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Statement of

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before the
United States House of Representatives
Committee on Financial Services

March 12, 2008

Hearing on
Municipal Bond Turmoil: Impact on Cities, Towns, and States

Good morning and thank you, Chairman Frank, Ranking Member Bachus and other members of the committee. I am Martin Vogtsberger and I am Managing Director and Head of Institutional Brokerage at Fifth Third Securities, Inc. I am pleased to be here today representing the Regional Bond Dealers Association (RBDA). RBDA is a new organization composed of regional securities firms active in the U.S. bond markets. Many of RBDA's members, including my own firm, are active participants in the municipal bond market. We serve our state and local government clients by structuring and underwriting bond issues that finance schools, roads, hospitals, water and sewer systems, libraries, airports, transit systems and a variety of other vital public infrastructure, and we serve our investor customers by providing market liquidity and other services.

The U.S. municipal bond market is an important national resource that brings together investors who have capital to lend with state and local governments who need capital to finance public investment. In our federal system of government, the responsibility for providing certain vital public services falls to states and localities—"issuers" in the municipal market—and they need access to the capital markets to meet this responsibility. The "muni" market has a long and successful history as old as the Republic of providing capital to state and local.

Municipal bonds are a distinctive asset class in the capital markets. Several characteristics make them unique.

- The interest on most municipal bonds is exempt from federal and often state income tax. This feature results in financing costs for municipal bond issuers that are significantly lower than if those issuers had to borrow at comparable taxable interest rates.

- Municipal bonds are incredibly safe. In recent years, the long-term default rate on municipal bonds overall has been less than 1/10th of one percent.

- There is a significant degree of participation in the municipal market by individual, or "retail," investors. At the end of last year, approximately 35 percent of outstanding municipal bonds were held by retail investors compared to 14 percent of foreign and corporate bonds and just six percent of government securities. Another 36 percent of outstanding municipal bonds are held by mutual and money market funds, which are often proxies for retail investors.

- The municipal market is fragmented and diverse. There are over 50,000 distinct issuers of municipal securities and there are over 2 million outstanding bond issues (as counted by CUSIP numbers).

- Most municipal bond issues are small compared to other sectors of the capital markets. The average size of a municipal bond transaction in 2007 was $34 million compared to $577 million in the corporate bond market. This market diversity and small average issue size means that many issuers of municipal bonds are not serviced by large, global securities firms, who tend to concentrate on new issues above a certain threshold in size. A large number of municipal bond issuers depend on regional securities dealers to underwrite and sell their issues.

Recent Market Developments

Despite the municipal market's long history of success, in recent months the market has unfortunately suffered significant stress. The origins of this disruption are in the downturn in the subprime mortgage market and in the residential real estate market in general that set in in earnest last year. Problems in the real estate financing markets have bled over into all sectors of the credit markets, including the municipal market. As recently as a year ago, credit markets were riding high. Credit spreads—the return investors earn for taking credit risk in the capital markets and a measure of investors' perception of credit risk—were at historical lows, and investors had a seemingly insatiable appetite for credit products, including corporate and municipal bonds, asset- and mortgage-backed securities, leveraged loans, collateralized debt obligations and others. Credit market conditions began to change quickly last summer, however, as it became apparent that the booming residential real estate market that was supporting the rapid expansion of subprime mortgage lending had turned a corner. With the deterioration in the credit quality of hundreds of billions of dollars of bonds backed by subprime mortgages, many investors suddenly became adverse to credit risk in general, not just credit risk associated with subprime mortgages or real estate-backed lending. As a result, there was a widespread, global repricing of almost all credit products. The values of many outstanding bonds and other credit instruments fell, and credit spreads—a measure of investors' perception of credit risk—widened. This occurred in market sectors even where there was no significant deterioration in fundamental credit quality.

The general correction in the global credit markets spurred the selling of municipal bonds by non-traditional municipal investors such as arbitrage and hedge funds. In recent years these opportunistic investors have become increasingly important players in the municipal market, often borrowing against their portfolios to leverage their investments. When prices of credit products began to fall last year, many of these investors were forced to sell assets, including municipal bonds, to meet margin calls. This selling in January and February exacerbated weakness in the market.

Early during the credit correction cycle, the municipal market was not affected as drastically as some other market sectors. However, over the last 20 years, the municipal bond market has become increasingly dependent on third-party credit enhancement. Last year, nearly half of all new municipal bond issues carried credit enhancement, mostly in the form of bond insurance. This dependence on bond insurance left the municipal market indirectly vulnerable to problems in other sectors of the credit markets.

In an insured bond transaction, a third-party, "monoline" insurance company—so-called because it provides only one type of risk underwriting, insurance of credit risk on financial products—promises to pay the debt service on a bond if the issuer fails to meet its payment obligations. In an insured transaction, the credit rating on the claims-paying ability of the monoline insurer automatically transfers to the bond being insured. By using bond insurance, a state or local government whose "natural," or uninsured, credit rating is lower than the bond insurer's can issue bonds at a higher rating and lower interest rate. If the premium paid for the bond insurance is less than the interest savings on the bonds, bond insurance can be a good deal for an issuer.

As noted above, municipal bonds are incredibly safe. The risk of default on "governmental" municipal bonds—those issued to finance traditional public sector investment—is close to zero. Monoline insurance companies that insure municipal bonds are exposed to minimal credit risk associated with their municipal portfolios. However, in recent years, some of the bond insurers that are active in the municipal bond market have also built portfolios in structured credit products such as asset-backed securities and collateralized debt obligations. Although the monolines' municipal portfolios have not deteriorated significantly in credit quality over the last year, some of their portfolios in structured credit products have suffered, causing an expected loss of capital and reserves available to pay potential claims on all their obligations. The result has been disruption and stress in the municipal market even though the fundamental, underlying credit quality of municipal bonds has not changed significantly.

Sectors Most Affected

Certain products in the municipal market have been more affected by the credit market correction than others. The sector most affected has been the collection of products that are designed to appeal to investors looking for money market-like, tax-exempt securities, particularly auction-rate securities (ARS) and, to a lesser extent, variable-rate demand notes (VRDNs) and tender-option bonds (TOBs). These securities have long-term nominal maturities but are designed to mimic the performance of short-term, money market instruments. Many of these securities carry bond insurance, and because the money markets in general are very

sensitive to changes in credit quality, investors have shunned these categories of municipal securities as the conditions of some of the monolines have deteriorated.

Auction-rate securities

ARS are securities with long-term nominal maturities that are designed to behave like short-term money market instruments. They appeal to corporations and other investors who invest cash for short periods of time but are not bound by strict regulations on the characteristics of their investments as registered money market mutual funds are. With an ARS, an auction agent conducts periodic auctions among investors. The auctions serve two purposes. First, an auction provides a means for investors who no longer want to hold their ARS to resell them to other investors. Second, an auction determines the interest rate the issuer of the ARS will pay during the period until the next auction. Typically, ARS have auctions every seven, 28 or 35 days, although there are other frequencies, as well.

A key feature of auction-rate securities that distinguishes them from other variable rate municipal bonds is that with ARS there is no “hard put” facility. This means that the only way investors can sell their ARS is if other market participants want to buy them. In general, no party to the transaction has an obligation to buy ARS under any circumstances. If an insufficient number of market participants bid for ARS at a periodic auction, that auction is said to “fail,” and there may be no other opportunity for investors to sell their ARS. This is a key reason why ARS are not eligible for purchase by money market mutual funds. Another key feature is the “penalty rate” associated with ARS that have experienced a failed auction. The penalty rate is typically an above-market interest rate that an issuer of ARS pays after an auction has failed until another rate is set at a subsequent auction. This penalty rate can sometimes be well above current market rates. The penalty rate provides some compensation to investors holding ARS where auctions have failed. However, despite earning an attractive interest rate, those investors have still lost the ability to sell their securities at auction as they had anticipated.

Most traditional ARS are sold almost exclusively to institutional investors such as corporations. However, a subset of ARS which are issued by leveraged, closed-end mutual funds are marketed to retail investors.

The ARS market has experienced significant stress and disruption in the wake of the credit market correction and the downturn of some monoline insurers. Hundreds of auctions have failed. Many investors are holding ARS they would like to sell but for which there are no buyers. Many issuers of ARS are paying onerous penalty rates on their outstanding ARS. Conditions have improved somewhat in the last several weeks as some opportunistic investors such as hedge funds have entered the market. However, the market has not returned to “normal.” Many ARS issuers are exploring options for refinancing out of their ARS debt and into other, less costly forms of borrowing. However, an overall lack of market liquidity and difficulty in obtaining credit enhancement is creating difficulties in some circumstances. As an indication of the downturn in the ARS market last month, the SIFMA Auction Rate 7-Day Index, an indication of rates of return in the market for ARS with weekly auctions, went from 4.03

percent on February 6 to 6.59 percent on February 13, by far the biggest one week spike in that index since its creation.

Variable-rate demand notes and tender option bonds

VRDNs are long-term, variable-rate securities where the interest rate changes periodically and is generally tied to an index. A key difference between ARS and other variable rate municipal bonds is that unlike ARS, VRDNs do have "hard put" facilities. This means that these transactions include standby liquidity providers—remarketing agents—who will buy VRDNs at face value at any interest reset date. The remarketing agents then try to sell the VRDNs to other investors or, if there are no buyers, hold the VRDNs in their own portfolios. VRDNs can carry penalty rates which apply if remarketing agents are unable to sell securities they have bought from investors under liquidity facilities, but those penalty rates generally are not as onerous as with ARS. Also, most VRDNs include a feature whereby issuers can convert the bonds to fixed-rate securities with sufficient notice to investors.

TOBs are variable-rate securities which are "created" in the secondary market from traditional, long-term, fixed-rate municipal bonds. In a TOB, the underwriter of the transaction deposits typically fixed-rate bonds with a trustee and issues variable-rate bonds which are backed by the repayments on the underlying fixed-rate securities. The original state or local issuer of the underlying bonds typically is not involved in the TOB transaction. Like VRDNs, TOBs generally include "hard put" facilities that allow investors to sell their bonds back to the liquidity provider on an interest reset date. In many cases, that put feature can be rescinded if the underlying bonds default or are significantly downgraded in their credit rating. Even though states and localities are not directly involved in the creation of issuance of TOBs, TOBs benefit state and local governments because they provide an important source of demand for traditional long-term, fixed-rate municipal bonds.

The VRDN and TOB markets have held up better than the ARS market in the context of the downturn of some of the monolines. Those securities which have retained their credit ratings and which are "2a-7 eligible"—or eligible for purchase by money market mutual funds—have actually been in short supply, and investors have bid down the rates on those bonds significantly, although that trend has mitigated somewhat in the last week or so. As an indication of the volatility in the VRDN market brought about by concerns regarding the monolines, the SIFMA Municipal Swap Index, an indication of rates of return on municipal VRDNs with seven-day resets, went from 3.02 percent on January 9 to 1.24 percent on February 13, jumping back up to 3.16 percent on February 27.

Municipal Bond Rating Scale

An important issue that has received much attention with the recent disruptions in the municipal market is the question of the credit rating criteria used by the bond rating agencies for municipal bonds in relation to the criteria the agencies use for all other debt securities. One year ago, Moody's Investors Service published a report entitled "The U.S. Municipal Bond Rating Scale: Mapping to the Global Rating Scale and Assigning Global Scale Ratings to Municipal

Obligations." In its report, Moody's used default and average loss rates to compare the credit performance of municipal bonds to bonds issued by corporations, financial institutions, sovereign governments and others. Moody's noted that for every rating category, default rates for municipal bond issuers are significantly lower than for non-state and local government borrowers. Moody's concluded that a state general obligation bond rated A1 on Moody's municipal rating scale, for example, is the equivalent of a Aaa rating on the global rating scale based on default and loss rates. Moody's also announced that they would begin assigning ratings based on the global rating scale to "(a) any taxable municipal transaction regardless of whether it is sold inside or outside the U.S., and (b) any municipal obligation under a swap transaction with a counterparty rated on the global scale." Moody's also announced that they would begin specifying more clearly when a municipal bond rating was based on the more stringent municipal rating scale. At least one other rating agency has stated that it uses a single, global scale for all its ratings. However, some market participants believe the two-scale system exists at other rating agencies as well.

Arguably, rating municipal bonds on a different, more stringent rating scale costs state and local government money when issuing debt. Either an issuer sells bonds at a nominal rating lower than the rating they would receive on the global scale, increasing the interest rate on their borrowing, or they must purchase bond insurance to raise their nominal rating on the municipal scale, again incurring costs. Supporters of the current, two-scale system argue that investors are sophisticated enough to compare bonds rated on the municipal scale to equivalent global scale ratings. While this argument may have some merit, not all municipal investors, especially retail investors, have the market sophistication to make that comparison. Moreover, some investors such as money market mutual funds are bound by regulation to buy only those bonds that fall into certain nominal rating categories and do not have the ability to substitute global scale ratings for that test.

A strong argument can be made for encouraging the rating agencies to rate all municipal bonds on a global rating scale in order to enhance market transparency and eliminate the cost disadvantage municipal issuers face relative to other borrowers in the capital markets.

Conclusion

The stress and disruption in the municipal market over the last several months is an unfortunate product of the overall correction in the global credit markets brought about in part by the downturn in subprime mortgages and other real estate-related lending. Market friction has raised costs for state and local governments around the country at a time when some governments' fiscal positions are beginning to weaken with the slowing economy. While the credit ratings of many thousands of bond issues have been downgraded in recent weeks—and investors and other market participants have suffered significant losses as a result—virtually all those downgrades have come about from downgrades in the claims paying ratings of some monoline insurers, not a downturn in the credit quality of state and local governments themselves. From the perspective of underlying, fundamental credit quality, the municipal market will remain the safe, sound investment arena it has been for decades. The market has weathered the "perfect storm" of bad news affecting municipal securities in January and February—the downgrading of certain

monoline insurers and the uncertainty overhanging credit enhancement, the failed ARS auctions, and the selling by non-traditional owners of municipal securities such as arbitrage and hedge funds brought about by margin calls and deleveraging. That the market has survived that storm, at least for the moment, is a tribute to the value of municipal bonds and to the traditional investors in the marketplace.

Thank you, Chairman Frank and Ranking Member Bachus, for the opportunity to be here today. I look forward to your questions, and I and the staff of the RBDA are eager to work with you as your examination of the credit markets continues.