Society and Municipal Bonds: An Introduction

The world of investing is changing. A large percentage of today's investors (particularly millennial investors) are not satisfied with a simple monetary return; they want their investments to reflect their values. Investors are focusing on sustainability, social and environmental outcomes, and ethical practices. They want their investments to have a positive impact in the world. As the United States struggles to come to terms with racial and social inequities compounded by climate change and world-wide pandemics, new mutual funds and investment strategies are emerging that focus on social, racial and economic justice. Municipal bonds have a significant role to play in building communities and in promoting sustainability and advancing justice, and bonds should be recognized as essential components of socially responsible, values-based investment portfolios.

Bonds at their Best

The municipal market is diverse and widespread. According to the Municipal Securities Rulemaking Board, in calendar year 2019 there was $3.9 trillion outstanding and more than 50,000 different issuers were participants in the municipal bond market. Over two-thirds of the outstanding bonds were held by individual investors, and the default rate was 0.18%.

Since the early 19th century, municipal bonds have been a key source of capital financing for states and local governments. Traditionally issued to finance governmental capital projects supporting community needs, such as healthcare, utility services, education and transportation, municipal bonds provide a variety of beneficial projects for their local communities. In many cases, local property taxes pay the debt service and the projects are voter approved. These are truly projects for and by the people.

By the mid-20th century, many state and local governments were also issuing revenue-backed bonds and providing conduit financing for community projects. These bonds are issued to finance housing, hospitals, convention centers, 501(c)(3) facilities, and a multitude of other projects that are intended to meet community needs and to foster economic development. In most cases, conduit issuance by states and local governments provide an avenue for tax-exemption, but the conduit borrower retains all financial liability with respect to the debt. At their best, these conduit bonds represent a partnership among the federal government, the state and local government, and the private entity financing and building the project for the benefit of the community.

Bonds Gone Wrong

The vast majority of municipal bond offerings successfully support beneficial projects in their communities. They may receive some local press but rarely make national headlines. Bonds generally receive national attention only in extreme circumstances, such as default, corruption or a failed project. The struggles of bond investors in Puerto Rico, the missed mortgage payments relating to Mall of America, the bond payment defaults by Jefferson County, Alabama, and the construction delays plaguing the American Dream Mall make the news, but thousands of other outstanding municipal bond issues quietly meet the expectations of investors and the related bond-financed projects enhance their communities without media attention.

Although the municipal bond market should generally have broad appeal to values-based investors, there may be segments of the market or particular projects that are out of alignment with investors' goals. With the increased focus in the United States on criminal justice reform and policing excesses, some investors want to avoid investment in prisons or jails. In 2019, investors raised concerns with the use of Chicago bond proceeds to cover payouts arising from police misconduct cases. Some investor groups have signaled unease with municipal revenues derived from a high percentage of citizen fines and fees. As the activist investing community grows and turns its attention to municipal bonds, issuers can expect more scrutiny relating to racial and fiscal justice, governance, and sustainability.

Bonds in the Future

Over the past 50 years, Congress has repeatedly turned its attention to perceived abuses, particularly with respect to private activity bonds, sometimes to the distress of local governments. Certainly, the benefit of tax-exemption should be reserved for projects that benefit the community or local economy, and some skepticism is healthy and can be productive. However, the focus is too often on lost federal revenues or perceived abuse rather than on maximizing the potential benefits of tax-exempt bond market. Ideally, future proposals relating to municipal bonds will recognize the long partnership between the federal government and local governments in providing financing for beneficial community projects and will serve to enhance existing programs rather than limiting them.

Conclusion

Municipal bonds have been building communities for over 150 years and have tremendous capacity for positive social impact. As a result, the municipal bond market has a natural overlap with values-based investing. Despite this natural overlap, municipal bonds are often overlooked as meaningful social impact investments and as tools for promoting social justice and other worthwhile initiatives. In this series, we will explore the evolving role of municipal bonds in society, including the rise of values-based investing and its relevance to municipal bonds, affordable housing and social justice, traditional and social infrastructure, and other topics.

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