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April 23, 2021

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: April 28, 2021 Oversight & Investigations Subcommittee Hearing entitled, "Examining the Role of Municipal Bond Markets in Advancing – and Undermining – Economic, Racial and Social Justice"

The Subcommittee on Oversight & Investigations will hold a hearing entitled, "Examining the Role of Municipal Bond Markets in Advancing – and Undermining – Economic, Racial and Social Justice" on Wednesday, April 28 at 12:00 pm on Cisco Webex. There will be one panel with the following witnesses:

- **William Fisher**, Chief Executive Officer, Rice Capital Access Program
- **Gary Hall**, Partner and Head of Investment Banking (Infrastructure and Public Finance), Siebert Williams Shank & Co., L.L.C.
- **Chelsea McDaniel**, Senior Fellow, Activest
- **Jim Nadler,** Chief Executive Officer, Kroll Bond Rating Agency
- **Chris Parsons**, Professor of Finance, University of Southern California

Overview

State and local authorities, cities, and other municipal issuers in the United States issued a total of $451.2 billion in municipal bonds in 2020, the strongest year for municipal bonds since records began in 1980.[1] This represents an 11% increase from 2019 levels ($406.8 billion) and a 41% increase from 2018 levels ($320.3 billion).[2] Municipal bond issues continued rising in 2021 with public issuers selling $102.1 billion of municipal bonds in the first quarter of 2021 as compared to $87.9 billion issued in the first quarter of 2020.[3] Education, general purpose, and transportation sectors accounted for approximately 70% of total 2020 bond issues, an increase from 67% of total 2019 bond issues.[4]

The Great Recession highlighted the importance of the bond market to state and local governments as a financial management tool.[5] Similarly, state and local governments have relied heavily on municipal bonds to generate revenue during the COVID-19 pandemic, driving municipal borrowing to a 10-year high in 2020.[6] The municipal bond market suffered severe disruption at the onset of the COVID-19

[1] Refinitiv, United States Municipals Review – Full Year 2020 (2021) (accessed Apr. 14, 2021).
[2] Securities Industry and Financial Markets Association (SIFMA), US Municipal Bonds Statistics – US Municipal Bonds: Issuance, Trading Volume, Outstanding, Holders (Apr. 1, 2021).
[3] *Id.*
[4] Refinitiv, United States Municipals Review – Full Year 2020 (2021) (accessed Apr. 14, 2021).
[5] Mikael Omstedt, *Reading risk: The practices, limits and politics of municipal bond rating,* Environment and Planning A: Economy and Space at 611 (Oct. 4, 2019).
[6] Heather Gillers, *Covid-19 Pandemic Drives Municipal Borrowing to 10-Year High*, The Wall Street Journal (Jan. 12, 2021).

pandemic.[7] In response, the CARES Act directed the Federal Reserve to establish the Municipal Liquidity Facility to extend assistance to states and municipalities so as to ease borrowing conditions in the private market.[8] The facility faced criticism for imposing steep penalty rates and offering less generous terms than the Federal Reserve's corporate credit facilities.[9] Following limited utilization, the Federal Reserve terminated the Municipal Liquidity Facility at the end of 2020.[10]

Many institutions of higher learning have also turned to the bond market instead of drawing on their endowments to compensate for lost revenue during the COVID-19 pandemic.[11] According to Barclays, 2020 set a record for university bond debt in which colleges and universities issued more than $41.3 billion in fixed-rate debt and fixed-rate debt re-financings.[12] Despite the influx of university bond issuances, historically Black colleges and universities, known as HBCUs, which have historically suffered from inequitable funding levels,[13] accounted for a very small portion of university bonds issued last year.[14] The biggest borrowers in the sector were well recognized names such as the University of Virginia, Harvard, and Stanford."[15]

The increased rates of bond issuance seen in 2020 and 2021 may continue even further, depending on the funding mechanisms used to fund President Biden's $2.3 trillion infrastructure plan. Congressional leadership and Biden administration officials have recently spoken positively regarding Build America Bonds, a bond program created under the Obama administration, which allowed municipalities to sell taxable debt with the federal government providing tax credits equal to 35% of interest costs of the bonds.[16] The federal government ultimately sold $181.5 billion in Build America Bonds between April 2009 and the end of 2010.[17]

Municipal Bond Issuance

U.S. states and territories, political subdivisions, government agencies, and other entities ("municipal issuers") issue bonds to raise funds for operations or public projects.[18] The federal government typically exempts the interest income earned on municipal bonds from federal income tax.[19] If the bondholder resides in the state where the bond is issued, the income from interest payments may also be exempt from state and local taxes.[20] These exemptions both motivate investors to purchase the bonds and lowers the cost of capital for the state and local governments who issue the bonds.[21]

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[7] Aaron Weitzman, *Unprecedented conditions stagger municipal market*, The Bond Buyer (Mar. 12, 2020).
[8] Congressional Oversight Commission, *Fifth Report of the Congressional Oversight Commission* (Oct. 15, 2020).
[9] *Id.*
[10] *Id.*
[11] Juliet Chung and Melissa Korn, *Bond Boom Comes to America's Colleges and Universities*, The Wall Street Journal (Dec. 26, 2020).
[12] *Id.*
[13] Danielle Douglas-Gabriel and Ovetta Wiggins, *Hogan signs off on $577 million for Maryland's historically Black colleges and universities,* The Washington Post (Mar. 24, 2021).
[14] Daniele Moran and Fola Akinnibi, *Howard Taps Bond Market Most Black Colleges Miss Out On*, Bloomberg (July 7, 2020).
[15] Yoruk Bahceli, *Facing pandemic squeeze, universities hit bond markets for cheap cash*, Reuters (Aug. 11, 2020).
[16] Karen Pierog, *Build America Bonds may stage a comeback in Biden's infrastructure plan*, Reuters (Mar. 31, 2021).
[17] *Id.*
[18] Securities and Exchange Commission, Investor Bulletin: Municipal Bonds – An Overview (Feb. 1, 2018).
[19] *Id.*
[20] Securities and Exchange Commission, Investor Bulletin: Municipal Bonds – An Overview (Feb. 1, 2018).
[21] Congressional Research Service, *Tax-Exempt Bonds: A Description of State and local Government Debt,* at 5 (RL30638) (Feb. 15, 2018).

Municipal bonds are generally divided into two categories: general obligation bonds and revenue bonds. General obligation bonds are issued by government entities and are backed by the "full faith and credit" of the issuing municipality.[22] In contrast, revenue bonds are supported by a specific revenue source, typically the income generated from the bond-financed project. Municipal borrowers can also issue revenue bonds on behalf of a private entity, such as a non-profit college or hospital.[23] These entities, or "conduit" borrowers, agree to repay the municipal issuer who is responsible for paying the interest and principal on the bonds.[24]

Municipal issuers customarily engage municipal advisors, bond underwriters, counsel, and rating agencies when issuing bonds.[25] Municipal advisors provide advice to issuers related to the sales of the bonds and act as a fiduciary to work in the interests of their government clients.[26] Bond underwriters usually act as intermediaries between the municipal issuer and investors by agreeing to directly purchase the bonds and sell them to investors.[27] The underwriters are either hired by the issuer in a negotiated bond sale or selected by the issuer after submitting a bid to purchase the bonds in a competitive bond sale.[28] Underwriters are compensated through the price difference of purchasing and reselling the bond, also known as the underwriter spread.[29]

Regulators face limitations in their ability to require municipal issuers to file disclosures ahead of offerings or to produce regular disclosures thereafter.[30] However, SEC rules prohibit underwriters from purchasing or selling municipal securities as part of an offering, absent a written agreement in which the municipal issuer promises to make certain disclosures.[31] The disclosures promulgated under these SEC rules provide increased accountability for municipal issuers and transparency for investors.[32] A number of reforms followed the 2008 financial crisis to increase oversight of the municipal bond market and to address the threat of fraud and corruption between municipal officials and bond underwriters; these reforms included the creation of the Office of Municipal Securities at the SEC as provided for in Sec. 979 of the Dodd-Frank Act, the creation of the Public Finance Abuse Unit at the SEC, and the creation of the Electronic Municipal Market Access (EMMA) public disclosure database.[33] In recent years, the SEC has increased their enforcement activity to challenge misstatements and omissions in municipal bond disclosures.[34] In recognition of the financial and operational strain placed on municipalities, the SEC has

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[22] Securities and Exchange Commission, Investor Bulletin: Municipal Bonds – An Overview (Feb. 1, 2018).
[23] Securities and Exchange Commission, What are Municipal Bonds (accessed on Apr. 14, 2021); Fidelity, Municipal Bonds (accessed on Apr. 14, 2021).
[24] *Id.*
[25] Municipal Securities Rulemaking Board, *Roles and Responsibilities: The Financing Team in an Initial Municipal Bond Offering* (accessed on Apr. 14, 2021).
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] Case Dougal et al., *What's in a (school) name? Racial discrimination in higher education bond markets*, Journal of Financial Economics at 571 (May 11, 2019).
[30] Tim Horstmann and Penny Pollick, *Continuing Disclosure in the Municipal Bond Market: Importance of Compliance*, McNees Public Sector (Apr. 17, 2018).
[31] *See* Municipal Securities Disclosure, 17 C.F.R § 240.15c2-12 (2010).
[32] Tim Horstmann and Penny Pollick, *Continuing Disclosure in the Municipal Bond Market: Importance of Compliance*, McNees Public Sector (Apr. 17, 2018).
[33] Steven M. Witzel and Daniel C. Fishbein, Increasing Enforcement in the Municipal Bond Market, 259 New York Law Journal 85 (May 3, 2018).
[34] Peter Hutcheon, SEC Focus on Municipal Securities: Disclosure and Enforcement – The Peculiar Structure of the Municipal Securities Disclosure Regime, 11 National Law Review 111 (Sep. 22, 2020).

placed an increased focus on timely and accurate disclosures for municipal securities during the COVID-19 pandemic.[35]

The Role of Credit Rating Agencies

Municipal bonds are rated by bond rating agencies, companies that assess both bonds and their issuers to assign a creditworthiness rating.[36] Bond issuers pay credit rating agencies a fee to evaluate and categorize the credit risk associated with a municipal bond.[37] Credit ratings can change over time as the bonds and their issuers are periodically reevaluated by the rating agency.[38] In general terms, higher credit ratings lead to lower borrowing costs. The importance of municipal debt has become increasingly central to the function of municipalities, and critics warn that state and local governments may be incentivized to pursue creditworthiness to the detriment to the provision of services or concerns of citizens.[39] Conversely, the model whereby issuers pay credit rating companies to rate their creditworthiness may incentivize credit rating agencies to artificially inflate ratings.[40] Indeed, the credit rating agencies were widely criticized following the 2008 financial crisis for introducing instability to the bond market by providing artificially high bond ratings and some market analysts believe the issue of artificially high ratings by the credit rating agencies was never truly resolved.[41]

Efforts to Drive Economic, Racial, and Social Justice Through Municipal Bond Markets

Researchers continue to examine the increasing financialization of urban governance, which can expose cities to financial risks and debtor discipline.[42] Because of the long-term social and economic impacts of infrastructure projects funded by bond issuance, advocates and academics acknowledge municipal bonds have "the potential to redress infrastructural inequalities," while still cautioning against funding priorities that could perpetuate *de facto* segregation and neglect of low- and moderate-income (LMI) and diverse communities.[43] Some municipal bond issuers and investors are seeking to drive positive change and promote fiscal justice through activism and market reforms. Examples include impact investment strategies and funds, targeting of proceeds to equalize infrastructure investments in LMI areas, and the utilization of metrics that provide an objective measure of municipal issuers with respect to policing policies and reliance on fines that disproportionately impact LMI areas to generate revenue.[44]

One such metric is the International Capital Market Association's Social Bond Principles, which seek to "promote integrity in the Social Bond market through guidelines that recommend transparency, disclosure and reporting."[45] Social Bonds are issued as "use of proceeds" bonds that raise funds earmarked

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[35] Securities and Exchange Commission, 2021 Examination Priorities Report (Mar. 3, 2021).
[36] James Chen, Bond Rating Agencies, Investopedia (Jul. 6, 2020).
[37] Municipal Securities Rulemaking Board, *Credit Rating Basics for Municipal Bonds on EMMA®* (accessed on Apr. 14, 2021); WM Financial Strategies, What is a Bond Rating (accessed on Apr. 14, 2021).
[38] Securities and Exchange Commission, *Municipal Bonds: Understanding Credit Risk* (accessed on Apr. 14, 2021).
[39] Mikael Omstedt, Reading risk: The practices, limits and politics of municipal bond rating, Environment and Planning A: Economy and Space at 612 (Oct. 4, 2019).
[40] Cezary Podkul and Gunjan Banerji, *Inflated Bond Ratings Helped Spur the Financial Crisis. They're Back*, The Wall Street Journal (Aug. 7, 2019).
[41] *Id.*
[42] Mikael Omstedt, Reading risk: The practices, limits and politics of municipal bond rating, Environment and Planning A: Economy and Space at 611 (Oct. 4, 2019).
[43] Destin Jenkins, *The Fed could undo decades of damage to cities. Here's how.*, The Washington Post (Apr. 27, 2021).
[44] *See* Alyxandra Goodwin et al., *Police Brutality Bonds: How Wall Street Profits From Police Violence,* Action Center on Race and the Economy (updated June 2020).
[45] International Capital Markets Association, *Social Bond Principles Voluntary Guidelines for Issuing Social Bonds*, The Social Bond Principles (June 2020).

for projects with positive social outcomes.[46] Similarly, Activest,[47] a research and advocacy organization, has proposed Social Justice Bonds which could provide investors with critical information that may not otherwise be readily available under current disclosure rules.[48] According to Activest, such disclosure could equip investors to identify and prioritize socially just investments while protecting themselves from the potential financial risks of inequitable policies.[49]

Disparate costs to access the bond market for HBCUs

A 2019 study published in the Journal of Financial Economics found that HBCUs pay higher underwriting fees to issue tax-exempt bonds compared with similar institutions that are not HBCUs, thus raising the cost of capital for HBCUs.[50] This effect is unrelated to the issuers' credit risk/quality, and is approximately three times greater in geographic areas of the United States where racial animus is severe.[51] Based on analyses of a 23-year dataset of over 4,100 tax-exempt municipal bond issuances by 965 universities, including 88 HBCUs that issued 102 bonds, HBCUs pay an average of 20% more to issue bonds than similarly-situated non-HBCUs, though the size of this differential varies by state.[52]

Researchers compared HBCUs and non-HBCUs with similar creditworthiness profiles.[53] The researchers concluded that the disparities in fees were attributable to "search frictions" that result from racial animus among limited in-state investor pools.[54] This conclusion is buttressed by their findings that frictions and thus cost disparities were magnified in states where anti-Black racial resentment is most severe.[55] As discussed in several hearings convened by Subcommittee on Diversity and Inclusion, these disparities are examples of longstanding biases against minority-owned firms that limit their ability to be fully competitive in the marketplace.[56] Further, these biases should be addressed given the important role HBCUs play in building a diverse talent pipeline.[57]

The authors of the 2019 study on HBCUs proposed a 'triple' tax exemption for HBCUs to make the HBCU bonds attractive to out of state investors, which could drive greater demand, lower bond placement expenses, and reduce capital costs for HBCU issuers by avoiding the search frictions created by racial animus in some states.[58]

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[46] *Id.*
[47] Activest uses economic modeling, financial analysis, and social policy research to advance racial justice and equity in municipal finance.
[48] Activest, unreleased report titled *Social Justice Bonds* (Mar. 2021) (on file with HFSC staff).
[49] *Id.*
[50] Casey Dougal et al., *What's in a (school) name? Racial discrimination in higher education bond markets*, Journal of Financial Economics at 571 (May 11, 2019).
[51] *Id.* at 29.
[52] *Id.* at 2-3, 5, and 40.
[53] *Id.* at 25.
[54] *Id.* at 41.
[55] *Id.* at 3-4.
[56] House Committee on Financial Services, *Subcommittee on Diversity and Inclusion Hearing on Diverse Asset Managers: Challenges, Solutions and Opportunities for Inclusion*, 116th Cong. (June 25, 2019) (Serial No. 116-35); House Committee on Financial Services. *Committee Memorandum from Hearing on Access Denied: Challenges for Women- and Minority-Owned Businesses Accessing Capital and Financial Services During the Pandemic*, 116th Cong., (July 6, 2020).
[57] *See* Neha Pradhan, *Why an HBCU Recruitment Strategy Is the Pillar of Diversity Hiring: Q&A With PwC*, Toolbox, (February 4, 2021); House Committee on Financial Services, *Subcommittee on Diversity and Inclusion Hearing on Promoting Inclusion: Examining the Need for Diversity Practices for America's Changing Workforce*, 116th Cong., (Oct. 17, 2019) (Serial No. 116-59).
[58] Casey Dougal et al., *What's in a (school) name? Racial discrimination in higher education bond markets*, Journal of Financial Economics at 589 (May 11, 2019).