Wall Street Meltdown has Municipal Impacts

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The Wall Street meltdown has given municipal money managers in Maine good reason to evaluate how they borrow and invest taxpayers' money.

The immediate worries over the ability to access cash and the safety of invested taxpayers' money have calmed. But longer-range questions have arisen over pending bond issues. The chief issue is whether the hungry construction climate outweighs higher long-term interest rates and predictions of slower tax collections.

Although the crisis atmosphere of late September has eased, municipal bonding looks to be entering a new era, according to the Maine Municipal Bond Bank (MMBB), a quasi government agency that sells bonds on behalf of Maine's smaller and mid-sized communities. Communities that sell bonds on their own without the backing of the bond bank will likely face much more stringent disclosure requirements, predicts Robert Lenna, executive director of MMBB.

"The long-term market for getting money to build schools, (or) road projects for individual community borrowers is going to be difficult," said Lenna. "We're moving into just a new place for that. There's no bond insurance, or if it's available, it's at a horrendous price."

Encountering Delays

The new climate arrived with a bang in late September when the bond bank got no takers for its offer of $50 million worth of transportation bonds. Market watchers were shocked since bonds – particularly tax-exempt municipal bonds – are supposed to be attractive investment options when stocks take a beating. As Lenna said at the time: "In 34 years I have never had a trader say, "I can't give you a sale price. There is no market.'"

Scheduled bond issues in early October were thrown in doubt as short-term interest rates shot up as high as 10 percent, more than double what they were a few weeks earlier. Moves at the federal level – including the $700 billion Wall Street bailout – eased the situation. Interest rates fell to around five percent and the bond bank went ahead with a $100 million sale of bonds for a slew of municipal road and sewer projects and purchases of equipment. Later in October, the bond bank proceeded with the $50 million transportation bond.

Some bond issues were postponed, even for projects under construction. In mid-October, Lewiston postponed selling a $29 million bond – $19 million of which would finance a new elementary school under construction. Lewiston Finance Director Richard Metevier said he hopes a delay until December will bring interest rates lower than the five percent-plus rates of mid-October. The delay necessitated another short-term borrowing to finance school construction already under way, he said. The city borrowed another $10.8 million for 60 days to pay off a $9.4 million note the city had issued last spring and to keep construction going into December. Another delay is not possible due to the state's budget schedule, he said.

"We're just hoping for some improvement in the marketplace," Metevier said.

SAD 51 delayed a $14 million bond to improve Greely High School. The Bond Anticipation Note – a short-term loan taken out so the project could begin – doesn't come due until the end of December. With high energy costs and a flat state subsidy, the district is looking to new income from tuition students to help, according to an open letter by SAD 51 board chairman David Perkins.

Also delaying bond issues were Westbrook, Gray, and Portland, according to Joseph Cuetara, senior vice president at Moors & Cabot in Boston.

More Disclosure Required

As Maine's economy slows, the timing of bond issues is the subject of discussion.

Although tax-exempt municipal bonds remain very safe investments (AAA municipal rating is close behind U.S. Treasury bills in its security), the market for them has changed. Up until last year, 40 percent of issuers of municipal bonds purchased municipal bond insurance to satisfy investors that bonds would be paid even if the municipal issuer was in default. The effect of acquiring the insurance was a lower interest rate on borrowed money. Since last year, many of the municipal bond insurance companies have taken a beating because of their own investments in sub-prime mortages. Their own credit ratings have been downgraded, beginning with ACA Financial Guaranty Corp. and Ambac Financial Group and spreading to others. Lenna predicts it will be five or six years before the municipal bond insurance market returns to normal.

Even though the default rate among municipalities nationwide is under one percent, it is likely that municipalities that float their own bonds will be required to disclosure more financial information in order to sell their bonds, said Lenna.

"As we go forward, I foresee a greater desire for more and more information, both from the regulatory side and the market side," said Lenna. The additional disclosure provides little benefit to investors since municipalities have been very credit worthy, but it does add a significant burden on municipalities, said Lenna.

"I could see on large projects . . . monthly or quarterly reports. Is the project progressing on time? When project is done, did all the money get spent? If not, what did you do with it?" says Lenna.

Lenna also predicts wider interest rate spreads separating investment-grade bonds. Triple A and Double A rated bonds will have significantly lower interest rates than A and Triple B rated bonds

The overall climate will drive more Maine cities and towns, that had floated bonds on their own, to the safety of the bond bank and its Triple-A rating, the only one in the state. (The bond bank's high rating comes from its diversified portfolio as well as its reserves, said Lenna)

"Certainly Portland and Bangor will continue to do bonds ... but smaller communities and smaller projects, they'll come to the bond bank," he said. "The numbers are going to be pretty compelling."

Good Time to Build?

The climate for construction projects is good, notes Joseph Cuetara of Moors & Cabot .

"I would probably be very bullish, interest rates are down, labor costs down," he said. Cuetara said even communities that are reluctant to borrow should try to take advantage of the situation. "Lets say you don't want to borrow, that's fine. Pay as you go, but do construct that public works facility because you're going to find you'll receive lots of bidders."

"Take advantage of the weakness," he said.

Cuetara recommends preparing for lower excise tax collections and slower property tax collections by building up the fund balance. The fund balance is the amount of available cash, which he says should be equal to at least one month's expenses. According to Cuetara, only about 10 percent of Maine communities have a two month cushion of cash reserves, which he considers a "very healthy" fund balance and which he recommends.

"I hate to use an analogy, but if you're expecting a cold winter, you should have an extra cord of wood . . . having a larger fund balance compensates for lower excise tax collections and slower property tax collections," he said, adding that it could also benefit a community in a higher credit rating.

"It's a sign of good management," Cuetara said. "I've seen municipalities get their credit upgraded during a downturn because they've managed it (the fund balance) so well."

In the past year, Standard and Poors has upgraded eight communities' credit rating, while Moody's has downgraded one and upgraded "a couple." Cuetara expects more will be downgraded in the coming year.

Others point out that the good construction climate should be weighed against interest costs and the weakening economy.

"I don't think there will be great deals on the cost of borrowing in the near term," said John Quartararo of Key Bank. "They're not going to see market loosen up for six months or longer. They need to take a look at what's going on with tax collections and with state revenue sharing (sales and income tax collections). It all has to be taken into account. If you can get really good deals on cost of construction, but the cost of long term borrowing is up, you may not see the savings you think you ought to get."

Ralph St. Pierre, Augusta's finance director, agrees. "I'm worried about the State of Maine. We get 35 percent of revenue from state GPA. We receive a substantial part of budget from GPA."

Investment Options

Of greater concern than the timing and cost of bond issues has been the safety of taxpayers' funds. Municipalities have large sums invested because they receive income in large chunks when taxes come due (annually, semi-annually or quarterly), but spend it intermittently on a daily, weekly and monthly basis. Alarm bells started ringing in September when some of the nation's most respected investment banks suffered huge losses from exposure to sub-prime mortgages. Lehman Brothers Holding Co. filed for bankruptcy and Merrill Lynch was forced into a rushed sale to Bank of America. There have been no reports that Maine municipalities had funds invested in sub-prime mortgages, but there was plenty of concern – given the interconnectedness of modern finance – about the solvency of banks where funds were invested.

The S-L-Y rule of thumb from Municipal Finance 101 remains: the highest priority should be *safety*, followed by *liquidity* and *yield* a distant third. In practice that means medium-term investments should be in U.S. Treasury bills, other government agency issues, Certificates of Deposits, and to a lesser degree, money market funds. It also means investments should be backed up with collateral, letters of credits, or the guarantee of the Federal Deposit Insurance Corp. (FDIC).

The crisis on Wall Street seems to have reaffirmed the natural caution among municipal finance directors.

"We're not doing anything out of the ordinary," said John McNaughton, finance director in Falmouth. He invests in U.S. Treasury bills, Fanny Mae and Freddie Mac and in money market mutual funds. "We've always been very conservative with our investments.... There wasn't much we had to change."

Likewise, it's been business as usual in Augusta.

"We have very little risk," said Ralph St. Pierre, finance director in Augusta, where the annual tax commitment is about $24 million. A majority of city investments are in two to five year Treasury bills or other federal agencies, such as the Federal Home Loan Bank, a lesser amount in Certificates of Deposit backed by third party collateral or letter of credit. The remainder is placed in "sweep accounts," which are essentially checking accounts that earn interest, he said.

"That (investment priorities) hasn't changed. It's just sort of reaffirmed the way we have it in the first place," said St. Pierre.

One aspect of investing that seems to be getting more attention is how to back up investments. Should it be with third-party collateral, letters of credit, or FDIC insurance? In the past, if a municipality wanted the security of the FDIC guarantee and had in excess of $100,000 to invest, it meant banking at multiple banks. (The FDIC limit of $100,000 per deposit was raised to $250,000 – at least through next year – as a result of the $700 billion Wall Street bailout package.) A municipality can obtain coverage for deposits exceeding the limit by splitting them up into smaller amounts and placing the money with separate banks. That can be a lot of legwork and paperwork. The City of Lewiston, for example, obtains full FDIC coverage on its $7 million portfolio of CDs by opening accounts at more than 60 banks across the country.

“We’ve been investing in CDs since the mid 1990s,” said Lewiston’s Metevier. “We work through a broker, he assists us in managing the portfolio.”

A new option has developed that provides the same FDIC coverage without the hassles of managing multiple relationships with banks. It’s called Certificate of Deposit Account Registry Service (CDARS) and it’s been available since 2003. It’s essentially the same as a brokerage service. You place the entire deposit with a single local bank and the money is placed at other banks at the same rate. The entire deposit – up to $50 million – gets full FDIC coverage. CDARS is available at 2,700 banks that are members of Promontory Interfinancial Network, including Bangor Savings Bank.

“It used to be that in order to stay insured, you literally had to travel to different banks to set up individual relationships,” said Chris Nelson, senior vice president at Bangor Savings Bank. “CDARS is a program that allows a depositor to receive the FDIC on the entire amount – one rate, one relationship.”

Nelson said the program has spread in popularity in the past five years and he knows of “no downside.”

Lewiston prefers to manage its 60 banks without CDARS, says Metevier. “We’ve been at it quite a period of years,” he said. “What we’ve found is the rate of return, by seeking out better deals out there, is a little bit greater than a CDARs program.”

John Quartararo wonders how much Promontory Interfinancial screens out weak banks. “Do you know the financial strength where the money is held?” asks Quartararo.

It’s never a bad idea to review the fundamentals, say John Quartararo. He suggests reviewing the state ’ s list of allowable municipal investment options and review what the investment policy of your municipality says is appropriate. In general, “ if you have been chasing rates, you should be moving to safety and liquidity and away from rate, ” said Quartararo.