What Was Once Lost May Now Be Found:
Revisiting the Value of Tax-Exempt Municipals in Anticipation of Higher Corporate Tax Rates

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(Editors Note: Conning acknowledges the uncertainty regarding future corporate tax rates but believes companies should begin thinking about them now, and many clients have asked for help. We outline our views below.)

Tax-exempt municipal bonds were one victim of the Tax Cut and Jobs Act of 2017 (TCJA): the lower corporate tax rates reduced the relative value of these bonds for many investors, including property & casualty (P&C) insurers.

However, with both the new Congress and the Biden administration expressing support for higher corporate tax rates, tax-exempt municipals may eventually regain their luster. P&C insurers may want to revisit the sector and consider its fit in their investment strategy.

After the passage of the TCJA, P&C insurers needed time to work through the impact on their businesses and investment strategies. Similarly, while a higher tax regime may be on its way at some point, policy specifics and their impact will take time to sort out. However, Conning believes changes in tax rates and accompanying legislation could impact insurers' businesses, including optimal asset allocation and specifically the appeal of tax-exempt municipals.

To examine the potential impact, we offer an early view of prospective changes in the municipal market, a look at recent trends in tax-exempt municipal ownership, and insights into what a new corporate tax regime could mean for municipal ownership in the P&C industry.

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Positives for the Municipal Market

Tax-exempt municipal bonds have long been a meaningful portion of P&C companies' investment strategy, especially prior to the TCJA. Compared to similar-duration taxable bonds, tax-exempt municipals have offered many insurers similar levels of yield with higher credit ratings. Additionally, municipals provide an ability to diversify issuers among geographies and revenue sources. Along with historically lower default rates, municipals have provided insurers meaningful value.

The 2020 elections may provide many positives for the broader municipal market. The American Rescue Plan, signed into law March 11, provides $325 billion for state and local governments. Additional funds are targeted to help K-12 and higher education institutions. These funds may help ward off rating-agency pressure for more troubled governments and be supportive of various municipal sub-sectors including health care and education. The white whale of infrastructure spending could be in the future: stimulus could support local and state governments as well as the transportation sectors, which have been adversely affected by reduced travel and use of mass transit.

Increases in corporate tax rates could make the tax-exempt component of the municipal market more attractive. If the state and local tax (SALT) cap is revisited and states raise taxes, that may drive taxpayer interest in tax-exempt municipal bonds. A change in the marginal tax rates of high earners could also add to demand for tax-exempt municipals. On the supply side, legislation that rewrites the TCJA limitation on tax-exempt refunding could create a greater supply of tax-exempt municipals (at the expense of taxable issuance).

Corporate Tax Rates' Impact on P&C Municipal Allocations

The TCJA reduced insurers' interest in tax-exempt municipals because it lowered tax rates and changed proration (the percent of income that is not exempt). A bond that previously held a tax-equivalent book yield of 2.92% upon passage of the TCJA instantly had a tax-equivalent yield of 2.40%; changes like this improved the relative attractiveness of many other sectors. In the P&C industry this resulted in a decline in the holdings of municipals by about 10% since year-end 2017.[1]

However, insurers' decreased demand for tax-exempt municipal securities did not lead to overall market weakness. Demand from high-income individuals remained strong. Meanwhile, supply tightened: the TCJA limited tax-exempt refinancing so municipalities had fewer opportunities to issue new tax-exempt bonds. Municipalities have since become more reliant on taxable issuance.

Should tax rates change again, **Figure 1** illustrates how some potential revisions might impact the municipal bond market.

For ease of analysis, assume the future higher corporate tax rate is somewhere between the current rate (21%) and the former (35%), splitting the difference at 28%. With no changes to the rules regarding proration, the multiplier on tax-exempt municipals for rate-paying P&C companies would increase to 1.32 from 1.20. For a tax-exempt municipal with a raw yield of 2%, this would raise the value to 2.63% from 2.40%. (The relative value for tax-exempt municipals increases as the after-tax value of other sectors decreases from higher tax rates.)

Figure 1 - Potential Impact of Higher Tax Rates on Tax-Exempt Municipal Bonds

	Tax Rate	Proration	Yield Multiplier	Tax-Equivalent Yield of 2% Raw Yield	After-Tax Yield
Pre-TCJA	35	15%	1.46	2.92%	1.89574%
2017-Present	21%	25%	1.20	2.40%	1.89475%
Hypothetical 28% Tax Rate	28%	18.75%	1.32	2.63%	1.89475%

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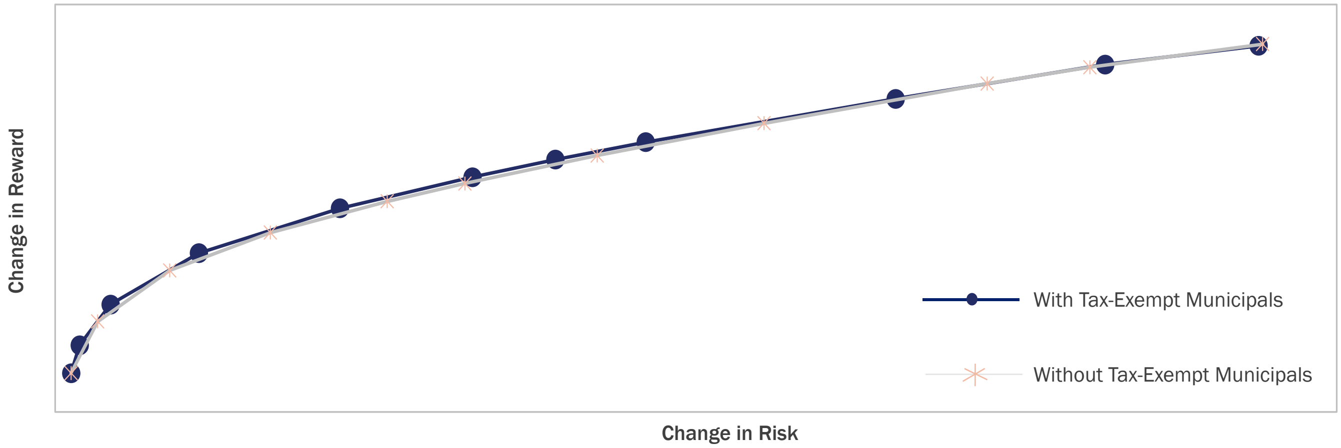
Tax Rate Jump May Raise Interest in Tax-Exempt Munis

A push for higher corporate tax rates would also likely raise demand for tax-exempt municipals. The lower valuations offered by tax-exempt municipals the past few years made many P&C insurers reassess their investment strategy and drove them to develop more robust and diversified portfolios. Conning does not believe the trend of investing in new fixed income sectors and other alternatives will reverse course. However, we believe P&C insurers would be very open to tax-exempt municipal bonds, a sector that has traditionally offered high-quality securities with similar or greater tax-equivalent yields from a broad array of issuers.

Let's examine the potential impact of the aforementioned tax change on the P&C industry's investment strategy. The top chart in **Figure 2** demonstrates that, under the current tax environment, the "value" of allowing for tax-exempt municipals (blue line) is limited and only adds marginal value in the lower risk portfolios along the efficient frontier. The bottom chart shows how, in a world with a 28% tax rate, the added value is meaningfully higher than the current tax regime. The efficient frontier with tax-exempt municipals (dark blue) is much higher than the gray one without tax-exempt municipals in all portfolios except the highest risk.

Figure 2 - Marginal Value of Tax-Exempt Municipal Bonds as Tax Rates Change

Current Tax Rate - 21%



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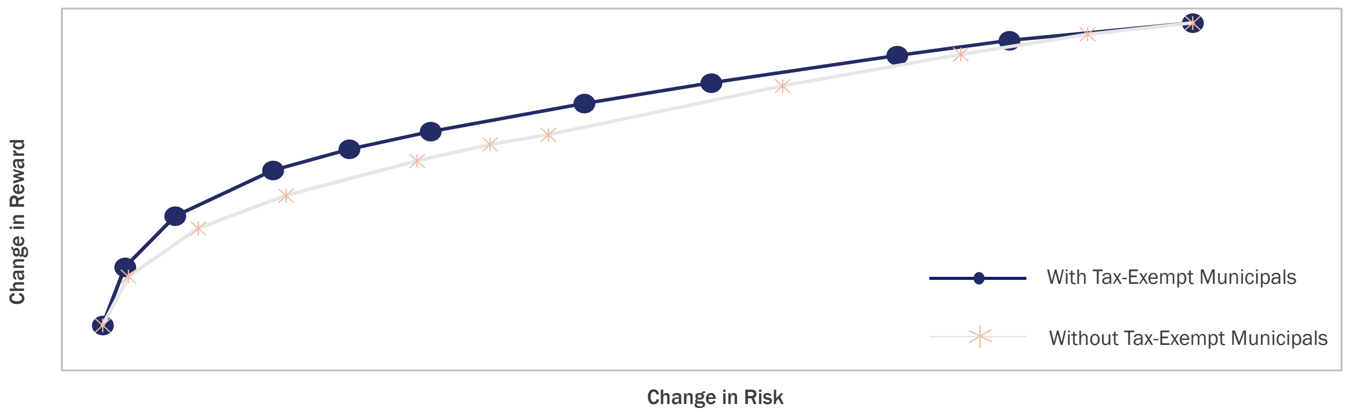
Prospective 28% Tax Rate



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Given the meaningful shift in the curves in the prospective tax-regime, we believe P&C insurers will seek out more tax-exempt municipals in a higher tax rate environment. As certainty over the future of corporate tax rates is unlikely to be settled in short order, we would expect those insurers with allocations to hold steady and possibly look to add to their exposure opportunistically. Additional purchases of tax-exempt municipals that offer relative value under the current tax regime may pay even greater rewards if we do see corporate tax rates rise in the future.

Conclusion

Overall, higher tax rates may be a headwind for the profitability of P&C insurers. It is still unknown what other implications a tax increase may include. The TCJA also affected the alternative minimum tax (AMT), brought about the base erosion and anti-abuse tax (BEAT), changed reserving methodology, and impacted net operating loss (NOL) carryback and carryforward. While it is early to forecast the full implications of any prospective tax changes, they are clearly on the mind of many clients and we are helping them understand the potential impact and opportunities in tax-exempt municipal bonds.

We do not believe this exercise should deter P&C insurers from diversifying into other potentially higher-returning sectors such as esoteric structured, private placements, lower-rated corporate bonds and alternatives. However, we do believe the re-emergence of a sector offering high quality and attractive yields such as tax-exempt municipals will be embraced by P&C insurers. As Conning learns more about prospective policies, we welcome the opportunity to engage and share our research on the subject.

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Footnotes:

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