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The Sad Story of Auction-Rate Securities

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Investors in auction-rate securities will fare better or worse depending on the ARS issuer. Our prognosis for key market segments.

ALL AUCTION-RATE SECURITIES are not created equal. How much money investors get back from these instruments devastated in the recent credit crisis -- and how quickly -- will depend on who issued them.

Some investors in the auction-rate securities sold by a municipality or a taxable, closed-end mutual fund already have gotten their money back or may do so within weeks. Those holding issues from tax-free, closed-end municipal-bond funds will likely see some money back before long. The folks running these funds are frantically working to come up with a replacement security, but some need approval from the Securities and Exchange Commission and the Treasury Department. That could take a few months, but it should happen.

In the toughest jam are investors who purchased auction-rate securities sold by a student-loan trust or a collateralized debt obligation -- about a third of the $330 billion market. Many are receiving little or no interest, and might not get their money back for years.

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As troubles mounted, ARS investors started looking for what they assumed were exits and found none existed.

Auction-rate securities, once considered a money-market alternative, are either debt that matures in 30 or 40 years or perpetual preferred stock, which never matures. Until recently, ARS were often considered short term because an auction was held every seven, 28 or 35 days to set a new interest or dividend rate. Participants -- both mom-and-pop investors and corporations seeking yields on their cash -- assumed they could sell their securities at auction to new buyers.

The system worked until February, when sellers outnumbered buyers and the auctions began to fail. Investors, who normally held onto their securities at auction, were now looking for the exits -- and finding none existed. In the general credit crisis, buyers and sellers grew skittish about companies that insured municipal ARS, rising default rates on student loans and CDOs' opacity.

INVESTMENT BANKS HAD THEIR own problems. They were taking billion-dollar write-offs related to the turmoil in the subprime-mortgage market and were stuck holding billions of dollars of leveraged-buyout bank loans. Some issuers believe the bankers were unwilling to be the buyers of last resort at the auctions because their own balance sheets were already stretched to capacity.

The upshot: The ARS market came to a grinding halt. Investor lawsuits against brokers and fund families are flying. (Issuers generally note that the brokers had no legal requirement to provide liquidity to the market and the liquidity risks were laid out in prospectuses.)

Now the nuances of who's likely to get money back and when are understood by investors in the secondary market, says Barry Silbert, founder and CEO of Restricted Stock Partners, which runs a trading platform that's handling a lot of the transactions. The longer it takes to get money back, the greater the discount buyers require to purchase the securities. For instance, municipal ARS trade at only a slight discount, 92-98 cents on the dollar, says Silbert. At the other end of the spectrum are CDO-issued ARS that can trade for about 50 cents on the dollar.

Ironically, there doesn't seem to be any effort underway to repair the auctions. Some issuers are being told by their investment bankers that the market is dead. But not everyone agrees.

"Investors should be demanding that the auctions be unfrozen by the issuers and their brokers," says Joseph Fichera, CEO of Saber Partners and a former investment banker involved in the market. The brokers and issuers could be providing more transparency about who is bidding and at what price, as in U.S. Treasury auctions, he says. They could also offer higher rates to compensate for liquidity risks, and more than one broker should be involved in each auction to bring in as many investors as possible, in Fichera's view.

Four months later, the municipal auction-rate market has regained a bit of liquidity, while other auctions remain paralyzed. Below we've laid out the main market segments and their prognoses.

Municipal Issuers

Issuers like cities and toll roads had about $165 billion of ARS outstanding at the start of the year, or about half the ARS market. When the auctions failed, rates on some securities jumped as high as 15% or 20%.

Rather than make such lofty payments, many municipalities chose to refinance their ARS with new debt. Bloomberg estimates that north of $63 billion of municipal ARS have been refinanced and that auction-rate holders were bought out without losing any money.

The high penalty rate also attracted other investors. As a result, about half of the municipal auctions are working again, with interest rates in the 4% to 5% area.

Some municipalities, like the Bay Area Toll Authority, were smart enough to require underwriters to agree to keep the rate on any failed auctions low. As a result, the rate on the authority's $720 million of ARS remains in the mid-3% to low-4% area despite failures, says Brian Mayhew, CFO of the agency that operates seven bridges. He'd like to refinance the ARS with variable-rate-demand bonds backed by a bank liquidity facility. The problem: finding banks willing to provide the facility at a reasonable cost. If Mayhew can't, he may leave the failing ARS outstanding since he's got a low rate.

The Bottom Line:

The value of auction-rate securities depends on who issued them. ARS from municipalities are worth the most right now; those from CDOs fetch the lowest prices.

So, in the municipal market, investors need to know their issuer. A large issuer with a good rating and ARS yielding more than 10% is likely to refinance. A small issuer with poor ratings or one with a low ARS rate may be inclined to leave the securities alone.

Taxable Closed-End Funds

These funds typically sell stock in the public market and use the money to buy equities or taxable bonds, like corporates or mortgage-backed securities. To boost returns, the funds often use leverage, selling auction-rate preferred stock or bonds and using the proceeds to buy more securities.

Closed-end funds are allowed to sell $1 of preferred securities for every $2 of investments they hold. But funds can offer only $1 of debt for every $3 of investments they hold. So by selling preferred securities, the funds could increase their leverage more than if they had sold debt.

Auction-rate preferreds were attractive because they had low, money-market-like yields on financing that was really long term: perpetual preferreds never mature.

At 2008's start, about $33 billion of auction-rate perpetual preferred stock was outstanding from giant fund families like Nuveen, Eaton Vance and BlackRock.

When the crisis struck, regulators told the funds they couldn't help the auction-rate preferred holders at the expense of the equity holders. So a fund couldn't replace the preferreds with high-cost debt.

Likewise, funds that were leveraged 2-to-1 couldn't replace the preferreds with debt because they would have had to delever to the debt requirement of 3-to-1. Doing so would also have reduced the payments, known as the net interest income, to equity holders.

So far, some of the less leveraged taxable funds have replaced their ARS with debt. At Nuveen, seven of 13 taxable funds plan to replace $1.7 billion of their $4.3 billion of auction-rate preferreds with alternative financing. The key again is finding banks willing to provide loans or guarantees.

The industry has asked the SEC to change the leverage requirements, so that debt financing can be leveraged 2-to-1, like preferred.

So far, about 40% of the ARS sold by taxable closed-end funds has been or will be refinanced, estimates Mariana Bush, a Wachovia Securities analyst. Many of the ARS yield about 3% now that the auctions have failed. That's not great for a long-term security, but it's not bad relative to a 2% rate on some certificates of deposit. Investors who can hold on for a year should consider doing so. There isn't much credit risk, and north of 80% of these securities are likely to get refinanced in the next year.

Municipal Closed-End Funds

These funds, which own municipal bonds, face all the above problems with an added twist. Dividends on auction-rate preferred securities of municipal closed-end funds are tax deductible. If the same funds sold debt, the interest payments wouldn't be deductible, and their interest rates would have to be higher.

So fund families that sold closed-end muni-bond funds have been scrambling to create a new preferred security. At Nuveen it's called Variable Rate Demand Preferred. At Eaton Vance, it's Liquidity Protected Preferred stock.

The securities vary but generally involve a frequent auction to set the dividend rate. If the auction fails, existing holders would have an option to put the security back to a bank that would agree to hold it for a preset term. On some securities the preferred dividend rate would rise so high the fund family would be forced to repurchase them from the bank.

Some funds have asked the SEC to allow money-market funds to purchase the security because it has a put option. If so, that would bring a huge new buyer to the market and the added liquidity might get the auctions working again. "We expect to be able to respond affirmatively fairly quickly in the next couple of weeks," says Robert Plaze, associate director, division of investment management at the SEC.

That said, the security faces tax questions. Will Treasury deem it preferred stock or debt, given the fund will ultimately buy it back? And again, banks must go along.

Municipal closed-end funds have about $28 billion of auction-rate preferred stock outstanding. Only $2 billion has been refinanced and the auctions are failing. Our guess is the fund families and the government are motivated to find a solution, though it might take up to a year. But since these securities sell in the secondary market at only 82 cents on the dollar, with minimal credit risk, it seems worth waiting.

Student Loans

Some of the thorniest issues have arisen in the student-loan auction rate market, where almost all of the auctions continue to fail and only $1 billion of the $85 billion outstanding has been refinanced.

In recent years private companies have originated federally insured student loans and financed them by selling them into a trust. The trust in turn sells some medium- and long-term debt and some ARS.

There are few refinancing options. Financing costs in the student-loan market have gone up sharply, so old trusts can't be refinanced. Congress and the Department of Education have agreed that the DOE can buy new student loans from private companies and make short-term loans to newly created trusts. But the DOE hasn't addressed ARS' biggest problem: illiquidity.

One option: The Federal Financing Bank, a unit of the U.S. Treasury, could provide a standing bid in auctions of London interbank offered rate, or Libor, plus half a percentage point, to give investors a way out of an auction if they desired, says Jamie Wolfe, CFO of NorthStar Education Finance, a graduate-school lender. It has $4 billion of student loans in trusts that were financed in part with $800 million in ARS that are frozen.

"The priority now is that students going to college this fall have access to capital," says Restricted Stock Partners' Silbert. Solving the problems may take awhile.

Some of the initial rates from failed auctions were 10% or more. But as more auctions fail, a mechanism kicks in that prevents the average rate from going so high as to push a trust into default. As a result, some student-loan-auction rate securities offer 0% rates to investors, but the rates tend to average 3% over time. And that doesn't encourage the trusts or the student-loan companies to fix the problem.

Collateralized Debt Obligations

In hindsight, the riskiest ARS were sold by the CDOs. Some CDOs bought fixed-income investments and financed them by selling ARS.

The problem is that most ARS holders have no idea what the CDOs own because the information is not disclosed. Some may have invested in the highly rated pieces of subprime-mortgage securities. Others have sold a put option to insurers that require the CDO to sell its investments and buy the preferred stock of the insurer.

There are about $20 billion of CDO ARS that are in failing auctions and illiquid. These ARS won't be redeemed. They'll stay outstanding until the CDO winds down, either because it's collapsing or because the investments it holds are maturing. Investors should push their brokers to find out what investments their CDO owns in order to make an educated decision about whether to hold or sell.

Caveat Emptor: Know the Issuer of Your Auction-Rate Securities

Below are the most important details about the five major kinds of auction-rate securities, categorized by type of issuer. Different sorts of issuers face different problems in this still-troubled marketplace, where many auctions continue to fail and prices vary greatly.

Issuers	Municipalities	Closed-End Funds Taxable	Closed-End Funds Municipal	Student-Loan Trusts	Collateralized Debt Obligations
Securities Auctioned	Tax-deductible 30-year, 40-year bonds	Perpetual preferred stock[1]	Tax-deductible perpetual preferred stock	30- to 40-year notes	30- to 40-year notes
Outstanding as of 1/1/08 (bil)	$165	$33	$30	$85	$20
Repurchased since 1/1/08 (bil) [2]	$63	$13.5	$1.7	$1	$0
Risk Profile/Credit Rating	Insured by Ambac or others/Triple-A	Collateralized 2-to-1 by fund assets/Triple-A	Collateralized 2-to-1 by fund assets/Triple-A	Loans are federally insured/Triple-A	Over Collateraization
Auctions failing as of 5/19 [3]	50%	99%	99%	99%	99%
Interest paid on securities that fail to sell	3.5% to 20%	2% - 4.5%	2% - 4.5%	0% - 10%	3% - 4%
Estimated market price of auction-rate securities (cents on the dollar)	$0.92 to $0.98	$0.88 - $0.92	$0.82 - $0.88	$0.75 - $0.80	$0.50
Outlook	Likely to be repurchased	Likely to be repurchased	Industry seeking approval for replacement securities	Absent a government bailout, likely to stay outstanding	Likely to remain outstanding

1. Preferred stock that never matures. 2. Includes announced repurchases. 3. Due to lack of demand.

Sources: Restricted Stock Partners; Wachovia Securities; NERA Economic Consulting