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Debt crisis spreads to US municipalities

Wednesday February 13, 8:45 pm ET

By Aline van Duyn and Michael Mackenzie in New York

A collapse in confidence in a \$330bn corner of the debt market has left US municipalities and student loan providers facing spiralling interest rate costs.

The implosion of the so-called auction-rate securities market - amid worries that bond insurers guaranteeing much of this debt could face rating downgrades - is the latest incarnation of the credit crisis.

ADVERTISEMENT The market, heavily used by municipal borrowers and backed by triple-A rated guarantees from bond insurers such as Ambac and MBIA (NYSE:MBI), was until now used as a safe harbour for investors.

The interest rates on such bonds reset either weekly or monthly and a lack of interest from investors can trigger a sharp rise to compensate holders.

The market's sudden slump has pushed interest rates as high as 20 per cent for entities from the Port Authority of New York & New Jersey to a hospital.

"The auction securities market is falling apart," said David Cooke, chief financial officer at Park Nicollet Health Services in Minneapolis.

Municipal borrowers are scrambling to seek letters of credit from banks and other fresh sources of finance.

The auction rate securities market, much like structured investment vehicle and asset-backed commercial

paper markets, had been growing fast.

Banks acting as dealers have been propping up the sector, but many pulled back this week amid a realisation that it might not be possible to restore confidence and woo investors back.

"Dealers who would normally pick up a slump are not doing so as their balance sheets are full," said Jon Schotz, chief investment officer with Saybrook Capital.

The importance of bond insurers to municipal borrowers has prompted regulators to push banks to provide capital or credit lines so that Ambac, MBIA and others can retain their triple-A ratings.

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