State Bailouts of Distressed Localities Present Challenges to Municipal Market

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PNC Capital Advisors Municipal Fixed Income Team

In March, the financially distressed City of Hartford, Connecticut inked a deal with the state allowing it to effectively transfer a debt burden of $550 million—$755 million including interest—to state taxpayers. Should this development establish a precedent for, or be seen as a worthy model by, distressed local governments across the country, significant challenges may arise for municipal market participants, including, but not limited to, the following:

- A bailout package may provide temporary relief to a troubled local government, but it may prove inadequate in resolving hard-to-modify structural factors stemming from unfavorable demographic trends, poor governance or ineffective oversight, eroding governmental finances, or a deteriorating tax base.
- The relief provided by bailout agreements could stir controversy, and its permanence or longevity could be vulnerable to other political imperatives.[1]
- Bailout agreements may promote fiscal wastefulness at the local level due to the potential for a bailout from the state (i.e., moral hazard), especially if the disincentives or conditions to getting state aid are weak.
- Assumption of local government debt could exacerbate a state's own budget gap and debt burden, which may result in widening credit spreads of the state's debt and/or rating downgrades.
- For investors, unexpected bailouts muddle price discovery for state or local debt: When the precedent of rescuing distressed localities has been set, should investors assume a full faith and credit state guarantee on all distressed local debt within that state?

Table 1
Rating Impact of Contract Assistance Agreement on Hartford's GO Debt

	Current GO Rating	Rating Prior to Contract Agreement	Super upgrade, in notches
Moody's	A2	Caa3	13
S&P	A	CCC	12

Table 1 highlights the significant impact the state-city agreement had on Hartford's general obligation (GO) bonds, which brought them from well below speculative grade to match or approach the state's investment-grade credit ratings (S&P Global Ratings and Moody's Investors Service rate the state's GO bonds A and A1, respectively). Notably, this contractual agreement was not costless to Connecticut, given that shortly after the contract agreement was signed, S&P downgraded Connecticut's GO rating to A from A+.

Our credit analysis process incorporates the full evaluation of both local and state governments and the interplay between the two. While some market participants have expressed skepticism that other distressed cities will rush to join Hartford in seeking aid or asking for a full debt bailout, we remain cautiously aware that additional cases could very well establish a new concerning trend.[2] With an eye toward Connecticut, distressed cities across the country could find that threatening bankruptcy to their respective state legislatures may alleviate their debt burdens if pursued aggressively. In turn, investors should remain attentive and carefully weigh the pros and cons of such relief packages.

[1] As of this writing, for instance, Connecticut's Senate overwhelmingly passed a bill (with a vote of 28 to six) that would effectively claw back contract payments to Hartford through cuts to non-education state aid grants beginning in 2022.

[2] In Connecticut alone, the following cities have at least one rating within three notches of speculative grade: New Britain and Hamden (both Baa2/negative), Bridgeport (Baa1/stable), and New Haven (Baa1/negative).

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