Municipal bonds — common terms

Wealth Management

With approximately $4 trillion outstanding securities, municipal bonds are one of the most popular investment choices. What follows is a brief glossary explaining some of the more commonly used terms unique to the municipal bond industry.

Ad valorem tax — A tax levied by a municipality based on the value of a property. In many cases, it is the ability to levy an ad valorem tax which secures general obligation municipal bonds.

Advance refunding — The process by which outstanding municipal securities are refinanced through the issuance of new bonds. The proceeds from the sale of the new bonds are typically invested in U.S. government or agency securities with the cash flow from these securities used to meet the debt service requirements of the old bond issue. Often at the first optional call date of the original bond issue, the cash flow from the U.S. government or agency securities is used to retire the outstanding bonds. This process is also referred to as pre-refunding.

Alternative minimum tax (AMT) — A separately computed tax that applies only if it exceeds an individual's regular tax liability. The purpose of AMT is to prevent taxpayers who enjoy certain tax benefits from avoiding a reasonable tax liability on their income.

Municipal bonds that finance quasi-public projects, including stadiums, housing projects, student loans, airports, seaports and industrial development projects are generally subject to AMT. In 2022, approximately 5% of all outstanding municipal bonds were subject to AMT.

Bank-qualified bonds — A class of municipal securities that enjoy a tax-advantaged status when purchased by commercial banks. There are several criteria an issue needs to meet in order to be designated bank qualified and meeting this qualification is not necessarily a reflection of an issue's credit quality. While commerical banks stand to benefit the most from owning these securities, individual investors can also purchase bank qualified bonds.

Bond insurance — A type of insurance policy that a bond issuer purchases that guarantees the repayment of the principal and all associated interest payments to the bondholders in the event of default. Bond issuers buy insurance to enhance their credit rating in order to reduce the amount of interest that it needs to pay.

Build America Bond (BAB) — Taxable municipal bonds that feature tax credits or federal subsidies for bondholders and state and local government bond issuers. They were introduced in 2009 as part of President Barack Obama's American Recovery and Reinvestment Act to create jobs and stimulate the economy. BABs attempt to achieve this by lowering the cost of borrowing for state and local governments in financing new projects.

Book entry — A form of ownership where possession of the security is not evidenced by a physical certificate but rather by an electronic entry in the investor's account at a bank or brokerage firm.

Certificates of Participation (COPs) — COPs are a form of lease revenue bond that allows the investor to participate in a stream of lease payments relating to the acquisition or construction of specific equipment, land or facilities. They are typically used by municipalities to finance prisons, office buildings, schools, libraries, vehicles, and more. COPs are not viewed legally as debt because payment is tied to an annual appropriation by the government body. As a result, COPs are seen by rating agencies as providing weaker security and often carry ratings that are a notch or two below an agency's general obligation rating.

Competitive bid — A method of submitting bids to underwrite new securities in which the securities are awarded to the underwriting group presenting the best price and terms. This is a sealed bid system used by many municipalities, railroads and utilities as opposed to a single bid negotiated sale.

Covenants — Enforceable promises made by the issuer of a bond designed to protect the interests of bondholders. For instance, an issuer may pledge not to sell additional parity debt unless a revenue test is met.

Dated date — The date from which a municipal bond begins to accrue interest. The dated date may be different from the delivery date.

Defeasance — Usually associated with the refunding of an outstanding bond issue, defeasance refers to the legal termination of the rights and interests of bondholders under specific circumstances.

De minimis/OID — Important tax-related issues pertaining to market discount municipal securities purchased in the secondary market. The level of the discount relative to a formula-driven threshold determines whether the gain is taxed as ordinary income (the discount exceeds the threshold) or capital gains (the discount is within the threshold). Original Issue Discount (OID) refers to bonds issued at a price below par value. Both of these issues could result in unintended tax consequences for municipal bond investors.

Double-barreled bonds — Bonds secured by a specific source of revenue as well as by the general obligation pledge of an authority with taxing powers.

Escrowed-to-maturity (ETM) — Similar to advance refunding, this type of refunding involves the purchase of a pool of securities designed to pay principal and interest on an outstanding issue all the way to its final maturity date as opposed to an earlier optional call date.

General obligation bond (GO) — A bond secured by the full faith and credit of an issuer with the authority to levy taxes. The authority to levy taxes may or may not be statutorily limited. A limited tax bond or LTGO is a type of general obligation bond in which the taxing authority pledges to repay debt is specifically limited as to rate or amount. An unlimited tax GO or UTGO is a type of general obligation bond in which the taxing authority pledged to repay debt is not limited as to rate or amount.

Gross revenue pledge — A pledge that all revenues received will be applied to pay debt service prior to payment of any expenses. It is generally considered to be superior to a net revenue pledge.

IDB or IDR or industrial development (revenue) bond — A type of revenue bond issued by a state or local development authority on behalf of a corporate borrower to finance the construction of industrial facilities. The security for an IDB rests with the general credit of the corporate borrower. They are not backed by the full faith and credit of the issuing municipality.

Junior lien bonds — Bonds that have a subordinate lien against pledged revenues.

Lease rental bonds — A type of bond secured by lease payments. The party leading the financed project must appropriate the necessary funds from its general fund in order to make the lease payments.

Letter of credit or LOC — A commitment made by an institution, typically a commercial bank, to honor demands for the payment of principal or interest on a bond if the issuer is unable to do so.

Moral obligation bond — In addition to being secured by the revenues from a specific project, this bond also enjoys a non-binding pledge that any shortfalls in funds necessary to meet debt service requirements will be made up through an appropriation by the state legislature. As the name implies, the obligation is only moral, and the state legislature is under no legal obligation to cure any deficiencies in debt service.

Municipal/Treasury ratio — The municipal/Treasury ratio, or M/T ratio for short, is a comparison of the current yield of municipal bonds to U.S. Treasuries which provides a way to assess the relative value of municipal securities to Treasuries on a pre-tax basis. If the M/T ratio is below 100% then municipal bonds are yielding less than Treasuries; if the M/T ratio is above 100% then municipal bonds are yielding more than Treasuries.

Negotiated sale — A method of selling securities in which the issuer has entered into an exclusive underwriting agreement with an underwriting syndicate. Unlike a competitive sale, the issuer entertains only a single bid with the main negotiating points being the interest rate and the purchase price of the issue. Most municipal revenue bonds are priced through negotiation.

Net revenue pledge — A pledge that all revenues received will be applied to pay debt service after the payment of certain expenses, usually operations and maintenance expenses. Generally considered to be inferior to a gross revenue pledge.

Official statement or final OS — The final version of the document published by the issuer giving pertinent information on the sale of securities. Included in the final OS is information on the bond's structure, security and redemption features.

Preliminary official statement (POS) — The preliminary version of the document published by the issuer, giving pertinent information on the sale of securities. Information contained in the POS is subject to revision and is used to gauge investor interest in a sale of securities. It is sometimes referred to as a red herring due to the red lettering on the cover.

Refunding — A general term describing the refinancing of an outstanding bond issue through the sale of a new securities. An issuer typically issues refunding bonds to take advantage of interest cost savings or to remove restrictive bond covenants contained in previously issued bonds. See advance refunding and ETM.

Revenue bond — A bond issue backed up by a specific pledge of revenue, most often from the project being financed. Unlike general obligation bonds, no taxing authority is pledged for the repayment of the bonds.

Senior lien bonds — Bonds having a prior or senior lien against pledged revenues.

Serial bonds — Bonds of an issue that is structured so a portion of the principal is retired at regular intervals.

Sinking fund — A fund established under the bond indenture that provides for the retirement of debt on a pre-arranged schedule. A sinking fund is most commonly associated with a term bond structure.

Super sinker — A specific maturity of a bond issue to which excess payments or prepayments are directed for early retirement. Most often associated with single-family mortgage bonds.

Taxable equivalent yield (TEY) — The pre-tax yield that a taxable bond needs to possess for its yield to be equal to that of a tax-free municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond in order to see which bond has a higher applicable yield.

Term bonds — Bonds of an issue structured so that a large part or the entire principal is retired at a single maturity date. Often the bond indenture provides for a sinking fund to retire a portion of a term bond prior to its stated maturity according to a predetermined schedule.

Thirty-day visible supply — The principal amount of bonds scheduled to be sold through either competitive or negotiated underwriting in the upcoming 30-day period. Often quoted as an indicator of near-term supply.

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