

CHAPTER 4

Primary Offerings and Syndicate Practices

(22 questions)

Types of Municipal Bonds

Municipal bonds come in two basic types: general obligation bonds and revenue bonds. The two types are distinguished by how they are funded. **General obligation (GO) bonds** are *unsecured bonds*, but they are considered very safe, because they are backed by the full faith and credit of the municipality and paid for by taxpayers. **Revenue bonds** are *secured bonds* used to finance specific projects and are funded by the revenue stream generated by the project.

GENERAL OBLIGATION BONDS

General obligation bonds are offered and sold to fund the general operating expenses of a municipal government or to provide funds for capital improvement projects, like roads, parks, courthouses, and schools. They are backed by the full faith and credit of the issuer, which means that the issuer must use its full taxing and borrowing authority to ensure the timely payment of principal and interest.

Voter approval is often required for the issuance of general obligation bonds. This is reasonable, because the taxpayer is the creditor of last resort. Only entities that have the right to levy and collect taxes may issue general obligation bonds. Most municipalities also have debt limits that cannot be exceeded without voter approval.

Periodic interest and amortization payments for government obligation bonds are usually paid out of the state or local government's general fund. Revenue in the general fund is generated by state or local taxes and by the government's ability to raise more funds through credit.

A state's general obligation bonds are usually paid with income, sales, and excise taxes collected at the state level. Local GO bonds are most commonly backed by property taxes.

Non-tax revenue, such as parking fees, parks, and recreation and licensing fees may also be used to pay debt service.

REVENUE BONDS

Revenue bonds are bonds that finance projects in which principal and interest payments to the bondholder are paid from the revenue generated by those projects. Issuers of revenue bonds may be municipal governments, government agencies, or public authorities. (Public authorities are government-created corporations formed to promote the public interest by financing the construction and operation of public facilities, such as the New York City Housing Authority or the Chicago Transit Authority, and they are governed independently of government oversight.) Revenue bonds finance airports, mass transit systems, roads, bridges, libraries, and hospitals.

Since these projects only serve those in the community who use the services, users of these services are asked to pay for them, not the general taxpayer. Income is raised from concessions, tolls, or user fees and put into a revenue fund. The project’s expenses are paid first out of the fund, with the remaining money going to bondholders. Revenue might also be generated by rental or lease payments. A state may create a nonprofit authority to build a school and then lease the facility to a local government.

Revenue bonds may be issued when voter approval for general obligation bonds cannot be obtained. Or revenue bonds may be used to finance projects when statutory or constitutional debt limitations prevent a municipality from issuing GO bonds. Because bond payments are contingent on a project’s success and have little access to tax revenues, revenue bonds are riskier than GO bonds and require higher yields to entice buyers.

GENERAL OBLIGATION BONDS	REVENUE BONDS
Backed by taxes of the municipality	Backed by user charges, lease payments, and special taxes
Issued for the benefit of the whole public	Issued to fund a specific project
Voter approval required	Voter approval unnecessary
Debt limits apply	Debt limits do not apply

TYPES OF REVENUE BONDS

Revenue bonds come in numerous types and sizes. For example, public power revenue bonds pay for the construction of power plants and transmission lines. They are funded by electricity rates. Water revenue bonds finance water and sewer projects. They are generally funded by connection fees and usage fees. Mortgage revenue bonds fund the construction of public housing and are backed by mortgage payments. Airport revenue bonds fund the construction of airports. Landing fees, fuel fees, and lease payments fund them. Industrial revenue bonds finance public power projects, such as factories, stadiums, and industrial parks. Fees, concessions, and lease payments fund these projects.

Taxable Municipal Bonds

The **Tax Reform Act of 1986** placed severe restrictions on qualifying for tax exempt financing. It would no longer permit governments to subsidize activities that do not provide a significant benefit to the general public. Taxable municipal bonds were created to fund *private activities* that would no longer qualify for exemption from federal taxes. These are known as **private activity bonds**. Besides supporting nonpublic functions, private activity bonds may also be issued to refund debt or bolster underfunded pension funds.

Variable Rate Securities

Variable rate securities are long-term bonds having interest rates that are reset on a short-term basis. Interest rates may be reset either at periodic time intervals or after the occurrence of specified events or conditions. They may be determined by an auction process or by some predetermined index, such as the London Interbank Offered Rate (LIBOR).

Until recently, the most commonly used type of variable rate bonds were **auction rate securities (ARS)**. With auction rate securities, interest rates are reset by Dutch auction, usually every 7, 28, or 35 days. They trade at par and are callable at par on any interest payment date at the option of the issuer. With a Dutch auction, existing bondholders willing to sell and potential investors enter a competitive bidding process through sealed bids. Each bid specifies the number of shares (in \$25,000 denominations) that the bidder is willing to purchase or sell at the lowest interest rate it will accept. The lowest-bid rate at which all the shares can be sold at par establishes the interest rate (clearing rate) for the next period. Investors who bid at or below the clearing rate purchase their bid at that rate.

Bonds whose interest rates are adjusted by a predetermined index are known as **floating rate securities**, or **floaters**. Interest rates are reset periodically at some fixed spread above the selected index. The spread might be 2% above the index, which remains fixed throughout the term of the bond. Interest rates may be reset daily, weekly, monthly, or annually. Some common indices are the LIBOR, the Federal Funds rate, and the Treasury bill rate (3-month, 6-month, and 12-month).

Variable rate securities may be useful in diversifying a municipality's debt portfolio, and they have the advantage of reducing the cost of debt by paying short-term interest rates. They also carry more interest rate risk should interest rates experience a rising trend.

Since 2008, auction rate securities have been plagued with a large number of failed auctions. ARS auctions fail when there are not enough bids to purchase all the securities offered for sale in the auction. Potential investors must be made aware that liquidity may be a problem with ARS.

When auctions fail, bondholders typically continue to receive an interest rate or dividend at above market rates for the next holding period, as stipulated in the offering documents. But there is no ready buyer if they wish or need to liquidate their holdings. Recently, many municipal issuers have either changed to a fixed rate structure or refunded and redeemed their ARS to avoid the problems with failed auctions.

MUNICIPAL NOTES

Municipal notes are short-term debt obligations, whose term may last from three months to three years, though most often, their term does not exceed a year. Like Treasury bills, they obligate the issuer to pay a specified principal by a certain date, and they sell at a discount to par in lieu of paying interest. The primary purpose of municipal notes is to meet an agency's cash flow needs in anticipation of the taxes, fees, or other sources of revenue that fund its ongoing commitments.

Municipal notes are called **anticipation notes**, because they are issued in anticipation of an expected source of income that will make the periodic payments on a bond. Anticipation notes allow a project to get underway before its funding has been received.

Notes are issued by different names, depending on where the anticipated receipts are coming from, whether from taxes, grants, or fees. Like any cash advance, municipal notes are meant to smooth out cash flows until income is received. They are tax-exempt to the note holders.

For example, tax anticipation notes (TANs) are issued to finance a project's current operations in anticipation of future tax receipts. TANs have first claim on any tax collections before they are otherwise disbursed. Revenue anticipation notes (RANs) are issued to finance the current operations of a project backed by a revenue bond in anticipation of fees from the completed project to repay the notes. Bond anticipation notes (BANs) enable work to start on a capital project before the municipality completes its issuance of a long-term bond. Rather than issue bonds before the project is finished and final costs are known and certain, a municipality may sell notes that will be retired by proceeds from the new bond issue.

Tax-exempt commercial paper is a short-term promissory note issued by states and municipalities, usually backed by a line of credit with a bank. Its maturity ranges between 1 and 270 days, and it is usually issued at a discount. Issuers typically pay the principal on maturing commercial paper by issuing new commercial paper. Such rollovers effectively permit long-term borrowing through the issuance of short-term loans.

Tax-exempt commercial paper has two advantages over anticipation notes. First, it permits municipalities to raise funds over the long-term without bearing the costs of repeatedly reissuing notes, which requires the payment of legal fees and the costs of preparing official statements and competitive bidding processes. Second, municipal notes generally must get prior approval from elected officials (and sometimes voters) before reissuing notes to replace maturing notes. With tax-exempt commercial paper, issuers have blanket authorization to reissue as many units of paper as necessary to provide a specified amount of funding for a specific period.

In the 1980s, Congress began imposing limits on certain types of bond issues. The **Tax Reform Act of 1986**, for example, placed a limit on the amount of tax-exempt commercial paper that could be issued by municipalities. Issuers who rolled over their commercial paper were deemed to have issued new debt. Once their debt limits were reached, any new issue would come without tax-exempt status. This would effectively eliminate any additional use of that source of funds. This new restriction led to the creation of **variable-rate demand obligations (VRDOs)**.

VRDOs are floating-rate obligations that have a nominal long-term maturity, but whose interest rates are automatically reset on a daily, weekly, or monthly basis. They also contain a put option, which gives investors the right to put the security back to the issuer at any time, at a price equal to the bond's face value plus accrued interest. The put option may be exercised after a notification period that normally corresponds to the length of time between interest rate adjustments.

VRDOs are a long-term bond with variable short-term interest rates. The put option allows VRDOs to sidestep the tax reform debt limits, because when an investor exercises the put option and puts the bond back to the issuer, the issuer can simply resell the bond to another investor without issuing new debt.

Example: Suppose the port authority in your state issues a \$100 million VRDO that matures in 2034. Its interest rate is set at the 30-day Treasury rate, plus 0.5%, and is reset monthly. At any given time on seven days' notice, the port authority must repurchase the bond on demand by any of its investors. The purchase is handled by the issuer's remarketing agent, Bank of America, which also backs up the bond with a letter of credit.

As a bondholder, you decide you want to sell your ownership and buy stocks with the proceeds. You exercise your put option, or "tender" the bond, to the remarketing agent, and seven days later, you receive par value plus any unpaid, accrued interest for your investment. The remarketing agent will use your seven days' notice to sell the redeemed bonds in the secondary market. Failing that, Bank of America's letter of credit will provide a loan to purchase and hold the redeemed bonds until they can be resold.

VRDOs are floating-rate securities with a twist. Unlike auction rate securities, they do not rely on a continuing demand in the secondary market. And unlike floaters, they can be put, or tendered, on demand and, therefore, require liquidity support from a bank.

MUNICIPAL FUND SECURITIES

A **municipal fund security** is a fund of securities that is issued by a state or municipality. Investments in a municipal fund security may consist of a wide variety of securities, including corporate stocks and bonds and government securities of every stripe. It is not to be confused with a **municipal bond fund**, which is a mutual fund consisting of municipal bonds. A municipal fund security is distinguished from the typical investment company by its issuer.

Because it is issued by a state or local government, it is exempt from the rules of the Investment Company Act of 1940. As such, it does not have to register with the SEC, prepare a prospectus, calculate and post its net asset value on a daily basis, or include independent directors on its board. Municipal fund securities are also exempt from federal taxes and often state and local taxes as well. Municipal fund securities are subject to MSRB rules. Examples of municipal fund securities are local government investment pools and 529 college savings plans.