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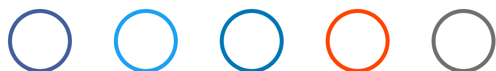
Municipal bonds: 5 studies on racism, climate change, aging populations and credit ratings

Covering municipal bonds may seem fun as chewing cardboard. But they can affect the social and cultural character of places people live. These five studies explore the intersection of munis, racism, climate change and more.

by Clark Merrefield | August 21, 2020

(Clark Van Der Beken / Unsplash)



Municipal bonds are loans state and local governments use to pay for everyday expenses and infrastructure projects that can take years to complete. Municipal bonds — also called "munis" — are attractive to some investors because states, counties, cities, school districts and other government organizations are unlikely to default. From 1970 to 2016, 0.18% of municipal bonds defaulted, compared with 1.74% of corporate bonds that companies issued, according to the Municipal Securities Rulemaking Board, a non-governmental organization that regulates the market. Another reason investors buy municipal bonds: They typically don't have to pay federal income tax on interest money they accrue.

The municipal bond market is huge and has grown exponentially in recent decades. There's about $4 trillion worth of bonds held in the municipal market today, up from $1.2 trillion in 1996, according to data from SIFMA, a security industry trade association that tracks municipal bond data.

Despite a dip in municipal bond issuance around the start of the coronavirus recession and recent defaults of some municipal bonds, year-to-date there's been nearly $50 billion more in municipal bonds issued across the country, a 23.7% increase. Municipal bond issuances rebounded in April after the U.S. Federal Reserve said it would buy up to $500 billion worth of bonds from states, counties and cities, which have three years to pay back the Fed.

Covering municipal bonds may seem, at first glance, as fun as chewing boiled cardboard. But these financial instruments have a direct effect on the social and cultural character of cities, metropolitan areas, counties and states. Munis may be the reason a new school is built or an aging bridge is replaced. They are also inextricable from local history, politics and forces beyond the control of a particular government — such as systemic racism.

The five studies that follow explore how municipal bond mismanagement can have disparate impacts on different racial groups, how climate change and aging populations affect bond interest rates, and provide insight on how credit ratings agencies — which can save or cost municipalities tens of millions of dollars — assess municipal credit risk.

Racism

The Violence of Municipal Debt: From Interest Rate Swaps to Racialized Harm in the Detroit Water Crisis
C.S. Ponder and Mikael Omstedt. *Geoforum*, July 2019.

C.S. Ponder and Mikael Omstedt argue that glaring examples of racial physical violence in cities, such as police killings of Black men, "are often underwritten by more abstract forms of financial violence."

They explore municipal debt as "a condition of financialized racial capitalism" by investigating the massive debt the Detroit Water and Sewerage Department had taken on by 2014. Ponder is an assistant professor of geography at Florida State University and Omstedt is a doctoral candidate at The University of British Columbia.

Financialized racial capitalism refers to financial situations or instruments, like municipal debt and bonds, with seemingly neutral elements — such as bond ratings and interest rates — that end up negatively affecting members of a particular racial group, through actions like water shut-offs.

The authors chronicle in detail the mid-2010s saga of the Detroit Water and Sewerage Department. The department was established in 1839 with a $20,500 bond. As the city became a capital of industry, the

department expanded to serve emerging suburban communities. Racial segregation entrenched in the 20th century, the result of white flight. The suburbs became largely white, the city largely Black.

"With this pattern of development, Detroit's suburbs were not only able to avoid taking out debt in the muni-market, they were also able to purchase water from the city at wholesale rates while charging increasingly exorbitant retail rates to their own suburban customers," Ponder and Omstedt write.

Around the turn of the century, the department agreed to several interest rate swaps. In the 1990s, banks marketed these swaps to cities as a way to hedge risk. Swaps could take a few different forms, but often the way it worked was that a city, or city department, would pay a fixed rate to a bank, which would in turn pay the municipal entity what's called a floating interest rate that varied based on the London Interbank Offered Rate, "the interest rate at which big banks loan to each other for short periods of time," the authors write.

If the LIBOR floated above the city's fixed rate, the city would come out ahead. If the LIBOR dipped below the fixed rate, the city would end up paying the bank more than it would have on the open market. In mid-2012, several large international banks were caught manipulating the LIBOR. American cities had paid some $6 billion more in interest to banks than they should have since the early 1990s, and $4 billion in fees to get out of interest rate swaps.

The Detroit Water and Sewerage Department subsequently took out a $650 million bond to cover early termination fees to jettison its toxic interest rate swaps, according to the authors. Financial trouble trickled down to ordinary Detroiters in 2014 when the department shut off water to 33,000 households owing more than $150, "in an attempt to pay down $561 million of debt incurred by predatory municipal finance deals gone wrong," the authors write. In 2015, another 23,200 households had their water shut off, and 27,552 households lost their water in 2016.

Ponder and Omstedt call it "financial whitewashing," with the department focusing on delinquent accounts rather than its own risky debt practices. They further argue that "both the white suburbs and the white state have successfully used the trope of payment delinquency and departmental mismanagement to take over local water governance." Black Detroiters are "scapegoats" and "the role of finance in the [department's] insolvency has become exonerated," Ponder and Omstedt conclude.

Climate change

An Inconvenient Cost: The Effects of Climate Change on Municipal Bonds
Marcus Painter. *Journal of Financial Economics*, February 2020.

Coastal counties facing rising sea levels pay more in fees and initial yields — which include interest rates — for issuing long-term municipal bonds, finds Marcus Painter, an assistant professor of finance at Saint Louis University. He finds no difference in bond fees and yields among short-term bonds that mature in less than 20 years.

Painter argues that "investors are more likely to account for climate change risk when investing in municipal bonds as opposed to corporate bonds or stocks." This is because a company can move out of town if the town perpetually floods, but the town can't move its infrastructure. Painter analyzes a sample of 327,152 bonds worth more than $1 million, 50,914 of them in counties at risk of climate change. Risk of climate change is defined as risk of monetary loss due to sea level rise — think homes and businesses under water — based on 17 at-risk cities such as New Orleans, Miami and Virginia Beach identified in a 2013 paper published in *Nature*.

"Because climate change risk is causing counties to be negatively affected today through higher debt issuance costs, these counties should be proactive in reducing the amount of damage that sea level rise is likely to cause to their municipalities," Painter writes.

Aging populations

Aging and Public Financing Costs: Evidence from U.S. Municipal Bond Markets
Alexander Butler and Hanyi Yi. Rice Business Working Paper, January 2020.

Municipal bonds cost more for states with older populations, find Alexander Butler, a professor of finance at Rice University and Hanyi Yi, a doctoral student there. States like Arizona, which have relatively high numbers of people over age 65 compared with states like California, where the population leans younger, may pay nearly a quarter of a percent more in interest. The difference "reflects an additional $71 million in annual interest payment," the authors find based on their analysis of more than 100,000 bonds issued by state and local governments across the country from 1996 to 2016.

Butler and Yi suggest two reasons for the higher interest rates in states with older populations. First, there's not as much tax revenue, which governments use to pay bond debts. Older people are less likely to work and less likely to pay income tax. If there's less tax revenue coming in to pay back lenders, those lenders will want more compensation in case of default in the form of higher interest.

The second reason has to do with pension obligations, which are constitutionally protected in some states. If a fiscal crisis hits, pensioners, who skew older, will get paid over municipal debt holders. So, just like with tax revenue, lenders want to be compensated for taking on more risk of default.

Bond ratings

Reading Risk: The Practices, Limits and Politics of Municipal Bond Rating
Mikael Omstedt. *Environment and Planning: Economy and Space*, October 2019.

Three credit rating agencies — Moody's Investors Service, Standard & Poor's Financial Services and Fitch Ratings — hold the keys to how much municipalities pay to issue bonds. If those agencies determine a municipality is a bad credit risk, that municipality is going to pay higher interest rates on their bonds. If the credit rating agencies determine a municipality is low risk, it will likely pay lower interest on bonds.

Omstedt, the doctoral candidate at The University of British Columbia, explains a paradox in the municipal bond market. In recent decades, the market has become increasingly complex, with varying laws across states and numerous types of issuers — from city governments represented by elected officials to organizations run by people who have been not elected, like water and sewage utilities. One former ratings analyst Omstedt interviewed said "you can't even compare city to city." And yet, as Omstedt points out, that is precisely what bond ratings do. They put cities in different geographies with different rules and different structures onto a simple ratings scale so that investors can assess their relative credit-worthiness.

Omstedt conducted 10 interviews with current and former ratings analysts and with 12 financial professionals working in New Jersey local governments. He finds that while municipal credit ratings are certainly based on financial data, such as whether a municipality owes huge sums for employee pensions, they're also based on subjective measures. Ratings analysts go out to observe economic conditions in municipalities and use those on-the-ground observations to help determine credit ratings.

The final ratings are a product of what the data and observations say about a municipality's budget flexibility. As Omsted explains, "their search for flexibility is essentially concerned with only one thing: the

municipality's ability to revise all other commitments that could stand between bondholders and the debt service in the event of a fiscal conflict."

Do Rating Agencies Benefit from Providing Higher Ratings? Evidence from the Consequences of Municipal Bond Ratings Recalibration

Anne Beatty, Jacquelyn Gillette, Reining Petacchi and Joseph Weber. *Journal of Accounting Research,* March 2019.

The authors examine nearly 6,000 credit ratings for 4,237 muni bond issues in 2008, 2009, 2011 and 2012 in Texas and California, the only two states that provide data on ratings fees. The authors skip 2010 because that's when two of the major credit ratings agencies, Moody's and Fitch, recalibrated their ratings scales. The recalibration meant more than 500,000 bonds across the country got better credit ratings without any change to their underlying default risk. Standard & Poor's, by contrast, didn't change its credit rating methodology. The authors want to know whether "credit rating agencies receive higher fees and gain greater market share when they provide more favorable ratings."

For bonds rated by the three major credit rating agencies, fees tracked consistently before recalibration. But in the two years after recalibration, Moody's and Fitch charged on average 11% higher fees than Standard & Poor's across the sample of bonds. The authors also find that for single-rated bonds — those that come with a rating from only one of the ratings agencies — issuers are more likely to go with Moody's or Fitch.

"These results imply that by increasing their ratings, Moody's and Fitch garnered new customers and increased their fees for both their existing customers and new customers," the authors write.

About The Author

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Clark Merrefield joined *The Journalist's Resource* in 2019 after working as a reporter for *Newsweek* and *The Daily Beast*, as a researcher and editor on three books related to the Great Recession, and as a federal government communications strategist. He was a John Jay College Juvenile Justice Journalism Fellow and his work has been awarded by Investigative Reporters and Editors. @cmerref