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From time to time, we publish guest articles that we think inform readers on topics of interest. Necessarily, the views and opinions of the authors are their own, but we think the article below is interesting and informative.

The article, "We Can See the Economic Dominoes Falling," by Lori Raineri and Jim Kleker certainly meets this description. We hope readers will gain a keener understanding of current financial market issues. We very much appreciate Lori and Jim taking the time to address this issue.

—Ron Bennett

We Can See the Economic Dominoes Falling

Guest Article by Lori Raineri and Jim Kleker

We have been reeling in the mess of the real estate mortgage markets for months. The Federal Reserve Board has dramatically lowered the federal funds rate, while bond insurer's credit ratings have been downgraded. Investors are operating in a mode of fear. Inflation is wielding its head. The economy is a prominent headline in many newspapers. Municipal bond borrowing rates have been rising. And, oh yeah . . . the State Budget is promising cuts to education apportionments. Aspirin anyone?

This article will review the direct impacts of current economic conditions on the municipal bond market, and some thoughts on what school administrators need to know.

Think of it like a game of lining up dominoes. Topple the first one, and if carefully placed, the whole row will tumble—the epitome of action causing reaction. In this case, the dominoes are pieces of the United States , economy and the effects are serious consequences for the financial markets. Ultimately, every school district with outstanding debt (general obligation bonds, special tax bonds, certificates of participation, lease-purchase financing, tax and revenue anticipation notes, etc.) or a need to borrow may be affected.

How We Got Here

Historically, we have thought of banking and insurance as two of the stable pillars of our economy. Money in the bank was safe, and insurance would protect in case of a catastrophe. In the past 12 months, banks have taken billions of dollars of write downs and, beginning in January, we have seen municipal bond insurers' credit ratings being downgraded. On March 10, 2008 we saw the total demise of Bear Stearns—the fifth largest investment bank on Wall Street. The pillars no longer appear stable.

Between 2000 and 2005, the banking industry realized how lucrative the mortgage market had become. With plenty of consumer demand for housing and rising real estate prices, the risk in the mortgage market

appeared relatively low. This gave the banks rationale to increase issuing "expanded criteria loans," often generically described as "sub-prime" mortgages—riskier loans. In an attempt to increase profit and spread the risk, the banks segregated the loans into "pools" based on their perceived risk. This is where the municipal bond insurers became involved.

Municipal bond insurers had experience insuring financial products, since their main line of business was guaranteeing payments to investors on municipal bonds. The bond insurers saw in these real estate loan pools an opportunity to increase profits. They did not insure the performance of the individual loans, but a derivative of them . . . the performance of the pool as a whole, dubbed "Collateralized Debt Obligations" (CDOs). In fact, the bond insurance industry would see substantial revenue and stock price gains on this strategy.

As time went on, the bankers wanted to open the mortgage market to more borrowers and create pools of loans with rates of return that large investors would be interested in. After all, loaning money across the country created location diversity. Backed by American real estate—and insurance—there was confidence in the safety of these new loan products. So, to expand the market, banks continued to lower the standards placed on each loan, creating more risk, but also more reward. The profit for the bank, the bond insurer, and the investor all rose dramatically.

We know now that the dominoes became unstable in the summer of 2005, with the first big fall in March 2006. The end began slowly as the first of the borrowers began to realize they had taken personal real estate loans they could not afford and the real estate they held was not continuing to appreciate sufficiently in value. By the spring of 2007, realizing the risk had substantially increased, investors started to bail out. (Foreign money dried up almost immediately.)

The dominoes began to fall faster and harder, tumbling into the banks and insurers who were left holding liens and insurance protection on billions of dollars worth of loans that were not being repaid and have substantially less value in the real estate behind them.

Where We Are Today

The bond market is simply in turmoil. Rates are fluctuating daily, with no market certainty. As of March 31, 2008, 30-year Treasury bills issued by the United States Government paid a taxable interest of 4.30% while the "Bond Buyer 20 Year Municipal Index" was paying 4.96%. This is a very rare market anomaly that has occurred only three times in the last 24 years—and at no time in that period to this magnitude. In the week of February 25, 2008, the Bond Buyer Index increased by 45 basis points (.45%), the largest one-week increase since the 51-basis-point increase the week before October 19, 1987, "black Monday."

Municipal bond insurers are "rated" based on their ability to cover the bonds they insure. As the value of the real estate CDOs decayed, so did the bond insurers' ability to cover their obligations. Consequently, their ability to cover the municipal bonds they insured was called into question, and, as dominoes go, the rating on many bond insurers has been lowered. In 2007, there were seven bond insurers rated triple-A by the three major rating agencies. Today only three are rated triple-A by Moodys, Standard & Poor's, and Fitch.

The market anomaly caused many large hedge funds to suffer market losses and consequently to sell their municipal bond holdings, increasing supply. Hedge funds by their nature are relatively high risk/high yield, and they utilize municipals to balance their portfolios. But, the market rate abnormality forced the funds out of the municipal market. Without the large hedge funds purchasing them, demand for municipal bonds

decreases. "Economics 101" tells us that an increase in supply with a decrease in demand forces the yield, i.e., the interest rate—school districts' borrowing costs—to go up.

With the bond insurer credit rating downgrades and stability concerns with large banks, investors are increasingly unwilling to invest even in short-term securities that have any liquidity risk. As a result, the market for municipal bond variable rate debt, including "auction rate securities" (ARS) and "variable rate demand obligations" (VRDOs) has seen lower demand and higher rates as well. In some cases, the "auctions" where the variable rate debt is priced have "failed", leaving issuers paying exorbitant interest rates—as high as 20%. (Bloomberg reports rates on bonds auctioned weekly averaged 6.72% as of March 26, up from 3.63% in January.[1]) As of February 26, the State Treasurer's Office filed a notice of intention to redeem $400 million of its $500 million outstanding ARS over the next 60 days. (Which means the very same brokers and bankers who made money helping the state do these ARS deals will now make money undoing them.)

On top of the volatile market, there is increased Internal Revenue Services (IRS) scrutiny of outstanding bond issues. Specifically, the IRS has targeted advance refundings completed in the late 1990s and early 2000s that used a questionable practice, a "forward purchase contract." Twenty-six California school districts are currently being scrutinized. There has been extensive publicity in the Bond Buyer about these cases and it is clear that these school districts are each facing hundreds of thousands of dollars of liability. Several public agencies in other states also engaged in this practice and some have banded together in a lawsuit against the banks and brokerage houses who advised them.

What You Need To Do—Now

All of this has multiple effects on all school districts, including higher borrowing rates, a reduction of refinance opportunities, borrowing rates above investment rates, and more regulatory scrutiny when borrowing. (The effect of borrowing rates above investment rates means that transactions that involve both will be less viable—i.e., OPEB borrowings, Tax and Revenue Anticipation Notes (TRANs), refundings, etc.)

With the change in the state's apportionment date, many districts are considering issuing TRANs for the upcoming fiscal year. Considering the current market, notwithstanding investment rates below borrowing rates, every school business official with responsibility for cash flow management and finance needs to understand current market conditions and educate themselves about relevant factors.

Educate yourself. Review in detail all of your outstanding debt. Understand your obligations for payments, accounting, and disclosure. Many (most?) of the financial problems we are experiencing are a culmination of greed and less-than-scrupulous advice from the finance and banking industry. Do not expect financial professionals who are paid on commission to be providing advice in the district's best interest. The Bloomberg website and the Wall Street Journal are good sources to follow the market.

Compliance is of special consideration at this time. Refer to each borrowing's transcript, educate yourself in particular on the district's legal responsibilities for disclosure, and be sure the district is in compliance. Also, be aware that you may receive requests for information from investors and analysts. Talk to your staff—remind them to not give information directly to them (unless the transcript indicates a requirement to do so); rather, refer all interested parties to the information repositories where the district has filed its annual continuing disclosure. (The repositories are available to everyone, so no one investor gets unique information or special treatment.)

The dominoes are falling . . . but the American economy is strong and will survive. There will be opportunities in this market to be good stewards of public monies. Stay on top of your game!

—Lori Raineri and Jim Kleker

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[1]Bloomberg.com April 1, 2008