



## Auction Cleanup Bill for New York Tops \$340 Million (Update1)

[Share](#) | [Email](#) | [Print](#) | [A A A](#)

By Michael Quint

Sept. 9 (Bloomberg) -- The collapse of the market for auction-rate bonds put New York state in the same position as millions of homeowners whose adjustable-rate mortgages reset: It wanted to refinance.

The state had \$4 billion in debt with interest rates, set in periodic auctions, that soared as high as 14.2 percent after bidders vanished in February. That was more than triple the January average. The cost to taxpayers rose even more when the state's first option, replacing auction-rate debt with variable-rate bonds, wasn't available for the full amount.

Taxpayers and not-for-profit institutions across the U.S. are on the hook for the same kinds of fees and added interest as New York. The bill for replacing the \$166 billion in auction-rate debt may top \$7 billion, not counting extra interest, based on New York's expenses. Most of that money is going to the same banks that created and controlled the auction market.

"It's unfortunate that borrowing costs will rise at the very time the state plans to increase bond sales and the budget is under stress," said **Elizabeth Lynam**, deputy research director at the **Citizens Budget Commission** in New York, a business-funded group that monitors state and city fiscal issues.

At the halfway mark in **New York's refinancing plan**, its costs already exceed \$340 million, including higher-than-expected interest rates and fees paid to the banks, according to state data compiled by Bloomberg.

To get out of the auction-rate market, which collapsed without warning from bankers, the Division of Budget in Albany cobbled together a patchwork of new fixed and variable-rate bonds and cash prepayments.

### Largest Single Expense

New York's largest single out-of-pocket cost for exiting auction-rate bonds was \$101.1 million. That was to repay borrowings by the state Dormitory Authority, on behalf of the City University of New York, that weren't due until 2014 and 2025. The early repayment, using funds appropriated by the state legislature, soaked up cash New York could have used to provide preschool classes for 32,000 children.

The state's \$4 billion **refinancing plan** for auction-rate debt is coming on top of the **\$6 billion of new bonds** it planned to sell this year for projects like roads, schools and state buildings. Auction-rate securities accounted for 8 percent of the state's \$49.6 billion of debt on March 31.

### 'Unprecedented Disruption'

"It is unfortunate that New York, like states across the nation, needed to adjust its bond portfolio to address this unprecedented disruption in the auction-rate securities market," said **Jeffrey Gordon**, a spokesman for the division of budget. "Over the long term, this restructuring will provide significant savings and reduce debt costs."

The state's "short-term costs were significantly lower" than \$340 million, Gordon said.

The state so far has replaced about \$1.19 billion of auction-rate debt with fixed-rate securities because there weren't enough banks willing to act as buyers of last resort for new variable-rate demand bonds, a cheaper alternative. Lenders offered to support no more than \$3 billion of variable debt, an amount "not sufficient to cover our entire need," said Matt Anderson, a spokesman for the Division of Budget.

In turning to fixed-rate bonds, the state had to pay to cancel interest-rate swaps while accepting higher rates and shelling out even more in bank fees.

#### Blowing Up

The swaps were agreements intended to insulate the state against fluctuations in auction rates. New York would pay a fixed rate to a bank, which in turn would pay the state a floating one pegged to wholesale bank deposits in London. The effect of the exchange was to hold the state's costs for 40 auction-rate debt issues at 3.47 percent.

All this blew up when auction rates rose and interest on bank deposits fell, instead of moving in tandem as bankers and borrowers expected.

To cancel interest rate swaps as it refinanced, the state paid \$37.3 million to six banks -- UBS AG; Lehman Brothers Holdings Inc.; Citigroup Inc.; Merrill Lynch & Co.; Bear Stearns Cos., which is now part of JPMorgan Chase & Co.; and Goldman, Sachs & Co. They arranged the swaps when the auction-rate bonds were first sold, according to the budget department.

The biggest swap cancellation fee was \$23.5 million on \$450.4 million of Empire State Development Corp. auction-rate bonds that were converted to fixed-rate debt. An additional \$5 million was for the early repayment of the \$101.1 million of Dormitory Authority bonds. About \$9 million more was to cancel swaps in the refinancing of a separate \$280.8 million of Dormitory Authority debt, also on behalf of CUNY.

#### Higher Feed

Bank fees for underwriting new fixed-rate bonds are about six times higher than for variable-rate issues. Goldman Sachs collected \$2.2 million for the \$450.4 million fixed-rate sale by Empire State Development and just \$315,000 for \$420 million of new variable-rate demand bonds sold at the same time for the agency. The New York-based bank declined to comment on the difference in the fees.

The first auction-rate bonds to be replaced, for \$3.45 million in fees, were those issued by the Tobacco Settlement Finance Corp. It was the only state-backed borrower whose debt specified a 15 percent rate if auctions didn't attract buyers. Failed auctions of other issues were pegged to market rates and never exceeded 6.27 percent.

#### Interest Costs

Interest costs for other new fixed-rate bonds, which averaged 4.76 percent for Empire State Development and 4.42 percent for the Dormitory Authority, will add \$69.7 million to the state's interest bill over the life of the bonds, compared with the **costs expected on the auction-rate bonds.**

The state's \$631 million of new variable-rate demand bonds, so named because investors can cash out on a week's notice, also resulted in new costs. Banks collect \$368,000 annually for setting new interest rates weekly at levels they expect will attract buyers.

A different group of banks is charging \$1.31 million this year for agreeing to act as buyers of last resort for the bonds. The cost of those accords, which range from 0.3 percent for one year from Royal Bank of Canada to 0.67 percent for three years from Wachovia Corp., can vary as they are renewed in future years.

The risk that bank agreements used for variable-rate bonds could become scarcer and more expensive in the future was one reason for why many issuers sold auction-rate bonds earlier in the decade, said **Brian Mayhew**, chief financial officer of the Bay Area Toll Authority in San Francisco.

To contact the reporter on this story: **Michael Quint** in Albany, New York, at [mquint@bloomberg.net](mailto:mquint@bloomberg.net).

*Last Updated: September 9, 2008 19:51 EDT*

