Muni Market May Bear Gifts

New Rules, Products Create Opportunities Around the New Year

This just in for the holidays: a veritable sleigh full of toys, games and sweets that will satisfy the most finicky portfolio manager, in the form of municipal investment products and strategies. But don’t delay: Some will be available for a limited time.

Some of these goodies are courtesy of Congress, some the consequence of the calendar and others the result of hard work by your ICBA government-relations staff. In any event, there are few banks that can’t find some way to improve their overall portfolio by using one or more suggestions here.

December/January Effect
The last month of the year is many times a bonanza for buyers of bank-qualified (BQ) munis. It was commonplace for a boatload of supply to be dumped on the market in the last month of the year to get that year’s dollars out the door. This naturally caused rates to rise in December and presented a buying opportunity.

The opposite set of dynamics took over just a month later. January has seen a dearth of supply, and, coupled with increased demand, rates almost always fell. (Jan. 1 is the most popular date for munis to mature and be called.) December buyers have almost always felt good about their purchases come February.

This year, several variables could either lessen these effects or make them worse. For one, the BQ limit has been upped to $30 million in a given year, so the supply could increase and cause rates to spike further right before year’s end. For another, taxable munis are being issued in record numbers and could crowd out tax-frees, making them relatively scarce and therefore valuable. You will want to stay in tune with your brokers regarding these developments.

Taxable Treasures
Many community banks have recently become devotees of taxable municipals. This shift is the result of two unrelated factors. First, a section of the main stimulus bill, the American Recovery and Reinvestment Act of 2009, created a taxable-muni sector known as the Build America Bond, or BAB. This has greatly increased the supply of taxable munis. Second, the fact that a huge segment of the banking industry may be a year away from “normal” earnings means that tax-equivalent benefits are not being realized.
The use of proceeds on BABs must be for capital improvements and not working capital or refinancing of outstanding debt. The vast majority are general-obligations, not revenue bonds as with a traditional taxable-muni structure.

An investor receives the coupon on a given BAB in full. At the end of the year, a 35-percent credit goes directly to the issuer. So, for example, a bond with a 5-percent coupon will end up costing the issuer a net 3.25 percent. The investor gets to keep the entire coupon, which is then taxable. Still, the spreads on high-quality BABs have been wider than on similar-quality corporate debt.

**The Curve Is Helping**

The muni curve is always steep, even in periods such as 2001 and 2006. Investor demand for short munis, including the retail sector, creates a constant supply/demand imbalance that depresses yields on, say, five-year and shorter munis. That is certainly the case now.

What this condition creates is the opportunity to greatly improve your earnings via an extension swap. The earnings improvement may be current, in the case of sales at a gain, or deferred, as when bonds are sold at a loss. Either way, the bank's net income will be greater by the maturity date of the original securities.

**The Clock Is Ticking**

The BABs mentioned here must be issued before Jan. 1, 2011. Non-BQ bonds can be subject to only a 20-percent Tax Equity and Fiscal Responsibility Act of 1982 penalty if they are issued in 2009 or 2010 and are considered “new money,” that is, for financing a new construction project. Banks can buy up to 2 percent of their assets in these issues. Tax-frees issued in 2009 and 2010 are not subject to the alternative minimum tax if they are for new money or used to refinance outstanding debt that was first issued since 2004.

As you can see, there are a lot of moving parts in the muni market. You will need to have a qualified, knowledgeable broker to help you dig around the Christmas tree. With the elves working overtime, an enterprising banker should be able to find a holiday gift or two for the investment portfolio.

**Your Resource**

ICBA Securities’ Investment Strategies department can consult with ICBA members on a variety of municipal investment strategies. Visit icbasecurities.com or contact your sales rep for details.