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Turbulent Markets Create ARS Management Challenges

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The $330 billion auction-rate securities (ARS) market is currently in disarray. If they are part of your portfolio, you must be considering ways to deal with them.

Many corporations thought these securities were as good as cash and managed their investments accordingly. Now, with very few buyers and no ready market, they recognize the sad truth that these are long-term bonds. Worse, they may have declined in value.

And, in attempting to get this debacle behind you, you are likely asking three fundamental questions.

How do we value these securities?
How do we account for them?
How do we manage this portfolio and develop an exit strategy?

Valuing Auction-Rate Securities

Since there is no ready market, establishing fair value requires examining the characteristics of the securities, estimating the future cash flows and the likely holding period and choosing an appropriate discount rate. To do this, focus on four dimensions.

- Credit Quality. The issuer's credit rating, the existence and quality of insurance, guarantees or other credit enhancement.
- Liquidity. The probability and likely timing of an investor's ability to cash out at par. Factors include the complexity of the penalty rate formulas, the possibility of successful auctions, issuer refunding or self-bidding, relief provided by the underwriter or distributor and the potential outcome of litigation or regulation.
- Scenario-Based Modeling. Modeling credit and liquidity outcomes against future interest rate scenarios for each security in the portfolio.
- Discounted Cash Flow. Net present value, based on estimates of cash flow timing and a discount rate that will clear the market.

Accounting for Auction-Rate Securities

Financial Accounting Standard No. 115 (FAS 115), *Accounting for Certain Instruments in Debt and Equity Securities*, and FAS 157, *Fair Value Measurements*, are major determinants of appropriate accounting treatment. Under FAS 157, companies must determine fair value. They must first look to actual prices for those identical securities (Level I). If reliable prices are not available, they must look to actual prices of similar securities (Level II). If that fails, Level III requires companies to develop a methodology or model to estimate the fair market value.

Participants in today's negligible secondary market appear to be distressed sellers and vulture buyers. For now, Level II, with its external valuation, appears to be the best approach.

FAS 115 calls for a company to determine whether an impairment is "temporary" or "permanent." Depending on that analysis, a loss may or may not need to be reflected in the company's income statement.

Deteriorating credit quality is more likely to be "permanent" since it may be a long time before the impairment is remedied and there is potential for even more deterioration. On the other hand, impairments from higher quality, but illiquid, issues are likely to be resolved when the market reaches a new equilibrium. These may be viewed as "temporary."

Portfolio Management, Exit Strategies

The best outcomes are associated with two factors. First, companies with the staying power to see this credit and liquidity crunch through to the end can avoid the consequences of "distress sales." Second, those with a deep understanding of each of their ARS issues can opportunistically sell securities at the best time, even at a discount.

Staying power is the result of good, basic cash flow management. Companies in this category employ best practices in cash forecasting, collections, disbursements, banking and working capital management. Optimal management of debt and the balance sheet can also provide additional liquidity with which to wait out the liquidity crunch.

To evaluate these securities, companies must analyze penalty rate formulas with the minimums, maximums, caps and look-back provisions embedded deep within the offering circular. These vary based on economic and interest rate scenarios. Comprehensive modeling across a number of economic scenarios yields appropriate sell signals and exit opportunities.

The current market for auction-rate securities is illiquid and, in some cases, credit-impaired. It may take a few years for this market to right itself, perhaps longer for the more complex student loan and asset-backed markets. The structure of these instruments encompasses periodic auctions, bizarre fail-rate formulas and myriad caps, maximums, exclusions and look-back provisions — which combine to challenge even the most astute treasurers and CFOs.

Meeting that challenge requires the use of the best practices discussed above in the areas of valuation, accounting practices and portfolio management and exit strategies.

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