

Update on Municipal Bankruptcies and Multi-Notch Downgrades

The municipal market is experiencing a heightened awareness of credit risk in large measure due to high profile bankruptcies such as Jefferson County, Alabama and Harrisburg, Pennsylvania. Pressures on municipal credits

Highlights

- Widespread municipal bankruptcies seem unlikely
- State oversight of local issuers can make a difference
- Legal protections strong in the majority of municipal bonds
- Multi-notch downgrades more prevalent
- Many issuers have considerable financial flexibility

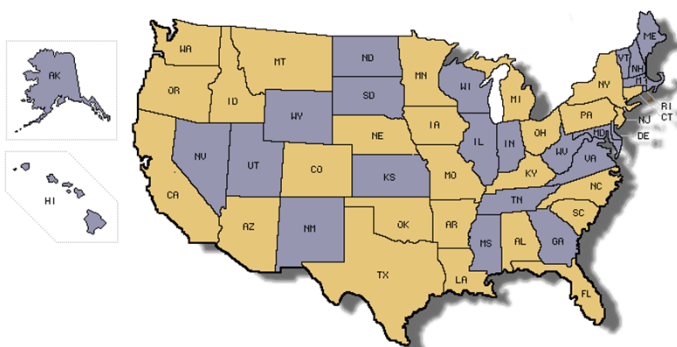
have increased over the last several years, manifesting in two notable developments: the rare municipal bankruptcy filing, and the more common multi-notch downgrade. Samson purchases only high quality municipal securities and our strict credit criteria, grounded in our capital preservation approach, means our clients have not been exposed to any municipal bankruptcies. Nonetheless, as these events are shaping public perceptions of broad trends in municipal credit, we thought it timely to review these bankruptcies, the increased trend towards multi-notch downgrades, and how they relate to the realities of municipal investing today.

Recent Bankruptcy Declarations

On November 9th, Jefferson County, Alabama filed the largest municipal bankruptcy in history. Approximately \$4.1 billion of debt was affected, most of which was issued for sewer improvements. Although it rarely occurs, bankruptcy represents the most extreme example of municipal credit stress. Year-to-date there have been just 13 bankruptcy filings by municipal issuers, only three of which had municipal bonds outstanding, representing less than 0.2% of total municipal debt. There are a number of reasons for the rarity of municipal bankruptcy filings:

1. Twenty-four states legally prohibit municipal entities from filing for bankruptcy.
2. Many states provide local government oversight, assist distressed municipalities and provide legal and fiscal support to avoid bankruptcy.
3. Municipal governments exist in perpetuity and cannot liquidate, making bankruptcy in municipalities a less useful and more stigmatizing process than in corporate bond markets.
4. The costs and reputational risks that are likely to be incurred in a bankruptcy filing are significant and should be well known to politicians.

States Authorizing Chapter 9 Filings for Local Governments



- Authorizes Chapter 9 Filings
- Does not authorize Chapter 9 Filings

In the case of Jefferson County, few of these deterrents existed. Alabama not only allows municipal bankruptcy but has also not taken a strong oversight role throughout the crisis. Furthermore, in light of the securities fraud convictions of several former elected county officials, the vast majority of residents believe that the county should not be held financially accountable. Supporting the adage that “all politics is local,” public opinion strongly in favor of the filing has prevailed over the reputational risks of bankruptcy. The county’s decision to file for bankruptcy was by no means unavoidable. A negotiated agreement was on the table and was expected to be

approved as recently as September. The bankruptcy was a conscious choice made by elected leaders in response to the sentiments of local voters. As we follow this case going forward, we believe the worst outcome would be a bankruptcy process in which judicial decisions correspond to current public opinion. The federal bankruptcy judge overseeing the case is expected to rule soon on the status of the sewer system receiver appointed by a state court last year. If the sewer bond documents are deemed subordinate to federal bankruptcy code there could be significant implications for bondholders. The receiver position could either be limited or abolished, and pledged sewer revenues could be determined to be part of the bankruptcy estate rather than expressly designated to repay bondholders. It would be ironic if the system that was overleveraged due to corruption and mismanagement were to be the example used to question bondholder rights. While we don't believe this is likely, we cannot predict the judge's decision.

In contrast, two other current municipal bankruptcy cases are being defined by more activist states. In October, the City of Harrisburg, Pennsylvania filed for bankruptcy, affecting roughly \$310 million of debt. Last week the filing was dismissed by a federal bankruptcy court on the grounds that it contradicts recent state legislation prohibiting bankruptcy while the city is under state oversight. This decision is expected to be appealed as the majority of the city council believes they have the right to file for bankruptcy. However, the state believes the correct forum for debt reorganization would be under an even stricter form of state fiscal oversight known as receivership, which is generally perceived to be more beneficial to bondholders than bankruptcy. The legal rulings in this case will hinge on the issue of state versus local government jurisdiction. The small city of Central Falls, Rhode Island filed for bankruptcy in August, primarily to seek relief from burdensome labor contracts. It had only \$21 million of debt outstanding. As in Harrisburg, the state has taken a bondholder-friendly stance, passing a law strengthening bondholder protections and implementing state-wide pension reform. With Central Falls already under the control of a state-appointed receiver this is shaping up as a confrontation between the state and organized labor.

The recent exit from bankruptcy by the City of Vallejo, California, which has just \$175 million in total debt outstanding, offers at least two key lessons. First, bankruptcy is a more unpredictable and inherently risky process for bondholders when the state does not play an active role. California exercises relatively modest fiscal oversight for its cities, especially when compared to its oversight of its K-12 school districts. Vallejo was able to consider and eventually declare bankruptcy free of state interference. This may change in the future given recent legislation making it more difficult for California municipalities to declare bankruptcy. But in the case of Vallejo, the state did not intervene in the bankruptcy process and certain bondholders took losses along with other creditors. Second, legal provisions matter. A clear preference was made for bonds which benefitted from specific pledged revenues, whether it was utility charges or motor vehicle fees. In contrast, unsecured debt holders took a large haircut on their positions. Also of note, existing pension benefits were protected while retiree health care benefits were reduced. California is one of a number of states under which pension benefits are explicitly protected by statute, a beneficial status not currently enjoyed by health care benefits.

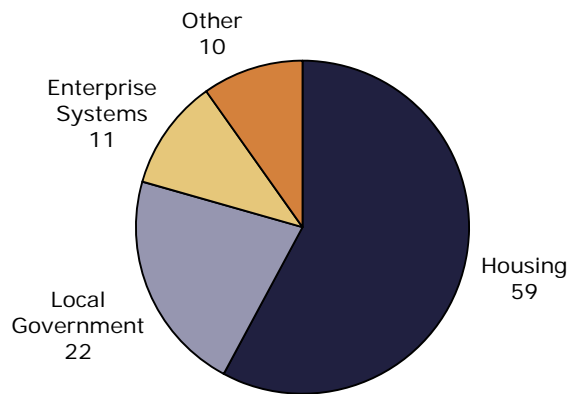
Multi-Notch Credit Rating Downgrades

Bankruptcy is undeniably a very severe form of credit risk given the legal uncertainties involved. However, credit risk is not limited to bankruptcy situations. For investors with a total return focus or liquidity needs, other types of credit deterioration can prove damaging to their investment goals. One particular risk which has become more prevalent is the multi-notch rating downgrade, which represents a rapid deterioration in credit quality.

These occur more frequently than bankruptcies do and may or may not presage an eventual bankruptcy filing. Multi-notch downgrades occur for a variety of reasons and often with limited notice. This further emphasizes the importance of municipal disclosure, both in terms of completeness and timeliness. We offer a few pertinent observations on some recurring causes of multi-notch downgrades:

1. *Weak management is exposed in a struggling economy.* Overreliance on reserves to meet recurring budget deficits has led to numerous multi-notch downgrades including Fresno, California which was dropped to A2 from Aa2 in October. Poor management decisions were also evident in Jefferson County. The state-appointed receiver of the County's bankrupt sewer system, John Young, has noted that management was either unwilling or unable to challenge the high level of Federally-mandated capital improvements. A stronger management team would have responded by producing debt affordability or independent consulting studies before launching the massive borrowing program. This borrowing became unsustainable when credit markets froze and interest costs soared.

Large* Multi-Notch Downgrades by Sector (since Jan. 2010)



*Downgrades of more than 2 notches (i.e. Aa2 to A2)
Source: Moody's Investors Service

2. *Awareness of counterparty credit risk has heightened.* Certain municipal financings depend directly on the performance of third parties. This is typically seen in housing bonds which make use of mortgage insurance and debt service reserves to provide additional security. Often, the providers of these services are financial services firms. Given that the rating agencies utilize a "weakest-link" theory when determining a rating, ongoing weakness and volatility in the financial sector has seriously impacted the credit profile of many municipal housing transactions. This significantly influenced the downgrade of the California Housing Finance Agency to A3 from Aa3 in April 2010.

3. *Off-balance sheet liabilities are often overlooked by investors, rating agencies, and the issuers themselves until it is too late.* Harrisburg, Pennsylvania and Collingswood, New Jersey serve as good examples. Harrisburg guaranteed debt service for a failed incinerator project and was downgraded to B2 from Baa2 within 4 months as it became suddenly apparent that it would not be able to honor its guarantee. This decline led to an eventual bankruptcy filing as noted above. Collingswood, on the other hand, guaranteed a development loan for a condominium and office complex and was dropped to Ba1 from A1. It remains under review for further downgrade. Our credit research team endeavors to gain an accurate understanding of off-balance sheet liabilities by examining the notes to the financial statements and by doing additional research to assess the likelihood of governmental support.

We continue to believe that the legal protections in a great majority of municipal bonds and the financial flexibility available to most issuers make the prospect of widespread bankruptcies unlikely. Nonetheless, Samson conducts a detailed credit analysis of each bond we purchase. Credit deterioration may or may not be readily apparent, further emphasizing the importance of adequate disclosure and accessible management. Our fundamental research process is focused on obtaining the necessary information to make informed credit judgments, regardless of the public bond rating.

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