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MSRB Report: VRDO Market Down Five of Last Six Years.

WASHINGTON — The market for variable rate demand obligations has contracted five of the last six years, the Municipal Securities Rulemaking Board said in a report released Wednesday.

VRDOs are long-term securities with short-term interest rates. Interest rates are reset periodically by remarketing agents on behalf of the issuers. The obligations have a tender feature that allows them to be sold at par. After VRDO issuance peaked at almost $120 billion in 2008, it declined in 2009, 2010, 2011, and 2013, the report shows. New issuance of VRDOs in 2013 fell to $13.2 billion, compared to $15.2 billion the previous year. During the first quarter of 2014, issuance totaled $1.49 billion, about 3% less than the amount in the first quarter of 2013.

While new issuance has stabilized in the area of $14 billion annually since 2011, the MSRB said, the overall size of the VRDO market has also shrunk considerably in recent years. It contracted 22% to $222 billion between April 2012 and March 2014, the report showed. VRDO par volume dipped 7% in 2013 from the previous year, while the number of trades declined by 9%.

Matt Fabian, a managing director at Municipal Market Advisors, said the continuous shrinking of the VRDO market is the result of a variety of factors. Investor demand for VRDOs remains very strong, Fabian said, but there isn't enough supply to go around.

"It is entirely a supply issue," he said.

VRDO issuers traditionally relied on bond insurance, Fabian said, but the decline of the bond insurance industry led many banks who provided letters of credit for VRDOs to stop doing so. Also, a large number of VRDO issuers were in the healthcare sector, Fabian added, and the uncertainty surrounding that sector generally has led those issuers to reduce the size of their VRDO programs.

Michael Decker, co-head of municipal securities at the Securities Industry and Financial Markets Association, said many issuers are going away from VRDOs because of the "costs and complexities" involved in them, such as needing letters of credit and remarketing agents.

"Some issuers might like to find a more simple solution," Decker said.

Bank direct purchases have largely stepped up to replace VRDOs, but Fabian said that the money market mutual funds that were major investors in VRDOs will continue to need floating-rate options, making the successful emergence of a Volcker Rule-compliant tender option bond structure extremely important. The first such TOB deal was completed late last week.

The MSRB report also details a decline in the market for auction rate securities, which were long-term securities that have variable interest rates that are reset on a short-term basis. No new ARS have been issued since 2008, and the size of the ARS market decreased 31% to $27 billion from April 2012 and March 2014.

The Securities and Exchange Commission and state regulators sued many broker-dealers for misleading investors about the liquidity risks associated with ARS. The ARS market collapsed on a

widespread basis in early 2008 after firms that historically supported the auctions but were under no contractual obligation to do so, stopped propping them up. Most of the cases were settled.

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JUN 18, 2014 11:55am ET

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