THE QUIET CORNER OF DUTCH AUCTIONS

Demystifying Auction Rate Securities

Last April, when Google Inc. unveiled its plan to use a Dutch style auction in its initial public offering, it brought the popularity of this peculiar way of setting securities prices to a new height. Meanwhile, a sea change has been taking place for several years that promises to redefine how debt issuers tap the short-term fixed income market. Due to limited public awareness of the potential risks involved, this quiet storm may catch an unsuspecting corporate cash manager by surprise.

The New "Dutch" Twist

The new trend involves long-term variable rate debt securities, generally referred to as auction rate securities (ARS), that are being resold to investors at short intervals using the Dutch auction to reset interim interest rates. The short auction cycle, typically every 28 days, allows the securities to behave like money market instruments with competitive yields.

The new "Dutch" twist is the serial nature of the auctions that effectively turns a long-term bond into a money market instrument with built-in renewal features. In addition to allowing bond issuers to pay short-term interest rates on long maturity securities, the structure saves issuers the additional expenses of retiring old debt with new offerings.

The securities' lack of a "demand" feature, or an agreement that allows investors to sell them at face value at any time, is a main risk concern for corporate cash investors. While ARS generally offer higher yield than the average money market fund, corporate treasurers should carefully consider the impact of the potential lost use of the company's cash balances when an auction fails.

Money market mutual funds, under a 2a7 rule of the Securities and Exchange Commission, are barred from purchasing ARS due to the securities' long stated final maturities, typically at 30 years.

The Torrid Growth of the ARS Market

Corporate cash accounts only recently replaced wealthy individuals as the largest group of buyers of ARS, followed by other retail brokerage accounts and institutional investors. Despite almost nonexistent public awareness, the explosive growth of the market in recent years is nothing short of spectacular.

According to data from Deutsche Bank at a 2004 Florida conference for municipal issuers, the ARS market doubled between the first quarter of 2002 and the end of 2003, with total outstanding debt increasing from $103 billion to $204 billion. By comparison, total treasury bills and commercial paper outstanding in 2003 were $928 billion and $1.28 trillion, respectively, according to the Bond Market Association. In particular, ARS bonds backed by municipal projects, both taxable and tax exempt, almost tripled, to $72 billion in the same period. Judging from recently announced deals, the trend shows no sign of slowing down.

Among the main driving forces of the ARS growth are the low interest rate environment and the rapid growth of consolidation student loans.

Compared to an approximately 1% yield on most large institutional money market funds, ARS typically offer 15 to 20 basis points in additional yield. For corporate accounts that attempt to maximize earnings power without taking on additional interest rate risk, this small margin still offers relative yield advantage over other cash management alternatives, such as corporate commercial paper.

On the supply side, a big push comes from asset backed issuers and the broker-dealer community to securitize the mammoth growth of student loans when cash investors are

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either unfamiliar or unconcerned with the liquidity and credit concerns of ARS investments.

Student loans have been the most popular form of asset collateral for ARS as it is easier to secure the coveted AAA credit ratings due to government guarantees on most outstanding loans. According to Moody's Investors Services, annual student loan volume jumped over 300% in a five-year period to reach $57.3 billion in 2003. As much as 50% of the loans were securitized using the auction rate market. Excluding Sallie Mae, the largest operator of student loans, the ratio moves up even higher to 76%.

Liquidity and Credit Risks

There is surprisingly little discussion in the financial press on the risk characteristics of ARS, especially considering the size of the market today and its recent growth.

The biggest drawback of ARS is the lack of an agreement or other arrangement that protects an investor from a failed auction or from an issuer's inability to make timely payments of interest and principal. In the occurrence of a failed auction, when there are fewer buyers than necessary to clear the entire auction, investors cannot sell the bonds until the next reset date. A secondary market does not exist other than the participating broker-dealers of a particular transaction.

While the conventional thinking frequently dismisses failed auctions as isolated and unlikely incidents, the mismatched nature of cash investors in long-term securities makes the structure more susceptible to market confidence factors that could result in a security never emerging from a failed status, leading to potentially significant credit losses to the investor. Due to the extremely conservative nature of cash investors, news of a failed auction may have a contagious effect on other, otherwise financially sound and highly rated, transactions that lead to more failed auctions.

A leading cause of concern for a failed auction comes from the credit risk of the ever-increasing student loan market, the popular asset collateral for most ARS transactions. While some cash managers presume that AAA long-term debt ratings will protect them from credit losses, rating agencies themselves are worried about the rapid growth of consolidation loans, and more specifically the growing numbers of for-profit student loan consolidators.

Unlike non-profit state agencies and traditional lenders that originate student loans themselves, for-profit consolidators purchase loans from the secondary market that are difficult to analyze as they commingle borrowings from different loan programs and geographic regions. Combining loans from different years also increases the difficulty of forecasting an issuer's cash flow conditions due to uncertain payment patterns by borrowers. More importantly, the consolidator's limited operating histories and more aggressive credit policies could result in higher claims rejection rates which disqualify certain loans from government guarantees.

In its review of the 2003 student loan market, Moody's Investors Services disclosed that among consolidation loans that skyrocketed over 1000% since 1998, the amount of loan volume from relatively new companies substantially exceeded many of the traditional lenders. The consolidators, with "unclear long-term business strategies", are generally "less established, more aggressive," and "have no strong parent affiliation, thin tangible capitalization, " and receive "little if any agency or government oversight."

A moderate credit downgrade of an ARS transaction may not immediately affect an issuer's ability to make interest payments, but the headline risk alone could drive away interested buyers and result in a failed auction. The increased interest expenses from paying the penalty rates could lead to further credit downgrades that would eventually result in principal losses for investors.

It is also conceivable that an auction may fail even with the security's AAA ratings intact if risk adverse investors decide to opt out of an auction for any reasons. In fact, rating agencies did not intend for investors to use the long-term credit ratings in predicting short-term auction results. An issuer's credit ratings and a failed auction are distinctively different, although mutually influential, credit concerns.

The Future of the ARS Market

The trend of asset securitization by way of Dutch auctions in tapping cash managers shows no signs of slowing down. Lower funding costs and the automatic renewal feature continue to draw public finance issuers to the market. The dealer community is exploring new and innovative ways of securitizing nontraditional ways of asset collateral. Relative yield advantage over money market funds and a fear of higher interest rates also contribute to the investments' continued popularity with cash managers.

As the growth of student loan generation slows in a rising interest rate environment, revenue bonds backed by electric utilities, hospitals, state highways and other public finance projects may become a larger component of the ARS market. The higher credit risk of these assets makes it necessary for issuers to use bond insurance by highly rated guarantors to attain the AAA ratings. More traditional asset-backed borrowers such as credit cards, auto loans and equipment finance companies may also find the cash market attractive enough to offer auction rate tranches in their regular offerings.

Meanwhile, the growth of the market is severely handicapped by denial of access by the largest group of cash investors, the $1.3 trillion money market fund market governed by the SEC. Other professional money managers and many corporate cash accounts are also skeptical of the product's credit and liquidity aspects to commit meaningful portfolio allocations to ARS.

Demand for a "Demand" Feature and More

A recent trend is developing with institutional investors using third party liquidity guarantees to make ARS eligible in money market funds. In 2002, the SEC issued a "No-Action" letter, permitting an asset management unit of Merrill Lynch to purchase auction rate preferred stock for its money market funds, when an unaffiliated guarantor promises to purchase unsold shares from the funds if a bond auction fails. The SEC interprets the agreement between an investor and a guarantor as a "demand feature" that turns ARS into "long term variable rate security that is subject to a demand feature", which would make the security satisfy the 2a-7 maximum maturity rule.

For the majority of corporate and individual cash investors, such third party arrangements may be too cumbersome or too expensive. A sure fire way of increasing market participation would be for the issuers to provide this demand feature from an unaffiliated party, either standard or optional with a cost, to cash investors. Without this protection, cash managers need to carefully weight the tradeoff between extra yield and the liquidity risk.

To remedy credit risks associated with an ARS, cash managers should focus on transactions guaranteed by highly rated financial guarantors. This approach would transfer the credit risk from the ARS asset collateral to that of the guarantors, who are in most cases easier to analyze than the former, considering the wider use of exotic asset classes and the new market dynamics in the securitization market.