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The Troubled Housing Behind a Muni Bond.

After federal subsidies are cut off, investors see a big loss.

At the Warren and Tulane apartments in Memphis, inspections have found roach infestations, broken windows, buckling ceilings, and missing or damaged appliances. "It's appalling," says Jessica Johnson-Peterson, who's lived at the Warren apartments with her husband and children since 2009. "We have to jump through extreme hoops to even get anyone's attention."

Such conditions led the U.S. Department of Housing and Urban Development in February to cut off rent subsidies for more than 1,000 residents. Those federal dollars were to be used to repay $12 million of bonds sold by the apartments' owner, Global Ministries Foundation. Without that money, the bonds went into technical default, pushing their price to as little as 21¢ per dollar of their face value.

The GMF debts were municipal bonds, government-sponsored debt that offers investors income free from taxes. Munis may call to mind investments in toll bridges and sewers, but they also include bonds like GMF's issued through "conduits"—local agencies with few, if any, employees that exist only to sell tax-exempt debt for a fee. With little responsibility for the projects they finance—sometimes in different states—the authorities have raised money for privately run nursing homes, charter schools, and even amusement parks.

"Conduits have been a perennial problem in the market," says Christopher Taylor, the former executive director of the Municipal Securities Rulemaking Board, the industry's regulator. About 60 percent of muni bonds that default are issued by such conduits, according to Matt Fabian, a partner at Municipal Market Analytics.

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The market for conduit bonds is one of Wall Street's most opaque niches. Seven days after GMF issued a letter to the bond trustee about the default, some bonds were sold in lots of $25,000 and $50,000 for as much as 10 percent more than face value. Neither the buyers nor sellers are known. The trades suggest that small-time investors may not be getting important information when they buy bonds. In 2009 the muni rule-making board launched a website for reporting such information, but investors may not know the records are available.

GMF, which says on its website that it works "for the glory of God and the eternal welfare of mankind," owns 10,500 low-rent apartments in eight states. It financed its purchase of the Memphis apartments through the city's Health, Educational, and Housing Facility Board. The agency's head says that GMF had a good reputation with the investment community before the default.

Richard Hamlet, GMF's president, says his organization has invested more than $3 million in the Memphis apartments, which were suffering from crime and poor maintenance before GMF purchased them in 2011. "Our management team, in addition to outside contractors we engaged, worked hard under very stressful conditions to mitigate physical deficiencies on the sites," Hamlet says.

GMF is a nonprofit. According to its tax records, Hamlet was paid $535,000 in salary and benefits in 2014. He says that's in line with his industry peers.

Conditions deteriorated after the GMF acquisition, federal reports say. An April inspection of 30 buildings and 25 units found "life-threatening" breaches including exposed wires and blocked emergency exits. Although GMF hasn't missed payments on the bonds, it's likely to do so within two years unless it can sell the buildings, Standard & Poor's Financial Services said on Feb. 19. The end of HUD subsidies put the bonds in technical default. Hamlet says this "is the first bond default I have had in my career in this space."

Federal housing officials have begun planning to relocate residents of the Warren and Tulane apartments.

"I'm ecstatic," Johnson-Peterson says. "I feel like it's an opportunity to be able to provide better chances for my children and a better environment to raise my children."

The bottom line: Municipal bonds don't only fund government and big public works. Sometimes the borrowers are private groups with shaky projects.

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