

## 2008 first-half municipal market review: The end of securities and bond insurance as we know it?

By Anthony P. Inverso, Managing Director, Phoenix Advisors, LLC

As the calendar flipped to 2008, a cloud of uncertainty shrouded the municipal bond market and the credit strengths of municipal bond insurers. Several "AAA" rated bond insurers, including well-known names such as Ambac and MBIA, were being threatened with downgrades to their ratings.

Then, in mid-January, the news hit the municipal market: Ambac was downgraded to "AA" by Fitch Ratings, becoming the first "AAA" monoline bond insurer to lose its elite status. Suddenly, the landscape, as the municipal market knew it, changed. Ambac's downgrade was followed by a Fitch downgrade of MBIA and the wheels began to fall off...ratings of more bond insurers dropped, auction rate securities began to fail (forcing default interest rates as high as 20% on certain securities), municipal interest rates spiked over 65 basis points in two weeks, and the credit markets were facing a crisis. The catalyst for these problems was the exposure of bond insurers and other financial institutions to sub-prime mortgages and the resulting liquidity shortage, or as the nightly news called it, the "sub-prime mortgage crisis."

Sub-prime mortgages are loans made to less creditworthy borrowers at higher rates, with unique terms varying from traditional loans, and

usually in the form of adjustable rate mortgages (ARMs). Borrowers, both sub-prime and more creditworthy, have been facing repayment problems as housing values decrease and the reset rates on ARMs increase. The inability to repay loans created a ripple effect through the financial markets, especially with municipal bond insurers, many of which have significant

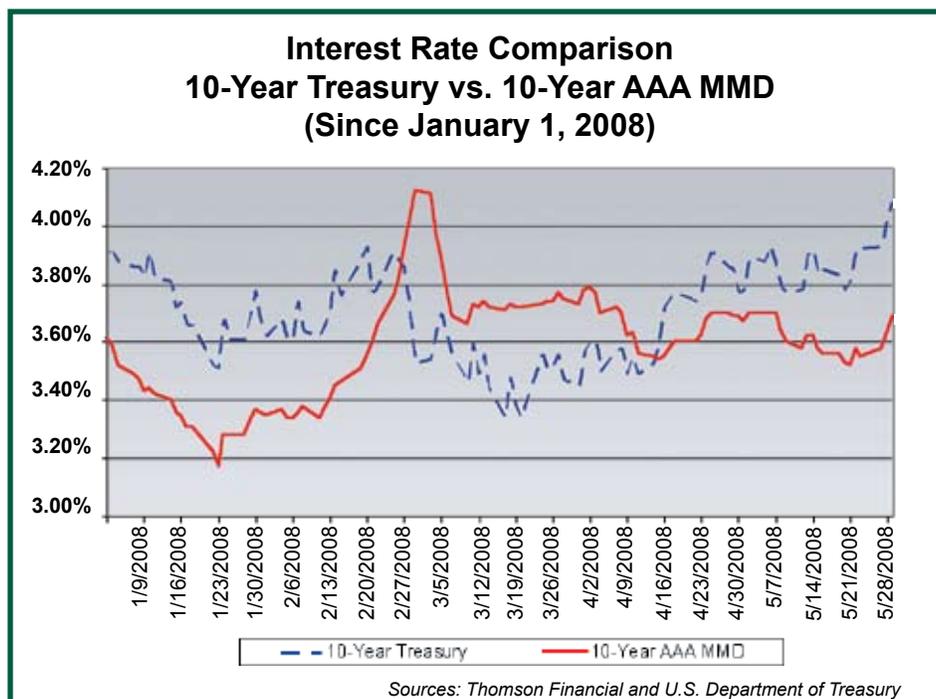
were victims of the sub-prime crisis. As the number of and speculation of more downgrades to bond insurer ratings grew, so did the rates on ARS. Investors shied away from these securities for fear of the securities losing liquidity in the marketplace. As this occurred, fewer, or in many cases, no participants showed up for the auctions, driving rates higher or to default levels.

Issuers then scrambled to restructure debt which suddenly was costing multiples of what it had been only weeks before. As a result, April and May became two of the busiest months ever in the municipal market, with a flood of over 2,000 issues sold nationally for a total par amount over \$88 billion. By the end of the first half of 2008, nearly half of all auction rate securities will have been converted or redeemed, mainly in the form of more predictable fixed rate debt or variable rate secured by a bank letter of credit. In

addition, according to Thomson Reuters, no new auction rate securities have been issued thus far this year.

As a whole, issuance nationally in the municipal market is down 5.8% compared to 2007 while New Jersey issuance is down 27.5% compared to 2007. But, several New Jersey state-level issuers, including the NJEFA, have

*Continued on page 3*



exposure to collateralized mortgage obligations (CMOs) secured by these loans. In addition, the rating agencies failed to adequately assess the riskiness of these investments. Thus, the downgrades and uneasiness in the municipal market began.

Auction Rate Securities (ARS), whose attractiveness was linked to the ability to procure bond insurance versus a bank letter of credit,



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**2008 BOARD CALENDAR \***

| DATE         | LOCATION                 |
|--------------|--------------------------|
| July 23      | NJEFA                    |
| August 27    | NJEFA                    |
| September 24 | College of St. Elizabeth |
| October 22   | NJEFA                    |

\* Meeting dates subject to change.

# A sea change for municipal bond ratings

By Roger L. Anderson, NJEFA Executive Director

The market turmoil described by Anthony Inverso on page 1 has forced us all to reconsider many market standards. One such is municipal bond ratings. Traditionally, the municipal bond market was separate from other markets, and, in the words of Moody's Investors Service, "As there were few cross-over investors making direct risk comparisons between municipal bonds and other securities, the meaning and loss expectations of the ratings diverged over time, so that today there is essentially a separate rating scale for US municipal bonds."

These separate scales unfortunately use the same symbols. The result of such divergence is that the historic rate of default on municipal bonds of a given rating is only a fraction of the default rate on comparably rated corporate bonds. Further, the historic risk of loss is also lower. Holders of those few municipal bonds that do default typically recover a higher percentage of their investments than do holders of defaulted corporate bonds.

Having different rating scales began to create problems as the municipal bond and other markets became more connected. Traditional institutional investors in municipal bonds understood there were different scales, but the last five years have seen a huge influx of foreign and hedge fund buyers into our market. These investors are not used to the municipal rating scale, and the different scale makes it harder for them to compare municipal bonds to other investments.

Bond insurance, which is rated on the corporate scale, served to paper over the differences, but, as the bond insurers' ratings got questioned and in many cases fell, investors focused more on the underlying borrowers' ratings. With the harmonizing effects of bond insurance falling away, the disparate ratings scales became a major problem.

While insiders have long known that the scales are different, most outsiders, because the symbols are the same, treat the ratings as equivalent. The SEC and many state investment

statutes require that certain kinds of investors hold securities with a particular minimum rating. For instance, the SEC requires that money market mutual funds hold assets rated AA/Aa or better, regardless of whether an investment is a municipal or corporate security.

Municipal bond issuers nationally therefore, in a movement spearheaded by California Treasurer Bill Lockyer and joined by the EFA, have been pushing the rating agencies to eliminate the discrepancies.

The rating agencies have recognized the issue, although they are approaching it differently. Moody's just announced that it plans to transition public finance ratings to its global scale, but there are no details yet on how that will occur.

In addition, U.S. Rep. Barney Frank, Chairman of the House Financial Services Committee, has just introduced legislation to require rating agencies to use a single scale for rating corporate and municipal bonds.

There has been some concern that, if most municipal bond ratings were raised, it could be harder to differentiate the credit characteristics of various issuers. Clearly, a revised ratings system has to provide useful information to investors for it to be valuable, but there are many ways to provide the fine gradations useful to traditional investors while also providing the global comparability useful to global investors. Moody's has stated it expects to continue to provide reasonable credit differentiation.

The global economy is too interconnected for our market to exist in an isolated bubble. Both prices and liquidity have benefited from the influx of new investors. We must recognize, adapt to and welcome this sea change, and we must eliminate barriers to its development.



*Roger L. Anderson*

*Having different rating scales began to create problems as the municipal bond and other markets became more connected.*

## NJEFA completes 10 deals in first half of 2008

Since January, NJEFA has completed 10 transactions for 8 colleges and universities with a total par value of approximately \$560 million. Over \$463 million financed refundings, while \$96 million financed new capital projects at Drew University and The William Paterson University of New Jersey.

NJEFA's financing for William Paterson provided more than \$84 million for the expansion of Science Hall that includes a new 66,000 square foot addition with research space, classrooms and teaching labs.

The market failures described by Anthony Inverso have affected 14 series of auction rate securities and 3 series of insured variable rate demand bonds issued on behalf of 9 of NJEFA's clients. Most of the year's refunding activity represents the Authority's efforts to help its clients move out of these adversely-affected short-term borrowings and into other types of securities

such as fixed-rate bonds or letter-of-credit-backed VRDOs. To date, NJEFA has closed debt and/or swap restructurings on behalf of Rowan University, New Jersey City University, The College of New Jersey, The College of

Saint Elizabeth and the Institute for Defense Analyses. The Authority expects to complete the restructuring of the remaining affected issues by the end of September.



*NJEFA's financing for William Paterson University provided more than \$84 million for the expansion of Science Hall, shown in the rendering above.*

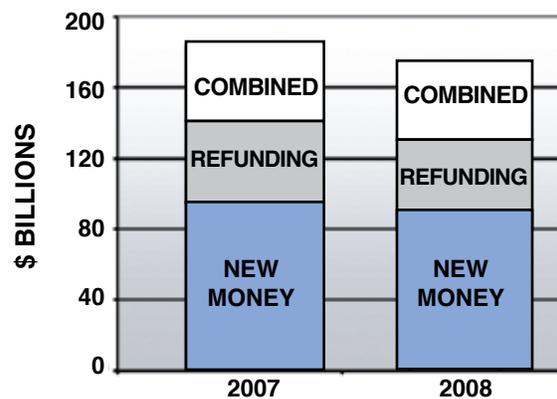
### 2008 market review, Continued from page 1

been busy restructuring their ARS. Although the ARS saved colleges and universities substantial amounts of money when originally issued, like all ARS, the rates had spiked to unfavorable levels. The NJEFA has been at the forefront of this process, already successfully converting five of these complex transactions (some involving multiple swap agreements), thereby saving substantial interest cost for both private and public entities.

As the dust finally settles and the first half of 2008 nears a close, the majority of issuance to restructure auction rate securities is complete, the ratings of several bond insurers are still under review, FSA and Assured Guaranty have remained unscathed by the sub-prime crisis (maintaining solid "AAA" ratings by all three rating agencies), and the supply of bonds in the municipal market is expected to return to pre-April levels. But, the wounds of the first quarter of the year remain. Now, the municipal market is faced with only two "elite" bond insurers from which to choose, many ARS have been restructured or redeemed, and borrowers are not issuing new auction rate debt.

So, how do we answer the question: "the end of Auction Rate Securities and bond insurance as we know it?" "Yes." 

**NATIONAL BOND ISSUANCE VOLUME AND BREAKDOWN**  
2007 and 2008 (January - May) Comparison



Sources: Thomson Reuters and The Bond Buyer

**Bond Insurer Ratings**  
(as of June 23, 2008)

| Insurer          | Moody's           | S&P                 | Fitch              |
|------------------|-------------------|---------------------|--------------------|
| ACA              | NR                | CCC (Credit Watch)  | NR                 |
| Ambac*           | Aa3 (Neg Outlook) | AA (Credit Watch)   | AA (Neg Outlook)   |
| Assured Guaranty | Aaa (Stable)      | AAA (Stable)        | AAA (Stable)       |
| BHAC             | Aaa (Stable)      | AAA (Stable)        | NR                 |
| CIFG*            | Ba2               | A- (Neg Outlook)    | CCC (Rating Watch) |
| FGIC*            | B1 (Neg Outlook)  | BB (Credit Watch)   | BBB (Neg Outlook)  |
| FSA              | Aaa (Stable)      | AAA (Stable)        | AAA (Stable)       |
| MBIA*            | A2 (Neg Outlook)  | AA (Credit Watch)   | AA (Neg Outlook)   |
| Radian           | Aa3 (Neg Outlook) | A (Credit Watch)    | Rating Withdrawn   |
| XLCA*            | B2 (Neg Outlook)  | BBB- (Credit Watch) | BB (Neg Outlook)   |

\* Formerly rated "Aaa/AAA/AAA"



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## NJEFA welcomes new controller

NJEFA welcomed Marie P. Mueller in March as its new Controller following the retirement of Donald Uyhazi who had served in the position for 25 years.

Ms. Mueller brings over 23 years of experience in finance to the Authority along with her expertise in SEC reporting, financial analysis, internal reporting and planning, budgeting, *Marie Mueller* cost control, strategic planning and asset/liability management.



Prior to joining the Authority, Ms. Mueller served in various positions at several financial institutions including, First Fidelity, Cenlar, JP Morgan Chase, United Trust, Community Bank of New Jersey, and Provident Senior Living Trust. Ms. Mueller holds a Bachelor's Degree in Accounting from the University of Arizona and an MBA in Finance from the Rutgers Graduate School of Management.

### NJEFA ISSUES CLOSED IN 2008

| INSTITUTION                                   | PROJECT   | CLOSING | AMOUNT                      |
|---|---|---------|-----------------------------|
| <b>PUBLIC</b>                                 |   |         |                             |
| Rowan University                              | Debt restructuring  | 4.10.08 | \$ 35,205,000               |
| New Jersey City University                    | Debt restructuring  | 4.24.08 | 74,620,000                  |
| The College of New Jersey                     | Debt restructuring  | 4.30.08 | 287,790,000                 |
| The William Paterson University of New Jersey | Renovation & expansion of the Science Building; refunding | 6.26.08 | 88,670,000                  |
| <b>PRIVATE</b>                                |   |         |                             |
| Drew University                               | Refunding   | 4.4.08  | 10,765,000                  |
| Institute for Advanced Study                  | Refunding   | 4.17.08 | 11,255,000                  |
| College of Saint Elizabeth                    | Debt restructuring  | 5.29.08 | 24,090,000                  |
| Institute for Defense Analyses                | Debt restructuring  | 6.25.08 | 15,015,000                  |
| Drew University                               | Capital improvements                                      | 6.26.08 | 12,000,000                  |
|   |   |         | <b>Total: \$559,410,000</b> |