Bloomberg Columnists

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U.S. Muni Market Marks a Very Special Anniversary: Joe Mysak

Feb. 18 (Bloomberg) -- It has been 10 years since a managing director in Smith Barney's municipal bond department blew the whistle on a crime he said netted Wall Street $1.5 billion.

``Accuser in the Municipal Bond Industry'' said the understated headline on the front page of the New York Times business section, above a photo of Michael Lissack standing in front of a Smith Barney office.

In the article, Lissack described a practice known as ``yield burning,'' in which underwriters systematically overcharged municipalities for the Treasury securities they used to refund their bond issues. The big loser on these transactions wasn't states and localities, but the federal government, specifically the Internal Revenue Service.

By raising the price on the Treasuries, dealers ``burned down'' the yield to the levels municipalities are allowed to earn under tax law -- hence the name. The government said it all amounted to an illegal arbitrage scheme, and the Securities and Exchange Commission and the IRS went to work.

Lissack, then 36, was the highest-ranking municipal finance professional to turn coat and tattle on the business, revealing the dirty little secrets about what went on after bond issues were sold and the proceeds had to be reinvested.

There was yield-burning, and bid-rigging, and escrow-churning, and Lissack talked freely about it to whoever would listen. An interview with Lissack was less like a conversation than a debriefing about the private world of public finance. He detailed how it all worked with spreadsheets and the occasional internal memoranda. It wasn't pretty.

Chihuahua

As crimes go, yield burning wasn't very sexy. It was almost impossible to describe in any detail without putting people to sleep. It never made it to ``60 Minutes.''

The New York Times story ran March 3, 1995, which is pretty much when the municipal bond industry, with a few exceptions, stopped talking to the press. The government reached a ``global settlement'' with 16 securities firms in April 2000, collecting $120 million. Eventually, 83 firms settled with the government for $500 million and promised not to do it anymore.

Lissack, as a whistleblower, got between 15 percent and 30 percent of that, and retired to Naples, Florida, where he lives today with a four-pound Chihuahua named Zeus. He won't say exactly how much he got but says he gave away or lost most of his money, some of it on Internet startups.

`Founded on a Lie'

``I don't really feel like I accomplished much of anything,'' Lissack said in a telephone interview earlier this week. ``I think the industry has gone back to yield burning, through guaranteed investment contracts and swaps and derivatives. All we did was move it.''

Lissack sounded chipper and said he acts today as a real estate buyer's agent for those relocating to Florida. Over the last two years, he said he's handled $20 million in sales.

He doesn't think much about municipal finance these days, although he is as opinionated as ever on the subject.

``The entire business is founded on a lie,'' he said. ``And that is, that tax-exemption is an efficient subsidy. That's the thing that leads to all these arbitrage schemes. Do you want to clean it up? Make everything taxable.''

Asked why 80 percent of municipal bonds are sold through negotiation instead of at competitive auction, Lissack replied, ``That's because public officials like having people pay attention to them, and people pay attention to them when they have business to give out, and you don't have any business to give out if you sell bonds through competitive sale.''

Lissack says he hasn't heard from many of his old friends in the municipal bond business.

Bunch of Cheats

It's not hard to see why. Lissack wasn't talking about sham bond issues designed by a few underwriters, or pay to play involving a couple of corrupt politicians. He was charging the entire municipal bond industry with cheating.

This wasn't one of the industry's finest moments. The situation cried out for a leader to say something like, ``Well, yeah, it looks like we've got a real problem here.''

Instead, the industry hemmed and hawed and said that, in essence, there was no way to check the U.S. Treasury securities prices that were the subject of yield burning. The only accurate prices were what the dealers said they were. That was convenient.

Wall Street didn't look good. Nor did the bond issuers. Some of them knew all about what was going on and countenanced it. That was bad enough. Perhaps worse were the ones who knew nothing at all and who basically trusted their professionals to, well, act professionally, rather than checking and double-checking their work.

It all happened 10 years ago this March 3. Happy anniversary.

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