A leading municipal bond industry analyst has concluded that even the Wyden-Coats proposal to replace tax exemption with a federal tax credit would result in higher borrowing costs to issuers. He stated that it would be impossible to overcome the massive complexity and liquidity problems associated with selling small pieces of annual tax credits along with small pieces of coupon income and a large amount of bond principal. This is because when a tax credit bond was issued, many purchasers cannot fully utilize the credit and so strip it off and sell it separately. Perhaps more fatal is the very narrow base of demand for taxable tax credit bonds; in 2009 and 2010, tax credit alternatives were available in the Build America Bond program but went almost completely unused.

Conclusion. Municipal bond tax exemption has captured the attention of Washington legislators. To date, the major proposals to limit this tax exemption are expected to result in higher borrowing costs and financial pressures on issuers. For updated information on these proposals and the expected impact on issuers, contact your financial advisor at Speer Financial, Inc.

Municipal Bond Buyers

For the first half of 2012, the volume of bond issuance is some 60% above that of 2011. This causes concern about who is purchasing the debt and what is the impact on rates. So far, the rate impact has been slight because the increase in volume is still below the combined amount of debt maturing and interest being paid. This means that there is still an imbalance of money available in the municipal bond market available for the purchase of new issuances. With basic supply and demand economic theory, rates, which reflect bond pricing, are staying low.

As to purchasers, the trend is currently away from individuals, that is, retail buyers. For the past several years retail has been very important, with bond issues often structured to appeal to retail buyers, as opposed to institutional investors. The likely cause of this decline in retail appetite is primarily “rate shock.”

Other reasons given are increased daily volatility and the increase of professionally managed accounts versus individual accounts directed by the individual owner. Rates are achieving low levels that are not attractive to individuals, who often buy for retirement. As tax exempt rates follow Treasury rates, tax exempts are yielding near 1% for 5 years and 2% for 10 years. These levels are appreciably lower than the 3% to 4% levels that individual investors saw on bonds purchased some 10 years ago, which bonds are now being redeemed.

As with most trends, this will probably change. However, until rates rise, it is unlikely that individuals will be net purchasers of tax exempt debt. If institutional purchasers and professionally managed accounts have sufficiently strong demand to keep rates low, issuers are likely to be fairly ambivalent.

Refundings

In the current extremely low interest rate environment, any bonds issued in 2002 or before with 10 year calls, or more recent issues with shorter calls, are very attractive to refund for savings. Even certain newer issues with negative arbitrage can be refunded in advance of the call date for significant savings.

Many issues being sold this year are refunding issues providing attractive savings to reduce debt service. In times of Equalized Assessed Value (EAV) reductions, this will reduce the tax rate or, if paid with other revenues, relieve some operating financial pressures.

Some of the refundings are being negotiated to assure hitting a savings target while many are being sold competitively if clearly above the minimal threshold. Savings are enhanced with a strong credit rating in today’s market while insured bonds have almost disappeared.

Naturally non-Illinois issuers don’t get dinged with the “Illinois Penalty” caused by investors’ concerns about the financial future of the State of Illinois where “balanced budget” is an oxymoron.

If you have an issue that you think is refundable for savings or where restructuring may be advantageous, please call your contact at Speer Financial, Inc.