



## **Debt Ceiling Crisis and the Municipal Market**

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As national and international markets are focused on the ongoing debt ceiling negotiations in Washington, municipal market participants may not realize that there are reasons for them to be concerned as well. While there is no way of knowing when or how the apparent impasse may be resolved, investors in state and local obligations should be aware of the potential impact on their holdings, which could be significant.

First and foremost, the major rating agencies have placed the rating of the United States on watch, signaling that a failure to reach an agreement before the August 2<sup>nd</sup> deadline could result in the loss of its AAA standing. There would be two immediate consequences of a downgrade of the United States for state and local governments. The first is that generally speaking, under the principle of “sovereign ceiling” applied by the rating agencies, the rating of any entity, including political subdivisions, cannot be higher than that of the sovereign itself. Thus, any downgrade of the United States below AAA could mean that any state or local government that is currently rated AAA may also be downgraded. In fact on July 19th, Moody’s put five AAA rated states, Maryland, New Mexico, South Carolina, Tennessee and Virginia, on review for possible downgrade due to the risk associated with a U.S. downgrade and their dependence on federal revenues.

Secondly, and perhaps not as obviously, the AAA rating of thousands of outstanding bonds that are backed by the U.S. government is in jeopardy. Obligations as diverse as housing and health care bonds are in some cases guaranteed or back stopped by an agency of the government. Thousands more are pre-refunded municipal bonds, which will also be negatively affected. Typically, if an issuer refinances an obligation before its due date, it will take the proceeds of the new debt and use it to fund an escrow or payment fund to meet its obligation to the original bondholders. These payment funds are invested in U.S. Treasury or agency securities, and as a result are rated the same, AAA. Any downgrade of the United States will result in an automatic downgrade of these bonds as well.

Finally, any interruption in revenue streams running from the Federal government to state and local governments could have an extremely negative impact on a variety of credits. Federal monies that flow to fund ongoing local obligations such as health and human services, transportation or education will need, in the short term, to be made up by local entities that are already stressed from the economic dislocation of the last several years. State and local governments will have to prioritize expenditures and may delay or defer some obligations that would have an impact on the creditworthiness and ratings of their own debt.

While the hope is that this crisis can be averted, it serves to underscore the need for investors to be aware of and assess all risks in their portfolios, whether they are the issuer’s own credit rating or other economic or market factors that could impact the value of their investment.

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Kate retired in 2007 from Ambac Assurance Corp., after a 25-year career in municipal finance. At Ambac, she most recently served as a Senior Managing Director and co-head of the firm's Public Finance business. Prior to that, she was General Counsel for Public Finance, having joined Ambac in 1991 in the Legal Department.

Before joining Ambac, Ms. McDonough was an attorney at Orrick, Herrington & Sutcliffe and Hawkins, Delafield & Wood where she specialized in municipal finance and securities law practice. Prior to that, she was employed in the securities and banking industries with Merrill Lynch and the New York Stock Exchange.

Ms. McDonough graduated summa cum laude from Fordham University with a B.S. in Accounting and earned her J.D. from Fordham Law School. She was honored by Irish America Magazine as one of the Wall Street Top 50 for 2001 and is a member of the YWCA Woman Achiever Class of 1995.