# The Hidden Risk in Municipal Bonds

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Investors generally regard municipal bonds as one of the safest investments – only Treasury bonds are less risky. But many of those bonds carry hidden risks. A proposed new SEC rule change will go a long way toward making investors aware of those risks.

Being a long-time municipal bond investor and advisor I have a framework of how a municipal bond should work. In essence it is quite simple. A community or one of its representatives decide that an essential service or facility needs development. They agree that if the community were to borrow funds to improve the sewers, schools, municipal buildings, sources of energy or other essential necessities could be created sooner. The people in charge – the politicians who represent the community –find an underwriter and financial advisor who will help them craft the borrowing. The bond issue is then sold to the public, including insurance companies, fund companies, advisors and individuals.

A general obligation bond is a bond backed by the full faith, credit and *ad valorem* taxes of the borrower. A revenue bond is backed by a stream of revenue for the life of the security. In exchange for buying the bonds, the purchaser will receive a stream of income – interest paid semi-annually – for the life of the bond. The bonds might have a call date, when the borrower call the bonds away, usually at 10-years – and a fixed maturity date.

The issuer receives the funds and the bond holder receives the interest and principal at maturity. This amounts to a clean deal and a method whereby investors can plan to pay for their children's education and envision a retirement with funding in place.

Unfortunately bonds are long-term investments and politicians are very short-term. They know they need to be re-elected and put the political issues before the long-term needs of the community. Politicians may have the skills to be elected, but not other necessary skills to run a fiscally sound government.

**What you don't know won't hurt you – really?**

Under SEC Rule 15c2-12, issuers of municipal bonds are required to disclose events that might impact an investment in their bonds.**[i]** However, issuers are entitled to decide if the event is "material" or significant enough to require reporting. Investors are told that they should look at the material events before purchasing a bond and continue to monitor them to evaluate current holdings. However, the recent push by the Securities and Exchange Commission (SEC) to add protections for investors makes it clear just how much investors and industry participants are kept in the dark.

Currently, issuers must post an event through the Electronic Municipal Market Access (EMMA), according to the Municipal Securities Rulemaking Board (MSRB). An event must be disclosed, if material, under the SEC rule.

These events include the following, if material:

- Principal and interest payment delinquencies and non-payment related defaults
- Unscheduled draws on debt and credit service reserves reflecting financial difficulties
- Substitution of credit or liquidity providers, or their failure to perform
- Adverse tax opinions or events affecting the tax-exempt status of the security
- Modifications to rights of securities holders and/or bond calls
- Defeasances
- Release, substitution, or sale of property securing repayment of the securities
- Rating changes
- Financial reporting
- Bankruptcy

The issuer has the right to decide if any of these actions are "material."

What do investors see when they review material events? They see rating changes, notice whether financial statements have been timely filed and a record of any bond calls.

But when a municipality is having problems, they generally fail to file their financials. There is no clarification as to the problems causing the failure to file. Investors are unaware of those problems.

**SEC Rule 15c2-12 Continuing Disclosure**

The SEC is trying to add some protections for investors by requiring issuers to disclose bank loans, private placements and derivatives. Currently issuers are not required to disclose them.

Where these loans exist, they may take priority over bond holders. The bank may have the ability to accelerate a loan payment or adjust interest payments if certain events occur, which compromise the issuer's ability to service its bonds.

For example, Standard & Poor's analysts[ii] found a costly clause in reviewing bank agreements of the town of Lawrence, Wisconsin. The clause stated that banks could demand immediate repayment if it decided the town had turned into a "mounting financial risk" for the bank. Lawrence, Wisconsin is a town of 4,600 persons, eight miles south of Green Bay. By 2015 it had borrowed $4.6 million from banks, about three times its annual revenue. Under current material event rules, it and other municipalities do not have to disclose bank loans because they are not securities. Upon review in 2015, S&P immediately cut Lawrence, Wisconsin's rating from AA to BB+. Under current reporting standards, cities and states may eventually disclose the existence of these bank loans, but they do not have to describe key provisions.

Under its Rule 15c2-12, the SEC would require material event notices be filed for a broad range of "financial obligations" … including guarantees and monetary obligations resulting from a judicial, administrative or arbitration proceeding." In addition, any modification of terms or other actions that are detrimental to the bondholder would have to be disclosed as a material event.[iii]

Though bondholders may feel confident they have senior and parity debt, it may in fact become subordinate to a bank or other lender. It may have triggers that lead to loan adjustments that even the borrowing entity may not be aware of if they are small unsophisticated borrowers.

Off-balance-sheet financings are very material to bond buyers, whether they are purchasing bonds directly or through a fund. According to Lynette Kelly, the executive director of the MRSB, "Until the amount and terms of these loans are understood, there's no way to assess the likelihood of a crisis in the making, one that could result in thousands of bank-leveraged bridges and millions of burned bondholders."[iv]

**Conclusion**

Recently, I listened to a *Freakonomics* episode moderated by Stephen Dubner on the work of Katherine Milkman and Angela Duckworth. They were discussing questions like: What do you have to do to make people's lives better? How do you translate individual behavior change to population behavior change? How do you make people change?

In the world of politics and government, shedding light on situations that had formally functioned in the shadows is the beginning. If the SEC is successful in expanding the reporting of material events, or as Vanguard[v] suggests just reporting events and letting the bond buyer decide if they are material, it would blow up the silos of political and financial operatives. Once it is necessary to report bank loans, risky swaps and other heavy financial decisions such as the expansion of pension and health care liabilities, there will be a marked increase in transparency for municipal finance.

There would be incentives for politicians to exhibit good financial behavior and not cave in to external pressures. We cannot assume that people will do the right thing. We need to attack the problem at the root by ensuring there will be financial transparency. Only in this way can we make the behavioral changes to produce financially healthy municipalities stick.

As Stephen Dubner asked: Which would you rather have – a vaccine against the disease or the treatment? Right now what we have in our states, cities and localities, is a painful treatment for the neglect of their financial health. Shedding light on the financial process will result in a behavior change producing healthier economies and governments that can balance current demands against long-term goals and desired outcomes. It will clarify risk-taking.

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*Secure Investment Growth, Bloomberg Press, 2011 second edition.*

[i] http://www.msrb.org/msrb1/pdfs/SECRule15c2-12.pdf

[ii] Martin C .Braun. “Swift dissent to junk shows buried risk as municipal loans s surge,” The Bond Buyer. October 5, 2015.

[iii] Jack Casey. Analysts. “Some issuers don’t see how they and holders of their bonds can be hurt by bank loans**.”** The Bond Buyer, May 18, 2017.

[iv] Lynette Kelly. “The Hidden Risks of a Growing Way to pay for Infrastructure.” http://www.governing.com/gov-institute/voices/col-transparency-disclosure-bank-loans-infrastructure.html

[v] Jack Casey. “Bankers want reductions in event disclosures, investors want more information” The Bond Buyer. May 25, 2017.