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Is the Tide Changing in the Municipal Variable Rate Market?

Interest Rate Policy & Money Fund Regulations are Key Drivers

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April 3, 2017

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Shifts in Federal Reserve interest rate policy and recent money market regulation may reverse the tide in using municipal bank loans and drive a tightening in the SIFMA/LIBOR ratio. Below is my outlook for the SIFMA market. It follows the Bond Buyer article published last week regarding the role of bank loans in the muni market.

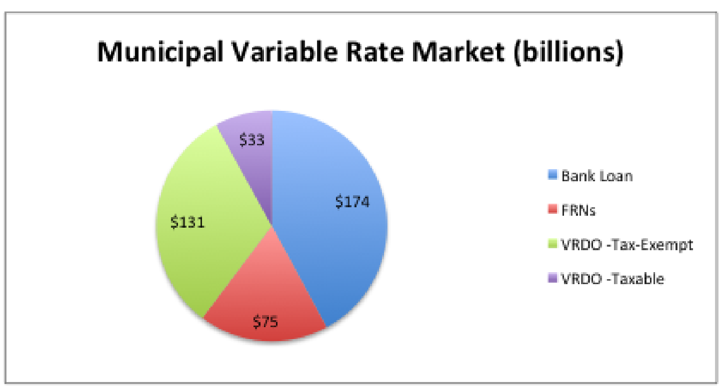
Opinion

In October 2016, money market reform required the structural need for taxable buyers absorb a portion of outstanding variable rate demand obligations (VRDOs). The influence of taxable buyers is expected to pressure the SIFMA/LIBOR ratio higher. I see a gradual return of pre-crisis economics whereby the markets may favor VRDO issuance and de-emphasize bank loans and FRNs.

Market Structure

Prior to the financial crisis in 2008, the approximately $450 billion of VRDOs were by far the mainstay of the variable rate market with little issuance of bank loans or floating rate notes (FRNs). The market was primarily a SIFMA rate market dominated by the tax-exempt capital market. As shown in Figure 1, the current $390 billion variable rate market is no longer dominated by any one financing method. Within the VRDO market, taxable buyers now account for $33 billion or nearly 20% of outstandings.

Figure 1



VRDO, FRN Data 4Q16, SIFMA Municipal Bond Credit Report
Bank Loan Data, 4Q16, FDIC Quarterly Banking Profile

<u>Market Dynamics</u>

The first impetus for change in market structure was the near zero interest rate environment brought on by the financial crisis in 2008. The Fed's actions compressed rates whereby banks' had a positive cash funding margin (CFM) for tax-exempt loans. The CFM is the difference between a bank's loan rate and its funding cost (not including and tax-exempt gross up).[1] A break-even or positive CFM allows a bank to earn a tax equivalent yield without incurring negative carry. The CFM is approaching breakeven assuming 1 mos LIBOR assuming a credit spread of 0.40%. As shown in Figure 2, the CFM has been positive but decreasing throughout 2016 as interest rates continue to rise.

Figure 2

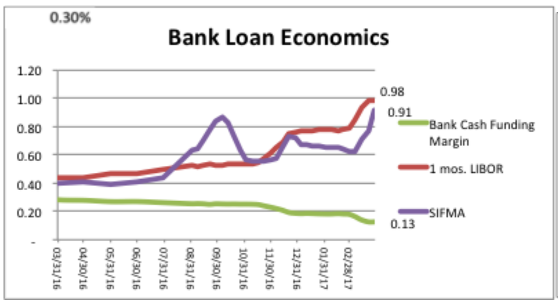
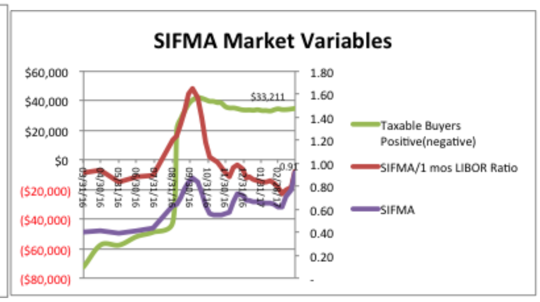


Figure 3

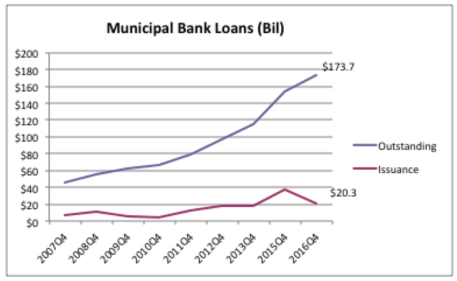


SIFMA's large spike in October 2016 (as shown in Figures 2 and 3) reflect the outflows in tax-exempt money market funds. As with taxable funds, tax-exempt institutional funds saw larger relative outflows than did retail funds. While the magnitude of the spike was somewhat exaggerated and short lived, the repercussions remain. In Figure 3 we see the demand for VRDOs from tax-exempt investors reversing itself in 2016 whereby taxable buyers now account for a stable 20% or $33 billion of VRDO investment. With the influence of the taxable buyers, we see recent tightening in the SIFMA/LIBOR ratio (see Figure 3.)

The market dynamic for the increase in bank loans was primarily due to the near zero interest rates environment brought on by the financial crisis in 2008. Bank loan issuance peaked in 2015 (see Figure 4). The Fed's actions compressed rates whereby banks' had a positive funding base for tax-exempt loans. As rates rise and the nominal spread between SIFMA and LIBOR returns, banks will lose the economics to lend directly. Therefore we may assume a return to the VRDO market of previously financed bank loans. Expiring VRDOs are $40.5 billion in 2017 and $33 billion 2018.

[1] CFM= ((1MLIBOR*72%) +CS)-1MLIBOR). While a bank's actual funding cost varies, we use 1 month LIBOR as a proxy. For calculation of the CFM in figure 2, we use 0.40% for a credit spread. ((1%*72%) +0.40)-1%)

Figure 4



Market Outlook

Currently the Fed is signaling another 2-3 interest rate hikes in 2017. Without any contravening factors, higher rates will continue to exert negative pressure on the bank loan market in favor of traditional VRDOs. If tax reform reduces the corporate tax rates, bank loans will be even more uneconomical.

Based on our estimates, I forecast $20 billion of potential annual conversions from bank loans to traditional VRDOs over a five-year period.[2] The full conversion would require $100 billion additional crossover buyers. However, unless there is a large inflow to tax-exempt funds, SIFMA will rise towards LIBOR levels to entice crossover buyers or keep banks in the loan product.

Summary

Increasing interest rates will induce shifts in the variable rate market with the potential for a reversion in use from bank loans to traditional VRDOs and more involvement from the taxable investment community. Issuers will want increasing access to taxable buyers. Tax-exempt investors will likely see cheaper levels and crossover buyers will want more access to SIFMA based paper.

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[2] We assume that $100 billion of the $174 billion in municipal bank loans are suitable VRDO substitutes (ie: large balances and not fixed rate). We also assume the average bank loan has a five year average term.

Contributors

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