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How Will Silicon Valley Bank Collapse Impact Bank Ownership of Munis?

Municipal bonds remain a viable, high-quality source of liquidity for banks, experts say, although they are divided about whether the collapse of two regional banks will curtail or eliminate the sector's ownership of municipal bonds.

Following the collapse of California-based Silicon Valley Bank on March 10 and New York-based Signature Bank (SGBG) on March 12, experts differ on how this will impact their holding of municipal bonds. Some say it will continue unabated, others say it could peter off, yet others believe banks may alter their duration to avoid the pitfalls of SVB and Signature.

"I do not believe banks will broadly reduce their ownership of municipal debt in light of the recent collapses of SVB and Signature Bank (SGBG)," Chris Brigati, managing director of municipal investments at Valley Bank, said.

Bank ownership of municipal bonds amounts to approximately 15% of the $4 trillion market, falling slightly during the COVID 19 pandemic, according to experts.

"I could even make a case for banks to increase their participation at some point," Brigati added.

Market and economic technicals, as well as the inherent benefits of municipals, support bank ownership, he and other experts said.

"Ratios versus Treasuries are presently rich as compared to historical norms," Brigati explained. "I do not foresee any immediate reason for this to change with anticipated near-term supply/demand dynamics."

If and when municipals offer a better relative value dynamic, banks could justifiably increase their engagement above recent norms, according to Brigati.

Cooper Howard, fixed income strategist focused on municipals at Charles Schwab (SCHW), agreed the inherent benefits of municipal bonds will continue to fuel ownership by banks.

"I would expect that banks will continue to be large buyers of municipal bonds because of their tax benefits and high credit quality," Howard said. "The issues in the banking sector didn't change that," he continued, noting the amount banks purchase in the future will chiefly depend mostly on yields relative to comparable securities.

Signature, SVB, and San Francisco-based First Republic – which is also under fiscal stress lately – all hold municipal bonds.

SVB held $7.4 billion of municipal bonds and notes as of Dec. 31, 2022, which were marked as having a fair value of $6.15 billion and ratings of A1 and above, according to its 10-K filing with the Securities & Exchange Commission.

Signature Bank (SGBG) – which in 2015 launched a public finance business – held $247 million of state and municipal securities in 2022, up from $7 million in 2018, according to its recent 10-K.

First Republic carries $19.4 billion of state and municipal securities, up from $8.19 billion in 2018.

But with the feds and large banks coming to the rescue of the banks, a “fire sale” of their municipal portfolios into the market appears unlikely, according to Lisa Washburn, managing director, chief credit officer at Municipal Market Analytics.

Should some banks have an initial “knee-jerk reaction,” which Brigati said is unlikely, the underlying fundamental reasons that make ownership of municipal paper within bank portfolios possible continues to offer strong justification for no change to their engagement in the asset class, he said.

“Naturally, the tax-exempt benefits of bank-qualified paper persist in offering a strong draw for banks in particular,” Brigati explained. “Additionally, the excellent credit quality, along with the diversification within the asset class offers another reason for continued engagement,” he said.

While markets, in general, remain volatile due to banking sector concerns, that shouldn’t stem municipal ownership by banks, according to John Miller, head of municipals at Nuveen, and Anders S. Persson, chief investment officer and head of Nuveen global fixed income.

“Some investors believe banks may be forced to sell municipal holdings and use the cash to shore up their balance sheets,” the pair said in a March 20 report.

“At this time, we see no credit issues appearing in municipals as an asset class,” that would force banks to sell their municipal holdings, they wrote.

“As regulators convene to discuss a way forward for banks in the wake of SVB, attention may be focused on munis, and while it is too soon to advance substantive prognostications, we will be on the lookout for anything that impacts demand for the asset class,” Jeff Lipton, managing director and head of municipal credit and market strategy at Oppenheimer & Co., said in a March 17 report.

The 2018 Economic Growth, Regulatory Relief and Consumer Protection Act reclassified municipal bonds as high-quality, liquid assets and provided another vehicle for banks to help meet their liquidity needs, Lipton pointed out.

“While active investment by banks has generally been softer more recently, this buyer class has remained part of the muni liquidity profile,” Lipton wrote.

Even with the lower corporate tax rates created by the Tax Cuts and Jobs Act of 2017, banks have remained a significant holder of municipals – albeit with higher allocations into taxable municipals, Lipton noted.

Going forward, Lipton plans to closely follow bank flows to gauge any meaningful selling pressure.

So far, there is little evidence that ownership of munis by banks – which hold about $540 billion of municipals, $140 billion of that is held by regional banks – will dwindle, according to Eve Lando, portfolio manager and managing director at Thornburg Investment Management.

About half of that exposure is in direct loans, so it shouldn’t be part of a sell-off, Lando noted.

“The total muni market is $4 trillion, so in isolation, the large bank numbers are a small fraction of the entire market and unlikely to flood the market,” she said in a March 21 report.

“We have seen one or two bid-wanted lists but nothing close to moving the market,” Lando added. “Contagion risk is low in the muni market prompted by bank selling.”

While others agree there will be little to no change in bank ownership of municipal bonds, they say banks could reduce their investment exposure.

“I do not expect bank ownership of municipal bonds will materially change,” Paul Mansour, a veteran New York City municipal bond analyst and current vice chairman of the New Hampshire Municipal Bond Bank.

However, the former head of municipal research at Conning said he expects financial institutions will shorten their duration.

“The ongoing banking crisis was created by a mismatch of short-term deposits secured by longer-term fixed-income securities of all types,” he explained.

“Deposits were withdrawn more rapidly than assumed could happen fueled by social media, forcing the banks to unload their fixed-income assets at distressed prices,” Mansour said, adding, he also expects the long end of the municipal curve to cheapen as a result.

Peter Delahunt, managing director of municipal securities at New York-based global firm StoneX Group Inc. (SNEX), said deposit growth and loan demand drive a bank’s appetite for bonds. The primary mission is to use the deposits to make loans, he explained. Where loan demand is insufficient for investing the deposits, banks will then invest in bonds, Delahunt added.

“Conversely, as funding becomes constrained when deposit growth deteriorates, there is less to invest in bonds and/or loans,” he continued.

“So far as this banking crisis leads to deposit deterioration, there will be less investment demand for bonds from the banks, whether tax-exempt or taxable,” Delahunt said.

The tax-exempt nature of bond demand will be determined by a bank’s tax status – vis-a-vis the tax equivalent alternatives amongst the various fixed income securities, he noted.

“The other narrative is how much loan demand will be squeezed by the Fed’s hawkish stance,” Delahunt said.

Banks significantly added municipal bonds to their portfolios just after the 2008-2009 financial crisis for two leading reasons: first, they liked the credit quality in the sector and second, there were not as many other investment options at the time, according to Tom Kozlik, managing director and head of public policy and municipal strategy at HilltopSecurities.

“Therefore, there is likely to be a natural reversion in bank investment patterns in the near term, but this was because they added them in the beginning to the middle of last decade,” Kozlik explained.

He said if banks reduce their municipal holdings going forward it might not necessarily be related to the current regional banking collapse.

Like others, Kozlik is cautiously watching the banking crisis unfold.

“We do not know if the banking sector issues are going to snowball and/or if the economy is going to face headwinds,” he said.

Jon Barasch, long time credit analyst and fixed income specialist in New York, said municipals meet the federal banking regulations pertaining to high quality liquid assets and liquidity coverage ratios to which banks are subject.

Rather than curtailing ownership, he agrees banks could work toward a slight drop in maturity duration given the recent developments.

“Perhaps the bonds banks do choose to own will be shorter in duration than years past,” Barasch said, noting the troubled banks owned bonds that featured longer maturities.

Jim Tinker, vice president of Alphaledger, who has more than 15 years in banking and municipal finance, said most banks are on pause in terms of adding to municipal holdings.

“This is mainly the result of deposit declines reducing excess cash, which was underway prior to the closings of Silvergate Bank, Silicon Valley Bank, and Signature Bank (SGBG),” he explained. “With the recent bank closures, I would not be surprised if banks decided to reposition some of their municipal holdings to reduce duration and/or reallocate to increase liquidity,” Tinker said.

In the meantime, banking concerns continue to roil the financial markets, with potential impacts on the municipal market, sources said.

Multiple recent rating downgrades of banks, including First Republic, engendered fear among investors and depositors.

The plethora of troubles that felled Credit Suisse last week and ended in a $3 billion takeover of the Swiss bank by its bigger rival UBS on Sunday added an extra dark cloud.

And news reports that the Biden administration was in talks with Warren Buffett, the chairman of Berkshire Hathaway (BRK/A), who famously swooped in with billions to bolster Goldman Sachs (GS) during the 2008 financial crisis, only signaled that the current panic might grow worse still.

Jennifer Johnston, director of research at Franklin Templeton Municipal Bonds, spoke of the uncertainty over the collapse during a March 21 webinar about navigating rates and risk.

With bank ownership at approximately 15% of the $4 trillion municipal industry, she is evaluating the potential for bank selling of municipals.

“That’s something we are watching and looking to see how it unravels,” she said.

By Christine Albano

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