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Muni Losses May Put Taxpayers on Hook for \$7 Billion

By Martin Z. Braun and Jeremy R. Cooke

April 3 (Bloomberg) -- On the evening of Jan. 22, Minooka, Illinois, school Superintendent Al Gegenheimer stood in front of the village board and said it had a problem: The district was running out of room to house its 3,700 students.

Minooka needed \$55 million to build two schools and renovate two others in the town 50 miles (80 kilometers) southwest of Chicago, he said. Two months later, the district sold 10-year tax-exempt bonds at a 4.16 percent yield, 0.8 percentage point more than Treasuries of similar maturity. It's the first time the district sold bonds yielding more than the taxable benchmark Treasury, data compiled by Bloomberg show.

"We need to have the buildings up and running by the fall of 2009," Gegenheimer, 51, said in an interview. "We're kind of behind the eight ball."

The premium, which translates into \$6.5 million in extra interest over the life of the bonds, has less to do with the Minooka school district's A1 rating and more to do with the credit crunch that has led investors to spurn all but the safest of government debt.

State and local borrowers across the U.S. may pay about \$7.2 billion more in interest over 10 years after municipal bonds lost 0.82 percent on average last quarter, their worst start since 1996, as a drop in debt prices pushed yields higher, according to a Merrill Lynch & Co. index.

Higher Than Treasuries

The extra interest is based on the \$90 billion of fixed-rate bonds borrowers typically sell this quarter and tax-exempt rates that now average about 0.3 per-

centage point more than Treasuries. Because of the tax benefits, municipal bonds due in 10 years typically yield about 0.5 point less than U.S. government debt, Bloomberg data show.

Rates on municipal bonds have surpassed Treasuries for five straight weeks, the longest period in at least 17 years, according to Bloomberg data.

Top-rated, tax-exempt bonds maturing in five years yielded 115 percent of Treasuries on March 28, while 30-year municipal bonds yielded 114 percent, according to New York-based Bear Stearns Cos. During the past 10 years, five-year municipals yielded 78 percent of Treasuries on average.

The weakness may continue through at least the third quarter as borrowers sell as much as \$100 billion of tax-exempt bonds to replace auction-rate securities, according to Merrill.

Refinancing Opportunities

While investors disagree about when the municipal market will return to a more traditional relationship to Treasuries, bonds sold in the coming months might be good candidates for refinancing at lower rates, said Dick Larkin, director of research at brokerage Herbert J. Sims & Co. in Iselin, New Jersey.

"These will probably be first in line to refinance, certainly within 10 years," Larkin said.

The auction-rate market collapsed in February as dealers stopped bidding for bonds investors didn't want. Rates on bonds auctioned weekly averaged 6.72 percent as of March 26, up from 3.63 percent in January, according to a Securities Industry and Financial Markets Association index.

"Supply is overwhelming the demand for municipal bonds and it's going to stay that way for the foreseeable future," said Gary Pollack, who oversees \$6 billion of municipal bonds as head of

fixed-income trading at Deutsche Bank AG's private wealth management unit in New York.

Rising Yields

The Bond Buyer 20-Bond General Obligation Index, which gauges the yield on municipal bonds maturing in 20 years, reached an almost four-year high of 5.11 percent on Feb. 28, from 4.15 percent on Jan. 17. The index currently yields 4.96 percent.

The crunch squeezing borrowers from Minooka to Houston and Albuquerque, New Mexico, has its roots in the subprime crisis that has sparked \$232 billion in credit losses at banks worldwide and led to a slowdown in the economy.

U.S. state-tax collections rose at the slowest pace in almost five years during the past three months as the economic slump curbed sales- and income-tax receipts, according to the Nelson A. Rockefeller Institute of Government in Albany, New York. The money that states collected during the fourth quarter rose 2.3 percent from a year earlier, the institute said.

On top of that, investors are calling into question the creditworthiness of bond insurers from Ambac Financial Group Inc. to FGIC Corp. that guarantee 50 percent of the \$2.6 trillion municipal market, after the firms sustained losses because they guaranteed debt backed by subprime mortgages. That is also causing investors to demand higher yields on municipals.

Credit Ratings Cut

U.S. state and local governments squeezed by rising interest costs may have their credit ratings cut, Moody's Investors Service said in a report released yesterday, potentially saddling them with even higher borrowing costs. Issuers with high levels of variable debt and interest-rate swaps, weak cash cushions or limited revenue-raising ability may face the biggest stresses, Moody's said.

For Minooka, whose bonds are insured by Assured Guaranty, the added borrowing cost can be

measured in textbooks and teachers' salaries. The money could be used to hire 153 teachers in a district that Moody's Investors Service describes as a hub for oil refineries and petrochemical producers in the Chicago area.

Minooka sought and gained voter approval Feb. 5 for the bond issue because the district has grown 130 percent in four years. The cash generated also covers renovations, including new classrooms, windows and pipes at its oldest school, built in 1922.

Added Costs

Delaying the bond issue would have been more expensive because the district would have had to put students in modular classrooms at a cost of about \$150,000 to \$200,000 per six units per year, Gegenheimer said.

"We're either paying out of one hand or paying out of another," he said.

The Houston Independent School District, the largest public school system in Texas, sold \$390 million of bonds March 10 to help renovate 133 schools, buy security cameras and add new facilities to alleviate crowding. The district has more than 200,000 students. Debt it sold that matures in 10 years yielded 3.86 percent, or 0.40 percentage point more than Treasuries.

"We needed the money because we're ready to start the projects," Melinda Garrett, the district's chief financial officer, said.

Albuquerque, New Mexico's water authority borrowed \$55.6 million on March 19. Included in the offering were bonds maturing in 2033 with an interest rate of 5.07 percent. That compares with a 30-year Treasury that yielded 4.21 percent the same day.

The agency is using the proceeds to help finance the \$443.8 million San Juan-Chama drinking water project, which will divert water from the San Juan River to a treatment plant.