# Bond Case Briefs

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## Disruptive Technology in the Muni Bond Market.

If you rummage through the records of the Smithsonian Institution, you'll find that at the dawn of the 1900s, the City of Dayton, Ohio had the most patents per capita for a city its size than any other in America. Not a surprise, really; in its day, Dayton was the epicenter of transformational industry. Along with innovative manufacturing of everything from cash registers to sewing machines, there were several bicycle building businesses. It was from one of those shops where what is undoubtedly one of mankind's greatest inventions took flight.

Fast-forward to these days of transformational technology. The hub that comes to mind is California's Silicon Valley, filled with apps and chips. Mentioning 'transformational technology' in the same sentence as the municipal bond market, the state of Ohio and tax-exempt variable rate debt seems wildly incongruous.

That would be a serious error. With the state of Ohio's recent issue of $32.3 million Series C Capital Facilities Lease-Appropriation Variable Rate Bonds (Aa2-VMIG1/AA-A-1+/AA-F1+) using ClarityBidRate's e-trading platform to reset the rates, this financing uses e-technology in a way that may well completely transform the variable rate securities market.

**Variable Rate Bonds In A Nutshell**

Given how many investors hold tax-exempt money market funds in their portfolios—the Investment Company Institute (ICI) reports there are nearly 270 retail funds/share-classes with nearly $130 billion in assets—it's surprising how little most investors know about the securities held in those funds. In fact, variable rate debt (VRDO is the abbreviated professional nomenclature) comprises a majority of the investments held in those funds.

Issuers like the state of Ohio borrow using VRDOs for a variety of reasons, such as taking advantage of short-term rates or as part of a larger debt management program. While VRDOs are structured with long maturities, 20 or 30 years, the rates are reset regularly. Customarily, the reset is done weekly, but there are some financings that reset as frequently as daily or as long as semi-annually. When the rate resets, the borrower—in this case, the State of Ohio—is obligated to pay on whatever is the new rate.

Traditionally, the VRDO market revolves around the remarketing agent, who determines what the reset rate is. Almost invariably, the agent is also the underwriter who brought the financing. The reset rate comes from those traders who buy and sell VRDOs off of the firm's short-term debt trading desk.

Utilizing ClarityBidRate's platform, the reset rate is set based on real trades between buyers and sellers directly. The highest bid clearing the last trade sets the rate. There is no remarketing agent.

In effect, the e-trading platform creates a VRDO exchange. ClarityBidRate takes the invisible hand of the market and makes it visible. No longer are VRDO rates dependent on an opaque over-th--counter market, controlled by the vagaries of a few short-term trading desks. On an e-trading platform, orders and trades are clear to everyone. For investors, this transparency translates into efficiency—better pricing, better executions, better liquidity.

**Ohio Leads The Transformation**

Why would the state of Ohio choose to lead the way for VDROs into the vanguard of an electronic trading platform? Mr. Seth Metcalf, the deputy treasurer for the State of Ohio, explained his rationale for his "faith in innovation." With $492 million of VRDO debt outstanding, Ohio has more than a passing interest in how the rates are set. He outlined the problems in the VRDO market since the Credit Crisis of 2008: banks are not readily extending credit, auction-rate securities are gone and bond insurance is gone—all three previously critical factors in the short-term market. With the numbers to back it up, he demonstrated that, at least for Ohio short-term paper, the market as it currently exists isn't functioning efficiently.

Mr. Metcalf's observations of the positive impact of an e-trading platform for the borrower are spot on: using ClarityBidRate's platform means more competition for the highly rated Ohio paper. For the good citizens of the state of Ohio, this means lower interest costs and fees—something always on the fore of the mind of the Treasurer's office. Mr. Metcalf shrewdly observed that leveraging this technology "democratizes the process." He hoped that others would have the courage to follow suit. Given the solid reputation of the Buckeye State and the billions in tax-exempt VRDOs being issued by municipalities and public authorities, it will undoubtedly garner attention.

**The Impact Of Electronic Trading Platforms**

Ohio and ClarityBidRate may be leaders in the VRDO e-trading space, but fixed income e-trading platforms are coming into the broader bond market—and with increasing frequency. The 2016 SIFMA Electronic Bond Trading Report details 19 electronic trading platforms, 15 of which entered the space in the past two years alone. However, the report notes, "more platforms support corporate securities than municipals securities." In fact, of all those new platforms, 13 were in corporate bonds. Only two were in municipals—including one platform that entered both markets.

The increase in electronic trading platforms in fixed income is being driven by fundamental market changes. With hundreds of bond funds fighting for performance in a low interest rate environment, every basis point is precious. Correspondingly, portfolio managers are demanding the best execution on their trades from their counter-parties. As never before has market transparency and price discovery been so important.

For the investment banks, this low-rate environment means that short-term desks can't find spread or charge fees sufficient to cover costs, much less create meaningful margin. They are becoming a concierge service rather than a profit center. Then there is the intense regulatory pressure on the market. On one side, the Federal Reserve Bank and Dodd-Frank placed limits on how much capital trading desks can commit. The short-term desks can no longer provide the liquidity for the VRDO market that they had in the past.

On the other regulatory side, the Securities and Exchange Commission issued its own set of money market regulations in October 2016. These came in response to the severe dislocation—and for a time the near complete breakdown—in the tax-exempt variable rate market during the credit crisis.

Among other things, the new SEC regulations permit floating net asset values in money market funds. Gone is the sacrosanct "$1 NAV" and with it the near religious admonition to "never break the buck." Additionally, the new regs allow funds to impose 'redemption gates'—meaning a fund manager can restrict a shareholder's ability to sell shares. The presumed ready liquidity a money market fund traditionally offered an investor is also gone.

Between low rates and regulator changes, some fund managers exited the business altogether. The ICI reports that for Q3-2016 alone, $58 billion left the retail side of these funds, a 31% decline. Even more dramatic is the near elimination of institutional tax exempt money market funds. That asset class had an exit of $38.6 billion—a stunning 89% decline. Barely $4 billion remain in those funds.

With diminished demand for VRDOs from traditional tax exempt money market funds, the municipalities, authorities and nonprofits (who still need to sell this paper), will have to attract investors from outside the municipal bond market—corporate treasurers, sovereign funds, non-domestic banks. These investors, more familiar with the more visible, structured and liquid taxable short term markets, will demand that the short-term municipal bond market offer the same efficiency, transparency and liquidity they are accustomed to in the taxable market. The tax-exempt VRDO market will have to compete with taxable short-term instruments on all of those.

For e-trading platform firms like ClarityBidRate, MarketAxess and others, it couldn't be better timing. E-trading offers standardization, transparency and liquidity — all of which result in the more efficient markets taxable short-term buyers have come to expect. For the municipal borrower, a more efficient market with more participants should translate into tighter spreads and lower interest rates.

Another benefit of electronic trading for municipal bonds will be the ability to capture significant amounts of trading data. Until recently, munis lacked the 'big data' capture other more trade-transparent markets offer. More and better market analysis will help both market participants garner trading efficiencies and regulators craft more effective policy.

Even so, as with any newly emergent technology and market, there are some aspects that need tweaking. Platforms may offer standardization, but there are still some 42 electronic trading and execution protocols across various vendors. There are also differing processes in place on book management and counter-party visibility. However, the market will evolve, and fairly rapidly, to ultimately create uniform best practices.

There are some detractors who prefer having a human element to counter-party with. What will happen if—and when—the market experiences another period of dislocation? How will all these e-trading platforms perform then? It's a reasonable question and concern. However, keep in mind that during the credit crisis of 2008, having people on the desks did nothing to make the market more liquid or efficient. If anything, it did exactly the reverse.

So how did Ohio do with the ClarityBidRate managed rate resets? Everything went off smooth as silk. The fourth reset was completed on November 30, 2016. Ohio is paying .565% (annualized)—a mere 1 basis point off of the bellwether SIFMA Municipal Swap Index rate for the week. The folks in Ohio's state Treasurer's office have got to be smiling.

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by Barnet Sherman

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