

Structural Challenges Facing Muni Bonds

Is there any worse feeling than stating your case and having someone give you a knowing smile, as if you say you have no clue as to what the real case is? I had this sense vicariously last week when I participated in a conference of municipal bond dealers, their self-regulatory organization the Municipal Securities Regulatory Board (MSRB) and the Wall Street self-regulator, the Financial Industry Regulatory Authority (FINRA). Also present at the conference was a representative of the Internal Revenue Service; the IRS often has to rule on whether various municipal securities pass muster as being tax-exempt or whether various financially engineered structures are just chicanery trying to grab tax-exempt status.

As an aside, the IRS really has a difficult position here; not only are they forever chasing Wall Street wise guys, they have to enforce laws made by others. Sometimes these laws are predictable time-bombs. Consider a proposal that would strip tax exemption away from municipal bonds if the federal deficit rose over a certain level; that would force municipal bond pricing into the realm of stochastic probability between tax-exempt and taxable while inviting non-stop litigation as to the meaning of deficit, GDP, recognition of each over time, revisions to the data, etc. As one speaker noted how local officials often ask the question, "If Treasury rates go up, will my rate?" we should strive not to confuse politicians with economists, much to the benefit of both groups.

Price Reporting

One intractable problem of market regulation is the naïve assumption prices always result from competitive auctions, are displayed immediately and are corrected swiftly if pushed out of line. This is seldom the case in the municipal market. Not only are few bonds traded after issuance, but the prices and terms reported on deals are not reported immediately or even inside of a thirty-day window. In addition, the sheer number of deals done and their relative lack of transparency is daunting; you can visit the MSRB's Electronic Municipal Market Access ([EMMA](#)) page to get an idea of how big the elephant is.

Buyers and sellers are facing increasing regulatory requirements to improve the transparency of this process. Obtaining multiple bids and offers to document a best-efforts attempt has been made to buy or sell bonds, especially in smaller-lot sizes for seasoned bonds is an expensive and time-consuming process, and the dealers are finding it challenging to absorb and recover these costs along with the costs of additional FINRA regulatory burdens arising from Dodd-Frank.

Then there is the market itself. We have been living in a world of sovereign credit crises; we also have multiple credit crises at the municipal level in the U.S. The 2009 American Recovery and Reinvestment Act shoveled close to \$200 billion to municipalities and helped defray bond issuance costs via the Build America Bonds program, but those efforts are in the rearview window. States have pension obligation problems to being with, and the ever-declining long-term interest rate is raising the present value of those obligations at a time when returns are being compressed. The commonly used long-term investment return assumption of 8% looks ludicrous in most cases.

If the municipal bond market continues to be roiled by rising regulatory costs, greater tax uncertainty and the impending cost mandates of ObamaCare, it will continue to be stressed. No one believed the widely circulated scare stories of runaway municipal market failures from late 2010, but almost all cautioned the health of America's infrastructure, schools, hospitals and essential services depends on this market being able to function in the face of an increasingly harsh environment. As one person said, "We could turn into a Third World country if we do not get this right."