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CEIS REVIEW INC.

Commercial Portfolio Advisors
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The CEIS Quarterly- Q2- 2019

In This Issue

New York, May 15, 2019 - CEIS Review Inc. is a Commercial Loan Portfolio Consulting firm serving the needs of Commercial Lending Institutions. In this issue of our newsletter, we discuss the continuing importance of conducting stress tests, and then we take a closer look at the role that municipal bonds play in supporting our nations state and local infrastructures, types of muni bonds, and how banks are involved in lending to municipalities.

ON MY MIND ...
CEIS' President and CEO, Joseph Hill, share his thoughts

The American Banker reports that since Trump's rollback of regulatory requirements under the Dodd-Frank Act, many Institutions that are now

not required to perform stress tests on their portfolios, are continuing to do so as the practice is recognized as a valuable practice in monitoring and managing the risk within their respective portfolios.

Banks that are still conducting stress tests are doing so to assist in monitoring asset quality and testing portfolios and their impact on capital in what might be more adverse scenarios. Stress testing ought to be continued as it helps to spot risks in loans help prepare for the transition to CECL required estimates on potential future losses at a time of loan origination.

And we understand from clients that regulators are still asking for stress testing results, even though the mandatory stipulation was eliminated. Bankers believe that stress-testing for economic shocks is simply a sound business practice.

Joseph J. Hill
President & CEO

Municipal Portfolio Reviews

In this Quarterly Newsletter, we examine the role and types of municipal bonds and bank loans to address the critical infrastructure needs of the nation's state and local governments. We look at the various lending types and how to make credit assessments as part of a strong portfolio risk management program. CEIS Review understands the complexity of the municipal market place and can assist banks to establish effective risk management practices in underwriting and portfolio surveillance.

Inadequate Condition Of the Nation's Infrastructure

The American Society of Civil Engineers publishes an annual "Investment Report Card", which grades and estimates the investment needed to maintain the nation's infrastructure in good repair in 16 categories - - including aviation, drinking water, roads, and transit. As of 2017, the ASCE gave an aggregate grade of "D+" reflecting the significant backlog of needs facing the nation totaling $2.0 trillion on a cumulative basis through 2025.

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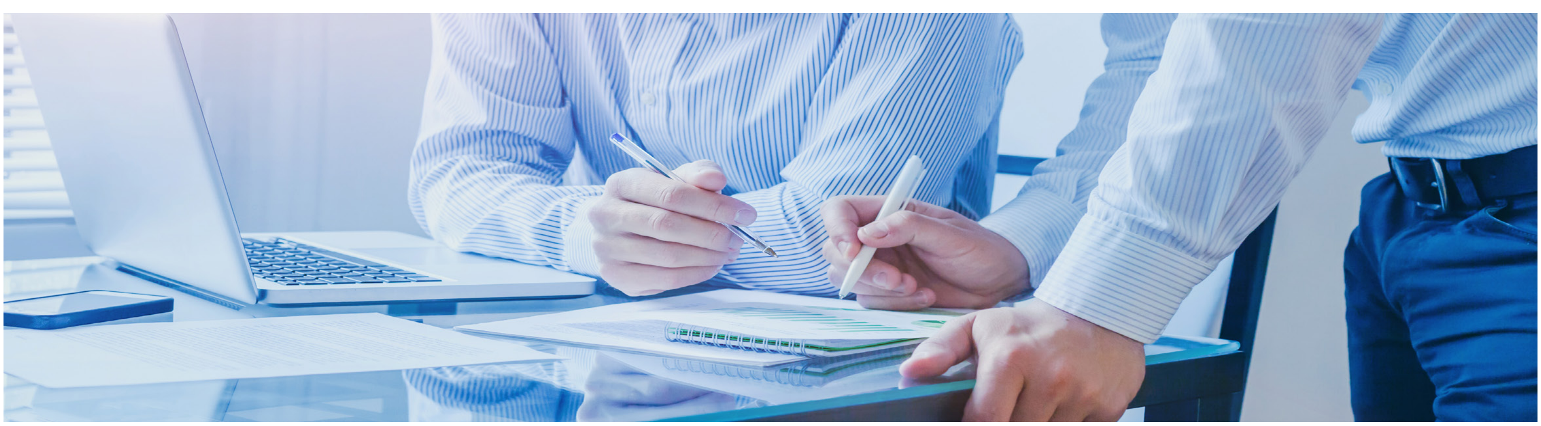
In February 2018, the Trump Administration released an ambitious legislative agenda to rebuild the nation's inadequate infrastructure. It calls for actions that will stimulate at least $1.5 trillion in new investment over a 10-year period. Congress has yet to focus on the plan in a meaningfully way as attention has been diverted away to other pressing matters. However, infrastructure renewal is one area where the Administration and Congress appear to be eager to find common ground.

Municipal Debt Market Funds Most Capital Projects

State and local governments have traditionally funded infrastructure needs through the public capital markets to finance new construction and repair of infrastructure. According to the Municipal Securities Rulemaking Board (MSRB), an average of nearly $435 billion in new municipal securities were issued each year in the last decade.

In recent years, local governments and their agencies are increasingly turning to banks to finance the acquisition of "brick and mortar" facilities and acquire equipment computer systems, vehicles, and energy savings systems. According to the National Federation of Municipal Analysts (NFMA), bank loans comprise about 20% of the municipal market.



Use of banks to finance capital needs has several potential advantages over bonds issued through the public markets. Obtaining bank funding is generally simpler than bonds issued through the public market, execution costs are lower, and ongoing compliance requirements are less burdensome.

Bond Types
Municipal bonds and obligations generally fall into two groups:

1. General Obligations: The "full faith and credit" of the issuer is pledged, usually from ad valorem (property) taxes in the case of local governments.

2. Revenue Bonds: Secured by specific revenue streams such as water and sewer systems (user fees), sales taxes, and airport fees (landing, terminal, and concession fees). Governments also issue lease appropriation debt which is supported by general or specific revenues.

Bank Loans
Bank lending takes many forms and varied names, which generically include direct purchase bonds, direct loans, and bank loans. In a direct purchase transaction, a bank buys a bond directly from the obligor (government). Bank loans are explicit agreements between a bank or other financial institution and a local government entity. Like publicly issued debt, bank loans are secured by general funds and/or dedicated revenue sources as well as collateral in the case of annually appropriated equipment leases.

"Bank loans are explicit agreements between a bank or other financial institution and a local government entity."

Banks also provide liquidity for variable rate debt in the form of Letters of Credit (LOC) and Standby Bond Purchase Agreements (SBPA). In the case of these instruments, the obligor needs to take special caution of triggering events that may accelerate loan repayment and impose high bank holding interest rates and termination fees.

Governments Face Growing Fiscal Stress
Many local governments face significant fiscal stress, often driven by costly pension plans and unrealistic budget assumptions. Some governments (including Detroit, MI; Jefferson County, AL; and San Bernardino, CA) have even filed for bankruptcy under Chapter 9 of the Federal Code, which differs markedly from Chapter 11 applicable to commercial entities. We point out that municipal bankruptcy filings are voluntary and permitted only with authorization under state statute. There are approximately 19 states that specifically authorize municipal filings, 20 that do not allow outright filings, and the remainder of states allowing filing in certain situations.

Despite high profile Chapter 9 filings, note that the overall historical performance of municipal obligations has been strong. Most recently, the average 10-year default rate of municipal bonds rated 'Baa' by Moody's has been significantly lower than that of corporate bonds rated 'Aa' by Moody's over the last 50 years.

“As with that of any loans, municipal creditworthiness, whether a general obligation pledge or revenue backed bonds, depends on the ability and willingness of issuers (obligors) to make timely debt payments based on ive catego-ries:”

Complexity of Municipal Credit Analysis

Municipal debt obligations are governed by the constitutional and statutory requirements unique to each state. Among the nation’s 50 states, there are approximately 90,000 units of municipal and other types of local government entities that differ dramatically in size, complexity, and resources. As with that of any loans, municipal creditworthiness, whether a general obligation pledge or revenue backed bonds, depends on the ability and willingness of issuers (obligors) to make timely debt payments based on five categories:

1. Security and Legal Provisions - Legal constraints can influence what revenue and/or asset sources are available for repayment and may also influence management decisions. The most common include:

-Revenue pledge backing the bonds/loans: General obligations or specific revenue sources;
-Essentiality of financed assets;
-Financing documents;
-Special rate, additional bond issuance, and debt service reserve covenants;
-Legal opinions; and
-Clean audit opinions

2. Demographics and Socio-Economic Characteristics – Municipal revenues are raised by taxes and/or fees on people, businesses and properties. Analyzing an entity’s demographic strength helps assess the revenue and debt service capacity of the ultimate constituents. Factors to look at include:

-Population and/or customer trends;
-Wealth indicators;
-Tax base size and composition
-Employment and unemployment rates;
-Age of infrastructure;
-Largest employers; and
-Industry concentration and susceptibility to economic downturns.

3. Finances – Debt repayment depends on the revenues available and the debt load against such revenue. Revenue is examined before and after payment of expenses. Other fixed charges such as pension and other post-employment benefits (OPEB) obligations that could diminish available funds are factored into the analysis. A basic analysis should include:

-Review of three years of comprehensive annual financial reports in conformance with GAAP;
-Analysis of Government-Wide and General Fund Balance sheet and cash flow analysis;
-Adequacy of budget reserves relative to overall spending requirements;
-Identification of areas of potential budget stress that could impair timely debt service payments;
-Historical financial and budget performance; and
-Management turnover.

4. Debt Profile - Debt affordability and structure are important considerations. Broad categories include:

-Fixed or variable rate debt structure;
-Debt amortization relative to the useful life of the asset being financed;
-Structural weaknesses in transactions, if any;
-Fixed costs including pensions and Other Postemployment Benefits (OPEBs); and
-Debt service coverage levels derived from operating income.

5. Management – Bringing all the above elements together is management. An overall assessment of management capability and its approach to governing is an important part of the review.

Continuing Disclosure

The MSRB is the self-regulatory organization charged by Congress with promoting a fair and efficient municipal securities market and supports municipal market transparency. The MSRB's Electronic Municipal Market Access system (EMMA) is a free website that provides investors with key information about municipal bonds.

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Publicly issued debt through the capital markets comes under the supervision of the Securities and Exchange Commission (SEC). Rule 15c2-12, requires that government issuers provide certain information about the securities on an ongoing basis. However, bank loans generally have no corresponding continuing disclosure guidelines. which has raised questions about transparency in general. The MSRB encourages issuers to voluntarily post information about their bank loan financings to its EMMA website in a timely manner.

Recent GASB Pronouncements

The Governmental Accounting Standards Board (GASB) is the independent, private-sector organization that establishes accounting and financial reporting standards for U.S. state and local governments that follow Generally Accepted Accounting Principles. Pronouncements in recent years of import to credit analysis include:

Statement #85: Published in March 2017, addresses, among other topics, disclosure for pensions and other post employment benefits (OPEB).

Statement #87: Establishes a single approach to accounting for and reporting leases by local and state governments for reporting periods beginning January 1, 2020. It eliminates the requirements to distinguishes between operating leases and capital leases based on the principle that leases are financings of the right to use an underlying asset.

"Many local governments continue to face inancial stress and recent signs of possible economic slowdown will challenge governments to maintain ongoing structural budget balance."

Under the statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources.

Statement #88: Addresses disclosures related to debt, including direct borrowings and direct placements for reporting periods beginning after December 15, 2019. It requires that debt be disclosed in notes to financial statements, including unused lines of credit; assets pledged as collateral for the debt; and terms specified in debt agreements related to significant events of default with finance-related consequences, significant termination events with finance-related consequences, and significant subjective accel-eration clauses.

Final Thoughts

The large and diverse municipal market makes the assessment of the ability of municipal borrowers to make timely debt payments a specialized and complex undertaking. Many local governments continue to face financial stress and recent signs of possible economic slowdown will challenge governments to maintain ongoing structural budget balance. Municipal loan review by the CEIS Review team can assist in helping identify the credit quality of specific municipal loan portfolios as well as provide practical rec-ommendations for improving overall risk management practices.

Sources:

American Society of Civil Engineers (ASCE)
Governmental Accounting Standards Board (GASB)
Government Finance Officers Association (GFOA)
Moody's
Municipal Securities Rulemaking Board (MSRB)
National Federation of Municipal Analysts (NFMA)
National Finance Officers Association (NFMA)
The Bond Buyer, Source Media

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Related Links

- RRA Regulatory Focus: State Utility Regulators Staying the Course
- Dimon Sees Recent Volatility as Harbinger of Things to Come
- Banks Healthy Enough to Absorb Leveraged-Loan Risk: Moody's
- Leveraged Loan Are the Weakest Link in U.S. Credit, UBS Says
- FDIC Issues List of Banks Examined for CRA Compliance
- Midwest Community Banks Post Slowest Relative Q1 Loan Growth Among US Regions
- Agencies Seek Comments on Revisions to the Supplementary Leverage Ratio as Required by Economic Growth, Regulatory Relief, and Consumer Protection Act
- Is A U.S. Recession Likely, Even Imminent?
- Fed Exempts Most Regional Banks from Stress Testing in 2019

Upcoming Events

• RMA New England - FinTech Banking Risks	Boston, MA - May
• IBANY's Lending Conference	Watkins Glen, NY - May
• NJ Bankers Commercial Real Estate	Edison, NJ - May
• Florida Banker Association's 131st Annual Meeting	Orlando, FL - June
• 129th Tennessee Bankers Association Annual Meeting	Orlando, FL- June
• 122nd Long Island Bankers Division Golf Outing and Dinner	Bay Shore, NY - June
• IIB Annual Membership Luncheon and General Meeting	New York, NY - June
• NJ Bankers Women in Banking Conference	Somerset, NJ - June
• North Carolina Bankers 123rd Annual Convention	Lake Oconee, GA - June

About CEIS Review

CEIS Review, Inc. is an independently owned financial consulting firm established in 1989 to serve the needs of lending institutions with commercial portfolio related services.

CEIS' mission is to assist institutions to better manage their commercial portfolios, thus avoiding regulatory hardships and enabling profitability. If you'd like to learn more, please contact Justin Hill at (888) 967-7380 or justinjh@ceisreview.com.

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