BANK MUNICIPAL LENDING

by Steve Brown

Municipal governments are a lot like boats. They look great when they are not doing anything, but the minute that boat goes in the water, you are asking for trouble. That same irony is true for the management of any state, city or county. The minute government does anything; it will have its detractors. These days, when it comes to municipal lending, there are many naysayers.

Around this time last year, Meredith Whitney, a well-known bank analyst, predicted "hundreds of billions of dollars" of municipal defaults in 2011 in a December 2010 "60 Minutes" broadcast. The press jumped on her predictions, which sent investors selling and led major banks to cut back on public entity lending. Fast forward to today and we see that the prediction was overstated. Of the approximately 50,000 issues, there are currently 24 public defaults in the market. Most of these are conduit issues largely comprised of speculative project finance (like the City of Harrisburg), housing developments that didn't pan out or hotel financing with debt issued by a quasi-municipal entity. If you look at historical data, municipal defaults are actually very rare. In fact, no state has defaulted since the Depression and only 4 cities / counties have defaulted in the last 40Ys. If you look at a shorter timeline of history from the 1980's, the probability of default for all issues is just under 1.5%. Exclude non-rated issuers and those that started out below investment grade and the probability of default drops to 35bp. This pales in comparison to the 90bp to 14% probability of default seen in all other areas of bank lending. Equally important, because spreads have increased in bond issuance (about 115bp wider for 15Y issues compared to 2008), many smaller issues (below $5mm) are not economically feasible. After tacking on $600k of underwriting costs, issuance fees and legal expenses; that $3mm financing for fire trucks is better done directly with a bank. Meanwhile, many large banks have reduced municipal lending due to higher headline risk, which has moved tax-equivalent spreads to the 350bp range. That is better than non-rated quality CRE lending hovering around a 220bp spread. When you combine all of this, there could be an interesting alternative for community banks looking to build C&I balances and diversify risk.

The confusion around municipal risk stems largely from a lack of understanding in the difference between current budget problems and longer term risk. Municipalities almost always have difficulty in making their budgets during difficult times and this recession is deeper than most. Such deficits make for frightening headlines, but it should be understood that these deficits are also largely cyclical. The facts are that state and local revenues improved as of 2Q for the 6th straight month, posting a 6.9% growth rate (the highest since the recovery). More important, local governments have done a good job in cutting expenses. IN fact, a Nat'l League of Cities report released in July showed personnel cuts, reductions in services and delays in projects, but no defaults on municipal debt payments. Since such defaults drive up costs for years to come, they are economically and politically the most costly option for all involved.

None of this is to say that municipal finances aren't seeing serious issues, but for the right risk (such as those tied to essential use services), banks can find a positive risk-adjusted return. Our advice is that as you set lending allocations for 2012; get competent legal advice and make sure you have a lender that understands municipal finance to explore these alternatives. We believe current headline risk presents an opportunity for community banks that should at least be considered as part of strategic planning.

BANK NEWS

Lending Competition

Community bankers should take note that Wells Fargo has announced plans to increase focus on capturing business customers with $2mm to $25mm in annual revenue. Wells joins Bank of America and other major banks that have been targeting small business customers and hiring business development officers.

CFPB Rules

The Consumer Financial Protection Bureau released its supervision and examination manual. The three main principles that will drive examinations are: focusing on risks to consumers, analyzing available data about supervised entities and enforcing consumer financial law consistently.

Downgrade Risk

Credit rating agency Fitch cited increased business model risk (due to increased challenges in the financial markets) and placed Bank of America, Morgan Stanley, Goldman, Credit Suisse, Deutsche, Barclays, BNP and Societe Generale on review for possible downgrade. Fitch downgraded UBS, Lloyds and Royal Bank of Scotland.

Industry Job Cuts

A WSJ report shows 17 major banks worldwide have announced plans to cut staff by an average of 6%, with a range of 1% to 14% of existing staff. Announced layoffs now exceed 100,000.

Debit Down

A Bankrate survey finds debit card rewards offers fell 30% in 2011, driven by Dodd Frank debit interchange restrictions. The survey also found that 71% of debit rewards cards have no annual or monthly fees, while fees for programs that are not free range from $1.50 to $10.00 per month.

SIFI Rule

The Financial Stability Oversight Council issued a proposed rule with criteria to determine when a nonbank financial firm meets the definition of a "systemically important financial institution." Criteria include: at least $50B in consolidated assets and any of the following: $30B in credit default swaps; $3.5B in derivatives; $20B in outstanding loans borrowed and bonds issued; a 15-to-1 asset to equity leverage ratio; a 10% ratio of short-term debt to total assets.