



The Unsinkable Muni Market

Tax-free securities have withstood many threats ... so far

By Jim Reber

And now, for something completely different: It gives me great pleasure to point out a segment of your community bank's balance sheet that has performed exceedingly well over the last year, even though the investing public in general apparently has no idea. This, happily, may still be an opportunity for your bank to exploit. And it may be a surprise to learn that it involves municipal securities.

managers everywhere, is only about two-thirds that of a taxable security. And, more recently, thanks to the headline effect, retail investors unknowingly created a buyers' market for banks.

Why the opportunity

You will recall that the vast majority of municipal investments owned by a bank are of a specific sub-category known as bank qualified (BQ). The reason BQ munis are coveted by

place since 1986. What, in effect, this has created is a bidding war among community banks for a very small piece (about 7 percent) of the muni market. How in the name of Meredith Whitney can there be any value to be gained?

The headlines whenever a municipal default occurs create paranoia among small investors. When Detroit declares bankruptcy, or when unfunded pension obligations of the state of Illinois make the newspaper, retail investors (who have never heard the term "bank qualified") run for the hills, and all muni bonds, good and bad, take a dive. This happened in mid- to late 2013. Savvy institutional buyers, which most assuredly include community banks, can snap up bonds at bargain prices.

Proof in the numbers

Between June 2013 and June 2014 yields on most investments that community banks own changed very little. In fact, the yield on the 10-year Treasury note rose 4 puny basis points (0.04 percent) in that period. At the same time, yields on 10-year investment grade BQ munis *fell* 36 basis points, and that's before putting the tax-equivalent adjustment to the numbers.

This one-year look back is a bit of a head-fake, as it obscures the fact that muni prices actually fell, and yields rose, during the third quarter of 2013 as Detroit's and Puerto Rico's financial problems were front and center. Bond funds, through which most retail investors participate in the securitized debt market, shed



Tax-free munis have some benefits that are unique among bank-suitable investments. They are typically priced off of a very steep yield curve, which helps preserve their market value in a gradually rising rate environment. Their coupon structure is such that price volatility, the bane of portfolio

banks is a tax advantage related to the deductibility of interest expense. BQs also have an outstanding history of repaying all principal and interest on time.

BQ issues are limited to \$10 million per issuer, per year. Despite ICBA's best efforts, that limit has been in

\$40 billion in the last part of the year. Unrelated to this, but aggravating the situation, is the fact that there is a seasonal spike of BQ paper printed in the last couple of months each year.

As 2014 has progressed with little headline effect, and as supply of BQ paper has been limited, prices have rallied hard this year. The first half of 2014 saw about a 19 percent drop in new issue volume compared with a similar time frame a year ago. Your community bank should have an unrealized gain in many of its muni positions. What's more, even though current municipal yields may seem painfully low to an investor, many parts of the taxable debt market (e.g., "bullet" agency bonds) are even lower.

What to watch for

This doesn't mean that it's safe to go out and take down any old tax-free security that you are offered. In particular, it's prudent to adhere to your bank's muni acquisition-and-monitoring procedures it established



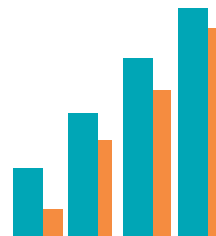
Investment Webinar

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last year to comply with Dodd-Frank Act requirements. It is also a good idea to focus your bank's purchases on issues that have underlying credit ratings (as opposed to those conferred upon the muni insurer, if any).

And, although it was mentioned earlier that BQs have a great track record of paying on schedule, general obligations (GOs) have an even better loss experience than do revenue bonds. It also needs to be mentioned that while the BQ market has thus far weathered most all threats, there could be some clouds on the horizon. Demographic changes, which are usually blamed for pension-liability shortfalls, can also eventually create problems for GO debt.

Finally, since the municipal yield curve is very steep, incrementally an investing bank is well compensated for extending its maturities. Longer maturities may mean higher yields, but they also certainly mean greater



Cutting-Edge Reporting

ICBA Securities' clearing broker Vining Sparks provides state-of-the-art bond accounting services to about one in 10 community banks in the nation.

price risk. A strategy that continues to work well is to purchase high-coupon (usually 3.5 percent and up) callable munis at prices above par. Your sales rep can show you how this works.

So, if your tax accountant is of the opinion that your community bank has room for additional tax-free income, it may be time to climb aboard the good ship Muni. The market's recent buoyancy, even in the face of choppy waters, has been a happy outcome for thousands of community banks. ■

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