Issue Brief: BANK DEDUCTIBILITY

Updated June 2011

Background

Banks historically have been major purchasers of municipal bonds. Prior to 1986, they were permitted to deduct all or a major portion of the interest costs they incurred to invest in these bonds. The *1986 Tax Reform Act* eliminated this deduction except for the bonds of certain very "small issuers." An exception to the law permits banks to deduct 80% of the costs of purchasing and carrying bonds of issuers that do not issue more than $10 million of bonds annually. Until 2009, the $10 million figure had not changed since 1986, nor did it apply to borrowers in conduit financings. The result between 1986 and 2008 was a substantial reduction in bank demand, which has led to greater volatility and less liquidity in the municipal market as well as higher borrowing costs for issuers.

The 2009 *American Recovery and Reinvestment Act* provided for the small issuer exception limit to be increased to $30 million in years 2009 and 2010. The *Act* also lets a bond issuer to elect to apply the exemption at the level of the ultimate beneficiary of the financing. Allowing the exemption to apply at the beneficiary level, rather than the single issuing authority level, benefits capital projects for those participating in pools, bond banks, and health care and educational financing authorities.

These changes to bank qualified debt were a proven success. In 2009 and 2010, the amount of bank qualified debt more than doubled, and local governments were able to reap the benefits of placing their debt with community banks rather than enter the open market.

As of January 1, 2011, the bank qualified limit returned to its $10 million level.

Recommendations

The existence of many buyers/lenders in the municipal bond market is essential to its efficient operation. Revising the "bank deducibility" rules – on a permanent basis – would restore bank demand and provide some stability by bringing this group of institutional investors back into the municipal bond market. As an added benefit, banks would be able to invest in less risky investments than those that have contributed to their financial difficulties. Local banks would be able to invest in their communities and issuers would be able to sell bonds through private placements with banks thus lowering borrowing costs.

Outlook 2011

A bi-partisan bill was introduced in the Senate, S. 1016. that would make the $30 million limit permanent. GFOA and other state and local government organizations strongly support this legislation.

Related GFOA Public Policy Statements (see www.gfoa.org)

- Federal Tax Policy and Preserving the Tax-Exempt Status of Municipal Bonds (2005)