
House Financial Services Municipal Bonds Market Hearing.

House Financial Services Subcommittee on Oversight and Investigations

Examining the Role of Municipal Bond Markets in Advancing and Undermining Economic, Racial and Social Justice

Wednesday, April 28, 2021

Witnesses

- William Fisher, Chief Executive Officer, Rice Capital Access Program
- Gary Hall, Partner and Head of Investment Banking (Infrastructure and Public Finance), Siebert Williams Shank & Co., LLC
- Chelsea McDaniel, Senior Fellow, Activest
- Jim Nadler, Chief Executive Officer, Kroll Bond Rating Agency
- Chris Parsons, Professor of Finance, University of Southern California

Opening Statements

Chairman Al Green (D-Texas)
In his opening statement, Green said the hearing will assess the municipal bond markets as a driver of discrimination and examine material disparities and the cost of capital raising for Historically Black Colleges and Universities (HBCUs). Green said this hearing will show how the municipal bond markets can also drive positive change and fiscal justice. He mentioned research that shows HBCUs, on average, face higher fees when compared to similarly situated non-HBCUs. He said the disparities in fees were attributable to racial discrimination and that the cost disparities were magnified in states where anti-Black racial resentment is the most severe. Green said all of these findings are deeply personal and profoundly troubling and noted that he looks forward to discussing solutions.

Ranking Member Andy Barr (R-Ky.)
In his opening statement, Barr said the municipal bond markets provides a reliable source of capital and a stable avenue for investors to put their money to work for the public good. He added that the muni market is a strong way for issuers to finance their operations. He continued that the pandemic weighed on the economic wellbeing of states and localities as typical sources of revenue declined. To respond, he said Congress established the Municipal Liquidity Facility (MLF), and shortly thereafter, the muni market stabilized. Barr said everyone can agree our infrastructure needs improvement and that municipal bonds are a key source for financing those plans. He said significant tax increases would not help, rather we should look for ways to incentivize and mobilize private capital. Barr said he hopes to find a way to improve the municipal bond market and ensure equitable access for issuers, specifically highlighting the importance of restoring the ability of issuers to advance refund tax-exempt municipal debt. He said discrimination in the municipal bond market is illegal and should not occur, and hopes the Committee works to ensure this does not persist.

Testimony

William Fisher, Chief Executive Officer, Rice Capital Access Program
In his testimony, Fisher said HBCUs play a vital role in higher education that is not easily recognized or appreciated by the capital markets, and that the lack of understanding forces higher interest rates which cause investments in physical facilities, student support initiatives, and academic programs to suffer. He added that the negative impact of expensive debt impacts not only the institution and its students, but the local community as well. Fisher applauded the creation of the HBCU Capital Financing Program as a tool for providing access to low cost borrowing and creating a path to financial stability. He urged consideration of the HBCU Capital Financing Advisory Board's recommendations to increasing the borrowing capacity of the Program and expand the use of the program to include operating lines of credit. He said these provisions would further secure the HBCUs' "place" in America and higher education.

Gary Hall, Partner and Head of Investment Banking (Infrastructure and Public Finance), Siebert Williams Shank & Co., LLC
In his testimony, Hall explained his career in the municipal bonds market having served as an issuer, lawyer, and banker. He also emphasized his firms' and his personal longstanding connections with HBCUs as an alumnus, parent, and benefactor. He emphasized that municipal bonds are a critical funding source for infrastructure in America for bridges, roads, schools, health care facilities, higher education facilities, airports, and seaports our communities rely on. Hall also thanked the Congress for their decisive action in passing the CARES Act and authorizing the Federal Reserve's Municipal Liquidity Facility, stating that this swift action helped stabilize the tax-exempt market last March during a period of heightened market stress. Hall said that after decades of underinvestment, the entire U.S. faces an extraordinary infrastructure deficit, if which this trend continues, will only lead to additional delays of investment in and maintenance of critical public projects. He added that the "burden of crumbling infrastructure" will fall disproportionally on low-income and minority communities. While he raised questions regarding the data and methodology underpinning Parson's study, Hall added that there is certainly more that can be done to assist HBCUs with accessing the capital markets more cost-effectively going forward. Specifically, he noted SIFMA's support for authorizing triple tax exemption for HBCU-sponsored debt. Hall continued by outlining additional SIFMA-supported policies that would help provide incentives to rebuild the nation's infrastructure such as: 1) preserving the tax exemption for interest earned by investors on state and local bonds; 2) reinstating the tax exemption on the advance refunding of municipal bonds; 3) expanding private activity bonds (PABs); 4) reinstating a direct pay bond program; and 5) expanding the small issuer exception so that states and municipalities have a variety of additional tools to finance their local projects. He commended the work of the Subcommittee and encouraged lawmakers to consider the previously suggested proposals. Hall concluded by commending the work of the Subcommittee, encouraging lawmakers to consider these proposals, and reiterating SIFMA's and its members' commitment to fostering not only a culture of diversity and inclusion within our industry, but also investing in diverse communities nationwide and increasing the availability of financing for critical local infrastructure projects.

Chelsea McDaniel, Senior Fellow, Activest
In her testimony, McDaniel said she plans to present a high level sectoral view of postsecondary education institutions in the context of the larger municipal finance market. She noted that as a result of longstanding policies born out of the segregation era, there have been social and environmental risks emerging within public entities, like local governments and schools. McDaniel stressed that these need to be updated. She continued by saying the cost of ignoring these fiscal justice risks is growing within government entities. She noted three examples of the growing materiality: predatory inclusion in higher education loans, outsized pricing among HBCU bonds, and

postsecondary schools "racing" to become federally recognized Hispanic-Serving Institutions (HSIs) to capitalize off the growing Latinx student population. Finally, McDaniel said that from a credit perspective, Minority-Serving Institutions (MSIs) are much stronger municipal investments than Predominantly White Institutions (PWIs) and recommended three solutions to counter the fiscal justice risks in the postsecondary market: accounting for equity research, social justice bonds, and investment in physical assets.

Jim Nadler, Chief Executive Officer, Kroll Bond Rating Agency
In his testimony, Nadler began by saying ten years ago, some might have argued the last thing the world needed was another rating agency to serve the muni market. He said last summer, however, his agency achieved a milestone when the Federal Reserve deemed KBRA to be one of only four major rating agencies whose ratings could be used by issuers accessing the central banks emergency Municipal Liquidity Facility window. He commended Congress support in being integral to allow credit rating agencies to participate in government bond programs. Nadler continued that bond investors are increasingly interested in the social impact of their investments, and in the municipal bond market, investors need to understand how state and local government issuers plan to address economic, racial, and social justice within their communities. He supports efforts to improve the quality of disclosure on these topics from all levels of municipal government, as well as improving diversity and inclusion in municipal roles and recalibrating municipal responses to economic, racial and social justice issues. He added there is an increasing interest in thorough climate-related disclosures and he believes climate risk should be incorporated in all ratings where it is relevant. He concluded that municipal stakeholders will continue to drive decisions on changes that need to be made, and that analyzing municipal managers' responses to stakeholder preferences and the implications on credit is the role of a credit rating agency.

Chris Parsons, Professor of Finance, University of Southern California
In his testimony, Parsons said economists have long been interested in discrimination and racial disparities in wages, job placement, home ownership, mortgage rates, access to capital and dozens of other areas. He said the challenge is that comparing differences in average outcomes between groups by gender, race, and age may not always "paint a complete picture". He said studying municipal bonds, however, provides good insight into the issue. He explained that when you buy a bond all that should matter is the financial return, and there is a well-accepted way of measuring an issuer's bond ratings. He asserted that his findings demonstrated that HBCUs pay 20 percent more in fees to underwriters, and that when HBCU-issued bonds are traded, it takes about 23 percent longer to find a willing buyer. Parsons concluded with one possible policy tool available to help remediate the challenges identified in his study: affording investors of HBCU-issued bonds tax exemption from state and local taxes. He said this policy would remove the tax disadvantages an investor living in, for example, New York or California currently faces when potentially investing in an HBCU-issued bond from another state.

Question & Answer
Discrimination Against Minority Serving Institution Issuers

Green asked witnesses if they believe these circumstances relating to HBCUs paying more on average than non-HBCUs indicates institutionalized discrimination. Parsons said the results of their findings are consistent with investors, not institutions and that their paper does not address that idea. McDaniel said it seems that way, judging by the outcomes of the studies. Fisher said yes, when discussing institutional investors. Hall said he has not studied that, and what he saw in the study with taste-based discrimination is not consistent with his experience in the marketplace and does not reflect the growth that has occurred since the study took place. He said he cannot conclude that there has been institutional racism.

Rep. Emanuel Cleaver (D-Mo.) asked witnesses if they believe socioeconomic factors like poverty, income inequality, and availability of affordable housing all factor in on a risk of a municipality and their ability to get significant bonding, or if race is not a factor at all. Hall said a lot of considerations are taken into fact when regarding the municipal bond market, but Socioeconomic background are not as important as is the economic power in terms of the tax base.

Rep. Alma Adams (D-N.C.) mentioned the data which showed HBCUs pay more to issue bonds than similarly-situated non-HBCUs. She asked how to quantify this cost in the years to come. Parsons said if the total cost is shown as 20-30 basis points, then it is in the hundreds of thousands of dollars and can be quantified a number of ways whether it represent a few professors or a few scholarships. He said he wanted their study to be able to look at the decisions to issue bonds that were not taken since every study is conditional on bonds that successfully went to the market. Parsons said no one can observe the cost to HBCUs that were not able to go to the market, and his intuition was that cost is significantly larger for those HBCUS.

Adams asked if there are solutions to address these fee disparities between HBCUs and non-HBCUs. Hall said the study mentions the notion of expanding the tax base for HBCUs, which SIFMA supports, by having triple tax exemption for HBCUs so that states who issue, like North Carolina, would be attractive to issuers in New York where the state income tax is high. Additionally, he suggested having a direct pay program similar to Build America bonds, allowing the HBCUs can access the taxable market, which has a wider investor base, thereby increasing the demand for HBCU bonds and closing their overall costs. McDaniel suggested looking at different factors that are not typically folded into the credit worthiness assessment of muni bonds.

Barr asked if provisions in the Investing in Our Communities Act would lower interest rates and help municipalities and issuers. Hall said yes, that the ability to refund existing debt with lower tax exempt debt is vital and needs to be reinstated.

Rep. Rashida Tliab (D-Mich.) said the Federal Reserve has been unwilling to facilitate meaningful emergency assistance for state and local governments and asked how Congress should step in to fill this gap and foster long term investments in communities. Parsons pointed to the findings with HBCUs, and stated his support for the triple tax exemption as being “almost a free market solution to a problem”. He said the issue is the market is too small, and the exemption opens up the market to other states.

Credit Ratings and Evaluating Bond Deals

Barr asked what criteria goes into signing a bond and what factors are considered to be material. Nadler said materiality is key and when thinking about a bond rating and a credit rating you need to make sure what you are analyzing does have an impact on the fiscal health of that entity, whether it is a city or a state. Nadler said they found disclosure to be the most important aspect. He added there are other aspects that impact the liquidity of a bond moving forward that may not necessarily impact credit worthiness today but would still be interesting to investors. He supports more disclosures that align with investor preferences and give insight around liquidity.

Rep. Chuy Garcia (D-Ill.) said that much of what goes into credit ratings is outside of an issuers control, like if Puerto Rico was devastated by a hurricane, and noted that communities of color tend to be hit hardest by these shocks. He continued by asking if ratings firms consider criteria like this. Nadler said ratings firms do not do a good job of consideration. He said it is important to have competing ideas and enough research out there for investors. He added that rating agencies “get into a rut” and look at the same things every time, but should be reimagining cities and states as they grow and evolve.

Rep. David Kustoff (R-Tenn.) asked when evaluating a muni bond deal, what factors are the most important that impact the cost of capital for the issuer. Hall said they have to evaluate the credit underpinnings of the investor and the actual size of the issuance, and whether or not it would be very liquid in the market. He said that liquidity is an important factor as it relates to the resonance of the bond in the market and these are all taken into consideration when evaluating the risks.

Municipal Liquidity Facility (MLF)
Barr said he was surprised that after supporting the MLF, there was not as much uptake, and that throughout the pandemic the municipal bond market proved to be fairly resilient. Barr asked Nadler where he sees the bond market moving in the future, and if the state and local governments bailouts were really necessary on top of MLF. Nadler said they were also surprised by uptake as it relates to the committee and believed it had to do with how quickly muni market moved back to some normalcy. He said that although recovery has been great and faster than anticipated, there were structural issues prior to the pandemic that will be exacerbated and cause unevenness moving forward post-pandemic.

Rep. Sylvia Garcia (D-Texas) asked about the Municipal Facility saying it did not work, there were high penalty fees, and it initially excluded many Black cities in America. Garcia asked if it is still needed and what changes would need to be made. Hall said at the time the program was enacted, there were $500 billion allotted to the program, which is larger than the entire muni market. He said it was a “shock and awe” program to make sure investors knew the Fed was behind them in the muni bond market. Hall said after the MLF program came in, the muni bond market had the largest issuance during a month time span ever in history. He said the overall benefit to the marketplace was stability, but now the market is extremely resilient so it is not necessary, but having the ability to stand it up as an emergency back stop is important.

Importance of Muni Bonds
Kustoff asked about the importance of muni bonds as a tool for individuals in their financial planning and saving for retirement. Hall said these products give citizens the ability to invest in their own communities. As a long-term investment vehicle, he said muni bonds offer a significant return and that benefit is evident from the fact that over 50 percent of the market is held by “mom and pop households.”

Higher Education Issuances
Kustoff also Hall what the market is like for higher education issuances and how that compares to other types of available debt in the market. Hall said key components of higher education is the size of the endowment, student mix, and different sources of revenues the institution has. He said there has been peak demand for social impact bonds in the current market, making higher education and even K-12 attractive investments.

Oversubscription
Rep. Michael San Nicholas (D-Guam) said he endorses a triple tax exemption status for HBCUs and mentioned another solution that would allow land grant institutions to classify as agencies with Federal backing similar to government sponsored enterprises, to help drive down interest costs. He asked what a typical oversubscription is that would be helpful. Hall said creating peak competition for bonds drives yields downwards. He said the good news is the market has had many regulatory changes, and one of the important features is the expanded inclusion of municipal advisors to have a defined fiduciary role. Hall said they are crucial to the underwriting process because when there is oversubscription, municipal advisors ask the underwriters to lower yields and reduce that subscription, which helps ensure oversubscription goes to the benefit of the issuer.

Public Banks

Tliab asked if a public bank would be more likely to consider other factors beyond profitability in issuing bonds compared with a private bond underwriter. McDaniel said yes, and an advantage is that muni banks allow cities to recapture the local tax revenues, keeping the money within the community. Parsons said public banks serve a role when the private markets are failing or struggling.

For more information on this hearing, please click here.