Community Finance Brief

Tax Payer Interest Rate Benchmark Changing

CSG
MATT POSNER | COURT STREET GROUP LLC

The interest rate a taxpayer pays on their governments debt obligations is in the process of undergoing an update. A changing of the guard in benchmarking is occurring, with little fanfare, and has rather large ramifications in terms of transparency in the world of public finance while also demonstrating its challenges. Municipal bonds issued by state and local governments are rarely in the headlines but they play a rather large role in the way in which our communities operate. Now, the even more opaque way in which interest rates are decided upon for a city, county or state bond, is in the process of switching benchmarks. As the markets moved from the London Inter-Bank Offered Rate (Libor) to the Secured Overnight Financing Rate (SOFR) in the adjustable-rate market, munis are in the process of moving from Municipal Market Data (MMD) to Bloomberg Valuation (BVAL). Let's explain.

HOW A MUNI INTEREST RATE IS DECIDED UPON

According to the industry's self-regulator, the Municipal Securities Rulemaking Board: "The underwriter uses recent sales of comparable bonds and yield curves, among other information, to set that price." Vague. And with reason - it's really difficult to defend a price for a municipal bond.

Pricing and benchmarking for municipal bonds is more challenging than other fixed-income markets for some of the following reasons:

- They issue more serial maturities, which means there are a lot more moving parts in a bond deal to take into account;
- Call-options vary from 10-year par to make-whole to other options whereas other markets lean towards just a make-whole that simplifies pricing;
- Not generally initially priced at par;
- Over 30,000 different obligors make up the market;
- Secondary volume for municipal bonds is around $9- to

Quick Takes

In December of 2023, the largest municipal advisory firm made it clear to the industry it would be pricing primary market transactions for its clients using Bloomberg's BVAL over LSEG's MMD - a major policy change
– *The Bond Buyer*

Since the 1980s, MMD has dominated the way in which municipal bonds are priced in the primary market and how trades are quoted in the secondary market
– *The New York Times*

Aside from benchmarking, financial instruments such as rate-locks and even call-options in an issuers's financial transaction are directly tied to the MMD rate
-*Wells Fargo documentation*

Bloomberg's BVAL began as a transparent, data-driven competitor to MMD

Municipal bonds trade over 100 times less than Treasury bonds on any given day, making price discovery challenging
– SIFMA

$12 billion daily whereas Treasuries is $500 billion (SIFMA), which greatly inhibits price discovery.

These are a few of the reasons that makes the process of pricing a municipal bond challenging. That said, the regulations dictate that underwriters much achieve the best price possible for the community when pricing bonds. As such, and as is done in all markets, the municipal bond market leans on benchmarks to support the process of determining an accurate price between a buyer and a seller. Since the 1980s, the municipal market has relied on a benchmark called Municipal Market Data (MMD).

MMD has no definitions of its methodology that are publicly available. As a previous subscriber and as someone who has tracked the intra-day moves of the municipal from between 2007 and 2015, MMD is known for reviewing trades and "talking to the Street" as many traders have told me over the years. Their daily market colors often refers to anonymous trader quotes in describing how they are writing their benchmark.

This would be fine if it were not the case that nearly every major municipal bond transaction priced between roughly 1990 until present has been priced as a spread to MMD. That means wherever MMD writes the triple-A scale on a given day is essentially pegging tax payer dollars to that scale on that day.

This may seem improbable, but, in the wake of the Libor scandal post-2008, both the *New York Times* and the *Wall Street Journal* wrote articles noting the similarities and even suggested that the Securities and Exchange Commission was investigating the MMD process. There was no change as a result of these articles or any substantiation to a SEC investigation.

"BVAL's municipals pricing and AAA Curves consistently demonstrate the highest degree of market responsiveness and transparency in the industry, which is the result of years of honing our unique combination of market expertise, proprietary models, and industry engagement,"

said **Stephanie Sparvero,** Global Head of Bloomberg's Evaluated Pricing Service, BVAL. "We are proud to support PFM and provide their business and clients with high quality municipal curves to help inform their decision making and advisory business."

The universe of trading and pricing municipal bonds at the institutional level is small one. It is no secret that the largest underwriters and institutional investors command significant power over the market as it is such an illiquid debt instrument. To suggest that the market's benchmark was being priced by people, who could be swayed by a discussion with a trader, underwriter or an investor who has a position in the market, would question the entire integrity of the market itself. As such, we assume it was simply a poorly organized and largely non-transparent benchmark from which to price billion of community dollars on a weekly basis.

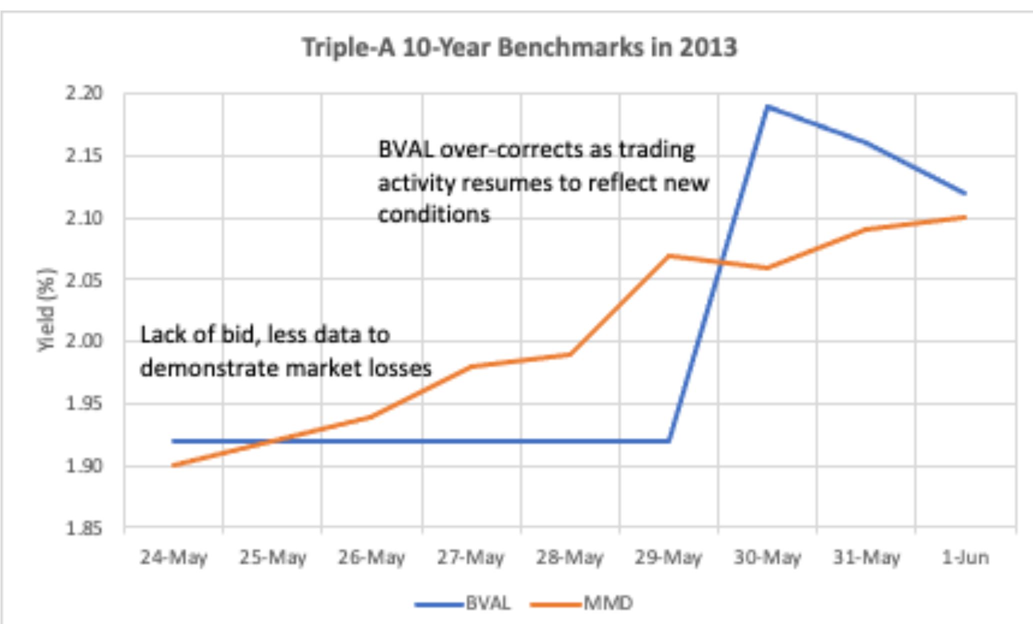
WHEN BENCHMARKS FAILS

CSG expects the market to begin to use BVAL over MMD in benchmarking in the coming years for reasons discussed in the next section. In theory, this is what a robust market should have. According to Bloomberg: "The production of these curves rely on sophisticated modeling techniques that normalizes credit differences of eligible AAA-rated credits, removes outlier trades and contributed levels, intelligently seeks corroboration within the data sources, and leverages BVAL's proprietary curve building technique. The BVAL AAA Municipal Curves are transparent, timely and easy to use."

Transparency is the operative word. Instead of an opaque, likely subjective process, Bloomberg's approach is data-driven. One issue with this approach is that the illiquidity of the municipal bond market can be problematic. At times, there are outlier trades that could sway an algorithm or other conditions that would make a benchmark not accurately reflect market sentiment. It is during these times that a community pricing bonds into the municipal market would want the most accurate benchmark possible to ensure protection of public funds.

In late May of 2013, then Federal Reserve Chairmen Ben Bernanke testified before Congress and signaled a pending change in rate policy. The market response was later dubbed "taper-tantrum." The municipal bond market followed Treasuries in a sell-off during this time (**chart below**) and we will use this case as an illustration of the problems discussed.

On the last week of that month over a decade ago, the municipal market experienced a dramatic sell-off, or a sharp rise in yields (and drop in prices). In a market such as this, investors become hesitant to bid bonds and overall trading volume will decrease dramatically. In this instance it was a policy headline but there are any number of reasons for market sentiment to shift quickly like it did during this week. When the bidding for bonds slows, a model like the one BVAL used at the time, has no trades to point to and thus will remain unchanged. In the chart **(left)**, note that the BVAL benchmark (blue) held steady from the 24th through the



29th of May.

Meantime, a team of analysts who are talking to market participants will hear from them that the the bid is backing up, meaning that in fact that market interest rates are increasing, even though there are no trade to reflect that. In the chart on the previous page, one can see that MMD (orange) was increasing in yield, better reflecting the real sentiment of the market.

For a community pricing bonds - if they were trying to price a bond to the BVAL curve during this week, they would have encountered serious challenges in pricing bonds as BVAL was not reflective of real market sentiment. As one can see on the 29th of May, buyers eventually came back to the market looking to seize value at adjusted yields and trading resumed, which allowed BVAL to adjust. Meantime, MMD was already at adjusted levels, all along better tracking market sentiment.

A QUIET ANNOUNCEMENT THAT CHANGES EVERYTHING

At the end of the last year, PFM Financial Advisors, the largest municipal advisory firm in the industry by a large margin (**see chart,** below), made an announcement that they would be pricing their clients bonds using the BVAL benchmark. That one advisory firm has shifted its methodology would normally not mean much, but as the largest advisory firm, this announcement should be taken as a sign of a shift in benchmarking. **CSG** expects the industry to move away from MMD over the next few years and begin using the BVAL curve.

This is generally a positive development as having an opaque and likely quiet subjective benchmark as the leading pricing process for municipal bonds is problematic for the public purse. That it persisted for over 40-years, which included a major financial meltdown in 2008 when other indexes were looked at with suspect, should be instructive about the transactional aspect of this marketplace.

BVAL is much more transparent, and according to market participants, has largely overcome the issues that were problematic back in 2012. Municipal issuers should be supportive (and that it is free to the public is important) yet safeguards should be put in place to monitor benchmarking. Until they exist, pricing of bonds remains suspect. The MSRB should act to create better understanding of these important, yet murky financial lenses for the public.