Watch for Pre-Refundings

Warning: this column is not another piece about the imminent collapse of the municipal bond market! Rather, it is my attempt to give you a few positive reasons to refocus your attention on the tax-free portion of your bank’s investment portfolio. Specifically, I am speaking of the many good things that accompany a security that has been pre-refunded, or “pre-re’d.” And there is a pretty good chance that your bank owns some pre-funded bonds—or will in the near future.

Pre-Re Basics
Municipal managers have long taken advantage of a strategy that allows an issuer to lower its borrowing costs before it is able to call away high-cost outstanding debt. Let’s use the security depicted in Table 1 as an example. There we see a Colorado muni that has a 4.25 percent coupon and a maturity date of 2020. The issuer can’t call away this debt until 2012 at the earliest, although at the time I’m writing this column, similar securities have a yield of about 3.90 percent.

What the issuer has done in this case, to its everlasting benefit, is created more debt at considerably lower rates than the old bonds. The proceeds of this “new” issue have been used to purchase Treasury securities that have identical maturities as the “old” call dates. (The “Prefunded 12/01/12 @ 100” line attests to this fact.) The Treasuries have been placed with a trustee who will use the maturing proceeds in 2012 to pay off the munis at the call date.

It’s Good For You Too
Let’s not stop at the issuer level. For the investors in the “old” bonds, something strange and wonderful has occurred. Let’s look at Table 1 again. Notice the credit ratings section in the bottom left. You can see that Moody’s and Fitch have, respectively, assigned this an A3/A rating, because that is the current status of the insurer, XLCA. When this bond was brought to life in 2003, it had Aaa/AAA ratings. You’ll notice also that both Moody’s and Fitch have this bond on “Watch Negative.”

The bond market could not care less about the credit ratings on a pre-refunded muni. That is because once the Treasuries were placed in trust, it became a certainty that the old bonds will be paid off in full at the call date. Castle Pines, the issuer of this bond, wisely chose to not pay for
an updated rating, because the market understands the unsurpassed credit quality that now attaches to the bond.

Accordingly, the bond used in this example is now trading at yield levels commensurate with a 2012 maturity that has an AAA/Aaa rating. Even if market rates are sky-high in 2012, the investor is assured of the bond being paid off. That is better news still for investors in pre-re’s.

**Muni Curve Norms**

Those unfortunates who have never delved into municipal securities should know that yet another benefit accrues to investors dealing in “short” munis. I’m talking here about bonds with maturity dates of roughly seven years and less. The retail sector and muni bond funds dominate the short end of the curve. They have different (i.e., higher) marginal tax rates and pay no TEFRA penalty, and can stand to pay higher prices than a typical financial institution.

Retail investors don’t mind buying bank-qualified (BQ) bonds, either. This has the effect of making the short end of the BQ curve very steep (see Table 2), which in turn supports very nicely the prices of pre-refunded bonds. So, if you are the lucky owner of a pre-re deal or two or three,

**How Do You Know?**

ICBA Securities’ municipal trading professionals have made it a policy to offer any of their customers or prospects a comprehensive review of their muni portfolio. Such reviews entail an inspection of the Description page from Bloomberg for each position. This offer, which was initiated in late 2007, was the result of the muni-insurer-downgrade situation.
The review will help you—the portfolio manager—identify the good and (potentially) bad spots in your bank’s muni stockpile. Not only will ICBA Securities point out which of your bonds have been pre-refunded, it will also unearth those that may have been downgraded because of the insurance or low or non-existent “underlying” ratings. Occasionally, we find a non-BQ issue, which is another no-no for banks.

It’s been our experience that most community bank portfolios have little or no credit exposure, and in some cases, the existence of pre-refunded issues has resulted in a bond portfolio’s credit quality actually being higher than expected. Whatever your situation, ICBA Securities investment professionals are prepared to help you deal with the changing municipal landscape.

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