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Citi Analyst: Two Options to Save Tender Option Bonds.

WASHINGTON — Tender option bond market participants have two options available to keep those programs viable under the Volcker Rule, though neither is without risk or likely to please everybody with an interest in TOBs.

Vikram Rai, Citigroup vice president of fixed income research, has written a report detailing the two possibilities which could allow TOBs to exist within the limits of the recently-completed final Volcker Rule. The \$70-\$80 billion market has a problem because the rule did not exempt TOBs from its requirements, though the rest of the municipal market generally received an exemption. TOB programs have traditionally provided a supply of short-term tax-exempt bonds to money market funds, and have generally accounted for approximately 25%-30% of the assets of muni MMFs, according to Fitch Ratings.

In a typical TOB program, the sponsor will deposit a fixed-rate bond or note into a trust, which will issue two new certificates — a floating rate certificate sold to a MMF and a residual certificate which may be sold to a mutual or closed-end fund or held by a bank. The floating rate certificate will have a tender option, through a liquidity facility that is typically issued by the program's sponsor or an affiliate, that shortens the maturity of the bond or note so it becomes eligible to be purchased by a tax-exempt money market fund.

This sponsor has normally been a banking entity or an affiliate of a bank, but the Volcker rule prevents banks and their affiliates from sponsoring a TOB program, owning a residual certificate issued by a TOB trust, or providing credit enhancement, liquidity, or remarketing services to these programs.

Rai's research report, published by Citi on March 27, lays out the two approaches he has found that could potentially allow the TOB structure to live on once full compliance with the Volcker Rule becomes mandatory in July 2015.

The first approach would involve restructuring TOB programs as "joint ventures," a type of entity exempted from Volcker. Joint ventures exist between banks or their affiliates and unaffiliated parties, and are exempt from the rule as long as they have no more than 10 unaffiliated co-venturers and only engage in activities permitted of banking entities. They also cannot be in the business of investing in securities for resale or hold themselves out as conducting such business.

The banking entity would be the sponsor in this scenario, while a co-venturing money fund would hold the floating note and a mutual fund would hold the residual note. This would allow the TOB structure to be redefined to comply with Volcker, "in theory," Rai wrote. This structure has the advantage of preserving the TOB structure for banks, but would not allow for the practice of splitting either the residual or the holding note into as many smaller internal funds as is sometimes the case for larger fund complexes, Rai wrote.

"By the definition of a [joint venture] under the Volcker Rule, each of the internal funds would be categorized as a co-venturer (which is capped at 10)," the report explains.

The report adds that there is also a risk that “regulators might view this as a re-definition of an existing structure to skirt the rules.”

The other option would be to swap the bank sponsor out for a non-banking entity such as a mutual fund or a dealer. This option would not carry the same regulatory risk as the first alternative but would not work for banks. Rai wrote that given the importance of TOBs to both banks and muni investors, it is likely that an alternative will allow businesses to go on “as usual, even if it is with lower profit margins.”

Fitch said in February that it expects “a gradual unwinding or restructuring of tender option bond programs over the next few months,” because banks’ ability to provide liquidity for them will soon be at an end if a solution for TOBs is not available. Like Rai, Fitch said it expects market participants to look for an answer because of the crucial liquidity short-term paper provides to the muni market.

David Cohen, managing director and associate general counsel at the Securities Industry and Financial Markets Association, said his group is continuing to explore the options its members will have under the Volcker Rule.

“SIFMA has a working group that is working diligently through this issue and hopes to come to a successful resolution in the near future,” he said.

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