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GLOBAL CORPORATE TRUST

Lessons From Tough Times: Understanding VRDO Failures



THE BANK OF NEW YORK MELLON



How well trustees and intermediaries managed their internal processing during these critical market events directly affected issuers and investors across the market.

When markets function normally, the trustee role is generally treated as an afterthought. It is only when markets go haywire—such as with the recent disruptions in auction-rate securities and variable-rate demand obligations—that market participants learn whether governing documents were prescient and their choice of trustee was the right one.

The ongoing credit crunch and bond insurer downgrades have brought many challenges to the operational or processing sides of both the ARS and VRDO markets. Most of the news coverage has focused on ARS troubles. Behind the scenes, however, the sheer volume of VRDO tenders forced trustees and other intermediaries to adapt their processes and adjust on the fly to compensate for the added complexity and volume of transactions. How well trustees and intermediaries managed their internal processing during these critical market events directly affected issuers and investors across the market.

How VRDOs Work

VRDOs are tax-exempt instruments on which the yield is usually reset on a daily, weekly, or monthly basis. While VRDOs are issued with long-dated nominal maturities of 20 to 40 years, they have short-term demand features that provide investors the ability to demand repurchase of their bonds at par plus accrued interest on a short-term basis. This allows investors to maintain a reasonable degree of liquidity while allowing the issuer to take advantage of the short end of the yield curve.

The put feature, which allows for the short-term interest rate, enables holders to tender the bonds with advance notice to the tender agent, usually on a daily, weekly, or monthly schedule often timed to coincide with the yield resets. However, this protection requires a high degree of liquidity to protect the issuer in case the bonds are tendered and cannot be remarketed to another investor. Typically, this liquidity is provided via a bank letter of credit or a stand-by bond purchase agreement.

For highly rated issuers, SBPAs are often sufficient liquidity support for a VRDO structure. With SBPAs, the financial institution agrees to serve as liquidity provider of last resort and will purchase the bonds if they cannot be remarketed. This structure results in a long-term rating for the VRDOs equal to the underlying credit rating of the issuer, while the short-term rating for the VRDOs is equal that of the SBPA institution. Frequently, issuers with VRDO structures using SBPAs will also secure the bonds through an investment-grade bond insurer to further enhance the long-term rating on the bonds.

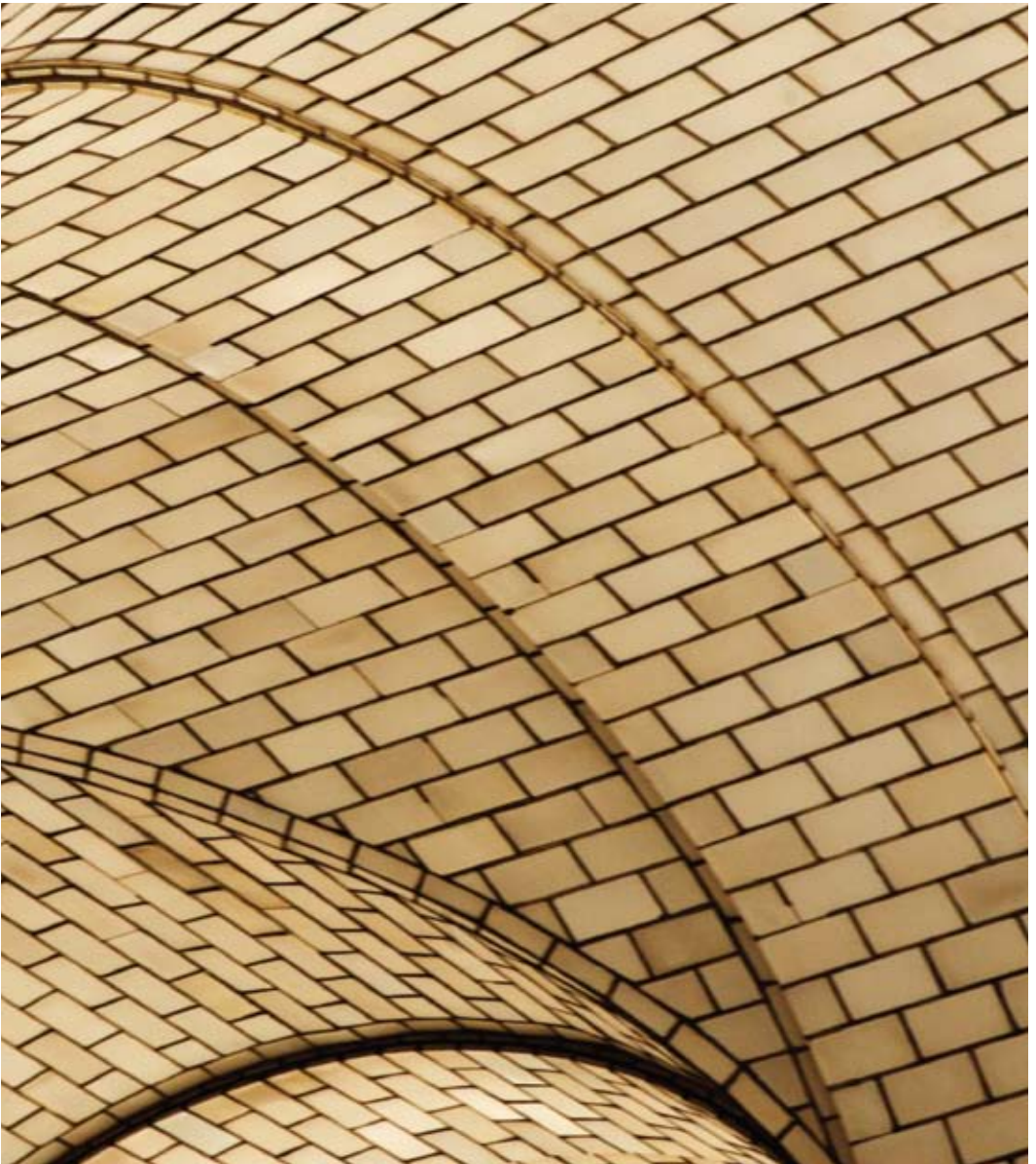
For other issuers, the option of having an LOC provides additional assurance to the issuer and investors. LOCs usually come in two forms, standby and direct pay. With a standby LOC, investors look to the issuer first for payment of principal and interest, and the LOC serves as a backup for funding, when necessary. The direct pay LOC, while potentially coming with additional cost to the issuer, requires the supporting bank to pay principal and interest directly to investors without the issuer becoming directly involved in the process. The bonds in these deals carry the rating of the LOC bank for the short-term aspect of the deal and will sometimes be wrapped with bond insurance to further enhance their long-term ratings.

Insurer Downgrade Exposure

To enhance the long-term rating of a VRDO, issuers sometimes use bond insurance. The higher rating serves to lower the cost of capital and meet the investment rating requirements of certain investment funds. This structure worked well until the monoline insurers were downgraded for reasons unrelated to municipal bonds. Some insured bonds previously rated triple-A were suddenly facing declines in ratings of the monoline insurers, which in many cases dropped below the underlying ratings of the issuer.

As downgrades occurred, many major investors were required to put these bonds back to the market because their investment guidelines would not permit them to own securities with lower ratings. As downgrade followed downgrade, tender volume increased as liquidity disappeared from the market. LOC and SBPA providers were faced with carrying more and more VRDO securities at a time when their own liquidity positions were stretched due to other aspects of the credit crisis.

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The pressure on the remarketing agent grows each day a new buyer is not found.

Many cities and municipalities that had assumed that they were in a relatively stable market because of LOC and SBPA support began to have deep concerns about their exposure to the credit crisis as tenders increased and rates rose dramatically. Market participants and regulators began calling emergency meetings, demanding to know what the overall downgrade exposure might be. Only over the course of several months did the picture become clearer.

Remarketing's Ticking Clock

Once the tidal wave of tenders began, remarketing agents came under tremendous pressure to perform in a very tight timeframe. The basic assumption behind the standard VRDO remarketing window is that everything is functioning normally, without negative credit implications, and that when or if bonds are tendered, new buyers can easily be found.

Once a bond is tendered, the trustee generally is required to notify the issuer, the remarketing agent, the liquidity provider, and the insurer of the tender. At that point, the clock starts ticking as the remarketing agent has a short window of time to find a new buyer. If the remarketing agent can find a new buyer, the trustee or tender agent facilitates the bond transfer and payment of principal and interest between the seller and buyer. Until the recent credit crisis, few bonds had ever experienced a remarketing failure and when they did, liquidity providers were able to step in with little risk to their balance sheets.

If a new buyer cannot be found, the trustee or tender agent will draw upon the liquidity provider. The provider must then take ownership of the securities (now known as "bank bonds"), which typically earn a higher rate of interest. Obviously, a failed remarketing is the last thing issuers and liquidity providers want. The issuer does not want to pay the potentially higher rate and the liquidity provider does not want to take ownership of the bonds.

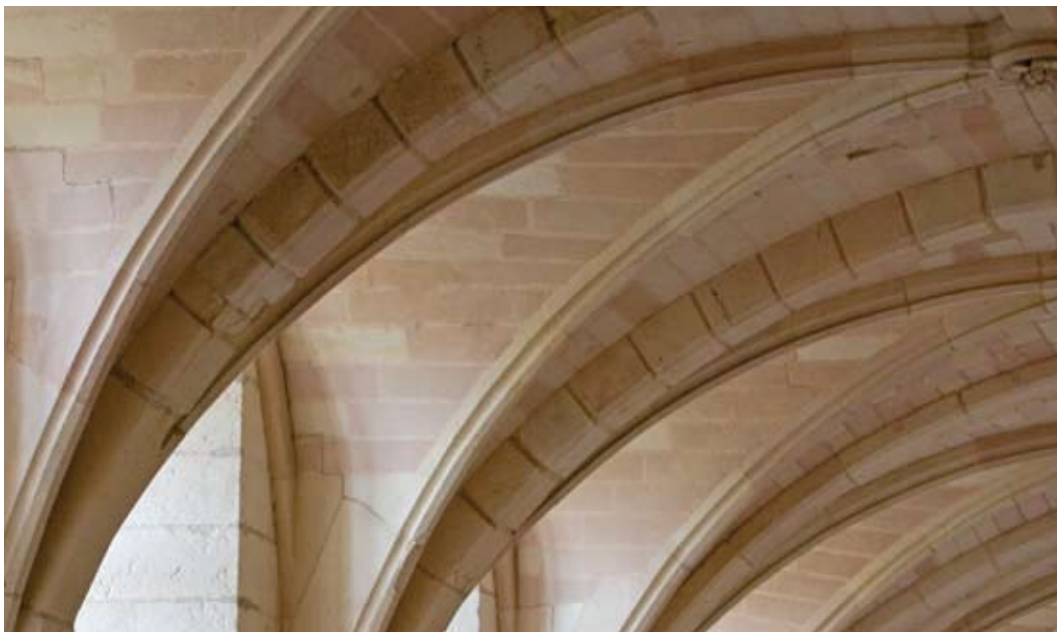
The pressure on the remarketing agent grows each day a new buyer is not found.

In a normal market, the remarketing agent might step in and buy the tendered bonds, in order to prevent an actual draw on an LOC or credit facility. But this time around, the volume of the tenders and restrictions on their own liquidity made this choice difficult, if not impossible, for many remarketing agents.

While the inability of broker-dealers to take failed auction-rate bonds onto their books led to a virtual collapse of the ARS market, the liquidity feature of VRDOs seems to have kept the market for these securities functioning. This has led to a large number of ARS securities being converted into VRDOs.

Settlement Flaws Exposed

Under normal market conditions, VRDO intermediaries can perform within the established timeline. Yet few in the industry anticipated how trade settlement would work if tender volume exploded.



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During the recent tender wave, some trustees drew on liquidity facilities to pay sellers who tendered their bonds, rather than wait for purchase proceeds to settle that day. Once the trade settled, these trustees reimbursed the liquidity draw with the purchase proceeds. With the high volume of tenders, some of these liquidity draws caused massive, and highly fluctuating, drains on the liquidity facility providers, leading to great consternation among liquidity providers, remarketing agents, and issuers who ultimately must pay the cost.

For issuers, each credit line tap increased the draw fees and potential future liquidity costs they would have to pay to the liquidity provider. For the liquidity provider, the huge daily and weekly draws were an expensive challenge during a time when liquidity was at a premium. With balance sheets under pressure from other areas, providers began to carefully monitor these draws and grew ever more critical of them as the tender wave increased.

The Trouble With CUSIPs

Tracking ownership and the proper payment of bonds is completed through individually assigned CUSIP numbers and paid through the Depository Trust & Clearing Corporation. While the interest rates on bank bonds often are reset to a much higher rate, any non-tendered bonds continue to pay at the weekly remarketed rate.

In this scenario, there is one security designated by one CUSIP number, but it is paying one rate for successfully remarketed bonds and a separate rate (at times paying at another frequency) for any bank bonds. Because so many aspects of the securities industry rely on a CUSIP number defining a security with the identical characteristics, the tracking of an individual security with divergent attributes causes challenges which can slow processing and clearing.

At the outset of the tender wave, internal workarounds were created to ensure proper ownership information and interest payments were matched to both the remarketed and bank bonds. These temporary measures were a stopgap until new bank bond CUSIP numbers could be established. But as the tenders increased, it became apparent that existing procedures for establishing a new CUSIP for clearing purposes could not meet the growing remarketing failures.

During this time, many banks participated in ongoing meetings and conference calls with DTCC, the American Bankers Association's corporate trust committee, and other parties to brainstorm how to develop an alternative, accelerated way of allocating new CUSIPs to facilitate bank-bond issuance. In April, the DTCC issued new guidelines putting these procedures in effect.

Improving VRDO Mechanisms

The credit crunch and bond insurer downgrades have had a tremendous impact on the municipal bond market in general and VRDO market in particular, bringing to light numerous challenges that the market had been unaware of or had papered over for years. The time has come for issuers and counterparties to strengthen and improve VRDO mechanisms and reduce potential exposure to credit downgrades that are beyond their control. It is important to start making changes now, including:

1. **Set aside DTCC-eligible CUSIPs.** Additional CUSIPs should be issued at the outset for all new variable-rate bonds. Easier availability of DTCC-eligible CUSIPs will improve payment flow among the remarketing agent, trustee, and liquidity provider.
2. **Consider timing requirements in the documents.** Quick turnaround times to facilitate the activity for a successful or unsuccessful remarketing (i.e., settlements, liquidity draws, VRDO payments) require prompt, decisive action by the tender agent or trustee.
3. **Bring the trustee in early.** The trustee is typically one of the last parties brought to the table on a financing team. The time to get trustee input is at the outset. The trustee and issuer may be working together for 30 to 40 years. Give your trustee an opportunity to examine the proposed documents and comment on them before they are final.

4. Address worst-case scenarios in governing documents. The indenture should provide clear, unambiguous procedure language in case of failed remarketings and bond insurer downgrades, among other issues. Ask advisers if all of the worst-case circumstances have been identified. Test preparations for these scenarios, similar to a fire drill.

5. Hire an experienced, proactive trustee and tender agent. Difficult markets serve as a wake-up call. Issuers need a strong, proactive trustee and tender agent to be involved at every stage, one that will follow the spirit as well as the letter of the indenture. Experience enables market participants to foresee problems early on, plan for them, and take a leadership position to keep the crisis from spreading.

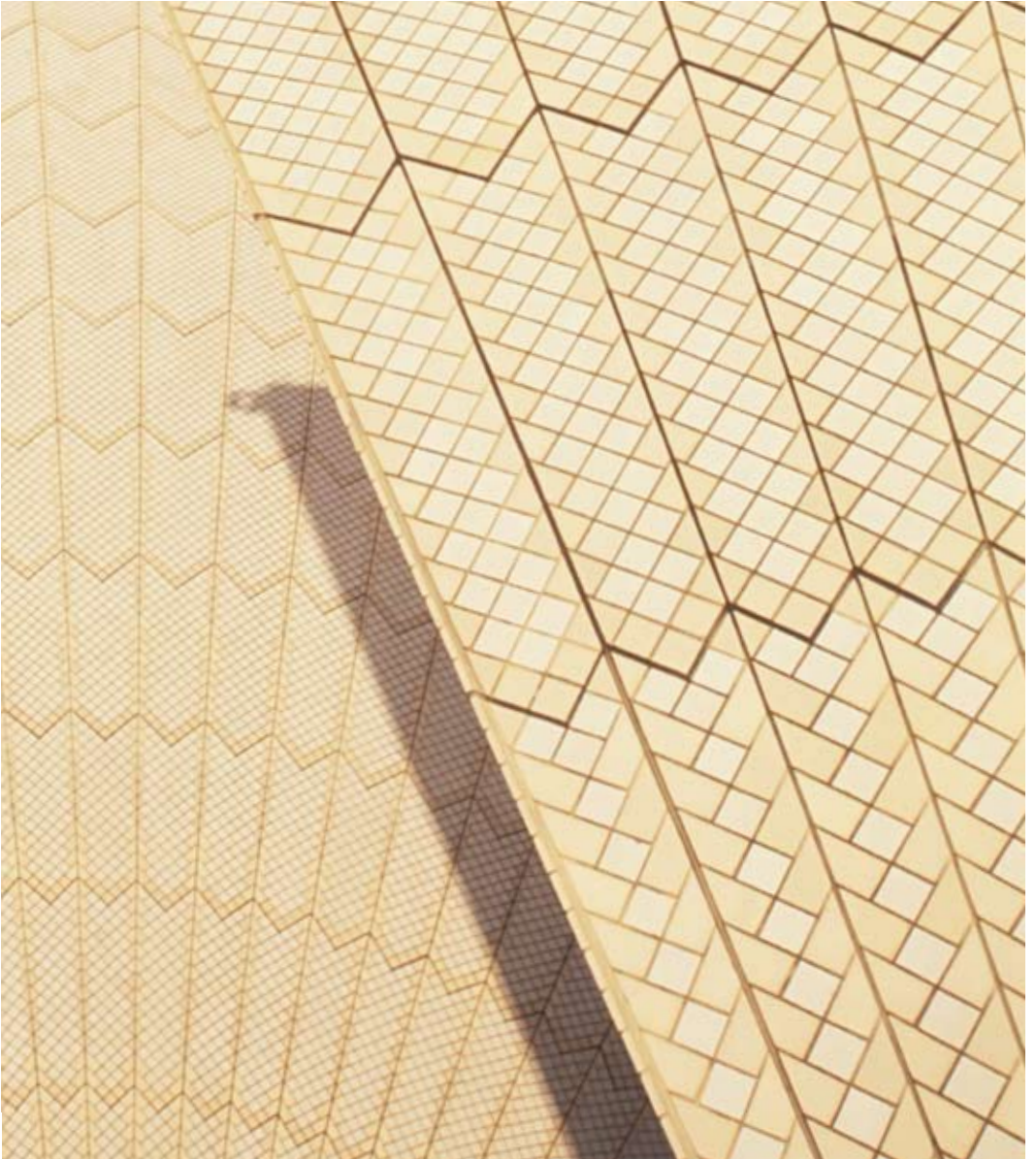
It is really a matter of getting back to basics. Variable-rate structures will continue to be an important long-term financing vehicle for municipalities and market challenges will likely continue to occur. The lessons learned during this recent crisis can help strengthen and improve the processing side of the VRDO market.

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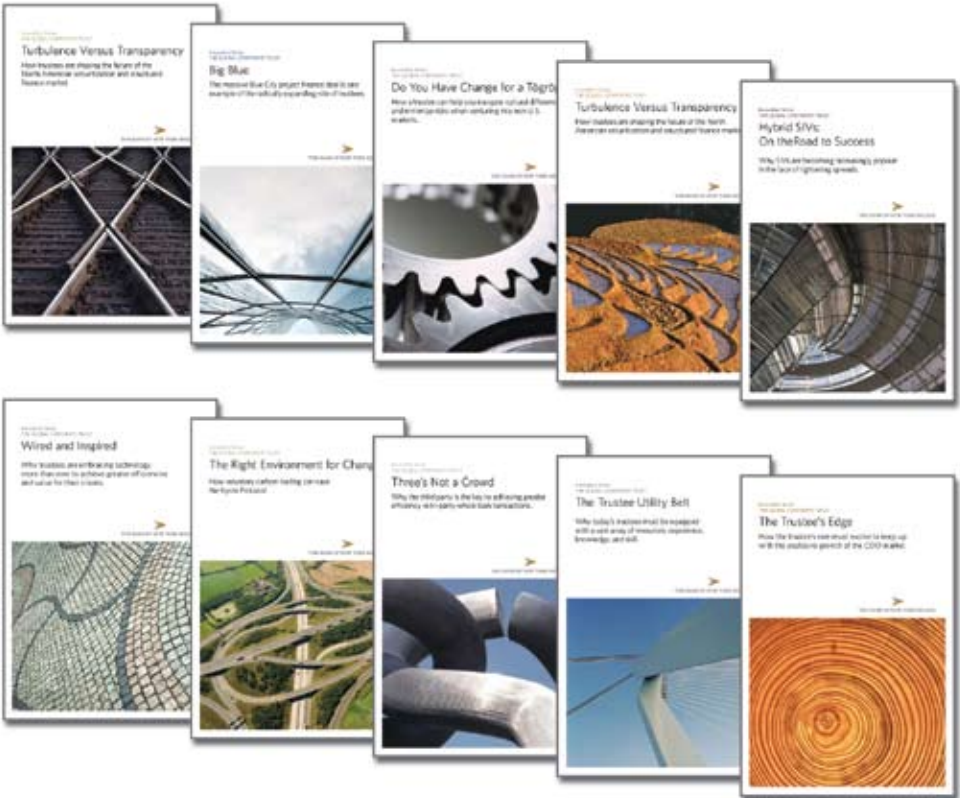
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