisis.

"We have this other macro factor that's out there called Greece," said Chris Alwine, head of munis at Vanguard Group Inc., which oversees $145 billion of the debt. "Most of the municipal market is high quality, and it's rallying based on the Greek news that's out there."

Puerto Rico had already exerted a drag on the muni market, with its securities losing 2.3 percent before Garcia Padilla's announcement, S&P Dow Jones data show. The index ended the first half down 9.4 percent.
Struggling states also contributed to the market's non-existent returns. During the first half of the year, Illinois debt dropped 0.9 percent, while New Jersey obligations plunged 1.1 percent, the steepest losses of the 27 states tracked by S&P.

Both have been unable to keep up with escalating retirement bills. In New Jersey, Governor Chris Christie rolled back a promised pension payment to close a budget shortfall, which may increase the cost in later years. The Illinois Supreme Court struck down lawmakers' solution for a $111 billion pension deficit in May, dealing a setback to the state's plan to steady its finances.

Pension Contagion

That ruling also caused Moody's Investors Service to cut Chicago to junk in May, saying the city has fewer options for shoring up its own underfunded retirement system.

Matt Posner, a managing director at Concord, Massachusetts-based Municipal Market Analytics, said the downgrade led investors to demand higher yields on debt from other borrowers with pension-fund deficits. On May 14, two days after Chicago lost its investment-grade rating, some New Jersey bonds traded for yields of 1.7 percentage points more than benchmark munis, the most since at least 2013 and up from a 2015 average of 1.2 percentage points until then.

"I've never seen the contagion or knock-on effect on seemingly unrelated credits like I did directly as a result of the Chicago downgrade," Posner said. "Investors are penalizing other credits when there's the perception of a pension issue."

The weakness in the municipal market will probably persist because of Puerto Rico's actions, Michael Zezas, chief municipal strategist at Morgan Stanley, wrote in a report Tuesday.
The worst-case would be if a debt restructuring by the commonwealth coincides with rising interest rates and deteriorating credit quality among large borrowers like Illinois and Chicago, Zezas wrote.

Like Puerto Rico, shortchanging pensions has been "a slow-moving train wreck," Vanguard's Alwine said. "A problem that was always more intermediate-term has become near-term."

Bloomberg

by Brian Chappatta

June 30, 2015 — 9:01 PM PDT Updated on July 1, 2015 — 8:47 AM PDT

Bloomberg Brief Weekly Video - 7/01/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

10:47 AM PDT
July 1, 2015

Fitch: EPA Ruling Relieves Pressure on US Public Power.

Fitch Ratings-New York-01 July 2015: The U.S. Supreme Court's decision requiring the U.S. Environmental Protection Agency (EPA) to take industry costs into account before it resumes its Mercury and Air Toxic Standards (MATS) is positive for a few public power entities but will not affect most, Fitch Ratings says. Utilities with high concentrations of coal-fired capacity that have struggled with the decision to install expensive pollution control equipment will now likely face a longer time frame for compliance and could benefit further if the compliance thresholds are lowered.

However, most public power and cooperative issuers have already transitioned to lower emitting resources by taking advantage of the improved economics of natural gas-fired generation and certain renewable resources. Moreover, the sector's exposure to generation at risk for retirement has proven favorable. Of the 45.8 gigawatts (GW) of coal-fired capacity closed since 2010 or earmarked for closure by 2017, only 1.0 GW, or 2%, of the capacity is owned by public power entities other than the Tennessee Valley Authority.

The Supreme Court decision leaves the next steps to a lower court. However, the EPA could issue new rules, rendering moot the lower court's decision. Although the fundamental framework of MATS is not expected to change, the EPA is likely to focus more closely on the cost for industry compliance as it reconsider the mercury rules and drafts future environmental initiatives. The agency is expected to be under pressure to revise the rules before President Barack Obama's second term ends.

Ironically, any lowering of the emission requirements outlined in MATS could frustrate compliance efforts related to the EPA's proposed the Clean Power Plan (CPP). In 2014, the EPA proposed the CPP, to reduce carbon emissions from existing plants by establishing mandatory carbon dioxide reduction targets for each state. Fitch believes these proposed rules are unlikely to have any near-term effect on public power and cooperative utilities given their reduced reliance on coal-fired generation, in part, as a result of MATS. Over the long term, CPP compliance could be more challenging and costly in states that continue to rely heavily on coal-fired generation.

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General Obligation – The Mayhem In Municipal Bonds.

Karen Shaw Petrou memorandum to Federal Financial Analytics Clients on the mayhem in municipal bonds.

TO: Federal Financial Analytics Clients

FROM: Karen Shaw Petrou

DATE: July 2, 2015

Transfixed as we are by the Greek tragedy, it's easy to miss another deadly drama in the financial arena. The other looming systemic risk is right here at home: municipal bonds. Let me quickly say that the hazard here isn't the solvency one doomsayers wrongly prophesized a few years ago. With a few, large exceptions, muni issuers are good for it. Rather, what alarms me—a lot—is the potential for a repeat cliff-effect scenario sparked by rating downgrades. Much here is an eerie repeat of the 2008 crisis that almost took down muni-bond insurers and, with them, everyone else. Ironically, changes since the crisis have made the muni market even more vulnerable to a systemic spiral; so much for all our "we learned our lesson" talk.

A very short bit of background: municipal bonds in the U.S. come in two flavors-general-obligation (GO) ones backed by the full-faith-and-credit of the issuing locality, and state and revenue bonds, backed by the proceeds of stadiums, water projects, and the like. The total muni market is $3.2 trillion and defaults across it—$9 billion last year—are miniscule. In most cases, GO bonds are backed not only by the strong word of an issuer, but also by constitutional or other commitments that force repayment, a solvency promise further strengthened by the clear understanding that any locality that doesn't honor its commitments faces years of financial starvation at great cost to its citizenry.

The problem in the muni market thus isn't traditional credit risk, especially for GOs. Rather, it's opacity. By definition, most muni issuers—especially in the revenue-bond category—are small in terms of the global capital market. Their finances are also often ill-stated, if not even flat-out misstated. Here's where the systemic-risk sparkplug comes in: municipal-bond insurance.

Muni-bond insurers slap their own guarantee atop many issuances so that investors—many of whom are retail ones either on their own or through mutual funds—need not worry their little heads. If a GO or revenue bond is AAA, it's not necessarily that the issuer is gilt-edged—far from it in most cases. Rather, it's that the insurer's guarantee got the rating agency's gold star.

This structure makes ratings critical not only to insurers, but also to the marketplace, and here's where the potential repeat of 2008 gets scary. In 2008, most bond insurers were AAA-rated even as almost all of them played faster than fast and looser than loose with their risk profiles. Muni-bond insurance is, as I said, very low risk. It's also, thus, low-margin. In the heady days leading to the crisis, bond-insurance management wanted to fly like the big boys so they doubled down and put their imprimatur also on a wide array of wild structured-financial instruments with strongly correlated risk across their balance sheets. Oops.

The first thing that happens when a rating agency wakes up is that it cuts ratings. Blithely ignorant of everything beneath the surface at the bond insurers when the crisis broke, each of the agencies sharply downgraded the companies often just days before bankruptcy or restructuring. As ratings went down, a cliff-effect scenario unwound.

The name explains the scenario: something suddenly changes market expectations and investors fall off a cliff. When this happens, investors required to hold only high-rated paper (mutual and pension funds, for example) try to unload their munis even as potential buyers-banks, for example-either can't pick them up due to their own woes or won't because they fear another cliff effect. In the end, there were huge jumps in unrealized losses as muni-bond prices plummeted because of the rating downgrades.

Fast forward to right now. The muni market is still an island of solvency strength, pension woes in Illinois and New Jersey notwithstanding. Puerto Rico is, of course, a huge dark cloud on this horizon, but this isn't so much because its $70 billion in outstanding debt is all that much compared to the total muni market, but rather because of what's happened since 2008 to bond-insurance companies.

Several of them didn't make it out the other end of the financial crisis, leaving a far smaller and considerably more concentrated industry. One company-Assured Guaranty-now holds 57 percent of the business all on its own. Combine that number with another bond-insurer holding a lot of Puerto Rico's direct and indirect debt, NPFG, and one comes up to a very concentrated industry dependent on two companies that could well lose their AA ratings in short order. Since these insurers are keeping one large Puerto Rico issuer afloat by not just insuring, but also buying, its debt, think not just exposure, but also correlation risk and be afraid.

If these companies are downgraded, the cliff-effect scenario could well start all over again in a financial system already on edge due to Greece. It also happens at a time when fixed-income market liquidity is very scarce and the ability of custody banks to husband liquidity reserves for investment companies-e.g. retail-bond mutual funds-is unduly constrained. In short, it's a perfect storm.

Maybe these clouds will pass-I surely hope so. They are, though, a critical and urgent reminder that it's not good to regulate the biggest banks within an inch of their lives. The fundamental mechanics of the 2008 crisis remain largely untouched outside the central-bank circumference-big banks and a couple of very large non-banking companies that drew unflattering attention the last time around. Outside this select sphere, though, there are massive pockets of potential market risk and illiquidity, some reverberating of course now through the sovereign-bond market but others to come in our own little muni-bond market here at home.

Puerto Rico Worries Put Focus On Municipal Bond Insurers.

Calls by Puerto Rico Gov. Alejandro Garcia Padilla to restructure the island's $72 billion debt load is putting renewed focus on whether insurers who back billions of dollars' worth of Puerto Rico bonds can absorb the losses in the event of a default.

The situation threatens to derail what has been a modest comeback for municipal-bond insurers, who suffered losses during the 2008 financial crisis after guaranteeing risky mortgage-backed securities. Nearly 60% of new municipal bonds sold in 2005 carried bond insurance, according to Thomson Reuters data, a figure that plunged to 3.6% in 2012 before recovering to 6.6% so far this year.

Investors are growing increasingly concerned. The stock prices of two of the biggest insurers, Assured Guaranty Ltd. and MBIA Inc., have fallen 12% and 28%, respectively, since Friday's close as analysts fret over whether the insurers can make good on their promises.

Bond insurers agree to make scheduled principal and interest payments if the municipality that sold the bond fails to pay. Investors expected Puerto Rico to have trouble paying bonds from some of its most stressed public authorities, a situation that analysts said appeared manageable for the insurers. But Mr. Padilla in a speech Monday said a more comprehensive restructuring plan is needed that could impact more of Puerto Rico's bonds.

As of March 31, Assured Guaranty backed roughly $10 billion in Puerto Rico principal and interest payments, and MBIA's National Public Finance Guarantee Corp. unit backed another $10 billion, according to financial documents from the insurers. Assured says it has $12 billion in claims-paying resources and National has about $4.9 billion, according to financial documents, though investors are likely to recover some value from Puerto Rico even if there is a restructuring.

The insurers also would have years to make the payments, given that some of Puerto Rico's bonds don't mature for decades. Still, significant losses could lead to fresh downgrades of the insurers' credit ratings, which would make it more difficult for them to write insurance policies on newly issued bonds.

In a research note last week, before Mr. Padilla's most recent comments, analysts at Barclays said that present-value losses of $750 million would "materially damage" MBIA and "potentially cause rating downgrades and diminished ability to write new business." Across two of Assured's subsidiaries, the analysts put the combined figure at $1.75 billion.

Mikhail Foux, head of municipal strategy at Barclays, said potential losses are now "more likely" to hit those numbers given the recent shift in Puerto Rico's stance.

Earlier in June, Moody's Investors Service said a "widespread, systemic default" could have a "significant adverse impact on the credit profiles and ratings" of some insurers.

Previously, "the governor was stressing the importance of maintaining access to the capital markets and paying debts when they come due," said James Eck, vice president and senior credit officer at Moody's. "It appears that maybe that desire is no longer feasible."

Despite the concerns about Puerto Rico, Standard & Poor's Ratings Services on Monday left unchanged the double-A ratings on Assured's subsidiaries and the double-A-minus rating on National. Insurers including Assured and National are also making payments in full on bonds tied to Detroit's bankruptcy, according to a report earlier this year from Kroll Bond Rating Agency.

Bond investors are still putting some faith in insurance, as Puerto Rico bonds that are backed by Assured and National are trading at higher prices than those on similar uninsured debt. Clark Wagner, director of fixed income at First Investors Management Co., said Tuesday that his firm sold a Puerto Rico bond insured by National and got nearly 100 cents on the dollar.

Puerto Rico bond prices have fallen broadly this week, with some bonds down roughly 11%.

Mr. Wagner said his firm sold the bond because he doesn't "want to go through this whole [restructuring] process," even though he expects investors that own the bond will ultimately get repaid in full.

THE WALL STREET JOURNAL

By MIKE CHERNEY

June 30, 2015 5:52 p.m. ET

Write to Mike Cherney at mike.cherney@wsj.com

Unlocking the Private Sector: State Innovations in Financing Transportation Infrastructure.

David Narefsky of Mayer Brown provided testimony in a Senate Finance Committee hearing on private investment in road infrastructure on June 25, 2015.

Download the Testimony.

Mr. David Narefsky, Partner, Co-Leader, Infrastructure Practice Group, Mayer Brown, Chicago, IL

GFOA's 2015 Awards for Excellence in Government Finance.

The Government Finance Officers Association of the United States and Canada announced the winners of its 2015 Awards for Excellence in Government Finance at the GFOA's annual conference in Philadelphia on June 2.

This year's Awards for Excellence-winning entries include innovations in areas of e-government and technology and pensions and benefits:

Montgomery County, Maryland

Financial Information: Transformation, Transparency, and Easy Access

Category: eGovernment and Technology

The county recently completed a new financial transparency suite (including the Online Open Budget Initiative, spendingMontgomery, and budgetMontgomery) to address the limited public use of the legally required online posting of budget data. Based on a survey of residents, the county addressed residents' four key critiques of using the current on-line data, including complicated data, lack of detail, lack of a "big picture," and overall accessibility. The new initiative provides data to the public in a more intuitive and interactive format and also allows the county to improve interaction with its residents and show residents how the county does business. Data are organized in a format that is more readily understood by the lay person. The county made this format available to other governments, making cross governmental comparisons possible. (Portions of the project have also been used by the City of Davenport, Iowa, and the City of Boston, Massachusetts.)

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Orange County (California) Employees Retirement System

OCERS Pension Portfolio Investment Fee Transparency and Management Initiative

Category: Pensions and Benefits

The Orange County Employees Retirement System adopted a comprehensive fee policy for heightened transparency to stakeholders and to guide the organization in investment management practices – which included publishing an annual fee report in 2014. The policy arose from the need to show fees for investment managers more accurately, particularly those that are not invoiced but deducted from portfolio holdings. In addition, collaborative and bundled investment management for private equity funds management reduced costs for services in this area by 65%. This strategy, implemented after securing a legal opinion from a qualified expert external counsel, was executed in collaboration with three other California counties.

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S&P: Supreme Court's ACA Ruling Has No Impact on Health Care Sector.

DALLAS (Standard & Poor's) June 25, 2015–Today's decision by the Supreme Court affirmed health care coverage for millions of Americans by its ruling which validated the legality of federal subsidies under the Affordable Care Act (ACA) in states where the state did not set up its own insurance exchange, but rather relied on the federal exchange. The subsidies have given lower-income Americans a chance to purchase insurance on the public exchange, the loss of which would have jeopardized as many as 6.4 million individuals in 34 states who purchase private health insurance through the federally run exchanges, according to the Centers for Medicare and Medicaid Services.

Standard & Poor's Ratings Services believes that this ruling will not have any impact on rated U.S. not-for-profit and for-profit providers, as it is a continuation of the current operating environment. (Watch the related CreditMatters TV segment titled, "The Supreme Court's Ruling Won't Affect U.S. Health Care Companies' Credit Quality," dated June 25, 2015.)

However, the subsidized exchange business is proving to be a benefit to U.S. health care providers, and that benefit will likely continue, although the benefit is proportional to each participant's share of the marketplace. While some of the conditions that gave rise to the ACA in the first place–medical costs that are too expensive; dwindling levels of employer sponsored care; huge number of underinsured/uninsured with limited access points–still burden the health care delivery system and remain potent concerns for the United States, the ACA and the insurance exchanges are helping to alleviate some of these concerns.

In addition, as the ruling represents an affirmation of the status quo, we don't expect it to have any credit implications for the state sector. It's possible that had the court ruled in favor of the plaintiffs, some states would have been motivated to attempt to establish their own state run health insurance exchanges. Alternatively, policy advocates in the states without state-run exchanges may have urged the legislatures in those states to backfill the withdrawal of federal subsidies. The court's ruling frees these states from having to consider undertaking these administratively complex and costly policy initiatives.

It is quite likely that political wrangling will still occur over the ACA and its assorted components, so the story is probably going to continue to unfold at least through the upcoming elections. But today's ruling maintains the ACA in its current form. The ACA is here to stay, including its goals of greater health care access for millions of Americans; higher quality care for all; and lower costs.

HEALTH INSURANCE

Today's ruling is a positive for the U.S. health insurance industry, especially for insurers that have invested heavily to compete on the insurance exchanges. This will help resolve an uncertainty that has been a pain point not just for insurers, but for the ACA as a whole. This ruling confirms that business as currently structured and forecast through the ACA continues for insurers and insureds, and supports the broader directions of national health care reform.

However, if the results had been different (i.e., the ruling had banned the use of subsidies for individuals gaining access to coverage via a federally facilitated exchange) there would likely have been a precipitous drop in the membership and premium base for insurers that are heavily concentrated in the individual insured marketplace reliant upon a federally facilitated exchange for distribution. Additionally, this ruling avoids the very real possibility of increased adverse selection impacting the insurers. The lack of subsidies would have resulted in higher net premiums for the affected individuals, and a rapid rise in premiums, which could in turn have increased the possibility of higher acuity individuals being the only ones willing to pay the higher premiums thereby increasing insurance risk.

Uncertainly is generally bad for credit, and makes it harder for insurers to price appropriately. The resolution of this issue does somewhat reduce the previously elevated industry risk and also puts the ACA on a stronger footing. However, it is important to note that 2014 was a fairly volatile year for many insurers due to underwriting losses in their individual lines of business. Higher-than-expected medical services utilization and cost trends negatively impact many insurers. Somewhat offsetting the earnings volatility and also supporting our stable view on the health insurance sector is the generally strong capitalization level in the health insurance industry.

Standard & Poor's Ratings Services, part of McGraw Hill Financial (NYSE: MHFI), is the world's leading provider of independent credit risk research and benchmarks. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 26 countries, and more than 150 years' experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information and independent benchmarks that help to support the growth of transparent, liquid debt markets worldwide.

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Advice for Preparing an Effective RFP.

Requests for proposals (RFPs) are designed, not only to attract suitable private partners, but to help the issuer to weed out unqualified bidders. Incomplete, vague or poorly written RFPs can have unfavorable consequences ranging from time wasted reviewing unsuitable bid submissions to charges of favoritism in the selection process.

“As more American municipalities embrace the P3 model, it is important for them to understand the risks and rewards of using the model,” explains Regina Sharrow, partner at Faegre Baker Daniels. “Risks include the potential for a losing bidder to claim that the winner was not selected fairly, which could result in a loss of credibility for the municipality and the selected bidder. In some industries, unsuccessful bidders’ challenges to the P3 selection process are becoming the norm rather than the exception. However, a carefully crafted RFP, including objective evaluation criteria, along with a disciplined evaluation process and an independent selection committee, can help the municipality gain public support for the project, maintain its credibility and avoid valid claims of foul play from unsuccessful bidders.”

Sharrow will be one of the featured speakers at the “Approaches for Preparing Effective Requests for Proposals” at P3 Connect 2015. She will be joined by John Finke, senior program manager and team leader of HEDC Public-Private Partnerships at the National Development Council and Bret Carlstad, director of the Pierce County (Wash.) Public Works & Utilities. They will address the critical components of an RFP, including creating objective evaluation criteria and a solid scoring matrix, and running a process that supports the client’s ultimate decision and deflects complaints from losing bidders.

This is one of five introductory-level sessions planned for P3 Connect, NCPPP’s annual conference, which are designed for attendees who are unfamiliar with P3s and wish to learn more about them. This session track kicks off with our first-ever Introduction to P3 Bootcamp, a comprehensive overview of many different aspects of the P3 process. This three-hour session will provide valuable insights into how to develop and maintain an effective partnership.

P3 Connect 2015 will be held July 20-22 in Boston. For more information about P3 Connect registration, sessions and speakers, please visit the conference website.

By Editor June 26, 2015

P3s Can Solve States’ Infrastructure Woes.

Mitch Daniels, one-time director of the Office of Management and Budget and now president of Purdue University, has worked on many financing policies and initiatives at the local, state and national levels. These include public-private partnerships, of which he is a strong proponent. Purdue is currently participating in a P3 with the city of West Lafayette Indiana.

In recent testimony before a U.S. Senate panel, Daniels, who, before assuming his current post, served as governor of Indiana, shared his thoughts on how public-private partnerships can be a major component of strategies to solve national infrastructure problems.

While testifying before the U.S. Senate Finance Committee on his state's effective use of P3s to build infrastructure projects, Daniels offered several pieces of advice on how ensure their efficacy. He urged Congress to encourage states' use of P3s to finance upgrades to existing assets, not just to fund new construction, and as a way of generating revenue. He also urged Congress to allow states to continue to carry debt on tax exempt bonds that were issued to fund new construction when entering into a P3 to expand or improve that project. Currently, states must pay off the debt or finance it as taxable bonds at a potentially higher interest rate, he pointed out.

Daniels called on states to invest revenues from P3 infrastructure projects in similar projects rather than spending it on current government operations. He also encouraged the federal government to change and expand programs that permit states to charge tolls on new, expanded or reconstructed interstate facilities in order to pay for infrastructure projects and attract partners that would be willing to bear most or all of the financial risk.

As governor, Daniels used the $3.8 billion sale of a 75-year lease for the Indiana Toll Road to fund a 10-year initiative, now in its ninth year, to build more than 100 new infrastructure projects and more than 1,000 bridges. "We became the only state in the union to have a fully-funded, 10-year infrastructure plan that required no new taxes and no new debt," said Daniels.

The state also put $500 million into a permanent trust fund to finance future projects. Under the toll road sale — which, in the state's hands, was valued at no more than $1.92 billion because of the cost to the state to collect the tolls — the private partner agreed to upgrade, maintain and operate the road and be paid through the tolls it collected. The partner also agreed to expand lanes, add electric tolling and make other improvements valued at an additional $450 million. To prevent taxpayers from bearing a burden, the tolls were to remain at 1985 rates for passenger cars for 10 years and rate increases were limited to inflation, GDP growth or 2 percent.

The poor economy reduced the road's anticipated use and the private operator of the toll road, which had to absorb the loss, declared bankruptcy last year; another firm stepped in to purchase the lease.

Daniels described two other successful P3 infrastructure projects that the state negotiated during his tenure as governor. The Ohio River Bridges project started out as a joint Indiana-Kentucky venture to be paid for with state and federal funds. When both legislatures decided to permit P3s as a financing option, Indiana negotiated an availability payment P3 for one of the bridges through which a private partner would finance, build and maintain the bridge for 35 years. The states would set and collect the tolls, using the revenue to compensate the private partners. The cost of building the bridge, which is scheduled for completion next year, will be $225 million less — a 23 percent savings — than the original estimate, reported Daniels. "Most importantly, over the next 50 years, the project is expected to generate an average of 15,000 jobs a year and a total of $30 billion in personal income and $87 billion in economic output for the region."

Another project was the Cline Avenue Bridge, which had been condemned due to structural weaknesses in 2009. The state negotiated a P3 that called for the private partner to fully finance the construction of a replacement bridge, with no risk to the government, invest $3 million in improvements to a state road leading to it and return a share of all toll revenue to the local community. Carefully devised P3 agreements like this can protect taxpayers from incurring the risks inherent in big infrastructure projects funded and conducted by the state, Daniels said.

NCPPP

By Editor June 26, 2015

Toll Roads: A Problem or a Solution?

Toll roads represent an old idea made new. Turnpikes, a term taken from a barrier used to block access to a road until a toll was paid, were used in colonial America to improve surface transportation between cities when traveling overland was a difficult alternative to more efficient and comfortable water routes.

As federal funding for highways became widely available, the Federal Aid Highway Act of 1921 imposed a ban on tolls for roads constructed with federal funding. A 1938 study by the U.S. Bureau of Public Roads, "Toll Roads and Free Roads," considered the possibility of financing a national highway system with tolls, deciding it was not feasible at the time. The Interstate Highway System, created by the Federal Aid Highway Act of 1956, offered toll-free roads financed by a federal tax on gasoline, credited to the newly established Highway Trust Fund.

About a quarter century ago, a new generation of toll roads began as the interstate system was built out, federal gas tax revenues stagnated, and private investment, especially from international funds, became available for such projects. Blockbuster projects included the Indiana Toll Road, built by the public in the 1950s and leased to a partnership of Spanish construction firm Cintra and Australian toll road operator Macquarie in 2006 for $3.8 billion, and the Chicago Skyway, leased to the same firms in 2004 for $1.8 billion.

The U.S. experience has been mirrored elsewhere. During the 1990s, according to the World Bank, developing countries increasingly turned to the private sector for construction, management, and maintenance of toll roads. Between 1990 and 1999, $61 billion in private investment was committed to 279 projects in 26 developing countries, comprising 21,355 miles (34,368 km) of toll highways, bridges, and tunnels, the World Bank reports.

But recently significant problems have arisen for some high-profile toll roads: some members of the public are having growing concerns about allowing private interests to profit from tolls on ordinary citizens, as well as expressing fear that state transportation bureaucrats might be bamboozled by Wall Street sharks. These concerns are being borne out in the following cases:

- California's San Joaquin Hills toll road—which has consistently fallen below its ridership and revenue projections, threatening its ability to keep up with debt payments—is restructuring at least half the $2.2 billion in bonds sold to build the highway.
- The ITR Commission, the partnership of Cintra and Macquarie that paid $3.8 billion in 2006 to operate the Indiana Toll Road for 75 years, filed for Chapter 11 bankruptcy protection in September 2014, reigniting debate about the merits of privatizing roads.

Amid growing backlash against toll roads, Texas voters approved a constitutional amendment in November 2014 by a landslide 4–1 margin to give the Texas Department of Transportation (DOT) about $1.7 billion a year in additional funding—with the caveat that the new money not be used on toll projects.

Toll roads are a niche product in the United States: revenue from tolls accounts for only about 5 percent of spending on major highways. This is a stark contrast with nations such as France, where the majority of motorways now carry tolls. A few state departments of transportation, however, are already demonstrating that tolls are acceptable to the public—if the tolled roads add significantly to road capacity. In the 14 states with major toll road expansion programs, tolls are already funding more than 10 percent of urban expressway miles; in the large and fast-growing states that have a great need for new road capacity, such as Texas and Florida, tolls are funding more than 25 percent of new capacity.

In addition, the private sector's role in investment and development is increasing. More than 10 percent of the toll roads developed since 1992 have involved private investment; this is particularly the case with greenfield projects. Wisconsin, which has no toll roads now but is facing enormous shortfalls in transportation funding, is planning a study of possible tolls—something former Democratic Governor Jim Doyle once said would happen "over my dead body." Incumbent Governor Scott Walker, who says he is not a fan of tolls, has allowed this study to go forward. A November 18, 2014, article in the Milwaukee Journal Sentinel says a planned toll study would gather odometer readings when people register their vehicles each year, a possible move toward a fee based on how many miles people drive—a tax on vehicle-miles traveled is widely admired by transportation professionals as broader and more equitable than tolls because it would apply to all roads.

Tolling the Interstate Highway System is the holy grail of financing options for transportation officials because it would open up potentially thousands of new miles to tolling with little political effort on their part. A 2014 Congressional Research Service study, "Tolling U.S. Highways," estimated that tolling the untolled urban interstates at rates that approximate the current averages for tolled interstate facilities might produce $37 billion in annual revenue, nearly as much as the Highway Trust Fund now receives from motor fuel taxes.

This, in turn, has the potential to leverage considerably greater investment, allowing states to spend these additional revenues to improve other key interregional highways, and possibly transit as well.

In the Dallas region, an area where toll road development is pervasive, the Wall Street Journal in October 2014 noted a backlash to conversion of part of U.S. Highway 75, a major north–south artery, to tolls. It also reported opposition to development of a new toll road northeast of Dallas by a private company, which would make it the only road in the United States fully built, owned, and operated by a private company. That private company, the Texas Turnpike Corporation, even has the power of eminent domain to seize land.

Inspired by the reaction, the state Republican Party amended its platform last year to add language hostile to toll roads. "A large segment of our party believes in having free access to transportation," Steve Munisteri, chairman of the Republican Party of Texas, told the Wall Street Journal.

A New York Times blog by Vikas Bajaj last October raised another perspective—that tolls would not be necessary if Texas had raised the gasoline tax from its 1991 levels. Another perspective comes from Tea Party activists, for whom toll roads represent a government power grab.

What is the public's view? A survey last year of 1,503 Americans by the Mineta Transportation Institute in San Jose, California, showed that a majority of people would support higher taxes for transportation if the use of the revenue were properly explained.

A gasoline tax increase of 10 cents per gallon was supported by 69 percent of respondents, while a mileage tax, similar to a trip-specific toll, was supported by 43 percent, on the condition that the toll would vary according to the vehicle's level of pollution.

And support for a mileage tax varying by the vehicle's pollution level has grown over succeeding years of the survey, from 33 percent in 2009 to 43 percent in 2014.

Toll roads typically are a one-time fix in most regions. However, places where tolls are central to development and growth plans—such as central Florida and Dallas—take a different approach.

Central Florida, a multicounty area around Orlando, has an extensive highway network extending 108 miles (174 km) that includes five toll roads, with a sixth planned. The Florida Department of Transportation's District 5 in central Florida accounts for more than 40 percent of all toll roads in the state, and nearly two-thirds of highway travel in Orange County, the central county of the region, and neighboring Osceola County is on toll roads.

For one of the most tolled regions in the United States, the effect of toll roads on travel and residential development so far seems minimal. The average amount of driving per capita is more than 30 miles (48 km) per day, second only to Houston among large regions. The average cash toll rate for the multicounty system is 15.3 cents per mile, and the average electronic toll rate is 13.4 cents per mile, comparable to rates on other toll roads in the United States.

A study on the elasticity of demand in the 2013 General Traffic and Earnings Consultant's Annual Report of the Orlando–Orange County Expressway Authority found that the 14 percent toll increase in October 2012 resulted in only very small reductions in driving among Orlando motorists. Along the two roads that had no other changes to complicate the comparison, state routes 408 and 417, the analysts found that each 10 percent increase in toll rates had a negligible effect on traffic, reducing traffic by only 1.4 percent. In fact, two toll roads serving growth corridors, state routes 429 and 414, were excluded from the elasticity calculation because they experienced increases in traffic over the period—a modest gain of 0.7 percent on S.R. 429 and a robust 13.7 percent on S.R. 414—despite the toll increase, reflecting underlying traffic growth due to new development.

Effects on Sprawl

With limited funds available in Florida for construction and maintenance, it is expected that more roads will be financed through user fees or tolls. However, planners worry that toll roads could lead to perpetuation of the sprawling patterns that most citizens dislike.

Research on toll roads in Tampa by Sisinnio Concas, a professor at the University of South Florida's Center for Urban Transportation Research, found that the improved access delivered by new toll roads to neighborhoods in the suburbs of Tampa and Miami increased land and property prices in both areas by about 5 percent. So the increased cost of driving was more than compensated for by the additional access to the affected neighborhoods.

The Orlando region metropolitan planning organization MetroPlan has been working with a leadership group called myregion.com, which undertook a regional growth visioning project called "How Shall We Grow?" that involved a large number of residents, officials, and civic and business leaders. The project resulted in a call for the redirection of the current pattern of land use and automobile dependence, which they thought was unsustainable for the future of central Florida.

Instead, they preferred a sustainable land use forecast for 2040 developed by MetroPlan that they said will demonstrate an environment with less driving, reduced suburban sprawl, and greater use of the new regional rail system. The forecast, incorporated into the regional transportation plan by MetroPlan, emphasizes compact development along corridors, infill development and redevelopment, mixed land uses, an improved jobs-to-housing balance within compact radiuses for urban travel, and development patterns that support multimodal transportation. Planned road expansion, accomplished primarily with toll roads, makes such roads part of the region's sustainability vision.

In Texas, the North Texas Tollway Authority operates 111 miles (179 km) of toll roads, covering four roads, two bridges, and one tunnel. In 2013, the last full year of reporting, annual traffic on these roads totaled 610 million vehicles and revenues were $525 million, generated by an average toll of 83 cents per trip.

Reliance on toll roads has been increasing for decades as the gasoline tax was stuck at 1991 levels—in terms of cents per gallon, not percentage—in Texas and nationally, thanks to Congress having kept the federal gas tax unchanged. In 2010, the North Central Texas Council of Governments projected that the combined state and federal fuel tax and vehicle registration fee collected in Texas would decline from 2.4 cents per vehicle-mile traveled in 2009 to 1.4 cents in 2030, with the net revenue to the Texas DOT declining from 1.6 cents to 0.7 cents per mile.

Toll roads bring market demand to the process of selecting worthwhile road projects, as well as badly needed funds. States and localities need improvements to serve existing and planned travel needs. Where these two needs intersect—needed projects matched by tolls to finance them—is the sweet spot for public agencies and private investors. It is important that planners first determine the critical needs, then shop for toll funding to support them, either through private ventures or possibly through public toll agencies. That ensures that the selected facilities will serve broader goals for growth and economic development. A clear expression of priority needs may also help expand support for public funding for transportation facilities and ensure that the money is put to the best uses.

The link to development plans seems central to the smart expansion of toll roads. With federal transportation planning requirements calling for fiscal constraint, planners need to live within the revenues expected rather than the revenues they desire.

Planners at the North Central Texas Council of Governments (NCTCG) recognized this fact in 1998. They noted in a long-term plan that year that "toll roads play a critical role in the transportation plan, both as a source of funding and added system capacity."

Today, NCTCG planners recognize that the funding available is substantially short of what might be considered needed investment. In its Mobility 2035 plan, the region's long-range transportation plan, and updates made in 2013, the NCTCG noted that in addition to expanding the network to accommodate growth trends, a major emphasis will be to "promote growth management strategies that strike a greater balance between land use and transportation. Programs and projects aimed at eliminating or reducing vehicle trips, shortening trips that would still occur, and utilizing the capacity of our system to its fullest are major recommendations."

Urban Land Magazine

By Robert Dunphy

May 28, 2015

Robert T. Dunphy is a consultant and teaches in the Georgetown University Master of Professional Studies in Real Estate program. He is an emeritus fellow of ULI and the Transportation Research Board.

S&P's Public Finance Podcast (Rulings On State Pension Plans).

In this week's Extra Credit, Senior Director John Sugden provides our take on recent court rulings regarding states' pension plans, including New Jersey.

Listen to the Podcast.

Jun 26, 2015

S&P: U.S. Public Finance Upgrades Outpace Downgrades for the 10th Straight Quarter.

In first-quarter 2015, U.S. public finance upgrades outnumbered downgrades for the 10th consecutive quarter. In this CreditMatters TV segment, Standard & Poor's Senior Director Larry Witte discusses the rating actions across the various subsectors.

Watch.

Jun 26, 2015

The Phone Call That Could Help Governments' Credit Ratings.

Economic data, revenue reports and debt burdens may be built on cold, hard numbers, but there's a soft, squishy middle when it comes to how credit ratings agencies look at municipalities: the human touch.

All ratings agencies place value upon who's running the show (although there are varying degrees of value from agency to agency). As such, they encourage local officials to keep an open line of communication with them.

"We don't take things just at face value," said Richard Raphael, managing director at Fitch Ratings. "It's always a good idea when there's good news or bad news to give us a ring. Give us a sense from your perspective what's going on."

Raphael's comments came during a webinar hosted last week by the Council of Development Finance Agencies on risk in the municipal market. Because of Chicago's recent downgrade to junk status by Moody's Investor's Service, many are wondering if the city's struggles indicate weaknesses in the market as a whole. The response from the three major agency representatives on the call was that the market continues to be strong with a few pockets of concern.

In Chicago's case, Moody's is worried that its outstanding pension liabilities will place an insurmountable burden on its tax base. Chicago's pension liability works out to about $26,000 per resident, according to Rachel Cortez, a vice president at the agency. New York City is the next-highest at $18,000 per capita. Just before it filed for bankruptcy, Detroit's was nearly $14,000 per resident. Moody's downgraded Chicago's credit rating last month, after the Illinois Supreme Court overturned the state's proposed pension reforms. The agency said Chicago's hopes to fix its budget by enacting similar changes have now “narrowed considerably.” Fitch and Standard & Poor’s agencies also downgraded Chicago, but Moody’s was the only one to drop it below investment grade.

Chicago isn’t the only city where action on the state level had an adverse effect on the city’s rating. After yet another budget deficit in New Jersey earned it a downgrade from Moody’s in April, the agency also downgraded two public universities. Both New Jersey City University and William Paterson University (which each rely on the state for approximately a third of their operating budgets) were docked by Moody’s this month because of expected declines in state funding.

Still, said Raphael, most governments are managing the new slow-growth economy. While some are still preoccupied with increasing pension costs, most are trying to address more discretionary expenses like restoring services, overdue raises for public workers and infrastructure investment.

“We still expect municipal bankruptcies to be rare,” he said. “The core fundamentals of local governments remain strong.”

GOVERNING.COM

BY LIZ FARMER | JUNE 22, 2015

Municipal Issuer Brief: Water Issues Impact Public Finance Industry.

Read the Brief.

Municipal Market Analytics | Jun. 22

Fitch: Long-Term Cost Assessments Difficult to Gauge in Availability-Payment P3s.

Availability-payment-based P3 projects, which tend to be conducted over decades and have little financial flexibility, are more likely to generate higher than expected operating costs over time than other types of P3s, according to a new report from Fitch Ratings, “Analyzing Costs in PPP Projects”. These types of projects, which are common in Europe and Canada and are being negotiated more routinely of late in the United States, typically involve established, reliable types of civil and social construction. But the risk of cost-overruns during the life of these projects can vary based on their size and complexity, reported Fitch Senior Director Scott Zuchorski.

“Projects with a more predictable cost profile, like most social and civil assets with small footprints or limited exposure to volatile commodities, are more predictable,” said Zuchorski. But those that have uncertain operating and life cycle costs or are subject to unexpected changes in design, construction, maintenance, materials, scheduling, regulations and other factors will “need greater financial margins to achieve similar credit quality.”

Fitch considers several factors in assessing a project’s potential for long-term cost overruns that could affect its credit quality: the extent to which the scope of a project could change unexpectedly, whether project costs can be predicted accurately and the presence or lack of contract provisions that protect the private partner from bearing the entire burden of unpredictable and unavoidable cost increases. Of these factors, changes in a project's scope is the most common reason for its operations and maintenance or life cycle costs to increase unexpectedly, said Zuchorski.

NCPPP

By Editor June 25, 2015

Bloomberg Brief Weekly Video - 6/25/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

8:53 AM PDT

June 25, 2015

Moody's: Annual State Debt Medians Experience First Decline in Nearly Three Decades.

New York, June 24, 2015 — For first time in 28 years, the 50 states' median net tax-supported debt (NTSD) declined in 2014, Moody's Investors Service says in its annual state debt medians report.

In 2014, the states' median net tax-supported debt declined by $6.2 billion to $509.6 billion. While $5.3 billion of this change was attributable to Moody's reclassification of the Texas' general mobility fund debt to self-supporting, debt levels still declined by $900 million.

"The 2014 decline follows three years of minimal growth in NTSD as states continue to be reluctant to begin new debt service commitments in the face of tight operating budgets and a slow and uneven economic recovery," author of the report and Moody's Senior Vice President Kenneth Kurtz says. "Uncertainty over federal fiscal policy and health care funding have also contributed to states' caution."

The state median for NTSD per capita fell to $1,012 in 2014, for the third straight year. Thirty-three states saw a decline in this metric. The top five states in NTSD per capita are Connecticut, Massachusetts, Hawaii, New Jersey, and New York.

The median for net tax-supported debt as a percent of personal income declined to 2.5% for the second consecutive time as personal income grew.

The medians report also shows the use of general obligation (GO) bonds varies widely across states. The 50 states' median value for GO debt as a percent of net tax-supported debt is 48%. Nationwide, GO debt accounts for 52% of total net tax-supported debt followed by appropriation debt at 21%.

Despite attention paid to pension obligation bonds (POBs) and public private partnerships (P3s), Moody's found states made limited use of these types of financings in 2014.

Moody's expects state debt levels will stay flat in 2015, but over the long term debt levels will rise again as states seek to address deferred infrastructure needs in the context of stagnant federal transportation funding.

Moody's 2015 state debt medians are based on the rating agency's analysis of calendar year 2014 debt issuance and fiscal year 2014 debt service. Net tax-supported debt is defined as debt secured by state taxes or other operating resources which could otherwise be used for state operations, net of obligations that are self-supporting from pledged sources other than state taxes or operating resources. It does not include the debt of the local governments in the state.

The report is available to Moody's subscribers here.

Muni Buyers Bedazzled by Junk-Bond Yields Let Protections Slip.

A hospital in Hagerstown, Maryland, sold more than $260 million of tax-exempt bonds on Wednesday without a debt service reserve fund, a standard backup for such offerings.

Two weeks earlier, HealthEast Care System in St. Paul, Minnesota, issued $142.5 million of bonds and placed $147 million more with commercial banks that can ask for immediate repayment if the company misses financial metrics. That would leave the other investors vulnerable should the system's finances deteriorate.

Municipal issuers including hospitals, charter schools and retirement communities are selling bonds without some protections typically demanded as investors seek returns over safety with interest rates close to the lowest levels since the 1960s. High-yield bonds have outperformed the broad municipal market since the start of 2014 luring a net $10.5 billion of cash to tax-exempt funds that buy the debt.

"Issuers don't need to provide protections to bondholders, because the funds need to put the money to work," said Carol Flynn, a money manager who helps oversee $25 billion at Deutsche Bank AG's wealth management-unit. "It's supply and demand, really."

Weak Covenants

Flynn said she's avoiding lower-rated muni bonds with limited protections, instead favoring A and AA rated issues that provide more relative value.

High-yield munis have gained 0.83 percent this year, beating the broad market's 0.06 percent decline, Bank of America Merrill Lynch data show. Last year, lower-rated debt returned 12.8 percent, compared with a 9.8 percent gain.

The inflow into high-yield municipal bond funds since the start of last year, represented about 18 percent of total assets on Wednesday, according to data compiled by Bloomberg. The funds can include some lower-rated investment-grade securities.

Even as $1.2 billion was withdrawn from the funds in May and June while the market braces for Federal Reserve to raise interest rates, covenants aren't being strengthened.

Meritus Medical Center, which runs a 251-bed acute-care hospital in Hagerstown, about 65 miles northwest of Baltimore, priced $263.3 million of debt Wednesday. Bonds maturing in 30 years yielded 4.38 percent, or 1 percentage point more than top-rated municipal bonds with similar maturities. The bonds were offered without a debt service reserve.

Not Bothered

Thomas Chan, chief financial officer at Meritus didn't respond to a request for comment. Douglas Davenport, CFO at HealthEast said investors placed 11 times as many orders as were bonds available in longer maturities and weren't put off by commercial banks' ability to require immediate debt repayment if financial covenants were breached. "It didn't seem to bother them at all," Davenport said.

Low- and non-rated borrowers have been jettisoning standard security provisions like mortgage liens, which give bondholders the right to foreclose on property in the event of default, and reserves the issuers can tap if they don't have enough cash to service debt.

"The only way to force those protections back in would be if the deals couldn't get sold," said Josh Gonze, who helps oversee $10 billion in munis at Santa Fe, New Mexico-based Thornburg Investment Management.

Rare Defaults

Defaults in the $3.6 trillion municipal market are rare. About 0.2 percent of hospital bonds are in default, compared with 0.005 percent of general obligations, according to Concord, Massachusetts-based Municipal Market Analytics. The rates for retirement projects and charter schools are higher, at 5.4 percent and 1.83 percent, respectively.

The $9.3 billion investors plowed into U.S. high-yield muni funds in 2014 was the second-highest ever, according to Lipper.

It's unclear how many borrowers in the municipal market — whose high-yield issuers include Indian tribes, toll roads and some private companies — have weakened investor protections.

Last month, fund managers clamored to get a piece of Albert Einstein Healthcare Network's $453.5 million bond deal even though the system had 99.5 days of cash and also didn't include a reserve as security. Money managers placed more than three times as many orders as bonds available, allowing the Philadelphia-area health-care provider to cut yields, said Chief Financial Officer David Ertel.

Less Cash

The cash Albert Einstein had available on March 31 was lower than the median for hospitals in the BBB rating category, according to a May 8 report from Fitch Ratings. The company is rated Baa2 by Moody's Investors Service.

"We had 53 separate institutional investors, so very widely distributed, very widely accepted in terms of both the pricing and in terms of the security covenant package," said Ertel.

Investing a debt service reserve in lower-yielding government securities would be a "financial drag," Ertel said.

A portion of the bonds from Albert Einstein's May sale that matures in 30 years yielded 4.72 percent at issue and has since declined to 4.57 percent in secondary trading.

Einstein paid a spread of about 1.3 percentage points more than benchmark municipal bonds to issue the debt, less than the 1.32 points charged to the similarly rated Boston Medical Center, which had a reserve fund for a bond issue in April.

In January, Peninsula Regional Medical Center, a hospital on Maryland's eastern shore, sold about $127 million of debt with a provision allowing the issuer to pledge accounts receivable for other loans, subordinating the rights of bondholders.

Pledging Receivables

That practice is "highly objectionable," said Jim Murphy, who oversees, T. Rowe Price Group Inc.'s $3.4 billion Tax-Free High Yield Fund. "They're saying they reserve the right to effectively prime you and give that collateral to another lender," Murphy said. "We're seeing it more and more."

The importance of receivables as a security pledge was highlighted in the 2007 bankruptcy of Pascack Valley Hospital in northern New Jersey, Murphy said. When Pascack filed, it had about $19 million in accounts receivables and about $79 million of debt, he said. The security helped boost bondholder payouts to 60 cents on the dollar, he said.

Murphy passed on Peninsula's bonds, which also weren't secured by a mortgage.

'Kicking Themselves'

Other hospitals in Maryland include provisions in their bond documents allowing them to pledge accounts receivable to new loans, said Bruce Ritchie, chief financial officer at Peninsula. Debt secured by receivables can't exceed 25 percent of total claims for payment.

The deal was five to six times oversubscribed, Ritchie said. "There was appetite for our bond issue in the market with the covenants written the way they were written."

In Boca Raton, Florida, a startup retirement community borrowed $190 million in unrated bonds last year without having final building permits from the county.

Construction on the Sinai Residence, a 237-unit continuing care retirement community that will feature rooftop gardens and a spa, is about 65 percent complete, said Mel Lowell, chief operating officer of the Jewish Federation of South Palm Beach County. The units are sold out and there's a waiting list.

The project had a letter from officials giving conditional approval for the permits if minor items were addressed, Lowell said. Thirty-five-year bonds that were sold at 98.5 cents on the dollar traded at an average of 112 cents on Wednesday.

Investors who balked at the bonds are "kicking themselves in the tuchas now," said Lowell, using the Yiddish word for rear end.

Bloomberg

by Martin Z Braun

June 24, 2015 — 9:00 PM PDT

Proposed Bonds to Encourage Public Private Partnerships and Improve Infrastructure: Butler Snow.

The nation's infrastructure is in need of dire repair. On February 2, 2015, to encourage private investments in infrastructure through public-private partnerships ("P3s") and as part of his 2016 proposed budget, President Barack Obama presented the concept of qualified private infrastructure bonds ("QPIBs").1 On May 4, 2015, also in an effort to encourage private investments in infrastructure through P3s, United States Senators Ron Wyden and John Hoeven proposed Move America Bonds ("MABs") as part of the Move America Act of 2015 (the "Act")2. Neither QPIBs nor MABs have been authorized by Congress, and both are still pending. These are only two alternatives to address infrastructure, but more legislation may be proposed in the future.

In addition to their similar purpose of encouraging private investments in infrastructure through P3s, QPIBs and MABs have a few other similarities. They are both tax exempt bond financing. Unlike Build America Bonds, they do not have a direct pay feature. The interest on both QPIBs and MABs are not subject to the alternative minimum tax.

However, there are some differences between QPIBs and MABs including the types of projects that each will finance. QPIBs will be used to finance seven types of facilities including (i) airports, (ii) docks and wharfs, (iii) mass commuting facilities, (iv) facilities furnishing water, (v) sewage facilities, (vi) solid waste disposal facilities, and (vii) qualified highway or surface freight transfer facilities.3 MABs will be used to finance nine types of facilities including (i) airports, (ii) docks and wharfs, (iii) mass commuting facilities, (iv) railroads, (v) surface transportation projects, (vi) projects for international bridges and tunnels, (vii) facilities for transfer freight from trucking-to-rail or rail-t--trucking, (viii) flood diversions, or (ix) inland waterways. Thus, MABs will finance more types of facilities than the QPIBs, including facilities, such as railroad, that cannot currently be financed as tax exempt facility bonds under Section 142 of the Internal Revenue Code of 1986, as amended.

Governmental ownership will be required for airports, docks and wharves and mass commuting facilities financed with QPIBs, but the safe harbor rules regarding ownership will be expanded in instances where the facilities are leased or subject to concession or management contracts. However, governmental ownership of the facilities will not be required for facilities financed with MABs, but the facilities must be available for general public use.

There will not be a volume cap for QPIBs, but MABs will have a separate volume cap, which will be 50% of the state's current private activity bond volume cap. MABs volume caps can be carried forward for a period of three years. After the three year carryforward, the unused volume cap can be reallocated to states that have fully used their MABs volume cap. MABs will increase the amount of the bond proceeds to be spent on land acquisition from 25% to 50% and the time to complete the construction of a rehabilitation from two years to five years. The Act also includes enlargements as qualified rehabilitations and allows states to exchange a portion of a state's MABs volume cap for the Move America tax credit ("Tax Credit").4

Footnotes

1. QPIBs are part of the President's budget, which includes only general concepts as to how the QPIBs will work. It is believed that QPIBs will operate in the existing tax exempt bond framework.

2. The Act is Senate Bill No. 1186. As of June 10, 2015, the Act has been referred to the Senate Finance Committee. If the Act is enacted, it will be codified as Section 142A of the Internal Revenue Code of 1986, as amended. The Act also provides for the Move America tax credits, which are discussed below in footnote 5 below.

3. All facilities that will be finance with QPIBs can currently be financed as tax exempt facility bonds under Section 142 of Internal Revenue Code of 1986, as amended, but they are subject to the private activity bond volume cap and the interest on these bonds are subject to the alternative minimum tax.

4. The state may exchange 25% of their MABs allocation for the Tax Credits. The value of the Tax Credit shall not exceed 20% of the estimated project costs or 50% of the total private investments in the qualified projects. The Tax Credit can finance the same type of projects as the MABs. The credit amount is 10% of the value of the MABs certificate per year over a period of ten years

Last Updated: June 23 2015

Article by Ashley N. Wicks

Butler Snow LLP

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

S&P: Pension Shortfalls Pressure Private and Public Sectors.

As life expectancy in the U.S. reaches new highs, with Americans born this year forecast to live to almost 79–five years longer than those born in 1980–the severe underfunding of pensions in the private and public sectors is taking on ever-greater importance.

Simply put, many older Americans will be hard-pressed to afford their golden years, in light of this underfunding and the budgetary pressures on Medicare and Social Security. With real median household income on the decline since 1999, Baby Boomers are right to be concerned that their retirement savings will be eroded by inflation, depleted by poor investment performance, or not last as long as they do.

At the same time, about half of American households age 55 and older have no retirement savings, according to a report in May from the U.S. Government Accountability Office (GAO). And many households without retirement savings have few other resources, such as defined-benefit (DB) plans or other savings to tap into for retirement, the GAO's analysis of the 2013 Survey of Consumer Finances showed.

Meanwhile, the average U.S. life expectancy has risen to 79 years (76 for men and 82 for women). Still, the official age of "full retirement" for Social Security has been raised only to 67, from 65, depending on when beneficiaries were born. So, post-employment medical costs have skyrocketed, along with the costs of prescription drugs and elder care.

Pension funding across all sectors benefited from sharp gains in stocks and a strengthening of the U.S. economic recovery in 2013, with underfunding among companies in the S&P 500 Index dropping by $224 billion. However, despite continued–albeit moderated–gains in stocks, strong corporate earnings, and companies holding record amounts of cash, corporate pensions and other post-employment benefits (OPEBs) remain severely short. At the end of last year, corporate pension underfunding had ballooned to $389 billion, almost 10% more than in 2011 and the second-highest level ever, below the 2012 record of $452 billion (see "Pension Funding Ratios Continue To Weigh On U.S. Corporate Credit Metrics," published June 9, 2015, on RatingsDirect).

Growing Obligations

Even as companies last year increased the assets they set aside for pensions and OPEBs, obligations grew faster. Combined, S&P 500 companies set aside assets amounting to $1.75 trillion, a 3.5% increase from year-end 2013. But obligations grew 11.3%, to a record $2.34 trillion, pushing combined underfunding to $584.7 billion, from $405.7 billion a year earlier.

The problem is not limited to the U.S.: In Europe, there has been a deterioration in the funding of corporate defined-benefit pension plans, especially for those companies that were already materially underfunded with DB plan deficits of more than 10%-15%. As the European Central Bank (ECB) tries to stimulate economic growth in the region with asset purchases of €60 billion per month, DB plan deficits could weigh on borrowers' credit quality in the next two years unless companies take extra care regarding risk management (see "Quantitative Easing Benefits Few European Corporate Defined-Benefit Pension Plans," Feb. 26, 2015).

All told, the funding position of the top 50 European companies we rate that are the most-exposed–with DB pension plan deficits greater than 10% of adjusted debt and with outstanding adjusted debt greater than €1 billion–had pension fund liabilities totaling €527 billion at the end of 2013. With plan assets of €356 billion, this means that, on average, they had a funding deficit of just over 30%.

Nonetheless, the private sector remains in better shape to meet pension obligations than the public sector does, mostly because of stricter funding regulations and the massive shifts over the past 20 years from traditional defined-benefit plans to enhanced 401(k)-type saving accounts.

The federal government projects that the Social Security Trust Fund will be able to pay full retirement and disability benefits only through 2033, and Congress has considered various measures to strengthen the system, especially, perhaps, because older Americans represent a significant voting bloc. Meanwhile, most states have pursued strategies to reform and strengthen their employee pension systems, although the effects of these initiatives will likely be gradual.

At any rate, there is little doubt that GDP growth of, say, 5% annually for the next generation would go a long way toward easing any worries about pension funding. But it is increasingly unlikely that we will see economic expansion of even 3% this year, still well short of the five-year average annual growth rate following past U.S. recessions (going back 50 years) of 4.6%. Even if, as we expect, the economy makes a comeback in the second half, in our May report we forecast 2015 GDP growth of just 2.4%–the same as in 2014 and down from our 2.8% forecast in April.

This below-trend growth–combined with inflation running below the Federal Reserve's 2% target–will likely keep the U.S. central bank's normalization of monetary policy on a slow track. We expect the Fed to raise rates in September, for the first time in nearly a decade, but minutes from the last Federal Open Market Committee meeting noted that a number of members are worried that weakness might persist.

States Suffer

Against this backdrop, a majority of states face budget gaps in either fiscal 2015 or fiscal 2016, or both. However, while we view the majority of these gaps as manageable and no immediate threat to a state's credit quality, they could test states' pension funding commitments (see "U.S. State Pension Roundup: Recent Court Rulings And Reform Slowdowns Make Active Management Essential," June 18, 2015). Still, given states' generally strong credit profiles, and the long-term nature of pension obligations, we do not see these liabilities as immediately jeopardizing state governments' capacity to pay their debts, but believe they can weaken a state's relative credit profile if left unmanaged.

Among states, levels of pension funding vary widely, playing a significant role in relative creditworthiness. Funded levels now average 71.16%, according to our annual survey for 2015 (based on 2013 valuations), essentially the same as in 2012. And more states (26) either maintained or increased their funded ratio. However, there remains a sizable and growing gap between well- and less-funded plans, and the fact that 24 states' funding ratios declined is notable.

For the most part, states have demonstrated a commitment to manage their long-term liabilities, including pensions. And there has seemingly been an increased focus and vigilance among policymakers, employees, taxpayers, and the media about the need to continue to do so. Testament to this is the unprecedented level of pension reform in the past few years. Since 2009, all 50 states and the Commonwealth of Puerto Rico have enacted some type of pension reform, according to the National Conference of State Legislatures. Whereas pensions for public workers were once considered sacrosanct, governments and employees alike may be softening this stance, as lawmakers face the dilemma of maintaining current benefits for both those retired and in the active workforce and restoring much needed services–or tax relief–to taxpayers. Either way, state reform efforts have slowed, and may continue to wane, in part because of recent court rulings against such efforts and perhaps due to reform fatigue.

In the end, many Americans are being, or soon will be, forced to make some difficult choices about the cost and timing of their retirement. And, as a society, we need to look at the extent to which employers and the government should be responsible for retirees' incomes and health care.

19-Jun-2015

The Dirty Business of Paying for Ratings.

An analysis by Municipal Market Analytics this week noted that the number of government issuers seeking two or three ratings on their bond offerings is slipping. Several factors are at play, wrote analysis Matt Fabian, but a big one appears to the fact that issuers pay for ratings and they don't enjoy paying for a lower rating. The result is that whichever ratings agency is trending higher, issuers tend to opt just for a rating from that agency. For example, Fabian said Moody's saw a small bump in its market share in 2011 following its rating recalibration in 2010 which resulted in a number of upgrades. But since then, S&P has had the advantage. "Moody's more cautious view of credit and S&P's criteria change that raised a significant number of local government ratings has resulted in S&P gaining market share as Moody's has waned," Fabian's report said.

Another factor is the still relatively young Kroll Ratings agency, which is offering its services at a cheaper price. According to Fabian, Miami International Airport recently chose to obtain a Kroll rating (which was higher) and drop its Moody's rating, which was lower and cost about 30-to-40 percent more. "As increasingly cost-conscious issuers consider issuing debt the immediate and future costs of obtaining and maintaining ratings," Fabian warned, "the benefit of multiple ratings or high cost opinions will reasonably come under scrutiny."

GOVERNING.COM

BY LIZ FARMER | JUNE 19, 2015

[What's Next for Pensions? Depends on the State.]

The slew of court rulings on pension plan protections in recent years has resulted in everything from a total rejection of any changes ([in Illinois]) to approval of some changes but not others ([in Oregon]) to allowing cuts to retiree pensions in the rare case of municipal bankruptcy ([in Stockton] and Detroit). Standard & Poor's rating agency took a look at what all this means and concluded in June 18 report that – surprise, surprise – there is a wide variety among the states in what's allowed and what's not, and as a result, the funded status of the pensions themselves varies considerably.

"Reform efforts seem to be slowing as all states have already proposed reform with varying degrees of success," said Standard & Poor's credit analyst John Sugden in a statement. "However, the gap is growing between well-funded and poorly funded pension plans. Despite six years of economic expansion, many states face budget gaps in either fiscal 2015 or fiscal 2016, or both years, and lean budget margins could lead to a greater reluctance for struggling states to fund actuarially determined contributions," he added.

The S&P report also noted that "a significant amount of states" in 2015 aren't funding their pensions sufficiently, which it believes "will continue to weaken their liability profile and potentially adversely affect their creditworthiness." Governing has also covered this issue; [click here] to look up how some of the largest pension plans are faring and how much of their actuarially determined contribution they received from their state last year.

GOVERNING.COM

BY LIZ FARMER | JUNE 19, 2015

[Local Government Procurement Laws – Who the Heck is a "Responsible Bidder"?]

All state and local government public works construction projects must follow the public bidding and procurement laws, which seek to protect the public against the squandering of public funds and prevent abuses such as fraud, waste, and favoritism.

Local governments1 are required to provide public notice and to competitively award public works construction contracts,2 unless an exception applies, such as where the estimated cost of the project will be less than $100,000.3 A contractor forfeits its right to payment if it performs work knowing that the local government did not follow the public procurement laws.

Local governments who take competitive sealed bids are not required to award the contract to any bidder.4 But if it decides to award the contract, the award must go to the "lowest responsible and responsive bidder."

In most cases the low bidder is awarded the contract; however, the local government must first determine that the bidder was responsible and the bid submitted was responsive based upon the requirements and criteria set forth in the invitation for bids before making the award. This article addresses what it means to be a "responsible bidder" in Georgia.5

A local government is not limited to looking at a bidder's financial ability to perform the public works contract. Rather, the term "responsible" looks to the bidder's ability to discharge the contractor's obligations in accordance with what is expected under the terms of the contract. Local governments may consider virtually any criteria reasonably or rationally related to the question of whether the contract, if awarded, could be completed by the bidder in accordance with its terms.

The determination of responsibility is a threshold issue qualifying the bidder for consideration of its bid, not an evaluation factor allowing an award to be made on the basis of the relative responsibleness of the various bidders.6 Indeed, a bidder can be found "not responsible" only if the government body would reach the same conclusion if the bidder was the only bidder submitting a bid. Thus, a local government must award a contract to the lowest bidder meeting the criteria for being responsible, even if another bidder is substantially more responsible and its bid only slightly higher than the low bidder.

In Georgia, O.C.G.A. § 36-91-2(13) defines a "responsible bidder" or "responsible offeror" as "a person or entity that has the capability in all respects to perform ***fully*** and ***reliably*** the contract requirements." The terms "fully" and "reliably" authorize the public entity to consider two distinct categories of criteria: whether the bidder has the ability to perform, and whether the bidder is dependable to perform.

In determining whether a bidder is capable of "fully" performing the contract, a public entity generally considers objective criteria such as the bidder's financial resources; labor, facilities and equipment; skill, experience in terms of ability to perform7, and applicable licenses and permits.

Reliability, on the other hand, calls for a more subjective analysis as the public entity considers criteria such as the bidder's ethical integrity, reputation, experience for successfully performing and completing projects, claims history, and litigiousness.

The broad definition of what constitutes a responsible bidder, and the public entity's ability to establish its own criteria, some of which are very subjective, creates an environment ripe for a bid protest as to the public entity's selection and application of the criteria. Sometimes the apparent low bidder protests that its bid was not considered because the public entity determined it was not responsible.8 Other times the second lowest bidder protests that the public entity should not have considered the low bidder to be responsible.9 In either event, a court reviewing a bid protest will consider whether the public entity used a decision-making process rationally designed to evaluate a bidder's responsibility.10 If the process was fair, a court will usually enforce the public entity's decision, even if reasonable minds might differ about the decision. However, where the process is deemed "arbitrary and capricious" a court will set aside the public entity's decision.

In *Harmony Const., Inc. v. State Dept. of Transp.*11, Delaware's DOT determined responsibility based solely upon whether the low bidder had assumed realistic startup dates on its proposed work schedule. Because this was the only factor considered by the DOT in its determination of responsibility, the Court found that the process was arbitrary and capricious and set aside the public entity's award to the second lowest bidder.

Under Georgia law, the local government is required to include the responsibility criteria in its invitation for bids. For example, Henry County recently identified the following criteria for determining the responsibleness of bidders in a bid invitation:

Responsibility – The determination of the Bidder's responsibility will be made by the County based on whether the Bidder meets the following minimum standard requirements:

- Maintains a physical location presence and permanent place of business.

- Has the appropriate and adequate technical experience required.
- Has adequate personnel and equipment to perform the work expeditiously.
- Able to comply with the required or proposed delivery and installation schedule.
- Has a satisfactory record of performance.
- The ability of Bidder to provide future maintenance and service for the use of the contract under consideration.
- Has adequate financial means to meet obligations incidental to the work.
- Such other factors as appear to be pertinent to either the bid or the contract.

All of the factors provided in the *Henry County* bid invitation appear to be rationally designed to determine whether the bidder is capable or qualified to perform the work required by public contract. However, if the County included only one factor in its responsibility evaluation, such as “a physical location presence and permanent place of business,” it is more likely that its decision could be overturned because that factor, standing alone, does not appear to have any bearing on whether the bidder is capable or qualified to perform the work.

In order to reject a low bid on a finding of not responsible, a public entity must present evidence that would cause reasonable persons to believe it was not in the best interest of the public entity to award the contract to the lowest bidder. Evidence of poor performance under a prior similar contract may constitute a rational basis for finding the actual lowest bidder irresponsible and rejecting its bid.

For example, in *Callanan Indust., Inc. v. Schenectady*,12 a New York court held that an asphalt contractor was not the lowest responsible bidder due to substantial evidence of poor performance under prior repaving contracts with the city. Specifically, on prior projects that the contractor performed for the city asphalt unraveled and potholes and contaminated surface mats appeared, and the city experienced difficulty resolving these problems with the contractor. Notwithstanding the holding in *Callanan*, a causal relationship demonstrating that the bidding contractor caused the performance issues must be established by the public entity. A contractor’s late completion on prior projects is not sufficient for a finding of irresponsibility without showing the contractor actually caused the delays that lead to late completion.13

Generally speaking, a bidder is responsible if they are qualified to perform the work required by a contract and reliable. In Georgia and throughout the United States, public entities are afforded wide discretion in determining a bidder’s responsibility, and their determinations will be overturned only if found by a reviewing court to be arbitrary, capricious, or not rationally supported.14 As a result of this high legal standard, courts are often reluctant to overrule decisions to disqualify a bidder as non-responsible.

Footnotes

1. O.C.G.A. §36-91-2 defines local government as any “county, municipal corporation, consolidated government, authority, board of education, or other public board, body, or commission,” other than “any authority, board, department, or commission of the state,” and certain public transportation agencies.”

2. O.C.G.A. §36-91-20.

3. O.C.G.A. §36-91-22.

4. *Letchas v. Sims Asphalt Co., Inc.*, 250 Ga.App. 179 (2001) (affirming city’s right to reject all bids, and to accept revised bids based upon reduced scope).

5. The article does not address what it means to be a "responsive bidder," which is a separate and distinct issue that may be addressed in a future article.

6. See, e.g., *Georgia Branch, Associated General Contractors of America, Inc. v. City of Atlanta*, 253 Ga. 397, 321 S.E.2d 325 (1984).

7. A bidder on a state public works construction project cannot be disqualified based upon lack of previous experience with a job of the size for which the bid or proposal is being sought if: (1) the bid or proposal is not more than 30 percent greater in scope or cost from the bidder's previous experience in jobs; (2) the bidder has experience in performing the work for which bids or proposals are sought; and (3) the bidder is capable of being bonded by a surety which meets the qualifications of the bid documents. O.C.G.A. § 13-10-4

8. *Mark Smith Constr. Co., Inc. v. Fulton Co.*, 248 Ga. 694 (1982) (low bidder denied injunction preventing County from proceeding with second lowest bidder pending hearing on whether it was responsible based upon its history of performance and its officer's affiliation with another company)

9. *Hilton Constr. Co., Inc..v Rockdale Co. Bd. Of Edu.*, 245 Ga. 533 (1980) (public entity not authorized to reject lowest bid on basis that bidder was "unknown")

10. *Credle v. East Bay Holding Co., Inc.*, 263 Ga. 907 (1994)

11. 668 A.2d 746 (1995).

12. 116 A.D.2d 883, 498 N.Y.S.2d 490 (1986)

13. See *Hilton v. Rockdale County*, 245 Ga. 533, 538, 266 S.E.2d 157, 161 (1980).

14. Public agency discretion is so broad that the Fifth Circuit has stated that a public agency "has the right to be wrong, dead wrong, but not unfairly, arbitrarily wrong." *Housing Authority of City of Opelousas v. Pittman Constr. Co.*, 264 F.2d 695, 703 (5th Cir. 1959).

Article by Darren G. Rowles and Scott Cahalan

Smith Gambrell & Russell LLP

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Back From The Brink - Why Bond Insurers Look Attractive Again.

Summary

- Assured Guaranty Ltd and MBIA, Inc. have largely recovered from the financial crisis.
- Assured Guaranty is healthier, but MBIA is poised to catch up.
- The time to invest is now, before the broader investment community catches on.

Since the end of the financial crisis bond insurers have been slowly clawing their way back from the brink of extinction. It wasn't the traditional business of insuring municipal bonds that got the insurers into trouble. It was the collapse in home prices across the country and the insuring of structured products (pools of mortgages) that nearly put the companies out of business. Some insurers have rehabilitated themselves to the point where, after a long absence, they are once again writing new insurance policies on municipal bonds. Assured Guaranty Ltd. (NYSE:AGO) and MBIA (NYSE:MBI), Inc. fall into this category. Others are still struggling mightily and look headed toward liquidation, mainly Ambac (NASDAQ:AMBC) and Syncora (OTCPK:SYCRF) (formerly XL Capital). In this article I will focus on Assured Guaranty and MBIA.

Continue reading.

Seeking Alpha

Jason Kaplan

Jun. 19, 2015 10:40 AM ET

Fitch: Public Power Riding U.S. Economic Recovery and Low Rates.

Fitch Ratings-New York-09 June 2015: Stronger cash operating earnings and lower interest costs are likely to sustain improvements in debt service coverage for public power and electric cooperative issuers, Fitch Ratings says. Stronger earnings are likely being driven by higher economic activity, timely rate increases and improved rate design. The sector's low exposure to variable rate debt (9% of total debt for Fitch-rated issuers) should further protect coverage metrics in the event of higher interest rates.

Wholesale and retail electric systems in all three measured rating categories ('AA', 'A' and 'BBB/BB') reported improved coverage medians for the first time since Fitch began the U.S. Public Power Peer Study in 2013. Coverage medians for retail systems, after considering transfers and purchased power obligations, also improved in all three rating categories. Debt service coverage, as measured by the Fitch Peer Study, began to improve in 2013 for many public power issuers following a period of weakness that began in 2009.

Leverage medians for 'AA' and 'A' rated retail systems were lower in 2014. However, higher leverage medians for 'AA' and 'A' rated wholesale systems will likely limit future upward rating actions, suggesting that the improvements in coverage may be more attributable to lower interest charges than improved operating margins for many issuers. We believe these metrics reflect a trend of higher investment by wholesale suppliers on behalf of member retail systems and increased cash funding of capital expenditures by electric distributors.

The results also show that liquidity ratios remain relatively stable and very robust for issuers rated in the 'A' and 'AA' categories. The strong liquidity metrics in recent years are likely driven in part by slower growth in construction and capital investment, as evidenced by historically low ratios of capital expenditures to depreciation. The downward trend in capital expenditures, which began in 2009, likely reflects slower sales growth and the deferral of certain capital projects.

Fitch's "U.S. Public Power Peer Study" and "U.S. Public Finance – Public Power – Fitch Analytical Comparative Tool (FACT) – June 2015" are available on our website www.fitchratings.com.

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Additional information is available on www.fitchratings.com.

The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article, which may include hyperlinks to companies and current ratings, can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.

S&P's Public Finance Podcast: Provider-Sponsored Health Plans.

In this week's edition of Extra Credit, Managing Director Martin Arrick provides an in-depth look at provider-sponsored health plans.

Listen to the Podcast.

Jun 12, 2015

S&P's Public Finance Podcast: Rating Community Development Financial Institutions.

In this week's Extra Credit, Senior Director Mikiyon Alexander explains the criteria we use to rate community development financial institutions and provides some rating examples.

Listen to the Podcast.

Jun 18, 2015

S&P U.S. State Pension Roundup: Recent Court Rulings and Reform Slowdowns Make Active Management Essential.

Despite six years of favorable economic expansion, a majority of states face budget gaps in either fiscal 2015 or fiscal 2016, or both years. Although Standard & Poor's Ratings Services views the majority of these gaps as manageable and no immediate threat to a state's credit quality, they could test a state's pension funding commitment. Furthermore, a state's commitment to funding its actuarially determined contribution (ADC) and how substantive and volatile these contributions are relative to the total budget remain key credit considerations in Standard & Poor's assessment of a state's credit quality. (See "U.S. State Budgets Face Lean Margins Despite Mature Economic Expansion," published April 27, 2015, on RatingsDirect.) Pension liabilities are not just long-term potential sources of credit pressure. We continue to differentiate states' credit quality by the status of their long-term liability profile in general, and the management of their pension liabilities in particular. States with relatively low ratings or negative outlooks have several characteristics in common, not the least of which is a track record of underfunding their annual pension contributions from an actuarial standpoint.

Overview

- We view pension obligations as long-term liabilities that must be funded over time and a state's commitment to funding its contributions is a key credit consideration.
- Public pensions clearly are in a period of transition based on accounting and actuarial changes, funding commitments, and the recent court decisions that deemed certain states' enacted reform efforts unconstitutional.
- Standard & Poor's expects pensions to remain a significant public policy and funding challenge for many state governments, and a continuing source of expanding liabilities for most.

Continue reading.

S&P: U.S. Public Finance Ratings Start 2015 With Another Positive Quarter Despite Puerto Rico Actions.

For the 10th quarter in a row, U.S. public finance (USPF) ratings achieved more upgrades than downgrades in the first quarter of 2015. It was also the fifth consecutive quarter in which upgrades outpaced downgrades among both nonhousing and housing ratings. However, the upgrade to downgrade ratios were lower in the first quarter of 2015 than in the previous quarter for USPF as a whole and for nonhousing bonds but were higher for housing issues. Better finances among issuers was the leading cause of the improvement in all nonhousing categories in the first quarter of 2015, spurring 139 upgrades. For the housing sector, the main contributor to the housing rating actions was an upgrade to the New Jersey Housing and Mortgage Finance Agency multifamily bond program, which lifted 19 separate ratings.

On a year-over-year basis, rating activity declined significantly, to 389 nonhousing rating changes from the first quarter of 2014, when 829 nonhousing ratings changed. The review of thousands of local government ratings in the first three quarters of 2014 inflated the number of rating actions in that time period. Combined, those quarters totaled 1,997 upgrades and 761 downgrades, a pace we don't expect to continue in 2015. Excluding local government and state ratings, USPF rating activity increased from the first quarter of 2014, but only by 29 rating actions, including housing.

Overview

- Upgrades again outpaced downgrades in USPF, but there were fewer rating actions due to a decline in the number of rating reviews under new criteria.
- Stronger finances contributed to more positive rating actions than did any other factor in all sectors.
- Rating actions related to Puerto Rico contributed to most of the multiple-notch downgrades in USPF and affected ratings in three sectors.
- Implementation of revised criteria increased health care rating activity, a trend that we expect should continue through the end of 2015.
- The only USPF default in the quarter was of a housing issue although upgrades outnumbered downgrades for the sector.

Continue reading.

Municipal Issuer Brief: Review of DC Happenings.

Read the Brief.

Municipal Market Analytics | Jun. 15

S&P Report: U.S. Cooperative Utilities are Maintaining Stable Credit Quality, But Regulatory Changes Might Upset the Cart.

U.S. electric cooperative utilities marked another year of largely stable credit quality in 2014. The sector's 40 ratings remain concentrated in the 'A' rating category. Over the years, these utilities have withstood many challenges, including the costs of complying with emissions controls, adapting to restructured wholesale power markets, and dealing with the economy's effects on ratemaking flexibility. Standard&Poor's Ratings Services attribute the sector's credit stability in large part to the utilities' conservative not-for-profit business model; the benefits of long-term wholesale power supply contracts that help ensure the recovery of operating costs and investments in assets; and the utilities' timely use of rate increases to keep revenues, expenses, and debt service in alignment. But several factors could threaten the…

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Report Published 2015/06/17

Bloomberg Brief Weekly Video - 6/18/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

Jun 18, 2015

Bloomberg Brief Municipal Market Expert Series.

Taylor Riggs, an editor at Bloomberg Brief Municipal Market, spoke with Miguel Santana, the Los Angeles city administrative officer, on the upcoming note sale, pensions and California's drought.

Watch the video.

June 17, 2015

Moody's: Unique Enterprise Risk Arises When Municipalities Operate Broadband Systems.

New York, June 17, 2015 — Local US governments that operate municipal broadband systems are vulnerable to enterprise risk owing to the support of a nonessential government service subject to robust competition from large private operators, Moody's Investors Service says in "Municipal Broadband Systems Expose Local Governments to Enterprise Risk." Most local governments providing broadband have managed the enterprise risks well. However, a few exceptions demonstrate the potential for significant financial strain.

A small but growing number of municipalities operate a broadband system. Despite restrictions on municipal broadband development in 19 states, the number of local government broadband operators could grow given expanding federal policy on high-speed internet access.

Moody's report cites several instances of municipalities that have experienced fiscal strain due to broadband enterprises, including Burlington, VT (Baa2 positive), Salisbury, NC (A3 stable), and Monticello, MN (A2).

"Unlike essential municipal water or sewer systems that are critical to public health and enjoy monopolies in their service areas, high-speed broadband carries distinct fiscal risks for municipalities," report author and Moody's Assistant Vice President Kristina Alagar Cordero says.

The competitive landscape can hinder the financial performance of a municipal broadband system owing to the dominant market positions of large cable and telecom companies, which can often offer lower prices or develop better customer features. This can erode a municipality's customer base, leaving the enterprise struggling to meet revenue targets or service its debt against multiple private-sector competitors.

Additionally, municipal broadband providers will also need to make regular capital improvements to incorporate technological change and increase broadband speed to remain competitive. These investments typically come with high capital costs and additional borrowing.

As a nonessential enterprise which requires ongoing financial support, a local government may become unwilling to maintain the broadband enterprise if faced with a choice of funding a struggling enterprise at the expense of core government operations.

The commitment to provide ongoing operating support or follow through on debt support could wane given the strain these commitments have on a municipality as well as the strength of the legal pledge to provide support. However, Moody's believes most governments will continue to honor their General Obligation pledges backing a broadband system, even in the face of a severely failing enterprise.

The report is available to Moody's subscribers here.

Behind Chicago's Rift With Moody's: Rater's Tough New Stance.

CHICAGO — More than a year before Moody's Investors Service downgraded Chicago's bonds to junk status, one of its senior analysts asked top city officials to explain why the third-largest U.S. city was healthier than a troubled island commonwealth flirting with insolvency, according to people familiar with the conversation.

"Help me understand why Chicago is different than Puerto Rico?" said the Moody's analyst, Rachel Cortez, during a February 2014 meeting that Mayor Rahm Emanuel attended, two of these people said. A spokesman for Moody's and Ms. Cortez said the firm doesn't discuss "private meetings with issuers or other capital-market participants."

The exchange inside City Hall came to embody a more aggressive stance by the world's second-largest ratings firm as Moody's cut Chicago's credit rating by seven notches over a two-year period. City officials were taken aback by the Puerto Rico comment and then angered by Moody's final move to junk in May 2015, a stance that differed from more optimistic conclusions made by other ratings firms. Since last summer, the city has left the Moody's Corp. unit off four bond deals.

Mr. Emanuel through a spokeswoman declined an interview request. He has described Moody's downgrade of Chicago's bonds to junk as irresponsible and premature, accusing the firm of playing politics.

Tim Blake, a Moody's managing director who heads its public pension task force, said the firm is "rationally applying" its ratings models. "Our job is to make judgments on credit risk as we see it," said Mr. Blake, noting some issuers with improved pension situations have been upgraded.

Other cities and counties from California to Florida are reconsidering their relationship with Moody's as it expands its stricter ratings approach around the U.S., threatening a seal of approval that for decades was all but a necessity in the municipal-bond world.

Santa Clara County, Calif., omitted Moody's from its past two deals because of the firm's disagreement over how some property-tax revenues were to be distributed. "We became convinced that Moody's was not being responsible and so therefore we moved away from them," said Jeff Smith, who oversees the operations of the county, which includes San Jose. "We don't think it has had, or will have, any effect on our ability to sell bonds."

The latest government to back away from Moody's is Miami-Dade County, which last week decided to hire Kroll Bond Rating Agency Inc. instead of Moody's for its $534 million sale of airport bonds. Kroll's rating is two notches higher than Moody's.

"We wanted a fresh set of eyes," said Anne Lee, chief financial officer of the Miami-Dade aviation department, of the decision to not hire Moody's, which she adds charges "30% to 40%" more than other rivals.

A Moody's spokesman declined to comment.

Moody's metamorphosis began after the 2008 crisis as ratings firms drew criticism in Congress and from regulators for their rosy grades on mortgage bonds that went sour. For local governments, the key change came in 2013 when Moody's decided it would no longer rely on cities' and states' targets for investment returns when it calculates pension liabilities—one of the biggest costs shouldered by local governments. Moody's own estimates are more conservative, meaning holes in pension funds look bigger.

As Moody's adopted the stricter ratings methodology, it diverged from rivals Standard & Poor's Ratings Services and Fitch Ratings in its assessment of problems facing local governments across the U.S. From 2002 to 2007, Moody's and S&P upgraded issuers at about the same rate. But from 2008 to 2014, S&P had seven upgrades for every one of Moody's, according to a recent Nuveen Asset Management LLC report.

Horacio Aldrete, who leads S&P's U.S. local government group, said the firm's ratings methodologies reflect the low default levels among state and local governments in recent years. "Our view is that credit quality is generally strong, a position that has been borne out in recent years," Mr. Aldrete said.

Fitch said it maintains "a relatively balanced view on U.S. municipal credit and that often places us somewhere in between" other ratings firms, said Dan Champeau, a managing director in its U.S. public finance group.

Nowhere did the Moody's shift lead to a more public drama than in Chicago, where top city officials including Mr. Emanuel attempted to sway Moody's even as the firm increasingly came to see the city as an outlier with a shrinking number of options to avert a full-blown fiscal crisis.

Moody's suggested that Mr. Emanuel should be more open to tax increases as part of plans to confront one of the nation's deepest municipal pension shortfalls, according to people familiar with the matter, and the mayor made public comments supporting such a move. He eventually proposed a pension overhaul that included a property-tax increase of $250 million over five years.

"Most investors want rating agencies to operate like referees standing on the sideline. Moody's appears to be less inclined to do that in recent years," said Christopher Mier, a managing director at

Chicago-based Loop Capital who oversees the firm's municipal analytics group.

The city's efforts to convince Moody's didn't slow a series of downgrades that began with a three-notch swoop in July 2013, following the change to its methodology for pension liabilities.

Mr. Emanuel pushed the city's finance department and other senior officials, people familiar with the matter said, to figure out a fix even as frustration mounted at City Hall that Moody's didn't maintain consistent standards, the people said. In January 2014, Moody's made additional changes to its methodology that increased the importance of debt and pensions and de-emphasized other economic factors, undercutting a city argument about the strength of Chicago's economy.

In March 2014, a team of Chicago officials flew to New York without Mr. Emanuel for a meeting at Moody's Manhattan offices. In a conference room overlooking construction at the former site of the World Trade Center, Chicago officials outlined the plan to address the city's $20 billion pension hole, plus alternative approaches and funding plans if Mr. Emanuel's overhaul was struck down by the courts in the years ahead, the people said.

But Moody's analysts didn't give a strong reaction one way or the other as to whether they were swayed by the city's plan, the people said.

Mr. Emanuel eventually won state approval for his pension cuts, but on May 8, the Illinois Supreme Court rejected a separate overhaul of state pensions similar to Mr. Emanuel's legislation. Moody's analysts called that day to say they wanted to talk the following Monday.

On the morning of May 11, city officials assured Moody's the ruling wouldn't derail its pension changes, according to people familiar with the matter. But by the afternoon, Mr. Emanuel was presented with the news, as he sat at his desk in his fifth-floor City Hall office: Moody's planned to slash the city's ratings two levels to Ba1—one notch into junk status, the people said.

Mr. Emanuel had few words to say in response as officials discussed next steps, according to people familiar with the situation, pitching in with phone calls with large creditors to say he was available to answer any questions.

The saga has left some city officials wondering whether Moody's has overstepped its bounds with Chicago. "It is one thing to point out the current financial situation. It is another to give political advice," said Alderman Patrick O'Connor, a city council ally of the mayor.

THE WALL STREET JOURNAL

By TIMOTHY W. MARTIN and MARK PETERS

June 18, 2015 12:26 p.m. ET

Write to Timothy W. Martin at timothy.martin@wsj.com and Mark Peters at mark.peters@wsj.com

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S&P: How the Rise of Solar Energy Could Affect U.S. Regulated Utilities' Credit Quality.

Solar energy, including distributed generation (DG), is growing rapidly and has become an integral component of U.S. electricity generation. DG–which allows consumers to partially sidestep traditional power generators by producing energy on-site–poses a mild competitive threat to many U.S. regulated utilities, and we think its growth will have long-lasting implications for the industry. Over the next several years, solar energy's growth will continue to benefit from various state energy policies, tax credits, grants, and rebates. However, over the longer term, demand for solar energy will likely be driven by its fundamental economics, including the decreasing costs of solar manufacturing and rooftop solar installations. Our base-case scenario projects that the vast majority of rated utilities will be able to manage the competitive risks of DG and maintain credit quality.

Purchase the report.

Project Runway: Airport Muni Bonds Strut Their Stuff.

Pulling into the big new parking garage at Charlotte Douglas International Airport, I smiled. Parking had always been a pain at the old garage, not to mention during construction (Yes. I fly there a lot). And I was suddenly reminded that, for all the legitimate talk about underfunded public transportation infrastructure, airports are a shining exception.

From 2002 to 2013, based on data provided by the Federal Aviation Administration, passengers at the nation's top 10 busiest airports increased 27%, from 230 million to about 293 million. That's 175,000 more people flying every single day–the entire population of Providence, RI. To keep up with the increased travel, those top 10 airports—Atlanta (Hartsfield), Chicago (O'Hare), Los Angeles, Dallas/Fort Worth, Denver, Charlotte (Douglas), New York (JFK), San Francisco, Las Vegas (McCarran) and Phoenix—are building and refurbishing at a furious pace.

Over the past five years, Los Angeles, Dallas/Fort Worth and Denver went to the bond market for $3.6 billion in new funds. Meanwhile, San Francisco and Orlando have multibillion dollar capital plans, and other airports are following suit. In fact, over the last decade, bond issuance for transportation (which includes airports) has been the second largest non-general purpose debt sold by municipal agencies and authorities, behind only education.

Airports sometime get overshadowed by airline news, and it's been a mostly rocky 15 years for the airlines. Bankruptcies (five, including the two by US Air) and mergers (six, at last count) have narrowed what were the 10 major domestic carriers at the start of the century to just three. But the airports these airlines use are very stable. Of the top-10 airports, seven enjoy double-A ratings on their senior lien bonds by at least one of the three major rating agencies (Moody's, Standard & Poor's, and Fitch). The other airport ratings fall squarely in the single-A investment grade category. Downgrades are rare; there have only been four over the past seven years, and those were modest adjustments.

For municipal bond investors, airports have been an opportunity for above average returns. According to the S&P Municipal Bond Airport Index, which has tracked this sector since 2011, compounded returns as of May 2015 were about 21%, outpacing the general market S&P Municipal Bond Index return of about 17% over the same period.

The bottom line is that no matter what corporate logo is on their wings, planes still need airports to take off and land. For all the negative headlines about fluctuating fuel prices and bankruptcies among airlines, the biggest airports remain relatively unaffected. They are essential public purpose entities; they are robust and they are growing.

FORBES

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Elisaveta Dejkoska, Analyst and Sarah Gehring, Associate of TIAA-CREF Asset Management contributed to the research of this article.

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The views expressed in this article are those of Barnet Sherman. These views may change in response to changing economic and market conditions. Past performance is not indicative of future results. The material is for informational purposes only and should not be regarded as a recommendation or an offer to buy or sell any product or service to which this information may relate. Strategies discussed do not guarantee a profit or ensure against loss.

Please note municipal bond investments are subject to credit risk, interest rate risk and inflation risk, among other risk factors.

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Recession's Legacy Leaves U.S. State Bonds as Muni-Market Laggards.

Six years after the recession, U.S. state budgets have yet to fully recover, reserves are shrinking and more than a dozen governors want to raise taxes.

Investors have taken note: the return on state debt is on pace to trail the $3.7 trillion municipal bond market for a second straight year, according to Bank of America Merrill Lynch indexes. The extra yield bondholders demand to own state debt instead of top-rated munis is close to a three-year high.

Even as the growing economy mends state finances, officials are contending with rising retirement bills, health-care costs and the need to make up for previous budget cuts, according to a report Tuesday by the National Association of State Budget Officers. Such pressure has led firms including Morgan Stanley to recommend limiting holdings of state debt, saying governments are vulnerable to an economic slowdown.

"The headline emergency is over, but if you look at the numbers below the top line, there are still some significant challenges," said Robert Amodeo, who helps oversee $30 billion of municipal bonds for Western Asset Management Co. in New York. He predicts that state general-obligation debt will cheapen compared with benchmark securities.

Slow Recovery

States have been slowly recovering from the longest recession since the Great Depression, which caused tax collections to tumble and left pension funds reeling from investment losses.

The rebound hasn't been strong enough to give states the revenue needed to make up for previous spending cuts and keep pace with some expenses, said Scott Pattison, the executive director of the Washington-based budget officers group.

"It's just not enough money to cover those growing fiscal costs," he said. "It's a real worry going forward."

The $756 billion that states will spend in the current fiscal year, which ends in June for most, is still $24 billion, or 3.2 percent, below the 2008 peak, when adjusted for inflation, according to the report from Pattison's group. Budgets are set to expand next year by 3.1 percent, the smallest increase since the economy began growing again in 2009.

While fiscal stress on states including California and New York has ebbed, others are still struggling to balance budgets. Louisiana lawmakers voted to raise cigarette taxes and limit business subsidies to help close a $1.6 billion deficit next year. The drop in the price of oil cut Alaska's revenue by more than half. In Illinois, the Democrat-led legislature and Republican Governor Bruce Rauner remain at odds over how to eliminate the state's $6 billion shortfall.

Rising Bills

Investors are demanding 0.15 percentage point over top-rated munis to own state bonds, according to Bank of America Merrill Lynch indexes. That's just short of the 0.16 percentage point reached last month, which was the most since June 2012. State debt has lost 0.23 percent this year, a steeper drop than the 0.11 percent decline for the muni market as whole. Last year, state bonds returned 6.9 percent, trailing the market's 9.8 percent gain.

For states, mandatory expenses for schools and health-care programs are rising faster than tax collections, according to the report.

"It's a simple math calculation that something's got to give," said Pattison.

Two dozen states, including Alaska and Ohio, are set to draw down cash reserves in the coming year, the report found.

'Biggest Underweight'

Sixteen governors proposed tax and fee increases, while 12 sought cuts. If fully enacted, that would result in an increase of $3 billion. In the previous two years, governors moved to cut taxes and fees overall.
"State and local credit is our biggest underweight," Michael Zezas, the chief muni strategist at Morgan Stanley, said in an e-mail Monday.

Zezas said in a research note to clients in April that states are "vulnerable" to the next economic downturn. He said investors "should be more circumspect" about buying state debt because prices relative to other securities are unlikely to improve.

Western Asset Management's Amodeo expects the gap between yields on state bonds and benchmark debt to widen. He has been buying debt backed by specific revenue pledges, instead.

"Investors are recognizing that they should be paid more," he said.

Bloomberg

by Romy Varghese

June 15, 2015 — 9:01 PM PDT Updated on June 16, 2015 — 6:01 AM PDT

Misrated Muni Market Hoists $1.8 Billion Annual Tab on Taxpayers.

U.S. states and localities still aren't getting the respect they deserve in fixed-income markets five years after Congress mandated that municipal debt be graded on a level playing field with company borrowings.

So says a study co-authored by Marc Joffe, principal consultant with Public Sector Credit Solutions in Walnut Creek, California, which estimates the misgrading adds about $1.8 billion a year to the cost of state and local-government debt. While rating companies have revised thousands of issuers higher, many grades still don't reflect municipal bonds' low default rates, said Joffe, a former Moody's Investors Service analyst.

"Taxpayers are the losers," said Joffe, whose study will be published as soon as August by the Haas Institute for a Fair and Inclusive Society, a policy center at the University of California at Berkeley. "This results in a transfer from taxpayers to municipal bondholders."

The Dodd-Frank Act, being phased in with new rules that take effect Monday, is designed to change that by requiring credit grades to reflect the risk of default while also expanding the Securities and Exchange Commission's ability to police the assessments.

Adjustments Made

Standard & Poor's adjusted its ratings "to a common set of stress scenarios and definitions" to make ratings across asset classes comparable, according to a statement from Alex Ortolani, a spokesman in New York. Moody's said in a June 8 press release that it has taken the steps to comply with the act.

"Fitch Ratings is prepared to implement a number of policy and procedural changes in response to new and amended SEC rules which take effect on June 15," Daniel Noonan, a spokesman, said in an e-mailed statement.

Historically, ratings haven't reflected the safety of local debt: Munis graded single-A defaulted at less than one-third the rate of like-ranked corporate debt over the 30 years through 2010, according to a study published last month by researchers at Rice University, American University and Georgetown University. Two-dozen municipal bonds out of 22,000 securities in Concord, Massachusetts-based Municipal Market Analytics Inc.'s database are in default.

2008 Pressure

"Default statistics show that muni ratings are too low, so anything short of AAA is not going to reflect default risk," said Matt Fabian, partner at Municipal Market Analytics. The new standard will lead to upgrades, he predicts.

Municipal issuers led by former California Treasurer Bill Lockyer began pressing rating companies in 2007 to show investors how they'd be assessed on a corporate scale. The localities said the system at the time raised borrowing costs because ratings didn't fairly reflect low default rates.

In 2010, Moody's and Fitch, both based in New York, revised their muni ratings to a standard used for corporations: default risk. Previously, municipal grades were based on various financial metrics. S&P also began revising rankings. In the year through September 2014 it raised at least 1,600 general obligations.

The difference between yields on double-A and single-A munis underscores the potential cost savings from an upgrade. An index of double-A munis has a yield to maturity of 3.13 percent, compared with 3.8 percent for single-A, Bank of America Merrill Lynch index data show.

Enforcement Actions

The Haas Institute's estimate of the $1.8 billion yearly tab is based on the extra interest expense and the cost of buying bond insurance to raise ratings, according to Joffe, who says he's an independent researcher and has developed a model for local-government credit scoring.

Congress passed Dodd-Frank in 2010 to prevent a repeat of the near-collapse of financial institutions during the recession. Besides requiring more disclosure of ratings criteria and default data, the act stipulates credit grades be applied "in a manner that is consistent for all types of securities."

Under the rules that take effect Monday, the SEC will be able to bring enforcement actions to ensure that the companies consistently evaluate debt fairly across asset classes.

The agency had no further comment beyond the rule, according to Kevin Callahan, a spokesman.

'Acid Test'

States and cities still have doubts about whether rating companies have gone far enough.
"I am skeptical about whether changes in the scale will lead to that" fair assessment of municipal default risk, said Jonas Biery, debt manager for the city of Portland. "You don't really see it doing anything for municipal credit."

The academic study showing the disparity in defaults between single-A munis and like-rated corporate debt has relevance for California, which is graded A+ by Fitch and S&P, and one level higher by Moody's.
The state, which has never defaulted and is the biggest issuer of municipal debt, is still rated on par or lower than companies with a higher risk of default, Catalina Martinez, spokeswoman for state Treasurer John Chiang, said in an e-mail.

In early March, California sold general obligations maturing in March 2025 at a 2.38 percent yield, while similarly rated Franklin Resources Inc. issued senior unsecured notes later that month that were due in 10 years and fetched 2.87 percent.

"The acid test for whether the federal law has been successfully implemented will be in whether ratings track with default rates," Martinez said.

Bloomberg

by Darrell Preston

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[CUSIP Request Volume Shows Possible Inflection Point in Bond Issuance Frenzy.]

NEW YORK, June 10, 2015 /PRNewswire/ — CUSIP Global Services (CGS) today announced the release of its CUSIP Issuance Trends Report for May 2015. The report, which tracks the issuance of new security identifiers as an early indicator of debt and capital markets activity, suggests a possible slow-down in the frenetic pace of new corporate and municipal bond issuance that has characterized the first several months of 2015.

Total CUSIP requests for new U.S. and Canadian corporate equity and debt decreased 8% in May, with a total of 2,170 new identifiers requested over the course of the month. On a year-over-year basis, corporate CUSIP request volume was down 3.9%.

“Within the broad category of domestic corporate CUSIPs, we’ve seen some mixed signals in May, following several months of unmitigated growth,” said Gerard Faulkner, Director of Operations for CUSIP Global Services. “While volume is still strong across all asset classes, the blip in corporates and municipal bonds this month is a noteworthy change in the recent trend.”

Municipal CUSIP request volume declined for the first time in four straight months, decreasing 3% in May, with a total of 1,527 new identifier requests made over the course of the month. On a year-over-year basis, municipal bond identifier requests are up 45% through May. Texas has continued to lead the way among municipal bond issuers, with a total of 851 new CUSIP requests made in the first five months of the year.

International debt and equity CUSIP International Numbers (CINS) orders showed mixed results in April. Requests for new international debt CINS remained unchanged in May, while requests for new equity CINS decreased 12%.

“As long as the Federal Reserve continues to keep rates low, we expect bond issuers to continue to issue new debt,” said Richard Peterson, Senior Director of Global Markets Intelligence, S&P Capital IQ. “While the slight pull-back this month may be the first sign of a slowdown in the runaway pace of new issuance, we do expect to continue to see a high overall volume of new security issuance in the days and weeks to come.”

To view a copy of the full CUSIP Issuance Trends report, please click here.

About CUSIP Global Services

The financial services industry relies on our unrivaled experience in uniquely identifying instruments and entities to support efficient global capital markets. Our extensive focus on standardization over the past 45 years has helped us earn the reputation for being the trusted originator of quality identifiers and descriptive data, ensuring that essential front- and back-office functions run smoothly. Relied upon worldwide as the industry standard provider of reliable, timely reference data, CGS is also a founding member and co-operates the Association of National Numbering Agencies (ANNA) Service Bureau, a global security and entity identifier database for over 25 million publicly trade instruments, contributed by 89 national numbering agencies and 27 partner agencies representing 123 different countries. CGS is managed on behalf of the American Bankers

Association (ABA) by S&P Capital IQ, with a Board of Trustees that represents the voices of leading financial institutions. For more information, visit www.cusip.com.

About The American Bankers Association

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. Learn more at www.aba.com.

1 "International" Debt refers to market requests for CUSIP International Numbers ("CINS") for non-U.S. debt offerings
2 "International" Equity refers to market requests for CUSIP International Numbers ("CINS") for non U.S. equity offerings
3 "U.S. & Canada Corporates" totals reflect requests for both equity and debt identifiers

SOURCE CUSIP Global Services

S&P: New Jersey Pension Ruling is No Reason to Celebrate from a Credit Standpoint.

NEW YORK (Standard & Poor's) June 9, 2015–While today's New Jersey Supreme Court ruling that the state's payments to its pension system under Chapter 78 (2011 pension reform) are not a constitutionally protected contractual right will likely provide budget and liquidity relief in the very near term, it will most likely weaken the state's liability profile, which is not a reason for celebration from a credit standpoint.

The decision is a double-edged sword. While it averts a potential liquidity crunch, it may do so at the expense of the state's liability position, which has steadily deteriorated over several years. The decision provides the state with more time to address its pension liabilities, and potentially some additional leverage in negotiations with labor unions. However, if this window of time does not produce a solution to pension and other post retirement liabilities, budget and credit pressure will accelerate and the state's rating could be vulnerable to further downgrade. New Jersey's general obligation debt is rated 'A' with a stable outlook.

Chapter 78, while less than perfect, provided the state with some much-needed discipline and structure for addressing its pension liabilities. Today's decision certainly provides the state with some increased budgetary flexibility, but if the past is any indicator, flexibility around pension payments does not bode well for New Jersey's liability position and is a key contributor to the state's current pension funding situation and deterioration in credit quality.

We will continue to monitor budget deliberations for fiscal 2016 and the progress being made on addressing the state's large and growing pension liabilities. Currently, the executive and the legislative branches are far apart on how to manage the long-term pension liability. Failure to develop consensus on a way forward, either through increased payments, benefit reform, or some combination of both, will only accelerate the growth of the liability and weaken the state's credit profile further. In our view, it is still, ultimately, how the state addresses its large and growing unfunded liability that will determine the future credit quality.

A Tale of Two Public-private Partnership Cities.

In 2012, Hurricane Sandy hit hard in the working-class port city of Bayonne, N.J., flooding east side industrial areas and the former Military Ocean Terminal. Water from Newark Bay swept through six Public Service Electric and Gas Company (PSE&G) switching terminals, and cut power to the whole city. Many long-time residents, who had lived through numerous storms, said they had never seen one so devastating.

Bayonne, with a population of more than 60,000, was struggling even before Sandy, but the storm made it all the more difficult for the city to address its water woes on its own. The city was buying 17.6 million gallons of water per day from the North Jersey District Water Supply Commission, but only using half of it.

The water came from reservoirs 50 miles northwest of the city, delivered through an outdated aqueduct in need of frequent repair that the city could ill afford. Like many other cities, Bayonne had deferred maintenance on its water systems. Its excessive debt burden led to a poor credit rating that made further borrowing more expensive.

Patrick Sabol, a senior policy and research assistant at the Metropolitan Policy Program of the Brookings Institution, said that ideally, “Bayonne should have been able to get it together, but the reality is they couldn’t take on new debt, even at high cost.”

Bayonne’s sewer system, pumping an average of 8.3 million gallons of wastewater daily, had similar challenges, including outdated infrastructure and outfalls that needed updating to meet federal regulations.

The Bayonne Municipal Utilities Authority (BMUA) needed a solution. Its options included selling its water utilities outright to a private company, or entering into either an operation-and-maintenance contract or a longer-term concession agreement. Only a few months after Sandy, the city chose the latter avenue — a joint venture partnership for both water and wastewater operations with Kohlberg Kravis Roberts (KKR) funding 90% of the effort with United Water, a unit of French giant Suez Environnement S.A.

While BMUA maintains ownership and the control of user rates, the joint venture made an initial payment of $150 million to the city. This infusion of capital was critically important to the city because it eliminated $130 million of existing debt and improved both the authority’s finances and Bayonne’s credit rating. In 2013, Moody’s Investor Service upgraded Bayonne’s bond rating from Baa1 with a negative outlook to Baa1 with a stable outlook, in particular citing the city’s recent progress in reducing its debt burden through the lease-sale of the MUA operations.

KKR and United Water further pledged to funnel another $157 million into the water systems over the 40-year length of the contract, with about $2.5 million a year earmarked for maintenance and upgrades. That work began quickly with the cleaning and inspection (using television cameras) of many miles of water and sewer mains. Some 1,500 water hydrants are also being checked to make sure the fire safety infrastructure is reliable. Installation of new water meters, which greatly expedites the finding and repair of leaks, is also underway. The new meters can be monitored directly from the offices of United Water Bayonne, and telltale signs — heavy water use late at night, for instance — are being used to direct repair crews and inform customers of possible leaks on their property.

Tim Boyle, BMUA’s executive director, said the initial efforts are part of extensive upgrades over the next several decades. “Remember, the city of Bayonne still owns the water and sewer systems, and it’s Bayonne that benefits,” he said. “We receive $2.5 million per year, which is a nice chunk of money guaranteed. What the partnership does is remove the need for political will for the maintenance of the system. It’s hard to imagine politicians committing an equal amount of money to maintaining our water supply.”

Water consumers are paying for some of the improvements: 8.5% rate hikes on both water and sewer bills were implemented in 2012 — the first BMUA increase since 2006 — and another 4% increase came in at the beginning of 2015. As a result of the 2012 increase, low-volume users saw their cost for 748 gallons of water increase from $4.29 to $4.65, and heavier users started paying $5.12, up from $4.72.

The authority said it would have had to raise rates even without its new agreement, but the hike was criticized by entities such as advocacy group Food & Water Watch.

In a report titled “Private Equity, Public Inequity,” the group said that private equity players typically focus on short-term profits and may seek to flip assets after driving down service quality and driving up prices. That means households and businesses could end up paying more for inferior service.

Still, a report by NW Financial Group, a financial advisory and municipal underwriting firm, estimates that Bayonne’s 4% annual rate increases are less than the 5% annual increases that New Jersey’s regulated water utilities have averaged since the 1970s. The report also said that the new partnership is locked into “a fixed-rate increase schedule that assures modest future rate increases over the 40-year concession period.”

At the Wharton conference, “Investing in America’s Public Water Systems — Making Public-Private Partnerships Work,” Patrick Cairo, a Suez Environnement senior vice president, said that Bayonne’s water rates “will be a little north of inflation levels — any more than that and the system will start to unravel because of upset customers.”

A law firm hired by BMUA estimated that the city could save almost $35 million over its 40-year contract, compared to operating the water utilities on its own. But a BMUA attorney cautioned that it is too early to say if those savings will actually be realized. So far, rate increases have occurred within the contractually agreed-upon amounts “and therefore — after four years — United Water is on track to realize the projected savings,” Cairo said.

It is indeed early in the relationship among United Water, KKR and the citizens of Bayonne. So far, the rate increase has been an issue locally, but few have complained about inferior service. United Water, for its part, reports fielding positive consumer comments about access to information from the smart water meters it has installed.

A Private Sector Lifeline for Rialto

The city of Rialto, 60 miles from Los Angeles in the region’s Inland Empire, provides water to 48,000 customers and sewer services to 100,000, with budgeted revenue of $37 million in fiscal 2014. As in Bayonne, the existing system suffered from deferred maintenance, but there was also serious water contamination by the chemical perchlorate that was not detected until 1997. After a decade of litigation, the estate of a former fireworks manufacturer agreed to an $11 million settlement in 2014 for polluting the groundwater with toxic chemicals.

Because of the contamination, Rialto has had to purchase water at a high premium from other municipal operations, and main breaks became commonplace. The city found itself in a situation familiar to municipal managers across the country – the presence of large debts aggravated by the recession, and problems of compliance with federal standards.

According to “Private Capital, Public Good,” a research paper from the Brookings Institution, Rialto’s “historically underfunded system also struggled to meet pension liabilities, which were starting to weigh on the utility’s ability to affordably raise capital in the tax-exempt market.”

Andrew Sawyers, director of the office of wastewater management at the U.S. Environmental Protection Agency, said that state revolving loan funds and municipal bond financing often have not been sufficient to meet local needs. That was a factor in the creation of the EPA’s Water Infrastructure and Resiliency Finance Center early in 2015. It is designed to be a resource for communities and municipal utilities that struggle with limited budgets.

In 2013, Rialto entered into a 30-year, $300 million public-private partnership (P3) agreement with Veolia Environnement S.A.’s Veolia Water as the operator of the project. Ullico, a labor-owned insurance and investment company, was the lead finance partner, along with Table Rock Capital. An agreement with labor unions ensured that all existing employees would keep their jobs for at least 36 months.

The structure of the concession agreement, which creates the new Rialto Water Services, is similar to that of Bayonne, but a significant difference is that Veolia has actually been a contracted operator for Rialto’s water systems since 2002. The new partnership deepens the relationship, with operational, management and fee-collecting responsibilities, plus the obligation to upgrade the system in the first five years. The partners also agree to settle $27.4 million of the city’s water-related debt, and provide a total of $35 million in cash.

The partners are guaranteeing 445 new construction jobs, and have committed to $41 million in capital improvement projects for Rialto’s water infrastructure. They project savings of $2.5 million for the city over the first five years of the contract. By mid-2014, more than $525,000 had been invested in maintenance repairs, projects and upgrades. New water meters are being installed, and a treatment plant digester is being rehabilitated.

Veolia has improved the customer service call answer rate by 95%, installed a new computerized work order management system, and is using geographic information system technology to map and monitor the 260-mile collection system. These are not inconsequential benefits. The value of water privatization to communities like Rialto is “finding companies that are willing to make capital investments on their own dime — that’s advantageous to constituents rather than onerous,” said Tim Carden, managing director of PFM Group.

But Rialto also experienced a 15% rate increase, which went into effect on January 1, 2015. That amounts to a 30-cent increase on each 748-gallon unit of water. Mary Grant, a researcher for Food & Water Watch, said the city agreed to increase rates by about 115% from 2012 to 2016.

Jeff Murphy, portfolio manager for the Ullico Infrastructure Fund, said that the rate increase was “reasonable,” given the necessity of upgrading the water system, and the efficiencies that Veolia brought to the operation. “The increases were lower than in surrounding communities that had raised rates,” he said. “The existing rate base was barely covering the operation, and was unable to pay for the capital improvements that had to be made.” He acknowledged that “raising water rates is not a popular thing to do.”

The West Valley Water District, a neighboring local public agency that provides drinking water to parts of Rialto, said the takeover was not to be blamed for the increases. The district said the need was based on a 2012 analysis –before Rialto Water Services was created – pointing out that "costs such as chemicals, lab fees and required permits were increasing. Since that time, those costs have in fact increased by an average of over 200%."

Still, there is no question that Rialto's water users will pay higher bills because of extensive capital improvement programs — the operators are going after profit, and the updates will not be a free benefit. But there also is no debate that those programs were both desperately needed and long deferred.

Wharton University of Pennsylvania

Jun 10, 2015

Junk Status on the Rise Among Local Governments.

The number of local governments rated at junk status has nearly doubled over the past four years, according to a recent Moody's Investors Service report. Although less than 1.1 percent of rated local governments — cities, counties, school districts and special districts — are rated at what's called speculative grade, as of March of this year, 92 local issuers had at least one speculative-grade rating on either general obligation, special tax, lease, revenue or tax increment debt, the June 5 report said. Excluding California tax allocation districts (which were devastated by a 2012 law that significantly altered the payment mechanics of those types of credits), the number of speculative-grade local governments has nearly doubled since 2011, to 51 from 33, Moody's said.

Of those 51 credits, 13 are local school districts — up from six rated at junk in 2011. Cities and towns account for about half of the junk bonds, jumping from nine to a total of 24 in four years. Notable examples include Woonsocket, R.I.; Central Falls, R.I. (which emerged from bankruptcy in 2012); Salem, N.J.; and East Greenbush, N.Y. All four have had speculative-grade debt since 2011, which shows how difficult it is to get back to investment grade (bad news for Chicago, which Moody's downgraded to junk last month and was not included in this tally). "Once a credit is rated below investment grade for more than two consecutive years … it is much more likely to remain there for some time," the report said.

But munis are scrappy. While many local governments with speculative-grade ratings remain weak for long periods, Moody's said a significant number ultimately return to investment grade. Vadnais Heights, Minn., for example, sold off a costly sports arena to meet obligations on its debt. The sale, along with keeping strong general fund reserve levels, contributed to an upgrade to Baa2 in October 2014. This upgrade and others, the report said, shows "the resiliency of local governments and underscore that the sector remains one with very few defaults."

GOVERNING.COM

BY LIZ FARMER | JUNE 12, 2015

Why State Budgets Often Aren't as Balanced as They Seem.

Governors love to tout a balanced budget among their accomplishments. But the truth is, in many cases, that budget isn't as balanced as it looks.

"There is a tendency among states to disguise the problem," Paul Volcker, chair and founder of the Volcker Alliance, said at a Monday press conference releasing the group's first of many planned reports that pick apart state budgets with an eye to gimmicks and other tricks that may make finances appear more stable than they are. Every state except Vermont has a legal requirement to pass a balanced budget, although some have more stringent budget rules than others. Still, Volcker said, "the fact is that many states had have had deep-seated problems they are not facing up to."

The report, Truth and Integrity in State Budgets, focused on New Jersey, California and Virginia. All three have opted for gimmicks at one time or another. California in 2009 issued $2.6 billion in what were essentially IOUs to pay businesses, local governments, and tax filers due refunds after legislators failed to pass a budget by the beginning of the fiscal year and the state was short on cash to pay bills. Since 2008, New Jersey has relied on transfers from its Clean Energy Program, a fund financed by utility revenue and intended to promote energy efficiency, to help balance its budget. And Virginia, which is often lauded for its conservative fiscal management, moved most of its payments for an $80 million transportation project into 2016 so that it could close a 2015 budget gap.

The message from the report is ultimately simple: states that habitually paper over budget deficits instead of addressing their structural problems will only see their fiscal stability worsen. California has taken steps to address some of its deficiencies in recent years. Namely, voter-approved tax increases and a voter referendum to strengthen the state's rainy day fund have contributed to revenue surpluses and four general obligation credit rating upgrades from the three major ratings agencies. The state's accumulated debt obligations also dropped from $34.7 billion in 2011 to $26.9 billion in 2013.

In Virginia, the state's strong financial reputation is deserved, the report found. Its budgeting practices include strict statutory constraints on borrowing and requirements for depositing money into its rainy day fund, which have allowed the state to turn its attention to issues that have stumped other states. In recent years, Virginia has passed three major pension reforms with a goal of 100 percent funding by 2019, and has actively raised revenues for infrastructure improvements through targeted tax increases throughout the state.

New Jersey, on the other hand, suffers from a "chronic inability" to match its expenses to revenues, the report said. This practice over years has contributed directly to the overwhelming problems the state faces today: a combined $90 billion pension and post-employment benefits gap, underfunding of public schools despite facing the fifth-highest cost per student in the United States and insufficient funds to address the state's growing infrastructure issues.

New Jersey's struggle isn't the fault of any one administration, said William Glasgall, who helped author the report. "It's a nonpartisan thing, it's gone on for decades," he said. "It's a state that shows the consequences that you can't afford to pay when you're passing budgets that are balanced in name only."

The alliance wants to eventually issue similarly detailed reports for all 50 states. In a hint of what state budget may next suffer under the spotlight, the group pointed out that Kansas has been making ample use of one-time fixes to balance its budget ever since lawmakers cut that state's income tax.

Richard Ravitch, an alliance board member and former Lieutenant Governor of New York, said he believes that taxpayers have been “fooled by dishonest budgeting” for too long. “When this study is completed,” he said, “the public will know exactly how much in one-shots there are embedded in operating revenues.”

GOVERNING.COM

BY LIZ FARMER | JUNE 9, 2015

[Municipals Should Turn Around This Summer, Experts Say.]

The recent volatility and weak demand in the municipal bond market, caused in part by problems in Chicago, Illinois and Puerto Rico, should soon begin to turnaround this summer.

This was the contention of bond officials at Thursday’s BlackRock’s Municipal Bond Roundtable in Manhattan. The recent problems in municipals, such as Chicago’s downgrading to junk status and Puerto Rico’s long-term payment problems, partly led to S&P Municipal Bond Index Yield dropping by 0.21 percent in May. That resulted in the third consecutive month of net outflows.

But this is creating an opportunity for munis, Black Rock officials said.

“The upside to a third down month is that the correction has created levels (higher yields and ratios) not seen in many months. We expect that this will attract both retail and non-traditional buyers back to the tax-exempt class,” BlackRock officials wrote in their latest municipal market update.

Peter Hayes, head of BlackRock’s Municipal Group, reviewing the last three months in which munis have been outperformed by Treasurys, now predicted a “positive return” for municipals. He said munis had reached a “relative value bottom.”

However, he warned that Puerto Rico is still problematic. Puerto Rico Electric Power Authority is still seeking to find a solution through $1 billion in savings from stakeholders, but it is possible that it might ask bondholders to take a haircut.

Still, June is a transition month in which the municipal bond market as a whole should begin to turn around, added Sean Carney, BlackRock’s head and director of Municipal Strategy.

“The underlying tone of the market feels better than it has in the past several weeks,” he said. Still, he added it will probably take until July, August and September to see better performance. “It does feel as though demand will come back to the market if we can get some rate stability,” Carney said.

BlackRock officials said how the Federal Reserve raises rates — slowly or quickly — is more important than rate hikes, which the market is already anticipating. Carney predicted that, after several years of net refundings in munis, 2015 will be a net issue year.

BlackRock officials offered these overweights and underweights.

Overweights

• State tax-backed and essential-service bonds, particularly in the Southwest and Southeast regions.
• School districts
• Dedicated-tax bonds

Underweights

• Puerto Rico and its authorities
• Local tax-based issues, particularly in Alabama, Nevada and Arizona.

FINANCIAL ADVISOR

JUNE 11, 2015 • GREG BRESIGER

Munis' Rare June Fund Exodus Compounds Worst Quarter Since 2013.

This is normally a time of year when the individuals who own the majority of municipal debt collect coupon and principal payments and direct the cash back into the market. This year, they appear to be taking their money elsewhere.

Assets in muni mutual funds fell by $381 million in the week through June 3, the fifth-straight outflow, according to Lipper US Fund Flows data. It was only the second time in a decade that the funds have shrunk at the start of June, in part because it coincides with a period when investors get paid from maturing debt and interest. Taxable funds pulled in about $1.2 billion.

The exodus signals weakening demand in a market dominated by investors who tend to buy bonds, hold them to maturity and roll them over into new securities. Tax-exempt debt has lost 1.4 percent since March 31, Bank of America Merrill Lynch data show. It's on pace for the largest quarterly drop since the same period of 2013, when Detroit's move toward bankruptcy and speculation that the Federal Reserve was close to paring its bond-buying prompted unprecedented withdrawals.

"You would expect to see a better top-line number for the first week of June," said Chris Mauro, head of muni strategy at RBC Capital Markets in New York.

Individuals' Sway

Individuals own about 60 percent of munis either through specific bonds or mutual funds, giving them outsized sway over the market's performance.

The latest withdrawals, the largest since tax-related outflows in the week through April 15, were surprising because of the estimated $35 billion bondholders are set to receive, Mauro said.

This month's payments will probably be the year's third-highest, behind July's $44 billion and August's $38 billion, he said.

Munis are joining a selloff in global bonds as signs of economic strength fuel bets the Fed will raise borrowing costs as soon as September. The recent fund outflows aren't as severe as the $1 billion or more seen almost weekly during the 2013 fixed-income rout dubbed the "taper tantrum."

Since the biggest yield increases in that 2013 episode took place later in June, it may be too early to count out a repeat of that event, Vikram Rai, head of muni strategy at Citigroup Inc. in New York, wrote in a June 8 report.

'Added Burden'

"Muni price volatility is first and foremost a function of Treasury volatility, but we have the added burden of facing some outflows," said David Manges, manager of municipal trading at BNY Mellon Capital Markets LLC in Pittsburgh.

The deteriorating finances of issuers including Puerto Rico, New Jersey and Chicago have also dimmed the appetite of some bond buyers, said Alan Schankel, managing director of fixed-income strategy at Janney Montgomery Scott LLC in Philadelphia.

Benchmark 10-year muni yields climbed to 2.39 percent Tuesday, the highest since July 2014, according to data compiled by Bloomberg.

Demand for tax-free income is shielding munis from the worst of the global bond losses. Their quarterly decline is more muted than losses of 2.2 percent for Treasuries and 2.6 percent for investment-grade corporate debt, Bank of America data show.

"In the total fixed-income world, munis have more appeal than other sectors mostly because of high tax rates and their high after-tax returns," Schankel said.

Yet even amid the stretch of fixed-income declines, investors have poured money into funds focused on taxable bonds, adding $15.4 billion over the last eight weeks, Investment Company Institute data show.

"Hopefully this is not like 2013, where the outflows become more substantial," said Manges at BNY Mellon.

Bloomberg

by Brian Chappatta

June 8, 2015 — 9:01 PM PDT Updated on June 9, 2015 — 8:32 AM PDT

[Puerto Rico Path to Easing Cash Crunch Hinges on Insurer Demands.]

The key to whether Puerto Rico can ease its cash crunch may depend on bond insurers that protect investors against losses.

The junk-rated U.S. territory wants insurers such as Assured Guaranty Ltd. and MBIA Inc. to guarantee some of the $2.9 billion of bonds that it plans to sell to stave off insolvency. Insuring some of the securities would lure investors other than hedge funds, lower borrowing costs, and generate more proceeds that Puerto Rico can use to replenish its coffers.

The problem is that the insurers' willingness to participate in the new deal depends on the amount of losses they're forced to take on $2.6 billion of debt issued by the island's power authority that they already back, according to Melba Acosta, president of Puerto Rico's Government Development Bank. Bond insurers pledge to pay investors if a borrower defaults on guaranteed debt or reduces insured obligations through negotiations.

"This is sort of their last shot at finding liquidity," said Daniel Hanson, an analyst at Height Securities LLC, a Washington-based broker dealer. If Puerto Rico is able to sell the new bonds "they need to get it done at enough size to avoid coming back to market again."

Restructuring Plan

Prepa, as the electric utility is known, submitted a restructuring plan to creditors last week that asks ratepayers, employees, bondholders and management to share the burden of the agency's recovery. It didn't disclose potential investor losses. Also last week, the insurers considered blocking an extension of an agreement that kept talks between creditors and the utility out of court, people with knowledge of the talks said at the time.

The planned bond sale, to be backed by oil taxes, may be a more difficult sell without the insurers. Proceeds would repay money the highway authority owes the GDB, which lends to the commonwealth and its localities. The bank will run out of cash by Sept. 30 without the deal, according to Puerto Rico financial documents.

Insurers have proposed covering about $600 million of the transaction "in return for being guaranteed that their principal debt will not be reduced as part of the restructuring of Prepa," Acosta said in Spanish to the House Treasury Committee on May 30. Without insurance, the interest rate on the bonds "could be extremely high," she said.

Funds' Demands

Hedge funds also have demands. They want a portion of the oil-tax bonds to be subordinate in payment and for the GDB to hold about $800 million of those securities, Acosta said. That would mean less proceeds to help relieve the island's cash crunch, she said. The funds are also asking for the debt to be immediately paid in full with future interest in the event of a default, Acosta said.

A group of hedge funds is negotiating to buy the majority of the planned bonds at a discount, according to two people with direct knowledge of the discussions. The group wants insurers to back part of the deal at par, said the people, who requested anonymity because the talks are private. Debt sold at a discount produces less cash for the issuer.

Russ Grote, a Washington-based spokesman for the hedge-fund group, declined to comment, as did Ashweeta Durani at Hamilton, Bermuda-based Assured, Kevin Brown at Armonk, New York-based MBIA, and David Millar, a spokesman for the GDB in New York.

Using bond insurance, "is going to lower the coupon payments that Puerto Rico has to make," said Hanson at Height Securities. "It's going to reduce the amount of money that's going to debt service and that's ultimately what people care about."

Units of Assured and MBIA have been in talks with the commonwealth about insuring some of the new debt, according to three people familiar with the discussions.

Discount Signal

Puerto Rico general obligations maturing in July 2035 traded Wednesday at an average of about 81.75 cents on the dollar, according to data compiled by Bloomberg.

Insurers cover about $14 billion of the $72 billion of debt that Puerto Rico and its agencies owe, according to the companies' websites. The island's securities have traded at distressed levels for about two years.

Prepa may not have enough money for a $416 million bond payment it owes July 1. The trustee for the securities told the insurers that debt reserves are short $150 million, according to a person with direct knowledge of the matter who requested anonymity because the talks are private. Insurers cover most of the bonds maturing that day, data compiled by Bloomberg show.

“Multiplying their exposure to the commonwealth and to their agencies may not be in the best interest of their shareholders,” said Phil Fischer, head of municipal research at Bank of America Corp. in New York.

Bloomberg

by Michelle Kaske & Laura J Keller

June 9, 2015 — 9:01 PM PDT Updated on June 10, 2015 — 6:03 AM PDT

Bloomberg Brief: Deal in the Spotlight.

Kate Smith, a reporter at Bloomberg Brief Municipal Market, discusses the Miami-Dade International Airport deal in this week’s Deal in the Spotlight.

Watch the video.

June 11, 2015

Bloomberg Brief Weekly Video - 6/11/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week’s municipal market news.

Watch the video.

June 11, 2015

GASB Proposes Enhanced Guidance on Irrevocable Split-Interest Agreements.

Norwalk, CT, June 12, 2015—The Governmental Accounting Standards Board (GASB) today issued an Exposure Draft proposing recognition and measurement guidance for governments that benefit from irrevocable split-interest agreements.

Irrevocable split-interest agreements are arrangements in which a donor transfers assets for the shared benefit of at least two beneficiaries: a government—typically a public college or university or public healthcare provider—and another beneficiary designated by the donor. The donor transfers the assets to either the government or to a separate third party, such as a bank.

The Exposure Draft, *Accounting and Financial Reporting for Irrevocable Split-Interest Agreements*, addresses when these types of arrangements constitute an asset for accounting and financial reporting purposes in cases where the resources are administered by a third party. The proposal also seeks input on expanded guidance for irrevocable split-interest agreements in which the government holds the assets.

"Irrevocable split-interest agreements can represent a meaningful source of resources for public colleges, universities, and hospitals," said GASB Chairman David A. Vaudt. "The Board believes that the proposed guidance will lead to more consistent accounting for these arrangements, which will make the information users have access to more comparable."

The proposed Statement would require a government that receives resources under an irrevocable split-interest agreement to recognize the assets, as well as a liability related to the other designated beneficiary's portion of those assets and a deferred inflow of resources related to the government's portion of those assets. If the agreement is administered by a third party, a government would recognize an asset for its beneficial interest. Revenue would be recognized when a government receives a disbursement under the agreement.

The full text of the Exposure Draft is available on the GASB website, www.gasb.org. Stakeholders are encouraged to review the proposal and provide comments by September 18, 2015.

GFOA Members Pass Policy Statement on Retirement Security.

Retirement Security

The goal of ensuring that Americans have adequate retirement savings continues to be part of the national conversation. For those who work in the public sector, retirement income may comprise benefits paid from state or local government retirement arrangements (which may include defined benefit plans, defined contribution plans and hybrid plans), personal savings, and in many cases, Social Security benefits.1

Adequate retirement income is essential toward ensuring that employees retire from the workforce with financial security, and that they can continue contributing to the economic well-being of the community in which they live. Optimally, retirement assets will accumulate over the employee's working career to be paid out and/or drawn down during the retirement years.

If retirement benefits are inadequate, individuals may face difficult financial challenges and be forced to rely on their families or taxpayer-funded public assistance programs such as welfare and Medicaid. Public assistance programs, in turn, place operational and financial challenges on the state and local governments that fund and operate them, which may ultimately shift responsibilities to a later generation of taxpayers.

Retirement security is vitally important to the economic viability and growth of this country. The trillions of dollars in assets held and invested by public-sector retirement plans, or by plan participants, will be distributed as retirement income to individuals and as a major source of revenue to businesses, helping stimulate the economy, create jobs, and revitalize communities.2

GFOA Position

GFOA supports government policies and practices that help to achieve the dual goals of individual retirement security and economically viable communities. To further the accomplishment of such goals, these policies should:

1. Preserve the authority of state and local governments to design and maintain public-sector retirement arrangements, regardless of type, that are tailored to the specific needs of the community. These arrangements should:(a) enhance the likelihood that employees will reach their

target level of replacement income to achieve retirement security;
(b) ensure the long-term sustainability of each state and local retirement system; and
(c) be affordable, financially prudent, and meet the sponsor's workforce management goals.
2. Encourage the long-term sustainability of federal programs that help to provide retirement security;
3. Promote workforce education about the importance of adequate income replacement in retirement, which may include workplace retirement plans, personal retirement savings, and Social Security, if applicable; and
4. Discourage laws and regulations that require excessive and unnecessary administrative costs and unfunded mandates on state and local governments and their retirement plans.

1 According to the Social Security Administration, nationwide, about 6.6 million public employees are covered by state or local government retirement plans in lieu of Social Security.

2 Pensionomics 2014: Measuring the Economic Impact of DB Pension Expenditures, the National Institute on Retirement Security, 2014.

Adopted June 2, 2015

U.S. Board of Governors of the Federal Reserve System Proposes Rule to Treat U.S. Municipal Securities as Level 2B High-Quality Liquid Assets Under the Liquidity Coverage Ratio.

On May 21, 2015, the US Board of Governors of the Federal Reserve System issued a proposal adding certain general obligation state and municipal bonds to the range of assets a banking organization may use to satisfy the Liquidity Coverage Ratio requirement. Under the LCR requirement adopted by the federal banking agencies in September 2014, large banking organizations are required to hold High-Quality Liquid Assets that can be easily and quickly converted into cash within 30 days during a period of financial stress. The proposed rule would allow investment grade, general obligation US state and municipal bonds to be counted as HQLA up to certain levels if they meet the same liquidity criteria that currently apply to corporate debt securities. The limits on the amount of a state or municipality's bonds that could qualify are based on the specific liquidity characteristics of the bonds. The proposed rule would apply only to entities subject to the LCR and supervised by the Federal Reserve Board. The deadline for comments on the proposed rule is July 24, 2015.

The proposed rule is available here.

Last Updated: June 8 2015
Article by Shearman & Sterling LLP

Virginia P3 Law Amendments: Good for the Public, Bad for Business?

Virginia, long at the forefront of public-private partnership (P3) legislation, has enacted new measures to protect the public from high-risk projects. On March 6, 2015, the Virginia General Assembly enacted House Bill 1886 (HB 1886), which requires a front-end assessment of project risk and a public interest finding for P3 projects.

The Virginia Public-Private Transportation Act of 1995 (PPTA) provides for the construction and operation of public transportation facilities via contracts with private entities. The purpose of the PPTA is “to encourage investment in the Commonwealth” with “the greatest possible flexibility in contracting with each other for the provision of [such] public services.” A private entity that seeks authorization to develop or operate a transportation facility must obtain approval of the responsible public entity. The responsible public entity may approve such a project if it determines that the project serves the “public purpose” of the PPTA.

HB 1886 adds two key requirements to the PPTA. First, when submitting a request for approval to the public entity, the private entity must state “the risks, liabilities, and responsibilities to be transferred, assigned, or assumed by the private entity for the development and/or operation of the transportation facility, including revenue risk and operations and maintenance.”

Second, before initiating any procurement, the chief executive officer of the responsible public entity must make a finding of public interest. HB 1886 establishes the Transportation Public-Private Partnership Advisory Committee, which is required to make the public interest finding for procurements initiated by the Department of Transportation or the Department of Rail and Public Transportation.

The public interest finding must include a statement of risks, liabilities, and responsibilities, including whether revenue risk will transfer to the private entity and how to mitigate such risks in the P3 agreement, and a description of the risks, liabilities, and responsibilities that the public entity will retain. In addition, the public interest finding must state (1) the expected benefits to the public entity; (2) whether the project delivery risk is low, medium, or high, and if high, how the public’s interest will be protected by transferring the risks or responsibilities to the private entity; and (3) if the public entity proposes competitive negotiation, why this is more beneficial than competitive sealed bidding. And, before entering a P3 contract, the public entity must certify that the risks, liabilities, and responsibilities have not materially changed since the public interest finding.

In accordance with the forgoing requirements, the amended PPTA incorporates a statement of risk into the definition of “public purpose.” Previously, a facility served the “public purpose” if, among other things, there is a public need and the plans are reasonable and efficient. Now, a project serves a public purpose if, in addition to the forgoing, “[t]he risks, liabilities, and responsibilities transferred, assigned, or assumed by the private entity provide sufficient benefits to the public to not proceed with the development and/or operation of the transportation facility through other means of procurement available to the responsible public entity.”

As enacted, HB 1886 may place a heavy burden on contractors seeking work in the Commonwealth. The bill therefore has the potential to stifle private investment and make Virginia less competitive with the 33 other states that have now enacted P3 legislation. We will continue to monitor the impact of this legislation.

Last Updated: June 4 2015

Article by Amy Elizabeth Garber

Bradley Arant Boult Cummings LLP

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

GASB Improves Reporting for Health Insurance and Other Retiree Benefits.

Norwalk, CT, June 2, 2015—The Governmental Accounting Standards Board (GASB) today voted unanimously to approve two Statements that will significantly improve the accounting and financial reporting by state and local governments for postemployment benefits other than pensions (OPEB), primarily retiree health insurance. The GASB also approved a third Statement establishing accounting and financial reporting requirements for pensions and pension plans that were outside the scope of the pension standards the GASB released in 2012.

The OPEB Statements

GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, addresses reporting by OPEB plans that administer benefits on behalf of governments. GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, addresses reporting by governments that provide OPEB to their employees and for governments that finance OPEB for employees of other governments.

The new OPEB standards parallel the pension standards issued in 2012—GASB Statement No. 67, *Financial Reporting for Pension Plans*, and GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*. Together, the pension and OPEB standards provide consistent and comprehensive guidance for all postemployment benefits.

“These OPEB standards usher in the same fundamental improvements in accounting and financial reporting that were previously introduced for pensions,” said GASB Chairman David A. Vaudt. “Because OPEB promises represent a very significant liability for many state and local governments, it is critical that taxpayers, policy makers, bond analysts, and others are equipped with enhanced information, which will enable them to better assess the related financial obligations and annual costs of providing OPEB.”

Statement 75

- Statement 75 replaces the requirements of GASB Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions. Statement 75 requires governments to report a liability on the face of the financial statements for the OPEB that they provide:
- Governments that are responsible only for OPEB liabilities related to their own employees and that provide OPEB through a defined benefit OPEB plan administered through a trust that meets specified criteria will report a net OPEB liability—the difference between the total OPEB liability and assets accumulated in the trust and restricted to making benefit payments.
- Governments that participate in a cost-sharing OPEB plan that is administered through a trust that meets the specified criteria will report a liability equal to their proportionate share of the collective OPEB liability for all entities participating in the cost-sharing plan.
- Governments that do not provide OPEB through a trust that meets specified criteria will report the total OPEB liability related to their employees.

Statement 75 carries forward from Statement 45 the option to use a specified alternative measurement method in place of an actuarial valuation for purposes of determining the total OPEB liability for benefits provided through OPEB plans in which there are fewer than 100 plan members (active and inactive). This option was retained in order to reduce costs for smaller governments.

Statement 75 requires governments in all types of OPEB plans to present more extensive note disclosures and required supplementary information (RSI) about their OPEB liabilities. Among the new note disclosures is a description of the effect on the reported OPEB liability of using a discount rate and a healthcare cost trend rate that are one percentage point higher and one percentage point lower than assumed by the government. The new RSI includes a schedule showing the causes of increases and decreases in the OPEB liability and a schedule comparing a government’s actual OPEB contributions to its contribution requirements.

Some governments are legally responsible to make contributions directly to an OPEB plan or make benefit payments directly as OPEB comes due for employees of other governments. In certain circumstances—called special funding situations—Statement 75 requires these governments to recognize in their financial statements a share of the other government’s net OPEB liability.

Statement 74

Statement 74 replaces GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. Statement 74 addresses the financial reports of defined benefit OPEB plans that are administered through trusts that meet specified criteria. The Statement follows the framework for financial reporting of defined benefit OPEB plans in Statement 45 by requiring a statement of fiduciary net position and a statement of changes in fiduciary net position. The Statement requires more extensive note disclosures and RSI related to the measurement of the OPEB liabilities for which assets have been accumulated, including information about the annual money-weighted rates of return on plan investments. Statement 74 also sets forth note disclosure requirements for defined contribution OPEB plans.

The Pension Statement

GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, completes the suite of pension standards. Statement 73 establishes requirements for those pensions and pension plans that are not administered through a trust meeting specified criteria (in other words, those not covered by Statements 67 and 68). The requirements in Statement 73 for reporting pensions generally are the same as in Statement 68. However, the lack of a pension plan that is administered through a trust that meets specified criteria is reflected in the measurements.

Effective Dates

The provisions in Statement 73 are effective for fiscal years beginning after June 15, 2015—except those provisions that address employers and governmental nonemployer contributing entities for pensions that are not within the scope of Statement 68, which are effective for financial statements for fiscal years beginning after June 15, 2016. The provisions in Statement 74 are effective for financial statements for fiscal years beginning after June 15, 2016. The provisions in Statement 75 are effective for fiscal years beginning after June 15, 2017. Earlier application is encouraged.

Availability of the Statements

Statements 73, 74, and 75 will be available for download at no charge from the GASB website in late June. Printed copies of the Statements will be available for purchase soon after. Other related resources also will be available on the website at that time.

Late State Budgets: Summer Cliffhangers No One Wants to See.

The arrival of June means that 46 states are now in their final month of fiscal 2015. Although a majority of them still have not finalized their budgets for fiscal 2016, Standard & Poor's Ratings Services expects that most will do so before month-end. A handful of states, however, continue to grapple with large projected budget gaps or still have major policy issues to resolve. This doesn't necessarily mean these states won't have budgets in hand by the start of the new fiscal year. But the significance of what remains unresolved does raise the specter that in at least a few of them, budget adoption could be late.

When states have difficulty reaching agreement on final budgets, it's usually because they face large projected budget deficits and lawmakers are stymied over how to close them. Negotiations are especially prone to go into stalemate in states with divided government, where opposing political parties control different legislative houses or branches of government. The lead-up to fiscal 2016 is no exception, although in our view, the projected shortfalls this time are rooted in public policy differences more than economic weakness. Divergent preferences among lawmakers on major public policy matters, such as whether to expand Medicaid or how to revamp their state's tax structure, have resulted in protracted negotiations in some legislatures. Given the importance of these issues, the stakes are high, which in our view sometimes warrants allowing the discussion to play out. And as long as debt payments are not impaired in the process, states are not always worse off for the wait.

Most of the time, however, the failure of a state to enact its budget prior to the start of the fiscal year amounts to a breaking down of the fiscal policymaking process. And while an extended legislative session can sometimes result in substantive policy reforms being undertaken, it also can be a time when states resort to the use of budgetary gimmicks. The latter usually undermine, not support, a state's structural fiscal alignment. In the extreme, late budgets or a heavy reliance on budgetary gimmicks represent a legislature's abdication of one of its most basic functions. Few activities are as fundamental to governance as that of enacting the annual (or biannual) plan for allocating a state's financial resources to its various needs. And yet, while late budget enactment is rarely a good sign, it's not necessarily an immediate threat to credit quality either.

Continue reading.

04-Jun-2015

S&P's Public Finance Podcast (California's Rating And Detroit's Public Schools).

In this week's Extra Credit, Managing Director Gabe Petek talks about the current rating on California and Associate Director John Sauter discusses what's behind our ratings on Detroit Public Schools.

Listen to the Podcast.

Jun 04, 2015

Municipal Issuer Brief: Difficult May Ends on a Positive Note.

Read the Brief.

Municipal Market Analytics | Jun. 1

Virginia Discovers P3 Projects Might Not Always Save Money.

Since Virginia passed a law 20 years ago authorizing public-private partnerships in the state, it’s been a model for other states interested in tapping private businesses to help deliver state services. Virginia officials frequently testify on Capitol Hill or at international conferences about their efforts.

Both Democratic and Republican governors have used the partnerships in Virginia. The most well-known examples are toll roads and tolled lanes on highways in the Washington, D.C., suburbs.

So it was significant when Aubrey Layne, Virginia’s transportation secretary, suggested recently that Virginia may be able to save taxpayer money by financing a $2.1 billion interstate widening project itself, rather than relying on a public-private partnership (P3) to finance, design and build the project.

“Heretofore, what the commonwealth did, is say ‘We want to do a P3,’” Layne explained. Agencies would then produce reports showing how much risk the state avoided by having a private company, rather than the state, build the project, he said. “That’s always going to lead to a P3 being a better solution. I wasn’t convinced that was the case.”

The closer scrutiny for the highway project came after legislators passed a law this spring to add safeguards for the state and provide more disclosures to the public before Virginia enters into public-private partnerships. Gov. Terry McAuliffe, a Democrat, pushed for the law with the support of Republican legislators in the wake of bad publicity for the deals.

The most significant controversy involved a proposed 55-mile toll road linking the Norfolk area to Interstate 95, a major commercial corridor along the East Coast. The project started as a P3 but morphed into a more conventional contract, albeit one shrouded in the type of secrecy that had been afforded to those public-private deals.

The state hired a private contractor to design and build the new road but, crucially, assumed the risk in case the necessary permits did not come through. A federal environmental review found that the highway would disturb far more wetlands than originally anticipated, significantly raising the cost of the project and delaying it.

McAuliffe halted the project last year, but the state had already paid the contractor nearly $290 million before construction ever started. The state cancelled its contract with the original vendor and is currently considering a scaled-back version of the project.

Commuters in the Norfolk area are also upset that they had to start paying tolls to use a tunnel that has been free for decades, in order to help a private consortium help pay for the construction of a new, parallel tunnel that is not yet open. (It's no coincidence the chief sponsor of the new law governing public-private partnerships is from the area.)

Another reason for the heightened scrutiny, though, is simply a change in administrations. New Virginia governors, like McAuliffe, who took office early last year, have often reviewed the state's partnerships and offered their own changes, said Jonathan Gifford, the director of a George Mason University program that studies P3s in transportation.

"The state is obviously taking a hard look at this P3 model," he said. "That's what states are supposed to do. This is not designed to be a giveaway to private concessionaires. The only time you want to go forward with these is when they are going to add value to what the state would be able to do on its own."

Layne, the transportation secretary, stressed that Virginia may still end up using a public-private partnership for the Interstate 66 expansion, as well as for other projects. But he claimed the state could save as much as $1 billion over the next 40 years by financing the deal itself, rather than relying on a private operator. The savings would come from cheaper borrowing costs and by collecting tolls that would otherwise go to a private company.

"Virginia is AAA-rated, so no private party, particularly those looking for return on their equity, can finance a project any cheaper than the commonwealth of Virginia," he said.

The cost of financing is key in Layne's analysis. The state could still reap many of the benefits of a P3 by simply hiring companies to design, build or operate the new facilities, he said.

The transportation secretary also stressed that, compared to other types of projects, there are relatively few risks involved in widening a highway. The public-private partnership in Hampton Roads, which is building a new highway tunnel, is more complicated because of engineering and environmental factors.

"But in this particular case, we're adding a lane or two on an existing interstate. We do that all across the commonwealth," he said.

Even the uncertainty of how drivers will react to tolling is not as great a factor as it might have been a few years ago, because the state can see how recently opened toll lanes in the region have fared, Layne said.

Robert Chase, the executive director of the Northern Virginia Transportation Alliance, supported the administration's cost-conscious approach, but he said the state should release its full analysis on the projected costs, rather than just the conclusions of that analysis.

The public and potential vendors do not know, for example, whether the cost of maintenance is included in the projected costs for both scenarios, or what happens if the state finances the road and toll revenues fall short. The anticipated breakdown of anticipated federal, state and regional funding sources also wasn't provided, even though that could affect the state's debt limit or the amount of money available for other projects in the region, Chase said.

Chase said that the state needs to be more transparent. The McAuliffe administration wants vendors to disclose more about their deals, but the vendors should also know how the state is planning on structuring its own finance deal, so they can offer a suitable alternative.

Chase agreed, though, that the state should provide more funding than it has in other area toll projects, if it does a public-private partnership, because that could keep tolls lower.

“If you’re spending billions of dollars to add new capacity but the pricing structure discourages people from using it,” he said, “you’re not getting your money’s worth out of the project.”

Governing.com

Daniel C. Vock | Staff Writer

June 3, 2015

Accounting Rule to Force U.S. Cities to Report Health-Care Bills.

U.S. state and local governments will have to report billions of dollars in health-care liabilities on their balance sheets under an accounting change aimed at improving disclosure of retiree benefits.

As a result of rules approved Tuesday by the Governmental Accounting Standards Board, municipalities and states will have to record the cost of health insurance and other benefits besides pensions in financial statements, the board said in a statement. Such costs are currently disclosed only in footnotes.

The change is part of a push by the accounting-standards setter to improve how governments report the cost of worker benefits that they haven’t set aside enough money to pay. Similar requirements started taking effect for pensions last year.

States alone have $529.8 billion of unfunded liabilities for health care and other benefits besides retirement checks, according to November 2014 report by Standard & Poor’s, the New York-based bond rating company.

The shift that was approved unanimously will “significantly improve” disclosure of the promised benefits, the board said.

Reporting the liability promises to “represent a very significant liability for many state and local governments,” said David Vaudt, chairman of the board, in the release. “It is critical that taxpayers, policy makers, bond analysts and others are equipped with enhanced information.”

The rule is set to take effect for the years starting after June 15, 2016.

Bloomberg

by Darrell Preston

June 2, 2015 — 2:32 PM PDT

Bloomberg Brief Weekly Video - 6/4/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week’s municipal market news. (Source: Bloomberg)

Watch the video.

2:46 PM PDT
June 4, 2015

Puerto Rico's $72 Billion Mess Reunites Lehman Foes.

Some of the same distressed-debt buyers that started battling seven years ago over the remains of Lehman Brothers Holdings Inc. are now girding for a rematch over the U.S. territory's $72 billion of debt. That's likely to pit investors such as Fir Tree Partners — among firms that snapped up $4.5 billion of bonds the island has to pay before other obligations — against creditors including Angelo Gordon & Co. and Knighthead Capital Management. Those firms are part of a group that owns a majority of the more than $8 billion of borrowings by the U.S. territory's power agency.

The conflict is heating up after the Puerto Rico Electric Power Authority, known as Prepa, met with the financial adviser to its creditors Monday to restart talks toward a restructuring that may ask bondholders to take a loss or wait longer to be repaid. Hedge funds now hold as much as 30 percent of the obligations of Puerto Rico and its agencies, Barclays Plc municipal-debt strategist Mikhail Foux estimates.

"It's extremely disorderly and nasty," said Joseph Rosenblum, director of municipal-credit research at AllianceBernstein Holding LP. This "messy approach to trying to resolve something with no clear structure or guidance doesn't give a bondholder any kind of confidence," he said.

Few Opportunities

The reason so much hedge-fund money is riding on the island is simple: an increasing number of distressed-debt funds are chasing a declining number of opportunities. Little wreckage remains from the 2008 financial crisis, and six years of central-bank stimulus has kept tomorrow's bankrupt companies flush with cash.

Two of the biggest borrowers that teetered after the financial crisis, Energy Future Holdings Corp., the Texas power producer formerly known as TXU Corp., and the main operating unit of Caesars Entertainment Corp., are now in the hands of bankruptcy judges.

The face value of bonds in Bank of America Merrill Lynch's U.S. Distressed High Yield Index of corporate securities has declined to $104.6 billion from as high as $644.1 billion at the height of the 2008 financial crisis.

New Funds

At the same time, hedge-fund managers began trading in 24 new distressed-credit funds last year, the highest number since 2010, according to data provider Preqin. Five have started this year, with total assets growing to $150.3 billion.

"There are not any obvious large distressed situations, such as a Caesars or a Lehman Brothers or TXU, coming down the pike," said Stephen Ketchum, chief executive officer of the $6.5 billion hedge-fund firm Sound Point Capital Management, among investors in the island. "We were comparing Puerto Rico to some of the worst sovereign-debt situations in history and it just didn't make sense to us, especially since Puerto Rico is a U.S. territory."

Prices on Puerto Rico's general-obligation bonds plunged to as low as 55 cents on the dollar last

July, data compiled by Bloomberg show. They've since rebounded to about 68 cents. Bonds sold by Prepa reached 33 cents a year ago, and have since climbed to 56.

Offering a Chance

While the hedge funds are teeing up for a fight, their money is giving the territory a chance at getting out of its mess as traditional buyers like mutual funds flee.

"The capital from the distressed funds has given the current government at least a chance to enact the agenda and balance the budget in the short term," said Aaron Rosen, a principal at Archview Investment Group, a Stamford, Connecticut-based hedge-fund that manages about $900 million and invests in some smaller Puerto Rico agencies.

Each of the funds is wagering in one way or another that Puerto Rico and its public agencies can raise revenue and cut costs before the Government Development Bank, lender to the commonwealth and municipalities, runs through its cash.

Angelo Gordon, Knighthead, D.E. Shaw & Co. and units of Goldman Sachs Group Inc. are among 11 firms that agreed to delay a default on nearly $5 billion of Prepa's debt until Thursday. In a restructuring plan presented to creditors Monday, the power agency said it can't support its debt service through existing cash flow and recommended at least $2.3 billion of investment to modernize operations and restore its finances.

Bondholders said the proposal is a basis for further talks, while calling some aspects "unworkable."

'Constructive Solution'

"While elements of the plan were positive from our perspective, there were also aspects that were unworkable and will require further negotiation," Stephen Spencer, a managing director at adviser Houlihan Lokey, said in an e-mailed statement.

Knighthead's Tom Wagner said in a statement that the firm continues to "believe that a constructive solution can be found that will result in Prepa receiving the capital funding needed to modernize its infrastructure" in a way that provides "more reliable service to consumers."

Representatives for Angelo Gordon, D.E. Shaw and Goldman Sachs declined to comment.

Familiar Foes

During Lehman's bankruptcy, Angelo Gordon, Knighthead, D.E. Shaw and Goldman were among investors that railed against a restructuring plan advocated by a group of creditors led in part by Fir Tree and Canyon Capital Partners, court records show.

Fir Tree, the New York-based investment firm founded by Jeffrey Tannenbaum, aligned with Monarch Alternative Capital and Stone Lion Capital Partners in other parts of the Lehman bankruptcy, the records show.

Fir Tree is now helping to lead a group of 35 firms that mostly own general obligation bonds. That also includes Monarch and Stone Lion. Canyon is also in the group, according to two people with knowledge of the matter.

Representatives for Monarch and Stone Lion didn't respond to telephone and e-mail messages. Spokesmen for Canyon and Fir Tree declined to comment.

If the commonwealth can’t come to an agreement with that group on a planned sale of $2.9 billion of new debt backed by oil taxes, the GDB will run out of money by Sept. 30, according to the commonwealth’s latest quarterly filing on May 7.

“We just blew the whistle of the first quarter of what will be a full game in Puerto Rico,” Michael Lipsky, a partner at MatlinPatterson Global Advisers, said in an interview at his New York office. Matlin, which manages $7.2 billion, is invested across Puerto Rico debt, Lipsky said. “The cadence will quicken.”

Bloomberg

by Laura J Keller

June 1, 2015 — 9:00 PM PDT Updated on June 3, 2015 — 3:36 PM PDT

Deals Gone Bad Push Muni Borrowers to Dump Interest-Rate Hedges.

With borrowing costs about to rise, why are U.S. municipal-bond issuers paying to dump interest-rate hedges?
Because they’re hoping to avoid the fate of Chicago, by simplifying their finances and controlling the timing of when they unwind floating-rate bond deals. Last month, the city tried to refinance debt tied to derivatives that went awry while it still had investment grades from the three biggest rating companies. Moody’s Investors Service cut Chicago to junk before it could sell the securities, driving up borrowing costs.

Issuers in the $3.6 trillion municipal market are finding that exiting the hedges now, even with the Federal Reserve poised to raise rates, beats having to pay them off in an unknown future. The money to end the interest-rate swaps is going to banks including Goldman Sachs Group Inc. and Morgan Stanley — many of the same Wall Street firms that got the governments into the deals in the first place.

“This is the worst possible time to voluntarily pay to terminate swaps,” said Saqib Bhatti, a fellow with the New York-based Roosevelt Institute, which advocates for municipal-finance reforms. “You’re subjecting taxpayers to additional fees and payments.”

Happy Banks

Even so, the authority that financed the stadium for the National Football League’s Indianapolis Colts paid Goldman Sachs $71 million last month to get out of a swap. Agencies in Pittsburgh and Denver are also exiting swaps on their own timetables. A Denver-area highway authority is bringing a deal next month that will allow it to partially end swaps with Morgan Stanley.

Michael DuVally, a spokesman for Goldman Sachs in New York, and Lauren Bellmare at New York-based Morgan Stanley declined to comment.

The swaps are wagers on the direction of borrowing costs. Banks sold them as a way to save on bond sales, but the bets went wrong for many issuers when the Fed cut rates starting in 2007. With the Fed’s benchmark near zero since 2008, the rates that municipalities typically receive on the swaps have been close to that level.

Cities, states and localities have spent at least $5 billion to end interest-rate swaps since 2008, according to data compiled by Bloomberg.

“I’m sure the banks are happy,” said Andrew Kalotay, chief executive officer of a New York-based advisory firm to municipal and corporate borrowers.

Chicago Surprise

Governments with swaps want to avoid the fate of Chicago, which refinanced after getting cut to junk, said Matt Fabian, partner at Concord, Massachusetts-based Municipal Market Analytics Inc.

Swaps contracts usually stipulate that banks can demand termination payments if issuers’ ratings fall below specified levels. Chicago’s downgrade put it in a position where banks could’ve forced it to make payments. It wound up paying $200 million to end swaps as part of the refinancings.

The case of Chicago “doesn’t exactly encourage issuers to keep large swap portfolios,” Fabian said.

Deutsche Bank and Wells Fargo & Co. are among counterparties with which Chicago terminated swaps, according to city documents. Gabriel Boehmer, a spokesman for San Francisco-based Wells Fargo, didn’t have an immediate comment. Amanda Williams at Deutsche in New York declined to comment.

Mayor Rahm Emanuel has focused on “ending the unsustainable financial practices of the past,” Carole Brown, Chicago’s chief financial officer, said in a statement. His plan “would continue putting Chicago’s fiscal house in order -- including addressing the city’s highly leveraged legacy debt portfolio.”

Swaps inflate the expense of exiting variable-rate debt, so issuers have to calculate the total cost of refinancing, Kalotay said.

“You pay a substantial penalty, but going forward you’re going to pay a lower interest rate,” he said. “Or if you wait for rates to go high enough, you could get paid on the swap, but then the cost of refinancing the bonds is higher.”

Same Debt

The Indiana agency that financed Lucas Oil Stadium paid Goldman Sachs in May as part of a bond offering to end a swap. The sale by the Indiana Finance Authority saved money by refinancing floating-rate-bond and derivative deals put in place in 2005 and 2007, according to CFO Dan Huge.

The authority is paying the same in debt service but eliminated the risk it would have to unexpectedly cancel the swap because of an event such as the downgrade of a party in the deal, Huge said.
“We used the interest-rate savings to terminate the swap,” he said. “It was a wash.”

Next month, the E-470 Public Highway Authority, which runs a toll road outside Denver, plans to pay $4 million to partially terminate a swap with Morgan Stanley as part of canceling and converting variable-rate debt sold in 2007, said CFO Stan Koniz.

“The thinking was, ‘We got the money, let’s get rid of it,’” Koniz said. “Is there ever really a good time to terminate a swap?”

Tangled Mess

Pittsburgh's Water and Sewer Authority has "done some unwinding where it is in our best financial interest," said Paul Leger, the city's debt director, who also sits on the utility's board. The city itself has no swaps.

"But in general, because of the cost-of-buyout provision, we're not looking to unwind them," Leger said. "Our water and sewer system has the most tangled mess of swaps and debt that I've ever seen. It's a no-way-out swap."

Issuers should negotiate lower termination costs, said Bhatti at the Roosevelt Institute. He cited the example of Detroit, where a judge forced the bankrupt city and banks to negotiate smaller payments.

"It's good that issuers are finally admitting these deals are bad," Bhatti said.

Bloomberg

by Darrell Preston

June 4, 2015 — 9:01 PM PDT Updated on June 5, 2015 — 7:21 AM PDT

Bloomberg Brief: Deal in the Spotlight.

Taylor Riggs, an editor at Bloomberg Brief Municipal Market, discusses the Pike Place Market bonds in this week's Deal in the Spotlight. (Source: Bloomberg)

Watch the video.

June 4, 2015

Government Retiree Costs to Be Put in the Spotlight.

State and local governments will have to add hundreds of billions of dollars in retiree obligations to their books under rules enacted Tuesday that spotlight the growing costs of health insurance and other benefits owed to former municipal employees.

The new rules approved unanimously by the Governmental Accounting Standards Board, which sets accounting rules for states and municipalities, will require governments to carry their unfunded retiree-benefit obligations on their balance sheets—thus making their overall financial position look worse. Currently, governments are required only to disclose the benefit costs in the footnotes to their financial statements.

In addition, governments will have to use more conservative interest-rate assumptions in calculating the value of benefit obligations that they haven't funded. That could increase the current value of the obligations, thus worsening the plans' funding shortfalls.

The changes are intended to provide more information to taxpayers, policy makers and municipal-bond analysts, GASB Chairman David Vaudt said in a statement. The rules won't require governments to commit more money to pay for retiree benefits, nor do they require any changes in the level of benefits provided to retirees. But by making benefit costs more visible, the changes could prompt more governments to take action to address rising benefit costs.

"I think we would expect to see ongoing efforts by governments to control these costs," Moody's Investors Service analyst Marcia Van Wagner said.

The rising costs of retiree benefits have plagued state and local governments and have played a role in the bankruptcies of cities like Detroit. According to Moody's, state governments alone had $454 billion in unfunded retiree-benefit liabilities for 2013, the most recent data available.

"These costs have been rising pretty significantly, and it's a cost states want to control," Ms. Van Wagner said.

GASB's new rules, which were first proposed in May 2014, will take effect in mid-2016 for benefit plans and in mid-2017 for governments themselves. They parallel similar changes that GASB enacted in 2012 regarding state and local governments' disclosure of their pension obligations.

THE WALL STREET JOURNAL

By MICHAEL RAPOPORT

Updated June 2, 2015 5:37 p.m. ET

Write to Michael Rapoport at Michael.Rapoport@wsj.com

GFOA: GASB Makes Significant Adjustments to Its Technical Agenda.

In late April the Governmental Accounting Standards Board (GASB) made two significant adjustments to its technical agenda. First, the Board removed from its current agenda a controversial project on financial projections. Second, Board members added new projects on going-concern and enhanced debt disclosure.

The GASB issued its preliminary views (PV) on Economic Condition Reporting: Financial Indicators, in November 2011. In the PV, the GASB proposed to mandate the presentation of five-year projections of: 1) inflows and outflows of cash and cash equivalents; 2) opening and closing balances of cash and cash equivalents, and 3) financial obligations as required supplementary information (RSI). It also proposed that governments be required to provide a narrative discussion of intergovernmental service dependencies (that is, how changes in the level of services provided by another government could have an impact on the government's own cost or the level of services provided). Many of the GASB's constituents, including the GFOA, vigorously objected to the proposal, questioning both the usefulness of the information and whether the presentation of future projections fell within the scope of the GASB's mandate as an accounting and financial reporting standard-setting body. The GASB's decision to remove the project from its current agenda would appear to be, to some degree, a response to those concerns. The GASB has taken no further action on the project since 2012.

Accounting and financial reporting presume that an entity will "stay in business." This going concern assumption potentially affects the valuation of assets and liabilities, as well as the reporting of deferred inflows and outflows of resources. Of course, governments, unlike private-sector enterprises, rarely "go out of business." That does not mean, however, that the going concern concept does not have relevance to state and local governments facing severe fiscal stress.

Accordingly, the GASB has added a project to its technical agenda to assess whether governments have sufficient guidance to appropriately evaluate and disclose uncertainties associated with severe fiscal stress.

Finally, state and local governments increasingly are using direct bank loans to replace bonds in many situations. The GASB plans to consider the adequacy of disclosures for such direct borrowings.

Wednesday, June 3, 2015

GASB: What You Need to Know about Local Government Investment Pools.

In June, the GASB plans to issue proposed guidance on local government investment pools operated by governments (also known as external investment pools). This proposal is intended to address rule changes recently adopted by the Securities and Exchange Commission (SEC) that will impact the related financial reporting requirements.

Local government investment pools function much like money market funds. Typically, government investment funds pool the resources of participating governments and invest in various securities as permitted under state law. By pooling their cash together, participating governments benefit in a variety of ways, including from economies of scale and professional fund management.

Under GASB Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools, as amended, governments are allowed to use an amortized cost basis for reporting their pool investments if the funds operate like SEC-regulated money market funds under SEC Rule 2a7. Likewise, governments that participate in pools report their shares at amortized cost. Using the amortized cost basis reflects the cost of the investment plus or minus adjustments made for the premiums and discounts associated with the purchase price of the underlying investments in the pool.

To qualify for amortized cost reporting under existing accounting standards, an investment pool has to meet the basic requirements of Rule 2a7, except for the requirement to file with the SEC—referred to a being “2a7-like.” However, under the SEC’s new rules, which take effect in 2016, many government pools are not expected to qualify for amortized cost reporting and would have to report their investments at fair value. This would have a significant impact on local governments.

After weighing its options—which included taking no action at all—the GASB decided to develop criteria to replace the 2a7-like guidance provided in Statement 31, as amended. The GASB is in the process of finalizing proposed guidance that would address issues raised by the SEC’s new rules. The guidance will be exposed for public comment in June. The proposal will seek input on what criteria should be in place for a pool to report at amortized cost.

We encourage you to follow our progress on this project at www.gasb.org.

As always, your input is critical to helping us develop high-quality standards. We encourage you to follow our progress on this project at www.gasb.org, and to review and provide comment on the Exposure Draft when it is issued.

More information on the project can be found here.

GASB On the Horizon: Business-Type Activity Governments.

In the months ahead, the GASB will issue three proposals intended to improve key areas of financial reporting for governments that engage in business-type activities (BTA). Unlike general purpose governments, which perform a variety of services supported by tax revenues, BTA governments are primarily focused on providing fee-based services. Examples of BTA governments include public colleges and universities, hospitals, water and wastewater systems, and public electric utilities. The projects contemplate guidance for BTA government reporting in three key areas:

- Split-interest agreements
- Blending requirements
- Asset retirement obligations.

SPLIT-INTEREST AGREEMENTS

The GASB in June will issue an Exposure Draft seeking comment on potential accounting and financial reporting guidance for split-interest agreements held by a third party for the benefit of a BTA government. These agreements are sometimes referred to as irrevocable charitable trusts.

Split-interest agreements are arrangements in which a donor transfers assets for the shared benefit of a government and the donor (or another party). The structure of these agreements can vary widely. In some cases, the donor transfers the assets directly to the government that will benefit from the agreement; in others, the donor transfers the assets to a third party, such as a bank.

The project addresses whether split-interest agreements of this type constitute an asset and, if so, whether the government should recognize an asset and related revenue when the resources are held by a third party. The proposal also will seek feedback on when revenue related to split-interest agreements should be recognized when the government holds the assets.

More information on the project can be found here.

BLENDING REQUIREMENTS FOR CERTAIN COMPONENT UNITS

Also in June, the GASB will issue an Exposure Draft addressing diversity in practice regarding the manner in which governments, primarily healthcare and higher education, present some of their legally separate component units. An example of the type of component unit addressed by this proposal would be legally separate healthcare facilities.

Under existing standards, these component units would be presented discretely—in a separate column—in a primary government's financial statements. The GASB will instead propose blending a component unit within the primary government if the component unit is incorporated as a not-fo--profit corporation for which the primary government is the sole corporate member.

More information on the project can be found here.

ASSET RETIREMENT OBLIGATIONS OTHER THAN LANDFILLS

In December, the GASB expects to issue an Exposure Draft containing proposed standards on asset retirement obligations (AROs) involving power plants, sewage treatment facilities, and other capital assets other than landfills. Specifically, this project seeks to provide recognition and measurement guidance that does not exist at present for these types of governmental capital assets, which would improve the comparability of financial reporting in this area.

The most common AROs encountered by governments involve landfill closure and post-closure care for decommissioned power plants, including nuclear facilities. The guidance for recognizing, measuring, and reporting AROs for landfills is provided in GASB Statement No. 18, Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs. However, Statement 18 does not apply to the retirement of other capital assets.

More information on the project can be found [here.]

[NYC Housing Development Corporation To Introduce Sustainable Neighborhood Bonds.]

NEW YORK, N.Y. – May 29, 2015 – (RealEstateRama) — Subject to Board approval, the New York City Housing Development Corporation (HDC) expects to price its inaugural Sustainable Neighborhood Bonds transaction under its Multi-Family Housing Revenue Bonds program during the week of June 15, 2015. Building upon the strength of the municipal market in Green Bonds and the growing interest in socially targeted investing, HDC is creating a new category of bonds to finance socially beneficial projects, specifically the new construction and preservation of affordable housing projects that contribute to the stability and economic diversity of neighborhoods across New York City. This is the first social bond for affordable housing in the United States.

HDC, the nation's largest local Housing Finance Agency and the leading issuer of mortgage revenue bonds for affordable multi-family housing, is working closely with the New York City Department of Housing Preservation and Development (HPD) to implement Mayor Bill de Blasio's Housing New York: A Five-Borough, 10-Year Housing Plan. Its latest innovation, Sustainable Neighborhood Bonds, will advance the plan's goals of creating and preserving 200,000 affordable units for low and middle income New Yorkers, while fostering thriving and diverse neighborhoods.

"Neighborhoods have been and will continue to be at the forefront as we implement Housing New York," said HDC President Gary Rodney. "HDC has long been a leader in pioneering innovative new financial strategies to meet our affordable housing goals, and Sustainable Neighborhood Bonds are a clear progression of our work. Looking to leverage the growing market for targeted social investment, we wanted to create a new category of bonds to finance safe, quality affordable housing that adds value to New York City's neighborhoods and fosters the economic diversity that is a hallmark of a great city."

"Housing is a catalyst for jobs, retail, transit, parks, schools, and all the services and opportunities that neighborhoods need to thrive," said HDC Chair and HPD Commissioner Vicki Been. "Sustainable Neighborhood Bonds are emblematic of the goals of Housing New York, which seeks not only to finance the construction and preservation of 200,000 safe, quality, affordable homes, but to foster thriving and diverse neighborhoods. I congratulate HDC President Gary Rodney and his talented team on this innovation, which will work in tandem with the City's more comprehensive and holistic approach to neighborhood planning."

This June, HDC will designate its first series of bonds as "Sustainable Neighborhood Bonds," a category that will allow investors to invest directly in bonds that finance the new construction and preservation of affordable housing projects in New York City, stimulating economic growth and revitalizing neighborhoods. These multi-family housing developments receive financing from HDC through a variety of subsidy programs, including its Extremely Low and Low-Income Affordability Program, Preservation Program, Mitchell-Lama Restructuring Program, and Mixed, Middle and Moderate Income Programs. Certain developments financed with Sustainable Neighborhood Bonds will also receive allocations of federal low income housing tax credits (“LIHTC”), which may generate additional sources of financing for the construction or rehabilitation of those affordable housing projects.

In addition to the affordability and holistic community development components, Sustainable Neighborhood Bonds will also address environmental benefits. The majority of projects that receive funding from HDC are required to comply with Enterprise Green Communities Criteria, the only comprehensive green building framework designed for affordable housing. This uniform green building policy provides proven, cost-effective standards for creating healthy and energy-efficient homes, and helps to ensure that the City’s investment in affordable housing goes towards buildings that achieve deeper affordability through lowered utility bills and healthier living environments. Administered through Enterprise Community Partners, Inc., many of the developments financed with Sustainable Neighborhood Bonds have applied for and will receive this Enterprise Green Communities certification.

Judi Kende, Vice President and New York Market Leader for Enterprise Community Partners, Inc., applauded this announcement by HDC as a major step forward for the affordable housing industry. “Enterprise has worked for many years with our partners in government and in the affordable housing development field to promote socially responsible approaches to housing that are both affordable and sustainable,” said Ms. Kende. “HDC has again demonstrated New York City’s commitment to innovative financing strategies which not only create and preserve affordable units but which empower communities and improve lives.”

The banking industry has also been quick to take notice and voice its support. “What HDC is unveiling is a game-changer in the municipal housing bond market and we hope that housing finance agencies around the country will also apply this ground-breaking and replicable formula,” said Geoff Proulx, Executive Director of Fixed Income and Commodities at Morgan Stanley. Paul Palmeri, Managing Director and Head of Public Finance at J.P. Morgan also commends “HDC’s unwavering commitment to and market leadership in the affordable housing sector, exemplified by its mission to create and preserve affordable housing and diverse neighborhoods for low and moderate income New Yorkers through the issuance of Sustainable Neighborhood Bonds.”

The first such social bonds for affordable housing in the United States, Sustainable Neighborhood Bonds are a continuation of HDC and the City’s work to extend affordability to low and middle income New Yorkers through the Housing New York plan. The plan commits to using housing as a catalyst for developing diverse and livable neighborhoods, and the City’s latest ten year capital plan includes more than $1 billion in capital funding for infrastructure investment to unlock new housing opportunities and ensure holistic and comprehensive neighborhood planning.

The Preliminary Official Statement describing the Sustainable Neighborhood Bonds transaction in detail will become available shortly after HDC’s Board Meeting, currently scheduled for Monday, June 8. HDC expects to price approximately $680 million in these bonds on or about June 15th.

Sustainable Neighborhood Bonds provide yet another important tool to support the administration’s vision of a more sustainable, equitable New York. The goals laid out in One City: Built to Last and One New York: The Plan for a Strong and Just City together present Mayor de Blasio’s comprehensive plan for a sustainable and resilient city. To meet these goals, HDC also recently launched its new Green Housing Preservation Program with HPD. This program will assist owners of small- to mid-sized multifamily properties across the city in undertaking energy efficiency and water conservation improvements as well as moderate rehabilitation to improve building conditions, reduce greenhouse gas (GHG) emissions, and preserve affordability.

Despite Bond-Selling Spree, Cities, States Spending Less on Infrastructure.

An Amtrak train that derailed earlier this month resulting in the death of eight people and the injury of more than 200, sparked a debate on declining infrastructure spending and its devastating effect on American cities and states.

Some claimed that conservative opposition to more funding for Amtrak contributed to the accident, while President Barack Obama pleaded for more infrastructure spending and former New York Mayor Michael Bloomberg condemned Congress for "kicking the can down a pothole-filled road."

However, the main point was this: construction spending has dropped significantly, relative to the size of the economy, in the last five years.

Yet the municipal bond market—which is where states, cities and all types of local agencies issue bonds to finance their needs—recorded pretty robust bond issuance in 2015.

"We'd have to go back to 2008 to experience an April with as much new municipal issuance as tallied last month," Alan Schankel, Janney's head of municipals said in a research note.

Earlier in the year, municipalities went on a bond-selling spree, with new issuance hitting a two-decade high on year-to-date volumes on March 6. That was a 88% increase from the same period in 2014.

So where did the proceeds from all these new muni bonds go? Not to new roads, bridges and tunnels, according to recent data.

In fact, almost 70% of year-to-date muni bond issuance went to refinance existing debt, as opposed to new capital spending, said Jim Grabovac, senior portfolio manager at McDonnell Investment Management.

Or, as Schankel put it, "there is 'new' [bonds] as in new to the market and then again there is 'new' as in new money for new projects."

As the chart below indicates, the share of new bond sales that is spent on capital projects has declined by 37.4% over the past 15 years:

The chart tracks the percentage of new muni bonds that are used for capital projects, such as roads, bridges and other public infrastructure—as opposed to refinancing existing debt.

The share of bond proceeds that is actually used for the construction of new projects, or maintenance, has declined over the past four years.

The reason is that cities and states are trying to take advantage of the low-interest rate environment to lower their debt obligations, said Rob Williams, director of income planning for the Schwab Center for Financial Research.

The word on the street is that “if you’re a local government and you can refinance your debt, you’ll do it,” Williams said.

As the window of opportunity is closing, given that a potential interest-rate increase could be approaching, the trend has picked up in 2015.

New muni-bond issuance year to date is currently at $145.9 billion, 60% above the same 2014 period, according to data from the Securities Industry and Financial Markets Association (Sifma).

But new capital has in fact fallen by 4% compared with last year, whereas year-to-date refinancing volume is currently up 122.7% from the same period in 2014, according to Sifma.

The trend may suggest that U.S. states and municipalities are still in austerity mode. Refinancing muni bonds—just like refinancing mortgages or student loans—is a way to obtain lower interest rates on existing debt, thus reducing the cost of repayment.

This means that municipalities aren’t increasing their debt, but rather paying off their existing loans and substituting it with new bonds with a lower interest rate.

“The aftermath of the 2008 recession is still very sharply in the minds of public administrators,” Williams said.

Unlike the corporate space, where debt is ballooning even as earnings fall, public administrators are in fact hesitant to borrow for new projects and are still in the process of delevering balance sheets.

After the recession, monthly municipal-bond issuances dropped about 68%, according to a Brookings Institution research paper.

In response to the credit crunch, Congress created the Build America Bonds (BABs) program through the “stimulus” bill of 2009, which authorized state and local governments to issue special taxable bonds that received either a direct federal subsidy or a federal tax credit.

The program expired in 2010 and in the past two years, congressional budget sequestration put a damper on the market. In fact, spending cuts reduced the federal BABs subsidy by 8.7% in 2013 and since then, municipalities have been redeeming their BABs to cut costs and to take advantage of historically low interest rates, the Brookings report showed.

In this context, it is no coincidence that net government investment as a share of GDP has been near all-time lows at the beginning of 2015.

MARKET WATCH

ELLIE ISMAILIDOU

May 27, 2015

S&P Report: U.S. Regulated Water Utilities' Credit Quality Remains Buoyant,

But Key Risks Remain that Could Weigh it Down.

Standard & Poor's Ratings Services continues to maintain high-investment-grade ratings on most U.S. regulated water utilities (USRWUs) even though we estimate these companies' capital spending will exceed more than $2 billion in capital spending annually by 2020. We've identified three key areas that we expect will likely affect USRWUs' ability to manage regulatory and operating risks in coming years: Regulatory lag, drought, and declining sales. USRWUs have fared well thus far in managing these risks. And this is reflected in USRWU ratings, which compare favorably to ratings for regulated gas and electric utilities (see chart 1). Nevertheless, USRWUs will continue to confront these three aforementioned issues, which could likely affect their credit quality over the long term. In evaluating these…

Purchase the Report.

Bill Would Create DOT Competitive Grant Program for Infrastructure.

WASHINGTON – Rep. Brian Higgins, R-N.Y. has introduced a bill that would direct the Transportation Department to establish a competitive grant program for state and local governments, as well as transit and port authorities, to help finance their infrastructure projects.

The bill – H. R. 2332: the Nation Building Here at Home Act of 2015 — would authorize up to $985 billion for grants under the program for fiscal years 2016 through 2020. It would authorize the Treasury Department, in consultation with DOT, to create within 180 days after enactment of the bill, a Nation Building Here at Home Financing Initiative to finance the grants.

The Treasury would be able to issue up to $300 billion of bonds in amounts and with interest rates as it sees fit to carry out the grant program. The grant program would have to be fully established within 270 days of passage of the bill.

"Infrastructure investment can be an economic game changer," Higgins told colleagues in a speech given on the House floor.

The measure stipulates that up to 85% of the grants could be used for highway, road, bridge, and interchange projects as well as public transportation projects eligible under chapter 53, title 49 of the U.S. Code and passenger or freight rail transportation projects. At least 9% of the grants could be used for water infrastructure projects, 4% for aviation infrastructure projects and 2% for port infrastructure projects. These projects would have to significantly impact a metropolitan area, region or the entire country, according to the legislative text.

DOT would coordinate grants for projects with the Environmental Protection Agency and Secretary of the Army through the Chief of Engineers.

DOT would have to establish criteria for the grants within 90 days after passage of the act, including whether financial commitments had to be in place, the degree of certainty needed for financial commitments, and whether some funding would have to be from non-federal sources.

The grants would have to be distributed geographically in an equitable manner and would have to address the needs of both urban and rural areas. Contractors would have to give veterans a preference in hiring. In addition, a certain percentage of the grants would have to be expended through small business concerns owned and controlled by socially and economically disadvantaged individuals.

Grants would not be available for projects unless all of the iron, steel and manufactured goods used in them were produced in the U.S., according to the legislation. However, there could be exceptions from this provision if these items were either not available in sufficient quantities in the U.S., would raise project costs by more than 25%, or were "inconsistent with the public interest," under the bill.

The measure would require grant and project information to be made available to the public. In addition, DOT would have to submit to Congress, not later than the year after the first grant was made and annually thereafter, a report on the progress made on the grant-financed projects. DOT would also be required under the bill to submit to Congress, within 180 days of enactment, a comprehensive report on the transportation needs of the U.S. for 20-, 30-, and 50-year periods.

The Bond Buyer

by Lynn Hume

MAY 20, 2015 3:36pm ET

Municipal Issuer Brief: Chicago Implications.

Read the Brief.

Municipal Market Analytics | May 26

Bloomberg Brief - Deal in the Spotlight.

Kate Smith, a reporter at Bloomberg Brief Municipal Market, discusses the Los Angeles wastewater green bonds in this week's Deal in the Spotlight.

Watch the video.

May 28, 2015

Bloomberg Brief Municipal Market Weekly Video - 05/28/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch.

Moody's: US State and Local Government Credit Quality Underpinned by

Strong Federal Disaster Support.

New York, May 26, 2015 — US state and local governments vulnerable to major disaster events will continue to rely upon strong federal assistance to sustain their relatively high credit quality, Moody's Investors Service says in a new report "US Federal Disaster Aid is Critical for State and Local Governments".

These issuers typically lack the financial resources and borrowing capacity to independently fund their own post-disaster rebuilding of infrastructure and maintenance of core services.

"Without strong federal support for recovery from hurricanes, earthquakes, floods, tornadoes and other disasters, the credit quality of affected issuers would be weaker," says Moody's Associate Analyst Aaron Ampaw.

While the federal government rarely provides financial support to alleviate financial management challenges or bankruptcies, we expect federal resources to support state and local issuers that lack the capability to absorb major disaster costs on their own. In many cases, the federal government is the only level of government able to afford disaster costs because of its large budget and ability to finance deficits. Any federal policy or action that constrains future disaster relief funds would be a credit negative development for state and local issuers.

However, the safeguard of federal support does not ensure municipal credits will avoid downgrades post-event. Without the availability of federal aid after a disaster, however, issuers would have much greater credit risk and lower ratings.

Following a disaster event, both state and local governments experience short, medium, and long-term risks amid their recovery. But local government credit quality is more vulnerable to disaster-related expenses than states because of smaller budget and borrowing capacities, which can be inadequate to tackle unexpected costs and damages.

This includes short-term liquidity risks stemming from unanticipated spending during the federal application process, and a medium-term risk associated with the timing and amount of approved reimbursements. For some issuers, economic risk can linger long after a disaster event, though for most, federal reimbursement absorbs the costs and stimulates rebuilding spending.

Local government issuers often issue short-term emergency spending notes backed by future operating revenues to alleviate liquidity pressure while they await federal reimbursements. Some issuers have pledged federal imbursements to secure these notes.

"Some notes issued in the past few years have been backed by pending federal disaster reimbursements, a narrower pledge that increases risk for investors," Ampaw says. These notes secured solely by federal payments are subject to timing and reimbursement risks and can present additional liquidity pressure for issuers. Instead of easing municipal liquidity strain, notes with narrow pledges could actually become long-term obligations that worsen liquidity risk if federal reimbursements are not received prior to note maturity and refinancing options are limited, an unintended consequence, according to Moody's.

The report is available to Moody's subscribers here.

Global Credit Research – 26 May 2015

Borrowing to Replenish Depleted Pensions.

HARRISBURG, Pa. — Facing a shortfall of more than $50 billion in his state’s pensions, and with no simple solution at hand, Gov. Tom Wolf of Pennsylvania is proposing to issue $3 billion in bonds, despite the role that such bonds have already played in the fiscal woes of other places.

And he is not alone. Several states and municipalities are considering similar action as they struggle with ballooning pension costs.

Interest in so-called pension obligation bonds is expected to intensify in the wake of a recent Illinois Supreme Court decision that rejected the state’s attempt to overhaul its severely depleted pension system. The court ruled unanimously that Illinois could not legally cut its public workers’ retirement benefits to lower costs, forcing lawmakers to scramble for the billions of dollars it will take to keep the system intact.

Since the late 1980s, state and local governments have issued about $105 billion in taxable pension obligation bonds. Borrowing through such bond deals is being considered by many states and municipalities this year to help underfunded pensions.

“My reaction was, ‘Yeah, that’s going to play here,’ “ said John D. McGinnis, a lawmaker in Pennsylvania, which has also been diverting money from its pension system, setting the stage for a crisis as more and more public workers retire. The state has no explicit constitutional mandate to protect public pensions, as Illinois does, but that is irrelevant, said Mr. McGinnis, a Republican and former finance professor at Pennsylvania State University.

“The judiciary in Pennsylvania has been solidly of the belief that there are ‘implicit contracts,’ and you can’t deviate from them,” he said. If lawmakers in Harrisburg were to unilaterally cut pensions now, he said, they could be taken to court and be dealt a stinging rebuke, like their counterparts in Illinois.

Against that backdrop, pension obligation bonds may appear tempting, even though such deals have contributed to financial crises in Detroit, Puerto Rico, Illinois and other places.

The deals are generally pitched to state and local officials as an arbitrage play: The government will issue the bonds; the pension system will invest the proceeds; and the investments will earn more, on average, than the interest rate on the bonds. The projected spread between the two rates makes it look as if the government has refinanced its pension shortfall at a lower interest rate, saving vast sums of money.

But that’s just on paper. In reality, the investment-return assumption is just that — an assumption, and a deceptive one at that because it does not take risk into account.

Fiscal analysts say it is possible, in theory, to shape a pension obligation bond deal responsibly, but that is not what they usually see.

Instead, the deals are typically used to make troubled pension systems seem a little less troubled for a few years, allowing elected officials to celebrate a pension reform without having to make the system sustainable over the long term.

The flood of cash from the bonds may also tempt officials into taking a break from their pension-funding schedule — the very action that has caused so much pension distress to begin with. Skipping annual pension contributions produces an off-balance-sheet debt that can start growing exponentially.

“These deals are being done as a budget gimmick,” said Matt Fabian, a managing director at Municipal Market Advisors, who keeps a database of municipal bond defaults and other mishaps. “They should not be done at all.”

But that has not stopped officials from pursuing them. Kansas recently authorized a $1 billion pension obligation bond and is seeking an underwriter. Alaska has been mulling the idea, although the governor, Bill Walker, opposes it. Hamden, Conn., recently borrowed $125 million for pensions, and the Atlanta school district wants to borrow up to $400 million to revive a dwindling pension plan for bus drivers and cafeteria workers.

In California, Orange County recently borrowed $340 million for pensions; South Lake Tahoe borrowed $12 million; and Riverside and Pasadena each took out new pension obligation bonds to refinance their old ones.

Municipalities are borrowing for their pension funds even in Michigan, where local governments are said to carry the stigma of Detroit, which dealt steep losses to its bondholders in bankruptcy. How a state handles the distress of one city is seen by credit analysts as the implicit policy for all municipalities in that state.

After declaring bankruptcy in 2013, Detroit sought to have $1.4 billion of pension obligation bonds voided outright, saying they had been sold illegally in 2005 and were not enforceable. Ultimately, Detroit settled the debt for about 13 cents on the dollar, the lowest recovery rate of any of its bonds.

Michigan now takes extra precautions with pension obligation bonds, requiring local governments to be rated at least Double-A and to close their pension plans to new employees before borrowing. That has not thwarted Ottawa County, Saginaw County and Bloomfield Hills.

And outside Michigan, San Bernardino, Calif., has told its bankruptcy judge that it wants to settle its pension obligation bonds for just a penny on the dollar.

Investors evidently see the risk as acceptable, but it is still there. The governments typically invest the proceeds aggressively in their efforts to capture the widest spread. But success is more elusive than it looks in the presentations to officials.

The Center for Retirement Research at Boston College tracked a sample of 270 pension obligation bonds issued since 1992 and found that governments were borrowing in the wake of market run-ups, investing when asset prices were high, and reaping losses in subsequent corrections.

The center also found that the greater a government’s fiscal problems, the likelier it was to attempt the arbitrage play.

“Those least able to absorb the risk were most likely to do so,” said Jean-Pierre Aubry, the center’s assistant director of state and local research.

There are signs that at least some state and local officials are taking such findings to heart. In Kentucky, a plan to borrow $3.3 billion for the state-run teachers’ pension fund fizzled in March. In Colorado, a plan to borrow up to $10 billion was derailed by three Republican senators just before the legislative session adjourned.

But in Pennsylvania, Governor Wolf, a Democrat elected last year, sees the risk as acceptable. Five years ago, the state enacted what it called a pension reform that set up a new, cheaper pension plan for the public workers hired from 2011 onward; everyone in the existing plan continued to accrue the richer benefits. In the heat of the election campaign, Mr. Wolf called for giving the plan more time to work.

Indeed, a reform affecting only future employees will take decades to achieve appreciable savings because it will take decades for the current public workers to complete their careers, retire and be replaced by new workers with the cheaper benefits.

Pension obligation bonds look appealing as a stopgap measure. They are, in fact, illegal in Pennsylvania, but proponents say that is not a problem because the statute can be amended.

The idea has bipartisan support. Last year, a Republican state representative, Glen Grell, called for borrowing $9 billion for pensions, saying it "would save $15 billion over 30 years." His proposal mustered considerable support, but then Mr. Grell resigned to become executive director of the state pension plan for public-school employees.

Barry Shutt, a retired state worker, has been staging a one-man vigil against pension obligation bonds at the state capitol in Harrisburg. He had a sign that said: "Borrowing money is not a fix. It kicks the can down the road and steals from our children and grandchildren."

Mr. Shutt is a retired accountant who began his career as a state auditor and later administered food programs. He said there was little doubt as to when and why the state pension system went off the rails: In 2001, lawmakers increased everybody's pensions retroactively, causing a huge, wholly unfunded increase in the state's obligations.

The lawmakers figured that booming stock-market returns would pay for the costly increase, a mistake made by officials in many other states and cities as well. Two stock crashes later, the mistake is apparent, but it is too late to reverse the increase — it is deemed it an "implicit contract" that cannot be breached.

Pension obligation bonds would only make the problem worse, Mr. Shutt said. "When you're borrowing money for pensions," he said, "you're getting a new credit card to pay off the old one, and you still haven't paid off the old one."

THE NEW YORK TIMES

By MARY WILLIAMS WALSH

MAY 27, 2015

Atlantic City Bond Offering Attracts Hedge Funds as Buyers.

The City of Atlantic City, N.J., attracted a contingent of hedge fund investors to its latest bond offering as it works to restructure its obligations and operations in an effort to avoid filing for bankruptcy, a city official said in an interview.

Atlantic City's revenue and finance director, Michael Stinson, said Friday by phone that the city has completed a $40.56 million bond offering through a negotiated sale with six or seven investors, including some hedge funds that he declined to name.

The city sold taxable general obligation term bonds, one set of which matures in 2040 and has a 7.5% coupon, and another which matures in 2028 and has a 7% coupon. The bonds are priced at a discount to yield higher than their coupon amount. According to Stinson, the 2040 bonds will yield 7.75%.

The bonds were issued under New Jersey's Municipal Qualified Bond Act, a program that provides additional security for investors since the money for bond payments comes from the state and will never enter Atlantic City's general fund. New Jersey's treasurer will set aside a portion of state aid that was allotted for the city and give it directly to the paying agent for the bonds.

"I'm thankful that the deal went through," Stinson said. "I'm obviously disappointed at the rate of interest that the city has to pay."

Stinson hopes the next bond offering will be priced lower.

"I'm certainly hoping that it's not that high," he said. "It's a slightly shorter term and a [lesser] amount, so I'm hoping that it'll be a significantly [lower] interest rate."

Stinson revealed that the city is planning a competitive sale of $12 million in term bonds with maturities up to 15 years next week, also under the Municipal Qualified Bond Act.

Proceeds from the $40.56 million offering will be used to repay a $40 million bridge loan from New Jersey that comes due next month, while funds from the $12 million bond offering will go toward repaying $12 million in bond anticipation notes that mature in August.

Stinson said he hopes Atlantic City will be able to use the Qualified Bond Act for further debt issuance beyond the $12 million offering. There are no concrete plans for bond offerings beyond that one, and the question of further debt issuance "will play out based on the tax appeals for this year," Stinson said, referring to negotiations surrounding tax refunds to casinos.

Thanks to the Municipal Qualified Bond Act, the $40.56 million bond issuance scored an A- rating from Standard & Poor's.

Lisa Washburn, a managing director of Municipal Market Analytics Inc., a Concord, Mass., municipal credit research firm, commented by phone that the yield on the new bonds is "high, but it sure would have been a lot higher had New Jersey not provided its [Qualified Bond Act] program."

She said it is interesting that New Jersey is using funds from its municipal aid program to repay a loan to itself.

It's fortunate for Atlantic City that New Jersey has agreed to support the same structure for the upcoming $12 million issuance, since Washburn believes it would be much more difficult to get a bond deal done otherwise.

Even with that program, however, there is some uncertainty over whether the bonds would be safe if Atlantic City were to file for Chapter 9 bankruptcy.

Preliminary bond offering documents included a legal opinion from Woodbridge, N.J.-based bond counsel Wilentz, Goldman & Spitzer PA, asserting that Municipal Qualified Bond Act debt would be unimpaired in a Chapter 9 scenario.

Investors may have taken comfort in how similarly structured bonds were unimpaired during Detroit's Chapter 9 restructuring.

Washburn was quick to point out, however, that Detroit doesn't provide a precedent for the treatment of these bonds in a New Jersey bankruptcy court.

"Michigan has no bearing on New Jersey laws," she explained. "This is based on state laws."

Having studied the legal opinion, Washburn came to the conclusion that the question of whether the bonds would be impaired in bankruptcy "doesn't seem clear cut."

Ultimately, that issue would be decided by a judge. As for the analysis in the bond documents, "that's an opinion, and there's faith being placed that that's actually going to hold up," Washburn said. "Given what we've seen in other bankruptcies, I think the best you can say is that you don't know what you don't know until you get into bankruptcy."

Another open question is the amount of aid that New Jersey will be willing–and able–to provide.

Atlantic City's emergency manager, Kevin Lavin, urged New Jersey to provide financial support to the gaming town in a March 23 preliminary report.

However, the state's own credit strength has some observers worried, particularly in light of a case pending in the New Jersey Supreme Court that will determine whether the state can uphold Gov. Chris Christie's cut to its pension funding.

"If [New Jersey] loses their pension case and they have to fund up for the 2016 budget, there could be some concerns around the amount of municipal aid that will be available," Washburn warned. "If the ruling goes against them, they're going to have to look everywhere for money, under every seat cushion."

That search may even have to include programs that provide financial aid to distressed cities, she added.

Washburn said she expects a ruling on the pension case to come soon. The state's fiscal year ends on June 30, and the court could order New Jersey to put up more money before then, or for the 2016 budget.

Christie appointed an emergency manager for Atlantic City in January as the city's revenues have shrunk because of rapidly declining property taxes from casinos. Of Atlantic City's 12 casinos, four have closed in the past two years.

The Deal

by Lisa Allen | Published May 22, 2015

[S&P 2014 Annual U.S. Public Finance Default Study and Rating Transitions.]

U.S. public finance (USPF) exhibited growing credit strength in 2014, following a similar performance in 2013. Upgrades outpaced downgrades by a ratio of 3.38 to 1 for nonhousing bonds and 2.6 to 1 for housing bonds, for an overall ratio of 3.33 to 1. Positive rating trends were more evident across the various sectors as both housing and nonhousing bonds had more upgrades than downgrades in 2014 whereas the ratio of housing upgrades to downgrades was 1 to 3 in 2013. The positive trend was also more consistent in 2014 as upgrades outnumbered downgrades in every quarter for the first time since 2007. Defaults slowed as well, with eight occurring in 2014 compared with 15 the previous year.

A significant factor in the positive rating change trend was the implementation of new criteria for local governments and for unenhanced multifamily properties. More than 4,000 local government ratings fall under the local government criteria. Following a review from mid-September 2013 through Sept. 30, 2014, Standard & Poor's Ratings Services upgraded 41% of these credits based on the new criteria and downgraded 4%. The difference between the actual and anticipated (30% upgrades and 10% downgrades) rating changes is attributable to qualitative analysis and updated information. The impact of the housing criteria was much less in terms of the number of ratings, but the trend was in the same direction as the criteria contributed to 50 upgrades and 19 downgrades. Strengthening economic fundamentals also provided a lift to rating trends, particularly for local government ratings. Furthermore, local government and unenhanced multifamily housing ratings combined for two defaults in 2014, indicating that the criteria accurately capture their credit risk.

Overview

- Standard & Poor's upgraded 2,224 bond ratings while downgrading 658 in nonhousing USPF in 2014.
- There were 117 housing upgrades and 45 downgrades in 2014.
- All but two sectors in USPF — higher education and health care — had more upgrades than downgrades in 2014.
- Eight defaults occurred in USPF in 2014 compared with 15 the previous year.
- Since 1986, the average annual number of defaults in all of USPF combined is five, out of a universe that now surpasses 21,000 ratings.

Continue reading.

05-May-2015

Chicago Says Banks Won't Demand Penalties After Cut to Junk.

Chicago said Bank of America Corp., Goldman Sachs Group Inc. and other banks won't force it to pay penalties triggered when its credit rating was cut to junk by Moody's Investors Service, giving the city time to refinance debt.

In bond documents released Thursday, Chicago said it reached an agreement with banks that backstop its general-obligation bonds and sold it interest-rate swaps. The city said they won't demand penalties before Sept. 30, unless it can't refinance the floating-rate debt by June 8 or Moody's lowers the rating again.

The agreements provide time for Mayor Rahm Emanuel to bolster the city's finances after downgrades from the three biggest credit-rating companies. Chicago plans to sell about $806 million of bonds next week. It had planned to issue $383 million on May 19, but delayed the sale as investors demanded increasingly higher yields.

The loss of an investment-grade rating threatened to put added pressure on Chicago by giving banks the right to require it to repay debt early or pay fees to break swap contracts. Moody's said Chicago faced as much as $2.2 billion in such penalties.

Kristen Kaus, a spokeswoman for Bank of America in New York, declined to comment on the agreement. Michael DuVally, a spokesman for Goldman Sachs, which has a swap agreement with Chicago, also declined to comment.

Eliminating Risk

Emanuel's administration had already been planning to avoid the penalties with the refinancing that's now set for next week.

So far, it has used short-term borrowing and other city funds to pay about $139.5 million to break swaps, including one with Bank of New York Mellon Corp. on May 19, according to the bond documents released Thursday.

The city has also been able to secure more credit from some banks. JPMorgan Chase & Co. and Morgan Stanley will each provide an additional $200 million to Chicago, according to the documents. A unit of Bank of America, the lead underwriter on $423 million of planned Chicago deals, has an existing revolving line of credit with the city.

Chicago was cut to junk by Moody's after the Illinois Supreme Court ruled that retirement benefits are safeguarded under the state constitution. That cast doubt on Chicago's ability to plug a $20 billion pension shortfall that threatens the city's solvency.

Bloomberg

by Brian Chappatta & Elizabeth Campbell

May 21, 2015

[Appellate Court Warning: Pension Funds May Get Stuck With Unintended Oral Contracts With Their Investment Managers - Reed Smith]

On May 8, 2015, the Second District Court of Appeal in Los Angeles revived a $35 million lawsuit against CalPERS in *Centinela Capital Partners LLC v. California Public Employees' Retirement System*. In an unpublished opinion, the appellate court reversed in part a trial court ruling dismissing the plaintiff's claims against CalPERS. According to the appellate court, plaintiff's pleading contained sufficient factual allegations to establish that CalPERS and the plaintiff had entered into an enforceable oral agreement that CalPERS allegedly breached.

Centinela Capital Partners, LLC ("Centinela") had been engaged by CalPERS as an investment manager for two separate funds. When CalPERS declined to enter into a third Centinela fund, Centinela sued, claiming that CalPERS had orally agreed to award Centinela a contract to manage an additional $100 million.

On appeal, the appellate court reversed the trial court's ruling on the $100 million investment portfolio breach of contract claim. Centinela's pleading alleged 13 specific material terms of the oral agreement. The pleading further alleged that the parties had agreed that the management of the $100 million portfolio was to be governed by the same terms and conditions set forth in a separate preexisting written agreement the parties had for the management of another fund. Based on these allegations, the appellate court found that Centinela's pleading contained sufficient facts to establish a breach of contract claim against CalPERS for the oral promise related to the management of the

$100 million portfolio. The court stated that "[w]hether the parties intended their communications to be a binding…agreement or an agreement to further negotiate after a formal draft was prepared is a factual question not properly the subject of a demurrer." The case was remanded back for further discovery and trial.

Centinela Capital Partners LLC v. California Public Employees' Retirement System provides an important warning to plan fiduciaries and their investment staff: Be careful what you say when discussing investment opportunities with managers, especially those incumbents with whom you already have a contractual relationship. Make it clear in your communications – whether by phone, in person, by email or letter – that nothing will be binding on your plan unless and until a complete set of documents has been approved and inked by both sides.

Last Updated: May 15 2015

Article by Harvey L. Leiderman and Maytak Chin

Reed Smith

Munis in a Rising Rate Environment? Yes, But Use Caution and Stay Nimble.

After enjoying a year of stellar performance in 2014, municipal bond investors have had to contend with heightened volatility and more mixed results this year. With returns likely to be more in line with the historical experience versus last year's stand-out results, some investors may be asking: Are municipals a good investment at this point in the rate cycle? PIMCO believes the answer is: Yes. But the current landscape calls for a bit of extra caution – and ideally an active manager who has the experience to skillfully navigate a volatile environment.

Continue reading.

PIMCO

BY JOE DEANE AND SEAN MCCARTHY

MAY 22, 2015

Butler Snow: Should Bond Lawyers Care About Chapter 9 of the Bankruptcy Code?

I have been practicing public finance law for almost thirteen years, and during the first half of that period, I never gave Chapter 9 of the Bankruptcy Code much thought, as prior to the financial crisis, municipal bankruptcies were extremely rare. And while the bankruptcy courts are not overflowing with Chapter 9 cases today, there have been a sufficient number to force bond attorneys to pay closer attention.

The municipal bond market demands secure investments, and as bond attorneys we strive to document bond transactions in order to insulate bondholders from any challenges to the expected return on their investment, whether there are challenges to the validity of the bonds or challenges to the priority of the pledges of revenues securing the bonds. Out of necessity, municipal issuers facing dire economic circumstances, and their bankruptcy attorneys, are forced to comb through bond documents in an attempt to find language that allows them to use pledged revenues for other purposes (e.g., ongoing operating and capital costs) or pay other creditors (e.g., municipal employees and pensioners). The terms of the settlements resulting from the Chapter 9 cases that have been filed are forcing the public finance industry to reexamine long-standing views regarding various types of municipal bonds and the security pledged in support of their payment. Unfortunately, recent Chapter 9 proceedings have focused more on encouraging negotiation and settlement than adjudicating provisions of bond documents and therefore have offered little clear precedent to help us with such reexamination of the long-standing views.

A quick look at the settlement resulting from the City of Detroit's Chapter 9 case offers us a glimpse of what we do (and do not) know about Chapter 9. Until recently, general obligation bonds issued by a municipal issuer and supported by the full faith and credit and taxing power of the issuer were the "gold standard" of municipal credit. That notion took a bit of a beating in Detroit. Detroit's initial Chapter 9 plan treated general obligation bondholders as unsecured creditors and sought to divert funds pledged to the payment of the bonds to the City's general fund. As expected, bondholders objected and, as with most else everything in Detroit's case, there was a settlement. In exchange for their consent to divert some of the pledged revenues to the City's general fund, bondholders received relatively favorable repayment terms under the plan ($0.74 on the $1.00 – pensioners received approximately $0.60 on the $1.00), a covenant that ensures that no unsecured creditor can recover more than any general obligation bondholder, and a lien on specific tax revenues that the bankruptcy court held to be special revenues. Notwithstanding this relatively favorable treatment, however, the public finance industry is somewhat troubled by the Court's statement that the City's chance of success on the merits of the question of whether the general obligation bonds were unsecured was a "coin toss."

While revenue bonds, such as bonds secured by revenues from a utility system of a municipality, have not traditionally been thought of as being as strong of a credit as general obligation bonds, they are generally accompanied by a covenant of the issuer to set rates and charges at levels sufficient to pay debt service and therefore they are still viewed as a relatively strong credit in the municipal market. In addition, revenue bonds benefit from a unique provision in Chapter 9 that affords special protection for "special revenues," which are defined to include, among other things, receipts derived from the ownership and/or operation of projects or systems that are primarily used to provide transportation, utility, or other services. Chapter 9 provides that obligations secured by a lien on special revenues retain such lien post-petition. Consequently, special revenue bonds should have continued access to the revenue stream that secures the debt service payments.

As with the general obligation bonds, Detroit's initial plan sought to impair the lien of water and sewer bondholders and divert water and sewer revenues to the City's general fund. Bondholders objected, and Detroit agreed to pay "special revenue" bond debt in full, but only after bondholders, facing prospects of a lower rate and a stripping of their call protections, accepted an "invitation" to "voluntarily" tender their bonds. Thus, even with bonds secured by special revenues, the threat of impairment spurred a settlement. While a few years ago, the general consensus was that general obligation bonds were the better municipal credit, there is now a more open question as to whether it is better to be a general obligation bondholder or a special revenue bondholder in a Chapter 9 proceeding.

Butler Snow LLP

By Michael J. Bradshaw, Jr.

May 1, 2015

A Debt-Ratings Rift Rattles Chicago.

The world's two largest ratings firms are divided in their view of Chicago's fiscal health as the city grapples with a $20 billion pension hole, a potential preview of battles expected to break out around the U.S. as retirement obligations mount.

Moody's Investors Service lowered Chicago's bonds to junk status last week while rival Standard & Poor's Ratings Services settled on an investment-grade A-minus rating , a more optimistic view of the nation's third-largest city. As recently as five years ago, both firms gave Chicago the same grade of double-A-minus.

The highly unusual four-notch ratings gap is the result of a change Moody's made two years ago when it decided it would no longer rely on the investing returns targets submitted by cities and states to calculate pension costs. Its own estimates are more conservative, meaning the city's pension problems look worse.

Chicago represents the most prominent example yet of how diverging views of bulging pension obligations can have huge ramifications for financially strapped cities. The split views are befuddling investors and the bearish grades could lead to higher borrowing costs, difficulties refinancing debt and new doubts about navigating the $3.7 trillion municipal-debt market.

"Moody's precipitous downgrading of Chicago's credit should raise questions about the suitability of using ratings to market bonds to retail investors," according to a report Monday by Concord, Mass.-based research firm Municipal Market Analytics.

Mayor Rahm Emanuel called the Moody's downgrade "irresponsible," but the firm defended its more aggressive methodology. "Our adjustments are geared toward improving comparability" of liabilities among pensions, Tom Aaron, an assistant vice president at Moody's, said in an interview.

S&P analyst Helen Samuelson, however, said the firm stood by its more optimistic rating. The city still has "options," she said, including increasing taxes to boost revenue.

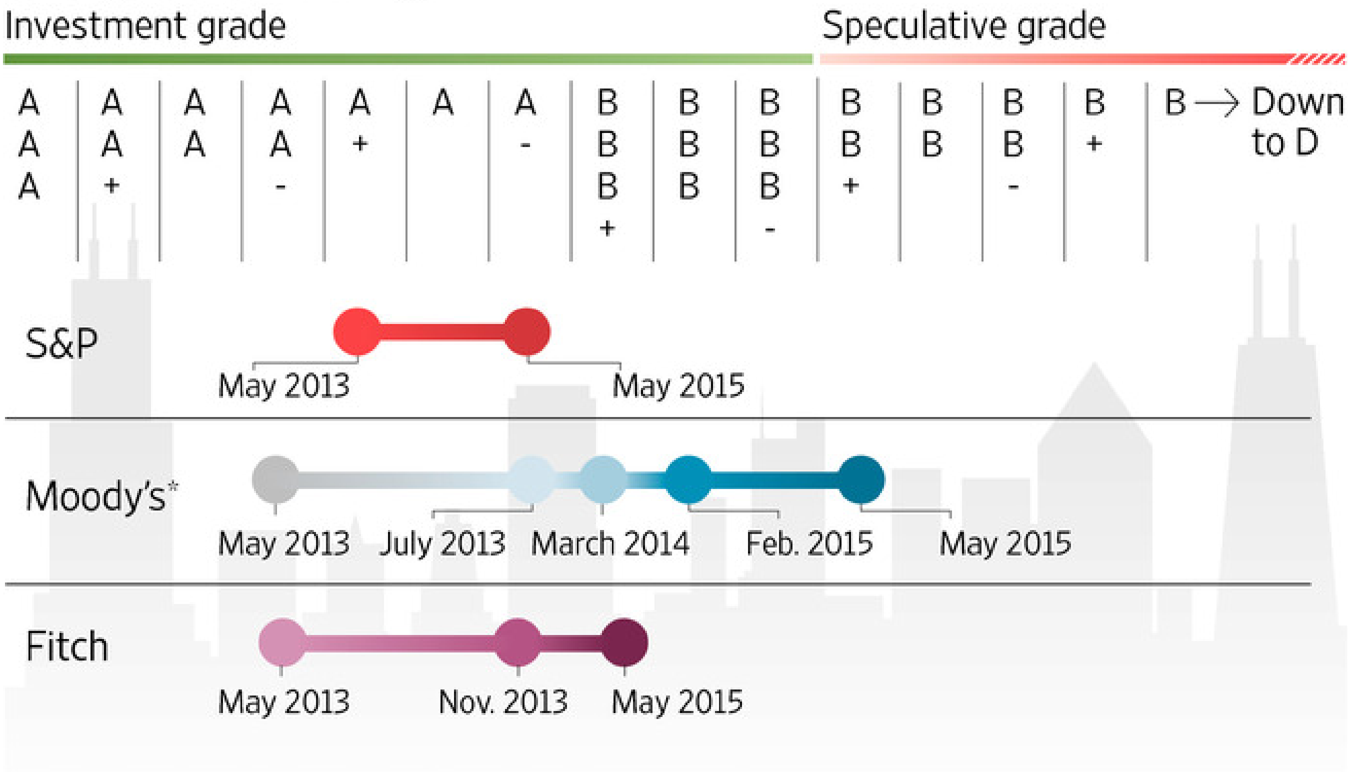
The changes made by Moody's in 2013 and S&P's tweaks last year have already had a dramatic effect on the direction of municipal-bond ratings. In the first quarter of 2014, S&P said it had upgraded 533 cities and other municipalities due to revised criteria against just 39 downgrades, according to a Janney Capital Markets report published last year. During the same period, Moody's downgrades outnumbered its upgrades.

Janney titled the divergence "The Great Municipal Bond Rating Dislocation."

Credit Chasm

Major credit firms disagree about the fiscal health of the nation's third-largest city.

Chicago's credit ratings



*Moody's scale of rating differs from the other companies
Source: the companies

THE WALL STREET JOURNAL.

Other cities with big pension problems, such as Atlanta and Pittsburgh, have yet to show sizable grading disparities, but the frequency of ratings rifts could accelerate in coming years as cities wrestle with how to solve a collective $1.2 trillion pension funding shortfall, said Eric Friedland, head of municipal research at Schroders PLC and a former Fitch Ratings analyst.

Projected pension costs can vary greatly based on what state or local governments select as their return assumptions. Public officials are under pressure to keep those targets high as a way of avoiding higher taxes or benefit reductions as they try to recover from heavy investment losses incurred during the 2008 financial crisis.

State and local pension liabilities ballooned at more than twice the rate of their assets in the aftermath of the crisis, according to the National Association of State Retirement Administrators. Public pensions now have about $3.8 trillion in assets versus $5 trillion in liabilities, according to Nasra.

Philadelphia has $5.3 billion in unfunded pension liabilities, while Phoenix has $2.5 billion and Atlanta has $1.5 billion, according to Merritt Research Services LLC, a municipal-bond data provider. Both firms agree on Atlanta at double-A and Phoenix at double-A-plus, but Moody's rates Philadelphia one notch lower than S&P does.

What makes Chicago unique is the magnitude of its retirement shortfall. The city has only half the assets it needs to cover its pension liabilities, or the equivalent of four years of general operating budgets. Mr. Emanuel's cost-cutting pension overhaul looks less likely to win court approval after the Illinois Supreme Court struck down a similar proposed law earlier this month that sought similar benefit cuts.

"As Mayor Emanuel has repeatedly stated, the City of Chicago's financial crisis is real, urgent, and has been decades in the making," said Chicago Deputy Mayor Steve Koch in a statement. "Moody's decision to downgrade the City was driven by the Illinois Supreme Court's reversal of the state pension reform bill and has substantially magnified the City's financial challenges, adding real costs to Chicago's taxpayers.

Moody's chose to prejudge both the outcome of the City's pension reform law that solves half of our unfunded pension liabilities before it is heard in court as well as the active police and fire discussions that would help address the other half of our pension issue, putting them out of step with all the other major ratings agencies."

Last week's Moody's downgrade—the fourth in two years for Chicago—could trigger around $2 billion in accelerated payments by the city, Moody's said.

The sudden four-notch ratings gap in Chicago caught some market participants by surprise and prompted selling from some retail investors, said Daniel Solender, head of municipal-bond management at Lord Abbett & Co., which manages $17 billion. It may also affect the city's effort to refinance about $900 million in bonds in coming weeks, by reducing the number of institutional investors who can buy the debt.

Returns on Chicago general-obligation bonds have fallen about 3.4% since the downgrade, counting price changes and interest payments, according to data from Barclays PLC. Yields rise as prices fall.

If both S&P and Moody's downgrade Chicago to junk status, it could have a wider effect because some big buyers of municipal bonds such as pensions and insurers can only invest in debt that carries an investment-grade rating from the big agencies. Fitch's triple-B-plus rating is notch below S&P's grade.

But some investors are already avoiding Chicago debt. Burton Mulford, portfolio manager at Eagle Asset Management in St. Petersburg, Fla., which oversees about $2.5 billion, is already steering clear of most Chicago debt and may sell bonds from the city's park district, he added.

"Because our client base is very conservative, we'll probably eventually get out of those credits," Mr. Mulford said.

THE WALL STREET JOURNAL

By TIMOTHY W. MARTIN and AARON KURILOFF

Updated May 20, 2015 10:21 p.m. ET

Write to Timothy W. Martin at timothy.martin@wsj.com and Aaron Kuriloff at AARON.KURILOFF@wsj.com

The Rieger Report: Munis Face an Unholy Trio.

Three storms are converging on the municipal bond market: supply, interest rates and bad news headlines – a powerful trio of bad news for the municipal bond market.

- The S&P Municipal Bond Illinois Index is down 1.55% for month-to-date and is the worst performing state index for the month so far. The index is down 1.16% year-to-date.
- The S&P Municipal Bond Illinois General Obligation Index is down 2.63% month-to-date and is the worst performing G.O. index. The index is down 3.06% year-to-date. Chicago General Obligation bonds make up 35% of this index by market value.
- The S&P Municipal Bond New Jersey Index is down 1.07% month-to-date and is the second worst performing state index for the month. The index is down 1.1% year-to-date.
- Puerto Rico is having a dead cat bounce in May as the S&P Municipal Bond Puerto Rico General Obligation Index is up 2.37% month-to-date. The index remains in the red for the year so far down 0.97% year-to-date.

The combination has put a heavy weight on the investment grade tax-free bond market which has seen negative returns in 2015. The S&P National AMT-Free Municipal Bond Index is down 0.73% month-to-date and 0.36% year-to-date.

One bright light is the municipal high yield bond market as the S&P Municipal Bond High Yield Index is up 0.82% year-to-date helped by positive performance in May by Puerto Rico bonds and a recovery over 3.2% of the Tobacco Settlement bond sector.

May 20th, 2015

This article was written by J.R. Rieger, global head of fixed income, S&P Dow Jones Indices.

FT: Muni Risk Rises as Pensions are Put First.

A low hum of anxiety has surrounded the issue of public pensions in the US municipal bond market for years. Now, that hum is getting louder.

The third largest city in the US became a junk rated issuer when Moody's last week cut Chicago's credit ratings on concerns about its unfunded pension liabilities. The downgrade is the latest in a string of high-profile instances of pension woes spilling into the bond market at a time when investors, rating agencies and rulemaking bodies are scrutinising pensions.

"Politicians and other government stakeholders besides the pensioners themselves are taking pensions much more seriously," says Matt Fabian, managing director at Municipal Market Advisors. "The long-term promise of pensions had been taken rather lightly. Because the costs were so far into the future, political managers and others really dismissed pensions as a threat to solvency."

Pensions have been increasingly thrust into the spotlight, having become a significant factor in the most widely watched municipal distress stories.

Puerto Rico's pension is funded at just 5 per cent. Pensions have also played a large part in municipal bankruptcies, most notably in Detroit where a bankruptcy judge put limits on cuts to pension benefits at the expense of bondholders.

Governments have been poor managers of their pensions for some time, but the financial crisis and ensuing recession lifted the veil on chronic underfunding and rosy return expectations. Stock market declines deepened unfunded liabilities considerably while states, cash-strapped by the economic downturn, had less money to plug the gaps.

Academics and other analysts began to publish calculations of a few trillion dollars for the total funding gap, grabbing attention from, and contrasting with, the official numbers, which benefited from unique and controversial accounting.

Against this backdrop, Moody’s a few years ago changed its rating methodology to give more weight to pension issues, while new accounting rules are coming into effect and will provide more transparency and a financially conservative view of pensions.

“We’re on the cusp of evolutionary change related to pensions. What we’re seeing is a clear indicator that courts are willing to treat pension beneficiaries as ahead of creditors,” says Thomas McLoughlin, head of municipal fixed income at UBS Wealth Management Americas.

”That will transform the risk parameters for municipal finance. For years muni analysts looked at idiosyncratic credit risk, but now we are looking at a systemic risk related to pensions. It’s a really important trend we have to incorporate into our analysis. We have to focus far more on this in the future.”

“Munis” are reflecting only modest pension risk. Chicago was penalised by investors after its downgrade. Yields on the city’s 10-year bonds have risen by about a percentage point since. States with poorly funded pension systems, such as Illinois, New Jersey, Pennsylvania and Connecticut, have higher borrowing costs than their peers.

Many muni investors believe there is time to fix most pension problems. Even if that does not happen, the day of reckoning is far into the future and governments have a lot of options, as the argument goes.

“The most likely scenario is rather than triggering defaults or insolvency, pensions will squeeze out other spending, such as infrastructure investment, educational spending and social services,” Mr Fabian says. “It is not a great scenario, but different than default or bankruptcy.”

Indeed, even the more troubled pension systems do not face imminent threats of running out of money. Several states, including Rhode Island, Minnesota and Colorado, also have been successful in enacting reforms to shore up their pensions.

Others, like Illinois, have been blocked by the courts — its thwarted reform bill was a key factor in the Chicago downgrade.

Pensions are governed by state law, which means the reception to change varies. The meatier cuts to public pensions — those that involve existing rather than new hires, and accrued benefits — clash with contract law, case law and in some cases state constitutions.

The financial markets play a big role, too. The pension drama has played out at a time of very easy monetary policy. One question is what kind of rate investors will demand for bonds of areas with more pension risk once rates rise.

The bull run coming off the financial crisis and taking US equities to new highs has helped pensions, but critics point out that pension plans have increased their risk-taking, with larger allocations to equities over the years. Ratios of existing workers to retirees have also moved decidedly in the wrong direction.

“The ratio is an indication that plans are getting more mature and need to pay out more benefits, and that they are increasingly reliant on investment income, which is scary,” says Don Boyd, a fellow at the Nelson A Rockefeller Institute of Government.

Financial Times

May 20, 2015 11:07 am

Nicole Bullock

Additional reporting by Robin Wigglesworth in New York

How Standard & Poor’s Rates Community Development Finance Institutions.

In this CreditMatters TV segment, Senior Director Mikiyon Alexander discusses the ratings recently released on two Community Development Finance Institutions and how Standard & Poor’s determines these ratings. Topics include the rating outcome for the Clearinghouse and Housing Trust Silicon Valley.

Watch.

May 20, 2015

Liquidity Concerns Prompt a Standard & Poor’s Rating Action on Chicago.

In this CreditMatters TV segment, Director Helen Samuelson explains the rationale behind our rating action on the Windy City. Topics include distractions, such as the mayoral run-off, which took city management’s focus off the larger issue of pension reform.

Watch.

May 19, 2015

S&P 2015 U.S. Public Finance Team Directory.

View the Directory.

May 20, 2015

Partnerships Can Contribute to Rebirth of Infrastructure.

Despite having spent $416 billion on transportation and water infrastructure last year, the United States still is not doing enough to deliver the infrastructure the nation needs to create more equitable, resilient and economically vibrant communities, wrote Patrick Sabol and Robert Puentes in a recent article published as part of the Brookings Institution's Metropolitan Infrastructure Initiative.

"There is no single reason for America's failure to invest in its infrastructure," they wrote. "It's a story of death by a thousand cuts — declining federal dollars, political dysfunction, high levels of state and local debt, the age of our assets, a growing population, hangovers from the Great Recession, and a multitude of other smaller issues — that have left us bereft of sufficient support."

They identified one of the biggest trends across all levels of government isn't in developing new financial tools or generating new revenue, but rather in enhancing the public sector's capacity to work with the private sector to design, build, finance, operate, and maintain infrastructure assets. "While specific approaches vary, efforts like the Chicago Infrastructure Trust, the West Coast Infrastructure Exchange, Virginia's Office of Transportation Public-Private Partnerships, and the Obama Administration's Build America Transportation Investment Center are working to get more private capital into public projects," they noted.

"None of these efforts alone can solve America's multitude of infrastructure challenges. Rebuilding and renewing economically critical roads, water treatment facilities, ports, airports, public buildings, and transit systems will require unprecedented cooperation between all levels of government and the private sector," they added. "While significant progress has yet to be made, pockets of innovation across the United States are paving the way for the next generation of American infrastructure investment."

NCPPP

By Editor May 18, 2015

Will Green Bonds Experience a Boom-and-Bust Cycle?

Green bonds are fixed-income, liquid securities that are used to raise funds for activities like clean energy finance, climate mitigation, and other sustainable initiatives. On April 15, in a panel titled "Business Response: Green Bonds," experts at the Bloomberg New Energy Finance Future of Energy Summit 2015 in New York City came together to discuss the green bond market's accomplishments and challenges.

The Next Five Years

Moderator Lenora Suki, head of sustainable finance product strategy at Bloomberg LP, asked the panelists where they thought the market would be in five years. Would the highly sophisticated deals of today continue a transition to the more vanilla proceeds bonds attractive to retail and institutional investors?

Suzanne Buchta, co-author of the original green bond principles and managing director in debt capital markets at Bank of America Merrill Lynch, said asset-backed green bonds will indeed proliferate. They will include innovations such as the pooling of green mortgages into mortgage-backed securities. Green car loans, solar leases, and commercial energy efficiency are all candidates, she said, and they may eventually price at a discount compared to regular asset-backed bonds.

When asked about potential risks in the industry, Kyung-Ah Park, head of environmental markets at Goldman Sachs, replied that an obvious one would be a green bust. If a high-profile clean energy company goes under or fails to deliver on environmental commitments, investors may start to think twice before purchasing green bonds.

Resulting tightened definitions of “green” could also make the process more costly for issuers than it is now, Park said. If the pricing advantage associated with green bonds’ resilience to climate and policy risk fails to materialize soon, such threats could discourage issuers from taking advantage of the market.

Park also warned that an eventual tightening of monetary policy could affect the green bond market. “As yields come up, we know that price moves in the opposite direction. Inflation has been incredibly benign, but inflation is going to uptick as well. What does that do in terms of the capital that is right now in the fixed-income market? There is going to be a level of exiting. Is that going to be an orderly [exit] or is that going to be a volatile one?”

Accomplishments to Date

William Nelson, United States power and environmental commodities analyst at Bloomberg LP, began the session by highlighting the rapid growth and evolution in this sector of the debt capital markets. He said green bond issuance jumped to $39 billion last year, more than doubling from 2013’s figure of $14 billion.

Although supranational organizations such as World Bank Group and European Investment Bank formerly accounted for much of the sector’s rapid growth, 2014 saw a five-fold increase in issuance from utilities and financial institutions, Nelson said.

Notably, Crédit Agricole worked with GDF Suez to issue a $3.4 billion green bond, the largest-ever bond of this type, while Iberdrola made a $1 billion offering.

Nelson also said corporate green bond issuances increased by 50 percent in 2014. This was driven by clean energy companies.

According to Nelson, these trends have continued through Q1 of 2015, with new energy companies accessing the debt capital markets in four primary ways:

- Issuance of green bonds by yieldcos seeking to acquire new projects and expand their pipelines (NRG and TerraForm Power)
- Issuance of solar-asset backed securities (SolarCity)
- Refinancing of operational assets through project bonds (wind in Peru, solar in Canada)
- Issuance of convertible bonds by clean energy companies (SunEdison, Tesla Motors)

Peter Sweatman, chief executive of Climate Strategy & Partners, projected that new green bonds will total $80-100 billion this year. “Clean energy, by its sheer magnitude, and now through the maturity of the technologies and the stability of the cash flows, [is] certainly a stable and clear place for revenues and cash flows that investors need … [The green bond] is a product that is really covering all of the asset classes and is really emerging.”

Jeffrey Eckel, president and CEO at Hannon Armstrong, noted that this rapid growth was not unique to green bonds; other fixed-income instruments were booming as well.

Drivers of Growth

Park noted that easy monetary policy played an important role in this trend. According to Park, the prolonged period of ultra-low and even negative yields from fixed-income instruments made investors hungry for higher-yield opportunities. This demand was, by default, conducive to clean energy.

Park emphasized that a critical mass of poolable assets from deployed clean energy, a virtuous technology cycle, and investors' increasing focus on sustainability criteria were all driving the rapid growth in green bonds.

"Greater deployment and greater visible cash flows mean that we have many more financial toolkits … that we can open up to clean energy companies, and that in turn drives expanded investor access, gets many more investors interested in the underlying credit quality of these green assets, [and] in turn drives down the cost of capital," Park said.

Sweatman said continued exponential growth in green bonds will require tapping into transactions that are currently invisible to the market. While approximately $500 billion in climate-themed bonds is issued annually, only a small subset is explicitly classified as such.

According to Sweatman and his co-panelists, energy and water efficiency, waste management, and corporate issuers represent the greatest opportunities for expansion. Increasingly robust verification standards will help bring these offerings to the market.

Park said, "On the issuer dimension, let's not just work with the green companies. Let's try to figure out how we can work with the companies that are in the non-green space and really try to help them identify where they can [put more] proceeds into environmentally beneficial purposes and help them tap into the green bond market."

Limitations of the "Green" Label

The panelists stressed that while green bonds have proliferated, the absence of a standardized carbon metric has somewhat limited the usefulness of the "green" label. Furthermore, while some companies specifically used the word "green" in the bond document, others used only words like "solar," "wind," or "efficiency" – or fell into the unlabeled category, like Tesla.

Buchta said, "In my mind, the label 'green' comes from the investors' opinion. Each investor looks at a bond; if the bond has followed the green bond principles, it will have transparency and disclosure about the categories that the proceeds should go to… It's up to the investor to decide what they consider green and what is green enough for them."

Despite these challenges, Park is convinced that there is value in the label. She pointed out that since the vast majority of investors had not previously invested in green bonds or clean energy, the 'green' label provided them with confidence that the use of proceeds would go toward environmentally beneficial purposes. As the market evolves, she expects investors to become more discerning, requiring a better definition of "green" and perhaps relying on a specific carbon intensity metric that could be integrated into the Bloomberg tracking system.

Clean Energy Finance Forum

by Fedor Petrenko

May 8, 2015

Moody's Explains Itself.

Last week, a court ruling struck down Illinois' pension changes, and days later, Moody's Investors Service downgraded the Chicago's (but not Illinois') debt to junk status. Moody's phones must have been ringing off the hook. So this week, in an unusual move, it released an FAQ regarding the downgrade of the city and not the state.

Moody's said in the May 18 document that it didn't downgrade the state because Illinois has more flexibility and isn't in as tight a financial predicament as Chicago. Illinois had not yet enacted its pension law so it wasn't incorporated into its credit rating. Chicago's pension law, which cuts retiree benefits, is also tied up in a legal battle and has yet to be enacted, but Moody's said the recent state-level ruling will lead to a reversal of that law. That, Moody's said, leaves the Windy City left only with the option of increasing its payments into the pension plan to keep it solvent — a feat that will require considerable cash for a city that's already heavily leveraged. Illinois, on the other hand, has potentially other options, Moody's said. The agency added that the Supreme Court could have ruled more narrowly and said that benefit modifications are permissible under certain circumstances, which would have been more favorable for Chicago's own hopes at reducing its pension liabilities.

"Instead, our interpretation of the court's opinion is that benefit modifications are impermissible under any circumstances." Moody's said. "Given the stridency of the court's opinion, we believe that the opportunities for benefit reform are now significantly more limited."

Moody's also said that while Chicago has a strong economy, immense tax base ($187 billion) and population (2.7 million), its "overall debt and unfunded pension liabilities are very high compared to other major U.S. cities." Any future ratings changes for Chicago — for better or worse — will "largely reflect city officials' actions on pension contributions and, ultimately, the growth of debt and pension leverage on the city's balance sheet." The agency also clarified it doesn't think Chicago is at risk of defaulting on debt or declaring bankruptcy.

GOVERNING.COM

BY LIZ FARMER | MAY 22, 2015

Bloomberg Brief Municipal Market Weekly Video - 05/21/15

Taylor Riggs, an editor at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

Fitch Exposure Draft: Rating Public Sector Counterparty Obligations in PPP Transactions.

This exposure draft outlines Fitch Ratings' proposed global approach to rating the obligations of a public sector grantor (grantor) under a concession, lease or other agreement (referred to herein as a "framework agreement") used to support a public private partnership (PPP) financing for public infrastructure assets. Such ratings are an input in the rating process for PPP transactions.

The criteria establish a globally consistent framework to:

- Determine if the PPP framework agreement qualifies for assignment of a counterparty rating.
- Establish a methodology for notching from the general credit quality of the public sector counterparty to reflect any perceived higher risk of default under a framework agreement.
- Guide how to consider the PPP obligation in the public sector counterparty's general credit rating (as expressed in the IDR) as well as how late payment or rejection of an obligation under the framework agreement would be reflected in the counterparty's IDR.

Public sector counterparties considered in these criteria include sovereign, state, provincial, regional and local governments, departments and agencies thereof, as well as public sector entities. Not all rating factors outlined in this report apply to each individual rating. Each specific rating report discusses those factors most relevant to the individual rating assignment.

Continue reading.

Chicago Doesn't Hire Moody's to Rate Its Latest Debt Refinancing.

Moody's Investors Service has missed out on a lucrative assignment for Chicago about a week after the credit-rating firm downgraded the third-largest U.S. city's debt to junk status.

Chicago instead hired rivals Standard & Poor's Ratings Services, Fitch Ratings and Kroll Bond Rating Agency Inc. to provide grades for a refinancing of $800 million in general-obligation bonds expected to hit the market in coming weeks, according to a sales offering document released Thursday.

The exclusion of Moody's is the latest fallout from a disagreement among large ratings firms about the city's fiscal health and its $20 billion pension hole. Moody's angered Chicago officials on May 12 when it lowered the rating on Chicago's bonds two notches into junk because of a pension deficit that is equivalent to about four years of annual operating budgets. Mayor Rahm Emanuel called the Moody's downgrade "irresponsible."

S&P, a unit of McGraw Hill Financial Inc., and Kroll have a more optimistic view of Chicago and rate the city's bonds much more favorably at A-minus—four notches higher. Fitch, majority owned by Hearst Corp., grades Chicago's bonds one note below S&P.

A spokeswoman for Mr. Emanuel declined comment on why Moody's was left out of the new offering and whether it had anything to do with the downgrade. The Moody's Corp. unit also declined comment.

"Issuers have walked away from one ratings firm or another over the years because of a bad rating," said Mitchell Savader, chief executive of a municipal- debt research firm and a former Moody's senior credit officer. “It can happen.”

Mr. Emanuel hasn’t minced words on the Moody’s downgrade, accusing the firm last week of playing politics with the financial future of the city and questioning why it would lower the city’s rating and not the state’s, which is struggling with its own pension problems.

Moody’s has defended its more aggressive methodology, which changed two years ago when it decided it would no longer rely on the investing return targets submitted by cities and states to calculate pension costs. Its own estimates are more conservative, meaning the city’s pension problems look worse.

Still, the mayor likely doesn’t face much political downside by taking on Moody’s and its downgrade of the city’s bonds, according to Dick Simpson, a political-science professor at the University of Illinois at Chicago and a former Chicago alderman.

“Since Moody’s already downgraded Chicago to junk-bond status, there’s not really much to be lost,” said Mr. Simpson. “Moody’s doesn’t have any votes.”

The mayor truly believes Moody’s has made a mistake here, said Bill Daley, who served as chief of staff to President Barack Obama like Mr. Emanuel and has deep ties in Chicago with both his father and brother serving as mayors. But the politics also are on the mayor’s side, Mr. Daley added, since the rating firms don’t have many supporters amid frustration over their opinions leading up to the financial crisis.

“I don’t think there are a lot of defenders of the ratings agencies. There is not a big consituency out there,” he said.

Moody’s has been absent from several recent Chicago debt deals despite its status as a major firm. It wasn’t hired for a $300 million issuance in April for the city’s board of education plus bond offerings last year of $178.1 million with the Chicago Transit Authority and a group of bonds tied to the Chicago Park District.

“I think you’re going to see that more and more,” said Howard Cure, director of municipal research at Evercore Wealth Management in New York. ‘“Ratings shopping’ is the word.”

Ratings shopping is a term used when debt issuers, who pay firms such as S&P and Moody’s to rate their bonds, choose the highest grades over lower ones.

Until recently, Laurence Msall, president of the Civic Federation, a Chicago-based fiscal watchdog group, said the relationship between the city and the rating firms drew little attention because Chicago had an investment-grade rating and dropping to junk status didn’t seem possible. “It was almost inconceivable five years ago that the city of Chicago would drop to less than investment grade,” Mr. Msall said.

There are practical reasons why Chicago would want to omit Moody’s from certain offerings, industry analysts and bankers said.

First, Moody’s generally charges debt issuers more to rate their municipal-bond deals. Chicago has paid Moody’s $824,000 since January 2014, versus $605,000 to S&P and $77,000 for Fitch over the same time period, according to the city’s vendor, contract and payment information database.

Cities also can look beyond the three major firms because of new rivals that emerged following the 2008 financial crisis and ignore raters that offer lower credit grades. Cities pay higher interest rates for lower-rated debt.

In recent years even lower-rated issuers have tended to sell bonds at historically low rates, said Matt Fabian, partner at Municipal Market Analytics. “So what incentive does any borrower have to use the lower one?” Mr. Fabian said.

THE WALL STREET JOURNAL

By TIMOTHY W. MARTIN and MARK PETERS

Updated May 21, 2015

Write to Timothy W. Martin at timothy.martin@wsj.com

CUSIP: Requests for New Municipal Bond Identifiers Increase at Fastest Rate Since 2012.

“As long as the Fed continues to keep rates low, bond issuers in particular are going to take advantage of what might be the last hurrah to get into the markets at such low rates,” said Richard Peterson, Senior Director of Global Markets Intelligence, S&P Capital IQ. “While the CUSIP indicator is still telling us that the pace of new issuance will not slow down anytime soon, it will be very interesting to watch for signs of a change in sentiment as the macroeconomic situation evolves.”

Read the Press Release.

May 14, 2015

After Moody's Bombshell, What Will Other Ratings Agencies Say?

When Moody’s Investors Service downgraded Chicago debt to junk status, it did more than tick off City Hall with its timing. It ramped up pressure on other rating agencies, giving them something else to ponder in deciding how soon to act.

Moody’s announcement on May 12 preceded—and threatened to short-circuit—city efforts to refinance $900 million in variable-rate debt and borrow $200 million to pay off interest-rate swaps and avoid termination fees and other financial penalties associated with a lower credit rating.

“The fact is, the risk has escalated because of Moody’s actions,” said Richard Ciccarone, the Chicago-based CEO of Merritt Research Services. “They’ve become part of the problem.”

While Moody’s has dropped the city’s debt rating by seven notches, to Ba1, one level below investment grade, since mid-2013, Standard & Poor’s Rating Services has maintained an A-plus rating—five rings from the top—for more than four years.

The six-notch spread is the widest for any city, creating challenges for debt traders.

“The market is having difficulties on price discovery,” John Donaldson, who helps manage about

$700 million of munis, including Chicago debt, tells Bloomberg. The director of fixed income at Haverford Trust in Radnor, Pa., adds, “What level should something with that big a gap trade at?”

OTHER DOWNGRADES COMING?

S&P warned last week that it, too, could lower the city’s rating by more than one notch. But it gave the city breathing room, indicating that a downgrade would happen only if the city failed to implement a plan by the end of this year to “sustainably fund” its pension contributions, or if it “substantially” draws down its reserves to do so.

Chicago pensions are underfunded by about $20 billion.

After Moody’s acted on May 12, Fitch Ratings, which rates Chicago debt A-minus, said it was “in contact with city management and will assess the rating impact of the recent downgrade.”

Mike Belsky, a former group manager in public finance for Fitch in Chicago, contends that Moody’s acted prematurely, underestimating Chicago’s “booming economy” and City Hall measures to work out of its pension mess. He adds, “S&P puts more weight on underlying economics than Moody’s.”

Mayor Rahm Emanuel termed Moody’s decision “irresponsible.” Meanwhile, yesterday Moody’s downgraded Chicago Public Schools debt to three grades below investment quality and lowered the Chicago Park District’s debt rating to match the city’s.

The city maintains that its pension situation is different from the state’s. It argues that if changes to Chicago’s pension system are overturned, the city won’t be on the hook for obligations of municipal and laborers funds. Instead, the city will revert to a multiplier-based funding obligation, it says, “and the funds will go broke in 10 and 13 years, respectively.”

Some municipal market veterans expect S&P and Fitch to issue downgrades on Chicago debt soon, but possibly not until after seeing what the Illinois General Assembly does about the pension bomb before adjourning later this spring.

Rating agencies tend to act more in lockstep when upgrading ratings than downgrading them, according to municipal finance officials.

MOODY’S EXPLANATION

Moody’s downgrade of city debt came just days after the Illinois Supreme Court on May 8 ruled unconstitutional pension law changes enacted by the Legislature in 2013. The decision wasn’t a surprise to Moody’s, which said it had anticipated such a result, baking it into a prevailing A3 rating and a negative watch on state debt.

Why, then, did it choose to downgrade Chicago debt, without first putting it into a “rating under review” category that typically opens a 90-day window for rating changes?

“The Supreme Court decision on pension reforms affects both entities, but widens the flexibility difference between them, as the option of reforming pension benefits was relatively more important to the city than the state, in our view,” Moody’s said. “Among the state’s broader set of options are reversing recent income tax cuts, reducing revenue sharing with local governments, and shifting pension costs to school districts and universities.”

Last month, preceding a $300 million bond sale, Chicago Public Schools did not seek a rating from Moody’s, after the Chicago Park District and the Chicago Transit Authority shunned the agency last year.

That history could have factored into Moody’s move this week—but not as payback, according to some municipal market observers.

“A rating agency that did that . . . you’d be out of business,” says Bill Morris, a retired investment banker and former state senator. “They might have felt need to give them fair warning before they do anything else. In fact, not hiring them may have precipitated this. All three (rating agencies) evaluate the big issuers whether you use them or not.”

City Hall wouldn’t say what agencies it approached about pending refinancings. Moody’s declined to comment on the matter.

‘STREET CRED’

Paul Vallas, a former Chicago budget chief and CEO of CPS, said Moody’s move, while “accurate,” is striking. “It is bold, but the bottom line is, certainly, anyone who looks at the city’s finances should not be surprised. But it’s bold that they would do it now . . . just after the mayor’s been re-elected.”

Others argue that Moody’s and its ilk are still compensating for overly rosy ratings that preceded the mortgage-market meltdown.

“All the agencies are trying to re-establish their street cred,” says Bill Brandt, a former chairman of the Illinois Finance Authority. “When the pendulum swings, it tends to swing to the extreme.”

About $10 million of federally tax-exempt Chicago debt maturing in 2040 changed hands yesterday at an average yield of 5.84 percent, the highest since December 2013, according to data compiled by Bloomberg. By comparison, the yield to maturity on BBB general obligations is 5.2 percent, Bank of America Merrill Lynch data show. It’s almost 8 percent for the high-yield muni index.

CRAIN’S CHICAGO BUSINESS

By STEVEN R. STRAHLER

May 14, 2015

A Lower-Risk Strategy for Muni Bonds.

Investors often are encouraged to think about the long run. But with municipal bonds, it also could pay to focus on the near term.

In recent months, investors have been lured by longer-term debt issued by U.S. cities, states and other government entities with yields that look relatively appealing in an era of low interest rates.

That contributed to a rally that pushed muni bonds up 9% across the board in 2014, including price changes and interest payments, according to Barclays.

But those bonds could be vulnerable if the Federal Reserve increases interest rates later this year, as many experts expect, because longer-term bonds tend to be more sensitive to changes in interest rates.

As a result, investors who worry that prices could fall sharply may be better off buying funds that hold short- or intermediate-term munis, which may not get hit as hard, according to experts.

“Sticking to intermediate and short-term funds of all flavors is generally a good idea,” says Scott Brewster, president of Brewster Financial Planning in Brooklyn, N.Y. “I would get out of anything extremely long-term, because you’re just an interest-rate spike away from heartache.”

Investors who own short-term muni bonds—generally those that mature in less than five years—also could have an opportunity to get a bargain after interest rates rise, because bond prices likely will be lower and yields more favorable, experts say. The same is true of investors who are currently on the sidelines but are considering buying munis down the road. (Bond yields rise as prices fall.)

That kind of bargain could be particularly appealing to investors who turn to the $3.7 trillion muni-bond market as a source of safe and stable income, often to help fund retirement. Those investors, who plan to hold the bonds more or less indefinitely, can be indifferent to short-term price swings.

“In those periods where the market sells off, I would view those as an opportunity to put some money to work and buy,” says Peter Hayes, head of municipal bonds at investment giant BlackRock.

This year, the prospect of higher interest rates has helped put a damper on muni bonds, which are essentially flat through Thursday, according to Barclays. Mr. Hayes says they are inexpensive relative to U.S. Treasury or corporate debt, even after last year’s rally.

Munis are often favored by investors who can benefit the most from the tax advantages. Investors typically pay no federal income tax on interest payments, and there is usually no state income tax due on the interest when residents buy bonds issued by their state or its municipalities.

Investors face certain risks with muni bonds, including the threat of default—a threat underscored by Puerto Rico’s ongoing struggles with a high debt load and a weak economy, which has pushed down the value of its bonds.

Morningstar, the Chicago-based investment researcher, recommends several muni-bond funds that focus on shorter-term bonds and that charge low fees, including the Vanguard Limited-Term Tax-Exempt Fund, which has assets of $21 billion and charges annual fees of 0.20%, or $20 on a $10,000 investment.

Low fees are key to boosting returns from low-yielding assets such as muni bonds, experts say.

Other options include the Fidelity Limited Term Municipal Income Fund, with $4 billion in assets and fees of 0.48%.

Intermediate-term muni bonds, which typically mature in five to 12 years, generally offer higher yields but also are more sensitive to changes in interest rates—though not as sensitive as long-term debt.

“Historically, intermediate has been an attractive balance,” says Chris Alwine, head of the municipal-bond group at Vanguard Group. Funds that hold intermediate-term bonds tend to “outperform when it comes to interest rates,” he says.

Among intermediate-term funds, Morningstar recommends the Vanguard Intermediate-Term Tax-Exempt Fund, with assets of $43 billion and fees of 0.20%; the Fidelity Intermediate Municipal Income Fund, with assets of $5.4 billion and fees of 0.36%; and the T. Rowe Price Summit Municipal Intermediate Fund, with assets of $4.1 billion and fees of 0.5%.

To be sure, buying shorter-term debt can mean giving up some of the potential gains that long-term bonds can enjoy if, for example, the stock market drops sharply.

“Short-term funds tend to have a higher correlation to equities, so you’re not getting as much diversification,” says Robert Bradley, chief investment officer at NorthLanding Financial Partners, an advisory firm based in Rochester, N.Y. “If the S&P 500 is down 7% in a month, long munis or Treasurys are likely going to rally in that event, and short-term debt is more likely to just hold its value.”

For investors willing to accept that trade-off, one way to decide whether to favor short-term or intermediate-term muni bonds is to think about when you will need your principal back, according to Christine Benz, director of personal finance at Morningstar.

An investor who needs the money in the next few years might want to steer clear of intermediate-term funds, she says, because the bonds in the fund portfolio could drop in value if interest rates rise.

If your bonds mature before you need the money, that risk goes away. In that case, she says, you aren’t “in the position of guessing what the Fed will do.”

THE WALL STREET JOURNAL

By AARON KURILOFF

May 15, 2015 9:43 a.m. ET

Write to Aaron Kuriloff at aaron.kuriloff@wsj.com

Cities, Towns See Historic Savings on Bond Refinancings.

Officials who manage the Indianapolis Airport Authority’s $1.1 billion in bond debt typically refinance bonds when they can shave at least 3 percent off total remaining debt payments.

These days, 3 percent seems paltry. The Indianapolis Local Public Improvement Bond Bank handles what the industry calls bond refundings for entities including the airport, and it recently helped refund a $165 million airport bond to chop total projected debt obligations by about 9 percent.

“Those are incredible savings,” said Gregory Clark, executive director of the Indianapolis Bond Bank. Clark said since 2012, the airport has refunded four of the six bonds involved in building the 1.2-million-square-foot, 40-gate facility, effectively eliminating $59.5 million in projected payments through 2034, after adjusting for inflation.

Those kinds of opportunities have sent the bond bank and other municipal bond issuers on a refinancing tear the past few years. Historically, new municipal capital has outpaced refundings. But from January 2012 to December 2014, some $600.2 billion of municipal bonds were refunded nationwide, compared with $445 billion in new bond issues, according to the Securities Industry and Financial Markets Association.

And things don’t appear to be slowing down. In the first three months of 2015, there has been $75 billion in refundings versus $30.4 billion in new issues.

Some in the industry, including Clark, point to Federal Reserve policy as one of the factors behind the refunding spree. On Dec. 16, 2008, the Fed lowered its key interest rate to 0.25 percent, which ultimately sent bond yields lower.

The move was aimed at stimulating the economy during the Great Recession. Nearly seven years later, it's still unclear when the Fed will increase rates to ward off inflation, but some bond issuers are rushing to refinance debt—sometimes prematurely—before sizable interest-rate spreads tighten.

Speaking of municipalities advised by H.J. Umbaugh & Associates, partner Brian Colton said, "If there's one that they want to refund and they like that savings amount, you typically move pretty quickly because you don't know what's going to happen with rates."

Then and now

Average interest rates on AAA-rated, 20-year bonds hovered between 4 percent and 5 percent a decade ago, according to Thomson Reuters Municipal Market Data. Bond issuers usually have to wait 10 years to refinance without incurring a penalty, so today, they can effectively refund those old 20-year notes for 10-year notes with a 2-percent yield.

Municipal bond issuers typically have always been able to extract savings by refunding. But since the Fed lowered its key rate in 2008, the savings have been particularly attractive.

Using Thomson Reuters data, IBJ analyzed the difference, or spread, between yields on 10-year notes and 20-year notes from exactly a decade earlier. The average spread has been about 2.49 percentage points—or 249 basis points—since Dec. 16, 2008.

Over the same span before that date, the average spread was about 189 basis points.

Greenfield is one example of a local municipality that took advantage of wide spreads. The city's water utility issued $11.3 million in debt in 2004 for its Beckenholdt Park water works project, and had $8.6 million left to pay in principal and interest as of January.

Otto "Buzz" Krohn, the city's municipal bond adviser, helped the utility slash that $8.6 million to $6.5 million by refunding the bonds. After the costs associated with refinancing, the utility saved $955,000.

"They gave us rates that were over 2 percent but less than 2.5 percent," Krohn said about the debt, which has a blended interest rate structure. "We were trading off rates that were between 4.25 percent and 4.75 percent."

Windows of opportunity

Not only have the savings been relatively higher since 2009, but there have been more opportunities for sizable savings.

Yields on new 10-year bonds have been at least 250 basis points lower than yields on decade-old 20-year bonds for more than half of the 332 weeks following the Fed's rate decrease, according to an analysis of Thomson Reuters data.

In the 332 weeks before the rate cut, spreads of at least 250 points occurred in only 35, or 11 percent, of the weeks.

The result: Municipalities have had more opportunities to refund for big savings.

Carmel, whose population has leapt 60 percent since 2000, has issued nearly $500 million in debt since then. The bonds have been used for projects including The Palladium at the Center for Performing Arts, the Keystone Avenue road project and City Center.

City officials have refunded six bonds since 2011, including three in 2014, and have achieved an inflation-adjusted $64.2 million in savings through those transactions, according to city records provided by Umbaugh.

“The bonds that were issued in the mid-2000s are reaching their sweet point for refunding as they approach their call dates,” Umbaugh’s Colton said.

Some municipalities have been pulling the trigger on refundings before bonds are callable at the 10-year mark. The move, called advanced refunding, entails paying debt service on two notes until the old note becomes callable.

The further from the call date, the more costly the maneuver.

Noblesville has done nine, mostly advanced, refundings since 2012, city attorney Michael Howard said. They’ve managed to net $14.7 million in inflation-adjusted savings, including $3.9 million on the 146th Street extension project.

The savings might have grown had the city waited for call dates, but city officials decided to lock in the $14.7 million.

“It’s a gamble either way,” Howard said.

How savings are used

Total savings aren’t fully realized until bonds mature, but bond issuers will see it gradually in the form of lower debt-service payments.

Some city officials plan to use the money they save through refinancing for other expenses. Carmel Mayor Jim Brainard said the savings that have stayed in the city’s general fund will help pay for expenses like firefighters and sidewalks. For its separate redevelopment fund, the savings will help fund new projects, he said.

Noblesville Mayor John Ditslear said savings should help the city bolster project ambitions. For instance, he said elected officials there intend to spend $1.3 million on street resurfacing next year, and, “Frankly, if we had twice that [amount] that we were able to spend, then we would.

“So these savings over the next several years will help do things like that.”

Some bond issuers have opted to keep debt service payments steady and lower the term of the loan. Krohn, Greenfield’s bond adviser, said he’s witnessed bond issuers taking the savings “on the back end instead of the front end.”

Jennifer Wilson, a Crowe Horwath director specializing in municipal finance, said savings can mean two things for utilities: “It will either, one, postpone a rate increase … or it will give them funds for additional capital projects.”

Savings entail relief for some municipalities. Noblesville has had to divert general-fund cash in the past to help service debt of some projects, said Howard, the city attorney.

The city can now keep that general fund cash and use it for things like public safety hiring, Howard said.

Window closing?

Speculation has swirled for years that the Fed will raise interest rates to ward off inflation, but the key rate remains at 0.25 percent. Fed policymakers await sustained momentum in the national economy before acting.

Economists thought a rate hike might come in June, but the predictions have been pushed back because of recent economic weakness.

So no one knows how soon the Fed will increase rates. But even if they stay flat and yields on 10-year, AAA-rated municipal bonds—around 2 percent lately—stay flat into the 2020s, interest rate spreads will shrink.

That’s because 20-year, AAA-rated bonds have dipped near 2 percent in recent years.

“When you’re at historically low rates like we are right now,” said Umbaugh’s Colton, “there’s a good possibility that 10 years out that you might not be able to refund something.”

Rates and spreads are unpredictable, so some bond issuers are moving swiftly to lock in savings and aren’t finished yet.

“Because we’ve rarely ever seen rates this low,” Clark said, “you really have to look at everything, whether it’s callable or not.”

Officials at Umbaugh said they’re considering an advanced refunding on a Carmel bond that’s callable in 2021.

Howard, the Noblesville attorney, said interest rates could get lower before they get higher. But Noblesville isn’t banking on that and has decided to exit the guessing game with its $14.7 million now.

“If they go down 10 or 15 basis points, yeah, maybe you save that. But it takes 60 days to put one of these deals together. It’s not like you’re sitting there at your computer and interest rates go down 20 basis points and you lock.”

Indianapolis Business Journal

Jared Council

May 16, 2015

S&P Webcast Replay Now Available: State and Local Governments Outlook 2015.

Standard & Poor’s Ratings Services held an interactive, live webcast on Thursday, January 15, 2015, at 11:00 a.m. Eastern Time where we discussed the 2015 outlook for U.S. state and local governments.

Held on Thursday, January 15, 2015

Listen to the replay here.

BAML Economist Tells Muni Analysts: Don’t Fear the Fed.

LAS VEGAS – “Don’t fear the Fed” and looming interest rate increases, a senior economist at Bank of America Merrill Lynch Global Research told municipal analysts meeting here Wednesday.

The Federal Reserve is likely to begin hiking interest rates at a very slow pace in the final quarter of 2015, presenting little risk to the municipal bond market, said Michael Hanson, presenting his outlook on the economy and its impact on the market at the National Federation of Municipal Analysts’ annual conference here.

Hanson, who is responsible for Fed analysis at his bank, said he expects the Fed to begin raising rates at a rate of 0.25% every other meeting beginning in September and to shift its reinvestment strategy in early 2016.

The Fed has been holding interest rates at extremely low levels for several years now, and some market observers have warned of a potential liquidity problem in the fixed-income markets when the central bank stops holding rates at artificially low levels.

“They’re going to go very slow,” Hanson said, adding that the Fed is now much more communicative about its intentions than it has been historically. The past perception of a central bank’s job was that policy changes should “shock” the market, he said, but now the emphasis is on communication in an effort to nudge the market into doing the work itself.

“Back in 1994, you didn’t even get a press statement after a meeting,” he said.

Hanson said that while there is a chance the market could misread the Fed’s intentions and present some volatility when policy shifts, he does not expect the kind of sharp reaction that occurred during such shifts in the mid-1990s.

“The bottom line here is: Don’t fear the Fed,” Hanson said.

He added that he is relatively upbeat about the overall economy, and expects a modest 2nd quarter rebound followed by a better than 3% gross domestic product growth rate in the second half of the year. While Congress remains divided, he added, there is no longer the “budget brinkmanship” that persistently damaged the U.S. economy over the last several years, Hanson said.

“It is a better environment than it was a few years ago, and that should be a net positive,” he said.

Jeffrey Burger, a senior fixed income portfolio manager at Standish Mellon Asset Management, said during a later panel discussion that municipal bonds have historically exhibited less interest rate sensitivity than many other financial products because it is a more buy-and-hold market than most others and because the tax-exemption is attractive. Intermediate duration bonds could be especially well-positioned, he said.

“A good place to be would be intermediate municipals,” Burger said.

An analyst attending the meeting said there appears to be at least some doubt that the Fed will act or will act even more slowly than it seems to be indicating.

Burger warned that there is the possibility of a blow to the market if inflation exceeds the very low expectations of most economists, but said the chance of that seems fairly small. Another threat could be a change of sentiment about munis if there is some kind of regulatory or legislative change to the landscape, such as a tax reform change to the tax exemption, he added.

The NFMA conference continues through Friday.

THE BOND BUYER

BY KYLE GLAZIER

MAY 13, 2015 3:52pm ET

Calpers' Pension Hammer Forces 'Unfair' Bond Ruling by Judge.

California's public retirement fund holds so much power over local officials that pension-bond investors can't expect equal treatment when a city goes bankrupt, a judge said in a ruling that she acknowledged seems "unfair."

U.S. Bankruptcy Judge Meredith Jury on Monday threw out a lawsuit in which investors had claimed their pension bonds must be paid off at the same rate as the California Public Employees' Retirement System in the San Bernardino bankruptcy. The $304 billion fund is the biggest in the U.S.

Jury acknowledged that her decision may discourage investors from buying pension-obligation bonds in the future.

"What I see as unfair, and might seem unfair to the outside world, does not matter under law," Jury said, referring in part to the powerful remedies Calpers can seek if the city doesn't honor its contract.

Monday's ruling sticks with a pattern seen in the bankruptcies of Stockton, California, and Detroit, said Marilyn Cohen, president of Envision Capital Management in El Segundo, California.

An investor who buys pension-obligation bonds "is just asking for trouble," said Cohen, who manages $345 million for individual investors. The cities' bankruptcies show that pensioners and municipal employees have an advantage over bondholders, she said.

'New Template'

"That's the new template," said Cohen, who recommends that her clients buy revenue bonds and avoid municipalities with high pension obligations.

San Bernardino filed for bankruptcy in 2012, blaming the high cost of fire and police labor contracts, including pensions. At first, officials balked at paying Calpers before other creditors. After months of mediation, the city agreed to repay Calpers in full and maintain normal monthly contributions on behalf of its employees.

By the end of the month, San Bernardino must file its debt-reduction plan, which will give bondholders an idea of how much they may recover. Any proposal must go to creditors for a vote before Jury makes a final decision.

Jury's ruling on the pension debt wasn't a surprise, said Robert D. Gordon, an attorney at Clark Hill PLC. Gordon represented pension systems in Detroit's record-setting municipal bankruptcy.

Contract Rights

Calpers has a contract to provide services to San Bernardino, which gives it different legal rights than the debt contract with bondholders, Gordon said.
In Detroit, pension bondholders owed about $1.4 billion were forced to take deeper cuts than city workers and retirees, some of whom recovered more than 90 percent of what they were owed.

Even before the ruling, the municipal bond market had begun treating an agency's decision to issue a pension-obligation bonds as an act of desperation, said Howard Cure, director of municipal credit research in New York for Evercore Wealth Management LLC, which oversees $5.9 billion.

The bankruptcy cases show there's little security for pension bondholders, Cure said. Unlike lease-revenue bonds, there's no collateral, he said.

Investors are "on the verge" of making decisions based on whether a state allows its cities or counties to file bankruptcy and the existence of state-mandated bondholder protections, Cure said.

Bank Sues

Pension-bond holder Erste Europaische Pfandbrief- & Kommunalkreditbank AG sued San Bernardino, claiming it should be on equal footing with Calpers. The Luxembourg bank holds about $50 million in pension-obligation bonds.

To get permission to issue the pension bonds in 2005, the city obtained a court ruling that it wasn't creating new debt but simply using the bonds to repay an existing Calpers liability, bondholder attorney Vincent J. Marriott told Jury Monday. That ruling means the bond debt should be treated the same as any debt owed to Calpers, Marriott said.

Jury disagreed.

One of the biggest differences between pension bondholders and Calpers is simple power, Jury said. If Calpers isn't paid, it can reduce pension payments to a city's employees, she told Marriott. Bondholders don't have that kind of recourse, according to the judge.

'Right Decision'

"We feel the judge made the absolute right decision," Calpers spokeswoman Rosanna Westmoreland said in a phone interview. "Now San Bernardino can get on to working on their path forward."

In Stockton's bankruptcy, a federal judge approved cuts to bondholders, while allowing the city to fully repay Calpers. The judge ruled that Stockton could have tried to reduce its obligation to Calpers also, since pension debt has the same general priority as other debt that's not backed by collateral.

The city argued that fighting Calpers would take too long and could endanger employee pensions.

The San Bernardino case is Erste Europaische Pfandbrief und Kommunalkreditbank AG v. City of San Bernardino 15-ap-01004. The bankruptcy case is In re San Bernardino, 12-bk-28006, U.S. Bankruptcy Court, Central District of California (Riverside).

Bloomberg

by Steven Church and Romy Varghese

May 12, 2015

S&P: Chicago; General Obligation; Joint Criteria.

Standard & Poor's Ratings Services lowered its rating to 'A-' from 'A+' on the city of Chicago's outstanding general obligation (GO) bonds, and placed the ratings on CreditWatch with negative implications. In addition, Standard & Poor's affirmed its 'AAA/A-1+' rating on the city's existing variable rate demand bonds (VRDBs).

The lowered rating reflects our view that short-term pressures are challenging the city's ability to implement timely solutions to its structural budgetary problems. These short-term disruptions, such as the recent mayoral run-off and the current need to address potential liquidity pressure due to rating triggers, raise concerns from our perspective regarding management's ability to focus on the timely implementation of needed measures to successfully address its long-term structural challenges. We believe the rating is currently constrained by the risk regarding management's plans to address its high fixed costs in light of this need to address short-term pressures.

Continue reading.

14-May-2015

What Pension Rulings in Illinois and Oregon Could Mean for States.

Twice in two weeks, courts struck down state attempts to cut pension benefits of state employees and retirees, a development that indicates just how hard it is for states to solve budget problems by slashing public pensions.

On Friday, the Illinois Supreme Court ruled that the state's 2013 pension legislation that raised the retirement age and reduced Cost-of-Living-Adjustments (COLAs) was unconstitutional. The court ruled similarly last year on a proposed change to the state's retiree health benefits, so observers expected the latest ruling. However, the situation puts Illinois, which already has the lowest credit rating of any state, on the verge of a rating downgrade if it can't solve its fiscal crisis and fix its $7 billion budget deficit.The court ruling has already resulted in Moody's downgrading Chicago's credit rating to junk status; the city's pension debt is a huge component of its financial problems.

In Oregon, the state's high court ruled on April 30 that its 2013 reduction to COLAs was unconstitutional. The court dismissed the state's argument that the cuts were necessary for the state to continue its essential services, an argument similar to the one Illinois offered.

"One important difference in all this is that Oregon doesn't have the explicit constitutional [pension] protection Illinois had," said Keith Brainard, research director for the National Association of State Retirement Officers. "But nevertheless Oregon's supreme court found that COLA reform did violate the contract protection those workers had."

Over the past several years, states have litigated scores of pension cuts with different results. In places like Colorado, Florida and Washington, courts upheld benefits changes. Elsewhere, like in Arizona, courts struck down such changes.

Experts say that last week's ruling leaves cash-strapped Illinois with little recourse except to take drastic action. Even before the ruling, Gov. Bruce Rauner proposed slashing current employees' retirement benefits in an effort to close his state's continual budget gaps. Rauner's proposal would allow current employees to keep the pensions they've already earned but future benefits would be less generous. He estimated the move would save $2.2 billion in 2016 alone. Key to his plan would be a voter referendum clarifying that the state's constitutional public pension benefit protection clause applies neither to future accruals nor to health insurance.

Changing the state constitution is extremely difficult, but for states that have been rejected by the courts or don't have a good track record, it may be the last available option, said Frank Shafroth, director of the Center for State and Local Government Leadership at George Mason University.

"These governors and legislatures are going to have to go to the people and say it's not adding up," said Shafroth, who is a Governing contributor. "Something's got to give here."

That may also be the case for New Jersey, which has pending litigation regarding its elimination of COLA benefits in 2011. Like Illinois, the state has struggled repeatedly with budget deficits and has neglected its pension funding requirements as a result. Without waiting for a ruling on the 2011 legislation, Gov. Chris Christie has proposed going even further. Earlier this year he said he wants to close down the plan entirely and move active public employees into a hybrid of a traditional pension plan and a 401(k)-like plan.

James Spiotto, a bankruptcy expert and co-publisher of the MuniNet Guide to municipal research, said the message the Oregon and Illinois rulings send is that states should avoid pension litigation at all costs. He pointed to the recent pension settlement in Rhode Island that changed COLA payments and ultimately reduced pensions payouts (although not as drastically as the initial legislation proposed). Litigation drags on for years and creates uncertainty, Spiotto said. In the case of Oregon, a negative ruling can create additional budget pressure as the state and its municipalities must pay more in pension contributions in future years than the pension fund forecast.

"It's clear that in not just these cases but all of them that we're far better off finding the solution and negotiating it rather than litigating it," he said. "If you don't fix it as a practical matter, then both sides lose."

GOVERNING.COM

BY LIZ FARMER | MAY 13, 2015

Chicago's Junk Rating From Moody's Puzzles Investors.

No U.S. city has provoked a bigger disagreement between the two largest bond-rating companies than Chicago. Investors aren't sure whom to believe.

Moody’s Investors Service has cut the third-largest city’s rating seven levels since July 2013, most recently knocking it this week to Ba1, one step below investment grade. Standard & Poor’s has rated it A+, the fifth-highest rank, for more than four years.

The six-level split is more than for any other city and unheard of for an issuer with $8.1 billion of general-obligation debt like Chicago, said Matt Fabian, a partner at Municipal Market Analytics. As the city plans $383 million of refinancing deals next week, trading in the $3.6 trillion market signals bond buyers are moving closer to Moody’s view, while stopping short of assessing it like junk.

“The market is having difficulties on price discovery,” said John Donaldson, who helps manage about $700 million of munis, including Chicago debt, as director of fixed income at Haverford Trust Co. in Radnor, Pennsylvania. “What level should something with that big a gap trade at?”

Emanuel’s Response

Moody’s lowered Chicago’s grade after the Illinois Supreme Court rejected a state pension-overhaul plan May 8. The New York-based company said the ruling reduced the city’s options for fixing its own system, which is underfunded by $20 billion. Mayor Rahm Emanuel, who last month announced a plan to fix the city’s financial mess, called the rating cut an “irresponsible decision.”

Federally tax-exempt Chicago bonds maturing in January 2033 were the city’s most frequently traded securities on Thursday, according to data compiled by Bloomberg. They changed hands at an average yield of 5.89 percent, the highest since they were issued in March 2014.

By comparison, the yield on an index of BBB general obligations with an average maturity of 16.9 years is 5.2 percent, Bank of America Merrill Lynch data show. It’s 7.9 percent for Bank of America’s high-yield muni index, which has an average maturity of about 19 years.

Chicago issuers have started to shun Moody’s in bond offerings. Both the Chicago Park District and Chicago Transit Authority didn’t use a Moody’s rating in June 2014 deals, data compiled by Bloomberg show. S&P rates the two issuers AA+ and AA, respectively, the second- and third-best grades.

The Chicago Board of Education excluded Moody’s when it sold $300 million of debt last month.

Schools Downgraded

Moody’s dropped the school system’s grade again Wednesday, cutting $6.2 billion of general obligations to Ba3, three levels below investment grade. The park district fell to Ba1, the same as the city. The company said the ratings reflect the strain of Chicago’s swelling retirement bills.

That emphasis on unfunded pension obligations differentiates Moody’s approach, said Paul Mansour, head of municipal research at Conning, which oversees $11 billion in munis for insurance companies.

“Moody’s rating methodology happens to disadvantage Chicago tremendously,” said Fabian at Concord, Massachusetts-based MMA, a research firm. “Chicago is a big, vibrant city that has a lot of things going for it, but it also has this gaping pension problem.”

David Jacobson, a Moody’s spokesman, referred to Tuesday’s report to explain the company’s rating. Alex Ortolani at S&P referred to a statement from analyst Helen Samuelson. She said the company would monitor how the Supreme Court ruling affects the city’s plan to address its unfunded pensions.

More Downgrades

Fitch Ratings and Kroll Bond Rating Agency both rate the city A-, two steps below S&P. The three companies will probably downgrade the city multiple levels because of the liquidity risks, Nuveen Asset Management said in an e-mailed report Wednesday.

Using Moody's assessment, Chicago and some of its related entities now comprise the largest segment of the high-yield municipal market outside of Puerto Rico and tobacco bonds. Moody's cut at least $15.7 billion of Windy City debt to speculative grade this week.

The only issuers with such divergent ratings are also deemed junk by Moody's. They include Clarendon Hospital District in South Carolina, school warrant obligations from Jefferson County, Alabama, and Yeshiva University in New York.

"Puerto Rico was a much worse credit at investment grade than Chicago is at non-investment grade," Fabian said. "Maybe it's not appropriate that Chicago be rated by Moody's anymore."

Bloomberg

by Brian Chappatta and Elizabeth Campbell

May 13, 2015

Puerto Rico Crisis Seen Muddying MBIA's Bond-Insurance Comeback.

The risk of losses tied to Puerto Rico is clouding MBIA Inc.'s comeback in the resurgent business of guaranteeing state and municipal debt.

After years of healing from the financial crisis that wiped out insurers' AAA ratings, MBIA's National Public Finance Guarantee Corp. has been starting to win new business. National backed two deals in 2014 and eight more this year, mounting a challenge to Assured Guaranty Ltd., the biggest guarantor in the $3.6 trillion municipal market.

A worse-than-expected outcome in the Caribbean commonwealth could derail MBIA Chief Executive Officer Jay Brown's progress. The bond insurer has almost double Assured's exposure to Puerto Rico's troubled power authority — known as Prepa — which is on the brink of an unprecedented $9 billion municipal restructuring. The cost of debt insurance on MBIA has been climbing relative to Assured, and researcher CreditSights Inc. cut its recommendation this week on MBIA's obligations to "underperform."

'Severe Scenarios'

"Assured Guaranty is a company that can withstand some pretty severe Puerto Rico outcomes without discussions of whether it can still pay dividends up to the holding company," said Josh Esterov, an insurance analyst at CreditSights in New York. "That question becomes murkier for National in some of the more severe scenarios."

Assuming an immediate default on all Puerto Rico bonds, a recovery rate of 50 percent would just about wipe out all of National's statutory capital, according to the CreditSights report from May 13. Such a loss would require 40 percent of Assured's funds.

CreditSights maintained its “outperform” recommendation on Assured in a May 10 report.

National and Assured will be able to absorb losses from Puerto Rico, said Mark Palmer, an analyst at BTIG LLC in New York. For National, however, the cost will become clearer sooner, he said.

“MBIA is more levered to the outcome at Prepa,” he said. “July 1 is a very important date for Prepa because that’s when the next meaningful maturity occurs.”

Kevin Brown, a spokesman at Armonk, New York-based MBIA, declined to comment on the CreditSights recommendation. CreditSights previously ranked the company “outperform.”

Rating Increase

Standard & Poor’s raised National’s financial strength rating in March 2014 to AA-, the fourth-highest rank, giving the insurer an opening to back debt from weaker localities. The rating is one step lower than Assured’s municipal-insurance units and competitor Build America Mutual Assurance Co.

S&P analyst David Veno estimated in a July 2014 report that National could withstand $450 million of losses from Puerto Rico beyond the credit rater’s expectations before its grade would be at risk. That figure is probably higher now, he said in a telephone interview Thursday.

By comparison, Veno’s report predicted Assured had a capital cushion of about $1.55 billion.

MBIA shares climbed 4.9 percent to $9.94 at 2 p.m. in New York, the biggest jump since March. Assured stock rose 2.1 percent to $28.73. Puerto Rico’s governor and lawmakers reached an agreement late Thursday on a plan to raise the sales tax on the island, which may help it sell debt and ease a cash crunch.

Of National’s $4.54 billion in Puerto Rico exposure, the largest portion of gross par outstanding rests with Prepa, which municipal analysts expect to be the first of the island’s agencies to restructure its obligations. The insurer backed $1.42 billion of the utility’s debt through March 31, compared with $773 million for Assured, company filings show.

Prepa Deadline

As Prepa gets closer to a creditor-imposed deadline in June to restructure and a $416 million bond payment on July 1, the cost is increasing to own insurance on MBIA’s obligations.

Credit-default swaps tied to MBIA have widened to 520 basis points from 489 basis points at the start of 2015, according to data provider CMA, which is owned by McGraw Hill Financial Inc. and compiles prices quoted by dealers in the privately negotiated market.

The cost of protection is 200 basis points more than swaps tied to Assured, up from 107.5 basis points in December, the data show.

Credit-default swaps, which typically fall as investor confidence improves and rise as it deteriorates, pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a contract protecting $10 million of debt.

“In the insured portfolio, the uncertainty over Puerto Rico commands a lot of attention,” MBIA Co-President Bill Fallon said in a May 12 call to discuss first-quarter results with analysts and investors. Prepa “is the immediate focus,” he said.

Bloomberg

by Brian Chappatta

May 14, 2015

Bloomberg Brief Municipal Market Weekly Video - 5/15/15.

Kate Smith, a reporter at Bloomberg Brief, talks with Joe Mysak about this week's municipal market news.

Watch the video.

May 14, 2015

Court Fight Revs Up Over Legality of Chicago Pension Reforms.

CHICAGO — Chicago began an uphill battle in court on Wednesday to keep its cost-saving pension reform law from meeting the same fate as an Illinois law that was declared unconstitutional last week by the state supreme court.

The city is trying to salvage a 2014 law aimed at stopping two of its four retirement systems from running out of money. It is also dealing with the aftermath of Tuesday's credit rating downgrade to "junk" by Moody's Investors Service.

Cook County Circuit Court Judge Rita Novak set a July 9 hearing on motions by lawyers for city unions and retirees to toss out the 2014 law based on the high court's sweeping ruling that found the state constitution gives public sector workers iron-clad protection against their pension benefits from being cut.

Michael Freeborn, an attorney who filed one of the two lawsuits challenging the law, said a ruling by Novak could come soon after the July hearing, adding that Friday's supreme court ruling leaves "little if any wiggle room" to keep Chicago's law alive.

At a Wednesday status hearing on the lawsuits, Novak acknowledged that no matter how she rules, her decision will be appealed to the Illinois Supreme Court.

Chicago's top staff attorney, Stephen Patton, urged the judge to hear the case quickly, saying a prolonged process would be "extremely harmful to the city."

"We need certainty no later than the end of this year," Patton said.

Chicago contends its law, which boosted pension contributions by the city and its workers to the municipal and laborers' retirement funds and reduced benefits, differs from the now-voided 2013 law aimed at easing Illinois' $105 billion unfunded pension liability for state workers and educators. Illinois argued its so-called police powers to fund essential services allowed it to cut retirement benefits, but the supreme court disagreed.

“(Chicago’s law) doesn’t diminish and impair pensions, it saves pensions,” Patton told the judge. “That argument has not been addressed.”

Without additional funding and reforms, Chicago’s municipal and laborers’ retirement systems are projected to run out of money in 2026 and 2029. Meanwhile, the city must increase payments to its police and fire funds by $550 million next year.

Moody’s downgrade triggered $2.2 billion in accelerated debt payments and fees related to Chicago’s debt that banks could force the city to make.

Richard Prendergast, an attorney representing Chicago, said the city was engaged in “time-sensitive” negotiations with banks over those payments.

By REUTERS

MAY 13, 2015, 2:14 P.M. E.D.T.

(Editing by Matthew Lewis)

[San Bernardino Bankruptcy Plan: Bondholders Hammered While Pensions Kept Whole.]

SAN BERNARDINO, Calif. — The Southern California city of San Bernardino wants to repay its pension bondholders just a penny on the dollar while paying the state pension fund Calpers in full under its long-awaited bankruptcy exit plan released on Thursday.

Under the bankruptcy plan, called a plan of adjustment, San Bernardino also intends to virtually eliminate retiree health insurance costs, and outsource its fire, emergency response and trash services.

Gary Saenz, San Bernardino’s city attorney, said of the offer to the pension bondholders: “It’s obviously a tiny offer. From a fairness point of view, it looks like an insulting offer. But it is not an insult. Given the city’s circumstances, it is all the city can afford.”

San Bernardino’s bankruptcy blueprint follows the approach taken in the recent bankruptcies of Detroit, Michigan and Stockton, California, where bondholder debt and retiree healthcare costs were slashed or eliminated, while pensions emerged relatively unscathed.

In Detroit, general obligation bondholders received between a 22 percent and 66 percent cut to their debt.

The move could likely make capital market lenders more wary about loaning money to struggling cities, and could increase borrowing costs for cities already in debt.

“The city needs a workforce. And you can’t have a workforce without pensions,” Saenz told Reuters in January.

That issue was the driving force underpinning the bankruptcy plan, another city official said on the condition of anonymity, noting the city has a daily relationship with its workers that it needs to maintain for survival as a municipality, while its Wall Street lenders are wealthy absentee creditors.

San Bernardino proposes paying the Luxembourg-based bank EEPK, holder of $50 million in pension obligation bonds and the city's second largest creditor, a fraction of its original debt, according to the plan, posted on the city's website.

EEPK, along with Ambac Assurance Corp, which insures a portion of the pension bonds, and Wells Fargo, the bond trustee, have the $50 million principal amount of their debt slashed to just $500,000, or a penny on the dollar, under the bankruptcy plan.

Vincent Marriott, a legal representative for EEPK, said the bank would have no comment until it had fully read and considered the plan.

Under San Bernardino's plan, the city also asks that any creditor, including its pension bondholders, who object to its terms be forced to a judicial "cramdown", where the judge overseeing the case orders that the city's debt cutting wishes be met.

Final approval of a bankruptcy plan, which must be ratified by U.S Federal Bankruptcy Judge Meredith Jury, is likely to take months. Negotiations with city firefighters, who are suing San Bernardino over contract issues, have broken down. The police union still has not signed off on parts of the bankruptcy deal affecting its members. Bondholders are likely to vigorously fight the virtual elimination of their debt under the plan.

In March, San Bernardino revealed terms of a deal with the California Public Employees' Retirement System (Calpers), its largest creditor.

Calpers, which administers San Bernardino's pensions, is America's largest public pension fund, with assets of $300 billion. It is the administrator of pensions for more than 3,000 California state and local agencies, and has long argued that pensions cannot be touched or renegotiated, even in a bankruptcy.

The judges overseeing the bankruptcies of Detroit and Stockton both stated that pension rights are not inviolate in a bankruptcy. But city leaders in Stockton, and now San Bernardino, have chosen not to take on Calpers, despite the fact that the pension giant is hiking city contribution rates by up to 50 percent over the next 10 years.

Under San Bernardino's bankruptcy exit plan, the city under covenant pledges to pay Calpers all arrears and to continue paying Calpers in full in the future.

San Bernardino, a city of 205,000 that is 65 miles east of Los Angeles, declared bankruptcy in August 2012 with a $45 million deficit. Along with Detroit and Stockton, its bankruptcy is one of a handful that have been closely watched by the $3.6 trillion U.S. municipal bond market.

By REUTERS

MAY 14, 2015, 7:41 P.M. E.D.T.

(Editing by Bernard Orr)

Muni Default History Poses a Ratings Riddle.

When is a triple-B bond safer than a triple-A? The answer, based on historical default rates, is when the triple-B is a municipal bond and the other is a corporate security.

The ratings divergence isn't only a consideration for investors trying to choose between munis and corporates. On June 15 a Dodd-Frank Act rule goes into effect that requires rating agencies to adopt procedures designed so credit ratings weigh default risk "in a manner that is consistent" for all rated obligors and securities.

The approaching deadline "creates an imperative to get everything lined up," said Mark Adelson, a former chief credit officer at Standard & Poor's.

S&P and Moody's spokesmen said they were taking the rule seriously.

"We've been making preparations for this for years," a Moody's spokesman said. "Most of the preparations are pretty much done. We've already made most of the changes."

In the long run, the new rule "will only help the municipal upgrade trend," said Municipal Market Analytics managing director Matt Fabian. "Historically municipal ratings have been too low and have exaggerated the risk of default."

An attorney with experience in SEC regulatory compliance, speaking anonymously, said he was skeptical the current ratings for munis and corporates would be acceptable to the SEC.

"There is no way that is a uniform scale, and all it really takes to get the ball rolling is a complaint to the SEC that points out that disparity in default statistics," he said.

As for the investor implications, since BBB munis offer higher yields than AAA corporates as well as a tax exemption that the corporates lack, some may ask: why should anyone or any entity own corporates?

Default Rates and Yields

Studies published by Moody's Investors Service and Standard & Poor's show that the default rates of munis 10 years after being rated BBB are lower than the default rates of corporates 10 years after being rated AAA.

According to a Moody's report "US Municipal Bond Defaults and Recoveries, 1970-2013," the 10-year cumulative default rate for munis rated Baa1, Baa2 or Baa3 was 0.32%. According to the same study, the rate for Aaa corporates was 0.49%.

S&P Wednesday released its latest default report. The study by analyst Lawrence Witte found that in the 10 years after municipal bonds were rated BBB-plus, BBB, or BBB-minus, 0.42% defaulted. A March 2014 study by S&P managing director Diane Vazza and several others found that in the 10 years after corporate bonds were rated AAA, 0.87% defaulted.

If that history provides guidance, then Chicago (Baa2) is a safer investment over the long-term than Microsoft (Aaa). Moody's dropped the city's general obligation rating in February, citing the city's high levels of debt and pension obligations and expected growth in unfunded pension liabilities. S&P rates Chicago A-plus.

Even with lower default rates, investors in the munis are getting higher yields. On April 27, according to S&P Global Fixed Income, the average yield for a triple-A corporate bond with a 10 year maturity was 2.69%.

By comparison, according to Municipal Market Data on that date the average yield for a BBB general obligation municipal bond with a 10-year maturity was 2.94% and for a BBB taxable municipal bond with this maturity it was 4.13%. The BBB-rated muni yields are the average for BBB-plus, BBB, BBB-minus, Baa1, Baa2, and Baa3 bonds.

The interest of the GO would be tax-free while the interest from the corporate would be taxable.

After federal taxes, for those in the highest federal tax bracket, a corporate 10-year AAA bond bought on April 27 would have yielded 1.51% and the taxable muni would have yielded 2.31%. For those in a more moderate federal 25% tax bracket, these same bonds would have yielded 2.02% and 3.10% after federal taxes, respectively. These after-tax yields take into account federal taxes but not state or local taxes, which would normally lower the effective yield further.

Triple-B category GO muni bonds have consistently had more yield than AAA corporates. One year ago the spread was 31 basis points, five years ago 43 basis points, and 10 years ago nine basis points. None of these spreads take into account the impact taxes have in lowering corporate bonds' effective yields.

At any given point on the rating scale, munis have far less history of default than do corporates. In the 10 years after being rated Aaa 0.00% of the munis defaulted, while 0.49% of corporates defaulted, according to Moody's. Ten years after being rated Baa1, Baa2, or Baa3, 0.32% of munis defaulted, while 4.61% of corporates defaulted. Finally, in the 10 years after being rated Ba1, Ba2, or Ba3, 3.53% of munis defaulted, but 19.27% of corporates defaulted.

The Differences' Origin and Significance

Given munis' apparent superiority over corporates in terms of both yield and safety, The Bond Buyer asked several investment firms about the wisdom of holding corporates instead of munis. Citi, JPMorgan, Franklin Templeton, OppenheimerFunds, and Bank of America Merrill Lynch declined to answer.

MMA's Fabian said munis were frequently less liquid and less transparent than corporates. As for the liquidity issue, many munis "lack price discovery or ready markets," he said. Corporate bonds "often have a homogenous security pledge while municipal deals are essentially bespoke financings requiring that investors fully read the documents to know what they own."

"Lenders will look past these problems with municipals only because the default rates are so low," Fabian said.

At Charles Schwab, managing director Rob Williams and director Collin Martin wrote in an email that the default studies looked backward not forward. The migration of ratings upward by Moody's and S&P in the munis space in recent years may make their default rates more closely compare to corporates in the future. "Still, we expect that the default rate, on average, for investment-grade munis should remain lower than the default rate on investment-grade corporates," they wrote.

The Schwab officials also said there are fewer high-yield munis to choose from, compared with the selection of corporates. For investors who want to buy higher-yield bonds, corporates offer a wider choice, they said.

Corporate bonds can also be a wise choice for investors who plan to put them into tax-deferred accounts, like 401(k)s, they said.

"While default and recovery statistics appear better for municipal than like-rated corporate debt, that is based on historical information," said Howard Cure, director of municipal research at Evercore Wealth Management. "We are in a new era where we can see more municipal defaults going forward."

Alexandra Lebenthal, chief executive officer of Lebenthal Holdings, said she assumed that most corporate bonds are held in tax-deferred accounts, and people generally want to spread their eggs around.

The default rates and returns "show why munis make more sense," she said.

The U.S. Securities and Exchange Commission provision requiring comparability of ratings within an agency is paragraph (b)(3) of Rule 17g-8 on Nationally Recognized Statistical Rating Organizations.

In the final rule the SEC noted that the divergence between ratings' default rates at ratings agencies are not just between safer munis and riskier corporates. According to one study up to 2005, the five-year default rates of collateralized debt obligations at the lowest investment grade ratings from one ratings agency was about 10 times higher than the five-year default rates for corporate bonds, the SEC said.

The 2010 Dodd-Frank Act requires the SEC to examine each nationally recognized statistical rating organization once a year and issue an annual report summarizing the examination findings. The annual report to Congress is required by the Credit Rating Agency Reform Act of 2006.

In a December 2014 story on the SEC's increased demands on the ratings agencies, Moody's said in a statement to The Bond Buyer, "Moody's continues to enhance our policies and procedures in light of regulatory developments, and the SEC staff's findings and recommendations are helpful in that effort."

Ratings Agencies Respond

How the new rule affects ratings agencies' ratings remains to be seen.

In recent years both Moody's and S&P have engaged in recalibrations or applied new criteria to U.S. public finance, leading to broadly higher ratings for munis.

On average the changes were subtle. For example, in 2013 and 2014 S&P introduced a new local government rating criteria. This led to an approximately average 0.4 notch increase in the local government credits. Local government credits are 28% of all credits that S&P's U.S. Public Finance Group handles. So the changes to the local government rating criteria led to an average increase in ratings of about 0.1 notch across all the credits.

In 2010 Moody's did a recalibration of some of its municipal issuer ratings to address the category's comparative lack of risk at different rating levels. In categories closest to government, like general obligation and public water and sewer utility bonds, it raised ratings about one notch in the Aa category, two in the A category, and about three in the Baa category. Speculative grade ratings were left unchanged. For non-utility enterprise, public university, mass transit and a few other categories, S&P raised the ratings by one notch around the Aa and A categories. It left ratings unchanged for several other categories like nonprofits and public electric power utility bonds.

Neither S&P nor Moody's provided details on the overall average shift in their ratings due to these broad-based rating shifts.

One reason the ratings agencies maintain different levels of credit risks for given ratings between munis and corporates is that, “if you call [all municipal bonds] AAA then one is not creating a lot of value,” for the user of municipal ratings, said Adelson, the former S&P chief credit officer, who now is chief strategy officer at BondFactor.

In response to queries from The Bond Buyer about the divergent default histories at a given rating between munis and corporates, S&P and Moody’s gave similar answers.

“Comparability of ratings across asset classes and geographies is one of Standard & Poor’s main goals and one of the benefits of our global ratings scale,” S&P said in an email. “To accomplish this goal, we’ve adjusted all of our ratings to a common set of stress scenarios and definitions, which are embedded in all of our criteria.

“Our criteria are subject to regular periodic review across sectors to provide additional transparency and comparability. These improvements are intended to help market participants understand our approach to assigning ratings, enhance the forward-looking nature of these ratings, and enable better comparisons across ratings.”

Moody’s vice president Al Medioli said, “This is why Moody’s underwent its recalibration back in 2010, which put all our ratings on a single, universal scale.” He added, “Muni default rates are rising although still very low, and recovery rates are now similar to corporates in recent bankruptcies.”

Both S&P and Moody’s have known that default risks of their ratings diverge between corporates and munis since at least the early 1990s, Adelson said. They have shifted their responses back and forth over time but have never gone beyond making small adjustments to the ratings, he said.

THE BOND BUYER

BY ROBERT SLAVIN

MAY 6, 2015

Kyle Glazier contributed to this article.

Assessing Bond Insurers’ Exposure to Puerto Rico Still Tough.

Seven years after their ranks were decimated by the housing crisis, bond insurers are back in the spotlight as Puerto Rico struggles to stave off default.

Companies including Assured Guaranty Ltd., MBIA Inc. and others insure more than $14 billion out of the $72 billion in debt outstanding by the commonwealth’s government, utilities and other agencies, according to financial documents from the insurers.

But investors and analysts say the lack of detailed disclosure has made it hard to assess the insurers’ capacity to pay potential Puerto Rico claims should the territory default. While companies disclose principal and interest owed across their entire portfolios, sizable interest costs aren’t disclosed for individual bonds in some cases–including certain Puerto Rico debt.

Insurance-company financial statements are “more complex than looking at your average government,” said Bill Bonawitz, director of municipal research at PNC Capital Advisors, which oversees $6.5 billion in municipal debt. “There’s a lot more moving parts.”

Puerto Rico has been burdened for years with a sluggish economy and a high debt load, and warned in a report this month that it “may lack sufficient resources” to fund government programs and pay its debt in the upcoming fiscal year. Puerto Rico has been negotiating with creditors, but it is unclear whether the talks will allow the island to avoid what could rank as one of the largest municipal defaults ever.

Puerto Rico bonds are widely held by U.S. mutual funds and individual investors, in part because of generous tax advantages. If an issuer such as Puerto Rico defaults, insurers agree to make the scheduled principal and interest payments.

The island’s financial problems represent a major test for a bond-insurance industry that is still recovering from the financial crisis. Insurers lost billions of dollars during the crisis on the default of mortgage-backed securities and some have stopped writing new policies.

Investors have penalized surviving bond insurers in part for the difficulty of analyzing their books. Shares of Assured Guaranty and MBIA trade below their adjusted book value, a measure of net worth. Assured Guaranty stock closed Friday at $27.07, a 50% discount to adjusted book value, according to brokerage firm BTIG. MBIA closed at $8.74, a 65% discount.

“The stock prices of the bond insurers are where they are in part because of the complexity discount,” said Mark Palmer, an equity analyst at BTIG.

Assured’s stock is up 4.2% on the year and MBIA is down 8.4%, compared with a 2.8% advance on the S&P 500. Both companies’ shares, however, are trading higher than they were during the depths of the downturn. From 2007 to 2009, MBIA’s stock fell 94% to $4.50, while Assured Guaranty’s fell by 58% to $11.29.

Some insurers are planning to improve their disclosures, making it easier for investors to assess their claims-paying abilities. National Public Finance Guarantee Corp., a unit of MBIA, said it plans on Monday to update its website to include both principal and interest exposure for individual bond issues. Currently, only the principal amount is listed.

The distinction is important because bond insurers are on the hook for both principal and interest payments if an issuer defaults.

Assured Guaranty doesn’t provide a full list of individual bonds it insures across its various subsidiaries. But a spokesman said it provides principal and interest exposure on specific issuers “where we feel that may be useful to the market.” A breakdown of its principal and interest exposure to Puerto Rico entities is available on its website.

For a report in January, research firm CreditSights had to estimate certain figures regarding the insurers’ principal and interest exposure to Puerto Rico.

The firm concluded that Assured Guaranty and MBIA are strong enough to withstand defaults from Puerto Rico public agencies that were subject to a restructuring law passed last year. The law has been struck down by a federal court, but is on appeal.

Rob Haines, senior insurance analyst at CreditSights, said it would be “very helpful” if insurers offered more information on both their principal and interest exposure.

“I don’t see why the companies can’t disclose this themselves,” Mr. Haines said. “It won’t violate any kind of conflict of interest they have or any kind of confidentiality that they have.”

Of particular concern to some investors are so-called zero-coupon or capital-appreciation bonds, which pay no interest until they mature and can cost municipalities more in interest than regular bonds. Puerto Rico has sold billions of dollars of these bonds, including $2.6 billion tied to sales tax revenue in 2007.

Ambac Financial Group Inc., another large insurer, backs $808 million of that. When interest is factored in, Ambac is actually responsible for roughly $7.3 billion. The numbers were disclosed in a special report regarding Ambac's Puerto Rico exposure. In a separate spreadsheet, Ambac lists the principal amount for every bond issue it insures, but it doesn't provide the interest.

"A more accurate disclosure would be to provide full principal and interest," Mr. Bonawitz said. "The issue is more acute when you have a zero, because the difference between the principal and interest is so much greater."

A recent report by Kroll Bond Rating Agency showed insurance policies can still be beneficial, saying bond insurers paid claims in full and on time in 26 of 29 insured municipal-bond defaults between 2008 and the present.

Bond insurance "has some value," said Doug Benton, an analyst at Cavanal Hill Investment Management, which oversees roughly $6 billion in assets. "But anybody that's lived through '07 through '09, you've got to discount it."

THE WALL STREET JOURNAL

By MIKE CHERNEY

MAY 10, 2015

Clean Energy Loan Program Raises Questions In Florida Supreme Court.

The Florida Supreme Court is debating a 2010 clean energy measure allowing homeowners to fund improvements through special assessments. Challengers are attacking the process itself and the agency that administers it.

In 2010 the state Legislature passed the PACE act. The measure allows local governments to set up a program funding home improvements for clean energy or storm preparedness through the Florida Development Finance Corporation, or FDFC. But rather than extending money for the improvements in the form of a loan—which would follow the borrower, this program is funded through the special assessment process. FDFC attorney Raoul Cantero explains.

"This allows a homeowner—let's use an example, to spend $20,000 on solar panels, and later, three years later, if the homeowner sells the house they're not responsible for that $20,000. It stays with the house, so homeowners are more comfortable making these kinds of improvements," Cantero says.

The idea is that homes that can better withstand a storm or place a lighter burden on the power grid provide benefits to the entire community. So to encourage homeowners to make those improvements, liability is tied to the property, and repayment is made through an increase tacked on to the homeowner's property tax.

Justice Fred Lewis says the system could provide an important tool for improving blighted areas.

“You know I could look at this, and I could say Detroit and some of the blighted cities, this could be a way that they could come right back,” Lewis says

But he’s also skeptical of employing special assessments, which are primarily used for public improvements, to fund projects for private homes.

“You know just because somebody puts a name on something, you know as well as I do you can call it anything,” Lewis says. “I have never seen a case where it is benefits to an individual home that are being made like a home improvement loans, and it is qualified as a special assessment.”

Those assessments have the Florida Bankers Association upset. While the program looks an awful lot like a loan, it’s treated differently in the event of a foreclosure, with repayment of the tax assessment taking priority over the mortgage. Association attorney Ceci Berman says this violates the state constitution.

“And we know that under Florida law that it is an immediate contract impairment when you supersede a lien position,” Berman says, “I meant that’s been in the law for many years.”

The FDFC came up again in the next case Justices heard Thursday; this time the complaint focused on bonding. The money homeowners use for their improvements has to come from somewhere, and Florida’s program raises funds by selling municipal bonds. But attorney James Dinkins, argues only local governments can issue bonds—not the state-backed FDFC.

“The reason that these bonds are not valid is not because of any infirmity in section 163.08,” Dinkins says, “but instead because Florida Development Finance Corporation is simply not a local government that’s authorized to impose these assessments, to enter into financing agreements as is specified in that statute.”

“They didn’t follow the statute,” Dinkins concludes, “therefore the bonds are not valid.”

But the lawyer for the finance corporation says it simply administers the program on the municipality’s behalf.

WFSU

By NICK EVANS • MAY 7, 2015

Feds Offer Puerto Rico Advice, But No Bailout.

Investors wondering about the U.S. government’s role in the Puerto Rican debt crisis are hearing echoes of Detroit.

In 2013, lawmakers opposed a federal bailout of the auto-producing hub, and the Obama administration didn’t step in to prevent the largest municipal bankruptcy in U.S. history, in July of that year. The Treasury has a similar no-rescue approach with the Caribbean island beset by unsustainable debt.

What Treasury officials are offering Puerto Rico is advice on how to help ease its fiscal burdens and ensure the U.S. territory receives all federal funding it’s eligible for — about $6 billion a year. More extensive aid such as loan guarantees requiring Congressional approval is unpopular with lawmakers, and it's unlikely the federal government will aid Puerto Rico after refusing to help Detroit, investors said.

"I can't see any way that they would do that when they didn't do it for Detroit," said Brandon Barford, partner at Beacon Policy Advisors LLC in Washington and a former Senate Banking Committee staffer. "Treasury could ask, but it would only exacerbate market disruptions if prices spiked and then fell even further after an inevitable congressional defeat."

Instead, the Obama administration is making a special effort to support the $100 billion Puerto Rican economy by helping the commonwealth and its residents take full advantage of aid that's available to it through programs such as Social Security and Medicaid, and funds for nutrition, education and agriculture.

Infrastructure Funds

Another channel is financing for infrastructure expenditures with federal money that allows the Puerto Rican government to use its own funds elsewhere, said Daniel Hanson, an analyst at Height Securities LLC, a Washington-based broker-dealer.

Puerto Rico and its agencies owe $73 billion. The U.S. municipal debt market, which includes securities of states, cities and counties, is worth $3.6 trillion. While debt sold by the commonwealth and its agencies has lost 2.3 percent this year through Tuesday, the broader municipal market has gained about 0.3 percent.

Even though the law allows the Fed to buy municipal bonds in durations of up to six months, "it would be extraordinarily unlikely that the Fed would take such action on any muni debt, much less that of Puerto Rico," Hanson said in an e-mail Tuesday.

'Political Fallout'

"The Fed would need to be comfortable establishing such a precedent" and "be able to stomach the political fallout," he said.

While Puerto Rico's debt is tax-exempt and was once popular among traditional buyers of municipal bonds such as mutual funds, its financial troubles are pushing more of the securities into the hands of alternative asset managers and distressed buyers speculating on price swings.

As a result of the shift, the Fed no longer sees a Puerto Rico default as a threat to the broader U.S. financial system, Barford said.

A Fed spokesman declined to comment.

The Government Development Bank of Puerto Rico, which acts as the island's fiscal agent, financial adviser on bond sales and handles the same debt-management functions local treasury officials perform in the U.S. states, is not federally regulated and doesn't have access to Fed's discount window, a lending facility aimed at boosting liquidity, according to Hanson.

Weiss Visits

As the crisis dragged on, Treasury officials have traveled to the territory since at least 2013 to discuss its finances. Antonio Weiss, counselor to the Treasury secretary, and Kent Hiteshew, who runs the office of state and local finance, met with officials in San Juan earlier this year.

Secretary Jacob J. Lew spoke by phone with Puerto Rico Governor Alejandro Garcia Padilla, Senate President Eduardo Bhatia and House of Representatives President Jaime Perello Borras on April 28. Lew urged the officials to develop a “credible” budget and implement a long-term fiscal plan.

Treasury spokesman Daniel Watson reiterated on Monday that “federal policy experts are sharing their expertise with the Puerto Rican officials that are leading the Commonwealth’s economic policies, but these efforts should not be interpreted as any kind of federal intervention.”

Options such as the federal government possibly guaranteeing a Puerto Rico financing haven’t been offered by the U.S. Treasury or the Federal Reserve, Senator Jose Nadal Power, said in an interview May 5 in San Juan.

‘Helpful’ Advice

“So far they haven’t been open to that,” said Nadal Power, who chairs the Senate Finance Committee in the Puerto Rican legislature. “They’ve been very helpful in terms of advice. And they’ve been very aware of what is going on on the island.”

The U.S. Treasury’s efforts may include crisis planning and facilitating talks with investors, Barford said.
Another option would be to help Puerto Rico’s electric authority by seeking legislation that would allow it to bypass some federal regulations, said Richard Larkin, senior vice president and director of credit analysis in Boca Raton, Florida, with Herbert J. Sims & Co.

Matt Fabian, a partner at Concord, Massachusetts-based Municipal Market Analytics, said the only situation in which the administration would be willing to provide aid to Puerto Rico would be to help keep order if a default leads to social unrest.

Cash Crunch

Puerto Rico, which has struggled to grow since 2006, faces a cash crunch and has been unable to pass a tax overhaul that would have paved the way for a $2.9 billion debt sale.

Standard & Poor’s, which downgraded Puerto Rico to CCC+ in April, doesn’t expect any extraordinary federal assistance.

“Our general-obligation rating on the commonwealth does not assume any federal intervention to either improve the island’s economy or to provide extraordinary financial assistance,” S&P analyst David Hitchcock said in an e-mail Monday. “To the extent there was extraordinary federal assistance, it would be a positive rating development, but one that we do not expect.”

After the financial crisis of 2008, Congress took some tools away from Treasury. For instance, the Exchange Stabilization Fund, which had been used to help Mexico during the 1990s, can no longer be tapped for emergency purposes, Barford said.

“Beyond asking for Congress to appropriate money or the Fed purchasing bonds — highly unlikely due to politics — there are no other pots of money that could be used for direct and unrestricted fiscal relief,” he said.

Bankruptcy Bill

Even a bill that would allow Puerto Rico to file for Chapter 9 bankruptcy protection is unlikely to pass, according to analysts including Robert Donahue at Municipal Market Analytics in Concord,

Massachusetts.
Intervening to rescue the island's finances could actually spook markets, signaling that problems are larger than investors now believe, Hanson said.

"If Treasury were to take such extraordinary steps, the types of steps that are supposed to be reserved for a Lehman-style crisis, to bail out Puerto Rico, that would send the wrong message," he said, referring to the $613 billion collapse of investment bank Lehman Brothers Holdings Inc. in 2008.

Bloomberg

by Kasia Klimasinska

May 6, 2015

S&P RFC: Not-for-Profit Public and Private Colleges and Universities.

1. Standard & Poor's Ratings Services is requesting comments on proposed changes to its methodology for assigning stand-alone credit profiles (SACPs), issuer credit ratings (ICRs), and issue credit ratings to not-for-profit public and private colleges and universities globally.

2. The request for comment (RFC) proposes changes that are intended to provide additional transparency to help market participants better understand our approach in assigning ratings to not-for-profit public and private colleges and universities globally, to enhance the forward-looking nature of these ratings, and to enable better comparison between these ratings and ratings in other sectors and asset classes.

3. If adopted, these criteria will supersede "Approaches To Rating U.K. Universities Amid Growing Credit Diversity," published March 28, 2003. These criteria would also partially supersede the "Higher Education" criteria, published June 19, 2007. Specifically, the sections "Private College and University Credit Ratings", "Management and Governance", "Debt", and "Rating Public Colleges and Universities" would be superseded by these criteria. This methodology is related to our criteria article: "Principles Of Credit Ratings", published on Feb. 16, 2011.

Continue reading.

08-Apr-2015

S&P Issuer Credit Ratings for Community Development Finance Institutions (CDFIs).

Standard & Poor's Ratings Services' U.S. Public Finance Housing Enterprise Group assigned and released its 'AA' issuer credit rating (ICR) on Clearinghouse CDFI, Calif. on April 2, 2015. Subsequently, on April 28, 2014, Standard & Poor's assigned and released its 'AA-' ICR on Housing Trust Silicon Valley (HTSV), Calif. For both ratings, despite comprising a very minimal sample, Standard & Poor's found some common trends within the community development finance institution (CDFI) industry involving strategy and management (impact) and financial performance.

In particular, we found CDFIs have minimal loss exposure that can typically be absorbed through reserves and unrestricted equity. Moreover, the debt profiles of those assessed, and the first two CDFI entities we rated publicly, have low-risk debt, with little long-term liabilities. In addition, we found the history of loan performance for publicly rated CDFIs has historically been positive, with very few delinquencies. We believe the ratings for Clearinghouse and HTSV are solid and present a level of stability in line with the 'AA' rating category.

Standard & Poor's began analyzing the industry using its housing finance agency (HFA) criteria to assess various CDFIs nationwide, where public financial statements were made available via their respective public websites. We concluded with a small sample of five distinct CDFIs using three to five years of financial statements to assess common trends. We subsequently found each CDFI to be a unique entity, despite having similar core social missions. Each has their own distinct lending activity, ranging from housing finance (first-time homebuyers and affordable multifamily housing) and commercial/small business lending to charter school lending. We determined that our state "Housing Finance Agencies" criteria (published June 14, 2007) was most applicable to form an appropriate credit opinion for each CDFI, factoring core missions, portfolio, credit risk, and management. We also used "Criteria: Principles of Credit Ratings" (published Feb. 16, 2011) to apply U.S. Public Finance ICR criteria for this analysis. As a result, we view CDFIs as similar to HFAs, albeit with a broader range of lending activity for community development, rather than mortgage loan programs, posing the greatest risk.

In our initial financial analysis using the above-mentioned criteria, we found from our publicly rated CDFIs and the small sample assessed that the CDFIs' liquidity ratios tend to be similar to those of state HFAs — and, in some scenarios, with equity ratios in line with or above our rating categories for social lending issuers. In our view, funding sources and equity levels go hand-in-hand. For example, CDFIs with more reliance on federal grants may have more annual revenue volatility. In some instances, however, prudent risk management allows for a gradual increase in equity, leading to very stable financial performance. While some CDFIs' equity may be lower than those of publicly rated social lending institutions, their total equity-to-total debt tends to be either extremely high (representing little debt, with adequate equity), or very steady, coupled with stable financial performance. Despite the size of the CDFIs' balance sheets and overall loan portfolios, their assets and liabilities tend to be adequate or have appropriate ratios.

Continue reading.

07-May-2015
