



City of San Bernardino California to Seek Chapter 9 Bankruptcy Filing (7/12/12)

On Tuesday evening July 10th, the San Bernardino City Council voted 4-2 to authorize a bankruptcy filing. While the city's economic and financial difficulties have been evident for many years, the city council's vote was triggered by a report from the acting city manager: "City of San Bernardino Budgetary Analysis and Recommendation for Budget Stabilization". The report while outlining a long list of sustained fiscal deterioration, including depletion of reserves, suggested that the city council consider a bankruptcy filing. The report also stated that prior fund balances were "erroneously" reported by the city.

Some background:

- San Bernardino County, including the city, was once one of the fastest growing areas of the nation as the development of affordable housing approximately 65 miles east of Los Angeles led to significant growth in population and revenues for more than a decade.
- The recent "Great Recession" resulted in a swift and significant decline in local housing valuations, tax revenues, employment and all facets of economic activity.
- The city's cash reserves were emptied as revenues declined and expenditures remained near levels which preceded the housing crises. This overhead imbalance exists despite city cutbacks which included more than 250 layoffs.
- It is interesting to note the city manager's report did not specifically mention their debt burden as a factor in considering a bankruptcy filing. According to the rating agency, the debt service on these bonds was less than 1% of general fund expenditures.
- At the time of the bankruptcy vote, the city's bond obligations, Joint Power Finance Authority (interest payments are secured by the city general fund) was investment grade "BBB+" with a stable outlook by S&P. On Tuesday July 10th, the rating was lowered to below investment grade "CC".
- S&P does, however, mention that the city issued approximately \$68 million of debt (not rated by S&P), including taxable pension bonds. The pension bonds were issued in 2005 while equity prices were high and interest rates on the debt were higher than present levels -- with declining equity valuations, pension funding has suffered while relatively high rates were locked in.



- The April 2012 unemployment rate for the city was 15.7%, significantly higher than the county and state average.
- City personnel expenditures are a relatively high 73% of the budget, including benefits and overtime, with fully 80% of these costs directly attributable to public safety (police).
- The city manager estimates that the budget deficit for fiscal 2013 will reach 38%, and that available cash will be depleted within 90 days.

A Bankruptcy Filing is Not a Done Deal

- By declaring a fiscal state of emergency, San Bernardino is poised to become the first California city to bypass mediation proceedings with their creditors.
- The state of emergency declaration however is subject to a vote on July 16th by the City Council.
- If accepted, San Bernardino would be allowed to skip the “neutral 60 day process” in which creditors have the right to participate.
- In the end, these legal maneuvers can be found to be irrelevant as a bankruptcy judge has wide discretion in approving municipal bankruptcy filings.

Summary

Similar to Stockton CA, a city in close proximity to a major population center (San Francisco and Oakland), San Bernardino grew exponentially near Los Angeles, fostered by low interest rates and the demand for affordable housing east of the high rent Pacific Coast. Both cities share common problems including “attractive public-sector benefits” awarded during a time of plenty that are unsustainable during times of relative duress. Both cities, as California entities, also are restricted in generating additional revenue under Proposition 13.

While we do not “short change” the issues confronting the nation’s public finances, we continue to state that bankruptcy and default remain isolated events in municipal finance. Local governments in California confront issues specific to the state: the real estate debacle, voter initiative petitions, and restrictive state constitutional mandates. This particular “kettle of fish” is not generally found in other states.



Bankruptcy filings and distressed credits in other states, including Jefferson County, Harrisburg, and Scranton were triggered by specific events including fraud, mismanagement and overly optimistic economic development -- specifically "if you build it they will come".

Notwithstanding the "second strongest asset class behind U.S. Treasury bonds" status that municipal bonds enjoy, we do not discount the stress being faced by specific issuers in this challenging economic environment. Ongoing credit vigilance, in the current context, remains a key ingredient to avoiding unpleasant outcomes when investing in today's municipal bond market.

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