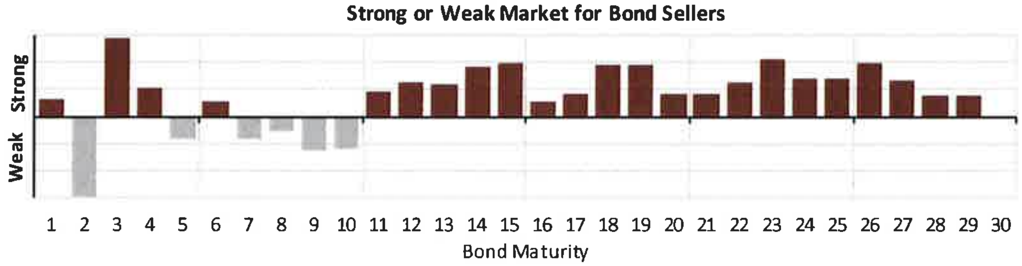
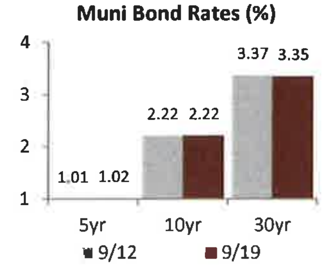
MMA The Power of Independence

SEPTEMBER 22, 2014

MUNICIPAL ISSUER BRIEF





Heading into this week, similar dynamics to last week are still at play with pricing power much more accessible for bonds maturing 11-years and out while shorter maturities have a more mixed message.

MARKET UPDATE

MARKET STABILIZES: After a difficult start to the month, interest rates stabilized last week as the Federal Reserve indicated it would not change its course and begin to raise the Funds rate.

INVESTORS & ISSUERS: There continues to be strong demand:

- In the middle of last week the Federal Reserve concluded its latest monetary policy meeting and largely kept their action in line with recent meetings. This came as a surprise to many who thought the central bank would hint that it would soon increase its target funds rate. **The Federal Reserve's status quo helped to stabilize Treasury yields and municipal borrowing rates.**
- A stable back-drop made for a strong market context for issuers last week. Last Wednesday MMA made note of **orders for 20-times more par than the Savannah School of Art and Design was offering and 10-times more than what the Miami-Dade Expressway Authority had to sell**. These issuers, and many others, were able to greatly lower their borrowing costs because of the demand. (See **page 3** for more on regional deals.)
- We also point out that **retail—or individual investors—have become more engaged in the marketplace lately** as the summer season has officially concluded. The Commonwealth of Massachusetts took advantage of the interest by placing nearly half of what it offered to individuals during its retail order period.
- This week California and the Sales Tax Asset Receivable Corporation of New York are offering longer retail periods that began last Friday to maximize retail interest—in **fact the New York issuer has already sold nearly $300 million to retail** since last Friday—a very strong start.
- One item issuers should keep in mind is that a few large asset managers continue to selectively sell bonds in the secondary markets last week. **If this continues it could force borrowing costs higher, but such investor behavior is common at a quarter-end in order to assist in performance evaluations.**

BUYERS BITES:

WHAT IS TRENDING HOT:
1) Retail order periods
2) California, New York names
3) Texas bank-qualified

CURRENTLY HARDER SELLS:
1) Tobacco-backed
2) Puerto Rico notes

WHO IS REPORTEDLY BUYING:
Individuals, large banks, property and casualty insurance companies, separately managed accounts (SMAs)

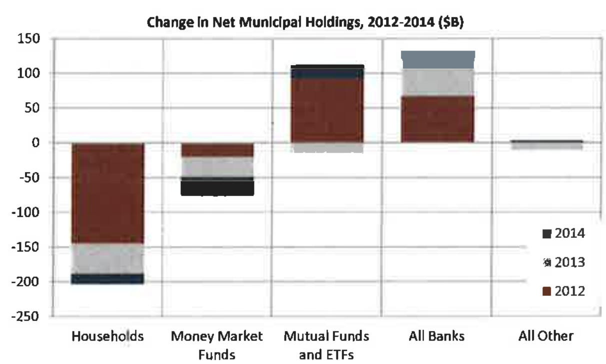
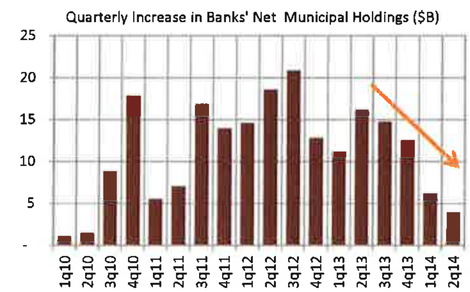


Figure 1**: The latest data out of the Federal Reserve shows household ownership slipping again to 43.8% of the marketplace while funds and insurance company holdings increased modestly. Bank investments in municipal bonds increased to 12.3% of the marketplace but the pace in which banks are buying municipals has declined compared to 2012 (maroon bar) and 2013 (grey bar). Recently proposed new rules could continue to curb bank investments in municipals. We discuss these rules further on **Page 2** in this week's **Topic of the Week.

SCHUMER TO FEDS: PUT MUNICIPALS IN HQLA: Last week, Sen. Charles Schumer (D-NY) sent a letter to Federal regulators asking them to change their rule to include municipal bonds in the high-quality liquid assets (HQLA) designation. Schumer said that excluding municipal bonds would have a chilling effect on the bank purchases in the municipal market and increase borrowing costs for issuers as a result. See **page 2** for more on bank holdings of municipal bonds.

TOPIC OF THE WEEK: BANKS AS MUNICIPAL INVESTORS

BANK BUYERS: Earlier this month the Federal Reserve announced more details on how it will regulate banks with the intent of shielding them from future financial crises. As **MMA** discussed in June (see full write-up here), there are implications for how banks approach municipal bonds as investments. Banks have become an important investor for municipal securities with the latest data released last week showing that banks now own $433 billion municipal bonds, or 12.3% of all outstanding municipal bonds. As for the latest ruling, the Fed determined that municipal bonds would not be considered high-quality liquid assets (HQLA) meaning that tax-exempt bonds would fall into a lower tier and banks would potentially have to increase the amount of collateral they hold against their municipal investments. However, **in its final rules, the Fed opened the door to perhaps include some municipal bonds as HQLA after a strong advocacy effort from the public finance industry.** This would mean that, in theory, the municipal market could be bifurcated into HQLA and non-HQLA instruments. We expect issuer and dealer lobbying to pick up as a result.



WHAT IT MEANS FOR YOU: There is an ongoing debate on what the impact of this Fed ruling means for the industry. Many advocacy groups have argued that by being ineligible for a HQLA designation, tax-exempt bonds will be less attractive investments for banks, and some may have to sell their municipal holdings, driving up issuers' borrowing costs. **MMA** does not entirely agree. In the near term we believe it would have only a modest effect as banks: A) have already posted the appropriate amount of collateral to continue to hold their municipal investments, making selling less likely; B) the current market dynamic is such that even if banks limited their new investment, other investors would easily supplant them (as proven by the latest data wherein banks invested less but market strength continued); C) the current fixed-income environment puts municipals in a relatively attractive light for banks that continue to purchase municipals on a relative value decision over other bond classes; and D) the municipal market is already better prepared to navigate pronounced market stress—when the loss of bank demand is a more realistic scenario—because of the decline in bond insurance, tender option bonds, interest rate swaps, and variable rate debt. Turning to the potential bifurcation of the market, which at this point appears likely, **MMA** sees longer-term unintended negative consequences, as the debate has now moved from all tax-exempts being HQLA to differentiating between issuers and GO vs. revenue bonds, effectively choosing winners and losers. Because they cannot rely on ratings—the likely course is to look at the amount of outstanding issuance or state versus local status—meaning smaller issuers or more revenue bond-centric ones are less likely to become HQLA. This is a long-term negative for generic market liquidity and (most) issuers' cost of capital. It is almost never a good idea to create hard, permanent distinctions between issuers without a careful study of potential implications for state and local policy. A counterpoint: many of the large banks covered by these rules generally invest in larger state GO or essential revenue bonds already, with smaller issuers borrowing from community and regional banks that are not affected by the new rule. As a result, any immediate market impact from an HQLA-oriented bifurcation is likely to be slight, in particular under current market conditions.

NEWS OUT OF NABL'S ANNUAL MEETING

SEC ENFORCEMENT:

- An SEC Enforcement Office official said issuers who are aware that an underwriter self reported one of their transactions under the MCDC Initiative could send the SEC a letter arguing why the perceived violation is not material or otherwise violates securities laws.
- The SEC Enforcement Office also said it would begin processing dealer settlements prior to the issuer MCDC self reporting December 1 deadline.
- The SEC will not tell issuers if an underwriter has self reported on one of their transactions. SEC enforcement staff has said that an issuer should check with their underwriters.
- SEC Enforcement Office said if the SEC believes a state or local government bond offering is fraudulent, it could use an emergency court action to stop the deal.
- SEC Enforcement Office officials also said that future settlements would likely be more detailed. Recently the office has been criticized for not making public more detailed explanations of its settlements. More information would help issuers, counsel and underwriters better understand what the office believes to be a securities law violation.
- The SEC Municipal Securities Division is considering publishing additional MA Rule guidance. To date, the office has published 2 Frequently Asked Questions documents to help market participants better understand the rulemaking.

IRS ALTERING ITS AUDITS:

- The IRS Tax-Exempt Bond Division is modifying the way it determines what types of transactions to audit, and will be targeting specific segments where noncompliance is likely to be greater versus the more overarching market approach it has been using.
- The IRS Bond Division is updating its internal Voluntary Compliance Program (VCAP) procedures. The IRS also made clear that it wants to allow issuers flexibility in developing best practices and policies and procedures for post issuance compliance, but at the same time wants to make sure these practices are being implemented, not just developed for the sake of saying they are written and are in place.

REGIONAL BOND ISSUES (Moody's/S&P/Fitch)

NORTHEAST

On September 17th, **Morgan Stanley & Co.** priced $680 million of general obligation bonds for the **Commonwealth of Massachusetts**; Aa1/AA+/AA+; callable in 9/1/2022:

Maturity	Coupon	Yield	+/- AAA 5%
2019	3.00	1.22	+21
2024	5.00	2.26	+4
2031	5.00	2.74	-20

Notes: With 3 days of retail orders, almost half was sold to retail

MID-ATLANTIC

On September 17th, **RBC Capital Markets** priced $305 million UPMC revenue bonds for the **Pennsylvania Economic Development Authority**; Aa3/A+/AA-; callable in 8/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	1.28	+27
2024	5.00	2.72	+50
2034	5.00	3.57	+45

Notes: Investor demand allowed for lower yields in re-pricing

MIDWEST

On September 16th, **Bank of America Merrill Lynch** priced $292 million of second lien wastewater transmission revenue bonds for **Chicago, Illinois**; A3/AA-/AA; Kroll: AA-; callable in 1/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.37	+36
2024	5.00	2.99	+76
2044	5.00	3.92	+55

Notes: Deal did even better than prior week's, despite lower rating

SOUTHEAST

On September 17th, **Wells Fargo Securities** priced $184 million Savannah College of Art & Design Projects bonds for the **Private Colleges & Universities Authority, GA**; Baa2/NR/BBB; callable in 4/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.89	+90
2024	5.00	3.36	+112
2044	5.00	4.20	+83

Notes: Deal had 20-times more orders than there were bonds

TERRITORIES

On September 17th, **Barclays Capital** priced $77 million of revenue bonds for the **Guam Power Authority**; Baa3/BBB/BBB-; (Assured Guaranty on 2032-2044); callable in 10/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.96	+95
2024	5.00	3.29	+107
2044	5.00	3.85	+48

Notes: Guam had almost $250M of orders on $77M deal

FARWEST

On September 16th, **JPMorgan Securities LLC** priced $97.6 million of non-AMT governmental purpose bonds for the **Airport Commission of the City and County of San Francisco**; A1/A+/A+; callable in 5/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2044	5.00	3.58	+21

Notes: This deal saw strong investor interest and was part of a larger AMT deal, which also was re-priced to lower yields