

A Special Editorial Supplement to *Independent Banker*

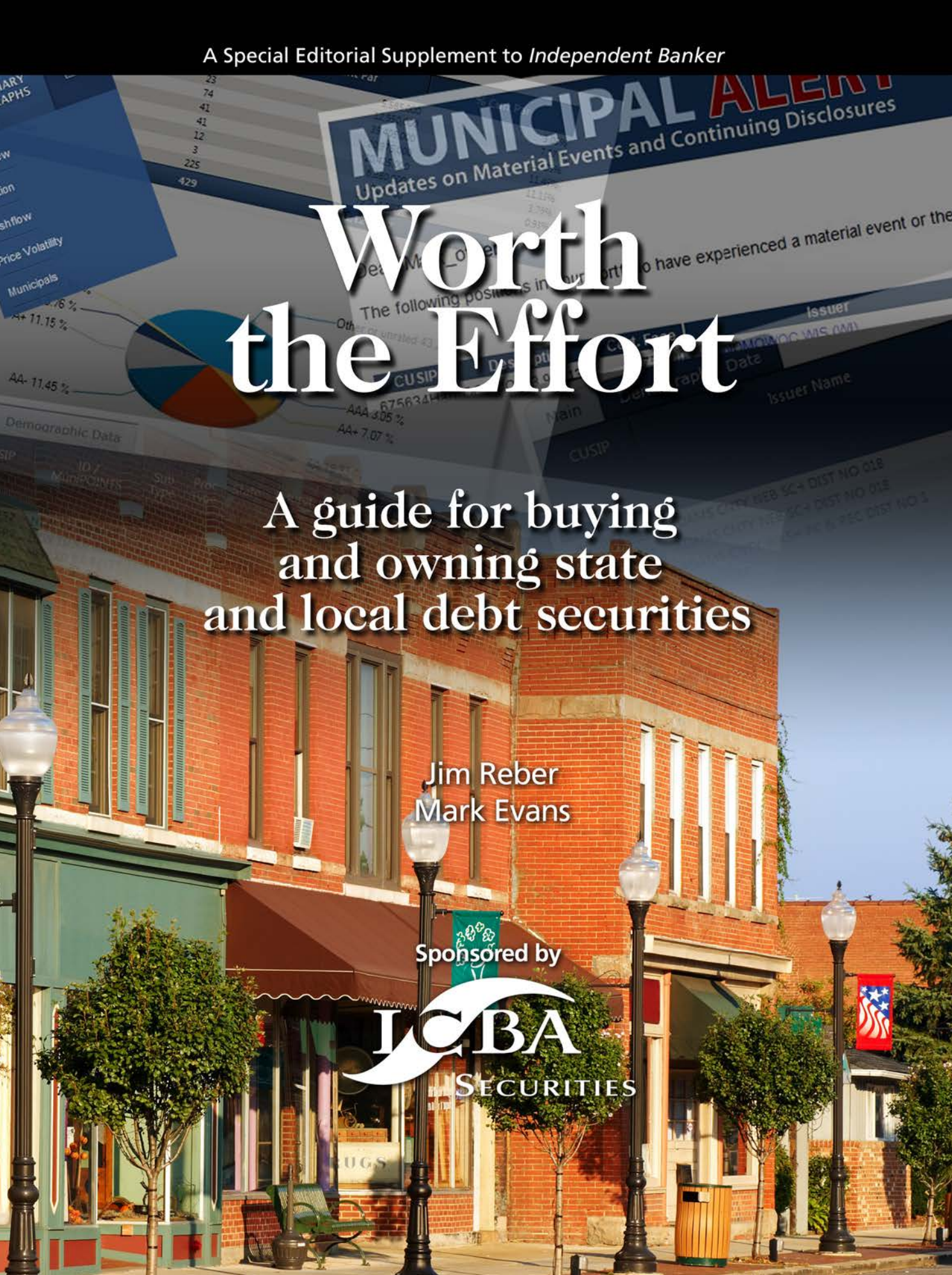
MUNICIPAL ALERT
Updates on Material Events and Continuing Disclosures

Worth the Effort

A guide for buying
and owning state
and local debt securities

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MUNICIPAL BONDS.

THAT TERM IS SINGULARLY CAPABLE OF PROVOKING AN ENTIRE CONTINUUM OF OPINIONS AND EMOTIONS AMONG INVESTORS, RATIONAL OR OTHERWISE. ARE THEY GOOD OR BAD? LIQUID OR ILLIQUID? DO I GET A TAX BREAK? DIDN'T SAN BERNARDINO GO BROKE? SHOULD I BUY SHORT OR LONG? AND WHAT WAS THAT THING THAT I HEARD ON 60 MINUTES A WHILE BACK? ANECDOTAL EVIDENCE ON SOCIAL MEDIA, AND EVEN SOME DOCUMENTED REPORTING ON TRADITIONAL NEWS SOURCES, DEMONSTRATE VARYING DEGREES OF UNDERSTANDING OF THE MUNICIPAL DEBT MARKET.

ADD TO THIS THE NEW REGULATIONS MANDATED BY THE OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC) EFFECTIVE JANUARY 2013, AND WE CAN SEE THAT COMMUNITY BANK INVESTING IN MUNICIPAL DEBT NOW REQUIRES CONSIDERABLE EFFORT. THIS SPECIAL EDITORIAL SUPPLEMENT OF ICBA *INDEPENDENT BANKER* WILL DISCUSS THE BENEFITS AND COSTS OF THIS IMPORTANT INVESTMENT SECTOR. IT WILL ALSO ADDRESS HOW A COMMUNITY BANKER CAN PRUDENTLY ASSESS THE CREDITWORTHINESS OF AN INDIVIDUAL DEBT SECURITY, AND AN ENTIRE MUNICIPAL BOND PORTFOLIO.

Same, only different

At their very core, municipal bonds are different from any other debt security. There are some similarities though, and enough so that they can be attractive to a wide range of buyers. The outstanding balance, or “face,” does not amortize, so they can be purchased and put away until they mature or get called. They also pay a fixed rate of interest semi-annually. Most municipal issues have some degree of liquidity as well.

Beyond that, there are a number of unique characteristics. We can begin with the source of repayment. The terms “Revenue” and “General Obligation” are common parlance for indicating how the debt is to be defeased.

A Revenue bond is one that will be paid back through a dedicated stream of tax collections derived from some type of user fee. Revenue bonds can be funded by an entire host of activities, including health care facilities, parking lots, stadiums or golf courses. While some muni investors view Revenue bonds with suspicion, there are many high-quality issues available that have enough revenue earmarked from the related activity to easily pay off the debt on time.

General Obligations are those that are backed by the full faith and credit of the issuing governmental entity, whose credit is bolstered by the fact that the entity has the authority to raise revenue through the levy of ad valorem property taxes. While it is often not politically expedient to raise property tax rates, the mere legal authority to do so creates the perception that GOs are superior in quality to Revenues. Also, while most GOs are backed by the issuer's right to raise taxes to whatever level is necessary to pay off the borrowers (“Unlimited Tax”), some have statutory limits (“Limited Tax”) that can be changed only by legislation or referendum.

Another distinction of municipal bonds is the “maturity run.” Most securitized borrowings are of a single maturity date, which either does or does not fit an investor's needs. Muni offerings are different in that there are normally a series of maturities over a number of years. These structures are the residue of both the cycle of tax receipts and disbursements and the long-term nature of many real estate projects for which a town or school district is responsible.

The most tangible difference between munis and other debt securities, however, is the fact that for the large majority of issues, the interest payments are exempt from Federal income tax. This allows investors, both institutions and individuals, to earn very attractive yields on a tax-equivalent basis if the investors owe Federal taxes. (See Table 1.)

Lots to like

For community bankers, tax-free munis have additional qualitative differences. The vast majority of munis held by banks are of the “Bank Qualified” variety. BQs are a subset of tax-free munis that allow beneficial treatment for the cost of carry for the munis. BQ status was created in 1986 by the Tax, Equity and Fiscal Responsibility Act (“TEFRA”), and specifically it allows the deduction of 80 percent of the cost of financing the BQ portfolio. Stated another way, 20 percent of the cost

TABLE 1

of carry is disallowed. This is also known as the “TEFRA penalty.”

For a given muni to be designated as BQ, the issuer is limited to printing \$10 million in a calendar year, and the purpose must be an essential service. (For bonds issued in the years of 2009 and 2010 the BQ limit was temporarily expanded to \$30 million as part of the patchwork of fiscal stimulus initiatives.) Many school districts and utility districts are BQs.

Another reason that portfolio managers like tax-free munis is that the price volatility is less than taxable munis of similar duration. The fact that the interest payments are roughly two-thirds that of taxables means that prices will only change about two-thirds as much, given a shift in market rates. This is especially important for interest rate risk purposes, since municipal bonds are often the longest duration assets on the entire balance sheet.

Lastly, for the 2,300 community banks that are S Corps, BQs offer an additional yield bonus. For community banks that have been operating as S Corps for more than three years, TEFRA penalty does not apply. This is important now, but will be even more important in other (higher) rate environments, as tax-equivalent yields will be greatly enhanced.

Municipal Market & Regulatory Changes

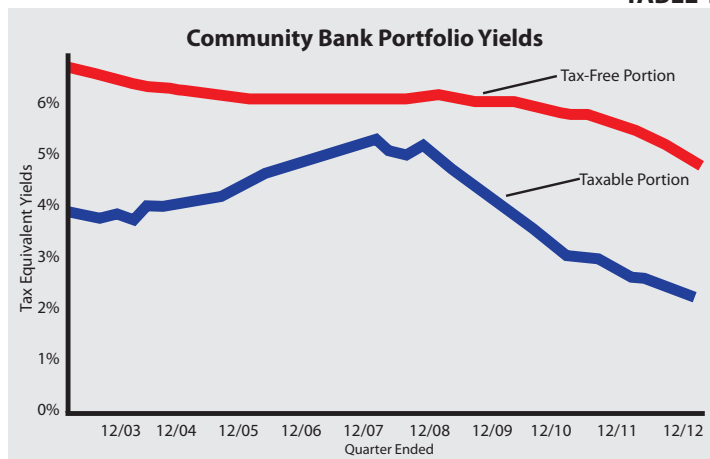
The financial crisis that began in 2007 triggered changes to the municipal market as well as regulatory changes for banks. Deterioration of municipal bond insurers, concerns about municipi-

pal credits and directives of Dodd-Frank brought on changes to the way banks purchase and manage their municipal bond holdings.

The first change was the demise of the AAA-rated municipal bond insurers. Prior to 2007, the vast majority of BQ municipal bonds were insured by AAA-rated insurers. For many investors and for the market, the insurance simplified the process of evaluating municipal bonds' credit and added liquidity to otherwise small and unknown issuers. While the insurance added an additional layer of protection from credit losses for investors, the rarity of defaults or credit issues on BQ issues meant that the credit benefit of the insurance was negligible, for the most part.

As the insurers saw their ratings downgraded throughout the financial crisis due to mortgage and collateralized debt exposures, investors were forced to get up to speed on the credit considerations of municipals beyond insurance. Issuer types, underlying ratings and enhancement from state programs became important considerations for investors. In addition, investors were forced to deal with a universe that was no longer AAA but was still relatively low risk. Banks quickly rose to the challenge to understand their bonds' issuers and credit considerations.

Next came general concerns about the creditworthiness of municipal bonds. Headlined by Meredith Whitney, questions



began to surface about the default risk in municipal bonds. Whitney's comments on *60 Minutes* had a greater impact on retail investors and their mutual fund managers than they had on the bank investors. Why? Historically, municipal bond defaults have been most prevalent in sectors such as health care, industrial development, corporate-backed, special purpose, and other segments of the municipal market that tend to fall outside the BQ space. And while banks are not prohibited from buying non-BQ bonds, there is a significant tax penalty for buying non-BQs.

Finally, there was Dodd-Frank which contained a requirement that banking regulators review their regulations “to remove any reference to or requirement of reliance on credit ratings.” In 2012, the banking regulators, led by the OCC, did just that by publishing two new rules. One, “Alternatives to the Use of External Credit Ratings in the Regulations of the OCC” redefined what constitutes “investment grade,” a determination which is required in order for certain securities to be permissible for banks to purchase.

The second, “Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment” addressed the considerations and analyses

banks should consider when determining whether an investment is prudent and consistent with safe and sound banking practices. The FDIC followed by requiring that all insured institutions follow the practices included in the OCC's guidance.

So, with the changes having occurred in the market and in regulations, banks need new approaches to purchase and maintain a portfolio of municipal bonds (as well as any other securities with credit risk).

A Top to Bottom Process

The FFIEC's 1998 guidance on investment securities required banks understand the interest rate risk (i.e., price volatility) of any security before purchasing the security. The 2012 guidance extends that expectation to credit risk by requiring banks understand the credit risk of securities before purchase and requiring policies and procedures that provide a construct for compliance.

Compliance starts at the board level, descends through management and extends to each investment purchase.

The Board should:

- Understand the risks being taken in the portfolio, both interest rate risks and credit risks. Doing so will require some knowledge about the credit risks which exist in municipal bonds (along with corporate bonds, asset-backed securities, and any other securities with credit risk that the bank may purchase).

- Set risk and concentration limits. The board must determine appropriate limits for both aggregate exposures to a sector or type

of investment (i.e., municipal bonds) as well as for individual credits. The limits are bank-specific and depend on the bank, its balance sheet, its management expertise and its capacity to take on risk. Policies, procedures and expertise should be commensurate with the level of risk being taken.

- Review the investment portfolio and policies regularly. The portfolio, any watch lists, new purchases and overall strategies should be reviewed at least quarterly. Policies should be reviewed annually.

Management must:

- Maintain a deeper understanding of the risks being taken in the investment portfolio, both interest rate risks as well as credit risks.

- Brief the board regularly (and additionally, as needed) on the risks in the portfolio, on any changes to the risk profile or strategies being pursued, on any securities of concern or on watch lists, and on compliance with board mandates and policies.

- Perform necessary pre-purchase analyses for both interest rate risk and credit risk considerations.

- Maintain documentation to support purchase decisions.

- Regularly review investments for potential issues or changes in their risk profiles.

Establishing a process for evaluating purchases and for surveillance of the portfolio will make compliance efficient and effective.

Prepurchase Considerations

Due diligence of a potential investment requires consideration of both interest rate risk and credit risk. The framework for both reviews is contained in the banks' investment policy. On the credit risk front, banks must evaluate every investment to determine whether the purchase is prudent and consistent with safe and sound banking practices.

For municipal bonds, pre-purchase credit considerations may include: obligor, management, type of issue, source of funds, general financial trends, demographic considerations, market considerations, material events, ratings, and enhancements.

In fact, if there is a recent detailed write-up from one or more of the major ratings agencies, a thorough review of that write-up may provide the information needed to make an assessment of the credit considerations of the security. Even the rating itself is a piece of useful information. The new guidance does *not* say that banks cannot consider information from the rating agencies; rather, it removes required reliance on *credit ratings* as a single, solitary determiner of permissibility or prudence of investments.

Any review of municipal bonds' creditworthiness will include consideration of credit enhancements from insurance or, perhaps more importantly, state school bond enhancement programs. Many BQ bonds are issued by school districts and many states have school bond enhancement programs. Those programs can

provide significant credit support to specific bonds.

Each bank must make its own determination of what should be reviewed prior to purchase, the types of municipal bonds the bank is comfortable buying, and how prepurchase reviews will be documented. Consider being flexible on the specific information and especially metrics to be reviewed as availability of information may vary. It's important to consider all available, relevant information, and make a credit determination based on that information. Nevertheless, being too prescriptive may be limiting but not credit enhancing.

Consider documenting a purchase rationale as a sentence or series of phrases. That rationale may describe the factors that give the bank comfort with the credit. It also might note concerns and mitigating factors. Example purchase rationales might include:

- GO, Strong area, good financials, recent A-underlying credit rating,
- weak demographics offset by strong fund balance, insurance support, and
- familiar issuer, school bond backed by state program, decent underlying financials.

By documenting what information was reviewed, noting a general summary of the credit assessment, and retaining relevant information in a credit file, it will be easy to answer questions that might arise in the future surrounding how and why a particular security was purchased.

The OCC's guidance provided

a table of "Key Factors" which an institution might consider when evaluating the credit risk in a security. The table is an example, not intended to be an exhaustive, detailed list or a set of items explicitly required to be reviewed. (See Table 2.)

Some of the key factors will typically require a review of specific information. For example, for municipal revenue bonds the suggestion is to consider certain financial metrics. Others may be

The suggestion that banks consider whether the spread of the security is consistent with bonds of similar credit quality is based on the old adage that there is no free lunch. If a bank is considering purchasing a bond that yields 75 basis points more than other, supposedly similar bonds (credit risk, maturity, call, issuer type, etc.), then there is probably some element of risk that is greater which should be evaluated.

The prepurchase due diligence



accomplished by reviewing financials and demographics, looking for "red flags" and for a general feel of the financial capacity and strength.

for certain securities including corporate bonds and asset-backed securities must, in addition to prudence, include a determination that the security is "invest-

TABLE 2

Key Factors to Consider	Municipal GO Bonds	Municipal Revenue Bonds
Confirm Spread to Treasuries is consistent with bonds of similar credit quality.	x	x
Confirm risk of default is low and consistent with bonds of similar credit quality.	x	x
Confirm capacity to pay and assess operating and financial performance levels and trends through internal credit analysis and/or other third party analytics, as appropriate for the particular security.	x	x
Evaluate the soundness of a municipal's budgetary position and stability of its tax revenues. Consider debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience.	x	x
Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values.	x	
Assess the source and strength of revenue structure. Consider obligor's fin'l condition and reserve levels, annual debt service and debt coverage ratio, credit enhancement, legal covenants, and nature of project.		x

ment grade.” For banks that are not “well capitalized,” the investment grade determination is also required for municipal revenue bonds. It is not required for municipal general obligation bonds or, for well capitalized banks, for municipal revenue bonds as those securities are deemed to be permissible for banks to hold.

The post-Dodd-Frank guidance defines “investment grade” as one in which “the issuer of the security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. To meet this new standard, national banks must determine that the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.”

Assess holdings

In addition to prepurchase due diligence, it is important that banks have processes in place to review holdings regularly. Management should routinely monitor the investment portfolio as well as the markets for events,

news, or changes which have a material, negative impact on the credit of holdings.

Routine monitoring does not mean scheduled reviews of every credit under the same criteria as was performed prior to purchase. Instead, routine monitoring means having a process in place to become aware of issues that need further review, dig deeper when issues become known and continually monitoring the portfolio for changes that impact the credit of holdings. A bucketing approach which subjects certain holdings to deeper and/or more frequent review is likely the most efficient and effective way to monitor a municipal bond portfolio.

Table 3 below, taken from our Sample Investment Policy, is an example of a schedule for reviewing holdings and reporting them to the board.

Policy considerations

The new guidance certainly means many changes to investment policies. Every bank will need to review and update its policies to ensure compliance.

Special consideration should be given to:

- Risk limits – The board should set risk limits for the total amount of credit exposures by sector, by individual credit, and for applicable concentration groups. Those limits will most often be tied to Tier 1 capital.
- Prepurchase credit reviews – The policy should specify what type of information will be reviewed prepurchase, the general expectations of the reviews and the documentation that should be maintained.
- Postpurchase Surveillance – The manner, frequency and board reporting required for postpurchase surveillance should also be included in the policy.

Still worth it

You have now spent some time learning how the requirements for pre- and post-purchasing munis have been greatly ramped up. Despite the advances in technology that allow for the electronic delivery of an official statement or material events notices, it’s clear that time available for community bankers to contend with such matters is at an all-time low. A logical question of a portfolio manager may be, “Why bother?” There are actually at least three good reasons. The first, it may surprise the readers to learn, has to do with safety and liquidity. Since the financial market meltdown in late 2008, yields on investment-grade municipal bonds have seen a non-stop march to ever-lower levels. This would not have been the case if investors’ perceptions of the quality of the product were in any way compromised. In spite of several notable headline-grab-

TABLE 3

Review Holdings Process	Review	Review to Board
Material Events on Municipal Bonds	upon notice	Report concerns, significant deterioration, or exceptions at next board meeting
Ratings for each municipal, corporate, and asset-backed security (where available)	At least quarterly	Report concerns, significant deterioration, or exceptions at next board meeting
Financials and news on any bond for which a payment has been or is expected to be missed.	At least quarterly	Report concerns, significant deterioration, or exceptions at next board meeting
Financials on munis on the “Annual Review” list maintained per policy.	At least annually	Report concerns, significant deterioration, or exceptions at next board meeting
News on out of area municipals for which there has not been a ratings update/affirmation in the past 12 months.	At least annually	Report concerns, significant deterioration, or exceptions at next board meeting

bing events, the number of issues in which the borrowers have actually missed principal and interest payments has been trending lower since 2008. It's also true that in recent quarters, some low investment grade or even non-rated securities have traded at levels that are very close to high-quality issues, at least from historical standards. This speaks to the good liquidity of the overall muni market.

The second is that there may actually soon be a scarcity of securities available that fit community banks' needs. Total outstanding debt in the overall municipal debt market is at a 15-year low, so the supply/demand profile for the entire \$3.5 trillion muni market is favorable for additional price appreciation. With the recent hike in marginal tax rates for individuals, many S Corps will ironically enjoy a boost to tax-equivalent yields. So portfolio managers, faced with difficult choices about managing a collec-

tion of investments in a record low yield environment, may conclude that munis are the best and highest use.

Thirdly, there still appears to be value in the municipal bond market. This is in spite of the reasons stated above. Thanks partly to the Federal Reserve's Quantitative Easing programs (we're now at QE3 and counting), which has invested over \$2 trillion in Treasury and agency issues, yields on Federal debt

securities have actually fallen farther and faster than on munis. Yield spreads on even the highest quality issues are currently wider than historical levels.

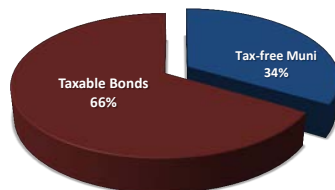
It has been a consistent finding that high-performing community bank investment portfolios own a significant amount of tax-free munis. (See pie charts at left.) It has also been demonstrated that those higher-yielding portfolios also have just marginally longer durations than their less profitable peers.

The proof is in. Municipal bonds: An attractive risk/reward proposition, and well worth the effort.

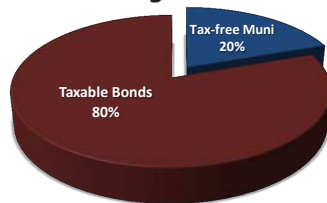
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High Performing Banks



Average Banks



ICBA Securities has an entire suite of analytics for municipal investments which it offers to any community bank. Some of them are described herein. To receive these and other services, contact your ICBA Securities sales rep or Jim Reber at (800) 422-6442 or jreber@icbasecurities.com.

For more a more detailed description of our muni tools, please log on to our website and go to myicbasecurities.icbasecurities.com/onlinemunitools



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