

The Diversity of Municipal Bonds and What You Need to Know About Risks

By Robert Doty

Article Highlights

- The municipal bond market is split between traditional secure securities and readily identifiable riskier securities.
- General obligation bonds, general fund securities, special tax bonds and revenue securities have different strengths and weaknesses.
- Bonds funding private profit-making or nonprofit projects have considerably higher default risks.

The Securities and Exchange Commission (SEC) estimates that there are 50,000 municipal securities issuers, and the Municipal Securities Rulemaking Board (MSRB) estimates that there are 80,000. Municipal issuers include states, agencies, cities, counties, school districts, fire districts and a host of special districts, agencies and authorities. It can be difficult to make sense of so much diversity.

In reality, the municipal market consists of two vastly different markets. One market is for traditional municipal securities that are very sound and secure, with extremely low default risks. The other is a market of readily identifiable riskier securities. Since the riskiest municipal securities can be identified readily in advance, there is no need for investors to be alarmed.

To know what you are buying requires reading official statements (prospectuses) and continuing disclosure filings made by municipal issuers and private borrowers. Those documents are available at the Electronic Municipal Market Access (EMMA) website maintained by the MSRB at emma.msrb.org. That website is a valuable resource.

Diversity of Municipal Bond Structures

It is important to understand varying municipal securities structures and their strengths and weaknesses—general



obligation (GO) bonds, general fund securities (which are quite different from GO bonds), special tax bonds, and varying types of revenue securities.

Plus, as bond counsel opine, when municipal securities are issued, state courts will enforce issuers' contractual obligations. This is why you should understand what the issuers have promised to do: Some promises are limited.

General Obligation Bonds

Local general obligation bonds are typically secured by pledged taxes and issuer agreements, as needed, to raise taxes without regard to rate or amount. Generally, there is no limit on that pledge. In some cases, however, there may be a cap on how much the taxes may be raised. Bond counsel opine that when the bonds are issued, the issuers' obligations are enforceable. According to James Spiotto, a noted bankruptcy expert with the bond counsel firm of Chapman and Cutler, when the pledge is supported by a statutory lien precedent, the pledge should be protected in bankruptcy. For example, Harrisburg, Pennsylvania, which filed for Chapter 9 (municipal) bankruptcy last fall, has failed to make general obligation payments, but bondholders will have to wait for a judicial ruling on the enforceability of the city's general obligation pledge. (At the state level, general obligation bonds are payable from state general funds, but states have more diverse resources from which to make payment, and debt service often has a high priority of payment.)

To emphasize this point: The pundits and media that have been making alarmist predictions about general obliga-

Table 1. General Obligation Bonds Versus General Fund Securities

	Local General Obligation Bonds	Local General Fund Securities
Structure	Most commonly are bonds	Usually are leases or participations in leases (called COPs) or lease revenue bonds
Secured By	Secured by pledged taxes, either unlimited tax or, in some states, limited tax	No specific tax security; secured by issuer's general fund as another expenditure payable from the issuer's receipts allocable to the general fund
Voter Role	Taxes or securities are often voter approved	Voters rarely have a direct role in issuance
Debt Repayment	Future payment is protected by obligations to levy and collect taxes	Annual appropriation usually is required in order to obligate monies for lease payments in each fiscal year (in California and Indiana, abatement leases may be used requiring lease payments if facilities are available for governmental use)
Essentiality of Funded Projects	Essentiality of financed governmental facilities is irrelevant due to obligations to levy and collect taxes to pay securities	Essentiality of leased governmental facilities is a key credit consideration. It pressures issuers to appropriate funds for lease payments to avoid losing use of key leased facilities
State Law Protection	Tax levy enforceable under state law	State law protection limited to agreement to pay from available and appropriated general fund monies
Bankruptcy Protection	According to bankruptcy counsel, based upon precedent, should be protected in bankruptcy when state law provides a statutory lien	No specially protected bankruptcy status

tion bonds are simply wrong. These are very strong securities.

A caution: Although Jefferson County, Alabama, atypically labeled securities on which the county recently defaulted as “general obligation” warrants, the warrants were not approved by the county's voters; the county did not promise to increase ad valorem property taxes, if necessary, in order to pay the warrants; and, as the county stated deep in its official statement, the county did not “specifically pledge” taxes for that purpose. Instead, the county promised to pay the warrants solely from its “general fund revenues.”

So it is important to review carefully

the security description in the official statement and to consider whether a statutory lien is present (a recent Moody's reports identifies 28 states that provide statutory liens).

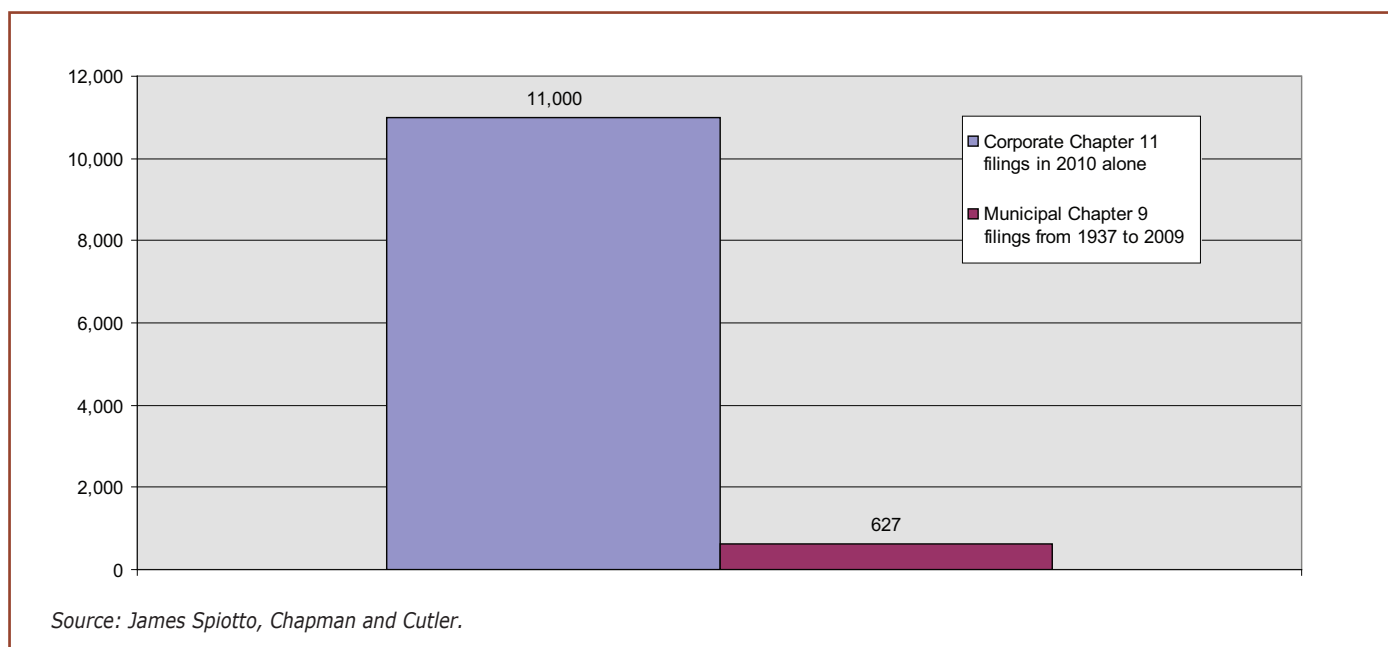
General Fund Securities

Despite the similarity of the name, general fund securities are NOT general obligation bonds. General fund securities are commonly, but not always, in the form of securitized lease-purchase agreements [certificates of participation (COPs) or lease revenue bonds] that are payable from whatever monies happen to be in an issuer's general fund. In Chapter 9 bankruptcy, general

fund investors are unsecured creditors. There is no requirement that the issuer raise taxes or revenues in order to pay the securities. Moreover, in most states, issuers must appropriate monies annually to pay the securities, a discretionary act. (In California and Indiana, the leases generally are “abatement” leases in which the issuers are obligated to make payments from their general funds as long as the facilities are available for the issuers' use.) Unlike the general obligation bond sector, the essentiality of the leased projects is a key issue.

In California, most of the city of Stockton's threatened securities are general fund securities (*not* general obliga-

Figure 1. Default Rates for Corporate and Municipal Bonds



tion bonds). The trustee for a defaulted Stockton parking facility lease, through litigation, recently obtained control of the leased parking facilities. Unlike Harrisburg, Stockton did *not* agree to raise taxes to pay its lease securities. Incidentally, Vallejo, California, also defaulted on general fund lease obligations but continued to pay its other securities, and Stockton is paying water utility revenue securities.

One key with respect to general fund securities, then, is to evaluate whether the leased property is “essential” to the issuer, so that they will not wish to lose the use of key facilities.

So, although these securities actually have an excellent historical record of payment, they do not offer the strong level of protection of general obligation bonds (or as discussed later in this article, traditional revenue bonds). General fund securities can have greater risk when issuers experience declining general tax receipts or fail to wisely handle their financial matters, such as their pension obligations or other employee benefit costs. This is evidenced, for example, by the recent financial problems of Stockton and Vallejo.

Table 1 illustrates the significant differences in structure and risk between

general obligation (GO) bonds and general fund securities, despite their somewhat similar names.

Special Tax Bonds

This is a diverse group of municipal securities that often (but not always) bears substantial risk. That is particularly true when the special tax bonds (including special assessment bonds) are payable from property taxes (or assessments) levied on undeveloped real estate to pay for infrastructure intended to serve the property. The risks vary somewhat from state to state, with Florida, Louisiana and Nebraska experiencing especially heavy defaults during the financial crisis, while in California and Texas, as a result of state action and improvements in market practices, these bonds performed much better (but not as well as traditional municipal securities). A related type of bond that bears similar risks is known as redevelopment bonds (RDA), or tax allocation/tax increment bonds. Stockton has a troubled redevelopment bond issue for which the private project (including a hotel and restaurant) did not work out. If special tax bonds are payable from taxes (or assessments) levied in fully developed areas, however, they tend to perform

much better.

California RDA bonds have a special problem due to state legislation that terminated redevelopment agencies. The implications are uncertain as of this writing, but a few successor agencies are indicating problems that may or may not be resolved. Overall, it appears that successors to the vast majority of the agencies will continue to pay the bonds.

Another form of special tax bonds is sales tax bonds. These are payable solely from sales taxes. These bonds have the potential to suffer in economic downturns. There is no obligation for the issuer to raise the sales taxes.

Traditional Governmental Utility Revenue Securities

Traditional governmental utility revenue bonds are very sound securities payable from pledges of revenues of established governmental water, wastewater and similar monopolies. As with issuer pledges to increase taxes to pay general obligation bonds, these issuers agree to raise the user fees that generate the revenues to pay these traditional securities. The issuers’ agreements are enforceable and are protected as special revenues in bankruptcy. People will not move out of town simply because they

do not like their water rates. They will pay increased user fees because they need the service.

In startup, rapidly expanding or substantially modified projects (e.g., Jefferson County's greatly modified wastewater system in Alabama) or in tiny special districts (e.g., the Xenia, Iowa, Rural Water District), the risks of these securities may be more significant. Jefferson County is a special case in which the bankruptcy court will decide how much it will permit the system's revenues to be raised. But even there, those net revenues that are being generated (after paying operation expenses) are applied to pay the securities. In addition, Jefferson County involves another factor (as did California's Orange County in the 1990s): very heavy issuer involvement with exotic instruments.

Diversity of Other Revenue Securities (Governmental and Private Credits)

There are a wide variety of other municipal revenue securities payable from user fees that bear diverse degrees of risk. Some of the securities may be relatively secure. Others are much riskier, especially when the bonds fund startup projects or projects of private profit-making or nonprofit borrowers. Unlike governmental utility bonds, the flexibility for governmental issuers or private profit-making or nonprofit borrowers to increase rates may be limited, as may occur, for example, in the case of toll roads, telecom systems, airports (especially since the American Airlines Chapter 11 bankruptcy filing), nursing homes or multifamily housing projects. It is wise to review closely and to question feasibility studies and financial projections presented in these financings.

Chapter 9 Bankruptcy

Local governments may file for bankruptcy under Chapter 9 of the U.S. bankruptcy code, if permitted to do so by state law. According to Moody's and bankruptcy expert James Spiotto, 22 states "either do not permit or give specific authorization for municipal bankruptcy." Involuntary bankruptcy is not permitted. The bankruptcy code is unavailable to the states themselves.

Spiotto provided data showing that local governments (generally small special districts that did not have bonded indebtedness) have used Chapter 9 of the bankruptcy code only 627 times since the enactment of the bankruptcy code in 1937, while in 2010 alone, corporations filed more than 11,000 Chapter 11 bankruptcy proceedings. This is illustrated in Figure 1.

Moreover, Spiotto pointed out that the laws of most states do not permit their localities to declare bankruptcy.

Identifiable Factors Suggesting Need for Careful Review

According to Municipal Market Advisors (MMA) data, traditional general obligation (GO) bonds have defaulted recently at the rate of only 0.01%, and traditional water/wastewater bonds have defaulted at the rate of only 0.02%. Meanwhile, in market sectors dependent upon private profit-making or nonprofit performance, nursing homes defaulted at the rate of 3.97%, assisted-living bonds defaulted at a rate of 4.48%, local multifamily housing bonds defaulted at the rate of 1.62%, and developer-dominated community development districts (CDDs) defaulted at the phenomenal rate of 16.56%. In

other words, nursing home bonds defaulted at a rate that was 397 times the rate for general obligation bonds, and CDD bonds defaulted at a rate that was 1,656 times the GO bond rate. To express that in words for emphasis, rather than numbers, CDD bonds defaulted one thousand six hundred and fifty-six times the rate of GO bond defaults.

Default data published by MMA shows that about 80% to 90% of municipal securities—especially those dependent primarily upon governmental credits—are responsible for only about 10% to 20% of the defaults in the municipal market. That means, though, that 10% to 20% of municipal securities—those dependent primarily upon private credits—are responsible for 80% to 90% of the defaults.

Investor Information Resources

There are substantial resources available to individuals regarding municipal securities. Although the disclosure of information is not always as complete or timely as you would wish, nevertheless, the Municipal Securities Rulemaking Board's EMMA platform (emma.msrb.org) is helpful in terms of giving you access to official statements and continuing disclosure documents that issuers and borrowers file annually or upon the occurrence of certain events.

In addition, resources that may assist you in deciding what information is important when you buy various types of municipal securities include disclosure guidance from the National Federation of Municipal Analysts at www.nfma.org, and information the rating agencies consider when rating municipal securities, which is available on their websites. ▲

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