



## Unlocking the Auction-Rate Mess

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It would be nice to think the auction-rate securities mess is about to have a happy ending, now that Merrill Lynch, Citigroup and, most recently, UBS have agreed to repurchase almost \$30 billion of auction-rate securities at face value from retail clients. But markets, like life, aren't so tidy. The headache that ensued when the market for these long-term-debt and perpetual-preferred-stock instruments froze in February merely has shifted to a new set of heads.

Retail and institutional investors alike loaded up on auction-rates in recent years, assuming they were almost as liquid as cash. Generally, investors can opt to sell such securities at weekly or monthly auctions -- or at least they could until the investment banks stopped bidding on them last winter. The result: Holders of \$330 billion of securities quickly found they had no buyers, and no way of unlocking their money.

That thousands of bank and brokerage clients will dodge losses and regain access to their funds owes largely to the efforts of state attorneys general and the Securities and Exchange Commission. And their numbers could keep climbing if regulators pursue claims at other banks and brokerages, including Credit Suisse (ticker: CS), Wachovia (WB) and Bank of America (BAC), that sold auction-rate securities. About \$220 billion of such instruments remains outstanding.

To a large degree, and many would argue appropriately so, Wall Street has transferred to itself the risks that previously resided with clients. Yet, this has been costly, and there's no endgame in sight. Citigroup (C) estimates it will lose \$500 million before taxes as a result of purchasing \$7.5 billion of auction rate securities from retail clients, while UBS (UBS) could lose \$900 million. Merrill (MER) didn't offer an estimate, but said the impact wouldn't be material.

"This is a relatively low-cost political settlement," says Brad Hintz, a brokerage analyst at Sanford C. Bernstein. Buying the securities won't help the firms' efforts to shrink their own bloated balance sheets, but even at Merrill, the \$12 billion of auction-rate securities it agreed to purchase is tiny relative to its balance sheet of about \$1 trillion.

To fund the purchase of these securities, the buyers might be able to put them in a trust that sells securities to finance itself. Last month UBS said it would do just that with \$3.5 billion of auction-rate preferred stock issued by closed-end tax-exempt funds and held by UBS clients. But it is likely the majority of brokerages will fund the repurchase of securities by raising short- and long-term debt.

Making retail clients whole, meanwhile, does little for the firms' institutional clients that purchased auction-rates. UBS has promised to buy back the \$10.3 billion of auction-rate securities its institutional clients hold by June 2010. Citigroup has offered its "best efforts" to liquidate by the end of 2009 the \$12 billion of auction-rates its institutional customers own. Merrill hasn't said how it will treat professional investors.

Some large investors are taking action on their own behalf. STMicroelectronics (STM) sued Credit Suisse last week for allegedly investing \$450 million in auction-rate securities without authorization.

A number of corporations reportedly have extracted sweetheart deals from the brokerages because of their size and heft, selling auction-rate securities back to the firms at above-market prices. Tim Batchelor, a managing director at Duff & Phelps, says he has heard of at least a dozen deals in which a broker dealer or its affiliate has purchased auction-rate securities from a corporate client at 90 cents on the dollar, when the fair market value was closer to 70 cents.

The consequences to brokerage-industry income statements and balance sheets of buying and holding large inventories of auction-rate securities will depend on the securities involved. Auction-rates were sold by

municipalities, closed-end funds, student-loan trusts and collateralized debt obligations, and as Barron's has noted in the past (in "The Sad Story of Auction-Rate Securities," May 26, 2008), knowing the type of security is key to understanding its worth.

The auction-rate market has shrunk by more than 30% since the start of the year, as many issuers successfully have replaced auction-rate securities with other securities. Municipalities have been the most active, in part because they have greater access to capital and a strong motivation. When many municipal auctions failed, the municipalities' interest rates rose to punitive levels.

The municipal auction-rate market totaled about \$175 billion at the start of the year. That number has come down by about \$70 billion and should continue to decline, says Batchelor. Some 5% to 8% of muni auctions are proceeding -- at interest rates of 8% to 15%.

Municipalities facing tough financial times will find it harder to refinance. Take Jefferson County, Ala., which has seen some of its debt ratings slashed to high-yield, or junk status, and has \$2.2 billion of auction-rate securities outstanding. Eventually, there may be \$10 billion to \$12 billion of municipal auction-rate securities that can't be refinanced for similar reasons, says Batchelor.

Closed-end funds have been almost as successful at refinancing the securities they've sold. At the start of the year the funds had about \$64 billion of ARS outstanding. Now that figure is closer to \$40 billion, a 37% decline, including what the funds have said they plan to redeem, says Cecilia Gondor, a closed-end fund analyst with Thomas J. Herzfeld Advisors.

The rate on ARS sold by closed-end funds doesn't jump if auctions fail. Nonetheless, fund families have a strong incentive to find replacements for the existing auction-rate securities: Only one new closed-end fund has been sold this year. "Retail brokers are not interested in selling any new [closed-end] funds until this [auction-rate security problem] is dealt with," says Gondor.

Nuveen's closed-end funds sold \$500 million of variable-rate demand-preferred shares last week to replace the same amount of auction-rate securities. The VRDPs, as they're known, have interest rates that reset in auctions but include a put option that allows an investor to put the security to a bank, in this case Deutsche Bank, if the auctions aren't successful.

If the VRDPs find a market, more than 50% of closed-end-fund auction-rate securities could be redeemed by year end, Gondor estimates.

Issuance of VRDPs is limited only by the number of banks willing to provide the put-option feature. "Getting the liquidity through a put option or a bank line of credit at a reasonable cost is becoming a problem, because there is so much competition for it from municipalities and closed-end funds," says Joseph Fichera, CEO at Saber Partners.

If brokerages hold large inventories of auction-rate securities, they may be more motivated to provide liquidity backstops to encourage refinancings, Gondor adds.

Almost no progress has been made in refinancing the ARS sold by student-loan trusts or collateralized debt obligations. Only \$2 billion of the \$85 billion of student-loan auction-rates has been refinanced since the start of the year. The problem: Student-loan trusts can't sell new securities at a low enough rate to make refinancing an option, explains Jamie Wolfe, CFO of NorthStar Education Finance, a graduate-school student-loan provider. The companies that originated the loans and put them into trusts are shrinking their operations as the business of making new student loans isn't profitable.

In the CDO auction-rate market, about \$20 billion of securities was outstanding at the start of the year. None are believed to have been refinanced so far, says Karl D'Cunha senior managing director at Houlihan Smith, an investment bank. Unlike other ARS, the problem here isn't just liquidity but the deteriorating credit quality of the CDOs themselves. Hence, refinancing often isn't an option.

Yes, the auction-rate logjam eased last week -- for some lucky holders. But continued difficulties in many markets suggest this crisis won't be over any time soon.

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