Fixed Income Insight
October 18, 2005

The Impact of Hurricanes Katrina and Rita on Municipal Bonds

Hurricane Katrina was unquestionably the worst natural disaster to hit the United States in the past 100 years. The second hit by Hurricane Rita was far less destructive but certainly widened the overall negative impression of the regional impact. The consequences of the combined crushing blows to the Gulf Coast on the municipal bond market are still unraveling and appear to be far more substantial than what is normally the case for such a catastrophe. When the final tally is calculated, damages are likely to exceed $200 billion. In addition, governments, hospitals, convention facilities, public housing and many other publicly served entities have experienced huge losses in their normal tax and revenue collections. Eventually, the affected states, the federal government and the bond market will likely have to pitch in "big bucks" or loans to settle the score. The state of Louisiana, the center of most of the impact, may also end up being a critical player in the overall bailout plan. While the bond market has identified approximately $10 billion in affected bond issues, the majority of the governmental related exposure has been guaranteed by private sector bond insurance.

The most devastated and financially vulnerable credits were located in and around New Orleans and along the Gulf coast in Mississippi, Alabama and, to a much lesser extent, Texas (as a result of Hurricane Rita). The New Orleans area was literally closed down for weeks forcing the city to be only a vestige of what it was before the storm struck. While residents are returning to the area, they are finding massive destruction of pre-existing housing stock forcing them to pay high prices for remaining space or to make do with temporary quarters.

Potential Impact on Municipal Bond Debt Service

The impact of the devastation and the accompanying loss of business activity, tax collections and enterprise fees have had a serious impact on normal government business and monies available to pay debt service on municipal bonds.

Municipal bonds related to the hardest hit areas are susceptible to missed payments and, in the worst of situations, are left exposed to bankruptcy. These worst case outcomes are likely to be avoided if help is received from the federal government in the form of loosening the restrictions on advanced refunding workout bonds and/or if there is external support from federal, state or other third party sources, such as the bond insurers. Initially, the bond market had not, for the most part, repriced Katrina-related bonds at trading prices well below their par value, which suggests that the market is expecting that fiscal relief will be made available in due time. Recently, however, bond prices have slipped on many of the affected bonds as risk of uncertainty begins hampering their trading value. In many cases, it has been reported that there were sufficient tax collections for the 2005 year prior to the storm or, in the case of revenue bonds, sufficient reserve funds available to forestall actual defaults on municipal bonds in the area. The immediate impact on municipal bond credits has been to lower their cushion of credit protection from downgrades or threats of downgrades. However, the longer it takes to realize a substantial state or federal relief and financing workout program, the more dangerous it will become to timely repayment of outstanding indebtedness, particularly related to bonds not guaranteed by a bond insurance company.

Bonds insured by a financial guarantee company like MBIA, AMBAC, FSA and FGIC, should be able to cover scheduled debt service on any covered issues if an underlying bond issuer defaults on its security. A variety of scenarios run by rating agency *Standard & Poor's* showed that the bond insurers had sufficient capital to cover losses and maintain their AAA ratings.

Fixed Income Insight
October 18, 2005

Most Affected Municipal Credits

Some of the most affected governments and revenue bond issues directly affected by the hurricanes are listed below. **This list is not meant to be comprehensive or conclusive as to outcomes.** Louisiana debt obligations appear to have experienced the most severe impact. Mississippi was affected to a somewhat lesser degree. Alabama and Texas coastal areas experienced pockets of significant damage.

Louisiana
City of New Orleans
Orleans Parish School Board
Orleans Levee District
Orleans Parish,
Plaquemines Parish
St. Bernard Parish
New Orleans Sewerage & Water Board
New Orleans Exhibition Hall
Louisiana Stadium and Exhibition Auth.
New Orleans hospitals
Various housing projects
State of Louisiana

Mississippi
City of Gulfport
Biloxi Public School District
Harrison County
Hancock County
Harrison County School District
State of Mississippi

Key Issues to Monitor

- Relaxation of Federal Treasury rules related to the limitations on the number of municipal bond advanced refundings allowed for municipal bonds. Tax-exempt bond refundings are critical to the ability to restructure debt schedules in line with workout plans and to the recovery of available tax and fee revenues. Refunding regulation exemptions have been proposed in Congress. It is expected that they will be approved to provide a waiver of the refunding rules. Restructurings would allow governments to defer the bulk of its principal repayment schedule.
- Degree and scope of federal aid or loans to provide funds for short term relief and long term rebuilding. The federal government is not expected to do a massive bailout through grants or guarantees. However, there is the possibility that federal programs may be available to help with infrastructure or housing rebuilding.
- Availability of state funding or guarantees to provide bridge financing for operating needs and debt service and to cover shortfalls needed by local government entities and borrowers.
- Private working capital derived from a consortium of banks being put together in Louisiana as well as Mississippi.
- Property value reassessments and tax relief programs relating to destroyed real estate as well as tax collection success are significant to longer term tax base viability.

Fixed Income Insight
October 18, 2005

- Sufficiency of reserve funds to offset the loss of sales, gambling and fuel tax revenues.
- The ability to garner market access at reasonable borrowing rates to cover the huge borrowing needs expected to come from state and local government issuers. Bond insurers are likely to consider underwriting new insurance on the refunding of outstanding bonds currently guaranteed by them.

Our Assessment

While the duration of rebuilding is likely to have long-term implications on credit conditions, investments in infrastructure, housing, and private development within the immediate area should eventually improve credit conditions in many situations, but not necessarily all. For example, a resized New Orleans, which has lost approximately half of its population, may require more expensive tax base development in order to offset the potential loss of population and businesses.

The problems are far more serious in Louisiana and in New Orleans than any other region. With higher overall long term interest costs likely to occur, the onus of a long term borrowing package and bailout at the state level raises the possibility of a bond downgrade(s). To some extent, a state financed bailout plan is reminiscent of 1975 when New York City's problems were taken up by the state. Like New York, the state was asked to borrow more on its own and guarantee a far greater share of the City's indebtedness. Local governments may initially experience downgrades related to the tax base downsizing and, in the case of revenue bond issuers, increased uncertainty related to resized market areas. Less vital hospitals may also be at downgrade risk because of decreased utilization.

It is expected that the linchpin of any expected workout of the serious problems impacting the hurricane devastated credits will focus heavily on a bond restructuring plan involving both the state governments and bond insurers. This is especially true in Louisiana, where the bond insurers have insured approximately 70% of the bonds at risk. In some cases, bond insurers may have to initially cover some missed payments until a full recovery plan has been put into place.

An unintended positive by-product of any advanced refundings is that the outstanding bonds affected will likely increase in value because the proceeds of the new issues will be used to buy U.S. Treasury obligations in an escrow to repay the existing bonds, making them eligible for a rating of "Aaa/AAA."

The silver lining to the problems arising from this devastating natural disaster is that the expected rebuilding boom in the affected areas could create a healthier, more vibrant regional economy ten years from now. This is likely to happen, however, only if businesses and people see the region as a stable and desirable place to do business and live in the long run. Such a business condition assessment will consider employment opportunities, tax burden, infrastructure and protections against similar future natural disaster destruction.

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