MUNI BONDS

NERVOUS MARKET EYES OBAMA TAX PLAN

Municipal bonds, long used in the US to fund infrastructure projects, particularly after events such as Superstorm Sandy, could soon lose their tax exemption under plans to reduce the country's growing budget deficit. By Alex Wright

Superstorm Sandy caused widespread destruction and devastated thousands of people's lives when it battered the US East Coast in October.

The category 1 storm resulted in more than 100 deaths and thousands of homes, schools, hospitals and businesses being damaged or destroyed as Sandy wrought $25bn worth of insured losses.

Sandy was the third costliest natural catastrophe since 1980 after Hurricane Katrina in 2005 ($62bn), and the Japan earthquake and tsunami in 2011, (between $4bn and $35bn).

An even bigger long-term threat than Sandy has emerged, however.

In 2011 US president Barack Obama, under pressure to tackle the country's $1 trillion deficit, proposed in his jobs bill to limit tax breaks for high earners on municipal (muni) bond interest at a 28% tax rate.

He put forward the same proposal again in his February 2012 budget, and in January this year the proposal was considered as part of the 'fiscal cliff' deal.

But the plans were shelved when the US government reached agreement to stave off the deal, which would have led to spending cuts and tax increases worth $600bn (£370bn).

The issue has raised its head again, however, this time as part of the 'sequester' on 1 March, which will result in about $85bn in spending cuts between March and October this year and a further $110bn cuts between October and October 2021.

Muni bonds are used to finance trillions of dollars of vital infrastructure projects, often after major catastrophes. The proceeds have been also used increasingly by state and local governments and authorities to rebuild roads, bridges, railways and electrical cables, particularly as they come under more financial strain.

Cutting tax exemptions may make investors less inclined to buy bonds.

Another source of fiscal help has come from federal aid. The US Senate voted 62-36 in favour of a $50.5bn emergency aid package for the Sandy victims in January.

But despite the money going towards flood protection and helping businesses recoup their losses, long-term a higher level of investment is required for the bigger infrastructure projects needed to rebuild the country, according to experts.

Bonds 'will escape sequester'

Municipal Market Advisors managing director Matt Fabian says the $3.7 trillion muni bond market was braced for a change to the tax code, but that nothing would happen anytime soon.

"The fiscal cliff agreement spoiled further the relationship between the Republicans and Democrats and their likelihood to do a more sweeping tax reform plan this year," he says. "Although the budget deficit remains problematic in the long-term, there is no real catalyst this year to force them to engage in tax reform discussions."

Fabian also doubts whether muni

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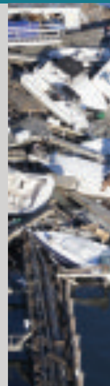
TIMELINE [MUNI BOND UNCERTAINTY]

January 2011
US president Barack Obama proposes to cap tax breaks on municipal bonds at 28% in his jobs bill.

February 2012
Obama puts forward the same tax exemption proposal again in his annual budget.

31 October 2012
Superstorm Sandy strikes the US East Coast, resulting in more than 100 deaths and damaging or destroying 305,000 housing units and disrupting more than 265,000 businesses in New York. In New Jersey, more than 346,000 households were damaged or destroyed. Sandy caused $20bn to $25bn worth of insured losses.



bonds would be included in March's sequester, as it was focused on spending cuts rather than tax. "We put our risk of impact on tax exemption at below 50% for 2013," he says.

"But the risk begins to rise every year because the principal plan that the Democrats are still pushing is the limit to the after-tax value of tax expenditures at a 28% rate.

"The Republicans would also like to either fully eliminate or otherwise damage the tax exemptions and other tax expenditures, but they want to use that money to reduce tax rates."

Threat to investment

Research by Citi Municipal Strategists estimated a decrease of at least $185bn in the value of existing muni bonds when the market's reaction to future tax uncertainty resulting from the proposal was factored in.

The Reinsurance Association of America (RAA) says that property and casualty insurers were already the second largest holders of muni bonds after life insurers.

The RAA opposed further restrictions on muni bond interest on the grounds that post-catastrophe rebuilding efforts would be hit as local governments would be forced to pay higher borrowing costs.

RAA senior vice-president Joseph Sieverling says: "If the exemption is reduced or eliminated, it is crucial that Congress 'grandfather' existing holdings of tax-exempt bonds. Changing the tax treatment of investments purchased for the long term would create a grave disruption of insurers' investment programmes."

Citigroup analyst Vikram Rai says a bigger threat was retrospective taxation on bond-earned interest. Citi research estimated a retroactive change would reduce the value of outstanding muni bonds by $200bn. "That freaked out the market," says Rai.

"When that fear was renewed in the last two weeks of December, we saw a large sell-off in the market because such a move would reduce the value of all outstanding bonds."

He continues: "If they make muni bonds taxable, the cost of funding for all municipal issuers will go up and they will just pass the average costs on to the taxpayer. We'll all end up paying more in terms of electrical and water utility costs and tolls."

Van Eck Global municipal strategist James Colby says that because the tax exemption was not constitutionally guaranteed, the government may decide to remove it to raise revenue.

"If they were to eliminate the benefit of the tax-free coupon it is suggested that it would generate only about $40bn of new tax revenues and that is fairly small relative to closing a $1 trillion deficit," he says.

"The entities that would be harmed or damaged by this type of activity are the state and local governments who issue these bonds, and the taxpayers who would be forced to pay higher taxes to enable their municipalities to access the capital markets for their capital needs."

Colby says although most of the government agencies who were rebuilding post-Sandy were receiving federal aid, that would not cover other projects already in the pipeline, such as new schools, roads and water and waste treatment plants.

"It would have an immediate impact on the marketplace as a whole of forcing prices of bonds to drop and yields to rise to accommodate the tax position on bonds," he says.

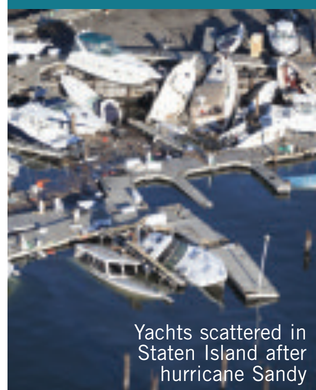
"It would be harmful not just to individual investors but also institutional investors like insurance companies." ■

HOW DO MUNICIPAL BONDS WORK?

1. A bond is issued by a local government or authority to raise financing for infrastructure projects and limit borrowing costs.
2. When the bond is bought by an investor, the money is loaned directly to the issuing authority on specific repayment terms and at a set interest rate.
3. The capital is used to fund projects such as new bridges, roads, schools and libraries.
4. The interest earned on the bonds by investors is exempt from federal tax or tax in the state where they were issued.

FURTHER READING

US Senate passes Sandy aid package
Find out more online at **goo.gl/vUoV9**



Yachts scattered in Staten Island after hurricane Sandy

January 2013
US government reaches agreement to stave off 'fiscal cliff' deal, which would have resulted in $600bn spending cuts and tax increases.

US Senate approves $50.5bn emergency aid package for Sandy victims.

How will the aid money be spent?

$16bn Housing & Urban Development Department package, out of which **£12.1bn** will be shared among Sandy victims and other federally declared disasters between 2011 and 2013

<$11bn Federal Emergency Management Agency disaster relief

$10bn Repair of New York and New Jersey transit systems

March 2013
US government decides on 'sequester' deal on $195bn spending cuts over the next nine years.