Testimony of Robin L. Wiessmann, Pennsylvania Treasurer
Before the Committee on Financial Services
U.S. House of Representatives

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Chairman Frank and members of the Financial Services Committee, thank you for inviting me to testify today about the current turmoil in the municipal bond marketplace and its effects on state and local government operations. State and municipal governments are experiencing collateral damage as a result of the crisis in today's credit markets.

My name is Robin Wiessmann and I am Pennsylvania's Treasurer.

My professional experience that is relevant to today's hearing includes municipal and bistate agency supervision, 24 years as an investment banker, which includes 10 years as an owner of a broker dealer investment banking firm, and 15 years of asset management oversight.

To give you a sense of Pennsylvania's debt profile, as of the end of last year, 2007, Pennsylvania had General Obligation debt outstanding of $8.515 billion and Revenue Bonds outstanding of $7.7 billion, which includes the Housing Agency, Turnpike Commission, the Commonwealth Financing Authority, Pennsylvania Industrial Development Authority, Pennsylvania Infrastructure Investment Authority, and the Philadelphia Regional Port Authority. In addition, the Commonwealth has about $980 million of lease and appropriation debt outstanding that is attributable to the Commonwealth's General Fund. There is over $28.16B in debt issued by various state authorities such as the Turnpike Commission, the student loan agency, etc. the but the debt service is on these issues is solely payable from revenues of the issuing authority The Commonwealth issued $706 million of fixed-rate bonds in December and the Commonwealth Financing Authority issued $187.5 million of fixed-rate bonds last week.

Our debt includes $1.04 billion in variable rate and $299.7 million in auction rate issues, almost all of which was issued by the Pennsylvania Turnpike Commission and is not a direct obligation of the Commonwealth.

Collateral Damage and Repercussions of Current Crisis

The turmoil in the capital markets and in public finance in particular has wide-ranging implications for governments and the tax-paying constituents we serve. My concern extends beyond the Commonwealth's direct debt to the constituent debt of our counties, municipalities, and school districts. The ability to finance much-needed projects and encourage economic development through building, expansion, and necessary maintenance of our capital investments is at stake. Lesser known and smaller issuers as well as large governmental entities are having trouble accessing the capital markets. However, larger issuers have other options and more financial flexibility. Frequent borrowers, established credits, and household names have an easier time reaching pools of investors, and obtaining the interest of the major financial institutions, and have internal reserves or other balances to provide intermediate relief. Smaller issuers and more local governmental entities have less exposure and familiarity with Wall Street, and are more vulnerable when traditional sources of funding are impaired.

Credit enhancement has been a tool for unrated or lower rated small localities to reach investors and obtain favorable market rates for their needs, like building schools, roads, sewers, and hospitals. Unrated or lower rated issuers, infrequent borrowers, and bond issues large and small have all benefited from the availability of credit enhancement. While it should not have been used by investors and investment banks to homogenize credits, and underlying financial wherewithal should always be evaluated, bond insurance was - and is - a cost effective way for hundreds of borrowers to reduce their interest costs by obtaining a AAA rating on their bonds. In addition, these issuers could potentially reach investors they may not otherwise access. Broader marketing of securities will always lead to better pricing and lower cost of funds.

The turmoil in the fixed income markets, stemming from a lack of liquidity for auction rate bonds and credit strains, means that many municipalities may not have capital funding or face extremely high borrowing costs. Average taxpayers will be further stressed in difficult economic times, with foreclosures and declining property values affecting tax rolls, increasing demand for public services and other budgetary constraints.

The crisis created by the deteriorating credit profile of the bond insurers has increased interest costs, limited access to financing, undermined confidence in the capital markets and reduced the investor base in tax-exempt bonds. Securing the future of this financing tool is critical to the fiscal health of governmental units in this country.

To that point, I am concerned that the present market disruption could leave municipalities facing budget shortfalls. Many Pennsylvania localities have adjustable rate debt. Many may have prolonged additional costs not budgeted for in their debt service. This could ultimately present a State aid issue. The Commonwealth itself has only fixed rate debt. According to all three rating agencies, Pennsylvania has manageable rate risk based on strong credit fundamentals, a favorable debt profile and a positive economic position which insulates the Commonwealth from much credit or financial impact. We are rated in the AA category by all three rating agencies.

Why Issue Variable Rate or Auction Rate Bonds Anyway?

But that is not to say that variable rate debt or auction rate securities have been a riskier financing strategy or have been imprudent in any way. Variable rate demand bonds became popular in the mid 1980's during sustained high interest rates when the prime rate was around 14 percent. These bonds were remarketed every seven days to the public, as rates were reset to current conditions, and investors had the right to put back their holdings if they no longer wished to own the securities. These instruments became a convenient way for public issuers to finance long-term projects on a permanent basis by using the short end of the yield curve, which normally represents lower rates. This, of course, saved taxpayers a lot of money in debt service.

About a decade later, replicating the manner in which many other debt issues are priced (Treasury securities and corporate bonds) in a long established auction process, municipal bonds adopted an auction pricing mechanism. Auction rate bonds garnered the same benefit as the variable rate bonds, using the short end of the yield curve to secure funding long term but reduced the overall costs and fees associated with each issuance. Auction rate bonds also provided a very flexible funding mechanism. The covenants with the bondholders allowed for changes in mode from 7 day paper to 35 day or other interest frequencies, allowing public borrowers to obtain funding at the best price or match to their needs.

An important point here is that up until last December, these short-term markets performed beautifully. Failed auctions were rare, variable rate bonds were typically remarketed easily, and public entities could align their short-term asset investments to their short-term liability strategies. It made fiscal sense for public financing of capital programs to include a component of adjustable rate securities in a borrower's debt portfolio mix.

Application of Bond Insurance

The Commonwealth's policy regarding bond insurance is that bond insurance may only be purchased if, in accordance with tax law and economic benefit analysis, the insurance would lower the cost of funding to an extent that the insurance premium is more than offset by the interest rate savings. With regard to the fiscal implications of a downgrade in a monoline's rating, the downgrades of many of the bond insurers' ratings has obvious implications to the cost of funding and relative pricing in secondary market trading as well. It is important to note the impact on the investors, institutional and retail, that own tax-exempt public debt. The implication to these holders is that their investments are valued much less and are not as secure – despite the fact that the governments who borrowed their money are no less responsible, fiscally sound, or creditworthy when the bonds were sold.

In addition, there are multiple financial instruments, such as liquidity facilities and some letters of credit that have termination or additional cost factors should the rating of the insurer be lowered. This is one reason the variable rate demand bond market has been affected. In order to market variable rate bonds where the investor could be repaid on any reset date, liquidity facilities are required to secure a funding source so that the investor can be repaid in the event a remarketing should not occur. Downgrade provisions in the liquidity documents relating to the insurer, not the issuer, have created havoc for some variable rate demand bond issuers. Similar to a failed auction, the bank providing the liquidity then owns the bonds put back. In the case of a rating downgrade on the insurer, this event triggers the bank's maximum rate.

In my view, the rating scale of municipal debt relative to corporate debt is important because as the relative value across asset classes changes, nontraditional muni buyers may be attracted to tax-exempt debt. New buyer purchasing would be facilitated by a simpler classification of rating categories for all debt issues, corporate or municipal. A more uniform credit rating system will make all bonds more comparable.

Ratings

In particular, state and local debt issuers rarely default, have minimal event risk, honor their covenants, and are monitored closely under strict standards. Despite the scrutiny over tax-exempt issuance and the lower likelihood of default, municipal bonds are often perceived and priced as inferior to corporate debt. A mechanism should exist to assess the true credit worthiness of government debt obligations in the financial markets and also relate these instruments to other fixed income investment options.

As the capital markets become more complex, and ratings categories require more precise differentiation, there may be more of a need for fine-tuning or further differentiation within rating categories. Gradations of ratings will ultimately provide more accuracy in credit assessment and in primary and secondary market pricing.

Now What? Possible Remedies

In terms of the outlook for the future, it is very important to stabilize these markets and prevent future disruptions to public financing. Going forward, Pennsylvania's ongoing infrastructure needs are likely to increase our issuance of debt. Dislocation in the market, higher credit spreads, and less liquidity will increase costs for all issuers, large and small. Fewer bond buyers or the emergence of opportunistic ones will keep borrowing costs high as well. Less available bond insurance or enormous premiums to obtain it may prevent many issuers from financing needed projects affordably.

Federal Stopgap

Mechanisms should be put in place to support trading when disruptions in the market occur, as has transpired recently. Just as triggers were established in the equity markets, providing for suspension of trading to avoid chaos, I suggest that the Federal Reserve or other federal agencies offer stop gap measures to support and sustain the municipal markets in times of psychological or actual crises, such as what we have seen and are still experiencing. Had measures such as these been available in December or January, we may not have seen the cascading affect of liquidity and credit concerns which are now impacting fixed rates and unenhanced paper.

Raise the Bank-Qualified Debt Limit from the Current $10 Million Level to $25 Million

Historically, banks have been a major investor base for smaller governments, purchasing their tax-exempt debt. Banks have been able to deduct 80 percent of the carrying cost of purchasing and holding bonds issued by governments whose total annual bond issuance does not exceed $10 million. In this way, many small issuers place their bonds with community banks, avoiding many of the fees associated with underwriting. Another benefit is a better interest rate because of the carrying cost deduction. However, with inflation and rising costs, many projects generally have capital needs in excess of $10 million.

Especially in the current market environment, “bank-qualified” financing is an attractive and more efficient funding vehicle for smaller public issuers. If Congress raises the bank qualified limit to $25 million, it would significantly assist smaller governments to finance their capital needs. An additional benefit would be to index the bank-qualified debt limit to inflation to meet the changing construction cost factors facing municipalities.

Permit One Additional Advance Refunding of Bonds

Current tax law permits refinancing an outstanding bond issue before the bonds become due at the time they are callable, a practice known as an advance refunding. Under present law, issuers have only one opportunity during the life of the bond issuance to take advantage of improved market conditions to achieve lower borrowing costs. To allow one additional advance refunding would facilitate the restructuring of auction-rate securities obligations, since issuers could view the conversion to fixed rates now as a temporary or interim cost of capital.

Under current market conditions, many issuers are transferring out of auction-rate securities or variable-rate demand bonds and into fixed-rate debt. While the current-fixed rate interest environment is better for government borrowers than the auction rate market, fixed rates are higher right now because of the credit crisis.

And under current regulations, when the market stabilizes and interest rates may be more favorable to issuers, many may not be able to take advantage of lower interest rates to refinance their debt. This is true if these issuers have previously used their advance refunding opportunity before this current situation arose. Allowing for an additional advance refunding would allow governments to secure better rates, reduce debt service, and save taxpayers money.

SEC Rule 2a-7

Despite the differences between the corporate and municipal ratings scales discussed by my colleague from California, the SEC has treated the two scales as equivalent under SEC Rule 2a-7, which governs qualified investments in money market mutual funds. This rule basically requires that money market mutual funds must hold investments rated AA or better. The standards used to define an AA corporate security are different from the standards used for a AA municipal security. Therefore, the SEC's rule that a mutual fund must hold an AA or better security inherently excludes many A-rated municipal securities which may very well be the equivalent of qualified AA corporate rating securities. Applying corporate-equivalent standards to municipal bonds and altering the rating requirement of Rule 2a-7 would expand the market for tax-exempt money market funds, benefiting both issuers and investors.

In summary, the capital markets have been operating as an efficient and available source of funding for public projects and programs all across our country. The public finance marketplace is unique in this respect; most other economies fund public works out of tax supported general funds. Unless it is a toll road or other user fee revenue producer, most public projects only are funded when cash is on hand. The tool our state and local governments have, to borrow funds when required and accelerate the delivery of projects through borrowing, is so valuable to maintain our economy, quality of life, and service to the taxpayers. Individual bondholders and institutions have invested in these projects and have fairly been rewarded for the level of risk and time their funds are deployed. It would be a major disruption to our economy and our system of governance if the financing mechanisms discussed today were not supported and sustained.

Thank you for the opportunity to testify today. I welcome your questions.