DOWSING, DIVINING AND DOODLE-BUGGING MUNI RISK

by Steve Brown

Way back when, people used "Y" shaped sticks to search for water, gemstones and oil. This was known as dowsing, divining and even doodle- bugging. While no scientific evidence exists that this process ever worked, we break out our own dowsing rod in an effort to find risk in the municipal sector. Municipal exposure can come in all shapes and sizes (from bonds to deposits to loans), but all municipal bonds are either general obligation (GO) or revenue, depending on how the interest and principal repayment is funded by the entity in question. GO's carry less risk, as they are supported by the full faith, credit and taxing authority of the issuing government. Revenue bonds, meanwhile, are backed by revenue streams generated through user fees or lease payments associated with specific projects that are being financed (can also be backed by sales, fuel or hotel occupancy taxes). A weak economy and press reports of hundreds of potential municipal defaults on the horizon has increased regulatory focus on this sector and bankers should be aware. To help, we highlight regulatory concerns, so you can better prepare and ensure risk is mitigated, in preparation for the next exam. A new report from the Fed (and echoed by the OCC) sheds new light on what bankers can expect in this area. Weak states and municipalities are driving much of this concern, as they deal with the economic downturn, predictions defaults could increase, weak housing (lower property taxes) and lower projected tax collections. This has heightened regulatory concern. Specifically, the report indicates that "as of mid-year 2010, 48 states faced fiscal-year shortfalls of 30% of their budgets, totaling $200B. This is the largest gap in recorded history, and the problems are likely to continue into-and, perhaps, beyond-the next fiscal year. In the end, such state budget shortfalls for 2011 and 2012 may reach $260B." These comments will drive more regulatory scrutiny at a minimum, so preparation, stress testing and documentation will be critical for all such exposures. Along similar lines, regulators also point out that "revenue bonds issued on behalf of private entities are characteristic of additional risk, as private organizations can declare bankruptcy, making them unable to service debt obligations, yet under no legal obligation to pay the debt." Reading the tea leaves in this case, the strength of the comments indicate bankers will need to have policies, processes, monitoring, contingency planning and remediation capabilities proactively in place around such exposures - well before regulators walk in. Another focus is on banker overreliance on credit ratings. Regulators have now begun to expect banks to maintain policies that restrict and limit the amount or types of municipal exposures; have approved risk tolerances; take inventory of all municipal exposures in the balance sheet (including investments, loans, and deposits); segregate exposures based on various factors (such as rating, geography and maturity); have adequate board reporting; understand how sensitive municipal holdings are to credit quality shifts, market prices, rates, liquidity and other risk factors. In addition, regulators expect banks to pay specific attention to issuers that are located in states or municipalities experiencing the most stress, as well as to revenue bonds. Finally, as with most things, the buck stops with the board of directors. Here, regulators expect boards to clearly demonstrate their fulfillment of these duties through meeting minutes and include reports and presentations on credit, market, liquidity risk, risk management processes, risk exposures and perceived emerging risk areas. As such, preparation and thorough documentation will be critical going forward. Given the municipal bond market alone is $2.9T in size, represents 50k different issuers and consists of about 75% revenue bonds; expect more regulatory scrutiny. As long as there is softness in the housing sector and municipal issuers are stressed, taking the time to review all municipal exposures is a worthy endeavor. Tomorrow we will dig into this subject further, as we use our divining rod to search for potential opportunities and highlight areas of potential risk for community bankers.

BANK NEWS

Congressional Testimony

FOMC Chair Bernanke in his semi-annual update to Congress warned that the US economy was "close to faltering."

Consumer Delinquincies

ABA data shows consumer delinquencies across 8 loan categories rose to 2.9% in the 2Q from 2.7% in 1Q. While credit card (down 18bp to 3.2%) and mobile home loan delinquencies fell (down 3.2% to 3.62%), all others increased. The largest net increases for the quarter were non-card revolving lines (up 15.6%), RV loans (up 12.7%) and home equity (6.25%).

BofA Suit

An inspector general for HUD has recommended that BAC face fraud charges relating to faulty borrowing data submitted to the agency in connection with its Countrywide unit. In his words "Countrywide did not properly verify, analyze, or support borrowers' employment and income, source of funds to close, liabilities and credit information."

BNY Suit

The Justice Dept. and NY Attorney General filed separate civil lawsuits against Bank of NY Mellon for allegedly giving banks, pensions, municipalities and other customers the worst bid or ask of the day for foreign currency transactions.

CRE

A DLA Piper survey of 280 C-suite officers from investment firms shows that 70% are "bearish" on commercial real estate performance over the next year. They cited a lack of confidence in Washington, D.C. and decelerating economy.