

MUNICIPAL BONDS: INVESTING IN AMERICA'S FUTURE

Introduction

During the past few years, public officials at all levels of government have become increasingly aware of how public capital spending affects productivity, competitiveness of American business, and the quality of life Americans enjoy. At the federal level, recognition of the importance of public investment has led to enactment of important legislative initiatives.

Nevertheless, the need to reduce budget deficits makes it quite unlikely that the federal government will be able to shoulder the burden of meeting the nation's need for increased public spending. The principal responsibility for creating the common foundations of future prosperity will thus continue to reside with state and local governments.

As they have for more than a century, states and localities will look to the nation's capital markets to finance increased investment in schools, highways, airports, transit networks, environmental systems and other facilities that are needed to sustain growth. And, as state and local borrowing needs grow, so will the contribution that financial guaranty insurance makes to making the public capital markets work efficiently and effectively for both borrowers and investors.

Municipal Bonds: What They Are, What They Do

Municipal bonds and notes are debt securities issued by state and local governments, or agencies they authorize to borrow, to raise money for various public purposes. Notes are short-term borrowing instruments – that is, they have a term of twelve months or less. In most cases, notes are used simply to balance the borrower's cash flow – to cover expenditures that occur early in the year, such as income tax refunds, while waiting for tax revenue to come in.

Bonds – debt obligations with a term of more than twelve months – are most commonly used to finance capital projects, such as building a new school, expanding a hospital or modernizing an airport. Since this report is primarily interested in how financial guaranty insurance helps states and localities meet their long-term investment needs, it will focus on the bond market.

The Early History of Municipal Bonds

The first known municipal bond, in the sense of a formal debt instrument with a fixed repayment schedule, was issued by the City of New York in 1812. Other state and local issues followed, and by 1840 the municipal finance market was well-established, with more than \$200 million in bonds outstanding. By 1880 this had reached \$1 billion and by 1900, about \$1.9 billion.

The growth of the municipal finance market in the 19th century did not follow a steady upward path. Defaults were common during the financial panics and depressions that periodically battered the nation's economy – especially on bonds that states and localities issued to finance construction of toll roads, canals, railroads, and other enterprises. Criticism of public borrowing for such purposes led many states to enact strict constitutional limits on state and local borrowing. Many states required that new bond issues be approved by the voters, and limited how much debt could be outstanding at any time.

Growth in the 20th Century

State and local borrowing grew rapidly with total indebtedness reaching \$3.8 billion in 1912 and \$12 billion in 1927. It peaked in 1932 at \$16.6 billion – and then, under the impact of the Great Depression, began once again to decline. Capital spending, and the borrowing needed to finance it, remained depressed until after the Second World War.

But as the United States embarked upon the remarkable growth cycle of the post-World War II years, the municipal finance market exploded. It took until 1951 for total state and local debt to reach 1927's level; but in the next thirty years, it grew by 1400%. As state and local governments took on new responsibilities, they found new uses for municipal bonds – financing construction of moderate-income housing, private hospitals and nursing homes, college and university buildings, as well as private industrial development.

As the federal government's share of public capital spending declined during the 1980s, state and local governments took on increased responsibility for public investment.

General Obligation and Revenue Bonds

There are several types of municipal bonds. General obligation bonds (or "GOs") are issued by state or local governments, and are backed by the full taxing power of the issuer. Because the taxpayers are ultimately responsible for this debt, each issue usually requires a specific legislative authorization – and often the approval of the voters as well.

Revenue bonds, in contrast, are backed only by a specified revenue stream. The bonds that finance construction of a bridge, for example, might be paid off solely from the tolls collected from those who use it. Bonds that finance modernization of a municipal water system might be supported by the water charges paid by local residents and businesses. These bonds are often issued by independent agencies of state or local government – a bridge authority or a water supply district. As these examples indicate, such agencies are often monopoly or near-monopoly providers of essential services. This monopoly quality tends to make their revenue streams relatively secure and predictable – which, in turn, makes their revenue bonds attractive to investors.

During the past thirty years, state and local governments have greatly increased their use of revenue bonds. As recently as the mid-1970s, two-thirds of all new municipal bonds were general obligation bonds. Today, just under two-thirds (64 percent) of all new bonds were revenue bonds. This shift reflects a continuing search by state and local officials for ways to finance new public investments without raising taxes.

Some bonds are actually a hybrid of revenue bond and GO financing. A municipal government, for example, might set aside a portion of the revenues from a hotel occupancy tax to support bonds that are issued to finance a new convention center, if the facility is not expected to generate enough income to pay off the bonds.

Tax-Exemption

Bonds can also be categorized according to whether the interest income they generate is subject to federal income taxes. Since the inception of the federal income tax in 1913, most income from state and local securities has been exempt from the tax. State and local authorities have argued that the Constitution does not permit the levying of federal taxes on such income. During the 1980s, however, Congress imposed a series of limitations on the issuance of tax-exempt debt; and the Supreme Court affirmed the federal government's right to grant or withhold tax-exempt status. Nevertheless, Congress has to date chosen to maintain the tax-exempt status of most types of state and local borrowing.

Bondholders are not required to pay federal income taxes (nor, in many cases, state income taxes) on the interest payments they receive from state and local bonds that are tax exempt. Because investors receive tax-free income, they are willing to accept a lower interest rate. Therefore, the ability to borrow at tax-exempt rates can reduce significantly the issuer's interest costs, saving them several billion dollars a year. Thus, tax-exemption is one of the most important forms of federal support for state and local infrastructure investment.

Terms and Structures

Most state and local bonds are issued for long terms – 30-year bonds are typical. Provisions for payment of interest and repayment of principal vary, according to the structure of the bonds. With *term* bonds, interest payments are made periodically (usually semi-annually), with the principal being paid in a lump sum when the bond matures. With *serial* bonds, the principal is repaid in installments, according to a set schedule, over the life of the bond. In recent years, some state and local agencies have also issued “zero coupon” bonds. These issues do not provide periodic interest payments over the life of the bonds; instead, interest charges are accrued and paid in a lump sum, along with the principal, when the bond matures.

Until the late 1970s, almost all municipal bonds were issued at fixed interest rates. Since then, state and local issuers have also begun to use variable-rate debt, with interest rates

that are adjusted periodically. Variable-rate bonds are usually issued with provisions that permit their conversion to a fixed-rate debt at a later date.

The Uses of Municipal Bonds

State and local governments use bonds to finance almost every conceivable type of public capital project – schools, streets, transit systems, airports, solid waste management and sewage treatment plants, water supply systems, public power systems, public hospitals, court buildings, jails and many others. They also issue bonds to finance certain kinds of private developments that are deemed to serve important public purposes, such as low- and moderate-income housing, private hospitals and colleges, and industrial facilities.

The distribution among various uses of state and local bonds issued has varied from year to year, education has consistently claimed the largest share of municipal bond financing in recent years. Other leading uses have included health care, housing, transportation and environmental facilities.

Bonds can further be distinguished as “new money” or “refunding” bonds. New-money bonds are typically issued to finance new capital projects. Refunding bonds are issued to refinance existing debt.

Issuers

There are about 16,000 governmental jurisdictions and agencies in the United States that are authorized by state law to issue bonds. They include the fifty states; county, city, town and village governments; school districts; water and sewer districts; and public authorities that finance, build and operate public facilities such as bridges, airports, hospitals, parking garages, and convention centers.

Investors

In 2004, individual households directly held almost \$666 billion in municipal debt – 33 percent of the total outstanding. Mutual funds and money market funds – which are, in effect, conduits for family and individual investments – held another 30 percent. Other major holders are property and casualty insurance companies and commercial banks, which together hold another 19 percent.

Since the early 1980s, the share of state and local debt held by banks has dropped sharply, while that held by individuals has risen. These changes in the pattern of investment in municipal bonds result primarily from the tax reforms enacted in the 1980s. These reforms reduce the tax advantages that banks and other institutions derive from owning tax-exempt bonds; and by eliminating other ways to shelter income from taxation, made tax-exempt municipal bonds a more attractive investment for many individuals.

Mutual funds have facilitated investing in tax-exempt bonds by allowing individuals to buy in units as low as \$100. Directly purchasing a municipal bond usually requires an investment of at least \$5,000. For many individual investors, tax-exempt bonds are an important form of retirement savings; a significant percentage of municipal bond owners are retired.

Underwriters, Syndicates, Brokers and Dealers

Several participants in the public finance market help connect the country's 16,000 issuers with its millions of investors. First are the *underwriters* – investment banks that contract with the issuers to buy an entire bond issue at a set price, for resale to investors. On large issues, an underwriter organizes a *syndicate* of several firms, each of which commits to purchase a prescribed portion of the issue. The purchase price may be determined by negotiation, or by competitive bidding among several syndicates.

On larger or more complex issues, a state or local agency may also use a *financial advisor* – an expert firm that advises the agency on its financing strategy, and on how to structure particular issues, but that does not take part in those transactions. And in almost all cases, the issuer also retains a *bond counsel*, to assure investors that the borrowing is in full compliance with the law – especially those provisions of the Internal Revenue Code that govern exemption from federal taxes.

Once the issue is sold, syndicate members try to re-sell the bonds as quickly as possible. Members that have their own retail operations may sell some bonds directly to their own clients; bonds are also sold “wholesale” to other firms that specialize in retail sales, or to mutual funds and institutions.

The bonds can then be traded freely in the secondary market. The “muni” market does not operate via a centralized exchange. It is instead an over-the-counter market – a loose network of dealers and brokers that connect buyers and sellers. (*Dealers* are firms that trade both on behalf of clients and for their own accounts; *brokers* trade only on behalf of clients.) The municipal market is not subject to the detailed regulatory controls that the Securities and Exchange Commission imposes on the markets for stocks and corporate bonds, and municipal securities are exempt from the registration requirements imposed by the Securities Act of 1933.

The Role of the Rating Agencies

Because of the large number of issuers, and the variations in credit quality that can occur from one issue to another, investors often seek some independent measure of the quality of municipal securities. This service is provided by rating agencies -- primarily Standard & Poor's Corporation, Moody's Investors Service, Inc., and Fitch Investors Service, Inc. They assign credit ratings based on their analysis of an issuer's ability to make interest payments and repay principal in a timely manner. Their ratings range from triple-A for securities of the highest quality to D for those already in default.

Bonds rated triple-B and above are generally characterized as “investment grade,” meaning that they have a high probability of being repaid and have few speculative features. Bonds with lower ratings carry higher risks, but they also pay the buyer higher interest rates to compensate for that risk.

About a quarter of all new issues are unrated and they tend to be relatively small. Being unrated does not necessarily imply that a particular bond carries a higher level of risk; it means simply that the issuer did not apply for a rating. A 1993 study of unrated municipal bonds by the then Public Securities Association (now the Bond Market Association) found that the default rate on these issues for the years 1986 through 1991 was 1.1 percent – only slightly higher than that for rated issues.

Financial Guaranty Insurance

One of the most important developments in the field of public finance in the past three decades has been the growing use of financial guaranty insurance to enhance the quality of municipal securities. Financial guaranty insurance provides an irrevocable guaranty that scheduled interest and principal payments will still be made, should the issuer of an insured bond default on its obligations. Rating agencies judge the quality of insured bonds not on the strength of the issuer, but on the claims-paying capacity of the insurer. The leading financial guaranty insurers – all highly rated – in effect let issuers “borrow” their credit ratings, and collect insurance premiums in return.

The Origins of Financial Guaranty Insurance

The first company to offer financial guaranty insurance was AMBAC Indemnity, which began writing policies in the early 1970s. It was quickly followed into the market by the Municipal Bond Insurance Association, a consortium of insurers that initially included Aetna Life and Casualty, St. Paul Fire and Marine, and Crum and Forster. (Both AMBAC and MBIA are now publicly traded companies.)

At first, few issuers or investors were convinced of the value of financial guaranty insurance. State and local governments had little trouble marketing their securities, and investors generally saw them as being quite safe. Moreover, most municipal bonds were held by commercial banks and other large institutions that were confident in their own ability to judge the quality of the bonds, without having to pay for the added security that financial guaranty insurance offered.

Over the course of the next decade, however, changes in the municipal finance market began to alter the outlook of both investors and issuers. In the mid-1970s, New York’s fiscal crisis resulted in a moratorium being imposed on payments to short-term note holders. At the same time, one of the New York State’s largest and most visible public authorities, the Urban Development Corporation (UDC), also defaulted. All of New York City’s and UDC’s obligations were ultimately paid off, but to many investors, municipal securities began to seem less secure. Other large cities also encountered serious fiscal problems in the late 1970s, which further heightened investor sensitivity.

A Decade of Growth

Then in 1983, the Washington Public Power Supply System (WPPSS) defaulted on \$2.25 billion in revenue bonds that had been issued to finance construction of several nuclear power plants. For the first time since the Depression, investors in municipal bonds confronted the reality of very large losses. The high level of security provided by financial guaranty insurance began to seem to many investors to be well worth the cost, which in actuality is only a slightly lower coupon rate than the equivalent bond without insurance. And as greater investor sensitivity to risk began to translate into higher rates on bonds with anything less than the highest ratings, issuers too found that the reduced interest costs associated with a higher credit rating offset the cost of the bond insurance premiums.

The growing demand for bond insurance led several new companies to enter the field. A group of companies that included General Electric Capital (“GE Capital”), Kemper Insurance Company, Merrill Lynch & Co., J.P. Morgan & Co., General Reinsurance and Shearson established Financial Guaranty Insurance Company (“FGIC”). Another group including American International Group, Xerox, Bankers Trust, GEICO and Salomon Bros. created Bond Investors Guaranty (“BIG”). (FGIC continues to be one of the major financial guaranty companies, though under different private ownership; and BIG later merged with MBIA.) Today, the industry is made up of eleven insurers and reinsurers of high quality municipal bonds and asset-backed securities. Eight companies have a triple-A claims-paying ability rating, two companies have a double-A rating, and one company is, by design, single-A rated.¹

The demand for financial guaranty insurance has grown steadily. Its appeal has been especially strong among individual investors who, as noted earlier, have become the dominant buyers of municipal bonds. For the past five years, approximately half of all new municipal bonds have been insured. In the first half of 2005, according to Thomson Financial, the penetration rate of insured bonds increased to 61 percent.

How Financial Guaranty Insurance Works

Financial guaranty insurance is sold mostly in the primary market – that is, bonds are insured at the time of issuance. Before determining whether to insure a particular issue, and what premium to charge, insurers carefully examine the overall financial health of the issuer, its current indebtedness, the particular revenue streams (if any) that are pledged to the bond, the underlying economic strength of the issuer’s community, and any other factors that might affect the issuer’s ability to pay.

Financial guaranty insurers are conservative in their judgment of issues for which insurance is requested. In many cases, however, the answer to such requests is not simply *yes* or *no*. The financial guaranty insurers’ analysts often work with state and

¹ A list the members of the Association of Financial Guaranty Insurance can be found at: www.afgi.org.

local officials to identify weaknesses in the credit structure of a particular issue, and suggest changes that would make it more insurable.

In some cases, an insurer will be asked to guaranty a bond, because of the company's intimate knowledge of the issuer's finances. In other cases, however, issuers invite competing bids from several insurers. Price competition is vigorous, and helps reduce the overall cost of borrowing for state and local governments.

When a policy is written, the premium is typically paid up-front in one lump-sum payment. (Premiums vary based on the degree of risk an issue presents, but are generally in the range .25 to .75 of one percent of the principal and interest being insured – or, in the jargon of the financial community, 25 to 75 basis points.) Premiums paid up-front are not immediately booked as income, however. Insurance regulations require that they be deposited in a reserve, and that they are then “earned” over time as the issuer makes payments on the bond issue, thus gradually reducing the insurer's exposure.

After the Bond Is Issued

While most insurance is written at the time a bond is issued, some – about 5 percent to 10 percent in 2004 – is written in the secondary market. In these cases, a dealer or broker will request insurance on a block of bonds from an issue that was not originally insured. The process for insuring these bonds is otherwise similar to that which occurs in the primary market.

Once a policy is in place, the insurer continually watches over the financial health of the issuer. This surveillance function facilitates early detection of any problems that might affect an issuer's ability to meet its obligations.

Reinsurance plays an important role in the financial guaranty industry. The primary insurers often “cede” a portion of their exposure, and a corresponding portion of the premiums they collect, to a financial guaranty reinsurer. This allows the primary insurers to spread the risks they incur – especially on a large bond issue. On average, the primary insurers cede about 10 percent to 20 percent of their exposure to financial guaranty reinsurers.

In the relatively rare case of default, the insurance contract calls for payments of interest and principal to be made to the bondholder as originally scheduled. While payments to investors are thus secure, the insurer will often work with the issuer to “cure” the default, in order to minimize its own losses.

Who Are the Financial Guaranty Insurers?

There are eleven insurers and reinsurers of municipal bonds in the United States that are members of the Association of Financial Guaranty Insurers (“AFGI”).² All of these companies are “monoline” insurers – that is, their only business is providing financial

² Ibid.

guarantees. Their claims-paying capacity is thus not vulnerable to the kinds of losses that “multi-line” insurance companies have suffered in areas such as property and casualty insurance and real estate finance.

Maintaining Claims-Paying Capacity

Financial guaranty insurers are subject to strict regulations governing the adequacy of their reserves, and how these funds can be invested. The financial strength of the AFGI members, which consists of the eleven insurers and reinsurers of municipal bonds, has increased every year since the inception of the association. Qualified statutory capital (consisting of policyholders’ surplus and contingency reserves) of the eleven monoline insurers and reinsurers stood at \$20.7 billion at the end of 2005. This compares to \$6.5 billion ten years ago. At the end of 2005, claims-paying resources totaled over \$41 billion.

The maintenance of a strong capital base – and the ability to acquire additional equity capital, whether generating it internally out of annual earnings, or obtaining it through the public capital markets or from corporate parents – is vital to the industry’s future. It is essential not only to maintaining their investment grade rating, but also to meeting issuers’ and investors’ appetite for financial guaranty insurance.

The Benefits Of Financial Guaranty Insurance

The foremost value that financial guaranty insurance provides is security. Municipal bonds are the safest investment now available other than U.S. Treasury securities – but no investment is completely safe. Less than 1 percent of the municipal bonds issued since the Second World War have defaulted; while defaults are relatively rare, they can be devastating for those who have invested heavily in a particular issue.

Over the past decade, we have, however, witnessed an increase in the incidence of default. This increase may in part reflect strains on state and local finances; but it also reflects longer-term financial problems in areas such as low- and moderate-income housing development, and the increased use of higher-risk financing techniques such as leases that are dependent on annual appropriations from state or local legislatures. Defaults are thus likely to remain an unfortunate fact of life in the municipal finance markets.

In times of financial stress, financial guaranty insurance provides investors with the *unconditional and irrevocable* guaranty of the financial guaranty insurers that, regardless of the fortunes of the issuer, interest and principal will be repaid on time and in full. In the 35-year history of the financial guaranty industry, no AFGI member company has ever failed to fulfill its payment obligations to insured bond investors.

Financial guaranty insurance also helps maintain the value of municipal securities in the secondary market. While it does not guarantee the price at which a bond will trade, financial guaranty insurance does help insulate municipal bond investments against

adverse market reactions. This is especially true where such problems are serious enough to result in a lowering of the issuer's credit rating. Because insured bonds reflect the rating of the insurer, they are more likely to retain their market value when an issuer's financial problems erode its ratings.

The near-bankruptcy of the city of Bridgeport, Connecticut in 1991 provides an interesting example. During that period, the value of uninsured Bridgeport GOs declined by 9 percent after the city filed for bankruptcy; but that of insured GOs declined over the same period by only 4 percent.

For Issuers

For the issuer, financial guaranty insurance can provide significant interest cost savings. A net reduction in interest rates of 25 basis points (1/4 of 1 percent) on a \$100 million bond will, for example reduce the borrower's interest payments by \$250,000 annually. Since the first municipal bond was insured in 1971, financial guaranty insurance has saved municipalities, and their taxpayers, approximately \$35 billion. These savings have been growing by over \$2 billion each year for the past 10 years. The rating that financial guaranty insurance affords can also provide an issuer with wider market access. Some municipal bond mutual funds, for example, purchase only insured issues.

As was noted previously, financial guaranty insurers can often help identify and correct weaknesses in the credit structure of a bond issue. They might, for example, suggest imposing stricter limits on additional borrowing, or "carving out" a portion of some local tax revenue to provide bondholders with an additional layer of security.

And for the Market

Financial guaranty insurance also helps to make the entire municipal finance market operate more efficiently. Because they are not so directly affected by the fluctuating fortunes of individual issuers, insured bonds improve the market's overall liquidity. Individual investors, institutions, and dealers can all be confident that they will have no difficulty selling insured bonds, whenever they wish to do so.

Financial guaranty insurance also provides a "bridge" between issuers and investors. The revenue streams that support bond issuers are becoming more diverse and complex. A single issue may be backed by revenues from several different sources of uneven quality. State and local governments are also beginning to use more complex financing methods – variable-rate demand bonds, swap provisions and other "derivative" techniques. While these methods may help states and localities maximize the value of their limited capital resources, they can also make it more difficult for investors – especially individual investors – to evaluate the quality of municipal securities. Financial guaranty insurance simultaneously reduces investor concern while enabling issuers to take advantage of financing techniques.

Conclusion

Financial guaranty insurers represent the long-term investment discipline that is essential to the ultimate success of a national public investment strategy. Their role is not transitory – in fact, on the contrary, bond insurers commit their own capital and expertise for as long as 30 years or more. The long-term perspective that this commitment requires can, and does, make a valuable contribution to the continuing national debate on public investment.