Dear Hildy,

In difficult economic times, investors begin to take a closer look at the type of security that supports bond payments. Some bonds are called general obligation bonds because they obligate the issuer to use its full resources to support the bonds, which are approved by the populace through a voter referendum. Revenue bonds are secured by a specific stream of income. Still yet a third category of bonds is called a moral obligation bond.

This Brief Communication describes what a moral obligation bond is. It illustrates why we recommend that you exercise caution when considering the purchase of this kind of municipal bond. As Arthur Levitt, former chairman of the Securities and Exchange Commission suggested, we concur that state administrators and politicians be held accountable for the validity of the information when they sign the offering statement.

Please let us address your questions by asking here.

Best regards,

Hildy Richelson, Ph.D.
215-646-7693

Why Some Moral Obligation Bonds are Like Farm Raised Atlantic Salmon:

The word moral means the rules of right conduct. Municipalities issue moral obligation bonds, which have a specific definition in the law. According to Black's Law Dictionary, a moral obligator is "a duty which is valid and binding in conscience and according to natural justice, but it not recognized by the law..."[i] Many people purchase moral obligation bonds, often without further thought because when there has been a problem they have usually been honored. However, administrators and politicians read the fine print when economic times are difficult.
Unfortunately words we think mean one thing are sometimes modified to mean something else. In some sense this is comparable to Atlantic salmon. Wild salmon are highly prized for their taste and nutrition. Farm raised Atlantic Salmon are fed a grain based diet and therefore have much lower levels of the essential Omega-3 fatty acids, and a much higher concentration of disease and sea lice that can spread to wild salmon populations.

Issuer defined "moral obligation bonds" are bonds backed by revenue that must be appropriated by a governing body. In the event that the governing body fails to appropriate funds for debt payment, there may be a reserve fund to pay the interest and principal when due. Initially only state governments issued moral obligation bonds. The market players accepted them because if the states walked away from bonds they were morally obligated to support, all types of securities they issued would suffer price declines and their credit ratings would be downgraded by the rating agencies.

Moral obligation bonds have become so acceptable that even small issuers use them to support their funding needs. Apparently some of these small issuers find themselves in a quandary. They can be moral and pay the obligation to the detriment of the community, or take the position that they won't pay if it might increase taxes or affect municipal services. According to the Wall Street Journal[ii], Buena Vista, Virginia, with a population of 6,349 in the 2000 census, issued $9.2 million of moral obligation bonds in 2005 to finance a municipal golf course. That is a per person debt of $1,449. Twenty-two percent of those individuals were under the age of 18 years, according to Wikipedia. Since businesses were leaving and the population was declining, Buena Vista decided to construct a golf course that was supposed to attract the development of residential housing, shops, hotels and small businesses.

Buena Vista pledged their court house and police station as collateral for bonds to construct the golf course. The Great Recession beginning in 2007 clobbered the value of real estate and strangled new developments. The usage of the golf course fell dramatically. Given the choice of raising taxes and cutting services or not paying the interest due on their bonds, the city officials decided not to appropriate the required funds. The insurer of the bonds, ACA Financial Guarantee Co, is now trying to repossess the municipal buildings but not without difficulty because they are the police station and the court house.

In another instance of small, inexperienced issuers swimming in deep waters, five Wisconsin school districts issued collateralized debt obligations (CDOs) to fund their pension obligations. CDOs are securities that are composed of fixed income assets, some of which were considered excellent credits. The CDOs imploded in 2007, according to an article in The Bond Buyer.[iii] Since the matter is in litigation, the school districts decided not to fund the repayment demanded by Depfa bank by deleting it as a line item in their budgets. The districts are alleging fraud in the original issuance of the CDOs and have decided to withhold payment until the court case is resolved.

Depfa bank is dissatisfied that the school districts are not immediately complying with the repayment of their obligations. An official at Depfa says that the actions of the school boards call into question the viability of the moral obligation pledge that is widely used in Wisconsin and many other states to support bond issues. It is a way for politicians to fund projects without vote approval or pledging dedicated revenue streams for repayment of the bonds.

Why is it that some government officials' with little financial experience are able to enter into complex financial matters that obligate an entire population without the approval of that population, or the experienced oversight of the state administrators? It might be helpful if the Municipal Securities Rulemaking Board (MSRB) actually makes a contemplated rule change that would prohibit an issuer's financial advisor from also being the underwriter of new negotiated or competitive bond issues.[iv] This rule change was suggested by Mary Shapiro, the chairperson o
the Securities and Exchange Commission. Do you think advising a client how to structure a deal and then actually doing the deal just might be a conflict of interest? We recommend that there should be a review of complex legal structures that enable town officials to legally commit all of a town's resources to a project that might bankrupt the town or that the majority of the citizens might not support.

We recommend that you proceed cautiously when considering the purchase of bonds backed by a moral obligation pledge, especially from small issuers.

[i] Black's Law Dictionary
[iv] Andrew Ackerman, "MSRB Eyes Limits on Dealer-FAs: Rule Would Bar Switching Roles," The Bond Buyer, August 18, 2010.

Our philosophy has always been to seek out highly rated general obligation bonds, and bonds backed by revenue streams from essential services like water or sewer that generally carry the lowest risk of default. These are examples of what we call "plain vanilla" bonds in our bestselling book Bonds: The Unbeaten Path to Secure Investment Growth, (Bloomberg Press, 2007).

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