A

ability to pay

Municipal bond analysts make two assessments when considering a government's creditworthiness: its ability to pay its debts and its willingness to pay. Ability refers to an issuer's relative financial condition. If a municipality is open for business and can levy fees and taxes, investors expect it to pay its bills and to repay its loans, even if it has to raise those taxes and fees to do so. Willingness to pay is far more difficult to judge, as it deals with political will at a point in time.

See also Orange County, California; willingness to pay.

acceleration

A provision, normally present in a bond indenture agreement, mortgage, or other contract, that the unpaid balance is to become due and payable if specified events of default should occur. These include failure to meet interest, principal, or sinking fund payments; insolvency; and nonpayment of taxes on mortgaged property.

Source:

Mysak, Joe. *The Handbook for Muni-Bond Issuers.* Princeton, NJ: Bloomberg Press, 1998.

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additional bonds test

A legal requirement that new additional bonds, which will have a claim on revenues already pledged to repay outstanding revenue bonds, can be issued only if certain financial or other conditions are met.

advance refunding

An advance refunding is a refinancing of a bond issue that will remain outstanding for more than 90 days after the sale of the refunding bonds, and is most often done to save money. Issuers are prohibited from doing more than one advance refunding per issue.

The issuer sells new bonds and uses the proceeds to buy either special State and Local Government Series securities from the U.S. Treasury or open-market Treasury or agency securities, and deposits them into an escrow account that will be used to pay off the refunded bonds at a call date or maturity. Tax law in general prohibits most municipalities from earning profits on the proceeds of bond issues, which is called arbitrage. In other words, the securities in escrow cannot spin off more in yield than the yield on the refunding bonds. If they do, the issuer must rebate the difference to the Treasury.

The refunded bonds are said to be prerefunded or escrowed to maturity. They usually rise in value because they are now secured not by an issuer's pledge but by a pot of top-rated Treasury securities. Most prerefunded bonds have maturities of five years or less, Bank of America Merrill Lynch Municipal Bond Strategist John Hallacy estimated in October 2010.

See also escrowed to maturity; prerefunded bonds; refunding; yield burning.

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advertised sale

An advertised sale is also known as an auction sale or, most commonly, a competitive sale. So-called because the issuer places a notice in a newspaper that it intends to offer bonds for sale and invites bidders.

See also competitive sale; negotiated sale.

"All bonds go to heaven"

This is an old market axiom describing how municipal bonds are bought and held, and rarely trade, after they are sold in the new-issue market. Trading is most active in the first 30 days of a bond's life, according to the Municipal Securities Rulemaking Board's transaction reports. This also helps explain why prices on outstanding municipal bonds rarely react to news in the way stock prices do.

The Securities and Exchange Commission's Office of Economic Analysis and Office of Municipal Securities studied municipal trading between December 12, 1999, and October 31, 2000, and found that about one-third of all bond issuers with outstanding debt had no trades in their securities during the period; about two-thirds had 25 or fewer trades; only 2 percent of issuers had 1,000 or more trades in their securities. In terms of the bonds themselves, about 70 percent did not trade at all during the period; another 15 percent traded five or fewer times; less than 1 percent traded more than 100 times.

See also issuer concentration; market activity.

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Ambac

The nation's first municipal bond insurer, founded in 1971.

See also insurance.

AMT

The Alternative Minimum Tax (AMT) was first introduced as part of the Tax Reform Act of 1986 to ensure that taxpayers pay some federal income tax. For taxpayers subject to the AMT, "certain tax preference items, including interest on some private activity bonds, otherwise not subject to taxation are added to the gross income of the taxpayer for calculating the federal income tax liability," says the MSRB. The American Recovery and Reinvestment Act of 2009 exempted these kinds of private-activity bonds from the tax during 2009 and 2010. About 3.9 million taxpayers were subject to the AMT in 2008. Onerous to calculate and unpopular with taxpayers, the AMT seemed a likely target for tax reform in 2011.

About 6 percent of new bonds are AMT bonds, Citigroup estimated in 2011, and over the years they have typically offered investors yield premiums of 30 to 50 basis points, although during the crisis year of 2008, this increased to almost 150 basis points. Most airport and other port bonds are subject to the AMT, as are industrial development bonds. Citigroup estimated that the AMT tends to be paid mainly by taxpayers making between $100,000 and $500,000 in adjusted gross income.

See also Mrs. Dodge; tax-exemption.

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appropriation

The act of setting aside money to pay debt service on bonds or certificates of participation. Issuers of appropriation-backed securities usually state that their lawmakers may make such appropriations, but usually caution that they are not legally obligated to do so. Securities that rely solely on a government's promise to set aside money are marginally more risky than credits where the money is automatically budgeted.

Certificates of participation are backed by appropriations, while general obligation bonds are secured, with certain exceptions, by a municipality's full faith and credit pledge of taxes.

See also risk factors.

arbitrage

In municipal finance, arbitrage refers to making a profit by borrowing at tax-exempt rates and investing in higher-yielding securities. This is forbidden by tax law, and the excess earnings must be rebated to the government. So-called arbitrage bonds are securities deemed by the Internal Revenue Service to have been issued not to make loans, but purely to make profits through an investment in guaranteed investment agreements. During the 1980s, various securities firms designed different securities structures to earn arbitrage, which were then investigated and often prohibited by the Internal Revenue Service. The Tax Reform Act of 1986 and subsequent amendments to tax law more sharply defined arbitrage and prescribed rebate requirements.

Arkansas Default of 1933

Arkansas is the most recent state to default on its general obligation bonds, and it did so in 1933, during the Great Depression. The default was remedied within months, but it took eight years and the federal government's help to solve the underlying problem.

In 1927, Governor John S. Martineau proposed that the state assume the $54.8 million debt of hundreds of troubled road improvement districts and embark on the construction of a highway system. Combined with the state's own $84 million in highway bonds and $7.2 million in toll-bridge securities, the assumption of district bonds pushed Arkansas's debt to $146 million. Coupons on the bonds were as much as 5 percent.

"We have a state ranking 46th in per-capita wealth in 1929, ranking first in per-capita indebtedness" was how state Senator Lee Reaves summed up the matter in a 1943 article for the *Arkansas Historical Quarterly*. "Under the best of circumstances it would have been difficult to meet payments on the mounting debt."

The state tried refunding the bonds through an exchange program in 1932. This failed. In 1933, the General Assembly passed the Ellis Refunding

Act, which sought to exchange all outstanding highway debt for state bonds carrying a 3 percent coupon, maturing in 25 years.

"Interest on highway and toll-bridge bonds, amounting to $770,500, due March 1, is in default, and this fact spurred the Governor in his demand for a refunding program that would yield revenue sufficient to meet any emergency and insure stability to outstanding obligations," the *New York Times* reported.

Bondholders were having none of it. They went to Governor J. M. Futrell (who took office in January 1933), and protested that the new refunding violated the state's contract with bondholders, in that it replaced their first lien on automobile and gasoline taxes with the state's own full faith and credit pledge. Bondholders preferred their portion of a specific, dedicated revenue stream rather than the state's promise.

The bondholders—mainly northern and eastern banks and insurance companies—also said that reducing the interest rate amounted to partial "repudiation."

That was a loaded word in those days. Bond investors were still smarting from the repudiation of bonds used to finance railroads, the Confederacy, and various carpetbagger governments.

"There is a vast difference between repudiation and inability to pay," Governor Futrell told the *New York Times*. "Repudiation is refusal to pay when you are able to do so." The governor then took a shot at bond underwriters: "Arkansas has been oversold through a wrecking crew with the assistance of the bond buyers, despite their knowledge that the State highway issues were excessive. Although Arkansas has not received full benefit from its highway bonds, the state owes the debt, and will pay in time, but our peoples are struggling for existence and cannot pay additional taxes, nor meet present requirements."

The bondholders headed to Little Rock to negotiate. The state failed to make $10.5 million in bond payments on August 1.

In January 1934, the bondholders got a permanent injunction against the state, blocking the use of automobile and gasoline taxes for anything other than highway maintenance and debt service. Now "at the mercy of the bondholders," in the words of Senator Reaves's article, the state in 1934 agreed to a refunding that extended some maturities and required an increase in both those automobile and gasoline taxes.

That cured the 1933 default.

But the story does not end there. State officials said default would be again possible in 1944 when $12 million in principal and interest had to

be repaid, and probable in 1949 when $41.3 million would come due. So in 1937, and again in 1939, the state tried to refund its $140 million in highway bonds. The effort was rebuffed by bondholders both times.

On April 1, 1941, $90.8 million worth of the outstanding highway bonds was callable; an additional $45 million was callable on July 1. The state made plans for another (this time uncontested) refunding.

A syndicate of 250 banks said it would bid on the new Arkansas refunding bonds, in conjunction with the Reconstruction Finance Corporation (RFC), a creation of Herbert Hoover's administration and a decidedly new entrant into the municipal bond market.

On February 27, 1941, to Wall Street's shock, the RFC bought the entire issue single-handedly. "In our several conferences with the bankers, they indicated to us they would not bid for as much as $90 million and that the interest rate would have to be 3.5 percent," RFC Chairman Jesse Jones said. "We thought this rate too high for a tax-exempt bond of a sovereign state," he told the *New York Times*.

The RFC bid, which averaged 3.2 percent, saved Arkansas $28 million over the life of the bonds. The corporation later sold the securities to Wall Street banks at a profit of $4 million. Arkansas never looked back. Today, the state ranks 46th in tax-supported debt per capita, at $312, according to Moody's Investors Service.

See also Chapter 9; default; refunding; repudiation.

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auction-rate securities

Auction-rate securities (ARSs) are bonds with interest rates that are typically reset by bidding every 7, 14, 28, or 35 days. The market for these kinds of securities froze in February 2008, when the Wall Street firms running the sales stopped bidding on the deals, leaving investors with billions of dollars of bonds they could not sell. States and localities have not sold any new issues of auction-rate securities since then.

American Express Company sold the first issue of auction-rate securities in 1984, with a $350 million sale of money-market preferred shares with dividends reset every 49 days. The first tax-exempt auction-rate security was sold by Tucson Electric Power Company in 1988.

"From the beginning, banks were manipulating the market," wrote Bloomberg News in May 2008, after the market froze. The story continued, "In 1995, investors learned that Lehman settled allegations by the Securities and Exchange Commission that it improperly bid at some American Express auctions," manipulating the process 13 times to prevent auctions from failing, and paying a fine of $850,000.

There were a lot of reasons for issuers to like this bond structure, which is why the market eventually grew to $330 billion, about half of which was municipal. It allowed them to borrow for long terms, sometimes as much as 40 years or more, at very short-term rates. Unlike variable-rate demand obligations, auction-rate securities were sold without a put option, so the issuers did not have to pay for a liquidity provider. ARSs were rated as long-term debt, so the issuers did not have to pay for a short-term rating. The securities were usually callable at par at any time, and convertible to variable- or fixed-rate debt. Issuers sometimes hedged their floating-rate risk with swaps, and often also insured the transactions against default. In 2001, municipal issuers sold $11 billion in auction-rate debt; in 2004, they sold a record $42 billion, and in 2007, $38.7 billion.

Investors, chiefly corporate cash managers and high-net-worth individuals, liked auction-rate paper because the securities paid them a little more in yield than they could earn in Treasury securities and money-market funds. And in the case of failed auctions, where there were more sellers than buyers, holders of some securities received a penalty rate, sometimes in the double digits. Not that auctions ever seemed to fail. From the market's origins in 1984 to 2006, there were only 13 failed auctions, according to Moody's Investors Service, out of the thousands held.

Issuers got to borrow at very low rates. Investors got a little more yield. The securities firms liked the market because it provided a regular stream of fee income after the initial bonds were sold; the underwriters also ran the regularly scheduled auctions.

In 2004, the SEC shook the market when it began an investigation into “deceptive, dishonest or unfair market practices” by auction-rate securities dealers. “There’s too much risk to both the investor and issuer for it to be a blind auction on such a frequent schedule,” Joseph Fichera of Saber Partners LLC, a financial advisory firm, an early critic of the process, commented at the time.

In May 2006, the commission fined 15 securities firms $13 million for sharing information about auctions and managing the process behind the scenes. Instead of prohibiting the practices, the SEC told the dealers they could continue managing the auctions in the way they always had, provided they told investors what they were doing. The Bond Market Association, a dealer organization, said it would put together “best practices” guidelines.

Underwriters began disclosing how these auctions worked. In August 2006, for example, the Culinary Institute of America sold $15 million in auction-rate revenue bonds to finance renovation and expansion at its Hyde Park, New York, campus.

On page 11 of the official statement, or offering document to the bonds, under “Bidding by Initial Broker-Dealer,” underwriter RBC Capital Markets spelled it all out. A broker-dealer was “permitted, but not obligated” to submit orders for its own account as a bidder or a seller, “and routinely does so in the auction rate securities market in its sole discretion.” The broker-dealer may place bids to prevent an auction from failing, or from clearing at a rate the dealer does not believe reflects the market, “even after obtaining knowledge of some or all of the other Orders submitted through it.” The broker-dealer may also “routinely encourage bidding by others in Auctions,” so that the auctions do not fail, or to prevent an auction from clearing at a rate that does not accurately reflect the market.

The head of the SEC’s Office of Municipal Securities expressed reservations about the process in September 2006, well after the settlement, saying it still was not being made clear to all investors that the sales were manipulated behind the scenes. Speaking at a conference in Chicago, the SEC’s Martha Haines observed that “it may not be accurate to call this an auction. I fear that investor and issuer confidence in the legitimacy of the market may be undermined unless market participants take active steps to address these issues.”

"The concern about the current auction process is that municipalities and companies that sell the bonds can't know whether they're getting the lowest borrowing costs and investors can't know whether they're overpaying," wrote Bloomberg's Darrell Preston.

Nothing much came of this intriguing pause. The auction-rate market hummed along until late 2007, when investors spooked by the subprime crisis and its impact on bond insurers forced yields higher; some auctions failed. In the week of February 13, 2008, the major dealers stopped bidding for the paper entirely, and then thousands of auctions failed.

The proximate cause of the death of the auction-rate securities market was the subprime crisis. Perhaps just as important, though, was a little-noticed March 2007 accounting rule change. When the Financial Accounting Standards Board started to require that auction-rate securities be listed on balance sheets as short-term investments rather than cash equivalents, the paper became less attractive to corporate and institutional investors. They began to sell. The Wall Street firms running the auctions took the paper off their hands—and sold it to individual investors.

This group, at the time estimated to number around 200,000, learned all about what happened when the nearly unthinkable occurred, and auctions failed, not once but again and again and again. They could see their money, they could collect yield, but they could not lay their hands on the principal. In some cases, usually those involving municipal securities, they got a higher penalty rate. This in turn spurred state and local issuers to convert the debt to variable or fixed rates, and so offered the holders redemption. Corporate issuers, including many closed-end funds that had sold auction-rate preferred shares, often had no such incentive. Even if they paid a penalty rate, it was usually capped. Investors found that these issuers were under no obligation to buy back debt that might not mature for 30 or 40 years or that even, in some cases, was perpetual. The dealers who originally sold them the investments no longer wanted to bid, although they were still paid to run the auctions.

It soon became apparent that most individual investors had not quite appreciated what they were getting themselves into, and that many of the brokers who sold the securities to them did not quite understand what they were selling, in many cases marketing auction-rate paper as a sort of cash equivalent that was very safe and very liquid. Unsurprisingly, few buyers bothered to read prospectuses or offering documents detailing what they were purchasing, even if they were readily available. There were a lot of angry investors.

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The states got involved soon after the freeze, with New York Attorney General Andrew Cuomo and Massachusetts Secretary of State William Galvin leading the effort to reunite investors with their money.

"One of the developments from the ARS episode is that securities regulators at the state level, organized through the North American Securities Administrators Association, as well as certain state Attorneys General, undertook a large number of coordinated actions, in cooperation with the SEC and FINRA, to achieve dealer repurchases of ARS sold to their customers," wrote financial adviser and lawyer Robert Doty in his 2010 book, *From Turmoil to Tomorrow*.

"This broad nationally coordinated effort . . . raises questions about whether there may be more state involvement in the municipal securities market in the future," wrote Doty. "State securities laws generally contain antifraud and anti-negligence provisions, often with longer statutes of limitation than under federal law and an easier reach toward secondary parties."

Municipal issuers rushed to convert their auction-rate paper, often using the same underwriters that had put together the auction deals in the first place; fund companies with national reputations to protect, such as Nuveen Investments Inc. and Eaton Vance Corporation, as early as March announced they were working on ways to offer stuck customers their money back, or "liquidity at par," as it was called.

The gridlock among the dealers was not really remedied until that summer. Massachusetts Secretary of State Galvin filed administrative complaints against UBS Securities on June 26 and then against Merrill Lynch & Company on July 31. The complaints spelled out in excruciating detail how the market collapsed, and were punctuated by embarrassing e-mails from bankers demanding that analysts produce more helpful reports about what an "opportunity" auction-rate securities represented, and in some cases exulting at the wave of new business from issuers desperate to convert their auction-rate bonds to fixed-rate instruments.

UBS, Merrill, and Citigroup announced plans to buy back individual investors' auction paper in early August. They were not the only entities affected by the freeze; institutions also owned auction-rate securities, as did states and municipalities. In November 2010, Citigroup agreed to buy back $869 million of auction-rate securities backed by federally guaranteed student loans it had sold the state, as well as repay Massachusetts for losses on $200 million it had sold. The state made its first investments in student-loan ARSs in 1998.

See also variable-rate demand obligations; window bonds.

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auction sale

See advertised sale; negotiated sale.

authorities

The proliferation of bond-issuing authorities is a periodically contentious issue in public finance. These creations, responsible only to the state and sometimes not even then, have been called unaccountable, a shadow government, and worse. Critics say their establishment and use subverts democracy and defies the will of the people. Proponents say authorities are

indispensable and allow governments to finance much-needed, long-term projects that might otherwise never see the light of day. What is inarguable is their proliferation. Of the 89,476 governmental entities in the Census Bureau's Census of Governments of 2007, 37,381 were "special districts," a number that includes authorities but excludes school districts.

The first authority in the United States was established by compact between the states of New York and New Jersey in 1921. The Port of New York Authority, as it was then called, was modeled after the Port of London Authority, founded in 1908. The London entity got its name from the legislation setting it up: almost every paragraph began with "Authority is hereby given." A key feature of the Port of New York Authority was that it be self-supporting, despite not having any taxing power of its own.

This is still a feature of many of the authorities established today. They are created to finance projects off-budget and without the use of taxes or the approval of voters. The bonds they sell are secured by user fees, such as tolls, although sometimes municipalities may pledge to make up shortfalls in debt service.

Not all authorities are alike. Authorities are often set up to finance single ventures, such as convention centers or stadiums. Some authorities are set up to help finance job creation in the private sector, such as the Arkansas Development Finance Authority, which acts as a conduit, selling tax-exempt industrial development bonds on behalf of corporate issuers. And there are authorities set up specifically to help finance campus housing, like the New York Dormitory Authority, or college and hospital expansion, like the New Hampshire Health and Education Facilities Finance Authority.

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