The big "if"

General market munis have gained favor among community bankers.
By Jim Reber, ICBA Securities

This column has been several decades in the making. Historically, broker-dealers like Vining Sparks that underwrite, position and sell municipal bonds to community banks have been reluctant to promote general market (GM) munis to their customers. Since the creation of the bank qualified (BQ) muni market in 1986, banks have mostly eschewed general market munis.

However, over the past few years or so, depositories have gradually become more accepting of this sector of the market, and its attendant risks and benefits.

In 2021, with liquidity-rich balance sheets and very low funding costs, many community banks have gone headfirst into the deep end with GM issues. There are some compelling reasons for this. For one, it expands the universe of available bonds at a time when the overall muni market has stalled out at around $3.9 trillion—where it's been for a decade. For another, an investor can find much larger block sizes than are available with BQs. For another, even when controlling for liquidity and risk, GMs usually yield more than BQs.

We'll examine why there has been a noticeable shift in sentiment among municipal bond investors.

Focus on funding cost

So what's the rub with general market munis as it relates to community banks? There are actually several layers of "ifs."

Let's go back to the basics of the Tax Equity and Fiscal Responsibility Act, or TEFRA, penalty. A bank is required to add back to income, when calculating its tax liability, 100% of the cost of funds it incurred to finance its position in GMs. However, *if* the organization's munis are of the BQ variety, it adds back only 20% of this figure. This gives rise to the term "disallowance" as it relates to expense deductibility. The calculation of the penalty looks like this: (Cost of funds %) X (Disallowance %) X (Marginal tax rate %).

One can see that *if* cost of funds rises, the penalty rises. When deposit rates are low, it's not too big of a punishment. However, *if* financing costs return to the 2% to 3% levels that has been more the norm, the penalty can increase geometrically.

For example, a community bank with a cost of funds of 40 basis points (0.4%) and a marginal tax rate of 21% will deduct only about 8.4 basis points from its muni portfolio's tax-free yield, *if* the munis owned are GMs. *If* cost of funds rises to 2%, the penalty is 42 bps, which is a wallop. The penalty on BQ munis is just one-fifth of this.

General market advantages

Now for the reasons that many portfolio managers are presently ignoring the big "if." Bond portfolios have jumped in size by 22% since the end of 2019, and community banks have bought all manner of securities, which historically have not been staples. First, there are no size limitations to a GM issue, as opposed to a BQ, which is capped at $10 million per issuer per year. From an absolute supply standpoint, GMs comprise around 96% of the muni market. Secondly, investors can control their credit risk by performing their due diligence before and after purchase.

Thirdly, due to the relatively ample supply of GMs, all things remaining equal, they usually yield more than BQs. Portfolio managers are betting that the head start on tax-equivalent yields they're enjoying in this low cost-of-funds era will be enough to offset the yield erosion once deposits become more costly to capture.

Comparison shopping

Recently, there were two nearly identical Texas municipal bond issues that differed in two important features: issue size and yield. Caddo Hills Independent School District and Aubrey Independent School District both borrowed money over a number of years; both were rated AAA by the major agencies. Caddo Hills, a GM issue, was $49 million, while Aubrey, a BQ issue, was $6 million. The 2036 maturities were priced to yield 1.4% and 1.2%, respectively, to a 2030 call date.

If the end investor was a community bank, and there's a good chance it was, the GM issue gives the owner a decent jump on a potential hike to its cost of funds down the road. In fact, this advantage wouldn't disappear until the bank's cost of funds climbs to more than 1.2%.

There is more to this story than we have space to discuss here. Nonetheless, if your tax-free muni portfolio is limited to BQ issues, you may want to investigate whether it's worth a dip into the general market pool. In 2021, you'll be in good company with thousands of other community banks. ■

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Education on Tap

Webinar series continues
ICBA Securities and its exclusively endorsed broker, Vining Sparks, will host the next webinar in the Community Banking Matter series on March 16 at 10 a.m. Central. Dan Stimpson and Katharine Bray will present Strategies for an Economy Set to Emerge from the Pandemic. Head over to ***viningsparks.com*** to register.

General market muni publication
Vining Sparks has published a Strategic Insight, Considerations for Bank Purchases of General Market Municipals. It discusses the risks and opportunities from investing in general market bonds. For your copy, contact your Vining Sparks sales rep.

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