DIVING INTO MUNICIPAL RISK

by Steve Brown

Professional cliff divers in Acapulco, Mexico, soar headlong from rocks into the seas below. This is a risky profession, as divers must time the waves to be sure they land in an area where the water is deep enough. This is tricky, as the rocks can give way and the seas ebb and flow. Timing is critical, as the depth can go from 6 to 16 feet. Similar to cliff diving, yesterday we touched on the risks in municipal securities, loan and deposit activities commonly found in community banks. We pick that theme up again today. As economic trials and tribulations continue at a macro level, the same thing is happening in the municipal sector. Just a few days ago in fact, the National League of Cities reported 57% of municipal officials said finances were worse in fiscal 2011 than in 2010 and inflation-adjusted revenue was rapidly heading toward its 5th straight annual decrease. Since local governments don't usually feel pain for 18 months after problems begin (it takes that long for declines in tax revenues to surface), it is still relatively early for this sector, so we will have to wait and see how deep these waves go over time. While there have not been many defaults to date, regulators are concerned nonetheless. One key reason is that there are virtually no underlying financial reporting requirements for many municipal issuers, so problems can go undetected for a long time. As a result, examiners want bankers to understand the issuers' financial condition, including projected tax collections. At the extreme end of the spectrum and depending on your exposures, regulators have suggested banks even call municipalities directly to understand capacity to repay. Examiners highlight that under current market conditions and existing guidance, they expect banks to do analysis to determine potential impairment, default or loss risk, so be prepared. It isn't always easy to tell who you are dealing with in the municipal sector, but in general, revenue issuers are non-profit organizations, private sector corporations (such as hospitals, housing developments, student loan programs) and entities that provide public service (power utilities, public transportation authorities, etc.). Some of these revenue issuers are also called "conduit issuers," because they are third-party entities that act on behalf of borrowers on specific projects. Conduits allow private entities to tap into low-cost municipal bond financing for projects that increase economic development, while the municipality is paid fees to issue bonds on their behalf. It is important to note that conduits are responsible for all principal and interest payments (not the issuing municipality) and the issuing municipality is not obligated to repay the debt in any way if the conduit borrower fails (unless explicitly stated in the offering memorandum). In short, conduits are supported by a given project, while conventional municipal issuance is supported by dedicated streams of revenue such as taxes, fees and tolls. This distinction is important, because conduit issuance represents about 70% of all defaults. If your bank is going to play in this sector, we have a few suggestions. First, make sure you have lending staff on board with expertise in municipal lending. Next, work hard to understand the risks you are taking because municipal lending has some unique characteristics that may not be obvious at first blush. These can include the ability for the issuer to call its debt due to "special" occurrences (such as a natural disaster, interruption of a revenue source, unexpended bond proceeds or even for a cancelled project), as well as another community's public work's project; unusual weather; economic downturn and repudiation (if deemed reasonable and necessary to serve other important public purposes). Finally, be sure you don't have to register with the Municipal Securities Rulemaking Board (MSRB) when originating a bank loan to a municipality or conduit. Under MSRB rules related to Dodd Frank, bank loans can be municipal securities if they purpose is to raise money for the general use of a business enterprise or if the public reasonably expected it would be for example. Even financing that is called a loan does not eliminate MSRB requirements and because the MSRB is the ultimate authority for all municipal securities, understanding this is critical. You don't have to jump off a cliff to have fun in banking, but since risk is everywhere, our advice is to make sure the tide is in before you leap off the rock.

BANK NEWS

M&A

Select B&T ($199mm, NC) will acquire Gibsonville Community Bank ($24mm, NC) from Bank of Atlanta ($196mm, GA) for an undisclosed sum.

SBA Production

SBA Lenders (including credit unions and non-banks) originated $31B in SBA loans for the fiscal year ending in Sept. The level is the highest in the organization's 58-year history. The increase in guarantee percentage and the raising of the maximum loan limit from $2mm to $5mm were the largest drivers of the 35% YOY growth.

SBLF Criticism

In an open letter to Tim Geithner, House Financial Services Chair Barney Frank said the Treasury was without justification when it rejected a majority of bank applicants to SBLF without reason or an appeals process.

Multifamily

Our preliminary estimates for 3Q show that the sector will be one of the best performing community bank lending areas due to tighter credit spreads (brought on by increased competition, lower vacancy rates and higher rents). Vacancy rates are now at their lowest level in 5Ys.