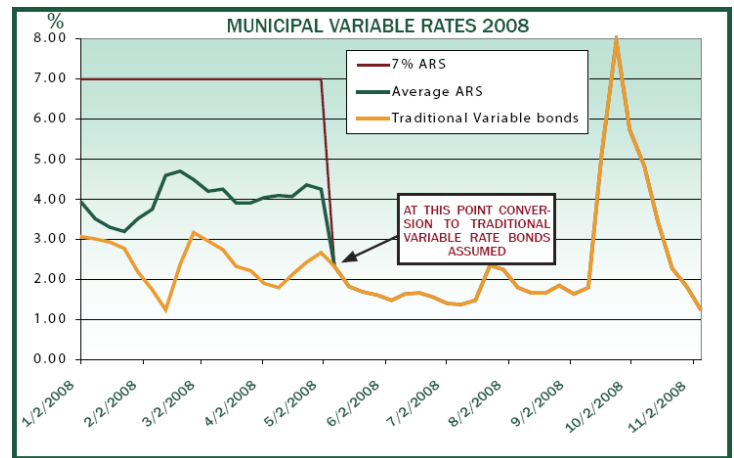


# MARKET UPHEAVAL FAILS TO UPEND VARIABLE RATE BORROWERS IN 2008

BY PAUL PENDER, ASSISTANT VICE PRESIDENT

Many California water districts with variable-rate bonds experienced volatile, often expensive, borrowing costs in 2008. Through November, however, many such districts assessing their debt costs over the entire year may find they actually paid nearly the same in interest as in recent, more stable years. This may be surprising, given that many variable-rate borrowers began the year in the now-defunct Auction Rate Securities (ARS) paying high rates. Then in September they were later socked with rates of 5-8% for several weeks as a result of the global financial crisis. What did not grab headlines in 2008, however, were significant periods in which borrowers paid variable-rates below 2%. This has resulted, to date, in average interest rates of some 3-4% for the year. This article's assessment incorporates certain rates Fieldman, Rolapp & Associates believes to be reflective of many water district borrowers and an analysis of data compiled by Securities Industry and Financial Markets Association (SIFMA).

The year began with unprecedented tumult for ARS borrowers. Such securities bear interest rates that are reset, usually weekly, based on investor demand. ARS carried a credit guarantee from a bond insurance company, such as MBIA or Ambac. But unlike traditional variable-rate bonds, the insurance company was not on the hook to unconditionally purchase any bonds investors wanted to sell back. The auction process typically served this liquidity purchasing function, but of course it could not without investor demand. In January 2008, investor confidence collapsed in the once-venerable bond insurance companies. Over just a few weeks, all traditional ARS investors sold out (or tried to) of the securities in a stampede, which rapidly drove up ARS borrowing rates from around 3% at the end of 2007 to as much as 12% in some cases. Higher rates also hit more traditional variable-rate bonds using bond insurers for credit support. By late February, most districts with these securities faced significant short-term financial stress.



With their debt costs spiraling upward to unaffordable levels, it seemed to many districts they had made an irreparable financial mistake. Many second guessed themselves, wishing they had instead issued traditional fixed-rate bonds. Indeed, these bonds had seen rates at historic lows of some 4.50% for long-term borrowings in 2004 and 2005. In the maelstrom of the usurious January-February ARS crisis, it was easy to forget that ARS and other traditional variable-rate bonds had provided borrowing costs averaging some 3.2% the previous 3 years—just slightly higher than the long-run average of the prior 20 years.

During the financial stress, districts debated whether to convert their ARS to fixed-rate bonds or retain their variable-rate borrowing strategy. Remaining in a variable-rate borrowing mode meant securing new credit commitments from a commercial bank – a structure that remained popular with investors. Indeed, such traditional variable-rate bonds in February were still paying interest rates below 3%. Further complicating the decision was the fact that most bond insurance companies, such as Ambac and MBIA, still were officially branded with “AAA” ratings from Moody’s and Standard and Poor’s. This plausibly suggested to many another prudent strategy was to

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## MARKET UPHEAVAL FAILS TO UPEND VARIABLE RATE BORROWERS IN 2008 *(CONTINUED)*

BY PAUL PENDER, ASSISTANT VICE PRESIDENT

“stay the course” in ARS rather than incur new costs to restructure.

As traditional variable-rate bond rates remained well under 3% throughout March and April, and ARS continued at rates 3-6% higher, many districts pulled the plug on their ARS and converted to the traditional structures. Although such new issues had restructuring costs, including in some cases new credit costs some 2-3 times higher than prior years, districts immediately saw their variable interest rates slashed below 2% in most cases.

The rates remained at those levels for months, averaging around 1.75% for the next 4 months, never topping 2.4%. But the tranquil period did not endure. On Monday, September 15, financial markets opened to a staggering trio of events: Lehman Brothers had filed for bankruptcy, Merrill Lynch was sold, and AIG was shockingly facing bankruptcy. In the ensuing turmoil, investors pulled money from everywhere, including funds invested in municipal variable-rate bonds. As the affected municipal funds scrambled to liquidate investments to meet redemptions, they drove even the highest rated, well-secured variable-rate bonds to rates approaching 8% for a week. For about a 2-week period, many variable-rate borrowers thought they were facing another ARS-type meltdown.

In October, however, rates fell to 3.5% and ultimately dipped below 2% by November. For the year through November 15, that brought the average interest-cost to around 2.5% for districts that began the year in the traditional form of variable-rate bonds. For borrowers that began the year in ARS with higher penalty rates (7% January to May), the average interest cost to date was approximately 4.25%; for districts that began in ARS with more average penalty rates, the average interest cost to date was approximately 3.05%. (Both ARS scenarios assume a conversion to traditional variable-rate bonds in early May.)

For many water districts that utilize variable-rate bonds, 2008 has therefore turned out to be surprisingly benign given the headline-grabbing periods of high rates and volatility. And while the financial crisis remains intractable, likely well into 2009, future periods of volatility could yet strike the same borrowers again. But as many districts have found in 2008, intermittent periods of unexpectedly high rates are unlikely to undermine the average long-term costs of their variable-rate strategies. ♦

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