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Treasury Should Use New Powers to Invest in Muni ARS

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Treasury can use the extraordinary powers granted in the Emergency Economic Stabilization Act of 2008 to solve several problems at once without increasing the risk to taxpayers or creating a moral hazard on Wall Street.

This legislation is mainly about toxic mortgage-backed securities, but it allows any distressed security to be purchased. If Treasury were to purchase municipal auction-rate securities directly from investors, it could provide approximately $60 billion infusion of liquidity through the taxpayers directly and lower taxpayer costs of the bailout both at the national and local level. It doesn't solve the entire problem the legislation is trying to address, but in this innovative way it uses the extraordinary new powers more efficiently and effectively.

The current course of solving municipal issuers' ARS crisis is to have them replace - by refunding or converting - their short-term, floating-rate auction securities with higher yielding, fixed-rate bonds. This hurts taxpayers in two ways. First, they'll pay higher interest costs on the new bonds, and another fee to the same people who brought on the crisis. Second, those higher interest costs increase the amount of tax-exempt interest, which increases lost income to the Treasury and increases the burden on taxpayers. Private capital invested in tax-exempt securities is not available for investments or securities that produce income that is subject to tax and produces revenue to the Treasury. The IRS has estimated this subsidy to be $35 billion.

Removing the estimated remaining $60 billion of municipal auction-rate securities from private investors and the balance sheets of brokers will reduce the borrowing costs of the municipal issuers and their taxpayers, increase revenues to the Treasury, and increase liquidity in the banking system for business investment. The risks to Treasury would be much lower than buying only the exotic mortgage securitizations and other hard-to-value assets. The federal government would be investing in the obligations of state and local governments, historically a relatively low-risk investment.

This proposal does not have to be a bailout of the brokers. Treasury could buy the $50 billion of bonds subject to the various settlements made by brokers with state regulators and the SEC, or any other bonds owned by the broker at a discounted price, for example, equal to the amount of added expense caused the municipalities since their unilateral decision to stop supporting the product or at their fair-market discounted value.

Treasury could then bid for the remaining outstanding bonds of each issue in the auctions at the minimum rate permitted by the security, thereby providing par liquidity for all other investors not covered by the settlement. All investors, both retail and institutional, would therefore be made whole and that capital available for other investments to be decided by the investors.

Moreover, by stemming the tide of municipal refinancing, this will prevent the brokers from being unjustly rewarded for their actions and free up capital for other municipal issues. Currently most issuers are paying the same brokers another fee to restructure the securities by selling a new bond issue or remarketing an old one.

Documents released in Massachusetts and New York investigations suggest that one of the primary objective of the brokers in exiting the bidding process was to get the refinancing business and fees associated with all those restructurings. Over $100 billion of forced restructurings have been done so far. Bloomberg estimated the fees paid to date exceed over $1 billion and over $7 billion in additional costs to taxpayers

This plan will also reduce the demand on commercial banks for liquidity facilities for those municipalities who were seeking to replace the variable-rate auction bonds with variable-rate demand (put) bonds. These bonds required the municipalities to secure letters of credit or liquidity facilities at ever increasing higher costs and to compete with private businesses for an increasingly scarce banking resource.

The terms of the auction securities allow for a very efficient use of the Treasury funds and a more effective subsidy to municipalities. Almost all auction securities allows for a very low rate to be automatically established if the investors choose simply to hold them. This rate is generally set at 68% of Libor. The Treasury would earn this return and generally should have only modest concerns about the value of the asset it is acquiring (unlike mortgage-backed securities or other collateralized debt obligations).

Because the rate on the bonds would float with short-term rates, Treasury's costs would likely be completely offset by the return on the bonds. Alternatively, Treasury could bid its actual cost of short-term funds, perhaps with a modest increment to compensate it for the incremental credit risk of the underlying state or local debt security. This would still be much less than what the municipalities are paying now. And the municipalities would no longer have to pay an annual 0.25% fee to the brokers nor would they be forced to terminate at penalty costs any swap agreements integrated with the bonds.

Treasury would likely hold these bonds to maturity. If the short-term rates rise and the municipality wishes to fix the rate, they would call and refinance the bonds and fully reimburse the Treasury for the principal amount invested. If the auction market stabilized, the Treasury could sell them in auctions to investors. The Treasury would also immediately benefit from the gain on the bonds they bought from the brokers at a discount.

The only other policy decision to make is whether to include not-for-profit institutions (such as colleges, universities, and hospitals) and other conduit borrowers who are also permitted to issue tax-exempt bonds through states or local governments. The plan would not be available to non-municipal issuers like closed-end investment companies. Yet the release of the capital and liquidity from municipal auctions could assist closed-end funds by increasing demand for their auctions. Extending this to student loans might also be possible, though for student loans Treasury might be losing money on the interest costs and the size of the program would increase.

In addition, even if the funds do not go into taxable investments but rather add billions of dollars of demand for other municipal bonds, all taxpayers still benefit. This increased demand should help stabilize or drive down long-term yields on new municipal issues and encourage deals to get done.

Effecting this proposal would make the U.S. government a primary lender to state and local government issuers at a critical time. These entities are being helplessly squeezed by the credit crisis, and the downturn in the economy is reducing state and local tax revenue. It would free up private capital for use in the private sector without the federal government solely lending to the private sector or subsidizing Wall Street. This is less intrusive to our system of capitalism than the current plan to remove private label securities from the banking system and provide a federal subsidy to the banks. It can be a "win-win" for taxpayers.

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