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The logo for CDIAC, consisting of a solid blue square with the letters "CDIAC" in white, bold, sans-serif font positioned in the bottom-left corner of the square.

**CDIAC**

# CDIAC Municipal Debt Essentials 2019

Evolution of the Bond Market | February 2019

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# The Birth of the Municipal Bond Market

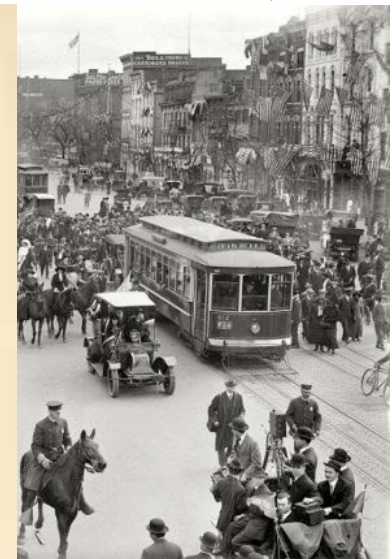
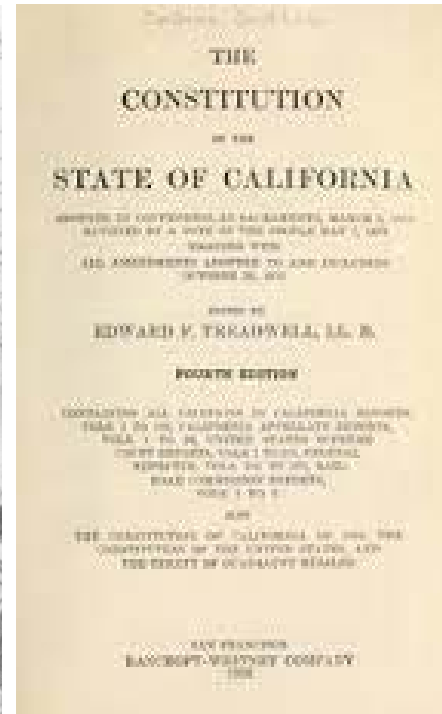
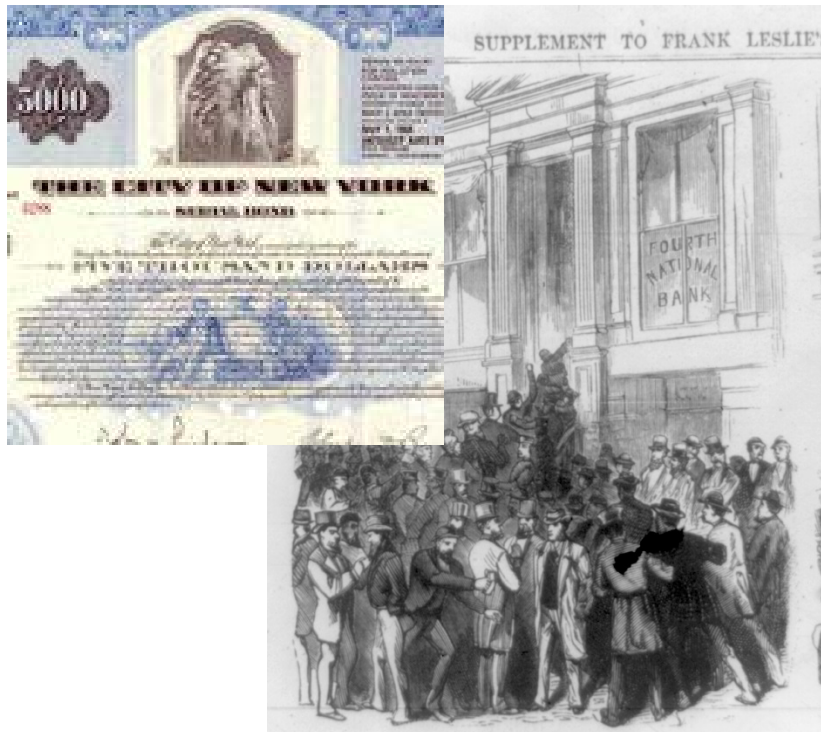
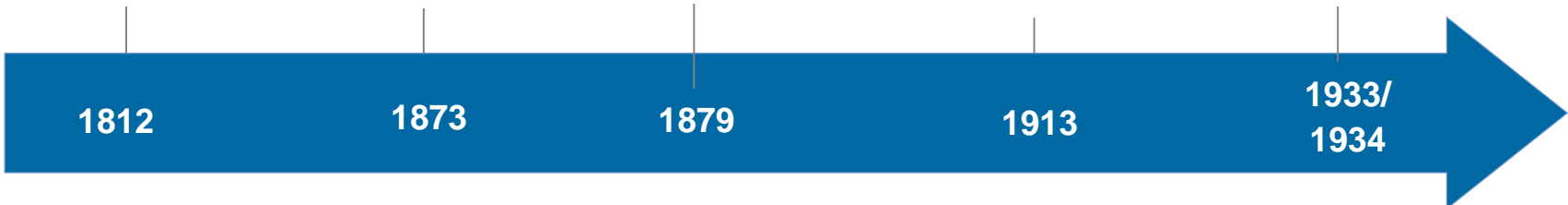
New York City  
Issues First  
Municipal  
Bonds

Panic of 1873

California  
Constitution  
Places Limits  
on Debt

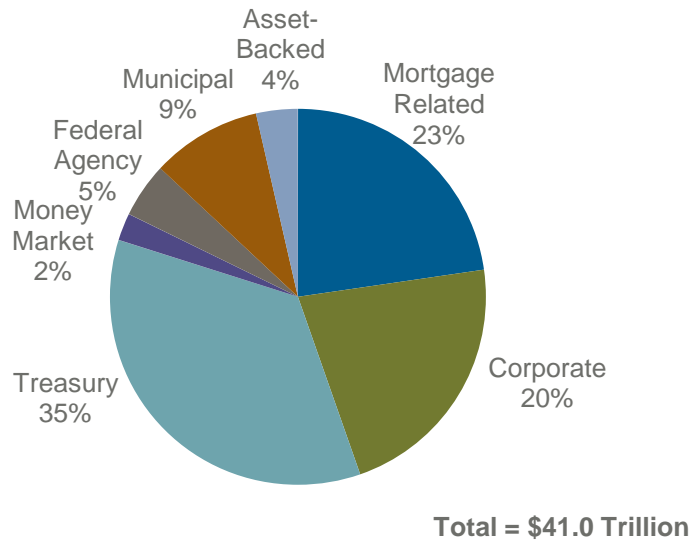
Revenue Act  
of 1913  
codified  
exemption of  
muni interest

1933 and 1934  
Securities Act



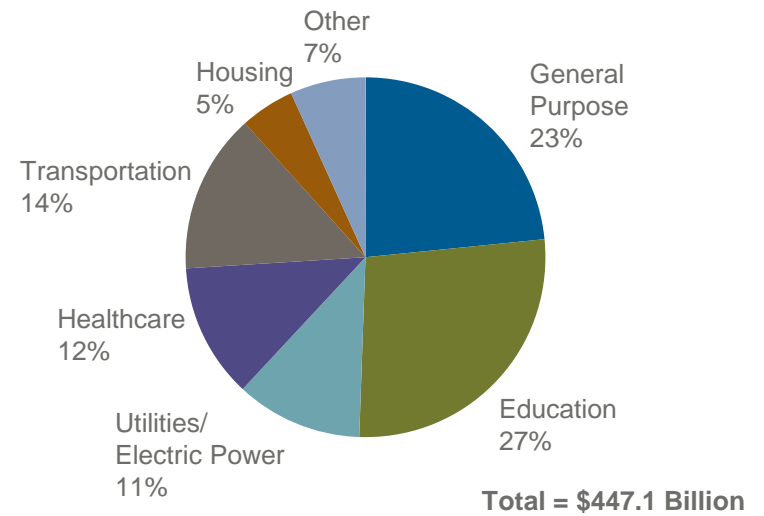
# Today's Municipal Market Characteristics

## US Bond Market Debt Outstanding (4Q 2017)



Source: SIFMA

## 2017 Municipal Issuance by Sector



Source: Bond Buyer

## How Does the Municipal Market Compare to Other Markets?

### Key Market Statistics

Market	Market Size	# of CUSIPs	% Direct Retail	Avg Daily Volume	Avg Daily # of Trades	Avg \$ / Trade
Equities	\$28.5 T	10,700	38%	\$80.5 BN	10,740,000	\$7,495
Corporate Bonds	\$8.8 T	30,000	10%	\$25.8 BN	58,900	\$424,450
Municipal Bonds	\$3.9 T	1,000,000	42%	\$10.8 BN	39,000	\$277,000

Source: MSRB *Muni Facts* <http://www.msrb.org/msrb1/pdfs/MSRB-Muni-Facts.pdf> , SIFMA FINRA TRACE, NASDAQ, Federal Reserve Statistical Release *Flow of Funds, Balance Sheets, and Integrated Macroeconomics*, Bloomberg as of 12/12/18.

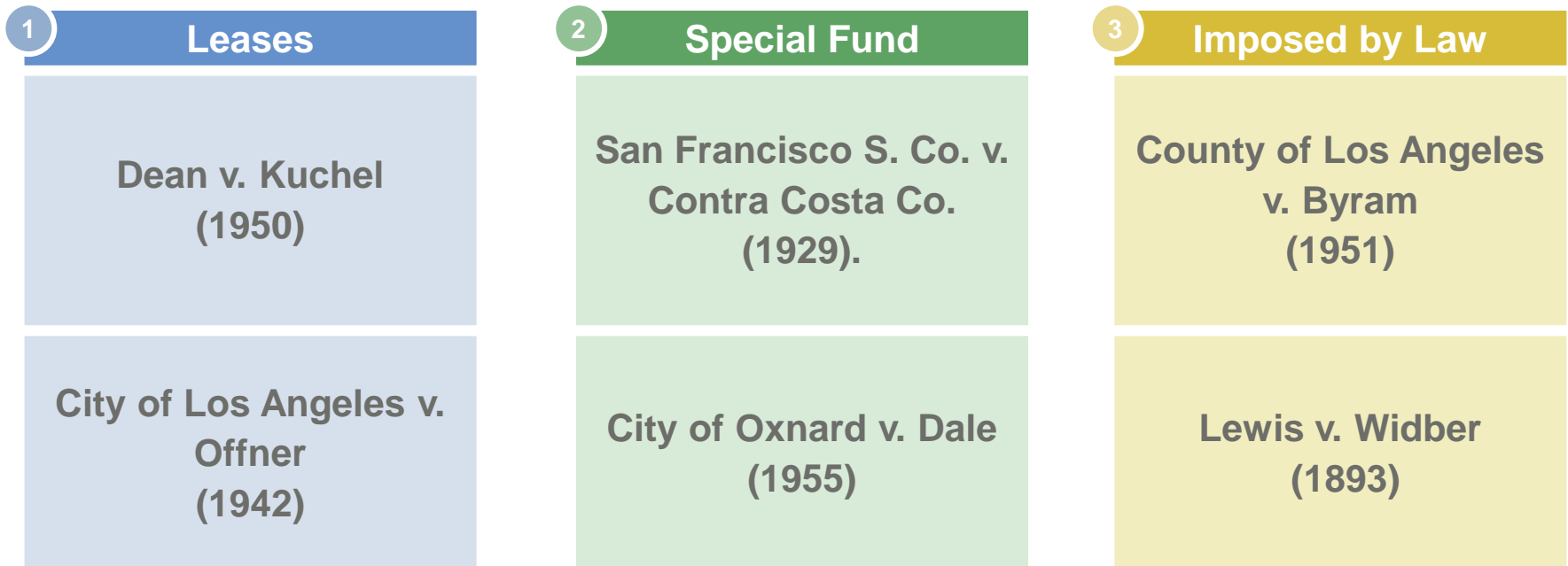
Note: Data reflects U.S. market only, bond data excludes money market activity

- Individual municipal bonds trade on average once every 26 days while an individual equity trades on average ~1000 times per day
- Municipal bonds are not registered with the SEC: the SEC cannot directly enforce continuing disclosure practices of municipal entities

# How is Debt Authorized in California?

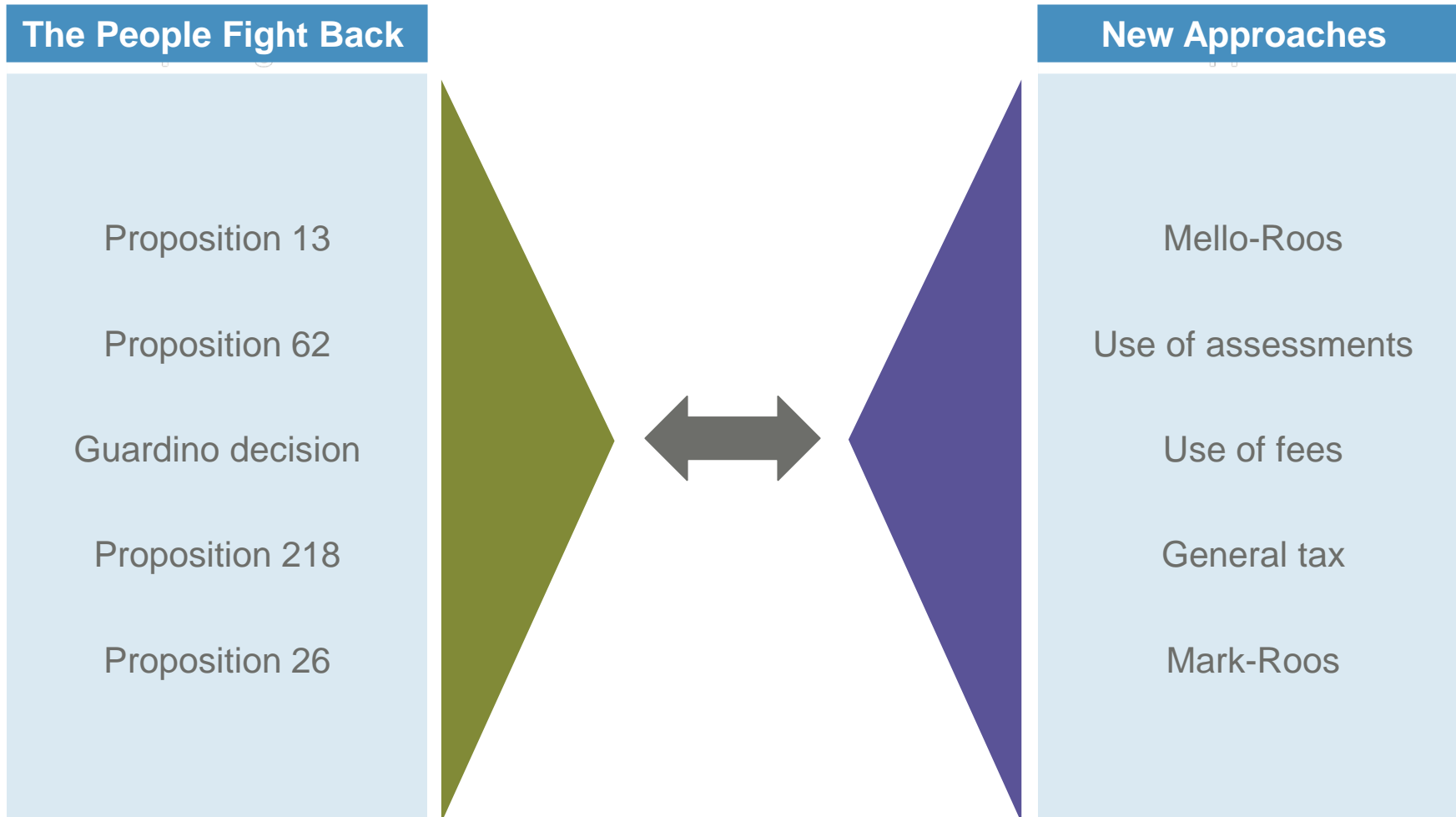
## California's Constitutional Debt Limit

- Article XVI, section 18, provides in part: "No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the qualified electors thereof, voting at an election to be held for that purpose ...."
- In 2015 California municipalities issued \$57 billion in debt, 38% was voter approved



# During the 20<sup>th</sup> Century, Californians and the Courts Redefined Voter Approval

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# The Financial Crisis Changed the Municipal Debt Market Landscape

## Casualties of the Financial Crisis

### Variable Rate Debt

- Auction Rate Securities
- Synthetic Fixed Rate Debt

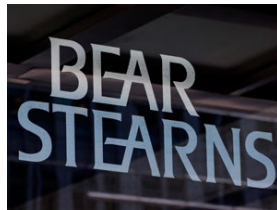
### Receivership of Fannie Mae and Freddie Mac

### Bond Insurers

- Insurance for debt service
- Surety Bonds

### Consolidation/Elimination of Firms

- Bear Stearns bought by J.P. Morgan
- Bankruptcy of Lehman
- Sale of Merrill Lynch to Bank of America



Investor Alerts

**Auction Rate Securities: What Happens When Auctions Fail**



J.P.Morgan



# Municipal Market Terms

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## **Bond Insurance**

A guarantee by a bond insurer of the payment of the principal of and interest on municipal bonds as they become due should the issuer or obligated person fail to make required.

## **Variable Rate**

An interest rate, sometimes referred to as a “floating rate,” on a security that is reset at specified intervals according to market conditions or a predetermined index or formula.

## **Refunding**

A procedure whereby an issuer refinances outstanding bonds by issuing new bonds.

## **Advance Refunding**

A refunding in which the refunded issue remains outstanding for a period of more than 90 days after the issuance of the refunding issue.

## **Current Refunding**

A refunding transaction where the municipal securities being refunded will all mature or be redeemed within 90 days or less from the date of issuance of the refunding issue.

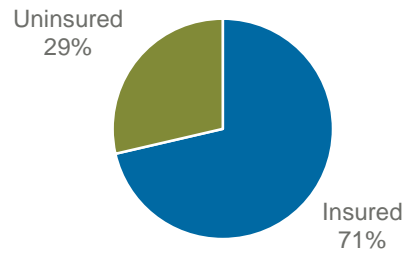
## **New Money Bonds**

A bond issued to raise money to finance capital projects such as roads, bridges, schools, and libraries

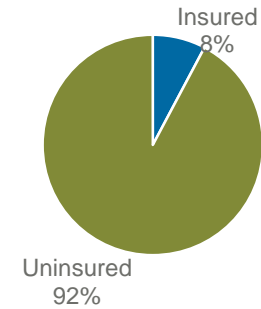
Source: Municipal Securities Rulemaking Board, Glossary of Municipal Securities Terms (except New Money Bonds)

# California's Municipal Market Trends Before and After the Financial Crisis

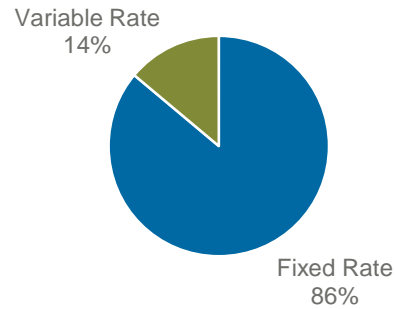
California 2006 Insured vs. Uninsured



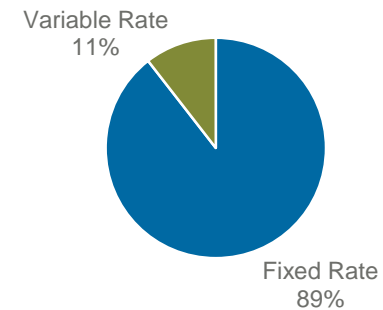
California 2017 Insured vs. Uninsured



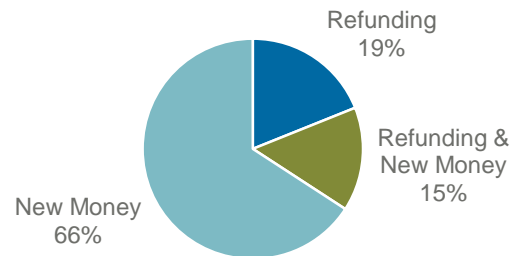
California 2006 Fixed vs. Variable Rate



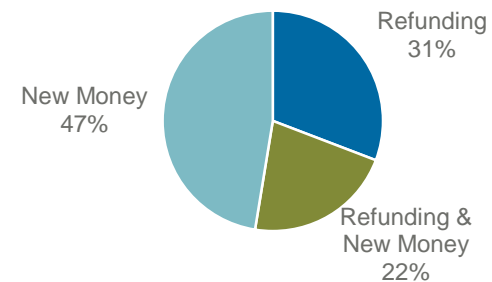
California 2017 Fixed vs. Variable Rate



California 2006 New Money vs. Refunding



California 2017 New Money vs. Refunding



Source: SDC as of December 12, 2018

# The Tax Cuts and Jobs Act of 2017

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## Individual Tax Rates

- Individual: maintain a 7-bracket system but with lower rates (0%, 10%, 12%, 22%, 24% 32% and 37%)
- Keep AMT, but at a higher income threshold
- Increased standard deductions overall

## Corporate Tax Rates

- Tax rate for “C” corporations reduced to 21% from 35% - effective in 2018
- Repeal of AMT

## State and Local Taxes

- Continues to allow for deduction of cost of state and local property taxes, consistent with current law -- up to \$10,000; allows individuals and families the ability to choose among sales, income, and property taxes based on their needs

## Advance Refunding Bonds

- For bonds issued after 2017, interest on advance refunding bonds would be taxable; interest on current refunding bonds would continue to be tax-exempt

## Tax Credit Bonds

- Eliminates tax credit and direct pay bonds including new Clean Renewable Energy Bonds, Qualified Energy Conservation Bonds, Qualified Zone Academy Bonds, and Qualified School Construction Bonds

## Modification of “proration” rules for Property and Casualty Insurance Companies

- P&C insurance companies are were eligible for a tax deduction for contributions to loss reserves, which was reduced by 15% of the tax-exempt interest a P&C earns - effectively a partial tax on otherwise tax-exempt interest. Under current rules, that disallowance percentage increases to 25% for tax years beginning after 2017

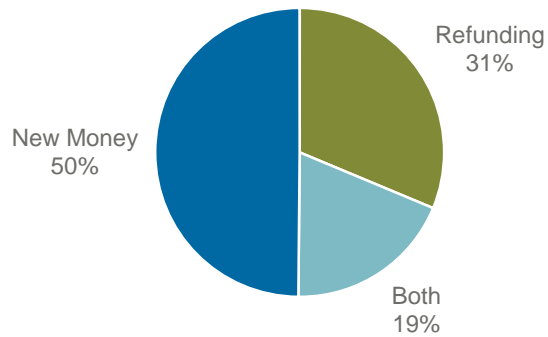
Source: House of Representatives, *Conference Report*, house.gov 12/29/2017; <sup>1</sup>Calculated by dividing 5.25% by the top corporate tax rate

# 2017 vs. 2018 YTD

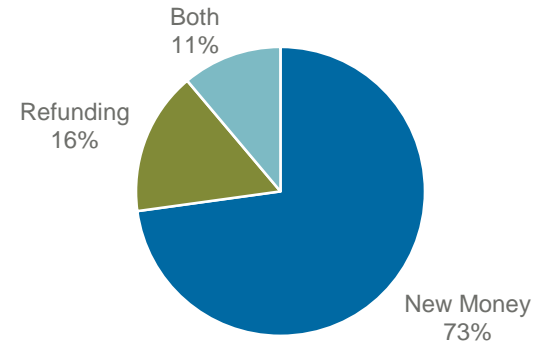
## Impacts of tax reform on municipal issuance

### Refunding vs. New Money

2017

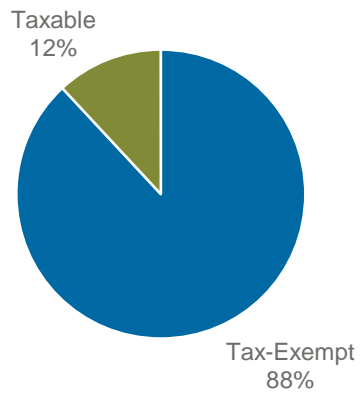


2018



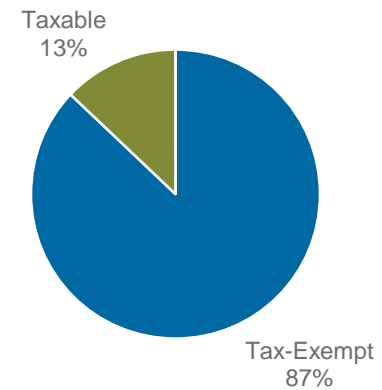
### Taxable vs. Tax-Exempt

2017



Total Issuance: \$496.847 billion

2018



Total Issuance: \$369.287 billion

## Direct Purchase / Loan vs. Publicly Offered Bond

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### Direct Purchase/Loan

- Interest payments may be fixed or floating
- Pricing will depend on a number of factors including issuer ratings, deal size, tenor, new money / refunding proceeds and relevant credit covenants
- Borrower is not subject to the performance of purchaser through the bond's mandatory tender date
- Upon a mandatory tender date for the bond/loan, a term-out provision and stepped-up rates may apply if the debt is not otherwise repaid or remarketed, similar to a bank facility or a put bond
- Bank loans may be subject to margin rate factor adjustments, while the risk of changes to tax rates falls on the purchaser of direct purchase bonds

### Publicly Offered Bond

- Ratings
- Official Statements
- Documentation
- Continuing Disclosure
- Remarketing / Term Out
- Issuance Costs

## Additional Municipal Market Terms

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### SEC

Securities and Exchange Commission. The federal agency responsible for supervising and regulating the securities industry.

### MSRB

Municipal Securities Rulemaking Board. A self-regulatory organization, consisting of representatives of securities firms, bank dealers, municipal advisors, issuers, investors and the public, that is charged with primary rulemaking authority over municipal securities dealers and municipal advisors in connection with their municipal securities and municipal advisory activities.

### Continuing Disclosure

Disclosure of material information relating to municipal securities provided to the marketplace by the issuer of the securities or any other entity obligated with respect to the securities after the initial issuance of municipal securities. Such disclosures include, but are not limited to, annual financial information, certain operating information and notices about specified events affecting the issuer, the obligor, the municipal securities or the project financed.

Source: Municipal Securities Rulemaking Board, Glossary of Municipal Securities Terms

## Enforcement, Regulation, Disclosure

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### Rule 15c2-12

- Enacted in 1989 in response to Washington Public Power Supply System default
- Governed disclosure for municipal bonds by regulating underwriters

### Amendment of 15c2-12

- Enacted in 1995 in response to Orange County bankruptcy
- Requires continuing disclosure

### Pension

- SEC Enforcement Actions for inadequate pension disclosures
- City of San Diego (2006), States of New Jersey (2010), Illinois (2013), Kansas (2014)

### Enforcement Actions

- Enforcement Division Unit created in 2010
- Dodd-Frank Act gave SEC new power to obtain fines in administrative (“cease and desist”) actions

### Independent Registered Municipal Advisor

- SEC’s Municipal Advisor Rule, in effect since July 2014, establishes a fiduciary duty on the part of a municipal advisor to its municipal entity client,
- Imposes certain restrictions upon the communications from a non-registered municipal advisor with its municipal entity clients

### MCDC

- Announced in March 2014 by SEC
- Focus on whether an offering document was materially accurate with respect to compliance with continuing disclosure undertakings
- In August 2016, the SEC enforcement actions against 71 municipal issuers and other obligated persons for violations in municipal bond offering

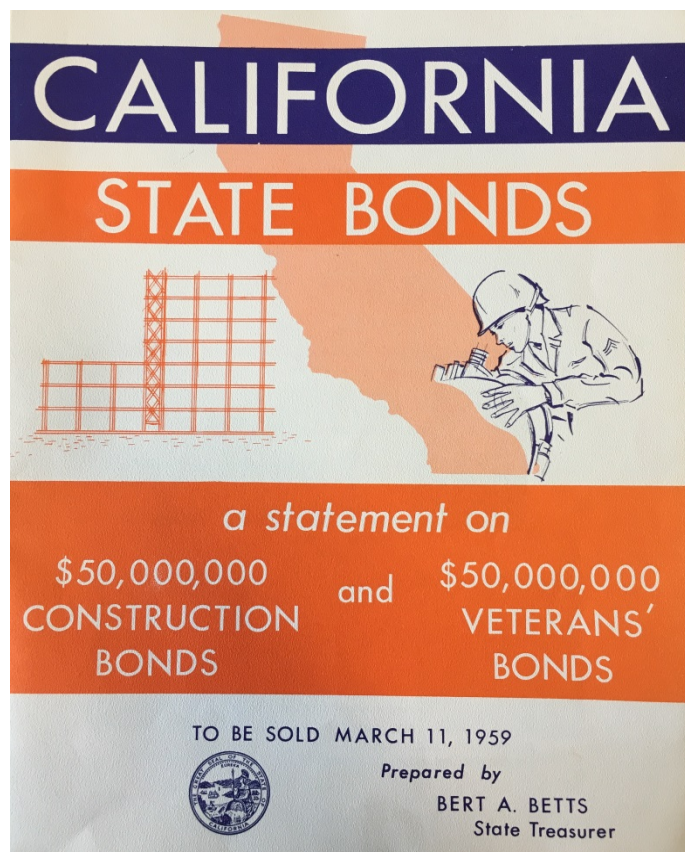
### 2019 15c2-12 New Disclosure

- Two new 15c2-12 disclosure items, effective February 2019
- Bank loans and any other material financial obligation entered into, as well as disclosure of events that may reflect financial difficulties, e.g., default.

# An Illustration of the Changes in Disclosure Practices

## California GO 1959

- 14 Total Pages
- 3 Pages Describing Current Budget
- Outstanding GO Debt of \$1.4 billion



## California GO 2016

- 372 Total Pages
- 15 Pages Describing Current Budget
- Outstanding Debt of \$83.3 billion

