INVESTORS ENCOURAGE THE DEVELOPMENT OF A UK MUNICIPAL BOND MARKET

INTRODUCTION

In March 2016 The Investment Association published the Productivity Action Plan that outlined how the investment industry plays a fundamental role in rebuilding the UK's economic foundations for a better future and sets out a series of actions to improve long-term investment. This includes steps that can be taken to help develop efficient capital markets more and to expand the diversity of financing options for UK companies.

Capital markets complement the traditional and central role of banks as lending entities. A well-functioning capital market facilitates the efficient allocation of funds from end-investors to companies and projects in need of capital to grow and invest. Without efficient capital markets, long-term investment relies on a narrow set of financial instruments, including many with short-dated maturities. Taking steps to expand companies' access to suitable financing options is a crucial part of ensuring that long-term investment is sustainable and sound. As part of this, The Investment Association is supportive of the development of a strong municipal bond market in the UK for local authority issuers keen on accessing capital markets. This would not only be beneficial to the local authorities as issuers, but to institutional investors and the wider economy as a whole.

In the past, institutional investors (ie. insurance companies and pension funds) through their asset managers have provided indirect financing to the wider economy through the purchase of corporate bonds. Increasingly these investors are seeking opportunities for direct lending as a means to diversify their investments away from existing corporate bond and equity markets. Given their long-dated liabilities, they are prepared to invest in longer-dated debt with the right risk/return profile, as long as the risks are transparent and within their risk appetite. This can be achieved by the development of a municipal bond market.

In the next sections of this paper we consider:

- the benefits of municipal bonds for;
    - the wider economy;
    - borrowers; and
    - investors.
- the ways that municipal bonds can be issued including through:

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  - Direct access to public bond markets;
  - The use of the aggregator model; and
  - Private Placements.
- Recommended features for municipal bonds
- Other considerations including – policy risk.

THE MUNCIPAL BOND MARKET

Municipal bonds are securities issued by local governments to borrow funds to finance new infrastructure projects, cash flow needs, or refinance outstanding bonds but are not fully backed by the central government. There are two common types of municipal bonds:

- **General obligation bonds ("GOs")**: GOs are unsecured bonds backed by the tax powers of the issuing government. These are normally used to finance non-revenue producing projects such as roads and schools. GOs are normally considered the safest of municipal bonds thanks to the credit-worthiness of the issuer and so tend to offer lower yields.
- **Revenue bonds**: Revenue bonds are issued to fund revenue-generating projects – this revenue is then used to pay off the bonds. These tend to offer higher yields than GO bonds but are still considered to be safe investments and are in some respects considered more secure than GOs, as a result of a first lien on revenues to pay debt service

Municipal bonds are a popular investment instrument in the United States, where the municipal bond market is worth $3.7 trillion[1]. However, no such market exists in the United Kingdom.

In the UK, local government authorities have more than £85 billion in outstanding debt and issue about £3 billion of new borrowing and refinancing every year. Approximately, three-quarters of this is lent to them by a Treasury agency called the Public Works Loan Board (PWLB), with a lot of the rest from commercial banks. The IA believe that the moment has come for local authorities to consider capital markets as an alternative source of finance given:

- the recent volatility in the PWLB's lending rates;
- a general reduction in longer term lending from commercial banks because of new capital and liquidity rules; and
- investor appetite for municipal bonds due to a decrease in alternative sterling investment opportunities.

BENEFIT OF MUNICIPAL BONDS:

FOR THE WIDER ECONOMY

The UK Infrastructure & Projects Authority expects that £297bn of spending on economic and social infrastructure will be needed in the UK between 2016 and 2020-21[2]. Achieving this will require a mix of public and private funding.

Municipal bonds:

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[1] MSRB Education Center, http://www.msrb.org/EducationCenter.aspx
[2] Infrastructure & Projects Authority, *National Infrastructure Delivery Plan 2016-2021*, https://www.gov.uk/government/publications/national-infrastructure-delivery-plan-2016-to-2021

- offer a means for local authorities to unlock private sector financing for necessary infrastructure projects at competitive market rates.
- offer a long term stable funding alternative to government lending through the PWLB freeing up resources to be allocated by the Government to other parts of the UK economy.
- free up bank financing for alternative uses that cannot be accommodated by other public markets, and
- replace bank's leverage and maturity mismatch between its assets and liabilities with unlevered institutional investors that can match their longer-term liabilities with the longer term borrowing needs of issuers.

FOR BORROWERS

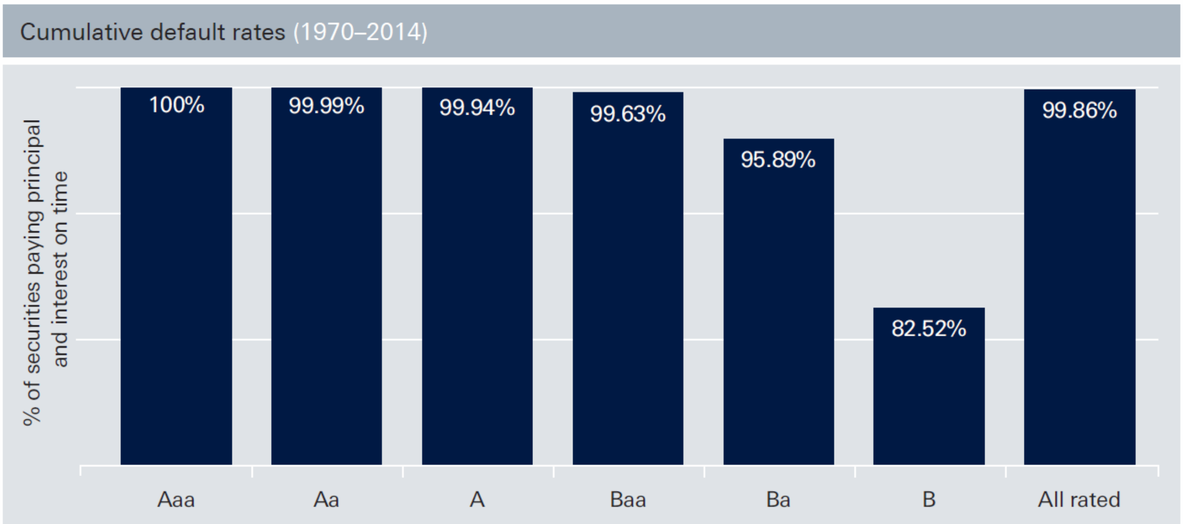
As noted above, local authorities issue about £3 billion of new borrowing and refinancing every year raised from the PWLB and through commercial banks. However, previous increases in the PWLG lending rate has led councils to consider alternative sources of financing. At the same time Basel III regulations are likely to cause banks to lessen their commitment to longer term lending because the new capital and liquidity rules make such lending more expensive therefore less attractive.

Institutional investors can bridge this funding gap through municipal bonds and provide issuers with additional benefits including:

- stable long-term funding alternative to issuers and reduce their dependency on the Government and the banking system,
- longer term financing, particularly from pension funds and insurers looking to match their long term liabilities that can be tailored to the borrowers financing needs therefore mitigate refinancing risk.
- flexibility in how to raise funds required including through private placements, direct access to public debt markets or through the use of an aggregator such as the UK Municipal Bond Agency.
- flexible payment structure (amortising or bullet maturities).

FOR INVESTORS

Municipal bonds in existing markets have proven to be a safer asset class when compared to corporate bonds. The cumulative default rate for municipal bonds between 1970 and 2014 was just 0.14%, and as of 1st quarter 2016 no municipal bond rated AAA had ever defaulted. This makes municipal bonds highly attractive to risk-averse investors who are looking for a relatively stable flow of income.



Source: Moody's Investor Service as of 12/31/14, the latest data available.

As much UK municipal bonds would be suitable for inclusion in mainstream fixed income portfolios as they would offer:

- institutional investors the long dated assets that they need to match their long-term liabilities. While municipal bonds may come in all maturity ranges, it is common to have repayment periods of 20 to 30 years, or even longer. Combined with the low default rates of municipal bonds, this means that that long-term investors can rely on a steady, relatively safe income stream over the long-term.
- strong diversification benefits as they tend to have a low or negative correlation to both existing corporate bond and equity capital markets.
- investors without the specialist knowledge to invest directly in infrastructure the means to gain indirect exposure to infrastructure investment.

PUBLIC BOND MARKET

Local authorities can issue municipal bonds directly on the public bond markets. This provides issuers with access to the largest possible number of potential investors thus diversifying their creditor base. In addition, as listed securities are easily tradeable, issuers will benefit for a lower cost of funding as no illiquidity premium will be applicable.

To be sure of meeting investment mandate requirements and to benefit from competitive market pressures, local authorities to seek to issue municipal bonds that are:

- Investment grade;
- Fixed-rate;
- Long-dated;
- Preferably inflation linked; and
- Security on specific projects, or clear backing from the tax revenue of the authority.

AGGREGATORS

For local authorities that are looking to access capital markets but issue below benchmark size bonds, an aggregator model offers an alternative option to listed public bonds.

An aggregator is an intermediary vehicle that issues bonds on behalf of a number of borrowers. Aggregators provide specialist knowledge that individual issuers may lack, and allow for the pooling of borrowing requirements to create benchmark size issues, for which there is greater demand. Pooling also allows for a reduction in overall costs. For these reasons aggregators provide smaller issuers an opportunity to access the bond markets where it might otherwise not be possible to.

Aggregators have proven successful in the housing association sector, where organisations such as The Housing Finance Corporation have provided loans to regulated providers since 1987. The Investment Association welcomes the establishment of the Municipal Bonds Agency, created with the intention of helping local councils' finance their investment in key projects, and believes it will help lower the cost of financing for local authorities and encourage greater issuance of municipal bonds in the UK.

While The Investment Association is supportive in principle of the use of aggregators, investors will require there to be sufficient transparency in place as to the underlying borrowers, and structures which ensure that sufficient funds will always be available to fund the administrative arrangements throughout the life of the bond.

PRIVATE PLACEMENTS

A private placement is where a medium-to-long-term fixed coupon debt instrument is issued directly to institutional investors, based on deal-specific documentation negotiated by the issuer and the borrower. These more bespoke arrangements offer issuers a number of benefits, including:

- Flexibility on the use of proceeds;
- A more flexible payment structure;
- A more stable business outlook and greater operational flexibility; and
- Reduced cost, as investors do not require the borrower to have a public credit rating;

CONCLUSION

The development of a UK municipal bond market would offer widespread benefits. Municipal bonds could provide relatively safe, reliable income streams to investors while giving local authorities access to cheaper, more diverse sources in funding. Most importantly, they offer a means to unlock the funding necessary to meet the UK's growing infrastructure needs, providing both social and economic benefits for local communities.

The Investment Association is therefore supportive of the development of a strong UK municipal bond market and will be engaging with relevant stakeholders to promote the development of this market [3].

ABOUT US

The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £5.5 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

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[3] The Investment Association, *The Investment Association Productivity Action Plan,* http://www.theinvestmentassociation.org/media-centre/press-releases/2016/press-release-2016-03-22.html

The UK is the second largest investment management centre in the world and manages 37% of European assets.