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Community Banks as Guides to Local Government: Help Avoid the Hippos

They say 40% of all statistics are wrong. Given current conditions, this funny phrase expresses about the same level of certainty enjoyed in credit markets these days.

It is not so funny when we consider the outcome of reliance placed on market experts who devised and engineered debt instruments intended to leverage so-called market efficiencies. The recent municipal bond auction failures, mono-line insurer downgrades, bid-rigging in municipal derivatives and the underlying sub prime mess reminds of another kind of adventure that suggests simpler solutions.

I have a friend who makes his living as a rafting guide on the Colorado River. During the off season he occasionally takes a busman's holiday to guide raft floats in Africa. He was describing his first guide job on the Blue Nile in the border region between Sudan and Ethiopia. This, he tells, is an unimaginably beautiful part of the earth with wonderful scenery and wildlife galore. In fact, while afloat, it is nearly impossible not to encounter the ubiquitous hippopotamus which loiters just beneath the surface as close to the middle of the stream as possible, and therefore is in perfect position to gape its enormous mouth and teeth to munch oncoming rafts. The circumstance would suggest that the safe path is to paddle along between the occupied middle and the shore line. A problem though is that when startled (as it is for most hippos when approached by a boat full of frolicking invaders), the two-ton, thirty MPH ruminant on shore desires the middle as quickly as possible and does not yield to oncoming traffic. The first time my friend found himself in such a predicament, with a hippo pod on the left shore, his reaction was to call for a portage requiring a large expenditure of time and effort. Fortunately a local guide who had been on hand to assist on the inaugural trip simply advised a route down the other side. Disaster averted; not so complicated after all.

Sometimes a simple word of advice goes a long way. This is true as well for local governments or municipalities which are infrequent issuers of debt. Most administrators and elected officials could not be accused of being municipal bond financing experts but they do the best they can. The closest person to meeting the description of "financing expert" in any community is found sitting within the walls of its community bank. That person however is rarely involved in assisting with the process.

The reason most community banks don't involve themselves in municipal financing is not because of a lack of desire to help their local public bodies; rather, it is that they have no place on their own books to accommodate a large, long-term, fixed-rate loan. Additionally, it's often the case that transactions are not pursued because they come about infrequently and sometimes require special knowledge and skill not normally found in the bank.

A logical answer to these concerns is for the bank to partner with a trusted investment bank that can bring required expertise to the table and help manage distribution of a financing through public offering. At the same time the bank can help manage the relationship based on its experience, knowledge and willingness to help guide its community.

Unless this local talent is tapped, it is often the case that more reliance is placed on outside advisors whose main concern may be to get the deal done in a market that best suits them rather than the issuer. This arrangement frequently manifests itself in unnecessarily complex transactions that can be beyond the experience and understanding of local government officials. No doubt, this is the source of some of our current trouble in the credit markets. A rigorous study of current market conditions is not necessary to realize that financial engineering by the “smartest guys in the room” has actually produced in some cases a riskier situation than anyone could have guessed. It is sure that fallout from the prior excesses will be painful for a while. But, as with past disruptions, markets will correct themselves over time. In the meanwhile we should pause to reflect and hopefully learn from the experience.

When community needs and challenges arise, as they will, it can be most helpful to have the assistance of someone who is knowledgeable and who possesses a bit of skill and experience in gauging financial transactions. But above all, a conservative approach which is the stock-in-trade of the community banker, can keep everyone out of the deep water.

Consider helping your community keep an eye down stream.

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