



Monitoring the Risks of State and Local Government Finance



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The finances of many state and local governments are in a somewhat precarious condition. First came the financial crisis and recession, which sapped tax revenue and stretched budgets. Then came the painfully slow recovery, which ramped up demand for social safety net services, especially unemployment benefits. Despite some modest improvements, the blows to state and local governments have been heavy. According to the Center on Budget and Policy Priorities, 29 states will be facing budget shortfalls for fiscal year 2013. On top of all this, governments are struggling to address chronic underfunding of their pension plans.

Just how much should most Americans worry that some state and local governments could go into default? That's what a team of researchers from the Federal Reserve Banks of Cleveland and Atlanta has been studying over the past year. The Municipal Financial Monitoring Team has been looking at how shocks to the municipal bond market, continued problems with pension funding, and general fiscal stress could ripple into something much larger — either in the form of a (rather unlikely) threat to financial stability or perhaps as an aggravation of regional economic woes.

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To understand these issues, the Monitoring Team has been exploring a number of areas where risks may be building. These include:

- **Connections to the financial system:** Chronic underfunding of public pension funds and the effects of the recession are straining municipal budgets. While widespread default appears unlikely, should the financial system's exposure to municipal budget problems be cause for concern?
- **Investment portfolios:** What are pension funds invested in? Those that are counting on high investment returns to close their funding gaps may be edging into riskier bets, which in the long run may imperil them further.
- **Defined-benefit versus defined-contribution plans:** Although the private sector has mostly moved into defined-contribution — usually 401(k) — plans, the public sector is dominated by defined-benefit plans. This puts state and local governments on the hook for providing the promised benefits. Would conversion to defined-contribution plans be a step in the right direction?
- **Contagion in the municipal bond market:** Downgrades of municipal debt or shocks to sectors of the municipal bond market could increase borrowing costs across the board, further deepening fiscal distress and creating additional headwinds for the recovery.

Getting a handle on the likelihood and severity of these outcomes can be a difficult task. Up-to-date, comparable data are scarce, especially at the county and city level. Most public pensions report only on an annual basis; even then, comprehensive data to support meaningful financial and risk analysis are limited. Despite these challenges, our team has made enough progress to arrive at some preliminary findings.

The State Scenario

At the state level, the bottom line is that the probability of a government defaulting on its financial obligations is extremely low. After all, state governments maintain the authority to raise taxes (however politically unpopular) to cover any shortfalls. And these entities are subject to the market discipline of higher borrowing costs should they fail to meet their financial obligations.

Even so, as the financial crisis demonstrated, improbable events can occur. So it's a useful exercise to think through what might happen if a government did fail, triggering a contagion that could spread to players ranging from banks to money market mutual funds. Or how investor concerns that lead to higher borrowing costs might compound a region's economic struggle.

Under what circumstances might the default of a large state government shock the financial system? It depends primarily on the exposure of large, complex financial institutions to the default. Our preliminary analysis suggests that an isolated default is unlikely to trigger a systemic event, but it might cause a temporary contraction of credit as financial institutions reallocate their holdings and divest downgraded municipal debt. And we're still digging into what might happen if more than one default were to take place at the same time.

The Local Scenario

Trouble in the municipal bond market is another possible risk to financial stability. It's a difficult market to assess: its transaction volume is typically low, since most investors buy bonds and hold them. This lack of liquidity makes it more difficult to accurately judge fair market prices. Also, the availability of information on issuers' financial condition varies greatly. While it's fairly easy to get reliable information at the state level, disclosures by municipalities or by other issuers, such as school and sewer districts, are provided inconsistently and with considerable lags. A sudden, unanticipated municipal bond default could cause a sharp decline in investor confidence, potentially leading to a rapid selloff. If investors thought that defaults among multiple issuers were highly correlated, growing uncertainty could fuel a downward spiral of selling and investor losses.

Yet the potential for systemic risk seems low. To be sure, a material decline in any given municipality's debt would put its taxpayers under stress and perhaps dampen the local economy. And financial institutions with exposure to those municipal bonds would take losses. Furthermore, the financial crisis taught us that the context in which an unanticipated default takes place matters greatly.

But the municipal bond market's reaction to recent events confirms some of our preliminary assessments. Several municipal securities were downgraded last summer after one credit-rating agency lowered its AAA rating on U.S. sovereign debt. A flight-to-quality strategy, however, actually increased investors' demand for municipal bonds more generally, producing yields that in some cases reached record lows. Despite its opacity and low trade volume, the market is clearly resilient. That's not to say there is no need for careful monitoring, particularly in light of the significant fiscal challenges many state and local governments face.

While municipal bankruptcies are rare, Jefferson County, Alabama, filed for financial reorganization under Chapter 9 of the U.S. Bankruptcy Code last year because of \$3.1 billion in defaulted sewer bonds, which made it the largest municipal bankruptcy in U.S. history. This filing followed the bankruptcy of the small town of Central Falls, Rhode Island. Although neither of these events

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had a spillover impact on municipal bond markets, they highlighted both the legal challenges associated with municipal bankruptcy and the political and legal realities of undertaking meaningful fiscal and public pension fund reforms. All the same, given the complexities of municipal bankruptcies, our team concludes that filings will likely remain rare, isolated, and last-resort events.

Assessing the mounting pressures on state and local government finance and evaluating the resulting implications for the stability of our financial system and regional economies is a complex, but important, challenge. While the conclusions of preliminary analysis do not suggest the risk of systemic threats, we remain vigilant in monitoring conditions that could shock the financial system or threaten the economy's footing on its path to recovery. ■



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