

Local default

State and local governments' fiscal challenges lead to opportunities on both the short and long side, says SunGard's Andrew Shinn

DATA PROFILE

Compared to other asset classes, municipal bonds have had a relatively short relationship with the securities lending market. Before 1982, when muni bonds were issued as bearer bonds, institutions did not lend them. Bearer bonds were not registered with DTC, and lending complicated the matter of receiving interest payments. After the US Congress passed a bill in 1982, however, muni bonds were no longer issued as bearer bonds and it became possible to lend them.

Initially, the securities lending market for muni bonds was not large. The muni bond market was not very volatile, and there was little demand to short. Recently, however, this has changed, because state and local governments are faced with massive fiscal deficits. From 2004 through 2007, as incomes and property values increased, tax revenues were high and state and local governments increased benefits and social programmes. With the downturn, tax revenues decreased significantly – as much as 35 per cent in the case of Vallejo, California. With fewer tax dollars, governments have been forced to either cut spending or raise taxes. In Vallejo, the city decided that it would not raise taxes, but it also couldn't convince its police and fire pension fund to accept reductions in benefits, so the city declared bankruptcy.

In addition to Vallejo's bankruptcy, muni bond investors were also spooked when Meredith Whitney predicted that there would be 50 to 100 local government defaults measuring hundreds of billions of dollars over the next few years. This led investors to withdraw billions of dollars from muni bond funds and muni bond ETFs over the past few months. According to the Investment Company Institute, from November 2010 through end of February 2011, there has been a \$38 billion net outflow from muni bond funds.

It seems that muni bond investors have a right to be concerned. Newt Gingrich has been calling for legislation that would allow states to declare bankruptcy in order to renegotiate pension fund liabilities. Also, there's the fear that if more cities declare bankruptcy, the stigma will wear off and many more cities and local governments will follow Vallejo's lead. Furthermore, some monoline insurers have exited the muni bond insurance market, so investors have less protection in the case of a default.

On the other hand, there is much more evidence that argues against massive municipal defaults.

When looking at the situation from a state or local government's point of view, there are many costs and not too many benefits to declaring bankruptcy.

Since most state and local governments have the ability to pay, the next question is whether they have the willingness to pay

First, the amount of money that state and local governments have borrowed from the municipal bond market is not that great compared to GDP and tax revenues. On average, muni bond interest payments are less than 10 per cent of tax revenue. So when Vallejo's tax revenue declined from \$29 million to \$20 million in 2009, it wasn't as if the city had zero dollars to pay interest to bond holders. Instead, it was a decision as to who would receive the \$20 million. Just as muni bond interest payments are not a large percentage of tax revenues, the average muni bond outstanding debt for states is less than three per cent of state GDP.

Since most state and local governments have the ability to pay, the next question is whether they have the willingness to pay. For states, there is no choice, because it is illegal for a state to declare bankruptcy. Newt Gingrich notwithstanding, it doesn't look like the federal government is going to change the law and allow states to go bankrupt any time soon. For local governments, declaring bankruptcy doesn't do much to help them. Of the stakeholders in the situation (bondholders, pensioners, current public employees, tax payers, and citizens), none are helped by a bankruptcy. Instead, additional legal costs are incurred.

The surprising thing is that in most cases of default, local governments end up making muni bondholders whole in the end. When Orange County declared bankruptcy in the 1990s after an official lost millions on bad derivatives bets,

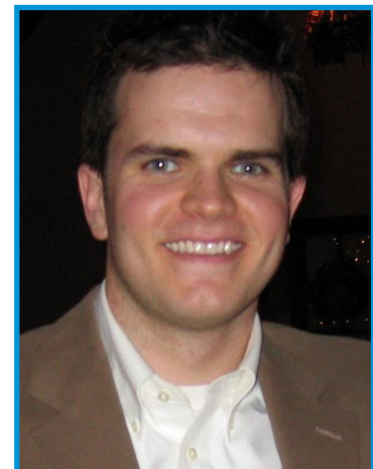
the county ended up paying bondholders every last penny. One reason for this is that muni bond investors are local citizens. Politicians don't want to leave local citizen bond holders with the check because it will hurt politicians' chances for re-election.

Nonetheless, over the past few months the muni bond market has taken a hit. This has created opportunities for short sellers who were quick to short muni bond funds back in November and December, as well as those funds that purchased muni bonds after the decline.

SunGard's Astec data shows that most shorting activity has been in muni bond ETFs such as MUB, the iShares S&P National AMT-Free Municipal Bond Fund. The cost-to-borrow shares of MUB are currently 1500 bps. The cost-to-borrow had been 400 bps in November and December 2010 but increased significantly on January 20, 2011. MUB's share price has declined by five per cent since early November 2010. Since its low on January 14, 2011, however, the share price has rebounded by 2.5 per cent.

TFI, the SPDR Nuveen Barclays Capital Municipal Bond Fund ETF, is the most borrowed muni bond ETF in Lending Pit with 370,000 shares outstanding. The cost-to-borrow shares of TFI is 300 bps.

Unless there's another prediction of mass defaults in the muni market, it looks like the market has stabilised for now. And even if more small retail investors sell, hedge funds will no doubt be waiting on the other side to take advantage of the bargains. **SLT**



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