KAYE | SCHOLER

Could Municipal Bonds be the Next Financial Titanic?

About the Author

Greg Wallance is a Partner in Kaye Scholer's New York office with a wide breadth of experience in white collar litigation and civil and commercial litigation. Greg has represented numerous individuals and companies in state and federal criminal and regulatory proceedings, in internal investigations, and in implementing corporate compliance programs. He served as a member of the Ad Hoc Advisory Group to the U.S. Sentencing Commission on the Organizational Sentencing Guidelines, and has testified before the Sentencing Commission and Congress as an expert on corporate governance issues. He can be reached at ***gregory.wallance@kayescholer.com***

This article originally appeared in *Forbes* on September 20, 2012.

It was recently reported that Warren Buffett had decided to terminate credit default swaps of Berkshire Hathaway's that insured $8.25 billion in municipal debt. When the shrewdest investor in America pulls back from a major market, attention must be paid. And the market is major. At the end of last year, the principal of municipal securities outstanding was more than $3.7 trillion, of which more than 75% was held, directly or indirectly, by individuals. A million different municipal bonds are outstanding, and there are 44,000 state and local issuers.

But the municipal securities market is thinly traded and largely exempt from the controls of both the Securities Act of 1933 and the Securities Exchange Act of 1934. It is dominated by a small number of dealers that don't disclose to their customers their markups on principal trades, even though they are higher than on equity trades, and it lacks pricing transparency. Disclosure of municipalities' financial conditions is not always timely and complete. And the market has been showing signs of stress, as in the recent bankruptcies by Stockton, California, Harrisburg, Pennsylvania, and Jefferson County, Alabama, among other places. In New York State, Suffolk County declared a financial emergency after its budget deficit reached $530 million; last year a state oversight board took control of Nassau County's finances; and Rockland County is auctioning off county property to help close a budget gap.

Until now, the municipal bond market has been the mom and apple pie of financial markets, wholesome, enduring, and unexciting. After all, municipal bonds overall have significantly lower default rates than corporate and foreign government bonds, and their permanent losses are even smaller. This was true even in the Depression, when only $200 million was lost on the $13.5 billion in municipal bonds in default in 1932. The market has always been there, chugging away through depression, recessions, and wars. If it's not broke, why fix it?

"When the shrewdest investor in America pulls back from a major market, attention must be paid. And the market is major."

Well, we used to think of the housing market, the one where prices only went up, the same way. The lesson of the 2008 financial market collapse (and of the *Titanic*, for that matter) is that we should never be complacent about anything. Remember the scene in the movie *Titanic* where, after the ship hits the iceberg, the chairman of the White Star Line insists that “this ship can’t sink”? Replies the ship’s architect, “She is made of iron, sir. I assure you she can. And she will.” The municipal securities market is, in the end, made up of people, that is, investors. Their confidence is ultimately what keeps it sailing smoothly, and even floating.

Investor confidence should never be presumed, especially if there are more municipal defaults. According to Anne Van Praagh, author of a recent Moody’s Investors Services report on government bankruptcies, financial travails “raise the possibility that distressed municipalities—in California and perhaps elsewhere—will begin to view debt service as a discretionary budget item, and that defaults will increase.” The Federal Reserve Bank of New York just found that municipal bond defaults are in fact much greater than rating agencies have reported. For example, Standard & Poor’s reported 47 defaults between 1986 and 2011, but according to the New York Fed, there were in fact 2,366. After a two-year study, the Securities and Exchange Commission released a report at the end of July that properly emphasized the need for improved disclosure of municipalities’ finances and pricing transparency.

“Until now, the municipal bond market has been the mom and apple pie of financial markets, wholesome, enduring, and unexciting.”

The SEC’s report also cited multiple enforcement actions involving municipal bonds, another cause for concern, since nothing erodes investor confidence like corruption. In the past decade and a half, the SEC has brought enforcement actions involving lack of adequate disclosure in bond offerings against Orange County (failure to disclose risky financial condition); the City of Miami (failure to disclose cash flow shortages); and the Massachusetts Turnpike Authority (failure to disclose cost overruns in the Big Dig road and tunnel project). In 2010, in response to a multi-agency investigation of bid rigging in connection with municipal bonds, five major financial institutions, including UBS Financial Services and Bank of America, paid more than $750 million in fines and penalties, and 18 executives in these institutions were charged criminally (so far, 13 have pleaded guilty, and three others were recently found guilty after a jury trial). And multiple civil and criminal actions have been brought by the Department of Justice and the SEC in connection with “pay to play” schemes in which an underwriter or other market participant allegedly made political campaign contributions in return for contracts for underwriting or other services. And all that may be only the tip of the iceberg (just in case you missed the *Titanic* analogy).

“The municipal securities market is, in the end, made up of people, that is, investors. Their confidence is ultimately what keeps it sailing smoothly, and even floating.”

Meanwhile there is a danger that reform will get entangled in political issues such as states' rights versus the need for federal regulatory oversight or the fight over the Dodd-Frank Act (which requires municipal advisers to register with the SEC). It will certainly not be easy. But Buffett's pullback should be a wake-up call, because the municipal bond market really is too big to fail. Its staggering size, role as a repository of household savings, and critical importance to the country's infrastructure merit it intense but bipartisan national scrutiny. Had such scrutiny been given to the housing market in 2006 and 2007, we might have at least mitigated the ensuing collapse of the financial system. Let's not make the same mistake twice.