

BARRON'S

SATURDAY, APRIL 11, 2009

FEATURE

Help Me, Uncle Sam

By JACQUELINE DOHERTY

The state's plea for federal help in selling municipal debt is a red flag.

CALIFORNIA HAS JOINED THE LENGTHENING QUEUE of supplicants seeking help from Uncle Sam. State Treasurer Bill Lockyer is lobbying some in Congress to secure a federal backstop or guarantee on \$12 billion to \$16 billion of short-term revenue anticipation notes, or RANs, that the state may need to sell as early as July.

Lockyer thinks it may not be possible to sell this debt without federal help, and is seeking to have the Troubled Assets Relief Program, or TARP, expanded to allow banks to sell municipal debt to the federal government, according to a state treasury spokesman. Barring that, he wants the feds to provide a direct guarantee, a service for which California would pay a fee.

In modern times, the federal government has never stepped in to guarantee a municipality's debt, and the fact that California is seeking such support indicates the deterioration of the state's financial condition under Gov. Arnold Schwarzenegger. Revenue anticipation notes typically are purchased by money-market funds, but California's debt was downgraded earlier this year to a level only one notch higher than what money-market funds are allowed to hold.

Normally, a municipality would turn to banks for a letter of credit to support a hard-to-sell deal. But the treasurer's office says such letters aren't available today.

Lockyer has met with House Financial Services Committee Chairman Barney Frank, the Massachusetts Democrat who is drafting legislation that may include a guarantee, confirms Steve Adamske, the committee's communications director.

The Federal Reserve may be less amenable to using TARP in this context. In a recent letter to Democratic Rep. James Moran of Virginia, Fed Chairman Bernanke acknowledged problems in the short-term muni market, especially the market for variable-rate demand notes. "However, because municipal obligations have historically not been securitized, and because of the unique characteristics of municipal debt and the municipal debt market, it seems unlikely that the Federal Reserve's [TARP] Facility would be an effective means of improving conditions in the municipal bond market," Bernanke wrote. "Accordingly, the Congress may wish to consider whether legislative measures would be more effective and more appropriate."

Calls to the Federal Reserve and Congressman Moran's office weren't returned.

Some believe California could sell the debt without federal support. The state's outstanding RANs sport a 1% yield, and California probably would have to offer 3% or 4% to entice investors, says Peter Hayes, head of municipal-bond investment team at BlackRock.

Others cite the potentially dangerous precedents such guarantees might set. Chriss Street, treasurer of Orange County, Calif., warns that if the federal government backs the state debt, the market for local municipalities will be harmed. "Why would anybody buy the debt of a local issuer if they can get federally backed debt sold by the state?" he asks.

Washington may well duck involvement unless or until a municipality is on the precipice of default. But the fact that California asked for an assist suggests bigger problems may loom.