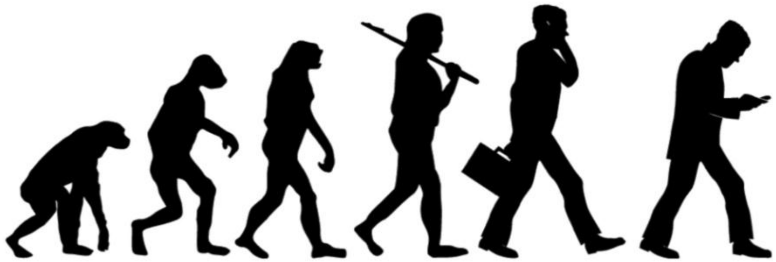
CDIAC Municipal Debt Essentials
Debt 1: Debt Basics
Introduction
March 17, 2015
Riverside, CA



The Evolution of the Bond Market

Presented by:

David Brodsly, Managing Director

KNN public finance

1300 Clay Street, Suite 1000, Oakland, CA 94612
phone 510 839 8200 fax 510 208 8282

17901 Von Karman Avenue, Suite 600, Irvine, CA 92614
phone 949 556 8880 fax 949 556 8881

5757 W. Century Boulevard, Suite 700 , Los Angeles, CA 90045
phone 310 348 2901

A Division of Zions Public Finance, Inc.

In the beginning...

- The first U.S. municipal bond was issued in 1812 by New York City as a general obligation bond to construct a canal
  - *Became commonly used to finance rail and other transportation* to support new development
- The roots of tax-exemption
  - *McCullough v. Maryland* (1819) introduced the doctrine of intergovernmental tax immunity: "the power to tax is the power to destroy"
  - *In Pollock v. Farmer's Loan & Trust Co.* (1895) the Supreme Court held the federal government had no power to tax interest on municipal bonds
- Panic of 1873 kicked off a major depression
  - Widespread municipal bond defaults from railroad improvements: they built them, but they didn't necessarily come
  - The introduction of legal restrictions on indebtedness
  - The introduction of bond counsel rendering enforceability opinions
- The second California Constitution introduced what is now Article 18, Section 16
  - "Indebtedness" requires a 2/3rd vote
  - Indebtedness requires the levy of a tax

The 20th Century

- The Sixteenth Amendment to the US Constitution allows for taxes on income
  - The Revenue Act of 1913 first codified exemption of interest on municipal bonds from federal income tax
- Moody's and Standard & Poor's credit rating services established
- California courts define the exceptions to the "debt limit" for revenue bonds, lease revenue bonds, and "obligations imposed by law"
- Various statutes adopted to accommodate various kinds of finance
- The New York City bond crisis of 1975 results in the creation of the Governmental Accounting Standards Board and Generally Accepted Accounting Principles
- The go-go 1980's
  - High interest rates in the early part of the decade lead to creation of "lower floaters" and other forms of variable rate demand obligations
  - Bond insurance begins its penetration of the municipal market
    - In 1980, only 3% of bond issues were insured compared to approximately 60% in 2007

The Revolution of 1978

- Voters approve Proposition 13, reducing taxing authority and revenues
- Spurred the requirement for "creative financing"
  - Growth in lease financing
  - The creation of the certificate of participation (to address problems with borrowing statutes)
  - The growth in conduit borrowing for private activities
- CDIAC created to keep track of it all

Pushing the limits of Proposition 13

- Creation of the Mello-Roos statute to fund capital improvements for development
- State court expansion of the use of assessments
- The expanded use of fees
- The distinction of the "general tax" from the "special tax"

And the taxpayers push back

- Proposition 62 attempts to impose voter requirements on general taxes
- The Guardino decision on "special taxes" requiring 2/3 votes
- Proposition 218 closes most of the loopholes
  - Constitutionalizes voter approval of taxes
  - Changes the rules of assessments
  - Changes the rules for fees
- Proposition 26 hammers the final nail

Tax Reform

- Major federal legislation in 1982, 1983 and 1984 contained provisions that impacted municipal bonds
- The Tax Reform Act of 1986 (begun in 1985) imposed numerous restrictions on
  - Investment earnings (arbitrage)
  - Size of reserve funds
  - Private use of tax-exempt bonds
  - Bank ownership of municipal bonds
- In 1988, the Supreme Court reversed Pollack (South Carolina v. Baker), finding Congress could tax municipal interest

Federal Securities Regulation

- The Securities Act of 1933 and the Securities Exchange Act of 1934 created the SEC and introduced anti-fraud provisions
- In 1942, the SEC adopted Rule 10b-5, specifically prohibiting any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security
- In 1975 the Municipal Securities Rulemaking Board (MSRB) was created, and the Tower Amendment limited its and the SEC's power to regulate municipal bonds
- In 1989, in response to the default of the Washington Public Power Supply System (WPPSS), the SEC published its first rule(15c2-12) indirectly governing the disclosure for municipal bonds by regulating *underwriters*
- Following Orange County bankruptcy of 1994, SEC requires continuing disclosure

Watershed events of the 21st Century

- San Diego self-reports a disclosure lapse that leads to a major SEC investigation
- Various market factors give rise to the use of swaps to create synthetically fixed rate debt
- The sub-prime mortgage collapse of 2007 and the great recession of 2008 transform the market
  - Bond insurers collapse
  - The Auction Rate Securities market collapses
  - Synthetic fixed rate transactions unwind
  - The federal government intercedes with ARRA, including Build America Bonds
  - Borrowing for new money falls
  - Borrowing for refunding rises

And what's next?

- Controversies in school finance
- Changing commercial bank regulation
  - Increased liquidity and capital requirements
  - Direct purchase of municipal debt
- The roll out of Dodd-Frank
- Does the SEC want fewer municipal issuers?
- Will interest on municipal bonds remain tax-exempt?