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## The Latest Class of Subprime Investor – You

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David Evans reported last week that short-term municipal tax funds were in some cases exposed to substantial amounts of subprime SIV and CDO investments. In many cases, those exposures were downgraded or placed on credit watch some time ago, but had yet to be reported to fiscal authorities. In particular, Evans reported that:

*Thousands of school, fire, water and other local districts across the U.S. keep their cash in state- and county-run pools. These public accounts... are supposed to invest in safe, liquid, short-term debt such as U.S. Treasuries and certificates of deposit. All told, there were about 100 such pools, containing more than \$200 billion at the end of 2006, according to Westborough, Massachusetts-based iMoneyNet, a research firm that tracks these funds.... Connecticut, Florida, Maine, Montana and King County, Washington... public funds hold \$1 billion of defaulted asset-backed commercial paper, including \$273.5 million from SIVs. Montana entrusted \$465 million, or 19 percent of its \$2.5 billion investment pool, to SIVs. (David Evans, "Public School Funds Hit by SIV Debts Hidden in Investment Pools," Bloomberg News, November 15, 2007)*

Those investment losses will hurt states with lower tax revenues in 2007. Especially hard hit will be states like Florida, that will be squeezed between decreased tourism and decreased large-ticket sales taxes on autos and homes. Florida already reported downgraded and watchlisted SIV exposures worth about 16% of 2006 tax revenues. Furthermore, Florida – having no personal income tax – is already facing acute sales tax revenue shortfalls stemming from lower auto sales and real estate transfer taxes.

*Economists forecast tax revenue will be down another \$1 billion, mostly because of the prolonged housing slump. That comes just weeks after lawmakers cut spending during a special session because of an earlier \$1.1 billion shortfall. The combined shortfalls represent about 3 percent of the state's original \$71 billion annual budget, which covers July 1 to June 30. The economists also predicted tax revenues will fall short of previous forecasts by about \$1.4 billion for the next budget year." ("Experts Predict Revenue Shortage," Lakeland, FL: The Ledger, November 15, 2007)*

Hence, states will have a hard time making up for SIV and CDO investment losses in a declining tax revenue environment, and will have little choice but to constrict municipal services and spending.

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Decreased tax revenues may increase the default risk on some municipal bonds. Those municipal bond defaults would arise in an environment of weakened bond insurers, whose capital is currently under stress from other subprime product exposures.

Another response to the combination of bond insurer distress and weakened tax revenue, at least for stronger states, may therefore be to switch out of weak insurers or even forgo the insurance altogether. This week, the Illinois Housing Authority, "...voted to drop bond insurer Financial Guaranty Insurance Co. and instead use Financial Security Assurance due to the potential credit crunch situation facing FGIC." In Ohio, officials similarly, "expressed confidence in FSA, which insured parts of the state's \$210 million revenue bond issue." ("Illinois housing agency drops FGIC as bond insurer," Reuters, November 16, 2007) The Texas School Fund already uses internal credit enhancements – in the form of a state-level coinsurance fund – instead of bond insurance for school district bond issues.

Part of that reaction also has to do with the Supreme Court ruling in *Kentucky Department of Revenue vs. Davis*. (See, for instance, Brian Wingfield, "A Taxing Question on Municipal Bonds," *Forbes*, November 5, 2007.) As a result of that ruling, Kentucky joins 38 states that exempt interest on their own municipal bonds from state income tax, but tax revenue on bonds from other states.

Taxation brings up an important distinction for municipal bond ratings, which are the principal reason municipalities seek bond insurance. If a municipal bond is sold at tax exempt, it receives the (punishing) municipal rating, whereas if it is sold as taxable it receives a corporate rating. In March 2007, Moody's Public Finance Credit Committee revealed the amount of ratings arbitrage between taxable and tax-exempt municipal bonds. According to Moody's, a state general-obligation bond rated as low as A1 is equivalent to a Aaa Corporate. ("The U.S. Municipal Bond Rating Scale: Mapping to the Global Rating Scale and Assigning Global Scale Ratings to Municipal Obligations," March 2007) Since many of the bonds may be sold outside the state of origin and receive the Corporate Aaa without bond insurance, it may no longer make sense to wrap municipal issues in bond insurance to gain the lower in-state yield, especially when the condition of the major bond insurers is in doubt.

The credit crunch is stressing state revenues just when bond insurers are at risk of fundamental insolvency. That combination can be expected to reduce the demand for bond insurance and further stress insurer capital levels. But mostly, the state investment fund exposures represent merely another glimpse into the incidence of loss in the structured finance markets, where investors are still grappling to understand their exposures. The originate and distribute model really did distribute risk far and wide. Tracking it down to assuage investor fears will, therefore, continue to be difficult.