STATE OF MISSISSIPPI

TREASURY DEPARTMENT

TATE REEVES
STATE TREASURER

POST OFFICE BOX 138
JACKSON, MISSISSIPPI 39205
TELEPHONE (601) 359-3600

State Treasurer Tate Reeves' Testimony to the US House Financial Services Committee

March 12, 2008

Chairman Frank, Ranking Member Bachus, distinguished members of the Committee, and other distinguished guests, I offer my sincere appreciation for the opportunity to speak with you this morning about the serious issues that state and local governments face in today's challenging municipal marketplace. I would also take this opportunity to congratulate you on your decision to invite my distinguished colleagues, in fact, my friends, from the state of Pennsylvania and California to testify on their perspective regarding current market conditions. I believe that we, in general terms, are going to agree more often than not on the solutions that will help solve the current turmoil in the market.

By way of background, I am serving my second term as the State Treasurer of Mississippi, I am the immediate past president of the National Association of State Treasurers, and I am currently serving at the request of Treasurer Lynn Jenkins of Kansas, our association's current president, as the Chairman of the Legislative/Regulatory committee which has jurisdiction over issues that relate to the municipal marketplace.

Accessibility and affordability of the capital markets – and the liquidity of those markets – is of great importance to our nation's state and local governments. The capital we raise in the municipal marketplace builds our schools, hospitals, roads, and other vital infrastructure and public projects. In times of disaster, municipal issuers are often called upon to use public debt to finance recovery efforts – New York City's post 9/11 Liberty Bond program and the Gulf Opportunity Zone Bond after Katrina are the two most prominent examples in recent years. My experience as Treasurer of the state that bore the brunt of largest natural disaster in the history of our country certainly confirms the advantages of tax-exempt borrowing. Many of the post Katrina recovery projects in Louisiana, Alabama, and Mississippi have been - and are being - aided by the Gulf Opportunity Zone Act of 2005. The bonds we have been able to issue as a result of Congresses action have greatly benefitted the recovery efforts and the citizens of the affected region.

Also, I would be remiss if I passed up this opportunity to thank the members of the Committee, as well as every other member of Congress, for your willingness to help my home state of Mississippi in the aftermath of Hurricane Katrina. Our recovery is far from complete, but the financial resources through appropriations and tax law changes approved by Congress make possible what seemed like a nearly impossible task of rebuilding in late August 2005.

It is extremely important to remember that what brings my colleagues and me before the U.S. House Financial Services Committee this morning - the current situation in the municipal marketplace – is not a general decline in the underlying credits of municipal issuers, but a disruption in the corporate marketplace caused by the collapse of securities backed by subprime mortgages.

In fact, the current stress in the bond insurance industry is not at all caused by the consistent, highly profitable cash flow derived from insuring municipal debt. Instead the problems with the insurers, and by extension the public debt they insured, are a direct result of their decision to insure higher risk ventures in the corporate securities market. The current loss of market liquidity has affected public issuers across the country. For example, in the auction rate market where interest rates reset on a daily, 7-day, 28-day, 35-day or longer term basis, the holders of these securities that want to sell may not be able to find buyers because of doubts over the status of the insurers backing these securities. The end result is a failed auction, resulting in dramatic spikes in interest rate costs on bonds which have little risk of default. In some cases, the rates have jumped to upwards of 20 percent. Obviously, the taxpayers foot the bill as the cost of capital increases.

In Mississippi, we have been more fortunate than many with respect to exposure to today's unstable market. By state statute, we cannot have greater than 20 percent exposure to variable rate debt. In practice, Mississippi has a well-diversified debt portfolio that generally helps position us to weather and even take advantage of short-term aberrations in the market. Of our $3.2 billion dollar debt portfolio, less than $140 million currently is held in auction rate mode securities. We have had one failed 7 day auction which led to an 11 percent rate for one week. Due to the diversification of our portfolio, this failed auction will only contribute an additional 2/100 of 1 percent to our overall debt service payments in the current fiscal year. The following week our auction was priced at a level more in line with our expectations, though it was (and continues to be) trading at a level significantly above the SIFMA index.

Many of the specific issues that are before the committee today as it relates to the present market disruption are, in my opinion, short-term aberrations caused by the credit crunch. Having said that, the issue of bond insurance, liquidity, and rating agency scales on municipal bonds are longer term issues that must be addressed. I am not convinced that Congress necessarily should play a role in these issues, but to the extent you should, I would recommend consideration of the following.

A traditional role of the federal government in past financial crises has been to provide short-term price stability and liquidity to the market during extremely difficult times – until the market can find its own footing. These are extraordinary difficult market conditions.

The Department of the Treasury, at the request of the National Association of State Treasurers and other market participants recently released extremely helpful guidance on reissuance rules for auction-rate securities and variable-rate demand bonds. This guidance allows many issuers to convert out of auction-rate securities into different products, such as fixed rate maturity bonds, without having the bonds deemed to be reissued, which can be costly to governments. This has allowed issuers to save taxpayers' money and limit their exposure in a volatile market.

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

The Federal Home Loan Bank System is not allowed under current law to offer this AAA guarantee to its member banks. Legislation proposed in this Congress would permit Federal Home Loan Banks to offer Letters of Credit, allowing for more options in the guarantor market. I believe this is an option worthy of consideration as it appears this would be beneficial for issuers and investors alike. I appreciate the support of Chairman Frank, Chairman Kanjorski, Congressman Bachus, Congresswoman Pryce and other members of the committee who have co-sponsored this legislation.

Of course, the fact that we have separate scales on municipal and corporate debt makes little sense to me and many of my colleagues. To quote Chairman Frank when he announced this hearing, "Municipal bonds are among the safest—second only to US Treasuries—in terms of losses to investors." Moody's Investors Service has indicated that the default rate on investment-grade municipal bonds from 1970 through 2006 is approximately 0.1 percent, far different from the 2.1 percent default rate among all investment-grade corporate securities over the same period and even less than the 0.5 percent default rate among Aaa-rated companies. Yet, municipal issuers pay a "penalty" to the market for the different scales which leads to higher costs of capital that is borne by the taxpayers.

It may be that the market will resolve this particular concern. But I think it important that Congress be aware of this discrepancy and to the extent that the rating agencies voluntarily establish a global rating scale that more accurately reflects relative credit risk, the market will be better off.

Of course, the Securities and Exchange Commission treats the two ratings scales as equivalent under Rule 2a-7, which governs qualified investments in money market mutual funds. This rule effectively requires that states' money market mutual funds must hold investments rated AA or better. Yet many A-rated municipal securities are the equivalent or better of qualified AA corporate rating securities. Applying corporate-equivalent standards to the investment grade requirement of Rule 2a-7 would expand the market for tax-exempt money market funds, benefiting both issuers and investors.

No single solution exists to solve the current market turmoil. To the extent possible, Congress, the SEC, and market participants all have a role in navigating our financial system through this storm. The key is to encourage investor confidence in the municipal marketplace. Investor confidence will return liquidity to this market.

I will conclude my prepared remarks by reminding you that the capital raised through the issuance of debt in the municipal markets is vital to our great country. Working together, we can continue to ensure a viable, efficient market which ensures the lowest cost of capital for our state and local governments, thereby maximizing the benefit to all of our taxpayers.