

Current Issues in the Municipal Auction Rate Market

Municipal Auction Rate Securities (ARS) have recently experienced tremendous liquidity strains. Strong, well known municipal issuers with auction securities have seen their rates increase by hundreds of basis points even if their auctions did not fail. These issuers are not in default, but are caught in a liquidity crisis. ARS are estimated to comprise half of the \$300+ billion total auction market and approximately 8% of the \$2.5 trillion of outstanding municipal bonds.

We have not advocated purchase of ARS for Samson's clients. We have instead focused on Variable Rate Demand Notes (VRDNs) which contain "hard puts" that provide liquidity on one or seven day notice. These puts are also supported by credit facilities from banks to ensure liquidity.

In the present market environment, for those clients who would consider using ARS as a tactical investment, we would consider making such an allocation. Nonetheless, given the uncertainty of the timing regarding the resolution of this liquidity crisis, such allocations should remain modest.

In this commentary, specific issues relating to the current auction market are addressed.

Auction Rate Securities

ARS provided an alternative financing mechanism for issuers who desired floating rate exposure in their capital structure without employing bank liquidity facilities. Most municipal issuers' securities were wrapped with bond insurance, and the recent credit rating downgrades of some of the monoline insurers is the primary reason for this current liquidity crunch. Issuers were also persuaded by the fact that there were no expiration dates for liquidity facilities, effectively eliminating credit facility renewal risk. Because the minimum purchase for ARS is much lower than that of VRDNs, the issuers accessed a direct, retail market.

ARS do not contain a hard put for liquidity but rely on a Dutch Auction process that typically takes place every 7, 28 or 35 days, depending upon the structure selected by the issuer. Upon each auction date, holders wishing to sell their securities submit their request to the auction agent who then attempts to find a market clearing rate at which all buying interest is met. If buying interest is insufficient for the amount of holders desiring to liquidate and the remarketing agent chooses not to purchase the securities using their own balance sheet, then the coupon rate is set to a "fail rate" (usually the "max rate" set by the bond indenture) and the holders cannot liquidate. This event is referred to as a failed auction. Until last week this was a very rare event, which historically only occurred as a result of credit-specific problems; however, in the past week, there have been hundreds of failed auctions.

ARS are not eligible investments for US money market funds, because the auction process does not provide a liquidation guarantee – a key determinant of eligibility for funds viewed as the safest in the industry.

Below are some questions and issues in the current auction rate market:

Can an issuer change modes?

Most issuers will structure their documents to allow for different rate periods, including auction, daily, weekly, long term or fixed rate mode. We have heard that many issuers currently in auction mode - those who are experiencing either high rates or failed auctions - are looking for ways to change those modes into ones that are more stable. If an insured issue is in auction mode, it would likely need to obtain a standby bond purchase

agreement from a bank to provide liquidity, or alternatively, would need to get a bank letter of credit to wrap the insurer. Problems in this area include:

- Availability and cost of the line or letter of credit;
- Existing bank exposure to both the insurer and the underlying credit;
- Unless the bond insurer is in default under the bond insurance policy (which they are currently not), they have approval and consent power over any changes. It is quite likely that the bond insurers would not want to cede control to another institution, which could make changes difficult.

How do tax laws about refunding and reissuance affect this market?

If an issuer is paying a very high rate on an auction rate bond, and wants to change modes or refinance, it is an extremely detail-oriented process. There are technical Treasury regulations and laws that must be adhered to in order to avoid taxability, arbitrage rebate or other penalties. On February 4, the National Association of Bond Lawyers sent a letter to the Department of the Treasury requesting guidance on “a specific, narrow issue that is affecting many issuers of tax exempt bonds”. They want guidance on:

- Providing relief for converting to a long term mode where there are not significant modifications to bond documents (changes in the source of payment could constitute a refunding), and
- Providing relief for changes in credit enhancement (this would apply, for example, if an issuer had XLCA and wanted to change to FSA without it counting as a refunding).

It is our understanding that the IRS is looking into these issues, as well as other proposals to clarify the rules, in order to potentially enable qualified issuers to refund or reissue without penalties. If they can change the relevant IRS notices it can happen quickly, but of course if it requires actual legislation, that will certainly prolong the process.

What about embedded swaps?

Issuers with auction mode securities often entered into embedded interest rate swaps in order to “fix” their longer-term debt service costs. Ordinarily these swaps involve paying long-term fixed rates and receiving short-term floating rates, where the floating rate payments typically offset their auction rate payments and they are left with simply the long-term fixed payments. Unfortunately, in today’s environment those auction payments likely far exceed the floating rate payments they may be receiving on interest rate swaps. Unwinding those swaps could cause termination payments to be made, which the issuer might be unwilling to do.

How do differences in documents affect the market?

Documents vary across programs. Reasons include:

- Different issuers, bankers, bond counsel, insurer, and age of deal;
- Maximum rates can be an absolute number (such as 12% or 15%) or a percent of an index;
- There can be differences in the time period (30 days, 60 days, etc) that an issuer needs to advise the market when there is a mode change.

These differences make for a more complicated and time intensive auction market.

Possible Outcomes

Until recently, ARS were widely viewed as a ready alternative to money market funds and other bona-fide short-term instruments. The perception of cash equivalency requires both high credit quality and essentially inviolable

liquidity, and while the credit quality of the underlying instruments remains generally very high, the belief in ARS liquidity has been significantly changed. For this reason the ARS market may be redefined, both in terms of relative pricing (we'll venture a guess that it should be cheaper than in the past) and the investment objectives of its holders. The hardest questions to answer are 1) what will be the outcome for the monoline insurers, 2) how long does it take to redefine a \$300+ billion market, 3) who will be the new participants, and 4) will the pricing levels set by the new participants still provide an attractive financing alternative to issuers?

It is possible that regulators and politicians will become more directly involved in the near-term, given the current high debt service costs and the potential adverse implications for issuers including hospitals, colleges, toll roads, and state and local governments.. We expect more transparency in the near-term, which should aid liquidity, although larger scale intervention is plausible.

Given the breadth of this market we believe that there will be a regulatory, political or market solution, or combination thereof, in an expedited time. The very high rates on failed auctions are a tactical opportunity for investors if:

- There is a strong underlying credit for a well known issuer.
- The investor understands that these are not liquidity substitutes, and there is a possibility that they may own the security for a long time.
- The investor is compensated for the 'illiquidity' of these instruments in the present market environment.

We will continue to monitor developments in the Auction Rate Securities market and look forward to providing updates on how investors and issuers will be affected.

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