The Evolution of the Bond Market

Presented by:
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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


- 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?