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Potential Impacts of Bank Downgrades on Variable-Rate Demand Bonds

Over the past few days, there has been a focus in the business media on the potential impacts on financial markets of additional credit rating downgrades of large U.S. Banks. In February 2012, Moody's indicated that it would review the ratings of banks worldwide because of slowing or stalled economic growth and developments in Europe that could impact bank liquidity and profitability. Although the rating reviews have been in the works for months, the results are expected by the end of June, so media and investor attention has begun to focus on what may happen if/when banks are downgraded again. One of the most significant effects in the municipal market could be the impacts on yields and marketability of variable-rate demand bonds and notes.

Variable-rate demand bonds and notes are taxable or tax-exempt securities that have long-term maturities but that have coupon rates that reset on a daily, weekly or monthly basis. These securities are issued by municipalities that want to take advantage of current low short-term interest rates. Investors have the right to put the bonds on any interest reset date. The ability to repay any bonds put back to the issuer is guaranteed by a bank letter of credit, and these bonds are typically rated both for short-term credit quality (the credit quality of the bank guaranteeing the put) and for long-term credit quality (the credit quality of the issuer ultimately guaranteeing the payment of principal and interest). In the municipal marketplace, these securities are often referred to as floating-rate bonds, "floaters," VRDNs or VRDBs.

VRDBs offer investors a highly liquid investment that does not vary in price. Instead of the bonds' price adjusting to changes in interest rates, these bonds' rate changes while holding the value at par. The bonds are remarketed on every interest rate reset date (daily, weekly or monthly), and the new coupon rate is set at whatever rate is necessary to entice investors to purchase the bonds at par. Investors have the right to continue to hold the bonds, and receive the new coupon rate, or to put them back for payment at par. VRDBs are commonly held by money market mutual funds due to their high credit quality and strong liquidity.

VRDBs usually have a bank letter of credit (LOC) that guarantees payment in the event bonds are put back for payment. These LOCs are direct-pay, which means that the bank makes payment directly to the investor putting his or her bonds, and then is paid back by the issuer. In this way, investors are insulated from any situation in which the issuer might not have sufficient funds to pay off all of the bonds that are put back to it on a reset date. It also ensures that investors can liquidate their holdings at par regardless of how much demand there might be for the bonds in the remarketing. As a result of the guarantee of purchase, bank LOC ratings are equal to the credit quality of the bank itself.

A VRDB rating reflects the credit quality of the bank LOC, as this is source of repayment for investors putting bonds. In the event that a remarketing fails – that is, that no investors are willing to purchase the bonds at any coupon rate – the bank is required to purchase back all of the bonds and hold them in its own portfolio (known as VRDBs “being in bank bond mode”). The only scenario in which a bank LOC might not be honored would be if the bank itself suspended payments on its obligations because of a Chapter 11 bankruptcy filing or seizure by bank regulators. In our 20 years in the municipal bond business, we have never seen any bank fail to honor payment under an LOC.

Should Moody’s downgrade many of the largest U.S. and international banks later this month, as is widely expected, this will not change the ability of the banks to honor their LOCs and will not change the liquidity of the VRDBs guaranteed by those banks. The rates that investors demand to hold obligations secured by those banks will go up, so the reset rates on VRDBs with LOCs from those banks will rise. For example, it would take the failure of Bank of America – something that we view as extremely unlikely and that the federal government would work hard to prevent – in order for an LOC from BofA to fail to make payment.

If a bank’s credit ratings are downgraded, the bank’s LOC rating also declines. Investors then determine how much additional yield they will require to take on the additional risk of holding that bank’s obligations, and the VRDB coupon rate adjusts at the next reset to reflect the new market risk of the bank LOC at the new rating. As a result, it is normal to see a wide range of interest rates offered in the VRDB marketplace, reflecting the range of credit quality of the LOCs securing the put features on those bonds.

VRDBs are very different from the auction-rate securities that experienced difficulties beginning in 2008. Auction-rate securities are also long-term bonds that had coupon rates that reset periodically. Unlike VRDBs, auction-rate bonds did not have a guaranteed put. Rather, liquidity was dependent on the bonds’ rate being reset through the auction process. Although broker-dealers implied that they would provide a market for the bonds, they were

not obligated to do so. As a result, when auctions failed to attract buyers and broker-dealers refused to buy back the securities, investors were forced to hold these bonds with no recourse and no ability to sell. VRDBs are specifically structured to avoid this risk.



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