MOODY'S
INVESTORS SERVICE

SECTOR COMMENT

Bank Lending to Municipalities Is Credit Positive for Both

Extracted from "Moody's Weekly Credit Outlook", dated February 21, 2011

Analyst Contacts:

NEW YORK 1.212.553.1653

Thomas Jacobs 1.212.553.0131
Vice President – Senior Credit Officer
Thomas.Jacobs@moodys.com

Joseph Pucella 1.212.553.7455
Vice President – Senior Analyst
Joseph.Pucella@moodys.com

The recent increase in direct lending from commercial banks to US municipal issuers is credit positive for the municipal sector. It increases the availability of credit and liquidity to those issuers and represents an alternative to Variable Rate Demand Bonds (VRDBs) as a debt structure. However, these lending programs include market access risk not found in the fixed-rate, fully amortizing structure that is the staple of the municipal market. For banks, the increase in lending to municipalities is also credit positive because it offsets some of the pressures that shrinking loan portfolios and low interest rates have on net interest income.

The direct loans that banks are extending to municipal issuers typically bear interest at a variable rate tied to a market index and mature in two to three years, with a firm expectation that the issuer will refinance at the end of this period, either in the capital markets or with a new bank loan. While this debt structure is not as conservative as fixed-rate, fully amortizing debt, it reduces some of the risk inherent in VRDBs, which are a significant component of many municipal issuers' capital structures.

VRDBs are long-term, variable-rate bonds that are puttable at par by investors on a regular interval, usually weekly. Puts are usually supported by credit or liquidity facilities provided by highly rated commercial banks, which are drawn in the event that bonds that are put cannot be sold to new investors (a failed remarketing). Liquidity support of this kind typically has a term of only two or three years, after which time it is usually renewed or replaced. If renewal or replacement is not available, the facility is drawn upon and the debt must be repaid on an accelerated schedule.

The main ways in which direct bank loans are less risky than VRDBs are the following:

» Refinancing risk in direct loans is limited to market access at the maturity date, in contrast to VRDBs, in which a failed remarketing can occur at any time over the life of the liquidity facility

» A failed remarketing of a VRDB can result from general market dislocation or credit deterioration of the issuer or the bank providing liquidity support. By contrast, the issuer has no exposure to the bank's credit or interim dislocation in a direct loan

What is Moody's Weekly Credit Outlook?

Moody's Weekly Credit Outlook provides our research clients with timely opinions on breaking credit market developments and trends. Published every Monday morning, the newsletter will help you start your week informed of Moody's latest opinions from across the organization.

However, direct bank loans and VRDBs share some key similarities that make both riskier for issuers than fixed-rate, fully amortizing debt:

» The issuer's obligation to repay the bank loan at the end of its term, or to repay a bank for a draw on a VRDB liquidity facility, results in accelerated pay-down period, usually two to three years, during which interest accrues at a penalty rate

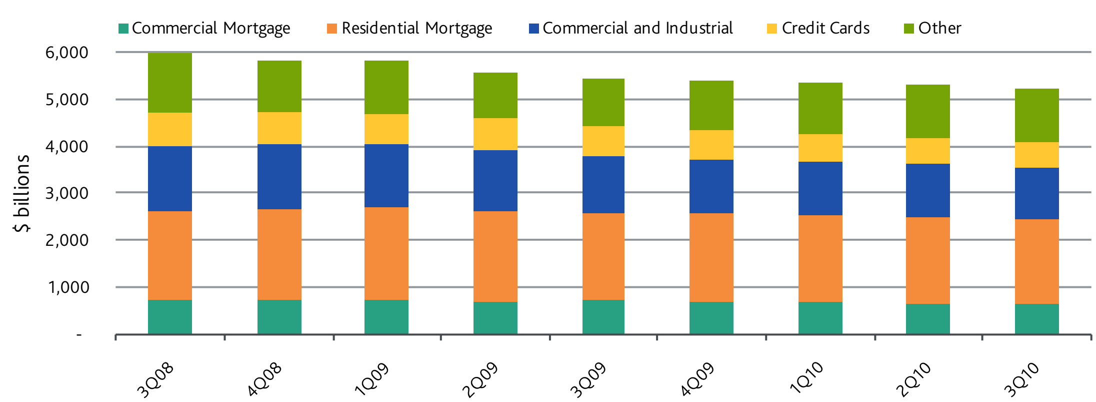
» If an event such as a downgrade or covenant breach occurs, the bank can force an immediate acceleration of the debt

» In either of the above cases, issuers can face unsustainable cashflow pressure owing to the acceleration of a 20-30 year financing to a much shorter repayment period

The municipal market is currently working its way through a liquidity support expiration bubble resulting from heavy issuance of VRDBs in 2008 to refinance auction rate floaters and insured floaters as the market for those structures collapsed. To hedge the variable interest rate associated with VRDBs, many issuers entered into floating-to-fixed interest rate swaps for the life of the bonds, making refinancing into long-term, fixed-rate financing very expensive in light of high swap termination payments and "soft" demand for long-term, fixed-rate, tax-exempt bonds in today's market. In the face of a significant reduction in the number of banks providing VRDB liquidity support over the past several years, direct loans are a welcome source of variable rate financing in the current liquidity expiration cycle. Many of the direct loans being made in the current market are refinancing VRDBs with expiring liquidity support.

Lending to municipalities provides banks with an opportunity to make new loans at a time when asset generation remains a major challenge because of tighter underwriting standards and lower customer demand. The exhibit below shows the continued decline in loan balances for rated US banks.

Loan Balances of Moody's Rated US Banks



Source: Company regulatory filings

The opportunity to lend directly to municipalities will alleviate some of the pressure on banks' net interest income. However, banks will continue to face revenue headwinds to the extent that interest rates remain at the current historically low levels. Of course, we note the importance of maintaining disciplined underwriting in this space, especially given the potential for increased lending by banks.

Report Number: 131346

Authors
Tomas Jacobs
Joe Pucella

Senior Production Associate
Wing Chan

MOODY'S
INVESTORS SERVICE