Credit Analysis for Bank Qualified Municipal Bonds

Overview:
Community banks have traditionally relied on municipal bonds as a key component of the investment portfolio. Generally, US banks in the $50 - $500mm asset class maintain one-quarter to one-half of their portfolio in bank qualified munis. It is no surprise, then, that the stunning developments recently regarding municipal bond insurers have raised serious concerns among bank managers and directors about the creditworthiness of this critical part of their earning assets. Perhaps the most important questions involve how banks should now proceed with respect to analysis and investment in municipal bonds. First, though, it is instructive to review the course of events that led to the current state of affairs.

The bond insurance so prevalent today essentially didn’t exist until the 1970s. Up to then, buyers of municipal bonds did a great deal of credit analysis on the issuer. Brokers, traders, and portfolio managers reviewed basic financial data on the municipality, district, state, or whoever was the issuing entity. Depending on whether the issue was a general obligation or a revenue bond, certain ratios and metrics such as debt / assessed value, per-capita debt, or debt coverage statistics were routinely monitored. Eventually, bond insurance companies began to offer credit enhancement to municipal issuers, changing the investment dynamic for all involved. The insurers, MBIA, AMBAC, and FSA among others, typically held a strong AAA rating. The logic behind insurance for a bond issue was simply that the cost of issuance for an insured bond was lowered by an amount greater than the fees paid to the insurers. This was true as long as the credit rating of the insurer itself was AAA. Sadly, this arrangement deteriorated as the insurers, seeking greater profits, began to guarantee high risk assets such as CDOs created from sub-prime mortgage loans.

Analyzing the Data:
It is critical for investors to analyze all pertinent financial information of an issuer’s underlying creditworthiness. Historically, the municipal bond market has experienced extremely low default rates. Moody’s report that between 1970-2006 investment grade municipal bonds have a cumulative default rate of only six one-hundredths of one percent (see Figure 1a). However, recent bond insurance downgrades and a stressed financial and housing sector should reinforce the focus on underlying credit analysis. Moreover, financial institutions often find value in non-rated, non-insured munis that did not obtain an underlying credit rating as it was too expensive to acquire. High performing financial institutions rely heavily on bank qualified munis in their investment portfolio’s and should address key measures that evaluate the financial stability of each issuer. For investors who hold General Obligation and Revenue bonds in the municipal sector, the following ratios and metrics should be monitored:

General Obligation Bond Underlying Metrics

- **Net Debt:**
  - The net debt figure will reflect the issuers total general obligation debt minus any self supporting debt, sinking funds and short term debt such as tax anticipation notes, and revenue anticipation notes.

- **Tax Assessed Value:**
  - The dollar value of an asset (property) assigned by a public tax assessor for the purposes of taxation.

- **Debt to Assessed Ratio:**
  - This ratio will highlight the issuer’s net general obligation debt as a percentage to the taxing authority’s tax assessed value.

- **Per Capita Debt:**
The amount of net debt of an issuer divided by the taxing authority’s total population

Revenue Bond Underlying Metrics

- **Annual Debt Service:**
  - Cash required over a given period for the repayment of interest and principal on a debt.

- **Debt Coverage Ratio:**
  - The pledged revenue’s divided by the total annual debt service for the year. A high ratio indicates a better ability to meet the debt service requirements.

- **Rate Covenant:**
  - A provision for a municipal revenue bond issue that sets requirements for charging revenue on the facility that is being financed by the bond issue. For example, a rate covenant might require that the rates from customers of a city sewage plant be sufficient to ensure adequate maintenance and repair for the facility.

- **Security:**
  - The source of payment or revenue stream that secures the required principal and interest payments. Security sources often include revenue streams such as utility payments, lease payments, and special tax provisions.

Credit Enhancement Programs:

It is important that portfolio managers have access to sound credit analysis of the financial underpinnings of municipal bond issuers. Bank management should have access to detailed reports that highlight characteristics such as credit enhancement and state aid programs that may support the credit of the issuer. This should all be part of a good bond analytics reporting system.

Credit Enhancement and State Aid Programs provide additional security through:

- An independent paying agent notifying the state in the event of default
- State Oversight of the program and its management
- Coverage of a revenue stream for any debt service deficiency

State aid programs vary both in the structure under which debt of the issuer is supported and the rating assigned to the program given any changes in the state’s rating. Programs such as the Texas Permanent School Fund have been tremendously successful in the support of school districts in the state of Texas. PSF maintains an AAA rating that is independent of the state’s rating and guarantees over $49 Billion in bonds as of July 2008.

External Characteristics:

Investors should also recognize that the dynamic of a municipality can change much like that of a corporation’s exposure to market conditions. According to a recent Wall Street Journal article, states are getting hit with shortfalls in tax revenue, and according to a report by the association of state legislatures, 22 states are showing below forecast sales taxes. The weak economy is affecting municipal finances as well as the private sector. Along with analyzing the issuers underlying credit and the presence of credit enhancement programs, investors should evaluate demographic and geographic features. County and city unemployment rates, major tax payers, home values, and population sizes are important features that may indicate whether or not the surrounding area is experiencing an economic contraction or expansion.

Implementation:

Informed investors with the right tools have an opportunity to make good investment decisions in the municipal sector. The Baker Group is working to make available to clients a Municipal Credits Data Base which highlights the ratios and metrics mentioned above for certain bank qualified general obligation and revenue bonds. This information is provided in a usable format derived from the issuer’s most recent financial reports and will be available to banks upon request. To
further discuss the credit quality within your municipal bond portfolio, please contact your Baker representative at 800-937-2257.

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