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Former Citi Auction-Rate Banker Heeds Lessons of Market Collapse.

At the advent of the financial crisis nearly a decade ago, former Citigroup Inc. banker Robert Novembre, who managed the firm's desks handling auction-rate securities, saw firsthand the disruption caused when banks withdrew support.

Dozens of banks stopped being buyers of last resort for auction-rate securities and variable-rate demand debt, leaving investors with bonds they couldn't sell and borrowers with little control of the interest rates on their debt. The $200 billion auction-rate securities market shriveled and Citigroup was among the banks that reached settlements with state and federal regulators to resolve claims they misled investors. The variable-rate market limped on in a smaller state.

Now Novembre, 47, plans to apply the lessons to a new alternative trading system for variable-rate debt. Within weeks, his Clarity BidRate Alternative Trading System, a division of Arbor Research & Trading LLC, expects to launch its first variable-rate demand deal as part of an enterprise designed to cut costs for state and local governments by getting bids from investors rather than relying on banks to remarket the debt.

"It's a very antiquated market that functions in the shadows," Novembre said. "But there's a conflict of interest in pricing because the banks are protecting their own balance sheets. Banks aren't pushing down the rates any more because they don't want to own the bonds."

The need for more competition has been shown of late as yields have come off historic lows of about 0.01 percent and soared to about 0.40 percent since the Federal Reserve raised its benchmark rate in December for the first time in almost a decade.

During the height of the market freeze, the weekly re-set rate on the index climbed as high as 7.96 percent.

Despite interest rates that are still low historically, the variable-rate demand market has been shrinking since the collapse of first auction-rate securities and then variable-rate demand obligations after sub-prime contagion brought down insurers and buyers of last resort in the muni market. Many banks and investors were stuck with debt they couldn't sell, while some issuers were forced into costly interest rate penalties and expensive restructuring. The variable-rate market stood at $222 billion and the auction-rate market was $27 billion in March 2014, according to the Municipal Securities Rulemaking Board.

Now with rates potentially poised to rise, Moody's Investors Service and others have predicted that borrowers may renew interest in the variable-rate structure to cut borrowing costs. New U.S. Securities and Exchange Commission rules requiring tax-exempt money-market funds to use floating net asset calculations also are encouraging more use of variable-rate debt.

The Securities Industry and Financial Markets Association, which represents banks and broker-dealers, supports the system of remarketing agents that "has served the market well for decades," said Michael Decker, managing director and co-head of the municipal finance division, in an e-mail. He declined to comment specifically on Novembre's company. That said, the association does "welcome market innovations that contribute to efficiency," Decker said.

Novembre, who worked for 18 years for Citi and oversaw about $170 billion of auction-rate securities, variable-rate demand obligations and tender-option bonds when the variable-rate markets collapsed starting in 2007, said his bank and others were glad to buy bonds to support the markets until it became a risk to their capital. Under variable-rate arrangements, remarketing agents aren't required to buy back the debt but did so voluntarily to support the market.

Trading Platform

With variable-rate demand obligations, issuers pay for so-called liquidity facilities, or buyers of last resort, that buy back the bonds when investors don't want them, something that can happen when the yields are reset.

During the global market turmoil, many buyers panicked and tried to unload the bonds because of fears generated by a freeze in fixed-income markets such as mortgage-backed securities. Following the auction-rate debacle in 2008, variable-rate demand obligations tumbled as buyers faced losses.

"There was a lot of fear," said Novembre. "People quickly started putting the bonds to the bank. The banks were no longer using their balance sheets to support the market."

Today, he said, that is still true because "dealers are loathe to deploy their balance sheets" amid increased regulation since the financial crisis.

By updating the market with an electronic-trading platform that replaces the traditional remarketing arrangement, Clarity is providing a place where buyers and sellers can make bids and offers for bonds that investors don't want to hold with more complete information about the market, he said.

Remarketing Role

"There is too much negotiation involved in setting yields now," he said. "There is an element of human decision making in setting the yields, instead of the actual market place competition."

Under his system, Clarity takes over the remarketing role, but instead of setting rates, buyers and sellers can see all the bids and offers and make their own bids and offers on an on-line trading platform during a remarketing period — up until the period for reselling the bonds closes.

"We take all the subjectivity out of it," he said. "Issuers are put in a position of competitive pricing."

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