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Understanding the Issuer Risk in the Municipal Bond Market

The municipal securities market is critical to building and maintaining the infrastructure of our nation. State and local governmental entities issue municipal securities to finance a wide variety of public projects, to provide for cash flow and other governmental needs, and to finance non-governmental private projects. Individual investors hold as much as 75% of the outstanding municipal securities both directly and indirectly, through mutual funds, money market funds, closed-end funds, and exchange traded funds. There are over one million different municipal bonds outstanding, with close to 44,000 state and local issuers, and a total face amount of $3.7 trillion in total aggregate principal amount. By comparison, there are fewer than 50,000 different corporate bonds. Corporate bonds and corporate equities outstanding totaled $11.5 trillion and $22.5 trillion, respectively.

Despite its size and importance, the municipal securities market has not been subject to the same level of regulation as other sectors of the U.S. capital markets. There have been improvements over time in disclosure practices of issuers in the municipal securities market, but many disclosure issues still remain. In primary offerings (new issue market), disclosure concerns are centered on smaller, less sophisticated issuers and non-governmental borrowers. In the secondary market (existing issues), the timeliness and completeness of filings, as well as compliance with continuing disclosure agreements, is the focus.

Primary market disclosure risk can be minimized by simply avoiding issuers with incomplete or questionable financial reporting. The biggest challenge is in the secondary market. Studies have shown that disclosure of audited annual financial statements by many municipal issuers is particularly slow. By the time annual financial statements are filed or otherwise publicly available, many municipal market analysts and investors believe the financial information has diminished usefulness or lost relevance in assessing the current financial position of a municipal issuer.

Investors can protect themselves from these disclosure and underlying financial risks by investing selectively. Following a selective well structured investment process can serve to help minimize the impact of any potential default risk that may exist in the municipal securities marketplace.

First and foremost, approximately 85% of all municipal bond defaults occur in non-rated municipal bonds. Limiting exposure to rated, investment grade municipal bonds dramatically reduces any potential financial or default risk. It should be noted, a majority of defaults in the municipal securities market are in conduit revenue bonds issued for non-governmental purposes, such as multi-family housing, healthcare (hospitals and nursing homes), and industrial development bonds (for economic development and manufacturing purposes). This applies to both rated and non-rated issuers.

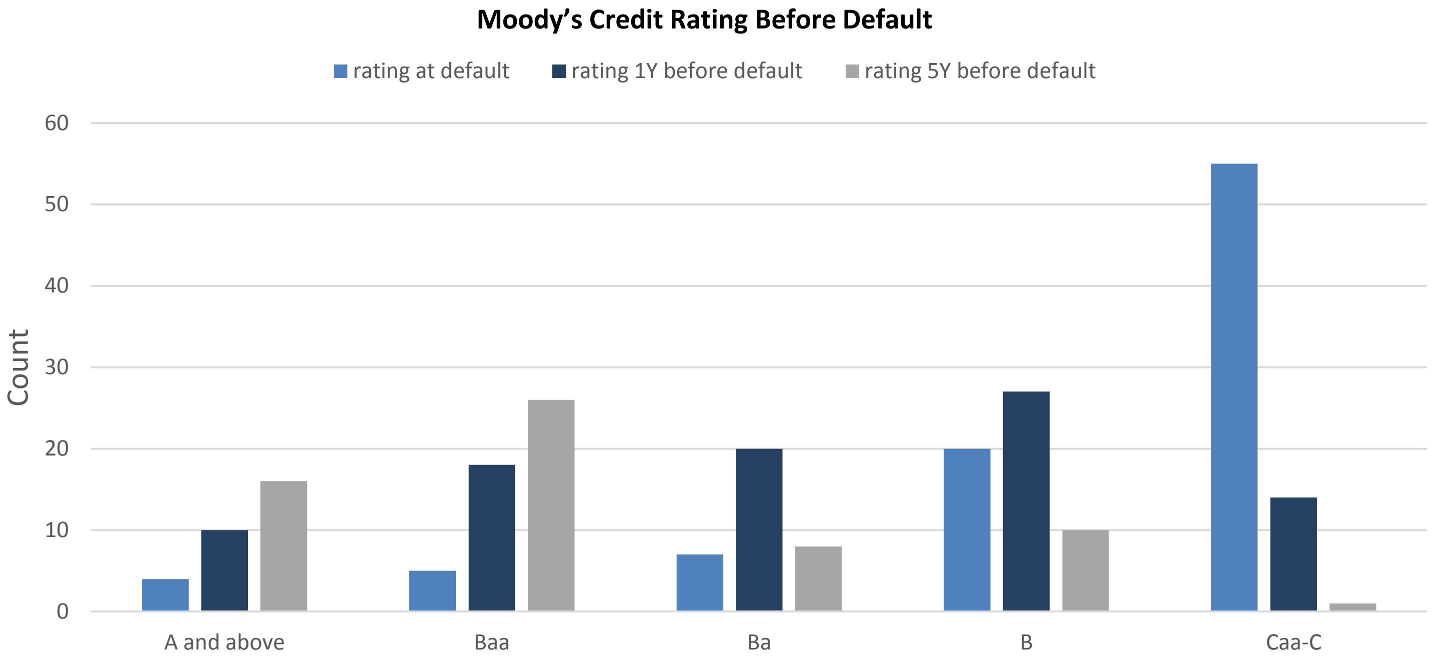
Moody's Rated Municipal Defaults by Sector, 1970-2014

Purpose	Number of Defaults	Percentage
Housing	44	46.3%
Hospitals & Health Service Providers	23	24.2%
Infrastructure	9	9.5%
Education	4	4.2%
Cities	4	4.2%
Counties	3	3.2%
Special Districts	0	0.0%
State Governments	0	0.0%
Pool Financings	0	0.0%
Other	0	0.0%
Non General Obligation	87	91.6%
General Obligation	8	8.4%
Total	**95**	**100.0%**

According to Moody's Rating Agency, there were only 95 defaults of Moody's rated municipal bond issuers from the period of 1970 to 2014. That's 95 of approximately 44,000 total issuers in the last 44 years. More than 70% of those 95 Moody's rated defaults, were in the three major types of conduit bond issues (healthcare, multifamily housing, and industrial development). By simply avoiding these particular sectors, an investor significantly lowers the probability of owning a defaulting municipal security even further.

Credit Rating agencies such as Moody's and S&P, offer further assistance in evaluating individual municipal credits although their findings are also subject to the poor timeliness of financial data. Rating agency accuracy is best when the issuer is coming to market with a new rated issue since the financial data is most timely and current.

Continuous monitoring of credit ratings is also crucial. Moody's research indicates that of the 95 rated defaults between 1970 to 2014 there was a deterioration of ratings prior to default. They state the median rating one year before default for a municipal issuer is Ba3, several notches below investment grade. Moreover, 90% of all defaulted issuers were rated speculative-grade (junk) one year before default. By constantly monitoring and maintaining the investment grade credit rating status of issues held, default risk can again be minimized in a portfolio.



If and when financial data is available, examination of levels of indebtedness (direct, indirect and overlapping) on a per capita basis and in relation to the overall economic market value of the municipality are crucial. If low and sustainable, probability of default is also minimized. Other financial data to monitor is the pension funding and other post-employment benefit obligations of the municipality. Although the data is often not readily available, the rating agencies reporting on the municipalities often comment on how minimal or significant the liability may be relative to the municipality's expenditures.

Overall in terms of default risk, general obligation bonds backed by the taxing power and/or "full faith and credit" of the issuing entity hold the least amount of default risk historically. A holder of a general obligation bond receives repayment from all sources of revenue received by the municipal entity that may legally be used for such payments, for example, the receipts of *ad valorem* taxes levied for that purpose.

Revenue bonds backed by specific non-*ad valorem* revenues are the next most secure. Essential service revenue bonds receiving non-*ad valorem* revenues from water, electric and sewer sales and use taxes are most secure. These are followed by revenues from specific projects or enterprises being financed (*e.g.,* toll roads or an airport or port facility).

The most risk is assigned to conduit revenue bonds that are issued by a municipality or an agency or instrumentality of a municipality on behalf of a third party (often called a "conduit borrower" or "obligated person"). If certain requirements in the federal Internal Revenue Code and Internal Revenue Service regulations are met, conduit revenue bonds may be tax-exempt. Tax-exempt conduit revenue bonds include industrial development bonds on behalf of private entities, as well as financings for both non-profit and for-profit borrowers: such as hospitals; colleges and universities; power and energy companies; resource recovery facilities; multi-family housing projects; hotels; and sports stadiums. In a conduit revenue bond financing, the bondholder cannot look to the municipal issuer for payment of the bonds, but rather must rely on payment from the conduit borrower.

Excerpts from:
Moody's Investor Service. US Municipal Bond Defaults and Recoveries, 1970-2014, July 24, 2015
U.S. Securities and Exchange Commission. Report on the Municipal Securities Market, July 31, 2012

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