MUNICIPAL LENDING

The Howard Bank, NA

PARTICIPANT PROFILES

Howard Bank is a national bank in Burlington, Vermont. The Bank has approximately $688 million in total assets and is a dominant regional institution with 13 branch offices in 4 counties. Its business is a mix of commercial, real estate and personal loans. At the end of 1997, the Bank had $482 million in loans with deposits totaling $531 million. Nearly 70 percent of the loan portfolio is commercial, while 65 percent of its deposits are retail. The Bank also has an active consumer, installment and credit card operation.

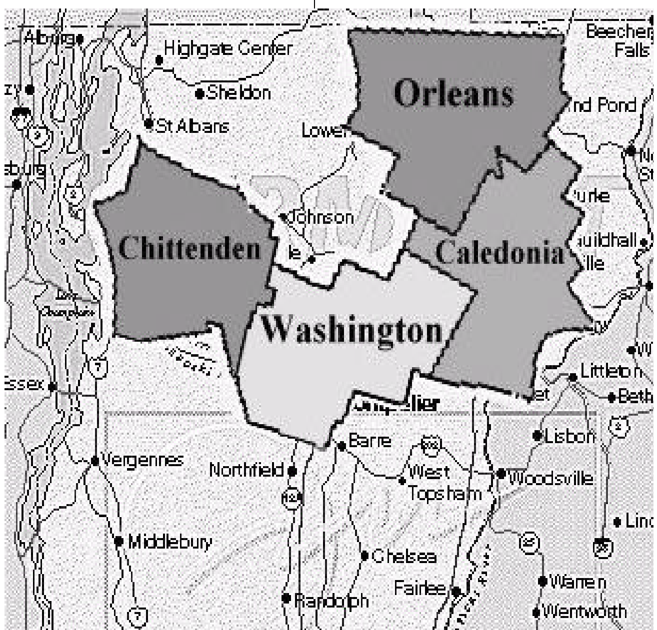
Howard Bank is heavily involved in equity investments in community development corporations ("CDC") in Vermont. These investments have provided funding for various housing and economic development initiatives. In 1989, the Bank received special approval from the OCC to invest in limited equity partnerships with CDCs. At that time, Howard Bank was the only national bank to request and receive approval for this type of investment.

In recent years, Howard Bank has directed its efforts toward municipal and community reinvestment lending. The Bank's municipal lending programs are the subject of the Best Practices focus of this paper. Howard Bank's unique lending programs have been successful for the Bank while providing its communities with an important partner for community development initiatives. Howard Bank has developed a solid reputation in its local markets as an innovative partner in strengthening communities through creative, yet sound lending practices.

COMMUNITY BACKGROUND

The state of Vermont is largely rural, with a total population of 585,000 in 1995.[1] The state is nationally known for its fall foliage and winter skiing, making tourism very important to the state's economy. Howard Bank serves two distinct markets, the urban market consisting of Chittenden County and the more rural market consisting of Washington, Orleans and Caledonia counties. All four counties are in the northern and central parts of the state.

Chittenden County has Vermont's greatest population density and includes the state's largest city, Burlington. In 1995 the population of the county was 139,000, 24 percent of the state's total population.[2] Chittenden County also is the most important economic center in Vermont. In 1995, its median household income was $36,877, while the unemployment rate was only 3 percent.[3] Major sources of employment include an IBM microchip manufacturing plant, a large regional health care provider, four small colleges and the University of Vermont. A strong presence of sales and service related companies, as well as financial service providers rounds out the Chittenden County economy.



Washington, Orleans, and Caledonia counties each have much smaller populations and are more rural than Chittenden County. In 1995, these counties had a combined population of about 109,000 and the median household income was $25,807. Employment is slightly higher and housing prices slightly lower than Chittenden County. Local agricultural and logging activities are the chief employers in the area.

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[1] Vermont Population Projections: 1990-2015, Vermont Health Care Authority, Center for Rural Studies, June 1993.
[2] Vermont Population Projections: 1990-2015, Vermont Health Care Authority, Center for Rural Studies, June 1993.
[3] Vermont Department of Economic Development.

Community Needs

The development and viability of the rural towns and villages are dependent upon access to affordable financing. The financial institutions in Vermont provide credit to fund a significant portion of the current expenses incurred and improvements made by these municipalities.

The municipalities need both short-term and long-term financing. Capital improvements such as construction of schools and the purchase of equipment like fire engines and police cars are generally financed with long-term credit. Short-term needs are generally caused by the mismatch between cash collections and expenditures. For example, taxes may be collected on a semiannual basis, while expenses are incurred daily. Credit to even out these cash flow problems is essential to meet municipalities' needs.

Howard Bank has been extending credit to municipalities, which for purposes of this paper is defined to include school districts, towns and other political subdivisions, for over 15 years. From a small beginning, Howard Bank has responded to demand and opportunity by expanding its municipal banking operation, adding a broad array of credit products and banking services. Howard Bank is now a key player in the small community municipal lending arena.

Howard Bank believes that municipal finance not only meets its profit objectives, but also represents a growing niche market. As the federal government transfers greater economic decision making powers to local jurisdictions, municipal needs are growing and diversifying. Howard Bank's senior management believes that municipalities will continue to need new products and services and that banking relationships with municipalities will continue to comprise a significant portion of their business for the foreseeable future.

BEST PRACTICE PROGRAM OR PRODUCT

In 1994, Howard Bank created a separate municipal lending department that focused on developing specific products and services to meet the needs of this market. The Bank recognized five important benefits from the development of a strong municipal lending presence in rural Vermont: (i) municipal investments were part of its commitment to community development; (ii) municipal lending could be incorporated into its CRA portfolio; (iii) providing municipal banking services was a profitable business; (iv) municipal loans represented relatively low-risk investments; and (iv) municipal lending created an opportunity to cross sell other deposit and cash management services.

Most municipal loans are relatively low risk. In Vermont, typically municipal loans are the "general obligation" of Vermont towns, villages, town school districts, and union school districts. As such, they are backed by the full faith and credit of the municipality. Furthermore, in Vermont, the municipality has the power and authority to raise taxes to meet its financial obligations, and is required to do so by law. 24 V.S.A. §§ 1751, 1898.

Another important benefit of municipal lending is its potential tax benefits to a financial institution. In general, municipalities issue tax-exempt notes for various financing purposes. Interest income from the notes is typically tax-exempt. In addition, Howard Bank is allowed to deduct 80 percent of the interest expense associated with funding these assets if the transaction meets the requirements of the IRS Code. In order for the Bank to qualify for this treatment under the Tax Code the borrowing municipality must meet certain criteria that includes, most importantly, not issuing more than $10 million in qualifying debt in a calendar year.

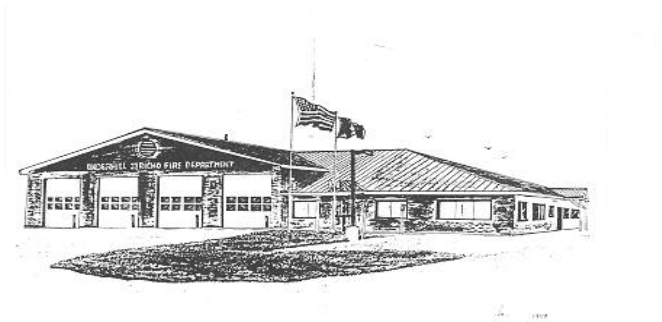
All municipalities have ongoing funding needs that include managing cash flow, balancing the fiscal budget, purchasing new equipment, and financing improvements in infrastructure. Typically, the following financial instruments are used to provide short-term financing:

- *Tax Anticipation Notes*: issued in anticipation of tax revenues to be received during the fiscal year.
- *Bond Anticipation Notes*: issued in anticipation of the sale of municipal bonds.

- *Grant Anticipation Notes*: issued for projects to be paid for by federal or state funds.
- *Capital Improvement Notes*: issued to finance construction projects and equipment or vehicle purchases.
- *Highway Equipment Notes*: issued to finance the purchase of highway equipment.
- *Current Expense Notes*: issued to finance other legal borrowings not covered by other products (e.g. school district financing).

Tax Anticipation Notes are some of the most popular financing instruments for municipalities because there are no monthly payments. Municipalities may draw against the loan as needed, while the bank provides the account management services. The terms for these loans are principal and interest due at maturity. According to Howard Bank management, municipal loans generally should be priced to achieve at least a 1.5 percent pre-tax spread. Howard Bank's current terms are less than 1 year at 4.5 percent.

Municipal Equipment Notes are another attractive form of municipal lending. This type of financing is essential to small communities whose budget cannot meet unexpected equipment needs or emergencies. For example, in 1996, the Bank lent $55,000 under a Highway Equipment note to the Town of Bolton to purchase a 1996 dump truck for snow removal and other municipal purposes. The loan was for one year, with a five-year amortization. The pricing was competitively bid at 4.3 percent and an annual rate adjustment with each renewal. Bolton town officials expect to retire the debt prior to full amortization.



The above rendition of the Underhill-Jericho Fire Station, located in Chittenden County, VT was financed by the Howard Bank. The total cost of the municipal construction loan was $500,000.

Municipal Equipment Notes are usually financed with a five-year adjustable rate product whose rate is tied either to the Federal Home Loan Bank index, the LIBOR, or the prime rate. Monthly payments or other terms are set up at the customer's request and for their convenience only.

In addition to designing new products, municipal lending requires the establishment of special underwriting criteria. Underwriting guidelines for municipal loans are not as complex as some other forms of commercial debt primarily because most of these loans are short-term notes that are made in anticipation of annual municipal funding and collected on or prior to the note maturity date, making them essentially self-liquidating. The vast majority of municipal loans underwritten by the Bank have a maturity of one year or less. The reduced risk associated with these loans as a result of Sections 1751 and 1898 of the Vermont statutes, which grant municipalities the right to raise taxes in order to satisfy general obligations, as well as the short term length have allowed Howard Bank to set up flexible underwriting criteria for its municipal customers.

In recent years, municipal treasurers have become much more knowledgeable about investing and maximizing the return on the investment of taxpayer dollars. To attract these investment dollars Howard Bank has designed specialized depository products to meet the asset protection and investment needs of municipalities. One such product is their Deposit Collateralized Protection Program. Under this program municipalities may elect to secure additional insurance on deposits not covered by the $100,000 FDIC guarantee. The Bank provides the additional deposit insurance through a third party insurer, Municipal Bond Investment Assurance Corporation ("MBIA").

MBIA was selected on the basis that the company would provide Howard Bank additional insurance coverage for up to $12 million in total municipal deposits. MBIA charges the Bank nominal rates, generally between ¼ to ½ of 1 basis point, for the coverage. The cost of this additional insurance is passed on to the municipalities that receive the coverage. This program is an innovative way to protect public funds by purchasing additional insurance while still serving Howard Bank's interest in managing large municipal deposits.

The Bank also offers "sweep accounts" on demand deposits that provide additional income to the municipality when the accounts are swept and the excess is invested in overnight instruments. Through this program, Howard Bank is able to offer high returns on deposits at minimum risk. By automatically "sweeping" and investing overnight checking account balances, the Bank may make temporary purchases of government or government agency securities on behalf of the municipality. Then the bank agrees to repurchase the securities, usually the very next day. This product provides the depositor with the liquidity and return it needs and wants, as well as the collateral protection necessary to safeguard public funds. This product has been very attractive to Howard Bank's municipal customers.

EXPERIENCES AND OBSTACLES

The relatively small communities and limited resources make municipal lending a challenge in Vermont. Historically, Vermont banks have made deposit services complimentary for their local municipal customers in exchange for large non-interest bearing balances. However, over the last decade, Vermont municipalities have experienced an increased awareness of how to invest excess cash to maximize interest potential. Municipal treasurers also have become more cognizant of the financial strength of insured depositories.

Various municipal organizations have attempted to educate their members about banking relationships and tried to provide recommendations for prudent management of the public funds. These efforts have increased the level of municipality expertise in these areas, which has in turn presented new opportunities for Vermont banks. The Howard Bank has worked with dozens of community leaders to meet the new needs of the municipalities.

Despite the progress made by the various municipal organizations, there still appears to be a significant opportunity for educating those responsible for municipal funds on the various banking services available to them. The Howard Bank has expended significant resources assisting local governments with the wide variety of financial services that can be helpful in managing their cash flow. For instance, in the past year, Howard Bank has successfully introduced lockbox and automated clearinghouse services to several municipalities that had not known about these services. Howard Bank has found that a strong cash management product line builds a solid banking relationship with its municipal customers.

The Bank established its municipal lending department as a self-funding operation from the outset, without funding a separate department budget, to give staff the incentive to make the department self supporting from the beginning. This self funding goal was accomplished through lending and cross-selling bank products to the municipal customers. The newly created department was generating significant revenues for the Bank by the end of its first year of operation.

Howard Bank also markets its municipal products extensively. Representatives from the Bank attend a variety of municipal functions and maintain exhibits at area trade shows. These activities have helped increase the Bank's visibility and demonstrate its commitment to the market.

CURRENT STATUS

In 1994, its first full year of municipal lending, Howard Bank made 59 loans totaling $9 million. The development of additional products and services has allowed the Bank to expand their municipal business by 368 percent over the last 3 years.

PARTNERSHIPS

Howard Bank has assisted many cities, towns, and villages, as well as various school districts and other municipal entities with their financial needs. Additionally, the Bank has partnered with organizations, such as MBIA to provide a full line of services to its depositors.

Additional Information Contacts

The Howard Bank, NA
Municipal Lending
111 Main Street, P.O. Box 409
Burlington, Vermont 05402
Contact: Ms. Amy Towle-Mailloux
Vice President
Phone: (802) 860-5541
Fax: (802) 860-5542
e-mail: howardbnk@aol.com

Additional Resources

Center for Rural Studies
207 Morrill Hall
University of Vermont
Burlington, Vermont 05405
Phone: (802) 656-3021
http://crs.uvm.edu/

Department of Housing and Community Development
State of Vermont
National Life Building
Drawer 20
Montpelier, Vermont 05620-0501
http://www.state.vt.us/dca/housing