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U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

Municipal Bond Turmoil: Impact on Cities, Towns and States
March 12, 2008

Testimony of
Bill Lockyer
California State Treasurer

Mr. Chairman and Members:

Today, the Committee considers upheavals in capital markets that dramatically affect governments, taxpayers and investors across the nation. I commend you for helping to shed light on these crucial issues. And I greatly appreciate the opportunity to share perspectives from the State of California, the largest municipal bond issuer in the United States.

I'll start by addressing an issue that lies at the foundation of much of the turmoil that led to this hearing – the system used by major U.S. rating agencies to grade municipal bonds. Remember back when you were taking tests in school? What if you had aced every test, and still received a lower grade at the end of the semester than a classmate who failed four exams? You would, with total justification, call the teacher's grading system unfair. Unfortunately for American taxpayers, that's exactly the situation faced by governmental entities that issue bonds.

Briefly, the agencies hold municipal issuers to a higher standard than corporate issuers. The disparate treatment means states, cities, counties and other governmental entities have a harder time than corporations getting their bonds rated triple-A. Put another way, municipal bonds are more likely than corporate bonds to receive a rating lower than triple-A.

We believe this system is fundamentally flawed. Here's why: Bond ratings should be based on the risk that the issuer will default and the investor will lose money. The ratings provided by Moody's Investors Service (Moody's), Standard & Poor's (S&P) and Fitch Ratings, however, have little relationship to this risk.

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The agencies' own studies substantiate this claim. Municipal bonds rated Baa by Moody's have had a default rate of only 0.13 percent, while corporate bonds rated Aaa by Moody's have defaulted at four times that rate, or 0.52 percent. Corporate bonds rated AAA by S&P have defaulted at almost twice the rate of municipal bonds rated BBB (0.60 percent and 0.32 percent, respectively). The State of California never has defaulted on its bonds. Yet, the agencies refuse to give the State a triple-A rating.

This differential treatment undermines the functioning of an efficient and transparent capital market. Worse, it misleads investors by greatly inflating the risk of buying municipal bonds relative to corporate bonds. Worse still – from my perspective as Treasurer of the people's money – the system costs taxpayers billions of dollars in increased interest costs and bond insurance premiums.

If the State of California received the triple-A rating it deserved, we could reduce taxpayers' borrowing costs by hundreds of millions of dollars over the 30-year term of still-to-be issued bonds voters have approved to finance infrastructure development. Billions of dollars more could be saved by municipal issuers across the country.

As you know, we sent a letter on March 4 to the three agencies asking that they work with issuers and investors to devise a unified rating system based on default risk. We believe such a reform would make the market more efficient and transparent, and better serve taxpayers and investors. So, far, 10 other State Treasurers, and four other state and local municipal issuers, have signed the letter. We expect to garner more support. For your reference, a copy of the letter is attached to this testimony.

The rating issue flows naturally into the question of bond insurance. Municipal issuers buy insurance on their bonds to obtain a triple-A rating that, in many cases, they already deserved based on the diminimus risk of default. Insurers' triple-A rating is transferred to the issuer's bonds.

Our policy on insurance is similar to most municipal issuers'. If, by insuring bonds, we can save taxpayers more money on interest than it costs to buy the insurance, we will insure the bonds. From 2003-2007, the State of California spent $102 million to insure $9.1 billion in general obligation (GO) bonds.

Defenders of the current rating system argue that the market understands the distinctions between the corporate and municipal rating scales. That argument holds no water. If investors truly possessed that understanding, our taxpayers would have had no need to spend that $102 million on insurance. The fact investors placed value on insurance as an enhancement of our credit shows the market does not understand the distinctions between the two rating scales.

Now, even though bond insurers almost never paid out a claim, since municipal issuers almost never default, the industry is in crisis because of risky bonds they insured in other markets. Some monoline insurers are fighting to save their triple-A status, while the rating agencies have downgraded others. And the triple-A rating of insured bonds purchased by investors has been lost or is endangered.

The effect of insurers' rating downgrades on municipal issuers differs depending on the type of bond. Most of the State of California's outstanding debt is in fixed-rate bonds. Ratings downgrades of insurers do not affect our debt service payments on fixed-rate bonds, since those rates are locked in for the term of the bonds.

We do, however, have some outstanding insured bonds in the auction rate and variable rate demand bond markets, which in recent weeks have suffered severe disruption caused, in part, by bond insurers' financial woes. The interest rates on such bonds reset periodically and do increase if bond insurers' ratings are downgraded.

Since early February, interest rates on some insured State water and energy revenue bonds in these markets have increased by almost 10 percentage points. We've had several auction failures that have doubled or tripled our interest rates in a few weeks. We're taking steps to help taxpayers avoid more increases in borrowing costs. This week, for example, we're refinancing to fixed rate $1.025 billion in energy revenue bonds now structured as auction rate or variable-rate demand instruments.

The fallout from the variable rate market chaos also has hit our uninsured bonds. We have $500 million uninsured, outstanding GO bonds in the auction rate market. In recent weeks, interest rates on some of these bonds have risen as much as rates on our insured revenue bonds, further increasing taxpayers' burden. Since we first issued these GO bonds in 2003, our interest rate has averaged 2.22 percent. The reset rate in our last three GO auctions almost tripled that four-year average.

State government is not the only victim of the current market turbulence. Local governments, school districts, hospitals and higher education institutions also have suffered damage. All told, issuers in California have issued $39.7 billion in variable rate demand bonds since 1998 and another $27.8 billion in auction rate bonds since 2000.

My office is sponsoring emergency state legislation to help local government issuers reduce their exposure in these markets. Additionally, conduit financing operations managed by my office and joint powers authorities have launched other relief programs for public and private issuers of variable rate demand and auction rate bonds. Federal regulators can help, too. States' efforts to protect taxpayers would be strengthened if the U.S. Securities and Exchange Commission provided assurance that municipal issuers would not be subject to potential market fraud charges if they bid on their own bonds in auctions.

California and the nation need a strong municipal bond market. For decades, that market has been the backbone of the system that finances and builds the infrastructure we need to secure our future. It's the original public-private partnership, and it has served us well. I believe replacement of the dual bond rating system with a unified approach would be a significant step toward preserving the structural integrity of this market, and protecting taxpayers. I hope you'll join us in urging the rating agencies to work with issuers and investors to accomplish that goal.

Thank you again for the opportunity to testify.

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March 4, 2008

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Dear Mr. Belsky, Ms. Sussman, and Mr. Montrone:

We, the undersigned representatives of major municipal bond issuers, urge the rating agencies you head to create new rating standards for U.S. municipal debt. For years, municipalities have been held to a higher standard than corporate issuers. This differential treatment undermines the functioning of an efficient and transparent capital market, a goal shared not just by investors and issuers, but rating agencies as well. For investors, the current system greatly inflates the risk of investing in municipal bonds relative to alternative investments, leading to investment decisions that are not based on the best information. For municipalities, the dual standard has cost our taxpayers and ratepayers billions of dollars in increased interest costs and bond insurance premiums.

Recent events in the debt markets have highlighted the problem. Many collateralized debt obligations (CDOs) and structured investment vehicles (SIVs) that your agencies rated triple-A have become insolvent or are at risk of insolvency. As a result, your agencies have been forced to downgrade those securities, as well as the ratings of some of the bond insurers who guaranteed them. Meanwhile, the vast majority of municipal issuers have not shown strains that would suggest they may default on their bonds. Nonetheless, many strong municipal issuers continue to carry much lower ratings than our corporate counterparts, in some cases even lower than the bond insurers about whom the market has understandable concerns. To illustrate this point, we note recent credit default swap levels for bond insurers with triple-A ratings have been many times higher than the levels for many of the biggest and most stable – but lower-rated – municipal issuers.

The ratings services your agencies have provided historically have been critical to the smooth functioning of the municipal bond market. Given the myriad state and local issuers of tax-

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exempt debt, your agencies have served an important role in helping investors choose and price municipal bonds. That function will remain critical in the future. But we believe your rating scale bears too little relationship to most investors' paramount concern: the risk that issuers of the bonds they buy will default.

Across the country, for decades, the evidence has been clear and convincing. State and local governments almost never default on the bonds they issue. The safety of municipal bonds is grounded in a fundamental fact: a city or a state simply is not going to go out of business during the life of its bond issue. That possibility is much more likely in the case of a bank or bond insurer, or a special-purpose entity created simply to issue CDOs or SIVs.

The lack of foundation for the differential rating standards applied to corporate and municipal issuers has been demonstrated by your agencies' own default studies. Municipal bonds rated Baa by Moody's have had a default rate of only 0.13%, while corporate bonds rated Aaa by Moody's have defaulted at four times that rate, or 0.52%. Corporate bonds rated AAA by S&P have defaulted at almost twice the rate of municipal bonds rated BBB (0.60% and 0.32%, respectively).

We do not advocate that all municipal bonds should be rated triple-A. Certainly some deserve lower ratings, based on their unique circumstances. But bonds with an exceedingly low risk of default should be rated accordingly, whether issued by governmental entities or corporations. If some investors want fine rating distinctions among such bonds, perhaps gradations within the triple-A scale could serve that purpose. Some bonds could be Aaa1 or AAA+, while others could be Aaa3 or AAA-. But the triple-A rating on all those bonds would tell investors the truth: The risk of default is minimal.

We applaud some agencies' growing acknowledgement of the dual scale that exists today. Moody's, for example, will assign a "global scale rating," but only to taxable bonds. It simultaneously requires the assignment of a municipal scale rating. When the State of Oregon in 2003 sold $2.1 billion in taxable general obligation bonds to fund its pension liabilities, Moody's assigned two ratings to the same bonds: Aaa global scale and Aa3 municipal scale. Similarly, when California sold taxable general obligation bonds in 2007, Moody's assigned ratings of "Aaa" global scale and "A1" municipal scale. These distinctions reflected both states' substantial credit strength compared to most corporate issuers, and helped attract new buyers for the taxable bonds. But they also created confusion because the very same bonds carried two different ratings. Such confusion does not serve investors well. Investors increasingly function in a worldwide capital market where the trading of credit risk is not isolated to distinct taxable and tax-exempt cash markets. Municipal credits are compared to corporate credits in a great number of markets, including the interest rate swap and credit default markets. An integrated, global capital market requires an integrated, global rating scale.

This dual rating scale burdens taxpayers and ratepayers with substantial, added costs. Taxpayers pay a higher interest rate when municipal bonds have a rating lower than triple-A. Consider, for example, the State of California, which never has defaulted on its bonds and ranks as the largest municipal issuer in the nation. The difference between triple-A and single-A interest rates in today's market is about 0.38 percentage points. [1] California plans to issue $61 billion of general obligation bonds for infrastructure projects already approved by voters. Over the 30-year life of those bonds, a 0.38% difference in interest rates would save taxpayers, and the state's General Fund, more than $5 billion. While a sudden recalibration of your agencies' rating scale likely would not produce the full amount of those savings, even a portion would provide welcome relief to California taxpayers. Similar examples abound in states, cities and counties throughout the country, resulting in hundreds of billions of dollars in unnecessary costs to American taxpayers.

Taxpayers incur other costs imposed by the bond insurance industry, which exists in large part because of your municipal rating scales. Municipal issuers have paid enormous sums to buy bond insurance that – at least in the past – brought their ratings up to the level they would have been on a corporate, or global, rating scale. For example, the State of California, with a global scale rating from Moody's of Aaa, nonetheless paid $102 million from 2003-07 to buy triple-A bond insurance on its general obligation bonds. Those purchases allowed the state to sell the bonds at a lower interest rate. But it would have been unnecessary to spend $102 million of taxpayers' money for a triple-A rating if the bonds had been rated by the same criteria as non-municipal debt.

Further, what California actually bought when it paid for bond insurance was not a triple-A municipal rating, but a triple-A global scale rating. Moody's has stated, "Like other financial institutions and insurance companies, the financial guarantors are rated on the global scale." (*Mapping of Moody's Municipal Ratings to the Global Scale: Frequently Asked Questions, June 2007*) Now consider: As noted above, Moody's gave a triple-A global scale rating to taxable bonds California issued in 2007. Applying that rating to all general obligation bonds the state insured from 2003-07, including tax-exempt issues, means that when taxpayers spent $102 million to insure those bonds, they effectively spent $102 million to put an Aaa rating on top of the Aaa rating the state already possessed.

The recent problems of municipal bond insurers, ignited by their exposure to securities based on sub-prime mortgages, have imposed serious, additional costs on numerous municipal issuers. The short-term municipal bond market has been built on the triple-A status of bond insurers. In part, the insurers' ratings have been used to satisfy regulatory requirements. But over time, the homogenizing nature of a market based on triple-A ratings meant that even issuers whose debt could be issued without bond insurance frequently found it useful to purchase insurance.

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[1] Municipal Market Data yield differential between Aaa/AAA and A/A 30 year bonds as of February 25, 2008.

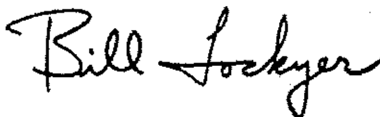
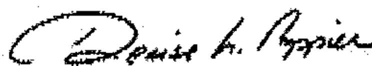
Under U.S. Securities and Exchange Commission Rule 2a-7, money market funds generally are allowed to buy securities only if they have long-term ratings of at least double-A. To provide that, many municipal issuers purchased bond insurance on their variable rate demand bonds (VRDBs). Of course, this would not have been necessary if municipal issuers were rated on a corporate scale. Corporations of much weaker credit quality comply with Rule 2a-7 without credit enhancement such as bond insurance.

The current turmoil in the tax-exempt variable rate market was sparked by the rating agencies' reassessment or downgrading of bond insurers. The agencies' actions caused many investors to worry that the insurers' ratings may drop below 2a-7's required levels. Already, insurer-backed VRDBs are costing much more than in the past. More troublesome, the liquidity facilities guaranteeing the demand feature of VRDBs can drop away if the bond insurer faces difficulties, at a time when the banks that remarket the bonds are facing their own sub-prime induced balance sheet problems. As a result, many issuers of VRDBs are finding that remarketing agents are putting their bonds to the liquidity banks, which in turn require issuers to pay them high taxable rates specified in the bond documents.

The fallout from the bond insurance upheaval also has hit the auction rate securities (ARS) market. Rating agencies' downgrades or reassessments of insurers – and the possibility of further downgrades in the future – have driven away many of the typical ARS buyers, including corporate money managers and wealthy individuals. Corporate money managers often have minimum rating requirements for the bonds they own. They relied on bond insurance for such ratings, since the underlying securities carried lower ratings assigned on a municipal rating scale. The well-publicized problems of failed auctions caused by insurer downgrades are imposing substantial costs on municipalities. Many issuers have found themselves paying interest rates as high as 15%-20% on debt that cost a fraction of that amount just a few weeks earlier.

We believe you share our desire to strengthen the municipal bond market that funds the infrastructure necessary to secure America's future. We respectfully request that you work with market participants – including issuers and investors – to develop a new, unified global rating approach that achieves that goal, and better serves investors and taxpayers.

Thank you.

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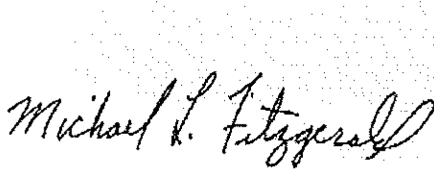

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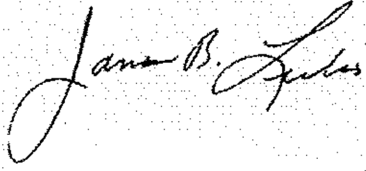

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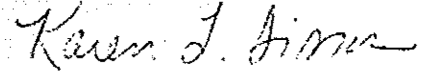

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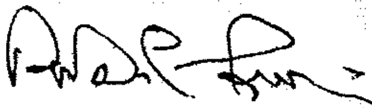

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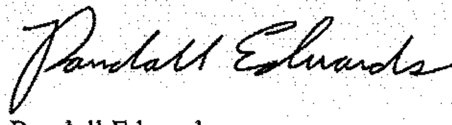

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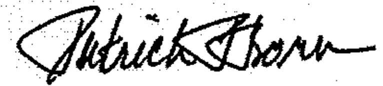

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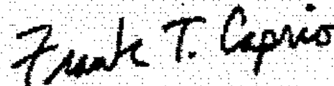

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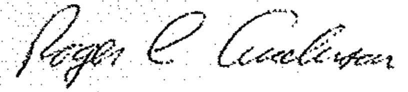

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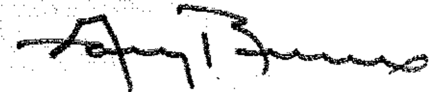

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