

# **Bond Case Briefs**

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## **Putting the Public Back in Public Finance.**

It all came down to the penguins.

Jase Wilson and Patrick Hosty, two self-described urban enthusiasts, were having breakfast in a coffee shop in Kansas City, Mo., one morning in 2012. They were discussing a \$500 million general obligation bond issue before voters that would pay for critical improvements in the city's sewer system as well as a host of smaller projects, including a new penguin exhibit at the zoo.

An acquaintance who overheard the conversation declared that she opposed the bond issue. "Why should I pay for penguins?" she demanded.

Mr. Wilson and Mr. Hosty asked if she had ever bought a municipal bond. She hadn't. Nor did she quite know what a bond was. And never mind that just a tiny fraction of the funds was earmarked for the zoo.

"We realized right there that our generation — and in fact most people — do not understand how public finance works, or that it finances projects for the public good," said Mr. Hosty, a bond broker in Kansas City. "Lots of people talk about taxes without understanding how the process works."

For Mr. Wilson, an entrepreneur who had founded Luminopolis, a company that creates open-source software systems for towns and cities, the penguins represented an opportunity to rethink municipal finance. Could you break that \$500 million bond offering into smaller, discrete projects that citizens — whether penguin lovers or more pragmatic sewer proponents — might want to back? And could you give them the opportunity to invest directly in the bond, the way they might back a project on the crowdfunding site Kickstarter?

Those musings prompted Mr. Wilson and Mr. Hosty to create Neighborly, a start-up that aims to connect citizens more directly to public finance. The idea is to use some of the practices of crowdfunding, which has begun to streamline financial markets from commercial real estate to student and consumer loans to small-business capitalization. Neighborly is setting its sights on a market that, though hardly sexy, may surpass them all in size and complexity: the \$3.7 trillion municipal bond market.

In many ways, municipal bonds — loans that finance public works like schools, roads, water treatment plants and other projects, often paying tax-exempt interest — are ripe for innovation. Compared with the stock market, the vast market for municipal bonds is opaque and relatively untouched by technological change, leading to higher prices for retail investors.

Although individuals hold 75 percent of municipal bonds, either directly or through mutual funds, they are typically at the end of a long supply chain, starting with bank underwriters that buy securities from municipalities and resell them to brokers and big institutions. A bond may change hands several times before it reaches an end investor. Each time it does, the price may be marked up — in ways that are not always clear. (Unlike stockbrokers, who must disclose fees, bond dealers are not required to reveal their markups.)

A 2012 report by the Government Accountability Office concluded that smaller investors were likely to pay higher prices to buy, and receive lower returns when they sell. The Securities Litigation and Consulting Group, a consulting firm, estimates the cost of excessive markups to small investors at \$1 billion a year.

For the 50,000 or so municipalities and agencies that issue roughly \$350 billion in bonds annually, the current muni market offers many benefits. Capital costs are typically low for issuers. Because the bonds are usually exempt from federal and state taxes, and sometimes local taxes, investors are willing to accept lower yields than for taxable bonds. And the fees that issuers pay Wall Street bankers have dropped steeply since 2008, when many municipalities took big losses because of ill-advised derivative deals.

Municipal governments in the bond market face challenges, though. Some banks have exited the market, put off by the thin margins that come with originating muni bonds. Structural and regulatory changes have also made the bonds less attractive to banks.

Yet as America's infrastructure ages, the need for state and local spending on road, bridge and building repairs is mounting. As a result, some states and cities have begun experimenting with new ways of pulling in capital, including green bonds for environmental projects; mini-bonds in lower denominations that ordinary investors can more easily afford; and more direct sales to individual investors.

"We want to create a more intimate link between issuers and investors — not just the large investor," said Steven Grossman, former state treasurer of Massachusetts, which sold the country's first green bonds and started an online ordering system that gives individual investors direct access to new bonds.

Muni bonds are historically a safe asset class, but some are looking more risky lately as many cities struggle with underfunded pension obligations.

"You want to make sure that people understand the risks that they are getting into," said Tom Kozlik, a municipal credit analyst at Janney Montgomery Scott. "There's a lot of stuff you need to be paying attention to, especially in this market."

Mr. Kozlik does not see a big need for crowdfunding in municipal finance. For one thing, he said, the market is pretty efficient as it is. He also worries that municipal bonds could be difficult for unsophisticated investors to assess. In addition to underfunded city pension obligations, he points to high-yielding bonds for charter schools as an area of risk.

Mr. Wilson remains undaunted. "Part of the challenge and opportunity is to turn one of the least understood investment classes in the world into what could and should be one of the easiest and most accessible," he said.

For a glimpse of one possible municipal finance future, look at Denver. Last August, the city made waves when it crowdfunded \$12 million worth of mini-bonds. The bond offering, the last phase of a \$550 million voter-approved bond program to upgrade roads and civic buildings, was available only to Colorado residents. The bonds were priced in affordable denominations of \$500, versus the typical \$5,000 minimum for municipal bonds. Orders were limited to \$20,000 per person. Had the bonds been offered in the usual way through Wall Street, the average purchase would most likely have been in the \$500,000 to \$1 million range, said Cary Kennedy, deputy mayor of Denver.

Denver had offered mini-bonds for five years, but this was the first time it did so online. They went

on sale at 8 a.m. on a Monday, and orders swamped the city's website. By 8:16 the bonds were gone; officials had to make refunds to 375 people who placed orders after the bonds sold out.

The bonds were unusual. Investors could buy either a nine- or 14-year zero-coupon bond — which does not pay interest until maturity — with a yield from 4.38 percent to 4.89 percent, higher than that for many municipal bonds at the time. The interest was exempt from city, state and federal taxes. But there was a catch: The Denver bonds could not be easily resold. And while Denver has a triple-A bond rating, these bonds were not rated.

"This was an opportunity for the people of Colorado to invest back into their hometown, in a very safe way," Ms. Kennedy said.

Denver worked with a local bank, Vectra Bank, to handle the online sales, and did not use a bank underwriter. "We had to start from scratch," Ms. Kennedy said.

That is where a service like Neighborly's could come in. Though the company has yet to help any municipality issue a bond, Mr. Wilson said it aspired to be "Denver in a box for all cities."

Neighborly is testing an online marketplace that offers conventionally issued and rated municipal bonds. Mr. Wilson said it could one day replace some fee-collecting middlemen with an automated system that tracked prices and transactions more efficiently. He also hopes to give municipalities a way to directly issue bonds that would still be rated by outside agencies. Neighborly is exploring block chain technology — a kind of distributed ledger system used by the virtual currency Bitcoin — as a way to accomplish some of that.

It is still settling on a revenue model, and is considering taking a small cut of transactions or licensing its technology to issuers.

It hasn't been a straight path for the three-year-old company. After their penguin epiphany in 2012, Mr. Wilson and Mr. Hosty began by starting an online platform that made it easier to donate money to civic projects like community gardens, dog parks and bike lanes.

In its first two years, Neighborly helped raise \$3 million for around 60 projects. Over that period, Mr. Wilson was accepted into three programs aimed at accelerating the start-up process: Points of Light, in Washington; Tumml, in San Francisco; and 500 Startups, in Silicon Valley. (Mr. Hosty has participated in Neighborly while continuing with his job at a bond firm.)

In the fall of 2014, Mr. Wilson began to tackle the municipal bond market. By this fall he expects to deploy a system that enables municipalities to market bonds directly to investors. The company has lined up seed funding from Structure Capital; the actor and investor Ashton Kutcher; and the venture capital firm Formation 8, which has invested in other civic innovation start-ups, including OpenGov.com.

Eliminating some of the layers in the municipal bond process would "put more money into the project rather than the hands of middlemen," said Adam Blowers, the comptroller for Geneva, N.Y.

Patrick Sabol, a senior researcher with the Brookings Institution's Metropolitan Policy Program, said the civic implications of the idea appealed to him. "The interest behind this is less about accessing low-cost capital and more about community involvement and engagement," he said. "That has kind of been lost in the U.S. in many ways."

In the building that serves as Neighborly's San Francisco headquarters hangs a framed municipal bond certificate from the 1930s. The Golden Gate Bridge and Highway District issued it to finance

the bridge. For Mr. Wilson, the certificate is a reminder of the vital role municipal finance should play, especially in smaller cities and towns, where many projects were once funded without the need for Wall Street banks.

For decades, though, municipal finance has grown increasingly complex. Under the guidance of Wall Street underwriters, bond deals grew larger and more intricate, combining many projects into single megabonds. A typical muni bond today bundles together all sorts of public financing needs. Sewage plant improvements are combined with zoo projects, making it difficult for ordinary people to comprehend funding that flows both to penguins and vital infrastructure. It has become hard for people to track how money is being spent.

“Muni bonds fell out of favor with people because they became decoupled from people’s civic lives,” Mr. Wilson said. Today, munis are often esoteric instruments bought mostly by high-net-worth investors looking to reduce their tax bills.

Is it possible, or even wise, to rewind municipal finance back to a simpler time?

Some industry professionals argue that the American municipal finance market works extremely well, and in fact is the envy of the world.

And while interesting in theory, crowdfunding may be ill-equipped for the challenges of municipal finance. “Crowdfunding is terrific at raising money,” said Sean W. McCarthy, chief executive of Build America Mutual, a municipal bond insurer, “but making a market around it is more difficult.” That includes tracking the performance of thousands of municipal issuers over time and providing a ready market when investors need to sell. In that sense, he added, “the market is served well now by established players” like national and regional underwriting banks.

The federal government effectively subsidizes municipal bonds by granting them an exemption from taxes, which allows municipalities to offer lower yields and also adds a layer of regulatory oversight. An army of advisers, specialists and bankers are typically required for a bond sale as a result, making it costly to sell bonds in small denominations. “There are 10 different participants to facilitate your \$5,000 loan,” said Thomas G. Doe, president of Municipal Market Analytics, an independent research firm based in Concord, Mass.

Abolishing this tax-exempt status is a perennial discussion in Washington, but for now that status makes the bonds most suitable to people in high tax brackets, said Tom Lockard, a former muni bond banker and now a vice president at the real estate crowdfunding site Fundrise. “It’s a bit of a slippery slope,” he said, to promote such bonds to people for whom the tax break is less important.

Fundrise used its crowdfunding platform in January to offer \$5,000 chunks of \$100,000 bonds with 5 percent tax-free yields issued by the New York Liberty Development Corporation to finance 3 World Trade Center. The catch was that investors had to be wealthy or, technically, “accredited.” “We know the difficulties” of offering muni bonds on a broader scale, Mr. Lockard said. “We continue to study it.”

Mr. Doe of Municipal Market Analytics said crowdfunding offered a direct connection between issuers and their constituents. “Is there a better way to attract capital to public projects in this new era of social media?”

It’s possible, he said, that crowdfunded bonds could play an important role, but they would need to meet large infrastructure needs while surmounting the regulatory hurdles that come with tax-exempt municipal finance. Important details need to be worked out, he said, but this much is certain:

“We need new ways of doing this.”

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By AMY CORTESE

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