

Any borrower using taxable bonds has been affected economically although some don't even know it yet.

The only question is "how much"?

TAXABLE BONDS A BORROWER'S WHITE PAPER

By Elizabeth Allport

**Understanding the problem
Assessing the damage
Taking Corrective Measures**

1. Understanding the problem – what happened?

- a. Taxable bonds backed by bank letters of credit have historically traded at or near 30-day LIBOR.
- b. Beginning in early September with unprecedented market disruptions, all taxable bond reset rates spiked significantly, no matter who provided the letter of credit, as Lehman Brothers failed and other bond buyers pulled out of the market.
- c. Over the next months, many bonds were "tendered" or put back to the remarketer by the bond holder who wanted cash in 2008 instead of the investment.
- d. Due to the incredibly high volume of tenders, many borrowers were never notified, or not notified in a timely fashion, that their bonds were tendered.
- e. Bonds that remained in the market were subject to higher weekly reset rates. Borrowers are often not notified of the weekly reset rate on an ongoing basis.
- f. **Borrowers with LIBOR based interest rate swaps were not protected** (even though most did not realize it) and became liable for the interest rate difference between 30 day LIBOR and the bond rate. That could have been as much as 3 or 4%.
- g. Borrowers may not notice that their swap reconciliation invoice is for a higher amount than it should be, as this bill often fluctuates.
- h. As 2008 year-end financials are prepared, borrowers may show an interest expense that is significantly higher than budgeted. This continues into 2009.
- i. Some bond reset rates have returned to within 30 basis points of normal, but many others are still several percent higher than normal.

2. Assessing the damage - how to gather the pertinent information

- a. Are your bonds in the market now? Were they ever tendered? Are they tendered now? – This information is essential to know, as it will tell you what rates applied during this period of upheaval. Your trustee is the best source of this information.
- b. If you have not been provided the weekly reset rates, contact your remarketer for a history. This will tell you what rates should have been charged during the times that the bonds were in the market.
- c. You will also need to consult your bond documents to determine the charges and fees that should have been and may continue to be assessed. These will include the following:
 - i. the letter of credit rate
 - ii. the tender rate
 - iii. the remarketing rate and
 - iv. trustee item charges for accepting tendered bonds, CUSIP replacements and other miscellaneous fees not normally seen

- d. Once you know the historical and current status of your bonds and you have the proper rates and fees, you can calculate what you should have owed versus what you have paid or are being billed. This audit is essential because the never-before-seen level of the activity has overwhelmed many banks, trustees and remarketers with resultant mistakes. Fees are sometimes over-charged and letters of credit may continue to be charged against tendered bonds.
- e. The greatest damage may yet lie ahead. Most banks are either significantly increasing the letter of credit fee at expiration or are refusing to renew the letter of credit entirely. To properly prepare for that event, you should know the following:
 - i. the letter of credit rate
 - ii. the periodic payment
 - iii. is it paid in advance or arrears
 - iv. L/C expiration date
 - v. the number of days notice and the form of notice that the bank is required to provide before a rate change or cancellation of the L/C
 - vi. tender period and
 - vii. CUSIP numbers.

3. Taking Corrective Action – Mitigating past and future economic damages

- **Audit the charges**
- **Contest the errors**
- **Evaluate the remarketing**
- **Prepare an alternative to the L/C**
- **Engage a swap advisor**

- a. **Auditing the charges** – run a comparison of what you have paid or have been billed to the fees and charges specified in your documents. The sheer level of the bond activity has surpassed the normal capacity of the banks, remarketers and trustees and resulted in an abundance of mistakes and costly overcharges. Letters of credit have continued to be charged during periods of tender, remarketers have charged fees during tender periods and trustees have billed egregious service fees under vague language which may be negotiated.
- b. **Contesting the errors** - When you find an error, have the bank, remarketer or trustee rectify the mistake. Unfortunately, the local banker is most often not familiar with bond transactions and significant cuts in personnel on the capital markets side have made it difficult to navigate or get responses. Do not be dissuaded.
- c. **Evaluating the remarketing** – Except for a very small number of banks, nearly all tendered bonds backed by bank letters of credit have been remarketed. The real question is “at what rate”? It is wrong to assume that a bank serving as its own remarketing agent will be the most successful. Actually, certain independent remarketers have regularly set rates well below the bond’s own letter of credit bank and saved the borrower thousands of dollars each week. Depending on the remarketing agreement, you should have the option to remove your remarketer or ask them to resign. Different notification rules apply, so check your bond documents. You can move the remarketing to a firm which has a better track record. You may be asked to pay another underwriting fee, plus the ongoing remarketing fee. These are all negotiable and generally small in comparison to the savings.

- d. **Preparing to replace the letter of credit** - If your bonds are tendered and cannot be remarketed or your letter of credit will not be renewed or will be renewed at a higher fee, you should issue an RFP (Request for Proposal) to local, regional and national banks in your area. The RFP should request proposals for:
- i. **A cost effective letter of credit replacement.** Although the majority of banks are not currently extending letters of credit, certain select banks are doing so. One large national bank has its own taxable bond pool and other smaller banks have used facing letters of credit from the FHLB. The RFP should specify the rate and term sought as well as specifics relating to remarketing, tender rates and tender period. Specifications of the bonds should be included.
 - ii. **A conventional loan.** If you are not able to maintain or replace your current letter of credit, the letter of credit bank will have to pay the letter of credit to redeem your bonds when the letter of credit expires. This will result in you having a loan to the bank at what is normally a very high rate of interest for a short duration. Therefore, your RFP should contain a list of specifications for a conventional loan meant to take out the current bond debt. Particular attention should be given to the term and amortization and careful consideration given to the debt service coverage ratio under the new terms, which should be calculated beforehand. The RFP should also address contingency mezzanine financing that may be necessary to cover that portion of the current debt unable to be covered because of decreased loan to value allowances and decreased property values.
- e. **Engaging a swap advisor** – In the event that you will either be changing the amortization to fit a new debt schedule at your existing bank or would like to move to another bank, it will impact your swap if you have one. Any of the aforementioned actions will result in a trade and an opportunity for one or more of the banks to create additional profit at the borrower's expense. While it is true that you can transfer, assign, unwind or re-set an existing swap in favor of a new swap with no cash out of pocket, you will pay for that trade in the new rate. And, without a swap advisor, the banks will be free to use their own discretion as to the level of that profit without your knowledge. A swap advisor will protect you at the time of the trade in recognizing the level of profit and making sure it is fair. The swap advisor will also assist in creating language to govern your transaction through maturity.

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