Munis for the many

Taxable municipal bonds have appeal for nearly all community banks.

By Jim Reber

I have some good news for community bank portfolio managers who have grown weary of some or all of the following conditions that have persisted since 2020:

* declining portfolio returns
* erratic cash flows
* call option exposure
* paltry yield spreads

Chances are, your bank’s portfolio has been affected by at least some of these conditions over the past year. The wild ride in interest rates kept producing surprises for the bond portfolio, and, in truth, about the only thing positive to be said is that prices rose—then declined—over that period. So, banks’ positions have lost value in 2021, but current investment yields have improved, which illustrates the mixed blessing.

Over time, one of the enduring determinants of investment performance is sector weighting. More specifically, the more a bond portfolio consists of municipal bonds, the more likely it will have above-peer yields. According to Vining Sparks, as of Dec. 31, 2020, municipal bonds made up 53% of top-quartile community bank portfolios. At the other end of the spectrum, the bottom quartile was only 9% invested in munis.

Historically, the amount of munis a bank owns in large part has been determined by a bank’s need to avoid tax liability. Some depository balance sheets have simply not had room for bonds, muni or otherwise. Others haven’t been profitable enough to worry about that option. Still others, such as S Corps, which pass through their earnings to their shareholders, don’t benefit from tax-free earnings.

Supply shift

Fast forward to the Tax Cuts and Jobs Act of 2017. Corporate tax rates were reduced around 40%. That was good news for bottom lines, but it lowered the effective yields on all tax-effected assets, such as traditional munis and bank-owned life insurance. Since that time, banks have shed about one-fifth of their tax-frees.

Another subtle, but significant, feature in that legislation was to no longer allow muni issuers to “pre-refinance” their outstanding debt into other, new tax-free issues. These older bonds could only be refinanced into taxable issues going forward. That has had a major impact on the types of munis being issued in the current environment.

In the 2020 calendar year, fully 30% of municipal bond issues were of the taxable variety. This is a decade-plus high-water mark. Less than 10 years ago, taxable munis were but a blip on the new issue screen. They’d constitute somewhere between 3% and 7% of total new issuances. In fact, the only year that taxable munis exceeded 2020’s volume was 2010, and that was purely a function of the narrow window for issuing Build America Bonds (BABs), a type of taxable munis only available for issue in 2009–2010.

Crowd pleasers

Now to the afore-promised good news. If your community bank isn’t much invested in munis, taxables could bring some welcome relief to the issues mentioned in the first paragraph. As supply has grown and the interest rate curve has steepened throughout 2021, taxable munis can serve a number of purposes, not the least of which is respectable return. An investor can also now realistically hope for an issue that’s reasonably proximate to its footprint.

Speaking of returns, a high-grade general obligation taxable muni will out-yield a bank-qualified (BQ) issue at any point on the yield curve. As of this writing, a 10-year AA-rated BQ bond will have tax-equivalent yield of about 1.85%, whereas a similar-duration taxable will be about 2.10%. There are a number of reasons for this, including the relative lack of supply of BQ paper. Also, it bears mentioning that S Corp banks, if they’re able to have tax-free income, will recognize higher tax-equivalent yields than their C Corp brethren.

What’s the downside? Just like any other taxable security, municipal bonds will have a higher degree of price volatility than tax-frees. However, the additional price risk is less than it used to be back in the era of 36% marginal rates for C Corps. It’s anyone’s guess what the impact of higher marginal tax rates will be to the tax-free muni market, but on the face of it, higher rates should be supportive of tax-effected assets.

In the meantime, the growing supply of taxable munis should continue to produce attractive yields. The supply, both in absolute dollars and for a given issue (which isn’t limited to $10 million per issuer per year that BQs are), should produce more than adequate liquidity. The benefits and availability of taxable munis should appeal to the many community banks looking for the right combination of risk and reward.

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[Sidebar]

**Loan portfolio management webinar**

ICBA Securities and its exclusive broker Vining Sparks will host its next segment of the 2021 Community Banking Matters webinar series on May 11 at 10 a.m. Central. We will present Balance Sheet Management and Your Loan Portfolio. Visit *icbasecurities.com* to register.