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## Municipal Bankruptcy: Standard & Poor's Approach And Viewpoint

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# Municipal Bankruptcy: Standard & Poor's Approach And Viewpoint

When a municipality files a Chapter 9 petition under the U.S. Bankruptcy Code, Standard & Poor's Ratings Services believes the municipality is raising the issue of its willingness to fund some or all of its financial obligations.

In our view, there are few actions that should carry greater stigma in the municipal credit markets than a bankruptcy filing. We believe any potential weakening of an obligor's willingness to pay its obligations may reflect degraded credit quality. Moreover, once a bankruptcy occurs, we anticipate the credit implications will remain after the municipality technically emerges from bankruptcy. Restoration of market access could be many years into the future.

## Overview

- Bankruptcy should, and does, carry a great stigma in the credit markets.
- Credit implications will remain after a municipality technically emerges from bankruptcy.
- It could take years to restore market access, at least with a Standard & Poor's bond rating.

If we learn that a municipal obligor is actively and publicly considering filing a Chapter 9 bankruptcy petition, we may place the credit ratings of all of the municipality's rated debt on CreditWatch with negative implications in accordance with our criteria. Such consideration of bankruptcy will trigger a review that will focus on the factors included in our published ratings criteria relevant for the obligor, including key financial metrics and managerial performance. As part of that review, we will request information about the municipality's bankruptcy plans. We will publish the results of our review, including any related ratings actions.

In our view, municipal bankruptcy continues to carry a substantial stigma inasmuch as it amounts to an abdication of a borrower's authority to manage its own operations. We also believe a bankruptcy filing is not a discrete event but rather part of a process, as it is likely to be only the beginning of a costly and possibly economically debilitating episode in the broader arc of a municipality's history. Once it has filed a Chapter 9 petition, it is less important whether a municipality managed itself into genuine insolvency or chose to use bankruptcy as a fiscal tool. In short, filing a Chapter 9 petition—no matter the reason—sets in motion a process with damaging consequences to a municipality's fiscal and economic prospects. And, technically emerging from bankruptcy, while necessary, could also be a long and costly process. Furthermore, emerging from bankruptcy alone is unlikely to be sufficient to reverse the direct and indirect costs to a municipality of having gone down this path.

In hindsight, we believe the factors precipitating a municipal bankruptcy can be years in the making. Budget gimmicks may be a feature of these situations, helping delay but not precluding the eventual day of reckoning. In fact, while use of accounting maneuvers can be expedient and may defer the need to make difficult policy choices they do not offer sustainable solutions to underlying fiscal imbalance. Fiscal erosion can occur rapidly, in the span of one year, or it can be gradual, taking several years before coming to a head. Sometimes, because it is being papered-over by accounting shifts, fiscal decline is difficult to detect as it is happening. Regardless of how quickly or slowly the process evolves,

however, when it culminates in a bankruptcy filing, management has ultimately relinquished its role as steward of a community's financial resources just the same.

Once a municipality's officials decide to file a Chapter 9 petition, we believe its prospects for future economic growth, and its credit standing, will likely be much weaker. In exchange, the municipality may obtain temporary cash flow relief and, potentially, the court's backing for a stronger negotiating position with some of its creditors. However, our review suggests to us that these benefits are likely to dissipate within a few years. They are also typically offset by the potential residue a bankruptcy can leave on the municipality's reputation that results in longer-term financial and morale damage to its residents. We believe the fallout from bankruptcy often includes reduced prospects for economic investment of all types. Measured against these more permanent costs, municipal officials may want to discount the value of any temporary benefits that they may obtain by filing bankruptcy.

### **Bankruptcies Are Likely To Remain Rare**

Due in part to the characteristics of municipal governments but also owing to the fact that municipal bankruptcy is unlikely to actually be beneficial, we continue to believe bankruptcies are unlikely to occur outside a very small minority of the obligors we rate (see "In 2012, U.S. State And Local Governments Confront Fundamental Questions To Balance Long-Term Budgets," published Jan. 25, 2012).

Our view remains that credit quality across the sector is generally stable and resilient. Furthermore, the recent bankruptcies are consistent with another point we have made: We expect there to be pockets of outright credit distress. But as our existing rating distribution implies, we believe the vast majority of obligors we rate are committed to meeting their financial obligations.

## **Indirect Costs Of Bankruptcy**

While a municipality is in bankruptcy, instead of funding services and investing in infrastructure maintenance and improvement, based on our review, a considerable share of the municipality's tax revenue typically goes to pay for the unavoidable legal and advisory costs of bankruptcy proceedings. Large indirect costs also occur when a municipality must divert its human resources to administer the bankruptcy process itself instead of fulfilling the municipality's mission.

Moreover, the burden of this cost is magnified in bankruptcy when, as is typically the case, the municipality is downsizing significantly. Redirecting the time and attention of remaining staff members to bankruptcy-related tasks only adds to the filing's overall costs and impacts, including foregone services to residents and the effect this may have on the city's image and desirability as a place to live or do business. Large opportunity costs are also associated with a municipal bankruptcy, which can contribute to the weakening of an obligor's future ability to pay.

## **Future Costs Of Bankruptcy**

Assessing an obligor's ability and willingness to pay its obligations lays at the heart of our credit analysis. And it

becomes even more important during periods of economic and fiscal stress. Typically, we view obligor willingness to pay as resolute in the municipal sector. However, because obligors can only voluntarily file Chapter 9 petitions, as noted above, we believe a filing raises the question of the municipality's willingness to pay at least some of its obligations. Moreover, in our view, willingness is easier to damage than it is to repair, and emerging from bankruptcy is not tantamount to willingness to pay.

Less appreciated, in our view, is that municipal bankruptcy also undermines the other central tenet of credit quality -- an obligor's ability to pay. Bankruptcy, therefore, not only may be the result of weakened management resolve; it may also be the precursor to future financial underperformance and ongoing underinvestment. This is another reason we believe municipal bankruptcy is so damaging to an obligor's short- and long-term credit quality.

Bankruptcy contributes to the longer-term degradation of an obligor's economic fundamentals and tax base largely because of what the municipality can no longer do. Vallejo, Calif. was in bankruptcy for three and one-half years and has not issued debt--due to a lack of market access--since prior to its filing. In addition, throughout the bankruptcy process and since it formally ended, the city--according to several of its own measures--inadequately maintained its infrastructure. Service level cutbacks that accompany fiscal distress and bankruptcy will likely impede economic development in most cities (see "Case Study: The Vallejo, Calif. Bankruptcy," published Oct. 4, 2012).

In our view, aging infrastructure and below-average service levels undermine not only a bankrupt city's ability to retain current residents, it also impedes its capacity to attract new residents, businesses, or their investment dollars. For the 10-year period ending in July 2011, Vallejo's population shrank by 1.8% compared with a 6.3% increase among the 14-largest Bay Area cities (which includes Vallejo). Without these key ingredients for an expanding tax base, we would anticipate long-term negative effects on credit quality.

Apart from capital funding, a lack of market access can interfere with regular financial operations as well. Although Vallejo had not done so, municipalities that rely on short-term borrowing as a cost-effective way to manage intra-year cash flow deficits could encounter serious liquidity problems as a result of a bankruptcy. In these cases, we believe an inability to finance a cash flow mismatch could easily overwhelm any immediate cash flow relief gained from a bankruptcy filing.

## **Defaulting On Debt Without Pursuing Bankruptcy**

When an obligor defaults without pursuing bankruptcy, it may have done so because it lost its ability--even temporarily--to fund its debt obligation despite retaining uncompromised willingness. But, in a bankruptcy scenario, we believe an obligor's willingness to pay has weakened, regardless of its ability to pay. (Of course, an obligor that does not pursue bankruptcy protection but voluntarily defaults despite having the ability to pay would, in our view, be deemed to have weak willingness as well. We believe the rating implications for this obligor's debt would likely be as significant as it would for an obligor that files for bankruptcy).

## **Bankruptcy Is The Start Of A "Negative Campaign"**

To be eligible to file under chapter 9, among other factors, a municipality must be insolvent in the eyes of the bankruptcy judge. And it's true that if a government's projected cash flow is unlikely to support its operations in the ensuing months it may be insolvent. From what we have observed, however, this tends to happen only in cases of questionable management and may be avoided by heeding early warning signs. Moreover, based on our observations, insolvency is rare in the municipal sector because governmental entities enjoy several unique characteristics not found in other quarters of the capital markets. Most notably, governments are perpetual entities and, with the force of law behind them, can literally bank on collecting tax revenues into the future. In our view, therefore, insolvency is not only uncommon among local governments, it can actually be difficult to demonstrate.

By volunteering to travel the path of bankruptcy, a municipality is embarking on a negative campaign of sorts. A municipality can't be liquidated. In effect, a "successful" bankruptcy requires that a municipality drive a hard bargain with its creditors, including labor unions. Doing so requires the city to argue on behalf of its own financial weakness and inability to perform the functions for which municipalities exist in the first place.

## **The Stigma Of Bankruptcy Remains**

Considering the implications of bankruptcy we have described here, we think that a Chapter 9 filing does--and should--carry a stigma. Based on what we have observed, bankruptcy is far from a simple "reset" button. Emerging from bankruptcy is likely to be a long, costly process. And considering that the investment climate of a city that has filed for bankruptcy is likely to have been materially degraded, it is questionable whether it benefitted financially.

Kaiti Wang provided research for this piece.

## **Related Criteria And Research**

General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

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