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Here's Why Muni-Bond Demand Could Get a Lift from Bank Legislation.

Banks own close to 15% of the municipal bonds outstanding

As municipal bondholders continue their struggle to make sense of last year's tax legislation, Congress is set to knock down one argument against participating in the $3.8 trillion market.

Investors are expecting the Senate to pass a bipartisan bill that would include municipal debt in the coveted category of high-quality liquid assets as part of a bid to roll back some elements of the Dodd-Frank law put in place after the financial crisis. The proposed legislation would stoke appetite for municipal bonds among banks, steadying a market still reckoning with the recent tax cuts.

"It takes one of leg of the argument against the muni market as it goes through a shake-up," said John Mousseau, director of fixed-income strategy at Cumberland Advisors.

It was only a few months ago when President Donald Trump's revamp of the tax code threatened to sink the viability of municipal debt by eliminating private activity bonds and advanced refunding paper, two key pillars of the $3.8 trillion market. That led local governments to issue billions of dollars in bonds in December in order to front-run the tax changes. But since then, municipal bonds have largely recovered.

The bill would put municipal bonds in the company of high-grade corporate paper and government debt in the eyes of financial watchdogs.

Rules elevating corporate bonds above munis in the regulatory environment has been a chip on the shoulder of market participants. The National Association of State Treasurers blamed the absence of municipal debt from the high-quality liquid assets designation, or HQLA, for contributing to higher borrowing costs for local governments.

Regulations mandating banks hold a minimum amount of HQLA to handle market turmoil were designed with the intention of avoiding a repeat of the 2008 financial crisis when banks found much of the investments on their books were difficult to off-load and less creditworthy than they had initially seemed.

On that front, analysts point out municipal debt features a lower default rate than their private-sector peers at every rung of the credit ladder as they are backed by the full taxing authority of local governments. According to a Moody's historical study stretching from 1970 to 2015, the frequency of defaults among BBB-rated municipal bonds was lower than that of AAA-graded corporate bonds.

"Why wouldn't you want better credit collateral than you're getting with existing legislation on corporation debt," said Mousseau.

Moreover, municipal debt could hold good value for banks with extra cash. The yield difference between municipal bonds and comparable Treasurys have widened, with the tax-free yield on a 10-

year municipal bond slipping to around 85% of the taxable yield on a 10-year Treasury TMUBMUSD10Y, +0.00% for most of this year, well below the 95% seen in early 2017. A lower ratio implies munis are cheaper relative to Treasurys.

Though the revamped bank legislation should boost their investment in municipal paper, its unlikely to return Wall Street to their previous role as the linchpin of the market.

Nonetheless, Mousseau says the bill, if passed, is an under-appreciated step that could prove a boon to smaller financial institutions and commercial banks that have few avenues for long-term investments.

In 1975, banks owned close to half of the municipal bonds outstanding. Their share hit a low in 2004, shrinking to 5%, before making a comeback to 15% in 2017 after former President Barack Obama expanded the allowance for banks to qualify for tax exemptions on interest payments, a key appeal of the municipal bond market.

“If individual investor ownership is the bedrock of municipal holdings, then bank ownership is the topsoil,” said Thomas Kozlik, municipal strategist for PNC Capital Markets, in a January note. He added that “bank buying patterns have historically been sensitive to tax reform and government incentives.”

Their role as a backstop against weakening demand for municipal paper has come to the fore in recent years. Bank holdings of municipal paper rose close to $120 billion from 2015 to 2017, even as households sold around $110 billion of municipal bonds, according to the Federal Reserve data.

But some investors are still waiting for the dust to settle from the Republican tax legislation before making up their minds on how much of a boon a renewed Dodd-Frank bill would be for the municipal bond market.

“Right now the market is trying to figure out what bank activity will be as a result of the tax-cut legislation. Banks very well could find relative value elsewhere,” wrote Kozlik.

Market Watch

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