

Fichera of Saber Partners Says Perhaps the Variable Rate Market “Should Shrink on the Municipal Finance Side”

This is Part I of a two-part interview with Joseph Fichera, CEO and Senior Managing Director of Saber Partners, where he discusses liquidity issues in the short-term municipal market, comparisons to the corporate market and the role of swaps.

MuniMarket Pulse Podcast

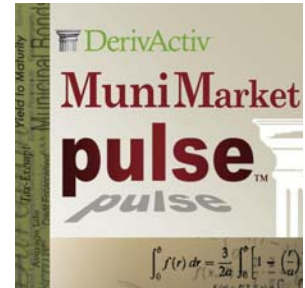
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Interviewee: Joseph Fichera, CEO and Senior Managing Director of Saber Partners, LLC

Interviewer: Johan Rosenberg, President, DerivActiv, LLC

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Episode Transcript: Joe Fichera Part I

Johan – Let's talk a little bit about VRDNs, that is Variable Rate Demand Notes. There's been some demands on Congress to cause legislation where the Fed would create a facility that would provide a backstop for the banks, there appears to have been a shortage in this market of letter of credit or banks willing to issue letter of credits. From your perspective, are issuers looking for intervention and for a liquidity backstop from the Fed because of higher prices or because of non-access? Which one of those two things is the bigger problem?

Joe–It's so hard to say because there's a lack of transparency in the marketplace. There has definitely been a pullback across the credit markets for providing liquidity facilities, particularly for lower rated entities. But we haven't seen as dramatic a price increase in the corporate market as we have seen in the municipal market. People going to the federal government for bailout is interesting and perhaps that is appropriate for lower rated credits but the variable rate market usually was reserved for higher quality credits as it is in the corporate market and probably should be and perhaps the market should shrink on the municipal finance side.

Johan– Let's just stop there for a second there and say Joe it was reserved for higher credits and maybe it should shrink. Let's now recognize that even the smallest 501(c)3 issuer in recent times got a letter of credit backing their deal and that was the way they accessed the capital markets.

Joe–You've got to look at two things here particularly in terms of what Bernake said. Generally it was also a letter of credit or a stand-by bond purchase agreement which is a very unique and strange animal in the municipal market, not found in the corporate

market that was also tied to bond insurance wrapping the credit. So you had multiple layers and a very complex transaction and costs associated with it and what is also fascinating is to look at what the Chairman said, that a very large portion was not meant to access the short end of the curve, but variable rate bonds were done and sold to facilitate interest rate swaps, fixed rate swaps. So there's a certain amount of irony in what is being said in terms of that the short-term market may have been disrupted not by issuers trying to borrow at lower costs on the yield curve, but trying to fix their interest rates through complex derivatives and had to sell variable rate in order to swap them into fixed, and now that is being seen as a major impediment to the entire variable rate market going forward according to the Chairman's own comments in his letter. I'm not sure that we're denying access to the short-term market because you could sell BANs and RANs. And why is it that you need to do a seven-day variable rate demand bond or a floater at a 30-year maturity? You could do commercial paper, there's all sorts of different things.

Johan– Let's take a \$7 million 501(c)3 little school or museum or something like that. They're not going to do a one year BAN, are they? Are you suggesting they should or could?

Joe–Maybe they should go to a bank and take a loan. Because a variable rate demand bond, what kind of liquidity does that have? Why would you do that? How is that appropriate in terms of your capital structure? You have to look at these things within the context of who the issuers are, what their capital structure, what combination of fixed versus floating there ought to be. This particular structure may not be appropriate for everyone. Maybe there are other structures. That's one of the reasons where the notion is going to have a federal government insurer, but then that seems very odd if that's going to be for the whole market because generally what will happen is that that will hurt the stronger credits and help the weaker credits. The municipal market seems to be searching for a “one size fits all” answer to sort of replace the “one size fits all” bond insurance answer, which didn't seem to work out so well. The notion that there's going to be probably different levels of market access based on your size, your credit quality, your management and such, shouldn't be a foreign concept. That's a market principal. Bigger issuers with stronger credits should be able to do more things than smaller issuers might be able to do with less resources and greater risk. The volatility of the short-term market may not be for somebody small, just like it shouldn't be necessarily for on the corporate side. We need to be looking at these issues fresh with the notion that what happened in the past 10 to 15 years with the explosion of bond insurance trying to commoditize the entire municipal market, and then adding on to that complex structures of stand-by purchase agreements, bank bonds converting to term loans, that then were involved with swaps in which the credit facility was tied to the insurer and not to the underlying credit in order to facilitate a 30-year non-callable swap, which we know no corporation would ever do, to take 30 year counterparty risk. Maybe we need to rethink this. And that there is going to be different market segments, there's going to be different types of products, it will not be a “one size fits all.” And financial advisors to issuers need to do more work and more homework and the underwriters are going to have to be thinking of other ways of mining fees and such, having a “back to basics” strategy.

Johan– I think we already have some evidence of even large issuers saying I'm not going to do long swaps anymore because I've felt the impact of a long swap with low rates and the mark-to-market effect and I don't want to be in that situation again. So I think that trend is already started. The issue with simplifying structures for smaller borrowers, I think I'm not entirely agreeing with you that these smaller borrowers can't, well I think they can intellectually handle the structures. Whether they're financial wherewithal is there to handle the structure in adverse times, I guess I would agree with you on that point. However, in the recent times, everything was good, right? So the prospect of having a bond put was not very high. Everybody thought that three-year letter of credits would be renewed indefinitely. So it was a very viable structure and it's only because of the credit crisis that that thought process has been interrupted.

Joe–I just don't accept the fact that people could not have thought about and accepted risk simply based on the observation that certain things didn't happen in their immediate memories. When I started in investment banking in 1982, in structuring a transaction, what you did was try to think through all the potential outcomes and have a specific plan. We worked on transactions in the municipal market for highly sophisticated issuers like Exxon Corporation; I've done numerous underwritings in the tax-exempt. They had over a billion dollars of floating rate, variable rate securities on their own credit. Major utilities like Southern California Edison, Florida Power and Light, and you made sure that your documents worked. That you had anticipated different scenarios, even if they were not likely, you had a plan. What we found I think in the past 24 months is that people didn't even understand their own documents.

Johan– I think that's true.

Joe–They didn't work because they said we never really need to use that and so a certain complacency and such. But that is a failure of our profession, not to do its job in the most rigorous and due diligent and excellent way. Hence we just say a high tide is just raising everybody, let's just keep going. What could go wrong? That seems a little bit reckless.

Johan– The stress scenarios that were created for certain situations, when interest rates were 200, 300 basis points higher and then you stressed the scenario down to where you are today, people would look at that and say, “We're in a new era, we're a complex society with communication and world trade and our financial systems are robust and completely different, and we just cannot envision a scenario where rates are 300 basis points lower. Therefore it's not in the realm of possibility for us.”

Joe–If that was actually the case and there was transparency and disclosure and discussion of that point and you made that decision then you would be right. I know of no situation where, for example, I've asked many issuers who dealt with the largest financial advisors, and I said, “Were you ever shown your maximum loss and your maximum gain from a transaction?”

Johan– And the answer is no?

Joe–No and people stressed often in different situations and we can go back and look at some of the presentations. They did various stress scenarios only if interest rates went up, not necessarily that interest rates went down or that credit qualities would deteriorate. You kind of wonder, how do you in the first place do a 30-year swap with a counterparty? You say, “Well hey at Citibank, I'm "AA".” If somebody does their homework they would go back and they say, “Let's see, we're going to do a 30-year with them, let me go back 30 years and look at where was Citibank? Who else was "AA" rated 30 years ago, and then 20 years ago, and then 10 years ago?” If you did that, you would realize that counterparty risk is extraordinarily high.

Johan– Yeah, they do change.

Joe–Probably a "AAA," one of the last remaining "AAA" banks was I think, Texas had "AAA" banks in 1986. The top "AAA" banks in the world in 1989 were Japanese. But when you look at the pricings, and you look at what people did, and you look at the disclosure, they disclosed that there was the risk, but they never calculated the risk and said this was the possible dollar amount. And when they looked at the cash flows between a synthetic fixed rate and a their natural fixed rate, they never adjusted them for risk, they just sort of added them up over 30 years and said, “Here's your present value savings from this deal discounted at this rate.” But wait a minute, that's not saving. You can't discount that at the bond rate. This is not a straight refunding. This has all these other risks. If I did a straight refunding you could do that because, why? Because the refunding rate is fixed, it can't change over the life. But when you do a synthetic fix, the synthetic fixed rate can change. Why? Because you have all these other risks, basis risk, counterparty risk, termination risk.

Johan– You sounded for a moment there that you were anti-swaps. I don't know if you are or not but you do realize that if you take away the VRDN market, the way to get that short-term exposure again is through the swaps market. So if the VRDN market constricts, one of the possible outcomes is that people will continue to want asset-liability matching and get that lower end of the yield curve and they'll do it through swaps.

Joe–Swaps are a toxic tool that need to be handled appropriately and can be a good effective hedge. But they should not be speculative. They should be able to match something on the other side so that there's a set collar in terms of your risk exposure. If the answer to the question, “How much could I lose?” If the banker says or the advisor says, “You know that's really hard to calculate, it depends on so many factors.” If that's the answer, then you should know I got a lot of risk here. You've just got to be comfortable with that kind of risk. I think the implication for the municipal market is to learn from the corporate market. Swaps are used, derivatives are used, all these products are used, but they're used sparingly. They're used within a more manageable time horizon like three to five years, maximum of ten. And they're not used a substantial

portion of the firm's balance sheet such that they cannot withstand the stress if something were to go wrong. Think about doing a \$100 million deal. You often wonder why did everyone think that if we were going to enter into a swap we have to swap the entire \$100 million. Why not just swap just \$50 million? They wanted to have a hedge because you have a natural hedge by being exposed by not swapping. A hedge is supposed to be able to counter risks or mitigate risks. Substituting one risk for another is not a hedge, it's substitution of risk. People should be seeing the more proper uses of these tools which are very important tools, but they can be toxic so you handle with care and make sure you do your due diligence, and you understand and can do the risks. And just because you say everyone else is doing it, doesn't mean it's been vetted. They may all be thinking that you vetted it, by that circular kind of argument. So the VRDN market is important for people who want to be able to have some floating rate exposure in their capital structure by which all financial principals suggest that you should. Asset-liability management, if you cannot access directly on it, you might be able to do it synthetically but there you need to understand the other risks associated with it. It just should not become the “deal of the day,” and how it exploded to such a level is really the question to be answered that hasn't been answered.

Johan– Don't you think the current market conditions has just given a wake-up call to these risks. I would project that there would be a moderated usage of these products on a go-forward basis. From the experiences, particular the mark-to-markets and the collateralizations. We're talking about swaps. I'd like to get back to VRDNs here in a minute, don't you think that's the case? That things have gotten a wake-up call.

Joe–Yeah I think there's been a wake-up call. Though I still see people pitching them very strong, I don't know how many of them are getting done. I think it's important that we don't overreact. They shouldn't be just thrown out completely as being inappropriate in all situations. No, it's that they were inappropriately used in every situation and done sort of in a sort of euphoric way as opposed to saying, “Wait a minute, this is a tool that can be used and needs to be used in more rifle shot, specific situations, for more manageable periods.” So if the swap market were to shut down completely, nobody did anything derivatively, that would be wrong. If they just continue to do the same thing that they always were doing, that would be wrong. It needs to bring back a balance to it.

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