

Municipal Securities

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Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

Before you begin, you may find it useful to click the thumbnails button to utilize thumbnails for navigating your way through this document. Thumbnails break the document into separate pages. Clicking the third thumbnail quickly advances the screen to the third page, clicking the sixth thumbnail quickly advances the screen to the sixth page, clicking the first thumbnail sends the screen back to page one, etc. Bookmarks operate similarly by advancing to different sections of the document. Simply use your mouse to click on the section of your choice.

Municipal Securities

Introduction

Municipal securities are debt securities issued by cities, states, and counties to finance public projects. There are many different types of municipal securities.

General obligation bonds (GOs) are bonds guaranteed by the “full faith and credit” of a municipality with taxing power. GOs are normally backed by a pledge of the money received from ad valorem taxes placed on all taxable property within a community. When states issue bonds they are usually backed by appropriations made in the state legislature. The source of the appropriations could be state sales taxes and state income taxes. The public is actually repaying these debts and voters must approve GOs prior to their issuance. An unlimited tax bond is a general obligation bond backed by the pledge of taxes that are not limited in rate or amount. A limited tax bond is a general obligation bond backed by the pledge of a specific tax (generally property tax) or category of taxes which is limited in rate or amount. Limited tax bonds are usually not as safe as unlimited tax bonds.

Some municipalities have a debt ceiling or debt limit. Debt limit is the maximum amount of general obligation debt a municipality is allowed to incur as identified in its constitution, statutes or charter. Debt limit is normally expressed as a percentage of assessed valuation.

Revenue bonds are payable from the fees for water, sewer, electric or gas services and bridge or airport tolls an agency is authorized to collect. The yield from a revenue bond is usually higher than from a GO because the GO is generally safer, but some long-standing revenue bonds have built a strong reputation and are sometimes rated higher than a GO.

Industrial revenue bonds (IRBs) finance the construction of a manufacturing or commercial facility for the good of a private user. The local community authorizes an industrial development authority to borrow funds by issuing municipal bonds. The revenue generated from the bond issue is used to construct a facility that is then leased to the corporate user. The safety of an IRB depends completely on the credit standing of the corporation for whom the

facility is constructed. More often than not, the lessee has a better credit rating than the issuing municipality's development authority.

Housing bonds are secured by mortgage repayments on single-family homes or multi-unit rental property. Additional backing may come from first mortgage on the property, reserve funds, FHA insurance, VA guarantees, or private mortgage insurance. Bonds may be issued by local or state housing authorities. New Housing Authority Bonds or PHAs are no longer issued, but are still bought and sold in the secondary market. They are virtually fail-safe because they are backed by the full faith and credit of the U.S. Government.

Special tax bonds are secured by one or more specially designated taxes other than ad valorem taxes. An example may be that a new bridge may be built and paid for through the collection of an additional tax on gasoline.

A special assessment bond is repaid from a charge to property owners in a particular locality because the property receives a special benefit because of its location.

A moral obligation bond is generally issued by a state agency or authority and secured by the revenues from the financed project and also by a non-binding promise that any deficiency in revenues will be reported to the state legislature which might designate money to make up the shortfall. Since the secondary backing is a possibility, the bond normally carries a lower interest rate.

A double-barreled bond is backed by the full faith and credit of an issuer with taxing power **and** a defined source of revenue other than property taxes. Double-barreled bonds are essentially general obligation bonds.

In order to reduce its interest expense, a municipality may decide to issue a bond to replace an existing, higher interest rate bond. The new bond is called an advance refunding bond. This procedure is often advantageous during a period of declining interest rates. The revenue generated by an advance refunding bond is escrowed in U.S. Treasury securities until the maturity or call date of the outstanding issue and will eventually be used to retire the existing issue. Because this money is set aside in this way, the bond will be considered AAA and the interest earned from the escrow account will defer the interest cost of the outstanding debt. Until the old debt is retired (on its call date), the higher coupon bonds are referred to as being pre-refunded.

Municipalities issue several types of money market instruments. Tax Anticipation Notes (TANs) are generally used by municipalities in anticipation of tax collections. Bond Anticipation Notes (BANs) are generally issued in anticipation of bonds. Revenue Anticipation Notes (RANs) are generally issued in anticipation of revenues, often from the state or federal government, to alleviate cash flow problems.

Construction loan notes (CLNs) are notes issued to fund construction of housing projects and are normally repaid by revenue from long-term bonds. Tax-exempt commercial paper is a very short-term unsecured promissory note issued in registered or bearer form. It is generally backed by a line of credit from a bank.

Moody's rates municipal notes MIG1, MIG2, MIG3, MIG4 and tax-exempt commercial paper Prime-1, Prime-2, Prime-3 (P-1, P-2, P-3). Standard & Poor's rates municipal notes SP-1, SP-2, SP-3 and tax-exempt commercial paper A-1+, A-1, A-2, A-3.

Taxable Status of Municipal Bonds

The U.S. Supreme Court has historically ruled that the interest on debt securities issued by the federal government is subject to federal taxes, but not state and local taxes. The Court has also ruled that the interest on debt securities issued by municipalities is subject to state and local taxes, but not federal taxes. However, since 1986, the federal tax treatment concerning interest income is determined by the purpose of the bond issue. The Tax Reform Act of 1986 designates that municipal bonds are "governmental use" bonds, "private activity" bonds or "taxable" bonds.

"Governmental use" bonds finance essential government operations such as schools, libraries, jails, etc. These bonds are exempt from federal tax but subject to state income tax unless issued in your state of residence or by Puerto Rico. "Private activity" bonds are bonds whose revenue is used for a private trade or business or loaned to a private entity. Examples are industrial revenue bonds, airport bonds, and multi-family rental housing bonds. Interest on

“private activity” bonds is exempt from federal tax but subject to alternative minimum tax (AMT) and your state’s income tax, unless the bond is issued in your state of residence or by Puerto Rico. Interest from “taxable” municipal bonds is subject to federal income tax. It is possible that state and local tax exemptions may apply. Examples are sports complex bonds, convention center bonds, and pollution control bonds.

The premium paid on a bond bought in the primary or secondary market is amortized each year. That is, the premium amount is divided by the number of years to maturity and this annualized portion is subtracted from the cost basis each year. This adjusted price is the investor’s cost basis. Because of this amortization of the premium each year, the adjusted basis and redemption price will be the same at the time of maturity. That is, there is no gain or loss due to the amortization. However, if the bond is sold prior to maturity, there could be a gain or a loss, depending on market conditions. The exception to the rule that premiums are always amortized is dealers who do not amortize the premium or accrete the discount because they are buying and selling these bonds as part of their normal business.

For bonds originally purchased in the primary market at a discount, an appropriate portion of the discount is accreted each year. The discount amount is divided by the number of years to maturity and the annualized portion is combined with the original cost basis of the bond to determine the investor’s adjusted cost basis. Because of this accretion, the adjusted basis will be equal to the redemption price when the bond is redeemed at maturity and no loss or gain will be reported at that time. If the bond is sold prior to maturity, the sales price is compared to the adjusted cost basis to determine the capital gain or loss. Bonds purchased at a discount in the secondary market are also accreted, but the annual accretion is treated as ordinary taxable income.

Because the IRS usually allows investors to claim interest income on municipals as tax-free income, the IRS will not also allow the investor to deduct any interest expense incurred if the bonds are purchased on margin. Margin interest costs are deductible only on “bank qualified” bonds. In order to be “bank qualified,” a municipality must not offer more than \$10 million of bonds in the subject year. The margin interest costs for carrying bank qualified bonds is 80% deductible by the purchasing bank.

The Self-Regulatory Organization (SRO) margin requirement for municipal bonds is 15% of CMV, or 7% of face-value, whichever is greater.

Investment Features

The higher the rating of a bond, the higher its marketability. Banks, insurance companies, and other fiduciaries are often required to invest only in securities which are rated BBB, Baa or better. For this reason, bonds which are of this quality are much more marketable than those of lesser quality. Standard & Poor's, Moody's and Fitch's base their ratings on creditworthiness, but White's ratings are based on marketability.

Investments with shorter maturities are more liquid than those with longer maturities. Shorter maturities minimize interest rate risk for investors. The longer the maturity of the bond, the more volatile its price. If interest rates rise, bonds with longer maturities decline more in price than bonds with shorter maturities. Most investors do not plan to hold bonds for the entire 20 or 30 years to maturity.

Bonds with call protection features are more marketable than bonds which are subject to potential calls. Call protection refers to the initial time period during which a bond is not callable. If an investor wants to "lock-in" a yield on a fixed income security, he must buy non-callable bonds. After the call protection period ends, the issuer may call in the bond and the investor would lose the higher yield.

If all other factors were equal, the investor would prefer a bond with a higher coupon rate. Therefore, the higher the coupon rate, the more marketable the bond. Because large financial institutions and wealthy individuals are the primary investors of municipal bonds, the most marketable block size is \$100,000. Discount bonds are more marketable than premium bonds because investors prefer lower prices rather than higher prices. Bonds issued by widely recognized issuers are more marketable than bonds from less recognized issuers.

Bonds are said to be trading flat when they are in default but continue to trade in the marketplace. In such a situation, the investor would not pay his proportionate share of accrued interest to the seller at the time of the transaction, but he is entitled to receive all the unpaid coupons. Even though these bonds trade at large discounts, most investors would not be interested in purchasing them; however, some professional speculators may buy them and hope they become solvent.

A bond with a sinking fund provision requires the issuer to pay interest each year **and** to set aside money into an escrow account to provide funds for the repayment of the principal. This prevents a large payment at maturity and usually results in greater marketability due to the public perception that the credit risk is lower. Additionally, the provision may require the issuer to call specific amounts of the bond issue on scheduled dates prior to maturity. This may be referred to as a partial or mandatory call.

Bearer bonds are no longer issued, but are still considered the most marketable because there is less paperwork involved in their sales.

There are three principal ways of diversifying a client's bond portfolio to insure against interest rate risk and default risk: geographical diversification, maturity diversification, and quality diversification. Geographical diversification guards against local or regional recessions and weaknesses in specific industries. By investing in issues with varying maturity dates, a client can protect himself from the disadvantages associated with a particular type issue and take advantage of the differences of short, intermediate and long-term municipals. By investing in varying qualities of bonds, an investor may receive a higher yield **and** minimize the risk of default.

Municipal Underwriting

There are two ways a municipality may finance securities: negotiated sales and competitive bidding. In a negotiated sale, the municipality contacts an investment banking firm and negotiates the terms of the offering directly. The investment firm then re-offers the bonds to the public. Or a municipality may negotiate the sale of the new issue with an institutional investor who is buying for its own account. This is called a private placement. An Agreement Among Underwriters and Selling Group is written which specifies the authority of the syndicate manager and the role of the firms in the syndicate and selling group. This type of underwriting is often used for revenue bonds and is almost always used for industrial revenue bonds.

Competitive bidding is the most common type of financing for general obligation issues and is required by law for GOs in many locations. A municipality uses a Notice of Sale (an ad placed in trade publications) to announce that it wants to borrow money and is looking for syndicates to submit bids. A Notice of Sale usually includes the date, time and place (for selling the issue to a syndicate), a description of the issue, the method for making a bid, the type of bond, the semi-annual interest payment dates, and the denominations for printing the bond. Also included in the Notice of Sale is the amount of good faith deposit required, the name of the law firm giving the legal opinion, where to get the bid form, and the basis used for awarding the bid.

A competitive sale usually awards the bid to the syndicate with the lowest computed net interest cost (NIC). This figure represents the total interest cost the issuer must pay over the years or the coupon rate times the par value of the bonds times the number of years to maturity. The total is reduced if the bond is bid for at a premium and increased if the bond is purchased at a discount. Sometimes, a sale will be awarded based on the true interest cost which takes time value into consideration.

After the underwriters are selected, the "Syndicate account letter" is written. This agreement is prepared by the syndicate manager and signed by each syndicate member showing that they accept the terms and conditions of the underwriting.

An Eastern account is an undivided account in which each member of the syndicate is responsible for the sale of the entire issue in proportion to his allotment within the issue. A Western account is a divided account in which the underwriter's responsibility is limited to his allotted share of the issues to be sold. In a Western account, each underwriter is "in it" for himself and bears no other liability.

The syndicate manager allots the securities to be sold to each member. Members try to obtain pre-sale orders from clients. The manager may make large group orders to an institutional customer who gives credit for the sale to his choice of syndicate members. The usual type of orders, in priority, is: pre-sale, syndicate, designated, and member. A pre-sale order is taken before the syndicate offers the bonds and has priority over all other orders. A syndicate order is made at the public offering price after the offering has begun and is credited to the appropriate syndicate member in proportion to his allotment. A designated order is made at the public offering price, but the investor is given the right to credit the syndicate member of his choice. A member order is an order by a syndicate member at the "take-down" price (spread minus the manager's fee) for the member's own account or for sale to another dealer or investor.

If an offering has higher demands than supplies, it is referred to as over-subscribed and the priority of pre-sale, syndicate, designated and members orders is used for filling orders. The underwriting manager has responsibility for handling group net and designated orders after the pre-sale orders are filled. That is, he must decide on the retention percentage or how much of the member's allotment he will actually have available for sale. If a member had an allotment of 1,000,000 bonds and an 80% retention rate, he could actually sell 800,000 bonds.

A scale for a municipal bond is a listing of coupon rates and maturity dates. It also includes yield or price the syndicate is re-offering the bonds to the public. A regular or positive scale shows that the yield to maturity is lowest on near term maturities and highest on long term maturities. The longer the maturity, the higher the yield. This is also called a positive yield curve. If a bond has a negative scale, the short term maturity yields are higher than the long term maturity yields.

A bond attorney or independent bond counsel is hired by the municipality to ensure that all state, local and federal requirements are met. The bond attorney establishes the eligibility from federal income tax and determines that there is proper authority from the state's constitution, a legislative decision, or judicial rulings for the bond issuance. The bond attorney also oversees the procedures of the issuance, makes sure the bond certificates are proper and then completes a legal opinion. The only securities that require a legal opinion are municipal bonds. The bond attorney is not responsible for preparing the official statement which gives investors all the information needed to make decisions about a possible municipal bond purchase.

A qualified legal opinion means that the affirmation of the legality of the securities is conditional, but an unqualified legal opinion refers to an unconditional affirmation of the legality of the issue. The issuer publishes an Official Statement that specifies all the information an investor would need to make a decision. This information includes the purpose of the issue, how it will be repaid and the financial, economic and social characteristics of the issuing body.

Municipal Securities Secondary Market

Most municipal bonds are quoted on a yield-to-maturity rather than a dollar price, but dollar bonds are quoted on a dollar price basis. Dollar bonds are usually traded more actively and are issues from larger, term securities rather than from serial issues. Municipal issues are generally purchased by banks, bond funds, insurance companies, other institutional investors, individual investors and small businesses. The Interdealer Market is the marketplace for transactions between dealers, including both securities firms and bank-dealers.

Position trading is when a municipal bond trader decides which long and/or short position to take on behalf of his firm. Firms which deal exclusively with other municipal securities brokers, dealers, and certain municipal securities professionals, but not with public clients are called broker's brokers. These firms find a buyer for those professionals seeking to sell, or find a seller for those professionals seeking to buy.

A firm quote is one that will not be changed for a specific time period. A nominal quote (or indication) is one that gives an indication of the approximate market value of an issue, but does not give an actual bid for or offer of the issue. Nominal quotes may be given only for informational purposes. A workable quote (or workable indication) is a bid price at which a dealer gives his willingness to buy an issue from another dealer. Revisions of workable quotes are allowed. An appraisal is a trader's recommendations based on findings in a client's portfolio.

Market Information Sources

The Blue List, which gives information on municipal securities, U.S. agency securities, corporate debt securities and bond funds, is published in an effort to provide a listing of securities that are for sale in the secondary market and the firms offering those securities. The List provides details on the issuer, the coupon rate, the maturity date, and the price or yield of the security. Often, the purpose of the bond issue, the call date, and the call price are also included. The total par value of all secondary market municipal issues, referred to as the Blue List Total, is also included in the Blue List.

Moody's Bond Survey and Standard & Poor's Credit Week are published weekly to provide information on the market yields, municipal credit updates, and schedules of recent and proposed primary offerings. The Bond Buyer is a daily paper that provides information on the primary market of municipal issues. Munifacts is a wire service which gives price and underwriting information that may be of interest to readers.

Municipal Credit

The creditworthiness of municipal bonds is determined by several factors. First of all, an investor should analyze the municipality's ability to pay its debt by investigating the value of the property the municipality can tax. Obviously, the more valuable the property, the more money the municipality will receive in taxes. It is an advantage for the municipality to have varied industries located within its boundaries. This stabilizes the economy of the area. Also, the investor should examine whether or not the municipality has a balanced budget, a surplus, or a deficit. Another factor to consider is any unfunded liabilities the municipality may have. These would be a negative for a potential investor. The population trends of the area are also important. If the area's population is increasing, its tax base will expand. This is generally considered a positive factor. Lastly, the characteristics of the municipality's debt must be analyzed. These are:

- A. Whether the debt base is increasing or decreasing.
- B. The structure of the issuer's debt. Direct debt is a given amount of money a municipality owes independent of any other municipality. An overlapping debt is one shared with another local government unit. The debt is usually shared based on relative assessed valuation. The net overall debt is computed by adding the direct debt and the overlapping debt.
- C. The time frame of any debt service requirements. A level debt service means the payments are consistent and can be easily planned. A balloon or term maturity requires a large payment of principal and is usually more difficult to meet.
- D. The order in which debts must be paid.
- E. Non-tax revenues.
- F. Tax rates and trends.
- G. Assessed valuation trends.
- H. Additional security sources.
- I. A comparison of the amount of money the municipality will have available to the amount of money owed which includes a ratio of debt service to annual revenues, a ratio of net overall debt to assessed property value, a ratio of net overall debt to

estimated real valuation, and a ratio of net overall debt per capita.

Revenue Bonds

Revenue bonds are payable from the resources derived from the operation of the project which they finance. Revenues from projects could be collected as user charges (example-tolls), concessions or fees (example-landing and fueling fees at airports), rental or lease payments (example-industrial bonds), special taxes (example-cigarette tax), or a legislative appropriation (example-construction of facilities).

Issuers often include protective covenants with bonds. A rate covenant is a pledge to charge rates or fees sufficient to cover costs plus the debt service. An insurance covenant is a pledge to keep adequate casualty insurance on a project. A maintenance covenant is a pledge to keep the facility open and operating for the life of the bonds. A non-discrimination covenant ensures that rates will be charged in a fair, non-discriminatory way. A financial report or outside audit covenant is a promise to have an impartial audit to ensure that funds are used properly. An additional bonds covenant is a pledge to monitor the issuance of any additional bonds. There are two types: open-end in which the issuer is allowed to issue additional bonds with equal claim on revenues as long as they can be covered by the projected revenues and a closed-end which prohibits the issuer from adding other bonds. A protective completion covenant is a promise to have a facility completed by a certain date.

A revenue bond's indenture specifies the order and priority of handling, depositing, and disbursing incoming revenue. This is known as the flow of funds. The revenues are usually deposited into a general account known as the revenue fund. A net pledge is an agreement that the lender will be paid after expenses; a gross pledge is a promise that the lender will be paid before any expenses.

Most revenue funds maintain several types of accounts which may include a revenue fund, an operation and maintenance fund, a sinking fund, a debt service reserve fund, a reserve maintenance fund, and a surplus fund.

These funds are self-explanatory since their names imply their basic function; by way of clarification, however, it should be noted that a revenue fund is similar to a checking account and a sinking fund is also called the “debt service fund.” Debt service coverage is computed by dividing the pledged revenues by the debt service requirements. The higher the ratio, the easier the issuers will be able to repay the debt. Bond insurance assures the timely payment of principal and interest on municipal bonds and noted if the issuer defaults. The American Municipal Bond Assurance Corporation (AMBAC), the Financial Guarantee Insurance Company (FGIC) and the Municipal Bond Insurance Association (MBIA) are the three major insurers of municipal bonds. If an issuer chooses to pay the premium for this type of insurance, the bonds automatically qualify for a AAA (Aaa) rating.

The Municipal Securities Rulesmaking Board

The Municipal Securities Rulesmaking Board (MSRB) has established rules to govern the municipal securities industry. Some of the more important regulations include:

1. Persons who manage or supervise functions of municipal securities must be registered as principals. Persons who underwrite, trade, sell, give financial advice or consultation services to issuers, and/or give research and investment advice for municipal securities must be registered as a representative. All representatives must do a ninety-day apprenticeship during which he/she may not discuss transactions with customers or receive commissions. He/she may discuss transactions with other brokers and dealers and may receive a salary.
2. The following records must be maintained for a period of six years:
 - A. All purchases, sales, receipts and disbursements of cash (known as blotters).
 - B. Ledgers of each customer’s account (known as account records).
 - C. Securities records which indicate all long and short positions.
 - D. Records of all written complaints.

These records must be maintained for a period of three years:

- A. Copies of confirmations and account statements.

- B. Information from each customer's account which is obtained before the settlement date and includes name, residence, business address, whether or not of legal age, tax identification/Social Security number, occupation, name and address of employer, whether customer works for another broker or dealer, signature of representative who introduced the account, signature of principal accepting the account, customer's written authorization of discretionary power if applicable and written approval of a principal.
3. Every syndicate must maintain rules that prioritize orders by category and the manager must fill orders based on the priority provision. A written summary of allocations by category must be furnished within two business days after the date of sale. If any syndicate member puts in an order for the portfolio of a municipal bond fund that the dealer sponsors, the dealer must disclose at the time of placing the order that the issues are being purchased for a "related portfolio."
 4. Transactions for municipal issues between securities firms should follow standardized procedures as established by the MSRB. Detailed procedures that deal with settlement dates, dealer confirmations and delivery of securities among other topics are developed by the MSRB and expectations exist within the industry that these procedures will be followed precisely.
 5. Confirmations to clients include all the information given in dealer confirmations except there is no concession. Client confirmations must also give the commission charges, the capacity of the firm (either dealer or broker) and must be sent or given no later than at the completion of the business transaction.
 6. Compliance with the MSRB rules will be audited by the NASD, the SEC, the Office of the Comptroller of the Currency, the Federal Reserve Board, or the Federal Deposit Insurance Corporation.

The MSRB regulates many other activities of the municipal securities industry and firms must be careful to adhere to all regulated policies.

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Now that you have completed reading this course, you may proceed to the accompanying exam to earn a verifiable certificate of completion.