CREDIT PERSPECTIVES | 1Q 2023

HISTORY NOT EXPECTED TO REPEAT IN THE MUNICIPAL BOND MARKET

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As the banking crisis continues to unfold, we are monitoring the potential impact on municipal bond credit. State and local governments utilize banking institutions for a variety of purposes including debt underwriting, credit lines, trustee services, and payroll cash accounts. Nonetheless, the exposure to banks has been greatly reduced in the last 15 years, largely due to lessons learned from the global financial crisis. Given these improvements in management practices and debt policies, we do not expect regional bank disruptions to have material credit implications for the sector.

The decade leading into the 1990s and 2000s witnessed an increase in the popularity of bond insurance, floating-rate debt, and the use of derivatives to manage interest rate costs and cash-flow variability. At the time, roughly 50% of municipal debt outstanding was wrapped with bond insurance. The insurance guaranteed investors timely debt repayment while also securing AAA-ratings (for most insurers) from the rating agencies, thereby reducing borrowing costs, particularly for lower-rated governments. Concurrently, finance officials were seeking to curb interest costs through the issuance of variable rate debt. In 2006, floating-rate instruments accounted for 24% of all debt sold during the year. Buyers usually required these offerings to include a bank liquidity backstop to cushion against rate volatility. Issuers went a step further and hedged the floating-rate risk with fixed-rate swap derivatives. Both the liquidity agreements and derivative contracts between banks and government agencies were predicated on the credit quality of the counterparties. As various complex subprime structured debt vehicles began to unravel in 2007, the viability of the both the guarantors and banks came into question, leading to wholesale rating downgrades and material changes to the credit quality of wrapped debt sold by borrowers with lower (underlying) ratings. By late 2007, the credit market disruption in the variable rate debt and swaps markets led to the widely publicized collapse of Jefferson County Alabama. By early 2008, the auction rate market for municipal bonds had failed.

Whereas municipal bond entities continue to employ variable rate debt structures and derivative products, the market landscape and issuer strategies have markedly changed since 2007. Bond insurance has a limited presence in the

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municipal market today covering only 8% of total market debt outstanding. The absence of the wrap translates into one less counterparty (and associated risk) in a financial contract between an issuer and a bank. Furthermore, governments have become more judicious in the use of adjustable-rate securities. For 2022, variable rate bonds represented a slim 7% of total new issue volume. Although the percentage of floating rate exposure across borrowers varies widely, many market participants carry no variable rate debt. Additionally, government entities have been deliberate in distributing counterparty risk across a variety of financial institutions. Liquidity agreements continue to include triggers that allow for termination under a variety of breaches including credit deterioration. In the event a borrower elects to drop a bank counterparty, there are suitable substitute institutions offering similar services. Finance officers have also pared down the use of derivatives and moved away from the riskier, esoteric contracts toward more straightforward hedges.

Currently, we do not hold variable rate securities in our composite and only one-third of our credits even issue floating rate bonds. Of those entities, less than a quarter (34 names) have more than 20% of their total debt in variable-rate mode. The liquidity providers involved tend to be global systemically important banks (G-SIBs), while the borrowers themselves (some of which use self-liquidity) are all rated A or higher. Since our credit process emphasizes available liquidity, financial flexibility, market access, and capable management, we are confident our issuers will navigate the challenges of the banking crisis.

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