

# B&B REVIEW

*Financial Services and Transactions*

## UNREST IN MUNICIPAL BOND MARKET CREATES OPPORTUNITIES FOR COMMUNITY BANKS

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### INTRODUCTION

Yields on triple-A rated 10-year municipal bonds have increased recently, sometimes to levels exceeding the yields on 10-year Treasury notes. This unusual situation is one of the aftershocks of the subprime mortgage problems that have resulted in the downgrade of bond insurers which in recent years had begun to insure securities backed by subprime mortgages. Those insurers' main business is the much less risky municipal bond market, but unfortunately the riskier part of the business has infected the less risky part. The result is that hospitals, municipalities and other municipal bond issuers are paying significantly higher rates on their long-term, variable rate debt issued to the public.

Tax-exempt borrowers still need to finance their activities, and in some cases might be looking to refinance public debt issuances that are no longer functioning as designed, such as "auction rate" securities. Community banks may be able to serve an important role in meeting the borrowing needs of these organizations, particularly the short-term needs. At the same time, banks might also be able to do so in a way that utilizes their investment portfolio in an efficient way.

This B&B Review summarizes several legal issues that must be managed by banks that wish to participate in this market.

### BANK QUALIFIED BONDS

In 1986, Congress tightened rules for tax-exempt bonds, believing that such bonds had come to be used for more than the public purposes for which they were originally designed. One of the new restrictions added was to deny banks that invested in tax-exempt bonds a tax deduction for interest expense incurred to fund their purchase of the bonds.

Responding to lobbying by community bankers and others, however, Congress created an exception for this interest deduction disallowance, for "bank qualified bonds." "Bank qualified bonds" are governmental bonds and bonds issued for the benefit of state or local governments or Section 501(c)(3) corporations, where the issuer and its "subordinate entities" issue less than \$10 million of such bonds in any calendar year. If a local government, hospital authority, water authority or similar entity issues less than \$10 million in tax-exempt bonds in a calendar year, it may be able to issue "bank qualified bonds."

Even if bonds are "bank qualified", there is still a penalty to be paid by banks investing in them. The Internal Revenue Code disallows 20% of the interest expense incurred on the bonds. However, with yields as high as they are, it nonetheless might make sense to make such an investment, particularly if doing so would meet an otherwise unmet need of a local bond issuer.

A recent decision by the United States Tax Court in PSB Holdings, Inc. v. Commissioner might help avoid this 20% penalty where a bank has an affiliated company that purchases the bonds. That case held that an investment company affiliated with a bank did not incur the tax deduction disallowance applicable to its affiliated bank, even though the bank and the investment company's tax returns were consolidated with those of their common bank holding company parent.

### PERMISSIBLE INVESTMENT SECURITIES

In order to promote bank safety and soundness, banks are not permitted to invest in all securities. Generally, banks may invest without limit in bonds that are a "general obligation" (meaning that it can be paid from a variety of sources available to the issuer) of a state or local government (GOs). By virtue of the Gramm-Leach-Bliley Act, the



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law also permits “well-capitalized” banks (see discussion under “Bank Capital Issues” below) to invest without limit in “municipal revenue bonds”, which are defined to include limited obligation bonds, revenue bonds of qualifying state and local units and qualifying bonds issued to finance a government-owned “exempt facility” (such as transportation, energy and waste disposal facilities).

A “revenue bond” can only be paid from a specific source, such as tolls from a bridge or fees for sewer usage. Note that “municipal revenue bonds” for purposes of the rules for permissible investments by banks is a narrower category of bonds than “bank qualified bonds.”

Banks that are not well-capitalized continue to be subject to limits (based on a percentage of the bank’s capital and surplus) on their investments in municipal revenue bonds and other governmental and quasi-governmental bonds that are not GOs. In addition, limits continue to apply to investments by well-capitalized banks in governmental and quasi-governmental bonds that are not GOs or municipal revenue bonds.

## **BANK CAPITAL ISSUES**

Many tax-exempt bonds receive favorable treatment under the risk-based capital requirements of the federal banking agencies. Banks are required to maintain capital that reflects the relative risks of their assets. Assets like cash, gold bullion, loans guaranteed by the U.S. government and balances due from the Federal Reserve Banks are not counted as having any risk for purposes of calculating the amount of capital which must be maintained. By contrast, commercial loans and consumer loans are counted at a 100% “risk weighting.”

A bank is considered to be “well-capitalized” if its total capital is at least equal to 8% of the bank’s risk-weighted assets.

Significantly, many tax-exempt bonds are counted at only a 20% risk weighting, the same rating assigned to U.S. agency bonds such as those issued by Fannie Mae and Ginnie Mae. For a tax-exempt bond to be counted at only a 20% risk weighting, it must be a “general obligation bond.” By comparison, a “revenue bond” is counted at 50%, because it can only be paid from a specific source.

## **COMMUNITY REINVESTMENT ACT TREATMENT**

Banks must meet the banking needs of all parts of their communities, as required by the Community Reinvestment Act. One of the tests under such Act is the “investment test.” Investment in tax-exempt bonds that have community development as their primary purpose would meet this test. Examples of these bonds include bonds to finance low-income housing and bonds that provide economic development in low- and moderate-income areas.

## **OTHER SAFETY AND SOUNDNESS CONSIDERATIONS**

The federal banking agencies require that a bank have risk management practices that focus on the market, credit, liquidity, operational and legal risks of all investments. Banks are required, for example, to stress-test their investment portfolios and periodically monitor the price sensitivity of their portfolios.

Banks that purchase tax-exempt bonds should have adopted policies and procedures that meet the requirements of this supervisory guidance.

## **CONCLUSION**

Local governments and public authorities may have borrowing needs that cannot be met through the issuance of tax-exempt bonds to the public. Banks may be able to fill these needs in a way that also is very financially attractive to the banks.