BONDS GONE WILD

by Joy A. Howard

***Editor's Note:** Article written on January 22, 2009. The market continues to change rapidly.*

The financial turmoil that began with subprime mortgage defaults is also affecting municipal borrowing. Recent changes include: fewer institutional buyers, loss of triple-A rated bond insurers, and weakening issuer credit. The credit crunch is making it difficult for some local governments to obtain borrowed funds. The difference in yields between non-rated municipal securities and rated securities is now historically high. Local governments may be left with a choice to either delay a financing (although there is no assurance that the market will improve in the foreseeable future) or pay interest at higher rates than originally budgeted. This article is intended to help political subdivisions understand the recent financial turmoil as it relates to the sale of municipal bonds and lease obligations, and outlines actions that can be taken to improve access to the capital markets.

Bond Insurance

Prior to 2008, more than half of all bonds were insured by triple-A rated bond insurers. To boost profits, the bond insurers insured collateralized debt obligations (CDOs) and other obligations that used subprime mortgage loans as collateral. In 2007, there were seven bond insurers that had triple-A ratings from all three major rating agencies (Moody's, Standard & Poor's, and Fitch Ratings). As a result of CDO write-downs, by July 2008 five of the seven insurers were downgraded. In November 2008, the remaining two (Assured Guaranty Corp. and Financial Security Assurance) were downgraded principally due to a loss of confidence in bond insurers that has eroded their business.

Many issues that previously would have been insured must now be

marketed with low credit ratings or as unrated securities. Without insurance, lower rated issuers will have to pay higher interest costs.

Auction Rate Securities

In February 2008, the $330 billion auction rate securities (ARS) market collapsed. Auction rate securities are long-term bonds that have the rates reset through auctions every one to 35 days. Since the rates on ARS were based on short-term rates, issuers expected to obtain lower borrowing rates. Investors thought they were buying something equivalent to highly liquid money-market funds. Investor demand diminished when the bond insurers, that backed the securities, began getting rating downgrades. Underwriters that were already suffering from their own capital write-downs and liquidity issues were unable or unwilling to participate in the auctions which would have forced them to purchase the ARS that didn't sell. When an auction failed, the rate was set according to the ARS' documents which, for some issuers, resulted in rates as high as 20 percent and as low as 0 percent. Issuers suffered from unexpectedly high interest costs and investors were left holding securities they could not sell.

Investors unable to liquidate their holdings, filed regulatory complaints and lawsuits that have resulted in a massive buy back of the securities and the assessment of over $500 million in fines against major banks and securities firms thereby reducing capital for the purchase of other tax-exempt securities.

Credit Concerns

The subprime crisis has drawn great attention to credit quality. In 2007, investors began losing interest in purchasing all but the highest rated bonds. Just as banks only want to lend to individuals and corporations with the highest credit ratings, institutional investors (mutual funds, insurance companies, and banks) are now avoiding insured bonds and tax-exempt securities rated less than double-A. As a result, only individual investors remain as significant buyers of lower credit quality and non-rated bonds.

Credit concerns are mounting as attention is now turning to the impact that a declining economy will have on municipal credit. The decline in new housing construction, decline in housing values and reduced consumer spending means less property taxes, sales taxes, and building permit fees. While general obligation bonds are insulated from economic downturns, annual appropriation financings (lease obligations) and special purpose obligations (such as tax-increment financing, community improvement district, and transportation development district bonds) are at a substantially higher risk of default during an economic downturn.

As a result of evolving credit concerns, the spread between high rated bonds and lower rated bonds (credit spread) has increased to historically high levels. In addition, the sale of lease obligations and special purpose obligations is becoming difficult.

Timeline

The following is a timeline of events that have specifically affected the sale of municipal securities:

1987-2007 – Mortgages are bundled into new securities called collateralized debt obligations (CDOs) by Drexel Burnham Lambert in 1987 and over two decades gain in popularity and volume. During this time another financial product, the municipal derivative, is also developed. A derivative is an unregulated contract tied to the value of a securities index or interest rates. Derivatives produce fees that are often 10 times higher than the underwriting fees for traditional fixed rate municipal bonds.

February 2007 – New home sales fall sharply; a 20.1 percent decline from the prior year.

February 2007 – Assets underlying CDOs begin to default.

May 2007 – New Century Financial, the largest subprime mortgage company, declares bankruptcy and other subprime mortgage lenders file for bankruptcy throughout the year.

November 2007 – Bond insurers that insured CDOs begin taking losses due to default exposure.

February 2008 – Several triple-A bond insurers have their ratings downgraded or are placed on review for downgrades.

February 2008 – The $330 billion auction rate securities market collapses.

March 2008 – Financially troubled Bear Stearns is acquired by JP Morgan. (In 2007, Bear Stearns ranked 3rd by dollar volume of municipal bond issues completed.)

April 2008 - Jefferson County, Alabama, declares that it is on the verge of bankruptcy and that $3.2 billion of sewer debt may go into default. The crisis evolved following the collapse of auction rate securities and the use of interest rate swaps which required the County to post $184 million of collateral.

May 2008 – Vallejo, California, with a population of approximately 117,000 and $200 million of outstanding debt, files for bankruptcy as a result of rising operating expenses and declining housing construction.

May 2008 – UBS AG discontinues public finance operations. (In 2007, UBS AG ranked 4th by dollar volume of municipal bond issues completed.)

July 2008 – Five of the seven triple-A rated bond insurers are downgraded due to deteriorating mortgage backed securities. The remaining two, Assured Guaranty Corp. and Financial Security Assurance, are placed on negative watch by Moody's.

September 2008 – Five Wisconsin school districts report losses of $150 million in connection with derivative investments and file a lawsuit against the bank and investment bank that arranged the transaction. The losses evolved from a 2006 post employment benefit fund program whereby the schools invested $35 million of their own funds and $165 million of borrowed funds in synthetic collateralized debt obligations. In addition, other municipal derivative programs, including interest rate swaps, are resulting in substantial costs to other issuers throughout the country.

September 2008 – By mid-September, as a result of regulatory investigations and lawsuits, more than a dozen banks and investment banks agree to redeem in excess of $65 billion of auction rate securities and pay more than $500 million in fines.

September 2008 – Securitized investment holdings, rating downgrades, and mortgage loan defaults lead to major financial institution bankruptcies, liquidations, and takeovers. American International Group (AIG), which ranked among the top five tax-exempt investors in 2007, files for bankruptcy and is rescued by the federal reserve. Lehman Brothers files for bankruptcy and the brokerage portion of its business is acquired by Barclays, Wachovia is bought by Wells Fargo, and Bank of America agrees to acquire Merrill Lynch. (Lehman Brothers, Wachovia, and Merrill Lynch each ranked among the top ten municipal bond underwriters in 2007.)

September 2008 – There is a run on money market funds that causes the funds to "break the buck." (Breaking the buck means that a $1.00 investment returns less than $1.00 upon withdrawal from the fund.) Money market funds liquidate holdings to increase cash for payouts. This includes tax-exempt money market funds which liquidate municipal bond holdings. The liquidation floods the market with municipal bonds and pushes yields on municipal bonds higher. To stabilize both taxable and tax-exempt money market funds, the government implements a temporary money market fund guarantee. The guarantee covers funds on deposit as of the close of business on September 19, 2008.

October 2008 – Firms that agreed to settlements on auction rate securities begin to buy back the securities from investors.

October 2008 – Beginning in mid-September, the bond market comes to a virtual halt. Few institutions have an interest in buying municipal bonds, some issuers postpone sales due to higher than expected borrowing rates, and some securities firms are unwilling to take underwriting risks and convince issuers to postpone sales.

November 2008 – Assured Guaranty Corp. announces plans to acquire Financial Security Assurance.

November 2008 –Moody's downgrades the ratings of Financial Security Assurance and Assured Guaranty Corp. Consequently, there are no longer any insurers rated triple-A by all three major rating agencies (Moody's Investors Service, Standard & Poor's, and Fitch Ratings).

December 2008 – Double-A general obligation bonds have yields as much as two times higher than yields on comparable maturities of treasury bonds.

January 2009 – Citigroup announces plans to merge its brokerage unit, Smith Barney, with Morgan Stanley's brokerage unit and to split into two operating firms. (Citigroup, which ranked 1st among municipal bond underwriters in 2008, reports that the proposed changes will not affect its municipal securities division.)

Present – Highly rated municipal bonds are selling at record high yields compared to treasury bonds (yields on double-A rated municipal bonds are as high 150 percent of treasury yields, while prior to 2008 yields were less than 90 percent of treasury yields). A "credit spread crisis" is evolving in which bonds rated lower than A rated bonds and unrated securities are selling with record high yields compared to bonds with higher credit ratings.☐

The Market Is Evolving

The credit crisis is continuing to evolve. Some events may have a positive impact on municipal bonds including the following:

Higher tax rates: If President Obama raises tax rates for the highest income tax brackets, as proposed, the demand for tax-exempt securities should increase.

Enticing municipal bond yields: The yields on treasury bonds are at historically low levels which may make the significantly higher yields on municipal bonds enticing and increase demand.

On a less positive note, several evolving events may put further pressure on the municipal market which could result in higher yields over an extended period of time and a loss of demand for lower rated and unrated municipal securities. These events are described below:

Increased bond defaults and bankruptcies: If there is a series of municipal bankruptcies or defaults there will be a loss of confidence in the bond market. The speculative financing that led to the demise of Jefferson County, Alabama, the budgetary constraints of Vallejo, California, and the $150 million derivative losses by five Wisconsin School Districts may be the tip of the iceberg. In Missouri, for example, from January 2007 to January 2009, several housing related issues had payment delinquencies and seven issues (three tax increment revenue bond issues and four transportation development district bond issues) had unscheduled draws on debt service reserves. If the economy continues to deteriorate, these issues could ultimately default.

Fewer investors: Mergers and bankruptcies are reducing the number of institutional investors thereby reducing demand and pushing yields on tax-exempt securities higher.

Less demand for "tax-free" income: As a result of financial losses by Wall Street and main-street, fewer investors need tax-free income. Consequently, the yields on municipal bonds must remain higher than treasury bonds in order to entice investors to invest in the less secure municipal bonds.

Increased treasury borrowing: Although treasury yields are presently at historically low levels, increased borrowing by the treasury to fund the $700 billion Troubled Asset Relief Program (TARP) and other government initiatives intended to restore the health of the economy may push the yields on both treasury and municipal bonds higher.

Settlements of auction rate securities: Settlements of auction rate securities will put money back into the hands of investors while taking funds from the banks and investment banks that are making settlements. At this time, it is unclear whether the settlement funds will be reinvested in tax-exempt bonds or will place additional capital constraints on the banks making settlements thereby further reducing the pool of institutional buyers. Lawsuits are still pending against several firms and it is unclear what the outcome will be of the lawsuits or the impact on the market.

What This Means To You

With the passage of time, the current cycle of credit concerns should dissipate and the market for bonds and lease obligations should improve. However, due to the intense disruption of the economy there is no assurance that the municipal market will return to "normal" anytime soon and it is possible that the market may never return to its prior condition.

In recent months, the yields on municipal securities rose at the same time that yields on treasury bonds were declining. Although municipal bond yields declined from December 2008 until mid January 2009, the decrease has not kept pace with treasury bonds. If this trend continues all municipal issuers will pay proportionately higher interest costs than in the past.

The demand for lower rated and unrated securities has declined and this trend is likely to continue for some time. The market for lease obligations has contracted significantly. If this trend continues, the market for unrated lease obligations may disappear.

What You Can Do

1. Take actions to maintain or improve your rating including the following:

- Prepare comprehensive annual financial reports.
- Establish a formal reserve policy.
- Take budgetary actions to maintain reserves consistent with the reserve policy.
- Establish a formal capital plan.
- Establish an investment policy.
- Engage a financial advisor to identify areas of credit weakness that will be identified by rating agencies and mitigate these factors if possible.

2. Do not delay your financing if the funds are needed. It may be years before the market returns to "normal." Work with an independent financial advisor to help you locate an underwriter or bank willing to complete your transaction. Be prepared to terminate the underwriter if the firm is unwilling to proceed with your financing.

3. Engage an independent financial advisor that can provide objective advice regarding the best approach to raising capital.

4. Educate yourself. Beware of bankers or underwriters that recommend newfangled financing. While some financial innovations may have fabulous results, be skeptical when you hear the following phrases describing a financing: first of its kind, below market rates, borrow to make money, or derivative.

5. Thinking about issuing lease obligations? Consider issuing general obligation bonds. General obligation bonds are insulated from economic downturns and will get sold. Although there is a possibility that general obligation bonds will not obtain the required voter approval, lease obligations are not a viable alternative if they can't be sold. While there continues to be a market for many issuers' lease obligations, careful consideration should be given to the added costs associated with this form of financing.☐

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