

Bank-qualified municipal bonds



Wealth
Management

What are bank-qualified bonds?

The term “bank-qualified” is generally used to describe a class of municipal securities that enjoy a tax-advantaged status when purchased by commercial banks. This preferential status was granted by the Tax Reform Act of 1986 (the “1986 Act”). Prior to the passage of the 1986 Act, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) allowed commercial banks to deduct 80% of the interest expense associated with funds invested in tax-exempt securities. The 1986 Act effectively removed this deductibility for all tax-exempt bonds purchased subsequent to August 7, 1986, except those securities officially designated as “bank qualified.” In effect, the 1986 Act created a tax-on-tax-exempt interest for banks on non-qualified securities. The net result has been that the demand by commercial banks for tax-exempt securities is almost entirely limited to bank-qualified issues.

How does a bond become bank qualified?

In order to meet the requirements for “bank qualification,” a municipal bond must meet several criteria. First, the issuer must designate the issue as “bank qualified.” In giving this designation, the issuer must not reasonably expect to issue more than \$30* million of bonds in the calendar year in which the

designation is made. Bonds eligible for this designation must also meet certain public activity tests. Certain “private activity bonds” (typically industrial development revenue bonds, certain types of single-family housing revenue bonds, pollution control bonds, and convention center bonds) are not eligible to be designated as “bank qualified.” More typically, bonds issued by states and their political subdivisions (towns, counties, school districts, sanitation districts) fall under the eligible category for designation as bank qualified. In addition to these general obligation securities, certain types of revenue bonds (some multifamily housing, hazardous waste bonds, etc.) can be designated as bank qualified.

The math behind bank-qualified bonds

To fully understand the advantages of bank-qualified municipals, it’s important to understand the underlying math. Although bank-qualified bonds have certain tax-advantages over non-qualified municipals, one must also calculate the spread to Treasuries to determine whether the true bank-qualified yield fully justifies their purchase. That’s because banks, when investing in fixed income securities, typically compare the true bank-qualified yield with that of Treasury securities.

The first step is to calculate the portion of a bank’s interest cost which is disallowed. This amount, sometimes referred to as the TEFRA haircut, is figured as follows:

TEFRA haircut = cost of funds x disallowance x federal tax rate

For example:

$$2\% \times 20\% \times 35\% = 14 \text{ basis points}$$

In this example, a 2% bank’s cost of funds and a 35% tax rate is assumed. The next step is to deduct this haircut from the quoted yield of a bank-qualified municipal. Let’s assume the yield on the bank-qualified bond is 4%.

Actual BQ yield = stated BQ yield - TEFRA haircut

Example: $4\% - 14 \text{ basis points} = 3.86\%$

In effect, the bank purchasing the 4% bank-qualified security is getting a tax-free bond with a 3.86% yield and paying tax on 14 basis points. The final step is to calculate the taxable-equivalent yield and compare the result to the appropriate yield available in the Treasury market.

Taxable equivalent yield = actual BQ yield divided by (1 - federal tax rate)

Example: $3.86\% / (1 - 35\%) = 5.93\%$

It is the 5.93% which must be compared to opportunities available in the Treasury market in order to gauge the attractiveness of the bank-qualified municipal bond.

Are bank-qualified bonds appropriate for all investors?

Probably not, since bonds designated as bank-qualified are generally more expensive than non-bank-qualified bonds. As such, an individual investor can expect to receive a lower yield on bank-qualified issues. If your customer is a bank, the favorable tax treatment helps compensate for the lower yield. An individual investor, however, does not benefit from the preferential tax treatment. Since bank qualification is not a measure of credit quality, other factors being equal, most individual investors would not benefit from restricting their investments to bank qualified issues.

*This amount increased to 30MM from 10MM under the American Recovery and Reinvestment Act of 2009.

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