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Citi's Exit Carries Costs for Issuers, Market Liquidity, But Industry Expected to Weather It.

A tough year for Wall Street municipal underwriting firms culminated Thursday with Citigroup's (C/PN) announcement it would exit the business, a stunning move that market participants warned would raise state and city financing costs and that Citi would come to regret as headwinds calm and business rebounds.

"It's a major disappointment," said Matt Fabian, a partner at Municipal Market Analytics Inc. "Near term, municipals already lack liquidity and dealer capital, and Citi was a major provider of those, so their removal makes things tighter, makes the market more prone to excess volatility in both up and down trends," Fabian said.

"In the longer term, when we expect municipal bond issuance to see substantial growth because of climate change and legacy infrastructure issues, our industry is going to need to expand as well to minimize the pricing impact on our issuers," he said. "So a major underwriter withdrawing now will add to that challenge, further stretch personnel and committed dollars. Frankly, Citi passing up on that opportunity - of much more product, much more spread - seems to be a massive unforced error."

George Friedlander, Citi's former head of strategy for 41 years, called the firm a "dominant force in the municipal bond market," and one that "played an extremely important role keeping the market liquid during its most difficult times."

Citi's announcement, just days before the holidays, comes after CEO Jane Fraser in October pledged "relentless execution" of restructuring across the firm and a month after rumors of the muni group's demise began to float across the market. The memo that went out to employees Thursday expressed regret for the termination of "municipal sales, trading and banking colleagues" but said the "economics of these activities are no longer viable given our commitment to increase the firm's overall returns."

The move ends a year of layoffs at several Wall Street firms, including the October decision by UBS to exit the negotiated underwriting business. The industry has weathered its second year of declining volume that increased competition for fewer deals and tightened underwriting spreads. Cheapening bond valuations have challenged balance sheets. The March banking crisis and political dynamics in Texas, one of the market's largest issuers and previously one of Citi's top clients, was another pressure point. UBS and Citi have both been banned from underwriting state, city, county, school, and other government debt in Texas since the state passed a pair of laws in 2021 aimed at protecting the fossil fuel and firearm industries against boycotts or discrimination.

Some market sources also blamed Citi's own mismanagement under Fraser's restructuring rather than industry pressures.

"This is a Citi problem, it's not a muni problem," said a sell-side source, saying management decisions had cut into profitability.

"It's a complicated business and you can't have a half-hearted approach; you have to be all in," the source said. The muni market finances the "fabric of our nation, and now, because of Citi's exit, the cost of financing for state and local governments is going to go up," the source added.

While noting industry-wide pressures, Friedlander said it was "sad" that after senior talent left the firm "Citi decided just to move away from the municipal market function entirely."

Citi decided that "rather than generating the kind of talent necessary to manage a very senior municipal market function, they were just going to say, 'never mind,'" Friedlander said. "But in saying 'never mind,' they left the market with some holes - in terms of liquidity, the management of a number of functions in the market and various subcategories like hospitals, airports, power [and] housing."

One prominent issuer called the move "terrible" for local governments.

"Municipal expertise is already limited when it comes to bankers sending good ideas to issuers and creating creative financing structures that save issuers and taxpayers money," the official said.

Nikolai Sklaroff, the capital finance director of the San Francisco Public Utilities Commission, called the news "unfortunate" for issuers.

"The loss of any firm focused on municipal bond issues, and any reduction in the competition for bonds or financing ideas is regrettable," Sklaroff said. "One could imagine it could negatively impact competition for competitive sales, or cause less frequent issuers to see less coverage."

"It should also serve as an important reminder for all issuers that our access to financing and the markets relies on the health of our financial partners and the value in keeping polarizing politics out of financial decisions," he added.

The move comes less than two weeks after Citi priced an upsized \$2 billion deal for John F. Kennedy International Airport. The firm is also listed as a senior managing underwriter for an upcoming \$2.5 billion deal of sewer revenue warrants from Jefferson County, Alabama, set to price on Jan. 14, according to MuniOS. The firm is also listed as a senior manager for a deal of undetermined size from the Regents of the University of California, also set to price in January 2024.

The bank said it would continue to work on public-private partnerships and private placements, and to buy muni bonds.

Two years of declining issuance have increased pressure on underwriters who have spent years complaining about compressed spreads on deals. That's an industry problem, said a banker, who added that Citi was often one of the low-bidding culprits.

"It's people killing each other for market share, which makes zero sense," the banker said. "Bidding a dollar a bond on a \$1 billion California deal just to make sure you're going to get the next deal doesn't make sense," they said. "Until we, as an industry, can start worrying less about the rankings and more about where we are adding value and about being paid for the risk we are taking when we are underwriting, this is going to keep happening."

Firms of all sizes are reviewing their muni business to make sure they are sustainable, said Ajay Thomas, head of public finance at FHN Financial Capital Markets.

"Compensation to execute has continued to narrow and thin, so if you don't right size the business, a firm can have challenges," Thomas said. "Strategically this is very beneficial to the regional firms,"

he added. “Fundamentally it’s a sound business. I’m very bullish on munis and so are we as a firm.”

Citi’s exit means the market could face “lower lows” in times of stress and outflows, said James Pruskowski, chief investment officer at 16Rock Asset Management.

“Citi was a known provider of lines of credit and liquidity to select mutual funds complexes, which lessened the impact of forced sales, the municipal derivatives market – mainly rate-locks where Citi is still a top market-maker – and high-yield munis,” Pruskowski said.

But the muni market has always “proven more resilient, always larger than any one firm or person,” he added.

“Citi’s going to look back in a couple of years and behind closed doors regret shuttering the department,” Pruskowski said. “The municipal market runs much deeper than any other sector, with public, private and government issuers and investors. We’re financing key U.S. essential service infrastructure we all use and appreciate every day.”

By Jessica Lerner

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Karen Pierog contributed to this report.

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