INVESTOR BULLETIN

Municipal Bonds: Understanding Credit Risk

The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to help educate investors about assessing credit risks they face when purchasing municipal bonds, which may also be called notes or certificates of participation. Credit risk—or default risk—is the risk that interest and/or principal on the securities will not be paid on time and in full. Investors need to know who is responsible for repayment of the securities and the financial condition of that entity to assess the credit risk and decide whether to purchase the securities. It is important to look beyond the short-hand label given to a municipal bond, such as "general obligation bond" or "revenue bond," or the bond's credit rating. Investors should read the disclosure document, known as the "official statement," which provides important details about the offering, including the factors described below.

What are Municipal Bonds?

Municipal bonds are debt securities issued by states, cities, counties and other governmental entities to fund day-to-day obligations and to finance capital projects such as building schools, highways or sewer systems. By purchasing municipal bonds, you are in effect lending money to the issuer in exchange for a promise of regular interest payments, usually semi-annually, and the return of the original investment—or principal. The entity responsible for repaying the principal and interest on the bonds may be the issuer, or an underlying borrower, known as the obligor or "obligated person." Obligors could be another governmental entity, a for-profit firm, or a non-profit entity. The date on which the principal is scheduled to be repaid, known as the security's maturity date, may be years in the future.

Generally, the interest on municipal bonds is exempt from federal income tax. The interest may also be exempt from state and local taxes if you reside in the state where the bond is issued or if issued by a U.S. territory, such as Puerto Rico. Given the tax benefits, the interest on municipal bonds is usually lower than on taxable fixed-income securities such as corporate bonds.

Factors investors should consider when assessing the credit risk of municipal bonds:

1. Types of Municipal Bonds

The type of municipal bond issued affects both the risk of default and the value of the municipal bond. Repayment may come from the issuer, an obligor, or from a single tax or revenue source. There are two major types of municipal bonds: "general obligation bonds" and "revenue bonds." Because these types come in many varieties, you should look beyond the short-hand label when deciding whether to purchase.

- General obligation bonds are issued by governmental entities and are not backed by revenues from a specific project or source. Some general obligation bonds are backed by dedicated taxes on real property and, on occasion, other taxes. Other general obligation bonds are payable from general funds and are often referred to as backed by the "full faith and credit" of the governmental entity. While in many instances "general obligation" means that the issuer or other governmental entity responsible for repaying the bonds has the unlimited authority to tax residents to pay bondholders, in other cases, the issuer or other governmental entity may have limited or no taxing authority. ***Investors should carefully read the official statement describing the general obligation bond before making an investment decision***.

- Revenue bonds are backed by revenues from a specific project or source. There is a wide diversity of types of revenue bonds, each with unique credit characteristics. For example, municipal entities frequently issue securities on behalf of other borrowers such as non-profit colleges or hospitals or certain for-profit entities. These underlying "conduit" borrowers typically agree to repay the issuer, who pays the interest and principal on the securities solely from the "revenue" provided by the conduit borrower. ***Investors should carefully read the official statement describing the revenue bond, and understand both the identity of the conduit borrower, if any, and what revenues are actually pledged to back the bonds, before making an investment decision***.

2. Non-Recourse Financings

Some revenue bonds are "non-recourse," meaning that if the revenue stream dries up, or if payments on the bonds are otherwise not paid, the bondholders do not have a claim on the underlying revenue source or against the conduit borrower. In instances where a conduit borrower fails to make a payment to the municipal issuer, the issuer is usually not required to pay the bondholders. *For these reasons, it is essential to understand the source of the revenues that will be used to repay the bonds*.

3. Purpose of the Financing

Municipal bond default rates vary considerably depending on a variety of factors, including the types of bonds issued and whether the ultimate obligor is a municipal entity or a non-municipal entity (i.e., a conduit borrower). For example, if you are considering purchasing municipal securities that finance speculative projects, including those involving for-profit businesses, pay close attention to the potential risks involved. The official statement for this kind of offering usually will include a feasibility study showing the key assumptions made in evaluating the project. Understanding those assumptions can help you evaluate the risks.

4. Financial Condition of the Issuer or Other Obligor

A key concern is whether the issuer or other obligor will be able to pay interest and principal in full. To evaluate the financial condition of the issuer or other obligor, consider (among other things):

- Debt and other longer-term liabilities payable from or impacting the same source of revenue as the bonds, including, if applicable, pension and other post-employment benefit obligations of the municipal bond issuer;

- The underlying local economy, including employment, income, wealth, and tax burden; and
- The audited financial statements of the issuer or obligor, including both revenues and expenses.

5. Other Sources of Funds to Pay Principal and Interest

While some municipal bonds are general obligation bonds, others are repaid not by an issuer or other obligor, but from a specific payment stream. You should evaluate the viability of the sources of revenue to be used to make these payments. In evaluating the source of payment for the bonds, you should consider (among other things):

- Economic or social trends that may limit demand for particular goods or services (such as gasoline or cigarettes) when those goods or services are being taxed to fund the repayment of the securities; and
- Statutory limits on raising revenues, such as the need for voter approval.

What are Credit Ratings?

While some investors find it helpful to consider credit ratings when making an investment decision, it is important that you not rely solely on credit ratings when deciding whether to purchase municipal bonds. ***Investors need to undertake their own independent review of the municipal bonds' risk by reading the official statement and other relevant information described below.***

Credit ratings are assessments of municipal bonds' credit risk at a particular point in time. You should be aware that because credit ratings may change over time, the credit rating found on the official statement may not be the credit rating of the municipal bonds if you purchase them on a subsequent date. Investors should also be aware that, in general, credit rating agencies are paid by the issuer whose municipal bonds they are rating.

Credit ratings are only assessments by credit rating agencies of the credit risk associated with a municipal bond. Each credit rating agency evaluates credit risk based on its own standards, applies its own ratings methodology, and weighs the various factors in the methodology differently. Credit ratings are not investment advice, guarantees of credit quality or of future credit risk, or indications that an investment is suitable. They are designed to address only one aspect of an investment decision—credit risk. As an investor, you may or may not agree with the credit rating.

Where should I look for information regarding municipal securities?

In most cases, official statements as well as updated information regarding the issuer and the municipal bonds can be found on the Electronic Municipal Market Access (EMMA) website, www.emma.msrb.org. The issuer's financial information is often updated each year. In addition, many municipal bond issuers provide "material event notices" that contain information concerning, among other things, delinquent principal and interest payments, other types of defaults, rating changes, events impacting the tax status of the securities, and bond redemptions or calls. EMMA also has some credit ratings information.

Often, the official statement contains a section titled "investment risk factors" or "investment considerations," which provides information relevant to your investment decision. In addition, pertinent financial information regarding the issuer generally may be found in an appendix attached to the official statement. This publication focuses on credit risk. Investments in municipal bonds entail other risks, such as call risk, interest rate risk, inflation risk, and liquidity risk. Please refer to the material listed below for more information on these risks.

Related Information

Investor Bulletin: Municipal Bonds (available at http://www.sec.gov/investor/alerts/municipal-bonds.htm)

FINRA and MSRB Investor Alert: Municipal Bonds—Staying on the Safe Side of the Street in Rough Times (available at http://www.finra.org/investors/protectyourself/investoralerts/bonds/p118923)

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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