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**TESTIMONY OF
ATTORNEY GENERAL RICHARD BLUMENTHAL
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
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I appreciate the opportunity to speak on the topic of "Municipal Bond Turmoil: Impact on Cities, Towns and States."

The current dual system of rating bonds issued by state and local governments is dangerously misleading and misguided. It imposes a secret Wall Street tax on states, cities and school districts across this nation.

Rating agencies admit that municipal bonds frequently receive substantially lower credit ratings than corporate bonds with the same or worse rates of default. This dual rating system costs municipalities in Connecticut and around the country millions of dollars in unnecessary interest and fees every year.

This costly scheme is quite possibly illegal under our state and federal antitrust laws.

My investigation -- which is still ongoing and active -- focuses on how this unfair system was started and perpetuated, who profits from it, and what anticompetitive effects it has on the prices that states and municipalities pay to borrow for essential projects like schools and roads.

My findings so far are deeply troubling. We know there was a concerted effort among supposed competitors to maintain the dual rating system and kill attempts at reform. There were discussions among insurers aimed at retaining the dual rating system when at least one rating agency suggested modifying or eliminating it. The effect of these activities was clearly to maintain prices and prop up the market for bond insurance. Such misuse of market power and restraint of competition is plainly anticompetitive and anti-taxpayer, causing direct harm to municipal and state customers issuing bonds.

No legitimate business reason appears to exist for maintaining separate rating standards. The two standards clearly have nothing to do with whether or not bondholders will be ultimately be paid back since the rating agencies own studies show that municipal bonds hardly ever default. Rather, the practice appears to benefit the rating agencies who issue and charge for multiple ratings on a single bond, the bond insurers who collect higher premiums for frequently unnecessary insurance and finally the underwriters who profit from and trade on the differing interest rate or "yield spread" between insured and uninsured bonds.

Wall Street profits, while Main Street pays

In addition to my investigation and possible state enforcement action, I urge Congress to provide quick relief to cities and towns across the country by prohibiting different rating standards for bonds and requiring fair and equitable treatment of all bond issuers. More specifically, federal law should prohibit credit rating agencies from assigning different credit ratings to bonds with similar rates of default and risk.

The reason that municipalities almost never default is fundamental to what they are: most are creatures legally of the state, defined in existence and authority by state law, with some state guarantee of intervention against fiscal insolvency. Local governments do not go out of business. They are different and distinct from private corporations.

The harm to Connecticut residents is very real and substantial. I have surveyed the issuance of bonds over the past ten years for all 169 towns in the state of Connecticut. The preliminary estimates clearly demonstrate that many towns are paying sizeable sums -- all together millions of taxpayers dollars -- for unnecessary insurance.

For example, the town of West Haven paid \$104,000 to upgrade their bond rating from A3 by Moody's to an Aaa rating. West Haven's rating on the corporate scale would have been equivalent to an Aa1 -- the second highest rating possible.

The town of Bethany -- with a population of 5,400 -- issued approximately \$5 million in general obligation bonds in 2003. Bethany was assigned an underlying rating of only A1 by Moody's and had to pay an insurance premium of \$17,861 -- or \$3 for each man, woman and child in the town -- to obtain bond insurance from Ambac and, hence, an Aaa rating from Moody's. Based on a 2006 Moody's report on municipal bond ratings, if the town of Bethany had been rated on a corporate equivalent scale, it would have enjoyed an Aaa rating with no need to purchase bond insurance.

Similarly, the town of Litchfield -- with a population of 8,600 -- paid \$30,000 or more than \$3 per resident -- in bond insurance premiums to MBIA to upgrade the rating on its 2006 general obligation bonds from Aa3 to Aaa.

In challenging economic times, as many cities and towns face budget shortfalls and program cuts, these additional costs are particularly burdensome and unfair. If these three towns had been rated fairly, such expenses would have been unnecessary.

States and municipalities issue general obligation bonds to fund critical public projects like schools, roads, and bridges. The interest rate paid on these bonds depends largely on ratings assigned to the bonds by the three major credit rating agencies: Moody's, Standard & Poor's, and Fitch. A bond rated Aaa likely will bear a lower interest rate than a bond rated A1. Accordingly, a town issuing an A1 rated bond will typically pay substantially more interest over the life of the bond and its citizens will pay more in taxes to support those interest payments.

The major credit rating agencies own studies show -- beyond any doubt -- that default rates for municipal bonds are substantially lower than identically rated corporate bonds. Moody's study shows that higher rated Aaa corporate bonds are four times more likely to default than lower rated Baa municipal bonds -- a rating seven notches lower than Aaa. Indeed, a 2006 Moody's report revealed that the top five municipal bond grades, Aaa through A1, would all be

rated Aaa if they were corporate bonds. These default studies make clear that Moody's employs two distinct rating scales for municipal bonds and corporate bonds.

Fitch published default studies in 1999 and 2003 that showed similarly low default rates for municipal debt. While Fitch adjusted some municipal ratings, it stated that it would only "partially incorporate" this default experience into its ratings. Thus, municipal bonds are still rated by Fitch at lower levels than corporate bonds carrying similar risk of default. Standard and Poors (S&P) has published similar studies to its customers and I believe that it awards lower letter ratings to municipal bonds than to corporate bonds with similar expected default rates.

In the face of a united front by major rating agencies and bond insurers, municipalities are virtually powerless against the double bond standard. Their options are few -- all imposing significant additional burdens on taxpayers.

First, a municipality can try to achieve an Aaa rating on its own under the current dual rating system. This task is daunting -- requiring a municipality to develop and maintain a substantial reserve fund to help pay the debt. To obtain such a fund, the municipality must increase taxes on its citizens. Additionally, many small towns are unlikely to ever achieve a Aaa rating under the current municipal scale because their tax bases are frequently limited by the amount and diversity of assets in the town. In Connecticut, for example, town taxing authority is limited by state statute to levying a property tax and some fees.

Alternatively, a municipality can obtain an Aaa rating by purchasing bond insurance from a bond insurer like MBIA or Ambac, with an Aaa corporate rating, thereby assigning the Aaa ratings of these insurers to the municipal bond. The premium for such insurance is passed along to taxpayers. Absent one of these two solutions, the municipality is forced to pay higher interest rates on its artificially "lower" rated bonds. Again, this increased debt service cost ultimately is borne by taxpayers.

Some towns do not directly purchase bond insurance but they still incur unnecessary costs. Often a town's bonds are sold uninsured to underwriters at an artificially high interest rate because of the double standard ratings system. These underwriters often purchase bond insurance themselves for the municipality's bonds in order to upgrade the bonds to Aaa and improve their marketability in the bond market. The underwriters then sell these more valuable Aaa rated bonds to their own clients at a lower interest rate (because they now appear to carry less risk) and pocket the difference in price. The difference is sometimes known as the "yield spread." In this case, the cost of the unnecessary bond insurance is paid for by taxpayers through the higher interest rate paid by the town to the underwriter.

While my investigation necessarily focuses on harms and costs to Connecticut, these practices affect every state as well as cities and towns across the United States. There are some 50,000 public entities authorized to issue public debt and each of them is impacted by the dual rating system.

The Credit Rating Agency Reform Act of 2006 expressly recognizes that ratings issued by the credit rating agencies are intended to protect the "public interest," not to enrich investment bank underwriters or bond insurers. The major credit rating agencies have been entrusted by Congress with tremendous power, which they have exploited to become extremely profitable.

Operating profits of the major credit rating agencies are typically in the 40% range, among the most profitable businesses nationally.

This federal law already prohibits rating agency practices that are unfair or abusive, but the dual system should be specifically banned

Maintaining a manifestly unfair municipal rating system conflicts with Congressional intent and public interest

I urge the Committee to take action to expressly eliminate the unfair, discriminatory, and abusive system that is currently in place. Federal law should prohibit credit rating agencies from assigning different credit ratings to bonds with similar or equivalent rates of default and risk. Congress should not regulate the methods and procedures by which rating agencies estimate risk or say that any bond issuer should be assigned any particular rating or equivalent. Rating agencies should be free to make these judgments on their own. Rather, Congress should ensure that all public and private issuers are treated equally -- allowing the market to compare the relative risk of all debt offerings. Such a system would improve market transparency and integration with global markets enhancing competition by adding market participants

I will continue to aggressively pursue my antitrust investigation and look forward to working with the Committee as it exercises its important oversight responsibilities.