

## Overview

Municipal securities represent loans by investors to a state, a legally constituted political subdivision of a state or a U.S. territory. They are issued by municipalities (like corporations issue other debt obligations) to raise capital. Most of the capital raised through a municipal bond issue is used to finance public works and construction projects (capital improvements) that benefit the general public. Examples of these projects and improvements include construction and maintenance of streets and highways, water distribution and sewage systems, and public welfare and health services. With certain exceptions, the Securities Act of 1933 requires the registration of new issues with the Securities Exchange Commission (SEC). Issuers of U.S. government, state and municipal securities are not required to be registered with the SEC. Although a security might be exempt from the registration requirement, no offering is exempt from the anti-fraud provisions of the Securities Act of 1933. The anti-fraud or anti-manipulation provisions of the act of 1933 apply to all new securities offerings, whether or not they are exempt from registration. Securities that are exempt from registration under the act of 1933 are not subject to most of the Securities Exchange Act of 1934's rules and regulations regarding trading. As with the act of 1933, however, no security is exempt from the act of 1934's antifraud and market manipulation regulations.

## Municipal Bond Basics

Since the issues of municipal bonds have a strong record of meeting interest and principal payments in a timely manner, municipal securities are generally considered as a relatively safe investment. The degree of safety, of course, varies from issue to issue and from municipality to municipality. Much of the safety of any municipal issue is based on the viability and rating of the issuing municipality and the community in general. One way to evaluate an issuer is to examine its credit rating. Many bonds are graded by ratings agencies such as Moody's Investors Service, Standard & Poor's and Fitch Ratings. Bond ratings are considered important benchmarks because they reflect a professional assessment of the issuer's ability to repay the bond's face value at maturity. Generally, bonds rated BBB or Baa, or better, by Standard & Poor's and Fitch, or Moody's, respectively, are considered "Investment Grade," suitable for preservation of investment capital. Non-rated bonds may be speculative in nature and not suitable for all investors. Bonds rated below investment grade or non-rated bonds are subject to Credit Risk whereas the issuer may not be able to make timely payments or may default. Generally, at a give point in time the higher the bonds yield, the higher the credit risk associated with that bond.

Municipal Bonds are subject to Market Risk as their prices fluctuate in response to changing interest rates. Prices increase when interest rates decline, and prices decline when interest rates rise. If the bonds are sold by a bondholder before maturity (provided that a secondary market does exist) or if they were purchased at a price higher than the original offering, the bonds may be worth less than original cost upon redemption.

Each new municipal issue is accompanied by documentation (Official Statement) that:

- sets forth the terms of the loan and the schedule of repayment;
- attests to the issuing municipality's authority to issue the debt obligation;
- lists the specific features of the issue;
- describes the intended use of the borrowed funds; and
- provides financial information about the economic health of the municipality and the community.

## Tax Benefits

The interest paid by most municipal securities is exempt from federal income taxation, but may be subject to state and local taxes as well as the Alternative Minimum Tax. The federal government does not tax the interest from debt obligations of municipalities; municipalities reciprocate by not taxing the interest from federal debt securities. This doctrine of reciprocal immunity was established by the Supreme Court in a decision handed down in 1895. To qualify for the exemption from federal taxation, the municipal security must be issued to fund government (public rather than private) activities. In many cases, interest from municipal bonds is also exempt from state taxation if the bond (1) is issued by a municipality in that state and (2) is sold to an investor who lives in that state. Some states also exempt from taxation bonds issued by a territory of the United States. This tax-advantaged status of municipal bonds allows municipalities to raise money at a lower cost than can corporations: municipalities are able to offer tax-exempt bonds at lower interest rates than offered by similar taxable bonds. Because municipal rates are generally lower than corporate rates, municipal securities are more attractive to investors in high tax brackets than to those in lower brackets (avoiding a 28% tax liability on interest is more important than avoiding a 15% tax liability). Investors should always carefully calculate a bond's overall yield, including tax savings, before choosing it for their portfolios. Moreover, as there are municipal issues that pay interest that is taxable, investors shall carefully review the status of interest payments. Tax exemption, if applicable, does not apply to potential capital gains if sold for a profit. Special rules may apply to tax-exempt bonds purchased at a premium or a discount and called or sold before maturity. Municipal bonds, like most other bonds, pay interest semiannually on a schedule set at issuance.

## Issuers

The three primary entities legally entitled to issue municipal debt securities are territorial possessions of the United States (Puerto Rico, the Virgin Islands and Guam), state governments and legally constituted taxing authorities (county and city governments and the agencies they create). Public authorities that supervise ports and mass transit systems (such as the Milwaukee Port Authority and the Ohio Turnpike Authority) are also permitted to issue municipal debt securities.

## Maturity Structures

The wide range of maturities available in municipal issues (from one month to 50 years or more) is an attractive feature to investors. The three types of maturity schedules common to corporate debt issuers are also used by municipal issuers. These maturity arrangements are called serial, balloon and term structures.

# Types of Issues

There are only two major categories of municipal security issues: general obligation bonds (GOs – bonds backed by the full faith, credit and taxing powers of the municipal borrower) and revenue bonds (bonds backed by revenues generated by the financed facility).

## General Obligation Bonds (GO)

GO bondholders have a legal claim to the revenues received by a municipal government for payment of the principal and interest due them. GOs are used to raise funds for those municipal capital improvements that typically do not produce revenues (building a new city hall, for example). The financial support for city and county bonds is ad valorem taxes (which means according to the value of the property). Sales and income taxes are the support for state bonds. GOs are also known as full faith and credit bonds.

### *Sources of Funds*

GOs are backed by taxes. State-issued debt securities are backed by income taxes, license fees and sales taxes. Cities, towns and counties issue debt securities backed by property taxes, license fees, fines and all other sources of revenue to the municipality. School, road and park districts may also issue municipal bonds that are backed by property taxes.

### *Legal Limitations*

**Statutory or constitutional limits on municipal debt.** While GOs are backed by the taxing powers of the issuer, the amount of debt municipal governments are allowed to incur may be subject to local and state statutory debt limitations. The purpose of these limitations is to protect taxpayers from excessive tax assessments. These limitations and restrictions also help make the bonds safer for investors. The lower the debt limit, the less opportunity there is for excessive borrowing and default by the municipality.

**Voter approval.** Because GOs are backed by the taxing powers of the municipal issuer, they usually must be approved by vote of the taxpayers in a referendum.

**Tax limits.** The municipal issuer may have either limited or unlimited taxing power. Property taxes are limited by some states to a certain percentage (expressed in mills: one mill equals 1/10th of one cent - \$.001) of the assessed property value or to a certain percentage increase in any single year. Bonds that are serviced by these taxes are still considered GOs even though the taxing power is limited. These bonds are frequently called limited tax bonds.

**Overlapping debt.** Debt limitations of a municipality can be quite misleading if there is overlapping debt – that is, debt can be issued by several taxing authorities that draw from the same taxpayers. A school district's debt, for example, is backed by taxes on the same property as debt issued by the city and county that the district is in. The school district and county, therefore, issue debt that overlaps the city's debt (debt issued by states is not included when calculating overlapping debt). Municipal entities that have overlapping boundaries are often described as coterminous, and their debt as coterminous debt.

## Revenue Bonds

Revenue bonds are a common type of municipal issue and can be used to finance any municipal function that generates income. The typical sources of revenue that finance the principal and interest payments to revenue bondholders include user charges for public utility facilities (such as a municipal water or sewer authority); tolls, concessions and fees from the operations of turnpikes, bridges, airports and other facilities; and rental payments under lease-rental arrangements between the issuing authority and a state or political subdivision. Revenue bonds are payable only from the earnings of specific revenue-producing enterprises. An analysis of the quality of revenue bonds would include sources of revenue, feasibility studies, maturity structure, call provisions, application of revenues and protective covenants of the indenture. Also, taken into account are the construction period costs (including capitalized interest). Unlike GOs, revenue bonds are subject to no statutory debt limits and require no voter approval. Revenue bonds may be issued by any municipally authorized political entity.

### *Sources of Revenue*

In contrast to the interest and principal payments of GOs, the interest and principal payments of revenue bonds are payable to bondholders only from the specific earnings of revenue-producing facilities such as:

- Utilities (water, sewer, electric)
- Housing
- Transportation (airports, toll roads)
- Education (college dorms, student loans)
- Health (hospitals, retirement centers)
- Industrial (industrial development, pollution control)

Revenue bonds usually are not payable from general or real estate taxes and are not backed by the full faith and credit of the issuer. Revenue bonds may include one or more of the following features:

- Additional bonds test – whether the indenture is open ended (allowing further issuance of bonds with the same status) or closed ended (allowing no further issuance of bonds using the same collateral unless the original bondholders agree);
- Sinking fund – to pay off interest and principal obligations;
- Consulting engineer; report on the project and its revenues;
- Catastrophe clause;
- Details of the application of the flow of funds;
- Outside audit of records and financial reports; and
- Call features – any call feature or requirement.



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