LEGISLATIVE PROPOSALS TO IMPROVE THE EFFICIENCY AND OVERSIGHT OF MUNICIPAL FINANCE

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

MAY 21, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–37

U.S. GOVERNMENT PRINTING OFFICE

51–596 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

LEGISLATIVE PROPOSALS TO IMPROVE THE EFFICIENCY AND OVERSIGHT OF MUNICIPAL FINANCE

Thursday, May 21, 2009

U.S. House of Representatives,
Committee on Financial Services,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m., in room 2128 Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Waters, Watt, Sherman, Moore of Kansas, Capuano, Clay, McCarthy of New York, Baca, Scott, Green, Cleaver, Ellison, Perlmutter, Foster, Carson, Adler, Driehaus; Bachus, Castle, Royce, Manzullo, Jones, Biggert, Hensarling, Garrett, Neugebauer, Campbell, Putnam, Posey, Jenkins, Paulsen, and Lance.

Also present: Representative Connolly.

The Chairman. The hearing will come to order. I want to move quickly because at 2:00 this afternoon, the Secretary of HUD will be here to talk about the Voucher program, and we are glad to have him. That has to be a full committee hearing according to the practices of the House. We cannot have Cabinet officers testify before a subcommittee. So we will begin.

This is a very important hearing on a subject that is not fully understood. Annually, in the broad category known as "municipal bonds," which are government, State, local, and county, and nonprofit organizations, hospitals, they issue approximately $375 billion a year of bonds. We believe the evidence is overwhelming that they now pay, because of a set of arrangements, a higher interest rate than is justified by risk. That is particularly true of full faith and credit general obligation bonds in which there have been no defaults, according to Moody's, in nearly 40 years.

Ajit Jain, who is the insurance expert for Warren Buffet—and Mr. Buffet has said he does not know that he can keep the insurance business going without Mr. Jain—testified at that panel, at that table, that if municipal bonds were rated by the same criteria as corporate bonds, no one would sell bond insurance because it would become clear that it was not needed. In fact, to the extent that municipal bonds paid a higher interest rate in the past few years, it was because of mistakes by their insurers.

The monolines, as they were called, used to just insure municipal bonds and then the monolines decided to take their sure-fire profit from insuring municipal bonds and insuring full faith and credit general obligation bonds—I am going to borrow an analogy I have used elsewhere—is kind of like selling life insurance on vampires: You are insuring against an event that never happens. And when you are insuring against events that do not happen and are collecting premiums, you make a lot of money.

The monolines then took that money from these insurance payments, from these municipalities, and speculated in collateralized debt obligation derivatives and lost money. As a consequence, a number of municipalities found the interest rates they had to pay went up because their insurers had gotten into financial trouble. If we could reduce by 100 basis points on the average the interest rates that are paid, that would mean $3.75 billion a year that would be saved by the issuers.

People have asked, "Why are you doing this? What is the problem?" The problem is that taxpayers financing schools and roads and police stations and fire stations and other physical needs of our communities pay more in interest than would be justified by a better system. And people have asked, "Well, why are you interfering with the market?" Because, as we have learned in a number of other contexts, markets play a very important role but market failure is also a factor.

And if you look at the rate of defaults in corporate bonds, and we have a slide that will show that, compare it to the rate of default in municipal bonds, you see a great disparity but that is not reflected in the rates. Part of it is the rating agencies, and we will be hearing from the rating agencies and from Moody's. But if we were able to get an accurate picture reflected in the interest rates of the safety of municipal bonds, then you would have an enormous savings to the taxpayers. And it is hard some time to find the money to help municipalities. Here is a way that they are helped. They are helped because interest payments to private recipients would reduce. And let me say, I am speaking here against interest, recognizing that municipal bonds pay an unfairly high interest rate because the risk is exaggerated.

I will now make my public statement, I am almost entirely personally invested in municipal bonds. And I have told the people who buy bonds for me to buy full faith and credit general obligation Massachusetts bonds, and the lower they are rated, the happier I am as a private citizen, although I am not happy as a public official, because I get more and more interest. And I escape paying about a 40 percent total tax between my Federal income tax and my State tax on bonds that will not fail.

So what we have is a package of measures that we believe deal with that. It is also the case that there have been some problems with some financial institutions, particularly the non-full faith and credit, WPPS is an example in Washington State, where there have been some problems. Part of the problem has been the peculiarly political nature here of the relationship of advisors, etc., so one of our bills would greatly strengthen the rules, in fact it would create rules which do not now exist, for advisors to municipalities. So we both have an investor protection system here, but we also have what we think are a set of rules that will result in a market which now fully understanding what the value of municipal bonds is and the low risk will result in a very substantial savings in taxpayer money on the part of State and local taxpayers.

The gentleman from Alabama?

Mr. BACHUS. Thank you, Mr. Chairman. And I thank you for convening this hearing to examine five legislative proposals designed to address problems in the $2.5 trillion municipal securities market.

All of us are aware of the financial hardships that municipalities across the country are facing from declining tax revenues, depressed property values, and underfunded long-term funded pension and health care obligations.

In my home State of Alabama, Jefferson County is on the verge on becoming the largest municipal bankruptcy in U.S. history caused, by the county's inability to repay $3.9 billion in sewer bond debt tied to interest rate swaps, valued notionally at almost $6 billion.

Some of my colleagues on the other side of the aisle believe the Federal Government can fix the municipal securities market with unprecedented interventions and bailouts. These interventions include reinsurance programs, for which no bond insurers may be able to qualify, and liquidity facilities that will increase the size of the Federal Reserve's balance sheet. It is important to note that for years, municipalities opposed Federal intervention into their financing operations. Only now, when short-term financing options have dried up, are municipalities seeking assistance from the Federal Government.

Mr. Chairman, of the measures that are the subject of today's hearing, the legislation, your legislation to regulate unregulated municipal financial advisors is one that I could accept, with some changes. We are in agreement with the basic premise that the SEC should require individuals who advise municipalities to register as investment advisors. However, as demonstrated by the Bernie Madoff affair, I am not sure that the SEC, and I say, Chief Haines, with all respect to your Agency, I am not sure whether the SEC has a present ability to effectively examine existing investment advisors. In that regard, I wonder if it would not be appropriate for this committee to delegate this important examination responsibility to FINRA.

Some of the other bills that we are considering today are more problematic, including legislation that could have the effect of forcing the rating agencies to rate municipal bonds triple A. It is wrong to assume that municipal bonds never default because they are backed by a taxing authority of the issuer. Moreover, I worry that any bill that directs the evaluation standards for credit rating agencies serves only to further solidify the government's endorsement of the credit rating agencies when we should be moving in an opposite direction.

Yesterday, we had a hearing on the credit rating agencies, and I made the statement there that I believe the credit rating agencies had failed spectacularly and their inability to properly rate securities I believe was a major contributor to the financial challenges that we are facing today. And I believe that the government's endorsement of the credit rating agencies, and almost their what I believe has contributed to almost a duopoly in credit rating agencies, was a contributing factor.

Also problematic is legislation that would create a Federal reinsurer of municipal bonds. Congress does not need to put the American taxpayer on the hook for more losses. The Federal Government should not be competing with private reinsurance companies that are active in the municipal bonds market, whether it is with these proposals today or in health care where there are more and more proposals for the Federal Government to assume private functions. I fear that we have already reached a point where government simply cannot afford the obligations that they have already assumed. And the more they assume, the higher all our taxes will go.

The Treasury has no experience in providing reinsurance to municipal bond insurers or at pricing for reinsurance. In addition, a Federal reinsurance program for municipal bonds insurers simply bails out bond insurers that strayed from their core business of municipal financial guarantees and to much riskier financial products.

Furthermore, a Federal reinsurance program may provide a competitive advantage to those legacy bond insurers that are unable to insure new municipal bonds because of their prior obligation.

Finally, a Federal reinsurer may scare off new capital into the industry and undermine the long-term health of the bond insurance market. We should all keep in mind that a properly functioning bond insurance market helps smaller insurers to access the capital markets at more favorable rates.

In conclusion, Mr. Chairman, I want to give the SEC real authority to oversee the municipal securities market, and I plan to introduce legislation to that effect or work with you on bipartisan legislation. The municipal securities market presents itself to the public as safe, stable, and secure for all investors. It should welcome more sunlight, consistency, and thorough disclosures that apply across the asset classes and commonsense modernization.

Thank you to the witnesses for testifying today. I yield back the balance of my time.

The CHAIRMAN. I thank the gentleman. I would just note that I believe 15 minutes for each side would be a reasonable allocation. I have used 5 minutes, and we have the gentleman at 6½ minutes, so the gentleman has 8½ minutes to allocate. I have 9½ minutes. We are going to go on that basis. The gentlewoman from California is recognized for 3 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to begin by thanking you and Speaker Pelosi for your leadership in this area. We are facing an unprecedented crisis where our towns, cities, and States cannot obtain the funding they need to operate. One of the most distressed areas is my own State of California.

We are here today in part because of the high costs municipalities must deal with when borrowing in the capital markets. Municipalities and States generally collect tax revenues twice a year, while they have to make payments to vendors, employees and government agencies 12 times a year. States use a combination of cash reserves and short-term notes to cover any shortfalls between the two tax collection periods. However, issuing these short-term notes is not without significant cost.

My own State of California has seen its borrowing costs on short-term notes jump 88 basis points over the past years. For a municipality, this means nearly an additional $9 million in cost for every $1 billion that is borrowed. That is $9 million that could have gone into education or health care. Instead, it leaves the State coffers and leaves municipalities with the tough choice between cutting services or raising taxes. While California is currently the epicenter of this problem, we are neither the first nor the last State that will have an issue with municipal debt.

In addition to high borrowing costs, some areas of our country have also been misled by so-called "municipal investment advisors." These advisors often pitch financial products that end up costing a municipality more than it bargained for. As was mentioned earlier, in Jefferson County, Alabama, investment advisors even assisted the county in refinancing itself to the brink of bankruptcy.

High borrowing costs, fast-talking pitch men and women, and dangerous products, such as credit default swaps, have proven to be a recipe for disaster.

This hearing today and the legislative proposals of this committee are an important first step.

Mr. Chairman, I look forward to hearing the perspectives of our witnesses. I thank you, and I yield back the balance of my time.

The CHAIRMAN. The gentleman from New Jersey is recognized for 2 minutes.

Mr. GARRETT. Thank you, Chairman Frank, and Ranking Member Bachus, for holding this important hearing today. And I do want to compliment Ranking Member Bachus because he has been highlighting the problems in this industry for some time and also for his close attention to this important issue.

The municipal bond market has experienced a tremendous amount of stress over the last year. Many States and municipalities are seeing their expenses rise as the spreads of their offerings continue to widen. So in an attempt to address some of the problems in this market, the chairman now has circulated a number of pieces of legislation. Well, I have significant concerns with several of these bills and the underlying rationale—that the Federal Government should always be the last resort for anyone in trouble.

First, you have the Municipal Bond Liquidity Enhancement Act, which would provide the Federal Reserve with the authority to fund new liquidity facilities with a variety of specific securities.

When Chairman Bernanke testified before this committee, it was last July, I asked him is there any limit on the Fed's power under Section 13.3? He essentially told me no, there were no limits. So if that is the case, I am not sure why we need to pass a bill giving the Fed even more power that it already has.

Secondly, regarding the Municipal Bond Insurance Enhancement Act, this legislation would create a temporary Federal Government reinsurance program for monoline insurance companies. I think we are familiar with the last time the Federal Government created a temporary reinsurance program, that program is still in operation and we just extended it.

So, in conclusion, once again the Federal Government is being called upon to bail out people who made bad decisions and this time it happens to be local and State politicians, who spent too much during the good times and refused to tighten their belts during the bad times. And I do not believe that we should pass any legislation that would de-incentivize States and localities from reigning in their bloated budgets and put more and more of that debt on an already over-loaded Uncle Sam.

So I thank you, Mr. Chairman, and I yield back the remainder of my time.

The CHAIRMAN. The gentleman from Georgia is recognized for 2½ minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. First, I want to thank you for holding this hearing. And I also want to thank you for introducing such important legislation, and I am proud to cosponsor it with you, legislation that will provide much needed relief to State and local governments around the country by helping to unlock the parts of the municipal market that remain frozen.

The creation of a liquidity facility to unfreeze the variable rate demand obligation and short-term debt markets is urgently needed and would allow projects like my City of Atlanta's construction of the new Maynard Jackson International Terminal at Hartsfield-Jackson Atlanta International Airport in my district. It will allow the airport to continue without negatively impacting thousands of jobs; 2,600 construction jobs alone are tied to the International Terminal's completion, which is scheduled for 2012. The viability of this and other similar projects, such as our City's water system that will be idled if they continue to be unable to access the capital markets, depends upon State and local government access to affordable financing options. A lack of funding would cause construction to cease and several hundred workers will be idled if we are unable to access the municipal commercial paper market.

Enhancing liquidity in the part of the State and local sector that remains stressed will not only help make that marketplace operate more efficiently but will help States and localities complete projects that are crucial to meeting public needs and consistent with job creation and economic stimulus.

Mr. Chairman, at a time when the Federal Government is searching for ways to create jobs and stimulate economic activity and help to stabilize the financial markets, opening up the Federal Reserve liquidity facilities to variable rate and short-term debt obligation will help very much to address these goals. The cost of delay, particularly from the standpoint of jobs that are at risk, is too great. I look forward to the testimony of our distinguished witnesses.

Thank you very much, Mr. Chairman, and I yield back my time.

The CHAIRMAN. The gentleman from Delaware is recognized for 1½ minutes.

Mr. CASTLE. Thank you, Mr. Chairman. I agree with most of the opening statements that we have just heard. It is clear to me that the municipal bond market has suffered and, like many other markets, is suffering more than usual because of the economic crisis we are in. And I think we should be concerned about the States and municipalities and the other entities that come under municipal bond funding as well, our colleges and universities, for example, who are bond issuers and are experiencing higher costs. We obviously do not want those institutions to pass on those costs to students. We do not want hospitals to pass on costs to patients, other insurers or whatever it may be, so we need to pay attention to all of that.

I am concerned about one of the provisions in the package of legislation that is before us which would expand the Federal Reserve's emergency lending authority authorized under Section 13.3 of the Federal Reserve Act. The problem is that particular section some of us have been requesting more oversight and accountability on. Although it is clear that the municipal bond market is in need of assistance, as I have indicated, I question whether we should be willing to support such expansion of the Fed's powers unless we also demand more oversight and accountability of the Fed. At the very least, GAO should be able to audit the Fed, as Representative Ron Paul's Federal Reserve Transparency Act would do.

But we have a problem here, I think we have identified the problem pretty well; now we need to identify the proper solution. And we thank all the witnesses for being here. We look forward to your testimony. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas is recognized for 2 minutes.

Mr. GREEN. Thank you, Mr. Chairman. And I thank the witnesses for appearing today as well. Mr. Chairman, I am grateful that you have called these issues to our attention. This is a $2.6 trillion market with 55,000 eligible issuers. It really is something that we need to take a look at. And in this time of adversity, I see a great opportunity for us to take affirmative action as well as corrective action. This should not be, and I do not think it is, an attempt to regulate the market. I really think that it is an opportunity for us to make some adjustments so as to prevent some conditions from occurring might be detrimental to the market.

I am grateful that we are looking at this area of the advisors, financial advisors, persons, many of whom are unregulated. I think this is ripe for us to take a look at. And I look forward to working with you, Mr. Chairman, and others. I thank you, and I yield back the balance of my time.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling, is recognized for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. First, I want to take the opportunity to welcome my mayor to the Nation's capital, the Honorable Tom Leppert, who is a great public servant doing many great things for the people of Big D. Welcome, Mr. Mayor. Having said that, we may differ on the subject matter of this particular hearing.

Mr. Chairman, in the last 30 days, the fiscal news for the American taxpayer has not been good. Freddie Mac has announced that their taxpayer bailout now totals $51 billion. Fannie Mae's Federal bailout has reached $34 billion. We just received news that the Pension Benefit Guarantee Corporation has announced that their deficit has climbed to $33.5 billion, the largest in the Agency's 35-year history.

Many of us know that recently the trustees of the Social Security Board just announced that Social Security will begin to go bankrupt one year earlier than originally projected in last year's report. And we all know, just weeks ago, Congress passed a budget which will triple the national debt in just 10 years, racking up more debt than has been racked up in the previous 220 years. It begs the question: Is there any cause or purpose for which we will not place more debt on future generations?

Today, we are considering legislation to backstop, and perhaps bail out, States and municipalities who experience investment losses, and bail them out with the hard-earned money of American taxpayers who have also experienced investment losses. I fear that aspects of this legislation can cause people to engage in riskier behavior, believing that the government will perform their due diligence for them on the front end and then bail them out on the tail end. This can be dangerous for the investor and disastrous for the Nation and the Federal taxpayer.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from Illinois, Mr. Foster, is recognized for 1 minute.

Mr. FOSTER. I would like to thank Chairman Frank for holding this important hearing. For some time I have been concerned about the municipal bonds market and, in particular for example, the irrational situation with tax-exempt municipalities trading upside down with respect to Treasuries and so on, and also the collapse of the municipal bond insurance bond, which as the chairman noted, was questionable in any case.

My home State of Illinois has not been immune to the turmoil in the municipal bond market. Moody's recently downgraded my State to the A level from the double A. Moody said that Illinois was having difficulty managing its cash, perhaps with some justification. And in recent weeks, Illinois has been trying to push scheduled pension contributions into the future. Thus, the issue of meaningful less than triple A ratings has become financially significant to Illinois. That is why this hearing on this important set of bills designed to address this problem is very timely.

In particular, I would like to focus for a moment on the Municipal Bond Liquidity Enhancement Act, which I am proud to sponsor. This bill would give the Federal Reserve authority to support certain variable rate municipal bonds which have been particularly hard hit during this crisis.

I look forward to testimony on this, and I hope that we can pass this and the other related bills expeditiously. I yield back.

The CHAIRMAN. The gentleman from California, Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman. Municipalities in States have traditionally been more fiscally responsible than the Federal Government, in part because often their constitutions and charters require balanced budgets but also in part because they do not have the ability to print money or borrow without end, as does the Federal Government.

I think it would be extremely unwise to allow municipalities and States to print money and borrow without end through proxy of the Federal Government because of guarantees. I think that would en-danger the fiscal stability and the future of many States and counties.

My home State of California needs to sell a lot of debt very soon but the municipal bond markets are actually functioning quite well out there, now albeit at high-risk premiums, reflecting the risk that exists in the overall market for municipal bonds and all types of bonds. The State of California can sell these bonds if they price them to the market. They should do so directly and without government interference or assistance in this or any other State.

I yield back.

The CHAIRMAN. We will now begin the statements from the witnesses. I have some charts that I have prepared that I am going to ask be shown. If anybody else has any, we would extend that same courtesy. They are fairly simple so they should not distract from the witnesses' statements too much. I will ask that those—there are four charts that I am going to ask to be shown.

And we will now begin with Martha Mahan Haines, who is the Chief of the Office of Municipal Securities of the U.S. Securities and Exchange Commission.

Ms. Haines?

STATEMENT OF MARTHA MAHAN HAINES, ASSISTANT DIRECTOR AND CHIEF, OFFICE OF MUNICIPAL SECURITIES, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

Ms. HAINES. Chairman Frank, Ranking Member Bachus, and members of the committee, my name is Martha Haines, and I head the Office of Municipal Securities in the Commission's Division of Trading and Markets. I appreciate the opportunity to testify before the committee today on behalf of the SEC.

The question of whether municipal financial advisors should be regulated is a topic of significant interest to the Commission. As described in my written testimony, we have been concerned about the conduct of some municipal financial advisors. However, the Commission's current statutory authority limits our ability to address these concerns adequately. As a result, the Commission believes an expansion of its authority over the conduct of municipal financial advisors would be appropriate.

The Municipal Advisors Regulation Act, proposed by Chairman Frank, would provide tools that would help address the problems we have observed concerning municipal financial advisors. In particular, we support the Act's clarification of the specific duty of care that a financial advisor owes to its client.

Dealers in municipal securities who are acting as financial advisors are subject to regulations adopted by the Commission and by the Municipal Securities Rulemaking Board. In contrast, the many financial advisors who are not broker-dealers currently are not regulated either as dealers or as investment advisors.

The Commission has brought more than 20 enforcement actions under the anti-fraud provisions of the securities laws against financial advisors, but enforcement actions are an after-the-fact remedy. They cannot provide the kind of specific and nuanced guidance or cover the broad scope of activities that regulatory authority under the proposed legislation would make possible. Furthermore, harmful activities of market participants who are not subject to Commission registration or oversight are more difficult to discover. Without the opportunity that reporting, inspection, and examination provide, it is difficult to monitor these activities and keep apprised of emerging practices.

Authorizing the Commission to require municipal financial advisors to have minimum qualifications, to follow conduct rules designed to ensure that they deal fairly with their clients, to eliminate pay to play activities, and avoid or disclose conflicts of interest would help prevent harm to issuers, taxpayers, and citizens who are dependent on the infrastructure financed with municipal securities—in addition to protecting the interest of investors. Notwithstanding these benefits, new regulations would, of course, impose some burdens on financial advisors, which could potentially be passed along to issuers through higher fees.

To the extent that credit ratings provide meaningful information that assists investors, counterparties, and others in deciding how to allocate capital or whether to enter into a transaction, they can play an important part in a well-functioning financial market. Congress previously addressed the role of credit rating agencies by enacting the Credit Rating Agency Reform Act of 2006. Moody's, S&P, and Fitch account for nearly all of the ratings of municipal securities. All three have noted that historical defaults on municipal securities have been lower than comparably rated corporate or sovereign securities.

Some municipal issuers argue that the use of the same rating symbols but different definitions for municipal and corporate securities result in municipal bonds being rated lower than corporate bonds with an equivalent risk of default. Some investors, however, argue that the use of common symbols but different definitions is a useful way to compare the relative of municipal issuers. They contend that using a common set of rating category definitions would cause most rated municipal bonds to be slotted into the top two rating categories, making it more difficult to assess the individual merits of a bond, particularly for individual investors.

The Municipal Bond Fairness Act, if adopted by Congress, would mandate that the SEC require rating agencies to establish and maintain credit ratings designed to assess the risk that investors may not receive payment, to clearly define rating symbols and to apply rating symbols in a consistent manner. The bill would permit NRSROs to determine complementary ratings provided that they use different rating symbols.

Finally, the bill would require the SEC to establish performance measures for use when considering whether to initiative a review of an NRSROs' adherence to its stated procedures and methodologies.

The SEC staff stands ready to provide technical assistance on the bill if that would be useful to this committee. Thank you again for providing me with an opportunity to testify about these two bills now pending before Congress. I look forward to engaging with you on this matter in the future.

[The prepared statement of Ms. Haines can be found on page 103 of the appendix.]

The CHAIRMAN. Next, a returning witness, after some absence, the Senior Advisor to the Secretary, Department of Housing and Urban Development, Mr. Bill Apgar.

STATEMENT OF WILLIAM APGAR, SENIOR ADVISOR TO THE SECRETARY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. APGAR. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to testify. HUD is pleased to see that the Financial Services Committee is examining the range of issues and considering legislation relating to the lack of liquidity and other constraints in the municipal bond markets. While the Administration is not yet ready to take a position on the proposed legislation, taking steps to improve the functioning of the municipal bond market is clearly an important component of the overall response to the current housing crisis. My testimony will focus on one aspect of that, namely, how the disruption in the municipal bond market has significant implications for the functioning of State and local housing finance agencies.

First, let me speak to the importance of State and local Housing Finance Agencies or HFAs. In strong and weak economies, HFAs have been reliable sources of finance for lower-income first-time home buyers and have played a key role in the delivery of Low-Income Housing Tax Credits, the Home Investment Partnership Program, and the Section 8 program. Through these programs, HFAs have helped 2.6 million families become first-time homeowners and have supported development of 150,000 new affordable rental housing units annually.

FHA has enjoyed a very strong partnership with the various HFAs. HFAs have worked collaboratively with FHA to offer low- and moderate-income families access to special affordable housing programs that rely on FHA insurance. More recently, HFAs have been engaged in dialogue with the FHA on issues relating to the current market crisis and the types of programs that can help families keep their homes, including new changes to the HOPE for Homeowners Program that President Obama signed into law just yesterday.

As you know, on February 18th, the President announced his Housing Affordability and Stability Plan, a plan that included initiatives to support HFAs in their effort to stimulate first-time home buying and provide affordable rental housing. The White House, the Treasury, and HUD are now finalizing the details of a proposal designed to address three distinct but interrelated challenges facing HFAs. First, the lack of financing for new HFA bond issuance, the lack of liquidity and support of HFA variable rate debt obligations, and ongoing credit and balance sheet stress for HFAs at risk of rating downgrades.

In light of the strong track record and considerable capacity, last year in the Housing and Economic Recovery Act, Congress provided HFAs with $11 billion worth of new housing bond authority to finance affordable single-family and multi-family mortgages. Unfortunately, they have not been able to take advantage of this expanded housing authority. Traditionally, HFAs have obtained funding through the issuance of tax-exempt housing bonds or mortgage revenue bonds. Currently, HFAs have been virtually frozen out of this market, unable to find investors willing to buy their bonds at rates that allow HFAs to lend the proceeds affordably. As a result, an important source of quality lending for low- and moderate-income borrowers has been severely curtailed.

In addition to MRBs, some HFAs issue variable rate debt obligations in order to offer mortgages at lower interest rates. The current market for VRDOs has all but evaporated, as buyers of these investments have left the market and have been significantly downgraded or are imposing unreasonable terms and excessive rates. State HFAs have over $23 billion in VRDOs outstanding.

Nearly 3 billion of the existing liquidity facilities have already expired or will expire at the end of 2009. Those unable to roll over their VRDOs have been forced to pursue more expensive mechanisms. For example, a growing number of HFAs have been unable to find buyers and often are forced to convert this debt to bank bonds, often requiring them to pay this debt off at higher rates or under accelerated or what some call hyper-amortization schedules, further depleting their resources and weakening their financial positions.

Additional threats to the health of HFAs are rating agency downgrades of private mortgage insurance providers, bond insurers, and liquidity providers, as well as deterring performance of HFA mortgage portfolios.

The side-lining of HFAs could not have come at a worse time for housing and economic recovery. HFAs project that they could issue $33 billion in tax-exempt funds over the next 2 years, providing HFAs the financing to continue as a key source of affordable, flexible mortgages. In a period of declining home prices and decreasing affordability, HFAs are no longer in a position to help first-time buyers take advantage of these good opportunities. FHA's inability to respond to a growing demand for first-time buyers in turn affects the broader housing market.

In conclusion, the disruption in the municipal bond market has severely hindered the ability of State and local housing finance agencies to achieve their mission. HUD looks forward to working with the committee on solutions to address the disruptions in the broader municipal bond market and especially their impact on State and local housing finance agencies.

[The prepared statement of Mr. Apgar can be found on page 75 of the appendix.]

The CHAIRMAN. Thank you.

Next, we have David Wilcox, who is Deputy Director of the Division of Research and Statistics of the Federal Reserve System.

STATEMENT OF DAVID W. WILCOX, DEPUTY DIRECTOR, DIVISION OF RESEARCH AND STATISTICS, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. WILCOX. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to comment on issues related to the markets for municipal debt. Today, I will provide some background on the structure of the municipal debt market, discuss current stresses in this market, and comment on some policy considerations.

The market for municipal debt is large and diverse. At the end of 2008, investors held about $2.7 trillion of municipal securities issued by more than 50,000 entities. Approximately half of municipal debt has credit enhancement from financial guarantors. These firms are often also called bond insurers or monolines. Banks also provide credit enhancement to municipalities as part of letters of credit.

Most municipal bonds have long maturities. Some municipalities have issued securities such as Variable Rate Demand Obligations, or VRDOs, and Auction Rate Securities, ARS, that combine long maturities with floating short-term interest rates. VRDOs have explicit liquidity support, typically from banks, which helps ensure that bond-holders are able to redeem their investment at par plus accrued interest even if the securities cannot be successfully remarketed to other investors. VRDOs often have credit enhancement from financial guarantors or banks.

The market for municipal debt has been strained by the weakened fiscal condition of municipalities, the diminished financial strength of the financial guarantors, and the higher costs of liquidity backstops and credit enhancement from banks. Despite these strains, the market for traditional fixed rate municipal debt appears to be functioning fairly well for many issuers. The lower rated municipalities are facing unusually higher costs of issuing debt relative to higher rated issuers.

The markets for floating rate municipal debt are in more serious condition. Market participants report that the cost of liquidity support and credit enhancement for VRDOs has risen sharply and the market for new auction rate securities is dead. Some municipalities have been able to issue new VRDOs but many lower-rated issuers appear to be either unwilling or unable to issue this type of debt. In addition, some VRDOs have reportedly been put to their liquidity providers, turning them into bank bonds, which typically carry penalty interest rates and can eventually be subject to accelerated amortization. This combination of higher rates and faster amortization can cause a sudden and substantial increase in the debt service payments required of the issuing municipality.

Some policy actions have already helped address these strains. For example, Congress has enacted two large stimulus packages. In addition, the Federal Open Market Committee lowered the Federal funds rate to its current target range of zero to one-quarter percent, a historically aggressive adjustment. And the Federal Reserve has created a range of facilities aimed at improving the functioning of financial markets.

The recently-concluded Supervisory Capital Assessment Program should also provide some indirect help to municipalities because many of the institutions subject to that program also provide liquidity backstops for VRDOs.

As Chairman Bernanke has noted before, the Federal Reserve has important misgivings about assuming a direct role in the municipal bond market in light of the political dimensions of the issue. Indeed, this is one reason why the Federal Reserve Act imposes limits on the ability of the Federal Reserve to purchase municipal debt, including a 6-month maturity limit. Accordingly, the Federal

Reserve believes that a direct role is better suited to the fiscal authorities than to the Central Bank.

In addition, it is important to note three key characteristics of the Federal Reserve's responses to the financial crisis thus far:

First, before lending can be extended under Section 13.3 of the Federal Reserve Act, the Board of Governors must find that unusual and exigent circumstances prevail.

Second, the Federal Reserve has been mindful of the need to protect both it and Federal taxpayers from credit losses.

Third, Federal Reserve programs have been designed carefully to allow clear exit strategies to help ensure the ability of the Central Bank to raise the Federal funds rate from its current level, when necessary, to promote the mandate given to us by the Congress to foster maximum sustainable employment and price stability.

These considerations are consistent with the Joint Statement on the Role of the Federal Reserve issued on March 23rd by the Treasury and the Federal Reserve and are critical to achieving the dual monetary policy mandate and preserving the Central Bank's independence.

As the Congress considers whether future action is warranted, it may wish to consider the degree to which government involvement in this market is appropriate in the long term and how to facilitate the government's exit from the market.

Thank you for the opportunity to testify today. We look forward to working with Congress to assist you in your deliberations on these matters. In addition, the Federal Reserve will continue to work aggressively to restore normal functioning to the financial markets and the flow of credit in the economy.

I look forward to addressing your questions.

[The prepared statement of Mr. Wilcox can be found on page 184 of the appendix.]

The CHAIRMAN. And now, the aforementioned Mayor of the City of Dallas, Mayor Leppert.

STATEMENT OF THE HONORABLE THOMAS C. LEPPERT, MAYOR OF DALLAS, TEXAS, ON BEHALF OF THE U.S. CONFERENCE OF MAYORS

Mr. LEPPERT. Thank you very much, Mr. Chairman. First, let me thank you, Ranking Member Bachus, and all the members of this committee for holding this hearing to focus national attention on a critical challenge facing the Nation's cities. I am Tom Leppert, mayor of the City of Dallas and chairman of the U.S. Conference of Mayors Metro Economies Committee, which addresses issues impacting the viability of local economies. Today, I am pleased to appear on behalf of the Nation's mayors to offer comments on pending legislation to assist State and local governments gain better access to the credit market.

Before I get started, I want to thank you, Mr. Chairman, for responding to the problems municipalities are experiencing in assessing the credit market. We appreciate your coming to speak to the mayors earlier this year and thank you for introducing legislation that would address some of the concerns we raised then about the capacity of local governments to secure needed financing.

For more than a year, State and local governments have suffered from the global credit crisis. According to BNY Mellon Asset Management, 2009 municipal bond issues are expected to decrease by an amount comparable to eliminating all Federal highway and transit spending for an entire year. And it is our citizens and taxpayers who will suffer the consequences.

Many capital improvement projects across the Nation, not filling operating shortfalls, both large and small, have been halted due to the lack of affordable access to the market and the inability of States and local governments to issue bonds. At a time we need to create jobs and economic activity, local governments have increasingly been unable to access the capital markets due to prohibitive borrowing costs. This lack of liquidity is holding back key projects that could collectively have an enormous impact on our national economy.

As an example, in Dallas we have several major projects we would move forward on if the municipal markets return to a "normal" state. Proceeding with these projects today would put people back to work and take advantage of reduced construction cost to the benefit of all of our taxpayers.

Cities and States across the country are in the very same position. According to Thomas Doe, CEO of MMA Advisors, with fixed rate yields having risen to extraordinary heights, many State and local issuers have tabled the majority of their planned primary market loans. MMA estimates that in 2008, more than $100 billion of planned new money infrastructure projects were delayed, the majority of that occurred in the fourth quarter. I would ask you to simply think of that quarterly number as a percentage of the infrastructure and public spending in the American Recovery and Reinvestment Act. Indeed, your action to support the municipal bond market would result in a major stimulus to the economy without a Federal outlay of funds.

Given the economic challenges my colleagues face in cities and States across the Nation, and you face nationally, I would also suggest to you that it is imperative these actions move forward with an urgency. Implementation in years, or even many months, is not what your Nation needs. We need to accelerate this to the current fiscal year.

That is why the four legislative proposals being discussed today are important in the short term to repairing our market and helping governments move their communities by building and repairing schools, firehouses, highways, and water systems. It is also worth mentioning that unlike the Federal Government, local governments do not have the luxury of carrying a deficit. By law, they are required to balance their budget every year. For many, the only way to provide vital infrastructure is through the issuance of bonds, which has been a viable way of financing critical infrastructure projects for more than 100 years.

Now that I have provided a brief overview of the situation local governments are facing, I would like to discuss briefly each of the pending proposals.

The Municipal Bond Fairness Act would give investors a more accurate portrayal of the low risk of municipal securities compared to their corporate counterparts. Government bonds, either pledged with the full faith and credit of the government, or governmental revenue bonds, as shown on the right side chart, have a nearly zero default rate. Ensuring that rating agencies use uniform and accurate credit ratings for all securities will lower borrowing cost and spur increased investment in municipal bonds. The Conference of Mayors supports this legislation.

We believe the Municipal Bond Insurance Enhancement Act would help increase the capacity of municipal bond insurers in the short term to ensure new risks and thereby make it easier for issuers to borrow in the capital markets. Again, the Conference of Mayors supports this legislation.

As has been frequently cited, nearly half of all municipal credits were insured until 2007. Often, the insurer chose to obtain bond insurance in order to receive a triple A rating on the issuance, which lowered the interest rate cost for both the bonds and savings at greater than the cost of insurance. Many public entities simply cannot issue debt without credit enhancement as they or revenue bond project they are offering are rated below double A. As mentioned, in many cases in today's market, there is neither a viable nor affordable bond insurer option. Short-term Federal support would be greatly beneficial to the municipal bond market, specifically for smaller insurers. And as a side, I would also ask you to consider this enhancement for the Build America bonds. It could have an enormous impact on the economy immediately.

Issuers of short-term debt have been most affected by the credit market crisis. Governments purchase letters of credit or secure liquidity in order to achieve lower borrowing costs than would be possible if they offered securities through their own credit. However, they have faced a double whammy as the markets have frozen and most liquidity providers have either ceased to exist over the past 6 months or have stopped providing these services.

Mr. Chairman, the legislation would greatly help this sector of the market. I would also point out there are billions of cash flow borrowing needs this legislation would assist. Issuers across the Nation have told us they are experiencing difficulty obtaining letters of credit that were due in recent months. Key examples are cited in my written testimony.

While the U.S. Conference of Mayors does not have specific policies supporting the regulation of financial advisors to State and local governments and requiring them to register with the SEC, we understand and are supportive of the intent to protect insurers and place financial advisors on the same regulatory playing field as the broker-dealer community.

In summary, Mr. Chairman, the municipal bond market is experiencing severe liquidity shortfall. Many local governments around the Nation have placed many infrastructure projects on hold until market conditions improve. As a result, thousands of short-term and permanent jobs have been placed on hold as well. This situation can change as soon as financing of these projects at reasonable rates can be secured, allowing cities to be full partners in efforts to renew our Nation's infrastructure, revitalize our economy and create jobs.

The U.S. Conference of Mayors expresses its support for your continued efforts to assist State and local governments' municipal bond market. The Nation's mayors stand ready to assist you in any way that we can.

Thank you very much.

[The prepared statement of Mayor Leppert can be found on page 123 of the appendix.]

The CHAIRMAN. And finally, Ben Watkins, who is the director of the State of Florida Division of Bond Finance.

Mr. Watkins?

STATEMENT OF J. BEN WATKINS, DIRECTOR OF THE DIVISION OF BOND FINANCE, STATE OF FLORIDA

Mr. WATKINS. Mr. Chairman, Ranking Member Bachus, my role as the director of the Division of Bond Finance is to be responsible for all of the State's financing programs from general obligation bonds to revenue bonds for small projects. We execute anywhere from 15 to 20 transactions per year, an annual issuance volume of approximately $2.5 billion. We borrow for schools, roads, buying conservation land, State office buildings, universities, dormitories, parking garages, etc.

The most meaningful insight I think I can provide to the committee is to share with you our personal experiences over the course of the last 6 months. The last quarter of 2008, the markets were frozen, and we effectively had no access to credit for any of our debt or any projects to be financed. Since that time, 2009 has been a mixed bag, depending on the type of transaction we were executing.

We have sold five bond issues totaling approximately $1 billion. The transactions that were State general obligation bonds, since we are a large high-grade issuer, were very well received in the market and the market for that type of paper is robust. However, on our lower rated credits, A category and lower, we are experiencing difficulty with market access issues and increased borrowing costs.

The market access is still an issue for smaller, infrequent issuers or lower rated issuers. State and local governments need access to credit, just like businesses do, to continue to operate and to continue to build America's infrastructure. The impact on issuers has been to delay or cancel projects that are needed and increasing cost to borrowing, which increases the cost to taxpayers and users of the facility.

The Municipal Bond Enhancement Act can help by allowing and providing market access to lower rated issuers and the market needs a new source of bond insurance to operate efficiently and effectively. The private markets are simply not providing the capacity for bond insurance that it once did and the demand and the need for bond insurance for smaller, infrequent issuers that make up the bulk of the municipal market is sorely needed. The means or the mechanism can be debated but the need is there.

The most acute problem confronting small and infrequent issuers, which make up the bulk of the municipal market, is the problems associated with the short-term markets. As my colleague Mr. Wilcox from the Federal Reserve has pointed out, there is simply diminished liquidity available in the market to support that market. Each of the products, whether they are variable rate demand bonds, auction rate securities or commercial paper, need liquidity to function. Liquidity is provided by banks in the form of lines of credit, letters of credit, and standby bond purchase agreements. That capacity is simply not available currently. This again increases the cost of the borrowing and creates impediments to issuers financing projects and moving capital projects forward.

The stimulus provided has created a bridge for governmental budgeting issues but there has been nothing done to assist with access to the credit markets and the problems in the credit markets persist. The Municipal Market Liquidity Enhancement Act can play a critical role in addressing the problems in the short-term market and sustaining the very important financing tool available to State and local governments. This can be done either directly through the Federal Reserve or indirectly through the banks that the Federal Government has supported with its investments.

The Municipal Bond Fairness Act and Uniform Ratings are also essential to the proper functioning of the markets. As the taxable and tax-exempt markets become more intertwined, it is imperative that we have a comparable basis for comparing municipal securities with our corporate counterparts. This will serve to expand the buyer base and put pressure, downward pressure on rates and provide issuers greater access to a larger pool of taxable buyers. So we are supportive of that initiative as well.

The problems in the municipal market are real. The problems with market access are real and tangible. The increase in the borrowing costs confronted by local governments at a time when it can be ill-afforded are also causing problems. This delays infrastructure and the much needed capital spending across the nation.

I want to thank you, Mr. Chairman, for raising these issues and, more importantly, proposing solutions to some of the problems confronted by State and local governments.

[The prepared statement of Mr. Watkins can be found on page 174 of the appendix.]

The CHAIRMAN. Thank you, Mr. Watkins. With the generous agreement of the ranking member, I am going to recognize one of our colleagues. We have two members on this committee who were themselves mayors: our colleague, Mr. Cleaver, who was the mayor of Kansas City; and our colleague, Mr. Capuano, who was the mayor of Somerville, Massachusetts. We also have the chief executive of one of the largest county governments in the country, our neighbor from Fairfax County, I recognize with unanimous consent the gentleman from Virginia, Mr. Connolly, for 2 minutes.

Mr. CONNOLLY. I thank the chairman and the ranking member for their generosity. I would hope that this committee would act to intervene to help municipalities in a time of need. I heard the remarks of Mr. Garrett, and I must take enormous exception. The Social Darwinism espoused there would basically throw municipalities and States in the United States into the ditch. It is not because of bloated budgets that municipalities find themselves in the quandary in which they find themselves today. It is because of the housing bubble, it is because of statutes and constitutions that require balanced budgets, it is because “safe money” after September 15th fled to U.S. Treasuries, even though as these charts prove, the default rate among municipals is minuscule, and combined with the double whammy of the loss of private insurance to basically provide credit enhancement. And that situation, while slightly improved, still leaves 55,000 municipal bond issuers in a very difficult situation.

If we do not want to see this economy contract further, we need to help municipalities and States access credit. They create jobs. They help provide an impetus to the economy and without which they will in fact unfortunately require further contraction of the economy, precisely the opposite of the public policy goal we seek.

So I would hope, and I have introduced legislation of course along with the legislation in front of this committee, H.R. 1669, it can make the Federal Government the insurer of last resort to make that credit enhancement possible. It can allow for Federal loan guarantees if that is what is required. It could even create new financial instruments that would market municipal bonds that would be serviced and be the responsibility of municipalities but in the market that would look like U.S. Treasuries.

Mr. Chairman, I know you recognized this in a colloquy you and I had back in January where in fact you referred to municipalities as among the most sympathetic victims of the current economic crisis. I agreed with you then. I agree with you now. It is a privilege to be with you this morning, and I would hope this committee would act.

The CHAIRMAN. The gentleman from Alabama has a unanimous consent request.

Mr. BACHUS. Thank you, Mr. Chairman. I ask unanimous consent to enter the following into the record: A written statement submitted by Mr. Tim McNamar, former Deputy Secretary of Treasury during the Reagan Administration; and a May 9, 2009, Wall Street Journal Op Ed entitled, “Muni Bonds Need Better Oversight,” by former SEC Chairman Arthur Levitt.

Chairman FRANK. Without objection, it is so ordered.

The CHAIRMAN. I want to just begin my questioning by putting some charts up, and I just want to review these briefly.

[charts]

The CHAIRMAN. First, we have a wide variety of things that are called municipal bonds. Full faith and credit general obligation bonds are issued with the full taxing power of the issuing entity behind them. They are in fact as good as Treasuries. There has been, according to Moody’s, one default since 1970 and that was a default in which the bond holders were in fact paid 15 days late. The total loss was one 15-day delay. General obligation bonds are very solid and the reason is, having served in the State legislature, and others who have served in State legislatures would know this, no State could afford to allow any of its entities to default because that would mean such terrible costs going forward. So everybody else is at risk, the teachers and the firefighters and everybody else, because you have to pay those bond holders to protect your capacity.

Secondly, default rates. Now, on triple A bonds, there have been zero municipal defaults, on corporate bonds, .52 percent. That is pretty significant but even more significant are the BAA because I believe that a number of municipal bonds, particularly full faith and credit, are unfairly rated to be double A when they ought to be triple A because they never default. And here corporate bonds at that rating default by 37 times as much as municipal bonds, .13 versus 4.64. The problem is that these are not reflected in the ratings.

If in fact a bond rated BAA were rated triple A, you would save $627,000 per $1 million. When you are talking about hundreds of billions of dollars of bonds issued, you are talking about a very significant cost to taxpayers. Either they pay too much or they go without bridge repairs and fire stations and new schools.

And, finally, here is the list of municipal bond defaults, as I said, general obligation, one. But look at the rest: water and sewer, none; public universities, none; private universities, one; electric power, two; and not-for-profit health care, 10. Of 8,591 bonds rated by Moody's in that 30-year period, 1970 to 2000, there were 5 defaults. That is simply not reflected in the market. Now people say, "Well, the market knows everything." Some people used to say that; I do not think they still do. Market failure is a part of capitalism. That does not mean the market does not work; it means it does not work perfectly.

But I was particularly pleased to see from Mr. Wilcox a mention of some of the problems the bonds now face, the municipal bond market. He said there were strains, and there were three strains: One, the weakened fiscal position of the issuing jurisdictions. I acknowledge that although the record is clear. If it is a full faith and credit general obligation bond, that weakness has not been a problem. Even recently with this terrible problem, we have not seen defaults.

But two of the problems are not the fault of municipalities and cannot be corrected by them. One is the pressures on the providers of liquidity support. Well, those are the banks, that hits everybody. But here is one unique to the municipalities, the weakened condition of the financial guarantors. We have forced municipalities to get into the business of buying insurance from people who were then in trouble themselves, and this is the case where we had somebody who was struggling to swim, and we sent them a lead life preserver and insisted that they wear it, and they have sunk a little. And what we want to do is to cut them loose from that. And these are indisputable facts.

Let me just ask, Mr. Watkins, I was very impressed because you have had this role. You are from the State of Florida, you are appointed by whom?

Mr. WATKINS. Originally appointed by the late Governor Lawton Chiles and served under two Administrations of Governor Bush and have been re-appointed by Governor Crist.

The CHAIRMAN. So you have served in a bipartisan way. Does Governor Crist know you are here?

Mr. WATKINS. Yes, sir, his staff does.

The CHAIRMAN. Okay, and I assume that what you say he would be supportive of?

Mr. WATKINS. I do not speak for the governor, sir. I am here representing the Government Finance Officer's Association, but I am happy to address any particular issue.

The CHAIRMAN. Okay, I appreciate that. I assume if you go back and no one yells at you, we will take it that there is some general agreement on the part of the governor.

[laughter]

The CHAIRMAN. I just want to close by saying people talk about too much staff for the Federal Government. If I had to choose frankly between the war in Iraq, at a cost of hundreds of billions of dollars, and reducing the interest rate cost of trying to build schools, I would go for the latter. And I want to make this point, it is a wholly theoretical risk for the Federal Government if we put the Federal Government's reinsurance—and by the way, one of the things—I am going to close, I will give myself 10 seconds—that the League of Cities is talking about is creating a Cooperative Municipal Insurer. That would be an ideal situation it seems to me because you would have this municipal insurer and then you could have the reinsurance, saving municipalities billions of dollars a year, municipalities and other issuers, for important public purposes at virtually no risk to the Federal Government seems to me a pretty good day's work.

The gentleman from Alabama?

Mr. BACHUS. Thank you. Mr. Wilcox, is the Federal Reserve concerned about taking any direct role in supporting the municipal debt market?

Mr. WILCOX. Yes, sir, we are concerned about taking a direct role.

Mr. BACHUS. What are your concerns? And pull the microphone a little closer.

Mr. WILCOX. Our concerns are several-fold. First of all, we are quite concerned about preserving our political independence and becoming interposed in the credit risk judgment that would be required under some interpretations of the draft language, discriminating between jurisdictions that would receive credit and would not receive credit. We think that the traditional function of the Central Bank has been to steer clear of credit allocation, and we would greatly prefer that functions that are intrinsically fiscal in nature be left to fiscal authorities.

Secondly, as Chairman Bernanke has expressed on a number of different occasions, we have a great need to preserve an exit strategy so that we can control the size of our balance sheet. At some point, the Federal Open Market Committee will make a determination that the Federal funds rate should be lifted from its current very low level. We need to be sure that we can control the level of bank reserves at that time. And in order to do that, we have to be able to either run off the assets that are on our balance sheet or have some other set of tools for controlling our bank reserves.

And, lastly, our balance sheet has to be protected from the risk of losses. And here, a particularly difficult issue in this context is the maturity mismatch between longer dated securities and the term of our lending. So if we were to take these securities onto our balance sheet now, and then be confronted in some future circumstance with a need to run them off, credit losses themselves would not necessarily be the only determinant of whether we as the Federal Reserve would sustain a loss at the point when the Open Market Committee determined that it needed to tighten the stance of monetary policy; it is possible that we would need to sell those securities, and we would have to take whatever price was available in the market at that time. So the maturity mismatch is a very important consideration in our analysis of this situation.

Mr. BACHUS. Thank you. Chief Haines or Ms. Haines. Should I call you Chief Haines? Would you prefer Mrs.? Thank you. In 1997, I helped Commissioner Betty Fine Collins write a letter to the SEC where we set out what we thought was a pay for play scheme. That letter and the materials that we forwarded, to the best of our knowledge, was never acted on. Now, on January 5th of 2007, I met with the SEC staff and followed that up on January 23rd with a letter asking you to investigate some of the investment banks that had dealt with Jefferson County, and there was an indication this month that you are going forward with an action against them. Can you give me any idea of maybe why nothing was done in 1997? Are you familiar with that file, or could you go back and locate it and see what happened? And also 2007, maybe why it took another 2½ years to do anything?

Ms. HAINES. I cannot speak to what happened in 1997, as I only joined the Commission in 1999. I would be happy to go back and try to get more information and get back with you about that.

I cannot, of course, comment on pending enforcement actions. I would only say that there is always a great deal going on at the Commission, which is beneath the surface and cannot be seen by the public—partly to protect those whom we are investigating who may turn out to have done nothing wrong.

Mr. BACHUS. All right, I would be interested in knowing maybe what, if anything, was done in 1997.

Ms. HAINES. I will be happy to go back and get you that information.

Mr. BACHUS. In fact, it was the same materials basically and some others. Let me ask one just final quick question: How quickly could the SEC establish an effective registration and examination program for municipal financial advisors, as the chairman suggested, and I have said that I would be supportive of in some form?

Ms. HAINES. I have not consulted internally about that. I am sure we could do it very promptly. There are really not all that many non-broker-dealer financial advisors. There are approximately 260 and so it should not be a huge undertaking.

Mr. BACHUS. Once you got statutory authority?

Ms. HAINES. Right, of course, we need statutory authority to do anything in that area.

Mr. BACHUS. Thank you.

The CHAIRMAN. The gentleman from North Carolina?

Mr. WATT. Thank you, Mr. Chairman. I am going to reluctantly put on my conservative Republican hat here for a second and explore with you the interplay between the Municipal Bond Insurance Enhancement Act and the Municipal Bond Fairness Act. The latter I am very much supportive of because I think we need to separate the municipal bond market from the corporate bond market and have them rated separately. But there is one thing that is a little troubling to me in your testimony, Mr. Wilcox in particular, it is your testimony about municipalities also issuing securities that combine long-term maturities with floating short-term interest rates that are reset on a weekly, monthly or other periodic basis. That sounds strikingly to me like what we just got through regulating in the private lending market, adjustable rate mortgages. And one of the concerns I have is if we provide a Federal Government backstop for that kind of mortgage as opposed to the 30 year long-term mortgage, that we would be encouraging municipalities into kind of gambling with short-term versus long-term interest rates, which is what we just discouraged individuals from doing. So am I missing something here?

First of all, the insurance and the guarantee part of what has been going on in the market I take it has been responsible for reducing municipal interest rates, I take it, is that correct, Mr. Apgar?

Mr. APGAR. That is my understanding, yes.

Mr. WATT. Okay, and so we would be substituting the Federal Government under this Municipal Bond Insurance Enhancement Act as kind of an insurer instead of the private market?

Mr. APGAR. Correct.

Mr. WATT. Now, should I be concerned about differentiating between a long-term 30-year bond, which has a fixed rate on it, for a long period of time, and these shorter term variable rate securities if I am worried about protecting the taxpayers?

Mr. APGAR. Concerned, yes, but both have a role to play in finance.

Mr. WATT. They have a role to play but should I be providing insurance on the same basis and reinsurance backstop on the same basis for those riskier kind of variable rate mortgages as I would provide on a 30-year fixed-rate mortgage? I guess that is the question I have. Is not that what we just differentiated between in the private market in our predatory lending bill?

Mr. APGAR. I believe that you would want to differentiate the two because the risks are different.

Mr. WATT. So we would then maybe put the same kind of constraints around this that we put in the Safe Harbor provision in the predatory lending bill, would that be a reasonable approach to it?

Mr. APGAR. I am not sure how this relates to that matter. I am not sure what constraints you are talking about.

Mr. WATT. Mr. Wilcox, maybe you can understand where I am getting to here. I think they are very much related, are they not?

Mr. WILCOX. One of the distinctions between an adjustable rate mortgage and an auction rate security, for example, is that the rollover risk in an instrument like the adjustable rate security is more acute. To be sure, an adjustable rate mortgage presents certain financial risks to the homeowner, but the homeowner is not at risk of having the financing withdrawn. With an auction rate security, what we saw is that support for that disappeared and so the rollover risk in that market proved to be more acute. So they share some similarities in terms of their characteristics but there are important differences as well.

Mr. MOORE OF KANSAS. [presiding] The gentleman's time has expired. Mr. Posey of Florida?

Mr. POSEY. Thank you, Mr. Chairman. I wonder if each panelist could give me in as short an explanation as possible why you think we ended up with you in the crisis? We can start with Ms. Haines?

Ms. HAINES. I am not clear on what your question is, could you repeat?

Mr. POSEY. What do you think the nexus of the crisis was that brings your organization into the focus?

Ms. HAINES. The downturn in the markets, of course, had a negative impact on many, many investors. We are concerned about those investors; we are an investor protection agency. That has always been our focus. And we are also concerned that investors get full information at the point that they are going to invest, from their broker and, if it is an initial offering, from the offering documents, so that they can make an informed investment decision. And in the recent economy, we have seen risks that certainly are unusual, and we believe they should be fully disclosed.

Mr. POSEY. The thing that appears relevant is obviously the entire crisis was driven by greed from many different angles around the world, and it appeared everybody wanted to get more and more competitive with the returns that they got. It is a natural phenomenon to do, and so people got reckless. Banks got reckless. Investors got reckless. And because somebody else did it, it almost seemed okay. Like your mother always said, "Well, if everybody else is jumping off the roof, are you going to go jump off the roof too?" Well, we saw a lot of people jumping off the roof. I know with banks we have heard from some of the experts that this is a 1-in-100-year phenomenon, just like a big storm, and usually so many of these misbehaviors are self-correcting. People are aware of the new scams, there is a new awareness to look out for this. It is going to be hard to sell anybody a derivative for any reason, I would suspect, for some time. And I am just wondering if a whole lot of new regulation might be a cure in search of new disease. Maybe if you could just comment on that?

Ms. HAINES. I think that new regulations need to be done very carefully, to the extent we go forward with them, and Congress gives us additional authority. Unintended consequences are something that we at the Commission worry about whenever we look at a regulation and in particular with the financial advisors, many of them are small entities.

Mr. POSEY. Okay, thank you. Mr. Watkins, your comments?

Mr. WATKINS. We come to the table because I borrow money for the State for a living.

Mr. POSEY. Right.

Mr. WATKINS. To finance infrastructure, all of the things that I talked about before. We are the sympathetic victims in all of this crisis. We have done nothing wrong. The State has been managed very well financially over the years. So this causes me two problems: One is that my ability to borrow money to fund infrastructure is impaired; and two is the cost of funding. Our number one mission is to borrow at the lowest possible cost for infrastructure needs for the State. To the extent that that is impacted, that is obviously of concern to us. So that is how we come to this crisis, as an innocent victim in trying to discharge our responsibilities.

Mr. POSEY. Would anyone else like to comment?

Mr. LEPPERT. I would simply like to add to Mr. Watkins. Again, when we are looking at largely the enhancement, I want to stress again two points: Number one, what we are looking at is simply a short term. We are not looking for something 5, 10, or 15 years out. We are only looking at short-term to buoy the markets up because the markets have clearly gone away, as Mr. Watkins has said, for no reason by the cities and the States.

That leads to my second point. The second point is we are talking about capital projects going forward, we are not talking about subsidizing budgets that we handle, we are not talking about operating shortfalls, we are largely talking about financing infrastructure and major projects going forward. And I think that is what needs to be kept in mind in terms of the policy decisions that we are looking forward. It is one short term, and again it is not talking about operating budgets, it is talking about capital projects to move forward because we simply do not have a market or we do not have viable options that we used to have on the enhancement side, monolines, insurers, etc.

Mr. POSEY. That is the same basic problems that all the small businesses have out there, the funds are just not available, and I do not think it is going to happen no matter what the government does unless and until they come up with a plan and say this is what you can expect us to do, here is how you can measure the progress back. I think people are going to sit on their money and not spend a dime until they have some degree of certainty that there is going to be a recovery. Everyone is expecting the worst now and so far we have just seen the Federal Government throw up some "Hail Mary's" and hope that they catch them in the end zone and score some points and turn the economy around but it does not seem to be working very well.

Mr. LEPPERT. I would say anecdotally, and I think we can come up with specific examples, on the municipal bond side, there is a different situation. There are projects that would be ready to move forward if there were enhancements. If you look at a lot of medium pieces of the market, rated A, those sorts of thing, if there was an enhancement available, which today is not, the six players that used to be simply are not around any more, if there was an enhancement, you would have those projects go forward and those are a whole array of projects literally across the country.

Mr. POSEY. This is the same problem.

The CHAIRMAN. I thank the gentleman.

Mr. POSEY. I thank the chairman.

The CHAIRMAN. The gentleman from Kansas?

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. Mr. Apgar, hospitals in the State of Kansas have felt the impact of the financial crisis, not just in their day-to-day operations but in the borrowing costs.

Hospitals want to deliver the highest quality care at the lowest possible costs, but they have been thwarted in recent months in their attempts to keep financing costs low by conditions in the financial markets. One idea would be to allow hospitals to rely on some Federal support of their existing obligations so they could be refinanced to lower interest rates. From what I understand, such backing is currently authorized under the HUD 242 Hospital Mortgage Insurance Program. But HUD has never issued regulations implementing that authority. Mr. Apgar, would this be something HUD could explore to provide low-cost financing for hospitals or do you have any other thoughts on providing low-cost financing for hospitals, sir?

Mr. APGAR. Hospitals are an important part of our mission and that particular 242 program is something we're reviewing now to see how we can respond to questions like you asked.

Mr. MOORE OF KANSAS. Any idea how long that review might take, how long it's going to take?

Mr. APGAR. I don't have a timeline on it, but I do know that as we gear up with the new team, that is high on our list of priorities.

Mr. MOORE OF KANSAS. Very good. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The gentleman from Florida, Mr. Putnam.

Mr. PUTNAM. Thank you, Mr. Chairman. Mr. Leppert, you made the point to Mr. Posey that any of these enhancements should be temporary. Could you define that for us, driven by market conditions?

Mr. LEPPERT. I think it is driven by market conditions and the hope is, and I think it's the hope of all of us, that we're going to see a normalcy of market. But the reality of it is, we're not there today. We have lost the insurers, the enhancers, they have gone away, so there's going to have to be some type of support mechanism, at least for a period of time. Now again, I want to stress again, from the City's standpoint, we're not looking for some long-term program and we're not looking for any type of a bailout of operating budgets. We're fundamentally talking capital budgets and we're talking a period of time to give some normalcy to this so that the private side can come back in, and I think over time, it will. I can't give you an answer when it will, but I think over time it will come in. But until that point of time, as I said in my testimony, there are hundreds of billions of dollars worth of projects out there that are important to re-energize the infrastructure of this country, as well as create jobs.

Mr. PUTNAM. But given the uncertain state of State and local budgets, given the uncertain state of the Federal budget, but you look at what's going on in California, look at what Florida legislatures just struggled with, isn't this just, you know, the increased rates? Is that not just market discipline? In other words, you refer to normalcy. What is the new normal, given these circumstances we're operating under?

Mr. LEPPERT. Well, I think normal, coming back to some historical sense of the spreads between municipals/corporates, municipals/Treasuries, those sorts of things. I mean, clearly, to look at those spreads, those are so far out of historically what we have seen that it clearly puts cities and State governments in a precarious position for financing going forward. And as I said, it's holding up projects that we believe are very important.

Mr. PUTNAM. Mr. Watkins, can you describe for us, share some of your experiences in terms of walking back to last summer when the bottom fell out of the market and any impact that Federal response has had on liquidity and pricing and where you find yourself today as a result.

Mr. WATKINS. I think that there have been tangible benefits to the market in general. In terms of restoring confidence to the market and you see it with respect to the interest rates for large frequent issuers with very simple credit structures. That market is functioning reasonably well now, so our ability to issue State general obligation bonds at favorable rates is good. But, then you look at the vast majority of issuers across the Nation, which are smaller, infrequent issuers. There are cities, counties, and school districts across the Nation that have need to access capital for infrastructure. And when you fall into the A category, you fall off a cliff. And I'm talking to the tune of 100 basis points, or 1 percent. Now, that may not sound like a lot, but when you do the bond math, and extrapolate the cost of that 1 percent to borrowed money over 30 years, the cost to a local government is significant. And it's an embedded cost that's there for the next 30 years. It's there incrementally, but when you look at the cost, the aggregate cost of that borrowing, it is significant. And it's occurring at a time when budgets are already under pressure. And that's the segment of the market that needs the temporary assistance to gain access to markets and normalize the interest rates and the cost of funding capital projects.

Mr. PUTNAM. Mr. Leppert, did you want to add anything to that?

Mr. LEPPERT. I think that says it all. The only thing I would add to that is, keep in mind that it may not just be large and small players at the State and local level. It very well could be a large player, but the project itself is rated an A category, so you will fall into that. So, don't assume it's just big versus small. It could be a larger player at the State or at the local level that has a project that falls into the A.

Mr. PUTNAM. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. We now have the first of our two mayors and I now recognize the former Mayor of Summerville, Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman. Mr. Mayor, have you been through a bond rating review for your City?

Mr. LEPPERT. I personally have not.

Mr. CAPUANO. Okay. I have, and it wasn't much fun. When you do it, have you dealt with any of the bond rating people, at all, that have come to your City on an individual issue?

Mr. LEPPERT. I have. Both on the municipal and on the corporate side, yes.

Mr. CAPUANO. Okay. Did you feel as though he had any ability to change whatever it is they came in with, a preconceived notion? Or did you feel like you had to be nice to somebody that you knew was going to stick it to you, anyway?

Mr. LEPPERT. In both cases, we tried to make the arguments as well as we could.

Mr. CAPUANO. Ha ha ha ha ha. Yes. Sure. And did they listen?

Mr. LEPPERT. I would say, in a number of cases, yes, they did listen. Perhaps we could influence in other cases. It may very have been as you said where the decision was made before people walked in the room.

Mr. CAPUANO. Now, before you were mayor, what did you do, Mr. Mayor?

Mr. LEPPERT. I was a corporate executive. I ran some relatively large companies across the Nation.

Mr. CAPUANO. Okay. So, do you, now you have done both sides. Do you think it's fair, reasonable, thoughtful, either in a business sense, an equitable sense, any way in particular that for some reason, corporate bonds should be viewed differently than municipal bonds? Or do you think it should just all be based on, you know, the ability to repay those bonds?

Mr. LEPPERT. As it was indicated in my testimony, I think it ought to be driven by hard economics. And I think, as was pointed out to an extent in the testimony, to an extent in the charts that you see to the right, that's a difficult conclusion to come to under today's scenario. Now, I would also tell you that before we saw this, what happened in the credit markets, there were moves of some agencies towards this, of combining and doing that. So, again, this isn't pushed into unknown territory. There were agencies that were moving to this earlier.

Mr. CAPUANO. Right. Moving towards them is all well and good, but Dallas is a relatively sizable community with some leverage, but I'm sure that you have lots of smaller communities that surround Dallas that don't have the leverage that you do, that would maybe feel a little bit more strongly about their inability really negotiate.

Mr. LEPPERT. And I would tell you, I'm representing cities across this Nation, small to large.

Mr. CAPUANO. I know. Right. And I heard earlier, I guess apparently, every city and town is just throwing money away? That there's no reason you would absolutely need on the one chart of only $25,000. But I don't know anybody who's out for a million dollar GO, anyway. People go out for GOs, it's usually, I don't care what size the city is, if it's 10 million or much more than that, I'm sure that Dallas would just not care about an additional $250,000 or so that you could use to either hire cops or give taxpayers a break, or anything else. I'm sure you don't need that, is that a proper—?

Mr. LEPPERT. If this answers your question, I would tell you, I think we do a very good job fiscally, of managing our portfolios across-the-board.

Mr. CAPUANO. And I would imagine that if you were to just ignore $250,000 sitting on the table, the people of Dallas probably wouldn't notice that. Do you think that's a fair statement?

Mr. LEPPERT. I can tell you, being a mayor, especially coming from the private side, people notice everything and they usually do it at the grocery store.

Mr. CAPUANO. Exactly right. Exactly right. The Mayor has hit it directly on the street level. People see what you do. If you had the audacity or any of my mayors, any of your mayors had the audacity to leave that kind of money sitting on the table, if you had something to do about it, first of all, I think people would know about it, second of all, I think they would fire you as quickly as possible. And they wouldn't be too nice about it. So, anybody who thinks that this money is just sitting there, you know, that we don't want it, but we enjoy overpaying interest rates with taxpayers' dollars, I take that as a little bit of a personal offense as a former Mayor. You don't have to say that, because you're much nicer than I am. I do. And I would tell you to tell your colleagues at home that at least I'm sitting here defending their honor because I don't mind disagreements, my understanding, we may come from different philosophical views on certain things. But when it comes to money, nobody that I know in a local government wants to waste it. We may have different views as to what to do with it, but we want to be able to use it to the benefit of our taxpayers and our constituents to the best of our ability. And I would imagine that is something that is shared by the Conference.

Mr. LEPPERT. Absolutely. And again, I would argue, at the local level, it's the most transparent of all elements of government. That's also why I was trying to stress that what we are talking about, the U.S. Conference of Mayors, is not dealing with trying to fill past budget shortfalls, we're not trying to fill operating gaps, what we're largely talking about is the availability of credit markets for capitol projects going forward.

Mr. CAPUANO. Right. And Mr. Mayor, I'm going to close because I think, obviously, this legislation is going to move forward and I think the time is right to treat cities and towns and States and county governments the same as all corporations. The same as everybody else. That's all. Not extra, just fair. At the same time, I would ask that the next time that the Conference sends somebody, I want to see somebody who has been through a rating review. That's what I want to see. I want to see somebody who has had the lovely privilege of having to spend days on end, spending tens of thousands of dollars of taxpayers' money, to convince somebody to do something that they're not going to do anyway and they're going to base it on their own judgment from 2,000 miles away. And actually, when you go through it, let me know. Because I'm sure you'll have a fun time with it.

Mr. LEPPERT. As I said, for 30 years, I spent time working on the financial side, so I understand exactly where you're coming from, and I have a real sensitivity on the public side to it. I would add, and I would like to stress this point, that if this legislation moves forward, and it talks about a Fiscal Year of 2011 or beyond, even 2010, that doesn't address the situation.

Mr. CAPUANO. I agree.

Mr. LEPPERT. The situation needs to be addressed today. If we're going to make an impact on the economy, it has to be literally trying to put the enhancement, the liquidity, the sorts of things we're talking about today, put those in place today. Down the line, I hope the economy comes back, some of the issues that we have talked about settle down. If we're going to make an impact, it has to be now, it has to be today.

The CHAIRMAN. If the gentleman would yield, that's why there's a package of bills. Because there are bills that address the regulatory side, the immediate and then going forward. And the other thing, I would be particularly interested if the Conference next time sends someone, because I would be very interested to meet him, who is not nicer than Mr. Capuano. We would be looking forward to that. He would make a heck of a witness.

Mr. CAPUANO. Mr. Chairman, I believe he's already sitting in the Chair.

The CHAIRMAN. Yes, but I'm not the witness. The gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman. The question for Ms. Haines and frankly, anyone is, Ms. Haines, you talked about the inequities between the rating agencies' view of municipal debt and actual defaults versus corporate. The disclosures are not equal, as well. Would you support equal disclosures for an equal rating?

Ms. HAINES. Our Chairman has on record as stating her belief that investors in municipal securities deserve the same strong investor protections that are enjoyed by investors in other markets. The lack of regulation of municipal securities and municipal offerings is currently a gap in the investor protection scheme of the Federal Securities Laws and we believe Congress should review this.

Mr. CAMPBELL. So, is that a kind of a yes?

Ms. HAINES. Pretty close.

Mr. CAMPBELL. Okay. Does anyone else have a differing view on this panel?

Mr. WATKINS. I would take exception with that in the sense that in looking at the regulatory burdens that would be imposed on issuers, that the burdens of those regulations, and compliance with those regulations would far outweigh the benefits that investors derive from that. And the reason that I say that is, we operate in the sunshine. Everything that we do is openly disclosed and available to investors all the time.

Mr. CAMPBELL. Okay. Does anyone in this room follow the irony of a government talking about the cost and burden of regulation not being worth the benefit? That's just a side comment, but since what governments do is regulate private industry, and private industry feels that, and now here is at least one government saying, "Regulation can be burdensome and costly and not worth the benefit." But anyway, if it's burdensome, costly, and not worth the benefit for municipal governments, I don't know why it is not equally burdensome and costly. You can argue whether it's worth the benefits on a private issuer. Mr. Wilcox, let me ask you, if I may, about one of my concerns. We talk a lot these days about moral hazard. And if the Federal Government were to, through this insurance mechanism in one of these bills, basically backstop all, potentially all, State and municipal debt, isn't there a moral hazard? My State, California, has gotten itself into a big problem. Shouldn't the State, if you will, bear some consequence for that and not have the Federal Government come in and shield the State from any of the negative consequences of an irresponsible budget?

Mr. WILCOX. I think that's intrinsically a fiscal consideration. The Congress would have to make that decision as to how to balance the considerations. They are important considerations that you raise in your question but I think those really lie outside the purview of the Federal Reserve.

Mr. CAMPBELL. It is a legitimate concern, though, is it not?

Mr. WILCOX. Yes. Yes, sir. I am not suggesting they are not legitimate concerns; I just don't think the Federal Reserve has any nexus with those.

Mr. CAMPBELL. How about something more specific to the Federal Reserve. What is the Federal Reserve's view on being asked, or to actually buy some municipal securities out there in order to prevent auction failures.

Mr. WILCOX. Well, as I mentioned in my written statement, I have, and the Federal Reserve has a number of concerns about those. We are glad to see in the draft language that was distributed last night the insertion of the language for unusual and exigent circumstances. We think it has been very important that the usual conditions for emergency functions of the Federal Reserve have been imposed. A very high bar has been set on our intervention in these markets and we think that's appropriate.

We are also, as I highlighted earlier, quite concerned about the potential political implications for us being interposed in these decisions. We are very focused on having an exit strategy, being sure that we can control the size of our balance sheet so that the Open Market Committee can be assured of being able to carry out its congressional mandate for—

Mr. CAMPBELL. Let me, so my time doesn't completely run out, just ask one last question. You mention that the municipal securities market is functioning fairly well. Can't most municipalities, if they price it right, and States, sell their, the auction rate security, there's an argument that never should have been there, but anyway, can't they sell in today's market?

Mr. WILCOX. I think as you have heard reflected today in the testimony that it's a mixed bag. It's a patchwork quilt, that some of the larger issuers, the better rated issuers, are able to issue securities and, indeed, the issuance over the 4 months of this year has been comparable to the issuance over similar periods before the onset of the financial crisis. For other issuers, lower rated, smaller issuers, circumstances are quite difficult.

Mr. CAMPBELL. Thank you.

The CHAIRMAN. Before I yield to the gentleman, I'm going to take 30 seconds, Mr. Wilcox, just to say, you said that under Section 13-3 powers of threat, it sets a high bar and as an exit strategy, the largest single expenditure under that was to AIG. And I must tell you that as I look at the AIG issue, without commenting on whether it was right or wrong, that's an odd definition of both the high bar and a good exit strategy. I would think most cities, frankly, would have an easy time in States meeting that AIG standard. The gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. And I thank all of the witnesses for appearing. Ms. Haines, I would like to ask you a question, if I may. In your testimony, you indicate that there are some activities that are of concern to you. And you talk about the pay to play practice. Would you please give me just a brief explanation by way of example of what pay to play is?

Ms. HAINES. Pay to play is a phrase that is used in the municipal industry a fair amount to refer to persons who make political contributions to issuer officials in order to obtain business from that issuer.

Mr. GREEN. And is this a lawful practice currently or is it unlawful currently?

Mr. HAINES. It is lawful currently. There is a restriction on broker/dealers under a municipal securities rulemaking Board rule, G–37. Political contributions, as free speech, are not prohibited under any circumstances. However if a broker/dealer makes a contribution to an issuer official, then that broker-dealer is prohibited from doing business with that issuer for a 2-year period.

Mr. GREEN. Have you had an opportunity to peruse the various instruments that we are proposing in terms of enactments of law? And I ask because I'm curious as to whether any of these would address the pay to play circumstance that you find to be invidious.

Ms. HAINES. We believe that the bill, with respect to municipal financial advisors, would give the Commission the authority to address pay to play practices.

Mr. GREEN. And would it give you the authority to address this in a punitive, penal fashion? Or would this be by way of civil remedy?

Ms. HAINES. By way of civil remedy. The Commission does not have any criminal authority.

Mr. GREEN. Do you find, have you had circumstances, and I believe from your testimony you have indicated that you have, but have you had circumstances, for the record, wherein there were situations that you wanted to pursue and prosecute civilly, but you were unable to do so because of a lack of legislation?

Ms. HAINES. Yes, there have been. In particular, the lack of a clear, consistent standard of care. The lack of the fiduciary obligation included in the legislation that a financial advisor owes to its client has been one of the stumbling blocks, when we have tried in the past to take anti-fraud enforcement actions involving financial advisors. Additional authority to regulate them would simplify any enforcement activities, of course, because it is much easier to bring a case against someone for breaking a rule than to undertake a full anti-fraud investigation.

Mr. GREEN. Mr. Chairman, I thank you, and I yield back the balance of my time. Thank you, Ms. Haines.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling. I know, by the way, Mayor, I know you have to leave at 10:30. We'll do Mr. Hensarling, we'll do our former Mayor, and then we'll excuse you. The rest of the panel, I know, can stay and we'll finish up. Mr. Hensarling.

Mr. HENSARLING. Mr. Chairman, let me offer my apology to the panel members. I have been straddling two hearings, this one and budget, so I missed the test. And we may be covering some old ground here. And I offer my apology for that.

I'm sure there has been a healthy discussion of the role of our credit rating agencies. But in your own experience, has there been an over-reliance upon the rating agencies? And as currently structured, has there been an incentive to do less due diligence, simply because of the, for lack of a better term, oligopoly that has been set up with the nationally statistical recognized NRSROs?

Whomever cares to comment?

[no response]

Mr. HENSARLING. Well, seeing no takers, the gentleman from Missouri had his chance last evening.

As I look at the Federal Government's track record with reinsurance programs, or insurance programs, again in my opening statement, I talked about the PBGC having an historic deficit. The Federal Flood Insurance Program was never supposed to need a taxpayer infusion. We know what is happening with Social Security.

For those of us who care passionately about the level of debt that is being placed upon future generations, for those who represent constituencies who may benefit from this program, given the history of the Federal Government, why should we feel convinced that ultimately the Federal taxpayer is not going to have bear even a greater burden than he and she already are?

Mr. WATKINS. I would submit to you the historical level of repayment of municipal securities in general is a very safe investment in protection of the Federal Government dollars investing and supporting local governments in this fashion.

I think the risk of nonpayment is overstated. And if you look at history and the level of defaults of municipal securities, it's virtually nonexistent. And relative to the other investments the Federal Government has made, I think this would be a wise and prudent use of resources available.

Mr. HENSARLING. I guess I would have two reactions to that, Mr. Watkins. One, if they're that safe, why are you here requesting the assistance in the first place? And two, I'm not going to push back on what you said, but I must admit it feels a little bit for some of us like deja-vu all over again, when we had representatives of Fannie Mae and Freddie Mac coming before us for years and years and years, telling us how terribly safe their investment portfolios were. And we all know how that story ended.

So I don't doubt what you say. I don't doubt that you believe it. But again, some of us are a little uncomfortable, and it feels a little bit like we have been down this road before.

And so again, those of you representing constituencies who might benefit from this program, at least for some of us, have a burden of persuasion that we're not going down Fannie and Freddie Lane once again.

As I understand it—and I haven't read carefully the four or five pieces of legislation that are being bundled together for the purposes of this hearing—but theoretically I believe these are going to be temporary programs.

Now temporary programs in Washington are fairly rare animals. You can certainly look at the TRIA Program as a data point. But if it is indeed a temporary program, in your opinion, how long should the program exist? What should be its length? What should be its duration? And why?

Anybody who cares to comment on that.

Ms. HAINES. I can't speak to the other bills; but the bill to regulate municipal financial advisors we think should be permanent.

Mr. HENSARLING. Any other comments?

Mr. LEPPERT. I would say on liquidity enhancement, again we think that should be a short-term bill. I don't have a perfect number for you but clearly it should be well under 5 years, and probably in the area of only a couple of years.

Mr. HENSARLING. I see I'm out of time, but Mr. Mayor, I want to thank you for taking care of the graffiti near my home, but there's a certain pothole I need to talk to you about.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from Missouri. It looks like we're going to have some votes, but we can get in a couple more questions.

Mr. CLEAVER. Thank you, Mr. Mayor, for being here.

I served as mayor during the 1990's, and we did not have at that time this derivative now called "swaption," which was designed especially to rip off cities.

And when you look at the swaption and the fact that, well it was supposed to have been a way of protecting municipalities, States, and cities from interest increases; but it turned out to be a loser in the long run, just like it has in the stock market.

And this bill will call for the Office of Finance within the Treasury Department to overlook this area. Do you believe that we have had adequate oversight in the past of municipal bonds?

If you look, most cities are going to have a triple-A rating or close to it, because in Texas where I was born and raised, like Missouri, where I live now, there is a State law that says your budget must be balanced. So there is virtually no way that you can have anything but a triple-A bond rating.

Today, Bear Stearns may be able to get a better interest rate than Dallas. And they collapsed. I am hoping that you would also agree that this bill is absolutely necessary, and that you would support the public finance within the Treasury Department of that office being established.

Mr. LEPPERT. Again I think, representing the U.S. Conference of Mayors, we clearly answer to the affirmative of that.

I would point out, as you said, though, that even though you may have entities, cities and States that have the highest rating, they may need to go out for individual projects and those projects without enhancement would be down in the A category or more, as I said earlier, in kind of the medium range of the market.

That's where the enhancement becomes so important. So even though you may be talking about a triple-A—you may have an individual project that needs enhancement.

Mr. CLEAVER. Right.

Mr. LEPPERT. And enhancement—

Mr. CLEAVER. Right. Thank you, Mr. Mayor, I appreciate you being here.

Mr. LEPPERT. Thank you, sir.

Mr. CLEAVER. Ms. Haines, are you familiar with the swaptions?

Ms. HAINES. Somewhat.

Mr. CLEAVER. How could that happen?

Ms. HAINES. That's an excellent question. I'm a lawyer rather than on the finance side of the equation.

Mr. CLEAVER. Okay.

Ms. HAINES. So I can't tell you—

Mr. CLEAVER. You can't tell me why nobody was put in jail for—

Ms. HAINES. In any kind of detail, other than when the rest of the economy and the markets went out of whack, so did they.

Mr. CLEAVER. Well, let me—you cannot in the United States of America buy a car with a one-in-five chance of exploding. Our consumer protection laws will not allow that. You can't buy it.

You know, there is no way you can go to a dealership, go into the showroom, and cars are out there with a sign on them, "One-in-Five Chances for this Car to Explode." Do you agree?

Ms. HAINES. I hope so.

Mr. CLEAVER. How can a product with those same odds be sold to a municipality, a one-in-five chance of blowing up the city's finances, without anybody noticing?

Ms. HAINES. The Commission is specifically prohibited from regulating any kind of derivative. And we only have anti-fraud authority over securities-based derivatives. So we have been unable to have any impact in that field.

Mr. CLEAVER. Who does?

Ms. HAINES. I don't know.

The CHAIRMAN. Nobody as of now.

Mr. CLEAVER. That is the point I am making. Cities are being hurt, and we have no agency, I mean, or no super-regulator or mini-regulator or anybody doing anything. And it is hurting municipalities, which means it hurts the Nation.

I think has to be corrected. Hopefully this legislation will begin to address those issues.

Mr. Mayor, I give you the remainder of my time, if you have any comments before you leave.

Mr. LEPPERT. Yes. We just appreciate the opportunity again, speaking on behalf of the U.S. Conference of Mayors, for the chairman and the committee to address this issue. We think it's an important one.

And again, as I want to stress again, it is not a long-term issue. It is a decision and an issue that has to be addressed today. That's where the impact will be made.

Mr. CLEAVER. Thank you for being here.

The CHAIRMAN. Let me say, Mr. Leppert, you are excused.

We are going to have some votes. I'm going to call on Mr. Manzullo and then Mr. Foster. We are going to dismiss this panel. We will start with the second panel, and we will begin the questioning.

The gentleman from Colorado has a quick question. But let me start with Mr. Manzullo.

Mr. MANZULLO. I read in the paper yesterday where a municipality in Indiana is no longer going to buy Treasury bonds as investments, because they consider the government to be a poor choice for investments, because this municipality also had bonds at Chrysler. And the government screwed them royally on those bonds.

And Mr. Mayor, my question to you is: If the government can come along and do that to municipalities, I mean, don't you think that's wrong what they did to this municipality, in discounting those bonds?

Mr. LEPPERT. I am afraid I am not familiar with that instance. If I knew the details, I would be happy to answer, but without knowing the details of it, I would feel uncomfortable.

Mr. MANZULLO. But this is a warning across the bow. If municipalities say it is no longer reliable to invest in U.S. securities, because of the way the Federal Government treats bondholders by taking over companies, firing their executives, that is pretty scary. Wouldn't you agree, Mr. Mayor?

Mr. LEPPERT. Well, I will tell you that in every capital market, the underlying strength of that capital market is a belief that treasuries are a zero risk.

Mr. MANZULLO. All right. Well, that—

Mr. LEPPERT. And that drives everything—corporate, everything else—

Mr. MANZULLO. Well, they probably thought the same on triple-A bonds that they had with GM and Chrysler at the same time. But I'm just saying that perhaps that is going to cause some rethinking on the part—

I think that the Treasury needs to understand that a lot of municipalities not only lost money in pension funds by investments into the regular market, but they have also money as a result of buying those triple-A bonds. And they have been hurt that way also.

The Federal Government better think again before it goes in there and devaluates bonds and prefers people in subordinate positions to bond-holders.

Just a comment.

And thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Illinois. And we will get to the gentleman from Colorado. The first votes are the chairman vote—and I am going to stick around—but I am going to dismiss the panel.

The gentleman from Missouri will temporarily preside. Mr. Mayor, you are excused. You said you had a plane to catch?

Mr. LEPPERT. Thank you, sir.

Mr. FOSTER. Right, very well—

The CHAIRMAN. The gentleman from Illinois, the gentleman from Colorado, and the gentleman from New Jersey.

Mr. FOSTER. Right. Okay, my question is a quick one. Now I am a scientist, and I find this business of having assigning these ratings, which are essentially names for numbers, just absolutely bizarre. In science, we do name numbers. We have Pi and E and so on. But when we talk about Pi, it's one number. And we're not in a situation like BAA can mean something in one context, and then an entirely different range of numbers in another context.

And I was wondering, my specific question is: Is there a meaning when you say "BAA?" Do those three digits, each position, have any specific meaning? Is there any logic to the specific names?

Can anyone answer that?

Ms. HAINES. Each rating agency is required to establish its own criteria, which are made public, for each of its ratings.

Mr. FOSTER. Okay. So are you aware of any specific meaning for the first, second, and third digit in BAA, for example?

Ms. HAINES. I would have to go look it up.

Mr. FOSTER. Okay. So at least it's not a well-known understanding?

Ms. HAINES. Right. Not that I am aware of—

Mr. FOSTER. And so have been there been proposals at any point to simply report the number? To say that look it, the probability is 10 to the minus 3, and 10 to the minus 4 of default, and just report the number? Instead of giving it an elaborate name that sort of, to my mind, makes the thing a lot more opaque?

Have there been suggestions ever, to your knowledge, of just reporting the number as a number, for the default probability?

Ms. HAINES. I am not familiar with any suggestions like that.

Mr. FOSTER. Okay.

Ms. HAINES. But as I said, I am a lawyer, not a finance person.

Mr. FOSTER. Okay. Thank you.

I yield back.

Mr. CLEAVER. The gentleman from New Jersey.

Mr. GARRETT. You know, I'm going to, since I just came in, I'm going to yield, and then come back to me.

Mr. CLEAVER. The gentleman from Colorado has shamed the gentleman from New Jersey.

[laughter]

Mr. CLEAVER. So we recognize the gentleman from Colorado.

Mr. PERLMUTTER. I thank my friend from New Jersey. Mr. Wilcox, I have questions for you. I want to talk about exigent and unusual circumstances. And the chairman was a little kinder than I plan to be.

Here we have municipalities who are under siege, and the work that they have to do will be investments for many years into the future, irrespective of what my friends on the other side of the aisle have to say.

Yet using exigent and unusual circumstances, you plunk $30 billion behind Bear Stearns on about 24-hour notice; you support AIG, and who knows how many other billions of dollars have been put into place? Yet, you don't support Lehman Brothers, which goes bankrupt, which affected a number of municipalities in the Denver metropolitan area and in Colorado.

So explain to me again why supporting Bear Stearns and AIG is something that the Federal Reserve can do under exigent and unusual circumstances, but not supporting municipal bonds that were affected by the Lehman Brothers bankruptcy, where the Federal Reserve chose not to underwrite that collapse?

Mr. WILCOX. The Bear Stearns and Lehman Brothers situations came up before the TARP was enacted. And as Chairman Bernanke has said many times, he is very grateful for the authority that was provided to the Treasury Department under the TARP, and very glad to be out of the business of stepping into those situations or being confronted with the need to contemplate stepping in under those situations.

Look, my purpose here today is not for one second to question the difficult circumstances that State and local governments are operating in. We are in the midst of a financial crisis of historic proportions. We're now well into a recession that is on track for being the deepest recession in the post-war period.

My remarks are essentially framed around the following idea. We have a nail and there are two questions that that raises.

The first is: Does the nail need hitting? That's an issue to be resolved by the Congress.

The second is: Is the Federal Reserve the best hammer for hitting that nail? Our view is that we have significant misgivings. While we do not prejudge the Congress' answer to whether that nail should be hit, we have significant misgivings about using the Federal Reserve as the hammer for hitting that nail.

Mr. PERLMUTTER. And I would too, except that it's hard to pick and choose here. And in the instance that I'm speaking about—and first of all, I'm supportive of TARP money being used to assist municipalities in rebuilding their infrastructure and moving forward.

I mean, I don't think there's any question about that. And that was put in the TARP II legislation that we passed to the Senate, that's still sitting over there.

But for me, it's more of a question of on September 15th, you, meaning the Federal Reserve, chose not to support Lehman Brothers. My State had a pooled investment group that had paper in Lehman Brothers. There was then a run on Lehman Brothers paper, causing the primary fund to break the buck. And we're still trying to collect on that.

And so I don't mean to be mixing apples and oranges, but I'm seeing you come in some spots, but not in others. And I don't understand the rationale behind that.

Mr. WILCOX. Again, the historical context and the other authorities that are available are critical to understanding the difference in situation. The availability of the TARP authority now at this point would mean that we would be out of the business of intervening in that kind of situation.

Mr. PERLMUTTER. So you think the TARP now alleviates the Federal Reserve from coming in, using the exigent and unusual circumstances? At least as it applies to municipalities?

Mr. WILCOX. I can't prejudge the Board's decision on a particular fact set. What I can say is that the availability of the TARP would present the Board with a very different and importantly different circumstance, if confronted with some of those earlier situations.

The critical issue from the Board's perspective in making that determination about unusual and exigent circumstances, is whether a particular market presents significant risk to financial stability. That is what they are focused on.

Mr. PERLMUTTER. All right. I thank my friend from New Jersey for yielding to me, and I yield back.

The CHAIRMAN. The gentleman from New Jersey will ask his questions. We will then dismiss the panel. We will reconvene, and continue with the second panel. I apologize, but we don't have any control over it.

The gentleman from New Jersey.

Mr. GARRETT. I thank the chairman, and I will be brief.

Just a little bit on the last discussion with regard to Lehman's, and I know we have been through this around and around on that.

One of the arguments is this, that you can say whether the government let them fail or whether the market let them fail. The argument in one sense is that the market let them fail, because in a sense it's the market players who are going to decide whether or not that they are going to actually engage in transactions with Lehman. So I think you can make that case.

A step back from that, of course, though, is: Why did they make some of those decisions that they did? And why did Lehman make some of the decisions that they made?

That can be attributed to what the government did previously, back to the signals that they were sending, back with Bear Stearns, that we would get involved in that situation, long-term capital before that, although it's slightly different with the New York Fed and the like.

Government set up certain expectations, and then when they weren't followed through on, then the market responded, you might say, in reliance upon that. And that's why Lehman failed.

My question is, I guess it may be the same, or along the lines of the comments of Mr. Hensarling from Texas.

This is just one question. We just came from a budget hearing, and in that we heard about the stimulus and the effects of it on the economy or the lack thereof. And I know here we're talking about what the connection is you are talking about and what's happening out in the State of California and the problems and across the country as well with regard to the municipal market and so on.

And the point that was made over in Budget is this: That we had the Administration come out with a stimulus plan, making certain projections as to where we were going to be if we took action, and spent actually $787 billion on the stimulus, as far as unemployment rates—and I had certain charts—I don't have them up here—and where we would be if we didn't do anything, the line of course being higher.

Well now we are in the month of May, and the charts that I had over in Budget show that in actuality, we are at higher unemployment rates at 8.5 percent in March and 8.9 percent in April, so the rate of job loss is considerably worse than what the President and the Administration projected, with or without the stimulus.

In other words, even though we did the stimulus, and they said that would be an improvement, actually things turned out worse, despite doing that.

The CBO Director made the comment that, well stimulus may take a little time to get moving out in 2009. You may see some of the effect in 2010. But then the rejoinder to that, of course, was that most of the money won't come out until 2010.

So here's my question to you. Congress has already taken decisive, bold action, the other side of the aisle would argue, with regard to trying to get the economy going, trying to help municipalities, trying to help States, through the stimulus. Is it your opinion that the stimulus, as statistics showed in Budget, was of no effect and actually did more harm than good? Or is it that it was good, and that maybe we should—before we take any of the action that is suggested here by the chairman on the short term on some of these expenditure items—maybe we should just wait a little while and give the stimulus a little bit more time to take effect.

So which is it? It didn't really work, or we need to give it a little bit more time?

Mr. WATKINS. I can comment on how critical the stimulus money was in balancing the State's budget, when the legislation just completed their work 2 weeks ago and tell you that it was absolutely critical. And the support for both credit enhancement as well as the liquidity support is to address a different problem, and that problem is with respect to being able to borrow money to fund infrastructure projects. So I would say that is a problem that has yet to be addressed.

Mr. GARRETT. But remember, that was part and parcel of the package that the Administration sold on the stimulus package. The stimulus was not just to say that we were going to put in ground in the shovel projects, which as you know turned out to be only 3 or 4 percent of the overall package. It has a much broader goal in mind, one of which was the overall economic picture at the time: The tight credit market, the liquidity issues, as well.

So it was supposed to be doing a number of those things. I only hit on the one point here with the unemployment numbers. The other numbers, the CBO would say, you actually have seen a loosening of that.

So is it that maybe they did some good for your town, or what have you; but maybe what we need to do is just give it a little bit more time, so we don't have to take this action now, and put this action aside a little bit, until we see whether it kicks in, as CBO indicates it may kick in next year?

Mr. WATKINS. So our view is that the stimulus package is in combination with the other policy actions, having an important affect now, along with some of the financial rescue steps that have been taken by the Federal Reserve.

I think it's up to the Congress as to whether more should be done.

Mr. GARRETT. Okay. Thank you. I appreciate it, thank you.

The CHAIRMAN. Time has expired. The panel is dismissed We appreciate it. I think it has been a very useful hearing, and we will reconvene probably in about 20 to 30 minutes with the next panel for probably an hour-and-a-half.

[recess]

The CHAIRMAN. The hearing will reconvene. I apologize. There was an unexpected resolution involving another controversy, unrelated. It took more time than it should have, and I apologize and appreciate the indulgence of the witnesses.

We will go until about 2:15, so that gives us a good deal of time, and we will get right into the witness list, as soon as I find it. And I have it now.

We will begin with Michael Marz, who is vice chairman of the First Southwest Company on behalf of the Regional Bond Dealers Association.

Mr. Marz?

STATEMENT OF MICHAEL J. MARZ, VICE CHAIRMAN, FIRST SOUTHWEST COMPANY, ON BEHALF OF THE REGIONAL BOND DEALERS ASSOCIATION (RBDA)

Mr. MARZ. Good afternoon. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. I'm pleased to be here.

The Regional Bond Dealers Association was formed a little over a year ago to represent the interests of Main Street securities firms active in the U.S. bond markets. The footprint of regional or non-Wall Street securities firms in the municipal market is expanding.

As a result of the financial crisis, a number of securities firms that previously were mainstays in the municipal market have shuttered, merged, or simply left the business.

Other market participants as a result of deleveraging and continued financial stress, are less able to offer the market liquidity they once provided.

During the height of the crisis last fall, many municipal bond issuers and investors came to depend on regional dealers for a substantial amount of underwriting and secondary market liquidity so desperately needed at the time.

We believe the role of the regional bond dealers in the municipal market will continue to expand, and we appreciate the opportunity to present our views.

The RBDA supports all four bills the committee is considering to help municipal bond issuers and strengthen market regulation.

Taken together, this legislation represents a reasonable, targeted, and transitioned response to problems bond issuers are facing as a result of the financial market crisis.

In the interests of time, I am going to focus my remarks on two proposals: the Municipal Market Liquidity Enhancement Act; and the Municipal Advisors Regulation Act.

The Municipal Market Liquidity Enhancement Act would primarily help two categories of municipal bond issuers: those who still have outstanding auction rate securities; and those who have variable rate demand notes.

As the committee knows, from your examination of the auction rate market last fall, the large majority of periodic auctions that are that sole source of liquidity for auction rate securities investors continue to fail on a persistent basis.

Investors are stuck holding securities they do not want and cannot sell, and issuers in many cases face extraordinarily high penalty rates on their borrowing.

The buy-back settlement that some dealers have reached with enforcement agencies helped individual auction rate investors, but they really only transferred the illiquidity problem from investors to dealers.

The real solution to the auction rate dislocation is to get the remaining auction rate securities restructured on a more permanent basis. The hurdle to doing that for many issuers is the inability to obtain bank liquidity facilities at a reasonable cost.

Issuers of variable rate demand notes face similar constraints. Many VDRN issuers face extraordinarily high borrowing rates on their debt, not because of their own credit problems, but because of problems with their liquidity banks or bond insurers.

The problem is often magnified for State and local governments, who issued VDRNs in combinations with interest rate swaps.

The Municipal Market Liquidity Enhancement Act would address these issues by allowing the Federal Reserve to temporarily assume the role of a liquidity bank for VDRN issuers. State and localities with auction rate securities outstanding could use the Fed facility to convert those bonds into low-rate VDRNs. And VDRN issuers whose liquidity banks are causing them to pay in the inordinately high rates could use the facility to lower their borrowing costs.

We are encouraged that members of this committee find value in the approach offered by this legislation.

We strongly support the Municipal Advisors Regulation Act. As you know, there exists a major gap in municipal market regulation. Most importantly, unregulated financial advisors, swap advisors, brokers of guaranteed investment contracts, and other parties that play a vital role in advising States and localities on bond issuance and other activities currently fall completely outside of this jurisdiction of the Securities and Exchange Commission and all other regulatory bodies, and as a result escape accountability for any misdeeds.

These regulations relate to conflicts of interest, professional qualifications and standards, capital adequacy, fair dealing, books and records, and a variety of other areas.

Financial advisors can serve a vital function in a bond deal, and their actions can have significant implications for issuers and investors. Indeed, there have been numerous examples in recent months of conflict of interest or poor advice from FAs that have negatively affected State and local bond issuers.

Even honest and qualified FAs should be subject to accountability standards, which provide fair and measured approach to regulation that is consistent with scope and degree of regulation for other market participants.

The Municipal Advisors Regulation Act would address the problem by giving the SEC regulatory and enforcement authority over municipal financial advisors.

The bill would weed out rogue and unqualified FAs and would help ensure that the advice States and localities receive is sound and in the best interest of issuers.

The RBDA also supports the other two bills that are a subject of this hearing, the Municipal Bond Insurance Enhancement Act, and the Municipal Bond Fairness Act. I would be happy to talk about these proposals during the question-and-answer session.

Thank you again, Chairman Frank, Ranking Member Bachus, and other members of the committee for the opportunity to be here and for your initiatives to help improve the Municipal Securities Market. I look forward to your questions.

[The prepared statement of Mr. Marz can be found on page 149 of the appendix.]

The CHAIRMAN. Thank you.

And next we will have Ms. Laura Levenstein, who is the senior managing director at Moody's.

STATEMENT OF LAURA LEVENSTEIN, SENIOR MANAGING DIRECTOR, MOODY'S INVESTORS SERVICE

Ms. LEVENSTEIN. Good afternoon. I am Laura Levenstein, senior managing director for the Global Public Project and Infrastructure Finance Group and Moody's Investor Service.

This is the group at Moody's responsible for, among other things, assigning ratings to municipal bonds. On behalf of my colleagues, I want to thank the Commission for this opportunity to provide Moody's views on proposals in the bill concerning rating agencies and municipal bond ratings.

We understand that the bill, if adopted, would require every nationally recognized statistical rating organization to clearly define its rating symbols, apply them consistently for all types of bonds, and have its credit ratings address the risk that investors won't receive payment in accordance with the bond's terms of issuance.

Broadly speaking, we understand that the bill seeks to promote ratings comparability between municipal and non-municipal bonds.

Since Moody's first began rating municipal bonds in 1918, we have sought the views of municipal market investors and issuers on which attributes make our municipal bond ratings most useful to them.

For many years, participants in the municipal market told us that they wanted our ratings to draw finer distinctions among municipal bonds than would be possible if global ratings were assigned to such bonds.

This is because historically many municipal bonds have had lower credit risk when compared to Moody's rated corporate or structured finance obligations.

It was not until 2008 that a larger portion of the market indicated a desire for greater comparability between municipal and non-municipal ratings.

Taking into account these views, in early September of 2008, Moody's announced plans to recalibrate our long-term municipal bonds to our global ratings.

In mid-September of 2008, events unrelated to our announcement triggered extraordinarily severe dislocation in the credit markets. Because of the turmoil that resulted from that dislocation, after talking with some market participants, we decided it would be prudent to suspend the recalibration process until the market stabilized.

We were concerned that pursuing our plans during such turbulence could unintentionally lead to confusion or further market disruption.

As credit markets have remained volatile in recent months, we have continued this suspension, but we look for an opportunity to implement the recalibration.

We remain committed to implementing our plans. We continue our dialogue with market participants, and we are monitoring market conditions to find an appropriate time to proceed.

The draft bill, therefore, mandates a rating approach that is consistent with the approach we plan to adopt in response to market feedback.

I would have issues about the draft bill that Congress and/or the SEC may wish to consider. These include, among others, the risk that the bill would effectively freeze recently expressed market preference in legislation, thereby making it difficult for NRSROs to compete and develop their practices as the market evolves.

I would also note that the draft bill represents the first substantive regulation of the content of credit opinions and rating methodologies. We have long believed that maintaining the independence and integrity of the content of ratings is critical to the effective functioning of our industry.

We would hope that this bill does not open the door to compromising that independence.

Moody's is strongly committed to meeting the needs of investors, issuers, and other market participants with respect to municipal bond ratings. We welcome the opportunity to work with Congress and other policymakers to achieve these goals.

Thank you. I am happy to respond to any questions you may have.

[The prepared statement of Ms. Levenstein can be found on page 137 of the appendix.]

The CHAIRMAN. Thank you, Ms. Levenstein.

Next, Keith Curry, who is the managing director of the PFM Group.

STATEMENT OF KEITH D. CURRY, MANAGING DIRECTOR, PUBLIC FINANCIAL MANAGEMENT INC. (PFM)

Mr. CURRY. Thank you, Mr. Chairman, and members of the committee.

My name is Keith Curry. I am a managing director of Public Financial Management, or the PFM Group, and past president of the National Association of Independent Public Finance Advisors.

In addition, I bring the perspective of also being the mayor pro tem of the City of Newport Beach, California.

For nearly 22 years, I had been a financial advisor to State and local governments throughout the Nation, advising on more than $14 billion in financings.

Let me say on behalf of PFM, the largest independent financial advisory firm in the Nation, and on behalf of the members of NAIPFA, that we support your efforts to promote transparency and accountability in the financial advisory industry.

We are proud to note that in the 34-year history of PFM, and in the 20-history of NAIPFA, our firm and NAIPFA members have never been associated with any of the scandals that have rocked the municipal market. Indeed, NAIPFA members have long ago adopted campaign contribution limitations to eliminate pay-to-play.

We have established a test for professional competency, leading to the certification of practitioners as certified independent public finance advisors, and we have a strong code of ethics.

We would offer the following comments for your consideration:

PFM does not quarrel with the proposal to require municipal finance advisors to register with the SEC, although it's appropriate to emphasize that there is no demonstrated need for registration and regulation to protect investors. As far as I know, nearly every publicized instance of abuse of investors or municipal issuers in the last decade has involved broker-dealer firms, which were already registered with the Commission.

We believe that the committee draft bill has taken the correct approach in looking to the Commission to provide regulatory oversight of municipal financial advisory professionals. The SEC fully understands the debt offering process, and the roles which professionals play.

We urge the Commission to resist the brokerage community's predictable efforts to subject financial advisors to the rules of the Municipal Securities' Rule-Making Board, or MSRB. The MSRB is a captive of the brokerage firms, who on day one compete with independent financial advisors for the role of advisor, and on the other days seek to obtain the highest rate of interest for their investor clients as the underwriters of municipal debt.

It is the local governments and their taxpayers who are best served by preserving the strong voice of an independent advisor. We applaud the committee's draft bill in focusing regulatory oversight on the maintenance of professional qualifications and fair practice standards for all financial advisors. This elevates the professionalism of the entire municipal finance community.

We also endorse SEC rules to avoid conflicts of interest and to eliminate improper influence of political contributions.

Our firm individually and NAIPFA for the independent advisors as a whole, have urged these measures.

Unfortunately, when NAIPFA went to the MSRP recently to seek strong rules against broker-dealers, taking both sides of municipal debt offerings—for example, serving as financial advisor and then flipping out to underwrite the same transaction—those proposals were rejected by the MSRB.

PFM believes that the committee draft bill should be properly strengthened by extending a duty of care standard to all securities professionals serving as municipal financial advisors, not just those who would be newly regulated under this bill.

By historical experience, the danger of abuse and dishonesty is presented by those who are already registered with the SEC as brokers.

All those participants in the securities process who serve as financial advisors should be bound by the fiduciary principles of this bill, particularly those who are registered under Section 15 of the Exchange Act.

It said of this proposed landmark legislation that it's intended to level the playing field in municipal finance. That goal will fail if brokerage firms are excluded from the duties which are imposed on their competitors.

Undoubtedly, special interest groups will be here to seek exemption for the banks, the financial advisors that operate in a limited territory, the firms that have a limited number of transactions, and others.

We urge the committee to resist these pleas. The municipal finance world is made up of a universe of different players. But they should all have the same ethical requirements and the same professional duties.

In summary, we support the efforts to ban pay-to-play, to provide for a standardized licensing and competency assessment process, to prohibit practitioners with prior records or fraudulent activity, and to ensure that a standard of professional care is established for the industry.

We encourage the committee to pay special attention to the phase-in period, so as not to disrupt the municipal finance industry or to delay planned State and local financings.

Be assured of our continued partnership to improve transparency and fair operations of the municipal securities market.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Curry can be found on page 89 of the appendix.]

The CHAIRMAN. Next, Mr. Alan Ispass, who is the vice president and global director of utility management solutions at CH2M Hill.

STATEMENT OF ALAN B. ISPASS, PE, BCEE, VICE PRESIDENT AND GLOBAL DIRECTOR OF UTILITY MANAGEMENT SOLUTIONS PRACTICE, CH2M HILL

Ms. ISPASS. Thank you, Mr. Chairman, and members of the committee.

I appreciate the opportunity to be here this afternoon on behalf of CH2M Hill, to present our thoughts on the municipal bond market. CH2M Hill is a global full service engineering, project development, and project delivery firm, with 26,000 employees worldwide. We are headquartered in Denver and have offices throughout the United States and throughout the world.

A significant part of CH2M Hill's core business is to help cities and counties plan, design, and construct major drinking water, wastewater, storm water, and transportation infrastructure projects.

The practice that I lead includes a financial services team that helps municipal clients address funding and financing issues in the water sector. This work includes conducting cost of service and financial planning studies and also assisting clients to identify and secure funding for their capital improvement programs.

We also serve in the role of consulting engineer, conducting independent analyses and certifications that are related to a client's financial situation for inclusion in official offering statements for municipal bonds. These bonds fund projects, which provide essential services such as safe water for drinking and for fire suppression, wastewater collection and treatment to protect the public health and the environment, and stormwater control to mitigate impacts from flooding.

These projects also return a significant amount of economic benefit to communities, estimated to be almost 9:1; for every $1 spent on stormwater projects, there is a $9 benefit, according to a report done by the U.S. Conference of Mayors last year.

During the past year, however, we have observed firsthand that the global financial crisis has dramatically impacted our clients' ability to effectively plan and finance their capital programs.

Utilities have had significant declines in revenues due to foreclosures of residential properties and reductions in commercial and industrial water use.

Many wastewater agencies are especially hard-hit, as they strive to meet Federal mandates to provide greater control of combined sewer overflows and sanitary sewer overflows.

And of course, this is all occurring at a time when an estimated $600 billion of investment is needed in our Nation's water and wastewater infrastructure to continue to protect the public health and the environment.

These financial concerns have been exacerbated since the fall of 2008. For years, utilities have been able to count on ready access to long-term municipal bonds to finance their capital improvement programs with interest rates often in the 4 to 5 percent range. However, accessibility to the bond market is now a problem for many utilities. Many of our clients have been informed by their financial advisors that utilities with credit ratings lower than double-A may not receive bids if they went to market, or the bids would be at a very high interest rate, very possibly causing unaffordable increases on their customers' water and sewer bills.

In the past 8 months, we have seen some clients that have previously had no problems issuing long-term debt, unable to issue bonds. Also, the downgrading of bond insurers has caused public utilities with less than a double-A bond rating to hold off on going to market, delaying needed capital improvement projects and putting commitments for meeting projects and regulatory deadlines at risk.

And even more troubling is the downgrading of bond insurers that has put some utilities in technical default of their current bond covenants for existing outstanding debt, because in some cases, these covenants require that utilities maintain bond insurance with a specified credit rating, or put significant funds into reserve.

Such situations put a cloud over the ability of these utilities to issue additional debt for future needs.

Without a doubt, the stimulus package provided some important financial assistance that is helping to fund some water and wastewater projects due to $6 billion that is being administered through the exiting State revolving fund programs, the SRFs.

However, the $6 billion is only a small fraction of the country's water and wastewater infrastructure needs.

As an example for the substantial needs for funding, this year, the State of Arizona received 300 applications for water and wastewater projects, totalling more than $1 billion in project value. They only had $80 million in stimulus funds available to give for those projects. So based on a priority of applications, the State expects to be able to provide funding for only 51 of those 300 water and wastewater projects.

Likewise, the State of Virginia received 240 applications for their $20 million in funds for drinking water projects. However, the State will only be fund 20 of the 240 projects.

In light of the billions of dollars in need beyond funding available through the traditional SRF programs and funds made available through the stimulus, it is crucial that there be a robust municipal bond market that provides access to municipal borrowers at reasonable rates.

Given the substantial financial challenges in the market today, the Proposed Municipal Bond Insurance Enhancement Act of 2009 represents an important step forward. By providing up to $50 billion in reinsurance over the next 5 years, it provides a mechanism for allowing many municipal borrowers with less than top credit ratings to move forward with their capital programs.

The specifics on eligibility and the cost of the risk-based premiums that will be detailed if the reinsurance program moves forward will be critical in determining how broadly the relief offered by this legislation will be felt throughout the municipal utilities sector.

From our vantage point, however, as consultants to many water and wastewater utilities through the United States, the passage of the Municipal Bond Insurance Enhancement Act could be crucial to providing continued access to municipal bond market, and for providing sustainable infrastructure to protect public health and property and enhance the environment and encourage economic growth.

Thank you.

[The prepared statement of Mr. Ispass can be found on page 120 of the appendix.]

The CHAIRMAN. Thank you.

Next, Sean McCarthy, who is the president and chief operating officer of Financial Security Assurance, Inc.

STATEMENT OF SEAN W. MCCARTHY, PRESIDENT AND CHIEF OPERATING OFFICER, FINANCIAL SECURITY ASSURANCE, INC.

Mr. MCCARTHY. Thank you. Chairman Frank, Ranking Member Bachus, and members of the committee, my name is Sean McCarthy, and I am president and chief operating officer of Financial Security Assurance Holdings, better known as FSA.

FSA provides financial guarantee insurance for municipal and global public finance obligations. We appreciate the opportunity to testify on the chairman's legislation, which will provide reinsurance capacity for qualified municipal bond issuers and insurers, and establish a temporary liquidity facility for variable rate demand bond obligations.

Such programs would provide much needed aid to the States and localities that depend on these sources of fundings, to provide municipal services and build infrastructure, which is a critical part of municipal finance role.

It will also increase the capacity to the bond insurance industry and facilitate additional bond issuance.

As you are well aware, the market for these State and local government bonds has been adversely impacted by the current credit crisis and lack of a unified regulatory authority.

Additionally the market is currently underserved by primary bond insurers due to the downgrades or failures of five of the original seven primary bond insurers. Thus, currently there are two active providers: Ourselves, an assured guarantee, and one new company owned by Warren Buffett, which has participated selectively; and three other companies, which are working currently to enter the market.

Further availability of reinsurance capacity has been significantly reduced over the past 2 years for the same reasons the primary guarantors were affected.

Although economic conditions have stressed local government bond credits, the problems facing them are more centered on the lack of liquidity in the market. These credits are not troubled credits, and across the spectrum generally remain sound investments.

A comparison of the large spread differences between municipal and wider-spread corporate and asset-backed bonds confirms municipals' higher credit worthiness.

Therefore, the illiquidity in today's municipal market is largely the result of problems elsewhere in the debt capital markets. And this circumstance will not correct itself without Federal assistance.

Just as liquidity is a key source of relief, Federal support of the bond insurance companies through the provision of credit capacity in the form of reinsurance is necessary for State and local government borrowers seeking to raise necessary capital to continue their operations.

The creation of an Office of Public Finance in the Treasury Department to oversee the reinsurance program would help restore investor confidence in local government bonds and generally promote a return of liquidity to the market.

Additionally, it is an effective way to assist municipal bond insurers in obtaining the necessary capacity to satisfy market demand and encourage private sector investment, all the while maximizing the government investment without the direct use of taxpayer dollars.

It is especially important to maintain private competition in the municipal bond insurance industry by allowing participation in such programs based on criteria that do not discriminate against companies that have continued to write the business and allowed participation for all bond insurers that are subject to State regulation.

The mandatory divestment of reinsurance program after 5 years also presents the private industry from relying on permanent government assistance and will promote responsible behavior among municipal bond insurers.

Treasury's Federal reinsurance vehicle also would facilitate the diffusion of risk currently on the balance sheets of the bond insurers. We support the creation of such a vehicle and believe that the risk-based premiums under such a program should be based in part on sound underwriting standards, ensuring that insurers of various credit qualities can participate in this program in a manner that protects the interests of the America taxpayer.

Such a program should be attractive to Congress and Treasury because it does not require a current outlay of Federal funds and would limit Federal reinsurance risk exposure in accordance with its criteria adopted for the insurance program.

We believe that Treasury should look at the FDIC Deposit Insurance Program for guidance in creating such a program, whereby long-term costs are mutualized and charged back to the participants.

Now returning to the issue of liquidity, we support the exercise of existing power of the Federal Reserve and Treasury under TARP, the Term Asset-Backed Securities Loan Facility, TALF, and other provisions of the Federal law, with the emphasis on:

One, new issues of local government bonds, i.e., not financings or refundings; and two, restructuring of existing auction rate and variable rate government bonds.

Specifically, we support the Municipal Liquidity Enhancement Act to provide a temporary liquidity facility for variable rate demand obligations, permitting the Federal Reserve to create a new liquidity facility that will ease the burden of interest costs on State and local securities.

Most variable rate demand bonds—

The CHAIRMAN. Mr. McCarthy, I'm going to have to ask you to wind it up. We are about to start running a minute over.

Mr. MCCARTHY. Okay.

The CHAIRMAN. If you can get to a conclusion fairly soon.

Mr. MCCARTHY. Thank you for introducing this important legislation, which will provide much needed relief to State and local governments around the country. We appreciate the opportunity to appear before you this afternoon. I will be pleased to respond to any questions.

[The prepared statement of Mr. McCarthy can be found on page 159 of the appendix.]

The CHAIRMAN. Thank you. Next is Mr. Bernard Beal, the chief executive officer of M.R. Beal & Company, and he is testifying on behalf of the Securities Industry and Financial Markets Association.

STATEMENT OF BERNARD BEAL, CHIEF EXECUTIVE OFFICER, M.R. BEAL & COMPANY, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. BEAL. Thank you. Good afternoon. Chairman Frank, Ranking Member Bachus, and members of the committee, my name is Bernard Beal and I am the chief executive of M.R. Beal & Company and vice chair of the Securities Industry and Financial Markets Association, SIFMA.

I am pleased to have the opportunity to testify before you today on behalf of SIFMA on these important pieces of legislation that address the critical issues for the municipal securities markets and its participants. We applaud your ongoing leadership and the bold steps that you are taking to stabilize this vital sector of the financial markets.

While many sectors of the municipal market are regaining health, some areas have been unable to regain their footings and seek assistance in the capital markets. Many lower-rated State and local government issuers are facing a critical need for reliable liquidity facilities and long term credit enhancement, and the lack thereof is making it difficult for them to bring some transactions to market. The legislation that has been the subject of today's hearings offers constructive solutions to the assistance that State and local issuers have in gaining access to the market and address important regulatory and rating matters that have in fact persisted for years.

With regard to market access issues, we support these temporary measures and offer suggestions to ensure efficiency in restoring and spurring market activity with the least amount of direct Federal involvement. We also support the provisions regarding regulating unregulated financial advisors, which generally are consistent with the MSRB's rules that govern regulated broker/dealer members who engage in the same financial activities today.

I will address each of the proposed bills with a focus on the benefits that they provide to municipal market participants. First, the Municipal Advisory Regulatory Act. SIFMA supports the proposed legislation to regulate independent municipal financial advisors, who have not been subject to any regulatory oversight and have operated unfettered in the market for years.

In early April of this year, an MSRB report found that 73 percent of the financial advisors that participated in at least one primary market transaction in 2008 were not subject to MSRB regulation. This legislation would fill the gap that has taken place in the regulation, and it would protect issuers and investors alike, and help restore confidence in the municipal security market. The legislation will also help to level the playing field for all market participants who offer financial advisory services, and we feel require currently unregulated financial advisors to be held to the same high standard which regulated broker/dealers currently adhere.

While we support this legislation, we caution against duplication in the regulatory regimes. Currently, the MSRB is the body that drafts the rules for the municipal securities market based on its deep understanding of the products and practices of the municipal securities dealers, and FINRA is responsible for enforcing those rules and regulation. SIFMA recommends that in defining the SEC's role in regulating financial advisors, that the committee recognize the role of the MSRB and its regulatory framework, and consider the existence of the current responsibilities of regulators.

In addition, while the fiduciary standard of care is defined under most State laws, the municipal finance market is a national one in which bankers, advisors, and trustees from all 50 States can work on transactions in all 50 States. Thus, a single standard of care under Federal law would regulate municipal financial advisors and at the same time establish a uniform standard which would apply throughout the country, regardless of the home jurisdiction of the advisor or the transaction.

Second, the Municipal Bond Insurance Enforcement Act of 2009. SIFMA supports the proposal to establish a temporary Federal Government reinsurance program for transactions covered by primary credit market enhancement policy providers. This model provides the most benefits to the issuing community and to investors alike without direct Federal involvement in State and local desk issuance. This program will help some of the bond insurers currently in the market as well as any new entrants to it, because by reimbursing their losses, the program will increase the insurance capacity for those insurers.

SIFMA endorses creating the Office of Public Finance within the Department of Treasury. This office will provide a point of contact for the municipal securities industry for non-regulatory matters, and it will help foster communication between State and local issuers with the Federal Government and provide municipal market stakeholders with an informational resource within the government.

I will conclude my remarks by saying that we are in support of the other two legislations as well and I would be happy to take questions. Thank you.

[The prepared statement of Mr. Beal can be found on page 80 of the appendix.]

The CHAIRMAN. Thank you. Next, Mary Jo Ochson, who is the senior vice president—by the way, we are going to have votes in about 15 or 20 minutes, and that will end this. So Mr. Watt and I will ask, so you will be out of here in 20 minutes, is my guess, 25 after we vote. We have 3 witnesses and 2 questions, 25 minutes.

STATEMENT OF MARY JO OCHSON, CFA, CHIEF INVESTMENT OFFICER FOR THE MUNICIPAL BOND AND TAX-EXEMPT MONEY MARKET INVESTMENT GROUP, FEDERATED INVESTORS, INC.

Ms. OCHSON. Good afternoon. Thank you, Chairman Frank, and members of the committee, for the opportunity to appear today. I commend your efforts to address the recent disruptions to municipal markets.

I am the chief investment officer for the municipal investment group at Federated Investors. I have been investing in municipal securities at Federated for over 27 years, and I am a former member of the Municipal Securities Rulemaking Board. Today, Federated manages $3.4 billion in municipal bond funds and $36.5 billion in tax-exempt money market funds. As investment advisor for our funds' shareholders, Federated is vitally interested in the health of the municipal market.

Before we get into our thoughts on the specific bills, let us consider some background on municipal money markets. The development of the municipal money markets has increased the amount and has reduced the cost of short-term financing available to State and local governments, hospitals, school districts, and other muni borrowers. Tax-exempt money market funds have been the driving force in this development.

The variable rate demand obligation, or VRDO, is one of the most prominent security structures in the municipal money markets. Its structure as a floating rate security with the liquidity facility meets the needs of the money market funds and the low cost financing goals of issuers. Some VRDOs have become ineligible investments for money funds because of the deterioration and the credit quality of many banks and bond insurers.

Interest costs on those VRDOs have increased, raising the cost of capital to muni issuers whose VRDOs now reside in the hands of their banks and are thus called bank bonds. In addition, new VRDO issuance has decreased as fewer banks are willing to provide the necessary liquidity facilities. Markets for municipal notes, however, have functioned comparatively better, although a limited number of issuers may face market access limitations.

Moving on to the four proposals. It appears that the Market Liquidity Enhancement Act would create a helpful vehicle to preserve the liquidity and lower the costs of capital to issuers struggling with the bank bond problem or issuers who may not have market access to issue cash flow notes. The Act would provide a purchaser of last resource for such issuers. We agree with the approach of letting issuers of cash management notes first come to market. Then, if they are unable to sell their notes, invoking the support facility.

More broadly, we applaud the many Federal efforts to support the credit quality and functioning of the banking system. Steps to support the banks directly support the functioning of the municipal money market, yet we encourage the committee and the Federal banking regulators to consider steps that would increase the availability and lower the cost of liquidity facilities to sound borrowers.

Turning to the Municipal Bond Fairness Act, we do not oppose the shift towards one global scale, but we do have some suggestions. Credit ratings are meant to indicate the risk of default and recovery in the event of default, regardless of whether the bond is issued by the government or a corporation. We suggest that the concept of recovery in the event of default be specifically added to section 1A of the bill.

Although we support the bill, we urge the committee and all the nationally recognized statistical rating organizations not to rest on an oversimplified approach to making municipal ratings more consistent with corporate ratings based solely on comparative default statistics. Although muni defaults are rare, the default rate is not zero. During the Great Depression and the early 1970's, muni defaults or the risk of defaults rose sharply. Lastly, qualitative forward looking factors such as variations in budgeting and unfunded pension and healthcare obligations have material effects on municipal credit quality.

Moving on to the third piece of legislation, we support the objective of the Municipal Bond Insurance Enhancement Act to increase the capacity of insurers for bond insurance to the municipal bond market.

And finally, regarding the Municipal Advisors Regulation Act, to the extent that this bill reduces situations where unsound advice may harm the creditworthiness of municipal issuers, we support the spirit of the proposed legislation.

Thank you again Mr. Chairman. We are ready to help you as you strive to restore and maintain the vibrancy of this very important market.

[The prepared statement of Ms. Ochson can be found on page 168 of the appendix.]

The CHAIRMAN. Next is Mike Allen, chief financial officer of Winona Health, on behalf of the Healthcare Financial Management Association.

STATEMENT OF MICHAEL M. ALLEN, CHIEF FINANCIAL OFFICER, WINONA HEALTH, ON BEHALF OF THE HEALTHCARE FINANCIAL MANAGEMENT ASSOCIATION (HFMA)

Mr. ALLEN. Thank you, Chairman Frank, and members of the committee.

I am Mike Allen, chief financial officer of Winona Health, a 99-bed, community-owned, not-for-profit health system serving over 50,000 residents in the State of Minnesota. I appreciate the opportunity to be here with you this morning representing the Healthcare Financial Management Association, or HFMA, in discussing the impact of recent municipal bond financing issues for not-for-profit hospitals. HFMA is a professional membership organization with more than 35,000 members working in a variety of healthcare settings. Our chief financial officers were heavily involved in developing the following comments.

So why is access to capital crucial for not-for-profit hospitals? Providing care in a hospital setting has always been a capital-intensive endeavor. However, the need for affordable capital has never been greater due to three reasons. First, hospital facilities are rapidly aging. Over the past 2 decades, the average age of a hospital facility has increased by 25 percent. Second, there are constant advances in diagnostic and treatment technology that require hospitals to invest large amounts of capital in new equipment and ensure that patients have access to the most up to date care available.

And third, hospitals are making considerable investments at reduced costs and pave the way for wider healthcare reform. This includes implementing fully integrated electronic health records to enhance patient safety and increase the efficiency of care provided. Few, if any, not-for-profit hospitals can fund their capital requirements solely through ongoing operations, and due to our tax-exempt status, we are prohibited from accessing equity markets. That is why it is critical that we have access to efficient debt markets.

Access to an efficient tax-exempt bond market is very important to our industry, and by extension, to achieving the Nation's healthcare goals. Current market conditions make it difficult for all hospitals to access the market, and for some, it is impossible. Today my hospital would have difficulty accessing credit markets at a reasonable rate. There are some signs of improvement, and the rates have stabilized, albeit at higher levels.

Here are the HFMA recommendations. First, on liquidity facilities, based on the encouraging signs of our economy, at least in the beginning here, our members urge this committee to do no harm to that recovery. Liquidity facility solutions that are brought to the market should first and foremost be optional, and the preservation of a private market should be maintained. We also urge you to keep the scope of the liquidity facility narrow, and perhaps limit it to only existing bond issues.

Second, on municipal bond reinsurance, our members believe a federally backed municipal bond reinsurance program would be beneficial to hospitals if it were simple and properly designed. The program should be short term and should be available for outstanding debt issues only.

On credit enhancement, our members recommend that the underwriting processes, the collateral requirements, the covenants, and the usage constraints of the existing FHA 242 programs be reviewed to meet the current needs of the market. While the program has been in place for a number of years, providers have not accessed this credit enhancement option due to the extremely long underwriting and approval periods and the onerous collateral provisions.

We also ask that the Federal Home Loan Bank Program that grants members permission to issue standby letters of credit for tax-exempt bonds be extended beyond its current December 31, 2010, expiration date, and relax the requirement that participating banks post collateral equal to 100 percent of the letter of credit amount. We cannot overstate the impact that simplifications will have on hospitals, particularly small to mid-size facilities that are not integrated with a larger health system.

Regarding financial advisors, our members would not recommend additional Federal regulation, but prefer to see a private sector solution, and if that does not work, then regulation to follow. Similarly, with rating agencies, our members would not recommend additional regulation and try to force an artificial consistency between healthcare and other industry credits. The healthcare business models are fairly unique in that their income statements are extremely dependent on the Federal and State legislative processes.

Further, the industry is about to go through a period of sweeping healthcare reform; 85 percent of all the hospitals are not-for-profit. That is more than 4,000 by my count. These organizations play a key role in their communities, acting both as a healthcare safety net for the underprivileged and an economic engine for their communities. In addition to being a major employer in most communities by providing jobs with stable wages and benefits, the American Hospital Associations estimates that hospitals spent $304 billion on goods and services annually.

In order for healthcare reform to be successful, the Nation's not-for-profit hospitals need to be financially healthy. Facilitating access to stable and inexpensive sources of capital will reduce the cost of healthcare, ensuring access to hospital care for all patients. Further, without reliable funding, it will be difficult for providers to implement electronic health records and take the next steps needed to facilitate healthcare reform.

Chairman Frank, I thank you on behalf of the HFMA's 35,000, and to your colleagues for hearing this testimony, and wish you the best in making the appropriate decisions to support the healthcare needs of our communities across the Nation. Thank you.

[The prepared statement of Mr. Allen can be found on page 65 of the appendix.]

The CHAIRMAN. Thank you.

And finally, Mr. Sean Egan, who is managing director of Egan-Jones Ratings.

STATEMENT OF SEAN EGAN, CO-FOUNDER AND MANAGING DIRECTOR, EGAN-JONES RATINGS CO.

Mr. EGAN. Thank you very much.

Before I get to my written comments, I have just a few points. The charts that were presented earlier say it all. In the municipal area, the probability of default and the loss given default are much better in the typical muni area than the corporate area. The problem is under the current industry structure, issuer-paid rating firms are paid twice: once by the issuers; the second time by the monoline insurance companies. And therefore, the issuer-paid rating firms have an incentive for lower ratings.

Furthermore, the proposed legislation cannot and will not change the fact that ratings are opinions, and I encourage you to look at section 2A on page 3 of the proposed legislation. It provides a massive loophole.

You might ask why some independent rating firms do not enter the market in a larger way. Egan-Jones is considered to be the leading independent rating firm. We rate a number of muni issuers, but not as many as some of the issuer-paid rating firms. We rate some sovereigns, but for the most part it is difficult to support a widespread effort based on the investor-pay model. There is, however, a solution. Joe Grundfest, an ex-SEC Commissioner, suggested a BOCRA type system which would provide the support for other ratings.

Now to my prepared comments. Egan-Jones is an NRSRO, but all the proposals under consideration at this hearing are directly related to the credit collapse, and the credit collapse is directly related to investors losing faith in the credibility of rating firms. In the municipal bond market, however, a large part of the current problem stems also from the financial deterioration of the municipal bond insurers, or monolines as they are sometimes called.

The bond insurers' problems arose because they went from enhancing relatively safe State and local obligations to complex asset-based credit instruments, which have been defaulting around the world for the last 2 years. From a credit quality perspective it has always been the case that public securities have both a low probability of default and an extremely low level of anticipated loss, even in the event of a default.

Nevertheless, it is accurate to point out, as the committee did in its statement of May 14, 2009, that municipal bonds with equal or lower default rates than corporate bonds have been given lower ratings by the major NRSROs. What has happened, unfortunately, is for years, State and local issuers have been told that they should purchase insurance which they really do not need. Ironically, these public entities now find themselves scrambling to maintain the marketability of their securities due to the financial weakness of the very companies which they thought to be enhancing those securities.

Because of this shift away from their traditional and less risky business model, Egan-Jones issued a rating report in 2002 that MBIA, which is the largest of the monolines, did not merit the triple A rating which Moody's, S&P, and Fitch accorded them. Our competitors kept ratings these companies rated at triple A until 2008.

Given the state of the monoline insurers, certainly Congress and the Administration should be working with the State insurance commissioners to develop Federal support programs. TALF, TARP, and numerous related government assistance programs are in place for commercial paper, inter-bank deposits, and a broad range of asset-backed securities. One can argue about the justification, cost, and even structure of these programs, but there is no compelling logic for saying that some forms of credit are eligible and others are less worthy.

My personal opinion is that these governmental programs—and there is no doubt that they have helped to stabilize the situation—must be viewed as dealing with only the symptoms of the credit crisis rather than their cause. And their cause is well enunciated in the recent report on regulatory reform by the Congressional Oversight Panel, and is as follows: If companies issuing high-risk credit instruments had not been able to obtain triple A ratings from the private credit rating agencies, then pension funds, financial institutions, State and local municipalities, and others that relied on those ratings would not have been mislead into making dangerous investments.

Thank you.

[The prepared statement of Mr. Egan can be found on page 91 of the appendix.]

The CHAIRMAN. I do agree, when you talk about independence, that the investor pay is also an independence question.

But beyond that, if you are worried about independence, you say in your introduction you were asked by investors and issuers to draw finer distinctions among municipal bonds which generally have had lower credit risk when compared to Moody's rated corporate or structured financial obligations, but the result of that was the reverse. You say here that they had lower credit risk, but every chart we have seen says that it came out the other way, that they were rated as having more credit risk than the corporates. Can you reconcile that for me?

Ms. LEVENSTEIN. Yes I can. I think by finer distinctions, what we are referring to is a broader array of—

The CHAIRMAN. No, I am not asking about the finer distinction part. You are saying that the motivation here was that municipal bonds generally have had lower credit risk when compared to Moody's rated corporate or structured finance. I mean, are you acknowledging that in fact, municipals were rated lower than they should have been if they had been corporates?

Ms. LEVENSTEIN. Municipals were rated on based—

The CHAIRMAN. No, that is not the—I understand how you rate them.

Ms. LEVENSTEIN. They are not comparable.

The CHAIRMAN. You say here that they generally have—you are the one who compared them. You say you are not comparable. Then don't compare things and then tell me they are not comparable. I am reading from your testimony: "Municipal bonds which generally have had lower credit risk when compared to Moody's rated corporate or structured financial obligations." Is that not an acknowledgement that they are rated lower than bonds that have a higher default risk?

Ms. LEVENSTEIN. The municipal rating system is capturing different content.

The CHAIRMAN. No, would you please answer my question?

Ms. LEVENSTEIN. They are not measuring the same thing.

The CHAIRMAN. Why did you say "compared to?" All right, I understand they are not, but the effect of it is—you said it. I am not putting words in your mouth.

Ms. LEVENSTEIN. If one were to extract—

The CHAIRMAN. Excuse me. I want you to tell me if I am reading something wrong: "Municipal bonds which generally have had lower credit risk when compared to Moody's rated corporate or structured finance obligations." No matter what the justification, no matter what your reasons are, am I correctly reading this that you are saying that municipals have less credit risk when you compare them to comparable rated bonds? You are the one who said that. Am I incorrect in this?

Ms. LEVENSTEIN. No. No, you are not.

The CHAIRMAN. Thank you.

Ms. Ochson, you talked about one reason not to do just defaults was that there were greater defaults or threat of defaults in the 1970's. I don't see those in the chart. I have the Moody's chart, Moody's rated municipal bond defaults. Actually, there were 10 in the not-for-profit healthcare, so I understand why healthcare may be a little nervous about this. On my chart here 1,300 of the 8,500 issuers were healthcare, but they had more than half the defaults, 10 out of 19.

But I don't see this. You said that municipals were defaulting or threat of default. Well, there is a big difference between a default and a threat of a default. Do you have a list of defaults in the early 1970's under municipals? I can't find it.

Ms. OCHSON. No, what I said is that there were many defaults in the Depression and there are—

The CHAIRMAN. No ma'am, you said the 1970's. Please.

Ms. OCHSON. And I said that there was increased default risk in the 1970's.

The CHAIRMAN. No, you said—I am going to check the record. I believe you said default or risk of default. But to make it clear, you are not saying there were defaults in the 1970's, there were risks of default, but not default.

Ms. OCHSON. There was heightened default risk in the 1970's with—

The CHAIRMAN. But not default.

Ms. OCHSON. Yes.

The CHAIRMAN. Okay. I believe that the record will show that you said that. Maybe I misheard, but I take the affirmation that there were no such defaults.

The gentleman from North Carolina. We can move very quickly so members can go vote.

Mr. WATT. Mr. Chairman, I think I will pass, except that I would like the gentleman on the far right to just tell me why the government would—in writing, not today—just tell me why the government would want to get into a reinsurance process that you testified, I thought, was not needed—the insurance was not needed in the first place. So if you can just give me some information on that in writing, I will pass.

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. I will have questions from the record—

The CHAIRMAN. Or the gentleman from Missouri. If you have questions, ask them. If you don't, don't.

Mr. SHERMAN. I just wanted to make the comment that I think it is important that we try to help 501(c)(3)s through the bill, and I think we do.

The CHAIRMAN. Yes, they are. Now they are different then the general obligation, but—

Mr. SHERMAN. I understand.

The CHAIRMAN. Mutatis mutandis, as we say.

The gentleman from Missouri.

Mr. CLEAVER. I pass, Mr. Chairman.

The CHAIRMAN. All right, the gentleman from Minnesota, quickly.

Mr. ELLISON. Thank you Mr. Chairman. I will go quickly. I only have one question, and it is to whomever would grab it on the panel.

Perhaps the largest contributor to the current crisis in the municipal bond market was the troubles of many in the bond insurance firms whose capital positions were severely undermined by losses in their structured finance book business. To prevent future problems of this sort, should we contemplate a sort of Glass-Steagall for municipal bond business that would prevent these bond insurers from going off and providing insurance on exotic securities when the municipal policyholders are left holding the bag if these bets fail? Mr. McCarthy?

Mr. MCCARTHY. I should probably have a stab at that. I think it is a good question. Two things to note. The contemplated legislation here would consider that participation in the reinsurance program would be for companies that on a look forward basis were only writing municipal bond insurance.

The CHAIRMAN. That is correct. That was a condition.

Mr. MCCARTHY. So number one, that would make sure that the risks that were endemic in asset-backed securities were not there, being shared with municipalities.

Second, if you look at the municipal—the problem with some of the—most of the municipal guarantors that got in trouble was really in the concentrated risk that they took with CDOs of ABS, so that they were really wrapping transactions that lost 90 cents on the dollar or will lose 90 cents on the dollar. Ourselves and others, Warren Buffett, and several other new entrants that are contemplating entering the space are really focused on putting credit enhancement in place for municipalities.

The CHAIRMAN. That will have to end it.

I thank the panel. We would appreciate if any of you want to supplement anything or respond to any comments that were made, so the record will remain open for 30 days. I appreciate it, and I am sorry for the truncation, but it was very useful for us.

[Whereupon, at 1:36 p.m., the hearing was adjourned.]

A P P E N D I X

May 21, 2009

Statement by Rep. Michele Bachmann
House Financial Services Committee Hearing
"Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance"

May 21, 2009

Thank you, Mr. Chairman.

This week, voters in California rejected $16 billion in tax hikes and budget gimmicks that were proposed to save the state from its spiraling budget deficit. Californians shouted loud and clear that it is their priority to curtail out-of-control spending and to balance the government checkbook. They won't approve another excuse for bloated, over-extended government.

Today, our Committee is considering several legislative proposals which, among other things, would provide California and similarly situated states and localities with a direct federal bailout. Essentially, this will be another bite at the apple, letting the state get from federal taxpayers what the Golden State's own taxpayers have refused.

Under Rep. Connelly's *Federal Municipal Bond Marketing Support and Securitization Act* (H.R. 1669), the U.S. Treasury could directly purchase municipal bonds, issue securities backed by pools of municipal securities, and provide credit enhancement or guarantees for municipal securities. It specifically permits the Treasury to serve as the insurer of last resort, continuing the cycle of government bailouts and putting taxpayers on the hook for billions more.

And under the *Municipal Bond Insurance Enhancement Act*, taxpayers in the Sixth District of Minnesota and elsewhere across the country would be asked to pony up $250 billion for a reinsurance fund to back municipal bond insurers who knows where.

As the *LA Times* recently reported, "With Uncle Sam fully backing muni bonds, and presumably thus lowering state and local governments' interest costs, the risk is that some would borrow like the proverbial drunken sailor -- and that those bingers would end up becoming burdens for U.S. taxpayers down the road." California's fiscal track record should give American taxpayers pause about the long-term consequences of these proposals.

Additionally, there is a serious question as to whether the federal government should be competing with private reinsurance companies that are already active in the municipal bond market. In my opinion, this is an area from which we should steer clear.

Today's hearing is a stark reminder that we have no exit strategy from the bailout cycle in which we find ourselves. In fact, today's hearing is evidence that we're not only failing to learn the lessons of the past six months but that we're repeating them with fresh vigor.

I thank the witnesses for being here today and look forward to the discussion.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Congressman Gerald E. Connolly
Opening Statement
Financial Services Committee
Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance

Mr. Chairman,

Thank you for the opportunity to join you and the Committee as you take up what I believe to be critical legislation to shore up the financial health of our state and local government partners.

Mr. Chairman, you captured it best during our colloquy on the House floor in January when you called municipalities "the most sympathetic victims of this financial crisis" and you pointed out that the ability of local governments to fund necessary capital projects "has been impaired by factors well beyond their control."

After spending the last 14 years in local government in Fairfax County, Virginia -- just across the Potomac River -- I can attest to the fact that our municipal governments are among the safest of investments. They also are among the most effective engines for creating jobs on Main Street.

Whether it is building new schools, fire stations, water treatment plants, or repairing our nation's ailing transportation infrastructure, when jurisdictions float municipal bonds, they put people to work quickly and efficiently, and give a boost to the regional economy.

Capital outlays by states and localities exceed $280 billion a year with nearly two-thirds of that sum -- $180 billion -- being spent each year by localities on bricks-and-mortar projects. Yet, despite the historically solid performance rating and low default rate of munis, investors fled from the municipal bond market to U.S. Treasury notes following the economic meltdown last fall. As a result, the nation's 55,000 issuers of tax-exempt bonds, our state and local governments, are experiencing limited access to the capital markets due to the liquidity crisis.

Further complicating the issue is the fact that the private insurance market virtually disappeared overnight, eliminating a viable means of credit enhancement for our smaller muni issuers across the nation. The drying up of bond markets and lack of insurance created a double-whammy for many state and local governments that continue to grapple with tough financial choices caused by steep revenue shortfalls.

If Congress does not address this serious problem, we could wind up in a situation where this squeezing of the municipal bond market has a counteractive effect on the benefits of our hard-fought economic recovery package.

It is my firm belief that one of the primary vehicles for delivering on our pledge to turn the economy around will be our investments in state and local governments, but we first need to relieve the financial stresses faced by local and state governments.

Reviving the municipal bond market is a critical factor in this process.

As you know, earlier this year I introduced H.R. 1669, the Federal Municipal Bond Marketing Support and Securitization Act, as a way to kick off this very discussion.

Among other things, my bill would give the Treasury Secretary the authority, either directly or through the Federal Financing Bank, to provide credit enhancements to issuers or to outright purchase municipal bonds. It also would allow the Treasury to serve as the insurer of last resort and to charge a modest premium so it could provide this service at little or no cost to taxpayers.

At its core, my proposal directs the Secretary of the Treasury and Federal Reserve Board to work together to strategically intervene in the municipal bond market to restore liquidity and spark local job creation.

I continue to hear from state and local government officials and industry representatives who say this is still a problem in search of a solution, particularly with respect to short-term variable rate debt.

As I have said since I got involved in the efforts to revive the municipal bond market, what is most important here is not which solution we pursue but that we do, in fact, pursue a solution. We need to resolve this matter whether it requires government involvement or a revival of the reinsurance industry.

The bottom line is let's *get it done* -- so municipalities, local authorities, and state governments can issue their bonds at a fair rate -- and help our nation move down the road to economic recovery.

I also want to congratulate the Chairman and his staff for drafting four pieces of thoughtful legislation to tackle this issue including, the regulation of financial advisors, the unfair treatment of munis by the ratings agencies, and measures to create new instruments within the Treasury and the Federal Reserve to provide targeted, short-term relief aimed at restoring liquidity to the market.

I look forward to today's robust discussion of the potential solutions that have been laid on the table. I am confident that in the end we will move legislation to the floor that will help revive the municipal bond market.

Again, Mr. Chairman, I thank you for including me in this critical discussion.

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hfma
healthcare financial management association

Testimony

Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance

May 21, 2009

Statement of
Michael M. Allen

Chief Financial Officer
Winona Health

Representing the
Healthcare Financial Management Association

Before the
Financial Services Committee
U.S. House of Representatives

Introduction
Chairman Frank, Ranking Member Camp, distinguished Committee members. I am Mike Allen, Chief Financial Officer of Winona Health, a 99 bed community owned not-for-profit health system serving over 50,000 residents in the state of Minnesota. I appreciate the opportunity to be here with you this morning representing the Healthcare Financial Management Association (HFMA) in discussing the impact of recent municipal bond financing issues on not-for-profit hospitals.

HFMA is the professional membership organization for individuals involved in the financial management of health care. HFMA's more than 35,000 members work in a variety of healthcare settings including hospitals, long-term care facilities, physician groups, managed care organizations, public accounting and consulting firms as well as other organizations. Our chief financial officers members were heavily involved in developing the following comments.

Why Is Access to Capital Crucial for Not-For-Profit Hospitals?
Providing care in a hospital setting has always been a capital intensive endeavor. However, the need for inexpensive capital has never been greater due to three reasons.

Hospital facilities are rapidly aging. In 1990, the average physical plant was 7.9 years old[i]. Despite the flurry of recent construction activity, the average age has increased 25% to 9.9 years old[ii]. Older facilities pose several challenges to the healthcare system as they:

- Are more expensive to maintain, driving up the cost of care
- Need to be rebuilt or renovated to accommodate advanced diagnostic and treatment equipment which physically requires more space than earlier modalities
- Lack the capacity in many parts of the country to address the healthcare needs of baby boomers

Second, constant advances in diagnostic and treatment technology require hospitals to invest large amounts of capital in new equipment to ensure that patients have access to the most up-to-date care available.

Finally, hospitals are making considerable investments to reduce cost and pave the way for wider health system reform. Implementing fully integrated electronic health records (EHRs) and computerized provider order entry systems (CPOE) will enhance patient safety and increase the efficiency of care provided[iii]. These computerized clinical systems may well be the linchpin of healthcare reform, providing a means of aligning providers to work together in increasing quality and lowering cost, while at the same time providing a rich stream of clinical data on which to base comparative effectiveness studies. While Medicare is funding some of these expenditures, the amount is unlikely to cover the entire cost of a clinical system. Additionally, Medicare funds will not be available until much of the expense has been incurred. In order to bridge these gaps, hospitals must seek external sources of financing.

Financing for Not-For-Profit Hospitals

Few if any not-for-profit hospitals can fund their capital requirements solely though ongoing operations and, due to their tax-exempt status, they are prohibited from accessing equity markets. Traditionally hospitals have had access to capital through multiple channels. However due to economic shocks, funding through each channel is impaired. The list of traditional funding vehicles and their current impairments includes:

- Tax-Exempt and Taxable Debt: Despite the historically low default rate within the municipal bond market, defaults in the sub-prime mortgage bonds have negatively impacted hospitals. In general, sub-prime defaults shook investor confidence causing a flight to quality. Funds flowed out of municipal bonds and into risk free instruments like treasury notes and bonds.

  Exacerbating the situation, financial institutions that provide credit enhancements such as bond insurance and letters of credit were overexposed to the sub-prime market. As a result, credit enhancements that were once widely available and accepted by investors are no longer either available or accepted.

  Limited credit enhancements are still available through the FHA 242 program. However the application process is time-consuming and the collateral requirements are onerous. Additionally, the program requires 20 percent of the debt issued must be used to finance new construction[iv], which is of little help to hospitals whose cost of capital have spiked resulting from an expired letter of credit. Due to these constraints, few hospitals use the FHA 242 program.

- Bank Lines of Credit: Losses in the sub-prime market have reduced bank liquidity, causing banks to tighten lending standards and reduce outstanding lines of credit.

- The Federal Home Loan Bank (FHLB): The FHLB is available for bonds closed on or after July 30, 2008 through December 31, 2010. FHLBs enhance credit by providing either standby/confirming or direct pay letters of credit. Under both structures, the FHLBs never assume any project-related credit risk, which is borne by the member bank – just as on a conventional business loan. To date, only FHLBs in Indianapolis, New York and Cincinnati have used this structure[v].

- Vendor Lease Financing: This option is normally available from vendors who can access capital markets at lower rates than their customers due to the size and strength of their balance sheets (i.e. General Electric). Despite their size and ratings, these companies are not immune to the overall contraction in capital supply, causing their traditional sources of funding to become much more expensive or evaporate. The associated increase in their cost of capital has made these commercial lenders much more selective about the markets and risk profiles they serve.

- Philanthropy: Over 80 percent[vi] of hospitals report seeing a decrease in philanthropic gifts due to losses in investment portfolios and donor concerns about job security.

HFMA Recommendations
Access to an efficient tax exempt bond market is very important to the hospital industry and by extension to achieving the nation's healthcare goals. While current market conditions make it difficult for all hospitals to access the market and for some impossible, there are encouraging signs that the market may be on the long road to recovery. Rates have stabilized (albeit at higher levels than those seen in recent years), the higher rated issues coming to market have found an adequate supply of buyers and retail buyers are returning to the market.

Liquidity Facilities
Based on these encouraging signs our members urge this committee to first do no harm to the fledgling recovery. Liquidity facility solutions that are brought to the market should first and foremost be optional and the preservation of a private market for these facilities should be maintained. This implies that initial pricing of these liquidity instruments should be set carefully to avoid crowding relatively strong, long term providers of liquidity facilities out of the market. Pricing the government offered liquidity facilities at market rates will not offer a great deal of relief for hospitals struggling to afford the higher cost of debt seen in today's market. However, it will create additional capacity for these instruments, providing relief for those good credits who cannot find a liquidity provider with available capacity.

Second, we urge you to keep the scope of the liquidity facility program narrow, perhaps by limiting it to only existing issues. This narrow scope will help to ensure that there is no long term adverse impact to the functioning of the tax exempt bond market. Provision of low cost liquidity facilities on new issues could attract more lower rated credits toward the VRDO market, when perhaps their organizations cannot adequately manage the risks associated with these instruments. Attracting riskier credits to this market increases the risk that defaults will cause investors to demand a higher default risk premium for the entire market.

Municipal Bond Reinsurance
Our members believe a federally backed municipal bond reinsurance program would be beneficial to hospitals if it was appropriately constructed. First the program should be short term, lasting three to five years. This window will give private bond insurers time to recapitalize, establishing the AAA ratings necessary to participate in the market again. Second, federally backed insurance should be provided at market equivalent rates. This will ensure that as private insurers comeback into the market they can compete and also prevents hospitals from receiving an artificial subsidy that is not sustainable long-term. Finally, this program should be available for outstanding debt issues only. We are concerned that opening the program to new issues makes it difficult to sunset and potentially interferes with the recovery of private insurers. Limiting it to existing issues allows hospitals that have experienced a spike in capital costs due to insurer downgrades

or expired bank letters of credit "breathing room" to cost effectively adjust their debt structure while the private sector recovers.

Credit Enhancements

Our members recommend that the underwriting processes, collateral requirements, covenants and usage constraints of the existing FHA 242 program be reviewed and optimized to meet the current needs of the market. While this program has been in place for a number of years, providers have shied away from this credit enhancement option due to the extremely long underwriting and approval periods and the onerous collateral provisions that call for a mortgage on all assets and a two year mortgage reserve fund. Additionally, the FHA 242 program's requirement that at least 20 percent of debt be dedicated to new construction limits its usefulness given the situations facing many of our members. Due to the events in the market discussed earlier, many hospitals need to refinance their existing debt as their current capital structures are cost prohibitive.

While we laud the recent efforts by the Office of Insured Health Care Facilities in reducing the processing time for FHA 242 deals down to 90 days from 9.5 months, we would ask for relief from the collateral requirements that prevent many credit worthy institutions from accessing this vehicle and provide some discretion in meeting the performance standards for the program. Many credit worthy institutions cannot access this program because they happened to have a single year of adverse financial results. Sound underwriting practices should be able to separate a financial event that has been dealt with by a seasoned management team from a long term trend of poor performance.

Our members also recommend eliminating the 20 percent new construction requirement. This will allow hospitals that are faced with onerous capital costs due to the loss of bank backed letters of credit to use the FHA 242 program to refinance at an economically sustainable interest rate.

Finally, we ask that the Federal Home Loan Bank program that granted FHLB members permission to issue standby letters of credit for tax exempt bonds be extended beyond its current December 31, 2010 expiration date and relax the requirement that the participating banks post collateral equal to 100% of the letter of credit amount.

We cannot overstate the impact that the suggested simplifications will have on hospitals, particularly small to mid-sized facilities that are not integrated with a larger health system and therefore have difficulty accessing capital at market-rates.

Financial Advisors

Regarding financial advisors, our members would not recommend additional federal regulation. Some of our members have commented that advisors were somewhat dismissive of the risks inherent in possible worst case scenarios. During these conversations considerable emphasis was placed on the upside of these debt structures while risks were couched in terms of the historical relationships between rates without considering the advent of substantial interest rate volatility similar to what we have recently experienced.

Bearing this experience in mind, we believe that moving forward the financial services industry should have the opportunity to correct problems related to risk disclosure. The committee should encourage the various trade groups representing financial advisors to develop a private sector solution. Potential components might include some or all of the following:

- Well defined standards of conduct
- Specific education/certification for bond enhancements and complex derivative products like interest rate swaps
- A complaint mechanism monitored by the trade groups for use in identifying "bad actors"

If the industry is unable (or unwilling) using the methods suggested above or similar approaches to correct the problems outlined, we would suggest the use of regulatory means to achieve greater risk transparency and disclosure related to derivative products.

Rating Agencies

Similarly, our members would not recommend additional regulation forcing rating agencies toward what may be an artificial consistency between healthcare and other industry credits. In point of fact healthcare business models are fairly unique in that their income statements are extremely dependent on the vagaries of federal and state legislative processes. Further, the industry is about to go through a period of sweeping healthcare reform that is likely to transform these business models in profound ways. To compensate for these income statement risks, rating agencies typically look for stronger balance sheets that will provide some assurance to investors that providers will have the cash to weather these storms and adapt their business models to the new market realities. Do the current ratings accurately reflect the relative risk inherent in healthcare credits? The low rate of healthcare defaults in the tax exempt market would seem to suggest that the ratings are not set too high. As far as lowering the ratings, with the tax exempt bond market just beginning to recover, now is not the time to relax rating agency standards and risk a default that would chase investors out of the market and impose higher risk premiums on all of the issuers in the market.

Concluding Comments/Final Thoughts

Eighty-five percent of all hospitals are not-for-profit[vii]. These organizations play a key role within their communities acting as both a healthcare safety net for the underprivileged and an engine for economic growth. In addition to being a major employer in most communities – directly providing jobs with stable wages and benefits – the American Hospital Association (AHA) estimates that hospitals spend $304 billion annually on goods and services from other businesses[viii].

In order for health care reform to be successful, the nation's not-for-profit hospitals need to be financially healthy. Facilitating access to stable and inexpensive sources of capital funding will reduce the cost of healthcare ensuring access to hospital care for all patients. Further, without reliable funding, it will be difficult for providers to implement electronic health records and take other steps needed to facilitate health system reform.

BACKGROUND DISCUSSION

Fixed Rate Debt and Bond Insurance

Tax-exempt bonds are a crucial source of financing for three-quarters of hospitals[ix]. The credit market meltdown that began during late 2007 has had a significant adverse impact on not-for-profit hospitals. During the spring and summer of 2008 access to capital became more difficult for all but the highest rated credits. From mid-September 2008 to November 2008 the credit market for fixed rate debt was inaccessible for all hospitals regardless of credit rating.

Facilities intending to issue debt in the fourth quarter of 2008 didn't do so until 2009 due to a dearth of buyers. As credit markets loosened somewhat in early 2009 these hospitals brought their issues to market. As a result, the supply of new issuance far outstrips demand. Investors, who are still extremely risk adverse, are taking only the highest quality credits and demanding higher yields. While markets are functioning for quality credits (AA & A), the demand for lower quality investment grade debt (BBB) is variable and non-existent for below-investment grade debt. The situation is exacerbated by the lack of bond insurance.

Prior to the credit crisis, 40 to 50 percent of not-for-profit health care bonds were backed by bond insurance[x]. A lower rated investment grade hospital could "buy-up" to a AAA rating which allowed pension funds and other institutional investors to purchase their issues. Higher rated bonds are also more likely to attract retail investors looking for low risk and tax-free yields. This has the effect of increasing overall demand and driving down the cost of capital.

Reliance on bond insurance however exposed hospitals to the credit positions and market acceptance of bond insurance companies. During 2008 the major bond insurers were downgraded or placed on watch lists by ratings agencies due to their sub-prime mortgage exposure. This had a negative impact on sources of capital for not-for-profit hospitals. Investors exited insured products due to the uncertainty around them. As defaults in sub-prime mortgage bonds accelerated, access to capital was limited to only those with high investment grade ratings (AA – A). By September 2008, the municipal market was closed even to these providers.

Floating Rate Debt

In addition to bond insurance coupled with fixed rate securities, not-for-profit hospitals relied heavily on floating rate debt in the form of auction rate securities and variable rate demand bonds (VRDBs) to access inexpensive capital.

Auction rate securities are debt instruments with a long-term maturity for which the interest rate is regularly reset through a dutch auction. Auctions can fail when demand for securities offered is less than the supply. Prior to 2007 this rarely occurred as banks that specialized in running the auctions would commit their capital to prevent failures. When these auctions do fail, the securities are priced at a penalty rate, typically equal to a state usury maximum or a spread over the London interbank offered rate (LIBOR). As an example, following a failed auction during the week of February 15, 2008 interest rates on the University of Pittsburgh Medical Center's auction rate debt topped 17 percent[xi].

When the capital positions of auction banks weakened due to sub-prime mortgage losses they became less willing to support the market. As a result investors withdrew leading to widespread auction failures which effectively closed the ARS market in the spring of 2008. Healthcare providers began to seek alternative credit vehicles that they could use to "unwind" their positions in auction rate securities. With the ARS market collapse, VRDBs became the only avenue for hospitals to obtain low cost floating rate capital.

VRDBs are debt instruments that are payable on demand and have an interest rate based on a prevailing money market rate plus a spread. Accessing the VRDB market requires a bank letter of credit for almost all hospitals, except for those with the strongest balance sheets.

As the financial crisis accelerated and bank balance sheets deteriorated, letters of credit became increasingly difficult to secure. Now, when they are available, they are considerably more expensive. By January of 2009, it is estimated that the cost of bank guarantees increased tenfold since the beginning of 2008[xii]. Additionally, the terms and conditions are tighter including more restrictive covenants and termination provisions. Under these circumstances, use of VRDBs increases a facility's capital structure risk as it is now exposed to put risk, renewal risk and credit event risk. As a result many providers have reduced exposure to this financing vehicle by issuing higher cost fixed rate debt.

Interest Rate Swaps

Many organizations paired variable rate debt with interest rate swaps to artificially create inexpensive long-term fixed rate debt. In these arrangements, providers made payments to a swap counterparty based on a fixed rate while receiving floating rate payments based on LIBOR. As credit markets collapsed, LIBOR rates spiked causing negative valuations on "fixed leg" payments, adversely affecting the operating statement of the hospital. As a result, hospitals were forced to post additional collateral putting pressure on already weakened balance sheets and leading ratings agencies to downgrade some facilities that heavily relied on interest rate swaps[xiii].

The Recession

The negative impact of credit market events has been amplified by the economic downturn. Many providers[xiv] report seeing volume declines, particularly in elective surgeries which can account for as much as 75 percent of EBITDA for some providers[xv]. The HFMA Healthcare Financial Pulse survey indicated that inpatient volumes are down in 55% of hospitals with 23% reporting more than a 2% decline in volume. This is a phenomenon that is unique to the current recession. Hospitals have traditionally not experienced decreases in demand during prior recessionary periods. Additionally, expenses for charity care and bad debt have increased as a result of growing numbers of uninsured and underinsured patients, putting pressure on hospitals already fragile operating statements.

Operating pressures, in conjunction with the capital market turmoil described in the preceding sections have resulted in a number of negative ratings actions. As an example Moody's downgraded 19 hospitals in Q1 of 2009 – compared to eight in Q1 2008 – and 27 in Q4 2008 – compared with 15 in Q4 2007. Additionally, all three ratings agencies have taken a negative outlook on the hospital industry. As a result, the cost of capital has increased for not only downgraded hospitals but for all institutions.

Impact on Not-for-Profit Hospitals

As a direct result of the issues discussed above, interest expense at hospitals increased 15 percent[xvi] in the third quarter of 2008 over the same period in 2007. By January of 2009, many hospitals were forced to replace some or all of what had been inexpensive floating rate debt yielding three to four percent with fixed rate debt costing between six to seven percent for AA rated facilities, six to eight percent for A rated facilities and was widely unavailable for BBB credits and below.

A recent HFMA survey[xvii] finds that increased capital costs are causing facilities to delay or abandon projects necessary to improve the access and quality of care. Seventy-nine percent of respondents report reducing investments in medical technology, seventy-seven report reducing investments in information technology and seventy-two percent report reducing investments in facility construction.

About HFMA

HFMA is the nation's leading membership organization for more than 35,000 healthcare financial management professionals. Our members are widely diverse, employed by hospitals, integrated delivery systems, managed care organizations, ambulatory and longterm care facilities, physician practices, accounting and consulting firms, and insurance companies. Members' positions include chief executive officer, chief financial officer, controller, patient accounts manager, accountant, and consultant.

HFMA is a nonpartisan professional practice organization. As part of its education, information, and professional development services, HFMA develops and promotes ethical, high-quality healthcare finance practices. HFMA works with a broad cross-section of stakeholders to improve the healthcare industry by identifying and bridging gaps in knowledge, best practices, and standards.

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Written Testimony

of

William Apgar
Senior Advisor to the Secretary for Mortgage Finance
U.S. Department of Housing and Urban Development

on

"Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance"

before the

Committee on Financial Services
U.S. House of Representatives
May 21, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to testify. HUD is pleased to see that the Financial Services Committee is examining a range of issues, and considering legislation, related to the lack of liquidity and other constraints within the municipal bond markets. The disruption in these markets has severely hindered the ability of state and local Housing Finance Agencies (HFAs) to achieve their mission of facilitating the availability of affordable mortgages and rental housing and could undermine the housing and economic recovery.

While the Administration is not yet able to take a position on the proposed legislation, taking appropriate steps to improve the functioning of the municipal bond market can be an important component of our overall response to the current housing crisis. In that context, I would like to discuss the Administration's efforts relating to HFAs, provide additional details on the role that HFAs play in the housing market, and the challenges they face in the current market environment.

OVERVIEW OF THE ADMINISTRATION'S HFA INITIATIVE

I serve as Senior Advisor for Mortgage Finance for HUD Secretary Shaun Donovan and have worked closely on the development and implementation of the Administration's Homeowner Affordability and Stability Plan (HASP) which was announced on February 18, 2009. In recognition of the important role that HFAs play, the President announced as part of this plan, his intention to develop an initiative to support HFA's and their efforts to aid distressed homeowners, stimulate first-time home buying, and provide affordable rental homes.

Building on the President's announcement of February, the White House, Treasury, and HUD are now finalizing the details of an initiative designed to address three distinct but interrelated challenges facing HFAs:

- Lack of Financing for New HFA Housing Bond Issuance;
- Lack of Liquidity to Support State HFA Variable Rate Debt Obligations; and
- Ongoing credit and balance sheet stress for HFAs at risk of ratings downgrades.

Working in consultation with the Federal Housing Finance Agency, Fannie Mae, and Freddie Mac, along with the National Council of State Housing Agencies and the National Association of Local Finance Agencies, and individual HFAs, the Administration's HFA working group is now exploring how best to support HFAs. Work continues to complete program design. Detailed guidance on this effort should be available in the near term.

THE ROLE OF HFAs

In strong and weak economies, HFAs have been reliable sources of flexible, affordable mortgage money for lower-income first-time home buyers. Using single-family Housing Bonds or, as they are commonly known, Mortgage Revenue Bonds (MRBs), the National Council of State Housing Finance Agencies (NCSHA) HFAs have made 2.6 million families first-time homeowners, adding another 100,000 families each year.

FHA has enjoyed a very strong partnership with various state HFAs. Over the years, the HFAs have worked very collaboratively with FHA to offer low-and moderate-income families access to special affordable housing programs that rely on FHA financing. More recently, the HFAs have been engaged in dialogue with FHA on issues related to the current market crisis and the types of programs that can help families keep their homes. Many of the discussions have focused on using state resources to complement and support the Federal programs, including the HOPE for Homeowners program, which may become one of the primary vehicles to help struggling families keep their homes, when pending legislation to modify the program is enacted.

Recognizing that not everyone is ready or suited for homeownership, HFAs also play a key role in the delivery of many other federal housing resources in addition to Housing Bonds, including the Low Income Housing Tax Credit, the HOME Investment Partnerships Program, and Section 8, programs that are central to HUD's efforts to promote expanded access to affordable rental housing. HFAs and their partners have produced nearly 2 million affordable rental homes with equity provided by the Housing Credit. Nearly half of these homes are multifamily Housing Bond-financed. HFAs have financed nearly another 1 million affordable rental homes with Housing Bonds alone. Using Housing Bonds and the Credit, HFAs add another 150,000 homes to our country's affordable rental housing inventory each year.

HFAs FACE SIGNIFICANT MARKET CHALLENGES

In light of their strong track record and considerable capacity, last year under the Housing and Economic Recovery Act (HERA), Congress provided HFAs $11 billion in new Housing Bond authority, to be available through 2010 to finance affordable single-family and multifamily mortgages. Unfortunately, HFAs have not been able to translate these additional resources into expanded housing opportunities in this time of expanded housing need. As is the case with many financial institutions, HFAs now face severe economic dislocation arising from a housing finance crisis they did not create. Though state HFAs did not engage in subprime lending and their delinquency and foreclosure rates are continue to be lower than industry averages, they are climbing. In cases where the HFA holds loans in portfolio, the loans with private mortgage insurance have also been adversely affected by the recent downgrading of the major mortgage insurers, putting some HFAs at risk of downgrades themselves, which may exacerbate the difficulties the HFAs currently face in funding new activity.

Moreover, for many months now, HFAs have been virtually frozen out of the tax-exempt Housing Bond market, unable to find investors willing to buy their long-term, fixed-rate bonds at rates that allow HFAs to lend the proceeds affordably. Investor interest has diminished dramatically because of declining investor income, financial institution deleveraging, and uncertainty about the economic outlook, especially for housing. Fannie Mae and Freddie Mac, traditionally large purchasers of Housing Bonds, are out of the market. Other traditional purchasers, such as banks, mutual funds, property and casualty insurance companies, and other financial institutions, have strictly limited their purchases or dropped out of the market altogether.

Some HFAs have managed to keep their mortgage programs operating, though at severely curtailed production levels and at higher interest rates, by selling modest amounts of short-term bonds to retail investors, relending loan sale proceeds, accessing credit lines, and tapping their own resources. Under normal market conditions, HFAs have typically offered high LTV mortgages to lower income and first time home buyers at approximately 50 basis points below conventional rates (although down payment assistance and other HFA services may be as important to HFA borrowers as a below-market mortgage rate).

As discussed, current market conditions have caused long-term municipal bonds to be priced at yields above comparable term Treasuries, thus driving up mortgage financing costs for HFAs, which have historically been reliant on favorable municipal financing. The result is that new long-term MRB issues cannot be priced to produce the mortgage market rates necessary for the HFA programs to originate mortgages. To a large extent, HFA lending activities have come to a standstill. This withdrawal from the market eliminates an important source of good quality home purchase lending for low- and moderate-income borrowers that not only benefit from the favorable rates historically linked to HFA finance, but also benefit from the counseling and down payment assistance programs that HFAs commonly provide.

Even further constrained is the lending and financial capacity of state HFAs that issued Variable Rate Debt Obligation (VRDO) in recent years. These VRDOs were issued to enable HFAs to offer mortgages at interest rates lower than those supported by fixed-rate debt. Unfortunately, these HFAs now struggle to remarket this debt, as the institutions they have relied upon in the past to remarket and serve as buyers of last resort of VRDOs have left the market, have been significantly downgraded, or are imposing unreasonable terms and excessive rates. State HFAs have over $23 billion in VRDOs outstanding. Nearly $3 billion of existing liquidity facilities have already expired or will expire by the end of 2009. Those unable to find buyers for their VRDO have been forced to convert it to "bank bonds," requiring them to pay it off under accelerated amortization schedules at high interest rates, further depleting their housing resources and weakening their financial positions. Rating agency downgrades of private mortgage insurance providers, bond insurers, and liquidity providers, deteriorating performance of HFA mortgage portfolios, and dislocations in the VRDO market could also result in downgrades of the credit ratings of some of the largest HFAs. Such downgrades would further exacerbate the VRDO market crisis.

CONCLUSION

The sidelining of HFAs could not come at a worse time for our housing and economic recovery. HFAs are a key source of affordable, flexible mortgage money for lower-income first-time home buyers, who often also need the counseling and down payment assistance that HFAs provide to access homeownership. The opportunity for HFAs to help lower-income families achieve homeownership is greater now than in some time, with the increased affordability created by today's declining home prices and the expanded lower-cost housing stock produced by home foreclosures. HFAs project they could issue $33 billion in tax-exempt bonds over the next two years in response to growing demand provided that the municipal bond markets are properly functioning. HFAs' inability to respond to the growing demand from first time homebuyers for their mortgages could negatively impact the broader housing market, as homeowners looking to trade up are unable to sell their homes to first-time buyers.

HUD looks forward to working with the Committee on solutions to address the disruptions in the municipal bond markets.

SIFMA®
Securities Industry and
Financial Markets Association

Written Testimony

of

Bernard Beal

Chief Executive Officer, President

M.R. Beal & Company

Vice Chair

Securities Industry and Financial Markets Association

Before the House Committee on Financial Services

May 21, 2009

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Good morning, Chairman Frank, Ranking Member Bachus and Members of the Committee. My name is Bernard Beal and I am Chief Executive Officer of M.R. Beal & Company[1] and Vice Chair of the Securities Industry and Financial Markets Association (SIFMA)[2]. Thank you for the opportunity to testify before you on behalf of SIFMA on these important pieces of legislation that address critical issues for the municipal securities market and its participants.

We applaud your ongoing leadership and the bold steps you are taking to help stabilize this vital sector of the financial markets. When SIFMA last addressed the Committee regarding municipal securities matters in September 2008, the focus was on the effect of the collapse of the auction rate securities (ARS) market on municipal securities issuers. While much of the dust from that breakdown has settled and many market sectors are regaining health, some parts of the municipal bond market have been unable to regain their footing and seek assistance accessing the capital markets. Many lower-rated state and local government issuers are facing a critical need for reliable liquidity facilities and long-term credit enhancement, and the lack thereof is making it difficult for them to bring some transactions to market. This delays important infrastructure projects, such as schools, healthcare facilities, and bridges and roads, which create jobs and revitalize communities.

The legislation that is the subject of today's hearing offers constructive solutions to assist state and local issuers gain access to the capital markets and addresses important regulatory and ratings matters that have persisted for years. With regard to market access issues, the legislation is consistent with recommendations that SIFMA advanced in a letter to this Committee in February and, therefore, we support these measures and offer suggestions to ensure efficiency in restoring and spurring market activity with the least amount of direct federal involvement. We also support the provisions regulating unregulated financial advisors, which, generally, are consistent with the Municipal Securities Rulemaking Board (MSRB) rules that govern our regulated broker-dealer members, who engage in the same financial advisory activities today. I will address each of the proposed bills with a focus on what benefits they will provide for market participants. I look forward to answering any questions the members may have.

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[1] M.R. Beal & Co. was founded in 1988, and is the nation's oldest minority-owned investment bank. The firm consistently ranks among the top-20 national underwriters of municipal debt transactions and among the top-100 underwriters of corporate equity and debt. M. R. Beal is a directed broker for major institutions and an approved broker for most major public and private pension plans. The firm also offers advisory services and proprietary research. Headquartered on Wall Street in Manhattan's financial district, M.R. Beal also has offices in Chicago, Dallas and Sacramento. The firm's equity trading group is based in Chicago.

[2] SIFMA brings together the shared interests of more than 600 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. SIFMA's members account for about 90% of the nation's municipal bond underwriting and trading activity by volume, which represented an estimated $5 trillion of municipal bonds in 2008. It has offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information may be found at our website: http://www.sifma.org.

"Municipal Bond Insurance Enhancement Act of 2009"

SIFMA supports the proposal to establish a temporary federal government reinsurance program for transactions covered by a primary credit enhancement policy from a private market participant. This model provides the most benefit to the issuing community and investors alike without direct federal involvement in state and local debt issuance. Moreover, the program does so in a carefully defined manner: after providing reinsurance for five years (which will last for the life of the underlying insured debt), the Secretary of the Treasury is obligated to provide a privatization plan to Congress.

SIFMA strongly endorses creating an Office of Public Finance within the Department of Treasury as proposed under this legislation. This office will provide a point of contact for the municipal securities industry for non-regulatory matters. This office will help foster communication among state, local and federal governments and serve as a point of information for municipal securities market stakeholders.

It is important to note that federal involvement in this area is not a poor reflection of the municipal securities market. Rather, it stems from the fact that most of the municipal bond insurance companies suffered catastrophic losses from their exposure to products and markets not related to municipal securities, such as secured subprime mortgages. As a result, most of the bond insurers lost their highly esteemed AAA and AA ratings, which had been in place since the industry began 30 years ago.

Municipal bond insurance serves a valuable function in the municipal securities market as it provides comfort to investors that a third party will make timely principal and interest payments on their bonds should the need arise, in addition to reducing an issuer's borrowing costs. The lack of AAA- and AA-rated companies has negatively impacted the market access of smaller issuers and those lesser-rated issuers whose purchase of insurance wraps for their debt offerings helps lower borrowing costs and makes their debt eligible for purchase by money market funds.

For example, in 2007 the percentage of municipal securities that were enhanced by bond insurance was 46.7 percent, while in 2008, the percentage declined substantially to 18.5 percent. During the first four months of this calendar year, only 12.5 percent of municipal bonds were insured. Municipal issuers rated A and BBB rely heavily on insurance to save on issuance costs. Of municipal securities rated A and BBB, 57.8 percent were insured in 2007, 44.8 percent in 2008 and 20.7 percent in the first quarter of this year.

"Municipal Market Liquidity Enhancement Act of 2009"

SIFMA supports the initiatives taken in this bill as they provide a method for the federal government to target assistance to a specific sector of the market. My testimony with respect to this piece of legislation is the synthesis of conversations among the members of SIFMA, in particular, broker dealers that underwrite and distribute municipal securities, some of whom are affiliated with entities that provide letters of credit and other liquidity facilities as part of their day-to-day business.

While, in general, the municipal markets are functioning properly, there are important sectors that are in need of affordable liquidity facilities. Injecting liquidity into the municipal securities market is a complex undertaking; doing so will affect the sector in need and each of the market participants in that sector differently. Because it is directed to serve the needs of those market sectors in greatest need, the facility can play a critical role in reinvigorating those sectors.

From a policy perspective, SIFMA is of the view that there are many ways for the federal government to inject liquidity into the municipal securities market, each of which has distinct policy ramifications. We would like to offer some alternative approaches and the potential market effects of each approach. It is our intention to work constructively with Congress and the Administration to assure that whatever federal liquidity facility is implemented is an efficient vehicle for troubled sectors while being the least disruptive to the markets that are functioning well.

The proposed legislation authorizes the Federal Reserve Bank to lend money to a special purpose vehicle that will be used to purchase three classes of variable rate demand obligations (VRDOs): (i) those that have already been issued by the date the legislation is enacted (new-money VRDOs are not included); (ii) those issued to refund auction rate securities (regardless of when they are issued); and (iii) short-term notes issued to assist a government with its short-term borrowing needs. The legislation also specifies that the special purpose vehicle can act as the liquidity facility of last resort only for those VRDOs and short-term notes that have been the subject of a public offering. Finally, the liquidity facilities to be made available by the special purpose vehicle will bear interest rates to be established by the Federal Reserve Bank and approved by the Federal Reserve Board, will be secured by the VRDOs that are being purchased.

Previously Issued VRDOs. VRDOs are municipal bonds with a long-term maturity, usually 30 years, and a coupon that is calculated periodically, be it daily, weekly, monthly or other short-term frequency. The purchasers of these instruments have the irrevocable right to sell them back to the issuer, which almost always has a liquidity facility issued by a bank that provides cash in the event an investor wants to sell them and another buyer cannot be found (some issuers use their own liquidity). Historically, issuers have used this product to manage their debt as it allowed them to borrow money for a long term while paying short-term rates. In the current market, issuers are trying to obtain liquidity facilities to replace ones that are expiring by their terms so they can keep their VRDOs in that mode. The cost of liquidity facilities, however, has increased dramatically for the entire market and especially for lower-rated credits and the healthcare sector, preventing some issuers from accessing the market. In 2007, VRDOs represented 11.7 percent of all municipal securities. In 2008, that figure jumped to 29.7 percent as issuers used VRDOs to refund auction-rate securities, which experienced a tremendous spike in rates. During the first four months of this year, VRDO issuance stood at 9.7 percent of all municipal securities.

The prohibitive cost of liquidity facilities also means that VRDOs, for which purchasers could not be found during the credit crunch, may still be held in the form of bank bonds by the banks that issued letters of credit, investors or broker dealers. Most of these entities would sell these securities if at all possible. Given this market stasis, SIFMA supports the legislation targeting previously issued VRDOs for purchase.

While the legislation describes the *instruments* that may be purchased by the federal facility, it does not provide any guidance with respect to the *market sectors* that will receive such support. It is well accepted that the not-for-profit sector, which includes health care, higher education, and the housing sector, now require the most help. Another sector of the market that should not be ignored are the lower-rated issuers, which have considerable difficulty accessing the markets. Significantly, these issuers enjoy investment grade ratings and, in a well-functioning market, could access the markets at will. In the current market, though, that is not the case.

On the other end of the need scale are higher-rated credits, including general obligation bonds, revenue bonds and private-activity bonds, that are functioning well.

Short-Term General Obligations. While certain large state and city issuers have experienced cash-flow shortfall due to economic conditions in general, it is not clear to us that general obligations as a class of debt are in dire need of assistance. Nonetheless, we do not oppose the inclusion of short-term general obligations in this legislation because some state and local governments should be assisted during this difficult economic time.

Liquidity Facility Provider of Last Resort. By establishing the special purpose vehicle as the liquidity facility provider of last resort for the three classes of municipal bonds noted above, the legislation creates an entity that will become a direct player in the municipal markets. While the appearance of a new player in the market can assist the smaller and lesser-rated credits, we have some concerns with this provision. Potentially, this entity can alter the dynamics of the market at the same time that it tries to revive it: issuers will know that they do not have to pay market prices for liquidity because the federal government will be willing to provide a liquidity facility to purchase all of the permitted unremarketed VRDOs and short-term notes. The potential for this type of disruption, of course, will depend on the pricing of the liquidity facility offered by the special purpose vehicle.

While creating a liquidity facility of last resort is one way to address the need to provide liquidity facilities to the market, other structures exist.

Federal Backstop — In this model, the federal liquidity facility will serve as a backstop to letters of credit issued by banks, so that the facility will make a payment if the letter of credit bank does not. This structure would give the banks another tool to mitigate the risks in the current marketplace without the need for direct government involvement. Such a structure could be similar to a Federal Home Loan Bank program, which also backs existing letters of credit in housing transactions. Banks funded by the federal liquidity facility should share the risk of the underlying credit by posting collateral equal to a portion of the loan.

Federal Participating Liquidity Facility — This structure includes the federal government as a minority partner with private letter of credit banks that are sourcing their own transactions. The federal government would increase the size of the private bank's letter of credit by a percentage, perhaps in the range of 20 percent to 40 percent. So, for example, if a bank is issuing a $200 million letter of credit, the federal participating liquidity facility could add an additional 30 percent — or $60 million — to the size of the letter of credit. The advantages of this model are that the federal government does not have to assess credit as it can piggyback on the credit decisions of the majority bank. The 30 percent multiplier of the federal facility would allow the majority bank to increase its capacity and issue more letters of credit. Finally, the transaction could be structured so that investors would look to the federal facility for 30 percent of the transaction. This would allow a 2a-7 fund investor with concentration limits to dilute its exposure to majority banks, as they would take on exposure to the federal facility.

Pricing of Liquidity Facilities. We believe that the special purpose vehicle should price its federal liquidity facilities in such a way that it helps issuers who otherwise could not obtain a letter of credit without discouraging private sector market participation. As I noted earlier, if the pricing undercuts the market, there will be the risk that issuers will look to the federal facility and not to the usual market participants. At the same time, we recognize that the special purpose vehicle cannot price the liquidity facilities too high because doing so would undermine its main purpose. One way to address this situation is for the special purpose vehicle to offer pricing that will increase over time, as this would create a strong incentive for the issuer to return to the functioning markets and its traditional investor base.

Size of the Liquidity Facility. The size of the liquidity facility, of course, will depend on the scope of the program. The legislation provides that VRDOs issued prior to enactment of the legislation may be purchased with loans provided by the facility, which is a finite number. The inclusion of VRDOs for refunding ARS and short-term debt obligations, however, has the potential to require a much larger facility as various issuers assess their borrowing needs.

Term of the Liquidity Facility. Although it is not addressed in the proposed legislation, the federal liquidity facility, in SIFMA's view, should be a safe harbor for the troubled sectors of the municipal market until those sectors stabilize. It is impossible, though, for anyone to predict when that stabilization may occur or what the term stabilization means. For our purposes today, I will define stability as the point in time at which the markets will be able to function without the need for federal intervention. Having said that, we believe the federal facility should be in place for a term of not more than three years.

"Municipal Advisors Regulation Act"

SIFMA supports the proposed legislation to regulate independent municipal financial advisors, who have not been subject to any regulatory scheme and operate unfettered in the markets. SIFMA has held this view for many years, as the unregulated financial advisors have taken advantage of gaps in the industry's regulatory structure. This legislation will fill in that regulatory gap, protect issuers and investors alike and help to restore confidence in the municipal securities markets. The legislation will also help level the playing field for market participants who offer financial advisory services to state and local governments, by holding currently unregulated financial advisors to the same high standards for registration, examinations and fair dealing as well as limiting potential conflicts of interest caused by unregulated provision of political contributions, gifts and entertainment.

Under the proposed legislation, the Securities and Exchange Commission (SEC) would be the entity responsible for such standards, which includes training, experience, competence and other qualifications the SEC deems appropriate for protecting investors. While we agree that there should be one body responsible for registering and regulating municipal financial advisors, we caution against duplicative regulatory regimes. Currently, the MSRB is the body that drafts the rules for municipal securities based on its deep understanding of the products and practices of municipal securities dealers with FINRA responsible for enforcing those rules and regulations. At the same time, the SEC is responsible for monitoring and enforcing compliance with antifraud and other provisions of existing legislation, such as the Securities Act of 1933 and the Securities and Exchange Act of 1934. SIFMA recommends that, in defining the SEC's role in regulating financial advisors, the committee recognize the role of the MSRB in the regulatory framework and consider this existing division of responsibilities.

We believe the crucial purpose of this bill is to require currently unregulated municipal financial advisors be held to the same high standards to which regulated broker dealers currently adhere. In early April of this year, the MSRB[3] found that 73 percent of financial advisors that participated in at least one primary market transaction in 2008 were not subject to MSRB regulatory rules. Of the total $453 billion in par value of municipal bonds that were sold in 2008, roughly 70 percent — or about $315 billion — were issued with the assistance of a financial advisor. Only 38 percent of those financial advisors were MSRB-registered broker dealers. These statistics and the amount of municipal securities for which unregulated entities provide advice clearly show the need for regulation over these market participants.

In a municipal bond transaction, the municipal financial advisor sits next to the issuer and advises its client on a range of topics, including the size and form of the transaction, how to invest the proceeds and whether to hedge some of the risks involved in issuing municipal debt. The municipal financial advisor also participates in the pricing call when the debt is sold to the market. Based on this very close relationship with the issuer, we agree, in principle, that municipal financial advisors should be held to a fiduciary standard of care, and we look forward to a dialogue with lawmakers and regulators to discuss what such a standard should entail.

While a fiduciary standard of care is defined under various state laws, the municipal finance market is a national one in which lawyers, bankers, advisors and trustees from all 50 states can work on transactions in all 50 states. Thus, a single standard of care under federal law will regulate municipal financial advisors and, at the same time, establish a uniform standard that will apply throughout the country regardless of the jurisdiction or the home state of the advisor. This clarity will simplify compliance and enforcement. Correctly, the new regulations would not cover bond attorneys serving in an accepted legal capacity or registered broker-dealers (acting the capacity of underwriters), who are already well regulated under the MSRB.

"Municipal Bond Fairness Act"

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[3] The Municipal Securities Rulemaking Board report, "Unregulated Municipal Market Participants: A Case for Reform," April 2009.

A move to global scale ratings — either by unilateral action on the part of the rating agencies or as a result of federal law — would represent a sea change to the municipal bond industry. Like any market, the municipal bond market can be disrupted if such changes are introduced too quickly. We would like to offer our views on the advantages of such a move, as well as raise some constructive suggestions on areas of concern.

Advantages

Fairness to the Municipal Markets. The first advantage of moving to global scale ratings is that it would be more consistent with the municipal market's history of an extremely low default rate coupled with a high rate of expected recovery in defaults. It would seem fair, as suggested by the title of this legislation, to acknowledge the historic safety of investing in municipal bonds and have them rated on the same scale that is used to rate all other debt securities.

Consistency Across Asset Classes. For about 90 years, Moody's Investors Service has used a single scale to rate the debt of all corporations, financial institutions, sovereigns, structured products as well as sub-sovereigns in the international markets — with the only exception being municipal securities. As more municipal bonds are purchased by non-traditional investors (such as, most recently, those who have gobbled up vast amounts of Build America Bonds), it is in the interests of all stakeholders in the markets to have all asset classes rated on the same scale. Doing so will bring greater uniformity to the markets in general and make it easier for all investors — institutional, retail and individual — to make informed investment decisions.

Issuer Benefits. If a transition is made to the global scale ratings, many municipal issuers would enjoy higher ratings, which would have several important benefits. Higher ratings, of course, mean less risk, which translates into lower borrowing costs. Lower borrowing costs for issuers will have a direct positive financial effect on the budgets of states and cities, resulting in more revenue and lower debt service payments that will benefit taxpayers. Another advantage is more limited but no less important — for those issuers that are moved from AA to AAA, it will mean that they will not need credit enhancement to achieve the highest ratings, which will translate into another cost savings. Finally, the transition will mean that the debt of more entities will become eligible for purchase by the 2a-7 money market funds, which have become an increasingly large percentage of municipal bond purchasers.

Credit Rating Agency Benefits. The credit rating agencies would also benefit from a transition to the global ratings scale as it would give them greater flexibility to adjust to the current economic environment, which is different from that of the past 30 years for many reasons, including the pressure on municipal issuers' due to reduced tax receipts and increasing other post employment benefits (OPEBs). While we cannot predict with any certainty what will take place in the future, it would not be surprising if there are more defaults of municipal bond issuers in the next 30 years than there were in the past 30 years.

Disadvantages

Effect on the Individual Investor. Perhaps the most profound effect of the shift to the global ratings scale will be on individual investors. Currently, municipal issuers are spread across the range of ratings from below investment grade to AAA, with fewest in the top categories, a distribution that has been the norm for all investors in municipal bonds. A transition to the global ratings scale could result in a dramatic upgrading of some municipal issuers — either overnight or spread over time — that would mean that more issuers would be moved into highest ratings categories. Institutional investors, on the one hand, that are quite sophisticated and have greater resources, will be able to discern between the AAA credits that have been so rated because of their ongoing credit quality versus those that, historically, have been AA credits and are simply enjoying the benefits of the recalibration. Individual investors, though, lack the resources of these institutions and may not be as able to easily discern the difference. Rather than resulting in greater transparency for the individual investor, the change could make credit assessment more opaque for that market segment.

Another overall concern is that regardless of what action the committee and the Congress take on this matter, it is essential that the market participants view the rating agencies as regulated, but independent entities, responsible for the ratings they assign to debt instruments.

Greater Homogenization of Credits. The issue noted above should also be considered from the issuers' perspective as well. With the sudden increase of AAA credits, those issuers that historically have been AAA credits would share that rating with others. This reclassification of the AAA together would, in effect, reward the newly classified AA credits at the expense of the legacy AAA credits and place downward pressure on the legacy AAA credits.

Moral Hazard. As noted earlier, converting municipal issues to the global ratings scale may result in upgrading of a significant number of issues and the lowering of borrowing costs for those issuers as well as a downgrading of some issuers and the increase of their borrowing costs. There is, however, the risk of a moral hazard in such an action as the sudden change in ratings — in either direction — may remove the market's incentive to distinguish between credit-driven ratings and those informed by federal legislation.

Thank you, Mr. Chairman, for allowing me to present SIFMA's views. We hope to continue the dialogue on this important part of the credit market and stand ready to assist this Committee with any of these matters.

TESTIMONY OF

KEITH D. CURRY
MANAGING DIRECTOR
PUBLIC FINANCIAL MANAGEMENT
MAY 21, 2009

Mr. Chairman, Ranking Member Bachus, members of the committee, my name is Keith Curry, I am a Managing Director of Public Financial Management Inc. ("PFM") and the past president of the National Association of Independent Public Finance Advisors. In addition, I bring the perspective of also being the Mayor Pro Tem of the City of Newport Beach, California.

For nearly 22 years, I have been a financial advisor to state and local governments throughout the nation, advising on more than $14 billion in financings.

Let me say on behalf of Public Financial Management, the largest independent financial advisory firm in the nation, and on behalf of the members of NAIPFA, that we support your efforts to promote transparency and accountability in the financial advisory industry. We are proud to note, that in the 34 year history of PFM, and in the 20 year history of NAIPFA, our firm and NAIPFA members have never been associated with any of the scandals that have rocked the municipal market. Indeed, NAIPFA members have long ago adopted campaign contribution limitations to eliminate pay to play. We have established a test for professional competency leading to the certification of practitioners as Certified Independent Public Financial Advisors and we have a strong code of ethics.

We would offer the following comments for your consideration.

PFM does not quarrel with the proposal to require municipal financial advisors register with the SEC, although it is appropriate to emphasize that there is no demonstrated need for registration and regulation to protect investors. As far as I know, every publicized instance of abuse of investors or municipal issuers in the last decade has involved broker firms which already were registered with the Commission.

We believe that the Committee Draft Bill has taken the correct approach in looking to the Commission to provide regulatory oversight of municipal financial advisors. The SEC fully understands the debt offering process and the roles which professionals play. We urge the Committee to resist the brokerage community's predictable efforts to subject financial advisors to the Rules of the Municipal Securities Rulemaking Board ("MSRB"). The MSRB is a captive of the brokerage firms who on one day compete with the independent financial advisors for the role of advisor to municipal governments, and on another day seek the highest rate of interest as the underwriter of municipal debt. It is the local governments, and their taxpayers, who are best served by preserving the strong voice of the independent advisor.

We applaud the Committee Draft Bill in focusing regulatory oversight on the maintenance of professional qualifications and fair practice standards for all financial advisors. This elevates the professionalism of the entire municipal finance community. We also endorse SEC rules to avoid conflicts of interest and to eliminate improper influence of political contributions. Our firm individually and NAIPFA for the independent advisors as a whole have urged these measures. Unfortunately, when NAIPFA went to the MSRB to seek stronger rules against brokers taking both sides in municipal debt offerings, that proposal was rejected by the MSRB.

PFM believes that the Committee Draft Bill should be properly strengthened by extending any "Duty of Care" (Paragraph (e)) to all securities professionals serving as municipal financial advisors - - not just those who would be newly regulated under this Bill. By historical experience, the danger of abuse and dishonesty is presented by those who are already registered with the SEC as brokers. All those participants in the securities process who serve as financial advisors should be bound by the fiduciary principles of this Bill, particularly those who are registered under Section 15 of the Exchange Act. It is said of this proposed landmark legislation that it is intended to "level the playing field" in municipal finance. That goal will fail if the brokerage firms are excluded from the duties which are imposed on their competitors.

Undoubtedly the special interest groups will be here in full armor to seek exemptions for the banks, the financial advisors that operate in a limited territory, the firms that have a limited number of transactions, and others. We urge the Committee to resist those pleas. The municipal finance world is made-up of a universe of different players - - but they all should have the same ethical requirements and the same professional duties.

In summary, we support efforts to ban pay-to-play, to provide for a standardized licensing and competency assessment process, to prohibit practitioners with prior records of fraudulent activity, and to insure that a standard of professional care is established for the industry.

We encourage the Committee to pay special attention to the phase-in period so as to not disrupt the municipal finance industry or to delay planned state and local financings.

Be assured of our continued partnership to improve the transparency and fair operations of the municipal securities market.

STATEMENT

of

SEAN EGAN

CO-FOUNDER & MANAGING DIRECTOR

EGAN-JONES RATINGS CO.

at the

HEARING

on

LEGISLATIVE PROPOSALS TO IMPROVE THE EFFICIENCY OF OVERSIGHT OF MUNICIPAL FINANCE

before the

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

May 21, 2009

Washington, DC

I appreciate the invitation to present testimony on the Committee's pending proposals to improve the oversight of the municipal finance market. These proposals include: (1) federal reinsurance; (2) a targeted liquidity program comparable to what the Federal Reserve has done in other areas of the capital markets; (3) SEC registration of municipal finance advisors; and, (4) the establishment of more specific standards for credit analysis and related functions for Nationally Recognized Statistical Rating Organizations (NRSROs).

Egan-Jones is an NRSRO and thus the last item is within our specific market niche, but all of these proposals are directly related to the performance or, more precisely, the lack of credible performance by S&P, Moody's and Fitch in the execution of their core mission to produce accurate and timely credit ratings. For example:

1. Reinsurance – Municipal bonds have the equivalent of guarantees or reinsurance from the private sector companies that successfully performed this function for years until they decided that using their AAA ratings to guarantee mortgage-backed securities was more remunerative.

2. Liquidity Programs – Until the credit markets collapsed in mid-2008, it was never necessary to have a federal backstop for debt obligations such as the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, and the Term Asset-Backed Securities Loan Facility. Investors fled these markets and many others for one reason and one reason only: they were misled into thinking that the AAA ratings being given out by the nation's dominant rating agencies were accurate. These investors, particularly in foreign countries, are not coming back to

the U.S. credit market until they see the Congress or the federal financial regulatory agencies put meaningful rating agency reforms in place.

3. Regulation of Municipal Finance Advisors – In Birmingham, Alabama, municipal officials budgeted $250 million for a project that eventually ballooned into a $3.2 billion bankruptcy after Moody's and S&P downgraded the debt issue from AAA to D (for default) over a four-month period. Of course, they were misguided by their advisors, but this could not have been done if the bonds had been properly graded in the first place.

4. Modification of NRSRO Standards – These proposals are well-intentioned and may move the process in a better direction, but like many of the reforms suggested to date they share a common problem: they proceed from the erroneous premise that the major rating agencies are in the business of providing timely and accurate ratings for the benefit of investors and now taxpayers when, in fact, these companies have, for the last 35 years, been in the business of facilitating the issuance of securities for the benefit of issuers and underwriters.

Municipal Bond Market

Like all financial markets, the municipal bond markets are being adversely affected by general economic recession, but a large part of it is due to the financial deterioration of the municipal bond insurers or "monolines" as they are sometimes called. Ambac, MBIA, ACA, and FGIC have performed highly valuable services for decades as a credit enhancement tool for cities, towns and other governmental entities across the nation. The bond insurers' problems arose in recent years, of course, from the fact that they went from enhancing relatively safe state and local obligations to the complex asset-based credit instruments which have been defaulting across the board for the last two years.

Because of this shift away from their traditional and less-risky business model, Egan-Jones issued the following rating report in 2002 that MBIA, which is the largest of the monolines, did not merit the Triple-A rating which Moody's, S&P, and Fitch accorded them.

> **MBIA INC**
> We do not view MBIA Inc. or MBIA Insurance Corp. as "AAA" credits and believe they face significant risks over the next couple of years. Major risks are: 1) Slim capital - MBI has only $5.5BB of equity (book value) compared to $490BB of guarantees, 2) Weakness in assets -Collateralized Debt Obligations and Credit Default Swaps comprise $66 billion of MBI's exposure and have suffered significant declines in market values, 3) Pressure on Municipalities - tax revenues are down thereby increasing the probability of losses, 4) Business model - if MBI is not rated "AAA" its business is likely to fall.

The earnings, capital and stock process of the monolines collapsed in late 2007, but even in 2008 when state insurance officials were actively pursuing multi-billion restructuring of these companies, our competitors were still rating them AAA.

How is it possible that the major rating agencies which have substantially more analysts than at Egan-Jones be six years behind us on a subject matter as critical as the municipal finance industry? I will come back to that subject in the course of my testimony, but the municipal finance ratings scandal is actually worse than I have already described.

From a credit quality perspective, it has always been the case that public securities have both a low probability of default and an extremely low level of anticipated loss even in the event of default. Hence, the probability of investors not receiving their payments on time and in full was minimal. Nevertheless, it is accurate to point out, as the Committee did in its Statement of May 14, 2009, that "municipal bonds with equal or lower default rates than corporate bonds have been given lower ratings by the major NRSROs."

What has happened, unfortunately, is for years, state and local issuers have been told that they should purchase insurance which they really did not need. Ironically, these public entities now find themselves scrambling to maintain marketability of their securities due to the financial weakness of the very companies which were thought to be enhancing their securities.

The municipal bond situation bears on another important point that is often overlooked in the debate over rating agencies. While this Committee has highlighted the shortcoming of the major rating agencies in the municipal bond market,[1] much of the public policy debate on the industry's performance would leave the impression that the problems have been confined to the structured finance debt such as mortgage-backed securities.

As an aside, the municipal bond debate is also a good example of the liability issue which received much discussion at the Capital Markets Subcommittee rating agency hearing earlier this week. When Egan-Jones continued to rate MBIA, we received a threatening letter from the company's Chief Executive Officer. The letter began by stating that "I find it difficult to understand how you could have an informed opinion" as to the financial strength of MBIA, but it concluded by suggesting that I refrain from making "public statements" about the company. We

[1] Hearing before the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee on "The State of the Bond Insurance Industry." 110th Cong. 2nd Sess. (Feb. 14, 2008).

declined to take this advice, but obviously we rely on the First Amendment freedom of speech protection when our modest-sized company takes on these multi-billion entities.

Federal Municipal Support

Given the state of the monoline insurers, certainly the Congress and the Administration should be working with the state insurance commissioners to develop federal support programs. As noted, TALF, TARP, and numerous related government assistance programs are in place for commercial paper, and a broad range of asset-backed securities including consumer and small-business loans, student loans, heavy industrial equipment, agricultural-equipment leases, rental-car fleets, and, most recently, commercial backed-mortgages and insurance premium loans. One can argue about the justification, costs and even structure of these programs, but there is no compelling logic for saying that some forms of credit are eligible and others are less worthy.

My personal opinion is that these programs – and there is no doubt that they have helped to stabilize the situation – must be viewed as dealing only with the symptoms of the credit crisis rather than their cause; and the cause, as well enunciated in a recent Report on Regulatory Reform of the Congressional Oversight Panel, was as follows:

> If companies issuing high-risk credit instruments had not been able to obtain AAA ratings from the private credit rating agencies, then pension funds, financial institutions, state and local municipalities, and others that relied on those ratings would not have been misled into making dangerous investments.[2]

[2] Special Report on Regulatory Reform of the Congressional Oversight Panel (January 29, 2009), p. 40.

The Minority views in that Report reached the same conclusion noting that "the credit rating agencies were caught up in the pursuit of fees."[3] I will not belabor the causal issues at this time as this Committee accorded me the privilege of testifying on previous occasions but we remain convinced that serial rating agency failures will continue to plague the credit markets until the compensation issue is addressed. As SEC Chairman Shapiro pointed out in a recent speech before the Council of Institutional Investors, "we all know that compensation drives behavior."[4] This is precisely the case, although much of the debate over credit rating agencies continues to ignore this compelling factor.

Earlier, I made the statement that the major ratings agencies are principally in the business of facilitating the issuance of securities for the benefit of issuers and underwriters. Should there be any doubt about that, here is how Harold McGraw, Chairman & CEO of McGraw-Hill, which is the owner of S&P, described that company's mission:

> "What we do is provide access to the capital market. If the markets want those kinds of products and the institutional investors want those products, then we move with the market and we're going to rate whatever." (October, 2007).

At Egan-Jones, we have a different mission and a different business model. Our revenues are produced by investors who subscribe to our services and investors want credible ratings. If our ratings are not timely and accurate, we lose our accounts.

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[3] *Id.*, at 71.

[4] Spring 2009 Meeting (April 6, 2009).

Issuers, on the other hand, want the highest rating possible since that reduces their funding costs. Under the issuer-paid business model, a rating agency which does not come in with the highest rating will, before long, be an underemployed ratings firm. It's that simple and all the explanations and excuses cannot refute the market evidence.

This is not an academic debate for municipalities and counties which have had to deal with the societal costs of rising foreclosures and declining tax assessments. As well summarized by the National Community Reinvestment Coalition (NCRC) in its Complaint filed with the SEC last year: "the rating agencies knowingly issued false and inflated ratings for securities backed by problematic high-cost loans that have created a financial nightmare for millions of families across the country whose homes have been lost to foreclosure or are now in jeopardy of foreclosure..." Because rating agencies are paid by the companies whose bonds they rate, the NCRC pointed out, the agencies suffer from "an inherent conflict that created one of the worst financial crisis this country has ever faced."[5]

Recommendations for Changing NRSRO Standards

With due respect to the proponents of the legislation intended to address the unfair treatment of municipal bonds, these proposals are too narrow to address the inherent and truly unmanageable rating agency conflicts lying at the core of the current multi-trillion dollar global financial crisis. As Damon Silvers of the AFL-CIO (and a member of the Congressional Oversight Panel) indicated at the SEC's

[5] Press Release of April 8, 2008: "Civil Penalties & Equitable Relief Sought For Consumers & Communities Injured By Rating Agencies Role In Foreclosure Epidemic; SEC Urged To Suspend Licenses Of Culpable Rating Agencies."

April 15, 2009 Roundtable on Rating Agencies, the current issuer paid credit rating system is fundamentally flawed and it will take more than a tweak here and a tweak there to fix it.[6]

Professor John Grundfest of the Stanford law School has suggested a very bold approach which would call for the creation of a category of credit rating agencies called Buyer Owned and Controlled Rating Agencies (BOCRAs).[7] Because BOCRAs would be controlled by the investor community they would have powerful incentives to issue prudent, even skeptical ratings, as opposed to the current system where the compensation model promotes inflated ratings. To provide a revenue stream for these new entities under the Grundfest plan, the SEC would require that every rating by a NRSRO paid for by an issuer be accompanied by a BOCRA rating that is also paid for by the issuer.

At Egan-Jones, our reform proposals for the credit rating industry have been more modest, but they are consistent with Messrs. Silvers and Grundfest and a recent report by the Group of 30, led by Paul Volcker, which also recommended that regulators encourage the development of payment models that "improve the alignment of incentives" in the rating industry, by which is meant, of course, the alignment of interests between the ratings firms and investors and now, of course, taxpayers as well since the federal government is taking these rated assets as collateral on a non-recourse basis.

We have a free market system and the government cannot and should not compel the use of one business model over another. However, it is the role of the

[6] Statement before the SEC Roundtable on Credit Rating Agencies, Wash., DC (April 15, 2009).

[7] *Id.*

SEC and other policy makers charged with the responsibility to align these incentives and, at a minimum, to protect investors to make sure that investors and taxpayers and other users of credit ratings know whether the seller or the buyer is paying for the work product. Our specific recommendations would include the following to accomplish these goals.

1. DISCLOSURE BY RATING AGENCY

The publication of any debt rating, whether in written reports or on websites, should be accompanied by a prominent disclosure statement that indicates how the entity providing the rating was compensated. For example, if a rating agency is paid by the issuer of the securities, a securities dealer, a securities broker or any other party being compensated from the proceeds of the sale of the debt obligations being rated, this fact would be disclosed:

"IMPORTANT RATING AGENCY DISCLOSURE"

"This rating was arranged and paid for by the issuer, sponsor or underwriter of the debt obligation being rated."

If the rating agency's report is paid for by investors or any other party, it would likewise be required to disclose the generic source of its compensation.

2. DISCLOSURE BY INSTITUTIONAL MONEY MANAGERS

Fiduciaries such as mutual funds, pension funds and investment advisors currently disclose the general risk profile of a particular fund in their annual or more frequent investor reports. If the fiduciaries invest in rated debt instruments, they should also be required to disclose and describe the extent to which they rely on external ratings and whether or not those ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

3. FINANCIAL REGULATORY REQUIREMENTS

Bank capital requirements, particularly after the recent adoption of the so-called Basel II revisions, rely on NRSRO ratings for purposes of prescribing appropriate capital levels. Assets with high quality ratings are subject to lower capital requirements than lesser rated and non-investment grade bonds. Financial regulatory bodies in the U.S. and abroad are increasingly concerned about the impact which inflated ratings may have on the banking system.

Since banks use external ratings to compute their capital compliance, they should also be required to disclose in their SEC and other regulatory filings the extent to which they rely on NRSRO ratings to value their bond portfolios and the rationale for this reliance, including whether or not those external ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

4. RELEASE OF ISSUER INFORMATION TO ALL NRSROs

The SEC currently has proposed that any issuer or other sponsor of a security seeking a credit rating from an NRSRO provide the same financial information given to a solicited NRSRO to all other NRSROs designated to offer ratings for that particular type of security. This would be true competition in that it would allow unsolicited NRSROs to issue pre-sale and ongoing reports to the investment community.

CONCLUSION

The only real reform for the ratings industry is to return the industry to the business of representing those who invest in securities, not those who issue them. This is how the industry was structured when John Moody founded his company in the early 1900s and the same was true for S&P and Fitch. This principle of putting investors first can be reclaimed through proper incentives, proper market disclosures and through a system that promotes actual competition through the flow of information used to rate securities to all NRSROs.

Thank you for inviting Egan-Jones to testify. I would be pleased to address any questions the Committee Members may have.

Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance

By: Martha Mahan Haines
Assistant Director, Division of Trading and Markets
United States Securities and Exchange Commission

Chairman Frank, Ranking Member Bachus, and members of the committee, I am Martha Haines. I head the Office of Municipal Securities in the Division of Trading and Markets, which coordinates the Securities and Exchange Commission's municipal securities activities, advises the Commission on policy matters relating to the municipal bond market and provides technical assistance in the development and implementation of SEC initiatives in the municipal securities area. The Division also administers the SEC's rules applicable to credit rating agencies registered as nationally recognized statistical rating organizations ("NRSROs"). I appreciate the opportunity to testify before the Committee today on behalf of the SEC.

Municipal Financial Advisors

Introduction

The question of whether financial advisors to municipal issuers and conduit borrowers should be regulated is a topic of significant interest to the Commission. We have been concerned about the observed and reported conduct of some municipal financial advisors, including "pay to play" practices, undisclosed conflicts of interest, advice rendered by financial advisors without adequate training or qualifications, and failure to place the duty of loyalty to their clients ahead of their own interests. However, the Commission's current statutory authority limits our ability to address these concerns adequately.

The Commission believes an expansion of its authority over the conduct of municipal financial advisors would be appropriate to address these concerns. The Municipal Advisers Regulation Act would provide tools that would help address the problems we have observed concerning financial advisors who advise municipal issuers and conduit borrowers concerning their securities offerings, transactions in swaps and other derivative products intended to hedge risk, and the investment of bond proceeds. In particular, we support the Act's clarification of the specific duty of care that a financial advisor owes to its client.

Today, I would like to describe our present jurisdiction to clarify the activities of financial advisors that may subject them to regulation as broker-dealers, the reasons the Commission supports an expansion of our authority in this area, and comment on the Fair Municipal Bond Regulation Act and Municipal Advisers Regulation Act recently introduced by Chairman Frank.

Background – Current Scope of Commission Authority

Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933 ("Securities Act"), and system of periodic reporting under the Securities Exchange Act of 1934 ("Exchange Act"). However, it did not exempt transactions in municipal securities from the coverage of the antifraud provisions of section 17(a) of the Securities Act, section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder. These antifraud provisions prohibit any person, including municipal issuers and brokers, dealers and municipal securities dealers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security. In addition, brokers, dealers and municipal securities dealers are subject to regulations adopted by the Commission, including those regulations adopted to define and prevent fraud. Municipal securities dealers are also subject to rules promulgated by the Municipal Securities Rulemaking Board ("MSRB").

Financial Advisors who are Broker-Dealers

The Commission and the MSRB have regulatory authority over municipal financial advisors who are registered broker-dealers. In contrast, financial advisors who are not broker-dealers currently are unregulated. To the extent that these persons act as "brokers" within the meaning of the Exchange Act, however, they are currently required to register and subject to Commission regulation and oversight.

Under the Exchange Act, a "broker" is broadly defined as any person engaged in the business of effecting transactions in securities for the account of others. Determining whether a person is a broker within the meaning of this definition is a fact-specific inquiry. The Commission and the courts generally look at the activities that the person actually performs to determine whether that person is participating at key points in a securities transaction. These key points typically include solicitation, negotiation, or execution of the transaction, and/or receipt of compensation that is dependent upon, or related to, the outcome or size of the transaction or deal, or receipt of other transaction-related compensation.

Notably, because the activities and compensation structure of municipal financial advisors vary widely, even a broad reading of the Commission's existing regulatory authority over brokers is likely to leave many municipal financial advisors unregulated. Legislation would be required to ensure that municipal financial advisors are regulated.

Investment Advisers

The Investment Advisers Act of 1940 ("Advisers Act") generally does not cover the activities of municipal financial advisors because they do not fall within the definition of investment adviser. Under the Advisers Act, an "investment adviser" is a person who, for compensation, is in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[1] Municipal financial advisors, in contrast, are generally in the business of providing municipalities with a range of services concerning the structuring, timing and issuance of their bond offerings. Among other things, municipal financial advisors assist states and municipalities in preparing bond-related documents and in selecting and negotiating with underwriters. They may also make recommendations about the investment of temporarily idle proceeds of a bond issue or monitor the performance of the issue.[2] In 2000, our Division of Investment Management issued a Staff Legal Bulletin to clarify the circumstances under which the staff believes financial advisors (a) may be investment advisers, and (b) may give advice to issuers of municipal securities

[1] Section 202(a)(11) of the Investment Advisers Act of 1940.

[2] *See In the Matter of O'Brien Partners, Inc.*, Advisers Act Release No. 1772 (Oct. 27, 1998) (the Commission found in a settled proceeding that a financial advisor acted as an investment adviser by advising municipal clients to invest their bond offering proceeds in securities, including repurchase agreements and guaranteed investment contracts ("GICs"), and by receiving compensation for providing that advice); *In The Matter of Rauscher Pierce Refsnes, Inc.*, et al., Advisers Act Release No. 1863 (April 6, 2000) (the Commission found in a settled proceeding that a financial advisor acted as an investment adviser by advising its client to invest bond offering proceeds in securities, including a forward supply contract and a GIC, and by receiving compensation for providing that advice).

regarding the investment of offering proceeds without being deemed to be investment advisers for purpose of the Advisers Act.[3]

Even if all municipal financial advisors were to meet the Advisers Act's definition of "investment adviser," most would be exempt from Commission registration and oversight because, under the Advisers Act, an investment adviser that has less than $25 million of assets under management registers with state securities authorities rather than the Commission.[4] Municipal financial advisors typically do not manage client assets. As a result, they would not be subject to regulation by the Commission even if they were deemed to be investment advisers for the purpose of the Advisers Act.

Antifraud Authority and Enforcement Actions

Municipal financial advisors are, of course, subject to the antifraud provisions of the securities laws to the same extent as any party who participates in a securities offering or transaction. The Commission has brought over 20 enforcement actions against municipal financial advisors, including several against financial advisors who were not broker-dealers. For example, the Commission found in a settled proceeding that a financial advisor did not adequately disclose to an issuer of advance refunding bonds a payment arrangement under which the financial advisor received a $104,000 payment in

[3] *See* Division of Investment Management Staff Legal Bulletin No. 11 (Sept. 19, 2000), available at http://www.sec.gov/interps/legal/slbim11.htm (a financial advisor that receives special compensation for providing investment advice with respect to the purchase or sale of securities or that provides specific advice about the investment of temporarily idle bond proceeds routinely or with some regularity is in the business of providing investment advice and therefore is an investment adviser under the Advisers Act).

[4] Advisers Act section 203A. Note, however, that the anti-fraud provisions of the Advisers Act apply to all investment advisers regardless of whether an investment adviser is registered. *See* Advisers Act section 206.

return for selecting a particular broker-dealer to sell government securities to the issuer.[5] This is demonstrative of one type of conflict of interest which a financial advisor may have. In other cases financial advisors have failed to disclose fees paid to consultants[6] or made material errors and omissions in preparing offering documents.[7]

Harmful activities of market participants who are not subject to Commission registration and oversight are more difficult to discover. Without the opportunity that reporting, inspection and examination provide, it is difficult to monitor these activities and keep apprised of emerging practices. In addition, the antifraud provisions are an after-the-fact remedy. Thus, antifraud enforcement actions cannot provide the kind of specific and nuanced guidance or cover the broad scope of activities that regulatory authority under the proposed legislation would make possible.

Possible Regulation/Areas of Concern

It is important to keep in mind the municipal securities market's unique importance because of the governmental nature of the issuers and the public nature of the projects financed. The impact on the functioning of this market that may result from poor advice provided, or misleading disclosure documents prepared, by unqualified municipal financial advisors, participation by financial advisors with conflicts of interest, or those engaged in pay to play activities, for example, can indirectly affect the daily lives of Americans. Furthermore, bad or self serving advice may have long term consequences for

[5] *In the Matter of John S. Reger II, and Business & Financial Advisors, Inc.*, Securities Act Release No. 7973, A.P. File No. 3-10221 (April 23, 2001) (settled proceeding).

[6] *In the Matter of Wheat, First Securities, Inc. f/k/a First Union Capital Markets Corp. and Teressa L. Cawley,* Exchange Act Release No. 48378, A.P. File Nos. 3-9688 and 3-9794 (August 20, 2003) (settled proceeding).

[7] *In the Matter of County of Nevada, City of Ione, Wasco Public Financing Authority, Virginia Horler, and William McKay,* A.P File No. 3-9542, Initial Decisions Release No. 153 (October 29, 1999).

an issuer's financial condition and ability to access the capital markets. Authorizing the Commission to require financial advisors engaged in the activities covered by the proposed legislation to have minimum qualifications, follow conduct rules designed to ensure that they deal fairly with their clients, eliminate "pay to play" activities, and avoid or disclose conflicts of interest would help prevent harm to issuers, taxpayers and citizens dependent on the infrastructure financed with municipal securities – for clean water, schools, roads, airports, fire stations and other essential public facilities – in addition to protecting the interests of investors. Of course, new regulations would impose some burdens on financial advisors, which could potentially be passed along to issuers through higher fees.

Standard of Care and Professional Standards

Presently, there are no professional standards or qualifications for financial advisors. The establishment of minimum professional standards for financial advisors and clarification of their standard of care towards their clients could help to raise the quality of the advice given by financial advisors. This is important because many municipal issuers do not access the market often and are highly dependent on their advisors regarding securities offerings. Of course, large, frequent issuers who may be more sophisticated may also benefit from obtaining advice from advisors that meet established professional standards.

The current situation may result in an issuer entering into transactions that are not in the best interest of either the issuer or investors. The quality of, and disclosure related to, the feasibility studies and asset appraisals upon which the economic justification for, and repayment risk of, some bond issues is based is very important both to investors and issuers. It is vital for the financial advisor "experts" who prepare such studies and reports to be qualified and not be subject to conflicts of interest, and for the assumptions forming the basis for projections to be reasonable. Furthermore, financial advisors generally have significant input into the content of issuer disclosure documents. Sometimes they prepare the entire official statement for the issuer. While this initially may appear to be a benefit for issuers, because financial advisors often disclaim responsibility for offering documents, they may be able to avoid responsibility for misleading or inadequate disclosure.[8] Regulations designed to ensure that municipal financial advisors have an understanding of the standards of the securities laws and require them to take responsibility commensurate with their activities could help improve disclosure to investors, prevent fraud and protect both investors and issuers.

Presently the duty of care that a financial advisor owes to its client is established by state laws, which vary widely. Although the case law of some states impose fiduciary duties on financial advisors, the standard of care required of financial advisors is not always clear. There are a number of benefits that could flow from consistent application of a fiduciary standard of care. Clarification that municipal financial advisors are fiduciaries should make uniform and standardize the level of care and duty of loyalty they are obligated to provide to clients, help eliminate conflicts of interest and reduce issuer, investor and regulatory confusion or ambiguity about the responsibilities of financial advisors.

[8] Public entities that issue securities are primarily liable for the content of their disclosure documents and are subject to prescriptions under the federal securities laws against false and misleading information in their disclosure documents. *See* Report under Section 21(a) of the Exchange Act. *Report of Investigation in the Matter of County of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors.*, Exchange Act Release No. 36761 (January 24, 1996).

Conflicts of Interest

The SEC has recognized for many years that increased attention needs to be directed at disclosure of potential conflicts of interest and material financial relationships among municipal issuers, advisers and underwriters, including those arising from political contributions.[9] Such conflicts can undermine the integrity of the marketplace.

In addition, secret payments made to financial advisors with funds that would otherwise have gone to the issuer and other undisclosed conflicts of interest on the part of financial advisors may even affect the issuer's credit quality. For example, a financial advisor might advise an issuer to structure an offering in a particular way (or not object to a structure proposed by another party) which is not in the issuer's best interest in order that the financial advisor may receive payments from a third party, such as the provider of a swap or guaranteed investment contract. Such undisclosed conflicts of interest are of importance to investors.

Thus, an explicit requirement that financial advisors disclose conflicts of interest and payments to or from third parties in connection with a municipal securities offering would be a significant benefit to both investors and issuers.[10]

Pay to Play Activities

Although broker-dealers who serve as financial advisors are subject to MSRB Rule G-37 regarding political contributions, independent financial advisors are not. Broker-dealers maintain that this creates an unlevel playing field when they seek

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[9]See, e.g., Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others (Interpretive Release Regarding Disclosure Obligations in the Municipal Securities Market), Securities Exchange Act Release No. 33741 (March 9, 1994), 59 FR 12748 (March 17, 1994).

[10] See, e.g., *IRS Turns Its Attention to Swap Fees: Excessive Charges A Growing Concern*, The Bond Buyer, August 18, 2005.

financial advisory work because financial advisors who are not broker-dealers are able to make political contributions to issuer officials without jeopardizing their ability to serve as financial advisor to that entity. However, broker-dealers who make political contributions to issuer officials are limited by MSRB G-37 in their ability to do business with that issuer. More importantly, however, "pay-to-play" may result in an unqualified financial advisor being chosen because of his political contributions. Serious concerns arise if issuers were to select advisors based on political, rather than objective, standards. Market integrity is a key objective of the securities laws and is critical in order to provide investor protection and maintaining confidence in the municipal market.

Summary

In sum, a number of issues concerning financial advisors, including their professional qualifications, standard of care, conflicts of interest and pay to play activities necessitate active consideration of statutory change. Granting regulatory authority over the activities of municipal financial advisors to the SEC would significantly benefit issuers and investors alike.

Credit Ratings of Municipal Bond Issues

The municipal markets have become much larger, more diverse and more complex in recent years. There are over $2.6 trillion of municipal securities outstanding, and more than $391 billion of new bonds and notes were issued last year. Daily trading volume in 2008 exceeded $19 billion. [11]

Individuals are significant investors in the municipal securities market, accounting for over one-third of the direct holdings of municipal securities, and that is not counting

[11] Source: SIFMA

their indirect holdings through mutual funds, money market funds, and closed end funds, which account for about another third of the market.

To the extent they provide meaningful information that assists investors, counterparties, and lenders in deciding how to allocate capital or whether to enter into a transaction, credit ratings can play an important role in a well functioning financial market, including the market for municipal securities. While a credit rating should never be the sole basis for making these decisions, the credit rating agencies develop quantitative and qualitative methodologies for assessing credit risk that can produce a useful data point to inform the decision-making of market participants. Consequently, investors and other users of credit ratings expect credit rating agencies to rate obligors, securities and money market instruments in a manner that provides a reliable and unbiased assessment of credit risk.

The Congress addressed the role that credit rating agencies play in the financial markets by enacting the Credit Rating Agency Reform Act of 2006 (Rating Agency Act). This statute was designed to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. The Rating Agency Act, among other things, defined the term nationally recognized statistical rating organization ("NRSRO"); specified the minimum amount of information a credit rating agency must furnish to the SEC to apply for registration and, if granted registration, disclose to the public; required NRSROs to disclose information about the conflicts of interest inherent in business models and to establish procedures to manage conflicts of interest and address the handling of material non-public information; and provided the SEC with exclusive authority to implement registration, recordkeeping, financial reporting and oversight rules with respect to NRSROs, and gave the Commission authority to require the disclosure and management of conflicts, and the authority to prohibit such conflicts. It also gave the SEC the authority to examine NRSROs for, and enforce compliance with, applicable law. At the same time, the Rating Agency Act prohibited the SEC from regulating the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings.

The operative provisions of the Rating Agency Act were implemented through the Commission's adoption in June 2007 of a series of rules putting in place a registration and oversight program for NRSROs. The initial round of rulemaking established requirements governing NRSRO registration, disclosure, recordkeeping, annual reporting, procedures to prevent the misuse of material non-public information, and procedures to disclose and manage conflicts of interest. The new rules also established prohibitions against engaging in certain activities that are conflicts of interest or are unfair, abusive or coercive.

The first credit rating agencies were registered as NRSROs in September 2007. At that time, the SEC began a staff examination of the three credit rating agencies – now NRSROs – most active in rating structured financial products linked to subprime mortgage securities. On July 8, 2008, the SEC released findings from these staff examinations that noted significant weaknesses in rating practices and the need for remedial action by the firms to provide meaningful ratings and the necessary levels of disclosure to investors. In particular, the SEC staff's examinations found that some NRSROs appear to have struggled with the increase in the number and complexity of subprime residential mortgage backed securities ("RMBS") and collateralized debt obligation ("CDO") deals. The examinations uncovered that these NRSROs did not have written comprehensive procedures for rating RMBS and CDOs. Furthermore, significant aspects of the rating process were not always disclosed or even documented by the firms.

In February 2009, the SEC adopted a second round of rulemaking to address concerns raised by the role NRSROs played in the events leading to the current credit crisis. These new measures:

- Require NRSROs to publish performance statistics for one, three, and ten years within each rating category in a way that facilitates comparison with their competitors in the industry. Performance statistics for the rating category encompassing government securities, municipal securities, and foreign government securities, must be further divided into three classes: sovereign debt, United States public finance and international public finance.
- Require disclosure by NRSROs of the way they rely on the due diligence of others to verify the assets underlying a structured product.
- Require NRSROs to disclose how frequently credit ratings are reviewed; whether different models are used for ratings surveillance than for initial ratings; and whether changes made to models are applied retroactively to existing ratings.
- Require NRSROs to make publicly available in Extensible Business Reporting Language ("XBRL") format a random sample of 10% of their issuer-paid credit ratings and their histories for each class of issuer-paid credit rating for which the NRSRO is registered and has issued 500 or more ratings.

- Require NRSROs to make and retain records of all rating actions related to a current rating from the initial rating to the current rating.
- Require NRSROs to document the rationale for any significant out-of-model adjustments used in determining a credit rating whenever a quantitative model is a substantial component of the credit rating process.
- Require NRSROs to retain records of any complaints regarding the performance of a credit analyst in determining, maintaining, monitoring, changing, or withdrawing a credit rating.
- Require NRSROs to provide the Commission with an annual report of the number of ratings actions they took in each ratings class for which they are registered as an NRSRO.
- Prohibit NRSROs from structuring the same products that they rate.
- Prohibit analysts who participate in determining credit ratings from negotiating the fees that issuers pay to be rated.
- Prohibit gifts from those who receive ratings to those who rate them, in any amount over $25.

In enacting the Rating Agency Act and giving the SEC authority to regulate NRSROs, the Congress acted in response to concerns that policy makers, regulators, and market participants raised about the reliability of ratings and the rating process. The substantial number of downgrades of mortgage-linked debt securities has contributed significantly to a lack of confidence in the accuracy of NRSRO ratings. This has been a factor in the broader dislocation of the credit markets, which has impacted municipal issuers.

Currently, there are ten NRSROs. Of these firms, eight have been granted registration in the class of credit rating that includes rating municipal securities. Three of these NRSROs, Moody's Investor Services, Inc. ("Moody's), Standard & Poor's Rating Services ("S&P") and Fitch, Inc. ("Fitch") account for over 99% of the ratings outstanding in this class of ratings. All three NRSROs have noted that historical defaults on municipal securities have been lower than comparably rated corporate or sovereign securities. For example, Moody's has stated that a municipal obligation rated 'A3'on Moody's municipal scale could be rated in a range between 'A1' and 'AA1' on its global scale.[12] According to S&P's U.S municipal ratings default study, S&P's public finance ratings have been significantly more stable than its corporate ratings.[13] Fitch has stated that a recalibration of municipal ratings so they denote a comparable level of credit risk as ratings in its international rating scale for corporate, sovereign and other entities would result in an upgrade of up to two notches for general obligation or senior revenue bonds of issuers rated between 'BBB' and 'A' inclusive.[14]

Some municipal issuers argue that the use by NRSROs of the same symbols to rate municipal and corporate bonds but different definitions for comparable rating categories results in the municipal bonds they issue being rated lower than corporate bonds with an equivalent risk of default. They believe that this raises their financing

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[12] See, The U.S. Municipal Bond Rating Scale: Mapping to the Global Rating Scale and Assigning Global Scale Ratings to Municipal Obligations, Moody's Investor Services, Inc. - March, 2007.

[13] See, U.S. Municipal Rating Transitions and Defaults, 1986-2009, Standard and Poor's – March 11, 2009.

[14] See, Exposure Draft: Reassessment of Municipal Ratings Framework, Fitch Ratings Special Report – July 31, 2008.

costs in terms of the interest they must pay and the need to purchase wrap insurance to have their bonds be highly rated. Some investors, however, argue that the use of common symbols but different definitions is a useful way to distinguish the relative financial strength of municipal issuers since defaults of rated municipal bonds are rare due to contingent factors such as sovereign support. They contend that using a common set of rating category definitions would cause most rated municipal bonds to be slotted into one of the two highest rating categories making it more difficult to assess the individual merits of a bond.

The Municipal Bond Fairness Act, if adopted by the Congress, would mandate that the SEC require NRSROs to establish, maintain, and enforce written policies and procedures designed: (1) to establish and maintain credit ratings with respect to securities and money market instruments designed to assess the risk that investors in securities and money market instruments may not receive payment in accordance with the terms of issuance of such securities and instruments; (2) to define clearly any rating symbol used by that organization; and (3) to apply such rating symbol in a consistent manner for all types of securities and money market instruments. The bill would permit NRSROs to determine "complementary" ratings that assess the likelihood that conditions other than an issuer's failure to make payments to a bondholder or creditor in accordance with documented terms might arise. In this case, the NRSRO would be required to use a different rating symbol. Finally, the bill would require the SEC to establish performance measures to consider whether to initiate a review of whether an NRSRO was adhering to its stated procedures and methodologies for determining credit ratings.

The SEC staff stands ready to provide technical assistance on the bill if that would be useful to the committee. Thank you again for providing us with an opportunity to testify about these two bills now pending before this Committee.

Testimony of Alan Ispass
Vice President and Director of Utility Management Solutions Practice, CH2M HILL
before the United States House of Representatives
Committee on Financial Services

Good morning Mr. Chairman and Members of the Committee. My name is Alan Ispass. I am a vice president with CH2M HILL and the director of the firm's Utility Management practice. CH2M HILL is a global full service engineering, project development and delivery firm with 26,000 employees world-wide. A significant part of CH2M HILL's core business is to help cities and counties plan, design, and construct major water, sewer, stormwater, and transportation infrastructure projects. The practice that I lead includes a Financial Services team that helps these municipal clients address funding and financing issues in the water sector. This work includes conducting cost of service and financial planning studies, and also assisting clients in identifying and securing funding for their capital improvement programs. We sometimes serve in the role of Consulting Engineer, conducting independent analyses and certifications related to a client's financial situation for inclusion in municipal bond official offering statements.

During the past year we have observed, first-hand, that the global financial crisis has dramatically affected our clients' ability to effectively plan the financing of their capital programs. Utilities have had significant declines in revenues due to foreclosures and reductions in commercial and industrial water use. Many wastewater agencies are especially hard hit as they strive to meet Federal mandates to provide greater control of combined sewer overflows and sanitary sewer overflows. And of course, this is all occurring at a time when an estimated $600 billion of investment is needed in our nation's water and wastewater infrastructure.

These financial concerns have been exacerbated since the Fall of 2008. For years, utilities have been able to count on ready access to long-term municipal bonds to finance their capital programs with interest rates often in the 4-5 percent range. However, accessibility to the bond market is now a problem for many utilities. Many of our clients have been informed by their financial advisors that utilities with credit ratings lower than AA are unlikely to receive bids, or that they would receive bids at very high interest rates, very possibly causing unaffordable increases on customers' water and sewer bills.

In the past eight months, we have seen clients that previously had no problems issuing long-term debt unable to issue bonds, sometimes receiving no bids when they went to market. We have also seen the downgrading of private bond insurers causing clients with less than an AA bond rating to hold off on issuing bonds delaying needed capital improvement projects. And, even more troubling is that the downgrading of bond insurers has put some of our clients in technical default of bond covenants for their existing outstanding debt, because in some cases these covenants require that the utilities maintain bond insurance with a specified credit rating or put significant funds into reserve. Such issues put in question these utilities' ability to issue additional debt for future needs.

Without doubt, the American Recovery and Reinvestment Act of 2009 (ARRA) provided some important financial assistance that is helping to fund some water and wastewater capital projects through the $6 billion that is being administered through the existing State Revolving Fund (SRF) programs. However, the $6 billion is only a small fraction of country's water and wastewater infrastructure needs.

As evidence of the substantial needs for funding, the State of Arizona received 300 applications for water and wastewater projects totaling more than $1 billion in project value, for the $80 million in ARRA funds made available. Based on the priority of applications, the State expects to be able to provide funding for only 51 of the 300 projects. Likewise, the State of Virginia received 240 applications for $20.1 million of ARRA funding for drinking water projects, and based on application of EPA-approved criteria, will only be able to fund the top 20 projects.

In light of the billions of dollars in need beyond funding available through the traditional SRF programs and funds made available through ARRA, it is crucial that there be a robust municipal bond market that can be broadly accessed by municipal borrowers at reasonable interest rates. Given these substantial financial challenges in the municipal bond market today, The Municipal Bond Insurance Enhancement Act of 2009, represents an important step forward. By providing up to $50 billion in reinsurance over the next five years, it provides a mechanism for allowing many municipal borrowers with less than top credit ratings move forward with their capital programs. The specifics on eligibility and the cost of the risk-based premiums that will be detailed if the program moves forward will be critical to determining how broadly the relief offered by this legislation will be felt through the municipal utility sector. From our vantage point as consultants to many water and wastewater utilities throughout the United States, this legislation could be crucial to providing continued access to the municipal bond market and for ensuring sustainable infrastructure systems.

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The Honorable Thomas C. Leppert
Mayor of the City of Dallas Texas

Testifying on Behalf of
The United States Conference of Mayors

Before the
United States House of Representatives
Financial Service Committee

Hearing on

Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance

Thursday, May 21, 2009

Room 2128, Rayburn House Office Building
Washington, D.C.

Mr. Chairman first let me thank you, Ranking Member Bachus and all of the members of this distinguished committee for holding this hearing to focus national attention on one of the most critical problems facing the nation's cities. I am Tom Leppert, Mayor of Dallas and Chairman of the U.S. Conference of Mayors Metro Economies Committee, which monitors tax and finance issues and recommends policy on legislative and regulatory proposals that affect local governments. Today I am pleased to appear on behalf of the nation's mayors to offer comments on pending legislation that has been introduced to assist state and local governments gain better access to the credit market.

Before I get started, I want to commend you Mr. Chairman for the leadership you have demonstrated in responding to the problems municipalities are experiencing in accessing the credit market. We appreciate you coming to speak to Mayors about the impact of the economic crisis on cities earlier this year at our winter meeting and thank you for introducing legislation, which you discussed with us, that would address some of the concerns we raised then about the municipal bond crisis and the capacity of local governments to secure needed financing.

Impact of the Economic Crisis on Local Access to the Credit Market

For more than a year, state and local governments have suffered from the global economic credit crisis. According to BNY Mellon Asset Management, 2009 municipal bond issues are expected to decrease 12 percent, or $48 billion, a decrease comparable to eliminating all federal highway and transit spending for one year. Our citizens and taxpayers are the ones who have suffered the consequences. Many capital improvement projects across the nation – both large and small - have been halted due to the lack of affordable access to the market and the inability of states and local governments to issue bonds. At a time when communities are confronting decreased revenue and growing unemployment, local governments have increasingly been unable to access the capital markets due to prohibitive borrowing costs. Local government actions are not to blame for this credit crunch, which has arisen solely as a result of the global financial crisis.

This has a significant impact on our economy at a time we need to create jobs and economic activity, this lack of liquidity is holding back key projects that could have an enormous impact on our local and national economy. Indeed, opening up the municipal bond market could be a major stimulus to the economy. This would have the additional advantage of creating a significant economic stimulus without a Federal outlay of funds. By increasing the support of the municipal bond markets, we will see many projects move forward, creating thousands of jobs.

In Dallas, we have several major projects we would move forward with if the municipal markets return to a more "normal state." Cities and States across the country are in the same position. We have also put several public works projects on hold until the bond market conditions improve. These include the substantial water and sewer infrastructure construction and improvements to Love Field that are mandated by law. We would like to proceed with these projects in order to put people back to work locally and take advantage of reduced construction costs. These are just a few of the many projects on hold in Dallas and many other cities across our nation waiting on market conditions to improve.

While we sincerely appreciate all the help from Congress and the Administration to create jobs, the legislation you have introduced will improve state and local access to capital markets and help us create far more jobs much more quickly as capital improvement projects that are currently on hold receive financing at reasonable interest rates. Indeed, your legislation would allow local governments with strong ratings to move forward and leverage the significant infrastructure assistance provided earlier this year by the American Recovery and Reinvestment Act. Other issuers, especially small issuers who may not have a credit rating or whose credit rating is low (BBB or A) would also benefit. They have been unable to obtain the bond insurance or credit enhancement they need to secure investors for their debt and issue bonds at affordable interest rates.

There are also other issuers who frequent the variable rate market for short-term debt purposes. That market all but shut down last year and has been slow to recover, leaving many governments, especially larger ones, without access to finance tools that they have depended on for years. Adding insult to injury, many governments that issue short-term, variable-rate debt secure that debt with a letter of credit (LOC) or a liquidity facility to help attract investors to these products. The number of LOC's and standby purchase agreement providers has decreased, and those providing those services are charging much higher premiums. Municipal Market Advisors estimate that liquidity premiums have grown by 10 times the magnitude from 2008 to 2009, which is a price level that has not been part of this market in recent history.

That is why the four legislative proposals being discussed today are so vital to repairing our market and helping governments improve their communities by building and repairing schools, firehouses, highways and water systems. It is also worth mentioning that unlike the federal government, local governments do not have the luxury of carrying a deficit. By law, they are required to balance their budget every year. For many, the only way to provide vital infrastructure is through the issuance of bonds, which has been a viable way of financing critical infrastructure projects for more than 100 years.

According to Thomas Doe, CEO of MMA Advisors, with fixed-rate yields having risen to extraordinary heights, many state and local issuers chose to table the majority of their planned primary market loans, waiting for conditions to improve. Smaller, lower-rated, and riskier credit issuers may have, at least temporarily, been unable to access capital. But large states and cities were always able to raise money. Their decisions were based on price. MMA estimates that, in 2008, more than $100 billion of planned new-money infrastructure projects were delayed, the majority of that occurred in the fourth quarter.

I am certain that the market experts in the next panel will elaborate more on these numbers, and there is no denying the fact that this market stands to greatly benefit from the legislation that you have introduced. Now that I have provided a brief overview of some of the key problems local governments are facing, I'd like to discuss very briefly each of the pending proposals and how we think they would address those problems.

The Municipal Bond Fairness Act (Global Ratings)

The Municipal Bond Fairness Act would require credit rating agencies to rate municipal securities on the same scale as corporate securities and take into account default statistics and the ability to repay debts, which we expect would give investors a more accurate portrayal of the low risk of municipal securities compared to their corporate counterparts. Mr. Chairman, this is a change that's long over due. We believe this will better ensure equality in the rating system and will spur increased investment in municipal bonds. Ensuring that rating agencies use uniform and accurate credit ratings for all securities will lower borrowing costs and make it easier for new investors to participate in the municipal securities market. The Conference of Mayors fully supports this legislation, as we have in the past.

Under the current system, the three major credit ratings agencies operate two separate but incomparable 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, the ratings on municipal bonds remain widely dispersed across the investment grade municipal scale.

Traditionally, issuers have been forced to rely on bond insurers (who were rated AAA on the corporate rating scale) to satisfy both investor regulatory requirements and a growing demand on the part of both institutional buyers and unsophisticated retail investors, who may not understand the difference between rating scales. This set of double standards has hurt issuers, who may have paid unnecessary fees for bond insurance premiums, and it adds to the hardships that issuers face in the current marketplace.

The double standard also has caused state and local governments to pay for unnecessary bond insurance and/or have more debt issuance costs than similarly rated corporate bond issuers. For example, according to an April 21 Bloomberg News story, the AAA-rated University of

Virginia paid more when issuing $250 million for 30 year taxable Build America Bonds than a company that issued taxable bonds on the same day, yet rated five levels lower - 6.22 percent for UVA versus 6.125 percent for the corporation. This is a recent apples-to apples comparison of the higher costs state and local governments have had to endure over the years due to the inability of the rating agencies to fairly and equally rate debt issuers of all types so that investors can know the true risks associated with various securities. The creation of an equitable credit rating system would help issuers and investors alike.

Governmental bonds, either pledged with the full faith and credit of the government or governmental revenue bonds, have a nearly zero rate of default as shown in the chart below. This should be better reflected in the ratings of governmental issuers. Your bill would also assure consistent debt ratings among local governments and improve the transparency of the rating process. These actions can only strengthen public finance.

The Honorable Thomas C. Leppert
May 21, 2009

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

Source: MMA Advisors

Municipal Bond Insurance Enhancement Act (Reinsurance)

There is no question Mr. Chairman, we believe the Municipal Bond Insurance Enhancement Act would help increase the capacity of municipal bond insurers to insure new risks and thereby make it easier for issuers, particularly small issuers, to borrow in the capital markets. Again, the Conference of Mayors fully supports this proposal. While many governments could be aided by an improved bond rating system, some governments, especially smaller ones, still need bond insurance. As has been frequently cited, nearly half of all municipal credits were insured until 2006. Often the issuer chose to obtain bond insurance in order to receive an AAA rating on the issuance, which lowered interest rate costs for the bonds at a savings greater than the cost of insurance.

This system has caused confusion for investors. When a bond insurer is downgraded, the issuance itself is downgraded. Even though the state and local government credits themselves are not downgraded when this happens, the issuer is required to file a material event. This is an example how the bad practices of the private sector hurt state and local governments.

The following examples illustrate the problems brought on by downgrades of bond insurers.

Example 1: Small issuers cannot afford to issue debt

A large state pool issues debt for plain vanilla fixed-rate debt for mainly local governments. Currently, there is a list of about 10 to12 or more small issuers that need to issue debt that cannot due to lack of credit enhancement. Their projects, mostly infrastructure, are on hold. The size of these issues ranges from about $3 million to $20 million. They cannot issue debt without credit enhancement as they are below AA ratings, and there is neither a viable nor affordable bond insurer option. A federal guarantee, subsidy or reinsurance as provided in the pending legislation, would be greatly beneficial to the municipal market, specifically for smaller issuers. The problem within the small issuer fixed rate market has not been as widely known as the variable rate issues due to the size of the entities. The smaller issuer is not in the market as frequent and many have just put their projects on hold. However, these needs will become more demanding in the upcoming months.

Example 2: The Loss of Aaa Rated Bond Insurers Leaves a Hole in Issuing tax Increment Bonds

A city uses tax increment financing to provide funding for a wide-range of economic development and transportation infrastructure projects within the City. These projects create high-paying jobs both in the short run (construction) and the long run (infrastructure for business development). The ratings on the city's tax increment bonds tend to fall in the mid to lower "A" category. Bonds of this rating category have historically benefitted from bond insurance. In addition, the complex state property tax system through which tax increment revenues are generated requires investors to devote substantial time and energy to understanding the credit behind the bonds. The credit review and insurance qualification function performed by the bond insurers allowed investors to look through the complexities of the credit and to rely on the presumed financing strength of the insurer. For these reasons, the availability of affordable bond insurance has been a critical element in the city's ability to access the public debt markets for these types of bonds. In addition, the inability to obtain a debt service reserve surety policy from a bond insurer in lieu of a cash funded reserve has reduced the amount of bond proceeds that the city is able to direct toward job creating investments.

Municipal Bond Liquidity Enhancement Act (Liquidity Provider)

Issuers of short-term debt have been most acutely affected by the credit market crisis. Governments purchase letters of credit or secure a liquidity provider in order to achieve lower borrowing costs than would be possible if they offered securities through their own credit. However, they have faced a double whammy as the markets have frozen and most liquidity providers have either ceased to exist over the past six months or have stopped providing these services.

The short-term markets have been specifically hurt throughout the global credit crisis. Auction Rate Securities (ARS) have ceased to exist, yet many government issuers are still left holding ARS paper and are paying dearly for the evaporation of this market. Mr. Chairman the legislation you have introduced to create a federal liquidity facility for outstanding variable rate demand notes would greatly help this sector of the market. It would fill the vacuum created by the absence of private sector providers and provide the Treasury Department authority to purchase these notes so that issuers do not have to continue to pay enormous amounts every time these products must be remarketed, saving local governments a tremendous amount of money.

According to MMA, approximately $50 billion in municipal ARS and $10 billion to $30 billion in variable rate demand obligations lack consistent money market fund acceptance and there are billions of cash flow borrowing needs that would this legislation would assist. Issuers across the nation have told us they are experiencing difficulty obtaining letters of credit that were due in recent months. For example:

- A large transit authority recently noticed the number of liquidity providers has shriveled dramatically over the past year. In 2005 they received 18 bidders to provide liquidity for a double A credit, a sharp contrast to 2009 when they only received two bids.
- A large Midwestern city has locked into a liquidity facility for its variable rate debt through 2012, at an annual average of 20 or less basis points. The city is concerned about finding a replacement facility in 2012, or sooner if the current bank providing the facility is downgraded, as the costs could skyrocket to 75 basis points.
- Three cities in Connecticut illustrate the problems facing others in the nation. One city with an A/A3/A credit rating had an existing variable rate debt insured by Ambac. When the issue became bank bonds in 2008, the city needed to refinance and unwind the swap. The swap termination cost on the bonds was $7.2 million. The city received a three-year letter of credit for 55 basis points. Another city with a A/A3/A rating terminated a forward-starting swap at a cost of $450,000 in March due to its inability to obtain a letter of credit. The city solicited a $12 million letter of credit from 13 bank providers and received a single bid at 125 basis points annually with an additional 30 basis points due as an upfront fee. The bidder also requested other banking relationships as a part of the deal. As a result, the city was forced to issue fixed rate bonds when it would have been advantageous to keep swap in place and issue variable rate bonds. Another Connecticut city, with a BBB+/Baa1/BBB+ rating, attempted to obtain a letter of credit for a $100 million taxable pension obligation bond issue. The city received an initial bid of 85 basis points for a three-year commitment; however, the provider's national credit committee was unable to

approve the credit due to a desire to have a broader banking relationship. As a result, the city was unable to take the proceeds from a bond issuance to increase its pension liability funded ratio, which is a top rating concern by the rating agencies. The city currently needs a reasonably priced letter of credit to achieve the savings a pension obligation bond issuance would provide.

Municipal Financial Advisors Regulation Act

While the USCM does not have specific policy supporting the regulation of financial advisors to state and local governments and requiring them to register with the SEC, we understand and are supportive of the intent to protect issuers, and place financial advisors on the same regulatory playing field as the broker dealer community. This bill is yet another step in restoring investor confidence in municipal debt.

In summary Mr. Chairman the municipal bond market is experiencing a severe liquidity shortfall, due in large part to the global credit crisis. Because of the high costs associated with issuing municipal bonds, many local governments around the nation have placed many infrastructure projects on hold until market conditions improve. As a result of, thousands of short-term and permanent jobs have been placed on hold as well. This situation can change as soon as financing of these projects at reasonable interest rates can be secured. We believe the legislation that you have introduced will significantly assist in improving market conditions and increasing local government access to credit at reasonable rates, allowing cities to be full partners in efforts to renew our nation's infrastructure, revitalize our economy and create jobs. The U.S. Conference of Mayors expresses its support for your continued efforts to assist state and local governments and the municipal bond market. The four pieces of legislation discussed today will go far towards helping my city and thousands of other cities across the nation. The nation's mayors stand ready to assist you in any way we can in securing their passage.

Moody's Investors Service

Testimony of Laura Levenstein
Senior Managing Director
Moody's Investors Service

Before the
United States House of Representatives
Committee on Financial Services

May 21, 2009

Hearing on Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance

I. Introduction

Good morning Chairman Frank and members of the Committee. I am Laura Levenstein, and I am the Senior Managing Director at Moody's Investors Service ("**Moody's**") for the Global Public, Project and Infrastructure Finance Group. On behalf of my colleagues at Moody's, I would like to thank the Committee for inviting me to provide Moody's views in this legislative hearing. I have confined my comments to the draft Bill that contains proposals concerning credit rating agencies (the "**draft Bill**") and Moody's ratings of municipal bonds. More specifically, my comments are on the version of the draft Bill that Committee staff provided to us with the invitation to testify at today's hearing.

We understand that the draft Bill, if adopted, would require every nationally recognized statistical rating organization ("**NRSRO**") to define clearly its rating symbols, apply them consistently for all types of bonds[1] and have its credit ratings for bonds address the risk that investors will not receive payment in accordance with the bonds' terms of issuance. Broadly speaking, the draft Bill seeks to promote ratings comparability between municipal and non-municipal bonds.

Throughout our history, Moody's has sought municipal market investors' and issuers' views on which attributes would make our municipal bond ratings most useful, and we have adjusted our rating system to respond to the changing needs of market participants over time. For many years, investors and issuers in this market indicated that they wanted our ratings to draw finer distinctions among municipal bonds, which generally have had lower credit risk when compared to Moody's-rated corporate or structured finance obligations.

It was not until 2008 that a larger portion of the market indicated that they sought comparability between municipal and non-municipal ratings. Taking into account these views, Moody's announced in early September 2008 our intention to recalibrate our long-term municipal bond ratings to our global ratings in order to enhance comparability between municipal and non-municipal ratings. In mid-September, an extraordinarily severe market dislocation was triggered by events unrelated to our announcement. Because of the severe turmoil that resulted from that dislocation, we decided it would be prudent to suspend the recalibration process until the market stabilized because we were concerned that pursuing our plans during such turbulence could unintentionally lead to confusion and/or further market disruption. The temporary suspension of the recalibration process remains in effect today because of ongoing volatility in credit markets. We remain committed, however, to implementing our plans and are monitoring market conditions closely as we look for an appropriate time to begin the recalibration process.

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1 The draft Bill refers to "securities and money market instruments". To streamline the discussion of the draft Bill in my testimony I use the term "bonds" instead to refer generally to fixed income instruments (including securities and money market instruments).

The draft Bill, therefore, mandates a ratings approach that is consistent with what we plan to adopt in response to market feedback regarding our municipal ratings. We believe that applying the draft Bill as introduced would not require us to change our planned approach to rating long-term municipal bonds because we intend to move forward with the recalibration process when the market stabilizes.

I would like to take this opportunity, however, to raise a few issues about the draft Bill that Congress and/or the Securities and Exchange Commission ("**SEC**") may wish to consider either now, or as part of the rule-making process. To put Moody's views on the draft Bill in context, I will first provide some background information on Moody's and the nature of our credit ratings, and then provide an overview of the U.S. municipal market,[2] current credit market conditions and Moody's approach to rating municipal bonds. I also will discuss our ongoing dialogue with participants in municipal bond markets about how best to ensure that our ratings meet the evolving needs of these participants and our plans to recalibrate our U.S. municipal bond ratings to our global ratings. Finally, I will provide Moody's comments on the draft Bill.

II. Background on Moody's Investors Service

A. History of Moody's and the Nature of Moody's Credit Ratings

The credit rating business has its roots in the American tradition of the marketplace of ideas. In 1909, American entrepreneur John Moody published a manual, Analyses of Railroad Instruments, which introduced a system of opinions about the creditworthiness of railroad bonds. Today, we are one of the world's most widely used sources for credit ratings, research and analysis.

Moody's credit ratings provide predictive opinions on one characteristic of an entity or fixed income obligation – creditworthiness. Our ratings are designed to rank bonds according to their relative credit risk and do not take into consideration factors such as the direction of future market prices, an investor's investment objectives, or the investor's risk parameters. Ratings are not statements of fact about past occurrences or guarantees of future performance and they do not constitute a recommendation to buy, sell, or hold a security.

We publicly disseminate our credit ratings through press releases and also make them available on our website. They are made simultaneously available to all market participants regardless of whether or not they purchase products or services from Moody's. The public availability of ratings helps promote the transparency and efficiency of financial markets, and allows the market and all users of ratings to assess independently the aggregate performance of our rating system.

B. Moody's U.S. Public Finance Ratings and Research

Moody's first began rating municipal bonds in 1918. Today, Moody's publishes ratings and research on a highly diverse group of issuers and securities, including bonds

2 The information contained in my testimony is based on the bonds that Moody's has rated in the municipal market. A large number of municipal bond issuances are not rated by Moody's and therefore our comments should not be construed as being applicable to the entire universe of municipal issuance.

issued by states, cities, counties, school districts, special local government entities and pooled groups of issuers. Bonds may be backed by, among other things, taxes, leases, appropriations and/or land development fees. Many, but far from all, of these rated bonds are backed by a government issuer's "general obligation" pledge, meaning that all of the government issuer's pledged, tax revenue-producing powers are promised to satisfy the debt, including the government issuer's ability to levy taxes sufficient to pay such debt. These bonds are sometimes called "General Obligation" or "G.O. bonds".

We also assign ratings to another large and diverse group of bonds issued by public authorities and non-profit organizations, which we collectively refer to as enterprises. These issuers back their debt with a combination of tax revenues and user fees to, for example, finance colleges and universities, hospitals, housing agencies and a wide range of public infrastructure projects such as airports, ports, public power utilities, transportation facilities and water-sewer systems.[3]

We assign our ratings in accordance with published analytical methodologies, which are available on our website, www.moodys.com, and we update our methodologies to remain current with evolving credit trends. We also publish numerous New Issue Reports and Update Reports each year, as well as in-depth analyses of high-profile issuers, rating methodologies, sector outlooks, and special comments.

III. Overview of the U.S. Municipal Finance Market

The municipal bond market has long been a critical arena for state and local governments to raise funds for major capital improvements, such as building roads, bridges, sewer systems and mass transit projects, to name a few. In this section of my testimony, I will discuss several important features of this market that, either historically or currently, have distinguished it from other markets.

A. Lower Overall Credit Risk than Other Credit Securities Markets

Historically, one of the most distinctive features of the U.S. municipal bond market has been the lower overall credit risk of most municipal bonds relative to other types of bonds. This has been especially true for G.O. bonds.[4] Four of the principal reasons for this are summarized below.

- *Municipalities typically are perpetual entities providing essential public services.* They do not need to generate a return on equity but merely to break even or generate a small surplus in order to continue operating.
- *Municipalities have the power to levy taxes or impose tax-like charges* for those essential services and can secure their bonds with a "general obligation" pledge.

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3 We use the term "municipality" to refer to state and local governments as well as local authority issuers, which collectively comprise the overwhelming proportion, by number, of issuers in the U.S. public finance market. References to the "municipal market" or "municipal bonds" do not encompass tax-exempt industrial development bonds issued by corporations or bonds technically issued by governmental entities but backed solely by corporate entities such as financial institutions.

4 Bonds issued by municipal authorities or other public sector authorities to finance healthcare, housing, higher education or certain types of infrastructure projects exhibit credit risk that is more comparable to that of similarly rated corporate bonds.

- *Unique bankruptcy laws* for municipal entities contribute to the lower credit risk of these bonds. For example, involuntary bankruptcy filings are not permitted, the municipality's debts can be adjusted but it cannot be liquidated, and the municipality's powers are not affected by the filing. It can continue operating during a bankruptcy, giving it the ability to raise revenue and make payments on any defaulted debt.
- *A municipality in financial distress might never reach default* because there are many avenues of relief available to most municipalities and, in some cases, a higher level of government, *e.g.*, the state or a third party credit provider, might take steps that prevent default on outstanding obligations. While very few Moody's-rated bonds have experienced payment defaults, numerous issuers have experienced financial distress.[5]

Many other state and local government-related bond issuers, such as most water and sewer authorities and public university systems, have shared these low-risk characteristics because they possess dependable revenue streams and are very likely to receive financial support from their sponsoring authorities in the event of distress. By contrast, some tax-exempt issuers (such as not-for-profit hospitals and private universities) increasingly share certain "corporate-like" characteristics, in the sense that they are governed independently, they compete in a market for the users of their services to generate revenues and they receive fewer direct governmental subsidies.[6]

B. Evolving Interests of Municipal Bond Market Investors

In our experience, investors purchasing municipal bonds historically have done so with different perspectives and risk appetites than investors in corporate bonds, and our municipal ratings evolved to reflect those differences. For example, unlike corporate bond investors, municipal investors generally have been more risk-averse and have looked for tax-free alternative investment opportunities to U.S. Treasuries. Moreover, many of these investors historically were active solely in U.S. public finance markets and did not cross over to invest in other sectors. As a result, they have been less diversified in their investment portfolios, more concerned about the safety and liquidity[7] of their investments, and in the case of individuals, often more dependent on debt service payments as a reliable source of income.

In particular, municipal investors generally have been highly intolerant of any diminished value or reduced liquidity in their investment portfolios, which can occur as a result of an issuer's financial distress even if the bonds do not default. Despite the low risk of default, valuation fluctuations may occur when a municipal issuer faces financial stress, because attempts either to resolve financial problems or have a third-party rescue

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5 In times of financial distress municipalities often can generate an internal solution to restore financial balance without involving a third party. However, there generally is a great deal of uncertainty with respect to the timing and content of the ultimate outcome.

6 There have been, however, some instances of governmental intervention to support these types of issuers when they are in financial distress.

7 Historically, less active issuers often addressed investors' concerns about the liquidity of their investments by obtaining bond insurance.

the issuer or its bonds usually occur only after lengthy political and policy negotiations. Consequently, municipal investors historically have looked to Moody's credit ratings for an opinion on the likelihood that a municipal bond issuer will experience financial stress.

In the late 1990s, however, we began to see municipal bonds increasingly traded by a wider range of multi-disciplinary investors who were active in the taxable and tax-exempt municipal markets as well as other bond markets. In addition, a number of larger issuers began issuing cross-border taxable bonds, which were targeted to foreign investors with limited knowledge of the U.S. municipal market. As I discuss in more detail in Section IV.C below, these developments led Moody's to start exploring the utility of recalibrating our U.S. municipal ratings to our global ratings in order to enhance comparability between municipal and non-municipal bond ratings.

C. Overview of Current Credit Market Conditions

Some tentative signs are beginning to emerge that may indicate that a slowdown in the deterioration of macro-economic conditions has begun in some countries, including the United States. Nevertheless, global credit markets and economic conditions are likely to remain stressed and affected by significant uncertainties throughout 2009. The downturn we are experiencing is unusual in several important respects in terms of its impact on municipal issuers. For example, this recession is now the longest running recession in the United States since the Great Depression. Moreover, while prior recessions in the U.S. were mostly regional in nature or industry-based, this recession has now encompassed every state in the nation. Job losses, depressed consumer spending and declining housing prices have reduced governmental revenues from income taxes, sales taxes, corporate taxes and property taxes. Consequently, this recession is longer, broader and deeper than prior, recent recessions.

Meanwhile, the severe disruption in the availability of short-term liquidity that developed in 2008 is continuing and has created significant, new challenges for many municipal issuers. Some issuers are finding it difficult to access short-term markets, facing rising interest costs or changing debt amortization terms, dealing with the consequences of financial counterparties that default or are downgraded, and/or are finding it difficult to obtain credit enhancement.

Many issuers can alter their behavior and undertake alternative plans of action to mitigate the impact of the current and near-term environment and maintain their strong credit ratings. A number of significant uncertainties, however, continue to affect credit market conditions for U.S. public finance issuers. These include uncertainties regarding:

- the duration and severity of the economic downturn;
- when the current disruption to public finance credit markets will be resolved;
- the potential for unanticipated changes to market access for certain issuers;
- the weakening liquidity of some states and municipalities, which is exacerbated by the ongoing disruption to some issuers' access to capital markets;
- the availability of credit and/or liquidity facilities;
- the declining credit quality of certain key counterparties; and

- how the deployment of the federal fiscal stimulus will benefit particular public finance issuers.

In this environment, Moody's has been continuing its ongoing surveillance of rated municipal issuers, keeping market participants informed about issuer-specific, sector-specific and broader trends that have the potential to affect long-term credit fundamentals, refining our rating methodologies and reporting on trends in ratings performance.

IV. Moody's Approach to Rating Municipal Bonds

A. Key Analytical Factors for Municipal Ratings

As I stated earlier, Moody's assigns ratings on a number of different types of municipal bonds. Broadly speaking, the issuers of these bonds can be divided into two categories: (1) state and local governments; and (2) enterprises. Moody's ratings of municipal bonds issued by state and local governments are based upon the analysis of the primary factors relating to municipal finance: the economy, finances, debt, governance/management strategies, and the bonds' structural features.

- *Economy*: Depending on the entity, we look at the breadth and diversity of the affected economy including its growth trends and comparative economic position to similar entities. For competitive non-profit organizations, we also look at market conditions that affect revenues, such as patient and student market trends.
- *Finances*: We analyze information contained in audited financial statements as well as current budget information and compare this information to sector statistics for comparable entities.
- *Debt*: Debt ratios are calculated to adjust for size (debt per capita) and wealth (debt to personal income or debt as a percent of full value), and are compared to sector medians.
- *Governance/management strategies*: We assess the type of governance, including legal powers to manage finances and any legal constraints on taxing, borrowing or spending.
- *Structural features of the bonds*: In addition to the fundamental credit analysis, Moody's analyzes the structure of the transaction, *e.g.*, the strength of the legal pledge of collateral to bondholders, the rights of other creditors and the nature and extent of external support.

All of these factors are important in assessing the entity's degree of financial flexibility to meet fiscal challenges and specific debt obligations. In each case, the factors are evaluated individually and for their interrelation with and impact on the other factors in the context of the municipality's ability to repay its debt and its relative degree of fiscal strength or stress.

Moody's also rates enterprise bonds, such as bonds relating to the construction or improvement of airports, toll roads, water and sewer facilities, public power plants,and bonds issued by healthcare institutions, housing authorities, and higher education institutions. These enterprise ratings incorporate many of the same factors noted above but also take into account the financial and business activity characteristics of the public enterprise. For example, an analysis of bonds relating to the construction and operation of a toll road would look at vehicular traffic, competitive position (*e.g.*, the existence of competing toll-free roads), the local economy served by the toll road, the coverage of debt service by toll revenue and the obligation of the entity to raise tolls to ensure sufficient revenue to pay debt service on the bonds.

B. Comparing Moody's Municipal Rating System with Moody's Global Rating System

Investors in corporate or structured bonds typically have looked to Moody's ratings for an opinion on whether a bond or issuer will meet its payment obligations. Our opinion takes into account both the probability of default and the expected loss if a default occurs. Historically, however, this analysis alone has not been as helpful to municipal investors. This is because, if municipal bonds had global ratings, the great majority of our ratings likely would fall within just two rating categories: Aaa and Aa. This would make it more difficult to differentiate among various municipal bonds, which is something that many investors indicated to us that they wanted our rating system to do.

Accordingly, Moody's municipal bond ratings developed so that they distinguished more finely among the various municipal bonds and ranked one against the other on the basis of intrinsic financial strength. Because the risk and potential severity of loss historically has been relatively low for governmental issuers, Moody's municipal ratings, taking into account the factors described in subsection A above, principally have focused on the risk that an issuer will face financial stress.

C. Moody's Planned Recalibration of Our Municipal Ratings

As I noted in Section III above, beginning in the late 1990s, Moody's began to observe a growing number of "cross-over", multi-disciplinary investors becoming active in both the taxable and tax-exempt municipal markets as well as non-municipal bond markets. Consequently, to ensure that our ratings were continuing to meet the needs of market participants, Moody's consulted the market and made several changes to reflect this evolution in, and feedback from, the market.

- ***In 2001***, Moody's met with over 100 market participants to understand their views on the need for and value of globally consistent ratings.[8] The vast majority of participants surveyed indicated that they valued our municipal ratings in their current form. Additionally, many market participants expressed concerns that any migration of municipal ratings to be consistent with our global ratings would result in considerable compression of ratings in the Aa and Aaa range, thereby reducing the discriminating power of the rating and transparency in the market. However, a segment of the market indicated that they would value a greater ability to compare municipal credits to other bonds in other markets.

[8] See *Special Comment: Moody's Municipal Default Study Highlights and Next Steps*, June 2002 (Document 75249).

- *In 2002*, we published a default study that highlighted the limited default experience in the Moody's-rated market for public finance bonds,[9] and we noted that some taxable bonds were starting to be placed outside of the United States. To accommodate the latter trend, we began:
    1) offering entities issuing tax-backed or essential service revenue-backed taxable bonds outside the U.S. the opportunity to request that, in addition to our municipal ratings, a global rating also be assigned; and
    2) providing broad guidance on how our municipal ratings would translate into our global ratings. In particular, we stated that it would be reasonable to conclude that nearly all Moody's-rated general obligation and essential service revenue bonds would be rated at or near the top of the global scale.
- *In 2006*, we published a *Request for Comment* asking market participants whether they would value greater transparency about the conversion of our municipal ratings to global ratings. We received over 40 written responses and had telephone and in-person discussions with many other market participants. Generally, the majority indicated that they valued the distinctions the municipal ratings provide in terms of relative credit risk, but that they would endorse the expansion of assigning complementary global ratings to taxable municipal bonds sold inside the U.S.
- *In 2007*, based on the feedback described above and to further improve the transparency of our long-term municipal bond ratings, we:
    1) implemented a new analytical approach for arriving at the complementary global rating, thereby enabling investors to compare municipal bonds to corporate bonds while maintaining the existing municipal ratings that investors and issuers told us they valued; and
    2) announced that, when requested by the issuers, we would assign a global rating to any of their taxable bonds, regardless of whether the bonds were issued within or outside the United States.[10]
- *In 2007 and 2008*, the market continued to evolve. In early 2008, prompted by recent market events and developments in market sentiment, Moody's again proposed recalibration of its municipal ratings to align them with our global ratings and actively reached out to a wide range of constituency groups to ensure that the feedback we received represented all users of credit ratings.[11] The comments we received on our *Request for Comment* publications and in our outreach efforts showed that a larger portion of the market sought comparability between municipal ratings

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[9] It is important to note, however, that the time period studied did not include a period of extreme financial distress such as the Great Depression and the study covered only Moody's-rated bonds. Default experience in the unrated portion of the market is considerably higher.

[10] To put the demand for global ratings by municipal issuers into context, since we first began offering global ratings for taxable securities in 2002, approximately 25 issuers requested that Moody's assign a global rating to their bonds.

[11] See *Request for Comment: Assignment of Global Ratings to Tax-Exempt Municipal Obligations*, March 2008 (Document 108116); *Special Comment: Assigning Global Scale Ratings to Municipal Tax-Exempt Obligations, April 2008* (Document 108470); and *Announcement: Moody's Extends Comment Period on U.S. Public Finance Rating Scale*, June 2008 (Document 109143), all of which are available at moodys.com.

and those in other sectors.[12] Feedback from nearly 200 market participants – including issuers, bankers, financial advisors, trade associations and major institutional investors with substantial positions in U.S. municipal bonds – indicated that:

1) recent market conditions had resulted in a greater interest in rating comparability between municipal and non-municipal bonds; and
2) ratings that facilitate such comparability would be preferable.

On September 2, 2008, therefore, we announced our intention to recalibrate our municipal ratings. In mid-September, however, and for reasons unrelated to our announcement, global credit markets experienced a sudden and severe dislocation that sent shock waves around the world. As a result, on October 7, 2008, we announced that conditions in the credit markets would delay our planned recalibration of U.S. public finance ratings. This delay was required because we recognized that proceeding with our plans in the midst of such credit market turmoil could unintentionally lead to confusion and/or further market disruption. The temporary suspension of the recalibration process remains in effect today because of ongoing volatility in credit markets. Nevertheless, Moody's remains committed to our plan to apply our global ratings to U.S. public finance bonds, and we intend to move forward swiftly with the recalibration process once macro-economic conditions and credit markets stabilize. Meanwhile, Moody's has maintained its surveillance of U.S. public finance ratings, taking rating actions as appropriate based on our long-standing approach to municipal credits.

V. MOODY'S COMMENTS ON THE DRAFT BILL

We understand that the draft Bill, if adopted, would amend the Securities Exchange Act of 1934 (the "**Act**") to, among other things, require every NRSRO to:

- define clearly its rating symbols;
- apply those symbols consistently for all types of bonds; and
- have its credit ratings address the risk that investors in bonds may not receive payment in accordance with the terms of issuance.

Other provisions in the draft Bill indicate that the proposed amendments are not intended to prevent an NRSRO either from: (i) considering additional credit factors in certain circumstances; or (ii) establishing ratings that are complementary to the ratings described above and created to measure a discrete aspect of a bond's risk.

We understand that the draft Bill seeks to promote comparability between municipal and non-municipal bond ratings. In this respect, the Draft Bill is consistent with the feedback we received from a large number of the users of Moody's long-term municipal bond ratings. Our plan to recalibrate our municipal bond ratings to our global ratings is intended to enhance ratings comparability between municipal and non-municipal ratings. Accordingly, we do not believe that application of the proposed requirements in the draft Bill poses problems for our planned approach to rating long-

[12] See *Announcement: Moody's to Recalibrate its U.S. Municipal Bond Ratings to the Company's Global Rating Scale*, September 2008 (Document 110987), available at moodys.com.

term municipal bonds because we plan to move forward with our ratings recalibration process.

The draft Bill, however, does raise some issues that Congress and/or the SEC may wish to consider, either in the legislative or rule-making process. I have outlined briefly some possible issues for consideration without attempting to provide a comprehensive list:

- The draft Bill mandates that the recently expressed preferences in the municipal market be frozen in time. This, in turn, could make it more difficult in the future for NRSROs to respond to evolving credit markets and needs of investors, issuers and other users of credit ratings.
- This legislative crystallization of recently expressed market preference could make it more difficult for NRSROs, and rating agencies interested in becoming NRSROs, to innovate and compete on the basis of providing credit ratings that meet market participants' evolving needs.
- While Moody's has concluded that it is appropriate for us to recalibrate our long-term municipal bonds to our global ratings, other NRSROs may have a different view. Congress may wish to consider whether a "one size fits all" approach to this issue should be mandated.
- While we believe that the draft Bill would not require us to change our planned approach to rating long-term municipal bonds, we note that the proposed amendments involve, for the first time in the United States, substantive regulation of the content of credit opinions and rating methodologies.
- The leaders of the G-20 declared in April 2009 that credit rating agencies "should differentiate ratings for structured finance products."[13] A question arises about how to reconcile the requirements in the draft Bill with the obligations implied by the G-20 Declaration. This is because the draft Bill could be interpreted as requiring an NRSRO to use the same set of rating symbols and rating scale for all of its credit ratings (whether of corporate, municipal or structured finance bonds) that assess the risk that bondholders may not receive payment in accordance with the terms of issuance.
- It is unclear whether and how the provisions in the draft Bill would apply to certain categories of credit ratings that are intended to measure more than a discrete aspect of a bond's risk but do not use the same rating symbols as those applicable to our long-term credit ratings. For example, Moody's short-term credit ratings assigned in the corporate sector are entity-level opinions about the ability of issuers to honor short-term financial obligations and, therefore, address more than a "discrete aspect of a bond's risk". The symbols used for these short-term ratings (*i.e.*, Prime-1, Prime-2, Prime-3 and Not Prime) are different from the symbols used in our long-term ratings. The same question arises with respect to short-term credit ratings assigned to U.S. municipal debt, where we use the symbols MIG-1, MIG-2, MIG-3 and SG (where MIG stands for Municipal

[13] G20, "Declaration on Strengthening the Financial System," April 2, 2009, available at www.g20.org.

Investment Grade and SG stands for Speculative Grade) for ratings assigned to short-term debt instruments.

- The draft Bill refers to credit ratings assigned to securities and money market instruments. In addition to assigning ratings to a variety of securities, money market instruments and other obligations (such as bank deposits), Moody's also assigns ratings at an entity level (*e.g.*, to corporations, financial institutions and funds). These ratings address more than a "discrete measure" of risk and, therefore, do not seem to fit within the concept of a "complementary" rating as defined in the draft Bill. A question arises as to whether and how the draft Bill would apply to ratings that an NRSRO assigns at an entity level.

VI. CONCLUSION

Moody's is strongly committed to meeting the needs of investors, issuers and other participants in the municipal bond market for assessments of the relative creditworthiness of bonds in that market – a market that plays a vital role in meeting public needs. Moody's supports constructive measures that encourage greater market transparency and seek to bolster confidence in credit markets. In this regard, we would welcome the opportunity to work with Congress to achieve these goals.

I am happy to respond to any questions.

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Statement of Michael J. Marz
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and

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Regional Bond Dealers Association

Before the Committee on Financial Services
U.S. House of Representatives

Hearing on Municipal Finance
May 21, 2009

Good morning. Thank you Chairman Frank, Ranking Member Bachus and other members of the committee for the opportunity to present the views of the Regional Bond Dealers Association (RBDA)[1] on the municipal finance legislation proposed by the committee last week.

The RBDA supports the four draft bills released by the committee last week. We believe this legislation would offer the municipal market targeted and temporary assistance for those sectors still acutely affected by the credit crisis and would provide federal accountability for all financial professionals by addressing long-standing holes in the regulation of the market. The bills to address the variable rate municipal bond market and to establish a regulatory system for municipal financial advisors are especially important in the current market environment. We commend the work of Chairman Frank and other members of the committee on crafting the draft legislation and we look forward to the quick enactment of all four draft bills.

Regional bond dealers play a vital role in the municipal market of underwriting new bond issues for states and localities and providing secondary market liquidity to investors. This role has expended during the financial crisis with the consolidation, downfall or withdrawal from the market of a number of large municipal bond dealers. During the height of the crisis in the fall and winter of 2008, the only source of liquidity available to many investors was regional dealers. We believe the role of regional firms in the municipal market will continue to expand, and we appreciate the opportunity to present our views.

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[1] The Regional Bond Dealers Association is the organization of regional securities firms active in the U.S. bond markets and is the only U.S. organization focused exclusively on issues in the domestic fixed-income markets. More information on the Regional Bond Dealers Association is available at www.regionalbonddealers.com.

Municipal bonds are a essential component of the U.S. capital markets. Under our federal system of government, states and localities bear significant responsibilities for delivering public services, and in order to meet those obligations, state and local government must make substantial investments in infrastructure and other capital assets. Because governments cannot issue stock, the principal means of financing those investments is debt raised by issuing municipal bonds. The municipal bond market has a long and successful history of bringing states and localities together with investors and lenders to provide financing for schools, roads, water and sewer systems, hospitals, airports, parks and a variety of other public facilities. Municipal bonds are also used to provide targeted lending such as student loans and low- and middle-income home mortgages to underserved sectors of borrowers.

Municipal bonds are an extraordinarily safe and stable investment. The default rate on governmental municipal bonds is close to zero, and save for securities guaranteed by the federal government, municipal bonds are the safest investment available. Despite that record of safety, the municipal bond market was effectively frozen last year with the rest of the credit markets in the wake of the global financial crisis. For a number of weeks last fall, most states and localities were essentially unable to borrow in the capital markets at all. The U.S. credit markets, including the municipal bond market, have recovered substantially since then. It is now possible for state and local governments with strong credit ratings to borrow at attractive terms, and indeed in the first four months of 2009, states and localities sold 3,191 bond issues with a par value of nearly $120 billion. While that volume is down by around 12 percent from the same period last year, the market is clearly functioning.

Nevertheless, some targeted sectors of the municipal market are still quite distressed, and friction in these sectors is causing significant fiscal pain for states and localities and investors. In particular, many state and local governments and agencies that have variable rate demand notes (VRDNs) outstanding are paying excessively high interest rates on this borrowing not because of their own fiscal problems, but because of distress at banks that serve as "liquidity providers" for their transactions and the collapse in ratings of many bond insurers. Also, there is still a large volume of auction rate securities (ARS) outstanding where states and localities and other borrowers have been unable to convert or refinance to other forms of borrowing because of constraints among banks. In addition, the loss of bond insurance, once a prevalent source of credit enhancement in the municipal bond market, has caused some state and local borrowers to pay higher borrowing costs than they otherwise would. These remaining problems associated with the financial crisis appear against the backdrop of severe fiscal stress being experienced by a large number of state and local governments around the country as a result of the recession and a weakened real estate market.

In addition, the credit crisis has magnified long-standing gaps in the regulation of the municipal market. Most importantly, unregulated financial advisors, swap advisors, brokers of guaranteed investment contracts and other parties that play the vital role of advising states and localities on bond issuance and other activities currently fall completely outside the jurisdiction of the Securities and Exchange Commission and all other regulatory bodies, and as a result escape accountability for any misdeeds. Moreover, initiatives previously announced by the credit rating agencies to revamp their rating systems for municipal bonds to bring them more into line with other credit products have been suspended as a result of the crisis.

Chairman Frank's draft legislation would help address all these issues. In the case of problems with the VRDN and ARS markets and the dearth of credit enhancement, the draft legislation offers targeted, temporary federal assistance to help states and localities until the credit markets return to normal. In the case of regulatory gaps, the legislation offers reasonable solutions to help assure regulators have the tools they need to hold all financial professionals accountable and keep the market safe.

Variable rate borrowing - background

It is common for state and local governments and others that borrow in the municipal bond market such as non-profit hospitals, colleges and universities to issue bonds where the interest rate varies periodically similarly to variable rate mortgages offered to home buyers. In some cases borrowers pay the variable rate as a way to take advantage of short-term interest rates, which are usually lower than long-term rates. In other cases, those borrowers use interest rate swaps or similar strategies to convert their variable rate borrowing to a net fixed interest rate at a savings relative to issuing fixed rate bonds directly. Over the last two decades two forms of variable rate borrowing have been prevalent, variable rate demand notes (VRDNs) and auction rate securities (ARS). At the height of the market in January 2008 there were approximately $330 billion of ARS outstanding. Now, a significant volume of those securities have been restructured or refunded, but nearly $200 billion remain outstanding, including both municipal and other forms of ARS. There is no reliable source for the volume of VRDNs outstanding; we estimate that approximately $400 billion are currently in the market.

Although both ARS and VRDNs are forms of variable rate financing, they differ in one key area. For ARS, liquidity—the ability for investors to readily sell their securities at par—depends on the success of periodic Dutch auctions. At an auction, which typically occurs weekly or monthly, ARS investors who want to sell their securities provide their orders to their broker-dealer who then submits the offer to an auction dealer, a firm contracted by the issuer to manage the auction process. Potential ARS buyers submit bids to the auction, and—at least by design—sellers are matched with buyers. The auction clearing rate becomes the interest rate paid by the issuer until the next auction. Beginning in February 2008 a large number of auctions began to persistently fail—there were insufficient buyers to cover all the offers from ARS sellers. In those cases, investors are unable to sell their securities, and rates paid by issuers on failed ARS increase to a pre-determined maximum, or "penalty," rate. Today, approximately 80 percent of auctions on ARS that remain outstanding continue to fail on a persistent basis, and many ARS investors are holding securities which offer no liquidity and cannot be sold.

Since last year, some state and local government ARS issuers have been able to refund or restructure their outstanding ARS, curing the problems of high penalty rates for issuers and illiquidity for investors. However, many ARS remain outstanding with no liquidity for investors whatsoever. In particular, many municipal and closed end fund ARS and virtually all student loan-backed ARS remain in the portfolios of investors with little prospect for resolution. Some broker-dealers who sold ARS have reached agreements with federal and state enforcement agencies that require those dealers to buy back ARS from certain investors at par. Those settlement agreements and voluntary offers have resulted in commitments from broker-dealers to buy over $68 billion of ARS from investors.[2] However, this represents only a minority of ARS that remain outstanding. Even for those investors who are covered by settlements, the buybacks simply transfer the illiquidity problems from investors to dealers, many of whom may be facing liquidity or balance sheet issues of their own, thus offering little resolution to the financial stress that currently exists within our financial system.

VRDNs do not use an auction process. Instead, each VRDN issue offers investors the opportunity to sell their securities at par, generally on a weekly or daily basis through a designated "remarketing agent," typically a broker-dealer. When a VRDN investor wants to sell their security, he or she submits an offer through their dealer to the remarketing agent. The remarketing agent surveys the market and determines a rate for the VRDNs that would attract sufficient buyers to cover all the offers. That rate then becomes the rate paid by the issuer until the next reset date. Unlike an ARS, however, if there are insufficient buyers to cover all VRDN offers, investors have the right through the bond trustee to place the securities with a third-party liquidity provider. VRDN liquidity providers, typically banks, have obligations under standby bond purchase agreements (SBPAs), letters of credit (LOCs) or similar contractual arrangements to purchase at par any VRDNs that cannot be resold through the remarketing process. When a VRDN is placed with a liquidity provider, the interest rate paid by the issuer on those bonds increases to a pre-determined maximum. After some defined period, frequently 90 days, VRDNs put to banks require accelerated amortization, forcing issuers to rush to refinance troubled securities at high cost and in difficult market conditions. VRDNs that have been placed with banks under liquidity facilities are known as "bank bonds."

While no data are readily available, an significant number of VRDN remarketings have "failed" in recent months, *i.e.*, there have been insufficient numbers of VRDN buyers to cover all sell orders on reset dates. The larger-than-normal volume of "puts" to liquidity banks in many cases is unrelated to the credit outlook for VRDN issuers. Rather, it reflects the financial distress of many liquidity banks or bond insurers. As bank liquidity providers face financial problems or are "downgraded," investors put bonds back to the banks. In some cases, if banks are downgraded to levels below those specified for registered money market funds, those puts back to banks are mandated by regulation. The collapse in ratings and withdrawal from the market of many of the monoline bond insurers has also been a cause of "failed remarketings" because a large portion of VRDNs carry credit enhancement in the form of bond insurance in conjunction with the SBPA. As a result, much larger than normal volumes of VRDNs have been put to bank liquidity providers, and those VRDN issuers are now paying high maximum rates and face shortened amortization on their financings.

One measure of the performance of the VRDN market is the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index, an index of rates on certain tax-exempt municipal VRDNs with weekly rate resets. After spiking to an all-time high of 7.96 percent in September 2008, that index recently fell to an all-time low of 0.44 percent.[3] That index,

[2] SecondMarket, Inc., "Auction-Rate Securities (ARS) Broker-Dealer Settlements/Offers," May 7, 2009.
[3] Securities Industry and Financial Markets Association, "The Securities Industry And Financial Markets Association Municipal Swap Index (2000-2008)," http://archives1.sifma.org/swapdata.html.

however, belies the experience of many VRDN issuers. The SIFMA index includes only the highest rated VRDNs and does not include bank bonds. The index also excludes the rates on all VRDNs that fall outside a specified range from the average. For VRDN issuers whose bonds are yielding near the SIFMA index, the market is performing as intended. However, many other VRDN issuers are facing extraordinarily high rates on their financings.

This condition may be exacerbated for VRDN and ARS issuers who have used swap contracts or other interest rate derivatives to hedge the floating rates on their VRDNs. Many states and localities used this strategy in the last decade to execute "synthetic fixed rate" borrowing. Under a typical swap contract a state or local government pays to a swap dealer a fixed rate of interest based on a "notional" principal amount. The government receives a floating rate of interest from the dealer which is designed to match the rate paid on its floating rate borrowing. Most interest rate swaps used by municipalities are based on the SIFMA index. For many years the rates on most VRDN and ARS tracked the index closely and SIFMA-based swaps were effective hedges. As the ARS and VRDN markets became distressed last year, however, the variable rates on many swaps diverged significantly from the bonds they were intended to hedge. Today, a number of state and local governments and other municipal market borrowers find themselves earning less on their swap contract than what is owed on their variable rate borrowing, causing their net cost of borrowing to rise significantly. Again, in many cases this is a result not of their own credit condition but of the condition of their VRDN liquidity bank, the downgrade of their bond insurer, or as a result of the failure of their ARS. Moreover, in order to unwind the transaction many of these governments and other issuers may have to pay large termination payments to their swap counterparty.

VRDN liquidity facilities have limited terms that are usually shorter than the maturities on the VRDNs they support. This requires issuers to renew SBPAs or LOCs periodically to maintain liquidity for investors. In recent years, some liquidity providers have agreed to terms on liquidity facilities as long as ten years. Recently, however, with banks facing balance sheet constraints and generally retreating from activities that subject them to credit or liquidity risk, the cost of VRDN liquidity facilities has increased significantly and terms offered by banks have shrunk. Some banks previously active in the VRDN market as liquidity providers have exited from this business entirely. Many of the banks that remain do not offer liquidity facilities longer than one year. We are concerned that continued constrained conditions for banks will make it increasingly difficult for issuers to renew expiring liquidity facilities and will increase the risk of future defaults.

Difficulties in the ARS and VRDN markets are occurring despite the fact that the credit quality of most ARS and VRDNs has not deteriorated significantly. Many student loan backed ARS are indirectly guaranteed by the federal government since they are backed by federally guaranteed student loans. Many ARS and VRDNs issued by states and localities have lost the benefit of third party bond insurance that may have originally provided them with "triple-A" credit ratings, but the underlying credit quality of the issuers has not deteriorated significantly in most cases. Problems in the ARS and VRDN markets are principally related to illiquidity, deleveraging and dysfunction in the broader financial markets, not to credit deterioration related to the issuers of these products specifically.

Variable rate borrowing – solution

The committee has drafted the Municipal Market Liquidity Enhancement Act of 2009 (MMLEA) to address issues in the market for variable rate municipal bonds. The bill would authorize the Federal Reserve to initiate a program to purchase VRDNs issued before the date of enactment of the bill, new VRDNs issued to refinance outstanding ARS, and short-term municipal notes. The bill would effectively permit the Fed to serve the role of liquidity bank for certain VRDN transactions.

The MMLEA would address the significant constraints being faced by state and local governments and agencies as a result of a weakened market for bank liquidity facilities. Many states and localities simply do not have the option to refinance out of these transactions because they could face large swap termination payments. Meanwhile, maintaining these transactions in many cases is resulting in excessively high financing costs because the health of the bank liquidity provider has deteriorated and capacity in the bank liquidity market is so constrained. By bringing the Fed into the municipal market as a temporary liquidity provider, states and localities would be freed from their excessive financing costs. Moreover, the provision allowing the Fed to buy short-term municipal securities would be an important help to those states and communities who are having difficulty securing short term, cash flow borrowing. The Fed's comparable program for short term corporate issuers—the Commercial Paper Funding Facility—currently is not available to state and local governments.

The Fed may want to consider expanding the MMLEA to address the non-municipal sectors of the ARS market. For example, many closed end mutual funds have outstanding auction rate preferred stock (ARPS) that was issued to provide leverage to the funds. Some mutual fund companies have been successful in replacing their funds' outstanding ARPS with preferred stock with some of the characteristics of VRDNs, but lack of access to bank liquidity facilities has been a constraining factor for others. Also, some non-municipal issuers of ARS backed by pools of student loans would like to convert their outstanding ARS to VRDNs or similar instruments but are unable to do so because of a similar lack of access to bank liquidity facilities. Expanding the MMLEA to include both ARPS and non-municipal student loan-backed ARS would be consistent with the spirit of the MMLEA, would help investors in those markets, and would help address problems in those sectors that are similar to parallel problems in the municipal market.

The RBDA supports the MMLEA because we believe it would provide a means of addressing the severe problems in the market for variable rate municipal bonds. The Fed could initiate a program that is targeted to those sectors of the market most acutely affected by the credit crisis and could set the program so that it would be self-terminating when banks have recovered and there is greater capacity in the market for bank liquidity facilities.

Unregulated market participants

Under current law municipal securities broker-dealers must register with the SEC and join the Municipal Securities Rulemaking Board (MSRB). They then become accountable to the SEC and subject to a range of regulations that govern virtually all their business activity. The MSRB has a long and successful history of overseeing the activities of municipal securities dealers and has developed and refined a set of dealer regulations that are tailored to the unique characteristics of the municipal bond market. These regulations relate to conflicts of interest, professional qualifications and standards, capital adequacy, fair dealing, books and records and a variety of other areas. In addition, municipal broker-dealers are subject to periodic examinations by the SEC and the Financial Industry Regulatory Authority (FINRA), and violators of regulations can be sanctioned by fines, censure or, ultimately, by a revocation of their registration. In general these rules and mechanisms apply to broker-dealers whether they are acting in the capacity of underwriter or dealer or in the capacity of financial advisor. None of these rules and mechanisms apply to so-called "independent" financial advisors (FAs) who are not also broker-dealers; FAs are effectively unregulated and without accountability at the federal level.

Unregulated municipal financial advisors are in the business of providing advice to state and local governments with respect to issuing bonds, investing bond proceeds, using derivatives and guaranteed investment contracts, selecting underwriters and other functions. They also may help prepare disclosure documents, place private placement securities with investors and carry out other tasks. FAs can serve a vital function in a bond deal, and their actions can have significant implications for issuers and investors. Indeed, there have been numerous examples in recent months of conflicts of interest or poor advice from FAs that have negatively affected state and local bond issuers.[4]

The committee has drafted the Municipal Advisers Regulation Act (MARA) to address this problem. The MARA would require that "municipal financial advisors" register with the SEC in a manner similar to current registration requirements for broker-dealers. The bill would also grant the SEC broad authority to establish rules for registered municipal financial advisors and impose sanctions on rule violators. In addition the bill would specify that municipal financial advisors would bear a fiduciary standard of care with respect to their state and local government clients.

The RBDA supports the MARA because we believe it would effectively address the long-standing regulatory gap regarding FAs who are not broker-dealers. While the majority of FAs are honest and competent, it is inappropriate for any party to a securities transaction whose decisions and advice have such significant implications to fall outside any regulatory jurisdiction. Giving the SEC authority to oversee FAs would be an important step in closing that regulatory gap. The MARA would assure accountability and provide a fair and measured approach to FA regulation that is consistent with the scope and degree of regulation for other market participants.

Credit enhancement

Before 2008 the municipal bond market depended to a heavy degree on bond insurance as a form of credit enhancement. Bond insurance in the municipal market had evolved over 30 years and had come to play an important role in how bonds were priced and traded. Bond insurance is a form of insurance that is provided by monoline insurance companies. Rather than insurance against a physical loss, bond insurance promises to maintain scheduled principal and interest

[4] See, for example, Mary Williams Walsh, "Bond Advice Leaves Pain in Its Wake," *The New York Times*, February 16, 2009.

payments to investors in case a bond issuer defaults. In general, when a bond is insured, it carries a credit rating based on the rating for the claims-paying ability of the bond insurer. Because bonds with a higher credit rating typically yield less than bonds with lower ratings and because bond insurance is priced so that the cost of a policy is less than the present value savings to a bond issuer associated with issuing insured rather than uninsured bonds, using insurance provided a built-in way for municipal bond issuers to save money on their borrowing costs.

When it was prevalent, bond insurance provided more to the market than direct credit enhancement. Bond insurance simplified municipal bond analysis by "homogenizing" diverse credits. There are perhaps 50,000-70,000 issuers of municipal bonds representing a wide range of purposes and structures. The transfer of credit risk to municipal bond insurance companies made it easier for investors to evaluate individual bond investments as credit analysis could be focused on the insurance company rather than on the underlying municipal credit. Consequently, bond insurance made bond analysis more efficient, which supported orderly trading and general municipal bond market liquidity. At its height, bond insurance was attached to more than half of all new municipal bonds sold.

As the members of the committee know, many of the monoline insurance companies were involved in insuring not only relatively safe and stable municipal bonds, but also structured credit products that in some cases were highly leveraged and subject to considerable exposure to subprime lending and real estate values. As the subprime market collapsed, losses associated with structured credit products eroded the capitalization of many of the bond insurers. Today, most are no longer capable of underwriting new business in the municipal market. Of the "legacy" bond insurers that were previously active in the municipal market, only two are still active today, and they are in the process of merging. As a result there is much less capacity for credit enhancement than over the last several decades.

The sector of the market that has been perhaps the most severely affected by the reduction in the capacity of credit enhancers is the market for lower-rated revenue and enterprise issuers such as hospitals. Credit spreads—the difference in borrowing costs for issuers if differing credit quality—have widened considerably in recent months. The remaining bond insurers are not aggressively providing credit enhancement to these issuers, and consequently they are facing significantly higher borrowing costs. While the market is slowly adjusting to a world with much less bond insurance, there are clear signs that both issuers and investors would benefit from more capacity among monoline bond insurers. Several new startup monoline insurers—some new startups and some affiliated with legacy insurers—have announced their intention to become active in the market.

Some of the legacy bond insurers have petitioned the Treasury Department to provide recapitalization funds so they can return to the market and offer credit enhancement. The Treasury Department, however, has reportedly rejected these requests.[5]

The committee has proposed the Municipal Bond Insurance Enhancement Act (MBIEA) of 2009 as a targeted and temporary solution to the reduction in bond insurance capacity in the municipal

[5] Andrew Ackerman Jack Herman and Patrick Temple-West, "Treasury Rejects Direct Aid to Insurers," *The Bond Buyer*, February 11, 2009,

market. The bill would direct the Treasury Department to offer $50 billion of reinsurance to monoline insurers who are active in the municipal market. Treasury would charge risk-based premiums for the risk they underwrite. The RBDA supports this proposal because we believe it would help restore credit enhancement capacity to the municipal market. We also believe that Treasury would incur almost no losses on its risk underwriting activities because the default and loss rates on municipal bonds are so low. It is important that the program be structured to help those municipal bond issuers who have been most severely affected by wider credit spreads and the loss of much of the credit enhancement capacity, singe-A and triple-B rated revenue and enterprise issuers. Even with this category of borrowers, Treasuries losses are likely to be minimal. In the end, Treasury would likely generate a profit for taxpayers on this activity while helping to restore confidence and efficiency to the municipal market.

The committee may wish to consider two enhancements to the MBIEA. First, the current draft of the bill specifies that Treasury could provide reinsurance only to those insurance companies "whose corporate or other governing charter prohibits the insurer from providing coverage for risks other than" municipal bonds. This limitation may be overly restrictive and could prevent Treasury from being able to offer reinsurance to any of the companies currently active in the market. The committee may want to consider an amendment that, for example, limits the reinsurance to firms predominantly involved in the municipal market and authorizes Treasury to impose additional restrictions on which insurance companies may be eligible to participate in the program.

Second, the MBIEA specifies that no later than five years after the date of enactment of the bill, Treasury is required to execute a plan "for the privatization of the operation of the program under this subsection through the submission of offers to purchase such operations." The principal value of the reinsurance program proposed in the MBIEA is that the federal government would be standing behind the credits that Treasury reinsures. If Treasury is required to sell off the portfolio after five years, because many municipal bonds often have maturities of 20 years or longer, the market will question who ultimately will be enhancing the credit. Because Treasury would be required to divest the portfolio, the market would discount the value of Treasury credit enhancement. The committee may want to revise the divestment provision of the MBIEA so that Treasury would not be required to transfer the credit portfolio to a private insurer. To the extent that the goal of the divestment provision is to limit the scope of the program, the committee may want to consider other limitations that would not bring into question the ultimate obligor on the reinsurance. For example, Treasury could offer the reinsurance service for a shorter period of time—say, two years—but that reinsurance would remain in force at Treasury for the life of the bonds.

Municipal bond rating standards

Because municipal bonds carry default risk, however small, investors depend on credit ratings as a evaluative opinions of the risk of default and loss on particular bonds. Certain rating agencies have stated that the scale they use to rate municipal bonds is different from that used to rate other credit products.[6] This can result in a circumstance where a municipal bond with a particular default and loss expectation carries a lower rating than a security in another market sector with a similar default and loss expectation. Some have argued that this factor causes states and localities to pay more in their financing costs than they otherwise would.

Last year several rating agencies announced that they would begin migrating their municipal ratings to a scale consistent with other credit products.[7] Later in the year some of those rating agencies stated that the project to move to a consistent rating scale for all credit products would be suspended "indefinitely."[8]

The committee has proposed the Municipal Bond Fairness Act (MBFA) to address the issue of divergent rating scales for municipal bonds and other credit products. The MBFA would mandate that the SEC require rating agencies to apply rating symbols "in a consistent manner for all types of securities and money market instruments." The bill would not dictate rating methodologies or factors associated with ratings, which could continue to differ across sectors of the credit markets. The bill would also require the SEC to establish and apply performance measures to assess the accuracy of rating agencies' credit evaluations.

The RBDA supports the MBFA because as we have stated in the past we believe a single rating scale "is in the long-term best interests of both issuers and investors, that it will lower financing costs for state and local governments, and that it will reduce confusion in the market and better enable investors to compare the credit risk of municipal debt with that of other debt products."[9] While we support the MBFA, we also urge the rating agencies who previously announced projects to move municipal ratings to a scale consistent with other credit products to resume those initiatives apart from a legislative mandate.

Conclusion

We again commend Chairman Frank and other members of the committee for your attention to the municipal market in this hearing and with the four draft bills you released last week. This legislation would provide targeted and temporary assistance to states and localities still experiencing the fallout from the financial crisis. The bills would also address regulatory gaps in the municipal market, provide federal accountability for all financial professionals, and thereby strengthen investor confidence in the municipal market. We support the four draft bills and look forward to working for their quick enactment.

Thank you again for the opportunity to testify. I look forward to your questions.

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[6] See, for example, Moody's Investors Service, "Testimony of Laura Levenstein, Senior Managing Director, Moody's Investors Service Before the United States House of Representatives Committee on Financial Services," March 12, 2008.
[7] Michael McDonald, "Moody's Set to Change Municipal Bond Rating Scale," Bloomberg Information Service, June 12, 2008.
[8] Jack Herman, "Fitch, Moody's to Delay Recalibrations," *The Bond Buyer*, October 8, 2008.
[9] Letter from Michael Decker and Mike Nicholas, Co-Chief Executive Officers, Regional Bond Dealers Association, to Lisa Washburn, Managing Director, Public Finance Group, Moody's Investors Service, June 30, 2008.

TESTIMONY OF

SÉAN W. MCCARTHY

ON BEHALF OF

FINANCIAL SECURITY ASSURANCE INC.

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

Chairman Frank, Ranking Member Bachus, and members of the Committee, my name is Séan McCarthy and I am President and Chief Operating Officer of Financial Security Assurance Holdings Ltd. and Financial Security Assurance Inc. FSA provides financial guaranty insurance for U.S. municipal and global public finance obligations, including municipal bonds, loans and infrastructure financings. FSA's basic financial guaranty insurance policy ensures that if the issuer of an insured bond fails to make any scheduled principal or interest payment, FSA will make the scheduled payment on time and in full. This unconditional, irrevocable guaranty covers all types of risk, including fraud. The FSA' guaranty bridges differences between the needs of investors and debt issuers and offers significant benefits to both sides.

We appreciate the opportunity to testify on the Chairman's legislation, which will establish a temporary liquidity facility for variable-rate demand obligations and provide reinsurance for insured losses of qualified municipal bond insurers. Such programs would provide much needed aid to the states and localities that depend on such sources of funding to provide municipal services and to increase the capacity of the bond insurance industry to facilitate issuance.

As you are well aware, the market for state and local government bonds has been adversely impacted by the current credit crisis and lack of unified regulatory oversight. Additionally, the market is currently underserved by primary bond insurers due to the downgrades or failures of five of the original seven primary bond insurers. Thus, currently there are two active providers and one new company, which has participated selectively, and three others, which are working on new entries. Further, availability of reinsurance capacity has been significantly reduced over the last two years.

State and Local Governments Facing Financial Difficulties

As many state and local governments around the country are facing their worst fiscal crisis in decades, their continued capital market access is essential to allow needed municipal services to be performed and expedite the recovery of the U.S. economy.

New bond issuances (not including refinancings) by local governmental issuers fell by 22% in 2008, decreasing to $242 billion from its 2007 volume of $309 billion. This reduction occurred in large part as a result of reduced investor demand for local government debt driven by waning confidence in bond insurance, which in turn resulted in significantly higher interest costs. Throughout 2008, new issuance slowed such that $102 billion of new bonds were issued in the second half compared with $140 billion in the first half of the year. Volume to date in 2009 has decreased approximately 16% from the comparable period last year.

Importantly, the cost of issuing anything but the highest rated state and local government debt is up. For example, the spread between the interest cost of 10-year single A-rated state or local government debt compared with the same AAA- rated state or local government debt reached a high of 160 basis points in March of this year, and even though this has recently decreased to 127 basis points, it is significantly higher than the 80 basis point historical ten-year average.

While the market for highly rated issuers of tax exempt bonds appears to be improving slightly in 2009, market conditions for other types of issuers have not improved. In fact, they may be worsening. Smaller and lower rated investment grade issuers of tax exempt bonds, which depend primarily on credit enhancement from banks and other financial institutions to allow their bonds to be sold at competitive rates, have suffered as many of these institutions have been downgraded or exited the municipal credit enhancement business.

This problem has been especially acute for issuers of variable rate demand notes, also known as VRDNs, as investors lost confidence in the viability of liquidity support banks and exercised their right to put bonds to remarketing agents, who in turn put them to liquidity banks. When a liquidity bank purchases such bonds as a result of an investor put, interest rates rise and amortization periods decline.

Additionally, in many cases, the issuer is required to pay a penalty interest rate, usually in excess of 12 percent per annum (as opposed to the original variable rate of 2 to 3 percent), and is also required to repay the debt on an accelerated basis, typically a five year period as opposed to an original amortization term of approximately 30 years. These dramatically higher interest rates and debt service charges have resulted in serious economic harm to state and local governments, especially those without a high credit rating. A well publicized example is the water and sewer revenue bond debt issued by Jefferson County, Alabama.

Although economic conditions have stressed local governmental bond credits, the problems facing the local governmental bond marketplace are much more centered on a lack of liquidity in the market. Local government assets are not troubled assets and across the credit spectrum generally remain sound investments. A comparison of the large spread differences between local government and wider-spread, corporate and asset-backed bonds confirms the higher creditworthiness of municipal bonds. Therefore, the illiquidity in today's local governmental bond market is largely the result of problems elsewhere in the debt capital markets and this circumstance will not correct itself without federal assistance to address these problems.

Federal Government's Proposed Response

While various programs have been created by both the Treasury Department under the Emergency Economic Stabilization Act (EESA) and by the Federal Reserve to stabilize our financial markets and enhance liquidity in the debt capital markets, any truly effective federal effort to deal with current economic challenges must also deal with the demands being placed on local governmental bond issuers and borrowers in the current credit crisis. Any such federal response must be targeted to the specific components of the financial markets in need of assistance.

In order to expand liquidity to local governmental issuers, we support the exercise of existing power of the Federal Reserve and Treasury under TARP, the Term Asset Backed Securities Loan Facility (TALF) and other provisions of federal law, with emphasis on (i) new issues of local government bonds (i.e., not refinancing/refunding issues) and (ii) restructuring of existing auction rate and variable rate local government bonds. A federal plan of action to address the current credit and liquidity crisis for local governmental issuers should include the creation of a federal reinsurance program for existing bond insurers that expands private sector capacity for local government bonds while encouraging private sector investment in this industry.

The key elements of an effective federal response to the current crisis in the local governmental bond market should reflect the following considerations and objectives.

First, any solution to the current crisis must focus on promptly restoring liquidity. The credit quality of our state and local governments is generally not the source of the current freeze in the local governmental bond market. Rather, the root of the problem is investors' reluctance to purchase 30 year tax-exempt paper because they are conserving cash. Liquidity is needed to improve investor demand for longer-dated local government bonds.

Second, the focus of relief must be on state and local governments and other local governmental borrowers. The government should create stability for investors and help local governmental issuers and borrowers respond to the current crisis by reducing the cost burden of failed auctions and variable rate bonds, which have been put by investors, and by providing a liquid market for new bond issues.

Third, where the private sector is ready, willing and able to perform its historic roles in providing liquidity and credit support to the state and local governmental sector, the federal government should not duplicate the private sector with federal governmental programs. Instead, in these times of crisis, there should be a partnership between the government and private liquidity and credit providers to ensure that states, localities and non-profit organizations have affordable access to the capital markets to meet public needs and create jobs.

We believe that the foregoing policy guidelines help identify the correctly targeted federal approach to the current problems in the local governmental bond market. The following steps will help restore stability to the local governmental bond markets, while avoiding a long-term federal intrusion into the market or any potential long-term negative impact on taxpayers.

Supporting the Establishment of a Temporary Liquidity Facility

We support the Municipal Market Liquidity Enhancement Act to provide a temporary liquidity facility for variable-rate demand obligations. Permitting the Federal Reserve to create a new liquidity facility will ease the burden on state and local securities. As indicated in the legislation, we believe it is appropriate for the Federal Reserve to cooperate with the Treasury in establishing a special purpose vehicle to provide liquidity relief to the municipal bond market. Treasury has the financial tools granted to it under EESA and TARP to help the local government bond markets. Treasury's prudent exercise of its authority under TARP can provide much needed liquidity to the market for local governmental bonds.

Most variable rate bonds are issued under documents that allow the substitution of liquidity support banks when downgrades or other problems arise. Normal liquidity commitments extend no longer than five to seven years. For this reason, we believe it is appropriate for the federal government to provide liquidity to previously issued variable rate bonds for a limited period of time while the issuer addresses its liquidity problems by either finding a longer term liquidity source from the private market or refinancing the variable rate bonds with fixed rate bonds, thus giving the federal government an exit strategy.

This new liquidity facility will increase the attractiveness of municipal bond investment by our nation's larger financial institutions. It is essential that commercial banks that receive TARP money not abandon the market for state and local government bonds. These banks and other financial institutions should be expected to continue to provide liquidity for the state and local governmental bond market through letters of credit and other support vehicles.

Chairman Bernanke has indicated that he does not believe that the scope of existing authority of the Federal Reserve to address liquidity and other problems through direct lending extends to local governmental entities. This legislation's addition of explicit authority under Section 13 of the Federal Reserve Act will clarify any prior ambiguity with respect to the Federal Reserve's ability to lend directly to local governmental borrowers.

Create Greater Bond Insurance Capacity for Municipal Issuers through Federal Government Reinsurance

Just as liquidity is a key source of relief, federal support of bond insurance companies against excess loss is necessary for state and local governmental borrowers seeking to raise necessary capital to continue its operations. The creation of an Office of Public Finance in the Treasury Department to oversee a reinsurance program is an efficient way to assist municipal bond insurers in obtaining the necessary capacity to satisfy market demand and encourage private sector investment in the bond insurance industry, all while maximizing the government investment without the direct use of taxpayer dollars.

The creation of a federally backed reinsurance vehicle would help restore investor confidence in local government bonds and greatly promote a return of liquidity to the market. In this regard, it is especially important to maintain private competition in the local government bond insurance industry by allowing participation in such a program based on criteria that do not discriminate against successful insurers and allow participation by all bond insurers that are subject to state regulation. The mandatory divestment of the reinsurance program after five years also prevents private industry from relying on permanent government assistance and will promote responsible behavior among municipal bond insurers.

Additionally, Treasury's federal reinsurance vehicle would facilitate the diffusion of the credit risk currently on the balance sheets of bond insurers. We support the creation of such a vehicle and believe that risk-based premiums under such a program should be based in part on sound underwriting standards, ensuring that insurers of varying credit qualities can participate in this program in a manner that protects the interests of the American taxpayer.

If properly structured, a federal reinsurance program for private bond insurance companies that provided protection against losses beyond a certain level would increase confidence in the marketplace, boost the amount of activity, encourage new private sector entrants and ultimately increase capital available for state and local governments. Such a program should be attractive to Congress and Treasury because it does not require a current outlay of federal funds and would limit federal reinsurance risk exposure in accordance with criteria adopted for the reinsurance program. We believe that Treasury should look to the FDIC deposit insurance program for guidance in creating such a program, whereby the long-term costs are "mutualized" and charged back to participants.

In conclusion, the state and local governmental bond market is a vital source of capital and funding for state and local governments, which are facing their worst fiscal crisis in years. Implementing federal programs to establish a temporary liquidity facility for variable-rate demand obligations and provide reinsurance for insured losses of qualified municipal bond insurers will assist state and local governments in the financing of necessary roads, schools, hospitals and other critical infrastructure projects. Congratulations on introducing such important legislation that will much provide needed relief to state and local governments around the country. Thank you for the opportunity to appear before you this afternoon. I would be pleased to respond to any of your questions.

Testimony of Mary Jo Ochson

CIO Federated Investors Municipal Bond and Tax Exempt Money Market Group

Before the

Committee on Financial Services
United States House of Representatives

On

"Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance"

May 21, 2009

Testimony of Mary Jo Ochson
CIO Federated Investors Municipal Bond and Tax Exempt Money Market Group

Hearing of the U.S. House Financial Services Committee
"Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance"

Good morning, and thank you Chairman Frank and members of the Committee for the opportunity to appear here today. You and the Committee are to be commended for your work in this particular area as well as the tremendous efforts you have led over the last months to address the major financial issues confronting us. Federated is vitally interested, as investment adviser for our funds' shareholders, in the health of the municipal markets. We support your initiative to examine, understand and resolve the disruptions to municipal markets, as well as other credit markets, that have occurred in the course of the financial crisis.

My name is Mary Jo Ochson. I am Chief Investment Officer for the Municipal Bond and Tax-Exempt Money Market Investment Group at Federated Investors, Inc. ("Federated"). I joined Federated as a municipal analyst in 1982, and have now been an analyst and portfolio manager investing in municipal securities for over 27 years.

I am a former Chairperson of the National Federation of Municipal Analysts, a member of the Society of Municipal Analysts and a Chartered Financial Analyst. I am also a former member of the Municipal Securities Rulemaking Board.

Federated has been a pioneer and innovator in investing in municipal bonds through its mutual funds, creating funds specifically designed to provide investors the opportunity to invest in municipal markets. Federated created one of the very first mutual funds to invest in municipal bonds in 1976. It was then that federal tax legislation was enacted permitting the flow-through of tax-exempt interest through a mutual fund.

After the regulatory approval of structured municipal securities, such as variable rate demand obligations ("VRDOs"), which enabled money market funds to comply with the requirements (now Rule 2a-7 under the Investment Company Act) for maintaining a stable share price, Federated created the first tax-exempt money market fund in 1979.

Today Federated manages $3.4 billion in 13 municipal bond funds and $36.5 billion in 23 tax-exempt money market funds. Federated trades more than $150 billion in municipal securities annually.

On a broader scale, mutual funds, including both money market and municipal bond funds, are among the largest investors in municipal securities. At the end of 2008, the total municipal market was about $2.7 trillion. Of this amount, approximately $750 billion was short term (one year or less in maturity).

At year-end 2008, mutual funds and other registered investment companies owned approximately $882 billion in municipal securities, over half of which ($491 billion) is in money market funds. Thus, mutual funds own about one-third of all municipal securities and tax-exempt money market funds own approximately two-thirds of the outstanding short-term municipal securities.

Municipal Money Market Background

The tax-exempt money market provides essential short-term financing to a wide variety of municipal borrowers and an attractive, secure place for investors seeking liquid, high quality, tax exempt investments. The tax-exempt money market fund has been a driving force in the development of the municipal money markets over the past thirty years with favorable impact on the amount and cost of short term-financing available to states, municipal governments, hospitals, school districts and other municipal borrowers. Access to municipal money markets has allowed municipal issuers to pay far lower borrowing costs than would have been available in long-term bond financings. Since the inception of the tax-exempt money market fund in 1979, assets in these funds have grown from nothing to almost $500 billion today, supplying about 65% of the short-term financing needs of municipal borrowers.[1]

The securities in the municipal money market are structured to meet the financing needs of the municipal issuers and the investment requirements of Rule 2a-7. Rule 2a-7 requires money market funds to invest in short-term securities with minimal credit risk in order to value their portfolio securities at amortized cost and thereby maintain a stable share price. The VRDO structure meets these objectives.[2] In fact, the VRDO is one of the most prominent security structures in the municipal money market, enabling municipal money market funds to maintain average maturities of less than the regulatory requirement of 90 days while still investing significant portions of the fund in notes that mature in six months to one year that are often issued to address short-term municipal cash flow needs.

The VRDO structure normally includes credit and/or liquidity enhancement in the form a bank letter of credit, a bank standby purchase agreement or a bond insurance policy coupled with a bank standby purchase agreement.

During the credit crisis, some VRDOs lost their status as eligible investments for money market funds because of the deterioration in credit quality of the liquidity provider, bond insurer, or letter of credit bank. The issuer of the VRDO is hurt in this event because the money market fund is required to tender or "put" the VRDO back to the liquidity provider who then cannot remarket it to another fund. In this instance, the interest rate on the VRDO changes from a short-term rate to a higher rate reflecting the liquidity provider's cost of capital in holding the VRDO. (VRDOs, when not held by money market funds, are referred to as "bank bonds".)

Further, new issuance of VRDOs has decreased substantially since the end of 2008 because fewer banks or other financial institutions are able or willing to provide liquidity facilities.[3] The loss of existing VRDOs and the drop in issuance of new VRDOs hurts municipal issuers by limiting their access to, and increasing their cost, of capital.

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[1] Report of the Money Market Fund Working Group, Investment Company Institute, March 17, 2009, p. 19.

[2] VRDOs are nominally long-maturity municipal bonds that have certain features that enable them to be treated as short-term securities by a money market fund. To reduce interest rate risk, the VRDO has a variable or "floating" interest rate resetting on a daily, weekly, monthly or quarterly basis coupled with the ability to "put" or tender the VRDO to a bank or other financial institution for purchase on seven days notice. For example, a VRDO with a floating interest rate resetting on a weekly basis and a seven-day put is treated as having a seven-day maturity for purposes of Rule 2a-7. If the money market fund tenders the VRDO pursuant to the put feature, the VRDO remains outstanding but is simply "remarketed" to another fund buyer.

[3] Issuance of VRDOs fell 20% in the fourth quarter of 2008 and an additional 62% in the first quarter of 2009. In 2009 issuance of VRDOs in the municipal sector is expected to be constrained well below 2008 levels. This is not a problem unique to the municipal market.

The market for cash management notes has stabilized to a greater degree (and in many cases is functioning well) than the market for VRDOs. For example, in 2009 alone, we have purchased over 100 notes including both cash flow borrowings and bond anticipation notes for various issuers, such as school districts. However, a limited number of issuers may face market access concerns.

Municipal Market Liquidity Enhancement Act of 2009

It appears that The Market Liquidity Enhancement Act could create a helpful vehicle to preserve the liquidity and lower the cost of capital of two types of issuers: (1) current and any future VRDO issuers struggling with the "bank bonds" problem, and (2) issuers that may be unable to have market access to sell cash management notes. The Act could provide a purchaser of last resort for securities of such issuers. We agree with the approach of letting issuers of cash management notes first come to market, and then if they are not able to sell their notes, invoking the support facility.

More broadly, I applaud the myriad efforts of the Federal Reserve, the Treasury and the other Federal banking regulators to support the credit quality and functioning of the banking system. Steps to support the banks will directly support the functioning of the municipal money markets given the essential role banks play in the VRDO structure. That said, many municipal issuers report a decline in the availability and an increase in the cost of such bank facilities. I would encourage the Committee and the Federal banking regulators to consider steps that would motivate banks to provide such facilities to sound borrowers at reasonable cost, perhaps by reconsidering the regulatory capital treatment of such bank facilities or other measures.

The Municipal Bond Fairness Act of 2009

The Municipal Bond Fairness Act instructs the SEC to require that all Nationally Recognized Statistical Rating Organization ("NRSROs") use a uniform and consistent standard for assigning ratings on any security or money market instrument based on the likelihood that the investor "may not receive payment in accordance with the terms of issuance of such securities and instrument."

I assume the effect of this requirement is to require that municipal bonds be rated on the same ratings scale as corporate bonds and other fixed income obligations. A shift from a municipal-specific ratings scale to one "global scale" (as Moody's Investors Service has labeled the unified scale concept) is intended to facilitate accurate investor comparisons across various bond markets about the risk of nonpayment (default) and recovery in the event of nonpayment. We suggest that this second consideration, namely recovery in the event of default, be specifically added to Section 1A of the bill.

I do not oppose the shift toward one global ratings scale; however, I have the following suggestions. Credit ratings are meant to indicate the risk of default and recovery in event of default. Default and recovery are concepts that apply to all bond obligations, regardless of whether the issuer or borrower is a government, a corporation or a hospital, and regardless of whether the bond is taxable or tax-exempt. Many of the factors that have been offered to explain the persistence of a separate and more stringent municipal ratings scale—namely the lesser liquidity of municipal bonds, differences in the investor base between municipals and other bonds and the short-comings in municipal disclosure—are not appropriate considerations in a credit rating.

Factors such as weaker disclosure or lesser liquidity are critically important to an investor when making investment decisions. For example, investors need timely and efficient access to accurate and comprehensive information about municipal securities to perform credit analysis, make informed investment decisions, monitor their securities portfolios, and otherwise protect themselves. Those factors, however, should be addressed by more stringent disclosure rules on municipal borrowers or by better information regarding the trading and markets in municipal bonds. I respectfully would direct the Committee to the comments of the Investment Company Institute on enhancing municipal securities disclosure.

As for the rating scales, in my opinion, the differences that exist now between the municipal and corporate rating scale likely reflect the historical evolution of the two separate rating scales at the NRSROs, the historic separation between the staffs at NRSROs and the historic differences between investors in municipal versus taxable bonds. Because such differences are fading, as illustrated by the recent warm market reception of Build America Bonds by non-traditional municipal investors, they do not justify maintaining separate ratings scales. The NRSROs themselves have acknowledged the benefits of greater consistency and comparability across bonds sectors and some have already begun to revise municipal ratings with that goal in mind. Over many years, the municipal market has become more and more integrated into other fixed income markets.

I urge the Committee and the NRSROs, however, not to rest on an oversimplified approach to making municipal ratings more consistent with corporate ratings. Relying solely on comparative default statistics of municipal and corporate securities over the last 20 to 40 years is not sufficient. Although defaults are admittedly rare, the default rate is not zero. In addition, in periods of great economic stress, including the Great Depression and, to a lesser degree, the early 1970s, municipal defaults or the risk of municipal defaults, rose sharply. The information inherent in such historical stress events should be considered when making municipal ratings more consistent with taxable bond rating standards.

In addition, even outside of periods of sharp economic stress, qualitative or forward-looking factors that have material effects on municipal credit quality--such as the wide variation in budget processes, the impact of political considerations on budget outcomes, and the growing strains on municipal governments from underfunded pension and healthcare obligations — cannot be ignored. Such factors must be included when assigning the credit rating to an individual borrower. In general, these factors are not adequately captured in relatively short historic data sets on municipal defaults.

The bill specifically allows for the introduction of historical, qualitative or forward-looking factors in Section 2A when it states that NRSROs are not prohibited from using "additional credit factors…that have a demonstrated impact on the risk an investor…will not receive repayment in accordance with the terms of issuance" or in section 3 where it states the SEC cannot prevent the NRSROs from establishing "ratings that are complementary" that are created to measure a "discrete aspect of the security's or instrument's risk." I urge the Committee and ultimately the NRSROs not to simply realign municipal credit ratings based solely on default and recovery statistics since 1970, but to use the latitude the existing bill provides to consider the historical stress events and the importance of qualitative and forward-looking factors in determining credit ratings and, perhaps, complementary ratings.

The Municipal Bond Insurance Enhancement Act of 2009

We support the objective of the Municipal Bond Insurance Enhancement Act to increase the capacity of insurers to offer bond insurance to the municipal bond market.

Enabling lower rated issuers to raise their credit quality should generally improve the functioning of the municipal market. The availability of insurance will reduce borrowing costs for these issuers.

Further, the bill could enable some issuers to create VRDOs that are eligible to be purchased by money market funds. Presumably the federal government reinsurance provided by the bill will be structured to enable a money market fund to treat the bond insurance as federal insurance. Federally reinsured bond insurance will attract liquidity providers by eliminating the liquidity provider's fear of losing the ability to remarket the VRDO due to loss of Rule 2a-7 eligibility.

While we endorse the notion of insurance support for municipal bonds, we also emphasize the private market is already responding to the need and strong demand from municipal issuers for insurance. We are concerned that the bill may not be necessary or may interfere with the various private market efforts already occurring to respond to this need.

The Municipal Advisers Regulation Act of 2009

As an investor in municipal securities, I am deeply interested in municipal borrowers receiving sound financial advice that does not unduly increase their financial risk profiles. To the extent that regulatory requirements described in the Act may help foster high standards for Municipal Financial Advisors and reduce situations where unsound advice may have harmed a municipal entities creditworthiness, I support the spirit of the proposed legislation.

Thank you again, Mr. Chairman. We stand ready to help you as you strive to restore and maintain the vibrancy of this very important market.

Testimony of
J. Ben Watkins, Director of Bond Finance, State of Florida

Thursday, May 21, 2009

U.S. House of Representatives
Committee on Financial Services
Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance

Mr. Chairman, Ranking Member Bachus, and members of the Committee, on behalf of the Government Finance Officers Association* (GFOA), thank you for the opportunity to join you today to discuss legislative proposals to improve the efficiency and oversight of the municipal bond market.

I am Ben Watkins, Director of the Division of Bond Finance for the State of Florida, a position I have held since 1995. As Director, I am responsible for administering the bonding programs for the state's departments of education, transportation, environmental protection and management services, Board of Regents, Florida Turnpike System, the Florida Hurricane Catastrophe Fund and the State Comptroller's Equipment Financing Program. The state currently has approximately $25 billion in outstanding debt and typically issues around $2.5 billion a year with 15 to 20 transactions. As a frequent issuer, I have direct experience with the crisis in the municipal bond market and have managed the state's debt portfolio and market activities to prevent the disruption of our capital programs and other vital public services.

Florida's story is much like many other states and localities across the country. The crisis in the municipal bond market results from the systemic problems in the broader capital markets. The demise of the major bond insurers and the lack of adequate liquidity providers, have compounded the problems of the frozen credit markets and have hit state and local governments especially hard. That is why having this hearing today is so important to all of our constituents. Discussing these issues will provide a better awareness of the problems in the municipal market so that adequate solutions can be formulated and state and local governments can return to the credit markets with confidence.

While the funds provided to state and local governments in the American Recovery and Reinvestment Act (ARRA) are helping state and local governments mitigate the effects of this recession, they are not a panacea. As we all know, state budgets continue to experience a considerable strain because of declining revenues and increasing demand for countercyclical public services. The problem is, of course, compounded by the profound disruption in the municipal marketplace, affecting even the most creditworthy governments. Unfortunately, neither the Federal Reserve nor the Department of the Treasury has provided any meaningful solutions to problems confronting state and local governments in our market. State and local governments need access to a properly functioning credit market to finance critical infrastructure such as roads, schools, water and sewer projects, affordable housing and healthcare, and in some cases to fund operations.

The passage of the Housing and Economic Recovery Act (HERA) last year and the recent passage of the ARRA provide state and local governments with new bond instruments and tax credit tools to help them deliver necessary public services and capital investments. Without stable sources for affordable capital, however, state agencies and departments and localities – in particular those that do not access credit markets on a regular basis – may not be able to use these new policy tools to their fullest intent.

It is important to note that the credit crisis has not just constricted access to capital but also has increased interest-rate costs for those issuers that can access the markets. The legislative proposals being discussed today could go far to tackle these fundamental problems.

The effects of the broader financial crisis on municipal markets have been most acute in the short-term markets for variable-rate demand obligations (VRDOs), auction-rate securities (ARS) and commercial paper (CP). Issuers continue to face interest rate resets on these instruments, sometimes into double-digits, which is atypical for these products. Probably the most severe market disruption occurred with ARSs, as these credits have been decimated by the credit crisis and some issuers, especially large governments, still have auction rate securities outstanding and are paying very high interest rates. This is due to the fact that there are very limited liquidity facilities available which are necessary to support these debt instruments or to restructure the ARSs into VRDOs or fixed rate obligations. Additionally, there is very limited bond insurance available to convert ARSs or VRDOs into long-term fixed rate debt.

As a result of these problems, state and local governments are faced with increased interest costs and accelerated amortization of debt. This has exacerbated already strained budget problems for most state and local governments, affecting state services to taxpayers and preventing many infrastructure projects from moving forward.

It has been a volatile time for the long-term fixed rate market as well, and one I have never seen in my 20+ years of public finance experience or was expected by anyone I have come across in the field. Large and frequent issuers, which are the states with simple credit structures such as general obligation bonds, have had access to credit but have also struggled with these market conditions. However, the majority of the country's debt issuers, which are smaller, less frequent issuers or issuers with lower credit ratings have been shut-out of the market altogether. This is in large part due to the lack of bond insurance or other credit enhancement. Although it is worth noting Mr. Chairman, that your leadership and that of Congressman Kanjorski to ensure passage of the Housing and Economic Recovery Act, made possible federal home loan bank support for bank letters of credit which has become an important tool for issuers since its enactment.

Given all of these adverse conditions – declining state and local revenues, increased demands on scarce public dollars for basic needs, higher debt maintenance costs, and decreased access to short- and long-term debt markets - many jurisdictions have had to delay or halt infrastructure projects that are vital to economic development and, generally, would contribute to a broader economic turnaround. This is why your attention to these issues is so important and why I am pleased that this committee is not ignoring such an important segment of the nation's credit markets. Once state and local governments are able to affordably and efficiently return to the market, governments will be able to provide the essential infrastructure and services that our communities deserve.

I have only highlighted the problems that governments are facing today, and there are many here who will give a more thorough explanation of the market dynamics and problems that have occurred since late 2007. There is a wealth of data, graphs, percentages, and so forth, to clearly portray what has been and is occurring. But, just as important, is the stark evidence of how this data translates to real problems in our communities. For example, in Florida:

- The $200 million Everglades variable rate bonds, which normally had rates from 2 to 3 percent, reset at 8 percent.
- Bond insurance has not been available for the State's Environmental Bond Program for land conservation and Lottery Bond Program for school construction.
- Recently, letter of credit provider rates from the Sunshine State Bond Pool have more than tripled.
- Miami-Dade County was unable to find a liquidity provider for its $475 million capital program.
- The Jacksonville Utility CP program has not been able to reset their rates and has had to halt construction on many of its projects.

- A $50 million road construction project expected to spur growth and development in Collier County, Fla., has been shelved as a result of the illiquidity in the commercial paper market. The road would link Ava Maria University, located in the eastern part of Collier County, to Interstate 75 and the urban area of the county. It was scheduled to be funded with tax-exempt commercial paper and was expected to spur the growth and development of both the university and the surrounding suburban area in both Collier and Lee Counties. Without financing from tax-exempt commercial paper, this project may be moved out several years, and the lost benefits will never be recaptured.

As these anecdotes show, and as Mayor Leppert has also described, state and local governments are facing some of the most extraordinary challenges ever, and the need for solutions is profound. The legislative proposals for enhanced bond insurance and liquidity enhancement being discussed today could go a long way to help state and local governments.

Uniform Credit Ratings - *The Municipal Bond Fairness Act*

Credit ratings that are uniform for both the taxable and tax-exempt markets are more important now than ever before. Especially with the tremendous growth in taxable municipal bonds, due in large part to the new Build America Bonds program, it is essential for investors to have an apples-to-apples comparison on credit quality for municipal and corporate securities. The GFOA continues to support this legislation as it has in the past and believes it will help many governments, especially smaller, lower-rated governments sell debt at more affordable rates and save taxpayers money. The organization agrees Mr. Chairman, with your assessment that the credit rating system can be improved and should be based on default rates and the ability to repay debts. The Municipal Bond Fairness Act, by not authorizing NRSRO status to rating agencies until they incorporate uniform ratings for corporate and municipal securities, is an important step forward. GFOA applauds your leadership on this issue.

Federal Reinsurance Program – *The Municipal Bond Insurance Enhancement Act*

There would be value in some form of assistance to obtaining affordable bond insurance for the municipal bond market. Prior to the financial crisis, over 50 percent of all municipal bonds were sold with bond insurance. However, as all four major bond insurers are no longer viable, the new issue market has suffered. In fact, I have seen that currently only one bond insurer is writing insurance for new issues; they are very selective on credits they will insure, and such insurance comes at a very high price. While the need for bond insurance, in general, is one that the market and the issuer community need to address, there is likely to always be a need for bond insurance, especially for smaller and lower-rated issuers who are effectively shut out of credit markets today. Supporting some form of municipal bond insurance, as is outlined in the Municipal Bond Insurance Enhancement Act, would help address the problems governments currently face with market access and will lower the cost of borrowing for governments.

It should be noted that the Act calls for $50 billion in coverage, and it is important to clarify that that amount is not a true exposure to the federal government, unlike other programs it has recently enacted to assist failing financial institutions. Due to the minimal risk associated with municipal securities, it is highly unlikely that the federal government would lose money by establishing such a facility.

Furthermore, Congress and the Treasury may also wish to review additional ideas to assist with the bond insurance market, including the National League of Cities' proposal for an Issuers Mutual Bond Assurance Company.

Federal Liquidity Enhancement Program – *The Municipal Bond Liquidity Enhancement Act*

As noted above, the variable rate debt market has been riddled with problems for over a year, and no complete solution has been able to help all of the governments that remain in this market. Liquidity providers (letter of credit and standby purchase agreement providers) have left the market or are charging significantly higher rates than issuers can tolerate. The Municipal Bond Liquidity Enhancement Act, which would allow the Federal Reserve to fund new liquidity facilities, would greatly help governments with outstanding variable rate obligations that need to be restructured, and also would aid in the restructuring auction rate securities. GFOA and many municipal market participants believe that the Federal Reserve and the Treasury currently have the power to assist this market and state and local governments; however, the Act's specific call to create programs for these instruments is tremendously beneficial.

We also suggest that the Committee consider making the facility available prospectively and have it available for the commercial paper market.

Regulating Financial Advisors – The *Municipal Financial Advisors Regulation Act*

While the GFOA does not currently have a policy position on the regulation of financial advisors, we understand the reasons behind the proposal that would place these professionals under a similar regulatory regime as is currently the case for the broker/dealer community. The intent to prohibit fraud and deceptive practices and establishing a fiduciary responsibility to the issuer clients are supported by the GFOA and articulated in our various Best Practices.

I think it is important to emphasize one more point. You hear terms like bailout fatigue, and worse. It is important, I think, to note that these legislative proposals being discussed today are not about municipal bond issuers seeking a bailout. Indeed, our problems are part of the systemic problems that originated outside of our markets -- collateral damage, if you will. State and local issuers operate in the sunshine. We are accountable to our constituents. They rightly demand – and receive – transparency, caution, and thoughtfulness when sanctioning their government officials to issue debt in their name. The problems in the municipal marketplace are real, and these difficulties affect not just state and local governments but also its citizens. Your willingness to address these problems is greatly appreciated.

Mr. Chairman, thank you again for the opportunity to speak with you and your continued support for state and local governments. I hope that this testimony and that of others, provides adequate information and insights to the problems in this market and that Congress, the Treasury, and the Federal Reserve will work with state and local governments and other market participants to improve the outlook for the municipal market.

* The Government Finance Officers Association, founded in 1906, represents over 17,500 state and local government finance officers from the United States and Canada. Our members include chief financial officers, budget directors, treasurers and other officials from city, county, and state governments. Our purpose is to enhance and promote the professional management of governments for the public benefit by identifying and developing financial policies and practices and promoting them through education, training and leadership.

For release on delivery
9:30 a.m. EDT
May 21, 2009

Statement by

David W. Wilcox

Deputy Director, Division of Research and Statistics

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

May 21, 2009

Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to comment on issues related to the markets for municipal debt. In my testimony today, I will provide some background on the structure of the municipal debt market, focusing particularly on the role of municipal bond insurance and the use of variable rate demand obligations by some municipalities. I will then discuss current stresses in the municipal bond market and conclude with some comments on policy considerations.

Background

The market for municipal debt is very large and diverse. At the end of 2008, investors held about $2.7 trillion of municipal securities issued by more than 50,000 entities. The vast majority of municipal debt is issued by state and local governments. A relatively small amount of municipal debt is issued by government authorities on behalf of qualified nongovernmental entities such as hospitals, private colleges, and some private companies. Households own a large amount of municipal bonds either directly or through mutual funds and other investment vehicles. Commercial banks and insurance companies are also significant investors in these securities.

Approximately one-half of municipal debt outstanding has credit enhancement in the form of insurance from financial guarantors; these firms are often called bond insurers or monolines. In exchange for a fee, financial guarantors agree to make timely payment of principal and interest on insured bonds if the municipality cannot. Before the financial crisis, most financial guarantors were rated AAA by the major credit rating agencies, and this rating was essentially transferred to insured securities. In effect, issuers of municipal securities rented the presumed balance sheet strength of the financial guarantors, thereby typically reducing their net borrowing costs. Banks also provide credit enhancement to municipalities as part of letters of credit.

Most municipal bonds have long maturities, reflecting the long lives of the municipal projects the debt is typically used to finance. However, municipalities do issue some short-term debt, primarily as a cash-management tool to bridge gaps between expenses and revenues. In addition to these "true" short-term securities, municipalities also have issued securities that combine long maturities with floating short-term interest rates that are reset on a weekly, monthly, or other periodic bases. Some of these floating-rate securities explicitly have what is known as liquidity support or a liquidity backstop, which is typically provided by a commercial or investment bank. Liquidity support ensures that bondholders are able to redeem their investment at par plus accrued interest even if the securities cannot be successfully remarketed to other investors. Securities that have this type of explicit contractual liquidity support often are referred to as variable rate demand obligations (VRDOs). Auction rate securities (ARS)--another form of floating-rate debt--do not have an explicit contractual liquidity backstop. VRDOs have much greater market share, with roughly $400 billion to $500 billion currently outstanding, as compared with less than $80 billion for municipal ARS.

Recent Developments and Current Market Conditions

The financial crisis has strained the market for municipal debt, as it has so many other markets. One source of this strain has been that losses on a range of nonmunicipal credit exposures have greatly diminished the capacity of financial guarantors to write new policies and have reduced the perceived value of previously written policies. The share of newly issued municipal bonds that are insured has fallen from about 50 percent in the fall of 2007 to about 10 percent in the first quarter of this year, and the market for reinsurance for such bonds is largely closed. Another source of strain has been that liquidity support for VRDOs has become more expensive while support for ARS has essentially disappeared. Yet a third source of strain has been that the recession has significantly reduced the revenues collected by many municipalities, in some cases by enough to raise concerns about their ability to service their debt.

Despite these stresses, the market for traditional fixed-rate municipal debt appears to be functioning fairly well for many issuers. Gross issuance of long-term municipal bonds has been fairly solid in recent months. For example, total gross issuance of long-term municipal bonds averaged about $30 billion per month during the first four months of 2009, in line with issuance during the first four months of both 2006 and 2007, before the crisis hit the municipal market. Moreover, although the spread between the yield on traditional fixed-rate municipal debt and comparable-maturity Treasury securities remains quite high by historical standards, it has narrowed notably in recent months. That said, lower-rated municipalities are facing higher-than-usual costs of issuing debt relative to the rates paid by higher-rated issuers. For example, the credit spread between municipal bonds rated AA and A is very high by historical standards.

Although the market for fixed-rate municipal debt is currently functioning fairly well, the markets for floating-rate municipal debt are in more serious condition. Auctions of ARS began to fail en masse in mid-February of last year. Many municipalities have reportedly succeeded in refinancing ARS into VRDOs or traditional fixed-rate debt, bringing down substantially the volume outstanding in the ARS market.

Strains in the market for VRDOs began to emerge in late 2007, largely in response to increasing concerns about the financial strength of guarantors that insured many of these bonds, and came to a head in September 2008. One commonly used measure of the interest rates paid on high-quality VRDOs skyrocketed from less than 2 percent on September 10 to almost 8 percent in just two weeks.[1] Since then, however, this measure has reversed its September spike and, indeed, has fallen with other short-term rates to below 1 percent. Nonetheless, market participants report that the cost of liquidity support from banks has risen sharply. As in the market for long-term fixed-rate debt, higher-rated municipalities are reportedly able to issue new VRDOs, but many lower-rated issuers appear to be either unwilling or unable to issue debt in this market at the prices that would be demanded of them.

Demand for some VRDOs has reportedly been so weak that the securities have been put to their liquidity providers, turning them into what are called "bank bonds." Under the terms of issuance, bank bonds typically carry penalty interest rates and can eventually be subject to accelerated amortization. The combination of these two factors can cause a sudden and substantial increase in the debt service payments required of the municipality that issued the bond. One market observer estimated that the value of VRDOs that are bank bonds may be about $50 billion, but precise estimates are not available.

The municipalities that issued the securities that have become bank bonds potentially face significant financial difficulties. As noted, if they do not refinance the bank bonds, they must pay higher interest rates and confront the possibility of having to

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[1] The measure referred to in the text is the seven-day swap index published by the Securities Industry and Financial Markets Association.

amortize the debt over a much shorter period. But refinancing is not an easy option either, partly because VRDOs are often paired with interest rate swaps that would be quite costly to unwind in current market conditions and partly because banks have significantly increased the fees they assess for new liquidity support, especially for lower-rated issuers.

Policy Considerations

Thus, the strains in some segments of the market for municipal debt remain significant. These strains reflect the weakened fiscal position of the issuing jurisdictions, the pressures on the providers of liquidity support, and the weakened condition of the financial guarantors.

Some policy actions that have already been taken are helping--and should continue to help--address these strains. For example, over the first 15 months of the financial crisis, the Federal Open Market Committee brought the federal funds rate down to its current target range of 0 to ¼ percent, an adjustment that was historically aggressive both in speed and scale. In addition, the Congress has enacted two large stimulus packages. The monetary easing and the fiscal stimulus will continue to provide important support to the overall level of economic activity in coming months--a critical determinant of the fiscal condition of state and local governments. The second stimulus bill also included authorization for Build America Bonds, which give issuers of taxable municipal bonds a 35 percent federal rebate on interest costs.

The Federal Reserve also has created a wide range of facilities aimed at improving the functioning of financial markets. And indeed, these facilities have achieved some success. For example, the spread of the London interbank offered rate, or

Libor, over the overnight index swap rate, a spread commonly interpreted as a measure of strains in the interbank market, has diminished markedly from its peak last fall. Similarly, the spreads on asset-backed commercial paper and on lower-rated nonfinancial commercial paper have narrowed over the same period. Moreover, the benefits of the Federal Reserve's facilities have been felt not only in the markets that were directly targeted, but also in financial markets more generally.

The recently concluded Supervisory Capital Assessment Program (SCAP) should also provide some indirect help to municipalities, because the institutions subject to the SCAP are among those that provide liquidity backstops for VRDOs. The SCAP provided a thorough, consistent, and forward-looking examination of the 19 U.S. bank holding companies with more than $100 billion of assets. By assuring that these 19 institutions will have a capital buffer in place sufficient to allow them to withstand even a worse-than-expected macroeconomic environment over the next two years, the SCAP and the Treasury's related Capital Assistance Program should help bolster banks' willingness to provide liquidity backstops and investors' confidence in those backstops.

If the Congress chooses to address more directly the strains in the municipal bond market, the most productive actions would likely be ones that address the stress points noted above--the weakened fiscal condition of the issuing municipalities, the diminished financial strength and capacity of the financial guarantors, and the reduced availability and higher costs of liquidity backstops and credit enhancement from banks and other financial institutions. Many of these potential policy responses likely would require fiscal action--such as grants to municipalities or the creation of new federal insurance or reinsurance programs to address the current problems in the markets for municipal bond insurance--and thus are properly in the realm of the fiscal authorities.

A threshold question for us, of course, is whether the Federal Reserve should play a more direct role in supporting the market for municipal debt. As Chairman Bernanke has noted before, the Federal Reserve has important misgivings about assuming such a role in light of the potential for decisions about the provision of credit to states and municipalities to assume a political dimension.[2] Indeed, this consideration is one reason that the Federal Reserve Act imposes limits on the ability of the Federal Reserve to purchase municipal debt, including a six-month maturity limit. The Federal Reserve believes that such a role is better suited to elected officials and the Administration than to the central bank.

In addition, it is important to note three key characteristics of the Federal Reserve's responses to the financial crisis thus far. First, the statutory authority under which the Federal Reserve has taken many of its policy actions sets a high bar for the exercise of extraordinary powers. In particular, before lending can be extended under section 13(3) of the Federal Reserve Act, the Board of Governors must find that "unusual and exigent circumstances" prevail. This provision assures that the Federal Reserve will not be involved in financial markets in these extraordinary ways unless market functioning is significantly impaired. Second, the Federal Reserve has been mindful of the need to protect both it and federal taxpayers from credit losses. In the case of the Term Asset-Backed Securities Loan Facility, or TALF, for example, private investors are in the position of taking the first loss on any given security, by dint of the haircut that we

[2] For example, see Ben S. Bernanke (2008), letter to Paul E. Kanjorski, October 28, http://kanjorski.house.gov/images/stories/08_10_28%20credit%20crisis%20muni%20fed%20reply.pdf.

apply to the value of the security when determining the amount that we will lend. In addition, the Treasury has provided the Federal Reserve with a layer of credit protection. We judge that these two features taken together provide us with a robust protection against credit risk. Third, Federal Reserve programs have been designed carefully to allow a clear exit strategy, thereby helping ensure our ability to raise the federal funds rate from its current level once the Federal Open Market Committee determines that such a move is necessary to promote the mandate given to us by the Congress to foster maximum sustainable employment and price stability. Credit protection, balance sheet control, and a clear exit strategy exist in the Federal Reserve's current facilities and are, indeed, consistent with the joint statement on the role of the Federal Reserve issued on March 23 by the Treasury and the Federal Reserve.[3] We believe these features are critical to achieving the dual monetary policy mandate and preserving the central bank's independence.

One issue that the Congress may wish to bear in mind as it considers whether future action is warranted is the degree to which government involvement in this market is appropriate in the long term. One effect of the current financial crisis has been to expose some important vulnerabilities of the VRDO market. For example, because contracts for liquidity support are typically of short duration, municipalities face significant " rollover" risks for their VRDOs that raise serious questions about whether these securities should remain a significant vehicle for municipal finance in the long term. If the Congress determines that other financial structures will likely be more robust

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[3] Board of Governors of the Federal Reserve System and U.S. Department of the Treasury (2009), "The Role of the Federal Reserve in Preserving Financial and Monetary Stability: Joint Statement by the Department of the Treasury and the Federal Reserve," joint press release, March 23, www.federalreserve.gov/newsevents/press/monetary/20090323b.htm.

under adverse market conditions, then the Congress may choose to tailor any government intervention in the municipal bond market relatively narrowly, aiming, for example, to encourage market participants to seek private-sector solutions, if possible, and to facilitate the government's exit from the market.

Conclusion

Thank you for the opportunity to testify on conditions in the municipal bond market and potential policy responses. We look forward to working with the Congress to assist in your deliberations on these matters. In addition, the Federal Reserve will continue to work aggressively to restore normal functioning to the financial markets and the flow of credit in the economy. I would be pleased to answer any questions you may have.

CITY OF OAKLAND

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May 27, 2009

The Honorable Barney Frank
Chairman, Financial Services Committee
2252 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank:

Thank you for the opportunity to submit this letter for the record in response to the hearing you chaired on Municipal Bond Financing before the House Financial Services Committee last week. As you know, the hearing's subject matter is very important to the City of Oakland, as well as to all state and local governments across the country. Recent trends in the municipal bond market, coupled with the current dire state of the economy, present direct and significant implications for the City of Oakland.

This has been a difficult time for the City of Oakland as we are facing a large budget deficit. Demand for City services remains high, but our resources are extremely scarce, given our limited local revenues. Our priority concern at this time is our ability to preserve our "A1/AA-/A+" (Moody's/S&P/Fitch) credit ratings to continue our ability to access the capital markets at reasonable interest rates. For this and many other reasons, the City of Oakland supports four bills currently under the consideration of your Committee:

- The Municipal Bond Insurance Enhancement Act of 2009, H.R. 2589
- The Municipal Market Liquidity Enhancement Act of 2009, H.R. 2551
- The Municipal Bond Fairness Act, H.R. 2549
- The Municipal Financial Advisors Regulation Act, H.R. 2589

Turning more specifically to the Municipal Bond Insurance Enhancement Act and the Municipal Market Liquidity Enhancement Act, we believe these programs will provide the much-needed stability in the municipal bond insurance industry.

In the spring of 2008, the City of Oakland struggled to find options to address the collapse of the auction rate securities ("ARS") market on municipal security issuers due to the fallout associated with subprime mortgages. These bond-auction failures forced us to pay interest rates as high as 12% on variable-rate securities, and had an undesirable effect on the City of Oakland's ARS. As a result, the City had to take a proactive approach and restructured its two auction-rate financings to a fixed-rate mode, resulting in a cost. Furthermore, the ARS were insured by XL Capital Assurance

Inc., which was downgraded multiple times by the rating agencies and was forced to exit the municipal bond insurance business. Had the Municipal Bond Liquidity Enhancement Act been in place, the City of Oakland would have been provided necessary relief by maintaining a liquidity provider in lieu of the existing bond insurer. A reinsurance program, such as the one proposed would allow cities such as the City of Oakland the opportunity to secure affordable insurance once again.

In closing Mr. Chairman, I know that you are attempting to address a myriad of issues in the municipal bond market, and I applaud your efforts to hold this hearing, highlighting the challenges confronting municipalities in reference to municipal bonds. The programs that you are trying to establish at the Federal Reserve and Treasury will contribute greatly to helping cities gain better access to the market, provide essential infrastructure for local residents, and maximize cost efficiencies for our taxpayers. I support your efforts because by stabilizing the municipal bond market, the City of Oakland and other communities around the nation will once again have access to credit at reasonable rates to build and repair essential infrastructure, including schools, healthcare facilities, highways, bridges and roads. These projects would in turn create jobs, and thus revitalize the local economy.

I look forward to continuing this important discussion with you and other members of the Committee and Congress. As always, I remain always ready to assist you.

Sincerely,

Ronald V. Dellums
Mayor

Nuveen Investments
333 West Wacker Drive
Chicago, IL 60606

Congressman Barney Frank, Chairman
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank:

We are pleased to see proposed legislation, the Municipal Market Liquidity Enhancement Act of 2009, which includes a liquidity facility to address the challenges faced by the auction-rate securities market, still frozen since its sudden and widespread failure in February 2008. We hope the final version will be expanded not only to facilitate the issuance of variable rate demand notes (VRDNs) issued by municipalities to refinance frozen municipal auction rate securities (ARS), but also to facilitate the issuance of variable rate preferred shares by closed end funds (CEFs), to refinance frozen municipal auction rate securities. We believe that supporting such municipal CEF share refinancing adds liquidity to the municipal bond market, and consequently serves the same public interest.

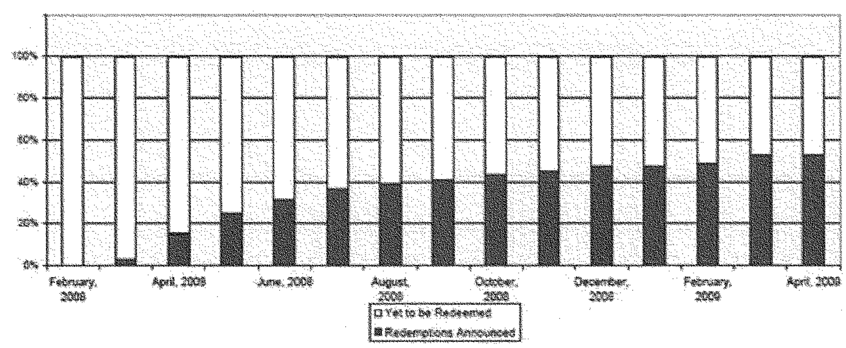
When auctions for auction rate preferred securities (ARPS) issued by closed-end funds began failing last year in tandem with the broader auction-rate securities markets, many tens of thousands of investors holding approximately $64 billion of these securities were unable to access their personal savings. Additionally, several million CEF common shareholders were adversely affected by elevated penalty rates for financing leverage. The CEF industry reacted quickly with a variety of actual and proposed solutions for refinancing the ARPS. Through August 2008, approximately $25 billion had been refinanced, including $596 million by four Nuveen municipal bond funds that issued a new form of preferred shares, Variable Rate Demand Preferred or VRDP, featuring a liquidity facility provided by a major financial institution and qualifying for purchase by money market funds pursuant to Rule 2a-7. Other CEF sponsors announced progress towards similar new preferred securities, and the industry was optimistic that additional and substantial refinancing would quickly ensue, for the benefit of both preferred and common shareholders of the funds.

However, as the credit crisis became more acute in September 2008, around the same time that Nuveen Investments testified about the ARPS crisis at the House Financial Services Committee hearing on the Auction Rate market, the financial capacity and interest of banks to act as a liquidity provider for additional VRDP shares evaporated. Similarly, conventional debt refinancing for taxable ARPS became unavailable or economically unfeasible, and virtually all ARPS refinancing ceased for an extended period. Maximum penalty rates for municipal ARPS climbed past 10% for some weeks, leaving common shareholders in those funds substantially "upside down". The ensuing uncertainty surrounding the markets in general and closed-end funds in particular led to CEF common shares trading to unprecedented discounts exceeding 25%, averaged across all funds.

Aggressive Federal Reserve actions taken during the fourth quarter of 2008 have brought some stability to the credit markets; however there has been no measurable improvement in the availability of liquidity for closed-end funds to continue their refinancing operations. Common shareholders of leveraged municipal CEFs are positively benefiting from the low cost of leverage at the present time, but still face considerable uncertainty and the potential of economically penalizing rates in the future. Although many preferred shareholders (perhaps a slight majority) had their shares purchased by their broker-dealers in settlements negotiated by the state attorneys general and FINRA, those remaining who purchased shares through smaller broker-dealers or self-directed trading platforms are still unable to access their funds at the expected par value. We know through our own telephone and written interactions that many of these shareholders are suffering great hardship as they cannot pay for needed healthcare, housing, education, or contractual obligations. While the settlements relieved the concern of numerous individual investors, the banking institutions involved are burdened with an enormous capital commitment, earning returns substantially below market rates. This capital could be used more efficiently for other investments, including municipal market liquidity. Thus far, the settlement has not helped restore liquidity to the market. This has added costs (or limited market access) directly to municipalities.

ARPS refinancing has slowed substantially; only about $5 billion more has been refinanced since September, and much of this was funded from portfolio investment sales to manage leverage to comply with Investment Company Act of 1940 requirements. Closed-end funds cannot give preferred shareholders any assurance when, or if, their shares will be fully redeemed.

Cumulative ARPs Redemptions Announced by Month



Source: Herzfeld Research

All parties – Congress, the Fed, banks, CEFs, and the SEC – should work toward a solution that benefits both CEF preferred shareholders who cannot sell their shares at par to access their funds, and common shareholders who face uncertain and potentially elevated financing costs to maintain the benefits of leverage they sought when they purchased their shares. There is substantial demand outstanding for new forms of highly rated closed-end fund preferred shares backed by a liquidity guarantee, particularly by tax-free money market funds. In our September 2008 testimony before your committee, we suggested that the most important regulatory changes to help the ARPS situation would be

- clarification of the ability of banks to own VRDP pursuant to their purchase obligations as a liquidity provider for VRDP, and
- approval from the Federal Reserve to allow banks to pledge VRDP as collateral at the Fed discount window.

Constraints regarding the ability of banks to own preferred stock, and the fact that VRDP is not eligible collateral for Fed discount window purposes, have significantly limited the ability of banks to provide liquidity backstops for VRDP despite VRDP's inherently high credit quality and despite significant potential demand from money market funds and other institutional investors. We ask that you act on these suggestions with all haste.

We also ask that you strongly consider including in the next and final versions of the proposed liquidity facility legislation these new forms of closed-end fund preferred shares among the types of securities eligible to receive Fed backing. This would facilitate the issuance of variable rate preferred shares issued by CEFs to refinance their frozen ARPS. This sort of liquidity support, along with the other regulatory actions listed above, appears to be necessary in the current environment to financially induce banks or other financial institutions to provide the necessary liquidity support for new preferred shares municipal bond CEFs would need to refinance their ARPS. The public policy served by the Fed providing liquidity support directly to municipals is also served by restoring the liquidity of the market and of those entities, including municipal bond closed-end funds that have systematically and efficiently channeled hundreds of billions of dollars in capital to that municipal market. To the extent that the ARPS crisis continues and CEFs remain negatively affected, closed-end funds cannot attract capital to flow to the municipal market, a situation which consequently contributes to raised costs or limited market access for municipal issuers.

Sincerely,

Mark Anson
President & Executive Director, Investment Services
Nuveen Investments, Inc.

NUVEEN
Investments

THE WALL STREET JOURNAL.
WSJ.com

OPINION | MAY 9, 2009

Muni Bonds Need Better Oversight

We seem to have a major debacle every decade.

By ARTHUR LEVITT JR.

As our nation's leaders rush to rewrite our financial regulatory structure, they risk committing a major error if they don't carefully consider the workings of the municipal- bond market. The opacity of this market is unrivaled and thus presents a significant threat to our economy.

Defenders of the status quo argue that the risk of large-scale municipal- bond defaults remains low, and that the market has not had an "Enron moment." In fact, we have had a major municipal bond-related debacle at least every decade: the New York City fiscal crisis in 1975, the Washington Public Power System defaults in 1980, the Orange County California derivatives crisis in 1994, and the San Diego pension fund fraud in 2006. Just last year, New York Attorney General Andrew Cuomo imposed fines and penalties on bankers who told investors that risky securities were safe investments. Throughout every decade we have had pay-to-play scandals.

We need major reform, beginning with industry-wide oversight. For the past three decades, the Municipal Securities Rulemaking Board has overseen only one slice of the market: the bankers and others who sell municipal bonds. There is no central regulator over municipal issuers other than the Internal Revenue Service, which limits itself to a narrow band of concerns. No regulator holds all market participants accountable.

The Securities and Exchange Commission (SEC) is prevented from regulating the municipal market because of restrictions established by Congress, including a 34-year-old relic called the Tower Amendment. We need a cop on the municipal-market beat with the tools to do the job right.

Reform should require that municipal-bond issuers follow effective and consistent accounting standards issued by an independent board backed by SEC jurisdiction and enforcement. All relevant disclosure requirements that apply to the corporate bond market should also apply to the municipal market. A review of disclosure rules would also include a review of whether ratings agencies actually bring rigor, transparency and uniformity to the process of assigning ratings to municipal securities. Currently, the Governmental Accounting Standards Board issues accounting guidelines, but the board isn't independently funded and doesn't have the power to enforce its own standards.

There should also be a "plain English" standard on disclosures and other documents so investors and issuers understand their risks and responsibilities. Those documents should be distributed on a system at least as fast and searchable as the SEC's EDGAR database, and should be updated when any material information arises. Failure to file disclosure documents on time should carry a meaningful penalty to issuers, many of whom now routinely fail to file on time or at all.

And though it would be unpopular with elected officials, the chief executive officer and chief financial officers of public-sector entities -- including mayors, county chairs and governors -- should personally certify the accuracy of the information in offering documents and subsequent disclosures. Likewise, CFOs of issuers should certify they have done a thorough and independent analysis of their proposed transactions and not just defer to the views of underwriters, ratings agencies and other intermediaries who are usually conflicted.

Conflicts in the municipal market often arise from pay-to-play practices that are widespread. As SEC chairman in the 1990s, I routinely called for an end to pay-to-play. Half-measures were taken and underwriters are now subject to SEC rules. But the lawyers, advisers and asset managers who routinely interact with issuers continue to win municipal-bond business by employing politicians' friends, donating to bond campaigns, contributing to charities, or picking up the check for entertainment. Banning such payments is a good start. Simply requiring that all lawyers, advisers and underwriters disclose all payments received from working on bond transactions -- as well as their political and charitable contributions -- would go a long way.

We need stronger accountability standards throughout the industry. All unregulated advisers should be regulated and licensed, and all professional participants in the bond market should be held accountable to the SEC. Advisers in particular should have a conflict-free duty of trust and care to the borrower.

Issuers should require written certification from underwriters and financial advisers that the recommendations and information they present are accurate, reliable and consistent with high financial principles -- not just "market conventions," which merely institutionalize the status quo. The magnitude of risks should be calculated and fully disclosed.

Finally, Congress should repeal the Tower Amendment and earlier exemptions so that the SEC can regulate the market the way it regulates other markets. Roughly a third of those buying municipal bonds are small investors: They need the SEC's full protection.

Mr. Levitt was chairman of the Securities and Exchange Commission from 1993 to 2001 .

Please add your comments to the Opinion Journal forum.

Printed in The Wall Street Journal, page A15

HOUSE COMMITTEE ON FINANCIAL SERVICES

Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance

May 21, 2009

Testimony of R.T. McNamar

Chairman Frank, Ranking Member Bachus and members of the Committee my name is Tim McNamar. I want to thank you for the opportunity to address one important facet of improving transparency in the municipal bond market; the timeliness of the financial statements that accompany Official Statements and continuing disclosure obligations.

Let me reintroduce myself to the Committee since I haven't testified here since 1984 when I was the Deputy Secretary of the Treasury during the First Reagan Administration. I have never been in the municipal securities business, but am in the technology services business. I have had an external technology relationship with the SEC since 2003 when I introduced the Extensible Business Reporting Language (XBRL) to the SEC. I had just co-authored the book **Enron, Lessons in Public Policy**, which recommended that the SEC adopt XBRL for public company reporting to mitigate the risks of future Enron and WorldCom situations.

First, I congratulate the Committee for having this wide-ranging hearing on municipal bond finance reform. I won't touch on all of the issues because I want to focus narrowly only on one badly needed reform; the current use of out of date financials by state and local governments to borrow billions of dollars from individual investors.

In March California sold $6.54 billion of new bonds with its accompanying "latest financials" for the fiscal year ending June 30, 2007, 20 months out of date. This means that the state with the nation's lowest credit rating borrowed more than $6 billion using financials that are over a year and a half old. Estimates are that California will need to borrow $12-15 billion in the summer of 2009 with financials that are at least a year out of date. No corporation would be permitted to issue equity or public bonds with such out of date financials.

Today, let me review the background of the problem of out of date financial reports being used by state and local governments for their Official Statements and continuing disclosure obligations, then describe a technology solution that solve this problem and save state and local governments money at the same time.

BACKGROUND

The Tenth Amendment to the Constitution of the United States limits the federal government's ability to regulate state and local governments. The Tower Amendment to the Securities and Exchange Act more specifically articulates that the SEC shall have no authority over the issuers of municipal securities. As a result the municipal securities market has grown without the type of direct oversight and rule setting that the SEC has developed for the corporate securities markets.

Periodically SEC Chairpersons have announced that they would request legislation from the Congress to address this lack of direct SEC authority. Nothing substantive has come from what I would call this lawyerly approach because of the Tenth Amendment and the Tower Amendment. As a result, the municipal securities market has grown to over $2.7 trillion dollars without the benefits of transparency and timely financial reporting that is a hallmark of SEC regulation in the corporate sector. Indeed the previous system of National Securities Depository Institutions did not provide a consistent method of accessing and displaying municipal securities, which denied the market the transparency that is the underpinning of functioning capital markets. The individual investor could not easily and inexpensively do research on the municipal bond market or individual issuers. There was no central place to obtain the information on municipal securities and whether the issuers were complying with their continuing disclosure obligations.

It has been extremely difficult to obtain information on municipal securities. Yet, this is at a time when they have been a refuge for many individual investors seeking refuge from the declining equities markets.

In late 2008, the DPC Data report "Estimating Municipal Securities Continuing Disclosure Compliance," highlights the continuing disclosure problem in the $2.6 trillion (outstanding) municipal securities market. The DPC study said: "...this study has brought to light a serious and systemic credit transparency problem in the municipal marketplace. Our findings indicate that non-disclosure is an established practice and a growing trend among obligors. It affects an increasing amount of debt, and presents risks to investors as well as the intermediaries that serve them."

The report found that 50 percent of the bonds outstanding nine years or more have one or more disclosure delinquencies and that 25 percent are chronically delinquent. In 2006, bonds in disclosure delinquency represented more than $348 billion in original par amount. This suggests that approximately 14 percent of outstanding bonds by par amount are delinquent.

Commenting on the failure of municipal securities issuers to honor their continuing disclosure requirements, the DPC report said: "At a minimum, it is a breach of the fundamental principals of investor protection, suggesting hidden problems or potential fraud." This raises the question for the 25 percent of bond issuers who are chronically delinquent. When is a pattern of failing to honor the continuing disclosure covenants or terms of the bond's Official Statement on continuing disclosure itself fraud?

The previously existing Nationally Recognized Municipal Securities Information Repository (NSMSIR) filing system did not permit the investor, analyst, credit rating agency, or government policy makers to even assess whether failure to file is fraud; much less identify non-compliant exceptions by municipal securities issuers. This has been the accepted practice in the municipal securities market.

These problems were all discussed in the SEC Staff Report, "Disclosure and Accounting Practices in the Municipal Securities Market" submitted to the Committee in July 2007. MSRB Chairman Ronald A. Stack reiterated the problems in his March 26, 2009 testimony to Senate Committee on Banking, Housing and Urban Affairs.

The problem is so well known that all former SEC Chairmen have called for more oversight and disclosure. Chairman Cox was outspoken about the need for more transparency. Former Chairman Levitt has been a continuous voice calling for more transparency and disclosure. Most recently, his Wall Street Journal op-ed piece of May 9, 2009 titled "Muni Bonds Need Better Oversight" is attached as Exhibit A. Current Chairwoman Schapiro agreed with Levitt that municipal securities financial disclosures should be as timely as corporate financial disclosures. Unfortunately, they are not close.

MSRB AND EMMA

The Municipal Securities Rulemaking Board is well aware of this problem and has been working diligently to address it. MSRB Chairman Stack was articulate in his presentation of the problems in his testimony to the Senate Committee on Banking, Housing, and Urban Affairs Committee on March 26, 2009. The MSRB has taken very positive steps to address the problem.

To their credit, the Municipal Securities Rulemaking Board has instituted a new state-of-the-art electronic information service, Electronic Municipal Market Access (EMMA) that began operations on May 11. It is a transforming event and the MSRB deserves public commendation for developing EMMA. For example, with EMMA the market can know electronically whether an issuer has even filed its continuing disclosure obligations. There will now be one location where information will be available on all municipal securities, and it will be electronically available over the Internet.

EMMA will permit electronic tracking and publication of issuers' continuing disclosure compliance to investors. Unfortunately, the "garbage-in-garbage-out" principal will continue to apply if the MSRB and SEC don't require the underwriters and issuers of municipal securities to improve the timeliness of their financials.

For municipal bonds, the financials are the Comprehensive Annual Financial Report, or CAFR, issued in audited form each year and required to be included with the Official Statement for a new bond offering. The "latest" financials are to be included with new municipal bond offerings Official Statement and their subsequent continuing disclosure filings.

On Sept. 10, 2008, the National Association of State Auditors, Comptrollers, and Treasurers published its survey for the fiscal years 2003 through 2007. The results of the survey are simply appalling.

The median average time from closing the books on the fiscal year until the results were published was 181 days or six months. For FY 2007, New Mexico took 398 days. This means that if the state issues municipal bonds with their "latest financials" 365 days after their CAFR is published, it would be over two years old at the time bonds are issued.

Of even more concern, the largest state, California, has over $47 billion of general obligation bonds outstanding, and took 272 days, or nine months, to publish its June 30, 2007, fiscal year financial statements on March 28, 2008.

California in March sold $6.54 billion of new bonds with its accompanying "latest financials" for the fiscal year ending June 30, 2007, 20 months out of date. This means that the state with the nation's lowest credit rating is borrowing more than $6 billion using financials that are over a year and a half old.

This is simply unacceptable in 21st Century America. As a citizen, I am outraged that these discrepancies exist.

In preparation for this hearing, we surveyed the National Association of State Auditors, Comptrollers, and Treasurers web site on May 18th. It showed that five states; Arkansas, Hawaii, Illinois, Ohio and South Dakota, had not filed their CAFR for the closing of their previous year, June 30, 2008. This means that if they borrow today, their financials will be 23 months out of date going back to the previous years June 30, 2007 CAFRs. See this complete list for all states filing status as of May 18, 2009 attached as Exhibit B. The municipal borrowers are reported to be even more out of date with one major Texas City reported to be three years out of date, but still borrowing in the municipal market.

Are state and local government officials' derelict in their official duties in preparing their CAFRs in a timely fashion and submitting them with Official Statements and continuing disclosure obligations? They are absolutely not. They are faced with a much more difficult accounting consolidation task than any corporate official.

Second, a CAFR report will have in it the financials for the year, but these are not just revenues from various tax sources, but also programs and grants that must be accounted for as well. A municipal government may have monies from the federal government, its state government, its county government, plus its multiple sources of tax revenues, and possible public-private partnerships or concessions.

Third, a CAFR represents the consolidation of all of a government entities component parts. Since Jefferson County has been widely publicized, at it is in Alabama, consider being the Chief Financial Officer for Alabama and doing the consolidation for the State of Alabama. (Alabama's most recent CAFR was filed March 31, 2009, 180 days after the close of their fiscal year.) In Alabama there is the state government itself with its individual agencies and bureaus, the schools and universities, the separate state pension funds for civil servants, police, fire, etc. There are grant funds and program management reports for each of these activities. Each of these will have separate accounting systems and computer systems purchased individually over time. They may even have different fiscal years within the state.

The state officials have been compiling this information by hand and having it audited by hand for years. There hasn't been a better, faster, cheaper way to prepare the CAFR. It has been built by hand each year often by highly educated and skilled public servants. This is why the state and local government CAFRs are late in being prepared. This is why they use outdated CAFRs for continuing disclosure requirements. It is time consuming and expensive to prepare quarterly or monthly reports.

One of the ten largest metropolitan areas's estimated that they spend over $1,000,000 annually just to prepare their CAFR. You can assume that the State of Alabama will spend at least that amount each year on accountants, consultants, etc. and so will almost all other states. It is simply an arduous sophisticated consolidation task to prepare a CAFR each year. The states haven't been able to push a button and prepare the report on demand. Each was built by hand. It is a little bit like lighting all the gas lamps by hand before the incandescent light bulb was introduced.

A TECHNOLOGY SOLUTION

Not providing timely financials is not only a dereliction of public duty but represents a systemic fraud on the municipal securities market. This is intolerable; it obscures transparency, inhibits effective price discovery, and materially increases borrowing costs for better-rated issuers.

The SEC must find a way to reform the muni bond market. Fortunately, today technology can provide the way.

The Commission has direct authority to regulate the underwriters of state and local government municipal bonds, but not the issuers of the debt, which is traded in the over-the-counter market. As a result, the market developed haphazardly and lacks rules and transparency.

Traditionally, the view was that the SEC couldn't do anything because it lacked jurisdiction over state and local governments. Those governments in turn have only been able to prepare their CAFRs by hand, merging hundreds of incompatible spread sheets from the executive branch, state higher education, pension fund, and bond authorities' financial systems.

The manual consolidation process plus delay in audits causes the six- or nine-month delay in publishing the fiscal year's results. Fortunately, today commercial software is available that can reduce the CAFR preparation time, shorten the audit process, and reduce preparation cost by 60% to 80% each and every year.

To reform the municipal securities markets, the MSRB can pass a rule stating that EMMA will only accept submissions of official statements and continuing-disclosure requirements filings that have timely financials, e.g., less than 30, 60, or 90 days old. The timeliness of official statements can be published on EMMA.

To improve continuing disclosure filings, EMMA can adopt the same requirement. Those that fail to meet their continuing disclosure filing obligations and provide untimely accompanying financial statements can be publicized and subject to market discipline. Failure or repeated failure to file timely financials could result in an issuer's securities being red-flagged, which could make it more expensive for the issuers to both raise new money and refinance outstanding debt.

Market pricing pressures will result in more complete and timely filings. With EMMA, this comparative performance information will be available for analysis and comparison on the Internet for the first time.

Broker-dealers will pressure the issuers to prepare and file timely financial statements. Market disclosures with red flags for noncompliance will cause the broker-dealers and issuers to act in their own self-interest.

To do this, the issuers will adopt the technology to prepare their CAFRs on a timely basis. The choice is theirs - the SEC isn't making them do anything, capital market pressures are promoting changed behavior. Technology enables that change. It is not an exaggeration to say that introducing technology to the municipal securities market is like introducing the incandescent light bulb to replace all of the hand lighted gas lamps at the beginning of the 20th Century. A previously unavailable technology is introduced to revolutionize how a manual task is done. It will reduce the annual cost of report preparation from and estimated $1,000,000 in my example to approximately $300,000 or so, an annual savings of $700,000. Over the ten year period often used in public accounting that is a savings of $7,000,000 plus publishing the CAFR in a timely fashion.

Using the commercially available software to prepare CAFRs means that a state or local government could then prepare a quarterly or monthly CAFR for little more than the cost of the electricity to run the software again. Hence there would be no reason not to submit timely financials with each continuing disclosure filing. It would no longer be burdensome and costly. The transparency and pricing ability of the market would be immeasurably enhanced.

SEC ACTION

The SEC website states "The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." The municipal securities market has not been fair, orderly or efficient. The MSRB's introduction of EMMA coupled with timely financial reports for Official Statements and continuing disclosure filings will help the SEC fulfill its mission in the municipal securities markets.

The SEC needs no additional legislative authority from the Congress to approve a MSRB proposed program to assist the states prepare timely financials with their Official Statements and continuing disclosure filings.

Congress may exercise its legitimate role in encouraging the SEC to use the authority it has to fix this problem and carry out its mandate to promote efficient capital markets. The Committee may request a report as to what the SEC is doing to improve the timeliness of municipal securities financial reporting.

The Feb. 23 edition of the New York Times reported that Chairwoman Mary Schapiro is looking to the law enforcement and intelligence communities to help identify potential investigations and strengthen enforcement actions. She has retained Mitre Corp. to design a computerized enforcement tip management system. This is smart management.

Bernie Madoff's Ponzi scheme would have been uncovered by the Securities and Exchange Commission years earlier if the many clues in its multiple databases could have been pulled together using sophisticated query technology. The right software can find the clues and informant leads in different databases in close to real time. If the SEC enforcement lawyers had the right information technology tools, they would have nailed Madoff years earlier. Hopefully, Schapiro will take a similar technology approach to the horrific situation in the $2.7 trillion municipal securities market.

Moving expeditiously, the MSRB could require timely financials from the states and the largest municipalities for all new offerings and continuing disclosure reports submitted to EMMA after Jan. 1, 2010. Smaller issuers could follow a year later. This would be a tremendously positive SEC reform at a time when state and local tax revenues are collapsing while governments' borrowing requirements are ballooning.

Chairwoman Schapiro told Congress, "It is time for those who buy the municipal securities that are critical to state and local funding initiatives to have access to the same quality and quantity of information as those who buy corporate securities."

Using available and proven technology, she can achieve these objectives by reforming the municipal securities market and introducing corporate-quality timely financial disclosures this year. I urge the Committee to work with Chairwoman Schapiro to accomplish this goal.

I would be happy to answer any questions verbally or subsequently in writing. Again, I commend the Committee for addressing the issue of timely financial reporting which is an underpinning of transparency and efficient capital markets. The MSRB has taken the first crucial step in establishing EMMA. Improving the quality of the information on EMMA is the next step. The MSRB deserves credit for what it started with EMMA.

It should now use the opportunity to ensure that municipal securities issuers' listings on EMMA have timely information concerning Official Statements and continuing disclosure filings. The disclosure of the issuer's performance will provide the information the municipal securities market needs to be certain it achieves the SEC mission of maintaining fair, orderly, and efficient markets, to both facilitate capital formation and protect investors.
The American people deserve it.

ATTACHMENT A

Wall Street Journal May 9, 2009

Muni Bonds Need Better Oversight
We seem to have a major debacle every decade.

By ARTHUR LEVITT JR.

As our nation's leaders rush to rewrite our financial regulatory structure, they risk committing a major error if they don't carefully consider the workings of the municipal- bond market. The opacity of this market is unrivaled and thus presents a significant threat to our economy.

Defenders of the status quo argue that the risk of large-scale municipal-bond defaults remains low, and that the market has not had an "Enron moment." In fact, we have had a major municipal bond-related debacle at least every decade: the New York City fiscal crisis in 1975, the Washington Public Power System defaults in 1980, the Orange County California derivatives crisis in 1994, and the San Diego pension fund fraud in 2006. Just last year, New York Attorney General Andrew Cuomo imposed fines and penalties on bankers who told investors that risky securities were safe investments. Throughout every decade we have had pay-to-play scandals. We need major reform, beginning with industry-wide oversight. For the past three decades, the Municipal Securities Rulemaking Board has overseen only one slice of the market: the bankers and others who sell municipal bonds. There is no central regulator over municipal issuers other than the Internal Revenue Service, which limits itself to a narrow band of concerns. No regulator holds all market participants accountable.

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There should also be a "plain English" standard on disclosures and other documents so investors and issuers understand their risks and responsibilities. Those documents should be distributed on a system at least as fast and searchable as the SEC's EDGAR database, and should be updated when any material information arises. Failure to file disclosure documents on time should carry a meaningful penalty to issuers, many of whom now routinely fail to file on time or at all.

And though it would be unpopular with elected officials, the chief executive officer and chief financial officers of public-sector entities -- including mayors, county chairs and governors -- should personally certify the accuracy of the information in offering documents and subsequent disclosures. Likewise, CFOs of issuers should certify they have done a thorough and independent analysis of their proposed transactions and not just defer to the views of underwriters, ratings agencies and other intermediaries who are usually conflicted.

Conflicts in the municipal market often arise from pay-to-play practices that are widespread. As SEC chairman in the 1990s, I routinely called for an end to pay-to-play. Half-measures were taken and underwriters are now subject to SEC rules. But the lawyers, advisers and asset managers who routinely interact with issuers continue to win municipal-bond business by employing politicians' friends, donating to bond campaigns, contributing to charities, or picking up the check for entertainment. Banning such payments is a good start. Simply requiring that all lawyers, advisers and underwriters disclose all payments received from working on bond transactions -- as well as their political and charitable contributions -- would go a long way.
We need stronger accountability standards throughout the industry. All unregulated advisers should be regulated and licensed, and all professional participants in the bond market should be held accountable to the SEC. Advisers in particular should have a conflict-free duty of trust and care to the borrower.

Issuers should require written certification from underwriters and financial advisers that the recommendations and information they present are accurate, reliable and consistent with high financial principles -- not just "market conventions," which merely institutionalize the status quo. The magnitude of risks should be calculated and fully disclosed.

Finally, Congress should repeal the Tower Amendment and earlier exemptions so that the SEC can regulate the market the way it regulates other markets. Roughly a third of those buying municipal bonds are small investors: They need the SEC's full protection.

Attachment B

Summary of State CAFR Filings May 18, 2009

STATE	FYE	Transmittal Letter Issued	Comments
Alabama	9/30/08	3/31/09	6 mo. Later
Alaska	6/30/08	12/15/08	5 1/2 mo.
Arizona	6/30/08	12/1/08	5 mo
Arkansas	6/30/07	12/21/07	2008 NOT FILED
California	6/30/08	3/24/09	9 mo
Colorado	6/30/08	12/19/08	6 mo
Connecticut	6/30/08	2/28/09	8 mo
Delaware	6/30/08	1/19/09	7 mo
D.C.	9/30/08	1/30/09	4 mo
Florida	6/30/08	2/26/09	8 mo
Georgia	6/30/08		Not Available
Hawaii	6/30/07	5/7/08	2008 NOT FILED
Idaho	6/30/08	12/31/08	6 mo
Illinois	6/30/07	6/25/08	2008 NOT FILED
Indiana	6/30/08	12/30/08	6 mo
Iowa	6/30/08	12/10/08	5 1/2 mo
Kansas	6/30/08	12/31/08	6 mo
Kentucky	6/30/08	12/19/08	6 mo
Louisiana	6/30/08	12/31/08	6 mo

Maine	6/30/08		2/19/09	8 mo
Maryland	6/30/08		12/12/08	5 1/2 mo
Massachusetts	6/30/08		12/23/08	6 mo
Michigan	9/30/08		12/31/08	3 mo
Minnesota	6/30/08		12/9/08	5 mo
Mississippi	6/30/08	12/19/08		6 mo
Missouri	6/30/08	1/9/09		6 mo
Montana	6/30/08	12/12/08		5 1/2 mo
Nebraska	6/30/08	12/24/08		6 mo
Nevada	6/30/08	12/15/08		5 1/2 mo
New Hampshire	6/30/08	12/19/08		6 mo
New Jersey	6/30/08	Not Available, probably not issued		
New Mexico	6/30/09	1/31/09		7 mo
New York	3/31/08	9/--/08		6 mo
North Carolina	6/30/08	12/8/08		5 mo
North Dakota	6/30/08	12/18/08		6 mo
Ohio	6/30/07	4/28/08		2008 NOT FILED
Oklahoma	6/30/08	12/30/08		6 mo
Oregon	6/30/08	1/23/09		7 mo
Pennsylvania	6/30/08	12/23/08		6 mo
Rhode Island	6/30/08	4/9/09		9 1/2 mo
South Carolina	6/30/08	11/12/08		4 1/2 mo
South Dakota	6/30/07	Issued; not dated		2008 NOT FILED

Tennessee	6/30/08	2/12/08	5 1/2 mo
Texas	8/31/08	2/27/08	6 mo
Utah	6/30/08	12/4/08	5 mo
Vermont	6/30/08	12/23/08	6 mo
Virginia	6/30/08	12/12/08	5 1/2 mo
Washington	6/30/08	12/17/08	5 1/2 mo
West Virginia	6/30/08	3/30/09	9 mo later
Wisconsin	6/30/08	12/11/08	5 1/2 mo
Wyoming	6/30/08	12/31/08	6 mo

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