

INVESTOR PROTECTION AND THE REGULATION OF SECURITIES MARKETS: MUNICIPAL BONDS

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ORAL PRESENTATION TO THE US SENATE BANKING COMMITTEE

Oral Testimony to the Senate Banking Committee - March 10, 2009

INTRODUCTION

Chairman Dodd, Senator Shelby and Committee members: It is a distinct pleasure that I come before you today to share my perspective on the U.S. municipal bond industry. I am Thomas Doe, founder and CEO of Municipal Market Advisors, that for the past 15-years has been the leading independent research and data provider to the industry.

In addition from 2003 to 2005, I served as a public member of the Municipal Securities Rulemaking Board (MSRB), the self-regulatory organization (SRO) of the industry established by Congress in 1975.

THE MARKET

There are nearly **65,000 issuers** in the municipal market that are predominantly states and local governments. Recent figures identify an estimated **\$2.7 trillion** in outstanding municipal debt. This is debt that aids our communities in meeting budgets and financing society's essential needs, whether it is building a hospital, constructing a school, ensuring clean drinking water, or sustaining the safety of America's infrastructure. A distinctive characteristic of the municipal market is that many of those who borrow funds, rural counties and small towns, are only infrequently engaged in the capital markets.

As a result, there are many issuers of debt who are inexperienced when entering a transaction, and unable to monitor deals that may involve the movement of interest rates or the value of derivative products.

THE GROWTH

According to the *The Bond Buyer*, the industry's trade newspaper, annual municipal bond issuance was \$29B in 1975 whereas in 2007 issuance peaked at \$430B. In the past 10 years derivatives have proliferated as a standard liability management tool for many local governments. However, because derivatives are not regulated it is exceptionally difficult, if not impossible, to identify the degree of systemic, as well as specific, risk to small towns and counties that have engaged in complex swaps and derivative transactions.

SYSTEMIC RISK EMERGES

Municipal issuers themselves sought to reduce their borrowing costs by selling bonds with a floating rate of interest, such as auction-rate securities. Because state and local governments do not themselves have revenues that vary greatly with interest rates, these issuers employed interest rate swaps to hedge their risk. Issuers used the instruments to transform their floating risk for a fixed-rate obligation.

A key factor in the growth of the leverage and derivative structures was the prolific use of bond insurance.

THE PENAL RATING SCALE

Municipal issuers are rated along a conservative ratings scale, resulting in much lower ratings for school districts and states than for private sector financial or insurance companies. Although most state and local governments represent very little default risk to the investor, the penal ratings scale encouraged the use of insurance for both cash and derivatives to distribute products to

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investors and facilitate issuer borrowing.

So instead of requiring more accurate ratings, the municipal industry chose to use bond insurance to enhance an issuer's lower credit rating to that of the higher insurance company's rating.

The last 18 months have exposed the risks of this choice when insurance company downgrades, and auction-rate security failures, forced numerous leveraged investors to unwind massive amounts of debt into an illiquid secondary market. The consequence was that issuers of new debt were forced to pay extremely high interest rates and investors were confused by volatile evaluations of their investments.

STEPS TO IMPROVE THE REGULATORY CONTEXT

The 34-year era of the municipal industry's self regulation must come to an end. Today, the market would be in a much better place if:

First, the regulator were independent of the financial institutions that create the products and facilitate issuers' borrowing.

Second, the regulator were integrated into the national regime of regulation.

Third, the regulator's reach and authority were extended to all financial tools and participants of the municipal transaction: ratings agencies, insurers, evaluators, and investment and legal advisors for both the cash and swaps transactions.

Fourth, the regulator were charged with more aggressively monitoring market data with consumers' interests in mind, both investors and issuers.

The good news is that this new era of regulatory oversight can be funded by the MSRB's annual revenue \$20-plus million, collected from bond transactions, and can be staffed by the current MSRB policy and administrative infrastructure.

CAUTION

I should be clear. The innovations of derivatives and swaps have a useful application and have been beneficial for those for which they are appropriate. However, it is also important that these instruments become transparent and regulated with the same care as the corresponding cash market.

GET THIS DONE

It is critical to get this right. There is too much at stake.

Thank you for asking me to testify today, and I welcome your questions during this session.

MUNICIPAL MARKET ADVISORS

Founded in 1995, MMA is the leading independent strategy, research and advisory firm in the municipal bond industry. MMA's intelligent approach to timely issues and analysis of market events has proven invaluable to a wide range of clients. As conditions have become more complex and difficult, MMA's recognized ability to concisely comment on the key issues of the market is of critical importance and value. The firm's independent research, data, market coverage and insight educate and inform without bias or product agenda.

OUR CLIENTS: INVESTORS, DEALERS, FINANCIAL ADVISORS, ISSUERS AND INDIVIDUALS: MMA's business has been predominantly portfolio managers and dealer firms (with a focus on sales, trading and underwriting). However, in 2007, demand for our services expanded to include issuers, financial advisors, individuals and public finance professionals who have recognized the increased value of accurate and insightful coverage of current historical market conditions. MMA does not advocate on behalf of its clients, we educate on behalf of the market.

WASHINGTON DC – EDUCATING AND WORKING WITH DECISION-MAKERS: MMA's Washington DC office has enabled our firm to provide more direct information to policy makers, regulators, trade associations and the Federal Reserve. MMA's role is that of an educator to provide immediate uncompromised assistance to entities that are actively engaged in working on issues pertaining to the municipal industry.

INFORMING THE MEDIA: In 2008, more than 200 publications and media outlets have sought MMA's expertise for definitive comment on the issues confronting the industry. At no other time has accurate market coverage been more valued, and trusted resources considered indispensable. Unbiased information is important for correct representation of market conditions, policy decisions and management of portfolios.

THOMAS G. DOE, FOUNDER AND CEO: Mr. Doe has been an analyst in the municipal industry for twenty-five years with a consistent focus on pricing data and information flows, investor and issuer behavior, and contextual investing. He has addressed all of the leading groups in the municipal industry, as Mr. Doe's insight, candor and historical context is sought to establish a clear perspective of current conditions affecting investors and issuers in the municipal cash and derivative markets. He has been a featured speaker at numerous industry conferences and has been frequently quoted in industry and national media. Mr. Doe's leadership was recognized when he was named to a three-year term with the Municipal Securities Rulemaking Board, (MSRB) the regulatory entity of the municipal securities industry in 2002. Mr. Doe received an undergraduate degree from Colgate University in 1980 and a Masters degree from Harvard University in 1984.

BACKGROUND ON HOW THE CREDIT CRISIS HAS AFFECTED THE MUNICIPAL MARKET

The municipal market has suffered repeated shocks from the credit crisis since August 2007. In a very primary sense, our sector was, and in many ways continues to be, exposed to the same systemic risks that collapsed the housing and securitization markets and undermined our nation's banks. The deep interconnectedness of the municipal market with the global financial and interest rate markets was unforeseen by most municipal regulators, issuers, investors, advisors, lawyers, and dealer banks; their surprise at, and misunderstanding of, the systemic risks at work has consistently exacerbated problems over the last two years. Further, there is little provision being made at present to create a more resilient and stable market in the future.

The initiation of the credit crisis in municipals, as it was elsewhere, began in 2001 and 2002, with the integration of leverage into municipal bond buying strategies. Leveraged investment vehicles, called Tender Option Bond (TOB) programs, borrowed low interest (floating-rate) cash from the tax-exempt money market funds to invest in higher yielding (fixed-rate) municipals. Not only does this strategy capture the simple difference between the high long and low short interest rates (the carry), but also TOB sponsors — which included hedge funds, dealer banks, mutual funds, liquidity providers, and many others — are placing bets on the tax-exempt market's outperformance of carefully selected taxable bonds or swaps via interest rate hedging.

However, one of the key conditions for the safe operation of a TOB was not implicit in the municipal market: liquidity. Because TOBs are subject to mark-to-market accounting, margin calls, and periodic adjustments of their leverage, they benefit from a well-traded and accurately priced bond market. A TOB invested in securities with unpredictable or volatile prices will itself provide unpredictable and volatile returns. The municipal bond market, as we have detailed elsewhere in this report, comprises 65,000 potential bond issuers and 1.5 million individual securities, most of which are rated along an overly cautious rating scale that intentionally exaggerates the risks and differences between individual issuers and bonds. Further, municipal issuers have long sold bonds in serial maturities, with a variety of interest rate coupons, call structures, security pledges, etc. And finally, the bulk of municipal investors are households, who either directly or indirectly through a manager, prefer to buy and hold small pieces of multiple bond offerings: these are not active securities trading operations.

This context was not conducive for TOBs, but, because their use of leverage they were permitted to purchase municipal bonds at substantially higher prices than other investors were willing to pay, so the primary market rapidly adjusted to their needs. This entailed the pervasive use of AAA-rated bond insurance and bank guaranties (creating the appearance of safe homogeneity) and the facilitation of very large, governmental-oriented bond sales carrying a standardized 5% coupon. For the period between 2002 and 2007, these adjustments permitted the near doubling of annual bond issuance (from about \$200Bn to about \$400Bn), and the amount of par volume municipal bonds outstanding swelled 77% from \$1.5T in 2001 to \$2.7T today. What's more, the rapid growth of TOB (and related strategy) investment — along with a large increase in demand from property casualty insurance companies riding post-9/11 waves of premiums and profitability — allowed municipals to be priced more and more aggressively, fulfilling the TOB investor's aim of outperformance of the taxable bond market and encouraging ever larger allocations to this strategy.

At the same time, the interest rates that tax-exempt money market funds were receiving from the TOBs were better than an investor could receive in a regular savings account, and aggressive TOB creation meant a surfeit of product in which the money funds could invest. This attracted more money fund deposits which, along with monetary policy, kept short-term interest rates low. Municipal

BACKGROUND ON HOW THE CREDIT CRISIS HAS AFFECTED ... (CON'T)

issuers themselves sought to reduce their borrowing costs by selling long maturity, AAA-insured bonds with a floating rate of interest, including variable-rate demand obligations (VRDOs), which can be purchased by the money market funds, and auction-rate securities, which were largely bought by individuals and corporate cash managers. However, because state and local governments do not themselves receive much revenue that floats with short-term interest rates, these issuers also employed interest rate swaps with these floating-rate bonds in an attempt to exchange their floating-rate liability for a fixed one (but with the addition of increased counterparty exposure to both a bank and the a bond insurer).

By these means, issuer interest rate swaps and derivatives became a fundamental, but unregulated part of the municipal industry's standard machinery, and systemic exposure to the financial sector, the bond insurers, and, more importantly, the rating agencies' opinions of the financial sector, and the bond insurers grew rapidly. In addition, our market had become substantially vulnerable to fluctuations in the value of taxable securities: remember that much if not all of the massive investment by TOBs (estimated to have peaked near \$500Bn although little was done by the municipal regulators to even tabulate this exposure) was hedged against the performance of Treasuries, LIBOR swaps, or other slightly more muni-centric derivatives.

The problems with this arrangement were exposed in August 2007 with the first surge of flight-to-safety buying of Treasury securities on news of worsening damage to the housing sector. Stronger Treasury (and LIBOR) prices created losses in TOB hedges, forcing margin calls that rapidly consumed available cash. In addition, sharp increases in the overnight lending rates pushed floating-rate product credit spreads wider: the source of TOB leverage, loans from the money funds, grew much more expensive, to the point where the money funds were demanding almost as much (or more) interest than the TOBs were receiving from their long-term, fixed-rate municipal position. Some TOBs thus began to liquidate their positions, forcing sales of their fixed-rate bonds into a municipal secondary market that quickly became oversupplied and illiquid. Keep in mind that, up until that point, the TOBs had been purchasing bonds at (and driving market clearing prices and statement evaluations to) higher levels than traditional institutional investors were reasonably willing to pay. Thus, when the TOBs needed to quickly sell their bonds to these same traditional buyers, large price concessions were required. Dealer banks helped soften the effects by acquiring bonds into their own trading inventories, but ultimately market pressures forced municipal bond yields sharply higher (while Treasury yields were moving sharply lower). Higher yields attracted enough demand to stabilize the market by the end of the month, but, through the end of the year, nervous investors repeated this pattern of fast selling/recovery, heightening volatility in prices, and encouraging a steady reduction in TOB investment. For substantially more detail on the daily and weekly evolution of our the market, please see the complete catalog of published MMA research, available to subscribers on our Web site and to Congressional staffs on request.

Importantly, market participants had by this time also become increasingly concerned about the future of the bond insurers, who had guaranteed subprime residential mortgage securitizations. Research firms such as MMA and private investors amplified former warnings about these companies. In particular, more cautious corporate cash managers began selling auction-rate securities that had been marketed to them, in part, based on the apparent safety of AAA-rated bond insurance. Once again, dealer banks managing auction-rate programs provided liquidity in the absence of incremental investor demand, but in December 2007, the rating agencies sounded formal warnings about the bond insurers. This precipitated vast selling pressure among auction-rate investors that, in January, overwhelmed dealers' risk tolerances for buying back additional auction paper, and auctions began to fail (please see **Auction Rate Securities**, below).

BACKGROUND ON HOW THE CREDIT CRISIS HAS AFFECTED ... (CON'T)

Auction-rate securities paying high penalty rates attracted investors away from other fixed- and floating-rate products, forcing both fixed and floating rates up sharply. At the end of February 2008, TOB programs were once again forced to sell bonds to pay margin calls, to unwind their leverage that had grown too expensive, and to afford investor redemptions. Extreme selling and uncertainty led to widely divergent pricing decisions across the industry; liquidity was almost completely interrupted, and state and local issuers were temporarily shut out of the capital markets.

Once again, high yields galvanized demand in March, and from that point until December 2008, the municipal market continued to face boom and bust pricing cycles of sometimes extraordinary depth. In general, these entailed yield-fueled, or media-driven demand bubbles that were ultimately pricked by yet another bond insurer downgrade that renewed fears and sometimes forced selling by leveraged bondholders. The worst of these cycles began in September, when the collapse of Lehman Brothers, plus concerns over other broker-dealer counterparties were realized in investor redemptions from municipal money markets, which put large numbers of variable-rate obligations back to dealers. The flow of bonds initially overwhelmed dealer balance sheets, forcing the unwind of some proprietary positions, but was ultimately managed through dramatically higher floating rates (the municipal industry's seven-day floating rate reset from about 2% to 8% and credit spreads to that rate widened sharply, in particular for TOBs because of their reliance on multiple layers of bank support) and the temporary withdrawal of a large number of floaters from active markets onto liquidity provider balance sheets. Still, higher floating rates forced many tender option bond programs to unwind their trades for perhaps the final time, as investors now began demanding their money back in earnest.

The excess supply created by forced TOB selling in September to November, along with downgrades to the bond insurers, pushed municipal yields sharply higher, prices lower. Institutional buyers retreated from the public markets until the end of the year (although many large buyers were able to buy portfolios of highly discounted bonds in the evenings and weekends, muffling the implications of these very cheap trades on broader market pricing), causing credit spreads to widen dramatically. Spread widening and price declines hurt tax-exempt mutual fund net asset values, giving the appearance of undue credit risk to their investors and initiating perhaps the largest sequence of mutual fund investor outflows (and thus forced selling of related holdings by the funds) on record. And, as was well covered by the media, with fixed-rate yields having risen to extraordinary heights, *many state and local issuers chose to table the majority of their planned primary market loans*, waiting for conditions to improve. Indeed, smaller, lower-rated, and riskier credit issuers may have at least temporarily been unable to access capital at all, but large states and cities were always able to raise money; their decisions were based on price. MMA estimates that, in 2008, more than \$100Bn of planned new-money infrastructure projects were delayed, the majority of that occurring in the fourth quarter.

Persistent institutional demand has not yet returned to the municipal market, but since the start of 2009, municipal fund managers and brokerages have been highly successful attracting retail investment on the back of both flight-to-safety allocations (out of equities) and, more importantly, on speculation that the stimulus will ultimately drive up municipal bond prices. In fact, yields on the kind of bonds favored by retail investors touched two-decade lows in mid-January, although they have since begun to retreat again. Lower-rated, risky credit issuers (like hospitals) still face difficulty finding cost-effective market access and even highly rated state and local governments are commonly required to downsize new bond issues or risk pushing market yields higher.

SUMMARY OF REGULATION ISSUES

INTRODUCTION

The Municipal Securities Rule-making Board (MSRB) is a self-regulatory organization (SRO) and was formulated by Congressional statute in 1975. Please see the attached National Federation of Municipal Analysts White Paper “Federal Securities Law Relating to Municipal Securities,” for background and more detail.

During Thomas Doe’s tenure as a Board member from 2003 to 2005, there was rarely a Board meeting where the subject of derivatives was not discussed and the risks to the industry and investors were not addressed. However, the outdated statute limited the Board’s regulatory purview to municipal cash securities and to activities of dealers and dealer banks. Proactive action was inhibited for three reasons :1) it was exceptionally difficult, however well intended, for Board members representing security firms to advocate for change that would reduce the revenue of its firm; 2) the volunteer nature of the Board resulted in a consistent deferral of strategy, tactics and policy to staff; 3) the Chairman of the Board served only one year and dictated the Board’s focus, which, in our opinion, was to sustain the status quo and could again be heavily influence by staff. Since staff, especially the Executive Director, worked for the Board, it appeared to be exceptionally difficult for innovation and proactive regulation to occur.

To be fair, there is now new leadership of the MSRB’s staff. However, the negative characteristics of a: 1) short-tenured Chairman; 2) volunteer Board; and 3) the tremendous challenge to advocate for the investor or issuer interest, which could hurt an employer’s revenue stream, are still present. These conditions can be inhibitive toward regulation in the best interest of the consumer—both issuers and investors.

OPPORTUNITY

In 2009, led by the catalysts of curtailed institutional demand, limited issuer access to the capital markets and the allegations revolving around municipal finance practices in New Mexico, the MSRB has suggested a review of the Congressional regulatory statute created 34 years ago. Specifically the Board has suggested an expansion of entities to be regulated - swap advisors. The willingness of the Board to advocate change is applauded however, the action falls short.

NECESSARY CHANGE

More entities should not alone be regulated, but rather legislative language should be expanded to be inclusive of all practices and products in which financial institutions would be involved related to municipal finance. By regulating the products, all entities involved with municipal finance—from creation to distribution—would be governed by transparency and regulations, which would advance and define a context for transactions in the municipal industry for the protection of issuer, dealer and investor. Only in this manner can responsibility and integrity be promoted and transparency ensured. The byproduct of such attention to derivatives would accomplish the disclosure required by issuers to both inform investors and those who choose to provide capital to public entities.

ACTION ITEMS

1. End the MSRB as an SRO.

SUMMARY OF REGULATION ISSUES (CON'T)

2. Integrate the MSRB formally and directly into a larger entity, possibly the Securities Exchange Commission, Treasury or Federal Reserve.
3. Congress expand the regulatory purview of municipal regulation to include all participants in municipal finance and all financial tools involved in a municipal finance transaction - this would include derivatives and swaps in addition to the cash market. Along with dealers: advisors, ratings agencies, and evaluation services would be included in the new regulatory scheme.
4. Ensure that the regulatory statute was adaptable and flexible to allow regulation to be proactive and timely.
5. Include the municipal industry within an organization, where its regulatory framework, data and action can be more easily coordinated with larger markets. (Too often critical regulation may not have been enacted or suggested as the industry is small relative to equities and taxable fixed-income. One might argue that the vulnerability of the eclectic resources of the 65,000 municipal issuers/borrowers of the industry demands more vigilant protection because of the critical importance of the financings to essential services and projects for town, counties and states in the US.)
6. Mandate better regulatory coordination with its consumers - specifically issuers and investors - not simply the dealer community.
7. Demand greater financial forensics to mine the vast municipal transaction data created by the Real-Time Transaction Reporting System in order to better identify market behavior that can adversely impact (i.e. volatility) issuer pricing and investor evaluations. In addition, better data analysis can better define conditions of market liquidity to assist market participants in risk management strategies and investors to better use performance data measurements, specifically indices of price performance and returns. This report highlights significant areas where more robust data collection would have helped manage and avert systemic risks exposed in the credit crisis.

CONCLUSION

The municipal industry has evolved outside of a confined regulatory context that is outdated and biased, and been consistently challenged by the temptation to regulate in its self-interest. The evolution resulted in detrimental practices and products that have proved penal to investors, issuers and the financial institutions. The opportunity to broaden the current regulatory framework has presented itself and in acting to take steps to protect the public entities, which require access to capital for infrastructure, the new broad regulation of the municipal industry with specific attention to both derivatives and cash financial products will provide precedence for global regulatory reform of all derivatives.

The best news is that the MSRB's current major funding mechanism, fees from municipal transactions (more than \$20 million in 2008), provides a revenue stream to fund expansion and transition of the regulatory purview. In addition, the existing organizational infrastructure of the MSRB allows for experienced personnel, technology and data to be powerfully integrated in a revitalized context.

The municipal regulatory entity must be independent of those it regulates and integrated within a regular Federal entity where the industry can be included and coordinated with regulation of the larger markets.

DISCLOSURE AND INVESTOR PROTECTION

For a background on municipal disclosure, MMA here quotes from the National Federation of Municipal Analysts March 2008 “White Paper on Federal Securities Law Relating to Municipal Securities.” The full paper is attached at the end of this report.

The SEC promulgated Rule 15c2-12 (the “Rule” or “Rule 15c2-12”) in 1989 and amended the Rule in 1994 to include continuing disclosure requirements. ... Direct regulation of issuers would have required repeal of the Tower Amendments, so the Rule instead applies to municipal broker-dealers and generally applies to financings where the principal amount offered is \$1 million or greater. The Rule applies indirectly to issuers, effectively denying their access to the market unless the Rule’s requirements are satisfied. The Rule contains primary disclosure requirements and continuing disclosure requirements. With respect to continuing disclosure, the Rule prohibits the purchase and sale of municipal securities by an underwriter in a public offering unless the issuer or an “obligated person” undertakes to provide continuing disclosure. Continuing disclosure obligations include both periodic reporting of financial and operating information and disclosure of the occurrence of any of a specified list of 11 events, if material. The annual information is required to include audited financial statements when available and material financial information and operating data of the type included in the official statement for the securities. ... Independent of contractual undertakings made by issuers and conduit borrowers and continuing disclosure obligations under Rule 15c2-12, the SEC maintains that issuers of municipal securities and conduit borrowers have continuing disclosure responsibilities under Section 10(b) of the Exchange Act and Rule 10b-5. While issuers and conduit borrowers have no affirmative duty to disclose information (unless they are engaged in the offering, purchase or sale of securities or unless disclosure is required under a continuing disclosure undertaking), if an issuer or conduit borrower chooses to disclose information to the market it is prohibited from disclosing information that is materially untrue or misleading, or that contains a material omission, “in light of the circumstances” in which such information is disclosed. There are no other limits on the issuer’s or the conduit borrower’s disclosure.

We also reference DPC Data’s report, “The Consequences of Poor Disclosure Enforcement in the Municipal Securities Market” that provides more information on how disclosure is disseminated. Currently disclosure occurs through a regime of several repositories (Nationally Recognized Municipal Securities Information Repositories, or NRMSIRs), but, with recent change in law, a single repository will exist: the Municipal Securities Rulemaking Board. In MMA’s opinion, **the state of disclosure in the municipal sector should be regarded as poor**, and recent changes in the law are unlikely to make much difference here. Issuers, as detailed by DPC data’s important (and accurate) study on the topic, regularly fall out of compliance with stated disclosure requirements, undermining liquidity in selected bonds and hurting smaller investors (those without credit analysts trained to track down, or mitigate the impact of, absent financial and operating data) who buy bonds, in part, based on statements in the prospectus that regular information will be disclosed.

In MMA’s opinion, disclosure gaps occur because: 1) many issuer representatives are not capital markets professionals and lose track of their responsibilities, and 2) there is little penalty to be suffered by the industry for not policing compliance. A specific failing of SEC Rule 15c2-12 is its leaving the decision on whether an issuer is in disclosure compliance to the individual participants trading the issuer’s securities. In our experience, firms have generally ignored this requirement and continued to trade likely safe, but disclosure-gapped bonds, albeit at a slight discount. Further, we note a pattern of smaller issuers falling out of compliance almost immediately after a new offering, remaining out of compliance for several years until, just prior to another

DISCLOSURE AND INVESTOR PROTECTION (CON'T)

new primary market loan, the issuer will send its past due financial information to the information repositories.

Again, MMA believes **a solution to municipal disclosure problems is available.**

- 1) We believe Congress should require that the SEC act as arbiter to determine whether each issuer is in compliance with their stated disclosure requirements. This would be a very large undertaking, potentially requiring a large staff increase by the SEC. Should the SEC subsume the MSRB, the MSRB's funds could offset at least a portion of the cost.
- 2) Bonds found to be not in compliance would be flagged, and registered firms would be prohibited in trading in such until either the issue's original underwriter or any other investor can succeed in getting the issuer to remedy the gap. We are reluctant to advise that the SEC be able to compel disclosure directly from the issuers for fear of abridging state autonomy.
- 3) The SEC would keep a database to track, for every Cusip and borrower, the number and percent of days it has been out of compliance on all of its outstanding bond issues. This statistic would be vitally important for potential buyers evaluating new purchases of the borrower's securities.
- 4) Additionally, all firms trading municipal bonds, regardless of their status, would need to track how many trades, and the volume of par traded, that firm had made with disclosure-flagged municipals Cusips. Again, this could be very important data for investors evaluating with which firm to invest their money.
- 5) MMA also believes that all tax-relevant calculations and investigations should be included in required disclosure topics. These include how tax-exempt bond proceeds are being spent, on a weekly basis, the precise formula by which bond counsel determines that a bond issue is tax exempt, and the presence and status of any SEC investigations.

THE UNDISCLOSED RISKS OF BANK BONDS AND SWAPS

MMA's principal concern for the municipal sector in 2009 is that variable-rate related problems will set off a wave of downgrades and even defaults among risky sector credits (such as hospitals and private universities), creating incremental economic loss and threatening more investor aversion to municipal bonds generally. But the risks in variable-rate demand obligations are not exclusive to hospitals; many state and local governments also issued these securities and face very similar credit challenges.

VRDOs are long maturity bonds where the interest rate is periodically (weekly, daily, etc.) reset by a remarketing agent—usually a dealer bank—who also attempts to make proprietary markets in these securities among a universe of the firm's clients with a strong focus on tax-exempt money market funds. VRDOs also entail some form of liquidity support (structured via a letter of credit or standby purchase agreement) from a highly rated bank. In other words, a bank is contractually obligated to become the immediate buyer of last resort for a VRDO, giving money market funds confidence in the liquidity of a VRDO investment. MMA estimates that there are about \$500Bn of outstanding VRDOs at present; this number has likely increased from \$400Bn since the start of 2008 reflecting numerous post-collapse ARS restructurings into VRDOs.

Yet today's financial markets entail substantially more investor caution among banks and between credits generally, and large numbers of VRDOs have been rejected by the money funds because of their reliance on a damaged or downgraded liquidity provider (most notably DEPFA and Dexia) or connection to a downgraded bond insurer. In the absence of other investors or remarketing agents' inability to bring yet more bonds onto their own balance sheets, many of these rejected bonds have triggered their liquidity features, requiring the liquidity providers to buy these securities directly. Provider-purchased VRDOs are referred to as "bank bonds," which the liquidity providers hold as available for sale for a period of time (for example, 90 days), but then convert to accelerated maturity term loans between the liquidity provider and the issuer. It is unclear whether any municipal bank bonds have actually yet converted to term loans, but their acceleration of principal and penalty interest rate would reasonably require either an immediate restructuring or a default forbearance agreement between provider and issuer. Because there is little hope for market interest in Dexia or DEPFA to improve, at some point, issuer defaults may become public. MMA estimates, based on our polling of industry sources, that there have been as many as \$50Bn of rejected floaters, with perhaps \$50Bn more being kept away from liquidity providers through special — and thus potentially temporary — intervention by securities dealers. MMA believes that the amount of bank bonds has fallen in 2009, as issuers are actively restructuring their bank bond obligations, although we underscore that we are unaware of any information being collected by any regulator or data provider on this topic.

Interestingly, the rejection of many VRDOs by the money funds has worsened problems elsewhere in the municipal floating-rate markets. First, it has required liquidity providers to become more cautious in writing new policies, increasing the scarcity and cost of same for municipal issuers. Second, by removing large swathes of floaters from money fund "approved" lists, and noting: 1) the near complete absence of TOB-related lending by the money funds (see "Background" section above), and 2) large, fear-driven investor inflows into the money funds, has created a severe supply/demand imbalance. Approved and available securities are scarce and — because the funds' alternative is not investing their funds at all — are being bid up to extremely low yields (weekly interest rates have been close to, or well below 1% since November). Low benchmark floating rates, along with very strong demand for long-maturity LIBOR swap rates, an unwinding of arbitrageurs' interest rate hedges, and a dearth of new mu-

THE UNDISCLOSED RISKS OF BANK BONDS AND SWAPS (CON'T)

municipal issuer derivative activity, has pushed the related long-maturity municipal swap rates to very low levels. And **this movement in swap rates has greatly increased issuers' cost of terminating any outstanding swap**, complicating the restructuring of any distressed VRDO position. Further, higher issuer swap termination costs have produced substantial cash drains away from issuers via requirements that the issuers collateralize their potential termination liability to their counterparty. (Many issuers had purchased bond insurance AAAs to ward off credit- or rate-driven collateralization requirements. But with the insurers' losing their ratings, many issuers are no longer shielded, sometimes removing cash to the detriment of normal operations.) As not-for-profit hospitals have been particularly large users of this debt structure, and as these same hospitals also face lower private pay revenues and strained governmental reimbursements, defaults are likely in the near term. Because swap positions are only dimly disclosed, even sophisticated municipal investors remain largely without information on their own portfolios' related risks.

Once again, these municipal issuer exposures to systemic risks were accreted with little public disclosure or regulatory insight. Further, MMA is unaware of any municipal regulator or information provider systematically collecting information on the size and scope of this problem. This not only inhibits better projection of potential losses, but also prevents a more robust response from national regulators (e.g., Treasury, the Federal Reserve, the SEC) who are struggling to grasp the depth of the problem and coordinate their response with those in other asset classes. Solutions are well within Federal abilities. *MMA recommends* that Treasury extend subsidized loans to municipal issuers to terminate difficult swap positions, with the cost of those loans recouped by Treasury via a surcharge on all future issuer swap activity. This would allow issuers to restructure their obligations into fixed-rate bonds, relieving liquidity provider balance sheets of troubled exposures, and potentially encouraging future policy writing.

AUCTION RATE SECURITIES AND UNCHECKED SYSTEMIC RISKS

Auction-Rate Securities (“ARS”) are long maturity bonds where the interest rate is periodically reset by auction among potential investors, or failing that, set manually by a bank pursuant to an index or (typically very high) fixed rate. Because they are valued at par, ARS were typically purchased by individual investors as a higher-yielding alternative to cash deposits. However, higher yields reflected the fact that an ARS holder cannot sell their bond without an identified buyer: a sharp distinction from other “cash like” instruments that required dealer banks to periodically step in as a buyer to prevent auctions from failing. In part because of this reliance on bank intervention, ARS programs were (and still are) set up as proprietary trading exchanges by individual dealers, inhibiting the easy flow of capital and information from program to program.

The implications of the ARS structure, in the context of the municipal industry’s systemic exposure to the bond insurers and the financial counterparties were little understood by issuers, investors, or the dealer banks themselves prior to 2007. It was the collapse of the bond insurers in 2007 that undermined investor confidence in ARS issuers and precipitated vast selling. (Remember that individual investors had long been sold on the AAA virtues of bond insurance; this myth was not so easy to dispel when bond insurer downgrades began). Banks were initially able to use their own cash to buy back securities, but in January 2008, bank risk tolerances prevented further purchases, and ARS auctions began to fail. Thus, current holders were left without a means to get out of their positions, and issuers were forced to pay sometimes highly punitive fixed interest rates. Since that time, MMA estimates that about two-thirds of ARS issuers have restructured or refinanced their securities, although many remain unable to do so as: 1) refinances with liquidity-supported floating-rate debt require the purchase of a liquidity policy from a highly rated bank — these policies have become both scarce and expensive as U.S. banks have reduced lending; and 2) refinances with fixed-rate debt are prevented not only by the high fixed rates many lower-rated issuers must now pay, but also the sometimes staggering cost of terminating the interest rate swap most municipal issuers have connected to their bond sales (please see bank bonds section, above).

Thus, many investors still remain stuck with highly illiquid securities that are paying well-below-market, index-linked interest rates. At issue is an unwillingness to allow ARS to trade at a discount to entice potential buyers, because of the increase in potential liability and because sub-par pricing of these holdings could result in additional waves of mark-to-market losses for the already stressed banks. Although private trading venues have emerged to provide emergency assistance to distressed clients needing to liquidate their holdings at any price, we are unaware of any broker dealer making sub-par markets in any ARS. On the other hand, several of the large banks have, on the intervention of state securities regulators, settled with their individual and small institutional investors, in effect buying ARS securities back at par. Indeed, the largest current holders of ARS are likely the dealer firms themselves that are still carrying their swollen inventories from 2008 and now the bonds purchased via settlement.

ARS shows another breakdown in the municipal regulatory framework. While there are initiatives to improve ARS price discovery, no market participant (including investors, dealer banks, nor the regulators themselves) knows precisely how many ARS are outstanding (MMA’s estimate was about \$200Bn municipal ARS at the market’s peak), how many bonds were being placed through each dealer program, how many ARS issuers were reliant on bond insurance for their marketing to investors, the extent and means by which these issuers were leveraging counterparty credit through interest rate derivatives, and how much dealer support was being directly extended to the market. The implications for systemic risk management, as now being discovered in the credit crisis, are clear in these questions, which can (and should) be extended to the still healthy, but periodically threatened, municipal VRDO market.

MUNICIPAL BOND RATINGS AND BOND INSURANCE

Most municipal bonds are rated on a different, more conservative rating scale than corporate bonds. Moody's and Standard & Poor's have shown that triple-A U.S. corporate bonds have up to 10 times the historical default rate of single-A municipals. In MMA's opinion, neither municipal issuers, nor the individual investors who own the large majority of outstanding paper or fund shares, understands this point. But instead of requiring more accurate ratings, the municipal industry (i.e., issuers, investors, and underwriters) has instead chosen to make bonds appear safer and more similar through bond insurance (the insurers are rated along the more generous corporate rating scale; much of the bond insurance model distills to simple arbitrage between the two rating scales). At its peak, the municipal bond insurance industry entailed just nine companies whose ratings were applied to more than 50% of annual municipal bond sales. And this invited massive systemic exposure into the municipal industry as the bond insurers carried in the risk of subprime mortgage-backed securities, the insurers' and the financial sectors' leverage of ratings on securitized debt, and failed rating agency models.

Attached, please find our January 2008 report, "MMA on Corporate Equivalent Ratings," and our April 2008 report, "Second Research Note on Moody's," for more detail on the problem with how municipal bonds have been rated. In the last year, both Moody's and Fitch ratings strongly considered reforming their muni rating processes, but both have tabled these initiatives because of the recession. Standard and Poor's continues to deny the existence of separate rating scales for municipals and corporate bonds, but that agency has embarked on a plan of sweeping upgrades to selected municipal sectors. Finally, the U.S. House of Representatives considered the "Municipal Bond Ratings Fairness Act of 2008," which MMA believes would, for little cost to taxpayers, successfully remediate much of the rating problem in our sector. We strongly recommend that Congress adopt this legislation in its current form. MMA has been a leader on the topic of ratings and the municipal sector's use of bond insurance; we welcome any opportunities to continue to educate Congress and its agents on these topics.

PRICING AND EVALUATION ISSUES

The events of the past 18 months have amplified the risks and challenges associated with illiquidity and limited price discovery for municipal bond investors and issuers.

The municipal bond industry has been challenged with a troublesome irony. While municipal bonds have favorable low historical default risks, the securities can be illiquid. How can a safe investment not have liquidity? Inconsistency of primary market pricing, the eclectic composition and multitude of issuing entities, the penal and overly granular ratings scale, reduced number of liquidity providers, the diminished number of AAA bond insurers and the inability to manage interest rate and credit risk have contributed to the challenges for the markets transactions to provide evaluation services with sufficient price discovery. The result is that evaluations that represent the price that investors receive on their investment firm statements or the prices that comprise the net asset value of a mutual fund share may bear little resemblance to an execution price should an investor choose to buy or sell. In addition, the periodic illiquid market conditions and limited price can result in sharp volatility that can be misinterpreted as credit or default risk, either of which may not be valid. In this manner the data can misinform an investor and potentially prompt emotional and inappropriate investment decisions. These same characteristics can also increase the difficulty for municipal issuers to assess market conditions and accurately predict market demand to give context for the pricing of their primary market deal.

An aggressive, investigative and knowledgeable regulator with access to all transactions and who conducted each transaction, can assist consumers — both the investor and borrower — with providing a context to ensure that the data is relied upon by consumers inspires confidence and provides an objective context in which investors and issuers can make decisions from the prices of their securities.

SCHEDULE OF ADDITIONAL ATTACHMENTS

MMA has attached the following documents, under separate Acrobat file, in support of the arguments made herein.

- ◆ NFMA White Paper “Federal Securities Law Relating to Municipal Securities” March 2008
- ◆ DPC Data “The Consequences of Poor Disclosure Enforcement in The Municipal Securities Market” January 2009
- ◆ Municipal Market Advisors “Corporate Ratings for Munis” January 2008
- ◆ Municipal Market Advisors “Second Research Note on Moody’s” April 2008