



# Evaluating a Municipal Bond's Default Risk

When considering the purchase of a municipal bond, an important consideration is a state or local government's ability to meet its financial obligations. The likelihood that the bond's issuer will fail to meet the requirements of timely interest payment and repayment of principal to investors is called default risk. Investors should work with a to evaluate a bond's default risk.

## Assess a State or Local Government's Financial Information

One way to evaluate a state or local government's default risk is to assess available financial information. When a state or local government offers new bonds for sale, it typically discloses details of the offering and information about its financial condition in the bond's official statement, a document similar to the prospectus used for a corporate securities offering. This information is typically updated for each new bond sale. State and local governments also disclose updated financial information after the initial bond sale has finished through two types of continuing disclosures: financial/operating disclosures and event disclosures.

Financial/operating disclosures from issuers of municipal securities consists of important financial information and operating data about an issuer and/or other entity that may be obligated to repay investors in the securities, frequently referred to as an obligated person. Such disclosures may include, for example, the issuer's annual financial information.

Event disclosures detail for investors delinquency in principal and interest payments, other types of defaults, unscheduled draws on debt service reserves reflecting financial difficulties, unscheduled draws on credit enhancements reflecting financial difficulties, rating changes, events affecting the tax-exempt status of the bond, bond calls, and other events.

Ongoing financial and event disclosures made by state and local governments are available to the public for free through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA®) website at [emma.msrb.org](http://emma.msrb.org).

Federal securities law requires financial professionals that buy and sell municipal bonds to have procedures in place to obtain event and other disclosures about municipal securities. Ask your financial professional if the state or local government that has issued a particular bond is current on reporting of annual financial and operating data, and consider missing or past-due financial information as a potential risk.



*Use the EMMA website to check the current credit rating assigned by Fitch Ratings, Kroll Bond Rating Agency, Moody's Investors Service, Inc. or Standard & Poor's.*

## Evaluate the Credit

Credit ratings are another way to evaluate a bond's risk of default and, in some cases, take into consideration the potential loss to investors in the event of default. It is important to realize that these ratings are opinions of the company issuing the ratings and one of many factors used in evaluating a municipal bond investment. Because ratings can change, investors should not assume the rating shown on the official statement when the bond was first issued remains in effect if it is purchased at a later date. Investors may wish to ask their broker for the current credit ratings on any bond they are considering purchasing or use the EMMA website to check the current credit rating assigned by Fitch Ratings, Kroll Bond Rating Agency, Moody's Investors Service, Inc. or Standard & Poor's.

Investors should understand that a high credit rating is not a seal of approval and does not reflect or guarantee stability of market value or liquidity. A high rating also does not mean that an investor will be able to sell the bond at a particular time, especially prior to maturity, or that the investor will receive a particular price.

Still, a low credit rating is an evaluation of a bond's risk of default and investors should carefully consider the risks of purchasing a bond with a low credit rating. Bonds with low credit ratings typically carry higher interest rates than those with higher credit ratings and the higher return is intended to compensate investors for the higher level of risk they are assuming with the purchase.

Not all bonds have credit ratings. While an absence of a credit rating is not, by itself, an indicator of low credit quality, investors in non-rated bonds should be prepared to conduct their own independent credit analysis of the bonds.

## Consider Payment Protection Features

Some municipal bonds have a repayment protection feature such as bond insurance, letter of credit or a guarantee by another unit of government. However, any such guarantee depends on the financial soundness of the entity providing the guarantee. For this reason, when considering such a bond, investors should be sure to take into account the credit rating and long-term viability of the entity providing the guarantee.

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