

December 2009

Municipal Debt Today: Expect More Turbulence, Invest Very Selectively

Contact

Nanci Fastre
Managing Director
503.574.3714 (office)
650.387.1440 (cell)
nfastre@svb.com

Written by

Melina Hadiwono, CFA
Head of Credit Research
415.512.4270
mhadiwono@svb.com

Key Points

- States and municipalities continue to face financial and budgetary pressures that eclipse the Orange County default environment of the mid-90s.
- Issuers' circumstances vary greatly and selectivity is essential. Those with more variable debt or auction rate debt, and heavily dependent upon cash flow borrowing for operations are to be avoided today.
- While corporate credit has stabilized or improved, expect NRSROs to increase negative rating actions on municipals to levels not seen in past recessions.
- Ongoing due diligence on the issuer's liquidity position, market access, revenue generation ability, operating risks, financial management, capital structure, investment portfolio risks and variability of cash flow needs should be considered when evaluating this asset class and its future. Not since Orange County have we seen the need for such fundamental, yet rigorous, research, selection and surveillance practices.
- Pre-refunded municipal bonds are a good first choice for corporations seeking high credit quality and federally tax-exempt income.

Stimulus Will Not Solve Municipal Market's Woes

The U.S. municipal bond market has been impacted by the volatility of tight credit conditions, federal regulation and stimulus as much as, if not more than, other sectors. What makes state and muni markets unique is how much remains unknown relative to corporate markets about their ability to recover. Depressed consumer spending, declining housing prices, job losses and high pension costs have created their most serious fiscal challenges in decades. The declining revenues combined with ongoing spending pressure to fund social services and critical infrastructures have contributed to large state budget shortfalls for fiscal years 2009-2011. Federal stimulus has been a net beneficial impact on stressed states and muni issuers so far, but unless states move to balance their budgets now, real credit risk will remain when the stimulus effect runs out. Adding to this pressure, the diminished access to credit markets and the collapse of credit enhancement tools only drive up their cost of borrowing. If that is not enough, high volatility and limited credit access have taken away banks' desire to support variable debt obligations, increasing the costs and risk of variable rate and interest rate swaps. We expect NRSROs to make good on warnings to issue negative rating actions steadily on select munis for the next several years.

Build America Bonds Seen As Short-term Relief

Tax-exempt bonds firmed up in early 2009 with historically low yields because of the Build America Bond (BAB) program, which is scheduled to expire January 1, 2011. The federal backing of BABs gave munis desperately needed access to the credit markets in an otherwise dry tax-exempt bond market. Issuers of these taxable bonds received a subsidy from the federal government for 35 percent of the interest payment. While this program may be extended further, the temporary program does little to address the underlying challenges of

issuers. Municipalities in severe financial distress have historically received some form of extraordinary support from other entities prior to default. Compared to similarly rated corporates, the default and loss rates are decidedly low for municipalities that have the ability to raise taxes or have monopolistic rate setting powers. Despite this strong track record, the form and timing of extraordinary support is perhaps less predictable than ever, and in any case, must be assessed individually. Support for a municipality under stress typically results from political and policy negotiations that are not finalized until there is considerable concern that a payment default on debt service may occur. We continue to opt out of exposure to issuers with the clear potential for headline risk and downgrade risk.

Risk of Variable Rate Debt and Swaps

Interest rate risk

State and local governments issue variable rate debt in order to achieve lower interest costs than those that are associated with fixed rate debt. However, variable rate debt is subject to interest rate risk, which may exert cash flow pressures if interest rates exceed those for which the issuer has budgeted. Beginning in February 2008, issuers of auction rate securities experienced increases in short-term interest rates following the widespread failure of the auction rate market. The deterioration in the credit quality of several financial guarantors contributed to increased interest rates on variable rate debt that was wrapped by those guarantors.

Risks embedded under swap agreements and liquidity facilities

Many state and local governments enter into swap agreements in order to hedge the interest rate risk of variable rate debt. While fixed payer swaps can effectively reduce an issuer's exposure to market fluctuations, they can carry several forms of risk that can stress an issuer's finances.

- **Basis risk** arises when debt service payments and swap payments are based on different variable rate indices. When the ratio between these indices is unfavorable to the issuer, the issuer makes net swap payments to the counterparty, in addition to its debt service payments. This ratio was unfavorable for many municipal issuers in the fall of 2008 when SIFMA rose well above LIBOR. As a result, many state and local governments faced high swap costs.
- **Amortization risk** arises due to a mismatch between the length of a fixed payer swap agreement and the amortization of the variable rate debt issue that it hedges.

- **Collateral posting risks:** Upon the occurrence of certain events, counterparties can usually terminate a swap prior to its scheduled end date following an Event of Default or a termination event. Such an event is the rating downgrade of an issuer or counterparty. A typical swap contract contains provisions for a mark-to-market settlement upon termination. The issuer may be required to make a cash payment or post collateral to the counterparty.
- **Counterparty risk:** A decline in a counterparty's credit quality including financial guarantors, swap providers and liquidity providers may trigger swap agreement termination, which could exacerbate the issuer's liquidity pressures.
- **Liquidity facility risk:** The majority of municipal issuers of variable rate demand obligations use dedicated bank liquidity facilities to support potential tenders by investors in the event of a failed remarketing following a tender. The liquidity facility may be drawn upon to pay bondholders, and the liquidity provider may take ownership of the bonds. Remarketing efforts typically continue, and issuers often attempt to restructure the debt. However, if such efforts are ultimately unsuccessful, issuers may be required to repay the bank with increased interest rates immediately or over a period of time that is usually shorter than the original amortization schedule.
- **Rollover risk** arises when the bank will not renew the liquidity facility and the issuer is unable to secure a replacement. The weaker financial position of liquidity banks has resulted in a lower supply of liquidity facilities, increased costs, shorter duration of facilities and possibly more onerous provisions. As a result, there is increased interest in issuing variable rate debt that is supported by an issuer's own internal liquidity, rather than a liquidity support from a bank.

Expertise and Ongoing Due Diligence Is Warranted: Cash Is King

Issuers with material amounts of outstanding debt in variable rate mode are generally more vulnerable to cash flow and liquidity risks. A strong liquidity position and satisfactory market access are critical to mitigating the risks of variable rate debt and swaps. Issuers with limited market access have fewer options available to them to respond to unexpected costs, while issuers with favorable market access are better able to avail themselves of solutions to alleviate short-term pressures caused by unbudgeted expenses. Timely, qualitative and accessible financial disclosure adds significant value.

Pre-refunded Municipal Bonds: High Quality and High Current Income

Pre-refunded municipal bonds are among the highest quality municipal bonds available. The income and principal from pre-refunded municipal bonds is normally secured by an irrevocable trust of high quality securities such as U.S. Treasury securities or U.S agency securities. Thus, the payments from pre-refunded municipal bonds are no longer dependent upon the revenue stream or tax collections of the issuing municipality.

As pre-refunded bonds are backed by these high quality securities they are considered to be rated “Aaa.” At the time of refunding, the issuer can apply to the credit rating agencies for a re-rating, at which point a “Aaa” rating would normally be assigned. However these pre-refunded bonds will keep their initial rating, but carry an implied rating of “Aaa” in the case where the issuers choose not to apply for a re-rating.

Higher Cash Flows and Better Price Stability

As pre-refunded bonds were generally issued when rates were higher, they are typically priced at a premium to their par value. However, pre-refunded municipal bonds are often offered with higher yields than par bonds of similar quality and maturity. This, combined with the higher coupon inherent in pre-refunded bonds, creates a potentially higher cash flow and may exhibit better price stability over the life of the bond in a rising interest rate environment.

Fixed vs. Variable Demand – Figure 1



Source: Thomson Reuters (based on data available on November 6, 2009).

Yield Compression with Lack of Supply in Short-term Municipal Securities

With bank credit profiles under tremendous pressure during the financial crisis, bank support for variable demand rate notes became more expensive, if it was available at all. While short-term borrowing rates have dropped, issuers have struggled to package short-term deals. The result is a real scarcity of tax-exempt, short-term municipal securities. Over the last 18 months, there has been a shift from traditional variable rate demand bonds backed by a bank liquidity facility into longer-term fixed rate bonds as well as new short-term products, such as extendible securities that have a put option which relies exclusively on market access or issuers with internal liquidity to repay a mandatory tender such as Windows, Extendible Reset Securities, X-Tenders (See figure 1). Municipalities have issued only \$26.6 billion in variable debt through October 2009 compared with over \$100 billion in the first ten months of 2008. Given the continued tight credit conditions, investors will need to focus on the underlying credit quality of the issuers as well as the marketability in the secondary market to assess the risk profiles of these new products. For more information regarding Extendible Securities, please review our [Extendible Securities SAM advisory](#).

Short-Term Tax-Exempt Yields – Figure 2

	11/30/09	11/27/09	12/1/08
Municipal Market Data			
Commercial Paper	0.25	0.25	0.85
One-Month Note (MIG-1)	0.27	0.27	0.85
Three-Month	0.27	0.27	1
Six-Month	0.3	0.3	1.02
One-Year	0.33	0.33	1.05
Variable-Rate Demand (Non-AMT/AMT)			
Daily General Market	0.25/0.26	0.26/0.26	1.05/1.20
Municipal Market Yields at 11/25/09 (%)			
Maturity	Aaa	Aa	A
2010	0.61	0.88	1.46
2014	1.85	2.16	2.79

Source: The Bond Buyer and Delphis Hanover Corp.

SVB  *Find a way*

SVB Financial Group

SVB Asset Management

185 Berry Street, Lobby 1, Suite 3000 San Francisco, California 94107 U.S.A.

Phone 1.866.719.9117 service@svbassetmanagement.com

This material, including without limitation the statistical information herein, is provided for informational purposes only. The material is based in part upon information from third-party sources that we believe to be reliable, but which has not been independently verified by us and, as such, we do not represent that the information is accurate or complete. The information should not be viewed as tax, investment, legal or other advice nor is it to be relied on in making an investment or other decision. You should obtain relevant and specific professional advice before making any investment decision. Nothing relating to the material should be construed as a solicitation or offer, or recommendation, to acquire or dispose of any investment or to engage in any other transaction. All material presented, unless specifically indicated otherwise, is under copyright to SVB Asset Management and its affiliates and is for informational purposes only. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior express written permission of SVB Asset Management. All trademarks, service marks and logos used in this material are trademarks or service marks or registered trademarks of SVB Financial Group or one of its affiliates or other entities.

©2009 SVB Financial Group.® All rights reserved. Member Federal Reserve. SVB, SVB> and SVB>Find a way are all trademarks of SVB Financial Group. SVB Asset Management, a registered investment advisor, is a non-bank affiliate of Silicon Valley Bank and member of SVB Financial Group. Products offered by SVB Asset Management are not FDIC insured, are not deposits or other obligations of Silicon Valley Bank, and may lose value. Rev. 12-07-09. 1209-0353