Why Banks Invest in Municipal Bonds

Banks invest in municipal bonds primarily to generate income. With the security portfolio often being the second largest earning asset on a bank's balance sheet, it is important to take advantage of the earnings your investments can produce. A portfolio with an allocation to municipal bonds can help protect or expand net interest margin (NIM), which has come under pressure at many institutions. This is a phenomenon that has been ongoing for over a decade. For example, in 2000, banks nationally had a median NIM of 4.40%. In 2017, it was down to near 3.75%.

To offset NIM contraction in an environment where funding costs are at or near floors (and have been for years in some cases), banks of all sizes have been looking to municipal bonds to preserve interest income. Banks under $10 billion in assets increased their average allocation in municipal bonds from 20% in 2009 to 26% by 2017. For banks under $1 billion a similar trend has taken place, with municipals increasing from 24% in 2009 to 34% in 2017.

Banks with higher performing portfolios, as measured by UBPR, often have a higher allocation to municipals. There are many different types of municipals that differ with respect to their tax status, credit worthiness, geography, etc. This is not to suggest that simply buying any municipal will add to profitability and improve portfolio yield. Rather, the purpose of this paper is to illustrate how banks can profitably and efficiently invest in a specific type of tax-exempt municipals, General Market municipals, a sector of the market where banks continue to find strong credit quality and higher returns.

Bank Qualified and General Market Municipal Bonds

Within the tax-exempt municipal bond market, there are two broad categories of municipal bonds, Bank Qualified (BQ) and General Market (GM). While both types are bank permissible investments, BQ is the more common type for banks to own. (GM municipals are sometimes referred to as "non-bank qualified", which is a misleading term, because they are bank permissible investments). In fact, there are two main differences between BQ and GM municipals: supply and tax treatment.

Supply and Demand of BQ and GM Municipals and Impact on Returns

The first difference between BQ and GM municipals is supply. For a bond issue to receive BQ status, the issuer is limited to issuing $10 million per calendar year. This means that BQ municipals can be cumbersome to accumulate and manage due to their low supply, small lot sizes, and large CUSIP count. For a bond issue to receive GM status, the issuer would need to issue more than $10 million per calendar year. It is common for GM municipals to comprise over 90% of the yearly tax-free issuance in the municipal bond market. As a result, the larger supply of GM bonds can offer several advantages over BQ.

- Better relative value (i.e., higher yields) for comparable duration and credit quality.
- Larger lot sizes can mean better liquidity.
- Larger municipalities often have more financial transparency to perform purchase documentation and ongoing credit due diligence. This has been an area of growing importance among regulators.

Why would GM municipals have better relative value and higher yields than BQ municipals, all else equal? The answer is the much lower supply of BQ securities (<10% of total tax-free municipal issuance) coupled with higher demand from banks, which causes prices for BQ securities to be higher (lower yields) relative to GM. The GM

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municipals we have observed in the marketplace often have tax equivalent yields of 3.50-5.50%, depending on duration.

Tax Treatment of Municipals - The TEFRA Penalty

Regarding their tax treatment, BQ and GM municipals are both subject to interest expense disallowance, a.k.a., the TEFRA penalty. Originating in 1982 from the Tax Equity and Fiscal Responsibility Act, the most relevant part of TEFRA relates to the ability to deduct interest expense for banks with tax-exempt securities (i.e. municipal bonds). The tax code does not allow banks to deduct interest expense on liabilities that were used to buy tax-free securities. This was perceived as “double dipping” and is known as the 100% Disallowance Rule. However, an exemption exists for BQ securities. For BQ securities, 80% of the interest expense is deductible, and only 20% is “disallowed”. For GM municipals, 100% is disallowed, meaning that the TEFRA penalty is five times as high for GM municipals compared to BQ municipals.

The TEFRA penalty depends on three factors: a bank’s interest expense (cost of funds), the tax rate, and the disallowance (20% for BQ and 100% for GM). As an example of calculating an estimated TEFRA penalty, consider a bank with a cost of funds of 50 bps and a tax rate of 21%.

Estimated TEFRA penalty for a BQ security is: (50 bps) x (21%) x (20%) = 2.1bps.
Estimated TEFRA penalty for a GM security is: (50 bps) x (21%) x (100%) = 10.5 bps.

The difference in TEFRA penalty is why it is more common for banks to hold BQ municipals, and is why the demand for BQ securities is high among banks. We have already seen there is a lower supply of BQ municipals in the marketplace. This supply and demand imbalance is the root cause of higher prices (lower yields) for BQ securities. The concern about a higher TEFRA penalty is the main economic reason why demand has historically been low among banks for GM municipals. While cost of funds may be low for many banks at the moment, as it begins to rise, the TEFRA penalty will increase along with it. However, there is a strategy component that enables banks to own GM municipals without being subject to interest expense disallowance.

Establishing a Subsidiary to Efficiently Own General Market Municipals

With all the advantages GM municipals have over their BQ counterparts, many years ago banks began exploring ways to most efficiently own and manage these assets. The answer was to establish a wholly-owned subsidiary of the bank to hold the GM municipals. This element of the strategy (establishing a wholly-owned subsidiary to efficiently own GM municipals) was validated by the courts in 2007, when PSB Holdings, a subsidiary of Peoples State Bank (Wisconsin), won a case against the IRS, who had challenged the structure. The issue was whether tax-exempt obligations, purchased and owned by an investment subsidiary of a bank, must be included in the bank’s interest expense disallowance (TEFRA) calculation. The court ruled in favor of the Bank, and in 2008 the IRS declined to appeal the ruling. It has not been challenged since.

Creating an investment subsidiary does not impact liquidity or capital ratios, and does not impact Call Report filing. In fact, the accounting entries are straightforward, and the subsidiary’s financial statements are consolidated with the bank’s. The bank creates an “Investment in Subsidiary” asset account, which eliminates with the subsidiary’s “Paid-in Capital” account. The key element here is that the subsidiary does not have interest-bearing liabilities. Therefore, there would be no interest expense, and correspondingly, no interest expense disallowance (TEFRA penalty).

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Business Purpose of the Subsidiary

One necessary step to take when establishing a subsidiary is to have a valid non-federal tax business purpose to provide substance and support. On-going business purpose activities typically include working with a third party municipal advisor who works on a variety of components, including, but not limited to: initial purchase analysis, on-going credit monitoring, portfolio analytics, broker/dealer list separation, and meeting facilitation, to name a few key elements.

When it comes to business purpose, the bank needs to have a defendable answer to this key question: "What are you doing differently at the subsidiary vs. what you are currently doing at the bank?" Business purpose weakens without the use of a third party who has expertise in the municipal market and can assist in the management and monitoring of this asset class. For example, having the bank's portfolio manager also manage the subsidiary's portfolio is not likely to be deemed acceptable for business purpose. The need to fundamentally change how this segment of the portfolio is managed and monitored remains central to the strategy, but it is important to note the bank does not give up control of the management of the portfolio.

Conclusion

The investment subsidiary strategy is a way to optimize your tax exempt holdings by capturing the large spread of the GM sector over the rich BQ market and efficiently owning them to maximize returns and risk oversight with sound and defendable business purpose. An important aspect of this strategy is the increased profitability does not come from taking undue interest rate or credit risk. Rather, the economic benefit results from the relative value of high quality GM municipals over other bank-permissible investment sectors. General market municipals have an important role in the effort to expand or protect net interest margin in a challenging rate environment, and could help enhance the earnings contribution from your institution's investment portfolio.

The best way to learn more about the strategy is through a short presentation offered by Taylor Advisors to determine if your institution would be a good candidate. This discussion would also review the elements of the strategy mentioned above, including a review of the earnings enhancement potential, a pro-forma modeling results using recently issued securities, TEFRA penalty, business purpose, accounting implications, implementation and operational best practices.

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