

Key Points

- > State oversight provides enhancement to local credit quality
- > Continued access to capital for other local governments motivates state oversight
- > Bankruptcy options are limited in some states
- > Costs associated with bankruptcy are significant



By Michael P. Taylor,
Senior Tax-Exempt
Fixed Income Research
Analyst

State Oversight a Key Factor in Assessing Local Municipality Credit Quality

These days, the aphorism "a rising tide lifts all boats" does not necessarily ring true in the world of municipal finance. Budgetary pressures driven by overall declines in economically-sensitive revenue collections, ballooning longer-term liabilities and overly-generous collective bargaining contracts have left a handful of local government issuers in a relatively vulnerable state of fiscal affairs.

While several national economic indicators are showing favorable signs of a rebound, affirmed with aggregate state revenues reporting growth for eight consecutive quarters and unemployment levels on the decline, many local government issuers (counties, cities and school districts) are only now beginning to feel the brunt of the recession, as state and federal aid and property taxes, their primary sources of revenue, are declining. Instances of credit rating downgrades at the local level have increased, reflecting the currently strained local funding environment and, for some, diminished credit quality. However, although the rate of credit rating downgrades has increased, defaults in relatively safe sectors of the municipal market (state and local general obligations, water & sewer bonds, and other essential service debt) have remained very rare, with Moody's reporting that just 59 defaults of Moody's-rated municipal entities occurred between 1970 and 2011.¹ We believe that this low default rate can be partly explained by the following:

- > **Transparency, surveillance and oversight help identify distress.** Given the mandatory disclosure requirements most debt issuers are now subject to, coupled with formalized budgetary oversight in several states, signs of fiscal distress and mismanagement are much easier to identify. Furthermore, many states have recently demonstrated their willingness and ability to enact direct oversight measures and retool management — which we view as a credit positive.
- > **States often look to help — before it is too late.** In the aftermath of the Great Recession, several states have recently adopted reactionary measures to aid distressed issuers in an effort to prevent bankruptcy filings and/or payment default. In general, these moves have been taken to preserve both capital market access and palatable borrowing costs for their respective local obligors, protecting both taxpayers and bondholders alike.



- > **Many states limit access to Chapter 9 bankruptcy filing.** Many states limit municipalities' ability to file for Chapter 9 bankruptcy protection. In addition several states (CA, NJ and RI) have recently enacted more stringent legislation to further limit or slow the filing process, and to identify and enact a variety of remediation measures to avoid filing altogether.
- > **Bankruptcy and/or default can be costly.** The costs of bankruptcy and/or default are difficult to quantify, although for municipal issuers it can be very expensive and, generally speaking, has very little upside.

Transparency, surveillance and oversight help identify distress

Overall, the surveillance of local governments is improving. Given the mandatory disclosure requirements most debt issuers are now subject to and the onset of public web portals offering free access to municipal securities disclosure and transparency information, signs of fiscal distress and mismanagement are much easier to identify. Increased transparency is often federally mandated — when governmental bodies issue bonds they take on specific continuing disclosure obligations to file information regularly to nationally recognized municipal securities information repositories (NRMSIRs). While failure to file oftentimes has limited consequences beyond notifying existing bondholders, institutional investors are becoming more aware of poor disclosure practices, which can result in higher interest rates on future borrowings.

Formally, seven states proactively monitor the financial position of their local governmental entities, including Florida, Maryland, New Hampshire, New Jersey, North Carolina, Ohio and Pennsylvania. These states have formal legislation and processes in place mandating additional levels of financial reporting and budget analysis, which have been instrumental in identifying and remediating financial distress before default. One of the strongest examples of state oversight is in North Carolina, where the Local Government Commission (LGC) analyzes the fiscal and accounting practices of all local governments, handles the sale of all debt, monitors repayment, offers ongoing technical assistance to local government managers and manages the audit process for all municipalities. Furthermore, a handful of additional states have reactively enacted direct oversight measures to ease distressed municipalities and retool management (see: States often look to help — before it is too late). Finally, rating agencies and investors, too, conduct ongoing surveillance of obligor fiscal performance, and model peer comparisons and bond valuations; red flags are often reported widely through credit research reports and media coverage.

States often look to help — before it is too late

In an effort to prevent distressed municipalities from filing for Chapter 9 bankruptcy protection, defaulting on debt service obligations or being forced to curtail the services provided to residents, several states have proactively intervened with a variety of support mechanisms. Such assistance may include bridge financing, transfer of costly services to other governmental agencies, loan or grant funds to cover budgetary gaps and/or an early release of state taxes payable to the municipality.² For the state and municipality, the benefits of avoiding bankruptcy are multiple, while the consequences of a filing can be painful, wide-ranging and long-lasting. Importantly, avoiding bankruptcy will likely result in uninterrupted access to market capital at reasonable costs and allowing the municipality to continue operating day-to-day, while seeking to bring its budget into balance over the longer term. In our view, demonstrated and repeated state-level support provides evidence of an additional layer of bondholder protection, one that is not always expressed in bond offering documents.

Please see Exhibit A for examples of reactionary measures states have taken in recent years.



Many states limit access to Chapter 9 bankruptcy filing

While states are legally prohibited from filing, municipalities can file for Chapter 9 bankruptcy, subject to state statute. Fifteen states presently permit municipalities to file for Chapter 9 protection on their own accord (AL, AZ, AR, CA, ID, KY, MN, MO, MT, NE, NY, OK, SC, TX, WA), while most others require state participation in the process (CT, FL, LA, MI, NJ, NC, OH, PA, RI). In some cases, the states retain the ability to aid the municipality in advance of filing. Three states grant very limited access to filing (CO, OR, IL). Further, Georgia remains the only state that expressly prohibits filing, while Iowa statute prohibits filing, though has an exemption provision. The remaining 21 states are either unclear or do not have specific authorization. Please see Exhibit B for a state-by-state listing of how states address municipal bankruptcy issues.

While, in recent years, a number of states have stepped-in to provide an additional level of support, it should be noted that states may not have the obligation, moral or legal, to step in and support municipalities in distress. In fact, not all states have shown a willingness to prevent a bankruptcy filing. In the case of Jefferson County, part of the negotiation process to prevent bankruptcy involved the belief that the State of Alabama had a moral obligation to back the debt. As negotiations proceeded, opposition over sewer rate hikes and deal structuring prevented the lawmakers of the state from agreeing to provide that backing. In this case, the political process broke down and opposing views on how to fix the problems prevented the various parties from reaching an agreement. The state did not want to support a deal in which the citizens would have to incur, in the form of rate increases, a portion of the costs. Ironically, in this case, it is very likely that rates will increase nevertheless and the county and state will have to deal with the stigma of bankruptcy and all the costs associated with it.

Bankruptcy and/or default can be costly

The cost of bankruptcy and/or default is difficult to quantify, although for municipal issuers it can be very expensive and generally has very little upside. Municipalities make the choice to file in an effort to achieve a degree of protection from their creditors and filing is often a first step to reorganizing or adjusting debt obligations to alleviate budget strain or to remove themselves from onerous labor contracts.

For distressed municipal issuers, access to the capital markets to fund cash flow shortfalls and near-term capital funding (through the issuance of BANs, RANs or TRANs) is oftentimes critical to maintaining a functioning unit of government and providing for the continuance of essential services. In our view, upon a default, issuers would likely be shut out of the capital marketplace or likely be forced to pay much higher borrowing rates to finance cash flow or capital needs — especially if marketed with a lower credit rating. Furthermore, in several cases, an issuer's ability to utilize Chapter 9 filing to renegotiate collective bargaining agreements or retirement benefits has been handicapped by state efforts to curb such practice, as is the case in Michigan.



Closing thoughts

During the ongoing period of unprecedented fiscal strain, we believe that states will be increasingly called upon to intervene in the financial operations of distressed local governments. However, states have different legal and moral obligations concerning whether or not they should step in and assist localities and, if they do step in, the level and timing of support varies. We continue to believe that defaults will remain very low and, as we have previously stated, earlier pundit calls for a massive wave of municipal defaults, which contributed to the poor market returns and massive mutual fund redemptions in previous quarters, have proved unfounded and are receding from memory. That said, we expect that credit downgrades will continue to outpace upgrades for the foreseeable future. The uncertainty associated with the volatile economic environment, ongoing fiscal strains and potential credit downgrades, combined with the undefined ability and willingness of states to step in may leave investors unsure of what to do.

However, the opportunity costs of avoiding local credits may be substantial and unwarranted. Appropriate and early monitoring of these credits provides investors with the ability to be proactive, rather than reactive, and to take advantage of potentially attractive investment opportunities. Thorough credit research and monitoring have never been more important and relevant than in today's municipal market.

Exhibit A

Examples of reactionary measures states have taken in recent years

- > **California:** State legislators recently enacted a law that mandates that distressed municipalities must declare a fiscal emergency or participate in a neutral evaluation process prior to filing for Chapter 9 protection, which the state considers a “tool of last resort.”³ By creating a window for mediation, legislators hope to minimize additional Chapter 9 filings, or at the very least slow the filing process. Given the state’s checkered history, as evidenced by the Orange County and the city of Vallejo filings, we view this move as a credit positive.
- > **Connecticut:** The state allows for Chapter 9 filing solely with the written consent of the governor. The state has stepped up to provide aid to distressed municipalities and has contested filings in the past. For example, when the city of Bridgeport filed in the early 1990’s, the state contested the filing and the city was later ruled to be solvent.
- > **Indiana:** The state’s Commission on Local Government Reform is charged with recommending ways to restructure local government to increase efficiency and reduce the financial burden on Indiana taxpayers. Municipal bankruptcy is not clearly expressed in state statute at this time, though the GOP-controlled house recently killed a proposal aimed at providing clarity on the issue. The state’s Distressed Unit Appeals Board has historically aided troubled credits. However, the unit’s ability to provide tax relief to issuers ends at calendar-year-end 2011, as the state recently enacted property tax caps through a ballot resolution.
- > **Massachusetts:** The state has taken over units of local government which were declared distressed (the City of Springfield, for example), or, in the recent case of Lawrence Public Schools, underperforming. While implemented on a case-by-case basis with no governing statute, the state has the ability to put into place a fiscal overseer, fiscal control board or receiver to govern the fiscal operations of a distressed local government.
- > **Michigan:** Early in 2011, Michigan governor Rick Snyder signed into law legislation that expanded the authority of state-appointed receivers, granting them the authority to terminate union contracts. This is notable because it strips the local government entity’s ability to use bankruptcy filing as a gimmick to re-open the contracts. This was likely done in response to Hamtramck’s 2010 filing, which was denied by the Governor. The state later provided loan options and a deal was struck with the city of Detroit to work out a shared revenue agreement and settle outstanding utility claims held in arrears.
- > **New Jersey:** The state’s division of local government services provides technical assistance, fiscal reporting, offers shared services, and reviews and approves all municipal budgets and many financial actions to govern the conduct of officials. The state’s Municipal Finance Commission serves as a regulatory body for each of the state’s 566 municipalities and 21 counties, overseeing their fiscal condition and ensuring law compliance.



- > **New York:** While the state permits municipalities to file for Chapter 9 protection, it has in the past stepped up to provide assistance to the city of Buffalo, as well as Erie and Nassau Counties, prior to filing. In these cases, the state has implemented control boards to oversee the finances of the governments, aided with the ability to freeze wages and trim expenditures. As instruments of the state, these boards have the ability to create and oversee all aspects of budgeting, financial forecasting and capital plans; to issue bonds, notes or other obligations to achieve budgetary savings and to finance short-term cash flow or capital needs; and, if necessary, to develop financial plans if the entities are unwilling or unable to take the required steps toward fiscal stability.⁴
- > **Pennsylvania:** Under Act 47, the state has the right to declare certain municipalities as financially distressed, enabling the state to restructure debt, limit government funding and to provide for the consolidation of governmental services to ease financial burdens. The state's Local Government Commission is one of the oldest agencies of its kind and serves as a conduit to the General Assembly for localities. The state has only seen one Chapter 9 filing to date, Westfall Township, which filed following a \$20 million judgment in 2009. While the filing set a precedent in the state, it is notable that the municipality had no bonds outstanding at the time and the state had appointed a coordinator to renegotiate its bank loan obligations. More recently, Harrisburg's filing has been hotly contested by the state and the capital city's filing was rejected in November citing the lack of Mayoral consent and violations of state statute.
- > **Rhode Island:** Following Central Falls' bankruptcy filing in August 2011, Rhode Island enacted a law bolstering bondholder security by establishing a priority for general obligation bond and note payments over other creditors. This move grants lenders a first lien on general and property tax revenues, a move that "could encourage other creditors to negotiate to avoid a Chapter 9 filing."⁵

Exhibit B

How states address municipal bankruptcy issues⁶:

State	Chapter 9 Filings Addressed in State Statutes?	Authorization Type	Notes
Alabama	Yes	Specific authorization	
Alaska	No		
Arizona	Yes	Specific authorization	
Arkansas	Yes	Specific authorization	
California	Yes	Specific authorization	
Colorado	Yes*		*Authorization for irrigation and drainage districts
Connecticut	Yes	Conditional	No authorization without express, written consent of Governor
Delaware	No		
Florida	Yes	Specific authorization	
Georgia	Yes	Bankruptcy specifically prohibited by statute	
Hawaii	No		
Idaho	Yes	Specific authorization	
Illinois	Yes	Conditional	Allowed if a Financial Planning Board is created and judges that bankruptcy is in the municipality's interest.
Indiana	No		
Iowa	Yes	Conditional	Allowed only if the municipality is insolvent as a result of involuntary debt.
Kansas	No		
Kentucky	Yes	Conditional	County must receive approval from state local debt officer and state local finance officer in order to declare bankruptcy.
Louisiana	Yes	Conditional	Need approval from State Bond Commission, Governor, and Attorney General.
Maine	No		
Maryland	No		
Massachusetts	No		
Michigan	Yes	Conditional	Multiple review processes
Minnesota	No		
Mississippi	No		
Missouri	Yes	Specific authorization	
Montana	Yes	Specific authorization	
Nebraska	Yes	Specific authorization	

Nevada	Yes	Conditional	
New Hampshire	No	Conditional	
New Jersey	Yes	Conditional	Can only file with approval from the Municipal Finance Commission
New Mexico	No		
New York	Yes	Conditional	A municipality may file for bankruptcy unless it has ARRA bonds outstanding.
North Carolina	Yes	Conditional	Need approval of the Local Government Commission
North Dakota	No		
Ohio	Yes	Conditional	Need approval of Tax Commissioner
Oklahoma	Yes	Specific authorization	
Oregon	Yes	*Specific authority granted to irrigation districts and drainage districts.	
Pennsylvania	Yes	Conditional	Authority with outstanding bonds issued under the Transportation Code cannot file for bankruptcy. Other municipalities must meet authorization standards under the Municipal Corporations Statute.
Rhode Island	Yes		
South Carolina	Yes	Specific authorization	
South Dakota	No		
Tennessee	No		
Texas	Yes	Specific authorization	
Utah	No		
Vermont	No		
Virginia	No		
Washington	Yes	Specific authorization	
West Virginia	No		
Wisconsin	No		
Wyoming	No		

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¹ "Municipal Defaults to Remain Rare Amid Continuing Credit Stress," published September 21, 2011 on www.moodys.com.

² Chapman & Cutler, James E. Spiotto, "Historical and Legal Strength of State and Local Government Debt Financing," published February 2011 on <http://www.ncsl.org/documents/fiscal/glm11spiotto.pdf>.

³ California Adopts Bill to Slow Municipal Bankruptcies, a Credit Positive," published October 17, 2011 on www.moodys.com.

⁴ Erie County Fiscal Stability Authority Resolution No. 09- 17, as published on <http://www.ecfsa.state.ny.us/Documents/PropDispGlines.pdf>

⁵ "Bankruptcy Bar? States Aim to Deny Distressed Cities Chapter 9 Option," published July 13, 2011 on www.amlawdaily.com.

⁶ Vinson & Elkins LLP, Paul S. Maco, Jane L. Vris, and William L. Wallander, "Public Finance Challenges and Opportunities for Resolution," *Municipal Finance Journal* 31:2. pp. 1-50.