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# Community Finance Brief

## *Black Tax, Liquidity & Bond Banks*

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The profile of environmental and social issues as they pertain to facets of community finance has been raised considerably in the last decade. With it, the analysis of climate change and the infusion of racial equity into the way in towns, cities, counties and states raise capital and for what purpose has increased to a level the public finance industry has never seen before. This emphasis should improve community wellbeing and the analysis of risk in the marketplace but along with it, certain structural components have been overlooked.

Recently, attention to the so-called 'black tax' and climate-adjusted yields has been elevated. Both have merit in their study and do offer clues as  to bias and risk assessment in the municipal bond market yet the reality of the hyper-local structure cannot be overlooked.

There is no regulated financial marketplace of its size in the world that caters to so may different participants as does the U.S. municipal bond market. Tens of thousands of obligors, no disclosure standards and intents and purposes that only have to meet a "public purpose" threshold leave investors demanding discounts for a variety of purposes. The singular most important element that affects the price of a security outside of its rating is that of liquidity. Compared to other markets, municipals offer little.

This is not to say that a black tax does not exist - **CSG** reads reports as the one reviewed in this week's brief and believes it is part of this marketplace as it likely is with any place where humans interact. Still, the bigger picture is the structure of the municipal bond market and the cost with allowing so many entities access to it, must be better understood above other vectors.

### Quick Takes

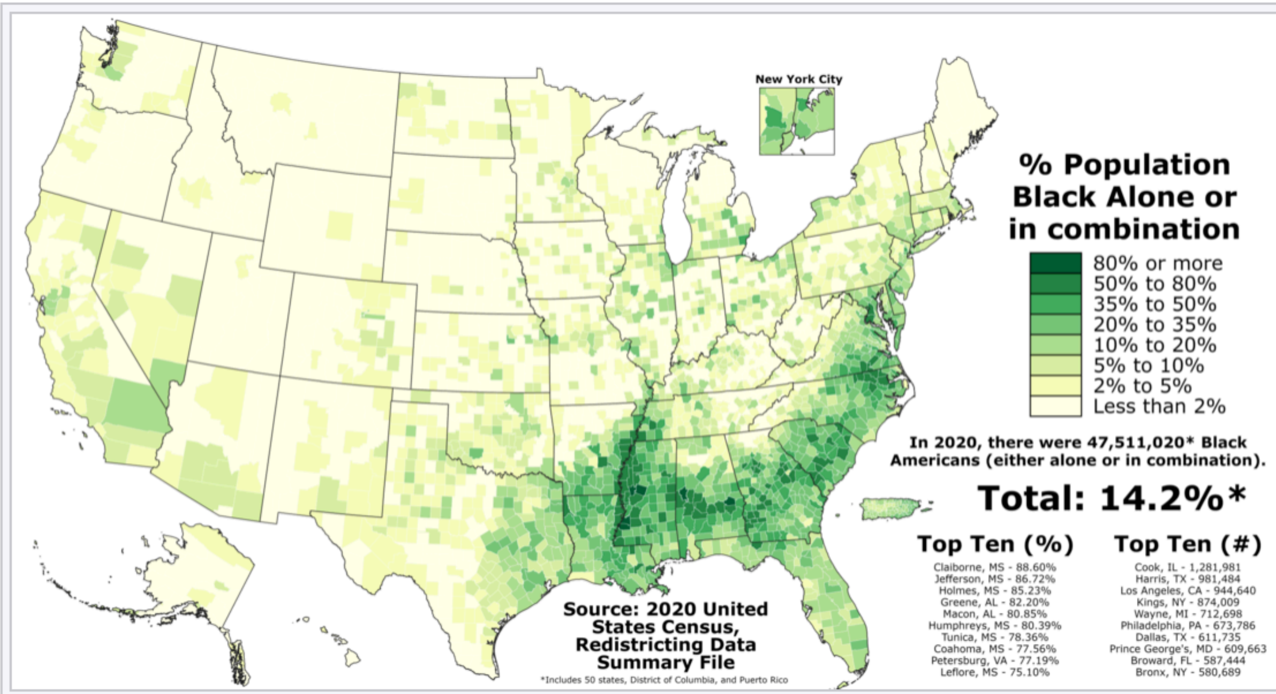
All else being equal, 100% black populated community would be penalized 19 basis points in a municipal bond offering compared to a 100% non-black community
*-Breckinridge, ICE SF*

Black or African American (alone) people represent 13.6% of the total U.S. population n 2021
*-US Census Bureau*

27% of urban counties are made up of Black people in the U.S. compared to 8% in rural counties
*-US Census Bureau*

The average daily trading volume of municipal bonds in 2022 was less than 10% of daily corporate bond volume
*-MSRB*

Households own 43% of outstanding municipal bonds compared to 3% of outstanding Treasuries and 1% of corporate bonds
*-Federal Reserve Board, 1Q2023*



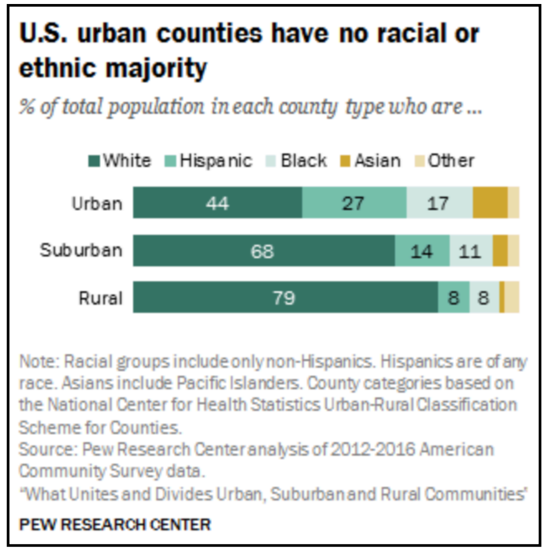

## STUDIES OF RACIAL BIAS IN MUNICIPAL BOND MARKETS

There have been a few studies in the last four years that have essentially asked the question of whether there is racial bias against communities with larger portions of black people living in them that is reflected in these government's borrowing costs in the municipal bond market. This has resulted in media coverage that for the municipal bond market, saw increased national media focus and was unique as a headline to parse.

The first few studies were somewhat isolated in nature, looking at Historically Black Colleagues and Universities or only looking at city and a county bonds utilizing county-level data. The most recent study, published in an open-sourced science publisher, PLOS, by a municipal bond asset manager and a data-provider (**CSG** uses this data provider, ICE, in its own research) is the most expansive study looking at this topic. The process not only looked at the entire universe of outstanding municipal bonds but also looked specifically at the water and sewer sector. Additionally, it reviews demographic data down to the census track level, which is as specific as one can get in the

"…we ask whether Black Americans effectively pay more for municipal debt, after controlling for economic conditions of debt-issuing communities," writes Erika Smull in Climate, race and the cost of capital in the municipal bond market. "We focus on Black communities because they have been subjected to racial and economic resource segregation and persistent negative income and wealth impacts for multiple generations (e.g., redlining practices in many U.S. cities leading to punitive borrowing rates)."

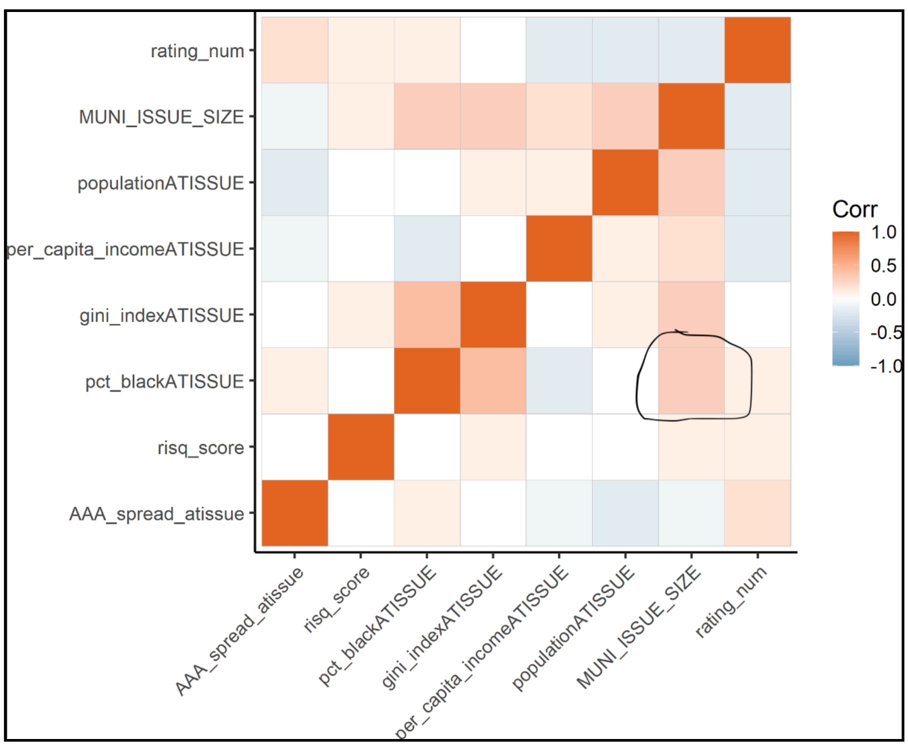
United States as fas as nationwide coverage and separated economic risk from demographics - our point of contention with previous studies.




There are numerous attributes to a bond structure or external factors that can impact the price of a bond in the primary and secondary market so the authors went about isolating these factors (maturity, coupon, call-options, rating, broad market conditions etc...) so as to be able to pinpoint the impact of race on a price. Their process is rigorous and is detailed in the conceptual approach and methods portion of the linked report. With non-demographic components removed from the data, this leaves us with the best apples to apples comparison of *how price is impacted by the percentage of a bonds's jurisdiction is black or not that has ever been conducted.*

Simple put, the results are that there is indeed a correlation between how black a community is and its cost of issuance in the primary market and in secondary trading. Specifically, all else being equal, an increase in the percent of black individuals in a community by 10% would result in a yield penalty of 1.9 basis points. This is a considerable penalty given the hundreds of billions of bonds issued annually.

In reviewing the study, **CSG** points to the correlations between "percent black" and "muni_issue_size" as a very important component to this study. In **the chart** to the right, the study authors offered a matrix look at various indicators, we've circled where these two vectors match but also note the higher correlations across the table along the municipal issuance size. All else being equal, the smaller the issuer,



the higher a penalty it pays to access the marketplace.

The Black or African-American community (alone) represents 13.6% of the entire U.S. population according to the latest U.S. Census Bureau. Yet, where in the U.S. they live is heavily skewed towards urban and suburban areas (about 80% of black Americans say they live in such areas). Further, of the counties that had 50% or higher amount of Black residents, 95 of the 96 were in the southern U.S. and considered rural, according to the 2020 Census.

This is important when looking at statistical probability and the structure of the municipal bond market because urban areas are more likely to issue larger bonds and encompass more of the black population in these transactions. As such, the number count of transactions with higher percentages of black people will be skewed towards smaller communities. Rural areas, where the actual number of deals is higher, will see a yield penalty regardless of the racial make-up.

Essentially, the deal count is skewed by smaller deals that are likely face a liquidity premium but also, as a percentage, will see higher amount of black people as part of the whole. This aspect of the market structure was not isolated as other components can be.

**LIQUIDITY REIGNS**

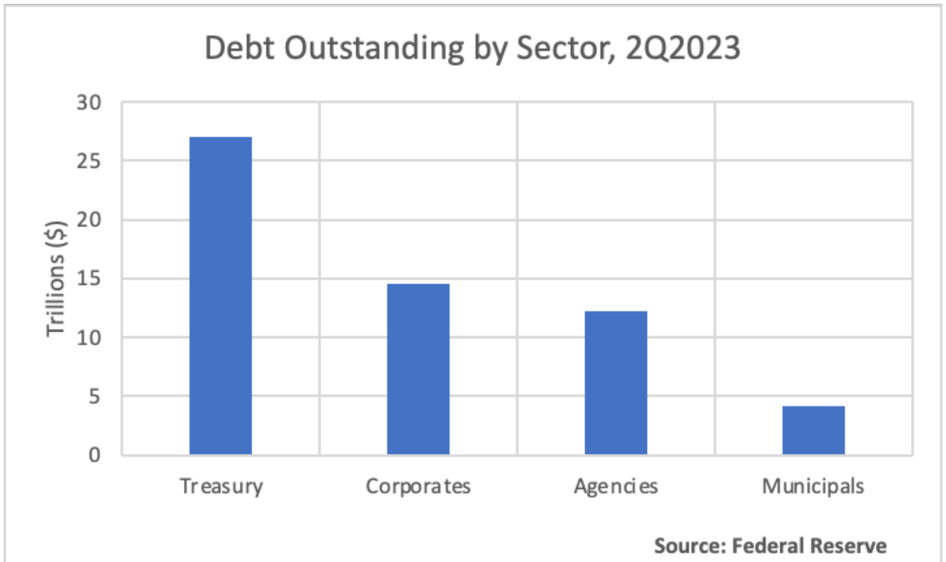
The amount of municipal bonds outstanding for an issuer, the size of a deal and the frequency of how often an issuer taps the market are the most important elements to price after credit is taken into consideration. With that said, given the minuscule default rates for municipal bonds, the ability to redeem the investment is the next most important item to consider. More than anything else, smaller issuers, which tend to be small communities, pay a so-called liquidity premium for their bonds.

Stepping back at the big picture, recall that the outstanding universe of municipal bonds is dwarfed compared to other sectors (see **chart,** below) and the average trading volume is, on average, 9.7% lower than corporates and about 1% of U.S. Treasuries (SIFMA). The massive differences in sizes of just the overall market sizes makes the cost of liquidity more significant for municipal bonds than it does in other markets.

Particular to the municipal bond market is that it is structured with over 50,000 different state and local governments with a wide array of use of proceeds. This means that the work to understand a security is more time intensive compared to

"...the municipal bond market is a very thin market; many municipal bonds are only traded a few times after issuance," writes MSRB's John Bagley in a white paper delivered to the Brookings Institute. "Average weekly muni trading volume is generally less than 12 percent of Treasury trading volume. One the other hand, the number of muni bonds far exceeds Treasuries well above one million different municipal securities are issued by over 50,000 state and local governments. Thus, most individual muni bonds are traded infrequently."

other asset classes. Also unique to the muni market is it more of a 'buy and hold' marketplace rather than a trading one. This is because the majority of bond holders are individuals, separately-managed accounts or mutual funds that invest in the asset class for it's tax-exempt feature that fits well into retirement portfolios. This mean they just generally don't trade as often as other asset classes.




With that, we emphasize that liquidity is king and the price on local governments and, all else being equal, extremely correlated to size of their bond issue, the outstanding amount of debt it has as well as the frequency within which a borrower accesses the marketplace. Obviously, over borrowing could be a problem, but that should be reflected in the credit rating. As such, it appears that the study backed their way into pricing the liquidity premium on community size as it did assessing a black tax.

## BOND BANKS

We are spending this much time on this topic because the liquidity premium is really the market problem to solve for more than anything else. The market is structured the way it is in order to keep sovereignty over financial decisions in the hands of local governments. The liquidity premium is a cost of that right. An effective solution is that of state bond banks. Interestingly, some of the media coverage of the black tax issue pushed bond banks as a solution to this problem. What this coverage failed to realize is the argument of economies of scale is about the economies of scale more than it is about racial bias.

A state bond bank is a state-sponsored entity that makes local infrastructure projects feasible by providing access to the municipal bond market and by providing direct and indirect financial assessments to localities, primarily through debt issuance. In essence, they sell their own municipal bonds and then resend the proceeds to local projects within the state. This allows smaller communities to overcome the liquidity premium by pooling their borrowing needs together through a state-sponsored vehicle. On top of that, many of these banks offer technical assistance to support with legal issues and reporting of financial information. Some offer credit enhancements as well.

Aside from being a liquidity solution, it is also somewhat of a middle ground to the sovereignty issue. In these instances, the local government still has control over their dollars but is accepting the state's help in the administration and financing of the dollars. With the influx of federal grant programs focused on infrastructure, resiliency and climate issues, the role of bond banks is expected to increase in the near future. So-called green banks and other conduit issuers have positioned themselves to help the flow of capital into local communities. We will expand more on bond banks in next week's brief.

"Following 2020, a larger portion of the country, including not only individuals and social justice organizations, but also corporations, major financial institutions and stakeholders of the municipal bond market, began to more openly grapple with the complex history of slavery, institutional discrimination and racial capitalism," writes Smull."Still racial bias in the municipal market is to widely considered by investors as material to bond pricing…our results, however demonstrate that race is being priced in the municipal bond market, even after controlling for other socioeconomic factors."

## IMPLICATIONS ARE STILL RELEVANT

*Impact Alpha* pointing to bond banks as a market solution, while misguiding in its reasoning, is offering a tangible solution and underscores a key delineation in the vernacular of 'a market.' An exact definition of a market is the coming together of a buyer and a seller. This brief has tried to separate the pricing of bonds from other important aspects of what a bond represents. Because capital is being raised for public purpose, the municipal market also entails the policy and decisions made before the pricing of a bond.

**CSG** would posit that the larger results of the study were the results of the challenges of having such a disparate, opaque marketplace. What has transpired since the conversation of racial equity in the nation was elevated as result of Black Lives Matter and other movements as it relates to the municipal bond market is better understanding how local governments can fight structural issues that enhance and fortify racial bias in communities. The municipal market can and should be used as a tool to break down such bias. As these efforts highlighting racial equity in local and state public policy grow, the market should reward these efforts as to price points, which would require asset managers like those that conducted the study to pay more for bonds wherein policies reflect an understanding of structural racism.

The municipal market, used as a term for the entire process of plans for raising capital and for what purposes, should focus on identifying racial equity components in the planning process for a bond. The use of proceeds of a bond is what carries a message to the public. A bond sets a legal precedent for how a government intends to spend its money and if racial equity is highlighted in that regard, it is a win for community wellbeing.