

# Innovative Bond Finance in a Credit Crisis

Sources and Status of the Finance  
and Credit Crisis and the Outlook for  
Emerging from the Crisis

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# The Municipal Finance 2008 Year in Review \*

- January - Bond Insurers show initial signs of distress due to increased loss provisions on mortgage-backed transactions and net mark-to-market losses on credit derivatives
  - 1/8 New entrant, Berkshire Hathaway insures its 1<sup>st</sup> bonds, NYC GO's
  - 1/14 S&P suspends ratings for ACA Financial Guaranty Corp
  - 1/18 Fitch downgrades AMBAC from AAA to AA

Sources: The events are derived from the Bond Buyer. The monthly captions were provided principally by Curtis Harris, a Director of Merrill Lynch

# The Municipal Finance 2008 Year in Review (cont)

- February - Short Term Market Troubles
  - 2/15 Auction Rate Securities (“ARS”) market begins to fail triggering penalty interest rates
  - 2/15 Banks are forced to buy back \$850 million of Jefferson County, AL bonds due to a failed auction which leads to a credit downgrade from A to BBB
  - 2/29 Credit crunch spreads from the ARS market to the variable rate demand bond market where issuers had flocked to get relief from soaring rates

# The Municipal Finance 2008 Year in Review (cont)

- March – Madness
  - 3/12 Mississippi, Chicago and five other municipal issuers file lawsuits against Bank of America, JP Morgan and 35 other firms alleging price fixing in the municipal derivatives business
  - 3/14 Concerns about Bear Stearns & Co. begin to swirl throughout the industry
  - 3/16 Bear Stearns is acquired by JP Morgan
  - 3/31 Jefferson County Commissioners approve forbearance agreements deferring payments to liquidity providers, bond insurers and swap counterparties

# The Municipal Finance 2008 Year in Review (cont)

- April – Fool’s Gold
  - 4/11 Spurred by complaints from investors stuck holding illiquid ARS the SEC begins investigating whether investors were misled regarding liquidity risks; settlements ensue
  - 4/14 London Interbank Offered Rate jumps dramatically amid concerns that banks reporting the rates were artificially providing low numbers causing havoc in swaps
  - 4/30 SEC files charges against Alabama bond dealer William Blount, Birmingham Mayor Larry Langford and lobbyist Al LaPierre regarding a securities based swap agreement, its first such filing

# The Municipal Finance 2008 Year in Review (cont)

- May – Day
  - 5/6 UBS announces that it will close its municipal finance department
  - 5/23 Vellejo, CA seeks Chapter 9 bankruptcy protection claiming that it can no longer pay agreed salaries and benefits to its public workers becoming the largest such filing since Orange County in 1994
- June – Summer Solstice
  - 6/2 JP Morgan cuts municipal finance unit by 15%
  - 6/18 AMBAC terminates its relationship with the Fitch Ratings Agency noting that it no longer needed the rating from the industry's smallest major credit rating agency
  - 6/26 Fitch withdraws its rating from AMBAC and MBIA bond insurers

# The Municipal Finance 2008 Year in Review (cont)

## ■ July – Downward Slope

- 7/17 Missouri state regulators, along with other states begin an investigation into Wachovia Corp's St. Louis based securities division's ARS practice
- 7/22 Moody's announces that Assured Guaranty Corp and Financial Security Assurance, Inc. (FSA) are on watch for possible credit downgrade
- 7/23 Los Angeles files suit against six bond insurers alleging that they sold what became "worthless" insurance policies by not disclosing their exposure to sub-prime loans
- 7/30 Connecticut sues all three rating agencies, state court, alleging that the states bonds received lower credit ratings than were merited cost tax payers millions in bond insurance fees and that ratings should be based solely on the basis of repayment

# The Municipal Finance 2008 Year in Review (cont)

- August – What a difference a name/credit makes
  - 8/4 XL Capital Assurance becomes Syncora
  - 8/8 Assured Guaranty Corp enters into a global settlement with its structured counterparties to continue honoring current claims while agreeing to no new policies
  - 8/27 Jefferson County moves closer to filing for bankruptcy after S&P downgrades its GO warrants to “B” from “BBB”
- September – Unfathomable
  - 9/15 158-year-old Lehman Brothers files for bankruptcy protection and 94-year-old Merrill Lynch is acquired by Bank of America
  - 9/16 Treasury authorizes the NY Fed to lend up to 85 billion to help stabilize AIG
  - 9/22 Fed approves applications from Goldman Sachs and Morgan Stanley to become “bank holding companies”

# The Municipal Finance 2008 Year in Review (cont)

- October – More Drama
  - 10/3 Congress passes the Emergency Economic Stabilization Act creating the \$700 billion Troubled Assets Relief Program (TARP)
  - 10/14 California sell \$5 billion in revenue anticipation notes (1 yr mat) with a record 78% sold to retail
- November – A new page in history
  - 11/4 Obama elected President of the United States
  - 11/10 Goldman Sachs makes significant cuts in its municipal finance department
  - 11/21 Moody's downgrades FSA and Assured to the Aa category and questions whether any monoline insurer can be Aaa

# The Municipal Finance 2008 Year in Review (cont)

- December – No More Drama, Please
  - Birmingham Mayor Larry Langford, lobbyist Al LaPierre and bond dealer William Blount indicted on a 101 indictment count charging them with conspiracy, bribery and money laundering schemes in connection with bond financing transactions
  - President-Elect Obama announces the single largest infrastructure program since the creation of the federal highway program
  - Fitch places a negative outlook on Florida's AA+ full faith and credit bonds
  - S&P places a negative outlook on Illinois's AA general obligation bond rating
  - 30-year tax-exempt yields rise to a record 200% of Treasuries

# Municipal Finance 2009 Year to Date\*

- January – 2008 Trends Continue
  - 1/6 Ambac investors file lawsuit claiming inadequate disclosure of exposure risks of structured financial products
  - 1/12 MSRB calls for federal regulation of GIC brokers and financial advisors
  - 1/23 Moody's puts A1-rated California GOs on watch for possible downgrade due to lawmakers' failure to resolve budget crisis
  - 1/26 Bank of America/Merrill Lynch begins first round of cuts expected in its merged municipal business
  - 1/26 Fitch becomes the third rating agency to drop Detroit GO ratings to BB
  - 1/26 California attorney general joins Connecticut and Florida in investigating bid-rigging of swaps and GICs

Source: The events are derived from the Bond Buyer.

# Municipal Finance 2009 Outlook\*

- Volume is uncertain
  - Impact of Federal stimulus program
  - Impact of federal regulation of intervention
  - Uncertainty regarding ARS/VRDO restructurings,
  - Possible forced issuance to finance year-end budget gaps
- Institutional demand remains weak
  - Fewer profits to shield and, if tax rates decline, less need for municipals
  - Buyers have less ability to pursue leveraged returns
  - Total return buyers have other attractive alternatives
  - Mutual fund have experience outflows until recently
  - Weak pricing and credit fundamentals

Source: The Outlook is derived principally from Municipal Market Advisors

# Municipal Finance 2009 Outlook (cont)

- Limited bank capacity and higher liquidity fees
  - Liquidity fees are ten times what they were until recently
  - High liquidity fees will constrain the use of fixed payor swaps to create synthetic fixed rate debt
  - Low volume of swaps will keep SIFMA swap rates low and exacerbate the negative termination values for issuer's outstanding swaps
  - Limited bank capacity will make it difficult and costly to refinance outstanding ARS and to take out bank bonds

# This a Time to Consider New Approaches

- Negotiated sales may be better than competitive bids
  - Triple-A Georgia will sell its upcoming GO bonds through a negotiated sale
- Rating targets should be reconsidered taking account of their impact on the issuer's tax policy, debt policy, budgetary flexibility and capital funding needs
  - It may be more important to maintain desired levels of annual and capital spending without raising taxes than to keep the highest possible rating
- Perhaps debt amortization period should be extended
  - EPA has endorsed the concept of financing projects over their useful lives rather than on an accelerated basis

# **EPA's Environmental Financial Advisory Board Issued a Report Entitled "Useful Life Financing of Environmental Facilities"**

- Useful life financing makes projects more affordable and distributes the cost more equitable among project users
- As compared with a shorter amortization period, useful life financing can reduce annual debt service by 10% to 34%
- Such savings can be used to fund additional capital projects. By using such savings, the cost of the additional projects can be reduced by 12% to 45% compared to using shorter amortization
- The conclusions of the report are equally applicable to non-environmental capital projects and could also be applied to support longer periods for funding sunk costs, such as unfunded pension costs

# Report on Useful Life Financing of Environmental Facilities

- The report considered three critical factors in evaluating various amortization periods:
  - The aggregate cost of each financing alternative (cost to the taxpayer rather than the cost to the municipality)
    - The cost to the taxpayer is independent of the amortization period
  - The fairness of each alternative among project users
  - The impact of each alternative on project affordability
- The report considered rationales for shorter periods
  - That sound practices for individuals also apply to municipalities
  - That use of a shorter amortization period creates savings or equity for the benefit of future taxpayers
    - The only way for taxpayers to benefit from the use of conservative amortization periods is to adopt a less conservative approach or to restructure or extend the debt to use a longer period