

Citigroup 'Double-Dipped' Louisiana Taxpayers With No-Bid Bond

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By Darrell Preston

Feb. 24 (Bloomberg) -- When Louisiana State Treasurer John Neely Kennedy told taxpayers in a Jan. 19 news release that he'd saved them \$27.7 million by selling municipal bonds to refinance \$650 million of debt, that wasn't the whole story.

Kennedy's statement didn't mention the hidden cost to Louisiana of the so-called negotiated sale, a no-competition process that dominates the U.S. municipal bond market. The state paid about \$8.2 million more in borrowing costs than in October, when it made banks bid for a bond sale, according to data compiled by Bloomberg. In January, Louisiana hired New York-based Citigroup Inc. and negotiated rates without taking bids.

Kennedy also didn't point out that \$45 million of the debt refinanced in January had just been issued in October's competitive sale, also through Citigroup. The world's biggest financial-services company by assets led six other underwriters in the January deal. They received \$1.5 million in fees, including \$104,000 for refinancing the October bonds.

Citigroup double-dipped on this deal by selling the same \$45 million of bonds twice in three months," says William Kittredge, 56, director of the nonprofit Center for the Study of Capital Markets and Democracy in Arlington, Virginia. "If they don't have a compelling reason -- and I can't think of one -- then this is just to generate more fees," says Kittredge. "It has the appearance of impropriety."

The \$1.5 million underwriting fees of the January no-bid issue were more than double the \$665,000 fees of the negotiated issue. In October, underwriters received \$1.33 per \$1,000 bond, according to Freda Johnson, president of Government Finance Associates Inc., Louisiana's bond adviser. In January, they received \$2.30 per \$1,000 bond.

Good Reasons

Citigroup spokesman Joseph Christinat said in a written statement: "There are good reasons why negotiated transactions may provide significant advantages to a client, including the timing and opportunity to select the bonds that will provide the most savings to taxpayers."

He declined to comment on the Louisiana transactions and the suggestion from Kittredge that the bank had "double-dipped."

State Treasurer Kennedy, 53, declined requests for an interview about the 14-year, \$650 million January sale; the 20-year, \$500 million October issue; or the refinancing of \$45 million of October bonds.

Kennedy's spokeswoman, Sarah Mulhearn, referred questions to New York-based Government Finance Associates.

While Louisiana's January refinancing may have reduced previous debt costs by \$27.7 million, those expenses were still \$8.2 million higher than those of the competitive sale in October, relative to benchmark interest rates, according to Bloomberg data.

Higher Relative Cost

The higher relative cost of the January issue is evident in comparing the yield to maturity of its bonds with those in October. Yield to maturity, a measure of a borrower's cost of capital, is the rate of return paid on a bond over the life of the security.

The January issue, with maturities as long as 14 years, was priced at an average yield to maturity of 3.53 percent, when weighted for dollar amounts. That compares with an average yield of 3.52 percent for the October issue, which included securities with maturities as long as 20 years.

The January issue was "a negotiated sale that wasn't priced aggressively," says J.B. Kurish, 49, a former investment banker in Chicago for First Boston Corp. and now a University of Illinois finance professor in Chicago.

Less Money Left

"Higher interest rates mean higher debt service, paid by the taxpayers," says Kurish, who has co-written three guides on bond sales for the Chicago-based Government Finance Officers Association. "There is less money left for other things." In competitive sales, underwriters submit bids by a set deadline to the issuer, who sells the bonds to the bidder offering the lowest cost. The winning bidder resells the bonds to investors, earning a fee by marking up the price.

In negotiated sales, an issuer chooses a banker and the two then agree on a fee as well as interest rates and an issue date at which the bonds will be bought by the bank and resold to investors.

The \$8.2 million the state might have saved with a competitive sale in January would have paid the salaries of 228 more teachers in Louisiana, which ranks 44th among the 50 U.S. states in spending on schools, according to the Washington-based National Education Association.

Raised Borrowing Costs

The savings could have provided Medicaid health insurance for 6,823 of the state's 174,478 uninsured children or bolstered its dwindling year-end financial reserves, which are likely to reach zero in fiscal 2005, according to a *Governing Magazine* report titled "Grading the States 2005."

Refinancing the \$45 million of October bonds actually raised rather than decreased the state's cost of borrowing that money, as measured by their yield to maturity, Bloomberg data show.

About 90 percent of the October bonds due in 2015 and 2016 were refinanced. The January 2015 bonds were priced to yield 3.75 percent, 27 basis points higher than the October 2015 issue. The January 2016 bonds were priced to yield 3.82 percent, or 21 basis points higher than the October 2016 debt. A basis point is 0.01 percentage point.

"That's a higher cost to the state, and that is not even counting the cost of issuing the debt twice," Kurish says. Louisiana's bond adviser, Johnson, says the state's negotiated deal with Citigroup allowed the state to time the January refinancing to obtain the bonds' lowest possible coupons, or semi-annual interest payments.

Very Competitive Rates

The bonds' coupons, not their yields, determine the state's true cost of borrowing and therefore are the most accurate measure of how much it saved through refinancing, Johnson says. By that measure, January's bond issue reduced the borrowing costs of the \$650 million of debt being refinanced by 4.26 percent, for a total of \$27.7 million in savings, Johnson says. That exceeded the state's goal of reducing costs by 3.7 percent, Johnson says, which would have saved \$24.1 million.

"We thought we got very competitive rates," Johnson says. Not so, says Kurish. Even though lowering the coupon interest rates may have saved the state money, Louisiana could have reduced borrowing rates even further by cutting yields through competitive bidding, Kurish says.

"The yield is the determinant of borrowing costs," he says.

Six Times Higher

Interest costs and fees are as much as six times higher for municipal bonds sold through negotiated deals than for those sold by competitive bid, according to three studies by William Simonsen and Mark Robbins, professors of public policy at the University of Connecticut in West Hartford.

"This certainly looks like an example of where the issuer paid more by going negotiated," Simonsen, 47, says of Louisiana's January bond issue.

Simonsen's review of 25 years of municipal borrowing data showed that competition provided savings ranging from 17 basis points to 48 basis points, he says.

Louisiana, on the southern U.S. coast where the Mississippi River empties into the Gulf of Mexico, is among states and municipalities taking advantage of a 25-year decline in benchmark borrowing costs to refinance higher-cost debt.

The Bond Buyer's 20-General Obligation Bond Index, a measure of yields on municipal bonds maturing in 20 years, was 4.35 percent last week, near an almost 40-year low of 4.21 percent reached in 2003.

Competitive Bidding Wanes

Across the U.S., local officials are jettisoning the century-old practice of competitive bidding in the municipal bond market, where \$2 trillion of outstanding debt finances the construction of roads, sewers, stadiums and schools, and pays for deficits in budgets and pension funds.

In 1973, 74 percent of municipal bonds were sold by competition. Last year public officials chose no-bid transactions in more than 80 percent of bond sales, according to Bloomberg data and Toronto-based Thomson Corp.

Among those officials this year is State Treasurer Kennedy, a two-term Democrat who last year ran for the U.S. Senate in Louisiana's Nov. 2 primary election, finishing third of seven candidates.

Kennedy's press statement, released in Baton Rouge, Louisiana's capital, said the state had achieved its \$27.7 million overall savings in January by paying off "high-interest debt by selling new bonds at a lower interest rate." The new interest rate, he said, "is 3.76 percent, which is a

significant drop from a previous rate of 5.2 percent" on the bonds replaced by the \$650 million issue.

\$8.2 Million Not Saved

Louisiana could have saved an additional \$8.2 million if it had conducted the January sale by competitive bidding, according to Bloomberg data.

The analysis compares the yields of the two bond issues with those of the Municipal Market Data generic triple-A yield curve at the time of both sales, taking into account dollar amounts and maturities. That comparison measures each sale's premium, or extra cost, in relation to the so-called MMD scale.

The listing of yields of various maturities on top-rated municipal debt is used as a benchmark for setting rates on state and local bonds.

The January issue was priced to yield an average 17 basis points higher than the MMD scale, weighted for dollar amounts.

The January premium was more than three times the 5 basis- point average that Louisiana paid in October's competitive sale. Several maturities in October were priced to yield exactly in line with top-rated debt.

\$780,000 More Yearly

The difference in yield premiums means that in the early years of the January issue Louisiana will pay \$120,000 more for every \$100 million borrowed, on average, than for the October bonds.

That will add some \$780,000 annually to taxpayers' cost of debt service on the \$650 million January issue during those years. The differential will decline as the principal is repaid.

About \$624 million, or 96 percent, of the issue was priced above par, or above 100 cents per dollar face value. The yields of the 14 maturities ranged from 2.15 percent to 3.99 percent at pricing, and their coupons ranged from 2.5 percent to 5 percent. The issue replaced bonds that the state sold in 1995, 1997, 1998, 2000, 2002 and 2003, as well as the two October 2004 maturities.

The yields at pricing of the October issue's 20 maturities, all of which were priced above par, ranged from 1.815 percent to 4.36 percent. The issue's interest rates ranged from 4.75 percent to 6 percent.

Triple-A Rating

Since both issues are insured for investors, they carry the top triple-A rating that bonds considered least at risk of default receive from the three leading rating companies -- Fitch Ratings, Moody's Investors Service and Standard & Poor's, all based in New York. Without insurance, the bonds would have ratings of A+ from Fitch and S&P and A1 from Moody's, four steps below the top grade.

Bond insurance pays the investor for the remaining interest and principal if there is a default.

Citigroup's investment banker for the January bond, Michael Hole in West Palm Beach, Florida, declined to discuss the sale. He referred questions to Citigroup's Christinat.

"Citigroup is committed to getting the best pricing execution for its clients," Christinat said, reading a prepared statement.

Kennedy and his spokeswoman, Mulhearn, didn't answer questions or requests for interviews sent by e-mail, fax and phone regarding the two bond issues.

They're All Embarrassed

"No one wants to talk because they're all embarrassed," says Kittredge of the Center for the Study of Capital Markets and Democracy. "The treasurer has abdicated his responsibility to the citizens. The citizens are going to be paying more for no apparent reason."

Kittredge, a former public finance professor at the University of Georgia in Athens, Georgia, says he isn't aware of a precedent for the refinancing.

"I can't think of any other cases of refinancing that took place this quickly, absent some major change in markets, for example rapidly falling interest rates," he says. "I am not aware of any major fluctuations in the market."

The Municipal Securities Rulemaking Board, the self-regulatory body overseeing securities dealers and underwriters, has no rules on how quickly bonds may be refinanced, says Christopher Taylor, executive director of the Alexandria, Virginia-based group.

The MSRB doesn't monitor how often issuers refinance bonds and has no records indicating when or if other issuers have refinanced as soon as three months after a financing, Taylor says.

Parks and Roads

"I am sure they had good reasons to re-fund everything they did," he says.

The October and January issues were both general obligation bonds, which are backed by state revenue and finance routine public projects such as building parks and roads.

The October bonds paid for new projects including improvements to schools, hospitals and ports as well as economic development and recreation programs.

January's issue refinanced earlier general obligation bonds that paid for improvements to schools, hospitals and ports and for police protection, universities and recreation, the treasurer's office said in bond-sale documents.

One reason negotiated sales have gained ground is that bond issues have become more complex and difficult for elected officials to understand without the help of bankers, Kurish says.

"Elected officials often make the decisions and they are beholden to investment banks," he says.

Officials Aren't Astute

The underwriters in negotiated sales have an inherent conflict of roles, says Joy Howard, a municipal bond adviser at W.M. Financial Strategies in St. Louis. That's because the sellers and buyers of bonds expect underwriters to represent their opposite interests -- the lowest interest cost for the issuer and the best price, or highest yield, for the buyer, she says. "They represent both sides of the market," Howard says. Getting advice from a banker who also represents a bond buyer often leaves the issuer at a disadvantage in getting the best deal for the taxpayer, she says. "Most government officials who handle bond sales aren't astute enough to know where the market is and rely on the underwriters to give them the best market price," she says.

Six Other Dealers

Besides Citigroup, the six other dealers of Louisiana's January transaction were New York-based Lehman Brothers Holdings Inc.; Memphis, Tennessee-based Morgan Keegan & Co.; New York-based Morgan Stanley; New York-based JPMorgan Chase & Co.; Detroit-based Siebert Brandford Shank & Co. and New Orleans-based Dorsey & Co.

Lehman spokeswoman Hannah Burns declined to comment. JPMorgan Chase spokesman Michael Dorfsman referred questions to Citigroup. Mark Lake, a spokesman for Morgan Stanley, declined to comment. Gail Rimer, a spokeswoman for Morgan Keegan, declined to comment.

Sherman Swanson, 45, senior underwriter and managing director of Siebert Brandford Shank, one of the underwriters in January, says that Louisiana paid higher yields relative to triple-A-rated debt in the offering.

Still, he says, the state wouldn't have gotten lower yields even with a competitive issue in January because demand for the bonds from insurance companies wasn't as strong then as in October.

"They got the deal they would have gotten anyway," Swanson says. "The October deal may have eaten up demand for the second deal."

The Market Was Better

Johnson, Louisiana's adviser, also says the January yields were higher than those in October relative to top-rated bonds.

The October bonds sold for relatively lower yields than the January issue because "the market was better in October," Johnson says.

If the market was better, that's not evident in the Bond Buyer index of 20-year municipal bond yields.

That benchmark index showed little difference in long-term rates for the two months. Yields were less favorable for issuers during the week of the October sale, when they were 2 basis points higher, at 4.43 percent, than during the week of the January sale, when they were 4.41 percent, according to the index.

Some of the January issues' 14 maturities had double or triple the number of interested buyers needed to sell out, says Philip Dorsey, the chief executive of Dorsey & Co., one of the underwriters.

Priced Too High

That level of demand for the January bonds during the sale suggested their yields were priced too high, says Kurish of the University of Illinois.

The yields drew a range of investors including individuals, trust companies, insurers, mutual funds and money managers, says Dorsey, 56.

The January yields were "very attractive," says Jeffrey Tanguis, who manages \$53 million in assets for the Hibernia Total Return Bond Fund at Hibernia National Bank in Baton Rouge. He invested in the bonds.

"We bought a significant amount," Tanguis says. He declines to say how many.

Other investors bought the debt when the January bonds began trading, pushing prices up and yields down, according to Municipal Securities Rulemaking Board records. Bond prices and yields move in opposite directions.

Ten days after Louisiana sold its Jan. 10 issue, an unidentified customer bought one \$44.8 million block of the 10-year bonds priced to yield 3.63 percent, a drop of 12 basis points from the time of sale, MSRB records show.

Falling Yields, Rising Prices

By comparison, yields on 10-year top-rated municipal debt as measured by the MMD scale fell just 3 basis points in the same 10 days, to 3.55 percent.

Those falling yields and rising prices in after-sale trading show that yields at pricing could have been set lower, potentially saving taxpayers millions of dollars in borrowing costs, the University of Connecticut's Simonsen says.

"It's all about getting the lowest rates, and there is more competition when you're taking bids," Simonsen says. It's not that simple, Dorsey says.

Refinancing bonds is a complicated process and is often better accomplished by an investment bank through a negotiated sale, he says.

"There are too many moving parts that have to come together," Dorsey says.

Just Not Practical

For example, a state must be sure to set and then hit its interest-rate targets in a refinancing, otherwise it will fail to save money, Dorsey says. That's because a sale's proceeds must be timed to buy securities, usually U.S. Treasury bonds or notes, that are put into escrow to repay holders of the refinanced bonds as they come due, he says. The state treasurer usually sets the targets.

Refinancing through competing bids is "just not practical," Dorsey says.

That wasn't the view of officials in California last week. The state sold \$803.4 million of bonds in a competitive deal on Feb. 16 to refinance earlier debt.

The refinancing saved California \$75 million, or 9.364 percent, in debt costs. That's more than double, in percentage- point terms, the 4.26 percent savings reported by Louisiana in January's no-bid bond.

California made more savings even though it has had the largest budget deficits among U.S. states, projected at \$9 billion in fiscal 2006, and credit ratings that are two steps below Louisiana's.

The underwriter that won the bid to buy and resell the bonds was Citigroup.

"The argument that you can't re-fund bonds with a competitive sale just doesn't work," Simonsen says. "California not only went competitive, but appears to have gone competitive successfully."

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