BNY MELLON
WEALTH MANAGEMENT

April 2020

General Safety of Municipal Bonds

The spread of the coronavirus and its potential negative impact to the economy recently resulted in a liquidity crunch that sent municipal bond yields rising and prices falling. The response from both the Federal Reserve to provide liquidity and Congress to provide aid through the Coronavirus Aid, Relief, and Economic Security (CARES) Act has helped to improve investor sentiment and restore some normalcy to the municipal bond market.

While some municipalities will face some distinct challenges as a result of COVID-19 and steps taken to shutdown parts of the U.S. economy, we believe it is important to focus on fundamentals during times of volatility. Municipal bonds offer several unique characteristics that we believe will prove useful in offsetting a temporary decline in revenue during this environment. These characteristics of municipalities include: low default rates due to their strong financial condition, the essential nature of the services they provide, support from higher levels of government, and their largely monopolistic status.

We remain confident in the role municipal bonds hold in the market overall and in our clients' portfolios. We hope that this background on the fundamentals of municipal bonds and their strength in this particular market cycle proves useful.

Current Challenges

Municipalities face challenges both from COVID-19 and from ongoing issues. The primary challenge facing municipalities is the revenue-related strains from COVID-19. Personal income, corporate and sales taxes are the key revenue drivers of states. Those revenues will decline. Profitable elective surgeries for municipal hospitals are down. Toll roads, municipal airports and even public power companies could see reduced demand.

Municipal governments are also experiencing pressure due to the following ongoing issues:

- Underfunded pension funds due to the generous payouts associated with defined benefit plans
- High debt loads
- Needed long-term funding for post-retirement health care using discounted cash flow analysis rather than just a pay-as-you-go approach
- Cost-of-living payroll increases for public employees, regardless of economic conditions

While rating agencies are expected to exercise patience with most municipal issuers, we do believe downgrades will outnumber upgrades in the coming months. Still, the vast majority of entities backing municipal bonds remain safe investments and will be able to make their scheduled and timely payments on interest and principal. This belief is based on several important built-in strengths of municipalities.

Municipal Bonds Can Weather the Storm

I. Assistance from the federal government in times of need

As a result of the COVID-19 induced market dislocations and economic shutdown, the federal government has stepped in forcefully, providing billions in direct aid to municipalities through the CARES Act, including the Municipal Liquidity Facility. This facility will purchase short-term securities – providing needed liquidity to help issuers through the COVID-19 period of uncertainty. The Federal Reserve recently expanded the scope and duration of the facility, offering to buy bonds up to three-years duration from small cities and counties. The program, which originally had a higher threshold, will now allow counties with a population of at least 500,000 residents and cities with a population of at least 250,000 to be eligible for selling their short-term debt. Additional assistance from the federal government is likely, with political leaders expected to follow through on their pledge to keep municipalities — the backbone of the American system of government — solvent.

II. Municipalities entered this period of weakness in strong financial health

The vast majority of municipalities have improved their credit status measurably over the past five fiscal years, as evidenced by more credit rating upgrades than downgrades.

Credit ratings of municipal bonds are very high relative to other types of bonds. Moody's ratings service, for instance, recently emphasized this point when noting that, at year-end 2018, an average of 94% of municipal issues were rated single-A or higher since 2008, while only 39% of U.S. corporate issues were rated single-A or higher over the same time period. These high municipal ratings are the result of effective governmental structure, prior years of economic growth and favorable bond legal provisions.

While we will see some credit downgrades, we do not expect a large number of issuers to experience material problems in the timely payment of debt service. In cases where there is a downgrade, declines usually begin from very high ratings levels. In summary, municipalities came into this period financially strong and have high credit ratings, a big help when facing challenging headwinds.

III. Historically, default rates for municipal bonds have been extremely low

Let's look at Moody's cumulative default rate through 2018, the most recent data available, and compare it to the corporate default rate.

Rating Category	After 1 Year	After 3 Years	After 10 Years
AAA	**0**/0	**0**/0.01	**0**/0.37
AA	**0**/0.02	**0**/0.11	**0.02**/0.78
A	**0**/0.05	**0.02**/0.32	**0.11**/2.10
BBB	**0.03**/0.16	**0.22**/0.75	**1.13**/3.70

The numbers in this table show the percent defaulting. The first number in each box, in bold type, shows the municipal default rate. The second number shows the corporate default rate for comparison. For example, three years after being rated A, municipal bonds had a cumulative default rate of 0.02%, or two in 10,000. By contrast, 32 out of 10,000 corporate bonds defaulted.

This demonstrates both the very low rate of municipal defaults and the low rate relative to corporate credits for a lengthy period. These numbers clearly point to the relative safety of municipal bonds even in what is expected to be a tough environment.

IV. Municipal bonds have some unique, built-in strengths

Compared to other types of bonds, municipal investments possess fundamentally different characteristics that should provide some reassurance, despite this challenging environment:

- States can tax as much as they deem necessary to pay costs such as debt service
- Most municipal bond issuers face limited or no competition
- Local governments, as well as states, provide services such as police, road repair and education that are absolutely required by our society. As a result, several higher levels of government — county, state and federal — have large incentives to provide assistance should a local government face economic difficulty. We have seen instances where financial control boards are established for troubled local and city governments, such as with the City of Philadelphia.
- Most state and local debt carries a "general obligation" pledge. This means that the "full faith and credit" of the issuer backs the bonds, including taxing power and sometimes a first lien on pledged revenue. For municipal utility, water/sewer and toll road bonds, issuers normally have full rate-setting autonomy for their essential services. They usually make a covenant with bondholders, committing to charging rates for their services that will in all cases meet or exceed debt service requirements.
- Municipal bond issuers have the power to enforce revenue collection; if a user does not pay a water bill, the water can be shut off, providing a powerful incentive to pay
- Unlike other types of issuers, such as corporations, almost all municipal issuers will continue to exist in perpetuity; if a municipality ever had a debt-repayment problem, the issuer would continue to exist as a cash flowing entity during and after the problem
- Municipal bond issuers often have varied reserve fund options from which they may draw. States in particular have built up their "rainy day funds" to meaningful levels that will act as an added source of financial cushion. Bond indentures often require a specific amount of reserves to be set aside for the life of the bonds in case debt service payments were ever in question. Municipalities often have internal funds from which they may borrow for their own purposes.

V. Payment of debt service on bonds is a priority expense for issuers

This is true for two reasons. First, it is often legally stated as such. For example, California's state constitution has designated debt service to be a "priority payment," equivalent to a few key categories, such as educational and state employee salary expenses that are deemed most essential and thus prioritized over all other types of expenses.

Secondly, municipal bond buyers demand timely payment of debt service. Should an issuer not make a payment on time, that issuer might easily lose access to the bond market. Since all municipalities need to issue bonds in order to fund their costs, maintaining access to the bond market is very powerful for all municipalities.

Our Approach

Given the current dislocations in the market, the importance of having a rigorous analytical process that can uncover value for our clients is only heightened. At BNY Mellon Wealth Management, we do not purchase bonds based solely on ratings or bond insurance. We base our buy and sell decisions on the fundamental characteristics of the issuing agency. Our experienced team of credit analysts, their multi-decade long tenure working together and the time-tested research process enable us to continue to uncover value for our clients. The quality of these professionals, coupled with the robust and disciplined research process, helps us construct municipal bond portfolios designed to withstand even challenging market environments.

More about the Municipal Liquidity Facility

- Originally part of the CARES Act, the Federal Reserve announced the expansion of the Municipal Liquidity Facility in a number of ways. The facility is $500 billion. It will be capable of buying short-term notes (now up to 36 months duration, up from 24 months) from municipal issuers with minimum sizes of 250,000 people for cities and 500,000 for counties. Previous minimum sizes were 1 million and 2 million people, respectively.

- The facility will be in place until December 31, 2020, extended from September 30, 2020.

- Notes will be purchased at time of issuance, not in secondary market. To qualify, the note issuer must have had investment grade ratings as of April 8, 2020, by two of three ratings agencies and, if subsequently downgraded, be rated at least low BB by two of three agencies at time of note issuance.

- Purpose of the issuance is generally for cash flow, but one additional specific use is to pay debt service on existing obligations. It may also be used to purchase notes of political subdivisions or instrumentalities of the issuer. If for an instrumentality of, for example, a state, revenues of the state must be pledged for repayment or the state must guaranty the notes. No note proceeds may be loaned to any instrumentality or subdivision that is insolvent.

- Pricing of the notes will be based on the issuer's ratings, but will include a penalty percentage above current market rates as the facility is meant to be used only in times of need or stress. Security must be the strongest security typically pledged by the issuer for public debt purposes, such as a general obligation pledge for a state or city.

- The program is primarily meant for general obligation issuers such as states and cities, but the program is now expanded to include "multi-state entities." These entities were "created by a compact between two or more states." Ratings thresholds for these borrowers would be higher: A3/A at 4/8/20 and if subsequently downgraded, at least Baa3/BBB- at issuance.

About the Author

Arthur R. O'Keeffe, CFA
Director of Credit Research,
Fixed Income Investment Management

Art is director of credit research for BNY Mellon Wealth Management. He is responsible for the credit quality of individual client and mutual fund fixed income portfolios. He also is the chairman of the organization's Fixed Income Asset Review. Art has more than 25 years of investment experience and joined the firm in 1991. Art was part of BNY Mellon's workout lending group in 1991 before joining the fixed income group as a municipal analyst in 1992. Prior to joining the firm, he was a credit analyst and a lending officer at Bank of New England. Art received a bachelor's degree from Harvard College and a master of business administration from the Darden School at the University of Virginia. He is a CFA charterholder and a member of the Boston Municipal Analyst Boston Municipal Analyst Forum and the National Federation of Municipal Analysts.