

A market being replaced

Auction-rate securities cannot recover from recent turmoil. But the same effects are being achieved elsewhere

Since the mid-eighties, auction-rate securities (ARS) have been viewed by the market as a stable financing vehicle. They offered issuers cheap flexible financing and, afforded closed-end funds a means of leveraging their assets and reinvesting the proceeds in the funds' portfolios. Pension funds and other institutional investors considered ARS to be high-quality liquid investments.

ARS are short-term investments bearing interest rates tied to broad-based, short-term financial rates that reset periodically through an auction process. Before February 2008, the financial intermediaries that served as broker-dealers participated in the auction process, actively bidding on the securities being sold. Their bids supported the market and ensured successful auctions. However, the level of support provided by these broker-dealers was not understood by most market participants and few understood that if the broker-dealers stopped these activities, auctions would fail.

Beginning in February, as financial institutions started facing serious liquidity issues, broker-dealers stopped participating. Without their bids, there were not enough buyers in the auctions and sellers were unable to liquidate their positions. This imbalance of buyers and sellers caused auctions to fail. This liquidity crisis is unlike most structured finance issues facing the market in that it is not an issue of credit quality (or asset quality). Most issuers whose ARS auctions failed,

including many municipal issuers, were then, and remain now, investment grade issuers and are not in danger of defaulting on their ARS.

When an auction fails, the issuer continues to make interest or dividend payments to holders. However, dividends or interest increase sharply to a specified maximum rate, which is typically set at a premium over the prevailing interest rates. Although the maximum rate payable on these securities following failed auctions is intended to compensate the investor for the resulting illiquidity of the securities, institutional investors that need liquidity or must mark to market their securities portfolios may not find this comforting, especially as there appears to be no immediate prospect of successful clearing auctions.

Similarly, public companies that invested their cash on hand in ARS, believing these to be liquid investments comparable to money market instruments, have now been forced to address difficult fair value accounting and disclosure questions. As a result of the illiquidity, many retail investors that invested in ARS have initiated lawsuits against financial institutions that sold these securities, claiming their now illiquid securities were touted as cash equivalents. Recently, several states, the New York Attorney General and the Securities and Exchange Commission (SEC) brokered settlements with a number of financial institutions that sold ARS, requiring the institutions to create liquidity for these securities (in some cases by repurchasing them from retail investors).

A changing market

It is unlikely that the ARS market as we knew it will recover from the events of the past six months. Auctions continue to be held as scheduled, but without buyers. Until auctions are successful, which seems unlikely while the credit crisis remains in full swing and financial institutions suffer from balance sheet issues of their own, investors will remain skittish about entering this market.

However, there is still a need for securities that accomplish the same results. That is, providing long-term funding on terms that match or reprice based on the prevailing

short-term funding rates. But it seems unlikely that investors will be interested in securities that reprice in auctions, unless there is more transparency in the auctions and an ultimate liquidity provider.

As a result, issuers are turning to VRDOs and tender option bonds as alternatives, with larger closed-end funds developing alternative products along these lines (such as the LLP shares). Closed-end funds continue to work with regulators and others not only to work through the specific details of these products, the largest of which is finding a liquidity provider, but also to find other sources of relief, including with respect to leverage. New products will be developed that include some of the elements of ARS and that have remarketing features or resettable rates or are puttable.

Background

ARS issuers generally fall into four categories: municipalities, student loan lenders, closed-end funds and structured ARS issuers (these issuers offer ARS backed by collateralised debt obligations, or CDOs). The ARS market is around \$330 billion, with municipal ARS comprising around \$165 billion, student loans \$85 billion, closed-end funds \$63 billion and CDO and other ARS the remaining \$17 billion. The cash flows on ARS do not vary much by category of issuer. When an auction fails there is no event of default; a penalty rate (maximum rate) is triggered. In most cases, higher penalty rates were triggered for municipalities, while the penalty rates for closed-end funds in some cases were actually lower than the rates that were previously being set at auction (in many cases, the penalty rates were Libor-based).

As a result, many municipal issuers have redeemed their outstanding debt, for which a high penalty rate was set. To the extent they have been unable to redeem these securities, they remain outstanding and continue to pay high penalty rates of interest. For this reason, municipal issuers have restructured their debt as either fixed or variable-rate instruments or have issued fixed or variable-rate debt instruments to refinance the existing ARS.

Valuation of ARS

Investors left holding ARS face valuation issues relating to their now illiquid securities. Institutional investors may have to record mark-to-market losses on the ARS. Individual investors whose ARS are held in brokerage accounts at financial institutions are seeing their securities marked down by the financial institution using computer models under fair value accounting (under Statement of Accounting Financial Standards 157, or SFAS 157).

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Following this approach, similar to other securities classified as available for sale, a holder of ARS must determine whether the value of such securities is suffering from more than temporary impairment. If it is probable that the holder will be unable to collect all amounts due (or obtain par value on a sale), more than temporary impairment may have occurred. Regardless of whether the issuer of the ARS suffered an actual credit loss, it is important to also consider the severity of a decline in value in evaluating more-than-temporary impairment. Once a determination has been made that a decline in fair value is other than temporary, a holder must adjust the cost of the impaired security down to fair value by a charge to income.

Under fair value accounting, assets are grouped into one of three categories depending on their relative liquidity, with the hardest to value assets put in Level 3. ARS are likely to fall within this level, unless the financial institution believes that it can resell the ARS or repackage them.

Another valuation issue arises in connection with the financial institutions that have agreed to repurchase ARS from their customers at par value. These institutions will likely record mark to mark losses on these securities, applying the same computer models to the ARS that they applied to the ARS held by their clients.

Recently, the SEC and the Financial Accounting Standards Board (Fasb) issued clarifications to SFAS 157 detailing that determining fair value in the economic environment was challenging for investors. The statement clarifies that in an inactive market a holder may use multiple inputs to determine fair value, such as internal models of cash flows and risk premiums or unobservable inputs. The Fasb also clarified that market quotes (such as broker's quotes) are not necessarily indicative of fair value. The guidance further clarifies that transactions that occur in a liquidation or fire sale are not necessarily indicative of fair value because fair value assumes orderly transactions, which these are not.

With respect to determining more than temporary impairment, reasonable judgment should be applied. Holders should consider, among other things, the nature of the underlying investment, decline in value, probability of recovery and anticipated time to recovery. It is anticipated that these clarifications may provide some relief to holders that have seen the value of their securities plummet under SFAS 157.

Regulatory relief

The government has stepped in to provide relief for the municipal ARS and closed-end

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fund ARS markets. However, there has been no relief for the student loan or CDO and other trust ARS markets. On the municipal side, the SEC set out conditions in March following which municipal issuers could bid for their ARS (subject, of course, to providing proper disclosure). Also in March, the Treasury issued Notice 2008-41, providing guidance to issuers in the tax-exempt market that wish to convert their outstanding debt from ARS to debt with a fixed or floating interest rate to maturity, or to repurchase their own ARS. In addition, following the Notice, under limited circumstances the conversion of a tax-exempt ARS to a bond with a fixed or floating interest rate will not result in a reissuance for US federal income tax purposes. The treatment of a conversion as a reissuance could result in adverse consequences for the issuer. Further, in applying the tax exempt bond rules, a governmental issuer may purchase and hold (for 180 days) its own tax-exempt ARS without the purchase resulting in a retirement of the bond for US federal income tax purposes, provided the bonds were purchased before October 1 2008. Also, an issuer can refund a bond while owning it with a refunding bond if there is a failed auction or remarketing. The Municipal Securities Rulemaking Board has proposed establishing guidelines for additional ARS transparency, including posting auction results.

On the closed-end side, issuers of ARS had limited options, as they were prohibited, except under limited circumstances, under the Investment Company Act of 1940, from redeeming their securities. In response, in June the SEC granted no-action relief to Eaton Vance Management in connection with the issuance by its closed-end funds of a new class of preferred stock. This stock, called liquidity protected preferred shares (LPP shares), provides an alternative to ARS. LPP shares bear a dividend that resets every seven days through a remarketing process conducted by one or more financial

institutions. At the same time, the closed-end fund enters into an agreement with a liquidity provider following which the liquidity provider has an unconditional obligation to purchase all LPP shares subject to sell orders not matched with purchase orders in a failed remarketing.

Shortly after the SEC granted this no-action relief, the IRS issued Notice 2008-55, which provides guidance on the treatment of variable rate demand obligations (VRDOs), such as the LPP shares, and tender option bonds. Variable rate demand obligations and tender option bonds are debt securities that bear interest at a floating rate adjusted at specified intervals (usually daily or weekly) and have a put option (either to the issuer or an agent). In addition, like the LPP shares, VDROs are supported by credit enhancement (either a letter of credit or a standby bond purchase agreement). From a tax perspective, in order to preserve the equity status for auction rate preferred stock for US federal income tax purposes, it is important that investors not be viewed as having the right to put the ARS to the issuer on demand. In this Notice, the IRS confirmed that it would not challenge the equity characterisation of auction rate preferred securities, such as the LPP shares. As a result, payments on these securities should still be characterised as exempt-interest dividends (to the extent of the issuer's exempt interest) and not as taxable interest, which would have been the consequence if the ARS were instead treated as debt for US federal income tax purposes.

Together, these actions broaden the market for potential ARS investors as money market funds, or 2a-7 funds, would be permitted to purchase these securities (where they were previously precluded from doing so due to maturity and quality requirements imposed on money market investments). Also, on October 2 2008, the SEC granted no-action relief to Eaton Vance permitting five of its closed-end funds to issue debt securities with asset coverage of 200% (the level required for preferred stock), rather than the 300% required at present. This permits closed-end funds to refinance their outstanding auction rate preferred securities with debt.

Despite this relief, we have not yet seen many closed-end funds restructure their debt – they have generally redeemed outstanding securities due to difficulties associated with finding the liquidity providers necessary to issue these new products. However, in August, Nuveen Investments LLC and Federated Investors Inc announced that they would redeem outstanding ARS with tender option bonds. In October, Morgan Stanley announced that it would refinance auction

rate preferred securities with tender option bonds issued by some of its closed-end municipal funds.

For student loan ARS, there has been no regulatory relief. As a result, the crisis in the credit markets continues to threaten the availability of student loan credit. Unlike with other forms of consumer credit, the interest rate on student loans guaranteed by the federal government is set by law, so lenders are unable to recoup their costs in these loans. Spreads on securities backed by student loans have widened by 150 basis points, or 15 times the levels seen last summer. Issuers of ARS backed by student loans have commenced tender offers for outstanding securities in attempts to refinance their outstanding ARS.

Settlements or restructurings

Recently, many financial institutions that sold ARS have entered into settlement agreements with various parties, including the SEC, the New York State Attorney General and other states regarding their sales of these securities. More recently, the Financial Industry Regulatory Authority, Inc (FINRA) announced a settlement with regional distributors. The firms were accused of materially misrepresenting the liquidity and risks associated with ARS.

This is not the first time that participants in the ARS market were accused of wrongdoing. Before the recent crisis in the auction rate market, the SEC had investigated ARS underwriting practices and bidding processes. In 2006, 15 firms entered into a settlement with the SEC for auction practices that were not adequately disclosed. As a result, the market developed best practices for broker-dealers of ARS, which included model auction procedures and sample disclosure language intended to provide clarity to investors on the bidding process. Specifically, the sample disclosure language stated that broker-dealers may participate in and bid on ARS in auctions.

Following the rash of failed auctions earlier this year, firms were again accused of inadequately disclosing the risks associated with ARS and of marketing the ARS to their customers, in marketing material ranging from press releases to the clients' monthly statements, as safe and highly liquid investments and of characterising them as cash equivalents. Specifically, the firms were accused of failing to disclose to investors that the reason the ARS were liquid was because the broker-dealers were artificially supporting and manipulating the auction rate market to maintain the illusion of liquidity and stability and a functioning, balanced market. The SEC, working in conjunction with other regulators, determined that the actions of

these firms misled investors. The SEC also determined that the firms failed to adequately disclose to customers the liquidity and investment risks associated with ARS, including the material increase in risk (when firms "knew that there was an increased likelihood that they and other broker-dealers would no longer support the auctions") in late 2007 and early 2008.

A key factor of these settlements is that they require that financial institutions repurchase from individual investors, small businesses and charitable organisations, at par, ARS sold by them. In addition, the financial institutions must make whole any losses sustained by customers that sold their ARS after the market froze and will offer no-cost loan programmes to certain eligible customers with immediate liquidity concerns. These settlements also require that the financial institutions provide liquidity to institutional investors still holding outstanding ARS by 2009 (though the mechanism for this is unspecified). It is interesting to note that the settlements defer financial penalties on the firms – with the government taking a wait-and-see approach to determine whether liquidity can be restored.

If the financial institutions are unable to provide liquidity, institutional investors may sell their ARS in the secondary market (although at a discount to par). A few private networks (such as the Restricted Securities Trading Network, which announced in March that it would begin trading ARS) have emerged that match buyers and sellers of ARS. On these markets, ARS trade in the secondary market, but at discounts of up to 30%. Also, there are a number of hedge funds that are interested in accumulating positions in ARS because they believe that these securities can be purchased at distressed prices and remain good credits. Issuers of ARS are looking at potential alternative securities, such as variable rate demand preferred or liquidity protected preferred, as a means of redeeming outstanding ARS.

Repurchases of ARS

A number of financial institutions have agreed under settlement agreements to repurchase ARS from their customers. However, the question still remains: what will these financial institutions do with the securities they now hold? The secondary market holds little possibility of relief for them. ARS trading in the secondary market are trading at significant discounts to par (with discounts ranging from 2% to 30%), though ARS issued by municipalities may fare better in the secondary market than those backed by student loans. Because of the

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difficulty of selling the securities in a secondary market, financial institutions are likely to turn to other alternatives for monetising their holdings. Many firms, including UBS, have announced that they will repack the ARS they are repurchasing from individual investors and issue bonds to raise additional funds (in part to finance the repurchases).

Most of the broker-dealers have publicly announced that they do not believe that the repurchases of ARS would result in additional writedowns. Given that the broker-dealers that have agreed to repurchase ARS from their clients are among the largest financial institutions and these same institutions are already facing writedowns and experiencing other financial challenges, it would be difficult to isolate the impact of the auction rate buybacks on their results or their credit default swap spreads.

Financing

The financial institutions that repurchase ARS from their customers will finance the repurchase in a number of ways. Many of them have been struggling to raise capital for most of 2008, so it is unlikely they will turn to the capital markets for funding. To the extent available, they are likely to rely on the Fed window for the funds necessary to repurchase the ARS (using the ARS as collateral). However, until recently, ARS issued by closed-end funds were not being accepted as collateral at the Fed window (eliminating this funding source for many institutions repurchasing securities of closed-end funds). The Fed considers ARS issued by closed-end funds to be hybrid securities (having elements of both debt and equity securities), but only debt securities may be presented at the Fed window. However, in light of recent market events, including the worsening of the credit crisis and the economic downturn, the Fed has liberalised the securities it will accept as collateral and has thus opened this avenue of financing to holders of ARS issued by closed-end funds.

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