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## **Extend Bank Qualified**

### **Bond Buyer Op-Ed**

**April 12, 2010**

The House of Representatives has passed a bill to extend some of the municipal financing provisions from last year's stimulus bill, the American Recovery and Reinvestment Act (ARRA) beyond their December 31, 2010 sunset dates, but two important provisions that promote investment in tax-exempt bonds by financial institutions were left out. The Senate should extend these provisions and they should be included in the final bill. These provisions have expanded the market for tax-exempt bonds; an expansion that has proved beneficial to issuers and that is still necessary.

One of the provisions, referred to as "bank-qualified" bonds permits banks to buy tax-exempt bonds issued by states and localities that expect to issue not more than \$30 million of bonds annually without the banks having to pay additional taxes due to the loss of interest deductions. Prior to the passage of ARRA, the "small issuer" limit was \$10 million annually. ARRA also changed the bank qualified rules so that pooled issuances were permitted if each individual member of the pool did not expect to issue more than \$30 million of bonds and it permitted 501(c)(3) bonds to be considered bank-qualified. The second ARRA provision expanded the two percent "*de minimis*" exemption to permit banks to invest up to two percent of their total assets in tax-exempt bonds without a loss of interest deductions regardless of the size of the issuer. Regrettably, both of these provisions expire at the end of this year and the Regional Bond Dealers Association, as well as many issuers, has urged Congress to extend them. These provisions are attracting critically needed participants into the municipal bond market at a time when issuers continue to struggle during this exceptionally difficult period.

Last year, Congress acted to expand the ability of banks to buy municipal securities precisely because law makers understood the grave difficulties facing issuers, especially smaller governmental bodies and non-profit

organizations, including colleges, hospitals and cultural centers. Raising funds in the municipal bond market was either impossible for these groups or prohibitively expensive as demand dropped off sharply from institutional investors like property and casualty insurance companies, hedge funds, tender option bond programs and others. Creating new demand was crucial in the face of the credit crisis.

Prior to the enactment of ARRA, banks had largely avoided the municipal market for more than 20 years. Culminating with the changes made by the Tax Reform Act of 1986, Congress had taken away the ability of banks and savings institutions that own tax-exempt bonds to deduct the interest expense on borrowed funds that were treated as used to hold the municipal bonds. The only exceptions were for bank-qualified bonds issued by small jurisdictions that raised less than \$10 million a year. This \$10 million limit was never adjusted for inflation, remaining at \$10 million since 1986. Pooled financings of over \$10 million were not bank-qualified, even if each of the individual members of the pool would have met the bank-qualified criteria. Further, 501(c)(3) organizations were not eligible at all for bank-qualified treatment.

The result of these legislative changes was predictable and dramatic. After the 1986 tax act was passed, banks and savings institutions unloaded the bulk of their municipal bond portfolios. The firms went from holding around 30 percent of the outstanding tax exempt bonds, at the end of 1985 to just eight percent of those bonds by the end of 1996.

The decline in bank investment and the resulting loss of liquidity directly affected the cost of financing in the municipal market. These impacts could be seen in the rates paid by issuers who could still sell to banks. Bank qualified issuers paid lower interest rates than other borrowers, historically, 25 to 40 basis points less. The difference was entirely attributable to greater liquidity and increased demand among banks.

Because of the changes in ARRA that increased the demand for tax-exempt bonds by banks, all issuers are now paying lower rates. First, there are more bank-qualified issuers able to take advantage of those provisions. For instance, at the beginning of last month, an Ohio college raised \$28 million using bank-qualified bonds under the exemption granted by ARRA. Investment advisors involved in the transaction stated that the institution was able to borrow at lower interest rates in several maturities that will result in a

savings for the college of \$244,000 over the life of the bonds. In addition, the college was able to include a five-year call option on the securities, instead of a typical ten-year call, because the investing banks were not concerned about the shorter call period.

Moreover, the increased demand by banks resulting from the expansion of the *de minimus* exemption is helping both small issuers (by creating more demand for the larger supply of bank qualified bonds) and larger issuers, too. Having this diversity in the market is important, especially as other purchasers of tax-exempt bonds, such as hedge funds, have left the market.

While some sectors of the economy appear to be slowly recovering, cities and states, especially smaller ones, probably will not see better times for several years to come. They desperately need help and lower borrowing costs are critical. Congress must extend the expansion of the bank-qualified provision and the two percent *de minimis* rule to help issuers raise money at reasonable costs. An extension will directly help smaller state and local governments, as well as tax-exempt entities such as schools, hospitals and cultural centers by allowing them to invest in vitally needed infrastructure projects. Those projects will create badly needed jobs and provide the investment needed for long-term economic growth.

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