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How De Minimis Fears Drive Illiquidity.

Kevin Bain, debt manager for Detroit, who got his start in the corporate taxable bond market, recalls being baffled by the obscure "de minimis" tax rule when he arrived at the city nearly three years ago.

The rule was one reason why, during a bond sale in 2021, the coupons needed to be set at 5% and 4% at the outset, to protect investors worried that the bonds would later tip into discount territory, Bain recalled. The rule also means the city has to parse issuance size versus par value when it asks voters for borrowing authorization.

"It's been around so long it's considered market practice to everyone who works with municipal bonds," said Bain. But the 5% standard seemed strange – especially in the low rate world of 2021 – compared to the corporate world, where par value tends to roughly equal issuance size and coupons roughly match yields.

That's "pretty straightforward," Bain said. "It's odd that municipal governments have the more complicated issue."

Investors in Detroit's 2021 deal proved correct about their concerns as a chunk of the 4% bonds are now trading at a discount, Bain said. When the city came back to market in July, amid a higher interest rate environment, it set coupons as high as 6% on some bonds.

The "market discount" de minimis rule carries a primary market impact for issuers like Detroit, but it is the rule's significant impact on the secondary market that's the focus of a paper from a quartet of muni market experts that was presented in July at the 2023 Brookings Municipal Finance Conference.

"Pushing Bonds Over the Edge: Investor Demand and Municipal Bond Liquidity" takes a deep dive into the de minimis rule's impact on a secondary market dominated by mutual funds that tend to buy bonds at a premium to avoid de minimis risk. Funds will dump entire positions as they approach discount territory, activity that leads to "substantial illiquidity" and drives up trading costs and prompts other institutional investors to head for the exit, the paper found.

The study takes on more relevance in the rising interest rate environment, where even 5% coupons are now trading near the threshold. More than 30% of bonds in the secondary are currently circling discount territory, said one of the paper's authors, Stefan Gissler, principal economist at the Board of Governors of the Federal Reserve System, who presented at the conference.

The so-called de minimis rule took effect in 1993 as part of the Omnibus Budget Reconciliation Act, which repealed the exemption of realized price appreciation – as opposed to interest payments – on municipal bonds from ordinary income taxes.

Under the rule, investors who buy municipal bonds at a discount from its face value at issuance will have to pay taxes on any realized price appreciation if the discount passes below the de minimis threshold, which is defined as one quarter of 1% of the stated bond price multiplied by the number of full years to maturity.

The rule has carried an outsized impact in the secondary market since mutual funds have started to dominate the buyer base, because mutual funds have strong incentives to avoid “discontinuous jumps in ordinary income taxes,” according to the paper, authored by Gissler as well as John Bagley, chief market structure officer at the Municipal Securities Rulemaking Board; Kent Hiteshew, a strategic advisor at Ernst & Young LLC who was formerly deputy associate director at the Federal Reserve Board’s Office of Financial Stability; and Ivan Ivanov, senior economist in the Research Division of the Federal Reserve Bank of Chicago.

Examining bond trading data from 2010 to 2022, the authors concluded that mutual funds are large net sellers of muni bonds above the de minimis threshold, with their selling peaking at four to five percentage points above the threshold, reaching nearly $500 billion quarterly.

Once below the level, the bonds become illiquid and trading becomes more costly, prompting other institutional investors like banks and property and casualty insurers to avoid them. Only life insurance companies, which tend to be buy-and-hold investors, showed more restraint around the threshold.

“These findings suggest that liquidity is not only the main driver of the trading dynamics around the de minimis threshold, but also has significant impact on trading costs,” the paper said.

The “exit of institutional investors such as mutual funds, insurance companies, and closed-end funds from the secondary market leads to significantly lower market quality and higher transactions costs?an important feature of this market even in ‘normal’ economic times,” the authors said.

The paper also notes that decisions by the Federal Reserve to hike interest rates “speeds up the path to illiquidity and higher transactions costs.”

During a period of monetary tightening, the bonds “underlying as much as a quarter of all secondary market transactions face significant probability of falling below the threshold,” the paper said.

The conclusions are not surprising given the shrinking municipal buyer base over the years, said municipal strategist Vikram Rai.

Mutual funds are exposed to flows and need to sell during an outflow period, Rai said.

“When a mutual fund buys a higher-coupon bond, they’re paying more for it but they need the liquidity; they don’t want to be stuck where they want to raise money and don’t have liquid paper to sell,” Rai said.

Because mutual funds have such a large footprint, their actions reverberate across the market, he said.

“It’s exacerbating illiquidity and it’s exacerbating the discontinuity and volatility in prices,” he said.

For Bain, who presented a response to the academic paper at the Brookings conference, the study helps explain a rule that he said remains unclear even to many of his issuer peers.

“It’s a very confusing rule that most people in the industry don’t know a lot about,” Bain said. “It’s really interesting to see the research on how big an impact it has on the market even though so few people are speaking about it and people have just come to accept it as the market standard.”

By Caitlin Devitt

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