

US

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Subprime ripple effect

If the subprime crisis were a stone cast into the water, you would have say that the ripples it has created are impressive. The most recent involves the auction-rate securities market. Auction-rate securities are used by municipalities and closed-end funds to raise capital. These securities are short-term investments bearing interest rates tied to broad based short-term financial rates, such as Libor or the prevailing money market rate. Interest rates are re-set periodically through an auction process. In contrast to other markets, the auction market disruption is not a credit issue. There have been no defaults. These securities are generally investment-grade rated. Rather, auction failures have been triggered, simply and only, by a liquidity crisis.

A glut of auction rate securities – an imbalance of buyers and sellers – has caused auctions to fail, regardless of the issuer's credit quality. Financial intermediaries that serve as broker-dealers for auctions have stopped making markets in the securities. If an auction fails, the issuer continues paying dividends to holders; however, dividends increase sharply to a specified maximum rate, which typically is set at a premium over the prevailing interest rates.

Auction rate securities traditionally were considered high quality liquid investments for pension funds and other institutional investors. These holders are now finding themselves forced to continue to hold securities following failed auctions. Although the maximum rate payable on these securities following failed auctions is intended to compensate for the illiquidity, institutional investors that need liquidity or must mark to market their portfolios may not find this comforting – especially when there appears not to be any immediate prospect of successful clearing auctions. Hedge funds and distressed funds with cash on hand are finding this an interesting opportunity to purchase high yielding securities. In due course, the markets are almost always able to reconcile supply and demand. Predictably, though, regulators announced they have added investigating the auction market to their to-do list.