

**Government Finance Officers Association
National Association of Counties
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Treasurers
National League of Cities
U.S. Conference of Mayors**

March 11, 2008

The Honorable Paul E. Kanjorski
Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2188 Rayburn House Office Building
Washington, DC 20510

Dear Chairman Kanjorski:

Our organizations thank the members of the Committee for your concerns about the current disruptions in the municipal bond marketplace. We appreciate this opportunity to comment on these conditions and their effect on state and local government operations.

State and local governments are suffering the consequences of the bursting of the subprime housing bubble, and the subsequent loss of liquidity and market disruptions in the municipal bond market. As a result, increased bond issuance costs and debt service on municipal bonds are being borne by American taxpayers.

We appreciate the Chairman's statement in announcing this hearing. His remarks make clear the minimal credit risk of municipal debt and summarize well the problems confronting state and local governments. To quote the Chairman:

"It is now clear that state and local governments have become the innocent victims of the credit crisis and they are being unfairly punished for market conditions far beyond their control. This committee will place a very high priority on this issue," said Chairman Frank. "Cities and states may now be forced to pull back or significantly decrease infrastructure investments and other vital services, which is the wrong thing economically and will leave shortfalls in this critical area . . . Municipal bonds are among the safest—second only to US Treasuries—in terms of losses to investors, and it will be of particular concern to this committee that they not be punished by the worsening credit market and overall economic picture."

Our principal concern is for the taxpayers, who ultimately bear the burden of increased bond issuance and interest costs. These costs are rising for reasons which are completely extrinsic to events in our market.

Municipal bonds remain among the safest securities in the world, and there are no inherent, special or new problems with the securities themselves (see Exhibit One). Despite market turmoil and the increased cost of capital to states and localities, at the end of the day, investors in municipal bonds will not face losses due to defaults, as have some who have invested in

the corporate securities market.

State and local governments issue debt to finance public capital improvements and other projects, including new and updated infrastructure facilities. The nation has a vital interest in maintaining appropriate public infrastructure and services to sustain the existing economy and to facilitate economic growth. For example, as the National Surface Transportation Policy and Revenue Study Commission reported last month, \$255 billion is needed annually to meet our country's infrastructure needs. A majority of that funding will need to be provided by state and local governments, which require access to the debt market to finance these expenditures.

The recent disruption in the municipal bond market is causing many governments to face new financing costs and expenditures which were not anticipated in their current budgets. This places additional pressure on state and local governments at a time when our budgets are strained, when transfers from the federal government are diminished, and when the needs of our citizens, particularly our most vulnerable constituents, are increased. Almost half the states already report declines in their revenues due to the housing sector slump, and according to some estimates, nineteen states will experience a collective shortfall in projected revenues of \$14.6 billion in FY08, and twenty-two states project a collective shortfall of \$32.3 billion in FY09.¹

To continue to revitalize existing infrastructure and to undertake new projects, and to provide public services – especially those which can mitigate the impact of an economic slowdown or recession – states and local governments must be able to access the credit markets in an efficient, prudent, and cost-effective manner.

Concurrent with the downgrading of monoline bond insurers, hundreds of thousands of municipal bond issues have been downgraded, solely because the bond issue is wrapped in insurance. Almost half of the municipal bond market is insured. It is important to note that the insurance may not have been purchased by the issuer, but rather by the underwriter in a competitive sale or in the secondary market. Thus, some issuers may not even be aware that their issue is insured. Compounding this problem, Wall Street, reeling from the credit crisis as a whole, is experiencing constraints on the capital available to support the municipal securities market.

Many issuers obtain bond insurance as an enhancement to their own credit rating. There is growing concern that, without a solid and stable bond insurance platform, some issuers will not have broad market access and will be unable to retain current investors and attract new ones. This dampens bond pricing and raises interest costs. In addition, smaller issuers who are not rated, or whose bonds are not guaranteed by a regular tax or revenue stream (e.g., hospitals), will face even greater difficulties in obtaining bond insurance or other credit enhancements as the costs of these enhancements increase.

A significant amount of current market unrest lies with short-term variable-rate instruments – a consequence directly attributable to the problems faced by municipal bond insurers who also insured other products (e.g., insured asset-backed securities), and the limited ability of capital to support these products.

As a case in point, consider the state of the auction-rate securities and variable-rate demand obligations markets. These are traditional, long-term securities with short-term demand features. The variable-rate demand obligations (VRDO) market sets rates on a short-term basis, which

¹ National Governors Association/National Association of State Budget Officers; *Shortfall Survey*. February 2008.

are supported by some form of liquidity. Bond holders are entitled to demand repurchase of their bonds at par, plus accrued interest, mostly on a daily or weekly basis. Auction-rate securities have no liquidity facility feature; the rates are set at the lowest interest rate at which buyers are willing to purchase all of the potential seller's securities.²

When governments first entered the auction-rate and VDRO markets, their main purpose was to save taxpayers' money by securing short-term rates on long-term bonds, and to diversify their debt portfolio by adding variable-rate exposure. For many years, the markets for auction-rate securities and variable-rate demand obligations have been stable, accessible, and liquid. In theory, the average of the short-term rates over the lifetime of the bonds plus fees should be less than issuing fixed-rate debt.³ This may no longer be the case.

In the current market environment auction rate securities – with interest rates reset on a daily, 7-day, 28-day, 35-day, or longer-term basis – do not have enough investors to purchase the securities that holders of these securities want to sell. The end result is a failed auction, in which case a maximum rate takes effect, pursuant to the terms of the bond indenture. Until recently, a failed auction was an extremely rare event.⁴ Today, many governments and obligors are experiencing very high auction rates, due to these failures.

Again, there is no problem with the securities' underlying credit, or with the governments themselves. The negative psychology currently pervading the markets, as well as the lack of liquidity, are responsible for the present volatility, not because states and municipalities are in danger of default. In addition, bankers and hedge funds are liquidating their floating-rate tender-option bond programs which contain insured underlying securities, creating still more liquidity demands on the market. With a tender-option bond, hedge funds, banks and others raise money through short-term borrowings to fund purchase of long-term municipal bonds. Investors, fearing losses, aren't buying, causing bonds worth billions of dollars are piling up at banks and brokerage firms.

Government issuers – and thus taxpayers – are paying the price for the municipal bond market decline in the overall market downturn. Exacerbating the problem are the fees charged by professionals to “unwind” these transactions and convert auction-rate securities into other instruments. Bloomberg News reports that governments are spending over \$1 billion in fees as a result of the collapse of the auction-rate securities market.⁵ These fees are being paid to the same broker-dealers who have caused the auction failures by refusing to bid on them, in addition to the fees paid for bond counsel and legal fees, financial advisors, swap termination fees, insurance termination fees, and other liquidity providers.

Because many governments are just now being able to convert their auction-rate and variable-rate securities into fixed or less volatile instruments, the extent of these costs are still unknown. As governments complete these conversions, we will provide the Committee with additional information.

² The Bond Market Association, *Fundamentals of Municipal Bonds*. Wiley Press, 2002.

³ Bloomberg News, 2/28/08. *New York Faces Double Whammy as Swaps Compound Failed Auctions*. Michael Quint.

⁴ Bloomberg News, 2/22/08. *Florida Schools, California Convert Auction-Rate Debt*. Jeremy Cooke. “Between 1984 and 2007, only 44 auction rate securities failed. On February 22 alone, 258 out of 386 auctions failed.”

⁵ Bloomberg News, 3/6/08. *As Housing Suffers Failed Auctions...*, Darrell Preston.

Many in the public finance arena have speculated that increased costs for short-term variable-rate products will spill over to the long-term fixed-rate market, at least in the near future. This means that many issuers may delay capital finance projects, or will pay additional interest costs. While investors seem to be bullish on munis, their appetite is being whetted by the favorable interest rate environment for investors, not for issuers. Indeed, as Bloomberg reported on March 7: “Debt sold by states and local governments suffered the worst monthly slump in at least nineteen years in February, and yields on tax-exempt securities rose to record highs relative to taxable Treasuries.”⁶

Possible Solutions

While a “silver bullet” capable of calming the turbulent marketplace is unlikely to appear, a variety of legislative, regulatory, and marketplace changes could ease the pressures on state and local government issuers. The most important way in which the federal government and the marketplace can assist both the municipal bond market and state and local governments is by encouraging investor confidence in the municipal bond market, which would bring more buyers – and resulting liquidity -- to the municipal bond table. We also believe that Congress, regulators, and the marketplace can more concretely help state and local governments. Below is a list of possible solutions that are worth discussing, both within and outside of the Committee’s jurisdiction.

Bond Insurance Regulations

State insurance commissioners are considering regulatory changes affecting the bond insurance industry. In addition, bond insurers themselves are looking for ways to secure capital in order to maintain or reclaim their Triple-A rating. The recapitalization of the bond insurers is extremely important in order to stabilize the entire market. All options should be reviewed, including the possibility of the federal government providing a backstop to the bond insurers.

Raise the Bank-Qualified Debt Limit from the Current \$10 Million Level to \$30 Million, and Index for Inflation Thereafter

Banks have traditionally been significant purchasers of tax-exempt debt, particularly for smaller governments. Since 1986, banks have been able to deduct eighty percent of the costs of purchasing and carrying bonds issued by governments whose annual bond issuance does not exceed \$10 million. This adds liquidity to the market and has helped many small issuers place their bonds with community banks, avoiding many of the fees associated with underwriting, and selling these bonds on the open market. However, since 1986, an increasing number of governments have regularly experienced capital needs in excess of \$10 million. As a result, governments must often defer projects in order to comply with this unreasonable limit, since inflation and infrastructure costs since 1986 have made the \$10 million limit woefully inadequate. Congress has never acted to increase the \$10 million limit, nor indexed it to inflation. If adjusted for inflation, the \$10 million in 1986 dollars would be worth \$19.26 million today.⁷ Especially in the current market environment, “bank qualified” financing is an attractive and vastly more efficient debt-issuance vehicle for these smaller entities. If Congress raised the limit to \$30 million, smaller governments would be much better able to finance their capital needs.

⁶ Bloomberg, 3/7/8. *Munis Rally as Highest Yields Since 2004 Lure Buyers*. Michael Quint

⁷ Bureau of Labor Statistics, Inflation Calculator.

Similarly, few statewide issuers of debt, including debt for non-profit education and health care, are able to issue any bank-qualified debt because the exemption is applied to the issuer, not at the borrower or beneficiary level. We recommend that the law be changed to provide a “small borrower” exemption instead of a “small issuer” exemption.

Increase Private Sector Investment Incentives for Purchasing Tax-Exempt Bonds

Municipal issuers fear that, in the future, banks and other counterparties will seek to insulate themselves from potential credit and valuation risks associated with municipal securities. There are already significant limitations on the amount of bonds which banks, corporations, and property and casualty insurers may hold. The *de minimis* rule allows corporations (other than banks or securities firms) to deduct interest expense, as long as their tax-exempt assets are 2 percent or less of total assets. This ruling means that money cannot be borrowed in order to invest in tax-exempt securities, and thus can be well “traced” per IRS regulations. We would argue that 2 percent is excessively low. If the percentage of allowable tax-exempt assets were increased, corporations would be able to legitimately invest more in bonds, without running afoul of IRS Revenue Procedure 72-18.

In addition, property and casualty insurers (P&Cs) are the single largest corporate investor category in municipal securities holding thirteen percent of the bonds outstanding. However, they are limited in their ability to invest in municipal bonds without penalty. Their holdings of municipal securities are funded entirely from loss reserves, not through borrowing. P&Cs are currently permitted a deduction for contributions to loss reserves, reduced by an amount equal to fifteen percent of their “proration income” which includes tax-exempt bond interest. Thus, P&C’s lose fifteen cents on every dollar of municipal securities interest that they earn. This creates a disincentive for P&Cs to purchase municipal securities. If the pro-rata restrictions were lifted, allowing P&Cs to purchase more munis, interest rates could improve, and P&Cs would be more inclined to purchase long-term, fixed-rate municipal bonds.

Allow for an Additional Advance Refunding, On a Limited Basis

Following the example set in response to the 9/11 and Katrina disasters, Congress could enact similar legislation to allow issuers an additional advance refunding if certain criteria are met. The parameters for additional advance refunding might stipulate that a government must already have used its advance refunding opportunity prior to the current market crisis, and that an additional advance refunding could only relate to debt during a certain period of time.

Advance refunding permits refunding an outstanding bond issue before the bonds become due or are callable (usually after 10 years). Under current law, issuers have only one opportunity during the lifetime of the bond issuance to take advantage of favorable market conditions to achieve lower borrowing costs. To allow an additional advance refunding would facilitate restructuring of auction-rate securities obligations, as issuers could view the current high tax-exempt fixed rates as a temporary cost of capital.

Today, many issuers are transferring out of auction-rate securities or variable-rate demand bonds and into fixed-rate debt. While the current fixed-rate interest environment is better for governments than the auction-rate market, fixed rates are higher than in recent years. Under current regulations, when the market stabilizes and interest rates are more favorable to issuers, many governments may not be able to take advantage of the more favorable interest rates to refinance their debt, because they have used their advance refunding prior to this crisis.

Permit Federal Home Loan Banks to Offer Letters of Credit

Some tax-exempt bond issuers secure Letters of Credit (LOC) from strongly accredited financial institutions to achieve lower borrowing costs than would be possible if they offered securities through their own credit. (Letters of Credit can be particularly helpful as a source of market access for small issuers who do not have high bond ratings or large bond issuances.) They are also useful to issuers of every size, as a mechanism to diversify access to credit markets through large, well known institutions.

The Federal Home Loan Bank System is not authorized to offer this guarantee to its member banks, who therefore cannot offer a Triple-A Letter of Credit to issuers. Pending legislation, H.R. 2091 and S.1963, would permit Federal Home Loan Banks to offer Letters of Credit, allowing for more options in the guarantor market. This would be beneficial for issuers and investors alike. We appreciate the support of Chairman Frank and other House Financial Services Committee members who have co-sponsored this legislation.

Allow Governments to Bid on Their Own Auction-Rate Debt on a Temporary Basis

Most governments are currently prohibited from bidding on their own auction-rate securities. Chairman Frank, Chairman Schumer, and Congressman Bachus, as well as a group of California and Massachusetts hospitals and the Securities Industry and Financial Markets Association have called upon the SEC to allow governments to be able to bid on their own auction-rate debt. The current turmoil in the auction-rate securities market has forced some governments to pay exorbitant interest rates on their short-term debt due to a lack of buyers. It would be most helpful if state and local governments – operating under specific conditions addressing the SEC’s concerns regarding market manipulation – were allowed to bid on their own auction-rate bonds to save taxpayers’ money. Additionally, clarification from the Department of the Treasury on the applicable tax regulations may also be helpful.

Corporate Equivalency Ratings

The three major credit ratings agencies have operated two separate but not comparable ratings systems – one for corporate securities and one for municipal securities. Although municipal issuers have shown historical default rates that are a fraction of similarly or more highly rated corporate bonds, safe muni ratings remain widely dispersed across the investment grade municipal scale. Traditionally, issuers have been forced to rely on the bond insurers (who are rated Triple-A on the corporate rating scale) to satisfy investor regulatory requirements (like SEC Rule 2a-7) and on growing demand from both unsophisticated retail investors (who may not understand the difference between rating scales) and institutional buyers. As was noted during the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee hearing on February 14, [*The State of the Bond Insurance Industry*](#), and again in a letter released on March 4 by the California Treasurer, Bill Lockyer, this double set of standards has hurt issuers, who may have paid unnecessary fees for bond insurance premiums. This double standard adds to the hardships which issuers face in the current marketplace. The creation of an equitable credit rating system would help issuers and investors alike.

SEC Rule 2a-7

Despite the well-known differences between the corporate and municipal ratings scales, the SEC treats the two scales as equivalents under SEC Rule 2a-7, which governs qualified investments in money market mutual funds. This rule effectively requires that money market mutual funds hold investments rated AA or better. As noted above, the standards used to define an AA corporate security are different from the standards used for an AA municipal security. Therefore, the SEC's rule that a mutual fund must hold an AA or better security inherently excludes many A-rated municipal securities which are the equivalent of qualified AA corporate rating securities. Applying corporate-equivalent standards to the investment grade requirement of Rule 2a-7 would expand the market for tax-exempt money market funds, benefiting both issuers and investors.

Regulatory Guidance

The Treasury Department released very helpful guidance on reissuance rules for auction-rate securities and variable-rate demand bonds on February 20 of this year. This guidance allows many issuers to convert out of auction-rate securities into different products, such as a fixed-rate bonds, without having to "reissue" the bonds. Governments are seeking this opportunity to convert, to save taxpayer's money without the costly reissuance process, and to limit their exposure in a volatile market. Tax counsel have questions regarding these issues, and we encourage the Treasury Department to continue to respond to their questions and distribute the answers as widely as possible.

Regulatory Oversight

The SEC should continue in its responsibility to maintain fair, orderly and efficient markets. It should review the factors contributing to recent market disruptions, and recommend market instruments which would not place new and unnecessary burdens upon municipal bond issuers.

Student Loans

A very large volume of student loans have been financed through auction-rate securities, and the increased costs of these securities are placing enormous pressure on student loan agencies. Two state student loan agencies have already said that the pressure of added interest costs means that they will not be able to make new loans. College students across the country depend on loans to finance their education, and our country's economic growth depends on the ideas and talents of college graduates. We encourage the Department of Education to work with state student loan agencies quickly, so that they will be able to make loans before the new school year starts.

Federal Reserve Bank Policies

There should be review of policies that would allow the Federal Reserve to purchase auction-rate securities, adding liquidity and price stability to the market during these extraordinary times.

Conclusion

State and local governments face a plethora of challenges in the current market. For many, converting out of auction-rate and variable-rate demand securities is a costly and time-consuming, yet necessary, task. Continued market volatility is causing governments to review their plans for various projects, either scaling back or not starting them. The end result is that taxpayers are paying the price, due to conditions beyond state and local government's control.

But as Andrew Feltus of the Pioneer High Yield Fund noted last week: “These are rock-solid credits.”⁸ The underlying strength of the municipal bond market cannot be overemphasized.

We understand that markets and market corrections must take their course. But, thousands of state and local governments and millions of their citizens are paying the price for the poor judgments of others in separate markets. We welcome the opportunity to work with the Committee, the Congress, and regulatory bodies to find solutions which would mitigate the harms that governments are facing, and prevent this type of turmoil from happening again in the future.

Sincerely,

Government Finance Officers Association, Susan Gaffney, 202-393-8020

National Association of Counties, Ed Rosado, 202-661-8809

National Association of State Auditors, Comptrollers & Treasurers, Cornelia Chebinou, 202-624-5451

National Association of State Treasurers, Dan DeSimone, 202-624-8595

National League of Cities, Carolyn Coleman, 202-626-3023

U.S. Conference of Mayors, Larry Jones, 202-861-6709

⁸ Reuters, 3/6/08. *Big Names are Hopping into Munis, Should You?*

Exhibit One: Courtesy of Municipal Market Advisors

| Rating Categories | Cumulative Historic Default Rates | | | |
|----------------------|-----------------------------------|--------|--------|--------|
| | Moody's | | S&P | |
| | Munis | Corps | Munis | Corps |
| Aaa/AAA | 0.00% | 0.52% | 0.00% | 0.60% |
| Aa/AA | 0.06% | 0.52% | 0.00% | 1.50% |
| A/A | 0.03% | 1.29% | 0.23% | 2.91% |
| Baa/BBB | 0.13% | 4.64% | 0.32% | 10.29% |
| Ba/BB | 2.65% | 19.12% | 1.74% | 29.93% |
| B/B | 11.86% | 43.34% | 8.48% | 53.72% |
| Caa-C/CCC-C | 16.58% | 69.18% | 44.81% | 69.19% |
| Investment Grade | 0.07% | 2.09% | 0.20% | 4.14% |
| Non-Invest Grade | 4.29% | 31.37% | 7.37% | 42.35% |
| All | 0.10% | 9.70% | 0.29% | 12.98% |

Source: Moody's and S&P

Moody's: Average cumulative 10-Year default rate between 1970-2006

S&P Municipals: Average cumulative 19-year default rate between 1986-2006

S&P Corporates: Average cumulative 15-year default rate between 1981-2005