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Congress Considers Reviving Risky Bonds to Boost Small Businesses.

Industrial development bonds historically have the highest default rate, but a bill in Congress would revamp them.

IDBs are the bad boys of the muni market. The less-than-stellar reputation comes because industrial development bonds, as they are otherwise known, default more than almost any other municipal bond. General obligation bonds, for instance, hardly ever default. Revenue bonds default only slightly more often. But IDBs account for 28 percent of all municipal bond defaults.

Perhaps it's because of this and the Great Recession that IDBs are no longer a favored economic development tool for state and local governments. Initially offered to help small, local companies find comparatively inexpensive financing to create jobs, IDB issuance is down by 70 percent, or roughly $700 million, from its peak in 2007.

Jason Rittenberg, director of research and advisory services at the Council of Development Finance Agencies (CDFA), thinks he knows what's holding IDBs back. I recently talked to him about the future of IDBs and about a bill in Congress to revive them.

Beyond the recession's effect, what do you see as the problem with IDBs?

One big reason for the decline in issuance of IDBs is that the portion of the revenue code [it's contained in] has not seen a significant revision since 1986. We at CDFA believe that if the code were updated to reflect the larger size of small manufacturers today, as well as the types of facilities manufacturers need to be effective, we would see more use of IDBs. For instance, a change in the code would make it easier for high-tech firms to have research facilities included as part of bond issuance. And seeing more use is important because low-cost capital helps small manufacturers grow and create more high-quality, high-paying jobs. Depending on the company, they might be able to get lower than traditional cost financing. As lending rates increase, this will be much more affordable.

IDBS usually come to market without a credit rating and without insurance. They have a relatively high rate of default. Is that a problem? Should legislation do anything to make them safer?

They are a higher risk asset than some other muni bonds. A general obligation bond is backed by the general revenue of a municipality so they have low default rates. But IDBs and other private activity bonds have higher yields. They're a worthwhile investment for those interested. This bill is not going to address that, but it is not going to make it more of a concern. IDBs are an asset that should be looked at by sophisticated investors. Unrated debt is generally understood to be a higher risk than rated debt and therefore produces higher yields for the investors. Often, it is secured by a credit enhancement [that is sometimes rated] and therefore a default does not necessarily preclude repayment to the investor.

Given the temperament of this Congress and its inability to pass almost any legislation, what sort of chance do you think the Modernizing American Manufacturing Bonds Act has? Is there a danger in it skirting dangerously close to tax reform that might set limits on muni bond issuance?

It’s difficult to predict the success of this bill, but it has bipartisan support. It is looking at modernizing the code, not creating a new vehicle.

Is it skirting close to looking at the muni market? A better way to look at it is not as tax reform or as a muni bond issue, but as an issue in creating jobs. If you look at the merits of what the country is trying to do with the national economy, this bill would be seen as effective and be passed. This is a vehicle that issuing authorities can use to support businesses in communities, especially companies that feed into the supply chain of major manufacturers, such as auto plants and airplanes. These smaller manufacturers are a huge job creation machine. Local officials want to support those smaller manufacturers in their communities. A lot of times these bonds are going to companies with a handful of employees; the capital is used to grow them into the next level. It’s economic gardening. It isn’t money going to speculative startups, but to small companies that have a track record.

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BY PENELOPE LEMOV | AUGUST 14, 2014

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