Kroll BondRatings™
Our name is on the line

U.S. Public Finance | Municipal Finance Commentary

Municipal Defaults in a Post-Bankruptcy World

A Follow-up to KBRA's 2011 Municipal Default Study

Analytical Contacts:

Kate Hackett, Managing Director
khackett@krollbondratings.com 646-731-2304

Sean Penchoff, Analyst
spenchoff@krollbondratings.com 646-731-2368

Alessandra D'Imperio, Senior Director
adimperio@krollbondratings.com 646-731-2383

Karen Daly, Senior Managing Director
kdaly@krollbondratings.com 646-731-2347

September 23, 2013

Kroll BondRatings™

Table of Contents

Executive Summary

KBRA's updated municipal default study envisions an entirely new landscape emerging from the financial crisis. While we don't expect widespread and systemic defaults, we do expect a higher default rate with substantially lower recoveries over the medium term. KBRA believes that these defaults will be idiosyncratic and harder to predict. The practice of municipal credit analysis has historically been rigid and backward looking. KBRA's new default study highlights the paradigm shift in municipal credit. Municipal credit analysis must now incorporate more due diligence and a forward looking view.

Since KBRA published its initial municipal default study in November 2011, there have been significant developments in the municipal credit markets. A number of high profile municipalities have defaulted and several have entered Chapter 9 bankruptcy protection as a result of fiscal stress and pressure from debt and pension obligations. Others, such as Harrisburg, PA, have made unsuccessful bids to enter bankruptcy. At the time of the initial study, several of these municipalities had already defaulted in the payment of their debt.

The recent actions by municipalities to default on outstanding debt and/or to pursue bankruptcy protection from creditors have challenged the conventional wisdom regarding risk in the municipal market. The expectation that municipal issuers are highly unlikely to default on their outstanding debt may need to be re-evaluated. The lack of a significant body of case law in municipal bankruptcy also raises key concerns about how bankruptcy courts will address issues relating to bondholder security and contractual priorities. The current overriding question before the bankruptcy courts is how to allocate available resources to pay existing obligations including debt, pensions and other contractual obligations. Resolution of this question will rest largely on bankruptcy court decisions as to whether Federal bankruptcy laws or existing State laws regarding municipal obligations take precedence. The decisions on these issues may test long held assumptions about the legal and credit framework under which municipal debt has been issued, including the strength of the General Obligation (G.O.) pledge. Recent actions also call for a re-examination of the role of States in managing distressed issuers in a way that helps to avoid the need for default and/or bankruptcy. Although several municipalities have emerged from bankruptcy, it will be years before the full implications of these cases provide a clear picture of municipal risk. The only thing that is clear today is that the rules are changing.

KBRA believes that debt of municipal issuers, and in particular in the general government sectors, will likely experience somewhat higher default rates in the near-to-medium term than experienced in the recent past. The actions of certain municipalities in the last several years have challenged long held assumptions about municipal credit. KBRA believes the developments of the last several years are indicative of a change in the basic legal and credit framework under which municipal debt is issued. In addition to the political and legal challenges, there is a question of whether the number of high profile defaults, especially if the trend continues, will make the decision to consider default or bankruptcy as a potential strategic option more acceptable. It is KBRA's view that the decision to default or pursue bankruptcy represents a basic change in the relationship between an issuer and the credit markets.

Kroll BondRatings™

While KBRA recognizes the magnitude of recent fiscal and economic pressures facing local governments, it is our view that the decision to default or pursue bankruptcy is just that, a decision, and that it reflects an essential unwillingness of an issuer to pay its debt. KBRA believes that this change of attitude towards payment of debt represents the greatest risk to the stability of the municipal credit markets. KBRA expects the municipal default rate to rise modestly rather than exhibit a pattern of widespread defaults.

When determining ratings for local government general obligations, KBRA assesses both the ability and willingness to pay obligations in full and on a timely basis. As noted in KBRA's municipal rating methodologies, KBRA would view a decision to default on debt as a substantial negative rating factor that could limit the ability of an issuer to achieve an investment grade rating. A situation where a default is quickly followed by a plan to restructure debt and pay bondholders over time could be considered a possible mitigation to this negative rating factor.

Overview

The purpose of this report is to provide an update on the municipal default statistics since our original study, and to examine the issues raised by the recent increase in municipal default and bankruptcy filings. KBRA published its initial municipal default study, An Analysis of Historical Municipal Bond Defaults: Lessons Learned – The Past as Prologue, in November 2011. That report analyzed municipal defaults of both rated and unrated debt issues over the time period 1920-2010. This updated report will incorporate municipal default statistics for the years 2008-2012. Recent default and bankruptcy activity has raised questions about how municipalities will treat their various contractual obligations over time, the resolution of which will impact the municipal market as a whole. As part of our research in developing our assessment and thinking on this subject, KBRA focused on the following municipalities that have defaulted and/or filed for Chapter 9 bankruptcy over the last five years: Vallejo, CA; Jefferson County, AL; Harrisburg, PA; Central Falls, RI; Stockton, CA; San Bernardino, CA and Detroit, MI. It is important to note the distinction between a filing for bankruptcy and a municipality being admitted to bankruptcy. As of this date, Detroit has filed but has not been admitted to bankruptcy. These distinctions are discussed further in the Municipal Bankruptcy section of this report.

Analysis of Municipal Default Statistics

In its original default study, KBRA found that municipal default rates have remained consistently low following the Great Depression. KBRA found that while the stresses of the Great Recession may share some similarities to those of the Great Depression, enhanced oversight by both state governments and the investment community have produced markedly different outcomes in terms of default rates. Our analysis of municipal default statistics covers the period 2008-2012. The numbers show that municipal defaults remain relatively rare, notwithstanding recent high profile bankruptcies and/or bankruptcy filings such as Detroit and Jefferson County. However, the composition of defaults has shifted, with defaults on G.O. debt increasing as a percentage of total municipal defaults since 2008. This largely reflects the defaults by the high profile credits noted above.

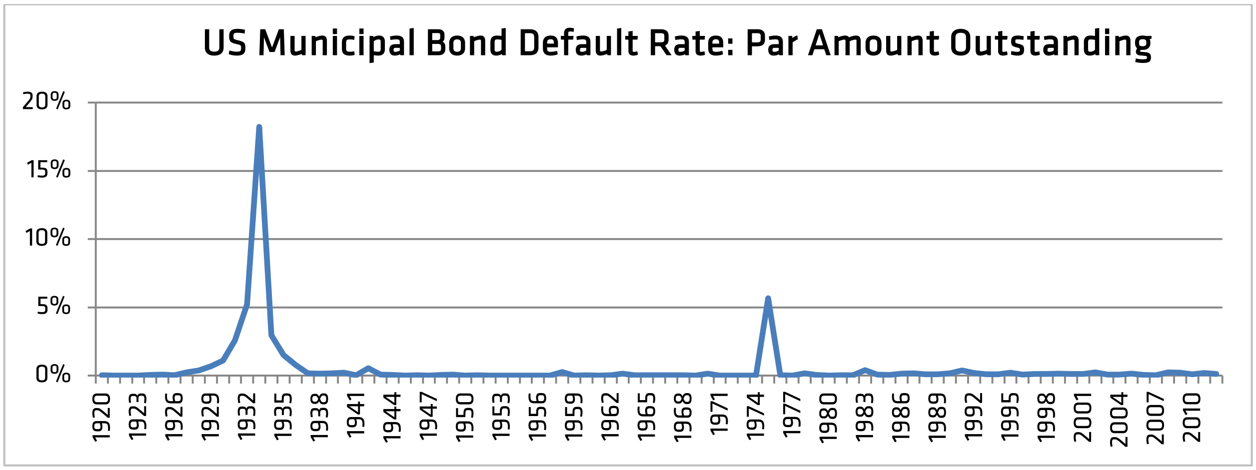
As in the 2011 default study, KBRA sourced its post-1980 default statistics from a database provided by Income Securities Advisors. This data source defines defaults to include non-payment by the obligor of principal or interest, notwithstanding payment under a bond insurance policy or bank letter of credit. The definition also includes non-payment due to a draw down from a reserve fund, whether it is funded in cash or as a surety, or a filing for bankruptcy. At the time of default, defaulted par is defined and recorded as the amount of the total par outstanding of the defaulted issue. In the case of a bankruptcy filing, all debt of the issuer subject to bankruptcy protection is included as defaulted par. In contrast to other published studies, this database surveys all defaults in the municipal marketplace, not just rated issues. Historically, the existence of bond insurance has served to reduce the number of reported municipal bond defaults. It has been common practice for a bond insurer to intervene when payment of debt service is threatened, sometimes recasting municipal debt obligations by extending maturities or structuring other changes.

In the 2011 default study, KBRA reported that, although a large number of municipal issuers defaulted during the Great Depression, most G.O. bondholders recovered close to their entire investment. To date, this high recovery experience continues. However, given the current default and bankruptcy events, there is a risk that the level of recoveries may be substantially lower going forward.

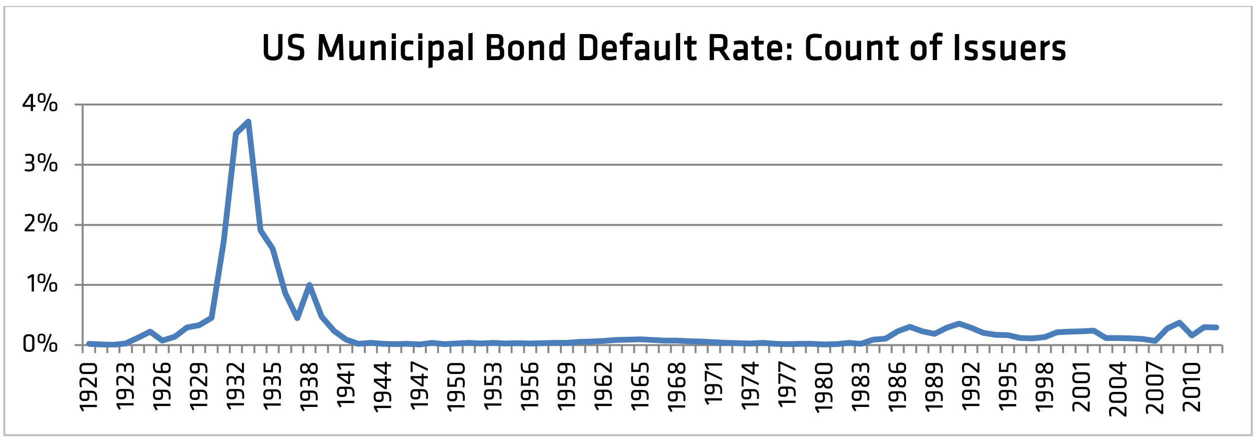
Recent Municipal Default History

The charts below show estimated annual default rates for the period of 1920 through 2012, calculated on the basis of par and number of issuers. Default Rate is defined as the dollar amount of defaulted par in a given year as a percentage of total market par outstanding at the beginning of the year. In the 32-year period between 1980-2012, the par amount of annual defaulted debt averaged 0.13% of total par outstanding. From 2008-2012, the par amount of annual defaulted debt averaged 0.17% of total par outstanding. In comparison, annual corporate default rates from 2008-2012, as provided by Standard and Poor's 2012 Annual Global Corporate Default Study (investment and non-investment grade), averaged 1.77%.[1]

In terms of the number of individual defaulted issuers, on average, only 0.18% of municipal issuers defaulted annually in the period between 1980-2012. For the period of 2008-2012, this rate increased to 0.29%. Although overall default rates remain very low, the figures for 2008-2012 for both par and number of issuers defaulted reflect a modest increase from historical levels.

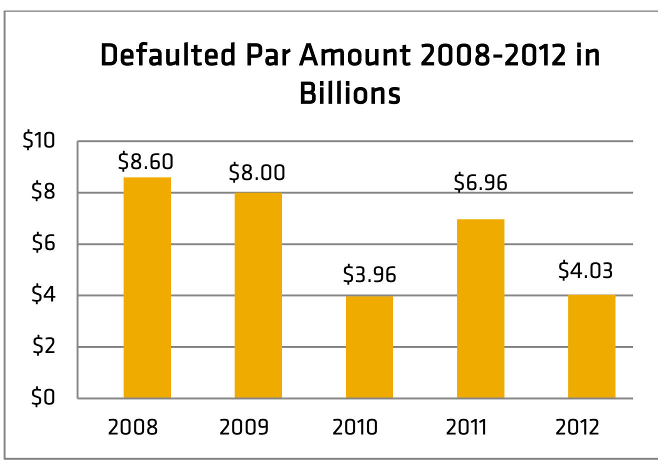


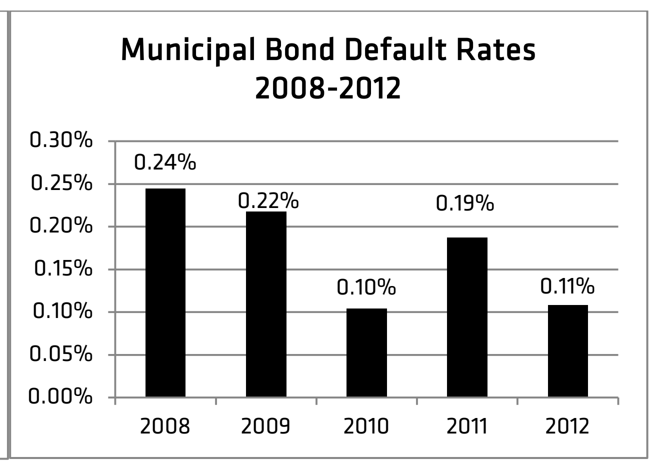
Data Source: KBRA, Income Securities Advisors, SIFMA



Data Source: KBRA, Income Securities Advisors, SIFMA

The charts below show the absolute par amount of defaulted debt and the par default rate for in each year from 2008 through 2012.



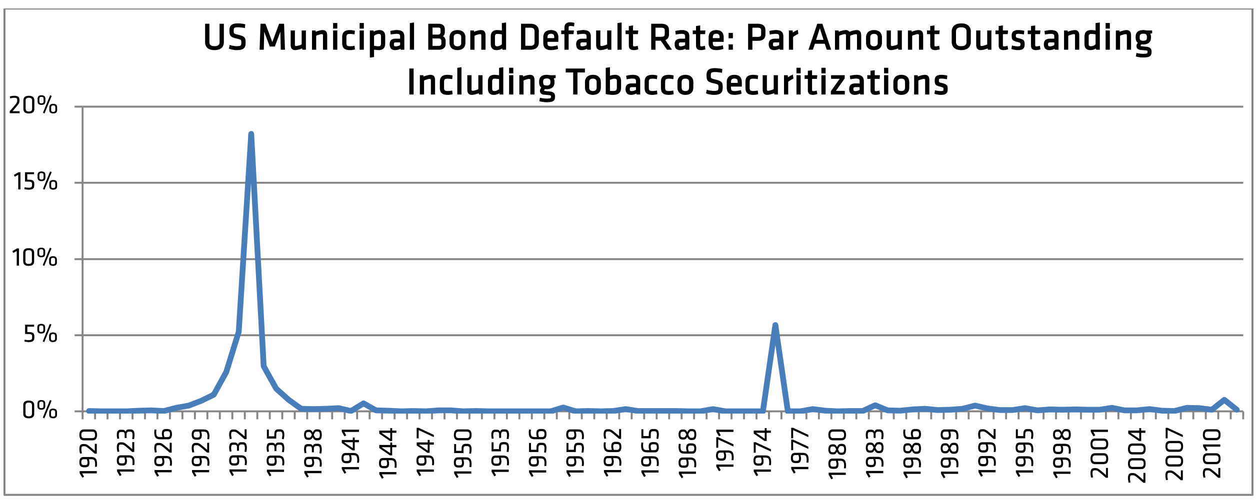


Data Source: Income Securities Advisors

Tobacco Securitization Deals

As stated above, default statistics from Income Securities Advisors include figures for issues that drew on reserve funds to pay debt service. The data includes par totals for five tobacco securitizations that drew on reserve funds in 2011 to pay debt service. The total par amount of tobacco securitizations affected by the draw on reserves was $21.65 billion in 2011. For the purposes of this report, the municipal default statistics in the charts above do not include these tobacco securitizations, as the large size of these transactions would obscure the base-line municipal default figures and render the year-to-year statistics less useful.

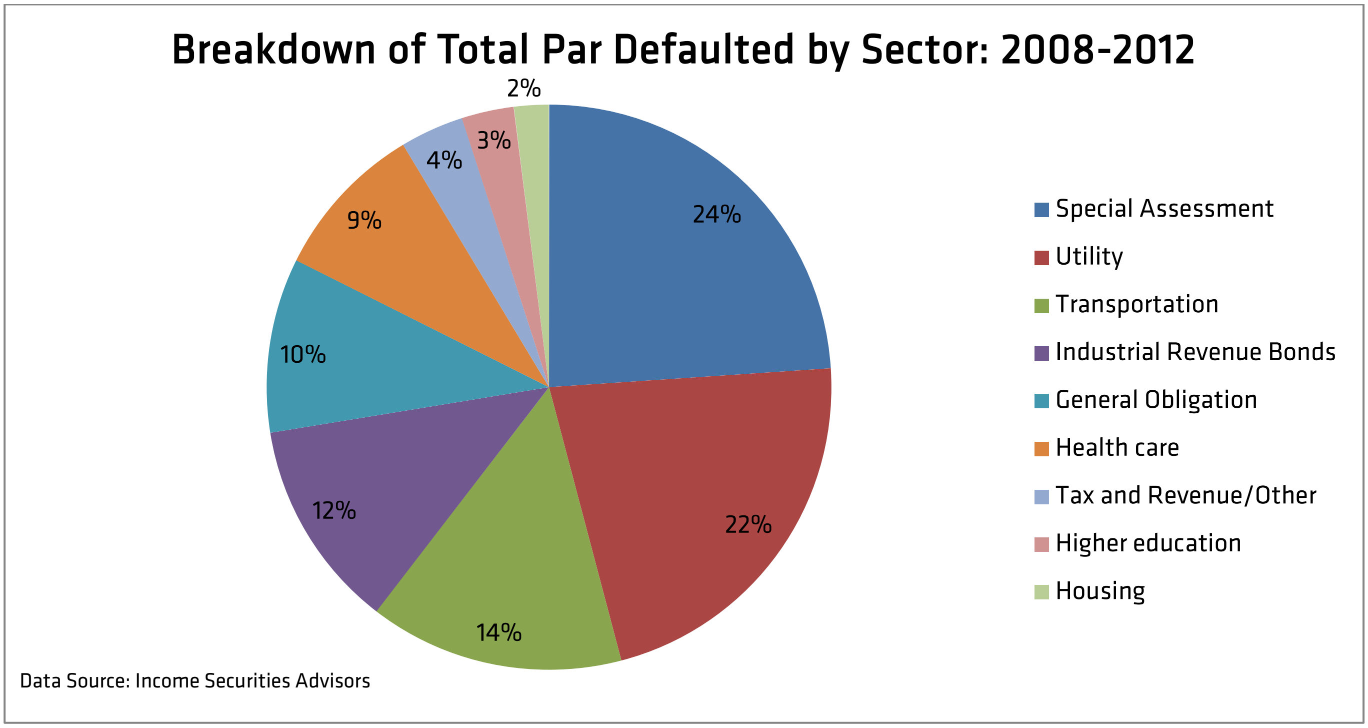
However, for informational purposes, we have included the graph below to show the increase in the municipal default rate when the par amount of the tobacco securitization issues is added to the 2011 default statistics. Inclusion of these tobacco securitization issues for 2011 increases the municipal default rate substantially, increasing the default rate in 2011 from 0.19% to 0.77%, and brings the average default rate for 2008-2012 up to 0.29% from 0.17%. These issues drew down on indentured reserves to pay debt service in 2011 because participating tobacco companies withheld payments due to the affected states under the Master Settlement Agreement (MSA). MSA funds were deposited in escrow pending resolution of litigation between the tobacco companies and the states; as of this time the litigation has not been resolved.[2]



Data Source: KBRA, Income Securities Advisors, SIFMA

Default Activity by Sector

The chart below shows the breakdown of total par defaulted from 2008-2012 by sector.



Over the 2008-2012 period, Special Assessment, Utility, Transportation, and Industrial Revenue Bonds represented the largest sectors for default and accounted for 72% of overall defaults.

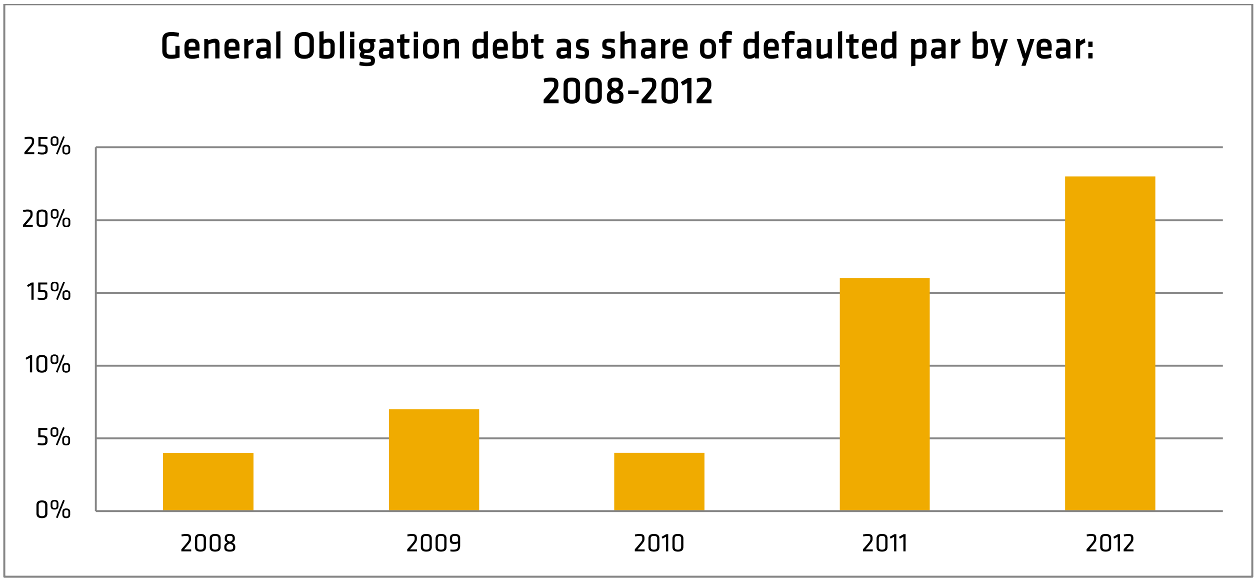
Special Assessment Bonds, typically issued to support real estate development, suffered significantly during 2008-2012, making up 20% to 42% of annual defaulted par. The cause of distress for this sector is largely tied to the collapse of the housing market in 2008. After 2010, the share of special assessment district defaults falls back closer to its historical average.

The utility sector accounted for 22% of defaults in the 2008-2012 period. This is largely attributable to Jefferson County's default on sewer system debt, which represented 55% of utility defaults over that period.

The transportation sector, which accounted for 15% of defaults from 2008-2012, was greatly skewed by the bankruptcy of American Airlines on November 29, 2011. This affected approximately $3.2 billion of municipal debt for terminal projects at several airports throughout the country. Netting out the American Airlines-related debt, transportation's share of municipal default drops to 5% for 2008-2012, which is much more in line with historical averages.

The chart below shows G.O. debt as a percentage of aggregate defaulted par amount for each year during the period 2008-2012. In contrast with historical trends, G.O. bond defaults have steadily increased as a percentage of total defaults over this recent period. From 2008-2012, the percentage of defaulted par for

G.O.'s increased from 4% to 23% of total defaults. In 2012, G.O. defaults were the largest share of defaults, slightly edging out utilities. Over this time period, certain high profile defaults accounted for an overwhelming share of this increase, as can be seen in the accompanying table.



Data Source: Income Securities Advisors

Highly Visible Credits' Share of General Obligation Defaulted Par					
	2008	2009	2010	2011	2012
Vallejo	30%				
Stockton					48%
Jefferson County	70%			94%	
San Bernardino					27%
Harrisburg		92%			5%
Detroit*					
TOTAL	**100%**	**92%**	**0%**	**94%**	**81%**

* Detroit default occurred in 2013

Impact of High Profile Credits on Aggregate Default Rates

As stated above, the average par default rate for the period 2008-2012 was 0.17%, as compared to a par default rate from 1980-2012 of 0.13%. During this five-year period, defaults of high profile distressed credits, including Vallejo, Jefferson County, Harrisburg, Central Falls, Stockton, and San Bernardino impacted annual default rates to varying degrees. The chart below shows defaults on debt of high profile credits as a percentage of aggregate default rates in each year for the period of 2008-2012. In 2008, the most distressed year in this period, Jefferson County's and Vallejo's defaults accounted for 51% of the total annual default rate. In 2009, 2011 and 2012, high profile defaults accounted for 6%, 16%, and 33% of the total annual default rates, respectively. Interestingly, there were no defaults on high profile credits in 2010 and only a 0.10% total default rate.

High Profile Credits' Share of Aggregate Annual Default Rate					
	2008	2009	2010	2011	2012
Vallejo	3%				
Stockton					22%
Jefferson County	47%			16%	
San Bernardino					9%
Harrisburg		6%			1%
Detroit*					
TOTAL	**51%**	**6%**	**0%**	**16%**	**33%**

* Detroit default occurred in 2013

The default by Detroit on its debt, which occurred in 2013, is another very significant event in the history of municipal defaults. However, inclusion of this debt into overall municipal default rates does not dramatically change the municipal default rate profile. Detroit's bankruptcy filing includes approximately $8.4 billion in bonded debt,[3] including G.O.'s, Pension Obligations and Water & Sewer Revenue bonds. This represents approximately 0.24% of total par outstanding in the municipal market in 2012. If the entire $8.4 billion in par was added to the defaulted par amount in 2008 – the worst year for default rates during the 2008-2012 period – the combined default rate would only be 0.48%. This is higher than the average 2008-2012 municipal default rate of 0.17%, but still significantly lower than the average corporate default rate of 1.77% over that period.

Factors Contributing to Increase in Default and Bankruptcy Activity

As discussed previously, there have been significant developments in the municipal credit markets over the last five years. Municipalities have gone into default and sought Chapter 9 bankruptcy protection at levels that are well above historic averages. This trend reflects a number of factors, but the underlying cause continues to be severe fiscal stress. The recent Great Recession resulted in significant fiscal stress for municipalities throughout the country, reducing general fund revenues and in some cases increasing social service costs. Pension and retiree healthcare liabilities increased dramatically following the market crash of 2008, due to reduced pension asset values and the increase in benefit levels granted during better economic times. In some cases, long-term structural budget imbalances worsened as fiscal pressure exposed existing weaknesses in financial condition. Political discord and paralysis increased as budget and fiscal pressure mounted.

While the factors contributing to fiscal stress will vary with each situation, the lack of long-term fiscal planning, faltering crisis management and lack of strategic alignment, either at the municipal level or vis-à-vis the state, seem to be common themes among the seven municipalities that were examined as part of this study. Whether this is reflected in the inability to manage growth in the boom-bust environment of the last decade, as was the case in Stockton, or the longer-term fiscal management issues which characterize Harrisburg and Detroit, the underlying economic problems are exacerbated by the focus on short-term goals over longer-term planning. In Jefferson County, the excessive use of derivative products to postpone required sewer rate increases resulted in a financial meltdown and required the County to seek bankruptcy protection.

Recent events also underscore the importance of the state in providing meaningful support and intervention for distressed local governments. The ability and willingness of state governments to provide guidance and intervention when needed is a major factor in the avoidance of default and bankruptcy. As discussed further in this report, state statutes and programs vary as to the level of assistance they provide and the interventions that can be undertaken. For example, the statutory framework of California and Alabama provides for a "hands off" approach, while Rhode Island took strong affirmative action to provide assistance and leadership to avoid default by municipalities. In Rhode Island, the State Legislature established a statutory lien, which ensured that bondholders of municipal general obligation debt would get paid under bankruptcy. Michigan has a very strong statutory framework for local assistance and has historically been very active in stepping in to manage distressed credits in a way that protects bondholders; in regards to the City of Detroit's G.O. debt, the state seems to have taken a different approach. Effective intervention also requires commitment and coordination between state and local officials, which can often prove difficult in stressed situations. Political receptivity at the local level to state interventions has also turned out to play a larger role than would have been expected.

KBRA also notes how the presence of bond insurance can change the dynamic between issuer and bondholder, possibly affecting the issuer's decision regarding default. If individual bondholders will continue to be paid principal and interest because of insurance, there may be less pressure on municipal governments to avoid default. It remains to be seen if issuers can selectively default on insured debt in a series of *pari passu* bonds by arguing that insured and uninsured bonds belong in different classes under bankruptcy law.

In the end, although each of these factors contributed to a significant increase in the number of defaults and/or bankruptcies, it is KBRA's view that the decision to default or pursue bankruptcy reflects a significant change in the willingness of issuers to protect bondholders and take whatever actions are necessary to ensure full and timely payment of principal and interest on their debt. The economic and fiscal pressures stemming from the Great Recession, severe though they may be, are not essentially different from events that created severe stress for municipalities in the past, particularly on a regional basis. However, not since the Great Depression have there been so many municipal defaults and/or bankruptcies. KBRA believes that this change in attitude towards repayment of debt represents the greatest risk to the stability of the municipal credit markets.

In KBRA's view, Jefferson County's bankruptcy filing was a critical turning point that may have changed the way municipalities look at default and/or bankruptcy. The Jefferson County filing took default out of the realm of "unthinkable" and thrust the concept into newspaper headlines. What had been previously been reserved for dirt bonds and project financings was now within the realm of basic infrastructure financing, which is at the core of municipal finance. KBRA believes that this filing in and of itself has altered the landscape of municipal finance and the probability of defaults in the future.

Municipal Bankruptcy

Bankruptcy Process

Not all municipalities in financial distress have the ability to file for bankruptcy protection, and not all municipalities in bankruptcy will default. The road to bankruptcy varies from state to state, with approximately half of the states having statutes that authorize certain of their municipalities to file for Chapter 9 Bankruptcy protection.[4] In many of these states, there are state-level requirements that must be met before the municipality is authorized to file. Half of the states that permit filing for bankruptcy require consent of a state official before Chapter 9 is authorized, while other states, including Michigan, Pennsylvania and Rhode Island, impose a process of increasing state supervision for distressed municipalities.[5] California requires that the municipality engage in a 60-day mediation period before a Chapter 9 filing is authorized, but such period can be waived in an emergency.[6]

Even with statutory authorization from the state, a municipality may still be ineligible for bankruptcy protection if it seeks to impair a creditor in a manner that would violate provisions of the state constitution, which is the issue being raised by the labor unions in Detroit's filing, as discussed below.[7] One of the primary impediments to bankruptcy is the ability to prove insolvency. Though insolvency is a defined term in the US Bankruptcy Code,[8] its application to municipalities can be difficult because, as a perpetual corporation which may not be liquidated, municipalities cannot be analyzed through the standard "balance-sheet insolvency" rubric (i.e., liabilities exceed assets) that is applied in corporate bankruptcies. Instead, courts must use a more amorphous framework couched in terms of cash insolvency, budget insolvency, service delivery insolvency, or some combination of the three. This can lead to lengthy litigation, as was the case in Stockton, California.[9] The eligibility question may also revolve around the question of whether the municipality has negotiated in good faith during pre-bankruptcy negotiations.

Purpose of Bankruptcy

The U.S. Constitution authorizes Congress to create laws and hold jurisdiction over bankruptcy matters. Congress enacted the current U.S. Bankruptcy Code in 1978. For distressed municipalities that have reached the point of insolvency, defined in section 101(32)(C) of the Code as a municipality being unable to either i) pay its debts as they become due or ii) generally not paying its debts while not under litigation, Chapter 9 may be available to provide relief from creditor suits and offer the ability to restructure debts. However, as recent cases have shown, the lack of federal case law regarding Chapter 9, as well as rapidly changing and complex state laws, make the road to bankruptcy uncertain. Moreover, because municipal bankruptcy is a lengthy process that often results in high legal fees, the decision to file a Chapter 9 petition should not be made lightly.

There have been so few Chapter 9 bankruptcy filings that state actions or court rulings on each individual bankruptcy case add to the emerging picture of how Chapter 9 operates. The overall goal of the Code is to provide debtors a financial fresh start.[10] Municipal bankruptcy under Chapter 9 differs from corporate bankruptcy under Chapter 11 in several ways. Unlike corporations, a municipality may not be forced into bankruptcy by its creditors[11] and it may not be liquidated to satisfy its debt obligations.[12] Indeed, much of the litigation in a Chapter 9 proceeding revolves around the determination of how much a municipality may pay its creditors, including bondholders, while still maintaining health, safety, and operational services. Further, once in bankruptcy, a municipality may be able to restructure or reject contracts under state law, such as collective bargaining agreements, pension obligations and other retiree benefit plans,[13] under less restrictive tests than in Chapter 11.[14]

Role of the Courts

The power and role of the courts is limited in municipal bankruptcy proceedings. As political subdivisions of the state, municipalities are protected from federal interference by the 10th Amendment of the U.S. Constitution,[15] which reserves sovereignty over a state's internal affairs to the state. Accordingly, bankruptcy courts may not interfere with the governmental powers of the debtor, the property or revenues of the debtor, or the debtor's use of income producing property without consent.[16] Further, the courts may not liquidate a municipality or interfere with the management of its fiscal affairs.[17] The municipality retains control over its finances and its recovery plan options. The role of the court initially is to rule on the municipality's eligibility for Chapter 9 protection, and then to rule on the plan of adjustment, which, unlike a plan of reorganization in Chapter 11 bankruptcy, may only be submitted by the debtor.[18] Indeed, the court's ability to confirm or deny a municipality's plan of adjustment is often its main point of leverage in a Chapter 9 proceeding.

Key Issues in Bankruptcy

A number of key issues have emerged as a result of the recent Chapter 9 bankruptcy filings. These include: i) whether Federal bankruptcy laws or existing state law regarding municipal obligations will take precedence in determination of payment priorities and protections, ii) how general obligation debt will be treated relative to other debt obligations, secured and unsecured, and other contractual obligations such as pensions iii) what the full faith and credit pledge means, and iv) the distinction between a limited tax general obligation pledge and an unlimited general obligation pledge. The resolution of these issues may ultimately challenge the long-held belief that the G.O. pledge, especially that supported by an issuer's unlimited taxing power, is the strongest form of municipal security. The recent bankruptcy filing of Detroit introduces each of these issues. Detroit's Emergency Manager has already proposed haircutting payments to G.O. bondholders and pensioners, notwithstanding the protections provided in state law. In fact, labor unions are challenging the eligibility of Detroit to file on the basis that a filing will result in the reduction of protected pension and other retiree benefits. Similar questions arose in the Stockton filing, based on CalPERS' assertion that State law protects CalPERS from impairment, even in bankruptcy. The issue is whether or not pensioners can be considered a different class of creditor than the bondholders. A decision in the Stockton case will impact the outcome of the San Bernardino bankruptcy case. San Bernardino, which stopped payments to CalPERS for almost a year after filing for bankruptcy, only resumed payments this past July, but has indicated that it wishes to restructure its CalPERS payments going forward.

What Chapter 9 Means to Creditors

If a federal bankruptcy court finds the municipality eligible for Chapter 9 protection, the rights of creditors holding both G.O. and Special Revenue debt can be significantly affected. While at least one state, Rhode Island, secures all of its G.O. debt with a statutory lien allowing those creditors to be paid first from specified revenues even during a bankruptcy proceeding,[19] most G.O. debt enjoys only the ability to seek a writ of mandamus – a court order compelling a municipality's officers to perform a ministerial act such as raising taxes to pay off its obligations.[20]

Outside of bankruptcy, a mandamus action can take years to resolve in state court, limiting the remedy's effectiveness. Once a Chapter 9 petition is filed, the Code operates to stay all creditor suits,[21] including any action seeking to enforce a claim against the debtor. A municipality that is determined eligible can eliminate the security underlying most of its G.O. debt for the duration of the bankruptcy, effectively rendering the G.O. debt unsecured, in line with all other unsecured contractual obligations. As a result, mandamus can be an ineffectual remedy to try to enforce a debt payment when a distressed municipality is considering filing for bankruptcy.[22]

Unlike G.O. bondholders, the rights of holders of Special Revenue debt – debt that is secured by a lien on a specific stream of revenue – are affected by a Chapter 9 filing in a different way.[23] While section 552(a) of the Code provides that any pre-petition pledge terminates upon bankruptcy, section 928 of the Code expressly renders that provision inapplicable to Special Revenue debt. Under section 928, holders of special revenue debt may be paid during bankruptcy.[24] However, section 928 also provides that necessary operating expenses shall be deducted from the pledged revenue stream before payment to the debt holders, even if the indenture provides bondholders with a gross revenue pledge.[25] Notably, a decision issued on July 3, 2013 by the court presiding over the Jefferson County, Alabama bankruptcy interpreted the definition of necessary operating expenses broadly, such that litigation expenses incurred as a result of the bankruptcy proceeding may be deducted before payment to the debt holders.[26] Therefore, despite the fact that the Code guarantees Special Revenue debt holders continued payment from the pledged revenue stream following a Chapter 9 filing, the net revenues available to debt holders may be significantly reduced if other bankruptcy courts follow the Alabama court's broad interpretation of necessary operating expenses.

Ongoing Fiscal Pressures: Pension Liabilities

Over the near term, KBRA recognizes that state and local governments will continue to face challenges that will impact their ability to manage limited resources. Employee pensions and healthcare obligations are among the most visible.

In June 2012, the Governmental Accounting Standards Board (GASB) announced sweeping changes to the manner in which State and local governments are required to report their pension liabilities. The new standards clearly distinguish the role of GASB in setting reporting standards from the role of state and local governments in establishing funding policies. The new standards relate only to how state and local governments must account for and report on pension liabilities and take effect for fiscal years beginning after June 15, 2014.

As the new GASB pronouncements regarding reporting on pension obligations roll out over the next 12-24 months, it is likely that we will see a clearer picture of the burden imposed by these long-term obligations. The GASB changes are intended to provide a more consistent basis for the presentation of pension obligations in financial statements. In many cases the prescribed methodology for calculating and reporting pension liabilities will result in significantly larger liabilities than previously reported. In KBRA's view, the new GASB requirements will provide a more consistent basis to compare pension liabilities across municipal issuers and improve the ability to assess progress towards full funding of total pension liabilities.

In response to the GASB changes, KBRA will modify its approach to evaluating the impact of the credit risk of pension liabilities on G.O. ratings of state and local governments. Currently, KBRA reviews i) the issuer's history of making its Annual Required Contribution (ARC), ii) the burden imposed by these required payments on the issuer's operating budget and iii) the level and trend of pension funded ratios. Although the ARC was not viewed as the perfect measure of an issuer's ongoing financial obligation, an issuer's consistent funding of its ARC evidenced a commitment to funding its current and unfunded pension liabilities. Going forward, KBRA's analysis will reflect the following adjustments:

- the absolute burden created by an issuer's total pension liability (the funded and unfunded portions) will be assessed by measuring the total liability against measures used by KBRA to assess debt burden.

- the year-over-year change in the plan's net position will be reviewed to determine whether i) the issuer is keeping up with current funding requirements, which is comparable to the normal cost portion of the old annually required contribution (ARC) and ii) it is making progress towards amortizing the unfunded portion of its liability.

- the impact of current funding requirements will be assessed relative to the overall operating budget.

- the additional impact of amortizing the unfunded portion of the pension liability on the operating budget will be assessed using a 30-year level dollar approach.

KBRA will also review the plan's asset allocation to understand the potential impact of credit risk and investment return on the plan's funding level over time. KBRA does not anticipate that these factors will have an immediate impact on rating assessments. However, as state and local governments begin to report against the new requirements, KBRA will seek to establish benchmarks for each of the quantitative factors relative to its rating categories. Over time, KBRA believes that the accuracy and level of transparency associated with ongoing pension liabilities will improve with this approach.

Conclusions

In conclusion, while KBRA does not anticipate a systemic wave of defaults in the municipal marketplace, it believes that municipal bond issuers, particularly in the general government sectors, may experience somewhat higher default rates going forward than the extremely low default rates of the past. Our analysis of recent municipal default history indicates that municipal defaults remain relatively rare. However, the composition of defaulting sectors has changed over the last five years. Defaults of G.O. debt, which has historically been considered the most secure sector within the market, have steadily increased as a percentage of total municipal defaults since 2008. Although the vast majority of municipal issuers have responsibly managed their finances and continued to pay their debts in full and on a timely basis, the actions of certain municipalities over the last several years have roiled the municipal markets and challenged long-held assumptions about security in that marketplace.

KBRA views these developments as indicative of a potential changes in the basic legal and credit framework under which municipal debt is issued. In addition to the political and legal challenges, there is a question of whether the number of high profile defaults, especially if the trend continues, will make the decision to consider default or bankruptcy as a potential strategic option more acceptable. While KBRA recognizes the magnitude of recent fiscal and economic pressures facing local governments, it is our view that the decision to default or pursue bankruptcy is just that– a decision—and that it reflects an essential unwillingness of an issuer to pay its debt. Although KBRA does not anticipate widespread defaults, we believe that this change of attitude towards payment of debt represents the greatest risk to the stability of the municipal credit markets.

When determining ratings for local government general obligations, KBRA assesses both the ability and willingness of an issuer to pay its obligations in full and on a timely basis. As noted in KBRA's municipal rating methodologies, KBRA would view a decision to default on debt as a substantial negative rating factor that could limit the ability of an issuer to achieve an investment grade rating. A situation where a default is quickly followed by a plan to restructure debt and pay bondholders over time could be considered a possible mitigation to this negative rating factor.

KBRA Rating Approach Going Forward

KBRA entered the market for municipal ratings in 2012, when many local governments were still struggling to recover from the recession and a number of municipalities had defaulted on their bonds. From the beginning, KBRA's rating methodologies for state and local government debt have underscored the importance of management quality in the rating review. KBRA will continue to focus on management's ability and willingness to make hard decisions to maintain fiscal stability and its framework of financial policies and procedures which support long term structural balance. KBRA is of the view that an increased risk of default or bankruptcy will generally be limited to situations of severe fiscal stress and KBRA will continue to identify and analyze credit factors which may lead to fiscal stress as part of its rating review. Further, KBRA conducts a bankruptcy analysis for every issuer it rates, which includes a review of state statutes regarding authorization of bankruptcy, state policies and procedures to assist municipalities in distress and how the state has responded to distressed municipalities. We will continue to monitor legal developments coming out of bankruptcy court decisions and expand our bankruptcy analysis as warranted.

There are several factors that mitigate the risk of increased default for the municipal market going forward. Most municipalities have time to deal with their long-term challenges. Municipalities generally have fairly long debt maturity profiles and time to address refinancing needs. In addition, the challenges of dealing with the scale of employee pension and health care obligations, while significant, will also generally play out over the long term, giving many municipal governments time to address the need for employee benefit reform. Finally, although numerous municipalities face stressed budgets, many have also taken the necessary steps to cut costs, enhance fee revenue and delay capital projects in order to maintain an adequate degree of fiscal stability as the economy undergoes a slow recovery.

Acknowledgements

KBRA would like to acknowledge the contributions of Nicolas Krawitz and Emily Luskind for their research assistance on this report.

Kroll BondRatings™

Appendices

Related Methodologies

[Public Finance: U.S. Local Government GO Methodology]

[Financial Guaranty: Financial Guaranty Rating Methodology]

Endnotes

[1] Standard & Poor's. (March 18, 2013). *2012 Annual Global Corporate Default Study And Rating Transitions.* Standard & Poor's

[2] Richard Larkin, S. W. (2012). Special Types of High Yield Municipal Bonds. In T. Nguyen, *Investing in the High Yield Municipal Market: How to Profit from the Current Municipal Credit Crisis and Earn Attractive Tax-Exempt Interest Income (Bloomberg Financial).* Hoboken, NJ: John Wiley & Sons, Inc

[3] City of Detroit Proposal For Creditors, June 14, 2013

[4] JAMES E. SPIOTTO & CHAPMAN AND CUTLER LLP, MUNICIPALITIES IN DISTRESS? (1st ed., 2012).

[5] Id.

[6] *CA AB506 / 2011-2012 / Regular Session*. (2011, October 09). *LegiScan*. Retrieved September 05, 2013, from http://legiscan.com/CA/bill/AB506/2011

[7] Paul Egan, Joe Guillen, & Matt Helms, *Legal battle brews over Detroit bankruptcy filing*, U.S.A. TODAY, Jul. 19, 2013, http://www.usatoday.com/story/news/nation/2013/07/19/detroit-bankruptcy-unconstitutional/2569481.

[8] 11 U.S.C. § 101(32)(C) (2006 & Supp. 2010).

[9] *See* In re City of Stockton, Cal., 2013 WL 2629129, *12-15 (Bankr. E.D. Cal. June 12, 2013) (discussing the definition of insolvency as it applies to municipal bankruptcies).

[10] *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (noting that one of the primary purposes of the Bankruptcy Act is that "it gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.") (internal citation omitted).

[11] *See* 11 U.S.C. § 303 (2006 & Supp. 2010) ("[a]n involuntary case may be commenced only under chapter 7 or 11 of this title . . . .").

[12] *See* U.S. Const. amend. X (reserving to states the powers not granted to the federal government); 11 U.S.C. § 903 (2006) (reserving State power to control municipalities); 11 U.S.C. § 904 (2006) (prohibiting nonconsensual interference by the court into any of the political or governmental powers of the municipality, any of the property or revenues of the municipality, or the municipality's use or enjoyment of any income-producing property).

[13] *See* 11 U.S.C. § 365(a) (2006) (as made applicable to Chapter 9 proceedings by section 901 of the Code); NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984) (holding that section 365(a) of the Code, which provides that, subject to the court's approval, the debtor may unilaterally assume or reject any executory contract of the debtor, was intended to include collective bargaining agreements).

[14] *Compare* 11 U.S.C. § 365(a) (2006) (permitting debtors to unilaterally reject any executory contract of the debtor, subject only to the court's approval), *with* 11 U.S.C. § 1113 (2006) (allowing Chapter 11 debtors to reject collective bargaining agreements only after the court finds the debtor made a proposal to restructure the agreement in good faith and after full disclosure, the authorized representative of the employees has refused to accept such proposal without cause, and the balance of the equities clearly favors rejection of such agreement).

[15] U.S. Const. amend. X.

[16] 11 U.S.C. § 904 (2006).

[17] *See* U.S. Const. amend. X (reserving to states the powers not granted to the federal government); 11 U.S.C. § 903 (2006) (reserving State power to control municipalities); 11 U.S.C. § 904 (2006) (prohibiting nonconsensual interference

by the court into any of the political or governmental powers of the municipality, any of the property or revenues of the municipality, or the municipality's use or enjoyment of any income-producing property).
[18] *See* 11 U.S.C. § 941 (2006); S. Rep. No. 95-989, at 112 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5898 (explaining that section 941 gives the debtor the *exclusive* right to file a plan).
[19] R.I. GEN. LAWS ANN. § 45-12-1 (West 2011).
[20] *See* Black's Law Dictionary (9th ed. 2009).
[21] 11 U.S.C. §§ 362(a), 922(a) (2006 & Supp. 2010).
[22] *See id.* § 922(a)(1) (2006) (expanding section 362's stay on creditor suits to include a "judicial, administrative, or other action or proceeding against an officer or inhabitant of the debtor that seeks to enforce a claim against the debtor" for Chapter 9 proceedings).
[23] *Id.* § 552(a).
[24] *Id.* § 928(a).
[25] *See id.* § 928(b).
[26] In re Jefferson County, Ala., 2013 WL 3358010 (Bankr. N.D. Ala. July 3, 2013) (reasoning that because a major impetus for the County's Chapter 9 filing was the restructuring of its Special Revenue financing obligations, to exclude those professional fees incurred to save the Special Revenue financed-system from economic collapse would "relegate the system to fail not just financially but also operationally, which is precisely what Congress wanted to avoid by enactment of § 928(b).").