

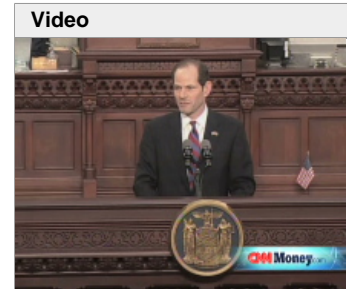
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## Credit crisis hits Main Street

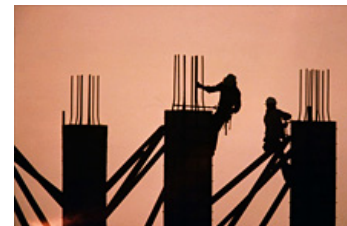
**Bond market woes make municipal borrowing more expensive and that could mean higher taxes and fewer services.**

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**Tami Luhby**, CNNMoney.com senior writer  
February 21 2008: 11:38 AM EST



**Video**  
The New York governor has given the bond insurers five days to solve their liquidity problems.  
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**Road construction and other municipal services are threatened in towns across America as the credit crisis sends cost of borrowing through the roof.**


NEW YORK (CNNMoney.com) -- When


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Wilkes-Barre Mayor Thomas Leighton hears about the troubles afflicting bond insurer Ambac Financial Group, he worries whether his Pennsylvania city can renovate a blighted park or repair the sewer system.

Wilkes-Barre, which suffers from a weak BBB credit rating, depends on bond insurance to issue municipal bonds at favorable rates. If Ambac were to lose its AAA rating and its credibility, it could mean higher taxes, fewer services and lost jobs for the people of Wilkes-Barre.

"Without affordable funding, projects don't get built, streets don't get repaved," Leighton said. "It affects the people driving on those roads and the people paving those roads."

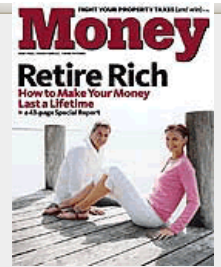
The credit crisis that began in the subprime mortgage market last year has now spread to municipal bonds. Governments and public authorities face steep increases in borrowing costs because investors are losing confidence in the credit markets and the companies that insure the debt.

Public officials nationwide are now weighing whether to restructure their debt to lower rates - if they have good enough credit ratings - or to ride out the storm with the hope that investors will return. However, some are concerned they may have to raise taxes or cut services to balance their budgets.

#### **Problems with auction-rate securities**

In recent weeks, many larger governments - and other credit issuers - have faced unexpected interest rate spikes when auctions of their debt drew no bidders. The interest rate on this debt is variable so it soared after the auctions failed. For example, the Port Authority of New York & New Jersey saw its interest rate skyrocket to 20%, up from 4%.

One reason these auctions are failing is because much of the debt is backed by struggling bond insurers such as Ambac ([ABK](#)) and MBIA Inc. ([MBI](#)) About \$1.5



Policy

trillion of municipal bonds - half of all municipal debt outstanding - is insured, according to the Federal Reserve.

But several bond insurers are at risk of losing their AAA-rating - some already have - because of their exposure to securities related to subprime mortgages. Investors now fear that the insurers won't have enough capital to cover potential defaults of these securities so the guarantees are not worth much.

This lack of faith in the bond insurers is wreaking particular havoc on smaller and weaker municipalities. Without trustworthy insurance, these governments must pay higher interest rates to lure investors. It could mean the difference between paying 4.5% on a bond backed by a solid insurer and 5.3% on a bond with no insurance, said John Mousseau, portfolio manager for Cumberland Advisors, a Vineland, N.J.-based money manager. That translates into an additional \$700,000 in annual borrowing costs on a \$100 million bond.

Already, some governments and authorities are growing concerned.

The Massachusetts Turnpike Authority, for instance, could have to raise tolls again because of increased borrowing costs, a spokesman said. It's now paying an additional \$300,000 a month on \$126.7 billion in interest because of a delay in refinancing the debt due to the bond market's volatility.

"The result of a destabilized bond insurance market is that some governments, already facing reduced income due to the slowing economy, will have higher borrowing costs," said New York Gov. Eliot Spitzer, testifying before Congress last week. "That means shifting funds from schools and police to pay interest."

New York state is paying an additional \$823,000 in weekly interest costs due to recent failed auctions, a state budget spokesman said. New York is looking to convert some or all of that debt to variable-

rate demand bonds, which are not subject to auctions.

"If more money goes to interest expense, then less money goes elsewhere," said Joseph Fichera, chief executive of Saber Partners, a New York City-based financial consulting firm for governments and corporations. Governments "have to find it somewhere. Taxes or fees would have to go up to pay for any additional costs."

### **Budgets already squeezed**

This spike in borrowing costs comes at a time when governments can least afford it. Many are already facing a budget squeeze from the national economic downturn. The drop in housing prices and sales and increase in foreclosures mean they are taking in less revenue from transaction fees and property tax revenue. On top of that, the pullback in construction and consumer spending translates into fewer sales tax dollars.

The lost revenue could total billions of dollars, according to the United States Conference of Mayors. The group sampled 10 states and estimated the total tax revenue loss at \$6.6 billion. The hardest hit: California, which faces a loss of \$3 billion in property taxes or nearly \$1 billion in sales taxes and \$39 million in real estate transfer taxes.

All the trouble in the bond insurance industry has led some to question whether the guarantee is needed at all. The number of municipalities that default on their debt is miniscule - less than half of 1% over the past 100 years, according to Mousseau. But the municipal bond market is not as transparent as other fixed income arenas so the insurance makes it easier to sell.

"The question is if bond insurance is not there, can [governments] access the market at an affordable price," said Bart Hildreth, interim dean of the Barton School of Business at Wichita State University and editor-in-chief of the Municipal Finance

Journal.

Some experts argue that municipalities, particularly larger ones with strong credit ratings, don't need insurance to entice investors to buy their debt. Public officials should do a better job explaining their credit-worthiness and bond issuances to banks and buyers and skip the insurance, Fichera said.

"There's an over-reliance on insurance in the muni market," Fichera said. Cutting back on the use of bond insurance "could be better in the long run. It would force greater transparency." ■

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