

# Endgame

July 21, 2008

How the Auction Rate Securities Crisis Ends

## KEY POINTS:

Mounting prosecutor evidence of misrepresentation and malfeasance in the sales and marketing of Auction Rate Securities (ARS) will pressure the major broker-dealers to ultimately make most of their affected clients whole.

Despite the lack of [an explicit fiduciary obligation to their clients](#), brokerages selling ARS still failed to meet basic standards of fair dealing for their clients.

ARS issuers paying low failed auction rates between 0 - 4 percent have very little motivation to refinance and will not drive a solution.

Taken together, recent events are giving ARS investors a clearer picture about how this ends: Wachovia brokerage headquarters are raided by a team of ten state regulators regarding their ARS sales and marketing practices. UBS agreed to fully redeem \$3.5 billion of the auction rate preferreds it sold investors (but not the much larger pool of student loan and muni ARS they sold). HSBC, a relatively small ARS seller, agreed to buy back all of the ARS it sold its clients.

SVB Asset Management believes that what began with the civil fraud charges filed against UBS by the Massachusetts secretary of state will soon build enough momentum and supporting evidence to force all major sellers of auction rate securities to make most of their investors whole.

While it is difficult to make a definitive list of which firms will take this path, we believe the firms that originally settled SEC claims of auction rate bid rigging in May 2006

represent a very good guess. The firms that were named in that settlement include UBS, Wachovia, Lehman, Merrill Lynch, Deutsche Bank, Morgan Stanley, Citigroup, Bank of America, JP Morgan, Piper Jaffray, Goldman Sachs, Bear Stearns, and others.

In relative order, here are the elements of the ARS meltdown that will drive this outcome:

## ACTIONS SPEAKING LOUDER THAN WORDS

Typically, (and ARS investors are really no different) investors in any security bear the responsibilities of *caveat emptor*: to acknowledge and understand the risks of investments, regardless of who bought it for them. What makes the ARS situation unique is that the brokerages that sold these had a clear understanding of the growing risks in these securities, but because these brokers were also the sole auctioneers of the auctions they held vital information about their eroding viability that investors couldn't possibly assess themselves. The brokerages also clearly understood that if they did not sell this inventory, if they instead notified investors of their growing difficulty in getting auctions to succeed, their own balance sheets would choke on most of the \$330 billion in illiquid securities. With this in mind brokerage houses continued to market ARS as safe as cash investments up to the point of collapse, urging investors to stay invested and pointing to the steadily higher pre-crash yields as a buying opportunity. These actions are a clear example of putting their own interests before those of their clients.

## AN UNDIFFERENTIATED MARKET

While the fraud charges filed in Massachusetts pertain directly to UBS, the elements of the market, its economics, its marketing, broker practices, compensation, and the buyers, were largely the same at every firm.

- The UBS fraud suit helps detail the increasing frequency with which UBS had to put up its own capital to prevent auctions from failing through in 2007 and early 2008. An astonishing 86 percent of auctions between 2006 and February 28, 2008, ultimately had to be supported by UBS' own capital. While these securities were marketed by each brokerage as liquid and safe, it's clear that that liquidity and safety was an illusion; it would last only as long as the firms supported the market. The simultaneous walk away that all brokerages took from the market in February 2008 makes clear that the same erosion of quality and understanding of eminent collapse was widely shared. Ultimately all auction rates shared the same fundamental problems that were largely invisible to investors. To keep the market viable every brokerage compensated for those problems in largely the same way.
- Industry wide, individual brokers were typically paid three to four times more for selling auction rate securities than other short-term fixed income investments. As market stress increased, many brokerages raised the payouts they would offer, and many brokers responded. Simultaneously no other security class had issuers pay underwriters upfront underwriting fees as well as a 50 basis point annuity for running ARS auctions going forward to their typical 20-30 year maturity. Both the firm and the employees were highly incentivized to sell these and keep this niche market alive.
- After the market failed, however, explanations as to who was to blame differed widely. Some brokers claimed they were entirely in the dark, others are acknowledged increased pressure from above to sell these, while others chose to confess little understanding of what they were selling. The late January urging that

many longtime holders received to stay in the market, and the steady migration of marketing from major corporations, to startups, to wealthy investors, and ultimately to retirees paints a different story.

## (VERY) SELECTIVE WARNING

Virtually all auction investors received no advance warning of the crumbling auction market from the brokerage houses, including some of the largest firms in the country. Yet the Associated Press reported that some of the highest revenue clients of JP Morgan, Lehman Brothers, Morgan Stanley, Bear Stearns and Merrill Lynch actually did. Tim Cahill, the State Treasurer of Massachusetts received warnings from each of weakening demand in auctions and was urged to consider refinancing. Perhaps a final example of the investment firms' clear understanding of the stakes, and apparently of who to warn.

While we feel that the growing risk of pronounced and probably permanent reputational damage will ultimately trump the financial damage that the brokerages will take for making their clients whole, what we don't know is when. In a marketplace where the much larger mortgage portfolio continues to force each of these banks to take major write downs, FASB 157 will force these firms to value ARS not at the price they bought them back at, but at the price they could sell them. By marking down the remaining ARS market to 80 percent of par (a conservative estimate) upwards of \$45 billion in more write downs would have to be realized.

The other side of the coin is the issuers, with perhaps \$230 billion in auction rate paper still frozen, it is worth considering what to expect from the issuers of specific security classes. The estimates of amounts still frozen are as of June 26, 2008:

*Student Loan ARS (\$84 billion illiquid):* The student loan industry was under stress before the failure of their ARS liquidity structures. Given that much of their paper is currently offering yields between 4 and 0 percent (many actually at 0 percent) most have little motivation to

quickly solve this problem and potential buyers are hard to come by. If restructuring could bring about better rates and conditions, many of these firms would restructure, but there has been little evidence of this. There have been some indications of student loan corps seeking to repurchase their own ARS debt at less than par, in essence paying back less than they were loaned.

This action may also dilute the motivation of secondary market buyers seeking a full par return off of whatever discount they can secure. Couple this with prosecutors pressuring brokerages to make whole original investors who have since sold their securities at a discount, and you have a scenario where now two entities want to be paid in full—but surely only one will.

*Closed-end perpetual mutual fund ARS (\$48 billion illiquid):* Closed-end fund providers such as Nuveen, Eaton Vance and BlackRock have stated intentions to retire their ARS paper. For the higher yielding failed ARS paper, many closed-end fund providers already have retired them, largely to reduce their own costs. A vehicle being proposed to retire the rest is a new ARS-like security class with investor put provisions and a structure tweaks that would allow rule 2a-7 money market mutual funds to buy them. We liken these structures to the helicopter that rescues trapped climbers off Mt. Everest: They are happy to get off the mountain, but they will still get out of the helicopter as fast as they can. The fundamental problem remains: finding a buyer. To do this the new security needs to offer a yield low enough to encourage refinancing, but high enough to entice money fund buyers. This may be difficult to do in a market seeking safe investments, especially for a new security class born out of such turmoil.

*Municipal ARS (\$48 billion illiquid):* Nothing motivates municipalities like taxpayer ire. Risking headlines about paying high yield premiums on failed auctions, most municipalities moved to unwind these pain points. For

the remainder paying low rates, the same motivation doesn't exist, but an ability to refinance generally does. We expect that alternative financing vehicles are being actively considered, and marketed by underwriters, to unwind these situations.

*Special situation private placement CDO, mortgage and sub Aaa-rated ARS (\$20 billion illiquid):* “The worst of the worst,” these securities are the least likely to be made whole by either the issuer or the selling broker. These once high-yield options also were sold with the highest payoff to brokers, and their risks were more apparent even before the credit crisis. Firms who were sold these as cash management tools stand the highest probability of permanent principal loss on the investment, and may need to consider adding direct legal arbitration to their efforts of being made whole.

SVB Asset Management has [long advised against the suitability of Auction Rate Securities in corporate cash portfolios](#). For any firm impacted by ARS investments—we encourage you to contact us directly for an independent perspective and updates as to the condition and outlook for your specific holdings.

Joe Morgan, CFA  
Chief Investment Officer and  
Head of Portfolio Management  
SVB Asset Management

415.512.4234  
[jmorgan@svb.com](mailto:jmorgan@svb.com)

Adam Dean, CFA  
President  
SVB Asset Management

415.512.4264  
[adean@svb.com](mailto:adean@svb.com)

[www.svbassetmanagement.com/commentary](http://www.svbassetmanagement.com/commentary)