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New York Bond Costs Rise as Banks Let Auctions Fail (Update5)

By Michael Quint

Feb. 19 (Bloomberg) -- New York state taxpayers' weekly borrowing costs increased $2.3 million after banks failed to attract bidders to auction-rate bonds and stopped buying unwanted securities.

Interest rates on Dormitory Authority bonds sold for the City University of New York rose to as high as 6.26 percent last week from 3.42 percent on Feb. 6, according to data compiled by Bloomberg. Buffalo's rate on water system revenue bonds soared to 11 percent from 3.30 percent. Bonds issued by the Museum of Modern Art climbed to 4.47 percent on Feb. 13 from 3 percent at the end of January.

Rates in the $330 billion auction-rate bond market are rising nationwide after banks from Citigroup Inc. to Goldman Sachs Group Inc. stopped bidding for the debt at periodic sales they oversee, according to Bloomberg data. New York, with $4 billion of auction debt, may convert the bonds to a fixed rate or a different type of variable-rate security, state budget director Laura Anglin said in an interview in Albany last week.

``It hurts,'' said Anthony Farina, executive assistant in the Buffalo comptroller's office. Interest costs on the $63 million of auction-rate bonds rose $93,000 for the week, he said. ``Nobody expected this kind of jump.''

Auction-rate bonds are long-term debt with interest rates that reset according to bids submitted through securities firms every seven, 28 or 35 days. When there aren't enough bids, the auction fails, and the rate is set at a level spelled out in bond documents and investors are left holding bonds they expected to sell.

Auction-Rate Review

State officials, who are reviewing the $4 billion of auction bonds sold by six different authorities as well as by the state in 2002-2004, said the debt was the least expensive type of bond in the two years ended Sept. 30, according to a Dec. 12 report. Since then, it has become the most expensive.

The auction-rate turmoil represents a reversal for state fiscal officials. As recently as Jan. 22, Louis Raffaele, a chief budget examiner who helps manage New York's borrowing, said higher rates on auction bonds across the country could benefit the state. ``Because of our high ratings and unblemished record,'' he said, the state could attract investors fleeing lower-rated issues.

The state's auction bonds backed by state appropriations are rated AA- by Standard & Poor's, the fourth-highest rating. Those backed by the sales tax carry the top AAA rating.

Hospital Pays Penalty

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 indexes compiled by the Securities Industry and Financial Markets Association.

Until the past two weeks, bankers who ran auctions prevented failures by purchasing bonds for their own account, though they weren't required to do so. Investors grew wary of relying on bankers to support auctions as the investment firms reported more than $146 billion of losses and writedowns.

Regulators allow dealers to bid when they choose, and to control auction information as long as they disclose that they might submit bids. Bankers don't have to say how often they buy or how much, and aren't required to make public the range of bids or when auctions fail.

The Securities and Exchange Commission fined banks in a settlement over bid-rigging two years ago. The U.S. municipal bond market's main regulator, the Municipal Securities Rulemaking Board, will soon propose rules requiring banks to disclose more, including the interest rate, bidding details and information about failures.

Inexpensive Debt

In the week of Feb. 11-15, 28 of New York's 43 auctions failed to attract enough bids, including all the auctions on Feb. 14 and Feb. 15. Across the U.S., more than 100 auctions failed.

Information on auction bonds is scarce. Local governments don't make results or bidding details publicly available as is done with traditional competitive bond sales. Wisconsin is an exception and has long published details on its taxable auction bonds.

New York, aware that some auction results were better than others, last year increased the number of banks bidding for some issues to four from one and changed some issues to seven-day auctions from a 28- or 35-day schedule. It said those changes saved $1 million annually.

``Issuers need to end the monopolies of a few banks making a market and earning the fees,'' said Joseph Fichera, chief executive of Saber Partners, a New York-based adviser to local governments and a critic of auction-bond processes.

Auction-Rate Introduction

Auction-rate securities were introduced in the corporate market in 1984, when American Express Co. sold $300 million of auction preferred stock. The securities, devised by Ronald Gallatin, a retired managing director at Lehman Brothers Holdings Inc., then Shearson Lehman, were widely used by banks and other companies before auction difficulties prompted many companies to move away from them.

American Express retired its issue in 1991-1992, and in 1995 Lehman was fined $850,000 by the Securities and Exchange Commission for manipulating auctions it conducted for American Express.

The first failed auction in the municipal market occurred in 1990 for bonds issued by the Pima County, Arizona, Industrial Development Authority for Tucson Electric Power Co., now a unit of UniSource Energy Corp., based in Tucson.

Use of auction bonds by local governments exploded in 2002, when the amount of new sales doubled from the previous year, to about $25.2 billion. New sales continued expanding to a peak of $42.4 billion in 2004 before subsiding to $38.7 billion in 2007.

Increasing Broker-Dealers

Local governments should open auctions to as many broker- dealers, investors and market makers as possible to improve liquidity and restore any lost confidence," Fichera said in a prepared statement.

Rates on New York's seven-day auction bonds last week ranged from 6.26 percent on the dormitory bonds to 3.14 percent for general obligations. The state is paying about 3 percentage points more on its auction debt than on variable-rate bonds it uses as a benchmark, state data shows. In the past, the state paid less on its auction debt than the benchmark.

New York sold 42 issues of seven-day variable-rate demand notes last week at rates from 0.95 percent to 4.5 percent, with 32 issues at 2 percent or less, according to state data.

Subprime Collapse

Costs began increasing in November as investors retreated from securities backed by bond insurers that faced losses and lower ratings from subprime-backed debt. When banks stopped bidding, investors couldn't sell holdings and taxpayers were left with higher rates.

Local governments, which paid banks to issue the auction bonds and annual fees of 0.25 percent of the outstanding obligation to run the auctions, may now pay still more to modify the debt.

New York will ask banks for proposals for letters of credit or standby purchase agreements, promises to buy debt when other investors can't be found, Jeffrey Gordon, a spokesman for the Division of Budget, said Feb. 15. The absence of such bank agreements helped make auction bonds a less expensive form of debt than variable rate demand notes, which have the bank agreements, according to state reports.

``We're undertaking an evaluation of that entire portfolio,'' said Anglin, the budget director. The state's additional weekly interest is equivalent to one year of health insurance payments for 1,300 children, according to state budget documents.

Interest-Rate Swaps

New York's interest-rate swaps haven't shielded it from rising auction rates as intended. The swaps are agreements with banks where the state receives a floating interest rate set at 65 percent of the one-month rate for wholesale bank deposits in London, and pays a fixed interest rate set when the swap is arranged. The floating rate the state receives has declined to 2.02 percent from 2.99 percent Dec. 31, while the floating rates on auction bonds have increased.

The University of Pittsburgh Medical Center plans to redeem $430 million of its debt after buyers at last week's auctions bid just less than the 18 percent penalty rate. The hospital offered to buy back $91 million of its debt, and will make similar bids for almost $340 million more, according to Tal Heppenstall, UPMC's treasurer.

New York Governor Eliot Spitzer said last week that banks, rating companies and federal regulators are to blame for the turmoil that has spread to auction bonds. The Democrat called for scaling back state spending after officials reduced revenue projections because of lower Wall Street profits.

Consumers Union

Rates for Consumers Union, the publisher of Consumer Reports magazine, rose to 11 percent at a Feb. 15 auction for $47.3 million of bonds issued by the Yonkers, New York, Industrial Development Authority, from 4.50 percent a week earlier. The additional expense of $59,781 for one week equals 2,299 annual subscriptions.

The weekly cost for the Museum of Modern Art in New York City rose $14,321 from January.

``At this early stage, it has not affected our financial planning,'' said James Gara, the museum's chief operating officer. ``Clearly changing some or all of these bonds into other securities is one option under consideration.''

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