

Municipal Market Comments



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Jefferson County Files Bankruptcy

Largest Muni Bankruptcy in History is Not a Sign of Things to Come for the Market

On November 9, 2011, Jefferson County, Alabama filed for bankruptcy protection under Chapter 9 of the U.S. Bankruptcy Code. The filing marks the start of a new chapter in the County's three year story of corruption and financial collapse. What it does not signal, in our view, is any shift in the credit landscape for the municipal market as a whole. We do not believe that Jefferson County's action portends any significant rise in the risk of municipalities filing bankruptcy. Nor do we take it as a sign that the market is more risky going forward than it has been historically. Rather, we believe Jefferson County represents a unique situation, and does not reflect the dynamics facing the vast majority of municipalities in the United States. Nor do we believe that this filing will have significant impacts on the municipal market or bond valuations going forward.

Jefferson County, with \$3.1 billion of sewer debt and \$1 billion of general obligation and school construction bonds outstanding, has now eclipsed Orange County, CA's \$2 billion filing in 1994 as the largest municipal bankruptcy on record. Like Orange County, Jefferson County's problems did not result from any fundamental deterioration of the economic and financial fundamentals of the issuer. We would also note that the County's filing did not result from a lack of financial resources or willingness of creditors to work with the County to resolve the situation. Rather, we believe this step reflects a lack of willingness on the part of the elected officials in the County and the State to take responsibility for the County's past decisions, and a failure to make a good faith effort to meet the County's financial obligations.

In 1995, Jefferson County entered into a settlement with the US EPA that required it to finance substantial improvements to its wastewater system. The County began a poorly planned sewer expansion that rapidly grew out of control. Rather than fund such core infrastructure using long-term debt, as is the norm with municipal utilities, the County undertook an elaborate sewer financing program that relied on bets on interest rates to artificially lower the costs to rate payers. At the same time, investment banks and other financial professionals bribed county officials to win business and expand the size of

borrowings well beyond the actual capital needs of the system. The result was a financial structure that collapsed when the financial crisis of 2008 disrupted markets and the Fed dropped interest rates.

Jefferson County has been in default on its sewer-related debt obligations since 2008. Once its financial structure became unmanageable, the County began negotiations with its sewer debt creditors. Ultimately, the County rejected a proposal that would have cut its sewer debt by approximately 33% and restructured the rest over a longer term, to be served by increased sewer rates. The County had been seeking a negotiated debt reduction of around 50% and, having decided that negotiations were at an impasse, chose to pursue Chapter 9 bankruptcy to try to force a better resolution. The County's decision runs against the advice of the state-appointed receiver for the sewer system, who warned that rate increases could be far higher under a court-directed settlement. The bottom line is that the Chapter 9 filing does not represent any new deterioration of the situation. Rather, many market participants have assumed that the County would ultimately take this step, and the market has had more than enough time to absorb the story.

Chapter 9 filings remain relatively rare - Jefferson County marks the fourth local government bankruptcy filing in 2011. Of the other three – Boise County, ID; Central Falls, RI; and Harrisburg, PA – each represents a unique situation in which poor financial management or uncontrollable events created a financial crisis. As we have noted in previous market comments, we continue to believe that municipal bankruptcy will remain a rare event, due to factors including:

1. Municipalities must be allowed to file for Chapter 9 protection under state law and meet other legal criteria. Only 27 states permit municipal bankruptcy, and many of those that do often make filings extremely hard to pursue. States typically do not want their political subdivisions seeking bankruptcy and often work actively to preclude such actions.
2. Municipal bankruptcy can be long and expensive. Unlike corporate Chapter 11 filings, municipal Chapter 9 bankruptcies are often protracted affairs that take many years to conclude. The resulting costs, both legal and economic, often outweigh what are initially viewed as the potential benefits of seeking bankruptcy protection.
3. Very few municipalities ever face unmanageable financial obligations. As political subdivisions with taxing power, municipalities generally have the financial wherewithal to meet their obligations, even if debts must be renegotiated or restructured to allow an issuer a chance to "grow into them." It is only truly exceptional cases – typically involving financial or economic

speculation, gross mismanagement, or corruption – that will so stress a municipality's financial structure that it becomes untenable. And, most states have active programs to monitor and assist municipalities in working out of difficult situations before they become acute.

For municipal investors, Jefferson County provides an important lesson in the importance of knowing your issuer. Although we regularly note that essential purpose utility revenue bonds are among the most stable and secure investments in the municipal market, it remains critical to examine issues individually. Problems like those of Jefferson County do not arise overnight – such situations take many years to develop, and there are plenty of warning signs along the way for those that would look for them. Careful selection of credit cannot eliminate all possibility of negative credit surprises, but it can ensure that the types of situations that can degenerate into defaults and bankruptcies are identified and moved out of portfolios long before they become headline news.

A handwritten signature in black ink, appearing to read "B. Tournier", with a long horizontal flourish extending to the right.

Brian Tournier
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Ascent Investment Partners

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