



ADVISORY

A GFOA *advisory* identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Understanding the Issuer's Role in Secondary Market Securitization of Tax-Exempt Obligations **(2005) (DEBT)**

Background. Tax-exempt municipal bonds may be securitized after they are issued in order to create secondary market products. This practice has greatly increased over the past ten years. These securities can take many forms, most notably tender option securities, but also certificates of participation (COPs), putable floating rate receipts, Dutch auction/inverse floater receipts and stripped-coupon municipal securities. In a securitized bond transaction, a financial institution places a government security (or pool of securities) with a trustee or custodian, and the underlying stream of payments is then packaged as a new security and sold to new investors in the secondary market.

As with bonds, securitization is also common with government leases. In a secondary lease securitization, a financial institution places a government lease (or pool of leases) with a trustee or custodian, and the underlying stream of payments is then packaged as a new security, generally COPs, and sold to new investors in the secondary market. Issuers should determine when executing a lease if the issuer intends for the leases to be sold as part of a public offering.

In most cases, the securitization takes place after the debt is issued and the deal is closed, and often the issuer is unaware that their obligations have been securitized. Less frequently, except in the case of tender option bond programs, securitizations occur at the same time of the issuance of the original obligation.

With regard to secondary market securitization, in competitive sales, issuers have less control over what occurs to their bonds in the secondary market, than they have in negotiated sales. In a negotiated sale, and in private placements, issuers *may* play a stronger role in determining how their bonds should be treated in the secondary market, and may ask their underwriter for an agreement about these practices prior to the sale of the bonds. However, issuers should recognize that placing such limitations on underwriters could result in reduced market liquidity that could result in higher interest rates paid by the issuer.

In some cases, the securitization may raise questions for the issuer such as:

- Tax counsel may question how secondary market securitizations that occur concurrently with the issuance of the bonds should be treated for purposes of calculating the arbitrage yield for a bond offering.¹ This

¹ When a governmental entity sells bonds, it must compute the arbitrage yield on the bonds based on the "issue price" of the bonds. Currently, some tax counsel are uncertain as to the appropriate treatment of such transactions under existing tax law if the securitization is undertaken contemporaneously with the primary offering, such that it raises the question as to public offering price. These tax counsel question whether the "issue price" of securitized bonds must be calculated with reference to the price paid by the purchasers of the securitized interests, or whether it is based on the price paid for bonds by the institution setting up the securitization. Generally though, while many tax counsel may conclude, at least with respect to tender option bond programs, that the "issue price" of the bonds is not affected by the securitization, the form of the issue price certificate may change since secondary market securities are not offered to the general public.

issue is of particular concern in refundings and when documentation is provided in the form of issue price certificates.

- Securitization of leases that were originally structured as private placements may create disclosure issues for an issuer if the securitization takes place without lessee approval and/or involvement.
- Determine which party has the continuing disclosure responsibility with respect to the securitized product.
- An issuer may be uncomfortable with its name being associated with a secondary market product. Due to the current identification system for municipal securities through CUSIP numbers, a new securitized product in the secondary market will be assigned the issuer's current six-digit base CUSIP number, even when the issuer is not involved in the securitization. This may cause confusion by the certificate holders of the securitized product regarding the responsible party as the issuer of the product. It is very important to note that the certificate holders are not direct bondholders of the original issue; the bondholder is the trust which created the new certificate, and the trustee is representing the bondholder's legal and economic interest in the underlying bonds.

Given the increase in secondary market securitized products, and the complexities involved with the transactions, issuers should be aware of the risks and rewards associated with these transactions.

Recommendations. Government Finance Officers Association (GFOA) recommends that certain actions be undertaken by a state or local government to address potential problems associated with secondary market securitization of its tax-exempt obligations. Actions recommended by GFOA are:

1. Issuers should speak with their bond counsel and financial advisors in advance to determine if underwriters in a negotiated sale should be required to make certifications in the bond purchase agreement, as well as in the issue price certificate delivered at closing, that:
 - each of the bonds of the issue is being directly offered to the public, or alternatively;
 - the underwriter expects to offer some or all of the bonds to the public through a securitization format, either directly or through a party related to the underwriter in conjunction with the underwriting, and;
 - ensure that the underwriter provides information to bond counsel in order to properly calculate the arbitrage yield and verify compliance with other tax rules.
2. For leases, the original lease documents should explicitly state what is and is not permissible regarding secondary lease securitization. They should require that any secondary lease documents clearly (a) identify the role and responsibility, if any, of the government as part of the lease offering, including any relationship between the lessee and the new investors; and (b) that the offering is a secondary offering and whether all requirements relating to the tax-exemption of the securities have been met.
3. In a secondary market securitization, the trust, as the bondholder, should receive the same continuing disclosure treatment as any other bondholder. The certificate holders, as purchasers of the trust certificates, are not considered the bondholders of the primary bond issue; but they are the certificate holder of the new product created in the secondary market. The issuer has no disclosure obligations to the certificate holders. If both products – the issuer's original obligations and the trust's new product, have the same six-digit base CUSIP number, an issuer may receive inquiries from the certificate holders regarding the underlying obligations. An issuer should refer these inquiries to the trust and is under no responsibility to act or respond to these inquiries.

References

- GFOA Best Practice, "Selecting and Managing the Method of Sale of State and Local Government Bonds," 1998.
- GFOA Best Practice, "Debt Management Policy," 2003.

Approved by the GFOA's Executive Board, October 11, 2005.

This RP replaces two Recommended Practices – *Securitization of Tax-Exempt Bonds* (1996) and *Securitization of Leases* (1993)