



# North Carolina Department of State Treasurer

RICHARD H. MOORE  
TREASURER

State and Local Government Finance Division  
and the Local Government Commission

T. VANCE HOLLOMAN  
DEPUTY TREASURER

October 9, 2008

TO: Officials of Local Governments and Public Authorities

FROM: Vance Holloman, Deputy Treasurer *TVH*

SUBJECT: Current Conditions in the Debt Market

There have been a series of unprecedented events in the national and international financial markets which have greatly impacted the market for municipal debt. We have received a recent update on the municipal debt market which we wish to share with all of you. We share the concerns cited in this report and encourage local governments and public authorities to be very cautious in their debt management practices.

There is very limited liquidity in the current debt market and this has resulted in limited demand for new money issues and increased rates on variable debt outstanding. Although some units have continued to finance smaller projects through private placements with financial institutions, these financings have carried higher rates.

Local units should carefully evaluate their ability to service their current and any new debt issues in light higher rates of proposed debt issues, of increased variable debt rates and the potential loss of revenues due to the current economic downturn. Until market conditions become more settled units should limit their debt issues at this time to essential projects that can not be delayed.

Members of our staff are available to discuss specific projects of your unit and answer any questions that you may have. You may contact me at [vance.holloman@nctreasurer.com](mailto:vance.holloman@nctreasurer.com) or 919-807-2351. You may reach Tim Romocki at [tim.romocki@nctreasurer.com](mailto:tim.romocki@nctreasurer.com) 919-807-2360.



5925 Carnegie Blvd.  
Suite 104  
Charlotte, NC 28209

704.731.2080 Direct  
704.731.2086 Fax

October 9, 2008

Mr. Richard H. Moore, State Treasurer  
North Carolina Department of State Treasurer  
325 North Salisbury Street  
Raleigh, North Carolina 27603-1385

Dear Treasurer Moore:

Per your request, we are sending you this letter to provide an update on current market conditions and offer recommendations for North Carolina local governments with borrowing needs. Market events are happening at unprecedented speed and local governments should continue to exercise prudent and conservative debt management practices. The events of September and October alone are staggering; below is a partial list:

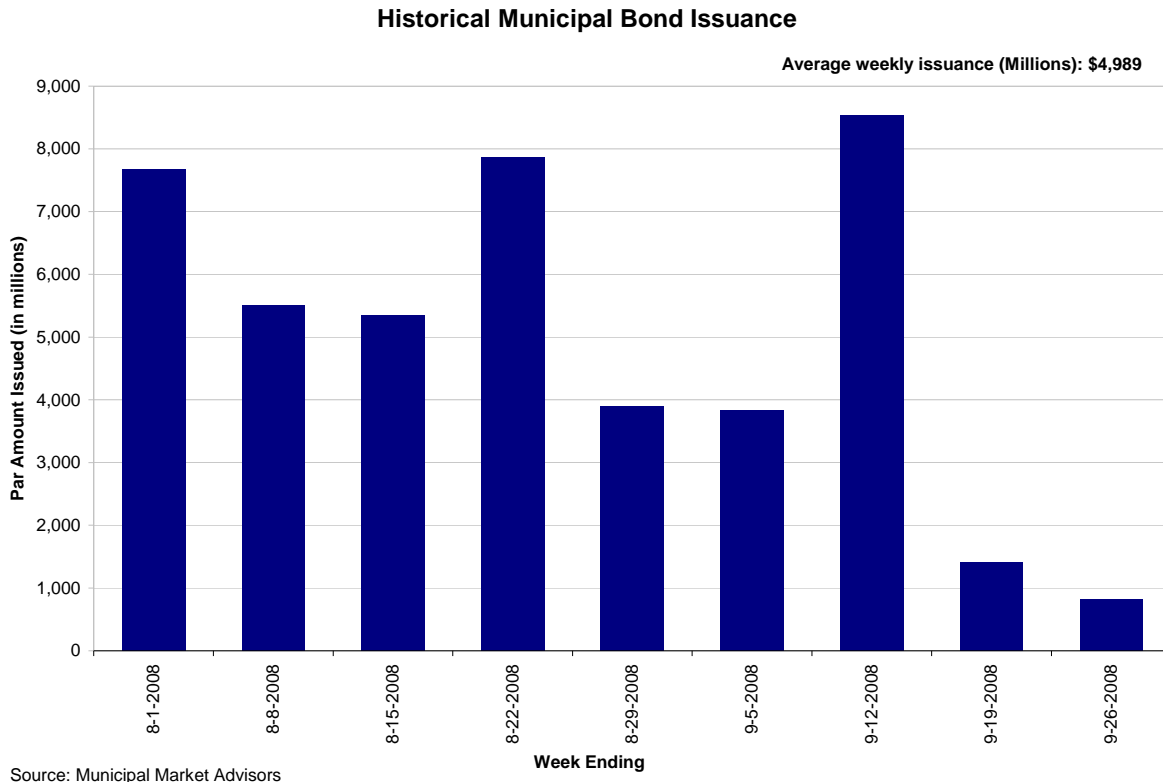
- Fannie Mae and Freddie Mac are put into conservatorship;
- Lehman Brothers becomes largest bankruptcy in U.S. history;
- Merrill Lynch is taken over by Bank of America;
- AIG effectively placed under government control in exchange for \$85 billion loan;
- Morgan Stanley and Goldman Sachs become bank holding companies and give up large equity stakes in return for capital investments;
- Washington Mutual becomes largest U.S. bank failure in history and is taken over by JPMorgan;
- Citigroup makes offer to acquire Wachovia Bank. Wells Fargo submits competing acquisition proposal.

The above conditions, and the related market implications spawned by them, have virtually eliminated new issue volume resulting in extremely limited market access for local governments. Many of those issuers that had to sell debt during the past three weeks experienced significantly higher interest rates. Banks and other institutional investors which have historically been among the largest purchasers of municipal bonds have instead been investing in US Treasury obligations, in what is commonly referred to as a "flight-to-quality". In addition, in both the primary and the secondary market variable rate debt has been difficult to place with investors. Outstanding variable rate debt is pricing at levels significantly above previous historical highs and in many cases, investors are exercising their option to put the bonds back. In some cases this increased put activity adds stress to remarketing agents' inventory levels and in other cases results in failed remarketings (with draws on letters of credit or liquidity facilities) which adds to the liquidity issues already facing the letter of credit banks.

Issuers who expect to issue debt in the next 30 days should consult with their finance team (LGC staff, financial advisor, bond counsel and underwriter) to determine the most appropriate



course of action in the current market. Many issuers nationwide are delaying their bond sales, at least temporarily. The total new municipal bond issuance nationwide for the month of September dropped to \$19.9 billion versus \$32.8 billion for last year (source: Thomson Reuters data). The chart below shows the weekly issuance volume of tax-exempt debt nationwide since August 1, 2008.



If issuers' borrowing needs are urgent, and should they decide to move forward with their borrowing, it will be important to quantify the potential increased debt service costs and verify that projected revenue sources will be sufficient to meet those increased costs. For issuers who have more flexibility in scheduling debt issues, they may want to consider delaying projects, or at least delaying the financing.

In planning debt structures, the majority of issuers should continue to use a fixed rate structure. For those considering variable rates, they should be extremely cautious in drafting reimbursement agreements and understand the financial burden that a bank bond rate and penalty rates could place on their entity. Having bonds tendered to a letter of credit or liquidity provider was historically considered to be only a remote possibility, but it has become very common over the past several weeks and many issuers are experiencing increased debt service costs as a result. Additionally, the fees charged for letters of credit and liquidity facilities have risen dramatically (in some cases doubling) and many issuers are finding it more difficult to find banks willing to provide these services.

For issuers considering interest rate swap agreements, it is extremely important that they consider counterparty risk and that they quantify the potential termination payments that could be owed if a termination should occur.



With the considerable economic pressure and budget uncertainty, we urge caution in planning for future debt service payments. Revenues may not continue to grow at the rate they have in the past and issuers should have alternatives in place and build in a cushion for a worsening economic downturn. In scheduling bond issues, it is important to build flexibility in the timeline in case the issuers need to postpone their bond issue at the last minute.

We are hopeful that the current market situation is temporary and the markets will return to some level of normalcy soon; no one can predict when that will occur; however, we do know that the dislocation in the broader credit markets must resolve prior to the municipal market doing so. That will take time and in the meantime an extra measure of caution is wise.

Sincerely yours,

Janice T. Burke  
Senior Vice President