ANOTHER BANK PROBLEM - MUNICIPAL INVESTMENTS

by Steve Brown

Now that the Rescue Plan is in motion, liquidity should be ramping up, eventually putting the economy on the path to restoration. The problem is that while the Plan helps liquidity, it doesn't help credit. The next big wave of credit problems is coming in the form of municipal defaults. As reported a couple of weeks ago, the largest municipal default is looming (on their 4th bankruptcy stay) in the form of Jefferson County, Alabama's $3.2B sewer issue.

To put this in perspective, for all of 2007, only $300mm of municipal bonds defaulted. So far, this year, we are well past the $1.3B mark. Part of the problem is that during the 90's municipalities issued about $100B per year. If you exclude 2008, the average issuance has been around $350B per year, or 3.5x the previous decade's volume. In fact, so far, over the past 8Ys, voters have approved 77% of bonds put before them. This compares to a 65% rate during the 1990's.

The result is that there is a lot of paper outstanding - paper that is highly dependent on tax revenue, which is highly dependent on property values. Further compounding the problem is the dislocation in the short term, auction rate (commercial paper-like) market. It has forced many municipalities to take these obligations back onto their balance sheet, refinance at higher rates or pay a high punitive rate of interest. This has further stressed the public finance market.

It appears that Wall Street wasn't the only one that failed to plan. The reality is while Wall Street was certainly an enabler; Main St. got its fair share of the spoils and was a complacent accomplice. From the homeowner that had no business owning a home and couldn't afford it, to the municipality that issued bonds in order to rake in development fees, all played a material part in the ballooning of American finance. Now, with property values dropping by 30%, property revenue is dropping by a similar amount.

In municipal investing, general obligations are the safest ones, but unfortunately most bank qualified bonds aren't general or even limited obligation bonds (despite their label since many limited obligation bonds masquerade as revenue bonds). Revenue bonds have a less diverse and exhaustible revenue stream which is usually comprised by a single cashflow stream (such as water revenue, a small percent of property tax or educational allocations). The problem is that these streams are also dramatically lower and there is no other alternative.

For years, bank portfolio managers have relied on monoline bond insurance to ensure the safety of municipal bond principal and have treated many of these bonds as generic, commodity-like investments akin to Treasuries (but allowing a much higher return). This is a big mistake and banks should be prepared for potentially higher write downs should some of these bonds become "other than temporarily impaired" (which some of them already are). While we hate to be the bearer of bad news and we know this thought is largely unthinkable, given what has already occurred in the market, we feel bankers need to be prepared for further asset problems.

Unfortunately for bankers, municipalities don't have the capitalistic intent or risk management discipline to act to solve their own problems. Worse, municipalities were not included in the Plan (or other associated facilities) and many face the same illiquidity in their respective short-term funding markets.

BANK NEWS

Bank Capital

The Treasury Secretary is now reportedly considering injecting capital directly into US banks.

Deposits

Banks are pouring more resources into stealing deposits from troubled rivals. A number of campaigns focused on deposits were unveiled in the past 2 weeks at national banks (Citibank, CapOne, TD Banknorth & etc.)

Security

Thus far in 2008, over 30mm records have been reported exposed in information breaches. Unfortunately, this number is likely understated, as nearly 40% of incidences reported did not disclose the extent of the breach.

Under Water

Of home mortgages originated within the last 5Y, nearly 30% of people now owe more than the value of their home. Across the US, 1 in 6 homeowners are under water.

AIG

The FRB will lend an additional $37.8B to AIG.

Credit Drop

According to the FRB, consumer credit fell for the first time in 10Ys, sinking to 3.6% in August. The drop was a result of banks cutting back on credit availability.

Office Vacancy Surge

According to preliminary data, 3Q office vacancies jumped to 13.6%, the largest since 2002.

SBA Loans

7(a) and 504 loan volumes have dropped 13%, as banks have tightened their grip on capital. The number of 7(a) and 504 loans fell by 30% and 17% respectively.