



Solid So Far

By Jim Reber

Muni debt market maintains its footing

Jim Reber is president and CEO of ICBA Securities. Reach him at (800) 422-6442 or jreber@icbasecurities.com.

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“Who’s Next” was the title of an album by the rock group The Who in the early ’70s, and it’s also been a question in the minds of many bond investors over the last three years. Tens of billions of dollars of investment-grade debt have been written down to junk status or defaulted, all with negative consequences for the investors (including community banks) that own them.

Culprits include Fannie Mae/Freddie Mac preferred stock, collateralized debt obligations (CDOs) backed by trust-preferred securities, garden-variety corporate notes (e.g., Lehman Brothers) and even municipal debt.

What is widely misunderstood is that the muni bonds that end up in community bank portfolios are of sufficient quality that very few of them have encountered defaults or are expected to. For this segment of the fixed-income market, the salient question is “who’s first?”

Considerable market strength: It’s true that a number of muni issues have defaulted in the past several years. Some estimates have been in the \$14 billion range for 2008 and 2009 alone. However, those defaults almost exclusively involved revenue bonds backed by nursing homes, golf courses or other “non-essentials.” They were also above the size limit that allowed them to be designated bank-qualified (BQ) issues. Remember that for tax purposes banks generally can deduct most of the cost of financing their BQ bond investments. BQ bonds are required to be for essential purposes, such as sewer systems, roads and new school buildings. This, and the fact that the vast majority are of the general obligation (GO) variety, makes their likelihood of default much smaller. And the default history has borne this out. Since 1970, only five GO issues rated by Moody’s have defaulted, and it is believed that none of those was of the BQ variety.

To this market we can add the Build America Bonds (BABs). These are a segment of the taxable muni market created by the main federal economic stimulus bill of 2009. BABs have become very popular with investors, including community banks, and in some cases are crowding BQs out of the way. These bonds, like BQs, are primarily for essential purposes.

The strength of the muni market was confirmed by an advisory committee to the Treasury Department


in an Aug. 3 letter that stated, among other findings, “Broadly, municipalities still have a low probability of default, historically high recoveries, low absolute cost of funds [and] access to a broader investor base via the Build America Bonds Program.”

Current market activity: Much has been made about the recent flattening of the yield curves for fixed-income investments. The point of these analyses is that much of the benefit for extension may have eroded. This is not the case for muni curves.

Municipal yield curves, whether tax-free or taxable, are almost always the steepest in the bond market. This has everything to do with supply/demand machinations. As of early September, the difference in short (two-year) and long (15-year) yields was within a few basis points of that in early 2010. To an investor, this means it’s beneficial to extend maturities, within reason. This is also still a suitable environment for tax swaps.

Timing may be good: Usually in the fourth quarter of the year comes some market action that warrants your attention. This year should be no exception. The issues relate to the “December effect” and the potential sunset of tax-advantaged issues. In BQ world, there is usually a rush to the new issue market at the end of the calendar year as school districts, local utilities and the like try to maximize their annual size allotment of outstanding debt. (You may recall that the annual limit jumped from \$10 million to \$30 million in 2009.) As supply swells, prices are forced to drop at least temporarily, which usually makes December a very good month to purchase BQ munis. However, the fallout from the jump in the annual limit, contrasted with the growth in BABs, makes this year hard to handicap.

Also, depending on last-minute legislative changes, certain benefits attached to tax-free issuances dated 2009 or 2010, which may be alternative minimum tax exempt or offer special TEFRA (Tax Equity and Fiscal Responsibility Act) benefits, may be allowed to sunset. The further issuance of BABs beyond 2010 is also not a certainty as of this writing.

That will almost certainly add value to existing BAB bonds. If you are fortunate enough to own any of these, the market value of your community bank’s muni portfolio will improve, all things remaining equal. Advice: Stay in touch with your broker regarding these last two items for current market information. He or she can also help you avoid the answer to the question “who’s first?” 

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