PROBLEMS IN THE MUNICIPAL MARKET

by Steve Brown

A regular feature of this column used to be the warning that municipal bonds for bank investment portfolios are not all that they are cracked up to be. If you measure risk by earnings volatility, then municipal bonds have some of the lowest risk in the industry. If you measure it by after tax contribution to net income, bank qualified municipal bonds produced some of the highest returns. The combination of these two has made municipal bonds the star of many bank portfolios.

Over the years, we have agreed with the premise that municipal bonds can be a stellar investment. The market has historically underestimated the risk of municipal bonds. For example, most banks fail to take into account the volatility of their marginal tax bracket or the bond's risk of loss of tax status ("judicial risk"). Primarily because of these two factors, we have argued historically that most banks should invest no more than 15% of their investment portfolio in the sector.

This month has brought home to roost the true risk of municipal bonds. Even in the best of times, bank qualified municipal bonds have low liquidity. These days, liquidity is even lower, as the bid-ask difference has tripled when compared to the average comparable security (i.e. Â½ point in price vs. 1 Â½ points). The reasons for this are several and begin with reduced credit. While most municipal tax receipts are slowing, the underlying credit risk of municipal bonds is hard to measure. What is easier to measure, however, is the exposure banks have to monoline insurance companies that protect municipal bondholders.

Three in particular (AMBAC, MBIA and FGIC) usually compose the 4th largest aggregate exposure residing in most banks (behind FNMA, FHLMC and FHLB). Now, each of these 3 entities is at risk for a credit downgrade from "AAA" to "AA." If this occurs, many mutual funds will no longer be able to hold these bonds and will have to liquidate, pursuant to their investment policies. This will in turn flood the market with huge supply, further widening the bid-ask price and increasing mark-to-market.

In addition to liquidity and credit risk, judicial risk has also raised its ugly head this month. A couple of weeks ago, the U.S. Supreme Court heard arguments in the Kentucky vs. Davis case. This case brought into question whether a state can avoid taxing revenue from municipal bonds issued within it, while taxing the revenue earned by the bond investors that hold issues from other states. This common practice was ruled unconstitutional by the KY Court of Appeals back in 2006 for violating sections of the Commerce Act. The ruling was further supported when the KY Supreme Court refused to hear the case again. While the U.S. Supreme Court may overturn the decision, it is not likely.

A ruling could mean many things to the bond market, but the most likely outcome would be the concept of "double exemption" would go by the wayside. The effect would impact bonds issued in 42 states, as they would now have to tax revenue on those bonds. While this might strengthen the credit for state issues, most issuers are lower down the issuer food chain, so they would probably not benefit much from this additional revenue. What is more likely would be to see an increase in required yield to sell the bonds, further hurting the market prices of bonds held by banks in states with high marginal tax rates (i.e. CA, OR and MN).

As if all of these undercurrents were not enough, more and more banks are expected to post losses for next year due to issues in their loan portfolio and more aggressive restructuring. This in turn will further reduce the benefit of holding municipal investments, which get a boost from tax-exempt income. This could also result in decreasing return.

In summary, banks with an already high concentration of municipal bond exposure should take extra steps to ensure they are getting realistic market prices and truly understand the risk in the portfolio. Most just get "theoretical pricing," which skews the results and can be very wide the mark. Additionally, banks should look at their exposure to monoline credit insurers and those states where a KY vs. Davis ruling could adversely affect return. Once banks get a handle on their municipal bond holdings, prudent investment managers will pay closer attention and begin to limit overall portfolio exposure.

BANK NEWS

Resilient Consumer

A recent Conference Board study found that the percentage of US households with discretionary income rose to 64% (or 73mm households) last year from 52% (or 57mm households) in 2002. According to the report, Americans controlled $1.7T of extra income in 2006, up from $1.2T in 2002, with the majority of spending power concentrated in households that earn $100k+ per year and live in or near the nation's biggest metropolitan areas.

Survey

39% of Americans feel their household finances are in better shape than they were a year ago, according to a recent survey. 38% said finances are worse than a year ago while 23% felt they've stayed the same. By region, people in the Midwest were the most pessimistic, with nearly 50% saying their finances have gotten worse in the last year.