

# Emerging Issues Related to State, County, & Municipal Securities

Atlanta Regulatory Conference Call

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# Call Overview

- Description of Municipal Securities
- Depiction of Muni Risks
- Overview of Muni Market
- Summary of Agency Guidance
- Outlook for Next Examination

# Description of Municipal Securities

- **General Obligation Bonds**, referred to as GO bonds, are issued by states, cities or counties. They are backed by the “full faith and credit” of the government entity issuing the bonds. The creditworthiness of GO bonds is based primarily on the economic strength of the issuer's tax base.
- **Revenue Bonds** are backed solely by fees or other revenue generated or collected by a project or facility.

A benefit to investors in municipal bonds is that interest on such bonds generally is exempt from federal income tax and may also be exempt from state and local taxes for residents in the state where the bond is issued.

# Depiction of Muni Risks

- **Credit risk.** Risk that the bond issuer may experience financial problems that make it difficult or impossible to pay interest and principal in full
- **Interest rate risk.** Risk that the value or cash flow will adversely change as interest rates change
  - *Call risk.* Risk that a bond issuer will retire a bond before its maturity date, typically if interest rates decline.
- **Liquidity risk.** Risk that investors won't find an active market for the municipal bond, potentially preventing them from buying or selling when they want and making pricing more difficult. The lack of Liquidity in a Muni could be a result of a credit downgrade or just an unfavorable desire for Munis by the market

# Overview of Muni Market

- There are currently about \$3 trillion in municipal bonds outstanding from some 60,000 issuances.
- Approximately \$400 billion in new issuances each year
  - Down 40% from last year
  - Last year issuances were bolstered by the aforementioned Build America Bonds
- Defaults are about \$8.9 billion (.31% of outstanding) and another \$28 billion are using sources other than the intended cash flows to pay.
- Ownership is evenly split between households, bond funds and banks.

# Overview of Muni Market

## Why the concern?

Muni's are a concern due to several quantitative and qualitative factors including the following:

- Tax revenue (e.g., real estate taxes, sales taxes, income taxes, etc.) to repay general obligation (GO) debt has declined because of the weak economic conditions
- Cash flow from projects used to repay revenue bonds has declined because of the weak economic conditions
- Prominent analysts have proclaimed \$100s of billions in Muni defaults would occur
- Downgrade of US debt ratings and debt ceiling debate
- Contingent Liabilities
- Lax Oversight
- Low Interest Rate Environment

# Overview of Muni Market

## Atlanta Region Snapshot

- 94 banks with concentrations of at least 100 percent of Total Risk Based Capital
- Compared to the other Regions, Atlanta is at the low end of all banks:
  - SF 41 (6%)
  - NY 86 (7%)
  - ATL 94 (10%)
  - Dallas 354 (20%)
  - Chicago 362 (23%)
  - KC 478 (26%)
- Broken down by state
  - 35 AL
  - 28 NC
  - 19 GA
  - 12 FL

# Summary of Agency Guidance

**FIL 45-98 April 1998:**

***Supervisory Policy Statement on Investment Securities  
& End-User Derivatives Activities***

- Board
- Senior Management
- Policies & Procedures
- Limits

# Summary of Agency Guidance

## Board

- The board of directors is responsible for approving major policies for conducting investment activities, including the establishment of risk limits.
- The board should ensure that management has the requisite skills to manage the risks associated with such activities.
- The board should review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits.
- Board or ALCO packages should be comprehensive and discussions adequately documented in the minutes (so that a third party reviewer has complete understanding).
- Boards that do not have an adequate understanding of Munis should obtain professional advice to enhance its understanding.

# Summary of Agency Guidance

## **Senior management**

- Senior management is responsible for the daily management of an institution's investments.
- Management should implement board approved policies and procedures, and report compliance with limits, etc.
- Senior management should have an understanding of the various risks and how such risks fit within the institution's overall business strategies.
- Management should ensure that the risk management process is commensurate with the size, scope, and complexity of the investments.

# Summary of Agency Guidance

## **Policies and Procedures**

- Policies should provide the structure to effectively manage investment activities.
- Policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and risk tolerance.
- Policies should identify relevant investment objectives, constraints, and guidelines for the acquisition and ongoing management of Munis.
- Policies should also identify the risk characteristics and should delineate clear lines of responsibility and authority.
- Policies should also provide credit risk and concentration limits, relating to a single or related issuer, a geographical area, or obligations with similar characteristics.

# Summary of Agency Guidance

## **Policies and Procedures**

- Bank policies should provide guidance on both pre- and post-purchase (credit) analysis for municipal securities. Ratings should be considered only one of the tools or indicators for pre- and post-purchase analysis.
- Policy should address how ongoing analysis will be performed, including actions management will take in the event of material events i.e., rating downgrade, financial reporting is not being updated by the municipality, significant changes in the economic environment of the municipality, etc.
- Policy should include the type of supporting data that approved brokers are expected to provide for pre- and post-purchase.
- Periodic analysis should be performed for approved third party credit providers or insurers.

# Summary of Agency Guidance

## Pre/Post Purchase Analysis Sources

- Ratings
- Bloomberg Screenshots
- Preliminary Statement
- Electronic Municipal Market Access (EMMA) website
- Comprehensive Annual Financial Report (CAFR)

# Outlook for Next Examination

- Review Policies & Procedures
- Verify Reporting (packages and Minutes)
- Evaluate Documented Pre and Post Purchase Analysis
- Assess Risk
  - Type (GO or Revenue)
  - Level of Concentration
  - Risk Management

# Questions?

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