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**CALIFORNIA
DEBT AND
INVESTMENT
ADVISORY
COMMISSION**

13TH Annual Pre-Conference at
The Bond Buyer's 24TH Annual
California Public Finance Conference

ALTERNATIVE FINANCING IN THE MUNICIPAL MARKET: FINANCIAL AND POLICY CONSIDERATIONS

OCTOBER 8, 2014

SAN DIEGO, CA

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**CALIFORNIA
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**SESSION ONE:
THE MAKEUP OF
ALTERNATIVE FINANCING IN
THE MUNICIPAL MARKET**

DAVID DOYLE

12TH DISTRICT CREDIT RISK COORDINATOR
BANKING, SUPERVISION & REGULATION
FEDERAL RESERVE BANK OF SAN FRANCISCO



The Makeup of Alternative Financing in the Municipal Market

California Public Finance Conference
San Diego, California
October 8, 2014

David Doyle

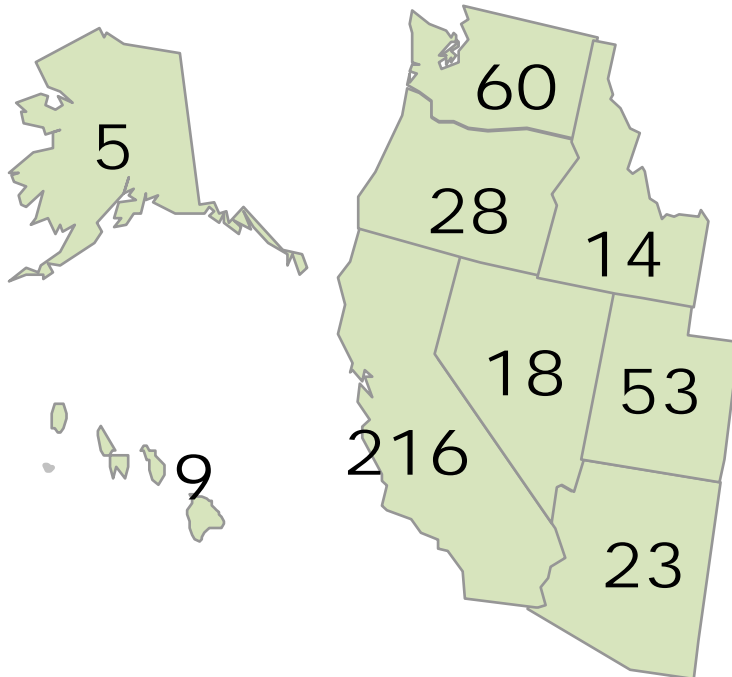
12th District Credit Risk Coordinator
Banking Supervision and Regulation
Federal Reserve Bank of San Francisco

Views expressed are those of the presenter and are not necessarily those of the Federal Reserve Bank of San Francisco or the Board of Governors.

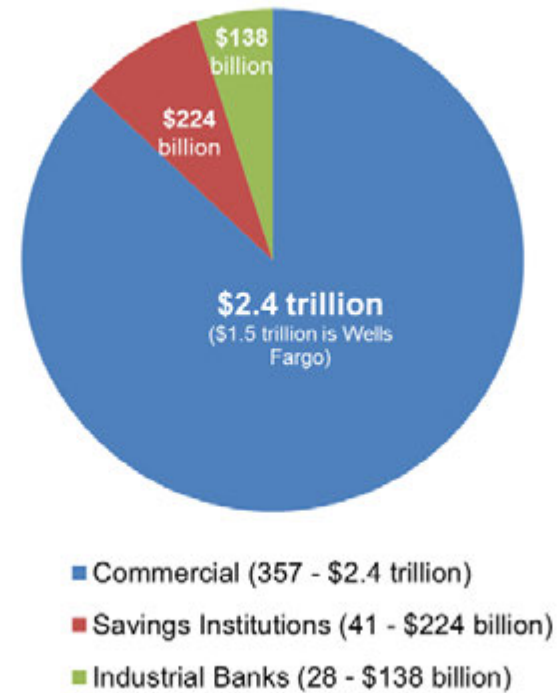


Banking Profile in the West

Number of Financial Institutions



Banking Assets

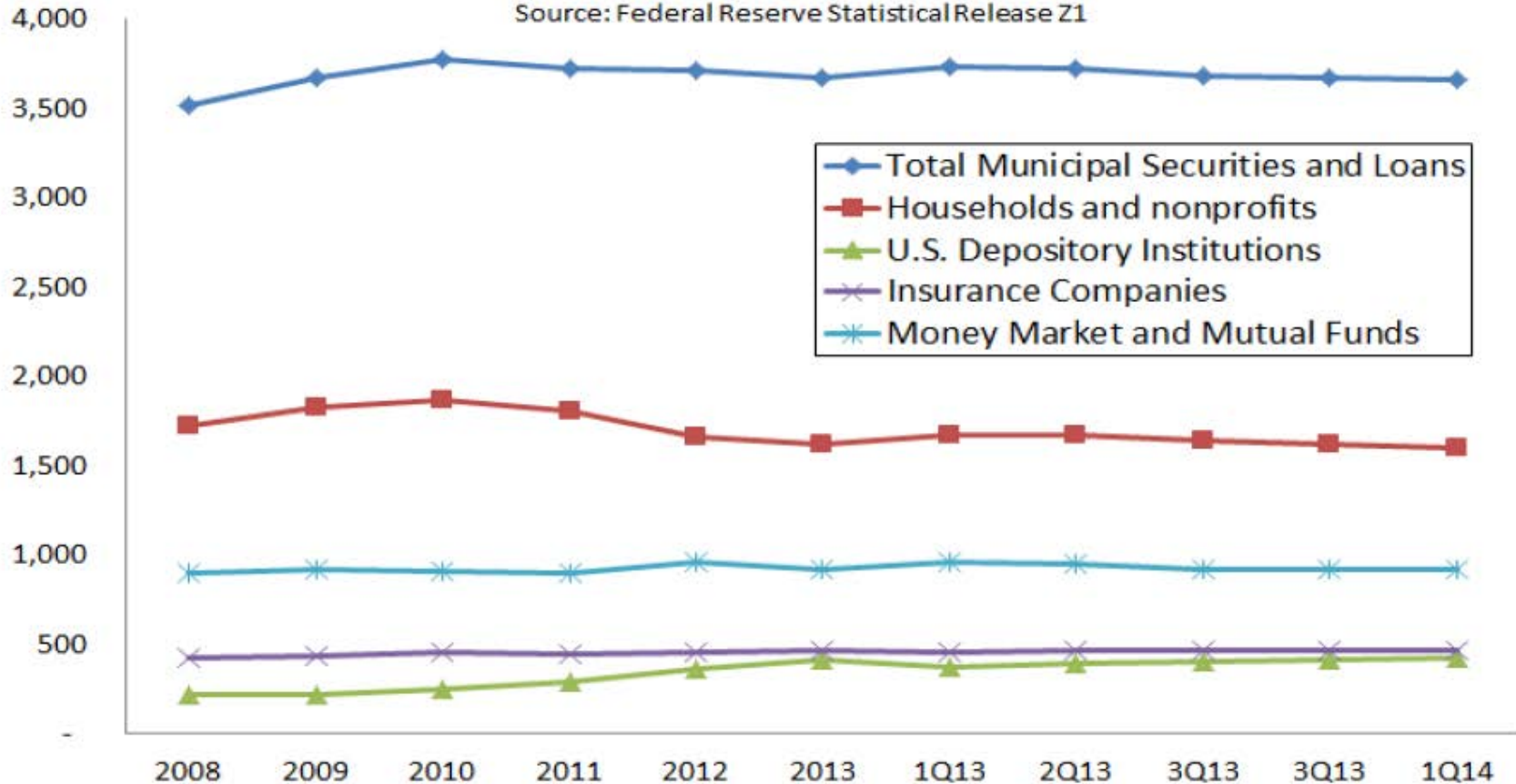




Municipal Securities and Loans

Aggregate Outstanding Municipal Securities and Loans
(\$ in Billion)

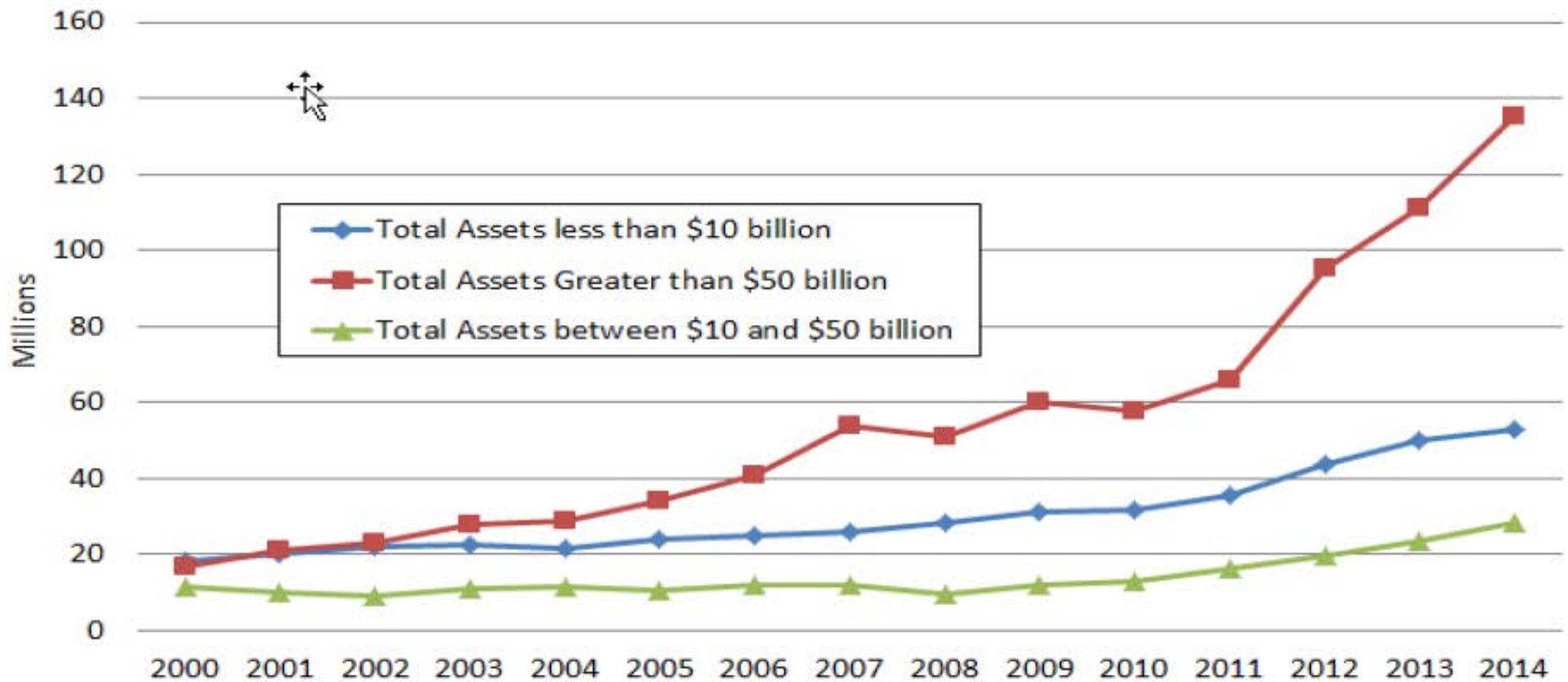
Source: Federal Reserve Statistical Release Z1





Financial Institutions

**Aggregate Municipal Securities Outstanding
As of June 30th of each Year**

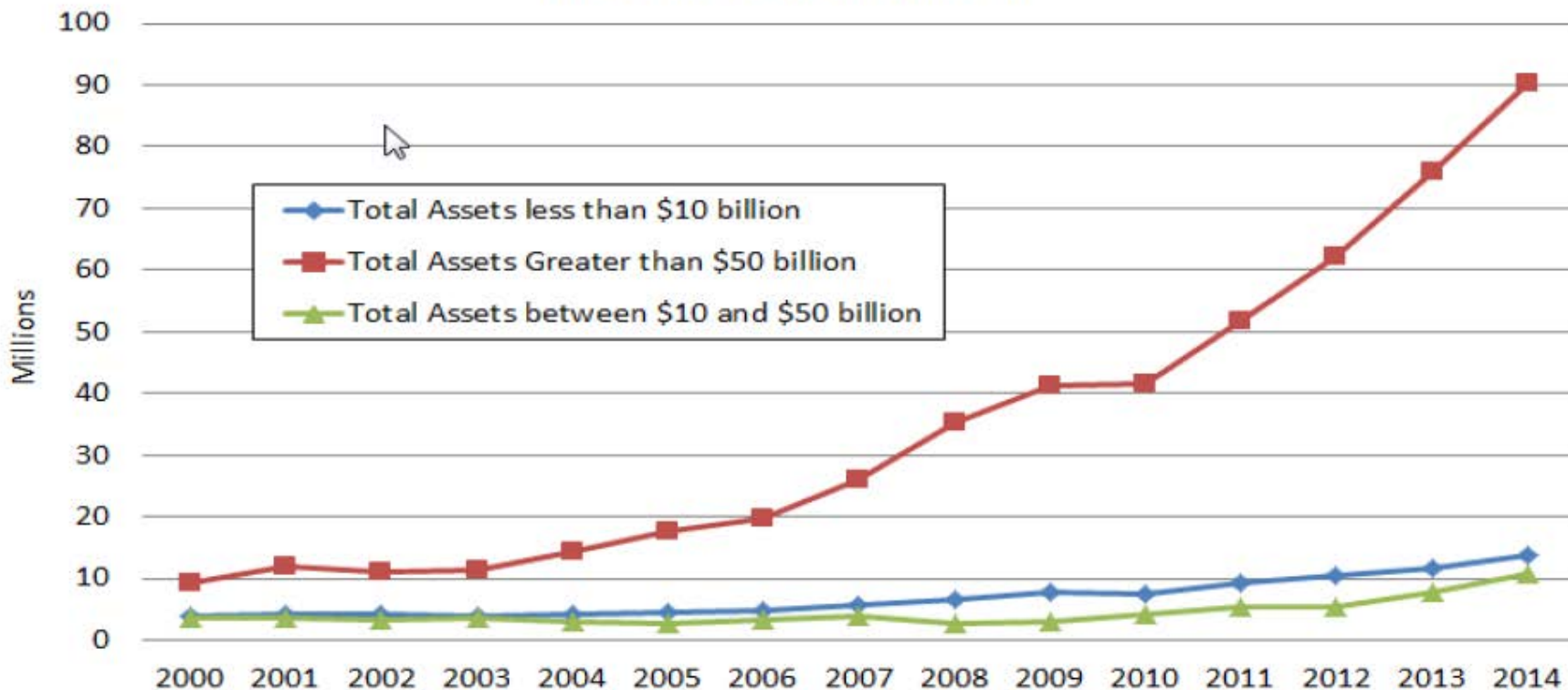


Source: CALL Report



Financial Institutions

**Aggregate Municipal Loans Outstanding
As of June 30th of each Year**



Source: CALL Report



CDIAC Question

What are the trends driving alternative lending?

Capital market challenges facing Issuers

- Availability of bond insurance
- Risk of bank rating downgrade of support facilities
- Liquidity/remarketing risk
- Capital market appetite for infrastructure needs vs new economy and small or weaker issuers
- Recent events: Detroit and Puerto Rico
- Future: Rising rates and pension costs



CDIAC Question

Why are lenders encouraged to provide funding to municipalities?

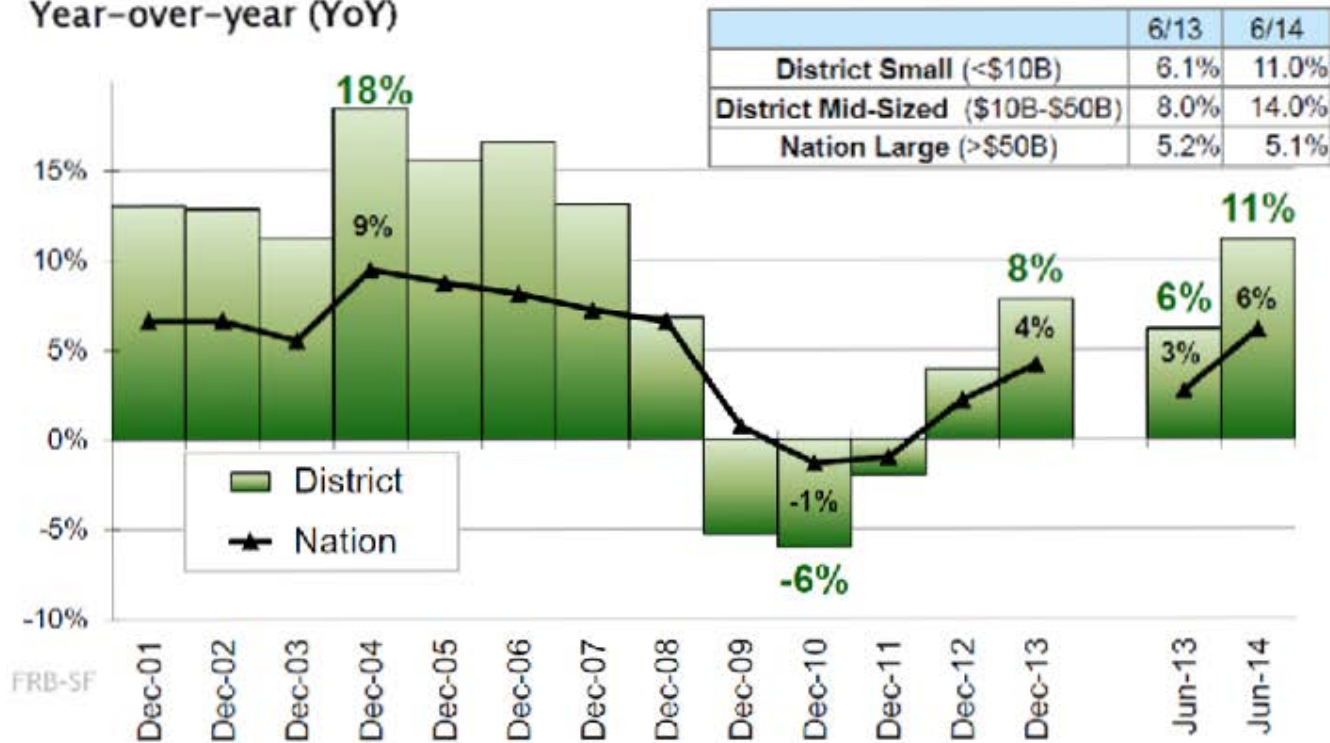
Factors contributing to renewed interest from financial institutions:

- Direct lending more profitable than providing support facilities to municipal issuers
- Municipal defaults and recoveries compare well to corporates
- Loan growth targets/budgets
- Heightened investment purchase due diligence (DFA)



Loan Growth Rates: Returned to Double-Digit Levels At 12th District Banks on Average

Net Loan & Lease Annual Growth Rates
Year-over-year (YoY)





CDIAC Question

Direct Lending: what are the benefits to municipal borrowers?

Issuer friendly instruments

- New loans can be closed quickly and without need for public documentation, ratings, bond counsel, advisory or underwriting
- All in cost of direct loans made more competitive by absence of bond-related costs
- Direct loans do not rely on bank LC or require remarketing agent
- Issuer not required to provide ongoing disclosure to market
- Competition between banks has provided attractive rates and terms
- Flexibility dealing with one lender versus set of bondholders



Municipal Issuer

Other direct lending considerations

- Banks of all sizes offering the product, resulting in terms and covenants less clearly defined and less uniform
- Lack of disclosure to market. Investors may not know about the credit and/or terms of a new direct loan
- Liquidity implications of reliance on direct lending
- Need to understand regulatory expectations for banks that offer direct lending



Direct Lending ----

Bank Regulator Concerns

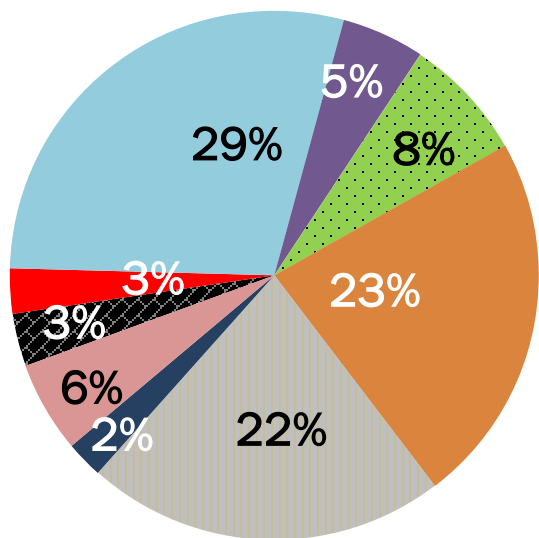
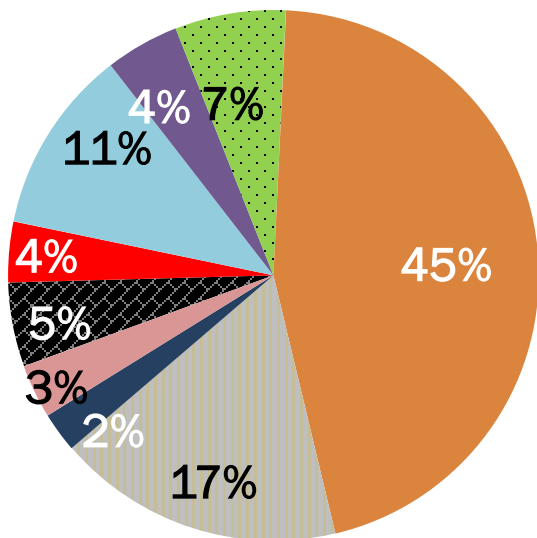
- **Section 939A of the Dodd-Frank Act -----> Securities**
 - Banks can no longer rely *solely* on external credit ratings. Historically banks very reliant on external credit ratings for municipal securities and loans.
 - DFA “investment grade” test:
 - (1) the risk of default by the obligor is low and
 - (2) the full and timely repayment of principal and interest is expected.
- **Financial Statements**
 - Obtain and maintain current financials to assess municipal’s *ongoing ability to repay*
 - Sometimes difficult for bankers to get good quality and current financials
- **Expertise**
 - Banks must have the resources to do the analytical work internally or may choose to engage third parties.
 - The depth of the due diligence should be a function of the municipals credit quality, the complexity of the structure, and the size of the transaction.



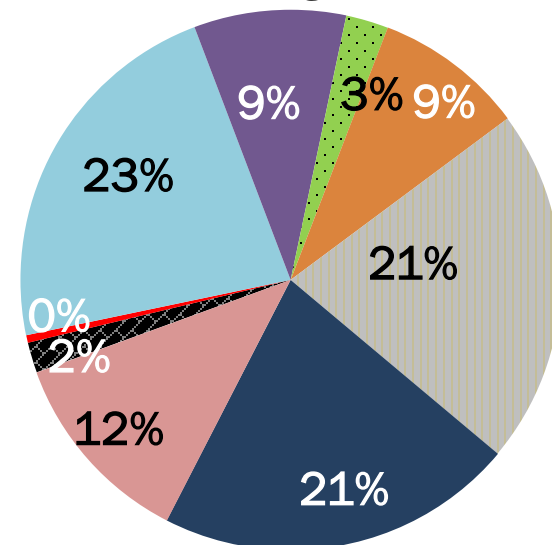
12th District Loan Mix (%) by Asset Size

District Mid-Sized (\$10-50B)

District Small (<\$10B)



Nation Large (\$50B+)



- Construction & Land Development
- 1-4 Family First Lien
- Multifamily
- Commercial & Industrial
- Other
- Ag + Farmland Secured
- HomeEquity + Jr Lien
- Nonfarm Nonresidential (NFNR)
- Consumer



Municipal Loan Concentrations

-- Top 12 in Nation

06/30/14 Bank & Thrift Loan Growth Rates

Bank & Thrift Information				
- CLICK ANY COLUMN HEADER TO RE-SORT -				
ID RSSD	Name	Total Assets (\$000)	Loan Mix (%) Oblig (other than securities & leases) of US States & Political Subs	% of RBC Oblig (other than securities & leases) of US States & Political Subs
		A	A	A
377908	CENTURY BANK AND TRUST COMPANY	3,550,059	42.18	228.78
472858	HOUSTON COMMUNITY BANK, NATIONAL ASSOCIAT	319,996	16.71	109.08
2963547	LANDMARK COMMUNITY BANK	277,977	13.21	98.98
529958	TIB THE INDEPENDENT BANKERSBANK	2,251,411	31.61	95.73
503453	BREMER BANK, NATIONAL ASSOCIATION	731,143	12.06	95.01
3138146	WESTERN ALLIANCE BANK	9,892,546	12.34	93.86
78559	SUMMIT NATIONAL BANK	61,513	14.51	92.14
623454	BANK AND TRUST, SSB, THE	420,818	13.91	87.78
3476192	CARTER BANK & TRUST	4,653,337	13.06	83.88
750341	HASTINGS CITY BANK	283,174	14.51	83.06
926342	STATE BANK	22,561	35.94	81.07
245276	ORIENTAL BANK	7,649,578	12.96	80.69



Bank Liquidity Coverage Ratio

Topic of fierce debate

- September 3rd Final Rule issued which excludes debt issued by municipalities from high quality liquid assets (HQLA)

Opponents of the exclusion warn that municipals will face higher borrowing costs

- Banks will have less incentive to buy municipal bonds

Proponents of the exclusion argue that the rule is aimed at preventing a repeat of financial crisis liquidity crunch

- Expect minimal impact because market dominated by retail investors
- “Municipalities are notorious for having unreliable and opaque financials that come out only once a year....these type of securities can hardly be considered high quality.” *American Banker*, September 4, 2014, Mayra Rodriguez Valladares



Bank Liquidity Coverage Ratio

Federal Reserve Governor Tarullo:

- Most municipal bonds are not sufficiently liquid to serve the purposes of HQLA during stressed periods.
- Analysis suggests that the liquidity of some municipal bonds is comparable to that of the very liquid corporate bonds that can qualify as HQLA.
- FRS Staff working on criteria for determining which municipal bonds fall into this category...may be considered for inclusion as HQLA at a later date.



Questions?



<http://www.frbsf.org/banking-supervision/>

Banking Supervision Highlights

[Supervisory Spotlight: September 2014](#)

Posted September 18, 2014

Federal Reserve supervision of community banks continues to evolve, as we undertake new initiatives in response to changing and emerging risks. The latest *Supervisory Spotlight* highlights changes to the Fed's community bank supervision program, risks of bank owned life insurance, the accounting implications of improving asset quality, and cybersecurity.

[Asia Focus: Priority Sector Lending In Asia](#)

Posted September 15, 2014

This *Asia Focus* discusses Asia's experience with priority sector lending, reviews the current state-level priority sector lending policies in several Asian economies, assesses the implications for the respective domestic banking systems, and examines potential alternative mechanisms to encourage lending to priority sectors.

[Outlook Five: Frequently Asked Questions on the TILA-RESPA Integrated Disclosures Rule](#)

Posted September 11, 2014

On October 1, the Federal Reserve is hosting a webcast by the Consumer Financial Protection Bureau, *Frequently Asked Questions on the TILA-RESPA Integrated Disclosures Rule*. The event will address specific questions related to interpretation and implementation challenges and focus on questions about how to complete the loan estimate and closing document.

[First Glance 12L: Second Quarter 2014](#)

Posted September 11, 2014

The 2014 issue of *First Glance 12L* shows that conditions in the District continued to improve. Though trends are positive, a return to "normalcy" by pre-crisis standards has not yet materialized.

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Publications



Supervisory Spotlight

Observations on current banking and regulatory issues by the Division Director of Banking Supervision and Regulation



First Glance 12L

Quarterly reports highlighting key indicators of 12th District banking conditions



Banks at a Glance

These quarterly reports highlight key indicators of banking conditions within each of the nine states comprising the 12th Federal Reserve District.



<http://www.federalreserve.gov/bankinforeg/default.htm>

Board of Governors of the Federal Reserve System

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Features

-  **Frequently Asked Questions**
Implementation of Regulation YY Enhanced Prudential Standards for Foreign Banking Organizations (Released June 26, 2014)
-  **Stress Tests and Capital Planning**
The Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act (DFA) stress tests are regulatory tools the Federal Reserve uses to ensure that financial institutions have robust capital planning processes and adequate capital.
-  **Basel Coordination Committee (BCC) Bulletins**
BCC Bulletins provide examination guidance relating to the implementation of the advanced approaches risk-based capital rule. [View All >>](#)

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