



Auction-Rate Collapse Costs Taxpayers \$1.65 Billion (Update1)

By Michael Quint and Darrell Preston

May 16 (Bloomberg) -- In 2003, the Culinary Institute of America outgrew a former Jesuit seminary building on its Hyde Park, New York, campus. So it asked **Edward Shapoff**, a Goldman Sachs Group Inc. banker on its finance committee, for advice on **borrowing** to pay for new housing and parking.

Shapoff recommended auction-rate bonds, securities that pay short-term interest rates yet don't come due for as long as 40 years.

``The advice seemed quite reasonable," said **Charles O'Mara**, the institute's chief financial officer, who arranged three auction-rate bond sales totaling \$56.8 million.

For about three years, the school's weekly auctions cost the institute as little as 0.7 percent. Then, in September 2007, rates began to rise when investors saw auctions of other debt fail to attract buyers and they grew concerned that bond insurers might be laid low by the subprime-mortgage contagion. By Feb. 19, after dealers halted a two-decade practice of buying bonds that didn't sell at auctions, the institute's rate peaked at 14 percent. Over the next 12 weeks, it paid \$561,000 more in interest than it had in the previous 12.

``Auction bonds had been around in the municipal market for 10 or 12 years and had worked well," O'Mara said. ``Nobody knew then that bond insurers would plunge into subprime mortgages or banks would stop their support."

\$1.65 Billion

The **Culinary Institute** is among hundreds of borrowers facing an unexpected rise in financing costs. Across the country, local governments and operators of hospitals and schools that issued about \$166 billion of auction-rate bonds - - about half of all such securities -- have paid an estimated \$1.65 billion in **additional interest** since the market soured in September, according to data compiled by Bloomberg.

That money comes right out of the pockets of taxpayers, from New York to California, and organizations such as the Culinary Institute that are allowed to borrow in the municipal market.

Auction-rate securities, which increased to \$330 billion over 24 years, are marked by a history of secrecy and dealer manipulation of borrowers and investors, according to U.S. Securities and Exchange Commission **documents**.

``Proponents of auction bonds downplayed the risks for issuers and buyers, first by not talking about earlier problems, and then managing auctions to keep rates at levels that pleased everybody, at least for a while," said **Joseph Fichera**, chief executive officer of New York-based **Saber Partners**, which advises governments in their negotiations with banks.

Billions in Fees

Rates on the bonds are determined by bidding typically every 7, 28 or 35 days. If buyers are scarce, the auction fails and some bondholders who wanted to sell are left holding the securities. The issuer gets stuck with a penalty rate.

For investment banks, the bonds generated more than \$1 billion in fees at the initial sale. They also received annual payments for handling the auctions of a quarter percentage point, or about \$825 million a year based on the \$330 billion outstanding before the collapse.

Bankers earned additional, undisclosed profit from arranging swaps intended to convert the variable interest rate on an auction bond to a fixed one. Culinary Institute, for example, expected the combination of auction-rate bonds and swaps to result in fixed borrowing costs of 3.36 percent to 3.68 percent on its three sales, less than O'Mara says it would have paid for ordinary fixed-rate bonds.

Wrong-Way Swaps

Most borrowers also entered into swaps where they agreed to make a fixed payment in exchange for variable payments from the banks arranging the transaction, according to Jeff Pearsall, a managing director at Philadelphia-based Public Financial Management, the largest adviser to U.S. municipalities.

For issuers, the variable rates they received, based on the London interbank offered **rate**, or Libor, roughly matched the cost of the bonds for more than five years. The relationship broke down this year as the bond rates soared and Libor fell.

``We're spending the bulk of our time fixing broken, insured auction bonds, many of which have swaps attached," Pearsall said. ``It tends to raise their cost of capital."

After the market collapsed in February, the interest cost on New Jersey's \$3.4 billion of auction-rate debt increased by \$2 million a week, forcing the state to spend \$17 million to convert it to other kinds of debt. Hospitals, athletic stadiums and other state and local borrowers saw monthly debt service rise.

Ignoring Risk

The combination of short-term borrowing costs and long-term debt also appealed to other issuers, such as student-loan agencies and closed-end mutual funds.

Investors ranging from Fortune 500 companies to individuals collected higher yields than they would have received from money-market funds or Treasuries, and ignored or were ignorant of the risk that they couldn't easily sell their investments if auctions failed. Many, like William Kannall, got caught with securities they couldn't unload when the market broke down.

Kannall, 64, who invested \$500,000 in auction-rate securities in December 2007, learned in February that he couldn't get access to his money, which he needs for living expenses and to treat a disease that suppresses his immune system. The Spokane, Washington, resident said he has filed a complaint with the Financial Industry Regulatory Authority against the dealer who sold him the securities, A.G. Edwards Inc., now part of Wachovia Corp. Justin Gioia, a Wachovia spokesman, declined to comment on the case.

``The brokers created and manipulated this market," Kannall said. ``My broker told me A.G. Edwards always buys these and that they're safe."

Failed Auctions

With auction-rate bonds, Wall Street firms had a product they could sell to corporate cash managers for a fee as much as four times greater than what they collected for alternatives. They also offered investors more yield than Treasury bills or money-market mutual funds.

Everyone was happy until the market collapsed when credit-market losses raised concerns that **MBIA Inc.** and **Ambac Financial Group Inc.**, the two largest insurers in the auction-rate market, might lose their AAA ratings. Banks stopped bidding at auctions for their own accounts while they were absorbing more than \$320 billion of losses on subprime mortgages.

By mid-February, Citigroup Inc., the largest underwriter of auction-rate bonds, held \$11 billion of them, up from \$8.1 billion at the end of 2007, the bank said when it reported a \$5.1 billion loss for the quarter ended March 31.

Thousands of auctions failed, forcing issuers such as the Port Authority of New York & New Jersey to pay interest rates as high as 20 percent. The investors were left with securities they couldn't sell, though the bonds continued to pay interest.

'Unsuspecting Public'

Investors bought the bonds seeking higher yields for money they wanted invested short-term, said **Eduard Korsinsky**, an attorney with the New York law firm of Levi & Korsinsky, which represents **investors in lawsuits**. They thought they would have quick access to the money because the securities were highly rated and often insured, he said.

``This is something Wall Street foisted on an unsuspecting public," Korsinsky said.

Now, hundreds of individuals have filed lawsuits with **Finra**, saying they were misled about the safety of auction-rate securities. Some have seen the value of their investments decline as dealers who sold the bonds then wrote them down.

The **Securities Industry and Financial Markets Association**, which represents 650 securities dealers, defends the sellers' actions.

``For 20 years the auction-rate market has met the needs of issuers and investors," said **Leslie Norwood**, managing director and associate general counsel for the group. The failure of the market ``was completely unexpected, like a dam break," she said.

Father of the Bond

American Express Co. sold the first auction-rate securities in 1984, with a \$350 million issue of money-market

preferred shares with dividends reset at auction every 49 days. At that time, "the minimum purchase was \$500,000, and buyers were treasurers of very large companies," said **Ronald Gallatin**, the former Lehman Brothers Holdings Inc. managing director who invented the securities.

Other banks copied Gallatin's idea, leading to sales by companies ranging from Citicorp, then the largest U.S. bank, to MCorp, a Dallas bank holding company that later collapsed.

The first unsuccessful auction occurred in 1987, when investors avoided auctions of MCorp's \$62.5 million issue. Many corporate borrowers and banks, including Citicorp, now Citigroup, and Chase Manhattan Corp., now JPMorgan Chase & Co., turned their backs on the concept in the 1990s and retired the securities after interest rates exceeded 13 percent.

Manipulating the Market

From the beginning, banks were manipulating the market. In 1995, investors learned that Lehman settled allegations by the SEC that it improperly bid at some American Express auctions. Lehman, which the SEC said manipulated bids 13 times and prevented two auctions from failing, paid an \$850,000 fine without admitting or denying wrongdoing.

The first tax-exempt auction-rate security was sold by Arizona-based Tucson Electric Power Co., now part of **Unisource Energy Corp.**, in 1988. The utility's \$121 million of bonds qualified for tax-free financing because they funded pollution-control equipment.

The deal worked because Goldman was expected to buy securities to ensure the auctions' success, said **Susan Wallach**, Tucson Electric's treasurer.

"No one ever questioned the banks' liquidity," she said. "People were willing to take the credit risk."

Municipal Explosion

In 1990, when Tucson Electric began losing money and its credit rating plunged, rates on the auction bonds rose to 12.6 percent. Investors soon found funds frozen because there weren't enough bidders. **Bear Stearns & Co.** was brought in to manage the auctions and convert the debt to bonds with a fixed rate of 7.25 percent.

The market took off after 2000, with sales of municipal auction-rate bonds exploding from \$9.56 billion a year to more than \$40 billion in 2003 and 2004, according to Thomson Reuters.

To avert failed auctions, bankers encouraged municipal issuers to insure bonds, bringing top ratings and investor confidence. Insurance promised investors they would receive principal and interest, not that they would be able to sell when they wanted, said **Robert Fuller**, principal at Capital Markets Management, a Hopewell, New Jersey-based financial adviser.

"There was a misconception in the municipal market that the AAA ratings of bond insurers would create liquidity," Fuller said.

New York Study

Auction-rate bonds proved popular enough that they usually sold at **yields lower than variable-rate demand bonds**, or municipal debt that allows investors to seek repayment from a designated bank even if the dealer handling the bonds can't find buyers.

A **study** by the state of New York for the two years ended in September 2007 found that the average interest rate on its \$4 billion of auction-rate bonds was 3.16 percent, or 0.27 percentage point below the 3.43 percent for its \$4.2 billion of variable-rate demand bonds.

Because there is no bank guarantee of repayment, auction-rate issuers should pay more, not less, Saber's Fichera said.

The SEC began investigating alleged manipulation in the market in 2004. It asked dealers to review and report on how they conducted auctions. In the following years, auction-rate municipal bond sales fell to about \$30 billion.

SEC Fines

In May 2006, the commission fined 15 dealers **\$13 million for manipulating the market**, though the dealers didn't admit or deny wrongdoing. Rather than forcing them to abandon practices that had become standard, the SEC said the practices could continue as long as they were disclosed.

Norwood of the dealers' association denied that the market was manipulated. The 2006 SEC action was an example of market regulation and led to even more disclosure, she said.

The SEC action didn't appease Wisconsin's debt director, **Frank Hoadley**, who warned securities dealers in July 2006 to stop manipulating auctions. He said the term "auction" was inaccurate because dealers controlled all information and influenced bids. The **association didn't heed** his call for greater disclosure.

``There were a whole bunch of things that just didn't happen," Hoadley said.

The SEC was so unconcerned about possible failures that its list of material events requiring disclosure never included unsuccessful auctions.

'Collapse and Fail'

``I don't think the SEC ever envisioned that a market would just collapse and fail," said **Daniel Johnson**, managing partner at Chicago-based law firm Chapman & Cutler LLP and former head of its public finance group. ``The focus in the past was on events that related to the underlying borrower," not the market in which the bonds are traded, he said.

Now, the commission is preparing rule changes to require additional disclosure, including information on the number and size of bids, **Martha Haines**, head of the SEC's municipal division, said at a meeting of government finance officials in Albany in April.

``Investors and issuers need to know where the liquidity is coming from," Fichera said. ``Is the auction one where there are only five bids and the bank is always buying for its own account? Or are there 175 bidders, and the bank rarely helps?"

If those disclosures had been in place sooner, ``it might have limited the size of the auction-rate market to one that was sustainable," Haines said.

The lead-up to February's **meltdown** began in July, when MBIA and Ambac reported lower profits because of losses on securities backed by subprime mortgages. In August, insurers' subprime losses led to \$1.8 billion of failed auctions for their own securities, according to Fitch Ratings.

'Guilt by Association'

By September, as word of those auctions spread, **yields of auction-rate securities for municipal borrowers rose** above those of variable-rate bonds. **George Friedlander**, a Citigroup analyst, blamed higher rates on ``guilt by association" with unsuccessful auctions in the taxable market, where securities issued by subprime-tainted collateralized debt obligations had gone bust.

``Investors are nervous that if there aren't enough buyers at the auctions, they have to rely on bids by dealers and might have to hold the bonds," said Richard Davis, assistant commissioner at the Utah Board of Regents, which began issuing the bonds in 1998.

Corporate investors started unloading auction-rate investments in the last half of 2007. By Jan. 1, they had sold off \$70 billion, cutting holdings to \$100 billion in six months, according to **Treasury Strategies**, a Chicago-based adviser to corporate treasurers.

Synoptics Stuck

Not everyone could sell. In October, Synoptics Communications Inc., a Santa Clara, California-based maker of local area network systems, was the first to reveal holdings of auction-rate bonds it couldn't dispose of. It was followed by other companies, from Silicon Valley startups to industry giants such as New York-based Bristol-Myers Squibb Co., which reported a \$275 million loss on \$811 million in investments in auction-rate securities, according to its earnings report for the last quarter of 2007.

At the same time, yields climbed. In November, the seven-day average rate for municipal auction-rate bonds reached 4.03 percent, almost half a percentage point higher than variable-rate demand bonds.

The market broke down the week of Feb. 13, as banks let dozens of auctions fall through. More than 60 percent of the thousands of auctions conducted each month have failed since then, Bloomberg data show. Interest rates on municipal bonds that come up for auction weekly rose to an average of 6.89 percent the week of Feb. 20, up from the average of 3.65 percent for 2007.

'We Are Not Happy'

The banks' decision to stop supporting auctions reminded investors and issuers ``that when push comes to shove, the banks will do what's best for their shareholders," the SEC's Haines said.

New York Attorney General **Andrew Cuomo** has issued subpoenas to at least 18 banks, including Merrill Lynch & Co., UBS AG and JPMorgan, seeking information about how they persuaded issuers to sell the bonds and how they decided to curb their bidding at auctions, a person familiar with the investigation said. Cuomo, along with a Massachusetts-led task force of nine other states, the SEC and Finra, which oversees brokerages, are examining dealer disclosures.

``We are not happy with the way investment banks have performed," said **David Brown**, former executive director of

the New York State Dormitory Authority, which issued \$1.3 billion of auction-rate bonds for hospitals and private colleges, including the Culinary Institute, and \$1.2 billion for the state. ``This was a product sold to a lot of borrowers as being appropriate."

The Market's Future

Many issuers are getting out of auction-rate debt and say they will never use it again. State and local governments have already replaced or announced plans to replace at least \$66 billion of the securities, according to Bloomberg data. Many are switching to variable-rate demand bonds, whose 2.25 percent average in the past month is about half the 4.56 percent for auction-rate bonds. Others are stuck, unable to issue new debt. Some investment banks, including Citigroup, say the market will never come back.

``It's a damaged product, and I can't imagine issuers using it again," said Wisconsin's Hoadley. ``A lot of people will have to die and institutional memory go away before people will come back to it."

The Municipal Securities Rulemaking Board and **Sifma** have put together proposals to address some of the complaints Hoadley and others made about the lack of transparency. The **MSRB advised creating a Web site to** disclose more information on auction results.

``I hope it's not too late," the SEC's Haines said.

Gallatin, the father of auction-rate securities, doesn't hold out much hope. He expects auction-rate bonds will be replaced by other debt because too many investors and issuers lack confidence.

``The back of the market is broken," he said. ``I think the market's problem started with credit, but now credit isn't the problem."

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