MSRB Research Indicates Rise in Municipal Securities Transaction Costs for Individual Investors Amid Rising Rates and Market Volativity.

Washington, D.C. — The Municipal Securities Rulemaking Board (MSRB) today published a new research report that indicates a rise in customer transaction costs for municipal securities since early 2022, particularly for individual investor-sized trades.

"This increase in transaction costs is likely due to the steep decline in bond prices triggered by rising interest rates and market volatility starting in 2022, as those factors are often associated with higher effective spread," said Simon Wu, MSRB Chief Economist and lead author of the report. "Tax implications associated with buying discount bonds tend to make them less liquid, which in turn impacts the costs of trading these securities. Moreover, since dealers may be inclined to charge relatively fixed markups for customer trades, when bond prices decline, transaction costs as a percentage of the purchase price generally increase."

As previous MSRB research has shown, other than a sharp but brief spike in 2020 attributable to the COVID-19 crisis, transaction costs (as measured by effective spread) in the municipal market declined steadily between early 2009 and late 2021. However, starting in early 2022, that trend reversed. Bond prices suffered a steep decline as interest rates began to rise due to rising inflation, and market volatility increased. Declining bond prices resulted in more trading of discount bonds, which become less liquid the greater the discount from par value. This is because of the Internal Revenue Service's Market Discount Rule, which sets the threshold at which a discount municipal bond should be taxed as a capital gain rather than as ordinary income, making bonds with deeper discounts less attractive.

During this time, the average effective spread for municipal securities trades began to rise. Since the effective spread is calculated as the difference between customer purchase price and customer sale price and expressed as a percentage of bond price, declining bond prices with a relatively fixed markup would make the effective spread on a customer purchase higher.

The rise in effective spread was especially pronounced for individual investor-sized trades. As of March 2023, the effective spread for the sub-$100,000 par value trades, a proxy for individual investors, was three times as large as the effective spread for the over $1,000,000 par value trades that are generally attributed to institutional investors. Whereas, as recently as 2021, the effective spread for individual-sized customer trades was only 1.7 times the effective spread for institutional-sized customer trades. Additionally, the authors found that customer trades flagged with non-transaction-based compensation typically tied to a fee-based customer account, such as separately managed accounts, received a 30-basis point lower effective spread than customer trades from a regular non-fee-based customer account.

"While we do not tell dealers how much markup they can charge a customer, we do have rules to ensure that they charge fair and reasonable prices and clearly disclose markups on customer confirmations," said John Bagley, MSRB Chief Market Structure Officer. "In addition to writing rules designed to protect investors and ensure a fair and efficient market, monitoring market trends and publishing research reports is another way the MSRB supports market transparency and empowers investors to make informed decisions."

Read the report.

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