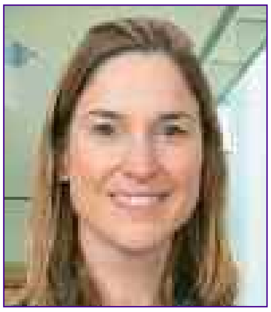
Capital gains through municipal bonds



Christine Todd
Head of Tax
Standish Mellon Asset Management

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Global bond markets look set to welcome some fresh entrants in 2015 as the UK public sector works to attract new capital through the issuance of municipal bonds, while other countries such as China step up their own public sector debt initiatives.

In January it was announced the UK's first municipal bonds agency, the Local Capital Finance Company Ltd (LCFC), would launch a range of municipal bonds backed by 48 local councils and the influential Local Government Association (LGA).[1]

The first issuance is expected this spring with the authorities expected to initially issue bonds in a tranche worth £250-300 million. But analysts believe the market could quickly ramp up to create a multi-billion pound municipal bonds sector.[2]

Borrowing boost

The debt could offer a potential financial lifeline to local authorities increasingly constrained by austerity measures introduced by central government. It could also cut the cost of borrowing for these institutions, by removing their dependence on the UK Treasury's existing Debt Management Office (DMO) and create new opportunities for fixed income investors.

While the market awaits final detail on the exact disclosure requirements and cross-guarantees underpinning issuance by the new UK agency, proponents of the scheme are optimistic its development will ultimately lower costs and boost the creditworthiness of municipal finance.

Commenting, the LGA says: "Experience from other countries has shown that an agency's credit processes, aligned with the incentive of lower borrowing costs and the oversight of peers, has strengthened the overall creditworthiness of the sector much more than governments could achieve on their own."[3]

While the UK is taking its first steps in the sector, municipal bonds are big business in other global markets such as the US, where a well-established pool of almost US$4 trillion serves mainly retail investors and so-called "munis" are exempt from federal, and often state taxes – a position unlikely to be replicated in the UK municipal market.

While the US muni market shrunk in 2014 with moderate issuance underwhelming bond redemptions, issuance has spiked this year. According to recent data from Thomson Reuters, the first two months of 2015 saw US local governments issue record levels of municipal debt for the period, an 88% increase on the same period last year, triggering some concerns about a potential rise in near-term market volatility.[4]

US-based investment manager Standish is a major investor in domestic municipal bonds but is also taking a keen interest in the latest UK local authority debt plans. Commenting, its head of tax sensitive fixed income and insurance, Christine Todd, says the nascent UK muni market may hold broad appeal for institutional investors and could offer some specific benefits over other markets, including the US.

Market appeal

According to Todd: "The UK local authority bond market is likely to hold significant appeal for institutional investors with the sophistication and size to take advantage of its potential. Early entrants may benefit if relatively attractive pricing is required to clear the market. As this is a new market, it does have the potential to be a lot more efficient than the US muni sector, which is very fragmented and has more than 50,000 issuers in the index alone. In the UK, deals are likely to be more consolidated and that could drive larger deals and a more efficiently traded market."

In the US, Standish is an advocate of municipal infrastructure revenue bonds – which are commonly used to underpin infrastructure projects in areas such as transport, energy, and sewerage and water system development. According to Todd, these instruments provide a growing investment opportunity to capture relatively high levels of real current income, stable credit quality, and can, in some cases, enhance the overall risk and return profile of diversified investment portfolios.

Although nothing directly comparable has yet been proposed for the UK, Todd hopes the new wave of British munis will ultimately provide similar levels of credit quality, income and diversification characteristics as their US counterparts and might even offer greater levels of transparency.

"We anticipate annual issuance in the region of £2-3 billion a year in the UK as its municipal bond market becomes established. As yet, it is not clear if these new bonds will be traded on exchange or over the counter (OTC) – as in the US – which makes pricing transparency difficult and can impede liquidity. But the UK certainly has the opportunity to avoid this route and offer investors in this sector more clarity," she says.

The UK is not the only international market set to launch municipal bonds. China is increasingly keen to allow wealthy localities such as Shanghai, Beijing and Guandong to issue bonds for the first time in decades.[5]

The country opened a pilot project in June last year which invited six provinces – including Guandong – and four cities to issue municipal bonds through an interbank market supervised by the Shanghai and Shenzhen stock exchanges.[6] Depending on the success of the pilot, this scheme could soon be extended.

Cautious approach

While Todd sees potential in the planned Chinese issuance, she does believe many investors will view the market with some caution.

"Any new Chinese issuance is probably going to come at a discount with some sort of liquidity premium. The problem with China lies in its economic transparency. In the past this has often been called into question and lies at the heart of credit risk in the country. If you are investing in government, which is effectively leveraged to the economy, and you don't feel comfortable with the economic numbers available it will be hard to make a big commitment there," she adds.

In its latest move, the Chinese government said in March it would allow regional authorities to convert up to US$160 billion of debt obligations, including some high yield debt into municipal bonds.[7] The step is designed to finance costs on liabilities some brokers say have now reached US$3 trillion.[8] News of the initiative received a mixed reception from investors, but the likely issues and benefits this presents have yet to be fully assessed by the global investment community.

Either way, with movement to widen municipal debt markets in China, the recent surge in issuance in the US and the launch of the UK's own municipal debt market this year, fixed income investors look set to embrace an increasingly wide range of public sector debt related assets.

In turn, the growth of the municipal debt market has the potential to generate new returns, add diversification to investment portfolios and support funding for a range of vital public works and services in the months and years ahead.

1,2. Cash-strapped local councils to raise billions with new municipal bonds. FT. 02.02.14.

3. Project team appointed to prepare Bonds Agency. Local Government Association press release. 09.09.14.

4. Muni Bonds Headed for a Rough Patch. The Wall Street Journal. 08.03.15.

5. Back to the future. The Economist. 24.05.14.

6. Can municipal bonds shed some light on China's public finances? Institutional Investor.30.07.14.

7,8. China lets local authorities convert debt into muni bonds. Bloomberg Business. 09.03.15.