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Extendible Securities

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Key Points

- Given the relative newness of these securities, we are not convinced that a real secondary market for the debt exists. A strong supply and demand in the secondary market is necessary to create the kind of liquidity we want to see for investments in our client portfolios. Currently, we don't see either. If an investor in an extendible security wants immediate liquidity, we see a real potential for principal loss.
- While these types of securities have mandatory tender option to the issuers, investors need to have the ability to hold them until the extended mandatory purchase date, which typically can go up to one year.
- Since these securities typically do not have external bank support agreement and rely on the issuer's creditworthiness, dedicated expertise and resources are required to conduct ongoing due diligence on the issuer's ability to honor the commitment.

Description

Extendible securities are a new variation on a broad category of variable rate bonds that are typically issued by public finance sector with a put or tender feature. This put feature gives the bondholder the ability to tender the bonds at par to the issuer.

These extendible securities include a variety of structures and are marketed under various trade names (e.g., Windows, X-tenders and extendible reset securities; auction rate securities are also extendible rate securities but without a put option). These types of products or structures are introduced more frequently to public finance issuers and are developed by the investment banks to adapt to market demands. There are currently very few issuances of extendible securities in the market.

The coupon is reset weekly based on a fixed spread added to the SIFMA index. All three credit rating agencies have assigned short-term and long-term ratings for these securities.

While these extendible securities come with different structures, the products typically have a long nominal maturity with a weekly or monthly mandatory tender on each interest payment date at par to the issuer. If the investor tenders the debt, the remarketing agent has a certain number of days to remarket the security to other investors. If a new investor cannot be found, the mandatory purchase date is extended up to a maximum of a year depending on the structure of the securities. The issuer is then expected to be able to source funds within that period of time to repay the investor.

The issuer's failure to pay on the extended mandatory purchase date is an event of default. The structure typically includes a mandatory tender to make the bonds eligible for purchase by money market funds, which require put features or maturities of 397 days or less.

At the other end of the spectrum, typical variable rate demand notes are structured in daily or weekly modes or issued as commercial paper. However, in these types of structures, an issuer has a very limited amount of time between the notification of a failed remarketing of the variable rate debt and the deadline for transferring funds to the trustee for the debt payment.

Majority rely on issuer "self-liquidity" structure

Like variable rate demand obligations in shorter modes, these products typically have no dedicated external bank support agreement and rely on the issuer's "self liquidity" to fund un-remarketed tenders. Sources of repayment are typically from remarketing proceeds, the issuer's own investment portfolios and/or proceeds from new bond issuance.

Generally, self-liquidity structures are most common for highly-rated issuers that have ample cash and investment holdings, such as higher education and healthcare issuers. These structures may be less common for state and local government sectors where liquid financial reserves are more restrained.

Background

The majority of public finance issuers of variable rate demand obligations use dedicated bank liquidity facilities (either standby bond purchase agreements or letters of credit) to support potential tenders by investors. In the event of a failed remarketing following a tender, the liquidity facility may be drawn upon to pay investors and the liquidity provider may take ownership of the bonds.

Nonetheless, the market turmoil of the past two years has exacerbated the refinancing risk for public finance issuers. For many issuers, the credit crisis has resulted in a more limited access to capital and less availability of bank support for variable rate debt obligations. Many banks are limiting the length of agreements, charging higher fees or declining to provide liquidity facilities altogether. The reduced supply of liquidity providers and the increased demand for liquidity facilities have resulted in increased prices of liquidity agreements, placing yet another strain on variable rate demand obligations issuers.

As a result, there is increased interest in issuing variable rate debt that is supported by issuers' own internal liquidity rather than the more expensive commercial bank liquidity support, which subjects them to stringent financial covenants. They also provide diversified funding sources other than bank secured debt and bond insurers' credit enhancement.

These "self-liquidity" programs rely on the issuer maintaining adequate sources of liquidity to meet un-remarketed tenders of variable rate bonds.

Ongoing due diligence on the issuers' creditworthiness is key

While the U.S. recession seems to be abating, the negative pressure on municipal issuers across sectors is expected to remain, which is evidenced by continued revenue deterioration, increased spending pressure and the expectation of a lagging national economic recovery.

Ongoing due diligence of the issuer's ability to provide liquidity from its own position to support variable rate demand debt is crucial. The key credit factors would be the issuer's sources of liquidity, the debt structures, the amount of puttable bonds relative to total investment portfolio, the structural elements of the liquidity agreements (if any), the enforceability of the agreement, the variability of the issuer's cash flow needs and the ability to access capital markets.

Some issuers rely on hybrid bank lines which are lines of credit from commercial banks that are used as a source of liquidity for issuers that have variable rate debt in a self-liquidity structure. However, hybrid lines do not provide the same level of protection to bondholders as traditional Standby Bond Purchase Agreements (SBPA), which are specifically dedicated to pay for un-remarketed tenders of specific bonds and can only be terminated in the event of severe credit deterioration. While the hybrid line can help reduce the need for immediate liquidity, these lines can expire or be terminated. Hence, the issuer's capability to manage its liquidity and maintain the bank line is extremely important.

In addition, with limited and inconsistent public disclosure in the municipal market, investors will need to have the expertise and dedicated resources to conduct ongoing credit assessment of the issuer in order to accurately assess the strength of the issuer's self-liquidity coverage.

Unknown: The breadth and depth of the secondary market for the extendible securities

If an investor in an extendible security wants immediate liquidity, we see a real potential for principal loss. Illiquid securities usually trade with a relatively wide bid-ask spread. In the absence of a robust secondary market, investors may realize less than the par amount if they choose to sell to the open market instead of extending their bonds.

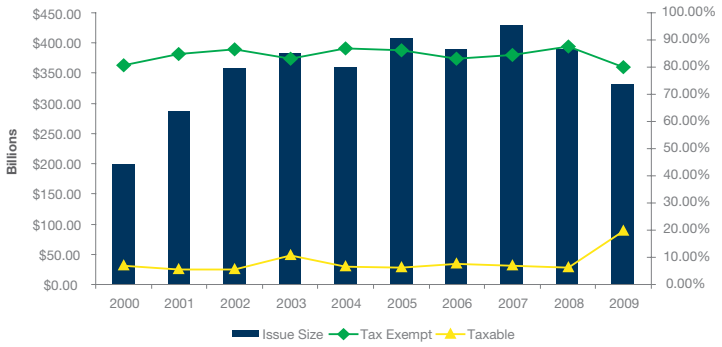
Given the relative newness of these securities, we are not convinced that a real secondary market for the debt exists. A strong supply and demand in the secondary market is necessary to create the kind of liquidity we want to see for investments in our client portfolios. Right now we don't see either.

Lack of supply in short-term municipal securities

With bank credit profiles under tremendous pressure during the financial crisis, bank support for variable demand rate notes became more expensive, if those securities were available at all. While short-term borrowing rates have dropped, issuers have struggled to package short-term deals. The result is a real scarcity of tax-exempt, short-term municipal securities. Taxable municipal issuances have picked up some of the slack. As of October 2009, nearly 20 percent of the $331 billion in municipal bonds offered were taxable compared to around 7 percent in 2008. (see Table 1). The explosion of taxable bonds traces its roots to this February, when President Obama signed the American Recovery and Reinvestment Act and created The Build America Bond program (BAB). Many of these bonds are structured like traditional taxable corporate securities with long-term bullet maturities. Issuers of these bonds received a subsidy from the federal government for 35 percent of the interest payment. In the current market, this feature has produced a lower net cost of funds than the tax-exempt equivalent rate, particularly for longer-dated maturities. The BAB program is slated to expire January 1, 2011, and as long as tax-exempt bonds remain more expensive, we expect BAB to remain a popular choice for issuers. Since the first BAB issuance in April, municipalities have issued almost $48 billion through October 2009. By comparison, municipalities have issued only $26.6 billion in variable debt in 2009, compared with over $100 billion in the first ten months of last year.

Changing Landscape of Volume

Taxable Debt Rises as Tax-Exempt Volume Wanes



Source: Thomson Reuters

Short Term Tax-Exempt Yield			
Municipal Market Data	**November 2, 2009**	**October 30, 2009**	**October 29, 2008**
Commercial Paper (30-Day)	0.25	0.25	1.55
One-Month Note (MIG-1)	0.3	0.3	1.7
Three-Month	0.3	0.3	1.6
Six-Month	0.33	0.33	1.55
One-Year	0.42	0.42	1.5
Variable-Rate Demand (Non-AMT/AMT)			
Daily General Market	0.21/0.21	0.25/0.26	1.27/1.29
Municipal Market Data	**October 28, 2009**	**October 21, 2009**	**October 29, 2008**
The SIFMA Municipal Swap Index	0.26	0.26	1.82

Source: Bond Buyer

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