What is this Financial Mess and Where are Municipalities Going?

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There are many sophisticated analyses about what happened in the financial markets and what it means for the future of the country. In a nut shell, the economy was stacked up like a bunch of dominos. All went well and we were flourishing as long as all sectors held up. Many capital ventures were based on increased value in the future to make money in the present. When those increases disappeared, the dominos all started to topple.

The mortgage sector began to unravel as homeowners who took on too much risk saw interest rates reset upwards and payments dramatically increase. As mortgages began to default and homes were placed into foreclosure, the securities that were backed by them came under severe strain. The financial guarantors that insured these bonds were not viewed as having adequate resources to make good on the policies they had underwritten (everything was fine when prices were going up). As these bonds soured due to problems with the underlying collateral and as the insurance that wrapped them was perceived as worthless, the investors and dealers who held these complex instruments began experiencing tremendous losses in their portfolios. Unfortunately, these investors and dealers, just like their counterparts in the real estate market, were working with borrowed funds in an extreme fashion. As the lenders of these funds watched their collateral and the balance sheets of these institutions deteriorate rapidly, they naturally refused to offer additional credit or called in the financing. Forced selling rippled its way through every market, which begat more selling, lower prices still, and so on.

Then, after a number of massive shocks characterized by the nationalization of Fannie Mae and Freddie Mac and the bankruptcy of Lehman Brothers, liquidity or the availability of capital simply disappeared. Anyone with capital held on to it to meet their own needs and one by one the dominos fell. Unlike normal times when the toppling of one financial sector was difficult, but could be overcome in a short period, this time the dominos were all in a line and all financial sectors were impacted. During the last crisis, when the IT sector overheated, we at least had the resulting IT infrastructure as a result. This time we have a lot of vacant homes.

Because all sectors were impacted, this will not be a short recovery. It will take time to rebuild the economy because all financial sectors will need to be rebuilt and those with capital are not likely to reinvest until they believe the worst has occurred. It would seem that the tremendous economic gains of 2003 – 2006 were built on mounds of leverage that is still being worked off, and may continue to for some time.

What does this mean to municipalities? In the short term, it may mean you have vacant homes in your community with which to deal. If you were a high growth community, you may have a problem with replacing impact fee funds that you expected to offset expenditures. In a worst case scenario, you may have a problem with your SSA bonds if your developer goes bankrupt and is no longer able to pay his assessments. You may have the improved land as an asset, but it may take time to convert that land. However, it is unlikely the banks owning the land will renege on the bonds due to the asset of the improved land.

Longer term, you may have an increase in unemployment amongst your residents meaning fewer revenues and more service needs. Less spending by the consumers who are also holding onto capital may also lessen sales tax proceeds. Longer term ramifications may also mean a reduction in the value of homes as well as vacant homes resulting in reduced EAV's and reduced taxes.

If you are caught in this spiral, it is important that you not react quickly, in a knee-jerk fashion. You must consider long term affects of your actions and solve your current budget crisis in a fashion that will not create bigger problems long term. On the IML Web site www.iml.org; Library; IML 2008 Annual Conference Materials; "Budgeting in Tough Financial Times" is a presentation made at the IML conference that may assist you in long term financial planning as you tighten your budget.

Tightening of your budget does not necessarily mean that you delay your capital expenditures. While you may need to look at borrowing as opposed to "pay as you go," you still need to make improvements to your infrastructure. Delaying these may mean that you increase eventual costs due to lack of maintenance or miss the opportunity for growth in your community when the economy returns. Increased construction costs due to inflation may end up costing you more than financing costs. You are still going to have financial and capital needs during this period. So, can you borrow money? The answer is yes. Local governments still borrowed money even in the Great Depression. Markets may be temporarily interrupted

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as we recently saw, but they do return. As with Treasuries, GO's are a safe haven for investment. However, there are some changes:

BOND INSURANCE

With the recent purchase of Financial Security Assurance Holdings Ltd. by Assured Guaranty Ltd., there is, in reality, one "AAA" insurance company for bond insurance. (Berkshire Hathaway is now available for only very large $100 million+ offerings). However, the reduction in the number of vendors does not mean bond insurance will go away. First, some fund policies require bond insurance for the purchase of bonds. Second, bond insurance will always be seen as a second set of eyes. On the other hand, based on the diminishing availability and potential increase in cost of bond insurance, the underlying credit rating of the community will be more important than ever.

CREDIT RATINGS

While credit ratings are becoming more important, they too are changing. It has always been known that a community with an A credit rating is a far more solid guarantee to make bond payments over the life of the bonds as opposed to a similar A rated corporate bond. Local governments with taxing authority do have a deep pocket base upon which to call. To this end, bond ratings are beginning to be viewed more in line with this lesser risk. Standard and Poors has already begun this migration. Communities with smaller tax bases may see an upgrade as a result. Moodys was in the process of this conversion, but has temporarily halted it in the financial crisis. However, it too will ultimately make the conversion. Overall this conversion is of benefit to communities, but be aware, it is not as simple as it seems. While there will be the likelihood of upgrades for some issues in the future, it is expected that there will still be gradations within these new upgrades—a new term, granularity.

GO VERSUS REVENUE BONDS

As the bond market settles, GO bonds are beginning to sell normally. There is a slight increase in rates, but a GO that is a sound credit should have no problem in the competitive market.

Revenue bonds are an entirely different matter. Purchasers of bonds are going to need expanded information in this market to find the comfort needed to purchase. Illinois municipalities should look at GO alternatives, whether they are a regular GO bond, an alternate bond or a debt certificate, if they possibly can. TIF bonds that are alternate bonds are going to sell at a much better rate than revenue bonds. However, communities should exercise caution before they provide this enhancement to bonds. Communities should avoid risky projects at this juncture.

Revenue Bonds are likely to see significantly increased rates.

BANK QUALIFIED VERSUS NON BANK QUALIFIED

A community can issue no more than $10 million in bonds during one year for the bonds to be bank qualified. If you can issue bank qualified bonds, you are currently saving approximately 85 basis points in your rates. It is not expected that this huge differential will hold (25 to 50 basis points in the near past), but the differential is there now and it is likely to be important that bonds be bank qualified in the future. If you have a large issue, try to straddle two years with that issue. Structure and timing of bonds are extremely important in this market and you need, with the help of your financial advisor, to carefully construct your financial plan.

COMPETITIVE VERSUS NEGOTIATED OR PRIVATE PLACEMENTS

Competitive sales have returned and are still the way to assure that financial institutions throughout the country bid on your issue. If you have a normal issue that is a GO, this likely continues to be the mode of sale that will give you the best price in terms of rates and issuance costs.

Negotiated sales and private placements may gain more prominence for revenue bonds in today's market given the need for increased information by buyers. Given the increased information needs and increased difficulty in sale of bonds, there is likely to be an increase in underwriting costs for these bonds. Finally, you may turn to a negotiated sale or a private placement for these bonds, but it continues to be important to follow the Governmental Finance Officers' recommendations that your financial advisor have a fiduciary responsibly to you alone. When you use an independent financial advisor, there is no question related to this responsibility.

DISCLOSURE

As noted, the more information the better. It is important that you submit your disclosure in a timely and complete fashion. If you are called by a potential bond purchaser (this is a new happening) you must be timely and complete in your response and disclosure to them. If your financial advisor advises you of the need for additional disclosure due to a change in the markets (insurance company downgrades triggered a number of these alerts), you must be prompt in your response.

Finally, there is no doubt that the bond market has been recently affected by the financial markets. There are fewer buyers of bonds due to company failures and mergers, and limited capacity by institutional investors. However, municipal bonds are still one of the safest investments for buyers. The market for GOs is getting back to normal. The market for Revenue Bonds continues to be challenging, but not impossible. Correct structuring with sound information should be a key to communities weathering today's financial challenges.

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