Defaults in retreat

First let's discuss credit quality. The bar was set on Dec. 20, 2010, when celeb stock analyst Whitney Meredith announced that there would be “hundreds of billions” of municipal defaults in 2011. The final number was barely two billion. To put this in perspective, defaults totaled $8.5 billion in 2008, $7.3 billion in 2009 and $2.9 billion in 2010.

Notice a trend? It's a myth that there have been widespread defaults. What needs to be hastily added is that there have been a lot of credit rating downgrades in the last two years—and to be sure, there will be more defaults in the future. And there are several large issuers who as of this date have declared bankruptcy but not yet defaulted. But wholesale catering this is not. And so far the issues that have gone south are for the most part general market revenue bonds.

Supply has shrunk

Which brings me back to the munis that banks like to buy. You will recall that bank qualified (BQ) bonds are greatly preferred by community banks because they have tax advantages relative to the TEFRA penalty. The size limit for an issue to be BQ was raised from $10 million to $30 million for 2009 and 2010. That provision was allowed to sunset at the start of 2011, and the result is shrinkage of BQ supply.

Also, remember the type of taxable munis known as Build America Bonds? They also had a short life, as $187 billion were printed in 2009 and 2010, and the presses were summarily shut down. Those bonds are available in the secondary market; there is simply a finite amount of them.

Both of these factors caused new issues to swell in 2010. For the year, total muni issuance topped $430 billion.
billion, which is a record. Through 11 months of 2011, new issuance was about $233 billion. It has been more than a decade since we have had a year with so little new supply.

**Yield still available**

So, a rational marketplace that sees improving default history and shrinking supply will force prices higher, correct? And that is what has happened since 2009. For the 582 community banks that use Vining Sparks as their bond accounting servicer, as of Sept. 30, 2011, the average unrealized gain in a municipal portfolio was 4.31 percent. It has never been that high since we began keeping records a decade ago.

And the fun hasn’t ended. For one, the muni curve remains very steep, so a rising rate environment, when it happens, will help protect your market values. For another, even though prices have risen, they’ve gone up no more than comparable maturity Treasuries. Yield spreads on high-quality general obligations are about where they were a year ago, even after the Whitney bombshell.

**Keep abreast**

There are several ways for you to keep up on muni developments. The first is to subscribe to the weekly *Muni Market Update* newsletter, which is compiled by ICBA Securities’ Investment Strategies Department. You can do this at our website. Another is to use the new Muni Monitoring Report, which is ideal preparation for an exam. (See more details in the sidebar to the right.)

For actual offerings, be sure to keep track of the amount of “2 percent” bonds that are in your portfolio. As BQ supply shrinks, this is an entirely new muni market that can be used to find suitable securities, at essentially the same tax-equivalent yields and quality. The same goes for AMT-exempt bonds. Your broker should be equipped to walk you through the qualitative features of each. The result should be a portfolio with all the comforts of home: yield, quality, price stability and, quite possibly, local investment.

**Muni Monitoring Report**

ICBA Securities can create a Muni Monitoring Report for any community bank. This complimentary analysis will display the current credit rating and credit enhancements for each security in your municipal portfolio.

For more information on this report, contact your ICBA Securities sales rep or visit www.icbasecurities.com.

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**Why I use ICBA Mortgage (reason #128):**

“By participating in the ICBA Mortgage Solutions web-based program, we have created an avenue into the secondary market that enables us to provide interest rates and products to our customers that we couldn’t offer in the past.”

Your customers are looking for a mortgage lender they can trust—someone who will be there for the long haul.

ICBA Mortgage offers your community bank a complete range of secondary mortgage lending programs and solutions to exceed your customers’ demands as well as your business strategies, including Fannie Mae and Freddie Mac access.

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Quote: Rob Lawley, Miners Bank, Minersville, PA