

Auction-Rate Bonds Force 'Predatory' Yields on Cities (Update3)

By Jeremy R. Cooke and Martin Z. Braun

Feb. 25 (Bloomberg) -- U.S. municipal borrowers from Camden, New Jersey, to Sacramento, California, may face a third week of higher interest costs as failures in the auction-rate bond market persist.

Auctions run by banks to determine the rate on more than \$45 billion of bonds didn't attract enough buyers last week, according to JPMorgan Chase & Co. research. Even some successful auctions resulted in rates that were twice what borrowers paid in January, as investors who submitted bids demanded higher yields.

"The market right now is very predatory," said Marcia Maurer, chief financial officer of the Sacramento Regional County Sanitation District. The agency's weekly expense on \$250 million of debt more than doubled to \$343,000 from last month.

Investors enticed by rates that jumped as high as 20 percent are seeking opportunities in the \$330 billion market no longer supported by dealers from Goldman Sachs Group Inc. to Citigroup Inc. and UBS AG that for years committed their capital to prevent failures. Thousands of unsuccessful auctions have driven up taxpayers' borrowing costs and left investors in the securities unable to get their money.

"Aggressive institutional investors have moved in to pick up auction-rate issues at short-term rates ranging from 5 percent to as much as 15 percent or more," George Friedlander, a municipal strategist at Citigroup in New York, said in a report at the end of last week.

Failure Rate

Four of the biggest agents that collect orders from bond dealers and determine winning rates reported failures on 258, or 67 percent, of 386 auctions Feb 22. That's in line with the average since Feb. 15, according to data compiled by Bank of America Corp. and Bloomberg.

Auction bonds, created in 1984, had until recent months allowed municipalities, hospitals, student lenders and funds to borrow long-term at money-market costs by adjusting interest rates through bidding every seven, 28 or 35 days.

When an auction fails, the rate reverts to a "maximum" specified in bond documents, or one pegged to money-market benchmarks. Holders of the bonds are stuck with the securities until a later auction attracts enough demand.

Hedge funds and other non-traditional investors showed "strong interest" last week in tax-exempt deals with high rates, Alex Roever, a JPMorgan fixed-income analyst, said in an e-mail. The average rate for seven-day municipal auction bonds rose to a record 6.59 percent on Feb. 13 from 4.03 percent the previous week, according to a Securities Industry and Financial Markets Association index.

Closed-End Funds

Many of last week's failures occurred at auctions of debt issued by closed-end funds with penalty rates ranging from 3 percent to 6 percent, data compiled by Deutsche Bank AG, Bank of New York Mellon Corp., Wells Fargo & Co. and Wilmington Trust Corp. show. Closed-end funds have about \$60 billion in auction securities outstanding. Municipalities have \$166 billion.

The auction-rate market began unraveling late last year as investor confidence in the health of bond insurers backing many of the securities waned. A bank bailout of New York-based Ambac Financial Group Inc. might come as soon as this week, according to a person familiar with rescue talks.

The collapse accelerated as banks including Citigroup and UBS, which have taken losses of about \$162 billion from securities related to the collapse of subprime mortgages, grew unwilling to commit capital to support the auctions.

Scant Disclosure

While dealers aren't obligated to prop up the auctions they get paid to run, they routinely stepped in when bidders didn't show up. Investors and borrowers never knew the extent of banks' bidding because of scant public disclosure of details known only to dealers, such as the number and range of bids. The Municipal Securities Rulemaking Board in Alexandria, Virginia, is seeking increased disclosure.

State regulators are scrutinizing sales of auction-rate securities by closed-end mutual funds after investors complained they couldn't sell their holdings. Ohio Attorney General Marc Dann may file lawsuits after state funds bought the securities, spokeswoman Jennifer Brindisi said last week.

The Securities and Exchange Commission fined New York-based Lehman Brothers Holdings Inc. \$850,000 in 1995 for manipulating auctions conducted for American Express. Almost two years ago, 15 securities firms paid the SEC \$13 million to settle claims of bid-rigging in auction-rate bonds. The banks neither admitted nor denied wrongdoing.

Twice as High

The Delaware River Port Authority of Pennsylvania and New Jersey faced \$460,000 in additional costs two weeks ago when rates on \$358 million of its debt soared as high as

12 percent, said John Hanson, chief financial officer of the Camden-based agency that owns four Philadelphia bridges.

Investors attracted by those levels brought rates down to about 8.9 percent last week, still about twice as high as what the authority had paid, Hanson said.

“I am just hopeful that our auctions continue to clear,” he said. “I don't think this market is ever going to come back to where it was.”

New Jersey is considering alternatives for some of its more than \$3 billion in auction-rate bonds after costs climbed by more than \$2 million, said Nancy Feldman, the state's director of debt management. Houston, the fourth most-populous U.S. city, plans to shift out of all \$1.9 billion of its auction debt.

“We've made a decision to get out of auction-rate securities,” said Jim Moncur, deputy city controller.

Supply Concern

Fixed-rate municipal bonds fell last week, as yields on top-rated 30-year debt rose to 4.60 percent, the highest in three months, according to Municipal Market Advisors. States and municipalities plan to sell \$4 billion of fixed-rate bonds this week, up from about \$2.5 billion last week, data compiled by Bloomberg shows.

“People are concerned about the potential for added supply to our market,” as some auction-rate securities get converted to conventional bonds, said Eric Boeckmann, a portfolio manager at Northern Trust Co. in Chicago.

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