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New Hit to Strapped States

Borrowing Costs Up as Bond Flops; Refinancing Crunch Nears

By MICHAEL CORKERY And IANTHE JEANNE DUGAN

With the market for municipal bonds tumbling, cities, hospitals, schools and other public borrowers are scrambling to refinance tens of billions of dollars of debt this year, another sign that the once-safe market is under duress.

The muni bond market was hit with the latest wave of bad news Thursday, prompting a selloff that sent the market to its lowest level since the financial crisis. A New Jersey agency was forced to cut the size of a bond issue by about 40% because of mediocre demand, and pay a higher rate than expected. And mutual fund giant Vanguard Group shelved plans for three new muni bond funds, citing market turmoil.

"We believe that this delay is prudent given the high level of volatility in the municipal bond market," said Rebecca Katz, spokeswoman for the nation's biggest fund company.

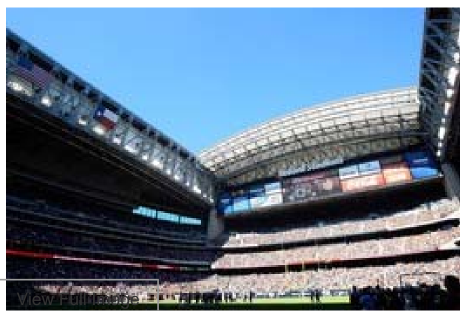
The market has fallen every day this week, and investors have been net sellers of their holdings in municipal-bond mutual funds for nine straight weeks, according to fund tracker Lipper FMI.

Yields on 30-year triple-A rated general obligation bonds shot higher to 5.01% on Thursday, reflecting a spike in perceived risk, according to Thomson Reuters Municipal Market Data. The last time those bonds yielded 5% was Jan. 30, 2009, during the financial crisis.

Amid the selloff, public borrowers such as states and utilities face a wave of refinancing stemming from deals cut mostly during the crisis. The deals involved letters of credit from banks that were designed to keep financing costs down for government entities in need of cash.

Though the financing deals can be meant to last decades, the letters of credit underpinning them are expiring sooner. That could force the borrowers in many cases to pay higher interest rates or seek guarantees at higher costs. For the weakest borrowers, new guarantees may not be available and refinancing too costly. There are about $109 billion worth of letters of credit and similar backstops expiring this year, according to Bank of America Merrill Lynch. Some $53 billion in letters of credit alone is expiring this year, according to Thomson Reuters.

"Municipalities may be hard-pressed to come up with this money or refinance this debt," said Eric Friedland, a municipal analyst at Fitch Ratings. The ratings firm is scouring to identify risks


Associated Press

The agency that runs Reliant Stadium in Houston is being forced to pay back a 30-year bond in a few years.

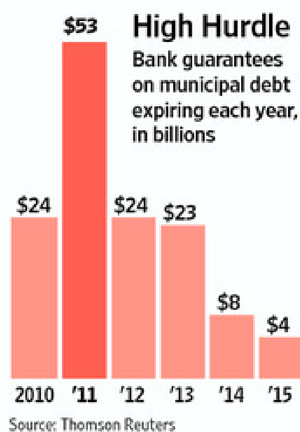
among weaker municipalities that are seeking to renew these deals, and says it could downgrade some.

The rollover rush stems from the credit crisis that roiled the U.S. in 2008. Municipalities had issued so-called auction-rate securities, instruments whose rates reset at weekly auctions. Amid the credit crunch, buyers at these auctions vanished.

Many municipalities scrambled to convert the debt into other instruments, including variable-rate demand obligations, which are long-term bonds with interest rates that reset periodically. For a fee, big banks guaranteed many of these deals.

These so-called letters of credit from banks typically only last two or three years, leaving municipalities to refinance the deals or obtain a new guarantee. The issuers expected to easily renew the letters of credit.

But many of these letters of credit have become much more expensive and scarce, state officials say, leaving them with little choice but to try to refinance at a time when the broader muni market is under pressure.



The short-term squeeze is unusual in the $2.9 trillion municipal bond market. Most debt is paid back over decades. And state and local governments generally don't need to borrow money to fund their daily operations. The long-term nature of the market is a key reason why most experts don't see the problems with state and local government debt spiraling into another financial crisis. Analysts say that many large states and cities with good credit ratings have been able to roll over deals well ahead of their expiration.

But there are parts of the market where short-term cash crunches could emerge, leading municipalities to potentially default on their debts. The risks could spill over to banks that backed bonds with the letters of credit.

"This is one area of risk the market hasn't focused on," said Frederick Cannon, a banking analyst at Keefe, Bruyette & Woods. Mr. Cannon says it is difficult to determine banks' exact exposure to such deals because they don't typically report them in their financial statements.

The stress is on display at the New Jersey Economic Development Authority, a governmental agency. This week, the agency sought to refinance some variable-rate debt, but met mediocre demand from investors. The state had to reduce its planned $1.8 billion offering to $1.1 billion because of the rates investors were demanding.

Part of the $1.1 billion will be used "to eliminate the need for $1 billion in letters of credit at what were sure to have been prohibitively high prices," said Andrew Pratt, a spokesman for the New Jersey Treasurer. Mr. Pratt said the state was able to achieve "favorable rates" in the scaled-back bond sale.

In Texas, J.P. Morgan Chase & Co. has taken control of a debt that it back-stopped in a 2001 deal that requires the public agency running the Houston Texans' football stadium to pay back a 30-year bond over the next three-and-a-half years.

"Think of having a 30-year mortgage, and then someone suddenly says you have to pay your house off in five years," said Janis Schmees, executive director of the Harris County Houston Sports Authority, which built the stadium. "That is pretty much our scenario." A representative for J.P. Morgan declined to comment.

California, which has letters of credit backing about $525 million in debt coming due in November, is planning to renew the guarantees. "We expect when November rolls around, we will get those letters renewed," said Tom Dresslar, a spokesman for the state Treasurer.

According to Moody's Investors Service, of the 500 municipal issuers that it rates with variable-rate demand bonds backed by some form of bank support, about 200 don't have the top ratings.

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The biggest concerns, analysts say, are smaller muni borrowers such as hospitals and schools that have subpar credit.

Municipalities borrowed $122 billion of variable-rate demand debt in 2008, roughly twice the amount of these types of loans borrowed the year before, according to Thomson Reuters.

Rollover crunches were a major part of the financial crisis, as banks that had relied on short-term debt couldn't borrow and became insolvent. More recently, rollover issues contributed to Greece's financial crisis.

Banks are reluctant to renew the letters of credit in part because of impending rules that restrict the amount of risk they can take.

Besides banks, one provider of muni letters of credit is the giant California pension fund, the California Public Employees' Retirement System, which has back-stopped $2.5 billion of adjustable-rate bonds.

Calpers' chief investment officer, Joe Dear, said in an interview that the pension fund partly uses the letters to make it easier for local California entities to borrow money, but it has no plans to ramp up its involvement in such deals.

"We, like a lot of people, are watching the muni market, and it is not getting any healthier," said Mr. Dear.

—Kelly Nolan contributed to this article.

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