

CLIENT UPDATE

NOT JUST A HOUSING PROBLEM: SUBPRIME FALLOUT EXTENDS TO VARIABLE AND AUCTION RATE BONDS AND SECURITIES



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Although much attention has been devoted to the adverse effects of the subprime mortgage crisis on the housing market and the financial institutions owning substantial portfolios of collateralized mortgage obligations consisting of subprime loans, there is now a growing focus on the related adverse effects in the bond and securities markets¹. Briefly stated, issuers of variable and auction rate bonds and securities – whether taxable or tax-exempt – who relied on credit enhancement from monoline insurers (either to support auction rate obligations or paired with a liquidity facility to support variable rate demand obligations) have experienced interest rate increases that have ranged from 200 to 1600 basis points above the previous rates on these obligations.

Adding to the concerns that originally surfaced on January 2008, virtually all major investment banking firms stopped supporting auction rate securities during the week of February 11, 2008, which sent an already disrupted market into turmoil. Since many of these firms had previously counseled their clients to amend their documents to allow increased interest rates to keep auctions from failing, some issuers have had to pay as much as 20% on tax-exempt obligations, a five-fold increase above previous levels.

This client update will discuss both the underlying causes of these market disruptions and strategies that issuers should consider pursuing in order to ameliorate the effects of the disruptions on their outstanding obligations. Because the effects have been so widespread – extending to as much as 40% of the variable rate debt market – highly rated banks have been overrun with requests for letters of credit. Even where an issuer can find such a facility, it may take months before the positive effects of that credit support are realized due to required notices and other processes under the debt documents. A fixed-rate solution is generally only available to issuers with ratings at least in the “A” category.

There are two primary causes for the problems facing issuers of variable rate obligations enhanced by monoline insurance or auction rate securities. First, the three major rating agencies (Moody's, Standard and Poor's and Fitch) recently have downgraded virtually all of the monoline insurers. Second, by their nature, auction rate securities lack the guaranteed liquidity of securities backed by a letter of credit or a liquidity facility. The only sector of this market to emerge unscathed is that comprised of variable rate demand obligations (VRDOs) backed by a letter of

¹ Fixed rate tax-exempt bonds and taxable securities that are enhanced by a downgraded monoline insurer have not experienced changes in interest rates, as the risk of adverse rating changes were accepted by the original, or subsequent, purchasers of these securities. In addition to receiving interest rates that are depressed in relation to the current, lowered ratings on these securities, holders will find that the value of these securities in the secondary markets has been subject to a substantial decline, resulting in a two-fold detriment to holders.

credit issued by a bank with an “A” or higher rating or with a liquidity facility paired with an underlying credit or unaffected insurer with at least a “AA” rating.

VRDOs typically carry both a long-term and a short-term rating. In most cases the long-term rating reflects the rating of a letter of credit bank. However, certain VRDOs are enhanced by the rating of a monoline insurer which has issued a policy insuring the timely repayment of the insured obligation. In order to provide a short-term rating and liquidity, most issuers enter into a liquidity facility, typically a standby bond purchase agreement. In either case, the purpose of the letter of credit or liquidity facility is to assure the holders that their rights to tender the obligation on short notice (e.g., on seven days prior notice) will be guaranteed by a bank or other financial institution with a short-term rating at least in the “A” category.

Although these two types of obligations would seem identical in terms of the liquidity provided to investors, the monoline insurance/liquidity facility model has, with respect to the downgraded insurers², resulted in interest rates which exceed the letter of credit model by 200-400 basis points, reflecting the market’s concern about the future of the downgraded insurers.

Auction rate securities (ARS) carry variable rates of interest (subject to a stated maximum rate) which are set by an auction process that may take place at intervals such as every 7, 28 or 35 days. Unlike VRDOs, ARS do not have a bank-supported short-term liquidity mechanism and thus do not have a short term rating. ARS carry long term ratings based either on the credit of a third party enhancer (typically a mono-

line insurer) or the underlying trust estate (e.g., federally guaranteed student loans). This lack of short term liquidity, when combined with the market concerns about monoline insurers, has resulted in auctions which have either reached the maximum rate permitted under the related documents or have failed because there were no bidders willing to take out existing holders³.

Issuers of obligations who have experienced significant increases in variable rates as a result of the subprime crisis need to be aware of several things as they formulate a strategy for the future. First, it appears unlikely that holding on and hoping that an insurer will be upgraded or that this portion of the market (non-letter of credit VRDOs and ARS) will settle down in the foreseeable future. Second, and as a result of this, letter of credit banks have been deluged with requests to “wrap” or refinance these troublesome debt issues, resulting in credit rarely being available to issuers without a strong preexisting relationship with a bank. And, even where credit is available, its cost has risen dramatically. Third, as mentioned above, certain highly rated issuers may be able to refinance their affected debt obligations into fixed rate obligations, an option that may be attractive in an historically low interest rate market.

The primary lesson, however, is that action needs to be taken sooner, rather than later, with a team of professionals who can help restructure the debt affected by the subprime crisis.

If you have any additional questions regarding this Update or have any other Corporate & Business needs, please contact any member of the Corporate & Business Law Group.

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²At this writing, MBIA, Ambac, FGIC, XL, Radian and ACA have been downgraded by at least one of the rating agencies, with only FSA and Assured Guaranty retaining their ratings.

³Although not legally required to, many broker-dealers traditionally made a market in ARS to assure liquidity. As noted above, those efforts came to an abrupt halt recently.