

NON PROFIT BORROWERS & THE CREDIT CRISIS

Is this the End of Easy Access to Inexpensive Capital?



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INTRODUCTION – THE AVAILABILITY OF TAX-EXEMPT FINANCING

Charitable corporations and other entities holding 501(c)(3) status under the Internal Revenue Code of 1986, as amended (“Code”) generally have had access to tax-exempt financing to pay for their capital projects.¹ Although this access has been available in most states since the late 1960s or early 1970s, it was not until the early 1980s that large numbers of these entities (often referred to as charitable corporations) began accessing the tax-exempt bond and note market through state or local agencies empowered to issue tax-exempt debt on their behalf.

As their name suggests, tax-exempt bonds and notes do not result in taxable income to the purchasers of such debt. Consequently, the interest rates on tax-exempt debt are lower than conventional, taxable debt, with the concomitant result that the borrower’s debt service obligations are decreased. The availability of tax-exempt debt reflects a legislative policy determination that entities that perform charitable functions should have certain tax advantages. While the primary advantage is tax-exempt status, requiring no payment of federal income taxes and exemptions at the state level from certain taxes, less expensive borrowing for capital projects is

a significant benefit to most charitable corporations.

Before passage of the Tax Equity and Fiscal Responsibility Act of 1986 (“TEFRA”), banks and other financial institutions were the primary purchasers of tax-exempt debt issued by smaller charitable corporations; more substantial 501(c)(3) borrowers issued bonds through public offerings. Because of a general concern at the federal level about the loss of revenue due to the growth in tax-exempt debt, TEFRA included provisions to make access to tax-exempt debt more difficult.² The results were mixed: although the new restrictions limited the purposes and uses of proceeds of each individual issue of tax-exempt bonds or notes, the growing popularity of such debt led to a substantial expansion of the total number of debt issues and the overall amount of tax-exempt debt.³

ISSUING TAX-EXEMPT DEBT IN NEW HAMPSHIRE

In New Hampshire, virtually all tax-exempt debt for 501(c)(3) borrowers is issued through either the Business Finance Authority (“BFA”) or the New Hampshire Health and Education Facilities Authority (“HEFA”). In essence, any tax-exempt borrower can issue bonds or notes through BFA or HEFA for virtually any capital purpose. Hospitals, ambulatory care facilities, retirement and nursing homes, colleges and universities, private schools, cultural institutions and social service agencies, among others, can access the tax-exempt market through BFA and HEFA to acquire land and existing buildings, to construct new or expanded facilities, to renovate existing facilities and to pay for associated furnishings and equipment as well as related soft costs such as architectural and engineering expenses and legal fees.

TAX-EXEMPT STRUCTURES: THE GROWTH OF NEW PRODUCTS

As the use of tax-exempt debt as a financing vehicle became more widespread, so did the number of ways to issue it. Investment bankers, known for their creativity in developing corporate financing structures such as leveraged buyouts and initial public offerings, realized that the expansion of tax-exempt borrowing could be further fueled by new structures as well. While tax-exempt debt issued through the late 1970s

generally was based on a borrower's own creditworthiness, in the 1980s the concept of "credit enhancement" — the use of bond insurance provided by monoline bond insurers or letters of credit issued by banks — was introduced to the municipal marketplace.⁴ The use of credit enhancement was perceived to offer significant benefits for many borrowers. For less creditworthy institutions, bond insurance or a letter of credit allowed access to the public market, where interest rates were markedly lower than in the private placement marketplace; for more creditworthy borrowers, credit enhancement could lower the cost of obtaining capital.

In a credit-enhanced transaction, the ultimate risk of repayment to the bondholders shifts from the underlying borrower to the credit enhancer, which charges what it considers an appropriate upfront premium or annual fee for assuming the risk that it may not be repaid by the borrower. In addition to the creditworthiness of the entity seeking credit enhancement, bond insurers and letter of credit banks also base their fees on the cost of meeting their regulatory requirements for providing credit enhancement, such as capital set asides or reserves.

When credit enhancement was first gaining acceptance, the few bond insurers sought, and obtained, "Aaa/AAA" ratings from Moody's Investors Service ("Moody's") and Standard and Poor's Ratings Group ("S&P"). Although initially most letters of credit were issued by United States banks rated in the single or double "A" category by Moody's and S&P, Japanese and European banks soon entered the market, providing competition and often driving down the rates charged to borrowers for letters of credit-backed issuances. As a general matter, investors, particularly mutual fund investors, often prefer tax-exempt debt backed by a highly-rated credit enhancer because of the perceived security provided by such an entity despite the somewhat lower yield on the enhanced debt. The primary advantages for borrowers are the lower cost of capital and the ability to deal with any problematic issues with one institution rather than hundreds or thousands of bondholders.⁵

As the use of credit enhancement spread, more bond insurers entered the marketplace, with some having ratings in the "AA" category and at least one rated "A". The lower-rated insurers tended to take on less creditworthy borrowers for higher premiums, and required that their borrowers meet more strenuous economic and operating covenants. Although these insurers were less well-capitalized than their "AAA" rated counterparts, the obligations they supported were nevertheless rated at least "A", and the yield was higher.⁶ By the time these non-"AAA" rated insurers began enhancing transactions, the municipal market had become comfortable with letter of credit banks with "A" category ratings.

Transactions employing bond insurance as enhancement originally only used for long-term, fixed rate bond issues because bond insurance covers the bonds for the life of the issue. Because letters of credit do not cover the related debt for its life, but typically provide enhancement for between three and five years, letters of credit have tended to be used most often in variable rate bond issues where the interest rate is reset frequently. The majority of such issues have had weekly interest rate resets. While the bond-insured issues generally have had an up to 10 year "no call" period, in which the bonds cannot be prepaid by the borrower, variable rate issues allow the borrower to repay on 30 days' notice to the bondholders, who have the right to "tender" their bonds, i.e., have them repurchased, on seven days' notice, resulting in these bonds being referred

to as variable rate demand obligations or "VRDOs". Because these bonds often change hands, they require a remarketing agent whose function is to find new bondholders when existing bondholders tender their bonds.⁷ The remarketing agent also sets the weekly (or other variable) rate, based on its judgment as to what rate will allow the bonds to be resold at par. As might be expected, variable rate bonds generally carry considerably lower interest rates than fixed rate bonds because of the difference in the period for which the interest rate is set. Variable rate bonds by their nature also are more volatile and correlate much more closely to current, short-term market interest rates.

As variable rate bond issues became more accepted and provided lower costs of capital, and the use of bond insurance for fixed-rate transactions declined, the investment banking community created another opportunity for the use of bond insurance: auction-rate securities ("ARS"). These securities combined what was perceived to be the best feature of traditional insured fixed rate bonds — a guarantee that the bonds would be highly rated through the use of bond insurance for the life of the bond issue and thus would continue to trade until their final maturity without the risk that a letter of credit would not be renewed or could not be replaced — with the lower interest rate benefits and purchaser liquidity associated with VRDOs.

Auction-rate securities take their name from the frequent (7-, 28- or 35-day) auctions in which the interest rate is reset and the holders have an opportunity to have their bonds purchased. Buyers and sellers participate in a so-called "Dutch auction" process in which orders to sell ARS are matched with orders to purchase ARS, with purchasers willing to accept the prevailing auction rate (the lowest rate at which all bonds to be sold can be sold). However, unlike a letter of credit backed bond issue, there is no third-party financial institution guaranteeing that the ARS will be purchased. Rather, the process of selling ARS assumes that there will always be sufficient buyers so long as the highest potential rate at which the bonds can bear interest, the so-called "Maximum Rate", is high enough to produce purchasers looking for higher yielding short-term obligations. Like the VRDO market, where remarketing agents can purchase for their own account to ensure that there is not a failed remarketing, the ARS market has broker-dealers who similarly may purchase and hold ARS in inventory in order to avoid a failed auction.

PAIRING INTEREST RATE SWAPS WITH BOND ISSUES

There is an additional Wall Street creation — the "synthetic fixed-rate bond issue" -- designed to provide the stability of a long-term fixed rate bond issue by combining the short-term variable rates of the VRDO and ARS, with interest rate swaps. Interest rate swaps are agreements entered into by the borrower with a third party, referred to as the "counterparty". Under the swap structure, which is a separate agreement from the documents relating to the bond or note issue, the borrower agrees to pay the counterparty a fixed rate in return for the counterparty paying the borrower a variable rate.⁸ The most common swap for VRDOs and ARS has been one in which the counterparty pays the borrower an amount equal to 67 percent of one-month LIBOR. That amount historically has served as a proxy for the weekly tax-exempt interest rate paid on the bonds, a rate based on what initially was the Bond Market Association ("BMA")

rate, and now is the Securities Industry and Financial Markets Association (“SIFMA”) rate.⁹ Although borrowers can also choose swaps based on BMA or SIFMA, they typically pay a greater fixed rate to the counterparty, in return for a swap which carries less risk that the payment back from the counterparty will vary significantly from the related bond interest rate.¹⁰¹¹

Interest rate swaps carry other risks as well. The first risk is counterparty risk. Since many swaps reflect the up to 30-year maturity of the related bonds or notes, and the swap agreement is a separate contract between the borrower and the counterparty, the borrower will only be paid if the counterparty continues to remain solvent and honor its payment obligations to the borrower. As discussed below, the September 2008 bankruptcy of Lehman Brothers, a major swap counterparty, demonstrated the reality of that risk.

A second risk is referred to as “pricing risk”. Unlike the stock market, there is no readily available, transparent market for interest rate swaps. As a consequence, a borrower wanting to assure itself that it is receiving appropriate pricing and terms for the swap either has to engage in a competitive process, in which the potential swap is bid out to numerous providers, or retain a swap advisor to provide the equivalent of a fairness opinion relating to the specific terms of the swap negotiated with the one counterparty (often the letter of credit bank) with whom the borrower enters into the swap agreement. Without either protection, a borrower will enter into a swap without any assurance that it is “on market”, i.e., not at a higher rate than it should be or on terms stricter than are appropriate in light of the borrower’s creditworthiness.

A third risk is referred to as “termination risk.” Although the swap agreement may be for as long as 30 years, there are circumstances under which it may be terminated early. Termination events range from typical defaults to declines in the borrower’s credit rating from Moody’s or its S&P rating being downgraded, or the borrower’s failure to meet specific economic covenants (e.g., a debt service coverage ratio, a liquidity ratio, or a similar measure). Early termination may present significant issues to a borrower because the termination payment associated with an interest rate swap will be determined based on how the fixed rate paid by the borrower on the swap relates to what the borrower would pay as a fixed rate if the swap were entered into on the date of termination. If interest rates have fallen, the borrower will owe the counterparty a termination payment, which may be substantial.¹²

A fourth risk relates to the potential need by the borrower to post collateral to assure the borrower’s performance under the swap. To the extent that the mark to market value of the swap is negative as to the borrower beyond a certain defined threshold, the borrower will be required to post liquid collateral to reflect that negative value. This may require the borrower to liquidate certain of its existing investments to provide cash or cash-equivalent investments which will yield less than the liquidated investments. A related risk is that the posting of collateral may cause the borrower to be out of compliance with certain of its economic covenants, most typically a liquidity or days cash on hand covenant.¹³ A breach of those covenants can have harm the borrower’s bond issue and, in some cases, can put the borrower in default.

Finally, LIBOR-based swaps carry two risks: basis risk and tax risk, which reflect the difference between the taxable nature of the index

used to determine the counterparty payment to the borrower and the tax-exempt index used to set interest rates on the bonds.¹⁴

RISKS IN VARIABLE RATE AND AUCTION STRUCTURES

In addition to the risks presented by interest rate swaps, VRDOs and ARS carry their own risks. Most VRDOs are marketed to so-called “2a-7” funds, which are money market funds permitted to purchase “First Tier Securities” as that term is defined under Rule 2a-7 of the Investment Company Act of 1940, as amended.¹⁵ A First Tier Security is one with a short-term rating in the highest rating category from one of the nationally recognized rating agencies, which include Moody’s and S&P. Typically, as a matter of practice, tax-exempt money market funds will limit their purchases to VRDOs with short term ratings of “VMIG 1” from Moody’s and “A-1” or “A-1+” from S&P. Because the bond rating is usually the rating of the letter of credit bank, a VRDO carries a risk that is analogous to the counterparty risk in swap transactions. If the letter of credit bank’s short term rating(s) is downgraded below these levels, the universe of purchasers for the VRDOs will change and shrink, with a related rise in interest rates paid by the borrower. In the worst case scenario, there will be no third party buyers and the bonds will be held by the letter of credit bank at a higher rate of interest until they are remarketed.

A second risk in VRDO transactions is renewal risk. Most bond issues have a long term maturity – typically 20-30 years, but at times up to 40 years – but letters of credit are short term commitments of between one and 10 years. If a letter of credit is not renewed, or an appropriate substitute is not found at the end of its term, the borrower must either convert the bond issue to a fixed-rate issue based on the borrower’s credit, or repay the letter of credit bank over a brief period. Even if the letter of credit is renewed, or an appropriate substitute found, there is no guarantee that the terms of the renewal will be as favorable as the original letter of credit.

The primary risk with ARS is auction failure. Unlike VRDOs, where a third-party bank provides liquidity, ARS depend on auction participants for their liquidity. The theory behind ARS is that that self-generated liquidity always will be there, thereby eliminating the renewal risk associated with VRDOs.

Despite all of these risks, the VRDO and ARS structures (and the related interest rate swaps) worked well until the subprime mortgage crisis hit the financial markets. Although there might seem to be no clear relationship between that market and the municipal tax-exempt market, there were two common threads. Many monoline bond insurers had enhanced collateralized mortgage obligations (“CMOs”) and were beginning to experience substantial and dramatic losses as the underlying mortgage obligations failed in numbers far beyond those anticipated.¹⁶ Similarly, banks issuing letters of credit that held significant amounts of CMOs as investments (or the underlying subprime loans) began to experience those losses. The result was a substantial tightening of the credit markets, including the tax-exempt market, beginning in late 2007.

THE SUBPRIME CRISIS' EFFECTS ON THE TAX-EXEMPT MARKET

The ripple effects of what began as problems in the housing markets that affected the financial institutions holding substantial amounts of subprime mortgages and CMOs was first felt in the tax-exempt market in November and December of 2007. For the first time since their inception, ARS issues became difficult to sell.¹⁷ In the preceding years, letter of credit banks had been supplying longer term and lower priced letters of credit but in late 2007 and early 2008, increasing demand led to tighter terms, and greater economic and operating covenants for those borrowers who could receive commitments.

Beginning on February 13, 2008, the major investment banks/broker-dealers stopped supporting auctions and the ARS market experienced a widespread failure for the first time in its history. Most auction rate bond documents anticipated the possibility of a failed auction, but no one was prepared to have the entire ARS market stop functioning all at once. Essentially what occurred was that the major investment banks no longer believed they should continue to support the market by purchasing ARS issues that otherwise would not have been purchased. This change in position, which involved all of the major broker-dealers, completely undermined the ARS market.

When the ARS market had first started tightening in December, 2007, many investment bankers counseled their clients to amend their documents on a temporary basis to allow increased interest rates. The concept was that this would create sufficient liquidity in the ARS market to keep it functioning. Implicit in the request was a *quid pro quo*: the increased rates would provide greater numbers of buyers, and the investment banks would continue to support the market to the extent buyers otherwise could not be found.¹⁸ Between the pre-existing clauses which set forth maximum rates and amended documents which raised them, starting on February 13, 2008 borrowers suddenly found themselves paying up to 20 percent on tax-exempt obligations, a 500 percent increase above prior market levels.

In addition to the systemic issues in the ARS market, and because of the increased exposure of major financial institutions to the subprime housing market, Moody's and S&P began a series of downgrades of the monoline insurers whose policies were supporting many CMOs and ARS. As defaults rose on mortgage obligations, their value fell as securities dropped. It became clear that the monoline insurers, also highly involved in the ARS market, were exposed to substantial and continuing losses. In addition, many of the major, highly rated, banks that had issued letters of credit to support VRDOS had invested in the CMOs (initially rated in the "AAA" category) in order to obtain the yield presented by the portfolios underlying the CMOs.¹⁹

As a result, although the VRDO market was still attractive to investors, the availability of letters of credit became scarce at the same time that the costs rose, the conditions tightened and the length dropped.²⁰ Banks were increasingly forced not just to choose their existing customers over requests for new credit support, but also to choose among their existing customers.

Over the course of the spring and summer of 2008, borrowers saw a variety of other major changes, with a number of major Wall Street and national banking companies acquired by others during this period. The

concept driving many of these acquisitions and mergers was that certain key financial institutions were "too big to fail". In the initial stages, the investment banker Bear Stearns was merged into J.P. Morgan Chase while the commercial bank Wachovia was merged into Wells Fargo.

The credit crisis hit a new level in the week of September 15, 2008, when Merrill Lynch was taken over by Bank of America, Lehman Brothers filed for bankruptcy protection²¹, and the federal government began a massive bailout of AIG.²² Merrill Lynch and AIG, major players in the municipal marketplace, appeared to have met the "too big to fail" criteria and were shored up. Merrill Lynch, through a merger (with subsequent bailout money, to Bank of America) and, in AIG's case, through an infusion of many billions of dollars of federal assistance.

The filing by Lehman Brothers Holdings, Inc. ("Holdings"), the "A"-rated parent of numerous Lehman entities, ran counter to the "too big to fail" theory as certain of its subsidiaries, primarily Lehman Brothers Special Financing, Inc. ("Special Financing") were deeply involved globally in derivatives in the hundreds of billions of dollars, including many interest rate swaps entered into between municipal borrowers and Special Financing. Special Financing was a favorite swap counterparty for many less creditworthy tax-exempt borrowers because of Special Financing's relatively lenient credit terms.²³

Many borrowers who had Special Financing swaps already were experiencing problems with their VRDOs because of letter of credit bank downgrades, with the uncertainty over the future of the swap tied into the uncertainty of the continuing credit quality of the bank. For those borrowers who had entered into synthetic fixed rate bond issues in the expectation that they had a vehicle which was subject to few risks and would provide a significant measure of interest rate protection, the Lehman Brothers bankruptcy created a whole new set of realities. Borrowers learned quickly that, unlike most executory contracts, interest rate swaps are *not* subject to the automatic stay under the federal Bankruptcy Code.²⁴

Because there is very little case law about what happens to a derivative contract in bankruptcy, borrowers became subject to conflicting advice about how to proceed with their swap and to what extent they, or Special Financing, could withhold payments or terminate the swap as a result of the bankruptcy. Leaving aside the legal issues, many borrowers who had swaps maturing up to 30 years out realized that Special Financing not only had lost its credit support partner (Holdings), and thus its "A" rating, but also the certainty that a swap counterparty would be available to make any required payments.²⁵

One further, and shocking consequence of the mid-September developments was that the SIFMA index began to rise rapidly as investors pulled their money from the 2a-7 funds in order to create liquidity. On September 24, 2008, SIFMA jumped to 7.96 percent, an almost 500 percent increase from its 1.63 percent level just three weeks earlier on September 3, 2008.²⁶ By the end of 2008, SIFMA had dropped below 1.00 percent, and has remained at very low levels since then. But as bond insurers²⁷ and banks continued to be downgraded, even the very low interest rate environment did not solve the problems faced by many borrowers.

WASHINGTON'S EFFORTS TO SHORE UP THE TAX-EXEMPT MARKET

The Bush Administration and the Congress recognized these problems, and took one ameliorating step in the summer of 2008 by passing the Housing and Economic Recovery Act of 2008 ("HERA").²⁸ Although the Code has expressly prohibited any federal guarantee of tax-exempt bonds, HERA created an exception to this rule by permitting Federal Home Loan Banks to guarantee tax-exempt bonds under certain circumstances during the period July 30, 2008 through December 31, 2010 without violating the Code's prohibition on federal guarantees. That initial step was followed by the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA") in early 2009.²⁹

ARRA contains a number of provisions seeking to provide some relief to tax-exempt borrowers, primarily through making it possible for banks and a broad range of 501(c)(3) institutions to make direct purchases at levels up to \$30 million of tax-exempt bonds in each of 2009 and 2010.³⁰ These changes free borrowers from the concerns about downgraded banks, as a purchase by a bank is in no way dependent on its credit rating. The changes thus permit smaller local and regional banks, as well as the banks that had been issuing letters of credit based on their ratings, to purchase tax-exempt bonds or notes.³¹

While HERA and ARRA create opportunities for tax-exempt borrowers, they only can be used through the end of 2010. Nevertheless, they have reopened the municipal market to a significant degree, allowing an increased flow of transactions for charitable corporations that have critical projects to complete and for which tax-exempt financing will help defray the costs of those projects. Institutions needing to borrow more than \$30 million in tax-exempt bonds or notes in a year are, however, left to the more traditional marketplace.

Although the concept is not new, another tool available to certain 501(c)(3) borrowers is so-called "FHA 242" financing. In an FHA 242 financing, the borrower applies for mortgage insurance to enhance its long-term, fixed-rate bonds. If insurance is granted, the bonds will be rated in the "AA" category. Traditionally this type of financing has been available only when it included a significant new construction/major renovation component. However, in July, 2008, the FHA 242 program was extended to institutions otherwise qualifying that simply wish to refinance existing bonds. For qualifying borrowers who have issued VRDOs or ARS that carry numerous risks, this enhanced program may permit them to return to long-term, fixed-rate debt.³²

CONCLUSION

Tax-exempt financing for 501(c)(3) borrowers experienced much the same easy access to credit and unparalleled growth as the housing and stock markets did in the two decades leading up to 2008. While it is not possible to predict the extent to which the tax-exempt marketplace may expand to meet its borrowers' increasing needs for capital over the next decade, the present market likely is in transition to a new reality for charitable corporations. It seems clear, however, that so long as there are borrowers with capital needs and banking institutions designed to meet them, structures will emerge which will allow the borrowers to obtain funds, albeit perhaps not as readily as they have been able to in the most recent period of economic growth.

ENDNOTES

1 The Code permits each state to determine through legislation what types of 501(c)(3) entities (sometimes referred to as charitable corporations) may have access to tax-exempt financing, often referred to as "municipal bonds". In order to qualify as tax-exempt debt, the bonds (or notes) must be issued by an entity which is a subdivision of the state. In New Hampshire, there are two primary entities, both of which are state agencies, through which tax-exempt debt can be issued by charitable corporations: the Business Finance Authority, established under NH RSA 162-A, with authority to issue bonds under NH RSA 162-I) and the New Hampshire Health and Education Facilities Authority, established under NH RSA 195-D, with authority to issue bonds under that statute and, for student loan corporations, under NH RSA 195-E. Charitable corporations issuing tax-exempt debt through such an entity are referred to as "conduit borrowers" as the agency is the conduit through which the tax-exempt debt is issued.

2 As examples, these provisions included new restriction on the extent to which, and the amount of: (a) positive arbitrage that could be earned by investing the proceeds of tax-exempt debt in higher yielding, taxable investments; (b) tax-exempt proceeds that could be used to pay for costs of issuing the debt and other expenses not directly related to the borrower's charitable purposes (so-called "bad money"); (c) moneys that could be used to finance so-called "blind pools", where bonds were issued based on possible need for access to moneys by a range of tax-exempt borrowers, without a commitment on the part of any of the potential borrowers to actually use the moneys; and (d) the deduction banks and other financial institutions could take on the tax-exempt moneys loaned directly to charitable borrowers (effectively raising the rates for such loans).

3 One period of substantial activity was the last three months of 1985. Although TEFRA was not enacted until August 1986, Congress made clear in 1985 its intent to pass such legislation and suggested that its provisions could be retroactively effective to January 1, 1986.

4 A bond insurance policy issued in connection with a tax-exempt debt issuance guarantees the timely payment of principal and interest on the bonds or notes. If the underlying borrower defaults on its payment obligations, the bond insurer may either make principal and interest payments as they come due or accelerate the debt issue and pay all outstanding principal and accrued interest at one time. The decision whether to continue payments or make one payment typically is driven by the difference between the interest rates on the bonds or notes and prevailing interest rates at the time of default by the underlying borrower. Unlike a bond insurance policy, in which the full premium is paid upfront and the insurance covers the bonds or notes until they mature or are prepaid, a letter of credit has a limited period of coverage for the related debt, most typically from one to five years, although in the period from 2003-2007, some banks issued letters of credit with up to 10 year terms. A letter of credit provides for the payment of principal and interest as they come due and, upon its expiration, if it is not replaced, pays all outstanding principal and accrued interest at that time.

5 Most amendments to bond documents or waivers of covenants breaches or defaults require at least majority bondholder consent. In a credit enhanced issue, however, so long as the credit enhancer is not in default of its obligations and has not repudiated them, it is treated as the sole bondholder for most purposes.

6 For the most part since the mid-1980s, there have been appreciable differences in the interest costs between bonds or notes in different rating categories. Thus, an "A" rated obligation will frequently provide up to 50 more basis points in yield than a "AAA" rated obligation and up to 100 less basis points than a "BBB" rated obligation. Those differences assume a normal yield curve, in which short term rates are markedly lower than long term rates and differences between ratings categories are distinct. There have been times, however, when the yield curve flattens or inverts and the ratings differences are much less significant. That tends to happen when there is a lack of highly rated debt available to purchasers and significant demand for tax-exempt debt.

7 In the event that the remarketing agent cannot find purchasers for bonds which have been tendered, the letter of credit bank will become the owner of the bonds, at least for some period of time. If the bonds can never be remarketed, the letter of credit bank converts the bond issue into a taxable loan with the borrower. For the period from the first use of variable rate bonds issues backed by a letter of credit in the 1980s until September, 2008, there were very few failed remarketings, even during the week of September 11, 2001. As set forth in this article, the credit crisis ultimately led to many failed remarketings. There were several factors which led to the failed remarketings, but one critical factor was the remarketing agents' decreased use of their own capital to purchase bonds for their own account to ensure that there were no failed remarketings.

8 Interest rate swaps and other derivatives (so named because they derive their value from a separate transaction) are by no means limited to floating-to-fixed rate or fixed-to-floating rate transactions. The widespread growth of derivative products, which have been generally unsupervised, played a critical role in the global economic crisis. The so-called "credit default swap", which received considerable publicity in connection with the crisis, is an example of a product that produced substantial revenue, but whose risks far outweighed its benefits and was a substantial contributor to the problems faced by AIG. Credit default swaps reflect the market's view of the likelihood that a swap counterparty (e.g., Lehman Brothers, which filed for bankruptcy protection in September, 2008) will default on its swaps. If it does, as Lehman Brothers did, payments become due under the swaps.

9 The SIFMA rate (like its predecessor, the BMA rate) is set weekly, reflecting a cross section of tax-exempt interest rates, and serves as the reference for where weekly tax-exempt bonds

trade.

10 Historical studies demonstrated that, despite the variation from BMA or SIFMA, 67% of one month LIBOR produced slightly greater payments back from the counterparty over a 10 or 20 year period. Since most swaps were for periods between 10 and 30 years, and LIBOR-based swaps typically required the borrower to pay a fixed rate that was 50-75 basis points less than what a BMA or SIFMA-based swap would require the borrower to pay and 70-100 basis points less than a traditional fixed rate bond issue. The specific risk associated with a LIBOR-based swap is referred to as "basis risk", which refers to the fact that a taxable rate (LIBOR) is being used as a proxy for the tax-exempt rate (BMA/SIFMA) paid on the related bonds. Although historically 67% of one month LIBOR have averaged out to an amount slightly greater than BMA/SIFMA, there have always been variations on a month-to-month basis, some significant. In addition to basis risk, LIBOR-based swaps carry tax risk. Substantial variations in marginal tax rates will affect the tax-exempt bond interest rate. The lower the marginal rate, the greater the tax-exempt BMA/SIFMA based payment will need to be to provide the intended benefits of the tax-exempt bond or note. If marginal tax rates were to be lowered, the correlation between a 67% of LIBOR payment and the current 33% marginal rate which most tax-exempt bondholders pay, would diminish as BMA/SIFMA based rates would most likely increase while the 67% of LIBOR payment would not.

11 The safest swap, rarely employed in the tax-exempt marketplace, and considerably more expensive to the borrower is what is referred to as a "cost of funds" swap. In that swap, the counterparty pays whatever the borrower's interest rate on its bonds is on a monthly basis. Since bonds do not always trade at BMA/SIFMA, for a variety of reasons, a cost of funds swap provides a perfect, if expensive, hedge in which the borrower always pays the agreed to fixed rate. Since September, 2008, cost of funds swaps have generally not been available.

12 The changing value of an interest rate swap, known as the "mark to market" ("MTM") of the swap, is reflected in the borrower's audited financial statements. Most simply stated, the MTM is similar to an unrealized gain or loss on a security based on changing market conditions.

13 An interest rate swap agreement generally provides that the counterparty will have to post collateral upon the occurrence of certain events, such as a downgrade in its Moody's or S&P credit rating or if the MTM value is greater than some percentage of its shareholders' equity. Generally these thresholds are so high (because swap counterparties are typically rated at least in the "A" category) that posting is almost never required. Although Lehman Brothers was required under certain of its swap agreements to post collateral under these circumstances, its drop from an "A" rated institution to a bankrupt institution overnight precluded any collateral posting.

14 See notes 10 and 11, *supra*.

15 17 CFR 270.2a-7

16 Many of the CMOs that were at the heart of the subprime crisis carried ratings in the "AAA" category, often based on the bond insurance provided for the CMOs. However, the CMOs contained several tranches of mortgages, from those that were traditional, highly secured mortgages with borrowers capable of repaying them to subprime loans that were based on limited documentation and made to borrowers who might be able to afford the initial interest rate, but did not have the means to pay when those rates reset to market rates. Whether the rating agencies rating the CMOs properly analyzed the portfolios has been a source of contention since the subprime crisis began.

17 Although not directly relevant to this article, many investment bankers who marketed ARS on behalf of borrowers, whether tax-exempt or for-profit, sold the securities to their retail and institutional customers as the equivalent of cash or a cash equivalent investment, and (incorrectly) claimed that the ARS had the same liquidity. The reality of ARS illiquidity became clear on February 13, 2008, when the investment banks and broker-dealers that had marketed the ARS on behalf of their borrowers stopped supporting the ARS market, leading to widespread failures in the market, and in turn to actions brought on behalf of retail and institutional purchasers by several states (most notably Massachusetts, New York and Texas) as well as the Securities and Exchange Commission.

18 Although not the focus of this article, many of the same investment banks that served as broker-dealers for the ARS market also sold them to their retail clients. In many cases, the ARS were represented to be "cash equivalents", and were shown on retail and institutional brokerage accounts in that manner. As became clear when the ARS market stopped functioning, ARS were by no means cash equivalents as they depended on a willing purchaser for liquidation (unlike VRDOs, where bond holders had the liquidity of an "A" or better rated bank ensuring their ability to liquidate their securities on short notice). The practices of many of the major broker-dealers in the

ARS market led to a series of state and federal proceedings referenced in footnote 17, *supra*.

19 Most CMOs were issued in "tranches", or tiers of indebtedness. While the CMOs included many conforming and secure mortgages, lower tranches included much more risky mortgages which failed at significant rates.

20 In the first part of 2008, one major provider of letters of credit, JPMorgan Chase Bank, N.A. (Chase) reported requests for letters of credit at a ratio of 4 to 1 to the amount it could provide based on its capital requirements.

21 Lehman Brothers Holdings, Inc. (Holdings) was the initial bankruptcy filer. Holdings carried ratings in the "A" category from Moody's and S&P prior to its filing and was the credit support provider for Lehman Brothers Special Financing, Inc. (Special Financing), which was the Lehman Brother counterparty involved in the vast majority of swaps entered into by Lehman Brothers. Special Financing followed Holdings into bankruptcy in early October, 2008.

22 AIG's presence in the municipal marketplace was primarily in the form of investment contracts. Guaranteed Investment Contracts, or "GICs", are a vehicle frequently used for the investment of bond or note proceeds which have been borrowed, but which will be spent over time. AIG's "AAA/Aaa" ratings made it a major player in municipal GICs, which generally are limited to investments in entities rated in the two highest rating categories by Moody's and S&P.

23 As a major example, Special Financing frequently entered into interest rate swaps where there was one-way collateralization running from Special Financing to the borrower, but no required collateralization back from the borrower even if the borrower was not highly creditworthy.

24 See 11 U.S.C. § 560, which provides in part: "The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title [the insolvency of a debtor or filing of a bankruptcy petition by the debtor or the financial condition of the debtor] or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title."

25 Special Financing has not been making any periodic payments since the bankruptcy filing. For parties who were "in the money", i.e., the mark to market value of the swap was an asset, a termination of their swap at the outset of the bankruptcy would have resulted in their becoming an unsecured creditor of Special Financing with a possible payment of some reduced amount at the end of the bankruptcy. In this sense, and although it is somewhat counterintuitive, it was better to be "out of the money" at the time of the filing.

26 SIFMA Research - "Municipal Bond Credit Report", September, 2008 (Securities Industry and Financial Markets Association).

27 As examples, FGIC, one of the first highly-rated bond insurers, fell from "Aaa" to "A3" on February 14, 2008, from that level to "Baa3" on March 31, 2008, and to "B1" on June 20, 2008. Ambac, also traditionally one of the premier bond insurers, lost its "Aaa" from Moody's on September 18, 2008, when it was downgraded to "Aa3" and fell further to "Baa1" on November 5, 2008. (Bear Stearns - Municipal Market Update)

28 Public Law 110-289, adopted on July 30, 2008.

29 Public Law 111-5, adopted on February 17, 2009.

30 Prior to ARRA, so-called "small issues" were limited to \$10 million per year and to the issuer of the obligations. Thus, a conduit entity like BFA and HEFA, as the actual issuer of bonds for its conduit borrowers, would be limited to \$10 million of bonds in the aggregate in any year, which made use of these provisions of limited application. ARRA not only changed the amount that could be issued in any year to \$30 million, but also determined the applicability of the issuance at the conduit borrower (i.e., charitable corporation) level rather than the issuer (i.e., BFA or HEFA) level.

31 ARRA also contains favorable conditions with respect to interest deductions for banks purchasing these obligations, making them as attractive as they were prior to TEFRA.

32 Issuing bonds through the FHA 242 program is a complex, expensive and often tedious process. Not all institutions that wish to issue bonds through this process will qualify. Nevertheless, it is another example of attempts at the federal level to make more tax-exempt financing available.



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