

## Municipal Bonds: FAQs

# Frequently Asked Questions About Municipal Bonds

### What are municipal bonds?

Municipal bonds (“muni bonds”) are debt securities issued by state and local governments, or their authorized agencies, to borrow or raise money for public purposes such as building schools, highways, or hospitals. When you purchase a municipal bond, you lend money to the “issuer” (i.e., the government entity that issued the bond), which, in turn, pays a set amount of interest while you hold the bond and returns your principal investment on a specified maturity date.

A primary feature of many municipal bonds is that the interest income an investor receives is generally exempt from federal income tax. The interest may also be exempt from state and local taxes if the investor lives in the state where the bond is issued. Municipal bonds, therefore, also are known as tax-exempt bonds.

Because they offer tax-free income, municipal bonds generally have annual yields below those of corporate bonds or U.S. Treasury bonds. These low yields allow state and local governments to borrow money for public projects at below market rates.

### How are municipal bonds traded?

The municipal, or “muni,” market does not operate via a centralized exchange. Instead, it is an over-the-counter market—a network of dealers and brokers that connect buyers and sellers. Some bonds are “actively traded,” meaning that they are traded on a regular basis. However, many investors buy and hold their bonds until they mature, so certain municipal bonds may not trade for months or years at a time.

Securities dealers that trade municipal securities must register with the Municipal Securities Rulemaking Board (MSRB), which sets the rules for the municipal bond market subject to the oversight

of the U.S. Securities and Exchange Commission (SEC).

## Who owns municipal bonds?

Individual, or “retail,” investors are the largest holders of municipal securities. They hold 35 percent of municipal bonds directly and another 36 percent indirectly through mutual funds, closed-end funds, UITs, and ETFs. According to ICI’s most recent data, investment companies of all types hold \$907 billion, or 36 percent, of the \$2.5 trillion municipal bond market. Mutual funds alone account for 32 percent of all U.S. municipal securities, totaling over \$809 billion. Closed-end funds hold 4 percent, totaling \$89 billion; municipal bond UITs hold \$8 billion; and ETFs that track municipal bond indices hold \$575 million in assets.

## How are municipal bonds regulated?

Unlike registered investment companies, issuers of municipal securities do not have to file registration statements with the SEC. However, information about these issuers, including details of their financial condition, is available from various sources.

## What is the role of credit rating agencies related to municipal bonds?

One way to evaluate a municipal securities issuer is to examine its credit rating. Credit rating agencies assign credit ratings based on their analysis of an issuer’s ability to make interest payments and repay principal in a timely manner. (Credit rating agencies also grade corporate bonds, but their analysis of corporate bonds differs from their analysis of municipal bonds.)

Bonds rated BBB or Baa, or better, are characterized as “investment grade,” meaning that they have a high probability of being repaid and have few speculative features. Municipal bonds with lower or no ratings carry higher risks, but may also pay the investor higher interest rates to compensate for that risk.

In addition to the ratings provided by credit rating agencies, most institutional investors, including investment companies, conduct their own credit analysis.

## What is bond insurance?

Bond insurance is a type of credit enhancement. A bond insurer unconditionally and irrevocably guarantees that interest and principal will be paid as scheduled—on time and in full—even if the bond issuer defaults. If a bond carries insurance, it typically is insured in the primary market, at the time of issuance, but it may be insured at any time in the secondary market. For some small municipal issuers, access to capital markets is made more affordable by the use of a credit enhancement like bond

insurance.

Many of today's municipal bonds are insured by monoline insurers, or insurers that back debt securities only and are not exposed to risks from any other lines of business. They may, however, be exposed to other forms of risk (i.e., interest rate risk, market risk, etc.) Monoline insurers must meet the requirements of insurance regulators in every state where they do business. They are closely monitored by the major credit rating agencies.

Monoline insurers conduct an underwriting process before insuring a municipal bond: the insurers examine the issuer's tax base (if applicable) and operations, regional economy, financial condition, existing debt, expected future borrowing, and spending requirements, as well as the legal provisions securing the bonds.

Bond issuers, or the investment banks and securities dealers that sell the bonds, typically pay the insurance premiums. There are no direct charges for investors, but the investor may earn less income than if the bond were not insured because of the added protection provided by the insurance.

## Why do bond issuers buy insurance?

Bond issuers use bond insurance because it improves the credit quality of a bond, making it easier to sell. Bond insurance boosts credit quality by offering protection against default or downgrade if a bond issuer cannot meet its obligations to pay interest and principal to bondholders.

Insured municipal bonds are rated based on the credit of the insurer (based on its claims-paying ability) rather than the underlying credit of the issuer. Historically, this has improved the credit rating of the bond. A higher credit rating allows the issuer to benefit from lower financing costs because bonds with high ratings—and, therefore, greater security—pay lower interest rates. This also leads to enhanced liquidity for insured bonds because there is greater demand among investors for highly rated securities.

Accordingly, an issuer may seek bond insurance for a number of reasons. If a bond issuer's credit would not earn a high rating, bond insurance could improve the credit quality of the bond. But even highly rated bond issuers use bond insurance—to lower the costs of borrowing.

## How are monoline insurers rated?

Credit rating agencies frequently evaluate bond insurers' claims-paying ability—through detailed analyses of financial resources, operations, and exposures—and publish regular reports on each insurer. Credit rating agencies look at key indicators, including the quality of the insured portfolio, capital adequacy, financial performance, operating efficiency, risk management, liquidity of assets, reinsurance, business viability, ownership, and the skill and experience of management.

## What happens if a monoline insurer is downgraded?

Because an insured bond carries the rating of the bond insurer, the bond's rating will be downgraded when a monoline insurer is downgraded. With a lower credit rating, the market value (i.e., price) of the underlying municipal bond could fall because the perceived risk of owning the bond has increased. The presence of an insurance policy alone does not guarantee a municipal bond's price in the secondary market. As with any other security, the actual price is determined by the market at the time of resale. Municipal bonds sold prior to maturity may be worth more or less than their original cost. Generally, if the price of a municipal bond drops, higher yields will follow.

As noted above, however, some issuers obtain bond insurance primarily to lower their costs of borrowing. If these issuers carry a credit rating independent of the credit rating from the monoline insurer, market participants may "look through" or disregard the downgrade of the insurer. Depending on the market at the time of resale, this might enable the issuer to maintain a higher trading price.

Presently, the credit ratings of certain insurers are under review due to subprime lending exposure that threatens their ability to pay claims. This, in turn, has resulted in some rating downgrades. Municipal bond funds and money market funds holding municipal bonds face certain regulatory requirements regarding the quality of the securities held in their portfolios. These funds also state in their prospectuses that they will only hold securities of a certain quality. If these funds hold securities that have been downgraded because they are insured by downgraded monoline insurers, the funds may have to determine whether they can continue to hold those bonds.

In the long term, the inability of monoline insurers to maintain high credit ratings may restrict the supply of high quality, short-term securities for municipal [money market funds](#) and other municipal bond funds.

## What is the credit quality of most of the underlying municipal bonds?

Monoline insurers typically insure only municipal bonds that are of investment-grade quality on their own. The underlying bonds may or may not be rated by a credit rating agency. A bond without a rating does not necessarily carry a higher level of risk; it simply means that the issuer did not apply for an underlying rating (a rating on the uninsured bond), possibly because it did not want to incur the additional cost.

## What other types of municipal securities are insured by monoline insurers?

In addition to traditional municipal bonds, monoline insurers provide insurance for variable-rate demand obligations (VRDOs) and tender option bonds (TOBs). Monoline insurers also insure structured finance bonds and certain international debt securities.

# What are variable rate demand obligations and tender option bonds?

Variable-rate demand obligations (VRDOs) are debt securities that bear interest at a floating, or variable, rate adjusted at specified intervals (daily, weekly, or monthly) according to a specific index or through a remarketing process. Holders can redeem these securities at designated times. Issuers offer VRDOs in order to access the short-term market to obtain lower interest rates. Tender option bonds (TOBs) are similar to VRDOs but are synthetically created by a bond dealer with long-term bonds purchased in either the primary or secondary markets. Both VRDOs and TOBs are short-term, tax-exempt instruments whose yield is reset daily or weekly based on an index of short-term municipal rates.

VRDOs and TOBs are purchased at par, the face value of the security. Each structure includes a liquidity facility which provides a “put” or demand feature. This allows the bondholder (e.g., a fund) to put the security back to the remarketing agent and receive face value plus accrued interest with specified notice. A remarketing agent—a bank or other entity—helps to make a market for the securities and ensures that a holder’s put is honored by reselling the products, holding them in its own inventory, or arranging for the holder to be paid from the bank liquidity facility. In addition to providing a source of cash to satisfy redemptions by fund shareholders, these liquidity features operate to shorten the long-term bonds’ maturity and make them appropriate for a [money market fund](#).

## What is the credit quality of VRDOs and TOBs?

Most VRDOs and TOBs are highly rated due to credit enhancements (such as bond insurance or letters of credit), which guarantee timely principal and interest payments, as well as the liquidity facility, which provides payment for tendered bonds. In most cases, the liquidity facility requires that the municipal bonds maintain certain credit ratings. Consequently, like insured municipal bonds, VRDOs and TOBs may be affected when monoline insurers are downgraded. For example, a downgrade of the monoline insurer may trigger a “termination event” that releases the liquidity facility from its obligation to buy back the security.

Funds are taking action in advance of this possibility. Some funds are unloading the securities from their portfolios by exercising the put feature to the remarketing agent, thereby receiving par and accrued interest for the security. Other funds are obtaining changes to their contracts with liquidity providers to preserve the liquidity facility regardless of the monoline insurer’s rating, by linking the termination events to the credit rating of the underlying issuer and/or the monoline insurer.

A [money market fund](#) that holds VRDOs or TOBs in its portfolio may have to review whether it may continue to hold securities that are enhanced by the downgraded monoline insurer.

## What is an auction rate security?

Auction rate securities (ARS) are municipal securities with a variable interest rate that is set periodically through a “Dutch Auction” process. Auctions are typically held every 7, 28, or 35 days, and interest on these securities is paid at the end of each auction period. ARS trade at par and are callable at par on any interest payment date at the option of the issuer. Although ARS are issued and rated as long-term municipal bonds (20 to 30 years), they are priced and traded as short-term instruments because of the liquidity provided through the interest rate reset mechanism.

During the auction, a broker-dealer submits bids, on behalf of current and prospective investors, to the auction agent—typically a bank. Based on the submitted bids, the auction agent will set the next interest rate by determining the “clearing rate,” the lowest rate to clear the total outstanding amount of ARS. The program documents for an ARS also define situations under which a “maximum rate” is used for the next interest rate period. Generally, the maximum rate is a multiple of a specified index or a fixed rate.

Unlike TOBs and VRDOs, ARS holders do not have the right to put their securities back to the issuer; so a bank liquidity facility is not required. As a result, money market funds cannot hold ARS because SEC rules restrict them to securities with a final maturity of 397 days or less. In addition, because ARS do not carry a “put” feature, they are very sensitive to changes in credit ratings and normally require the highest ratings to make them marketable. This is usually achieved with bond insurance. Thus, when a monoline insurer is downgraded, investors are less likely to participate in an auction for the ARS, reducing demand for the securities.

[Typical investors of ARS](#) include corporate and high net worth individuals, bond funds, and bank trust departments.

## What is a failed auction?

An auction fails when there are more shares offered for sale in the auction than there are bids to buy shares, or if the clearing rate of the auction would be above the maximum rate defined in program documents. A failed auction does not mean the security goes into default, because the issuer continues to pay interest at the maximum rate; however, existing holders of the securities who wanted to sell them generally are not able to do so in that particular auction. Auction failures are the result of [limited liquidity in the market](#) for the particular ARS and not necessarily the result of an event of default by the issuer.

March 2008