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U.S. Public Finance | Municipal Finance Commentary

Not All G.O. Bonds are Created Equal

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Introduction

Much has been written lately about defaults and bankruptcies among U.S. municipalities. The combination of increasing fiscal stress and rising burdens from pension, labor and benefit costs has led some distressed municipalities to consider default and bankruptcy as a means to restructure their financial obligations. The stigma of default and bankruptcy seems to have diminished in the wake of widespread home foreclosures and personal bankruptcies. In addition, historically low interest rates have moderated the effect of any market penalty associated with such an action. Recent activity serves to highlight the differences in the nature of the general obligation pledge across issuers in the municipal market.

In broad terms, the municipal market is divided into general obligation bonds and revenue bonds. General obligation bonds are secured by an issuer's general operating revenues and taxing power. Revenue bonds are secured by a defined revenue stream, typically from the operation of a project or enterprise. Historically, the general obligation bond sector was viewed as the more secure of these two sectors, since defaults were relatively rare and debt service was typically repaid in full. However, over the last few years, significant defaults and bankruptcies affecting general obligation debt have caused a change in the market's perception of risk in these bonds. This heightened sensitivity reflects the fact that not all "G.O.s" are created equal, and it underscores the need for investors to be more aware of the statutory authority underpinning the security pledge.

The default history of rated general obligation bonds continues to support the view that defaults are rare. Moreover, recent defaults have been largely idiosyncratic in that there is no consistent macro-economic factor that correlates with them. Instead, defaults have resulted from a variety of factors, including i) issuer involvement in projects whose revenue fell substantially short of expectation, ii) fraud or financial mismanagement, and iii) pressure from legacy costs, such as pensions and benefits, to name a few. Although fundamental credit analysis remains key in assessing potential default risk, the nature of the underlying pledge will ultimately affect recovery.

This commentary focuses on distinctions in the general obligation pledge. It is intended to provide investors with a framework for evaluating and comparing the strength of a pledge across issuers. It highlights the issues an investor should focus on to fully understand the security supporting their investment. As recent history suggests, there may be underlying risks in the structure of a general obligation security that investors may not be fully assessing.

Nature of Obligation

In its simplest form, a general obligation bond is supported by an issuer's pledge to use all its available resources and taxing power to provide for annual debt service requirements. This is essentially the "full faith and credit" pledge that most people associate with a general obligation bond. However, the value of this pledge will vary by state and by the type of issuer within each state. For example, at the local level, a general obligation pledge is usually supported by some degree of ad valorem taxing power. This provides comfort that an issuer can raise property taxes to support annual debt service requirements if other resources are insufficient. In addition, it allows bondholders to compel a tax levy in the event of a default. The amount of this levy can be limited or unlimited, as discussed below.

By contrast, a general obligation pledge at the state level does not include ad valorem taxing power. Instead, the full faith and credit pledge is supported by a broad mix of revenue sources, as well as the state's flexibility to impose additional taxes and fees, if necessary. The mix of revenues at the state level generally includes income taxes, sales taxes and fees. Although bondholders can use mandamus to enforce the obligation to raise revenues, there is no comparable obligation to raise a specific tax, such as the property tax.

The issuance of general obligation debt is controlled by state statutes and local authorizing resolutions. State statutes govern the type of debt that can be issued by the various units of local government within the state and any debt or taxing limits relating to general obligation debt. Most states currently allow local governments to issue general obligation bonds in some form. Below is a description of the typical forms of general obligation pledge in the municipal market.

Characteristics and Risks of Different Types of G.O. Pledges				
	Unlimited Tax	**Limited Tax**	**General Fund**	**Guaranteed Debt**
Pledge	No restrictions on the rate or amount of property taxes that can be levied to support debt	Limits the rate or amount of property taxes that can be levied to support debt service obligations	No pledge of ad valorem taxing power	Obligation on parity with direct general obligation debt
Taxing Power	Issuer can be compelled to raise property taxes to support its obligations	Issuer cannot be forced to levy in excess of specified limitations	Issuer has no obligation to raise taxes or fees to support debt service obligations	Issuer can be compelled to raise property taxes to support its obligations
Payments under Bankruptcy	Payments may be subject to automatic stay following a bankruptcy filing	Payments may be subject to automatic stay following a bankruptcy filing	Payments may be subject to automatic stay following a bankruptcy filing	Payments may be subject to automatic stay following a bankruptcy filing
Credit Risks	Excess leveraging of tax base results in high debt burdens; deterioration in credit fundamentals or financial mismanagement may create fiscal stress and affect willingness to raise taxes to pay debt service, although obligations to do so exists	Contraction in tax base affects level of revenues derived from limited tax pledge; deterioration in credit fundamentals or financial mismanagement may create fiscal stress and reduce available resources to pay debt service	Deterioration in credit fundamentals or financial mismanagement may create fiscal stress and reduce available resources to pay debt service	Timing and volatility in level of obligation resulting from guaranteed debt make it difficult to budget effectively; nature of project and obligation can effect willingness to pay

General Obligation Pledge - Unlimited Tax

The strongest form of general obligation pledge is supported by an issuer's full faith and credit and a specific pledge of its ad valorem taxing power that is unlimited with respect to the rate or amount of levy. This pledge requires the issuer to raise property taxes to the extent necessary to support debt service. The obligation is enforceable through a writ of mandamus, a legal process by which a court can compel specific performance of the issuer. For the pledge to be legally enforceable, the issuer must have the statutory authority to raise taxes in an unlimited amount, and the revenue stream must be specifically pledged in the authorizing resolution.

Typical unlimited tax language would read as follows:

The Bonds are issued pursuant to the Constitution and statutes of the State. The Bonds will be general obligations of the issuer and will contain a pledge of their faith and credit for the payment of the principal of and interest thereon. For the payment of such principal and interest, the issuer has the power and statutory authority to levy ad valorem taxes on all taxable real property in their jurisdiction, without limit as to rate or amount.

General Obligation Pledge - Limited Tax

A variation on the unlimited tax pledge is the limited tax ad valorem pledge. As the name suggests, this pledge limits the ability of the issuer to levy property taxes. These property tax limits can be in the form of an absolute cap on the millage rate or a limit on the total dollar amount of taxes that can be levied in any one fiscal year. A pledge would be characterized as a limited tax if the taxing limits do not exclude taxes levied to pay debt service. Since an issuer typically uses property tax revenues to support general operations as well as debt service, there is a heightened risk that fiscal stress or financial mismanagement could result in a deficiency. Absent any other statutory or legal protections for debt service, the issuer would then be required to make decisions about what to pay. The issuer has no legal authority to levy taxes above the specified limit. If the issuer cannot satisfy debt service obligations within the prescribed limits, bondholders have no ability to enforce an additional levy.

An example of entities issuing under a limited ad valorem pledge tax obligation would be local governments in Ohio. State statutes require general obligation debt that is not voter approved be subject to a 10-mill limit. Revenues from these 10 mills are used for both operations and debt service, and the amount of revenues generated by these 10-mills will fluctuate with changes in the tax base. Although all general revenues are available to cover debt service payments, there is no requirement to increase property taxes above the 10-mill limit if the issuer cannot satisfy both general operating requirements and debt service from available resources. Limited tax general obligations rely more heavily on an issuer's ability to manage financial operations within its revenue constraints. From a credit perspective, it is important to assess how much room exists within the cap to allow the issuer to raise taxes to support operating expenses and future debt requirements. For tax limits in the form of a millage cap, stress testing can also be done to show how a drop in property values might affect revenue generation. Debt profiles that include variable rate debt and swaps can introduce a level of uncertainty for future coverage and should be reviewed more carefully.

General Fund Pledge

A third variation to the general obligation pledge is one that does not include any ad valorem taxing power. This can be found in states where the statutes do not authorize local governments to pledge ad valorem taxing power. This is still a full faith and credit pledge, since the issuer pledges all available resources to support annual debt service. However it is significantly more limited. These obligations are often referred to as general obligations, although they are more aptly defined as general fund obligations. The mix of available resources can include property tax revenues, but there is no obligation to raise these taxes to satisfy debt obligations.

In Alabama, for example, a general obligation warrant is essentially a general fund pledge. The issuer is required to make debt service payments from available resources, but it has no obligation to raise property taxes or other taxes and fees in order to do so. The State Constitution contains very specific limitations on the ability of local governments to levy taxes, and without voter approval, an issuer cannot issue general obligation bonds secured by a property tax levy.

As with the limited tax pledge, the credit profile is heavily dependent on the issuer's ability to manage operations within its available resource base. An investor should look for healthy operating margins and increases in operating and debt service expenses that closely mirror increases in revenues. A well-managed budgeting process that requires officials to periodically assess actual performance against budget and make necessary adjustments to maintain budget balance is a credit strength. Similarly, a well-defined and managed level of reserves and a formal reserve policy can help to protect against unexpected events.

Guaranteed Debt

In many cases, a local government can use its general obligation pledge to guarantee the debt of a project or enterprise fund. From a security perspective, the nature of this obligation is on parity with its direct general obligation debt. However, since the financial obligation arising from this general obligation pledge can fluctuate depending on the revenue generation of the project or system, the ability of the local government to budget for and manage these obligations is quite different. In addition, since the funds to support the guarantee are not used to finance general operations, the willingness to support these obligations can become controversial over time.

There are many examples of this debt in the municipal market. In Scranton, PA, the city had guaranteed debt issued by its Parking Authority. As the City's financial operations became more constrained, it elected not to appropriate the funds necessary to cover debt service requirements associated with the guaranteed Parking Authority debt. However, it continued to support its own general obligation debt, which was essentially at parity with the guaranteed debt. The City subsequently reversed this decision and supported the debt, but the case illustrates the higher risk associated with guaranteed debt versus direct debt. A more prominent example concerns Harrisburg, PA. In this instance, the financial obligation associated with the City's guarantee of a garbage disposal facility became so onerous that it stopped making such payments. The debt associated with this project was ultimately responsible for the City's bankruptcy petition.

Other Statutory Considerations

There are a number of other statutory provisions that can affect the nature of a general obligation pledge across issuers. These provisions can either enhance or weaken the pledge. Provisions that can enhance the pledge include:

- Payment Priority,
- Continuing Obligation and
- Statutory Lien

Payment Priority

The preference for general obligation debt service payments requires issuers to fund annual debt service requirements in advance of all other operating expenses. This preference is often termed a "first budget obligation", referencing this priority. This is a particularly strong provision where the nature of the obligation is limited and where there is some uncertainty about the ability of the issuer to manage obligations within available resources. To the extent that it reduces the discretionary nature of a debt service payment in periods of fiscal stress, this feature can provide added protection for bondholders. This preference can exist at both the state and local level.

Continuing Obligation

For general obligation debt that is not supported by an unlimited property tax pledge, the ability to carry forward unpaid debt service from one fiscal year to the next enhances recovery in the event of a payment default. It provides some protection against unexpected events that can affect the issuer's ability to pay, by requiring that any unpaid amounts are carried forward until such time as the issuer can support repayment from available funds. This situation would generally arise if the security is a limited tax or a general fund obligation, where the issuer does not have an obligation to raise taxes to cover debt service payments. In effect, the issuer would be making a choice to pay other expenses ahead of debt service. The failure to make a full debt service payment would trigger a default, and any unpaid amounts would get picked up in the ensuing fiscal years, if they can be carried over. This is a remote risk, but one that legally and structurally exists in certain forms of general obligation bonds. In periods of economic and fiscal stress, and when debt service is not afforded any constitutional priority, it is important to understand if there is a continuing obligation or if an unpaid obligation is extinguished at the end of the current fiscal year. In cases where the debt service can be carried forward, there is a greater likelihood that it will eventually be repaid in full.

Statutory Lien

A security pledge that is enhanced by a statutory lien on pledged revenues protects bondholders from an automatic stay in the event of a bankruptcy filing. General obligation bonds that do not benefit from a statutory lien are considered unsecured obligations under Chapter 9 of the U.S. Bankruptcy Code. As such, issuers who have filed for bankruptcy protection are prevented from making debt service payments, and bondholders cannot sue to enforce payment. There are only a few states that provide such a lien, but this provision can help to ensure full and timely payment following a bankruptcy filing. The State of Rhode Island recently passed such an amendment in response to the bankruptcy petition by the City of Central Falls. This served to protect bondholders following the Central Falls bankruptcy and helped to support the market for other Rhode Island issuers.

Statutory provisions that can weaken the general obligation pledge include:

- Tax caps and
- Bankruptcy

Tax Caps

As voters become more concerned about rising property tax burdens, more and more states are imposing some form of property tax cap. These caps are typically enacted as a means to control growth in government spending. There are several variations on the form they can take, including i) an absolute cap on the millage rate ii) a cap on the total dollar amount of taxes that can be levied in any one fiscal year or iii) a limit on the growth of the tax levy from year to year, generally tied to fixed rate or an economic index. Although the specifics can vary from state to state, the net effect is to reduce the resources available to issuers to fund operating expenses and fixed obligations, like debt service.

The most recently passed property tax limits have been in the form of a limit on annual growth. In most cases, levies for outstanding general obligation debt and voter-approved debt should be excluded from the limitations. However, this may not always be the case. In New York State, legislators recently approved a limit on the ability of municipal governments to increase tax levies to the lesser of 2% or the rate of inflation. There were only limited exceptions for debt service on outstanding general obligation debt. The net effect of these caps on general obligation debt is to further limit issuers' financial flexibility.

Given the desire of state and local legislators to reduce tax burdens, it is likely that more states will undertake similar measures. Features, such as a payment priority or carryover, help to ensure that general obligation bondholders are better protected against future uncertainty.

Bankruptcy

In the municipal market, bankruptcy is governed by Chapter 9 of the Federal Bankruptcy code. Bankruptcy is a voluntary action available to local governments in certain states. Local governments cannot be forced into bankruptcy. They must make a petition for Chapter 9, and it must be accepted by the bankruptcy court.

There are several threshold issues to a bankruptcy filing, including the statutory authority for the filing and a determination of insolvency. Without these, a local government cannot use bankruptcy as a form of relief from its financial obligations. State governments cannot file for bankruptcy protection. However, they control whether local governments within their states can file.

Currently, 28 states allow their local governments to file for protection under the Chapter 9 of the Federal Bankruptcy Code. The remaining states are either silent on the issue or do not allow it. Half of the states that allow for bankruptcy protection require some form of state intervention prior to prior to the filing. In the case of the City of Harrisburg, for example, the initial petition was denied. Instead an oversight board was put in place to help restructure the City's obligations. As these negotiations failed, the City was subsequently allowed to seek Chapter 9 protection.

Many states have emergency programs that are meant to support issuers through periods of severe fiscal stress and prevent the need for a bankruptcy filing. This is because a bankruptcy filing can be economically and financially disruptive to both the filing issuer and others within the state. Emergency programs are generally legislative in nature and give the state the ability to establish fiscal control boards or oversight committees that will work with the local government to address and correct financial problems. The power of these boards will vary, from providing oversight and guidance on budgets, to limiting expenses, reviewing contracts and restructuring financial obligations. State legislation can also provide additional security sources for debt issued by the local government while under the oversight program, thereby enhancing the credit profile and providing necessary market access. The objective is to help the local government make necessary modifications to achieve fiscal stability.

It is important to remember that default and bankruptcy are not the same thing. A default is defined as i) the failure of an issuer to conform to the covenants within its bond documents, i.e. a technical default, or ii) the failure of an issuer to make full and timely payment on an outstanding debt obligation. Bankruptcy may lead to a default as a result of the automatic stay which is imposed on most general obligation bonds following a bankruptcy filing. In a default, the parties on both sides of the transaction can try to negotiate a fair settlement. These negotiations can result in some agreed-upon reduction in debt service payments, a restructuring of outstanding debt obligations or some other form of settlement. As part of these negotiations, bondholders can bring a writ of mandamus against the defaulting party to force specific performance as required under the bond documents. In an ad valorem tax supported general obligation bond, this can include an action to raise property taxes.

Ultimately, the purpose of Chapter 9 is to provide a means to adjust municipal government obligations. By law, the bankruptcy court cannot interfere with daily operations. This is different from the role played by the bankruptcy court under Chapter 11 where they can take control of various aspects of a corporation's operations. Since a Chapter 9 filing is voluntary, the local government can choose to make payments that it deems are necessary. This can include debt service. However, if the issuer does not elect to make debt service payments, the legal nature of the pledge will govern whether bondholders get paid. As noted earlier, payments on general obligation bonds with a statutory lien on a specific source of revenue, such as property taxes, will continues to be made through bankruptcy. Payments on general obligation debt without a statutory lien will be subject to suspension until a restructuring plan has been approved by the bankruptcy court and the issuer.

Although there is still limited case law on municipal defaults and bankruptcies, it is important to understand that bondholder remedies following a bankruptcy may be more restricted than they are following an event of default.

Final Thoughts

Clearly, there are a number of factors that can affect the strength of a general obligation pledge. These can vary by state and by issuer within each state. Therefore, not all general obligation bonds can be viewed in the same way. Although the term refers to the issuer's pledge of its full faith and credit, the value of this pledge will be heavily impacted by statutory and legal factors. Credit fundamentals remain the key to determining the potential for default, but in times of fiscal stress, an understanding of the statutory and legal framework underpinning the security pledge will be critical in evaluating the overall strength of the obligation and the potential for full recovery in the event of default.