MUNICIPAL BOND TURMOIL: IMPACT ON CITIES, TOWNS, AND STATES

HEARING

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MUNICIPAL BOND TURMOIL: IMPACT ON CITIES, TOWNS, AND STATES

Wednesday, March 12, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Watt, Sherman, Moore of Kansas, Capuano, McCarthy of New York, Lynch, Scott, Green, Cleaver, Moore of Wisconsin, Perlmutter; Bachus, Royce, Shays, Feeney, Hensarling, and Campbell.

The CHAIRMAN. The Committee on Financial Services will come to order.

I am pleased to see that the representative of the Securities and Exchange Commission passed security. I don't know about your exchanges, but you're okay on security.

And this is as important a hearing as we are going to have.

Earlier this year, when we began to talk about a stimulus package, there was a lot of pressure on Speaker Pelosi, who had been one of the leaders in the recognition of the need for a stimulus, to get into infrastructure, and it's a very widely supported goal among Members of both parties, especially many Democrats.

The speaker quite courageously, and I think thoughtfully, said no, we're going to do something that can be spent quickly and infrastructure doesn't meet that, but she gave her commitment that we would be working on improving infrastructure financing, because there is an admitted need in this country for bridges and highways and schools and sewer facilities, etc., all of which have to be paid for by the public sector.

Today, we are here playing defense because due to grievous misjudgments made by elements in the private sector, the public sector in this country now faces unfair excessive costs as they try to meet those infrastructure needs.

We are all, in America, capitalists today. We understand the value of the free market system. People on this committee understand the importance of the financial system as intermediaries in our system.

But those who have argued that the private sector should be left essentially alone, and that public sector intervention would do more harm than good, have nowhere been more decisively refuted than in the situation in which the municipalities and the States find themselves.

In yesterday's Washington Post, and I ask unanimous consent to put this into the record, Alan Sloane notes that he discovered to his surprise that a tax exempt money market mutual fund is now paying a higher absolute rate than a Treasury fund, even though the one paying the higher rate is taxable and the Treasury fund is tax exempt.

Here is the situation: Municipalities have been unfairly treated by the private sector for some time. I will be giving out this chart, "Sectoral Breakdown of Moody's Rated Issuers and Defaulters: 1970 to 2000." Under "General Obligation," there it is. Number of Issuers: 14,775. Number of Defaults: 0. Despite that, there has been pressure on issuers to buy insurance.

Now, to begin, the insurance for full faith and credit general obligation bonds has been unnecessary.

Requiring general obligation issuers of full faith and credit bonds, where the taxing power of the entity stands behind them, requiring them to buy insurance is, as I said yesterday—it occurred to me, and I was fond of it, so I will say it again—like asking a vampire to buy life insurance, because nobody is going to ever have to pay off.

The problem is that in this situation, the bloodsucking seemed to have gone in the opposite direction, because the vital substance of these municipalities has been sucked away, and what happened?

Mr. Callen from Ambac had an interview in the Wall Street Journal, and he said, well, the premiums paid by the municipalities were golden. They were AAA and better sources of revenue, but it was kind of slow growth.

So what some of these insurance companies did was, they took the insurance premiums from issuers that shouldn't have had to pay premiums in the first place, and invested them in sophisticated instruments, and did it badly, and as Mr. Callen said, when we got into CDO squared, we were a little beyond what we understood.

What happened? These private investments went bad. And who is paying the price? Among others, the municipalities.

It is an odd situation in which issuers are now being charged higher interest because they are hurt by their insurers. They are better propositions than their insurers.

We have had problems with rating agencies. There have been two scales. Rating agencies have had a separate scale for municipalities than for corporates.

Why? Because if you rated municipalities, and again, I'm talking particularly about general obligations, although you can see it's a pretty good ratio with some of others as well, if you rated municipals the same way you rated corporates, it would be boring, because everybody would get super duper triple A. And how do you make a business out of saying everything is perfect? So they get subjected to this separate rating system.

This is not a minor technical matter. The cost of schools and highways and sewer treatment facilities and bridges and a number of other important facilities now costs the public more.

There are areas where we have made mistakes in the public sector. This is an area where the private sector, left to its own, has made the great bulk of mistakes and the public sector is paying the price.

So I want to send a message very clearly from myself as well as, I believe, the majority of this committee, and I have also had some bipartisan conversations on this. This has to be fixed.

We cannot tolerate a situation in which elected officials trying to build schools and comply with mandates from the Federal Government to improve the treatment of sewage, to build highways, and to do other important things are charged much more than they should be charged, partly because of an initial undervaluing of their credit, and then compounded, adding injury to injury, by the fact that people took their premiums, and since they never had to pay any of those claims, had all the money to go invest, invested it badly, and inflicted damage on the public sector.

I have to say, I mean, I am not one of those who invokes religion in the public sector. People are free to do that, but it is not something that I generally do. But for me, it is the time of year when we celebrate the exodus from Egypt, and I have to say now as an elected official who is a partner in governance with the cities and States, I want to say to the private sector that has enmeshed them in this set of circumstances in which they're being unfairly penalized when they sell bonds, "Let my people go." This is a time to cut them loose. And if we have to part the "red ink sea," we will do that.

But I do not think we can tolerate, as a society, this situation where people are being required to pay so much.

Now, this has not been a traditional Federal role. Insurance has been State regulated. That is why we have one Federal regulator here and two very able State regulators. But that is not going to continue. I think the Federal Government has to be a partner with regulators such as we have here who have been stepping forward.

And we intend to listen today, but I am submitting an invitation now: Give us solutions to this. We are determined, I believe the majority of this committee, and I think the whole Congress, to deal with this.

Let me make one other statement, now. It's a personal statement. But we spent a lot of time on the ethics rules yesterday, and it was very controversial.

I will say this. I intend fully to comply with the ethics rules, so let me take this occasion to tell everybody, no, I'm sorry, I can't have dinner with you and we can't have breakfast, and if you see me sitting there, you have to leave me alone to read the paper and not buy me a cup of coffee, and that's the new ethics rules, and I can live with them.

But I plan today to buy some municipal bonds from the State of Massachusetts. I wish they weren't being forced to pay such a high rate, given that they are for me double tax exempt, but given that they are, me as well as anybody else ought to buy them, and I really say that, my advice to people, I don't usually do this, you get a great buy in municipal bonds right now.

I didn't want to say this before the hearing. I don't want to be accused of sort of influencing, you know, and buying beforehand.

But this is an intolerable situation. Some things are more complex than others. This one is clearcut.

We have to have a situation in which those numbers—I'm told there has been since 2000 one default in a general obligation. It was a default where they were not in full compliance with the covenants, and in fact nobody lost any money, everybody got paid off. So we have to restore some rationality here.

And this is one where the market has got it wrong. The market is a wonderful instrument, and it creates a lot of wealth, but it's not a perfect instrument, and this is a case where if this doesn't get corrected, we will have to intervene.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. I appreciate you holding today's hearing on the ongoing turmoil in the bond markets and the problems that cities and counties are facing in trying to issue, refinance, and price their municipal debt.

This is the committee's first hearing on the $2.6 trillion municipal securities market. We did have a hearing on bond insurers, at which time Mr. Dinallo testified, and I'd like to acknowledge at this time both the difficult and important work that you're doing with the monoline bond insurers in preserving liquidity, which is very important to our municipal bond market, as we all know.

Our hearing unfortunately comes at a time when that market, which I think the chairman, by his chart showed, has traditionally been known for its safety, security, and rate of return, presently is under severe stress.

Constituents in my congressional district are being particularly hard hit by the crisis. In my home county of Jefferson County, Alabama, the breakdown of the secondary bond markets has forced the county's interest rate payments on local sewer bonds to skyrocket from 3 to 10 percent, a more than triple increase.

Most of these are revenue bonds, and these higher costs will ultimately have to come out of the pockets of the users, the water and sewer system there, or there will have to be a reduction of services, or, as I said higher fees.

We need to act swiftly and responsibly to determine whether there's anything we can do as a Congress to get these markets on track before too much more damage is done, although at the same time, I'm not sure what that will be, other than perhaps the SEC's proposal.

I would respond to the chairman that I'm not as convinced as he is about not having a need for bond insurance.

I could see that, on occasions when you have an entity like maybe the port authority or you had a well-known entity, a State, but when you are dealing with particularly local governments or water boards that investors know nothing about, I would think that the insurance would almost be necessary to market the bonds.

Local governments across the country are facing a hostile environment in which to raise funds, with new issues plummeting and many municipalities forced to pay significantly higher interest rates to attract investors.

The downgrading of bond insurers and the constriction of the credit markets as results of the subprime mortgage problems have forced banks and hedge funds to dramatically reduce their municipal debt risk exposure.

I think this reduction of risk we're seeing in our economy, of people not willing to take as much risk, is probably a good thing. There has been too much risk in the past, and people are repricing that risk, and I don't think there's anything unnatural about that.

The extent of its impact on the municipal bond market, the municipal securities market, is however a problem, which I am still hopeful may be transitory.

As the economy picks up and liquidity improves, I think we'll see a lot of improvements in this regard, although I'm not sure we'll ever see the auction rate securities come back.

But the resulting collapse of the secondary bond markets has further impaired the ability of local governments to manage their debt exposure, and this is a serious problem.

Until the recent crisis, the secondary bond markets had ample liquidity, but auctions have been failing since the end of last year as the investment markets pulled back.

On March the 5th, Bloomberg reported 536 unsuccessful auctions in the market for floating rate securities. That is a failure rate of 68 percent of all auctions.

According to Bank of America, the rate of failures reached 87 percent on February the 14th, and has since ranged from 61 to 69 percent. These are sobering statistics.

Fortunately, this committee does have possible solutions available to better protect both local governments and investors.

SEC Chairman Cox presented a vision last year for increasing integrity, transparency, and accountability in the municipal securities market. Chairman Cox's initiative would require meaningful public disclosures that are current and understandable with a full accounting of all material information at the time of a new municipal bond issuance.

Chairman Frank has agreed, at my urging, to invite Chairman Cox to appear before the committee later this year to formally consider his proposal.

In addition to considering Chairman Cox's proposal for greater disclosure and transparency, the committee will also need to examine the dual credit rating scale used by the rating agencies that appears to arbitrarily assign municipalities a higher risk rating than other debt issuers.

This creation of risk perception has forced many municipalities to purchase insurance that, as the chairman said, may not have been otherwise necessary.

More business is created for the rating agencies who analyze the bond insurers' offerings, but it's the local taxpayers who end up paying the increased cost.

Not surprisingly, it has been the non-municipal debt that rating agencies severely under-assessed for risk, with investors in secondary markets absorbing huge losses as the result of a fundamentally flawed system of risk analysis.

In conclusion, Mr. Chairman, the municipal bond markets, as you said, finance the development of roads, bridges, sewer and water systems, hospitals, universities, and other critical infrastructure upon which local residents rely.

Efficient and liquid municipal finance markets are critical to keeping our economy moving forward and must be restored to working order as promptly as possible.

Thank you.

The CHAIRMAN. We have a vote; I believe it is to table the notion of requesting a privilege. But I think we can get some more opening statements in, and it usually takes about 20 minutes. So I apologize, but I think that will be the only vote for a while.

The gentlewoman from California, the chairwoman of the Housing Subcommittee.

Ms. WATERS. Thank you very much, Mr. Chairman.

The need to hold this hearing reflects the growing impact of the subprime and home mortgage loan market crises across the domestic and global economy.

Hedge funds, along with large commercial and investment banks, continue to take hits to their balance sheets as a result of their substantial investments in mortgage-backed securities of uncertain or clearly declining value.

As a result, they have been flooding the market with bonds in a rush to sell assets. This has had a dual effect.

First, demand for bonds has dropped over the past few weeks, putting upward pressure on yields and the cost of borrowing for bond issuers such as municipalities.

Second, it has meant that large commercial and investment banks have not been willing to step into their traditional role as a backstop in the municipal auction rate securities market when these auctions have begun to fail.

This has, of course, had disastrous results for municipal bond insurers, which have seen their costs of borrowing skyrocket.

Simultaneously, the municipal bond market has been operating under the spectre that one of the bond insurance agencies could face a ratings downgrade.

Currently, many municipal bond issuers purchase bond insurance primarily to take advantage of the higher rating the insurance confers on their bonds, even though the risk of default, even on municipal bonds rated below AAA, is statistically insignificant.

Without access to bond insurance or revisions to the municipal bond, we need a way out of this bind if the absolutely essential $2.6 trillion tax exempt municipal bond market is to return to smooth functioning.

I look forward to hearing from today's witnesses, including my former colleague, now the treasurer of the State of California, Mr. Bill Lockyer, about potential solutions to this dilemma.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from Alabama has a unanimous consent request.

Mr. BACHUS. Thank you, Mr. Chairman. I ask unanimous consent to submit for the record a statement from the Municipal Securities Rulemaking Board.

The CHAIRMAN. Without objection, it is so ordered.

The gentleman from California, Mr. Campbell, is now recognized.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I agree with many of the comments the chairman made in opening this hearing, but I think there's another factor at work here, which I hope we, in all three panels today, will discuss, and I hope the chairman would consider, as well.

Clearly, the risk premiums that exist now on municipal bonds, and I have personally taken some of the same actions in my home State of California that the chairman just described in his of Massachusetts, that risk premium appears to be unjustified at the moment.

But I do believe that there are risks out there which we can't tell what they are, and that's part of what is driving this.

In my home State, there have been several bankruptcies of governmental units, including my home county of Orange, in the last couple of decades, and there is at least one city municipal bankruptcy being threatened in California today.

And these bankruptcies and these fiscal problems usually occur from one of two things. Either they take their investment funds and invest them in risky investments which then don't turn out, and the municipality or civic organization loses money, or, and this is the great threat, I think, going forward, there is substantial, in many cases, unrecorded and unfunded liabilities largely for pension and health care and other union obligations, which are out there, which appear to be completely unsustainable, but they're not shown on the books.

So I'm a CPA, and this kind of stuff, as you can imagine, drives me nuts, and so one of the things I think we need to look at in this whole process is transparency, so that investors and potential bond insurers can see what is really going on in that municipality.

If there are substantial pension obligations, they first of all shouldn't be unrecorded, and they probably shouldn't be unfunded, but they absolutely should be disclosed and discussed and put in as part of the risk factor.

And my concern is that we do have potential failings of municipalities down the road if we don't start exposing and dealing with all these things now.

And so I do think that that is a part of the equation that I hope this panel and the subsequent panels will discuss and that we will have a part of the conversation, Mr. Chairman.

The CHAIRMAN. Thank you.

We have 5 minutes left, so we are going to break and vote. When we come back, we will have an opening statement from the former mayor of the city of Somerville, my colleague from Massachusetts, Mr. Capuano, and then we will get to the witnesses.

[Recess]

The CHAIRMAN. Please be seated. We want to move as quickly as we can.

Please be seated.

We will resume, and we will now turn to the gentleman from Connecticut for 3 minutes for an opening statement.

Mr. SHAYS. Thank you very much, Mr. Chairman.

I want to align myself with the basic thrust of your comments. I might take off a little of the rough edges, because you're pretty emphatic about it. But I do buy into your comments.

And I do want to say, in particular, I want to welcome the attorney general from Connecticut, Richard Blumenthal. I read his entire statement, and I agree with it almost in its entirety. I commend it to all the members to read.

And I just, I am ending up, for me, what I wrestle with is why shouldn't—why not just have the Federal Government insure municipalities?

Because in the end, it's really going to be the same taxpayers, and it does seems to me, however, small the fee is, the premium is, it seems like a premium that one should not have to pay, number one.

And number two, given that the insurance companies are the ones that have gotten themselves in trouble, it seems unfair to, basically, the taxpayers, that they have to pay the penalty.

I almost feel like municipalities should insure insurance companies, rather than insurance companies insure municipalities.

I thank you for the time, and I welcome all our witnesses, but particularly my colleague from Connecticut.

The CHAIRMAN. Thank you. And from time to time, we in Massachusetts are glad we have our suburban neighbors to clean up our act a little bit. As long as we're in general agreement, it's okay.

The former mayor of the city of Somerville, the gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Chairman, I want to start my remarks by stating right from the outset that I do not enter this issue as a neutral observer. I am a former mayor. I am not neutral on this issue. I have very strong opinions. And I think what I'm about to say is on behalf of every single mayor and governor and government official who currently serves and doesn't have the freedom to say what I'm about to say.

The monolines started to back up some questionable municipalities. They're no longer monolines. They're now bond insurers. And they really use the municipal and State bonds to shore up their other risky investments. They're completely upside down.

But I don't want to blame them alone. They're in business to make money. They can't do it alone.

Even though the State municipal bonds are the safest investments in bonds you can make, they need the help of the credit rating agencies to basically hold hostage cities and towns and States across this country until they pay them a ransom.

Now, they call those ransoms nice little things, like fees or bond enhancements, but it's still a ransom: "Until you pay us, we're not going to rate you in the way you deserve, the way your taxpayers deserve, and when we do, we're still going to shake you down, because we're going to make you get bond insurance that you don't need."

To me, as I've said before, and I will continue to say, this is nothing more than legalized extortion.

But even they didn't do it alone. They had the help, or the acquiescence, if not the active help, the benign neglect of most Federal regulators, and many State regulators. They sat by and said, "Well, what's the big deal?"

This fell particularly heavily on poorer cities and towns who didn't have the negotiating power of some of the larger bond issuers.

The rating agencies, the bond insurers, and those compliant regulators effectively, in my opinion, stole billions, if not trillions of taxpayers' dollars to put in their pocket.

When people in my position, my former position, were not able to hire police, firemen, teachers, or sanitation workers, or to improve their cities and towns, we had to pay them their ransom, their extortion. And I will tell you that, unfortunately, I'm not—there are mixed emotions.

I'm not happy we're here today, because my friends who are still at the city and town level are still being held hostage and are being hurt even more today because of the neglect and the malfeasance and misfeasance of people who have been doing this for years.

I can't tell you how much I will do to do my utmost to make this legalized extortion stop, to give the cities and towns and States their due, to let their taxpayers have their money back, and to stop this stealing from people whose money you don't deserve to have.

Mr. Chairman, I yield back whatever time I might have, unless you want to give me another 5 minutes.

The CHAIRMAN. No, because it's going to take 3 minutes for Mr. Shays comment on you now. But that's fine.

Mr. SHAYS. I would align myself with my colleague—[off microphone]—rough edges.

[Laughter]

Mr. CAPUANO. Mr. Chairman, without the rough edges, they don't hear it.

The CHAIRMAN. And you wouldn't be yourself.

[Laughter]

The CHAIRMAN. The gentleman from Pennsylvania, the chairman of the Subcommittee on Financial Institutions, who has been taking the lead for us in dealing with some of the related issues here, such as the rating agencies, and who had a related hearing on this, Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

Mr. Chairman, I want to congratulate you for convening this hearing of the full committee on this important subject, because certainly it is a major part of what I think is a crisis of confidence in the credit markets of not only the United States, but indeed, the world.

We must recognize the seriousness of the problem and the need for fast, pragmatic solutions. Even though some of these solutions will not always work, they must be tried, because the failure to try and the failure to stem the whirlpool that is occurring out there in the credit world could be catastrophic for the American economy and the world economy.

I think it is so important in the bond insurance market to see the ramifications of what can happen when there is a disqualifier of losing a certain rating that is necessary and required of trustees of various funds who are purchasers of municipal bonds, that it can destabilize. Although a very small part of the premium world of insurance, the municipal bond market is a $2.6 trillion market, and it could be tremendously destabilized by the credit crunch that is prevailing today.

But I may say, it does not only apply to the municipal bond market. It applies to the student loan bond market. It is now starting to spread into so many other fields. So we have a metastasizing that is occurring in the credit markets of the world.

So this committee has the chief jurisdiction to put the effort forward to make the stops, and for that, I am pleased to see that we are going to have the treasurer of the Commonwealth of Pennsylvania, Robin Wiessmann, as one of our witnesses. I look forward to her testimony.

And I look forward to what we are going to turn out here as a product, eventually.

I ask, Mr. Chairman, that two letters, one to the Ways and Means Committee and the second letter from the Governor of Finance Officers Association, the National League of Cities, and the National Association of State Treasurers, the National Association of State Auditors, Comptrollers, and Treasurers, the National Association of Counties, and the U.S. Conference of Mayors be submitted and entered in the record with suggestions of some of the things that can be done.

Thank you, Mr. Chairman.

The CHAIRMAN. Without objection.

And with the consent of the committee, I'm going to go to one more speaker, because we have another former mayor of one of our large cities, and we did want to get his input, the gentleman from Missouri, Mr. Cleaver, and then we'll go to our witnesses.

Mr. CLEAVER. Thank you, Mr. Chairman.

I want to associate myself with the statements of Mayor Capuano, both in tone and content.

I served as the mayor of the largest city in the State of Missouri, and in the State of Missouri, State law prohibits any city or municipality from spending into the red, which means that every city in the State, at the end of its fiscal year, is debt free with regard to overspending. There's no deficit spending.

And so we don't have either a debt, other than the bonds that we are paying on, but we have no debt, and no deficit.

And in spite of that, we end up getting the roughest treatment from the bond insurance companies, and yes, the roughest treatment comes to the cities, even if they have the highest rating possible.

We can't get a AAA bond rating in Kansas City, Missouri, in spite of the fact that we have AAA status.

Now, the State can get it, the State of Missouri can get it, but the municipalities—neither St. Louis nor Kansas City can get it, and we don't have any deficit spending.

Wilbur Ross, the billionaire, just bought $1 billion in municipal bonds. This is not some stupid guy playing the stock market. He knows what he's doing.

And if we can invest in municipal bonds $1 billion, and then have J.P. Morgan and Chase Company and Lehman Brothers recommend that debt, it seems to me that it's safe.

We have had one little piece of a default in almost 4 decades, 4 decades, and then we still get ripped off.

And so I'm here today—and I'm not going to leave—because I want to hear every single word that comes out of your mouths with regard to what is happening to cities, because I want to be able to translate this, not only to my home of Kansas City, but to the U.S.

Conference of Mayors and the National Conference of Black Mayors, with whom I used to be affiliated.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

I would point out that there are some seats there. I know they say "staff," but if staff comes, you can get up. If people want to sit, they should sit.

We will now go to the witnesses, and we will begin, and as I said, this is an area—we have to vote, but we'll get in one statement, and I think that we'll be okay after this for a while.

Historically, this has been State regulated, but there is a Federal role, as well. So we will begin with Erik Sirri, the Director of the Division of Trading and Markets of the SEC. He is a regular witness, and we appreciate, Mr. Sirri, your continued cooperation with us.

Please go ahead.

STATEMENT OF ERIK R. SIRRI, DIRECTOR, DIVISION OF TRADING AND MARKETS, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. SIRRI. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for inviting me here to testify on behalf of the Securities and Exchange Commission about the current turmoil in the municipal bond markets, its impact on cities, towns, and States, and the Commission's responses.

There's no question that the recent dislocations in the muni bond market have created unanticipated hardships for municipal issuers, and in some cases, have dramatically increased borrowing costs.

Today, I'd like to discuss some of the current problems in the bond markets, with particular attention to problems that have developed in the market for certain short-term municipal securities known as auction rate securities.

Auction rate securities are municipal bonds, preferred stocks, and other instruments with interest rates or dividend yields that are periodically reset through auctions, typically every 7 to 35 days.

Auction rate bonds are usually issued with maturities of 30 years, but maturities can range from 5 years to perpetuity.

Auction rate securities were first developed in 1984, and the market has grown to over $325 billion of securities, with State and local governments accounting for about $160 billion of the outstanding auction rate debt.

As you know, hundreds of auctions for auction rate securities issued by municipal issuers recently have failed to obtain sufficient bids to establish a clearing rate.

Consequently, issuers who decided to use this type of financing to obtain favorable short-term interest rates are instead paying what are known as "penalty" interest rates, which can be as high as 20 percent, at least until the next auction. In addition, investors cannot sell their holdings through the auction process until the next successful auction.

The Commission has received many requests to address this market dislocation from municipal issuers, conduit borrowers, dealers, and investors.

For a variety of reasons, including the current lack of dealer support for auctions and frequent auction failures, many holders of auction rate securities now want to sell them. Recent downgrades of bond insurers have caused many holders to desire to sell bonds insured by companies who recently have been downgraded or soon may be.

In addition, many holders of bonds insured or supported by the credit of insurers whose ratings have not been threatened may now also wish to sell, which may be due to a general loss of confidence in the muni auction rate market.

As a result of these factors, among others, we understand that sellers of muni auction rate securities have often far exceeded buyers in auctions, resulting in auction failures.

Estimates of the value of recent failures for auctions of muni auction rate securities exceed $80 billion.

Prior to the current disruption in the auction rate market, participating dealers retained to solicit bids for the auctions generally supported the liquidity of the auction rate securities by placing proprietary bids as necessary in order that the auctions not "fail," and disclosed the fact that they might do so.

However, in recent weeks, for a variety of reasons, including liquidity concerns and uncertainty surrounding the monoline insurers, participating dealers have ceased to intervene proprietarily in auctions, with the result that hundreds of auctions have failed.

Due to these failures, and the resulting higher borrowing costs, we understand that some muni issuers and conduit borrowers would like to, and in many cases have begun the process to convert their auction rate bonds into variable rate bonds backed by letters of credit or other type of credit enhancement or fixed rate bonds.

However, the ability to convert auction rate securities may be slowed due to heavy demand for such substitute instruments and further overall concerns about the credit markets.

We also understand that certain participating dealers may be unwilling to accept bids from issuers in an auction because of questions about the scope of a settlement in a past enforcement action.

The Commission has received several requests to consider ways to assist issuers with an orderly exit from current market conditions.

On February 28th, the leadership of this committee asked the Commission to clarify for the market as quickly as possible that issuers can, within the bounds of applicable laws and regulation, participate in auctions for their own securities. The staff is developing approaches to providing further guidance in this area in light of market developments and the settlement.

Due to the severity and immediacy of the auction rate market decline, and the implication for investors, Commission staff is developing appropriate guidance to facilitate orderly markets and continue to protect investors.

This guidance would be designed to clarify that, with appropriate disclosures and compliance with certain other conditions, municipal issuers can provide liquidity to investors that want to sell their auction rate securities without triggering market manipulation concerns.

This may also have the secondary effect of easing the substantial financial burden on muni issuers and conduit borrowers from unusually high interest rates.

It should also facilitate an orderly exit from this market by municipal issuers and conduit borrowers who seek to do so.

We hope to have such relief prepared by the end of this week.

The CHAIRMAN. Mr. Sirri, I'm going to interrupt, just because this is a very important subject.

When you use the phrase "municipal" there, is that in the broadest sense of the other tax exempts, as well?

Mr. SIRRI. Yes.

The CHAIRMAN. Thank you.

Mr. SIRRI. Enhanced transparency would be a key component of this guidance, as it is to the auction process.

For example, if municipal issuers or conduit borrowers want to bid in auctions, they must disclose, among other things, certain facts related to price and to quantity.

Of course, issuers have to comply with their disclosure obligations under the Securities Act of 1933 and the Securities Exchange Act of 1934, as applicable.

Staff anticipates that this guidance should remove any hesitancy on the part of broker-dealers and auction agents to allow municipal issuers to bid at auction.

Of course, this guidance cannot modify the terms of contracts between buyers and sellers or contracts between issuers and bondholders, and so municipal issuer bidding could only take place if consistent with the terms of the auction rate securities as reflected in their respective indentures and governing instruments.

The guidance does not address the amendment of the terms of any auction rate securities in accordance with their governing instruments.

I also should note that the Commission staff is closely monitoring the potential effects of the developments in the muni auction rate securities markets on mutual funds, including money market funds, and on closed-end funds.

Tax-exempt money market funds, with $465 billion under management, are key investors in muni securities and part of the $3.3 trillion money market industry. Money market funds typically have as their investment objective the generation of income and the preservation of capital.

To help meet this objective, they are required by Rule 2a-7 under the Investment Company Act of 1940 to limit securities in which they invest to high-grade, short-term instruments that the funds' advisers determine also involve minimal credit risks.

As part of this rule, Rule 2a-7 employs NRSRO ratings to determine whether funds may purchase a security.

As much as 30 percent of the muni securities currently held by tax-exempt money market funds are supported by bond insurance issued by monoline insurance companies. Some of the securities may be eligible for investment by money market funds because of the insurance that monoline insurers provide.

Given the importance of money market funds as investors in muni securities, some have raised questions regarding the effect of credit rating conditions in Rule 2a-7 on the funds' ability to purchase and hold muni securities affected by downgrades of monoline insurers.

The Commission staff recognizes that a significant downgrade in a monoline insurer's rating could result in the securities becoming ineligible under Rule 2a-7 for investment by money market funds.

The credit rating conditions only create a "floor" below which funds may not invest, however, and constitute one among several risk-limiting conditions of Rule 2-a7.

Since its adoption in 1982, this rule has continued to serve the purposes that the Commission intended. It is notable that, despite the current liquidity crisis, money market funds and their sponsors have not asked the Commission for any changes to the risk-limiting conditions of Rule 2a-7, including the credit rating floor.

The CHAIRMAN. Mr. Sirri, I'm going to stop you here. We're going to come back to you. This is a very important subject. I don't usually do this, but I don't want you to be rushed. This is very important, so we are going to go vote, and then we will come back.

I have nothing to do until 3 o'clock. I hope the rest of you don't, either, because we're going to do this hearing. It's as important a subject as we get.

I appreciate the clarifications you have already given on this. We will be back as soon as we can.

[Recess]

The CHAIRMAN. Let's take our seats.

Sit down, please.

We will resume, and Mr. Sirri, I apologize for interrupting you, but this is a hearing where we don't want anyone to feel rushed, so please continue where you left off, and would other people please take their seats and be quiet.

Mr. Sirri, go ahead.

Mr. SIRRI. I believe we were talking about Rule 2a-7, so let me continue.

The CHAIRMAN. Yes.

Mr. SIRRI. There are also some other possible effects that a significant downgrade in a monoline insurer's rating could have on money market funds. The municipal securities they hold include variable rate demand notes and tender option bonds that typically have liquidity backstops, or puts, that are provided by a financial institution.

The CHAIRMAN. Excuse me. Hold on.

All right, let's get in here in a hurry or get out. I'm sorry for this, but we're not going to add to the inescapable problem of the votes, so people, either stand or sit.

Mr. Sirri, I apologize. Please continue.

Mr. SIRRI. These liquidity features serve to provide a source of cash to satisfy redemptions by fund shareholders, and also to shorten the muni bonds' maturities and make them eligible investments for a money market fund.

A significant downgrade could terminate the put, and thus result in money market funds holding long-term securities that would be inappropriate for funds maintaining a stable net asset value.

The Commission staff has been in regular contact with fund management companies, which are aware of these risks and have taken steps intended to protect funds, and thus fund investors, from the loss of these puts.

Now that I've discussed mutual funds and other investment companies as investors in municipal auction rate securities, it's important to also understand that closed-end funds are also issuers of a particular type of auction rate security, called an auction rate preferred security. The general loss of confidence in the auction rate market has spilled over into this market, and many of these auctions have failed, as well.

There are important differences in how auction failures have affected municipal and closed-end fund issuers.

Although closed-end funds also issue auction rate securities to obtain financing, they use the financing to leverage their investment in portfolio companies in order to seek higher dividends for the funds' common shareholders.

Also, although the funds have been paying penalty rates to their preferred shareholders to compensate them for the illiquidity, the rates generally are much lower than those paid by muni issuers.

One effect of the respectively lower penalty rates is that the rates are generally not as detrimental to fund issuers.

As long as the amount they pay to their preferred shareholders through penalty rates is less than the returns they generate from converting the proceeds of the financing, the underlying mechanics continue to work as intended and the funds have positive carry.

This does not mean that the current status of auction rate preferred securities will continue, however.

Although the closed-end funds pay the preferred shareholders the penalty rate, failed auctions mean that these shareholders may have to continue to hold the securities, which are perpetual, or attempt to sell them in a secondary market at what may be a heavy discount.

Preferred shareholders have pressured closed-end fund companies to find solutions to the failed auctions, and the companies have recently begun to contact the SEC's Division of Investment Management for guidance.

Due to the special issues raised by the auction failures in the auction rate preferred securities market, such as those raised by the fiduciary duties owed by funds to both preferred shareholders and common shareholders, the staff guidance in the muni auction rate securities market may not extend to the closed-end funds issuers.

The Division of Investment Management continues to asses requests for guidance, however, and to monitor the developments in this area closely.

Thank you for the opportunity to testify in front of you today. I'd be happy to answer any questions you may have.

[The prepared statement of Mr. Sirri can be found on page 202 of the appendix.]

The CHAIRMAN. Thank you, Mr. Sirri. That was very useful, and we will get back to it.

Next, we will hear from Eric Dinallo, who is the superintendent of insurance for the State of New York.

Mr. Dinallo.

STATEMENT OF THE HONORABLE ERIC R. DINALLO, SUPERINTENDENT OF INSURANCE, DEPARTMENT OF INSURANCE, STATE OF NEW YORK

Mr. DINALLO. Thank you, Chairman Frank.

It's good to be back before you. It's an honor to testify. And I thought I would take a few minutes and update this committee on what has gone on since I testified in front of the subcommittee just about a month ago.

I think substantial progress has been made in seeking company solutions in the monoline or bond insurance industry in helping facilitate market stabilization and beginning to define the future regulatory landscape for these activities.

I hope our role reflects a proactive approach by the regulator here. I think that's the proper approach here. I think we need to be facilitators, we need to be catalysts when we see something that has to be jump-started.

I think doing nothing here would have been a grave error, and although we took some risk by getting involved, I think prudential risk in times of what has been described as a crisis is better than doing nothing, which is still a choice of doing something, you're just not actually doing anything, you're instead accepting the status quo.

We began a three point plan in the fall. The three point plan consisted of:

Number one, bringing new capital and capacity into the monoline insurance area;

Number two, to begin to begin to deal with and prepare for chronically distressed bond insurers; and

Number three, to begin to rewrite the rules of the road and develop new regulations and statutes in this area.

I thought I would just take a minute and go over where we are in those three areas, and that will be a description of at least what our role has been to date.

First, in the area of capacity and capitalization, we have created or facilitated conditions that have attracted approximately $7 billion of capital injections and a total overall capacity, including the Berkshire Hathaway offer of $12 billion in total that have helped insure the ratings of the two publicly traded companies, kept the market fairly competitive, and helped to stabilize that market.

Those activities include inviting Ajit Jain of Berkshire Hathaway into the industry and helping facilitate the licensing of Berkshire Assurance Corporation in record time, and working with the other States in facilitating the licensing by 30 States in approximately a month, also receiving a bid on the municipal book for FJIC, Ambac, and MBIA from Berkshire.

Second, we approved and facilitated MBIA's capital raising, which led to $2- to $3 billion of additional capital into that company.

And as you're well aware from when I was here last time, we fostered and helped create the consortium behind Ambac that resulted in the capital raise that occurred just about a week ago.

We worked with Wilbur Ross and spent a lot of time speaking with private equity, and between his purchases of bonds and injection in Assured, there's a billion into the system, and we will be seeking out other capital, including other private equity on investors' sovereign wealth, and some bulge bracket investment banks have sought licensing through the Department of Insurance.

In the second category, concerning dealing with distressed companies, we have done the capital raising activities that we just discussed—

The CHAIRMAN. Mr. Dinallo, we're going to run out of time, and that's in your written statement. If you could get to some of the forward-looking things, I think that might be more useful.

Mr. DINALLO. Okay.

The forward-looking ideas here are to facilitate reinsurance and support of the markets, to engage in the possibility of a rehabilitation or restructuring of the companies that would be done by the government, including the good book/bad book scenarios that have been talked about, the Citibank concept of an optionality built into such a situation.

I have also spoken to this committee about the potential for a Federal backstop, which we could discuss, and I would explain what that would look like, if you have questions about that.

The third category is around new regulations. We have done a serious research and discussion with experts of what new regulations would look like. We have drafts of those.

Basically, we're considering the requiring of more capital to be engaged in this industry, the elimination of certain guarantees of structured products, such as CDO squares, which you have discussed, the possible segregation of the businesses of structured municipal and possibly project finance, and finally, the prohibition of insuring credit default swaps and other instruments that cause events of default or acceleration, which is generally not regarded as a good thing for insurance book, because you can't manage the claims if the worst-case scenario arises.

And on the reinsurance, the Federal backstop, because I know that you're seeking solutions that Congress could facilitate, my view is that a lot of the offers that we have received from private equity and from Mr. Buffett are essentially reinsurance transactions, and it seems to me that the Federal Government could rather inexpensively, in a certain sense, guarantee and reinsure the municipal sides of these books.

That would actually, ironically, free up capital to put the structured side in the best possible position going forward, so their policyholders were as protected as possible, and for the Federal Government, it would at least be just a backstop. It would be simply a guarantee against the book that, as your statistics showed, was already proven to be a fairly safe bet.

[The prepared statement of Superintendent Dinallo can be found on page 103 of the appendix.]

The CHAIRMAN. Thank you, Mr. Dinallo, and we're going to pursue some of these. That's exactly what we were hoping for.

Next, we will hear from Attorney General Blumenthal.

STATEMENT OF THE HONORABLE RICHARD BLUMENTHAL, ATTORNEY GENERAL, STATE OF CONNECTICUT

Mr. BLUMENTHAL. Thank you, Mr. Chairman, and members of the committee.

Thank you, first of all, Mr. Chairman, for having this hearing, and I want to join in saying how important it is, and say how pleased I am to be here with Superintendent Dinallo, who is doing great work, as the regulator in New York, in attempting to address many of these problems, and working very closely with the folks at Berkshire Hathaway Assurance Corporation.

I am also pleased to be here with them, and particularly with Ajit Jain, and want to say that I'm going to try to avoid the rough edges, but I feel as deeply as anyone in this room about the cost of this system on the towns and cities and States around the country.

The cost of insuring these bonds per year is about $2.3 billion. That's money paid by everybody in this room and the people whom you represent.

They are costs that are unnecessary and avoidable. They fall directly on taxpayers, and they inhibit infrastructure improvement and upgrading. That is exactly what the chairman mentioned at the outset of this proceeding.

The cost is not just on them, but it's also on investors, because the current dual system, the double standard that disadvantages municipalities and inhibits their use of public debt, is one that also confuses investors. It makes the market less transparent, and it restricts competition.

I have an investigation ongoing into potential violations of law. This system is not just unfair and unwise as a matter of public policy; it is also, in how it has been perpetuated and sustained, quite possibly illegal under our Federal and State antitrust laws.

My investigation is ongoing and active. It focuses on how this system started and how it was perpetuated, and I will say to you that our findings so far are very, very deeply troubling.

We know there was a concerted effort among supposed competitors to maintain the dual rating system and kill attempts at reform.

There were discussions among bond insurers aimed at retaining this dual rating system, when at least one of the rating agencies suggested modifying or eliminating it.

And the net effect of these activities was clearly to maintain prices and prop up the market for bond insurance.

This misuse of market power and restraint of competition is plainly anti-competitive and anti-taxpayer, causing direct harm to municipal and State customers—

The CHAIRMAN. Mr. Blumenthal, hang on one second.

That is another motion to adjourn. I do not plan to make that vote. I would advise other members, if you want to go and come back to do so, but I am going to keep going.

Go ahead, Mr. Blumenthal.

Mr. BLUMENTHAL. Thank you. I will be brief, and I would ask that my full remarks be included in the record, but just to summarize—

The CHAIRMAN. Don't feel rushed. This is too important. You know, the chicken scratchings can go on without us.

Go ahead.

Mr. BLUMENTHAL. Thank you.

We have found no legitimate business reason for this dual standard by itself. Just as one example, a triple B municipal bond, according to Moody's ratings, is one-fourth as likely to default as a triple A corporate bond. A municipality in that situation either has to buy bond insurance—and as I have described, we have documented how discussions perpetuated this system, involving the bond insurers as well as the rating agency—or a municipality has to pay higher interest rates for the debt that is issued.

Either way, taxpayers and citizens pay more, $2.3 billion more every year to insure that debt than they would otherwise. And this dual rating system, so far as we know, has no justification. I will be interested in whether any is presented later in the day when you have at least some of the rating agency representatives before you, and I would suggest, with all due respect, that you put this question to them and request them to justify how the dual system can possibly be justified.

Let me just close by saying that I am here to urge you to abolish it and prohibit it. It should have been prohibited in the 2006 Act, the Federal Credit Rating Agency Reform Act. In my view, arguably, it was prohibited because it is an unfair and anticompetitive practice. But, obviously it should be specifically prohibited under law, and I would ask that the United States Congress do that. It may well result, in any event, from voluntary actions by the rating agencies themselves because it is so contrary to the globalization of our credit markets that eventually it will probably fall of its own weight. But in the meantime, we are paying billions of dollars in unnecessary and unwise cost.

Thank you, Mr. Chairman.

[The prepared statement of Attorney General Blumenthal can be found on page 94 of the appendix.]

The CHAIRMAN. Thank you. This has been very useful and very much in point. Mr. Sirri, let me express my appreciation, and please convey to the Chairman and the other members of the Commission, few though they may be these days, that what you have done has been very responsive, and the way you have explained it has been very helpful.

On Rule 2a-7, I guess what you're saying is that nobody has raised that of course. What we would hope to do is fix the ratings, or have the ratings fixed so that it wouldn't come into play, that people would not be—and I agree with you. I don't want to accommodate an inequitable and inaccurate rating system.

Mr. Dinallo, you listed some very useful things we could do in terms of the regulations that would apply. Obviously under the current system in America, those are within the jurisdiction of the States. But would there be any Constitutional obstacle to our also doing them under Federal jurisdiction? I know many of us are reluctant to have preemption, but in some cases, there is some argument for uniformity. We could do a kind of regulation that would not preempt the State's ability to go beyond that.

And Attorney General Blumenthal, I would ask you as well. Would there be any Constitutional or other obstacles to our doing some of those things as a floor, for example, on the national level? Mr. Dinallo?

Mr. DINALLO. I don't think there would be any Constitutional objection to it. I am not such a staunch objector to a Federal regulatory system for insurance. But I would point out that I am fairly against an optional Federal charter, because I think you end up with a regulatory arbitrage situation.

The CHAIRMAN. We're not talking about that.

Mr. DINALLO. But I think you could have—here you could have sort of a Federal floor on this. It is true, as Congressman Kanjorski said, that it was sort of shock and surprise at how much of the national and the global financial system was hung off of this small part of the market.

The CHAIRMAN. This is separate from the optional Federal charter. I mean, that's—

Mr. DINALLO. I think it's a place where the Federal Government should inquire, because it turns out that a big part of the economy is driven by this kind of insurance, which—

The CHAIRMAN. You know, and there's direct context, connection here. We talk about—and we have all acknowledged State and local spending on various infrastructure projects is impacted. As you know, there is an intermix of Federal and State and local funding there. So, Federal transportation policy can be frustrated by excessive charges at that level.

Attorney General?

Mr. BLUMENTHAL. I see no Constitutional objection. I think that preemption, as you know, Mr. Chairman, is very, very frequently used. I think as a State law enforcer, I would object to any preemption of State enforcement authority if there are—

The CHAIRMAN. That's a very good point.

Mr. BLUMENTHAL. —criminal or even civil prohibition.

The CHAIRMAN. Well, in fact, let me just underline that. Yes. It would be a grave error for us to try to do that because even if we were to promulgate some rules, we have no Federal enforcement entity for insurance, and it would be—that's a very good point that you would have them work together.

Mr. BLUMENTHAL. Exactly, Mr. Chairman. And I think that for all the reasons that Mr. Dinallo has stated so well, there might be an argument that more of the bond insurer or that aspect of the insurance industry might be federalized so far as rules of—

The CHAIRMAN. Let me ask one last question here, and that is on the backstop. I would say, the gentleman from Connecticut, Mr. Shays, had mentioned that, and others had. And I know—and Mr. Buffet has also talked about doing that, and we are very pleased to have Mr. Jain here and we have talked to Mr. Buffet, and we will deal with that later. And there may be a context in which Mr. Buffet and the Federal Government are equally attractive alternatives, or maybe these days he might have the edge in the minds of some in terms of financial stability.

But what about—what are your initial reactions, the two of you, to a Federal financial reinsurance?

Mr. DINALLO. I think I'll just tell you what I learned along the way that would maybe inform. When we explored the possibility that the investment banks would engage in a consortium, one of the very first ideas was whether it would just be a line of credit, essentially a backstop. And I thought the rating agencies would give it very high credit without actual capital being put up. I assume that the Federal Government's guarantee would be even more highly rated.

And so what you do is you put in place a reinsurance situation where you essentially guarantee a certain amount of capital in case there are defaults. What that does is it lets the insurance company release a lot of capital that it was otherwise holding to cover on the municipal side. And that would go towards a situation that would elevate the ratings across the board, including on the structured side.

But if you were in a situation where you wanted to not have to do damage to other policies or establish the worst-case scenario of a good bank, a bad bank, that would be extraordinarily helpful to releasing capital and coming out of what looks like a liquidity crunch situation.

The CHAIRMAN. Attorney General?

Mr. BLUMENTHAL. I support it strongly, and the reason is very simply that it represents the best hope for achieving the goal that you stated at the start of the season, to let our people go, to free the towns and cities from a tax, a secret tax, that is now imposed by Wall Street. Let's face the facts. Except for Orange County and a couple of other aberrations, no towns and cities and certainly no States cease to exist. They continue in business. They almost never default, and the Federal Government as a backstop would eliminate the tax that currently towns, cities, and States have to pay.

The CHAIRMAN. Well, I appreciate that. I am going to finish with this, but it strikes me that as you talk, you mention Orange County. There have been a couple of bumps. But in every case, it seems to me it was because the issuer got cute and tried to get into investments that were over its head, and there would be nothing stopping us if we were to do this from saying, here, we are the backstop for full faith and credit, general obligation, plain vanilla. And if you start getting fancy, then you're out of our loop. And I think that might save a lot of grief as well.

Mr. BLUMENTHAL. Mr. Chairman, if I can just add, there is another aspect of this whole issue legally, which is that right now, the States often function as backstop for the towns and cities.

The CHAIRMAN. Yes.

Mr. BLUMENTHAL. In fact, one of the first actions I did as Attorney General was to go to bankruptcy court and prevent the city of Bridgeport from declaring bankruptcy and defaulting on its bonds. So the States will not let—

The CHAIRMAN. Right. Because of the negative effect it would have had on everybody else, and in fact the bondholders were held harmless, and that may be another problem.

Mr. BLUMENTHAL. Exactly.

The CHAIRMAN. I would just—we have been joined by our colleague from Connecticut, and I just wanted to tell him we have been talking about his—the idea he and I had talked about, about the backstop, and we will be pursuing that further.

The gentleman from Alabama.

Mr. BACHUS. I thank the chairman. When it comes to the municipal securities market, we have functional regulators and they focus on different things. The Fed focuses on one part, and the insurance commissioners focus on another. You have all this, you know, obviously the SEC on broker-dealer matters. But are there gaps in that regulation, or is there a need for some—for better coordination?

Mr. SIRRI. Well, Congressman Bachus, I think our chairman has gone on the record and said that he feels that disclosure, in particular in the municipal area, could be stronger. I think when you compare disclosure in the municipal area to, say, disclosure in the corporate area, some immediate gaps arise. And Chairman Cox has stated very clearly, I think he sent material up to the Hill that details this very precisely, that disclosure could be improved both in its accuracy, its completeness, and its timeliness.

I think issues like accounting, accounting protocols, and the independence of certain accounting standard setters, could also be improved, so as to bring disclosure and the quality of information that investors get more in line with the standards we have in the corporate area.

Mr. BACHUS. Okay. Attorney General Blumenthal, you proposed prohibiting different rating standards for the corporate municipal bonds. Would you—what about municipalities that may not be able to pay? I mean, how do you—and would you run through that? And you may—exactly how that would work?

Mr. BLUMENTHAL. Well, I think that goes to the heart of the idea, and is obviously a very profoundly significant question. I'm not proposing that every municipality be rated triple A, but simply that the criteria and the standard be the same for the municipality as it would be for the corporation. And there are a lot of corporations that don't deserve triple A ratings also.

So, if a municipality has insufficient reserves, is not taxing enough, in fact is uncreditworthy for some reason, then it should be judged accordingly, but it should be judged by the same standard, not a dual standard, but a single, unified standard known either as a global standard or the corporate standard, call it what you will, it should basically be the same for corporations as it is for municipalities, but not give either of them a break.

Mr. DINALLO. May I comment for just a second on the triple A rating issue? I think that it's important to note what I think the bond insurers did here, because I heard the words "extortion," etc., and I do think that there is a serious issue that has to be looked into. But they did perform one important function for small municipalities, water authorities, school boards, and hospitals. They essentially commoditized their bonds such that they could be traded in and out of triple A rated situations.

Now we know that money markets, Fidelity, even hedge funds have triple A tranches that have to be filled with a triple A rating. So what I think they essentially did was they took sort of a statistical gamble, which has paid off, in that they did not in fact examine every one of those authorities. And the rating agencies themselves did not rate every one of those authorities.

I think I would just challenge a bit that it would be a very difficult and inefficient and expensive system that would have every single municipality, authority, school board, hospital, or museum rated by the rating agencies, or, in fact, examined by the insurers. But across the whole board, as Chairman Frank showed, the gamble is a good, safe gamble, it seems. And I think that was the system.

I don't want to comment on the investigations, but it seems to me that approach was a way to let all municipalities come to market and be commoditized in a positive way so they could be held as they deserve statistically triple A rated. If you begin to pluck, cherry-pick out of that system, and I'm sure it's perfectly appropriate for Florida and California to want to do this, you will create a situation where the lesser municipalities, so to speak, which still statistically are good bets, will find it much more difficult to come to market. So the system will have to change dramatically.

Mr. BACHUS. It does appear to me at least that there has been a double standard or there have been harsher ratings on the municipal securities, when as you say, they have historically been much safer. So, you know, I have not understood that.

Let me ask you this. What about the difference—we talked about general obligation bonds. What about revenue bonds? Is there a different approach to them? Since the revenue bond is a dedicated source. And Mr. Sirri or—well, anyone who would like to—

Mr. DINALLO. I would say that one thing you'll learn this afternoon is I would seek answers from the rating agencies about how they would go about doing the ratings. I know it sounds kind of tautological, but the point is, I think that what municipalities do doesn't necessarily fit well into sort of the box checking that the rating agencies usually look for. They don't have a revenue stream. They don't have a return of equity. They don't have capital. It's a very different way of judging. What they have is a very secure promise on a risk, on an obligation. And I agree with those who have commented it may be the most secure of all.

But in fact I would urge the rating agencies not to necessarily rate them the same as corporates, because they're not going to be able to be rated the same as corporates. They don't have the same structure. But they need to be statistically brought in line with corporates under their own system. And I think the SEC will work, I assume, with rating agencies to try to produce that and get better standardization.

Mr. BLUMENTHAL. And I would just add, if I may, sir, that there are ways to minimize the tasks of the rating agencies in looking at either revenue bonds or the school boards and the resource recovery agencies or all of the municipal agencies and simply say or ask, are there backstops, for example, State guarantees? And in many instances, it will be found that the reason why their default rates are so low is the State will not let them default, period. End of story. And so why are they paying insurance? Well, they're paying insurance because they have been bludgeoned and intimidated into doing it by the markets and by the powers that be.

Mr. BACHUS. Mr. Sirri. Thank you.

Mr. SIRRI. I would just point out that there is a difference between general obligation and revenue bonds. General obligations are backed generally by the taxing, full faith taxing authority of the municipality, whereas with revenue bonds, the payments are secured by some particular project, whatever it is.

Much that we have been talking about today about the strong credit performance of municipal securities is related to general obligation instruments. When it comes to revenue instruments, the picture becomes somewhat more cloudy. Not all revenue bonds are insured. They're not all wrapped. And in some cases, there have been performance issues. And in those cases, because the performance is secured by a particular project, you can't bring in general taxing authority.

Mr. BACHUS. Yes. And there is some political pressure on not raising rates or not raising charges. And sometimes a Federal judge has to intervene.

The CHAIRMAN. Thank you. The gentleman from Massachusetts.

Mr. CAPUANO. Mr. Chairman, I just want to assure the gentlemen at the table that though I wasn't here, I was watching from a secure location.

[Laughter]

Mr. CAPUANO. First of all, Mr. Sirri—

The CHAIRMAN. Excuse me, but that's because he was the author of the ethics bill. It has nothing to do with you. That's why he had to be hidden.

Mr. CAPUANO. Mr. Sirri, I want to thank you and the SEC for the report you have done. I haven't read the whole thing yet, but what I have seen of it, I like, and what I have heard of it, I like.

However, it's only a portion of the problem that I'm interested in. Honestly, I cannot believe that anybody is going to look me in the eye and tell me that most GOs have to go to auction at all. Most of them don't. Most of them—and those who do only go to auction because they're bundled with something that's junk. And so—I understand what you're saying and I don't disagree with you about the ARS. That's a problem. It's a serious problem for the country, and I'm glad you're addressing it—finally—but you're addressing it. At the same, it's only a portion of the problem.

Mr. Blumenthal, thank you for being smoother than me, but I heard you say almost the exact same stuff I said, just nicer. And I would encourage you not—

Mr. SHAYS. Much nicer.

Mr. CAPUANO. And I would encourage you, though, not to wait too long for Congress to act. We tend not to act until way too late on almost everything. And if we don't do it, I'm begging you to please do it and gather your other attorneys general to do it. And I'm also asking you, you know, you have all kinds of laws. You have RICO laws, you have all kinds of laws you can use on cabals that extort people. Basically, that's illegal, and it shouldn't be allowed, and if I can help you in any way, that's fine.

I do have some comments, though, Mr. Dinallo, about some of the things you just said. I will tell you that in Massachusetts, it's exactly as Mr. Blumenthal said, cities and towns have gone bankrupt, but not a single bondholder has been unpaid because the State steps in and pays directly. Not one.

And according to—this was just handed to me this morning. This is from Moody's. Source: Moody's Investors. GOs, since 1970, 14,775, not one default. Not my numbers. Moody's. Not one default. They didn't say the big ones, the small ones, the tiny ones, the ones that don't matter. You could also have things like pooling of issuances. If you have some small community that needs a fire truck, you pool it with five other communities and issue that bond.

And if the State of New York doesn't want to step in behind, fine, then the State of New York should know that their cities and towns are going to pay higher rates. But for those States that have the foresight and the wisdom and the desire to provide the backup for the municipalities, they should be allowed to do so.

Now, I understand that. And I'm not—I'm hoping that some of your commentary is not based on the fact that most of these people are there. I also want to make one particular point. When I asked the credit agencies to rate my city, I paid for that. They didn't come in and say, "Oh, Mike, we're good guys. We're just going to do it for you." Not only did I pay for it, I wined them, I dined them, I bused them around, I begged them, I treated them nice. And I had to keep my mouth shut the entire time. I don't have to do that any more.

[Laughter]

Mr. CAPUANO. So let's not pretend that they're doing us a favor. And by the way, I also want to be very clear. The dual system is a problem, but it is not the only problem. If we had a unified system, they would still rate me, my poor city, lower than somebody else who is just as likely to pay back their bonds. Corporations go bankrupt every day and walk away. Most municipalities don't, particularly those who have States that back them up. We're not going anywhere.

So even with a unified rating system, that's all well and good, but it is only one step towards the final process. The final process is to treat all bond issuers the same, only looking at the likelihood of the bondholders being paid back, and that is a fair and reasonable standard. Other than that, it's extortion, especially when you have only a handful of people making those judgments. I guess I must—I don't know if I have a question in there somewhere, but they can—

The CHAIRMAN. Let me just, if the gentleman would yield briefly, let me just underline what's been said. Several of us here were State legislators, my colleague from Massachusetts, and were mayors. Here is the point: No State, no State legislators, no governor, can allow any one of its municipalities to default because then every other municipality would pay through the nose. So that is why this is not just some charity here; this is self-defense.

The particular municipality, you might pity the municipal workers there. Services may get cut back. Maybe the trash won't get picked up. But we can guarantee you, we have all been there, you can't do that. Because if any one municipality falters, every municipality in that State would pay, and there isn't a State governor and legislature in the country who doesn't understand that, and that's why the State guarantee is such a good one.

I'm sorry.

Mr. DINALLO. No. But if that's the absolute truth, which I don't dispute, then you could essentially federalize the rating systems for municipalities. It wouldn't be an outrageous concept to either socialize the rating agencies completely and take out the conflict that the Congressman just recited. That's not—

Mr. CAPUANO. Sign me up.

Mr. DINALLO. That has been discussed. You could, on the municipal side, essentially federalize that rating system and say that the

U.S. Government through the States, through the municipalities will stand behind all those obligations, and I assume it would immediately get the equivalent of a triple A rating in those asset management situations that I described before. I mean, these are not insane ideas. You just described a situation where you're essentially saying, as the chairman of the Financial Services Committee, that we just don't let those fail, which is probably a good situation for the reasons you say, you could change the system.

The CHAIRMAN. The gentleman from Connecticut.

Mr. SHAYS. I thank you again, all three of you, for being here. I was waiting for that vote that never happened, so I didn't hear your statement. I did read yours, Mr. Blumenthal, and thought it was again quite excellent.

I'm struck with a number of different reactions. One is, again, it seems to me that local municipalities are better off than the insurance companies that were rating them. And I just find that, you know, rather curious. And we all have stated that you're not going to see defaults, which is fairly obvious. I moved to the City of Bridgeport that previously had attempted to go bankrupt, and the local community rose up in arms, and the State said no way are you going to go bankrupt.

The only value I see—and then I'm struck by this reaction, that, particularly with subprime, the rating agencies have lost their brand. They are meaningless, because they have been so wrong. They were wrong about Enron. They were wrong about other companies, but in particular, they were wrong about the subprime market. And so I'm even questioning the value of rating agencies now.

The only thing I am struck with is that there is value in having a mayor or governor in fact, have to be held—be given a grade as to how they're managing the city. But other than that, if I was an investor, I'm struck by the fact that the ratings are almost meaningless. Tell me why the ratings aren't meaningless. Tell me why a businessman or woman in this day and age who is investing would pay much attention to rating agencies.

Mr. DINALLO. I'll just say, I'll just give a general response and defer to Mr. Sirri. I think the credit markets need some efficient commoditization that they can rely on. You cannot take away all ratings. It would I think result in sort of credit market chaos. I think that the municipalities are potentially a separate situation. But once again, we're dealing with thousands and thousands of companies, and it is impossible for credit providers, loan givers and investors to make all of those individual distinctions, especially when they're running a large asset base.

Mr. SHAYS. I hear that, and yet they have been so wrong.

Mr. DINALLO. They have had some—well to be fair, they have had some dramatic wrongnesses, there is no doubt. But I bet if we look at it statistically, you would actually give them a higher grade than just based on some of their largest so to speak mistakes. To be fair. I think that they need to stand up on those. They need to get over this inference of a conflict of interest, but I don't know that I know a better system. That's all that I'm saying.

Mr. BLUMENTHAL. I would just add that I agree, Congressman Shays, and I want to thank you, by the way, for your work on behalf of Connecticut's towns and cities in infrastructure and credit and so forth.

Mr. SHAYS. This is called the quid pro quo that we have developed. Thank you, Dick.

Mr. BLUMENTHAL. But I would agree that—I would agree with Mr. Dinallo that in theory there is a need for some objective, dispassionate, disinterested agency that evaluates whether investors will be paid back. In other words, the likelihood of default, the creditworthiness of a corporate bond. In the municipal situation where there is the kind of State guarantee—

Mr. SHAYS. See, that's the irony. That's why I wonder what is the value of the rating, because they're going to be paid back. They can say that a town is well-run or not well-run, but in the end, it's almost irrelevant.

Mr. BLUMENTHAL. And the problem is that they have no business telling Bridgeport or Stamford or Boston or any other city whether it is being run well. That's for voters to decide. All they should be deciding is will somebody who buys the bond receive his or her money. And in the case of most cities, there's no question that they should be getting triple A ratings, and that's why in my view, a single, unified standard would accord many of the towns and cities, and States obviously, a triple A rating because of those legal guarantees, but also because they're not going anywhere, as Mr. Capuano said more eloquently than I could. They're going to be in business, and they are not going to default when they have to go into the market again and again and again in the future.

Mr. SHAYS. Mr. Sirri? Thank you, Dick.

Mr. SIRRI. I think it is interesting to realize how credit rating agencies came about. Historically, they came about over 100 years ago when investors sought to understand the credits of, at the time, railroad bonds. At that time, people couldn't distinguish between the credits, so they looked at credit rating agencies to help them with that. So in that context, they were a point of efficiency.

Fast forward to today, I think you have pointed out quite correctly some issues with credit rating agencies, whether it's Enron or certain issues in the subprime area. But in some ways, this has partially been addressed with the Credit Rating Agency Reform Act of 2006. To my reading of that Act, what Congress thought to point out to us was that we should let the competitive markets determine how useful credit ratings are.

So to what we're talking about there, a few things have happened. We have seen new credit rating agencies enter the market that weren't there before. We now have nine credit rating agencies where we used to have five. If it's the case that these credit ratings aren't useful, then one of two things will happen, I believe, in the long run: (a) if they don't improve, investors will ignore credit ratings. They'll start to be written out of the process; and (b) the second thing I think will happen is that credit rating agencies have an incentive, given this legislative framework, to improve their act. And I believe they will over the long run.

I think you've seen some steps in that direction. They won't happen instantly, and there may be a role for entities like ourselves, the Securities and Exchange Commission, to step in. Our chairman has indicated that we will engage in some rulemaking this year I think that's based on some of the things we've observed. But there is this framework under which credit rating agencies are governed, and I think this will play out over time.

Mr. SHAYS. This may seem like a stupid question, but wouldn't the best investment be the State that has the worst credit rating and therefore the highest interest rate?

The CHAIRMAN. Yes.

Mr. SHAYS. Yes. I mean.

Mr. BLUMENTHAL. And—

Mr. SHAYS. So you really want to find the worst. I'm sorry, Dick.

Mr. BLUMENTHAL. You know, just to put a footnote on the point that has been made. You know, the elephant in the room here—

Mr. SHAYS. Don't use elephant. You can use donkey.

The CHAIRMAN. That's right. We're for diminishing the number of elephants in the room.

[Laughter]

Mr. SHAYS. Give him the microphone and you're dead.

Mr. BLUMENTHAL. You know, it may well be that there are a few more credit rating agencies, but let's face the facts. It's a highly concentrated market. You have S&P and you have Moody's, and they dominate the market. It is a highly concentrated market. And in the long run, Mr. Sirri may be right, but it's a very long—

The CHAIRMAN. Can I just—if I could interject. And there is also the question—Mr. Sirri is right—we generally like competition, but there is some question here about where the competitive effects are pulling you. Who's paying? And I think there is a question here about how the, you know, where the competition, in some cases, the way it is now structured, might have had a countervailing effect, and that's one of the things I hope will be addressed in the rulemaking.

Mr. SIRRI. There is one other point I'd like to make. We have been focusing on credit ratings, but I think it's also equally important to focus on market prices, or in this case on yields. If all municipalities were as we say, and that none of them were ever to default, then those bonds should all trade at the same yields, but they don't. The market actually, as it trades bonds, prices them at different yields. And that's—

The CHAIRMAN. That's right. And by the way, the market is wrong. I mean, it's demonstrably wrong. There would still be some different yields but probably because you have different State tax structures. For me, the double tax and triple tax exemptions would give you one market versus another. But I do think this is a case where the market clearly doesn't get it right.

Mr. SIRRI. It may be. I mean, it's hard to say. I appreciate the point you make, since the default rate is so low. But not only do they trade at different yields, but as credits change, as municipal credits change, you see yields widen on those credit—

The CHAIRMAN. Yes, but again, isn't it—that's because the credit rating agencies have been giving different views, and that may be changing.

The gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank the members of the panel for helping us. Just to pick up on this last point, I do agree with Mr. Capuano and the attorney general who have talked about the disconnect between the corporate bond rating and the municipals. But I think there is value in the rating system for the—principally for the second reason that Mr. Sirri raised, which is not all municipalities are the same. We need that competitive incentive for municipalities to get their act together, as Mr. Sirri said.

And we don't have to look back very far. The whole change in GASB 45 where municipalities now had to lay out in their financials the long-term pension obligations and health care obligations with respect to their employees over the long term, we saw some municipalities handle that very well, others not well at all. And so now it's a huge burden on some older cities with a lot of public employees.

So I think relative to a measurement between municipalities and States and towns, I think that that rating is an important factor for investors to consider. But let me just—aside from that, would there be a way, rather than this whole tangled mess that we have right now with the rating agencies, would it not be possible for the Federal Home Loan banks to step in here? The chairman has talked about a Federal backstop. Mr. Shays has talked about a Federal backstop. What about the Federal Home Loan banks issuing, say, a letter of credit on the bond rather—in place of I guess or maybe even belt and suspenders, on the bonds themselves? Is that something that could work or take the—you know, take this rating agency, and at least the double standard, mitigate that somewhat?

Mr. DINALLO. Well, I was about to comment that on the $236 billion line of credit that the Fed just created, you could in a sense take a small sliver of that and stabilize the bond insurance industry overnight. I mean, the stress amounts that are at issue there, as I testified to the subcommittee, are somewhere in the range of $7 to $10 billion. In other words—

Mr. LYNCH. Just on that thought, if you did it, you know, nationally, how do you eliminate the moral hazard of backing up someone who's not doing the right thing? Unless you do it on a municipality-by-municipality basis? And say here's the opportunity. You have to prove yourself.

Mr. DINALLO. Well, the moral—look, the moral hazard problem is a serious problem. I think that is why I sort of illuminated that everyone assumes that there really is no chance of a municipality defaulting on its obligations.

If that is really true, then the moral hazard is already baked into the system, it seems to me, and you might as well save all the money on the wrap and the insurance and the Federal Government should just sort of de-clear it, so you will have moral hazard, but it seems to me you have just kind of annunciated today that the moral hazard is already there. The markets do not seem to believe it.

Mr. LYNCH. I appreciate that.

Mr. DINALLO. If you took it away, you would get at a very wealthy truth, so to speak.

Mr. LYNCH. Mr. Blumenthal, any thoughts on that?

Mr. BLUMENTHAL. I think it is an idea that ought to be explored. Certainly anything that relieves costs—the Home Loan Bank Board may be a good prospect—should be explored; absolutely.

Mr. DINALLO. I think that the chairman's point is well taken. I do have one idea. The way that most municipalities have gotten into trouble is on their asset liability match and sort of investing in situations to try to boost their returns and cover their liabilities.

If you were essentially guaranteeing their backstop and then prevented them, because they would not have to go into some of the riskier investments, and sort of take out the moral hazard of getting into the situations that we described before, you might be able to take out what is the most difficult moral hazard, which is the risky investment side.

Mr. LYNCH. Mr. Sirri, do you have anything to add to that?

Mr. SIRRI. No, not in particular. I would just point out that any time you issue a guarantee like that, you have to manage your liability with respect to the guarantee. As people have said, that can be difficult.

I think the moral hazard issue is a serious one and one that has to be thought about.

Mr. LYNCH. Mr. Chairman, I yield back.

The CHAIRMAN. Thank you. Let me just note, by the way, as my colleague talked about or somebody talked about, the $236 billion in the Fed. Apparently, the Fed is by statute currently prevented from getting into the longer term municipal bonds, and we are in the process of writing Chairman Bernanke.

I think what the Fed has done this week has been neutral, but if they can take AAA mortgage backed securities in the swap with treasuries, we are talking about something that has a higher value even than that.

We are going to explore that with the Fed as well. I think we are all moving in that general direction.

The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for appearing.

Let me start by asking if we are in essence talking about the auction rate securities and available rate demand notes, is that the bottom line here that is creating the increase in fees and costs that we are seeing? Is that where we are?

Mr. SIRRI. I think my comments earlier were directed to relief that we are aiming to providing in the auction rate securities space.

The variable rate demand obligations space still appears for the most part to be functioning well, although there have been some capacity issues there.

Mr. GREEN. With the monoline insurers, when their credit rating is downgraded, the cost of their borrowing increases, correct? This impacts the bond issuer.

It does not impact what we will call the notes that they already have in place, the debt that is already in place. It does not impact their debt service payments.

It does impact their payments on new acquisitions going forward; is that correct?

Mr. SIRRI. One place—in general, I think what you are saying, the answer is yes. One place it can have an important effect is the relationship in the variable demand space, variable demand obligations.

If there were to be a sufficient problem with an insurer, then these bonds could be put back to a backstop provider. Again, the bonds are issued. I just want to point out there could be a significant effect there.

Mr. GREEN. My intelligence indicates that the cost of borrowing increases greatly when the credit rating is downgraded. Give me an example of what "greatly" really means, please.

Mr. DINALLO. You can take a look at what happened to the Port Authority, I guess. One week, they were paying 3 to 4 percent, and when the wraps sort of fell off and the auction rate market went haywire, they were paying 18, 19, 20 percent. We are talking about the Port Authority of New York and New Jersey, which is about as good of a bet as you can reasonably imagine, as Chairman Frank said earlier.

Mr. GREEN. Permit me to ask you, if you can, to translate that into dollars so I can get a more comprehensive understanding—3 percent in dollars and the 18 to 20 percent in dollars, please.

Mr. DINALLO. I cannot quite do that for you. I do remember that the week that they had to pay, that one week was, I think—it might have been just for the day, it was several hundred thousand just for that day. I am speculating a little.

Mr. GREEN. Did you say several hundred thousand?

Mr. DINALLO. Yes, I believe so.

Mr. GREEN. We have gone from a few thousand dollars to several hundred thousand dollars?

Mr. DINALLO. If you took what Mr. Sirri said earlier, which is on the day we were testifying, 600 or so auction rate bonds failed, I think across that list, you are into—I am going to speculate—it has to be hundreds of millions of dollars for that round of bonds.

Mr. GREEN. I was going to get to that, the failure at an auction, when you have that, then you have the penalty interest rate that you have to contend with.

Is the penalty interest rate contained within some codified agreement? How do we find the penalty interest rate? How does it get defined in this process?

Mr. SIRRI. When the auction rate instrument is set up, it provides for the eventuality that an auction possibly may not succeed. When that happens, there is a maximum rate or penalty rate that is set. It could be particularly high. We were using the example of 20 percent. It might be lower. It might be 6 or 7 percent. That depends on the design of the instrument.

It is part of the set of documents and contracts, the auction rate agreements, that constitute the papers supporting the issue.

Mr. GREEN. The auction rate fails because the company, the bonding company, no longer has its AAA rating. All this is no fault of the municipality?

Mr. SIRRI. The failure here is defined as having more sellers of the bond than buyers. If a group of sellers came and wanted to sell 100 bonds but there were only 80 bonds that wanted to be bought, that auction would fail.

Mr. GREEN. I understand. The reason you do not have the buyers is because of the ratings the insurer's have; is that correct?

Mr. SIRRI. That may be one of the reasons, but there could be other reasons, too. Let me give you a concrete example.

When you start to have some failures in this space, you could also have failures in credits that are otherwise unaffected, say credits in the student loan space, where the underlying credits are perfectly fine. There may be explicit or implicit government supports.

What people anticipate is their auction may fail for whatever reason. Knowing their auction may fail and given that people who hold this paper have a very high demand for liquidity, they view it as a short term money market substitute. They do not want to be the last person to get out, so they jump for the exits. If people anticipate folks jumping for the exits, they all jump for the exits, and thus you see good credits where there is not a question of a downgrade, you see in those credits failed auctions.

Mr. GREEN. Final question. The municipality, in this scheme that you just gave to me, is not at fault in this process. Nothing has happened with the municipality. It is still there. They are still doing the same things they have been doing. It is the insurer that has the problem.

Mr. SIRRI. If I can interpret "fault" as saying there has not been some event at the municipality in terms of its credit or its ability to—

Mr. GREEN. Let me ask someone else to respond.

Mr. DINALLO. I think the way to phrase it would be to say that the underlying creditworthiness of the municipality had not changed, and that instead, there were two events that were going on, there was a doubt as to the viability of the insurance wrap that you are referring to, the AAA wrap, and in general, at exactly the same time, the credit markets were starting to withdraw credit and liquidity, so the auction rate market, I think, was impacted both by the monoline crisis and a general tightening of credit.

The CHAIRMAN. The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to thank all of our panelists for being here today.

It is very important that we understand what is going on and see what we can do to assist in dealing with this economic situation we find ourselves in.

Mr. Dinallo, it strikes me that we have a somewhat odd situation here. On the one hand, you have bond insurers having started to insure much riskier bond products, such as mortgage backed securities. On the other, an entire class of bonds, municipal bonds, which seem to have to rely on borrowing the bond insurer's AAA ratings, even though their riskiness is probably much lower than the municipal bond rating system reflects.

Am I correct in identifying this duality and if so, how are you dealing with it at the State level?

Mr. DINALLO. I think you are correct in identifying the duality and we have spent quite a bit of time talking about it.

At the State level, I think we have gone in to try to both stabilize the markets and infuse capital to make sure that we do not at least lose the ratings that were attached to the municipality on the structured side.

What I find interesting is that as presented to the bond insurers, the ratings for the structured side were usually already AAA rated. In other words, it was the super senior tranches of the CDOs and the banks wanted the equivalent of a credit default swap to basically assure that no matter how the value changed, they had a AAA wrap around that.

The municipalities, as we pointed out today, ironically, many people believe they were woefully underrated or unrated.

If you were a computer just judging risk, the monolines took a riskier bet in uplifting them from no rating or A or AA into AAA. It is all very ironic now and clearly not true.

If you were going in and relying purely on the ratings or a lack of a rating, it was the case that you were essentially being riskier on the municipality side just from a ratings point of view.

I think there is going to be a large sorting out, which is appropriate and should be done quickly, which we are working on the new regulations to get there, about essentially separating the businesses potentially going forward, assuring the credit default swaps are no longer the instruments for securing that kind of obligation, and probably prohibiting credit CDO squared, which is the sort of recreation from a BBB into a AAA, sort of the silk purse out of a sow's ear problem that exacerbated it.

Mr. BLUMENTHAL. Can I add just an answer as well, please?

Ms. WATERS. Yes.

Mr. BLUMENTHAL. I think the thrust of your question is absolutely right. What happened was a great many of these instruments, the CDOs, the SIVs, the structured investment vehicles, the structured finance securities, were overrated, and the municipalities were underrated.

I ran across a quote. It happens to be from Warren Buffett. It is not directly quoted, so I apologize if he did not say it or if I am getting it wrong.

He said: "It's poetic justice in that the people who brewed this toxic kool-aid found themselves drinking a lot of it in the end."

The folks who brewed the mix are now having to swallow it. The point is that we need to change this system so it does not happen again.

Ms. WATERS. Mr. Chairman, I thank you very much. Even though we do not have time to get into it, I would hope that at some time we can really get into understanding the tranches and how they were packaged, how it worked, and how they were determined to be risky or not.

That is one area where I just need more information.

The CHAIRMAN. We certainly are going to try hard. I am not going to promise anybody that by the end of this year, I am going to understand what the derivative of a collateralized debt obligation really means. I will just take comfort in the fact that nobody else seems to know either.

[Laughter]

The CHAIRMAN. The gentleman from Pennsylvania, and then the gentleman from North Carolina.

Mr. KANJORSKI. What was it that you did not understand, Mr. Chairman?

My problem is somewhat related to what Ms. Waters has been addressing. There are so many bad signs here. I recall about 3 weeks ago meeting with one of the monoline insurance carriers that did not get into as much difficulty as some of the others.

They showed me a study that they had undertaken of their competitors. One of them was the pools of securities that were purchased and insured by their competitors, and it showed that in one year, in 2007, 18 percent of the first installments on the mortgage obligations were not paid.

The only thing I can relate to is the prior experience I had on a board of directors of a small bank that when our default rate on mortgages went above one percent, everybody seemed to get into a nervous state and started at least experiencing the pains that may indicate a heart attack.

How did we get to an area where 18 percent of the mortgages did not even perform on the first installment and why did not people know about this? Two, why did it not set off a bell in any number of places, from the owners of the securities, the purchasers of the securities, the people that made up the pools, or for that matter, the insurance carriers that were putting their resources into the pools?

It seemed to me everybody turned a blind eye and should have known with even a cursory review of the record that something was wrong.

I will grant one thing. It is practically impossible to figure out what is where and what the impact is because there does not seem to be any inventory that exists in the public realm anyway that you could find out how these securitized pools are manipulated and sold off in various configurations.

Certainly, should not a regulator—and maybe I should direct this to you, Mr. Dinallo—is your inspector or auditor of these insurance companies able and does he make an in-depth analysis of the securities held as collateral to know whether or not they are performing, and if they are not performing, does he take some action to indicate therefore, they do not meet the criteria established by the law?

Mr. DINALLO. I think that is a great point. There is a history here where in fact there is something called the Securities Evaluation Office of the NAIC, which is a group of 100 people who value securities separately.

We did once, I am told, long before I came onto the scene, seek to value hybrid securities, hybrid equity securities, differently than the rating agencies, and it created a brouhaha because the States in their capacities, regulators, were sort of daring to question to not create chaos in the marketplace.

I am considering sort of juicing that up. It is located in New York. I think it is important, but do recall, please, Congressman, that our first order job is solvency and I think on solvency of policyholders, we have done quite well, frankly.

People will be paid on their losses it looks like because the assets of the insurance companies exceed the most aggressive liability projections or losses by someone say like Mr. Ackerman.

I think on that, we have done well. On the AAA rating that comes before the insurance company, I will just tell you that I have a theory. You asked a question, a rather large macro question. I will say that the Congressman who has since departed hit on moral hazard.

There was a day that when you gave a loan as a banker, you stood behind that loan. You owned the risks of that loan, and you had a book of business that was built on making good underwriting, good loan decisions.

Someone then had an idea that we could securitize that book of business and do good things. We could extend more loans to people who wanted homes or to buy a car or finance their children's education, and so it was securitized, and the banker could do more loans.

That first book of business was excellently built and it performed rather well. On the fourth or fifth iteration of that, it became a more dangerous undertaking.

Insurance. We need to be very careful that we do not over securitize the underwriting that is going on there, and it is something that I am very worried about.

Mr. KANJORSKI. Thank you. You may not be aware that the Governor of New York announced his resignation. I suspect you are an appointee of the Governor.

The CHAIRMAN. Why are we getting into that?

Mr. DINALLO. I am.

Mr. KANJORSKI. I would recommend to the new Governor that—

The CHAIRMAN. Let's not get into that. Let's go on.

Are there any further questions?

Mr. KANJORSKI. No.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. I thank you, Mr. Chairman. Let me first comment, I left the room after Mr. Capuano because I did not want to go after him. There was so much passion in his voice. A lot of the points he was making, the concerns about this resonated, but there is also a side here that is reflected by the chairman's comments about lack of understanding here, that may lead to some slightly different conclusions on how we proceed.

I think the value of this hearing is to expose that there are a number of irrationalities in this market as we have seen in virtually every market recently.

The first question I want to ask is, who is the prime regulator of this market? Whose responsibility as regulator would it be to step into the void that you all are describing here?

Mr. DINALLO. I guess that would be me, Congressman, to the extent that most of the monoline insurers are either located or domiciled in New York.

Mr. WATT. This is a New York issue, which leads me to one of the other irrationalities of this. We are dealing with a national market. This reminds me that the first irrationality I dealt with in this whole context, in the whole bond issuance context, was back in the mid to late 1970's when lawyers in the State of North Carolina could not issue opinions on bonds, legal opinions on bonds of any kind. It was all done in New York.

Mr. DINALLO. I may not have answered your question correctly. If you are asking who is responsible for the rating agencies and the ratings of bonds, creditworthiness.

Mr. WATT. I am asking if there is some regulator who, if a problem emerged in this market context, in the bond issuance context in general, is there a regulator we could point to and say this person has responsibility for it.

If there is not, then that is the first problem that it seems to me we have because everybody then will be pointing the finger at everybody else, the same way that everybody has been pointing the finger at everybody else on the whole other side of the credit crisis.

Is there a regulator that has super responsibility for this? I would have assumed Mr. Sirri would have been the first person to answer this question, not somebody at the State level.

I am not trying to influence that. I am just trying to find out who the regulator is.

Mr. SIRRI. I took Mr. Dinallo's answer to be for the bond insurers, and I think he clearly has responsibility for the monoline bond insurers there.

With respect to understanding your question, when you talk about the issuance of the securities, municipal securities are by and large exempt securities. The Securities and Exchange Commission, which generally oversees the offering of corporate securities, not so for municipal securities in the same way because they are exempt from the 1933 Act.

That said, there is a framework in which there are various—

Mr. WATT. So, you are telling me there is no regulator. Is that what you are telling me? Does the Fed have the authority to step into this and be a super regulator?

Mr. SIRRI. I think what I am saying is we are not a super regulator in the sense that we are all encompassing. We have various touches on the market, however, with respect to certain kinds of fraud that may occur. We have authority with respect to the operations of brokers when they trade—

Mr. WATT. Who would we hold accountable if this thing was completely out of whack as it is? Who would we hold accountable for that other than the market?

We all know that the market got out of whack. Was somebody supervising the market? I thought this was going to be a simple question. Apparently, it is a lot more difficult than I thought it was.

Mr. SIRRI. I think the best way I can answer it is there are various pieces that are divided between various entities.

For us, when it comes to credit rating agencies, when it comes to the work that brokers do in selling these securities, we have authority there. When it comes to issuance, the Securities and Exchange Commission does not. When it comes to the monoline insurers who wrap these securities, we do not.

Mr. WATT. Thank you. I yield back.

The CHAIRMAN. The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman. I would like to just ask a question dealing with something that is happening across the country, if any of you care to respond.

There are examples where communities across the country are experiencing incredible interest rate increases. I call to mind an example, a couple of examples that some of you may be aware of, where I recently read that Underwood Memorial Hospital in Woodbury, Pennsylvania, my own alma mater, the University of Pennsylvania's health system, and the Pennsylvania Intergovernmental Cooperation Authority all have had outstanding auction rate securities, and have all experienced interest rate increases, as much as from 4.5 to 8 percent.

This is happening in various places throughout the country where people are telling us of similar experiences of incredible interest rate increases.

I was just wondering if you think that providing additional sources of credit enhancement, such as that which is provided by the Federal Home Loan Bank's letters of credit and similar ideas are of value in addressing the financing needs of these communities?

Mr. Blumenthal. I would say yes. You hit on a point that I think is very, very important. Even before this credit crisis, the cost of those debt issues were rising in terms of interest and also in terms of insurance. The insurance companies, the bond insurers, were charging more and more as a percentage of what the interest savings could be.

That is a means that I think we have discussed today to reduce or minimize those costs. I think again going back to the question that was raised before and I was going to raise it when the Congressman was still in the room, clearly, in this whole system, there are gaps in terms of regulation. I think that is an important point that has emerged today.

There are gaps and there are some overlapping jurisdictions, but there are clearly deficiencies in the law that need to be corrected. One of them is the absence, in my view, of a provision that prohibits the dual system that again disadvantages the health system of your alma mater.

Mr. SCOTT. Thank you for that. Let me go to another point. With the initial question being whether we need to worry about a municipal bond or a muni market melt down, do you believe, each of you, that this issue is being overblown, or do you feel we have yet another blow to the economy ahead with bond insurers?

Do you believe it to be true that more and more insurers will lose their AAA ratings as Moody's and S&P look as though they are ready to lower the grades on more insurers, even such names as Ambac and MBIA?

It appears to be quite worrisome when a firm is downgraded to AA, it is most difficult for them to do any more municipal business.

Is this not the case, or is it not the case that many of these companies are themselves to blame for the mess that they are in after expanding out into the risky securities that some say they had no business or experience in insuring?

Will it not be hard to find investment banks who are willing to bail these guys out and will there even be a bail-out if necessary, or do you believe that investors will simply have to take these losses?

Finally, would an industry-wide bail-out be even a legitimate option as getting banks to agree on how much each should pitch in to help might prove difficult itself?

Mr. DINALLO. I think, Congressman, that it is a very difficult set of questions to answer that you have asked. I think the infusions of capital that you have seen into the bond insurers have at least for now maintained the AAA ratings of at least four or five of them, and others are going to shake out and possibly go to a lower rating.

If I were to be asked whether these were sufficient capital infusions for the absolute long run, I cannot answer that because the question is as difficult as answering exactly where is the economy going to be in fact several years from now.

If mortgage defaults continue at a certain rate, then we are probably going to be okay, if they are as projected by the rating agencies, but if they take off into a worse scenario, then the rating agencies will, I presume, require more capital as those projections go up.

Likewise, that could also have a serious pull on the municipal side because if there was a tax base erosion, then the municipalities could presumably default if permitted to default at a higher rate than they otherwise have been.

It is a question that is linked to the economy. That is why I think we should inject capital prudently and it should be market based solutions and let the assumptions crisis that we are in and the potential liquidity crisis play out a little bit.

Mr. SCOTT. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. Sirri, my city needs about $1 billion to upgrade its storm water sanitary sewers, combination sewers. I stepped out a few minutes ago to meet with Mayor Jim Odom, who is the mayor of one of the suburban communities in Kansas City, Missouri. His City is Belton. He just told me he needed $2 million to upgrade their infrastructure.

The National Service Transportation Policy and Revenue Study Commission says that we need $255 billion a year, a year, to upgrade the infrastructure around the country. If that is in fact true and if municipalities are going to do it, they are going to have to access the debt market to do it. No city has that kind of money in the city treasury.

When you add the market volatility, then municipalities are in serious trouble.

Is there something that the SEC can do within its regulatory authority to correct not a perceived problem but a very real problem with the bond rating agencies that to a large degree, and I want to talk to them directly about it, are causing the problem.

Do you see that the SEC has any responsibility for helping us out of what I think is a crisis?

Mr. SIRRI. I think there are several things we are doing at the moment. The first is, and I referred to this earlier, that we are providing some relief to dealers in the auction rate area so that municipalities, perhaps such as some of the ones you mentioned, would be able to bid for their bonds at auction, and be able to have those bids taken.

That should help in the short run. In the longer run, right now, and you brought up the credit rating agencies, as we speak right now, we are examining the credit rating agencies for a number of issues, most of them related to subprime, but that work will continue.

Our Chairman has asked that we engage in some rulemaking where appropriate this year to get at some of the issues that we have talked about. I think that rulemaking is still to be flushed out as to what it will entail precisely.

I think we do take very seriously our responsibility, our authority over the credit rating agencies is new. The Act was promulgated in 2006. It really just came on line in 2007. We are barely 9 months into our authority here.

I think we do not want to do something untoward, to do something that is not carefully—

Mr. CLEAVER. Do something what?

Mr. SIRRI. We want to be careful in our use of authority here. The Chairman has instructed us to be very measured, to think very carefully about what kind of rulemaking we engage in.

The CHAIRMAN. That is the Chairman of the SEC.

Mr. SIRRI. I am sorry, the Chairman of the SEC. I am sorry. Very good.

The CHAIRMAN. He is more measured than me.

[Laughter]

Mr. CLEAVER. I am not suggesting that you do something irresponsible. I am not sure it sounded like I was saying that.

I am asking that the SEC use the responsibility it has been given legislatively to deal with the problem. I understand you have not had that for a long period of time.

What I hope to convey to you is that it is a problem that is growing daily. It is not getting any better because the crumbling infrastructure around this country is not going to stop until we deal with this problem.

Is there something that you can do? Can you tell them to stop?

Mr. SIRRI. I think with regard to a number of things, we do have authority. For example, if in the process of our exams we were to find out there was anti-competitive behavior going on, and we have had some discussions here at the table about the nature of what that anti-competitive behavior may be, our authority is very clear there, that we could step in and stop that.

Mr. CLEAVER. Do you not think there is anti-competitive behavior?

Mr. SIRRI. I do not want to jump ahead of where our exams are. We are looking at—

Mr. CLEAVER. We have nine rating agencies—maybe that suggests something is awry.

Mr. SIRRI. It certainly raises that possibility. There are possibly some other benign explanations for it, but I certainly take your point.

We started our authority with five. We have had nine come in. As I said before, I think some of the cures that are provided by the Act will take some time. I certainly appreciate there is more urgency there and that we need to be focused on the here and now as well as a longer term view.

Mr. CLEAVER. Mr. Blumenthal, if you could write out a script for the SEC to address the problem, what would it be, please?

Mr. BLUMENTHAL. On the credit rating agencies?

Mr. CLEAVER. Yes, on credit rating agencies.

Mr. BLUMENTHAL. What I would like to see is that the SEC would require a single unified standard. In other words, I believe that under the current statute, it has authority to mandate that single standard, but it may be a fair issue for them as to whether they feel the statute does provide authority, so I am suggesting that there be explicit congressional action in that regard.

I believe that as part of this rule, they can and should take that action to make the system fair and eliminate these disparities. In effect, the system that we have right now puts municipalities in a lesser category of existence.

I will say to your point about anti-competitive conduct, that is precisely the focus of my investigation. It is not only on the dual standard and the way it started and perpetuated and maintained, but it is a variety of other practices that the rating agencies have engaged in doing that raise the cost of those ratings, the so-called notching practices, the basketing practices.

These terms have meaning and I know this hearing is not focused on the details of the rating agencies, but there are very, very profound and significant questions under the antitrust laws about whether or not they have restrained trade or otherwise impacted competition.

Mr. CLEAVER. Thank you.

The CHAIRMAN. The gentleman from Colorado.

Mr. PERLMUTTER. Thank you, Mr. Chairman. I am sort of with Mr. Kanjorski and Mr. Frank in not understanding some of the terminology. I would just like to go to basics for a second.

I represent an area with lots of school districts, and some health and hospital authorities, and they want to issue a bond. They have to get some money to build a new hospital or new school. Those are the guys, if I understand it, that are going to be affected by these higher interest rates.

Is that right or wrong?

The CHAIRMAN. The court reporter is very able, but she is not good at nods.

Mr. BLUMENTHAL. Yes.

Mr. DINALLO. Yes.

Mr. PERLMUTTER. Thank you, Chairman.

Let's move the credit enhancement piece aside for a second. Somebody who is going to invest or buy these bonds will look at a revenue stream that is generated by the township or the area of authority or whatever, look at the expenses, and say that looks like a good buy for me and I will buy it at 5 percent. That is how I look at the risk of this. Is that right?

Mr. DINALLO. Yes.

Mr. PERLMUTTER. There are a bunch of these out there. Some of what we have done, the market has done something to try to short cut analyzing the revenue stream and whether it is legitimate and a solid revenue stream or in the instance of some of my neighborhoods where there are lots of foreclosures and lots of people who are not paying their property taxes or sales tax has dropped, the revenue stream is not as solid as it once was. Still have all those expenses.

Some of these municipalities or authorities then buy down the risk; right? They buy down the risk by either getting letters of credit from a bank or they find an insurance company to buy down the risk, or they get a credit agency, the credit agency looks at everything and says this is a good risk.

Is that how this is working?

Mr. SIRRI. I think you mentioned two different kinds of risk there. When you cited the letter of credit, you are talking generally about liquidity risk, that is the idea that the bond can be re-sold.

When you talked about a monoline insurer wrapping the bond, you are talking about credit risk, the idea that if the municipality does not make their timely payments, that someone will step in and make it for them.

In the third instance, when you talk about the credit rating agency, you are talking about an opinion of a third party about the likelihood that they make timely payments.

The three of them interact together in the way you say.

Mr. PERLMUTTER. To be able to peddle or sell the bond. Where is it that we are running into trouble?

Is it because we do not have insurance any more or because the credit agency is saying hey, the markets are very difficult out there right now, we are going to tighten down on everybody, just like the appraisers and the accountants are tightening down, and the regulators are tightening down.

Is that the problem? Or is it because nobody has any money to buy these things?

Mr. DINALLO. I think Mr. Sirri just helpfully asked me to answer that question. I think there are several factors that are contributing to the issue. The rating agencies, I think, have gotten tougher because they have sensed a certain scrutiny, and I think it is appropriate for them to tighten up a bit.

It is the case that the bond insurers that would otherwise be giving the wrap have been under pressure and their ratings, which are the wrap that you talk about, have gone down or been in danger of going down.

The credit markets that are sometimes the way those municipalities come to market, the variable rate markets, etc., are very tight as Wall Street and other liquidity providers are beginning to worry about their capital requirements and pulling away from the lending activity that everyone just kind of got used to and maybe overly used to.

There are several factors that are contributing to it. We discussed today one other that is kind of at the heart of what you are saying, which is a belief that the rating agencies essentially have a two tier system for rating corporate credit risk versus municipality credit risk, and that the underlying credit decisions around municipalities should be more liberal, so to speak, and they should not have to pay as much because they ought to be starting off from either a higher rating or any rating at all, which some of them cannot even get rated so they buy the wrap.

The CHAIRMAN. We have a vote. We can finish.

Mr. PERLMUTTER. As regulators, are you seeing any trouble? One of the things we have been dealing with is this subprime mess here and we are seeing lots of foreclosures.

Do you see any problem with the revenue side? That municipalities really are starting to—

Mr. DINALLO. In a worst-case scenario, I have two concerns. My immediate concern, which I think is clear to everybody, is that the mortgage foreclosures and the mortgage defaults will definitely put a huge pull on the CDO side of the obligations that the monoline insurers have put out, and that will in turn put stress on the municipal side of their books.

Likewise, I do believe that if the economy goes abruptly and more so in the wrong direction, you may have underlying stress on the municipalities. I think that is where you will hear Ajit Jain from Berkshire say that it is not quite as safe, the risk, as everyone seems to be saying, that it is a riskless investment. I read his testimony.

Mr. PERLMUTTER. Thank you.

The CHAIRMAN. Thank you. I am not going to go vote. It is an adjournment. I will stay here and we will get to the next panel. We will finish with the gentlewoman from Wisconsin.

Ms. MOORE OF WISCONSIN. Thank you so much, Mr. Chairman.

I was very fascinated, Mr. Sirri, by your testimony and others regarding the auction rate securities and specifically want to know more about the Federal backstops that you might suggest.

I can see that you think that perhaps there is something that can be done in the regulatory area. I have heard others talk about the Federal Home Loan Bank.

As people want to get rid of these bonds and switch them to variable rate, you said that had been slowed tremendously because so many people are trying to do it.

I noticed in the footnote in your testimony on page four that you said some banks have already reached their entire yearly capacity for writing letters of credit policies.

What more can you do or what role could the Fed provide in enabling people to make these swaps?

Mr. SIRRI. What we have done specifically here is we have made something clear that had been slightly unclear to the market. We have a situation where we have issuers of bonds, municipalities, who are paying particularly high rates because their auctions have failed.

We have a situation where we have investors in bonds who normally would be happy to get those high rates. Of course, that is what they like to do at auction, but they also have a demand for liquidity. Because the auctions have failed, they cannot move their paper.

What we are striving to do this week is to issue some guidance by the staff of the SEC saying that municipal issuers can bid through dealers at auction and repurchase their paper, take it off the market. First, that is helpful to them, and second, by bidding, many of the auctions we hope will not fail. Once they do not fail, those rates will come down and the issuers' rates that they pay will be more in line with the traditional rates they pay for their credits.

We have provided some guidance there to make it clear that will not be deemed "manipulation," and that is one of the reasons why dealers have been not willing to accept the bids of municipalities.

Ms. MOORE OF WISCONSIN. Because there would be a huge discount to muni's if they bought their paper back?

Mr. SIRRI. There was an enforcement settlement in 2006 where there was some actual manipulation by dealers. In the wake of that settlement, dealers became very conservative. In our view, perhaps slightly overly conservative, and that is fine that they do so. They do not want to run afoul of the securities laws.

We just want to clarify for them that in this instance, and perhaps generally, that when they bid at auction, if they bid in a precise way that has good disclosure around it, they will not be deemed to manipulate the market.

We want to be very, very clear, we are not saying anything about the contracts around these. There are various private issues about the contracts, about the agreements between the parties. The SEC is saying nothing about those whatsoever.

We are just clarifying that the municipalities can place bids through dealers and neither the auction agents, the dealers, nor the municipalities will be deemed to have manipulated under a set of circumstances that has a lot of disclosure around it.

Ms. MOORE OF WISCONSIN. Thank you for that clarification.

The CHAIRMAN. I thank the gentlewoman. I thank the panel. The panel is dismissed with our thanks. There are a lot of specific things and we will all be back to this.

We will call our next panel, Mr. Lockyer, Ms. Wiessmann, Mr. Reeves, Mr. Newton, and Mr. Dillon. Will you all come forward?

I thank the panel. This is a very important subject, and while not all of the Members are here, people are watching this elsewhere, and there are staff members here on both sides, so we will get right to it.

First, we have Bill Lockyer, the treasurer of the State of California. Mr. Lockyer, do you want to go ahead? If you need to be excused after your testimony, feel free. Why don't you begin?

STATEMENT OF THE HONORABLE BILL LOCKYER, TREASURER, STATE OF CALIFORNIA

Mr. LOCKYER. Thank you very much, Mr. Chairman, and members of the committee. It is the red eye and Ambien on the plane that does not seem to work well for me.

The CHAIRMAN. We have about 50 Members in California who will not be sympathetic to that.

[Laughter]

The CHAIRMAN. None of them are here, so you go ahead.

Mr. LOCKYER. The committee considers upheavals in capital markets that dramatically affect governments, taxpayers, and investors across the Nation. I commend you for shedding light on these issues and appreciate the opportunity to share perspectives from California, the largest municipal bond issuer in the United States.

I would like to start by addressing the issue that lies at the foundation of much of the turmoil that led to this hearing, the system used by major U.S. rating agencies to grade municipal bonds.

If you remember back when we were taking tests in school, what if you had aced every test and still received a grade lower at the end of the semester than a classmate who failed four exams. You would with total justification call the teacher's grading system unfair.

Unfortunately, for American taxpayers, that is exactly the same situation faced by governmental entities that issue bonds.

The agencies hold municipal issurers to a higher standard than corporate issuers. There has been considerable comment on this by the Chair and others, so I simply point out that disparate treatment results in higher payments and that the system is fundamentally flawed.

The rating agencies' own studies substantiate these claims. Municipal bonds rated Baa by Moody's have a default rate of .13 percent while corporate bonds rated Aaa by Moody's have defaulted at 4 times that rate or .52 percent, and similarly with the other rating agencies.

S&P, who by the way, of the rating agencies has been the one most resistant to considering change, published an article last Friday on muni ratings, and focused on unrated bonds, ones that do not rely on a government's strength of issuance.

With regard to the rated municipal bonds at issue in this debate, however, the same article contained updated numbers of default statistics that support these claims, showing the disparity between corporate and municipal defaults.

California has never defaulted on its bonds, yet, the agencies refuse to give the State a AAA rating. It undermines the functioning of an efficient and transparent market. It misleads investors by falsely inflating the risk of buying municipal bonds relative to corporate bonds, and worse from my perspective as the State's banker, it costs taxpayers billions of dollars in increased costs and bond insurance premiums.

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

We have asked the rating agencies to work with us to devise a unified rating system based on default risk. We believe that reform would make the market more efficient and transparent and better serve taxpayers and investors.

A number of other State treasurers and finance officials have signed those letters or written similar letters of their own. You will hear from some shortly. That letter is attached, Mr. Chairman, to my written testimony.

The rating issue flows naturally into the question of bond insurance. Municipal issuers buy insurance to obtain a AAA rating that, in many cases, they already deserved, based on the de minimis risk of default.

Insurers' AAA ratings are then transferred to the issuers' bonds. Our policy on insurance is similar to most muni issuers. If by insuring bonds we can save taxpayers more money in interest than it costs to buy the insurance, we will insure the bonds.

During the 5 years of 2003 to 2007, California spent $102 million to insure $9.1 billion in GO bonds.

Defenders of the current rating system argue that the market understands the distinctions between corporate and municipal rating scales. I would suggest that argument holds no water.

If investors truly possessed that understanding, our taxpayers would have had no need to spend $102 million on insurance. The fact that investors placed value on insurance, that it is an enhancement of our credit, shows the market does not understand fully the distinctions between the two ratings.

Even though bond insurers almost never paid out a claim since muni issurers almost never default, the industry is in crisis because of risky bonds they insured in other markets. Some monoline insurers are fighting to save their AAA status while rating agencies have downgraded others and the AAA rating of insured bonds purchased by investors has been lost or is in danger.

The effect of these downgrades on municipal issuers differs depending on the type of the bond. Most of our State's outstanding debt is in fixed rate bonds, but downgrades do affect debt service with respect to other bonds, and you have talked earlier about auction rate and others.

The CHAIRMAN. Mr. Lockyer, we need you to summarize and finish up, if you can, and then we can get to questions.

Mr. LOCKYER. The variable markets have been hit because of the insurance difficulties.

The States are grateful for the fact that the SEC has indicated that they may provide rules that will provide assurance soon to local entities that if they repurchase, that it does not constitute a default or some manipulation of the market. Replacing the dual bond system with a unified approach, Mr. Chairman, is a needed reform, and we hope that you will be able to assist.

[The prepared statement of Mr. Lockyer can be found on page 132 of the appendix.]

The CHAIRMAN. Thank you, Mr. Lockyer. We appreciate the leadership you have taken. The letter you put together will be put into the record as well as anything else people want to submit.

Ms. Wiessmann, please go ahead.

STATEMENT OF THE HONORABLE ROBIN L. WIESSMANN, TREASURER, STATE OF PENNSYLVANIA

Ms. WIESSMANN. 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 what I have termed the collateral damage that is being experienced by State and local government entities.

My name is Robin Wiessmann and I am Pennsylvania's Treasurer. My professional experience that is relevant to today's hearing includes municipal and State 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.

Today's financial market problems are very disturbing to me, especially the failure of many auction rate securities and the high reset rates on variable rate demand bonds.

They are imposing extraordinary volatility and stress on all municipalities including States, local governments, other local political subdivisions, and student loan providers.

This credit crisis is affecting them through no fault of their own, but due to market disruption unrelated to the prudent financial management of State and local governments.

Such market disruptions are costing taxpayers in terms of increased expenditures and constrained budgets. Further, the potential exists that in an already tenuous financial situation, it may worsen and disrupt the provision of basic government services, including the availability of student loans for the next school year.

The market is in desperate need of some help, and to those who say let the market correct itself, one must recognize that the market has been unable to adjust itself.

While I have great faith in the resiliency of the American economy, the market has demonstrated an inability to self correct.

While I applaud the Federal Reserve's action yesterday in announcing the securities lending facility program, nevertheless, the situation in the municipal markets requires and demands a more targeted relief for this market.

I want to speak about Pennsylvania for one moment. The current state of the national economy is very difficult and challenging, but the real challenge is, as I said, the challenge in the credit markets.

Nevertheless, we in Pennsylvania are relatively optimistic about the Commonwealth's economic outlook and debt portfolio. Due to Pennsylvania's conservative debt policies and conservative investment policies, we are again relatively well positioned to weather the current market uncertainties and challenges.

However, the turmoil does have wide ranging implications and my concern extends beyond the Commonwealth's direct debt to the agencies, counties, municipalities and school districts.

I would like to turn now to some very specific recommendations. I would like to call on the Federal Government to provide liquidity and confidence to the municipal marketplace. Encouraging investor confidence in the municipal bond market, which will bring in more buyers and result in liquidity, is essential, so that market participants can have the time to restructure their products, services, and securities.

In particular, I would call on the Federal Government to consider temporary actions to provide liquidity such as serving as a buyer of auction rate and variable rate securities, providing liquidity which they have provided to the general market with specific direction to maintain the auction rate and variable rate market of municipal issuers, and providing short term credit enhancements for bonds suffering market failure because of downgrades of their bond insurer, so that the bonds can resume trading at reasonable interest rates.

There has been much discussion about credit ratings, and based on my years working on Wall Street, I know firsthand that the credit of investments is primary. I also know that credit evaluations of governmental obligations have withstood the test of time.

However, I do have some observations about the market. Since municipals are governed by such challenging standards and are monitored very closely, they are, as we have heard many times today, seldom in default. Despite the scrutiny and the reduced likelihood of default, they are often perceived and priced as inferior credits.

I would corroborate and support many of the statements that have been made here today.

There should be some mechanism for the true creditworthiness of governmental debt obligations to be recognized. That will only happen when some adaptation of the current rating system is made. A credit rating system that is analogous to the corporate rating system would serve this purpose and make bonds comparable. Specific distinctions could provide the differentiation if necessary among municipal credits.

Another reason for this is very market driven. Buyers are now investing across asset classes based on relative value, and this simpler classification might facilitate this crossover buying, which in turn will provide greater liquidity and market demand for municipal credits.

Markets change. Guidelines evolve. We need to adapt.

I would also suggest that there are mechanisms that should be put into place to support trading, when disruptions in the market occur, as has occurred recently. Just as triggers were established in the equity markets, I suggest that the Federal Reserve or other Federal agencies offer stop gap temporary measures to support and sustain the municipal markets in times of psychological or actual crises, such as what we have been experiencing.

Had measures such as these been available in December or January, we might not have experienced the cascading effect of liquidity and credit concerns which are now impacting fixed rates and unenhanced paper.

Some of the other immediate solutions that I will not go into detail on have been cited before, raising the bank qualified debt limit from the current $10 million level to $25 million, permitting an additional advance refunding of bonds, altering the rating requirement under Rule 2a-7, and permitting Federal Home Loan Banks to offer letters of credit, and allowing governments to purchase their own debt.

I would like to speak just one more moment and speak about looking forward and doing better going forward.

It is clear from our current credit crisis that changes need to be made in our approach to the marketing and securities market.

There are three major factors that are necessary in order to effectively direct our capital markets: First, a principles-based code of conduct for business operations, a deliberate conscientious decision making process with consideration of market ramifications as they relate to consumers, capital markets and the economy as a whole, not just the business entity itself; second, transparency and complete disclosure of financial operations and securities structures; and third, a regulatory discipline that accurately reflects the realities of today's marketplace.

Thank you very much for your time.

[The prepared statement of Ms. Wiessmann can be found on page 217 of the appendix.]

The CHAIRMAN. Thank you, Madam Treasurer.

Next, the Treasurer of the State of Mississippi, Mr. Tate Reeves.

STATEMENT OF THE HONORABLE TATE REEVES, TREASURER, STATE OF MISSISSIPPI

Mr. REEVES. Thank you, Mr. Chairman, for the opportunity to be here today. I would ask that my entire statement be entered into the record.

The CHAIRMAN. Anything that anybody wants to put into the record will be put in, without objection.

Mr. REEVES. For the record, 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 your 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 Hurricane Katrina are two of the most prime examples in recent years.

My experience as treasurer of a State that bore the brunt of the 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 congressional action have greatly benefitted the recovery efforts and the citizens of the affected regions.

I would be remiss if I did not take this opportunity to thank the members of the committee as well as every other Member of Congress for your willingness to help my own home State in the aftermath of 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 of 2005.

It is extremely important to remember that what brings my colleagues and me before the U.S. House Financial Services Committee this morning is the current situation in the municipal marketplace, and it 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 markets.

The current loss of market liquidity has affected public issuers across the country. 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 our State, we have been more fortunate than many with respect to our exposures in today's unstable market. By statute, we cannot have greater than 20 percent exposure to variable rate debt.

In practice, we have a well diversified portfolio that generally helps position us to weather and even take advantage of short term aberrations in the market.

Of our $3.2 billion debt portfolio, less than $140 million currently is held in auction rate mode securities. We have had one failed auction, but 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, and although 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 all of 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. Clearly, 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 re-issuance 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 bond deemed to be re-issued which can be costly to our governments. This has allowed our issuers to save taxpayers money and limit their exposure in a volatile market.

Some tax exempt bond issuers secure letters of credit 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.

As has been mentioned today, the Federal Home Loan Bank System is not allowed under current law to offer this AAA guarantee. Legislation proposed in this Congress would permit that, and I personally would like to tell you that I appreciate the support of Chairman Frank, Subcommittee 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.

Moody's has indicated that the default rate on investment grade municipal bonds from 1970 through 2006 is approximately .1 percent, far different from the 2.1 percent default rate among all investment grade corporate securities over the same period.

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. I think it is 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 rating 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.

I believe that a relaxing of Rule 2a-7 requirements would benefit 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.

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.

Thank you.

[The prepared statement of Mr. Reeves can be found on page 198 of the appendix.]

The CHAIRMAN. Thank you. Let me just say to the witnesses that I am apologetic and I appreciate your staying. If you want to get something to eat, you have time. There is a cafeteria right downstairs. I know people have been here all day. We are going to get to our third panel.

Let me get right to Mr. Newton.

STATEMENT OF MARK NEWTON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SWEDISH COVENANT HOSPITAL

Mr. NEWTON. Good afternoon. Thank you, Chairman Frank. My name is Mark Newton, and I am the president and chief executive officer of Swedish Covenant Hospital, located in Chicago.

I offer a ground-level view of this current situation and crisis. Swedish Covenant Hospital is a 334-bed urban community hospital. We are the largest remaining independent hospital on the north side of Chicago, and we serve a very culturally diverse community. Over 50 languages are spoken—

The CHAIRMAN. We have a time problem, so I want to get right to how—we stipulate that this is a very important institution—you were affected by this—

Mr. NEWTON. Well, Swedish Covenant is a Federal disproportionate share hospital, and as such we represent this critical safety net for the uninsured and underinsured. And we consider ourselves your partner in serving these communities.

The cascading nature of this turmoil over the last few months indicates that there is no predictable fire break on the horizon. And as the president and CEO of a hospital, I'm no stranger to responding to these kinds of community health risks, competitive market changes, malpractice crises, nurse staffing shortages, and possibilities of revenue stream cuts.

We have been able seemingly to weather each one of these risks to the healthcare system while trying to expand our infrastructure, and the key to our ability to respond truly has been the availability of predictable and efficient capital.

Let me share some details of our story. Since 2000, when I first joined Swedish Covenant, we have had hospitals close in our community with over 500 beds removed and 3,000 jobs removed from the community. Our best response has been to invest in new facilities, services, and technologies, while others have downsized and curtailed services. This is not only out of a sense of mission, but it is also our view that it is important that we strategically invest in health care facilities for our community.

We now find ourselves responding to a crisis that requires us to reinvent our balance sheet and rethink strategies of capital spending. We are currently in a refinancing process that is going to cost over $1 million in transaction fees. This amount is being taken directly from patient care. Our monthly insurance costs have historically been in the range of $600,000 a month, that has increased by an additional $350,000 a month, an increase that is directly related to failed auctions and the result and expectations of bondholders of default rates of interest between 10 and 15 percent.

The CHAIRMAN. We are not talking malpractice insurance here. You are talking about the bond insurance, correct?

Mr. NEWTON. Correct.

The CHAIRMAN. Yes. I just wanted to be very clear that it is just the bond insurance. Thank you.

Mr. NEWTON. All of this turmoil clearly has lessened the confidence in the financial markets. And what we find is that we have to be more alert to unintended consequences as we restructure our balance sheet.

Today our debt is approximately $150,000, with 83 percent fixed and 17 percent variable, and it is either insured by bond insurance or supported by bank letter of credit. We are an underlying Triple-B-plus credit. Our fixed rate now is 4.9 percent. We expect the fixed rate to increase to 6.5 percent.

After refinancing, we will have to increase the percentage of variable debt to about 60 percent. One unintended consequence is even greater reliance on bank letters of credit, which by nature are short-term. The cost of bank credit enhancement as a replacement for traditional bond insurance has increased significantly. Credit enhancement capacity has been reduced as we look forward in the next 3 months to a massive period of debt refinancing by hospitals such as Swedish Covenant Hospital. This remains a yet unexplored dimension of this ongoing crisis.

If this crisis is not resolved, hospitals like Swedish Covenant will face significant cost increases on our existing debt and may have very little capacity for access to new capital in the next few years. We would slow down projects investments in projects such as implementation of an electronic medical record; we would postpone expansion and renovations of core infrastructure; and we would conserve other spending to maintain needed cash balances as banks tighten other credit terms such as higher minimum levels of cash on hand.

Perhaps my final observation is that organizations such as mine truly need a fire break in this current cascading crisis. As I noted before, as your partner in providing health care services, we really need and want to get back to the basics of caring for people. The fabric of an efficient and effective health care system depends on access to stable and predictable sources of capital.

I want to thank the committee for the opportunity to discuss this important issue, and I welcome any questions.

[The prepared statement of Mr. Newton can be found on page 195 of the appendix.]

The CHAIRMAN. Thank you. I'm going to go vote, and we are going to come back. I appreciate your indulgence. People should feel free, you have 15 or 20 minutes to maybe get lunch. Not this panel, because we're going to be right back here with the others. But we will get right back to you. And I thank you. Our commitment to this issue, I think, justifies all of us doing this.

[Recess]

The CHAIRMAN. On behalf of the National Utility Contractors' Association, I should note that I spoke with Chairman Jim Overstar of the Transportation and Public Works Committee because we did want to make clear what the impact of this is on services such as health, as we have seen from Mr. Newton, and infrastructure in general. And Mr. Overstar strongly recommended that we ask someone from the National Utility Contractors' Association, so I'm glad that we were able to arrange that. Mr. Dillon, please go ahead.

STATEMENT OF TERRY DILLON, CHIEF EXECUTIVE OFFICER, ATLAS EXCAVATING, ON BEHALF OF THE NATIONAL UTILITY CONTRACTORS ASSOCIATION

Mr. DILLON. We appreciate your letting us testify today, Mr. Chairman. And I'm going to put a little different kind of color to your meeting today, so let's see how this thing goes for you.

My name is Terry Dillon, and I am the owner of Atlas Excavating in West Lafayette, Indiana. We have 150 employees who work on sewer, water construction, highway, and road reconstruction projects throughout the State. My wife and two sons are partners in my business.

My written statement today supports the need for municipal bonds and their effect on infrastructure projects. I will leave the reading of the statement for you and move on to actual projects these bonds are used for, and try to put some color in today's testimony. Ten miles south of Lafayette, Indiana, is the small town of Stockwell, where about 300 residents reside. Three years ago, you could drive through this town and see puddling sewage in the streets and in the yards. There was a bad sewage stench in the air. The local kids would be riding their bikes through the sewage and playing in it; small children could be seen playing in the muddy sewage as if playing in a sandbox.

Stockwell residents took control of this issue, and had a sewage system designed, financed, and built. Financing was done through the SRF program, the OC Grants, and municipal bonds. Today residents are painting the houses. They have cleaned up their neighborhood, and have taken their community back. It's a thriving Indiana town again.

My company, Atlas Excavating, has done about 30 such projects across the State of Indiana. In each one of these towns that we have gone into, I have found a dilapidated city and a bad attitude, and once these sewage lines have been repaired and the city has been cleaned up, the towns thrive once again.

Next, the City of Indianapolis is under Federal mandate to clean up its dumping of raw sewage through sewage overflows. This is at a cost estimate of around $2 billion, of which these are supposed to be done over the next 20 years. Indianapolis also has 80,000 septic tanks in the city limits that have to be replaced with a piped treatment system, and posted all over the City of Indianapolis at ponds and streams are big red warning signs where overflow structures dump raw sewage into the waterways. The signs say, and I quote, "Caution, sewage pollution. Keep out of the water. People who swim in, wade in, or swallow these waters may get sick." And it is repeated in Spanish.

Finally in the City of Lafayette, there is a 42-inch concrete sewer line that runs from Staley's Corn Syrup Plant 10 miles to the sewage treatment plant in the City of Lafayette. The sewage line goes through woods, creeks, residential neighborhoods, back yards, camp grounds, and playgrounds. This line is in such bad decay that it breaks 2 to 3 times a year, and in the last 10 years, my company has repaired this line on most of its breaks. I want you to imagine a 42-inch-diameter concrete pipe that has 5-inch wall thickness, with a daily flow of 15 million gallons per day. This 42-inch pipe, which was put in around 30 years ago, now has paper-thin walls, with a maximum thickness of about 1 inch left in the 5-inch-thick concrete walls. This pipe is a disaster waiting to happen.

My most memorable repair to this line was 5 years ago. The city engineer contacted me, requesting immediate response to a sewer break. Normally you get a call giving you hours to respond, but the urgency in her voice sent me driving to the site immediately. When I got there, it looked like a crime scene. There were fire trucks and emergency vehicles lining the roads to get to it, and the site was cordoned off. I ran up to the failing spot, and found a 20-foot-long, 5-foot-deep, 12-foot-wide sinkhole. In the hole, raw sewage was running down the broke and exposed pipes at a very rapid rapid rate, indicating a high flow and massive surcharging. The swirling of the water in the hole was eroding the ground conditions. I immediately had emergency crews who were standing there, gawking in the hole, get back away from the hole, and at the last minute, I grabbed a city official who was standing by the hole by the back of his shirt and pulled him back, and said, "I said get out of the way." At that point in time, the ground caved in out from underneath his feet; however, he did not fall into the hole due to my pulling him back. Had he fallen into that hole, it would have killed him instantly.

While that is scary, it is not the worst of the day. The reason that the emergency vehicles and the fire department were there quickly became aware to me when I looked at the surroundings. We were in a playground, and two small children were playing on a swing set 100 feet away from us. It would have been a very bad day if one of those children had fallen into that hole. If you fell into that particular sinkhole, your next stop would be the grinder pumps at the treatment plant.

This entire line has now been replaced, largely due to municipal bonds. Are bonds important to our infrastructure needs? Yes. It is probably the single most important funding source that we have, bar none, across the Nation.

Gentlemen, clean water is to me more important than oil. Without clean water to drink, you won't live more than a week. We need your help and you need to help take control of this bond market and the infrastructure across this country and help be responsible for it. I personally believe that you alone, with me working in this industry, we are the gatekeepers of our infrastructure system, and it is the greatest asset that the United States has.

Thank you for letting me testify today. I will be happy to answer any questions.

[The prepared statement of Mr. Dillon can be found on page 98 of the appendix.]

The CHAIRMAN. Thank you, Mr. Dillon. That's precisely why I consulted with Mr. Overstar, who is our chief infrastructure chairman, and why he recommended you. I should note that I believe we will be joined on this committee within a few days by the new Member of Congress from Indianapolis, Andre Carson, who is succeeding his grandmother, and we look forward—although we regret the circumstances of having him.

I want to note that Deputy Treasurer Paul Rosenstiel has replaced Treasurer Lockyer on the panel. And I want to move quickly here. But let me just ask—a number of things that we have talked about, merging the dual risk, some other things that are clear—I have been struck—a number of witnesses have mentioned, Mike—Massachusetts, Mr. Lynch—Federal Home Loan Bank. We will be looking at all those things. What about the question of a Federal re-insurance for particularly general obligation, full faith and credit municipal bonds? Any comment on that? Let's start with you, Mr. Rosensteil.

Mr. ROSENSTIEL. Well, I think that is the kind of thing that can give investors confidence. With the dual rating structure, unfortunately investors don't think that our ratings are as strong as we think the risk of State general obligation and other general obligation and strong revenue bond issues is. So I think the Federal Government stepping up and saying, you know, "This is not risky," that's a good idea.

The CHAIRMAN. Ms. Wiessmann?

Ms. WIESSMANN. I think if the Federal Government steps up to provide assurance in the marketplace, it is a good thing; however, actually administering it, there are differences among credits introduced in the marketplace. And actually managing and administrating the implementation of that, I think, will be a challenge.

The CHAIRMAN. Are there real differences among full faith and credit general obligation funds, do you believe? Or should there be?

Ms. WIESSMANN. Credit and markets are continually dynamic. They change all of the time. It's based on facts and circumstances at the time. So at different points in times, yes, there are differences among them.

The CHAIRMAN. Among full faith and credit general obligation? We have the record that none have defaulted, you know, since 1970. So what are the differences?

Ms. WIESSMANN. There are varying degrees of strength. I'm not disagreeing with the point that they're very, very strong and very secure. But they are because they have certain operating requirements, reporting requirements. They have accounting requirements. And to make sure that the incentive is still in place for them to achieve good credit ratings and to not have issues requires some administrative—

The CHAIRMAN. Well—the Federal Government could make some things conditional. But—it's sort of circular. If they don't have a good credit rating because credit rating agencies don't give them good credit and because markets undervalue—solidity.

Mr. Reeves?

Mr. REEVES. Thank you, Mr. Chairman. I think that I agree in general terms with Treasurer Wiessmann. The reality is that in the municipal marketplace, relative risk is always going to be important, and it's going to be important either relative to the way in which rating agencies rate securities, or it's going to be important relative to the buyers who are actually buying those securities—

The CHAIRMAN. But we are talking about full faith and credit general obligation bonds. Are there real differences and risks?

Mr. REEVES. Absolutely. There are real differences in risk. I mean if you look at the general obligation of the State of Pennsylvania, which has a very diversified economic situation within the State or my State and the State of Mississippi relative to the general obligation of a smaller entity that may not have the sort of diversified situations. Now, in terms of—

The CHAIRMAN. Which has never defaulted.

Mr. REEVES. The default risk is one component of the overall risk structure—

The CHAIRMAN. Well, but that's so fulfilling. Yes, if you leave it entirely to a market which undervalues the—and to a credit rating agency with a dual structure, then those differences are built in. The question is, what would happen if the Federal Government stepped in and said, "You know, with regard to these, there has been a default. We don't think that the way the rating agencies have treated them reflects reality."

Mr. REEVES. Well, I agree that the way in which rating agencies have treated municipal issuers has not reflected reality because when I say "relative risk," I think relative risk means not only amongst general obligation credits of larger entities and smaller entities. Relative risk also includes that of the corporate marketplace as well. And that's where the real distinction has been in the past, in my opinion.

The CHAIRMAN. By the way, the record does not show that the size of the State makes any difference whatsoever. There is simply no difference with regard to defaults with regard to State, because they don't default.

Mr. REEVES. I would agree with that, Mr. Chairman, but I would like to just note that when you talk about the entire municipal marketplace, you're not just talking about—

The CHAIRMAN. I said, Mr. Reeves, full faith and credit general obligation. I understand that. But that's exactly yes, there are some differentiations there. But even there, though, the market—the market undervalues all of this, but in different levels.

The gentleman from Pennsylvania?

Mr. KANJORSKI. Thank you very much, Mr. Chairman. As I understand it, the question in the municipal bond market is not that there aren't funds available the people would like to buy bonds with; it is the problem of getting to a triple-A rating, which is required by many of the entities that invest in municipal bonds. So having lost in some instances the value of the insurance wrap-around, that because the rating agencies were able to sell their wrap-around, triple-A rating to the particular municipal bond issuer, these qualified across the board to all potential buyers. Now that has disappeared, and in some instances the fiduciary relationship of the pension fund or whoever buys these bonds is now being forced to divest themselves of the bonds because they failed to meet the legal requirement of a the triple-A rating. Is that correct?

We are not talking about having to create an investment tool process by which the owners or purchasers of these bonds can continue to exist as they have in the past. And since they do not know what the rating is, they cannot depend on the rating right now, and the insurance companies are either incapable because of their draw-down of equity to issue the amount of capacity that they had in the past, we no longer have that clear triple-A rating.

Is that basically—do I have it right or do I have it wrong?

Ms. WIESSMANN. In that segment of the market, yes.

Mr. KANJORSKI. Well, so it seems to me that we have about a $2.6 trillion market. It has probably been working for your friends and associates in the construction industry and in the municipalities. It is a question of how do we get back to that status, so there isn't an interruption, as there has been?

And one of the interruptions would be the insurance companies. Their equity is being drawn down because they have wrapped too many high-risk securities that now they have to come forward and show support for that, and that limits the amount of equity they have left in their companies to give the triple-A guarantee to new issues. Is that about the correct analysis?

Mr. DILLON. But I would like to say, Congressman, there there has been—construction work is slowing and stopping. It's being affected immediately right now. And really it just has happened in our industry in Indiana probably in just the last three to five—

Mr. KANJORSKI. But we could probably cure that if we were to decide to pass a very limited Federal financing instrument and say that municipal bonds from this day forward may be insured by this Federal agency for the next 12 months or until other insurance in the private market is obtainable for a reasonable price. And that would then jilt the market right back to being a very sound triple-A document. Is that correct?

Mr. DILLON. That is my understanding from our local city engineer.

Mr. KANJORSKI. Right. And we should all be in favor of that, finding a way. So now we are in the darkness, trying to find the light. The problem that I have is it is quite an invasion and disruption of the private market. The question that I pose to you, and perhaps the treasurer from Pennsylvania: At what point should we worry about invading the private market? Is it so pervasive the risk to going on with municipal bonds and public projects, that we ought to just as a matter of course in good public policy delve into it to solve the immediate problem of stimulating the market to begin to operate?

Ms. WIESSMANN. Well, that goes to the heart of my testimony, which is that I do think these are very unusual circumstances, and that the increases and the expenses and the stress that is being created on States and municipalities and entities is something that needs to be obviated. And I have called for some intervention, both from a liquidity standpoint, and if the Federal Government were to see to having some from a insurance standpoint, if the Federal Government found fit to do that on a temporary basis, I think it would be justified.

Mr. KANJORSKI. Well, let me follow that reasoning. It would take us a considerable length of time to establish a new municipal bond government guarantee corporation. From my experience standing here, we are probably talking years, unfortunately. So that is one of the reasons I came up with the argument and the idea a number of months ago to use the Federal Home Loan Banks. If we authorize the issuance of letters of credit to operate as an insurer of municipal bonds, that could be implemented almost immediately. We have it all collateralized, and available in all 12 Federal Home Loan Banks across the country, and they could be operable almost immediately, or certainly within 30 days.

Ms. WIESSMANN. I think you have three State treasurers here on the panel, who have all concurred that would be a very good idea.

Mr. KANJORSKI. So we ought to urge our fellow members on the Ways and Means Committee to move as quickly as possible on that piece of legislation as a surgical procedure to at least restart the municipal bond operation to move projects along in the country, is that correct?

Ms. WIESSMANN. In my opinion, yes.

Mr. KANJORSKI. Right.

The CHAIRMAN. Thank you. Next? The gentleman from Massachusetts.

Mr. CAPUANO. Thank you, Mr. Chairman.

I'd like to ask each member of the panel—I notice that several of you work with treasuries in one hospital and one independent. I just want to make it clear in my own mind. Are you all currently, or any of you not currently issuing bonds on a regular basis, either for the State, or on behalf of cities and towns, or on behalf of the hospital? Are you not in the bond market? Oh, you—I'm presuming you are in the bond market.

Mr. ROSENSTIEL. We are in the bond market today, selling a billion dollars of revenue bonds because of the fact that they are not working—

Mr. CAPUANO. That's—I just want to know if you were in the market.

Mr. ROSENSTIEL. Yes.

Ms. WIESSMANN. The Commonwealth of Pennsylvania has issued bonds very recently.

Mr. CAPUANO. And I assume that you don't issue bonds directly, you just benefit from them when you can?

Ms. WIESSMANN. Correct.

Mr. CAPUANO. So then it's fair for me to believe that I have to be a little wary of everything you say, because if you're in the market, you really don't want to get the credit rating agencies upset with your State. You really don't want to get the bond insurers upset with your State. And I don't blame you. I was hostage for 9 years, I had to very nice and very professional, so I'd have to tell you that I feel sorry for you and I look forward to the day that you are released from your hostage situation, and then can speak freely.

In the meantime, I would like to know, if you can tell me, if you feel—again, I would never ask you to hurt your State or municipality, so if you have to couch them or just want to skip, go right ahead. Does anybody think that the dual-rating system is good or fair? Does anybody think that the similar treatment that's required by the SEC or the dual-rating system, is fair?

Ms. WIESSMANN. I made in my comments, I commented that the origination of the ratings, which of course have a long history at this point up until now have withstood the test of time. But our markets have become much more complicated, and when times call for it, changes should be made.

Mr. CAPUANO. That strikes me as a very nice and professional way to say they're not fair, and you know—

[Laughter]

Ms. WIESSMANN. Well, I like to approach things constructively.

Mr. CAPUANO. That's fair. I can't tell you how good it is to have some freedom. Believe me, when you get it, it's great.

[Laughter]

Mr. CAPUANO. I'm just curious. I know you each come from different States. I assume the three of you can answer; I'm not sure if the other two can. If you can, I'd appreciate it. Do your States back up municipal bonds? I know in Massachusetts if a city or town has trouble, the State will take it from Local 8. And they come in right away and we have had cities go bankrupt, and not a single bondholder has missed a beat. I'm just curious, is that true in each of your States?

Mr. ROSENSTIEL. There is nothing legislatively that requires it, but in fact when there have been problems, there has been a history of the State stepping in to—

Mr. CAPUANO. So there's a history, a recent history of that happening?

Mr. ROSENSTIEL. Yes.

Ms. WIESSMANN. In Pennsylvania, it also is done on a case-by-case basis. It's not legislated, but there is often a considered moral obligation.

Mr. REEVES. We have a specific conduit issuer in Mississippi, which by the way was very useful in the immediate aftermath of Katrina. But we do have a specific conduit issuer that on certain issues when requested does all for the moral obligation of the State. I will tell you just for the record that along with that moral obligation comes additional responsibility by the issuers to satisfy the members of the board that sits on that conduit issuer, including myself. Yes, we do have a conduit issuer.

Mr. CAPUANO. Good. And can you answer me relative to Illinois? Do you know?

Mr. NEWTON. I can answer relative to my institution.

Mr. CAPUANO. Okay. That's fair. What is the answer for your institution?

Mr. NEWTON. We're totally dependent on ourselves and our own performance.

Mr. CAPUANO. Okay. And do you know—again I don't expect you to know, but I figured you might—

Mr. DILLON. No, I don't. I don't.

Mr. CAPUANO. Okay.

Mr. DILLON. If you want to know how to put pipe in the ground, I'm your guy.

[Laughter]

Mr. CAPUANO. We're doing that right now in my city. As we had a brief discussion, my city is currently in the middle of doing a major sewer project that has been put off for 20 years, and had I been able to save all the money I had to waste on bond insurance, I could have done it years ago, and a lot of people's homes and businesses would not have flooded.

In that case, I appreciate you being here. I don't have any real questions for you. I can only tell you that if you have heard us say anything here that you think has been wrong, then I would suggest if you haven't, then talk to your local cities and towns, your mayors, and in particular your county commissioners. Whomever issues the bonds, in particular, GO's and revenue bonds, and see if they think it's wrong. And again, when the time comes when you are no longer in the market, I'd love to have a further discussion with you to see what your personal experience has been. In the meantime, I would like to say to the credit rating agencies and the bond insurers in the market in the room tonight, this afternoon, please don't hold against them what I have said.

The CHAIRMAN. The gentleman—I was sorry but not surprised to hear your report that this has already begun to affect a slowdown. Anything that your association wanted to send to us along those lines, we would be glad to put in the record, because I think it is important to show that, as I said, we're not talking about some narrow technical matter, but some real problems that will slow down the rate of needed physical improvements.

The gentleman from Texas? Oh, I'm sorry, the gentleman from Connecticut.

Mr. SHAYS. Yes. Thank you, Mr. Green, as well. Just on behalf of Ranking Member Spencer Bachus, I'd like to enter into the record a letter that Mr. Bachus sent to Securities and Exchange Commission Chairman Christopher Cox on January 23, 2007, not 2008, more than 14 months ago, long before the issues in the municipal securities market that we have been discussing here today. The letter states concerns that Mr. Bachus had about the oversight of the municipal securities market and the situation particularly in Jefferson County, Alabama. So if I could submit—

The CHAIRMAN. Without objection, that will be part of the record.

Mr. SHAYS. Thank you.

The CHAIRMAN. And the gentleman from Texas is recognized.

Mr. GREEN. Thank you, Mr. Chairman. And I thank the members of the panel for appearing. It appears to me that we are talking to a great extent about the monoline market. Is there anyone who is of the opinion that this market should be regulated at the Federal level? Or if you're at liberty to say, and perhaps I should start with Mr. Newton. Mr. Newton, should this market be regulated?

Mr. NEWTON. I don't know if I can give you a specific direct opinion on regulating the monolines. What I can share with you is that what really precipitated this was the failure in the auction market. And to the extent that there is oversight of the auction market, and to the extent that we can have available to us other options for credit enhancement, that would be a wonderful thing.

Mr. GREEN. The failure in the auction market is due in great part to the way the mono insurers conducted themselves, is that correct?

Mr. NEWTON. That's my understanding. Correct.

Mr. GREEN. So regulating that market would mean that we would again get back to the monoline market. I don't know how we get away from that. Maybe you can help me to understand how we get away from it.

Mr. NEWTON. Well, what really makes health care work is having this predictability and capacity of capital. And when we run up against things that frankly—I, like you, don't understand all of the arcane science of how these markets may choose to work, what I would be greatly in favor of is if transparency and visibility and greater understanding of the kind of debt instruments that are involved, that would be very helpful, if that helps clear the market.

But what we're facing is a bolus in the market of this refinancing, and that to me on a looking forward basis is really my greater concern. The past is past. I mean I can't really give some more in-depth conversation about how it really got this way.

Mr. GREEN. Well, Mr. Dillon, do you have a comment on it, please?

Mr. DILLON. No. I really can't advise you on that.

Mr. GREEN. Do you think that we should, the feds should regulate the monoline market in any way?

The CHAIRMAN. Well, let me just say in fairness to the witness, he was invited here to give his information about what the impact of this crisis has been on the industry he represents. He was not asked to be prepared on the—

Mr. GREEN. Thank you, Mr. Chairman. I appreciate it. Well, let me ask this question. Would regulation—and if this is the wrong panel to ask a question of, my apologies again—but would regulation have been of benefit, any kind of regulation in the monoline market have been of benefit to us in terms of preventing the failures that we're talking about?

Ms. WIESSMANN. I would just suggest that the insurance companies would respond today that they are regulated; they just happen to be regulated by different States. And one thing that I have been struck with about this is how different the different insurance companies are. So I do think it would be beneficial for there to be some uniformity of standards as it relates to the marketplace that they're operating in, so that there is a greater understanding of how they are conducting or managing their risk relative to this very important market sector.

Mr. GREEN. Thank you, Mr. Chairman. I'll yield back.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Mr. Chairman, I have one question—I'm anxious for the next panel—uniform standard. I mean insurance companies, Ms. Wiessmann, you said would argue that they are regulated—if there is a regulation supposed to be at the State level. And so I guess I'd like to know if you know of any kind of regulatory control over an insurance company that has addressed any of the issues that we're raising today? The dual standards, student loans. I don't know if Mr. Dillon talked about the problems with student loans.

Ms. WIESSMANN. Well, I think there are a number of factors, here. The dual standards I think are generally referring to the rating agencies in terms of all of that.

Mr. CLEAVER. Yes.

Ms. WIESSMANN. It is a complex mix. It's an interplay of a number of different factors. When I said that I thought that it would be useful to have some uniform standards, if there are particular criteria that Congress or other interested parties think need to be put into consideration when insuring municipal bonds, I think you could develop those. So I think there is something that you can do. I think we do have to do it, to say wholesale regulation is—I'm not really in a position from a jurisdictional standpoint to argue that. But I certainly think that there's a lot to be done to improve the information we have as well as knowing how the risk is allocated. So—

Mr. REEVES. I'd like to just touch on that. The regulation of the insurance industry has been an issue handled by the States for a long period of time as to whether or not that's the right approach or not that's not something I should necessarily comment on, because again, as the treasurer said, it's not under my jurisdiction.

But what I would like to say, and I think this is extremely important, is that the fact that the insurers have had the complications that they've had, and that they've lost their credit ratings really speaks to—as it relates to the challenges that we face today, speaks to a larger issue, and that is the lack of liquidity in the market. The real challenges that we have in the auction rate securities market is due to lack of liquidity. The reason that the insurers losing their triple-A ratings, at one reason, has really exacerbated the problem is because of the Rule 2a-7 requirements. Okay? So in essence, when the insurers lost their triple-A ratings, many of these securities were no longer eligible under Rule 2a-7. The chairman earlier mentioned his sensitivity to the private marketplace. My opinion is that the least invasive solution in the short run is actually a relaxing of the 2a-7 requirements for municipal bonds. Because the reality is it makes no sense that a 2a-7 fund can purchase a double-A corporate and not a single-A muni, when in fact the reality is and the facts show that that single-A muni has less of a default risk than the double-A corporate. So in my view, the least invasive solution in the short run is that relaxation and as the chairman mentioned earlier, secondarily, an additional possibility which again requires legislation, which takes time, is the allowance of the Home Loan Bank to offer letters of credit again, which would infuse liquidity.

Mr. CLEAVER. Thank you, Mr. Chairman.

The CHAIRMAN. Again, what we stress is the case where the low rating of the insurance drags down the entity it is insuring. This is the lead life preserver. You would be better off without the life preserver and floating on your own.

The gentleman from Colorado?

Mr. PERLMUTTER. Thanks, Mr. Chairman. And I guess, I have so many questions, I don't know where to begin but just basic question to the treasurers: Why do you have to go through Moody's if you are California or you are Pennsylvania or Mississippi, why cannot you just go straight to somebody who buys bonds and not have to go through any of this stuff?

Mr. REEVES. Well, one of the main reasons is that among the biggest buyers of municipal bonds are mutual funds, and they require the ratings. That is in their bylaws for each of their funds, that there have to be generally two ratings.

Mr. PERLMUTTER. Okay, so the mutual fund before it buys says we have to have something from Moody's?

Mr. REEVES. That's correct.

Mr. PERLMUTTER. Or we have to have insurance?

Mr. REEVES. We have to have certain rating levels from usually at least two rating agencies.

Mr. PERLMUTTER. Is there anything in the law that says that they have to have that?

Mr. REEVES. I don't believe so, but I am not an expert on their law.

Mr. PERLMUTTER. So if you went to a mutual fund, and I have represented for instance Pennsylvania Higher Education Authority, which apparently is struggling to make some loans because it cannot borrow any money or sell bonds, but your Pennsylvania Higher Education Authority. And you say, "But we are a good credit risk, and we can put on the dog and pony show to any bond buyer out there and prove to you that we are worth 5 percent interest, and that is a good risk for us. Why don't you do that?" They just say, "Sorry, you have to go through Moody's," or some other?

Mr. REEVES. There is that and there are other buyers who buy the bonds and then turn them into variable rate bonds and 2a-7 requires the ratings and just in general I think investors, individual investors, get a sense of security. The ratings have provided an important function in our market.

Mr. PERLMUTTER. But, Mr. Treasurer, listening to Mr. Lockyer, I am going wait a second, California has issued $9 billion worth of whatever, it has paid $100 million to insurance companies and to the credit rating agencies, you could have taken that $100 million and gone to Leonard Perlmutter and say, "Hey, we are good credit risk, will you buy $100,000 worth of our bonds?" Why do you not do that?

Ms. WIESSMANN. The short answer is that you rely on the negotiation of the credit markets, which are far larger than anything a State or a particular entity could access. When you talk about Pennsylvania student loans, there are securities on loans of $7 billion. We would have to find a lot of one-on-one placement in order to fulfill that type of liquidity requirement, which it brings us back to the point that it really does—rating agencies have provided an objective, a perceived objective standardization in the marketplace, just as the insurers have been up to this point have been perceived as creating a marketability for these.

The CHAIRMAN. Will the gentleman yield?

Mr. PERLMUTTER. Certainly, yes.

The CHAIRMAN. There is nothing objective. I understand that you were held hostage by this, but I do not understand why you, the victims, would defend a rating system that has totally undervalued you, that has cost you a lot of extra money. There is just no validity to this. They are drawing distinctions among bonds that never default. So I understand why you are forced into it, but frankly now some of them come in, I have to tell you at this point, and I have said it before, the ratings agencies worth—I have said about editorial writers, they come down from the hills after the battle is over and shoot the wounded. So they are never there to help anybody in advance, but I do not understand how you can talk about them as being objective.

Ms. WIESSMANN. I just want to qualify, number one, I do not feel held hostage to them at all. I feel quite independent in fact, but—and I do not think that what I say here today is going to affect the credit rating of Pennsylvania.

The CHAIRMAN. But I am saying this, as the gentleman from Colorado said, we have bonds that never default and you were all held hostage, what you are saying is if you did not go and subject yourself to the rating agencies and to this insurance, which is dragging people down because it is lower rated than you ought to be, you could not sell.

Ms. WIESSMANN. I just want to say I mentioned before that markets change. The sophistication of buyers, the sophistication in America in terms of what municipal bonds are is quite different from when rating agencies were first added.

The CHAIRMAN. But now you are worse off, is that what you mean?

Ms. WIESSMANN. And they provided market access.

The CHAIRMAN. I'm sorry, I want to get back to the gentleman from Colorado, but I do not think that is the case because you are now paying more than you used to, so if they are more sophisticated, that must mean that you are worse than you used to be as a credit risk, and I don't think you are. The fact is if they were so sophisticated, you would not be in the situation of having rates go up when there is no valid reason for it.

The gentleman from Colorado?

Mr. PERLMUTTER. And I will just cut it off at this. I can understand why the hospital authority or something else needs to go through a middleman, Moody's or have to have some backup from an insurance company because the marketplace or the Smith Barneys or the Goldman Sachs or whoever buys these bonds does not really understand you, but California, Pennsylvania, Mississippi, for goodness sakes, it really does not make sense to me how this process works.

Ms. WIESSMANN. Unfortunately, we just respond to the market. We are trying to change the market. We are trying to educate people that we are better credits, but we are in the market today with $1 billion worth of bonds, and we bought bond insurance on them.

Mr. CAPUANO. Will the gentleman yield for a second?

Mr. PERLMUTTER. Certainly.

Mr. CAPUANO. I appreciate your trying to educate them. Why would they get educated when they make money by being—well, uneducated?

Ms. WIESSMANN. What I mean is the investors.

Mr. CAPUANO. Why would the investors do it when they get a higher rate of return?

Ms. WIESSMANN. That is a very good point.

Mr. CAPUANO. If you are telling me that you are going to educate me, and when I am educated, I am going to get 5 percent back on my bond as opposed to 8 percent on my bond, guess what? I will stay stupid.

[Laughter]

Mr. CAPUANO. So therefore, how can you educate the people who are making money on the backs of your taxpayers?

Ms. WIESSMANN. You are defining part of our problem, but there are also a lot of investors, especially we had at other times in the market, as recently as less than a year ago, many of our bonds were bought by hedge funds. They put in a great bid for our bonds. They drove our interest rates down, and the reason they did that is they then put it into trust and they sold variable rate bonds. They now have had to unwind those trusts because of the problems of the bond insurers. That has been one of the problems.

Mr. CAPUANO. Because they were bundled with risky bonds. They were not sold individually.

Ms. WIESSMANN. They put into the trust insured bonds, and when the insurers were downgraded, the bonds—

The CHAIRMAN. Right, the insurers downgraded because they went into other things and not your bonds.

Ms. WIESSMANN. Yes, that is exactly right.

The CHAIRMAN. We are going to have to break now, but we have Stockholm Syndrome here, where you start thanking the kidnapper.

[Laughter]

The CHAIRMAN. People need to be much less accommodating intellectually to a system that has just mistreated you. We have to go and vote.

Mr. CAPUANO. Mr. Chairman, just one point?

The CHAIRMAN. Yes?

Mr. CAPUANO. Just one point. I need to remind everybody that even Patty Hearst said good things about her captors.

The CHAIRMAN. Yes, they talk about that. Anyway—

Ms. WIESSMANN. We would not be on this panel if we did not think there should be changes to be made.

The CHAIRMAN. I understand, but you have to make the arguments for the changes, not by defending the objectivity of the existing system. That is not going to help us. I want to say to the next panel that we will be back. It may take us about a half-hour. There are a couple of votes. I apologize but your testimony will be valuable. Let's take a little break. We will be back in about 45 minutes. If you can stay, I appreciate it, and we will get to you.

[Recess]

Mr. CLEAVER. [presiding] We apologize for how often we have to leave, and I wish I could tell you that this was unusual, but we are going to proceed and Chairman Frank will join us shortly. We are going to move on with the third panel, and we will begin to receive your testimony. By the time the chairman returns, hopefully we by then can become "dialogical." We will begin with Mr. Jain, Berkshire Hathaway Assurance Corporation. Thank you for being here.

STATEMENT OF AJIT JAIN, CHAIRMAN, BERKSHIRE HATHAWAY ASSURANCE CORPORATION

Mr. JAIN. Thank you to the members of the committee. It is my privilege to appear before you today. My name is Ajit Jain, and I am with Berkshire Hathaway. Recognizing the value of your time, I will get right to the three issues you have asked me to address, which are: One, the circumstances that prompted us to form Berkshire Hathaway Assurance Corporation, a new bond insurer, and the offer we made earlier this year to protect the municipal bond portfolios of the insurers. Two, the value of bond insurance to bond insurers and investors. And, three, what I think the future looks like for the bond insurance industry.

The first issue then is our decision to enter into the bond insurance industry. This was prompted by a phone call from the New York Superintendent of Insurance. I confess that when I was told that a regulator was calling, I was prepared for a complaint. Instead, he was calling to discuss a business-like approach to solving a problem, involving us to create New York-based insurer. Clearly, flattered by the phone call, we wanted to reciprocate by helping address a problem of national importance.

At about the time the superintendent called us, we felt there was a real possibility that the bond insurance industry would undergo a structural and permanent shift. For almost 20 years, we have been considering entry into this business. With our triple A ratings and excess capital position, this segment was always a natural for us. The attractive macro-features notwithstanding, when we analyzed the risk/reward characteristics of a typical transaction, we concluded that the pricing did not adequately compensate the capital provider for the risk, especially the tail risk. By "tail risk" I mean a black event defined as a random, difficult to predict event, an event that may have never happened and therefore is unlikely to happen. But when it does happen, it has a huge impact.

In about October of 2007, with the advent of the subprime crisis and the increased awareness of the financial losses it could bring, we hypothesized that risk in general, and financial credit risk in particular, would no longer be underappreciated and underpriced. Pricing going forward would reflect an expectancy of loss plus a reasonable return to the risk bearer.

In addition, we believe that the franchises of the existing industry leaders could be mortally wounded by the subprime and structured finance exposures. Whether or not these companies would raise additional capital, we believe there is a good chance that they could no longer maintain their all important triple A ratings. If that happened, there would be an opening for us in the business.

As for our offer to reinsure the municipal bond business of existing insurers, here again the New York superintendent gets the credit. He forced us to consider how our capital could be deployed to help alleviate the increasing pressure on the existing players and their policyholders. A comprehensive solution, including the structured finance and the municipal obligation, was everybody's first priority. However, we could not untangle the complex financial transactions that made up the structured finance portfolios. While we continued to feel that historical pricing on the municipal bond business was inadequate, we could at least take on that risk with a price adjustment, which we made in our offer to reinsure the company's municipal bond business.

I would like to briefly explain why we believe the offer had the merits from several perspectives. First, from the municipality's perspective, having a solid, triple A insurer backing their bonds would almost certainly have avoided the steep increases in interest cost that we have seen in the variable and auction rate securities. Similarly, for the bond investors, our protection may well have avoided the steep price decreases in the value of the bonds that they witnessed 2 weeks ago. Furthermore, by releasing capital from the municipal side of the business, the structured finance policyholders could have had more capital available to pay for their losses. Finally, the shareholders of these companies, having shared the 30 year municipal bond obligations, the companies could then negotiate with their counterparties to terminate their structured financial obligations and ultimately return capital to the shareholders. This might have been the best outcome for the shareholders given where the shares of these companies were trading then and are trading now. Despite these benefits, also it was clearly not in the best interest of the management of these companies, whose interest appeared to have trumped the combined interest of the investors, issuers, policyholders, and shareholders.

The second issue I have been asked to address is the benefit of bond insurance to issuers and investors. On this point, I can add almost nothing to what has already been spelled out by so many others. Historically speaking, the cost of a financial guarantee insurance policy was more than justified by the reduced interest that the municipalities paid investors for the funds being borrowed. Speaking historically once again, the rating enhancements of the insurance was good for investors because it helped maintain a stable and liquid market for bonds.

Given where we are today then, I can well understand the committee's interest in the large issue I am to address, which is where are we going with all of this? What my answer lacks in helpfulness, it makes up for in honesty: I do not know. There is a great deal of uncertainty. For our part, we are tiptoeing into the water and while we are writing business at pricing levels that are economically attractive to us, I remain very concerned about the long-term viability of the business in general and for us particular.

There are several reasons for my concern: First, as is true in all insurance, the product that is being sold is nothing more than a future promise to pay. With recent headlines of municipalities having to pay as much of 20 percent on auction rate securities and some insured municipal bonds selling at higher yields than corresponding uninsured bonds, buyers have every right to question—

Mr. CLEAVER. Mr. Jain, I notice you have a couple more pages, three more pages, if you could summarize that for us.

Mr. JAIN. Okay.

Mr. CLEAVER. And perhaps during the question and answer period, you will be able to respond to questions on that.

Mr. JAIN. Sure. The buyer has every right to question the value of the bond insurer's promise to pay. This concern about the integrity of the product is further reinforced by the "good bank," "bad bank" talks that are being discussed these days.

I will end there given that I have run out of time, and I want to thank you for giving me the chance to address you.

[The prepared statement of Mr. Jain can be found on page 109 of the appendix.]

Mr. CLEAVER. Thank you very kindly.

The next witness is Mr. Sean W. McCarthy, president and chief operating office, Financial Security Assurance, on behalf of the Association of Financial Guaranty Insurers.

Mr. McCarthy?

STATEMENT OF SEAN W. MCCARTHY, PRESIDENT AND CHIEF OPERATING OFFICER, FINANCIAL SECURITY ASSURANCE, ON BEHALF OF THE ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Mr. MCCARTHY. Mr. Chairman, Ranking Member Bachus, and other members of the committee, I am Sean McCarthy, chair of the Association of Financial Guaranty Insurers, AFGI, and the president and chief operating officer of Financial Security Assurance Holdings, Ltd., and its monoline, Financial Security Assurance, FSA.

AFGI is an association of 11 monoline primary insurers and reinsurers. Established in 1971, the monoline bond insurance industry has generally been a triple A-rated industry. It was initially founded to provide bond insurance to the U.S. municipal bond sector and today serves the municipal public infrastructure and asset back markets globally. As monolines, we provide financial guarantees and related products only. We do not provide other forms of insurance, such as property and casualty, life, auto, or health insurance products.

It is a highly regulated and transparent industry with few exceptions. The monolines are required to be licensed in States and/or countries in which they operate. For example, the monolines are regulated by the New York State Insurance Department and in the UK, by the Financial Service Authority. Of the six companies providing primary guarantees, three are public companies and three are privately held. All are subject to or voluntarily provide disclosure, consistent with the 1934 Act reporting requirements. The rating agencies also require ongoing information.

The industry's practice is to underwrite at least investment grade risks, meaning investment grade or better, with low severity of loss when default does occur. In addition to providing financial guarantees, monolines also provide surety bonds and credit derivatives, whose terms exactly mirror a financial guarantee. All of these policies have pay-as-you-go settlement terms, and there is no requirement to post collateral if the underlying credit deteriorates, thus minimizing liquidity risk.

Over the past 5 years, monolines have insured more than $1 trillion of U.S. funds to fund essential public projects, almost $82 billion of the funds to fund infrastructure outside of the United States, and more than $1 trillion of asset-backed bonds globally to lowering funding costs. The issuers do not pay more for bond insurance. The premium paid for the guarantee allows them to lower their overall cost of funding. Additionally, bond insurance provides for a larger, broader public finance market because it increases investors' capacity for individual credits.

For investors, bond insurance provides protection against default of principal and interest, built in analysis, surveillance and remediation so that problems can be worked out before a default. Bond insurers do not guarantee market value. As a result of conservative underwriting, the industry has up until now had a low loss record of three basis points on net debt service. This contrasts with the banking industry's weighted average annual charge-offs on principal of 60 basis points from 1992 to 2006.

What has happened lately? The crisis originates from a specific type of security: collateral debt obligations of asset-backed securities, referred to as CDOs of ABS, or another form, CDOs of CDOs. These contain large amounts of U.S. subprime residential mortgages in concentrated forms. While home equity lines of credits, securities called HELOCS, and subprime mortgages may also generate claims for the financial guarantors, they will not be of the magnitude to imperil the company's credit ratings. Thus, some companies made a mistake in a single asset type class. This does not represent a systemic failure nor does the industry request a Federal bailout. Going forward, industry members who have been degraded will do whatever possible to get back to a triple A level. We also expect the rating agencies to recalibrate their models with more conservative assumptions on all forms of asset-backed transactions, including the oversight of the monolines. The monolines will respond accordingly.

Even if a bond insurer goes into run-off, it can renew its capital reserves through investment income and freeing up of reserves if the bonds it has insured mature or are called. AFGI, as an association, does not take a point of view on how monolines are structured. I will say from the perspective of my company, FSA, it does not make sense to require companies to split into municipal and structured finance units, as the model works appropriately now if correctly applied with conservative underwriting.

I would also like to add a perspective on the causes of the recent option rate failures, which, while due in part to credit concerns about the bond insurance industry for sure, were also driven by dealers backing away from an implied obligation to provide liquidity and to credit liquidity concerns in general. In most cases, bond insurers will work—we certainly are working with issuers to convert auction rate to either fixed or variable rate bonds.

One further point: We believe that unrealized marks that insurers are required to take through the income statement on insurance policies issued in a credit default swap form under US GAAP are obscuring the true performance of the industry. Absent any claims under the guarantee and given the insurer's intent to hold these contracts until maturity, decreases or increases to income due to the marks will sum to zero by the time each contract has matured, eliminating any economic impact. These contracts are functionally identical to the financial guarantee policy and are not inherently more risky. Therefore, we can submit the fact that CDOs of ABS were insured in the credit default swap form have nothing to do with the economic loss that will be taken on these structures, it is the assets underneath them.

I thank you for taking the time to listen to me, and I would be happy to answer any questions.

[The prepared statement of Mr. McCarthy can be found on page 140 of the appendix.]

Mr. CLEAVER. Thank you very much, Mr. McCarthy.

We will move now to Ms. Laura Levenstein, the senior managing director of Global Public, Project & Infrastructure Finance Group, Moody's Investors Services. Thank you very much for being here.

STATEMENT OF LAURA LEVENSTEIN, SENIOR MANAGING DIRECTOR, GLOBAL PUBLIC, PROJECT AND INFRASTRUCTURE FINANCE GROUP, MOODY'S INVESTORS SERVICE

Ms. LEVENSTEIN. Thank you. Good afternoon, Chairman Frank, and members of the committee. I am pleased to be here on behalf of my colleagues at Moody's Investor Service to discuss our rating system for municipal bonds and how that system is designed to address the attributes of the municipal market. I will also describe some of the more recent changes we have made to our municipal rating system as a result of our ongoing dialogue with issuers, investors, and other market participants. I should note that more than 35 percent of the municipal bond issuances are not rated by Moody's or any other credit rating agency. Therefore, the information contained in my testimony is based on the securities that Moody's has rated in the municipal market and our comments should not be construed as being applicable to the entire universe of municipal issuance.

Moody's first began rating municipal securities in 1918. Today, our U.S. municipal rating system is used for rating securities issued in the U.S. tax-exempt and taxable bond markets by State and local governments, nonprofit organizations, and related entities. This system is different from our global rating system, which is used for rating issuers and issuances of non-financial and financial institutions, sovereigns and sub-sovereign issuers outside of the United States as well as for structured finance obligations.

Our municipal rating system grew out of and reflects the unique dynamics and needs of the municipal bond market and its participants. There are two aspects of the municipal bond market that have historically been particularly important. First, while it should be noted that the loss experienced from non-rated municipal issuers has been higher than that for the rated universe, municipal securities rated by Moody's have had relatively low credit risk when compared to rated corporate or structured finance obligations. This low credit risk is primarily the result of the special powers and the role of municipalities as public entities. These include their ability to levy taxes and the likelihood that in the event of financial distress, municipalities or other public entities will receive support from a third party, such as a State government. Because of these and other factors, the municipal market has had limited default and loss experience and our municipal rating system reflects that reality.

Second, investors in municipal securities have traditionally had different perspectives and risk advertised in corporate bond investors. Municipal investors generally have been more risk averse and less diversified in their investment portfolios. They typically have been more concerned about the liquidity of their investments and, in the case of individuals, more dependent on debt service payments for income. They have typically been highly intolerant of seeing their investment portfolios experience diminished value or reduced liquidity, which can occur as a result of an issuer's financial distress, even if the bonds do not ultimately default.

In response to these market characteristics, are municipal ratings more finely distinguished among municipal securities than do our corporate ratings? Because the risk and potential severity of loss is low, our ratings focus primarily on the risk that an issuer will face financial distress. This can result in delayed payments and reduced liquidity.

If municipal bonds were rated on a global rating system, the majority of the ratings would fall between just two categories: triple A and double A. This would eliminate one of the primary values municipal investors have historically sought from our ratings, namely, the ability to differentiate the relative credit risk among various municipal securities. We have been told by many investors that not providing that differentiation would make the market less transparent, more opaque, and presumably less efficient for both investors and issuers.

Nonetheless, Moody's recognizes that the municipal bond market has evolved in recent years, and we have taken steps to respond to the changing needs of investors and issuers. For example, in 2002, to accommodate the trend we saw of some taxable bonds being placed outside the United States, we began offering entities issuing such securities the opportunity to request a global rating. We also began providing broad guidance on how our municipal ratings would translate into global ratings. In 2006, we conducted extensive surveys of market participants. As a result of that feedback, in 2007, we announced that when requested by issuers, we would assign a global rating to any of their taxable securities regardless of whether issued within or outside the United States. We also published a conversion chart that allows the market to estimate a global rating from a municipal rating.

Finally, since our last formal outreach to market participants in 2006, we believe that the market has continued to evolve. As a result, we plan to assign global ratings at an issuer's request to any tax-exempt bond, including previously issued securities, as well as new issues beginning in May 2008. We are also re-evaluating the overall market use and understanding of our municipal ratings and will be issuing a request for comment this month.

Moody's has always maintained an active dialogue with investors and issuers to understand what would help make our municipal rating system most useful, and we welcome additional market feedback on measures that would improve the overall transparency and value of our rating systems.

Thank you.

[The prepared statement of Ms. Levenstein can be found on page 115 of the appendix.]

STATEMENT OF MARTIN VOGTSBERGER, MANAGING DIRECTOR AND HEAD OF INSTITUTIONAL BROKERAGE, FIFTH THIRD SECURITIES, INC., ON BEHALF OF THE REGIONAL BOND DEALERS ASSOCIATION

Mr. VOGTSBERGER. Good afternoon, Chairman Frank, and members of the committee. Thank you for the opportunity to be here today. State and local governments depend on a smoothly functioning municipal market to finance schools, roads, hospitals, water and sewer systems, and other vital infrastructure. This is a timely and important hearing, and I commend you for your attention to these issues.

My name is Martin Vogtsberger. I am a managing director and head of institutional brokerage at Fifth Third Securities, a regional broker-dealer, which underwrites fixed rate municipal bonds and variable rate demand obligations. Like most regional broker-dealers, we have not been active in the auction rates securities market. But I am here today representing the Regional Bond Dealers Association, of which my firm is a member. The Regional Bond Dealers Association is a new association that represents securities firms active in the municipal bond markets. Many of our members, including my own firm, are active in the municipal market.

One of the things that makes the municipal market unique is that it is dominated by many thousands of State and local entities that issue bonds in relative size issue sizes. In many cases, these small issuers do not attract the attention of large global securities firms, so the municipal market depends on the participation of regional firms to function smoothly.

The disruptions we have recently seen in the municipal market are the result of a perfect storm of negative events starting last summer. Sparked by the deterioration in residential real estate and especially subprime mortgages, credit markets began to freeze up. Investors retreated from the credit markets, liquidity dried up, and prices fell. While municipals were not as affected as other asset classes at the time, they were not spared. Hedge funds and arbitrage funds, who have become increasingly active participants in the municipal market, faced margin calls and began selling assets.

Finally, it became clear that some of the bond insurers who provide credit enhancement to more than half of the outstanding municipal bonds were suffering from their exposure to subprime mortgages, structured credit products and other assets, but notably not from their municipal bond exposure. These events together caused stress on the municipal bond market similar to what other sectors of the credit market experienced last year. The disruption was felt most in markets for products that are designed to mimic money market instruments, including auction rate securities and to a lesser extent, variable rate demand obligations and tender option bonds.

The most frustrating aspect of the current market disruption is that it is occurring despite the fact that the underlying fundamental credit quality of State and local governments has not eroded over the last several months. To be sure, the credit ratings of many thousands of bond issues have been lowered, but that occurred not because of weakening financial positions of States or localities but because of downgrades of some of the monolined insurers.

State and local governments have suffered in several ways as a result of the current market stress. First, some of the auction rate securities are now paying owners penalty rates on auction rate securities whose options have failed. Often, these penalty rates are well above market rates. Many issuers are trying to refinance out of auction rate securities into more economical forms of financing. In some cases, however, this is difficult because of lack of asset to credit enhancement. In addition, issuers who have come to market with traditional, long-term, fixed rate bonds have had to pay higher financing costs than they otherwise would have because of lack of credit enhancement and a general loss of market liquidity.

One question that has received significant attention in the context of the current market disruption is the rating scale used by bond rating agencies from municipal bonds, which differs significantly from the scale used by other debt securities. The separating scale of municipal bonds cost State and local governments money when they issue bonds, either because they have to issue bonds at a lower rating or because they have to buy bond insurance to issue at a higher rating. A strong argument can be made for encouraging rating agencies to rate municipal bonds on the same scale as other debt securities.

Although important segments of the municipal market have experienced significant stress in the last several months, the core of the market has remained relatively strong. Issuers of traditional, long-term, fixed rate securities have still been able to access the market to finance new public investment. This is attributed to the strength of municipal bonds as an asset class and is hopefully a sign that the market's distress will not have long-term negative implications for States and localities.

Thank you again, Chairman Frank, for the opportunity to be here. I look forward to your questions.

[The prepared statement of Mr. Vogtsberger can be found on page 210 of the appendix.]

The CHAIRMAN. Thank you. I apologize for being a little late, but again this is very important, and I appreciate all of you staying here. Let me start with Mr. Jain. And you reiterate, and we appreciate, we had a chance to talk with Mr. Buffer, and we appreciate your being here, you reiterate that you still think that going into the municipal only insurance business would be a very good deal?

Mr. JAIN. At current pricing levels, we certainly feel there is an attractive opportunity for us.

The CHAIRMAN. Meaning that you could get—there would be a very low default rate, so a fairly low premium structure and you could make some money?

Mr. JAIN. That is correct.

The CHAIRMAN. Well, of course, we are also thinking one possibility of course—well, I guess two things. There is a question about whether, and I apologize, I just tried to read your statement, you have made that offer but no one has taken you up on it, is that right?

Mr. JAIN. On the re-insurance for the existing municipal bond—

The CHAIRMAN. Have you thought about just going to that business and saying to the municipal issuers, "Here we are, come and be insured?"

Mr. JAIN. We are doing that as we speak. Over the last 2 months now, we have insured about four billion-plus of secondary market transactions and have written premiums.

The CHAIRMAN. What about primary, have you thought about doing it for the primary?

Mr. JAIN. Absolutely. We are in the process of trying to get ready, but you need a license in each and every State before you can write a primary transaction.

The CHAIRMAN. Unless the Federal Government were to pass a statute that licensed this. I can't think of any obstacle to our doing that constitutionally. It could be a specific license. The Federal Government could license you to do that for municipalities only, you know, for municipal bonds. If the Federal Government were to pass such a license, would that facilitate your efforts?

Mr. JAIN. We are, since we made our application to the NAIC, through the NAIC to the individual States, we now have 31 licenses already.

The CHAIRMAN. All right. I'll tell you how to get 19 licenses in a hurry. We'll file a bill for a Federal license. You'll get 19 more licenses in about 4 hours.

Mr. JAIN. Thank you.

[Laughter]

The CHAIRMAN. Now I do want to get to the issue of the duality. And I understand, Ms. Levenstein, your argument, but it seems to be somewhat circular. Well, first of all, I was struck with what Mr. Jain says in his statement. If the rating agencies had just one rating, there would be little need for a financial guarantee insurance marketplace because much municipal debt on a stand-alone basis wouldn't require the enhancement. So he's arguing against interest, and we appreciate the honesty of your doing that. But—and then, Mr. Vogtsberger, as I understand it, you're saying you think there's a strong argument—let me put it this way. Ms. Levenstein is, it seems to me, arguing, if I read correctly and listened to your statement, that the reason for the dual track is consumer demand; that the people who want to buy municipals because they are less—they are more risk-averse, they want a separate rating system. Is that essentially what you are saying?

Mr. VOGTSBERGER. Right. I think when you add mutual funds as proxies to households, roughly 70 percent of the municipal market—

The CHAIRMAN. And they want a separate rating system?

Mr. VOGTSBERGER. —are households, and they rely on ratings to—

The CHAIRMAN. Well, but, why do they—I understand that. But that's not the question. Please, let's stipulate. We'll get to whether or not there should be ratings in entities that never default. One default that was fully paid off since 1970. But why two ratings systems? That is, I understand they want ratings. But why—I mean, what we're being told is this. You know what? If we rated municipals the way we rated everything else, they'd always get 100. It would be boring. So, therefore, it wouldn't be good enough. That's the tail wagging the dog. That's the cart before the horse. That's all those metaphors. I mean, our—do investors demand a separate rating system from municipals because municipals don't fail enough to make the current—to make it interesting? I mean, let me ask you, Ms. Levenstein. Do investors in your view demand a separate rating system?

Mr. VOGTSBERGER. No. They demand a rating.

The CHAIRMAN. All right. Mr. Jain, you say if we had a separate rating system, it would just show that everybody was solid. Ms. Levenstein, your argument appears to be that while you're meeting the needs of investors by a separate rating system, what's the evidence for that?

Ms. LEVENSTEIN. We have been rating based on this scale since 1920.

The CHAIRMAN. No, that's simply that you've been doing it. But the fact that you've been doing it doesn't mean that there's an investor demand that you keep doing it. So, what makes you think—

Ms. LEVENSTEIN. But we've queried—we have queried the market many, many times, and the—

The CHAIRMAN. In what sense? You've done a survey? Have you—

Ms. LEVENSTEIN. We've reached out and had one-on-one meetings. We've had briefings. We've done publications. We've—

The CHAIRMAN. And they have told you that they insist on a separate rating system, even though they know that there's no default?

Ms. LEVENSTEIN. Yes.

The CHAIRMAN. All right, I'm going to tell you, I'm skeptical. Sometimes—I'm sure you're being honest with the results, but I don't know how these things are done. I mean, let me put it this way. You say, well, in general, you talk about likeliness of default, but you're saying that when people buy municipal bonds, they're not interested in likelihood of default. They're interested in financial stress on the entity, even though your own evidence is that financial stress on the entity appears to be unrelated in any statistically significant way to default. I mean, is that a rational basis for the market to do this?

Now, I do understand the argument that, well, no, but they're not as tradable. Right. They're not as tradable because of your rating system. It seems to me that's very circular. So why would people wanting to buy bonds not be influenced by whether or not they were going to default? And why is that relevant for corporate and not for municipal?

Ms. LEVENSTEIN. Well, I think they are influenced by that. But ratings have multiple attributes. Ratings don't measure one aspect or one metric. Ratings are meant to provide relative rankings as well as—

The CHAIRMAN. Well, but relative rankings, one in ten million versus one in a million? Relative rankings of what?

Ms. LEVENSTEIN. Relative ratings of likelihood of default.

The CHAIRMAN. Okay. And what is the likelihood—so, why don't you then put municipals in with everybody else and let them take the relative ranking of likelihood of default? Why can't you rate municipals like everybody else on the relative likelihood of default?

Ms. LEVENSTEIN. Well, on a forward basis, as I've stated in the testimony, we are going to do that. We are going to offer at the issuer's request to rate both—

The CHAIRMAN. I'm sorry. I didn't realize. So from now on, if an issuer wants to be rated the same was a corporate—

Ms. LEVENSTEIN. That's correct.

The CHAIRMAN. So the investor demand apparently—

Ms. LEVENSTEIN. —of this year.

The CHAIRMAN. —wasn't so strong after all?

Ms. LEVENSTEIN. I'm sorry. Excuse me?

The CHAIRMAN. Do you expect investors now to stop buying them?

Ms. LEVENSTEIN. No, I don't. But I do expect investors to still want to know what the relative ranking is, as well as the absolute likelihood of default of default.

The CHAIRMAN. Relative ranking of municipals and corporates together?

Ms. LEVENSTEIN. Relative ranking of municipals amongst municipal securities, and then the likelihood of default across the whole spectrum.

The CHAIRMAN. Well, let me ask you, you are all sort of market experts. If there is no—do I really care whether it's one in a million versus 1 in 900,000? I mean, why is that important information for me to have?

Ms. LEVENSTEIN. Because risk premiums are based on relative rankings, not—

The CHAIRMAN. Yes, but, then why—they're not absolute? They're relative?

Ms. LEVENSTEIN. Yes.

The CHAIRMAN. Is that rational—I mean, you would pay more for one in a million than for 1 in 900,000?

Ms. LEVENSTEIN. I don't know if those are—

The CHAIRMAN. You know, I mean, I've been listening for years people tell me you politicians, you act emotionally, you act irrationally. We, the market, are lucid. Based on today, not so much.

The gentleman from North Carolina.

Mr. WATT. Mr. Jain, you were about to make three points at the end of your testimony that you didn't get a chance to make. I'm going to give you the opportunity to make those three points quickly, if you can do it.

Mr. JAIN. The three points I was going to make was in relation to the outlook of the industry and why I felt the outlook of the industry was uncertain in general and our role in particular. And the reasons I have concerns for the outlook for the industry. Firstly, as we talked about, in insurance, the product that we are selling is a promise to pay. And buyers have rightly so have started to question what the value—

Mr. WATT. And when you say industry, are you talking about the insurance of these bonds, or are you talking about the bonds themselves?

Mr. JAIN. I'm talking about the bond insurance industry.

Mr. WATT. The bond insurance industry, not municipal bonds in general?

Mr. JAIN. No.

Mr. WATT. Okay. So you're talking about the insurance, and I guess if there weren't two rating systems, a triple A and a double A, as I understand it, there wouldn't be any insurance would there?

Mr. JAIN. There would be less of a need for bond insurance. If a number of the—

Mr. WATT. What does that insurance do, other than provide an absolute guarantee of payment in a market in which there is a one in one million absolute guarantee of payment anyway?

Mr. JAIN. The insurance certainly provides peace of mind to somebody who cannot really assess what are the true odds of the loss, to be able to get—

Mr. WATT. But isn't that what the triple A rating, or that's what the rating would do anyway, isn't it?

Mr. JAIN. Right. But—

Mr. WATT. So you are—the insurance adds an extra layer on top of the rating?

Mr. JAIN. Extra layer of protection in the event of default.

Mr. WATT. But do people understand that there hasn't been any default anyway?

Mr. JAIN. I am not sure—

Mr. WATT. Historically?

Mr. JAIN. I am not sure about that. A lot of the product is sold in the retail market, and I'm not sure if the retail investors are sophisticated enough to be able to analyze individual credits. What they do rely upon are the ratings of the underlying municipality and—

Mr. WATT. That's what Ms. Levenstein does, right?

Mr. JAIN. And the bond insurance protection—

Mr. WATT. Which is what you do? So you are—I mean, people are really paying a premium for both of those things, both of which do, as I understand it, essentially the same thing.

If you—if you give a triple A rating, Ms. Levenstein, isn't that a virtual guarantee that there's going to be payment? Historically, hasn't that been the case?

Ms. LEVENSTEIN. Historically, that is the case, but—

Mr. WATT. Okay. All right.

Ms. LEVENSTEIN. —I think you could step—

Mr. WATT. And if he gives an insurance premium, then does that do anything other than charge me an insurance premium to get the same historical guarantee? But I guess it gives me that assurance going forward. I'm not relying on history any more. I'm relying on his policy?

Ms. LEVENSTEIN. Can I just provide a little bit of background that may be helpful?

Mr. WATT. Absolutely.

Ms. LEVENSTEIN. I don't think that price or yield is driven only by the rating. I think it's driven also by the size, name recognition, amount of disclosure that's available. There are other factors.

Mr. WATT. Insurance premiums are driven by that, too?

Ms. LEVENSTEIN. Insurance premiums. Sean should answer that.

Mr. WATT. Mr. Jain?

Mr. JAIN. The insurance premium is, as far as we are concerned, is driven first and foremost by what our expectancy of loss is.

Mr. WATT. Okay. Well, let me ask this question, Mr. Jain. You say you're getting, if you get these other 20 States or so, you're going to get into the primary market. Are you going to require in that primary market, are you going to require insurance?

Mr. JAIN. We are providing the insurance, so, you say will I require?

Mr. WATT. You'll be playing on both sides, as I understand it, at that point. You'll be in insurance, and you'll be a purchaser of the bonds?

Mr. JAIN. No. No. We are not talking about us and our role in terms of purchasing the bonds. We will be the risk bearer taking on the insurance risk of the default of underlying bonds.

Mr. WATT. And you will be what else?

Mr. JAIN. That's it.

Mr. WATT. Well, what are you now?

Mr. JAIN. We are a bond insurer.

Mr. WATT. Okay. And once you get in on the next level after you get all these licenses, what will you be?

Mr. JAIN. We will be a bond insurer.

Mr. MCCARTHY. I think perhaps the point that he was making is that right now, Berkshire Hathaway is participating in the secondary market.

The CHAIRMAN. It's secondary and primary. The license is what is primary. Is that the—

Mr. MCCARTHY. —I think he's making is that once he obtains all of the licenses, he will participate in the primary market.

Mr. WATT. Okay. Well, and the question I was asking is, once you do that, will you require insurance also, or will you not?

Mr. MCCARTHY. No. He'll be—

Mr. JAIN. We will be—let me explain what I meant by the role we are playing right now. A number of bonds come into the market without any insurance whatsoever. These bonds end up with traders or with retail investors. At some point, these traders or these retail investors come to us on these uninsured bonds looking for insurance protection. We write insurance protection for these bonds on a secondary market basis, as opposed to negotiating with individual issuers, which is a primary basis.

Mr. WATT. I think I—

Mr. JAIN. So in both cases we are playing the role of an insurer only.

Mr. WATT. I think you've confused me sufficiently.

Mr. JAIN. I'm sorry.

The CHAIRMAN. Let me just—I want to go back to Ms. Levenstein again. Somebody just suggested, and you said, and I'm glad to hear that, that you're going offer the municipal issuers the choice. Will there be a price difference in what they're charged?

Ms. LEVENSTEIN. We haven't decided yet, and that's still under discussion. If there would be any incremental price, it would be an ongoing monitoring price. I should point out also that we currently—

The CHAIRMAN. You would charge an ongoing monitoring price to the corporation—I mean, different than—I don't understand that. Why should they—

Ms. LEVENSTEIN. Because there is additional work that we need to do in order to translate the ratings. But I would like to—

The CHAIRMAN. Well, no, no. So that's really taking back what it said in your opening—if they're in the same rating system as the corporations, why should—are they paying twice for this? I don't—

Ms. LEVENSTEIN. No. We're providing a municipal scale rating or a rating under the municipal system, and we are going to effectively translate that to the equivalent of a corporate rating or a—

The CHAIRMAN. Why don't you just rate them in the first place? Oh, so you're going to charge—so a municipality that wants to be rated as a corporate might have to pay more because they'll be first rated as a municipal issuer and then they have to pay a translation fee?

Ms. LEVENSTEIN. I think that hasn't been determined yet, but they will be first rated under the municipal system and then we will apply the—

The CHAIRMAN. Well, what if they just said, I'll skip the municipal system. Just rate me like anybody else right away?

Ms. LEVENSTEIN. That's not what we're planning to do right now.

The CHAIRMAN. I find that, from our public policy standpoint, unacceptable, and we would certainly try to legislate against that. To charge them double to be treated like anybody else—

Ms. LEVENSTEIN. No, we're not charging them double.

The CHAIRMAN. Yes. That's what you're saying. You'll charge them to be a municipal—

Ms. LEVENSTEIN. No.

The CHAIRMAN. You'll charge them for the separate rating when they don't want a separate rating and then charge them again to get the same rating as everybody else.

Ms. LEVENSTEIN. We're providing a municipal system rating which will allow for the sort of differentiation and relative ranking, which is valuable to the market. We're also providing or will provide upon request, only upon request, a global scale—

The CHAIRMAN. I must say, I misunderstood what you said. When you said you were going to offer them a choice, what you're going to offer them is a second item for which you can charge them. And I think you will be continuing to be abusive of them in that regard.

Ms. LEVENSTEIN. Again, I—

The CHAIRMAN. You're going to charge—they have to—get rated like anybody else, they have to pay for two ratings.

Ms. LEVENSTEIN. No. That is incorrect.

The CHAIRMAN. You just said that. They're going to be rated as municipal whether they want to or not, and then if they also want the global rating, there's an extra charge for that.

Ms. LEVENSTEIN. What I said is we hadn't determined it yet.

The CHAIRMAN. No, but—well, if you do—if you don't, then I withdraw my comment. But if you do, then you're charging them double. And when you suggested to me that they'll have a choice, yes, I have a choice. I can buy—pay for two or I can pay for one. But that's not what I usually mean by a choice.

Ms. LEVENSTEIN. But the other thing I should point out, it wouldn't be double. But the one thing I would like to point out is that we have offered global scale ratings or global system ratings since 2003 for any taxable issues, and it is interesting to us that we've only had 18 issuers—

The CHAIRMAN. Do they pay extra for that?

Ms. LEVENSTEIN. They do.

The CHAIRMAN. Okay. Well, surprise, surprise, they don't want to pay extra for it. Secondly, taxable is different than tax exempt.

Ms. LEVENSTEIN. I don't think that's—

The CHAIRMAN. The fact that people may not want to pay extra doesn't mean that they wouldn't make the choice if they didn't have to pay extra.

The gentleman from Massachusetts.

Mr. CAPUANO. Thank you, Mr. Chairman. Mr. Chairman, I beg to differ with what you said earlier. The investors are very lucid. Why would they want to do the right thing in order to get a lower return? They love the system they have now because they get eight points back when they should be getting five. They get seven points back when they should be getting four. Why should they change it? Why would any of these people at this table change the system when with a good system they'd be out of business? We wouldn't need you. So I think you're investors, and you are very lucid. You got it right. You have them by the short hairs. Keep them screaming. Don't worry about it.

Mr. McCarthy, I beg to differ when you saved us $40 billion?

Mr. MCCARTHY. Correct.

Mr. CAPUANO. That's like the local gang coming into my little corner store and saying we saved you $100,000 because your place didn't burn down last week. We gave you protection. You didn't save anything. You saved it because you have the system rigged so that cities and towns can't get the ratings they deserve due to their default rates, their lower default rates. You didn't save anything.

How can you possibly be shocked that they're now attempting to pretend to do the right thing and going to charge us for it? But I'm supposed to say thank you? When I was a mayor, I would say thank you. Have another croissant. I don't have to say that anymore. Getting double charged for doing what you should be doing in the first place, I don't have to say thank you. I can call it what I've said it is. It's extortion. All I see is the rate for extortion is going up.

I do want to ask one thing. On the historic default rates, am I wrong? Is my information incorrect that corporate double A bonds that are rated by Moody's have defaulted at a rate 43 times higher than double A rated munis?

Ms. LEVENSTEIN. No, I don't believe you're wrong.

Mr. CAPUANO. Yet they get a better rating. How is that defensible? If you're going to do this, then stick with the dual system. Just change how they get done. Why? Keep the dual system. Give the munis a better rate. They're a better deal, according to your own dual system. And I understand fully well that somehow I must be mistaken here in the documents you gave and the written testimony you said that you used analytical methodologies. Okay. That sounds very complicated, very mathematical, very precise. But then I just heard you say the reputation or the name recognition of the community. So if you don't know where my community is, though my community has never defaulted, just because you don't know where it is, I have to pay more?

Ms. LEVENSTEIN. No. That wasn't—

Mr. CAPUANO. That's obscene. That's offensive.

Ms. LEVENSTEIN. That wasn't what I was saying. What I was saying is the way the market prices things sometime depend—

Mr. CAPUANO. If the market knew that I was going to pay them back, they would price—I have no problem with ratings. I just want to be rated on a fair and equal footing. I have no problems with ratings, and I do understand that rateds is different than unrateds. I understand that within rateds—I accept all that. That doesn't bother me.

But put me in the category, put us in the category that we have earned. You didn't give it to us. We earned it by paying our bills. We've done what we were asked to do. We have done it better than corporations, and yet you still punish us because we have been silent. I'm not being silent today. And I don't expect to be silent ever again because I now have this new freedom that I am finding very good.

Simply treat us fairly, and there would be no problems. You can continue making a few bucks. You can continue insuring those issuances that need insurance. Everybody goes on. Everybody's happy, everybody makes a few dollars. The cities and towns get to do what they need to do. My sewers get fixed. My cops get hired, and you're still in business. Stop sticking it to us because you can. Otherwise, we will find ways to stop you.

Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentleman. I would note Mr. Jain's comment that if in fact the municipal issuances, the municipal bonds were rated the same as any other, there wouldn't be any insurance business because they would all do well. Mr. McCarthy?

Mr. McCARTHY. Just one point. I think—

The CHAIRMAN. Your microphone is not on.

Mr. McCARTHY. I'm sorry, Mr. Chairman. One of the functions of the insurance business in the municipal area is that we quote a bid in the market for every particular bond, and there are thousands and thousands of municipal credits. We have a very, very large staff that analyzes municipal bonds, and really the value we're bringing to, as an industry, to the municipal investor is that first we're putting our capital up so that to the extent that something does happen, whether there's a payment shortfall or something else, we stand by that.

I think the chart that the chairman produced earlier is a Moody's chart that actually excludes defaults that might be taken by the model lines. So the model line—

The CHAIRMAN. No. No.

Mr. McCARTHY. It's not?

The CHAIRMAN. No. There were just no defaults. These weren't defaults that were paid by somebody else.

Mr. CAPUANO. Mr. Chairman, I want to be clear. I don't think that you have no role in the marketplace. I think you do have a role. But I want you to market my bonds on the basis of the likelihood of me paying them back. And you can't do that without Moody's giving me an appropriate rating.

Mr. McCARTHY. Right. We're not the arbiter of whether we get used or not.

Mr. CAPUANO. Oh, I understand that.

The CHAIRMAN. But I also would have to add—

Mr. CAPUANO. Because you're the beneficiary of it.

The CHAIRMAN. I would also add while that's a nice model, in fact the way it's worked out for many municipal issuers, they have been carrying their insurers. They have in fact been rated higher than their insurers, and the insurers have dragged them down, and they have had to pay more money because of the low rating of their insurers, who improvidently invested the money.

Mr. McCARTHY. Well, some—in the model line insurance industry—

The CHAIRMAN. Yes.

Mr. McCARTHY. —there are several companies, thank goodness, FSA, which I represent—have maintained their triple A's from all three rating agencies in our State.

The CHAIRMAN. But let me say this. I don't know anybody who had to pay more for his car because his car suddenly became worth more than his insurance agency. You're saying it only happened with some insurance agencies—

Mr. McCARTHY. No, no.

The CHAIRMAN. Some insurers and not others.

Mr. McCARTHY. No.

The CHAIRMAN. Where the lousy performance of their insurers cost them money.

Mr. McCARTHY. Well, the financial wellbeing of the companies, if you think of it this way, as I said in the testimony, if you look at the CDOs of ABS, different model line companies were exposed to a single asset class which have very large losses and severe losses, and that single asset class—

The CHAIRMAN. Which asset class is that?

Mr. MCCARTHY. CDOs—

The CHAIRMAN. Okay. Excuse me. You say were exposed to. Now does that mean they were walking down the street and it wafted in and they caught it like pneumonia?

Mr. MCCARTHY. No.

The CHAIRMAN. They didn't—they weren't exposed to it. They took the profits from the municipals and went out and bought it. They weren't exposed to it.

Mr. MCCARTHY. No, I don't that's—I think the way it actually works is that each company has capital—

The CHAIRMAN. Excuse me, Mr. Callen said in the Wall Street Journal from Ambac, we took the profits, which were very good and very secure, and we went and invested in things, and we invested in things we didn't fully understand, CDOs. He wasn't exposed to it. He jumped in.

Mr. MCCARTHY. I would speak—

The CHAIRMAN. Well, but, that's one of the big companies.

Mr. MCCARTHY. I can speak for the industry generally, I can speak for FSA specifically.

The CHAIRMAN. Well, then, don't talk about it, but the fact is—

Mr. MCCARTHY. But Mr. Callen I can't speak for.

The CHAIRMAN. But you weren't exposed to it. These other—

Mr. MCCARTHY. No. We didn't underwrite that—

The CHAIRMAN. I understand that. But the point I'm making is, you know, the passive voice probably ought to be banned from the English language. It's the great excuser. Oh, we were exposed to it. No, they weren't exposed to it. They tried to make some money and made a bad guess.

Mr. MCCARTHY. Well, they underwrote it, meaning that those transactions that with a triple A—

The CHAIRMAN. But they volunteered to go and underwrite it because they thought they'd make money.

Mr. MCCARTHY. That's correct.

The CHAIRMAN. They were—yes. All right.

Mr. MCCARTHY. That's correct.

Mr. CAPUANO. Mr. McCarthy, if my city had gotten the rating I deserved according to these charts, I would have been triple A from day one and I wouldn't have needed bond insurance, so I wouldn't have been exposed to anything, because I wouldn't have had to get bond insurance.

Mr. MCCARTHY. We would—well, I'm not sure. We will still quote—

Mr. CAPUANO. And I would say thank you very much, no thank you.

Mr. MCCARTHY. And investors may or may not decide—

Mr. CAPUANO. And by the way, even when I needed bond insurance, I was never any lower than a B.

Mr. MCCARTHY. Right.

Mr. CAPUANO. And guess what? I didn't want to be put in with junk bonds.

Mr. MCCARTHY. Right.

Mr. CAPUANO. The people who did the CDOs, they chose to throw me into junk bonds. They were using my good credit to cover their lousy choices. I didn't get exposed by voluntary. I didn't ask, oh, gee, please throw me in with the junk bonds.

The CHAIRMAN. We're going to move on.

Mr. MCCARTHY. I think it's important to note that each of the companies that have experienced distress, MBIN Ambac, for example, have raised significant amounts of capital.

The CHAIRMAN. They didn't experience distress. They made lousy investment decisions. These were not—you know, they didn't experience distress. They made bad investment decisions.

Mr. MCCARTHY. You're exactly right.

The CHAIRMAN. Okay. Thank you. The only question I had was, my colleague from Somerville, I don't know if you know Massachusetts, but did you go to Cambridge to get those croissants you were giving people when you were mayor?

[Laughter]

The CHAIRMAN. I didn't think they had croissants in Somerville. All right. I'm sorry. The gentleman from Missouri.

Mr. CLEAVER. Thank you. I hope you understand, and I feel very similar to my colleague. As a former mayor, we have—for 8 years, I had to tiptoe around with the rating organizations—agencies, because we didn't—you know, the lawyers said, you know, you can't irritate them, you know. We have a double A rating with perfect payments with regard to the general obligation bonds, and so you have to play nice.

And so, like my colleague, I'm irritated, because I don't have to play nice now. You know, I guess maybe the mayor in Kansas City is afraid. I'm curious, Mr. Vogtsberger, or you and Ms. Levenstein, how much money have you had to pay out in municipal bond defaults in the last 10 years?

Mr. VOGTSBERGER. As a bond underwriter, we don't pay any money out for municipal bond defaults. We buy bonds and then remarket them.

Mr. CLEAVER. Well the truth is, nobody pays anybody off in municipal bonds, because there haven't been any defaults.

Mr. VOGTSBERGER. There have been defaults in municipal bonds, not general obligation bonds, but—

Mr. CLEAVER. Where?

Mr. VOGTSBERGER. Hospitals, for example, private colleges, industrial development revenue bonds. Those are all municipal bonds that from time to time—

Mr. CLEAVER. I'm talking about municipalities.

Mr. VOGTSBERGER. Municipalities, very few.

Mr. CLEAVER. One?

Ms. LEVENSTEIN. But that's of the rated Moody's universe. There may be others that are unrated. I simply don't know.

Mr. CLEAVER. Okay. But you can't name one?

Ms. LEVENSTEIN. I only know of one that was within our rated universe, that's correct, of a GO—

Mr. CLEAVER. A municipality. I'm not talking about a—

Ms. LEVENSTEIN. A general obligation pledge from a municipality.

Mr. CLEAVER. On the full faith and credit of that city?

Ms. LEVENSTEIN. Yes. They defaulted. There would have been others—there were others that were different types of revenue pledges.

Mr. CLEAVER. One out of how many?

Ms. LEVENSTEIN. One out of about 28-, or 29,000.

Mr. CLEAVER. Don't you think that the cities need a rebate now? This is a serious question.

Ms. LEVENSTEIN. No I don't.

Mr. CLEAVER. Why not?

Ms. LEVENSTEIN. Because, again, I think we provided to the market—

Mr. CLEAVER. What?

Ms. LEVENSTEIN. —what the market wanted, what was usable.

Mr. CLEAVER. What did you provide Kansas City?

Ms. LEVENSTEIN. We provided ratings that provided relative ranking.

Mr. CLEAVER. I'll tell the people when I go home this weekend—

Ms. LEVENSTEIN. That's what the market told us they—

Mr. CLEAVER. —because all they know is that they're having to pay, that our city is having to pay high insurance, no low interest, and there's no—there's such a minute change that we're going to go into default, that it's almost absurd that we have to do it. And you're saying you don't think anything has gone wrong there?

Ms. LEVENSTEIN. I think the market is pricing what they perceive to be the risk.

Mr. CLEAVER. So everything is fine?

Ms. LEVENSTEIN. All we're doing is providing an opinion of the relative credit ranking, and that's what we have done.

Mr. CLEAVER. So everything is fine? You don't see a problem with—

Ms. LEVENSTEIN. What has changed is that there is more of a crossover market and the market appears to want, as well as the municipal rating system, the global system. And that's why we're offering it on a forward basis.

Mr. CLEAVER. When did you discover this as the point, I mean—

Ms. LEVENSTEIN. We first started to talk to the market about this in 2001, and we talked to the market in 2001. We talked to over 100 participants in the market. The feedback that we got at that time—

Mr. CLEAVER. What—who—

Ms. LEVENSTEIN. —that for a certain segment of the market, global ratings would be helpful.

Mr. CLEAVER. Did you talk to the—

Ms. LEVENSTEIN. Only that segment.

Mr. CLEAVER. —the U.S. Conference of Mayors, the National Conference of—

Ms. LEVENSTEIN. We talked to issuers. We talked to investors. We talked to intermediaries.

Mr. CLEAVER. But you didn't—you never talked to any of the mayors or the organizations representing mayors?

Ms. LEVENSTEIN. We talked to issuers, so we did talk to—

Mr. CLEAVER. Who?

Ms. LEVENSTEIN. —who were representatives of mayors. I don't have the list. But we did talk to over 100 representatives.

Mr. CLEAVER. And they didn't go off?

Ms. LEVENSTEIN. No, they did not.

Mr. CLEAVER. Boy, I'd like to see them.

Ms. LEVENSTEIN. In fact, the overwhelming opinion was to keep things the way they were, and that's what we did, except for the small segment of the market that was taxable issuance outside of the United States or swap obligations. And so between 2003 and 2007, we offered global system ratings to that segment of the market.

Now as I've said earlier, it is clear that there's a change, and it is clear that there would be value to the market of global system ratings. So we will provide those on a forward basis to any issuer who wants them.

Mr. CLEAVER. The State government of Missouri has a triple A rating.

Ms. LEVENSTEIN. Yes.

Mr. CLEAVER. I think there are only five States with triple A in the United States. Our creditworthiness is higher than the State, and we have a double A. How do you explain that?

Ms. LEVENSTEIN. Well, I'm not in a position today to discuss the difference between your city and the State of Missouri. But certainly we could get back to you if you wanted to have that discussion.

Mr. CLEAVER. I do.

Ms. LEVENSTEIN. But clearly, we think on a relative ranked basis, but that's not the case.

Mr. CLEAVER. I'm sorry?

Ms. LEVENSTEIN. If you were to relatively rank the city versus the State, we think the State is stronger. But if you would like to talk about the specifics of that, we can—

Mr. CLEAVER. I want to talk about a rebate. When can we meet to talk about a rebate?

Ms. LEVENSTEIN. I don't think that's warranted.

Mr. CLEAVER. I'm sorry?

Ms. LEVENSTEIN. I don't think that is warranted.

Mr. CLEAVER. If we have a vote, it would be.

Mr. CAPUANO. Mr. Chairman, if the gentleman would yield for one minute.

The CHAIRMAN. Go ahead.

Mr. CAPUANO. As I understand it, the people that you were talking to are the very people who make money at this business. So you basically ask people, do you want to continue making more money than you would otherwise make if we make the system right? And you also talk to maybe a few hostages, people who didn't have the freedom to tell you what they really wanted. Or did you talk to anybody who had been a former mayor or a former issuer of bonds when you asked the market participants?

Ms. LEVENSTEIN. I don't know if we did or not.

Mr. CAPUANO. I mean, my expectation is market participants means either the people who are making the money, and you basically ask them, do you want to make less money? And they said no. And then you might have asked a few people who are hostages, would you like us to change it so you can save some money? And they said, oh, no, please don't do that, because if you do that, you're going to lower our rating. That's not the market participants that mean anything to me. Those are hostages, and those are people who are making money on the backs of my taxpayers. Their interest is no interest.

The CHAIRMAN. And I think you have a feedback loop here between the rated and then people who were asked. But let me ask you this. You said the State versus the city. What about if there were other instances—

Ms. LEVENSTEIN. There are instances. We do rate a number of intercept programs and other types of bonds.

The CHAIRMAN. Straightforward question.

Ms. LEVENSTEIN. Yes?

The CHAIRMAN. If the State stands behind the cities, are there still differences in the ratings?

Ms. LEVENSTEIN. It depends on the mechanism that the State uses to stand behind the city. If the State stood completely behind the city and it was effectively a guarantee, then there would be no difference.

The CHAIRMAN. Thank you, that was the question.

The gentleman from Colorado.

Mr. PERLMUTTER. I was never a mayor, and I don't have that sense or hostility that my two friends have shown, but I have done Chapter 9 bankruptcies, and so I do recognize that there are risks. I don't know whether these were Moody rated. I don't know whether there was a lot of underwriting or bond insurance behind it, so I recognize something here, but I have just some very basic questions again. First, who pays Moody's to do a credit rating, the buyers of the bonds or the issuers of the bonds?

Ms. LEVENSTEIN. The issuer does.

Mr. PERLMUTTER. The issuer does. Who pays, Mr. Jain, I kind of heard that it could be an investor wanting to protect the investment or it could be the issuer could buy the insurance, the issuer, is that right?

Mr. MCCARTHY. The issuer in a primary market and an investor in a secondary market position who owns the bonds already.

Mr. PERLMUTTER. Now, I asked the last panel, is there any law that says State, Federal, that requires Denver Health and Hospitals, who I spoke to a half-hour ago, to get rated by Moody's or to buy insurance before they issue bonds and sell the bonds, is there any law?

Ms. LEVENSTEIN. No, there is not.

Mr. MCCARTHY. No, there is no law.

Mr. PERLMUTTER. Okay, how many ratings agencies are there?

Ms. LEVENSTEIN. There are nine recognized rating agencies.

Mr. PERLMUTTER. Nine recognized for municipal or government type—

Ms. LEVENSTEIN. Nine recognized by agencies, there are nine.

Mr. PERLMUTTER. And not to pick on Moody's but since you are here, how much of that market, of those nine agencies, how much of the rating business do you do, does Moody's do?

Ms. LEVENSTEIN. I do not think that I know how much we do relative to the other rating agencies.

Mr. PERLMUTTER. Alright, so but the real reason we are here today, and the two mayors really and the chairman are talking about some structural things as to why people do not get better rates, the purpose of our hearing today though was here we were going along merrily, people are doing their—selling their municipal bonds, everything is honky dory until we hit February and all of a sudden it goes from 4 percent to 20 percent for the Port Authority in New York.

Mr. MCCARTHY. Right.

Mr. PERLMUTTER. And there has not been any testimony that the Port Authority of New York became any greater credit risk in February than it was in January or that the Denver Health and Hospitals are any greater credit risk—

Mr. MCCARTHY. That is correct.

Mr. PERLMUTTER. —than they were. What happened?

Mr. MCCARTHY. Well, what happened, I tried to cover, and not well, in my testimony. Essentially, auction rates, if I can give you just a one minute history of the floating rate market at the municipal area. Going back 25 years ago, which is when I had a lot more hair, the first floating rate transactions that were done were called "upper floaters." Cleveland Electric did the first transaction, and essentially they were just like auction rate deals today, meaning that there was a promise for the investment banker to re-market these bonds on a periodic basis and find new investors, okay. Then those bonds in the 1980's, right after they got formed, failed to actually clear the market.

Mr. PERLMUTTER. There were not any buyers?

Mr. MCCARTHY. There were not any buyers because they couldn't because there was again a market stress environment, if you remember back then, municipal long rates were 15 percent and the issue that happened there was that the community decided to attack real bank liquidity to these transactions such that if there was a put, that it was a bank who really is in the business of providing their liquidity to these transactions. That is the way that market operated for 20 years. Three years ago, all of a sudden investment bankers said, "You know what, we don't really need the liquidity provider. What we can do is we can re-market it for you and you will save 10 basis points instead of paying a liquidity provider some. We will charge you a little bit more for the re-marketing fee, but we will promise that we can make that market."

Now, I will tell you that part of the problem was that stress or the downgrade issues that have happened in the monoline area started people being nervous about owning option rate bonds that did not have liquidity. And no option rate bonds have liquidity attached to them, so they started to put them to the investment banks. Well, that is not really what they do. So they tried their best to re-market them.

Mr. PERLMUTTER. Just a basic question, option rate bonds does not have liquidity behind it but it does have a revenue stream behind it?

Mr. MCCARTHY. It does not. They have to clear the market. The way these structures work is they are floating rate, they are owned by funds and they are counted as a short-term financial instrument. Therefore, the difference between a variable rate demand bond, which has liquidity, and an auction rate bond that does not, those were counted as short term products. But the reason why that interest rate spiked up for all the auction rate products, regardless of whether it is the Port Authority, a student loan transaction or the State of California, was because investors, the liquidity market started to dry up and investors were nervous and not comfortable that they would own this bond and not be able to get out of it. They owned the bond thinking it was variable rate and therefore a short term security, which they had to qualify for. And they thought it is like musical chairs that say, "Holy cow, if I don't put this back to the re-marketing agent right now, I am going to own this as a long-term bond, and that is not what I intended." So all of those bonds came back.

Now, at FSA, we are spending—kudos to our municipal finance analytical team, they are spending 23 hours a day underwriting transactions to try to convert municipalities from auction rate, regardless of who did them, to either floating rate or fixed rate to solve this particular problem. And it has nothing to do with the quality, which in most cases for option rates is very good, it has nothing to do with the credit worthiness of the municipality.

Mr. PERLMUTTER. Thank you.

Mr. CLEAVER. A follow-up, please.

Mr. PERLMUTTER. I would yield to Mr. Cleaver.

Mr. CLEAVER. Thank you. One final question, what do you call the professionals who are paid a fee to unwind the option rate securities into other instruments?

Mr. MCCARTHY. Well, investment bankers.

Mr. CLEAVER. I'm sorry?

Mr. MCCARTHY. Investment bankers and then financial advisers are the two counter-parties. You can speak to that better.

Mr. VOGTSBERGER. That is right, yes. Investment bankers who underwrite bond issues are, as Sean mentioned, working to restructure option rate bonds into either variable rate bonds or fixed rate bonds, and they are paid a fee to do that.

Mr. CLEAVER. By whom?

Mr. VOGTSBERGER. By the issuer.

Mr. CLEAVER. That is all. Thank you, Mr. Chairman.

Mr. CAPUANO. [presiding] I want to thank you for putting up with this abuse today, and I hope you did not take too much of it personally, but at the same time, honestly, it is the first time I have had in 18 years to tell you what I think, and I was not going to pass up the opportunity. I also hope that you get some of the frustration and some of the disappointment that has happened over the years, and my hope, my preference is that the industry takes action without government interference, if you want the truth. However, I will tell you that if something does not happen, the likelihood of government involvement increases dramatically, and I think you have heard some of the frustrations. Some of the things that have been mentioned here today, I think many of us agree with relative to some of the SEC rules and some of the other things. But like many times, I for one would prefer that the market does its own work but government regulation to me is not a swear word, it is a bastion of last resort.

Before we dismiss, before we end this panel, the Chair notes that some members may have additional questions for the panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

With that, I declare that this hearing is adjourned.

[Whereupon, at 4:15 p.m, the hearing was adjourned.]

A P P E N D I X

March 12, 2008

THE HON. ROSA L. DELAURO
STATEMENT FOR THE RECORD
HOUSE COMMITTEE ON FINANCIAL SERVICES
HEARING ON MUNICPAL BOND TURMOIL
WEDNESDAY MARCH 12, 2008

I want to thank Chairman Frank for having this important hearing and for allowing me to submit testimony today. The sub prime mortgage crisis and credit crisis have an impact on our entire economy.

I also want to recognize my friend and colleague Connecticut's Attorney General Richard Blumenthal and thank him for testifying here today -- in particular to address the current dual system for rating municipal bonds versus to corporate bonds. He has highlighted the fact that cities and states appear to receive unfairly low ratings in comparison, costing taxpayers millions. I have always valued Attorney General Blumenthal's opinion and I am glad to see this committee has asked for his perspective as well.

It is critical that we do everything we can to respond and give our communities the tools they need to endure the serious consequences of a prospective recession.

But we must recognize that states and municipalities are struggling to handle not only today's churning markets but also the rising costs of consistently failing infrastructure that has gone underfunded for far too long.

Infrastructure represents the lifeblood of any economy. And lately, the pressure and growth requiring still more investment has increased at record pace.

The American Society of Civil Engineers estimates that we need $1.6 trillion over five years just to bring our infrastructure up to a good condition. As of 2006, 25.8 percent of the nation's bridges (154,101) were structurally deficient or functionally obsolete.

Airport capacity had increased only 1 percent from 1991 to 2001, yet air traffic had increased 35 percent during that same time period. According to recent estimates by the Environmental Protection Agency, as much as $390 billion will be needed over the next 2 decades to rebuild, repair, and upgrade the nation's wastewater treatment plants. According to the Texas Transportation Institute, traffic congestion continues to worsen in American cities of all sizes, creating a $78 billion annual drain on the United States economy in lost productivity and wasted fuel.

Things are difficult enough, and now the latest municipal bond turmoil has put states and municipalities in a worse position to confront these infrastructure challenges than ever before.

The widening credit crunch is making it harder for cities, towns, and states to secure funds for critical projects like buildings, bridges, schools, hospitals and roads. The $2.5

trillion market for municipal bonds has been stretched thin as a result of significant losses among bond insurance firms.

Municipalities with lower credit ratings are being forced to pay more to borrow money and possibly put off important projects. Ultimately it is the taxpayer who bears the cost – either in increased expenses for large projects or down the road when we see the consequences of crumbling infrastructure. Some cities have already put off planned bonds. It is clear that the investments once considered safe are now seen to be far riskier.

We must work in Congress to put the focus on a new agenda for our national infrastructure challenges. We have a responsibility not only to restore people's confidence in our markets but also to give our cities, towns, and states the support they need to make the critical long-term investment. That is why I have introduced legislation to launch a National Infrastructure Development Corporation (NIC).

If the National Infrastructure Development Act was implemented today, over the coming years the federal government would have an entity in place, the National Infrastructure Development Corporation, to make the critical investments needed in infrastructure to grow our economy to compete in the 21st century.

Moreover, because the Corporation would make loans, purchase securities and issue insured public benefit bonds, among other things, it would help make up for the shortfall in the municipal bond market, restoring confidence, and getting needed funds to these cities.

NIDA would provide the Corporation with powers including the ability to make senior and subordinated loans and purchase senior and subordinated debt securities and equity securities, the proceeds of which are to be used to finance infrastructure projects; issue and sell debt securities and voting and nonvoting equity securities; issue "public benefit bonds"; and make agreements and contracts.

When we ease the burden on commuters, modernize our public transportation systems or ensure we have safe drinking water, we are paving the way for new growth and opportunity. When we fail to do those things – when we neglect our air traffic control system or fall drastically behind other nations in broadband adoption -- we create a costly drag on our economy. By ensuring our towns, cities, and states can continue investing in infrastructure, we can rebuild America and keep our nation highly competitive throughout the 21st century.

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State of Connecticut

**TESTIMONY OF
ATTORNEY GENERAL RICHARD BLUMENTHAL
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
MARCH 12, 2008**

I appreciate the opportunity to speak on the topic of "Municipal Bond Turmoil: Impact on Cities, Towns and States "

The current dual system of rating bonds issued by state and local governments is dangerously misleading and misguided It imposes a secret Wall Street tax on states, cities and school districts across this nation

Rating agencies admit that municipal bonds frequently receive substantially lower credit ratings than corporate bonds with the same or worse rates of default. This dual rating system costs municipalities in Connecticut and around the country millions of dollars in unnecessary interest and fees every year.

This costly scheme is quite possibly illegal under our state and federal antitrust laws.

My investigation -- which is still ongoing and active -- focuses on how this unfair system was started and perpetuated, who profits from it, and what anticompetitive effects it has on the prices that states and municipalities pay to borrow for essential projects like schools and roads

My findings so far are deeply troubling We know there was a concerted effort among supposed competitors to maintain the dual rating system and kill attempts at reform There were discussions among insurers aimed at retaining the dual rating system when at least one rating agency suggested modifying or eliminating it The effect of these activities was clearly to maintain prices and prop up the market for bond insurance Such misuse of market power and restraint of competition is plainly anticompetitive and anti-taxpayer, causing direct harm to municipal and state customers issuing bonds

No legitimate business reason appears to exist for maintaining separate rating standards. The two standards clearly have nothing to do with whether or not bondholders will be ultimately be paid back since the rating agencies own studies show that municipal bonds hardly ever default Rather, the practice appears to benefit the rating agencies who issue and charge for multiple ratings on a single bond, the bond insurers who collect higher premiums for frequently unnecessary insurance and finally the underwriters who profit from and trade on the differing interest rate or "yield spread" between insured and uninsured bonds.

Wall Street profits, while Main Street pays

In addition to my investigation and possible state enforcement action, I urge Congress to provide quick relief to cities and towns across the country by prohibiting different rating standards for bonds and requiring fair and equitable treatment of all bond issuers More specifically, federal law should prohibit credit rating agencies from assigning different credit ratings to bonds with similar rates of default and risk

The reason that municipalities almost never default is fundamental to what they are: most are creatures legally of the state, defined in existence and authority by state law, with some state guarantee of intervention against fiscal insolvency Local governments do not go out of business They are different and distinct from private corporations.

The harm to Connecticut residents is very real and substantial I have surveyed the issuance of bonds over the past ten years for all 169 towns in the state of Connecticut The preliminary estimates clearly demonstrate that many towns are paying sizeable sums -- all together millions of taxpayers dollars -- for unnecessary insurance

For example, the town of West Haven paid $104,000 to upgrade their bond rating from A3 by Moody's to an Aaa rating West Haven's rating on the corporate scale would have been equivalent to an Aa1 -- the second highest rating possible

The town of Bethany -- with a population of 5,400 -- issued approximately $5 million in general obligation bonds in 2003 Bethany was assigned an underlying rating of only A1 by Moody's and had to pay an insurance premium of $17,861 -- or $3 for each man, woman and child in the town -- to obtain bond insurance from Ambac and, hence, an Aaa rating from Moody's Based on a 2006 Moody's report on municipal bond ratings, if the town of Bethany had been rated on a corporate equivalent scale, it would have enjoyed an Aaa rating with no need to purchase bond insurance

Similarly, the town of Litchfield -- with a population of 8,600 -- paid $30,000 or more than $3 per resident -- in bond insurance premiums to MBIA to upgrade the rating on its 2006 general obligation bonds from Aa3 to Aaa

In challenging economic times, as many cities and towns face budget shortfalls and program cuts, these additional costs are particularly burdensome and unfair If these three towns had been rated fairly, such expenses would have been unnecessary.

States and municipalities issue general obligation bonds to fund critical public projects like schools, roads, and bridges The interest rate paid on these bonds depends largely on ratings assigned to the bonds by the three major credit rating agencies: Moody's, Standard & Poor's, and Fitch A bond rated Aaa likely will bear a lower interest rate than a bond rated A1 Accordingly, a town issuing an A1 rated bond will typically pay substantially more interest over the life of the bond and its citizens will pay more in taxes to support those interest payments

The major credit rating agencies own studies show -- beyond any doubt -- that default rates for municipal bonds are substantially lower than identically rated corporate bonds Moody's study shows that higher rated Aaa corporate bonds are four times more likely to default than lower rated Baa municipal bonds -- a rating seven notches lower than Aaa. Indeed, a 2006 Moody's report revealed that the top five municipal bond grades, Aaa through A1, would all be rated Aaa if they were corporate bonds. These default studies make clear that Moody's employs two distinct rating scales for municipal bonds and corporate bonds.

Fitch published default studies in 1999 and 2003 that showed similarly low default rates for municipal debt While Fitch adjusted some municipal ratings, it stated that it would only "partially incorporate" this default experience into its ratings Thus, municipal bonds are still rated by Fitch at lower levels than corporate bonds carrying similar risk of default Standard and Poors (S&P) has published similar studies to its customers and I believe that it awards lower letter ratings to municipal bonds than to corporate bonds with similar expected default rates

In the face of a united front by major rating agencies and bond insurers, municipalities are virtually powerless against the double bond standard Their options are few -- all imposing significant additional burdens on taxpayers

First, a municipality can try to achieve an Aaa rating on its own under the current dual rating system This task is daunting -- requiring a municipality to develop and maintain a substantial reserve fund to help pay the debt To obtain such a fund, the municipality must increase taxes on its citizens. Additionally, many small towns are unlikely to ever achieve a Aaa rating under the current municipal scale because their tax bases are frequently limited by the amount and diversity of assets in the town. In Connecticut, for example, town taxing authority is limited by state statute to levying a property tax and some fees

Alternatively, a municipality can obtain an Aaa rating by purchasing bond insurance from a bond insurer like MBIA or Ambac, with an Aaa corporate rating, thereby assigning the Aaa ratings of these insurers to the municipal bond The premium for such insurance is passed along to taxpayers. Absent one of these two solutions, the municipality is forced to pay higher interest rates on its artificially "lower" rated bonds. Again, this increased debt service cost ultimately is borne by taxpayers.

Some towns do not directly purchase bond insurance but they still incur unnecessary costs Often a town's bonds are sold uninsured to underwriters at an artificially high interest rate because of the double standard ratings system. These underwriters often purchase bond insurance themselves for the municipality's bonds in order to upgrade the bonds to Aaa and improve their marketability in the bond market. The underwriters then sell these more valuable Aaa rated bonds to their own clients at a lower interest rate (because they now appear to carry less risk) and pocket the difference in price The difference is sometimes known as the "yield spread." In this case, the cost of the unnecessary bond insurance is paid for by taxpayers through the higher interest rate paid by the town to the underwriter.

While my investigation necessarily focuses on harms and costs to Connecticut, these practices affect every state as well as cities and towns across the United States There are some 50,000 public entities authorized to issue public debt and each of them is impacted by the dual rating system

The Credit Rating Agency Reform Act of 2006 expressly recognizes that ratings issued by the credit rating agencies are intended to protect the "public interest," not to enrich investment bank underwriters or bond insurers The major credit rating agencies have been entrusted by Congress with tremendous power, which they have exploited to become extremely profitable

Operating profits of the major credit rating agencies are typically in the 40% range, among the most profitable businesses nationally

This federal law already prohibits rating agency practices that are unfair or abusive, but the dual system should be specifically banned

Maintaining a manifestly unfair municipal rating system conflicts with Congressional intent and public interest

I urge the Committee to take action to expressly eliminate the unfair, discriminatory, and abusive system that is currently in place Federal law should prohibit credit rating agencies from assigning different credit ratings to bonds with similar or equivalent rates of default and risk. Congress should not regulate the methods and procedures by which rating agencies estimate risk or say that any bond issuer should be assigned any particular rating or equivalent Rating agencies should be free to make these judgments on their own. Rather, Congress should ensure that all public and private issuers are treated equally -- allowing the market to compare the relative risk of all debt offerings Such a system would improve market transparency and integration with global markets enhancing competition by adding market participants

I will continue to aggressively pursue my antitrust investigation and look forward to working with the Committee as it exercises its important oversight responsibilities

Written Testimony by

Terry Dillon
President,
National Utility Contractors Association
&
Owner, Atlas Excavating Inc.
(West Lafayette, Indiana)

before the

House Committee on Financial Services

addressing

"Municipal Bond Turmoil: Impact on Cities, Towns and States."

March 12, 2008

Chairman Frank, Ranking Member Bachus, and Honorable Members of the Committee, my name is Terry Dillon. I am the owner of Atlas Excavating Inc. in West Lafayette, Indiana. We have 150 employees who work on sewer and water construction and highway and road reconstruction projects throughout the state.

I appreciate the opportunity to participate in this hearing regarding the turmoil in the municipal bond market on behalf of the National Utility Contractors Association (NUCA). NUCA is a family of more than 1,750 companies from across the nation that build, repair and maintain underground water, wastewater, gas, electric, and telecommunications systems.

The current municipal bond market is indeed in trouble, and every day the "ripple effect" is taking its toll on a wide variety of public works projects, including those intended to improve the nation's dilapidated underground water systems and wastewater treatment facilities. I'm here today to describe the needs facing America's underground environmental infrastructure and what is at stake when projects to repair and rebuild it are put in jeopardy, as well as address the role played by the bond market in this situation.

America's Decrepit Environmental Infrastructure

NUCA has the privilege of testifying regularly before Congress on the state of America's water and wastewater infrastructure. Our testimony comes from the unique perspective of those who work on our underground infrastructure systems every day and see firsthand what it looks like when they fail. In brief, the view from the trenches isn't pretty.

Utility contractors build and repair America's unglamorous but vital water and wastewater infrastructure. What is out of sight and out of mind to most people is clearly visible to NUCA members every day. We routinely uncover rotting pipes with gaping holes that spill raw sewage into the surrounding ground of residential neighborhoods. This leakage can go undetected for months, even years in some cases. To make matters worse, these conditions are often within yards of waterways where we fish, beaches where we swim, and playgrounds where our children play.

The need to fund projects for the nation's water and wastewater infrastructure is clear. The U.S. Environmental Protection Agency's (EPA) 2002 *Clean Water and Drinking Water Infrastructure Gap Analysis* found that there will be a $534 billion gap between current spending and projected needs for water and wastewater infrastructure in 2019 if investment is not stepped up. Furthermore, EPA's 2004 *Clean Watersheds Needs Survey* documents America's existing wastewater infrastructure needs at $202.5 billion. That is not a projection. That number reflects a snapshot of documented wastewater needs in 2004.

NUCA serves as chair of the Clean Water Council (CWC), a coalition of some 34 national organizations representing underground construction contractors, design professionals, manufacturers and suppliers, labor representatives and others committed to ensuring a high quality of life through sound environmental infrastructure. These industries work collectively to improve critical underground systems that unquestionably enhance America's quality of life. For your reference, a list of CWC members is attached to this testimony.

An active member of the CWC, the American Society of Civil Engineers (ASCE) evaluates the nation's infrastructure and reports on the status of it every few years. For the past several years, America's wastewater infrastructure has been graded a "D minus" in the ASCE's *2005 Report*

Card for America's Infrastructure. Clearly, there is a consensus among both government and industry professionals that the state of this infrastructure is quickly going from bad to worse. Meanwhile, federal resources to address this quandary are plummeting every year.

The SRF Program and Use of Bonds
The 1987 amendments to the Clean Water Act (CWA) fundamentally changed the way the federal government provides financial assistance for water pollution control facilities by replacing the construction grants program with the Clean Water State Revolving Fund (SRF) program. Controlled and operated by the states, the SRF program provides loans and other financial assistance for water pollution control projects. The Drinking Water SRF was subsequently implemented for similar projects relating to infrastructure improvements for drinking water systems.

In general, SRF loans work in perpetuity over time, providing necessary resources for public projects that promote public health, protect the environment, create scores of high-paying American jobs, expand the local tax base and enhance our overall quality of life. The revolving nature of the program has made it an extremely successful federal financing program, and has been the primary reason for its continued funding through annual appropriations, despite the fact that SRF authorization expired in 1994. Nationally, interest rates for SRF loans average at approximately 2.5 percent compared with substantially higher market rates, and provide flexible repayment terms up to 20 years.

Here is where bonds enter the picture. Under the SRF structure, states are required to provide at least 20 percent of the federal capitalization grant in state matching funds. In order to provide states as much flexibility as possible in designing SRF programs, the Clean Water Act allows states to provide the match from a variety of sources. Match payments may be cash deposits made directly from state accounts or may come from proceeds of SRF bonds that are repaid with SRF interest earnings. In fact, the use of bonds as the source of state match has become very popular. Additionally, several states also use bonds to "leverage" SRF earnings in order to make the most of their federal resources.

Impacts of Turmoil in the Bond Market
NUCA and the CWC have taken the lead for years in advancing a host of legislative efforts to begin to address the skyrocketing water/wastewater infrastructure needs facing our nation. Our focus in recent years has been on increasing annual appropriations for the SRF programs and on reauthorizing them at significantly higher funding levels. Unfortunately, traditional annual funding of $1.35 billion for the Clean Water SRF has been significantly cut in recent years, and the program is facing a $555 million appropriation level in FY2009, reflecting more than a 50 percent cut at a time when the nation simply cannot afford it. The recent uncertainty in the municipal bond market only exacerbates an already enormous problem.

As noted previously, SRF projects are funded in large part by municipal bonds, which provide local governments with needed resources for a variety of projects, including water, wastewater, and surface transportation infrastructure improvements. Traditionally, they have been one of the safest choices of lending in the public market. Once issued, these bonds are traded on the market with the benefit of being tax free, at least with regard to federal taxes. The problem today is that the corporations that have insured municipal bonds have been caught up in the problems associated with subprime mortgages. This has caused them to lose top-tier credit ratings. Unfortunately, municipalities often depend on these firms to ensure a quality credit rating for their bonds, which in turn allows them to borrow at more affordable rates when looking to fund infrastructure projects. However, because their bond rating depends on the rating of their insurer, local governments are avoiding firms whose credit rating has been called into question.

In some cases, local governments have opted to skip insurance altogether, which creates yet another set of costly problems. Without quality insurance, local governments are forced to pay higher interest rates in order to attract investors rather than work with troubled bond insurers. Last month, for example, only $5.4 billion (27 percent) of the $20 billion in issued municipal bonds was covered by financial underwriters. All of these problems are especially hard on smaller towns and cities like those in my State of Indiana.

Overlooked Economic Benefits of Infrastructure Rehabilitation Projects
Although underground infrastructure rehabilitation projects are recognized for their success in enhancing public health and environmental protection, the *economic* benefits that result from this work is often overlooked. Clean water projects help maintain a strong economic foundation by creating jobs, expanding the local tax base and ensuring that safe, clean lakes, streams and shorelines will be available for our children, grandchildren and generations to come.

Clean water goes hand-in-hand with a healthy economy. According to the American Public Works Association, more than 40,000 jobs are created with every $1 billion invested in funding for this infrastructure. These are quality, high-paying jobs in both the short and long term. Importantly, the job creation and increased economic activity that comes with it enhances local economies and opportunities for disadvantaged communities to revitalize and empower themselves.

It is important to highlight three important types of economic impacts that are associated with water and wastewater infrastructure projects. There are:

- direct impacts through job creation and the purchase of materials and supplies related to the operation of the project;

- indirect impacts through jobs and the purchase of materials and supplies by vendors indirectly related to the operation of the project; and

- induced impacts, which are supported by the spending and re-spending of the income earned by workers. (Induced economic impact is often referred to as the "multiplier effect.")

Another essential point is that the jobs offered in this industry are good, high-paying jobs that are provided right here in America. These are not jobs that can be shipped overseas.

One need look no further than the stakeholders represented in the Clean Water Council to see the direct and indirect jobs that are provided. Contractors and subcontractors, engineers, suppliers and manufacturers, as well as countless construction laborers, all benefit from work that impacts virtually all sectors of our society. And, the economic benefits resulting from these projects don't stop with the construction industry. Clean water enhances individual productivity through reduced sickness and missed work opportunities, as well as increases community productivity through the influx of new residents and businesses resulting from revitalized neighborhoods.

Conclusion
America's underground water and wastewater infrastructure is in enough trouble already. These systems face hundreds of billions of dollars in existing needs at a time when federal resources are dwindling. And, the gap between what is needed and what is being provided to repair and rebuild this critical infrastructure is growing at a rapid pace. Moreover, federal water quality mandates are promulgated regularly without providing adequate resources to meet them. The current chaos in the municipal bond market only makes a bad situation much worse.

The bottom line facing states and municipalities is this: The mortgage quandary has moved into the world of municipal bonds. It costs more to borrow less. Insurers are losing their credibility, and some local governments are opting out of insurance and paying higher interest rates as a result. Because it is taking money to borrow, the downstream result is less money for badly-needed infrastructure improvements.

The turmoil in the municipal bond market is very real, with the impacts now reaching the public and private sectors, cities and towns, business, labor, and, in the end, all American citizens. Infrastructure needs are going through the roof while the resources to address them are declining. The current uncertainty in the bond market is making matters considerably worse, and is only tightening the stranglehold on America's already struggling economy.

Thank you for the opportunity to submit testimony for the record.

Testimony of the
New York State Insurance Department

Before the
Committee on Financial Services
United States House of Representatives

Regarding:
The Municipal Bond Market and Bond Insurance

March 12, 2008

Eric Dinallo
Superintendent of Insurance
New York

I would like to thank Chairman Frank, Ranking Member Bachus and the other members of the House Financial Services Committee for allowing me to testify today.

My name is Eric Dinallo and I am New York State Insurance Superintendent.

Today's hearing is about conditions in the municipal bond market and the impact of the problems in the bond insurance industry on that market. Your other witnesses who are directly involved in the market are better able to provide you with detailed and accurate information about the current state of the municipal bond market. I believe that we can most contribute to today's discussion by telling you what we have been doing to help that market by working to stabilize the bond insurance companies.

Bond insurers, also known as financial guaranty insurers or monolines, currently insure about half of outstanding municipal bonds. The insurers, who generally have top triple-A credit ratings, promise to pay bondholders if the government or other entity that issued the bond is unable to pay. That insurance provides the municipal bond with a top triple-A rating, which the bond itself would not have without the insurance. Many states, municipalities and state and city authorities are willing to pay for this insurance because it increases the market for their bonds and lowers the net cost of borrowing. Many institutional investors and retail investors have a much larger allocation to invest in triple-A rated bonds. The lower financing cost more than makes up for the cost of the insurance, so the government issuer and the taxpayers who must repay the debt benefit from the insurance.

Investors also benefit. While in theory investors should independently analyze the creditworthiness of issuers before they invest, practically it is difficult to study each of the thousands of small state and local government entities that issue debt. By insuring thousands of issuers, the bond insurers take on the task of analysis and the risk of default for investors. Gathering and analyzing information about issuers has a real cost. By reducing those information costs, the insurers thus make investing in municipal bonds easier and less costly for investors.

The problems for the municipal bond market arose when the bond insurers' credit rating was threatened by deterioration in the subprime mortgage market. The bond insurers had also insured billions of dollars of subprime structured securities. If the bond insurers were downgraded, then the municipal bonds they insured would lose their triple-A rating and would either have their own generally lower rating or in some cases no rating at all.

In fact, while the two biggest bond insurers have preserved their top ratings with the two major credit rating agencies, some other bond insurers have been downgraded. While these downgrades and the threat of more had a serious impact on the municipal bond market, the general credit tightening put pressure on all debt securities. It is important to understand that even restoring some confidence in the bond insurers' credit ratings is not likely to resolve all of the current problems

There has been a general tightening in the credit markets and a flight to safety. In the auction rate market, investors now find that those securities are not as easy to exit as once believed. But investors are choosing to exit the market for auction rate bonds, regardless of the insurer, for liquidity reasons, so improving the standing of the bond insurers is not likely to change the current situation in this market. In the variable rate demand market, there is still demand for uninsured bonds or bonds not tied to weak bond insurers, but only time will tell how this market will react to the newly strengthened bond insurers.

Now, I would like to review what the New York State Insurance Department has done and is doing. We are the primary regulator of most of the companies in this industry. Wisconsin is the primary regulator for Ambac, but the company's headquarters is around the corner from our office in New York City. Maryland is the primary regulator for Assured Guaranty, but its main office is in mid-town Manhattan. And we license both Ambac and Assured to do business in New York.

As insurance regulators, it is our responsibility to protect policyholders and ensure a healthy, competitive market for insurance products. In the case of bond insurance, there are two main groups of policyholders. There are the municipal governments who bought insurance for the bonds they issued and by extension the investors who bought those bonds. Then there are the banks and investment banks who bought insurance for the structured securities, including mortgage-backed securities.

The best way to protect all the policyholders is to preserve the triple-A ratings of the bond insurers where that is possible. So we have been facilitating additions to the capital strength of the bond insurers, not for their own sake, but to protect first policyholders and second the markets and broader economy.

This has been an extraordinarily challenging endeavor. Every single bond insurer is in a different situation with different strengths and weaknesses. Each has a different group of investors and owners, who have different views. Each must deal with a different set of counterparties; that is banks, broker dealers and investment banks, each of which has a different level of exposure. And there are different potential outside investors with differing types of offers. The search for additional capital has been undertaken in a market for the securities of financial services companies in general and bond insurers in particular that has grown extraordinarily difficult.

Since mid-2007, as we saw the increasing problems in the subprime market and came to understand the impact on the bond insurers, we have been increasingly active and have, as of this date, made important progress, though there is more to be done.

Late last year, we developed a three-point plan for the industry. First, bring in new capital and capacity. Second, prepare to deal with any chronically distressed companies. Third, develop new regulations that would seek to prevent a repeat of this problem.

Our primary focus has been on point one. We have been working with all parties, the insurers, banks, financial advisors, private equity investors, rating agencies and federal officials, to support efforts to strengthen each individual bond insurer.

To date we have facilitated the addition of $7 billion of additional external capital into five different companies. That includes $2.5 billion for MBIA, $1.5 billion for Ambac and the $1 billion that Wilbur Ross committed to Assured Guaranty. In addition, we invited Berkshire Hathaway to open a new bond insurer in New York and licensed it in record time. Berkshire has made a public commitment to add $1 billion in capital to support its new insurance company. And we are working with the NAIC to help the company get licenses in all 50 states.

That additional capital provides three very important benefits. Capital strength is the most effective way to protect the credit rating of the bonds insured by those companies, both the municipal bonds and the structured securities. The entry of new, healthy guarantors ensures that, if some of the smaller bond insurers cannot be stabilized, healthy companies will be willing and able to take over at least their municipal bond portfolio. This additional capital and market depth should help the municipal bond market stabilize over time.

Better-capitalized insurers and new entrants will guarantee a competitive market for bond insurance for those municipal issuers that want to purchase it. Time and the market will determine the need for municipal bond insurance. Some governments have stated recently that they believe they no longer need bond insurance and have been issuing debt without it. That may mean that the demand for bond insurance shrinks. But we believe that a substantial number of municipal issuers, especially the smaller ones, will continue to need bond insurance. And, it is our job to ensure that it continues to be available for those who benefit from it.

Stabilizing the bond insurers should provide time for others to deal with the much bigger problems caused by the general subprime issue, hopefully with less pain to the economy as a whole. The condition of the bond insurers became a focus of the broader markets because, if they lost their top credit ratings, it would have had a broad impact on other financial institutions and thus on the economy. Preserving the insurers' ratings was absolutely necessary to avoid worse problems, but it is obviously not sufficient to solving the much larger issues caused by subprime mortgages and other financial market problems. We certainly hope the federal government, other regulators and the financial community will make good use of the time provided by the efforts and capital provided so far.

As for point two of our three point plan, we have been studying what steps could be necessary if one of the bond insurers is unable to find the capital it needs to maintain its ratings and stabilize its business. Of course, we hope such steps will not be necessary.

Finally, point three, we are working on rewriting the regulations for bond insurance to prevent companies from taking on inappropriate risk in the future, while not discouraging the financial creativity that is essential to maintaining our position as the world financial capital.

Because any legislative proposal will be complex and could have a substantial impact not only on the bond insurers, but also on the public and structured finance market generally, we are proceeding carefully. We are consulting with the full range of interested parties, including the bond insurers and their industry organization, the three major credit rating agencies, issuers and underwriters of guaranteed instruments, and other government officials. We have begun these meetings and have an aggressive schedule in the next few weeks to gain input in this effort.

We do not yet have a final product, but I can present some of the broad ideas and concepts we are carefully considering. In general, we believe it is important that new regulations improve transparency so that risk can be accurately evaluated.

There is nothing inherently wrong with securitization. Properly used, it can be a valuable tool for raising capital and spreading and therefore reducing risk. But we must understand the risk of moral hazard and other agency problems when there are large-scale transfers of risk.

Clearly, there must be a way to ensure that the risks that are securitized are accurately reported through each stage of the process so that underwriters, credit rating agencies, bond insurers and investors all understand the actual risk and make decisions on that basis.

For example, there are securities known as CDO squareds. A collateralized debt obligation groups a large number of mortgages, credit card or auto or student loan receivables and sells bonds supported by the stream of income from those thousands of debts. These asset-backed securities are sold in tranches ranked by predictions of their likelihood of default. Tranches with the first right to the payments from the underlying mortgages or loans are the highest quality and have the highest ratings; those with the last rights to payments have the lowest ratings. The more secure tranches receive a higher credit rating, but a lower interest rate. The less secure receive a lower credit rating and a higher rate.

The CDO **squared** bonds are made up of middle or mezzanine tranches of the **CDO** asset-backed securities and are also sold in tranches. A CDO squared groups these tranches together on the theory that the risk that all of them will default is small and so by pooling a large amount of these riskier loans into a small tranche, that tranche can be highly rated. At this point there have been **two** levels of tranching, and it becomes much more difficult to accurately determine the risk of these securities.

We are considering whether bond insurers should be prohibited from guaranteeing CDO squareds.

We want to ensure that the municipal bond market will not be affected by problems in the structured securities market in future, or vice versa for that matter. These are two very different markets with different types of risk and different payment streams. So it is not clear that it makes sense to combine them. We are considering whether a bond insurer should at some point in the future have to select one type of business to conduct, either public finance or structured, but not both. Once the company made that decision, for the market it would no longer serve, it would continue to service its current clients, but would not take on any new business. So this would not "split" the companies with all the potential issues raised by that approach. But it would have the same end result of having companies serving only one or the other market.

Other possibilities are to limit the amount of structured business that a bond insurer could do or to increase the amount of surplus and capital that a bond insurer must hold for its structured exposure. In general, in regulating insurance we are moving towards risk-based requirements for capital. So it will be important to study what that means when applied to this type of insurance.

The primary goal of insurance regulation is to ensure that the insurer maintains an adequate level of solvency and is able to honor policyholders' claims. The business model for the financial guaranty insurance companies, however, requires that they hold levels of capital that will allow them to maintain the triple-A rating necessary to write new business.

It has become clear that the loss of the triple-A rating essentially cripples the company's ability to do business as a going concern and puts the insurer in a "run-off" mode. This can lead to a downward ratings spiral that can destroy the market value of the insurance policies that issuers have purchased. We are now considering whether the sustainability of the business model should be the regulatory standard going forward. While we will continue to regard claims paying ability as the benchmark, our goal for the future, for all insurers, is to do higher level risk-based examinations.

Financial guaranty insurance is a complicated business, which is largely based on modeling and underwriting of complex capital market instruments. Total reliance on the rating agencies is not prudent. Rather an independent analysis by regulators of risk positions taken by bond insurers is more appropriate. It would also require greater transparency between the bond insurers and their regulator, by which I mean more information and oversight regarding the nature of the risks being insured.

We are looking at ways to improve reporting requirements, so we will better understand what the bond insurers we regulate are doing and can discuss this with them before problems arise.

We welcome any suggestions about how to improve our regulations.

I welcome your questions.

AJIT JAIN

Chairman Frank, Ranking Member Bachus, and members of the Committee:

It is my privilege to appear before you today. Recognizing the value of your time; I will get right to the three issues you have asked me to address, which are:

1. The circumstances which prompted us to form Berkshire Hathaway Assurance Corporation, a bond insurer, and our offer to reinsure the portfolio of several existing financial guarantors;
2. The value of bond insurance to the issuers and investors; and
3. How will the bond insurance industry develop going forward?

Berkshire Hathaway's Initiatives:

Our decision to enter the bond insurance business was initiated by a simple phone call from New York Superintendent of Insurance, Eric Dinallo. When I was told Superintendent Dinallo wanted to speak to me, my initial reaction was to be ready to receive some sort of bureaucratic complaint. Instead, the Superintendent was calling to work on a very businesslike approach to solving a problem, and invited us to create a bond insurer in his state of New York. Clearly flattered by the phone call, we felt the need to reciprocate and be associated with an effort to help address a problem of national importance. At about the time Superintendent Dinallo called us, we felt there was a real possibility that the bond insurance industry would undergo a structural and permanent shift. For almost 20 years, we had considered entry into this business. With our AAA rating and our excess capital position, this segment was always a natural extension of our existing insurance operations. These attractive macro features notwithstanding, when we analyzed the risk/reward characteristics of a typical transaction we concluded that pricing did not adequately compensate the capital provider for the risk- especially for the tail risk- i.e. what is now commonly referred to as the “Black Swan” event, defined as a random, difficult to predict event--an event that may have never happened before (and is therefore very unlikely to happen), but when it does happen, it has a huge impact.

Our assessment of the business in this regard began to change radically in October 2007 with the advent of the subprime crisis and the increased awareness of the financial losses it could bring. We hypothesized that risk in general, and financial credit risk in particular, would no longer be underappreciated and underpriced. Pricing going forward would reflect expectancy of losses plus a reasonable return to the risk bearer. In addition, it was our hypothesis that the existing industry leaders could have their franchises mortally wounded by the subprime and structured finance exposures that they had taken on. Whether or not these companies were able to raise additional capital, we believed there was a good chance that, given their prior history of mismanaging this business, they could no longer maintain their all-important AAA ratings. If that happened, there would be a need for a new AAA rated bond insurer--a role we could play.

As for our offer to reinsure the municipal bond business of the existing monoline insurers, here again Superintendent Dinallo gets the credit. He forced us to consider how our capital could be deployed to help alleviate the pressures on the existing bond insurers, and in particular the municipal bond policyholders that they had insured. A comprehensive solution, including both the structured finance and municipal obligations, was everybody’s first prize. However, we were unable to analyze the numerous complex financial transactions that made up the structured finance portfolios. On their municipal bond side of the house, while we continued to feel that the historical pricing was inadequate, we could nevertheless take on *that* risk with a price adjustment, which we

AJIT JAIN

made in the terms of our offer to reinsure that portfolio.

We believe that our offer to protect the municipal bond side of the guarantors' business had merit on several levels. First from the muni bond issuers' perspective, having a solid AAA insurer backing the bonds that they had issued would almost certainly avoid the steep increases in interest costs they have seen in variable and auction rate securities. Similarly for muni bond investors, our protection may well have avoided the steep price decreases in the value of their bonds that we witnessed two weeks ago. Furthermore, by releasing capital from the muni side of the business, the structured finance policyholders could well have had more capital available to pay for their losses. Finally, for the shareholders of these companies, by shedding their thirty year muni obligations, these companies could then negotiate to terminate their structured finance obligations with their counterparties. They could then return capital to their shareholders. This may well have been the best possible outcome for the shareholders-especially given where the shares of these companies are currently trading. However, our offer was clearly not in the best interest of the management of these companies, although we were hoping that the combined interests of the investors, issuers, policyholders, and shareholders would trump management's interests.

Value of Bond Insurance:

The second issue I have been asked to address is the benefit of bond insurance to issuers and investors. On this point, I can add almost nothing to what has been spelled out by so many others. To briefly rehash the point: from the perspective of a municipality, and speaking historically, the cost of purchasing a financial guaranty insurance policy was more than justified by the reduction in the interest rate that municipalities paid the credit markets for the funds being borrowed. From the investor's perspective, of course, the ratings enhancement lent by the insurance maintained a stable and liquid market for the bonds. Thus, the insurance provided lower interest rates to municipalities and greater price stability and liquidity to investors.

Outlook of the Bond Insurance Industry:

Given all this, I can well understand the Committee's interest in the last issue it has asked me to address, which is "Where are we going with all of this?" What my answer lacks in helpfulness it makes up for in honesty: I don't know. There remains a great deal of uncertainty. For our part, we are tip-toeing into the water and, while we are writing business at pricing levels that are economically attractive to us, I remain very concerned about the long-term viability of this business in general and for us in particular. There are several very good reasons for my concern.

First, and this applies just as much to all insurance as it does to financial guaranty insurance, the product that is being sold is nothing more than a future promise to pay. Its value relies heavily on the credibility of the promisor. With recent headlines of issuers having to pay as much as 20% on auction rate securities and with insured muni bonds selling at higher yields than corresponding uninsured bonds, buyers have every right to question the value of the bond insurers' promise to pay. Efforts to create a "good bank/bad bank" situation will further reinforce buyers' concerns about the integrity of the insurance product. It is one thing for regulators to prioritize among policyholder obligations for the greater public good in a potential insurer insolvency situation, but for the management of a AAA rated going concern to use the concept of a good bank/bad bank as a tool to enrich their stockholders at the expense of certain categories of policyholders is something that can cause permanent damage to the insurance business.

Put yourself in the shoes of a chief financial officer of a health care facility. Your initial, superficial reaction to this "split" of insurer obligations may be one of relief, since in the first instance you are within the "good bank" bucket, and the value of the insurance on your bonds will not be eroded by structured finance claims. But tomorrow, when a few of your fellow health care facilities default, what assurance do you have that all health care bonds won't be put into a "bad bank," leaving the health care facilities to fend for themselves?

Second, if the rating agencies level the playing field in terms of how they rate municipal versus corporate obligations, there will be little need for a financial guaranty insurance marketplace as we know it, because much municipal debt on a stand alone basis may not require the enhancement of the insurance to manage the costs of that debt, depending on whether investors accept the altered rating approach.

Finally, if the rating agencies permit some of the more compromised monolines to maintain their historical AAA ratings, the ongoing efforts of those companies to underwrite their way back to strength will lead to pricing wars; that will be unavoidable. Unless you continue to believe that this is zero-loss business, that conduct assures a bleak future for this business. On that point, I am actually amazed that experts in the business continue to consider municipal bond insurance as almost a zero-loss business. There is hardly a sufficient history to conclude that there is a zero chance of loss in this business, although that is the assessment that gets reflected in the pricing. While there have been few municipal defaults in the past fifty years, Jefferson County, Alabama and Vajello, California, both having received publicity lately about possible defaults on their debt obligations, could just be the tip of the iceberg as municipalities are coming under increasingly unfavorable economic conditions, including reduced real estate and sales-generated tax revenues and underfunded future pension and healthcare costs, that by anyone's measure increases the risk of insuring long-term municipal obligations. Yet I am assured that this remains a zero loss business.

Given that gloomy sentiment, I feel confident in saying that it has been more my pleasure to appear before you then your pleasure in having me. I would be pleased to try and answer any questions you may have, and I thank you once again for inviting me to address you on this important issue.

Moody's Investors Service

Testimony of Laura Levenstein
Senior Managing Director
Moody's Investors Service

Before the
United States House of Representatives
Committee on Financial Services

March 12, 2008

Hearing on Municipal Bond Markets

I. Introduction

Good afternoon Chairman Frank and members of the Committee. I am Laura Levenstein, and I am the Senior Managing Director at Moody's Investors Service ("**Moody's**") for the Global Public, Project and Infrastructure Finance Group. This Group comprises the departments specializing in all levels of public finance globally, as well as project and infrastructure financings. On behalf of my colleagues at Moody's, I would like to thank the Committee for inviting me to participate in today's hearing during which I will broadly discuss the unique attributes of the municipal credit market, Moody's rating system for that market and how it differs from our global rating system. I also will describe the evolution of the municipal market in recent years and the various changes we have been making to our rating system as a result of our ongoing dialogue with issuers, investors and other market participants.

The U.S. municipal bond market has long enabled states, municipalities and counties, as well as school districts and non-profit institutions like hospitals, to finance a range of important governmental activities as well as infrastructure and other public works projects. Moody's first began rating municipal securities in 1918 and we have maintained two separate bond rating systems for the past 90 or so years. Our U.S. municipal system includes ratings assigned to securities issued in the U.S. tax-exempt and taxable bond markets by state and local governments, non-profit organizations, and related entities.[1] Moody's global system includes ratings assigned to issuers and issuances of non-financial and financial institutions, sovereigns and sub-sovereign issuers outside the United States, and structured finance obligations.

These different rating systems grew out of and reflect the unique dynamics and needs of the municipal bond market and the participants in that market. There are two aspects of the market that historically have been particularly important:

- Municipal securities rated by Moody's have had relatively lower credit risk when compared to Moody's-rated corporate or structured finance obligations. While these issuers may experience financial distress, the municipal market has had limited default and loss experience. (Although it should be noted that the loss experience for non-rated municipal issuers has been higher than that for the rated universe.)
- Historically, investors in U.S. municipal securities have had a lower risk tolerance than investors in other types of securities. While the investor base has recently become more diversified, traditionally many municipal investors have tended to invest in municipal securities primarily as a reliable source of tax-exempt income

[1] Please see **Annex I** for Moody's municipal rating system and the definitions of each rating symbol.

and have sought to differentiate the most secure municipal securities within the overall universe of such debt obligations.

Nonetheless, Moody's recognizes that the municipal bond market has evolved, and with it we have taken steps to respond to the changing needs of investors and issuers. We at Moody's are committed to our narrow, but important, role in helping markets operate effectively and efficiently. In this regard, and as I will explain in greater detail below, we have recently decided to assign global ratings to municipal issuers upon request and welcome additional market feedback on measures that would improve the overall transparency and value of Moody's ratings systems.

I note at the outset that the information contained in my testimony is based on the securities that Moody's has rated in the municipal market. A large number of municipal bond issuances are not rated by Moody's and therefore our comments should not be construed as being applicable to the entire universe of municipal issuance.

II. Background on Moody's Investors Service

Credit rating agencies occupy a narrow but important niche in the investment information industry. Our role is to disseminate information about the relative creditworthiness of, among other things, financial obligations of corporations, banks, governmental entities, and structured finance transactions.[2]

Moody's[3] is the oldest bond rating agency in the world, having introduced ratings in 1909. Today, we are one of the world's most widely used sources for credit ratings, research and risk analysis. Our ratings and analysis track debt covering more than 100 sovereign nations, 12,000 corporate issuers, 29,000 public finance issuers, and 96,000 structured finance obligations. In addition, Moody's publishes credit opinions, transaction research, and commentary serving more than 9,300 customer accounts at 2,400 institutions around the globe.

Moody's credit ratings are forward-looking opinions that address just one characteristic of fixed income securities – their creditworthiness. Ratings are not statements of fact about past occurrences or guarantees of future performance and they do not constitute a recommendation to buy, sell, or hold a security. Ratings are designed exclusively for the purpose of ranking bonds according to their relative credit risk and do not take into consideration factors such as the direction of future market prices, an investor's investment objectives, or the investor's risk parameters.

Our long-term debt ratings are expressed according to a simple system of letters and numbers, on a scale that has 21 categories ranging from Aaa to C. Bonds with the lowest relative credit risk are rated at the Aaa level, those with a higher relative credit risk are rated at the Aa level, those with an even higher relative credit risk are rated at the

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2 Please see **Annex II** for a brief description of the existing regulatory environment under which Moody's operates in the U.S.

3 As is a matter of the public record, Berkshire Hathaway is a shareholder of Moody's Corporation, our parent company.

A level, and so on down through the rating scale. A Moody's rating is not a "pass-fail" grade; rather, Moody's ratings are a relative ranking system.

Moody's credit ratings are widely and publicly available at no cost to investors and the general public. We publicly disseminate our credit ratings through press releases and also make them available on our website. They are made simultaneously available to all market participants regardless of whether or not they purchase products or services from Moody's. The public availability of ratings helps enhance the transparency and efficiency of financial markets, and allows the market and all users of ratings to assess independently the aggregate performance of our rating system.

A. Moody's U.S. Public Finance Group

Moody's began rating tax-exempt municipal debt in 1918. Today our Public Finance Group comprises approximately 100 analysts with diverse professional backgrounds. We publish ratings and research on bonds issued by states, counties, and school districts, as well as on bonds issued to finance not-for-profit healthcare, housing and higher education, public power, water and sewer systems, solid waste/resource recovery plants, airports, ports, mass transit, toll roads, and entertainment and tourism-related facilities. We also rate special financing structures, such as leases, land-secured transactions, state revolving funds, and other types of pooled financing.[4]

We assign our ratings in accordance with published analytical methodologies, which are available on our website, www.moodys.com, and we update our methodologies to remain current with evolving credit trends. We also publish numerous New Issue Reports and Update Reports per year, as well as in-depth analyses of high-profile issuers, rating methodologies, sector outlooks, and special comments.

III. Overview of the U.S. Municipal Finance Market

The municipal bond market has long been a critical arena for state and local governments to raise funds for major capital improvements, such as building roads, bridges, sewer systems and mass transit projects, to name a few. For tax purposes, municipal bonds are classified into two groups.

- *Tax-exempt* municipal bonds include governmental bonds issued to finance typical governmental functions of state or local governments. These functions include activities such as financing the construction or improvement of roads, sewer and water systems or government buildings. Tax-exempt bonds also include those which are issued to finance some non-governmental or quasi-governmental purposes, such as private higher educational institutions and not-for-profit institution. Like most debt obligations, these bonds function like promissory notes. The issuer of the bonds agrees to make scheduled interest payments, at a specified rate, for a fixed period of time, and return the principal at maturity. One attractive feature of tax-exempt bonds for investors is that the interest earned is free of federal income taxes and also may be

4 References to the "municipal market" or "municipal bonds" do not encompass tax-exempt industrial development bonds issued by corporations or bonds technically issued by governmental entities but backed solely by corporate entities such as financial institutions.

free of state and/or local income taxes if the bond's purchaser is a resident of the issuing state.

- *Taxable* municipal bonds include both fully taxable municipal bonds and municipal bonds subject to the Alternative Minimum Tax.[5] This taxable segment of the market exists because certain activities that do not provide a significant benefit to the public at large are not federally subsidized. Investor-led housing, local sports facilities, and borrowing to replenish a municipality's underfunded pension plan are three types of bond issues for which the interest earned is subject to federal income tax. Taxable municipal bonds offer yields more comparable to those of other taxable sectors than to those of tax-exempt municipal bonds.[6]

(**Table 1** shows the overall size of the municipal market and the dollar amount of issuance in 2007 for both tax-exempt and taxable bonds.)

Table 1
U.S. Municipal Finance Market:
Selected Statistics 2007

	In dollars
Total outstanding	$2.6 trillion[7]
Total long term issuance in 2007	$429.7 billion[8]
Total tax-exempt issuance in 2007	$362.4 billion[9]
Total taxable issuance in 2007	$67.3 billion[10]

The municipal market can be differentiated from other credit securities markets in two important respects: the lower overall credit risk for municipal securities and the unique interests of municipal bond investors. We discuss both differences in turn.

5 The Alternative Minimum Tax ("**AMT**") is a separate tax computation under the Internal Revenue Code, which, in effect, eliminates many deductions and credits and creates tax liability for an individual who would otherwise pay little or no tax. A potential investor might choose to purchase an AMT bond because the yields are higher, reflecting the risk that the interest earned on the bonds could become taxable to the investor at some point in time.

6 The taxable municipal market has grown rapidly in recent years. According to Securities Industry and Financial Markets Association ("**SIFMA**"), in the last five years alone, over $90 billion in taxable municipals have been issued.

7 SIFMA.

8 Thomson Financial.

9 Ibid.

10 Ibid. Out of the total issuance of $67.3 billion, $29.3 billion in issuance represented taxable securities and $38 billion represented issuances of AMT bonds.

A. Lower Credit Risk for Municipal Securities

Overall, the credit risk of municipal securities is lower than that of corporate and other securities for a number of important reasons. Four of the principal reasons for this lower credit risk are discussed below.

1. *Municipal Issuers Provide Essential Services*

   Municipalities typically are perpetual entities providing essential public services. They do not need to generate a return on equity but merely to break even or generate a small surplus in order to continue operating.

2. *Power to Levy Taxes or Tax-Like Charges*

   Municipalities have the power to levy taxes or impose tax-like charges for those essential services. Also, municipalities can secure their bonds with a "general obligation" pledge, meaning that all of the municipality's revenue-producing powers are promised to be used to satisfy the debt, including the municipality's ability to levy taxes sufficient to pay such debt.

   Further, if a default on general obligation debt occurs, bondholders can seek a *writ of mandamus*. The writ, ordered by a court, directs the appropriate governmental official to levy and collect taxes to pay debt service or to make required debt service payments using other available funds of the municipality. This ability to invoke *mandamus* provides a great degree of comfort that, in almost all circumstances, bondholders ultimately will recover 100% of the principal and interest owed.

3. *Distinctive Bankruptcy Laws*

   There are unique laws that apply to bankruptcies of municipal entities – which contribute to the lower credit risk of these securities. While corporations can file for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (capital structure reorganization), municipalities, when allowed by their governing state laws, would file for bankruptcy under Chapter 9. Bankruptcies of municipalities under Chapter 9 differ from corporate bankruptcies in several respects:

   - Involuntary bankruptcy filings are not permitted;
   - Chapter 9 provides only for an adjustment of the municipality's debts, not its liquidation; and
   - The municipality's powers are not affected by the filing.

   These differences in bankruptcy law allow a municipality to continue operating during a bankruptcy, giving it the ability to raise revenue and make payments on any defaulted debt.

4. *Third-Party Intervention*

   Finally, a municipality in financial distress will typically never reach default because a higher level of government, e.g., the state, will generally step in to prevent defaults on outstanding obligations. Even though very few Moody's-rated bonds have experienced payment defaults, numerous issuers have avoided defaulting on debt only because of intervention by a third party.[11]

Many other state and local government-related bond issuers share these low-risk characteristics, in part because they benefit from the implicit support of the state and local government authorities that create or sponsor them. For example, Moody's considers most water and sewer authorities and public university systems to be very strong credits, not only because they possess dependable revenue streams, but also because Moody's believes they are very likely to receive financial support from their sponsoring authorities in the event of distress.

Not all tax-exempt issuers share these inherently strong credit characteristics. Some tax-exempt issuers (such as not-for profit hospitals, issuers in public infrastructure project financings, and private universities) increasingly share "corporate-like" characteristics, such as exposure to true market competition and relatively less direct governmental subsidies and control.[12]

B. Unique Interests of Municipal Bond Investors

It has been our understanding that, historically, investors when purchasing municipal bonds have done so with different perspectives and risk appetites than investors in corporate bonds, and our rating systems have evolved to reflect those different needs. For example, unlike corporate bond investors, municipal investors generally have been more risk averse and have looked for tax-free alternative investment opportunities to US Treasuries. As a result, they have been less diversified in their investment portfolios, more concerned about the safety and liquidity of their investments, and in the case of individuals, often more dependent on debt service payments as a reliable source of income.

In particular, municipal investors generally have been highly intolerant of any diminished value of or reduced liquidity in their investment portfolios, which can occur as a result of an issuer's financial distress even if the bonds do not default. Despite the low risk of default, valuation fluctuations generally occur when a municipal issuer faces financial stress, because attempts either to resolve financial problems or have a third-party rescue such entities or securities usually occur only after lengthy political and policy negotiations. During such times of distress, the valuation or liquidity of the bonds can suffer significantly. Consequently, municipal investors have looked to Moody's credit ratings for our opinion on the likelihood that a municipal bond issuer will experience financial stress rather than default.

We note, however, that the attributes of the municipal investor community are changing and investors are becoming increasingly multi-disciplinary in their approach.

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11 It should be noted that in times of financial distress municipalities often can generate an internal solution to restore financial balance without involving a third party. However, there generally is a great deal of uncertainty with respect to the timing and content of the ultimate outcome.

12 Nevertheless, there have been many instances of governmental intervention to support these types of issuers when they are in financial distress.

IV. Comparing Moody's Municipal Rating System with Moody's Global Rating System

John Moody, the founder of Moody's Investors Service, first introduced a simple system for rating railroad bonds in 1909. This system was broadened a few years later to include all industrial bonds. When he later began rating state and local governments, he used a similar but distinct municipal rating system. The difference between the two rating systems was recognized explicitly in *Moody's Government and Municipal Manual* published in 1920,[13] and since that time we have continually published on it and talked to market participants about it.

Similar to the bond markets themselves, Moody's rating approach to municipal issuers (as well as issuers in other credit markets) has developed over time to address the unique needs of the investors and issuers. Investors in corporate or structured securities typically have looked to Moody's ratings for an opinion on whether a security or an issuer will meet its payment obligations.

Historically, this type of analysis has not been as helpful to municipal investors. If municipal bonds were rated using our global ratings system, the great majority of our ratings likely would fall between just two rating categories: Aaa and Aa. This would eliminate the primary value that municipal investors have historically sought from ratings – namely, the ability to differentiate among various municipal securities. We have been told by investors that eliminating that differentiation would make the market less transparent, more opaque, and presumably, less efficient both for investors and issuers.

Instead, Moody's distinguishes more finely among the various municipal securities and ranks one against the other on the basis of intrinsic financial strength. Because the risk and potential severity of loss is relatively low in the municipal market, Moody's municipal ratings principally focus on the risk that an issuer will face financial distress. In other words, we seek to measure an issuer's ability and willingness to service its debt without the need for third party intervention. This can be translated roughly into an estimate of its default probability without consideration of loss severity. This different calibration from the corporate market takes account of and reflects the unique interests and dynamics of the municipal bond market.

A. Key Analytical Factors and Rating Process for Municipal Ratings

Broadly speaking, Moody's ratings of securities issued by municipalities are based upon the analysis of the primary factors relating to municipal finance: economy, finances, debt, governance/management strategies, and structural features of the securities.

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13 Government and Municipal Manual of 1920: "...Municipal ratings 'are necessarily based on a broader and more general foundation than are the ratings supplied for the ordinary corporation or railroad issues. ... Thus, under all ordinary conditions, it can be accepted as a fact that a municipal obligation of a well established and growing city or town is substantially secure insofar as the strength of the principal is concerned. Qualifications in rating, therefore, are limited, and the variations between one type of municipal bond an another are not very great."

- *Economy*: Depending on the entity, we look at the breadth and diversity of the affected economy including growth trends and comparative economic position to similar entities.
- *Finances*: We analyze information contained in audited financial statements as well as current budget information and compare this information to sector statistics for comparable entities.
- *Debt*: Debt ratios are calculated to adjust for size (debt per capita) and wealth (debt to personal income or debt as a percent of full value) and compared to sector medians.
- *Governance/management strategies*: We assess the type of governance, including legal powers to manage finances and any legal constraints on taxing, borrowing or spending.
- *Structural features of the securities*: In addition to the fundamental credit analysis, Moody's analyzes the structure of the transaction, e.g. the strength of the legal pledge of collateral to bondholders, the rights of other creditors and the nature and extent of external support.

All of these factors are important in assessing the entity's degree of financial flexibility to meet fiscal challenges and specific debt obligations. In each case, the factors are evaluated individually and for their interrelation with and impact on the other factors in the context of the municipality or enterprise's ability to repay its debt and its relative degree of fiscal strength or stress.

Moody's also rates several other types of municipal bonds including bonds supported by special/dedicated taxes, enterprise bonds (e.g. relating to the construction or improvement of airports, toll roads, water and sewer, public power) and bonds issued by healthcare institutions and housing authorities. Our ratings incorporate many of the same factors noted above but also take into account the financial and business activity characteristics of the public enterprise. For example, an analysis of bonds relating to the construction and operation of a toll road would look at vehicular traffic, competitive position (e.g. the existence of competing toll-free roads), the local economy served by the toll road, the coverage of debt service by toll revenue and the obligation of the entity to raise tolls to ensure sufficient revenue to pay debt service on the bonds.

V. Performance of Moody's-Rated Municipal Bonds

A. Low Credit Risk and Default Rates for Moody's-Rated Bonds

Based on the historic performance of the public finance securities we have rated and the municipal sector's inherent credit strength and its extremely limited default and loss experience, Moody's believes that credit risk in the rated portion of the sector, particularly in the general obligation and essential service revenue sub-sectors, is very low. Even in the cases where default does occur, the severity of loss suffered by the bond holder is likely to be limited.

- Between 1970 and 2006, just 41 out of approximately 29,000 Moody's-rated municipal issuers defaulted. Twenty-two of these defaults occurred between 2001 and 2006.

- 16 of the defaults were for housing projects, 18 were for healthcare and other not-for-profit institutions, and seven related to local governments and related public sector issuers.
- Only one of the defaults among Moody's-rated municipal issuers involved an issuer of general obligation bonds, and this issuer recovered quickly and paid its obligations in full.

B. Greater Credit Risk in Unrated Municipal Market

As **Table 2** indicates, a significant number of municipal bond transactions are not rated. An issuer may elect not to obtain a rating for its debt for a number of reasons. In particular, if the transaction is small or the municipality is an infrequent issuer, the cost of public disclosure and other requirements to obtain a rating and access the public markets may make these options unattractive. Furthermore, access to public markets may not be necessary, since issuers in some circumstances may be able to place small deals directly with banks (i.e. bank-qualified deals) or with other private investors.

Table 2

Proportion of Rated Versus Unrated Market for Municipal Securities Issued in 2007[14]

	Dollar volume	Number of transactions
Rated long-term municipal bond issuances	93. 32%	62.46%
Un-rated long-term municipal bond issuances	6.68%	37.54%

There is evidence to suggest that, in general, issuers in the unrated municipal bond market may have higher levels of credit risk than rated issuers. While Moody's has not verified this data, *Income Securities Advisor,* an independent investment advisory and research firm, reported 1,311 defaults on unrated, tax-exempt bonds[15] during the period from 1980 through October 2004 – a significantly higher number of defaults than the number of defaults for Moody's-rated issuers.[16]

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14 Interactive Data Corporation and Bloomberg.

15 The reported number of defaults of unrated bonds includes "technical defaults" (i.e. violations of covenants) as well as payment defaults, whereas Moody's studies capture defaults of rated securities only in the event of actual payment defaults. As noted, the data has not been verified by Moody's and we cannot assess it accuracy or validity.

16 As noted earlier, only 41 out of approximately 29,000 Moody's-rated issuers of taxable or tax-exempt municipal bonds defaulted on payment obligations in the period 1970-2006.

VI. EVOLUTION OF MOODY'S MUNICIPAL BOND RATINGS REFLECT ONGOING DIALOGUE WITH MARKET PARTICIPANTS

In providing credit opinions to the municipal market over the past 90 years, Moody's has always maintained an active dialogue with municipal investors and issuers to understand what attributes would help make our municipal rating system most useful, and we have adjusted our rating system as the markets and the needs of investors and other market participants have evolved. While historically we observed that municipal bond investors have purchased such bonds with different perspectives and risk perspectives than investors in corporate bonds, in recent years we have seen municipal bonds increasingly traded by a wider range of multi-disciplinary investors. Over the course of the past few years, we have made several changes to our municipal ratings system and approaches to reflect this evolution in, and feedback from, the market.

- ***In 2001***, Moody's met with over 100 market participants to understand their views on the need for and value of globally consistent ratings.[17] The vast majority of participants surveyed indicated that they valued the municipal rating scale in its current form. Additionally, many market participants expressed concerns that any migration of municipal ratings to be consistent with the global rating scale would result in considerable compression of ratings in the Aa and Aaa range, thereby reducing the discriminating power of the rating and transparency in the market. However, a segment of the market indicated that they would value a greater ability to compare municipal credits to other securities in other markets.
- ***In 2002***, we published a default study which highlighted the limited default experience in the Moody's-rated market for public finance securities, and we noted that some taxable bonds were starting to be placed outside of the United States. To accommodate the latter trend, we began:
    1) offering entities issuing tax-backed or essential service revenue-backed taxable securities outside the U.S. the opportunity to request that a global rating be assigned; and
    2) providing broad guidance on how our municipal ratings would translate into our global ratings. In particular, we stated that it would be reasonable to conclude that nearly all Moody's-rated general obligation and essential service revenue bonds would be rated at or near the top of the global scale.[18]
- ***In 2006***, we published a *Request for Comment* asking market participants whether they would value greater transparency about the conversion of our municipal rating system to a global rating system. We received over 40 written responses and had telephone and in-person discussions with many other market participants. Generally, the majority indicated that they valued the distinctions the current rating system provides in terms of relative credit risk, but that they would endorse the expansion of assigning global ratings to taxable municipal bonds sold inside the U.S.

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17 "Moody's Municipal Default Study Highlights and Next Steps," Special Comment, June 2002.

18 It is important to note, however, that the time period studied did not include a period of extreme financial distress such as the Great Depression.

- *In 2007*, based on the above feedback and to further improve the transparency of our long-term municipal bond ratings, we:
  1) implemented a new analytical approach for mapping municipal ratings to global ratings, thereby enabling investors to compare municipal bonds to corporate bonds while maintaining the municipal scale that investors and issuers told us they valued;
  2) published a conversion chart that market participants could use to estimate a global rating from a municipal rating; and
  3) announced that, when requested by the issuers, we would assign a global rating to any of their taxable securities, regardless of whether the securities were issued within or outside the United States.[19]

Since publication of our report in March 2007, the market has continued to evolve. For example, recently, several of the largest municipal issuers, among the thousands we rate, have suggested that the municipal ratings system be eliminated altogether. We are very interested in learning more about the views of these and other issuers, as well as hearing from investors and other market participants. We are already re-evaluating our existing municipal ratings system and will be issuing a *Request for Comment* in which we will:

- propose assigning global ratings to any tax-exempt bond issuance, including previously issued securities as well as new issues, at the issuer's request beginning in May 2008;
- clarify that the conversion table we published in our March 2007 report can be applied to both tax-exempt and taxable municipal securities; and,
- ask whether market participants would prefer a simplified conversion table that would make it easier to estimate a global rating from a municipal rating.

During the *Request for Comment* period, we hope to gain a thorough understanding of issues important to market participants, including how issuers and investors are using municipal ratings today and how this has evolved over the past few years since 2006, when we last reached out formally to the market.

VII. MUNICIPAL BONDS WRAPPED BY FINANCIAL GUARANTEES

Both rated and unrated municipal bond issuers can choose whether or not to obtain credit enhancement for their bonds. Credit enhancement is available in different forms, such as guarantees, letters of credit and bond insurance. Consequently, the decision to purchase bond insurance rests solely with the municipal issuer, which weighs the costs and benefits of insuring its bond against its various other alternatives.[20]

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19 To put this demand for global ratings by municipal issuers into context, since we first began offering global ratings for taxable securities in 2002, only sixteen issuers have requested Moody's to assign a global scale rating to their bond issuances, while two issuers requested a global scale rating for their obligations under swap contracts.

20 Insurance can also be purchased by investors in the secondary market, after the bonds have been issued.

Bond insurance is provided by a third-party insurance company, which in return for an insurance premium, agrees to insure the timely payment of interest and principal for the bonds for the entire term of the bonds. The issuer remains primarily responsible to pay amounts owing on the bonds as they come due. The bond insurer (also known as a "financial guarantor") becomes obliged to pay only if the issuer fails to make timely payments of interest or fails to repay the principal when it comes due. An insured bond is sometimes called a "wrapped bond" (*i.e.* a bond wrapped by insurance).

When an issuer requests a credit rating for a wrapped bond issuance, Moody's analyzes the bond insurance policy to determine whether or not there has been full, effective credit substitution. Full credit substitution should insulate the investor from the issuer's financial condition, as well as from any legal or other risks associated with the mechanics of the transaction. Moody's examines the documentation for the transaction to determine, for example, whether all parties to the transaction have clearly defined responsibilities and whether the insurer is obliged to make timely payments on the security if the issuer does not make the required payments as scheduled. If the bond insurer's standardized policy includes any changes or endorsements, Moody's analyzes them to determine whether or not they create credit risk for the bondholder. If Moody's concludes that the structure of the policy provides for full, effective credit substitution, the bonds will receive the bond insurer's financial strength rating. Moody's insurance financial strength ratings are opinions about the ability of insurance companies to repay punctually senior policyholder claims and obligations.

An issuer that proposes to issue a wrapped bond often asks Moody's for a rating only on the wrapped transaction. An issuer can also ask Moody's to provide a separate opinion about the underlying bond without factoring in the bond insurance. In such circumstances, the bond will then have two credit ratings – one for the underlying bond and one for the wrapped bond. At the time the issuer is informed of Moody's rating for the underlying bond, the issuer can decide whether or not to have that rating published.

VIII. CONCLUSION

Moody's is strongly committed to meeting the needs of investors, issuers and other participants in the municipal bond market to assess the relative creditworthiness of securities in that market – a market that plays a vital role in meeting public needs.

Both issuers and investors in the municipal market have had characteristics that are different from those in other credit markets. Issuers – because of their unique powers and role as public entities and the laws that apply to them – have presented low credit risk. Although the characteristics of investors in this market have begun to change somewhat in recent years, historically investors purchasing municipal bonds have done so with different perspectives and risk appetites than investors in other areas of the credit market. Municipal bond investors traditionally have been, and we believe many municipal investors continue to be, highly risk averse and eager for a rating system that differentiates among various issuers' likelihood of experiencing financial stress.

Moody's is engaged in an ongoing dialogue with participants in this market and other markets we serve to ensure that our ratings meet the evolving needs of these participants. We have found a strong desire among participants in the U.S. public finance markets for a credit rating system that is distinct from that used for rating corporate bonds. At the same time, we have continued to provide the market with enhanced tools to increase the transparency and comparability of ratings between these two markets. We review our practices in this market and make changes as necessary so that we can apply our analytical expertise in a way that can best meet the needs of investors, issuers and other market participants.

Annex I

Municipal Long-Term Rating Definitions

Aaa	Issuers or issues rated Aaa demonstrate the strongest creditworthiness relative to other municipal or tax-exempt issuers or issues.
Aa	Issuers or issues rated Aa demonstrate very strong creditworthiness relative to other US municipal or tax-exempt issuers or issues.
A	Issuers or issues rated A present above-average creditworthiness relative to other US municipal or tax-exempt issuers or issues.
Baa	Issuers or issues rated Baa represent average creditworthiness relative to other US municipal or tax-exempt issuers or issues.
Ba	Issuers or issues rated Ba demonstrate below-average creditworthiness relative to other US municipal or tax-exempt issuers or issues.
B	Issuers or issues rated B demonstrate weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.
Caa	Issuers or issues rated Caa demonstrate very weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.
Ca	Issuers or issues rated Ca demonstrate extremely weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.
C	Issuers or issues rated C demonstrate the weakest creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Moody's applies numerical modifiers 1, 2, and 3 in each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

Annex II

Regulatory framework in which Moody's operates

In September 2006, the Credit Rating Agency Reform Act ("**Reform Act**") was passed into law. It created a voluntary registration process for rating agencies willing to have their ratings used in federal securities laws by being designated as a nationally recognized statistical rating organization ("**NRSRO**"). The Reform Act also authorized the Securities and Exchange Commission ("**SEC**") to oversee such NRSROs. The objective of the Reform Act is "to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry"[21]. It aims to:

a) enhance accountability by providing the SEC with oversight authority to assess the continued credibility and reliability of an NRSRO;

b) promote competition through a clear process by which a rating agency can apply for and receive NRSRO designation; and

c) improve transparency by requiring registered NRSROs to make publicly available most of the information and documents submitted to the SEC in their applications.

In June 2007, the SEC published its rules to implement the Reform Act and ensure rigorous oversight of the credit rating industry and on September 24, 2007 Moody's became a registered NRSRO pursuant to the new Reform Act rules. The rules include the following:

- Registration Requirements (17g-1): Implements the registration requirements for NRSROs.
- Recordkeeping (Rule 17g-2): Ensures that an NRSRO makes and retains records to assist the SEC in monitoring, through its examination authority, an NRSRO's compliance with the provisions of the Statute.
- Financial Reporting (Rule 17g-3): Requires NRSROs to furnish the SEC with audited financial statements and associated schedules on an annual basis to allow the SEC to monitor the NRSRO's financial resources and assess its ability to support robust credit analysis activities.
- Protection of Material Non-Public information (Rule 17g-4): Requires an NRSRO to have procedures designed to prevent potential misuses of material non-public information.
- Managing Conflicts of Interest (Rule 17g-5): Requires an NRSRO to disclose and manage those conflicts of interest that arise in the normal course of engaging in the business of issuing credit ratings.
- Prohibition of Unfair, Coercive, or Abusive Practices (Rule 17g-6): Prohibits NRSROs from engaging in certain acts or practices relating to the issuance of credit ratings that the SEC has determined to be unfair, coercive, or abusive.

[21] Credit Rating Agency Reform Act of 2006, Preamble.

Last summer, using its new statutory authority, the SEC began examinations of the role of the rating agencies with respect to the subprime markets. The SEC's examination is focused on whether the rating agencies diverged from their stated methodologies and procedures for determining credit ratings in order to publish higher ratings. As stated by Chairman Cox,[22] a final report discussing the results of the examination is expected in the Summer of 2008.

[22] "The State of the United States Economy and Financial Markets": Written testimony of Chairman Christopher Cox, U.S. Securities and Exchange Commission, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, February 14, 2008.

BILL LOCKYER
TREASURER
STATE OF CALIFORNIA

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

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

Testimony of
Bill Lockyer
California State Treasurer

Mr. Chairman and Members:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Thank you again for the opportunity to testify.

BILL LOCKYER
TREASURER
STATE OF CALIFORNIA

March 4, 2008

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

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

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

The ratings services your agencies have provided historically have been critical to the smooth functioning of the municipal bond market. Given the myriad state and local issuers of tax-exempt debt, your agencies have served an important role in helping investors choose and price municipal bonds. That function will remain critical in the future. But we believe your rating scale bears too little relationship to most investors' paramount concern: the risk that issuers of the bonds they buy will default.

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

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

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

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

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

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

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

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

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

Mr. Belsky, Ms. Sussman, and Mr. Montrone
March 4, 2008
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Under U.S. Securities and Exchange Commission Rule 2a-7, money market funds generally are allowed to buy securities only if they have long-term ratings of at least double-A. To provide that, many municipal issuers purchased bond insurance on their variable rate demand bonds (VRDBs). Of course, this would not have been necessary if municipal issuers were rated on a corporate scale. Corporations of much weaker credit quality comply with Rule 2a-7 without credit enhancement such as bond insurance.

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

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

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

Thank you.

Bill Lockyer

Bill Lockyer
State Treasurer, California

Denise L. Nappier

Denise L. Nappier
State Treasurer, Connecticut

Ron G. Crane

Ron G. Crane
State Treasurer, Idaho

Michael L. Fitzgerald
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Karen L. Sisson
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R. David Rousseau
Acting State Treasurer, New
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Michael J. Murphy
State Treasurer, Washington

Gary M. Breaux
Director of Finance, East Bay
Municipal Utility District

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ASSOCIATION OF FINANCIAL GUARANTY INSURERS

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Testimony of

Séan W. McCarthy

Chair

Association of Financial Guaranty Insurers

To The

U.S. House of Representatives Financial Services Committee

Hearing On The

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

March 12, 2008

Chairman Frank, Ranking Member Bachus and Members of the Committee, thank you for the opportunity to appear before you this morning. I am Séan McCarthy. I speak to you in my capacity as Chair of the Association of Financial Guaranty Insurers (AFGI), an association of eleven insurers and reinsurers of municipal bonds, asset-backed securities and other structured financings (collectively, "securities"). I serve also as President and Chief Operating Officer of Financial Security Assurance Inc.

My intent this morning is to:

1. Provide information on the financial guaranty insurance industry, its benefits to issuers and investors, its regulation, and the commitment of its members to maintaining their Triple-A ratings.
2. Comment on the implications for financial guaranty insurers of the current credit deterioration of one class of assets a number of our members guaranteed – collateralized debt obligations ("CDOs") of asset-backed securities ("ABS") and CDOs of CDOs.
3. Review the reasons for the recent turmoil in the municipal market.

Before beginning, however, I would like to state that investors owning securities covered by financial guaranty insurance have an ironclad -- irrevocable, unconditional -- guaranty against default on payment of principal and interest. Since the inception of financial guaranty insurance, no holder of an security insured by an AFGI company has failed to receive payment of debt service when due, and that will not change.

Moreover, the financial guaranty industry has never requested, does not need, nor do we seek a federal government bailout.

Background:

Financial guaranty insurance provides an unconditional, irrevocable guaranty to pay principal and interest *when due* should the issuer of an insured security default on its obligation. The financial guaranty insurance policies generally do not allow for acceleration of debt payment except at the will of the insurer. Financial guaranty insurers are generally rated Triple-A, and limit their insurance to coverage of investment grade securities.

While most insurance is written in the primary market at the time a security is issued, there is a significant secondary market. In these cases, a dealer or broker will request insurance on a block of securities from an issue that was not originally insured. The process for insuring these securities is otherwise similar to that which occurs in the primary market.

Reinsurance also plays an important role in the financial guaranty industry. The primary insurers often "cede" a portion of their exposure, and a corresponding portion of the premiums they collect, to a financial guaranty reinsurer. This allows the primary insurer to spread the risks it incurs – especially on a large issuances of securities.

Once a policy is in place, the insurer continually monitors the issuer. This surveillance function ensures early detection of any problems that might affect an issuer's ability to meet its obligations.

In the event of a default, the insurance contract calls for payments of interest and principal to be made to the holder of the security without regard to acceleration, thus eliminating liquidity risk to the financial guaranty insurer. While payments to investors are thus secure, the insurer will often work with the issuer to "cure" the default, in order to minimize its own losses.

History, Growth and Regulation

The industry was established in 1971 to serve the U.S. municipal bond sector. Today, the industry serves both public infrastructure and asset-backed global markets. In 2007, the industry insured approximately 47 percent of new issue U.S. municipal bonds. The total net par outstanding on the debt insured by the industry is approximately $2.3 trillion. Of that, the four largest primary insurance providers – Ambac, FGIC, FSA, and MBIA -- insure nearly $2 trillion.

From 2001 through 2006, financial guaranty insurers insured --

- more than $1 trillion of securities to fund schools, highways, airports, transit systems, hospitals, environmental systems and other projects;
- almost $82 billion of securities to fund essential public projects outside the U.S.; and
- more than $1 trillion of ABS to provide cost efficient funding to corporations and financial institutions around the world.

The industry adheres to strict investment-grade underwriting practices, meaning virtually all insured risks are rated Triple-B or higher. As a result the industry's loss experience has been low. From inception until now, the industry has incurred only three basis points (three one-hundredths of one percent) in losses on net debt service. That is far different from banks, which had weighted average annual charge-offs on principal of 60 basis points from 1992 to 2006.

The financial guaranty insurance industry is heavily regulated and highly transparent. It operates under the strict risk-based capital standards and reserving requirements of Article 69 of the New York Insurance Law ("Article 69").

Article 69 was enacted by New York in 1989. California enacted a very similar law the following year. Since then states have regulated with an even hand, proactively monitoring compliance with the strong provisions of those laws.

Also worth noting is that several insurers are owned by public companies subject to SEC regulation. Many insurers have U.K. subsidiaries regulated by the U.K. Financial Services Authority.

The major rating agencies, Standard & Poor's, Moody's, and Fitch, closely monitor the financial guaranty insurers, require ongoing information from the insurers, and issue frequent reports on the industry. In addition, both Standard & Poor's and Moody's review and rate every security that is wrapped by a financial guaranty insurer. Standard & Poor's and Moody's individual reviews of each transaction determines any additional capital that a financial guaranty insurer may need to maintain beyond that required under Article 69.

In this environment of strong regulation and conservative underwriting, the industry's claims-paying resources[1] have grown from $10.9 billion in 1995 to $48.8 billion in the first half of 2007.[2]

Article 69 requires that financial guaranty insurers be monoline, meaning that they may engage only in financial guaranty insurance and a few related lines of insurance. They may not write traditional property/casualty insurance or life insurance.

There has been some discussion that the term "monoline" originally meant that financial guaranty insurers could only insure municipal bonds. That is not correct. Article 69, from its enactment, has defined monoline financial guaranty insurance to include ABS – securities backed by income streams generated from consumer receivables, e.g., credit card receivables, auto loans and mortgage payments, and corporate risks.

Benefits Provided to Issuers and Investors

Financial guaranty insurance offers concrete benefits for issuers and investors.

Issuers can achieve higher ratings by attaching insurance to their securities. The higher ratings mean lower interest costs. Since their inception, financial guaranty insurers have saved U.S. state and local governments and their taxpayers more than $40 billion in interest payments. They have increased the economic leverage and funding sources of both large and small government borrowers. For small municipal issuers, access to capital markets is only possible with financial guaranty insurance.

[1] Includes statutory capital, unearned premium reserves, installment premiums, soft capital facilities, and loss adjustment expense reserves.

[2] Source: S&P and company operating supplements and financial reports of MBIA, Ambac, FSA, FGIC, XLCA (SCA), CIFG, Radian, Assured and ACA. Reported financials for Radian, CIFG and XLCA (SCA) combine financial guaranty insurance and reinsurance.

As noted earlier, investors have an unconditional guaranty against default on payment of principal and interest. No holder of an insured security has failed to receive payment of debt service when due. Financial guaranty insurers also waive all defenses including fraud and non-payment of premium. Unlike a trustee, a financial guaranty insurer has capital at risk and, therefore, its interest aligns with holders of the insured securities.

Investors also benefit from the financial guaranty insurer's:

- assessment of issuers' credit risks – assessments individual investors are not as well-equipped to make;
- remediation in the case of default or issuer financial problems; and
- ongoing surveillance of insured issuers.

Examples of municipalities that have benefited from the industry's remediation efforts include Philadelphia; Washington, D.C.; Miami and Dade County, Florida; Troy and Schenectady, New York; and Los Angeles and Orange County, California. Currently, the industry is actively engaged with issuers affected by Hurricane Katrina.

Types of Insured Securities

There are two main categories of insured securities -- public finance and structured finance.

Public finance encompasses municipal bonds and infrastructure financings. U.S. municipal bonds are backed by tax and other state or municipal authority revenues and support essential infrastructure, such as transportation and healthcare. Municipal and investor-owned utilities also issue bonds. Additionally, particularly outside the U.S., many essential public infrastructure projects are financed through private finance initiative (PFI) or public-private partnership (PPP) transactions involving long-term government concessions to private developers and operators.

Structured finance securities include mortgage-backed securities and ABS that are backed by revenue streams including credit card and other consumer loan receivables and corporate risk.

In addition to providing financial guarantees, financial guaranty insurers also provide surety bonds and credit derivatives, including credit default swaps ("CDS"), whose terms mirror a financial guaranty insurance policy.[3] There is little difference

[3] "A credit default swap ("CDS"), a type of a credit 'derivative,' is a transfer of credit risk on a specific obligation from one counterparty to another. The buyer of a credit default swap receives credit protection against the occurrence of a specific risk (generally, a default of an underlying obligation), while the seller of the swap, in exchange for periodic premium payments, guarantees the payments under the terms of the

between the risks undertaken by insuring a CDS and issuing direct bond insurance, since in both cases the financial guaranty insurer is committing to make a stream of payments in the event of a default. As with insurance, these derivatives and CDS generally have pay-as you-go settlement terms, and there is no requirement to post collateral if the underlying credit deteriorates, thus eliminating liquidity risk. The industry was asked to insure CDSs because of the more favorable regulatory and accounting treatment received by investors.

Financial Guaranty Insurer Involvement in U.S. Residential Mortgage Backed Securities (RMBS) and CDOs of ABS

The current market dislocation results primarily from the insurance of CDOs of ABS and CDOs of CDOs that contained a high percentage of subprime mortgages.

There has been unprecedented credit deterioration in the mortgage market that exceeded the most conservative historical loss expectations. Additionally, in the primary mortgage market, increased efforts by financial intermediaries and mortgage originators to introduce affordable products and facilitate homeownership have increased credit risk. Since the Great Depression, there has been no year-over-year decline in home prices for the entire U.S. (There have been only regional declines in successive years.)

The extent of the credit deterioration is reflected in the changes in rating agency requirements for a securitized subprime first-lien residential mortgage loan pool.

- In 2006, rating agencies' expected lifetime losses on pools to be 4.5% to 6% of the original pool balance.
    - By January 2008, rating agencies' expected loss on the same pools was 14% to 19%, depending on the transaction.

- In 2006, the financial guaranty insurer Triple-A "attachment point," ranged from 23% to 28%.
    - In January 2008, the rating agency Triple-A attachment point ranged from 36% to 42%.

- In 2006, the financial guaranty insurer attachment point at Triple-B was 8% to 10%.
    - In January 2008, the rating agency attachment point ranged from 14% to 22%.

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obligation. Because under this arrangement the risk of default is transferred from the holder of the security to the seller of the swap in exchange for a premium, CDSs are often regarded as similar or equivalent to [financial guaranty] insurance." Letter to The Honorable Paul E. Kanjorski, Chairman, U.S. House of Representatives House Financial Services Subcommittee on Capital Markets, Insurance and government-Sponsored Enterprises, from Eric R. Dinallo, Superintendent of Insurance, State of New York Insurance Department, February 4, 2008, pg. 6.

In the CDO market, financial guaranty attachment at the Triple-A level means that insurers should be able to withstand high levels of collateral losses. However, high grade and so-called mezzanine CDOs of ABS ultimately contained a high percentage of subprime mortgage loans. With regard to credit performance, it can be expected that:

- potential collateral losses will be higher than the original assigned credit rating;
- diversity and correlation assumptions may be low; and
- embedded leverage will magnify the effects of poor collateral performance.

Financial guaranty insurer involvement in the U.S. RMBS and CDOs of ABS amounts to $249 billion net part outstanding.

The sector and underlying rating distributions follow:

Sector distribution:

ABS/CDO High Grade	31%
ABS/CDO Mezzanine	8%
CMBS/CDO	22%
HELOC	26%
SUBPRIME	13%

Underlying rating distribution:

SUPER AAA	28%
AAA	38%
AA	4%
A	7%
BBB	22%
BIG	1%

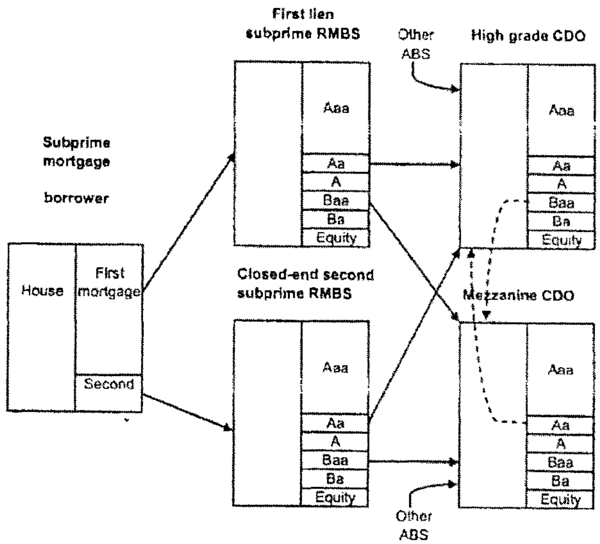
The allocation of subprime mortgage risks within CDOs is a key factor. To that end, it is important to understand the following points, which are illustrated by the graphic on the next page:

- subprime mortgage loans can be first mortgages, with a first lien on the property serving as collateral to the loan, or second mortgages (generally closed-end loans where the borrower receives a specified amount at closing) that are subordinated to the first mortgage;
- the loans are generally packaged by type into pools of collateral to form the basis of RMBS;

- different tranches of the RMBS, created with varying levels of priority on cash flows generated by the underlying pool, are then sold to third parties, with the AAA tranche having first priority, followed by the AA tranche, etc.;

- CDOs of ABS, in turn, may invest in tranches of RMBS transactions, as well as in other ABS, with Aa or higher tranches classified as "high grade" and Baa or higher tranches classified as "mezzanine"; and

- both types typically have a small allocation within the collateral pool that may be invested in lower-rated collateral.



In order to more fully understand the financial guaranty insurer involvement in the U.S. RMBS and CDO of ABS it is important to know the following:

- Under U.S. GAAP, insurance policies that are in CDS form typically must be marked to market through an insurer's income statement under a recently adopted rule of the Financial Accounting Standards Board.
- Absent any claims under the guaranty, any decreases or increases to income due to marks will sum to zero by the time of each CDS's maturity.
- The industry and rating agencies view the large, negative unrealized mark-to-market adjustments taken in the second half of 2007 as accounting requirements, not as measurements of capital adequacy. Capital adequacy is concerned with fundamental credit analysis and not mark-to-market losses.
- The mark-to-market accounting requirement has caused a problem of perception. The change in the accounting rules has created a misperception

regarding the industry's financial performance as spreads have widened. Mark-to-market losses are very different from actual credit losses.

Implications and Challenges for the Financial Guaranty Insurers That Have Exposure to this Asset Class (i.e., CDOs of ABS)

In the present situation, financial guaranty insurers are focused on maintaining their Triple-A capital levels and/or having their Triple-A ratings restored as soon as practical. In order to restore their Triple-A ratings, financial guaranty insurers facing potential downgrades can --

- reinsure well performing, capital-intensive insured financings;
- issue equity, debt, and/or hybrid securities;
- insure higher rated, less capital-intensive deals to limit incremental capital requirements; and
- run off from existing portfolios to generate significant incremental capital annually, and add to capital as exposure amortizes.

Already members of the industry have raised significant capital. Each company must take its own steps and make its own decisions consistent with its responsibilities to policyholders and holders of its insured bonds, and, in case publicly held companies, to its investors. And each company must work with regulators and interested governmental bodies.

This is not a systemic failure. The vast majority of projected credit losses are in a single asset class – CDOs of ABS and CDOs of CDOs which contain higher percentages of subprime residential mortgage loans.

The Recent Turmoil in the Municipal Bond Market

In recent weeks, the municipal bond market has undergone unusual turmoil as liquidity and credit concerns, including dislocation in the monoline industry, combined to cause the failure of auction rate bonds.

Over the course of the past five years, many state and local governments issued auction rate bonds in lieu of fixed rate bonds or variable rate debt obligations ("VRDOs") that typically are accompanied by a direct-pay or standby letter of credit from a commercial bank. The market for auction rate securities was robust, particularly in high-tax states such as New York, New Jersey and California. In conjunction with the sale of auction rate bonds, the issuers often executed a floating-to-fixed interest rate swap contract whereby they were committed to pay a fixed rate. The counterparty, usually the investment bank that initially marketed the auction rate bonds (though not always), would typically agree to pay a variable rate in return, usually a percentage of LIBOR.

In the past, investment banks acting as remarketing agents usually took the auction rate bonds into inventory if a remarketing failed to garner enough interest to preserve their client relationships. Over the past 90 days, however, the amount of inventory that could not be successfully remarketed has increased substantially, and the investment banks have let auctions fail with a resulting increase in the interest rates issuers were required to pay on the auction rate bonds.

Financial guarantors often were asked to guarantee the payment of debt service on auction rate bonds, and also frequently were asked to guarantee their net payments on the interest rate swap. In exchange for their guarantee, the financial guaranty insurers were paid a premium, similar to any other municipal debt obligation. In most cases, insurers will allow issuers to convert auction rate to fixed rate bonds or VRDOs. Issuers can face a financial impediment in converting auction rate bond issues that incorporated an interest rate swap because of the high termination fees some issuers would be required to pay the counterparty in today's interest rate environment.

Conclusion

The financial guaranty insurance business model remains viable if applied correctly. Not every financial guaranty insurer is under pressure. The viability of the model is also confirmed by the entry of Berkshire Hathaway into the business and recent investment in some financial guaranty insurance companies.

The industry's claims paying ability, as well as its conservative business model which requires it to pay losses only when due, should enable the industry to withstand deteriorating asset performance in the residential mortgage sector.

The unrealized mark-to-market adjustments that the financial guaranty insurers are required to take through their income statements on insurance policies issued in CDS form under U.S. GAAP accounting rules are obscuring the true performance of the industry, absent credit deterioration and given the financial guaranty insurers' intent to hold these contracts until maturity.

The recent turmoil in the municipal bond market is temporary and should abate.

As stated at the outset, the industry has never requested, does not need, nor does it want a federal government bailout. The industry is committed to working with its regulators to manage through the current dislocation.

Attached to this testimony is a presentation and summaries of the financial statements of AFGI members that are primary financial guaranty insurers, which we would like to submit for the hearing record along with this statement.

We appreciate the Committee's interest in these important issues and look forward to continuing to work with the Committee.

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Business Overview of Primary Bond Insurers and Report on Involvement in U.S. Residential Mortgage-Backed Securities and Collateralized Debt Obligations of Asset-Backed Securities

U.S. House of Representatives Committee on Financial Services

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

March 12, 2008

Submitted with Testimony by the Association of Financial Guaranty Insurers (AFGI)

AFGI is a trade association of 11insurers and reinsurers of municipal bonds and asset-backed securities.

Agenda

- Business Overview of Primary Bond Insurers
- Bond Insurer Involvement in U.S. Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations of Asset-Backed Securities (CDO of ABS) Sector
- Monoline Implications
- Appendix I: Rating Agency Timeline
- Appendix II: Profiles of Primary Bond Insurers

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Business Overview

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Business Overview
Executive Summary

- Financial guaranty is a pure credit business
  - Unconditional and irrevocable guaranty to pay scheduled principal and interest on U.S. municipal, public infrastructure and asset-backed securities; no acceleration
  - Product provides efficiency in capital markets
  - The closest equivalent to financial guaranty is an irrevocable long-term bank letter of credit
- Financial guaranty companies are generally rated AAA
- Policy forms also include surety bonds as well as credit derivatives, whose terms mirror a financial guaranty
  - No liquidity risk
  - No collateral posting
  - Pay-as-you-go settlement terms
- Financial guaranty companies take long-term credit risk
  - Cannot trade out of risk; hold to maturity, but may mitigate risk through reinsurance
  - Control of remedies and remediation is critical to loss mitigation
- Credit is principal driver of long-term profitability
  - Underwrite investment-grade risks only
- Industry is heavily regulated and transparent
  - New York State Insurance Department (or other state insurance departments)
  - Financial Services Authority in the U.K.
  - Rating agencies require ongoing information from the financial guarantors

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Business Overview
Monoline Financial Guaranty Insurance Industry Business Model

- Industry established in 1971 to serve U.S. municipal bond sector; today serves both public infrastructure and asset-backed global markets
- Monolines are specialized insurance companies – participants must operate solely as a separately structured and capitalized entity, providing guarantees of financial obligations only. No other insurance can be written.
  - Monolines do not originate securities or mortgages.
- Regulated by government agencies and rating agencies:
  - Insurance company operating under Article 69 of the New York State Insurance law
  - Three principal agencies: Moody's, Standard & Poor's and Fitch Ratings
- Investment-grade underwriting practice has resulted in low industry loss experience
  - Low probability/low severity/highly diverse credit portfolios
  - Withstand highly strenuous scenarios
  - Decidedly not a banking model
  - Since inception, industry has incurred only 3 bps in losses on net debt service. (Banks had weighted average annual charge-offs on principal of 60 bps from 1992 to 2006.)
- Total industry insured net par outstanding is approximately $2.3 trillion, and approximately 50% of all U.S. municipal bonds are insured. The largest primary providers: AMBAC, FGIC, FSA & MBIA have nearly $2.0 trillion in insured net par outstanding.
- From 2001-2006, monolines have insured:
  - More than $1 trillion of U.S. municipal bonds to fund schools, highways, airports, transit systems, hospitals, environmental systems and other projects.
  - Almost $82 billion of bonds to fund essential public projects outside of the U.S.
  - More than $1 trillion of asset-backed bonds to provide cost efficient funding to corporates and financial institutions throughout the world.

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Business Overview
Financial Guaranty Benefits

- Benefits to Issuers:
  - Allows credit rating of the guarantor to be applied to the bonds
  - Reduced cost of funds - since inception, the financial guarantors have saved municipalities over $40 billion.
  - Increased economic leverage through efficient structuring
  - Broader funding sources
  - Streamlined execution
  - In case of small municipal issuers, access to capital markets only possible through a financial guaranty.

- Benefits to Investors:
  - Default protection
  - Bond guarantor waives all defenses including fraud and non-payment of premiums
  - Enhanced liquidity
  - Reduced secondary-market price volatility, particularly if underlying issue is downgraded
  - Consolidated analysis, diligence and surveillance; exercise of remedies when necessary
  - Unlike a trustee, bond guarantor has capital at risk, therefore its interest aligns with those of bondholders.

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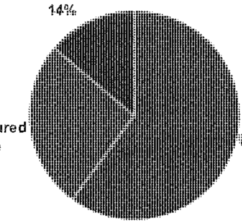
Business Overview
Types of Bonds Insured

- All insured bonds are rated by rating agencies ("shadow rating")
  - Needs to be rated investment grade by at least one rating agency
- Public finance bonds:
  - Backed by tax and other municipal authority revenues
  - Essential infrastructure (transportation, healthcare)
  - Municipal and investor-owned utilities
- Structured finance bonds
  - Mortgage-backed (MBS and home equity)
  - Asset-backed (consumer, franchise, future flows)
  - Pooled debt obligations (CDO, CLO, CBO)
  - Structured credit

Net Par Outstanding
As of December 31, 2006



$2.2 trillion

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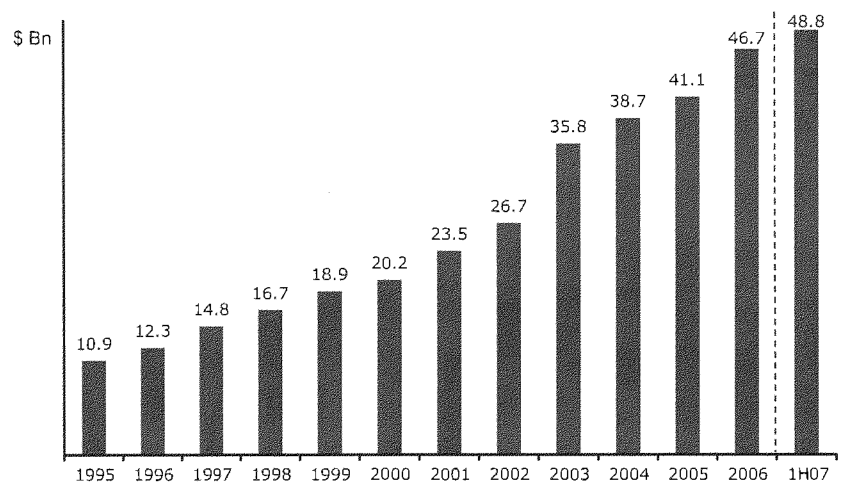
Business Overview

Monoline Financial Guaranty Industry - Total Claims-Paying Resources*



At 6/30/07

Source: S&P and company operating supplements and financial reports of MBIA, AMBAC, FSA, FGIC, XLCA (SCA), CIFG, Radian, Assured & ACA. Reported financials for Radian, CIFG and XCLA (SCA) combine financial guaranty insurance and reinsurance.

*Includes Statutory Capital, Unearned Premium Reserves, Installment Premiums, Soft Capital Facilities, and Loss and Loss Adjustment Expense (LAE) Reserves.

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Bond Insurer Involvement in U.S. Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations of Asset-Backed Securities (CDO of ABS) Sector

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Bond Insurer Involvement in U.S. RMBS and CDOs of ABS
Current Issues Related to Market Dislocation

Primary Mortgage Market

- Unprecedented credit deterioration in mortgage market exceeded the most conservative historical loss expectations
  - Since the Depression there has been no year-over-year decline in home prices for the entire U.S. (only regional declines).
- Increased activity by financial intermediaries and mortgage originators to introduce affordability products, which facilitated greater home ownership, increased credit risk.
- Mortgage deterioration was faster than projected.

CDO Market

- High-grade and mezzanine CDOs of ABS ultimately contain a high percentage of subprime mortgage loans. Some observations about expected credit performance:
  - Potential for collateral losses are higher than the original assigned credit rating
  - Diversity and correlation assumptions may be low
  - Embedded leverage magnifies the effects of poor collateral performance.
- Attachment at Triple-A or higher levels will be able to withstand greater collateral losses.

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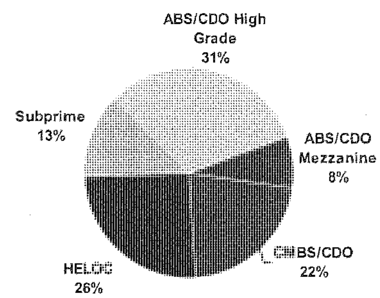
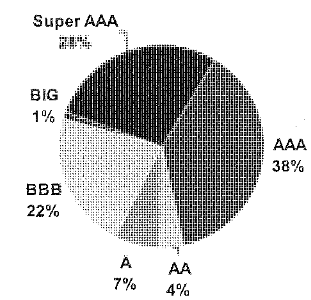
Bond Insurer Involvement in U.S. RMBS and CDOs of ABS

Industry Net Par Outstanding by Sector and Ratings Distribution

Sector Distribution



Underlying Ratings Distribution



$249 Billion
Net Par Outstanding

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Bond Insurer Involvement in U.S. RMBS and CDOs of ABS

First Lien Subprime RMBS Performance Expectations

Subprime First Lien Pool

	2006	January 2008
Rating Agency Expected Losses	4.5%-6.0%	14.0%-19.0%
Monoline Attachment Point at AAA	23.0%-28.0%	36.0%-42.0%
Monoline Attachment Point at BBB	8.0%-10.0%	14.0%-22.0%

Based on rating agency information for vintages 2005 to 2007.

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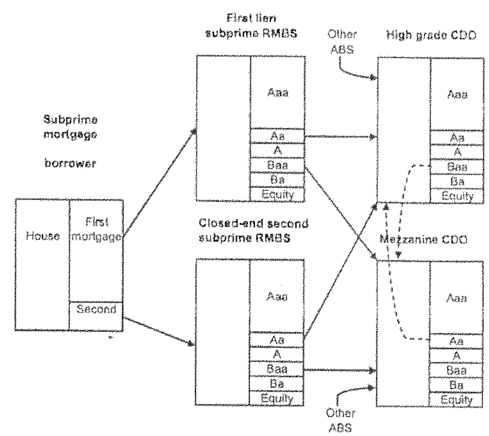
Bond Insurer Involvement in U.S. RMBS and CDOs of ABS

Allocation of Subprime Mortgage Risks in CDOs

- Subprime mortgage loans can be first mortgages, with a first lien on the property serving as collateral to the loan, or second mortgages (generally closed-end loans where the borrower receives a specified amount at closing) that are subordinated to the first mortgage.
- The loans are generally packaged by type into pools of collateral, forming the basis of RMBS.
- Different tranches, created with varying levels of priority on cash flows generated by the underlying pool, are then sold to third parties. The Aaa-rated tranche has first priority, followed by the Aa-rated tranche, etc.
- ABS CDOs, in turn, may invest in tranches of RMBS transactions, as well as in other ABS.
  - Classified as "high-grade"- Aa or higher tranches
  - Classified as "mezzanine"- Baa or higher tranches
- Both types typically have a small allocation within the collateral pool that may be invested in lower-rated collateral.



Source: Moody's, September 2007

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Bond Insurer Involvement in U.S. RMBS and CDOs of ABS
Unrealized Mark-to-Market Losses for Insured Derivative Portfolios

- Under U.S. GAAP, insurance policies issued in credit default swaps form typically must be marked to market through the company's income statement.
- Absent any claims under the guaranty, any decreases or increases to income due to marks will sum to zero by the time of each contract's maturity.
- The industry and rating agencies view the large, negative unrealized mark-to-market adjustments taken in the third quarter of 2007 as accounting requirements. Capital adequacy is concerned with fundamental credit analysis and not mark-to-market losses.
- Perception problem: the accounting effect has created a misperception regarding the industry's financial performance as spread widening due to liquidity and credit deterioration have become rolled into one ball of confusion.

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Monoline Implications

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Monoline Implications

- The monoline financial guaranty business model is viable, as confirmed by Berkshire Hathaway's entrance to business.
- Our industry is facing unprecedented stress from a variety of sources:
  - Deteriorating asset performance in the residential mortgage sector
  - Declining confidence in the rating agencies and Triple-A ratings
  - Rating agencies recalibrating standards to maintain Triple-A ratings
  - Aggressive and vocal short-selling community
- It is imperative for financial guarantors to maintain the Triple-A-rated capital levels.
  - Insured portfolios were underwritten and structured to a remote loss standard and to provide portfolio granularity to mitigate correlation risk, avoid liquidity risk, and generally insulate financial guaranty companies from event risk.
  - New business production will continue to be underwritten at high attachment points to minimize losses, preserve capital and maintain franchises.
- Rating agency downgrades on existing transactions will require increased capital; one or more industry participants may be required to raise additional capital to maintain:
  - Triple-A ratings
  - Investor confidence

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Monoline Implications (Cont'd)

- Capital can be raised through a variety of activities and sources:
  - Reinsure well-performing, capital-intensive insured financings
  - Issue equity, debt, and/or hybrid securities
  - Insure higher rated, less capital-intensive deals to limit incremental capital requirements
  - Run-off from existing portfolio
    - Earnings generate significant incremental capital annually
    - As exposure amortizes, capital is released
- Losses in the financial guaranty insurance industry are expected to be manageable.
- New York Insurance Department actively involved
- These turbulent market conditions present financial guarantors with a significant opportunity to increase profitable business production as a result of:
  - Increased perception of risk, versus real risk, in certain markets
    - Wider/widening credit spreads
    - More leverage to increase pricing and further strengthen structure

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Appendix I:
Rating Agency Timeline

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Subprime Crisis: Timeline of Rating Agency Actions

- July 10: First large-scale rating agency downgrades of RMBS: Moody's and S&P
- August 13: Fitch downgrades $13 Bn of RMBS.
- September 25: Moody's says guarantors' risk from subprime RMBS and ABS CDO potentially significant.
- October: Moody's, S&P and Fitch downgrade numerous tranches of subprime RMBS and ABS CDOs.
- October 11: Moody's downgrades $33.4 Bn of 2006 first-lien subprime RMBS.
- November 5: Fitch details approach to assessing guarantor ABS CDO exposures and assigns probabilities that each may experience erosions in capital cushion.
- November 7: Moody's cuts ratings of $33 Bn of SIV debt.
- November 8: Moody's announces plans to update opinion of financial guarantors and likelihood of rating actions.
- November 9: Moody's downgrades $10.3 Bn of U.S. ABS CDOs linked to subprime mortgages.
- November 12: Fitch downgrades the ratings of $37.2 Bn of global SF ABS CDOs.
- November 22: Fitch affirms CIFG's "AAA" rating with stable outlook following $1.5Bn capital injection.
- November 23: Moody's comments on CIFG's announced capital plan- "..greatly reduces the risk of the firm falling below Moody's target capital ratios for a Aaa."
- November 26: Standard & Poor's announces reviewing bond insurers' subprime transactions.
- December 1: Moody's says it downgraded or put on review debt totaling $119 Bn that was issued by SIVs.
- December 5: Moody's publishes comment & Q&A on monoline review process and re-assigns MBIA to "somewhat likely" to need more capital.
- December 11: Moody's comments on MBIA's $1bn capital injection from Warburg Pincus- "...meaningfully enhanced financial flexibility, supports financial profile of the insurance subsidiary... provided important signal of market support for the franchise."
- December 12: Fitch places SCA (XLCA) on rating watch negative.
- December 12: Fitch affirms Assured Guaranty's ratings.
- December 13: Fitch places 3,375 XLCA-insured issues on rating watch negative.
- December 14: Moody's announces rating actions on financial guarantors and holds a teleconference: FGIC and XLCA put on review for downgrade; MBIA and CIFG ratings outlooks changed to negative. All others affirmed.

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Subprime Crisis: Timeline of Rating Agency Actions (Cont'd)

- December 17: Fitch puts FGIC on negative watch after a review of its RMBS and ABS CDO portfolio.
- December 19: S&P takes rating actions on six bond insurers & holds teleconference: ACA to CCC/WatchDev; Ambac & Connie Lee to AAA/Negative; FGIC to AAA/Watchlist Neg; MBIA to AAA/Negative; XLCA to AAA/Negative. All others affirmed.
- December 19: Moody's places the debt ratings of XL Capital and the insurance strength of its subsidiaries on review for downgrade on pressure from its reinsurance of and investment in SCA.
- December 20: Fitch places MBIA on rating watch negative on CDO & RMBS review and says if MBIA is unable to raise about $1Bn in 4-6 weeks in addition the Warburg Pincus $1Bn, Fitch would expect to downgrade to AA+.
- December 21: Fitch places Ambac on rating watch negative on CDO & RMBS review – indicates that Ambac's capital adequacy falls below AAA guidelines by about $1 Bn and if the company were unable to obtain capital, Fitch would expect to downgrade to AA+.
- December 21: S&P and Fitch reduce CDO ratings on transactions worth $12.4 Bn – all securities previously rated AAA or AA remain investment grade.
- December 26: Fitch places 2005 insured RMBS issues on watch negative (64 Ambac, 35 FGIC, 19 SCA, 87 MBIA).
- January 9: Fitch states it expects to assign a 'AA' rating to MBIA's $1Bn offering.
- January 9: Moody's rates MBIA's surplus notes Aa2, downgrades holding company to Aa3 due to structural subordination. Moody's also comments on MBIA's capital plan- "...capital plans, when fully implemented and absent further deterioration in the insured portfolio, would cover shortfall from Dec 14."
- January 11: S&P suspends its ratings on public finance and corporate transactions insured by ACA that do not have an underlying public rating from S&P.
- January 15: S&P revises its loss expectations for 2006 vintage subprime loans to 19% from 14% based on worsening delinquencies and U.S. housing market conditions.
- January 16: Moody's places Ambac on review for possible downgrade.
- January 16: Fitch affirms MBIA's AAA IFS rating with a stable outlook, removing Rating Watch Negative following the completion of MBIA's $1Bn surplus note offering.
- January 17: Moody's announces MBIA's ratings are on review for downgrade.
- January 17: Moody's reported it downgraded $23 Bn of structured finance CDOs in December, bringing total to $76 Bn of SF CDOs downgraded in all of 2007.

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Subprime Crisis: Timeline of Rating Agency Actions (Cont'd)

- January 18: Fitch downgrades Ambac two notches to AA with Watch Negative following the company's announcement that it chooses not to raise equity capital under current market conditions.
- January 24: Fitch downgraded XLCA to A with Watch Negative
- January 24: Fitch affirmed FSA at AAA with Stable outlook
- January 30: Fitch downgraded FGIC to AA with Watch Negative
- January 30: S&P downgraded, or placed on review, $270 Bn, of U.S. RMBS securities backed by subprime, and $264 Bn of global ABS CDO and CDO of CDO transactions.
- January 31: S&P downgraded FGIC to AA with Watch Developing
- January 31: S&P affirmed ACA at CCC with Watch Developing
- January 31: S&P affirmed Assured Guaranty at AAA with Stable outlook
- January 31: S&P affirmed Ambac at AAA with Watch Negative
- January 31: S&P affirmed CIFG at AAA with Negative outlook
- January 31: S&P affirmed FSA at AAA with Stable outlook
- January 31: S&P placed MBIA on Watch Negative
- January 31: S&P placed XLCA on Watch Negative
- February 1: Fitch placed $139 Bn of U.S. subprime RMBS on Watch Negative on worsening mortgage performance.
- February 5: Fitch placed CIFG on Watch Negative
- February 5: Fitch placed MBIA on Watch Negative
- February 7: Moody's downgraded XLCA to A3 with Negative outlook
- February 11: Standard & Poor's cut ratings on $7.65 billion in CDOs backed by RMBS, following credit deterioration and downgrades of the RMBS underlying the deals

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Subprime Crisis: Timeline of Rating Agency Actions (Cont'd)

- February 14: Moody's downgraded FGIC to A3 on Review for Possible Downgrade, from AAA
- February 22: Moody's placed CIFG's AAA ratings on Review for Downgrade, from Negative Outlook
- February 22: S&P cut ratings on 114 tranches from 17 US CDO transactions affecting $12.7 Bn in issuance
- February 25: S&P placed MBIA at AAA on Negative Outlook, from Watch Negative
- February 25: S&P affirmed Ambac at AAA on CreditWatch with Negative Implications
- February 25: S&P downgraded FGIC to A on CreditWatch with Developing Implications, from AA
- February 25: S&P downgraded XLCA to A- on CreditWatch with Negative Implications, from AAA
- February 25: S&P affirmed CIFG at AAA with Negative Outlook
- February 26: Moody's affirmed MBIA at AAA with Negative Outlook, from Review for Downgrade
- February 27: Fitch placed $97 Bn of structured finance CDOs on Watch Negative due to worsening performance
- February 29: Moody's announced it is continuing its review of Ambac's Triple-A ratings
- February 29: S&P announced it may cut ratings on $14 Bn on subprime debt and related CDOs
- March 4: Moody's announced it does not foresee a CDO recovery in '08 after downgrading 1,655 tranches of CDOs in '07
- March 4: Moody's placed XLCA's A3 ratings on Review for Possible Downgrade, from Negative Outlook
- March 6: Moody's downgraded CIFG to A3 Stable Outlook, from Aaa Review for Possible Downgrade
- March 7: Fitch downgraded CIFG to AA- negative outlook, from AAA negative outlook

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Appendix II:
Profiles of Primary Bond Insurers

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Ambac Assurance Corporation

General Information

Date Established	1970
Headquarters	New York
Other Offices	London, Mexico City, Milan, Sydney, Tokyo, Bermuda
Ratings	AA Fitch – Rating Watch Negative Aaa Moody's – Review for Downgrade AAA S&P – Rating Outlook Negative
Ownership Structure	Subsidiary of Ambac Financial Group, Inc. (listed on NYSE)
Principal U.S. Regulators	Wisconsin Insurance Department, New York Insurance Department and other state insurance regulators. SEC

Statutory Financial Information (12/31/07)

Statutory Capital and Reserves	$10.6 billion
Total Claims-Paying Resources	$14.5 billion
Guaranteed Net Par Outstanding	$524.0 billion
U.S. Municipal Net Par Outstanding	$281.0 billion

GAAP Financial Information (Holding Company)

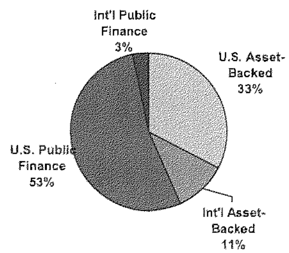
2007 Net Income	($3,229.9) million
2007 Net Operating Income	($23.7) million
2006 Net income (Loss)	$875.9 million
2006 Net Operating Earnings	$828.7 million
2007 Mark to Market Adjustment for Insured Derivatives	($6,016.3) million

Share Price

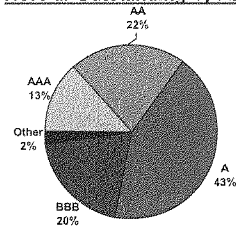
As of 3/6/08	Date	Amount
52-Week High	5/18/07	$96.10
52-Week Low	1/17/08	$4.50
Year-End Market Cap	12/31/07	$2,617 million
Recent Market Cap	3/6/08	$760 million

Ambac Assurance Corporation (Cont'd)

Net Par Outstanding by Sector



Net Par Outstanding by Rating



Ten Largest U.S. Municipal Risks (Net Par in $ Millions)

California State – GO	3,109.4
New Jersey Transportation Trust Fund Authority – Transportation System	2,162.2
Washington State – GO	1,878.9
Bay Area Toll Authority, CA Toll Bridge Revenue	1,838.1
MTA, NY, Transportation Revenue (Farebox)	1,723.8
California Department of Water Resources, Power Supply	1,693.9
NYS Thruway Authority, Highway and Bridge Revenue	1,487.9
New Jersey Economic Development Authority – School Facilities Construction	1,439.9
New Jersey Turnpike Authority Revenue	1,373.8
Massachusetts Commonwealth – GO	1,327.1

As of 12/31/07

Ambac Assurance Corporation (Cont'd)

Selected Current Exposures (Net Par Outstanding as of 12/31/07)

Vintage and Type	$MM	% of Total Insured Portfolio	Vintage and Type	$MM	% of Total Insured Portfolio
2005 Subprime RMBS	1,516	0.29	2007 Senior ABS CDO	5,997	1.14
2006 Subprime RMBS	1,026	0.20	2005 Mezzanine ABS CDO	79	0.02
2007 Subprime RMBS	576	0.11	2006 Mezzanine ABS CDO	0	0.00
2005 Senior ABS CDO	6,384	1.22	2007 Mezzanine ABS CDO	2,897	0.55
2006 Senior ABS CDO	12,993	2.48			

Assured Guaranty Ltd.

General Information

Date Established	1985
Headquarters	Bermuda
Other Offices	New York, London, Australia
Ratings	Assured Guaranty Corp.: AAA/Aaa/AAA Assured Guaranty Re: AA/Aa2/AA
Ownership Structure	Publicly-traded on NYSE
Principal U.S. Regulators	Maryland

Statutory Financial Information (12/31/07)

Consolidated Statutory Capital and Reserves	$3.0 billion
Total Claims-Paying Resources	$4.4 billion
Guaranteed Net Par Outstanding	$200.3 billion
U.S. Municipal Net Par Outstanding	$81.9 billion

GAAP Financial Information (Holding Company)

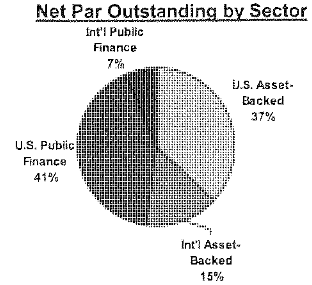
2007 Net Income	$(303.3) million
2007 Net Operating Income	$178.0 million
Fourth Qtr 2007 Net income (Loss)	$(260.1) million
Fourth Qtr 2007 Net Operating Earnings	$37.0 million
Fourth Quarter 2007 After-Tax Mark to Market Adjustment for Insured Derivatives	$(302.9) million

Share Price

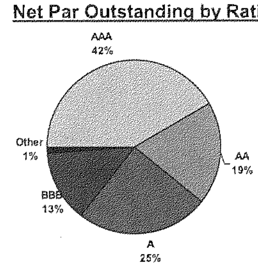
As of 3/6/08	Date	Amount
52-Week High	5/4/07	$31.99
52-Week Low	11/5/07	$13.34
Year-End Market Cap	12/31/07	$2,123 million
Recent Market Cap	3/6/08	$ 1,989 million

Assured Guaranty Ltd. (Cont'd)

Net Par Outstanding by Sector



Net Par Outstanding by Rating



Ten Largest U.S. Municipal Risks (Net Par in $ Millions)

State of California GO & Leases	1,311
City of Chicago GO & Leases	913
New York City GO & Leases	894
Puerto Rico GO & Leases	822
State of Washington GO	803
Denver International Airport System	765
Los Angeles Unified School District	749
State of NJ GO & Leases	687
Massachusetts GO & Bay Transportation	685
State of NY GO & Leases	676

As of 12/31/07

Assured Guaranty Ltd. (Cont'd)

Selected Current Exposures (Net Par Outstanding as of 12/31/07)

Vintage and Type	$MM	% of Total Insured Portfolio	Vintage and Type	$MM	% of Total Insured Portfolio
2005 Subprime RMBS	3,818	1.91	2007 Senior ABS CDO	0	0.00
2006 Subprime RMBS	1,928	0.96	2005 Mezzanine ABS CDO	0	0.00
2007 Subprime RMBS	663	0.03	2006 Mezzanine ABS CDO	0	0.00
2005 Senior ABS CDO	0	0.00	2007 Mezzanine ABS CDO	0	0.00
2006 Senior ABS CDO	0	0.00			

CIFG Holding, Ltd.

General Information

Date Established	2001
Headquarters	Hamilton, Bermuda
Other Offices	New York, San Francisco, Paris & London
Ratings	AAA -S&P Aaa Moody's stable outlook AA – Fitch negative outlook
Ownership Structure	Privately Held
Principal U.S. Regulators	New York

Notes re CIFG financial information:

- Capital contribution of $1.5 billion made in December 2007 is not reflected in these balances.
- The financial statements are stated in Euros. The translation of Euros in U.S. dollars is presented solely for the convenience of the reader of the financial statements, using the observed exchange rate at December 31, 2006 of $1.31435 to € 1.00. This convenience translation should not be construed as representation that the euro amounts have been, could have been or could in the future be, converted to U.S dollars at this rate or any rate of exchange.
- CIFG NA, CIFG Europe and CIFG Guaranty are combined for purposes of calculating claims paying resources. Amounts are considered pro-forma since the CIFG Group does not file combined U.S. statutory statements.

Statutory Financial Information

Pro-Forma Statutory Capital and Reserves (3/31/2007)	$1.0 billion
Total Claims-Paying Resources (3/31/2007)	$1.4 billion
Guaranteed Net Par Outstanding (9/30/2007)	$90.9 billion
U.S. Municipal Net Par Outstanding (9/30/2007)	$23.9 billion

GAAP Financial Information (Holding Company)

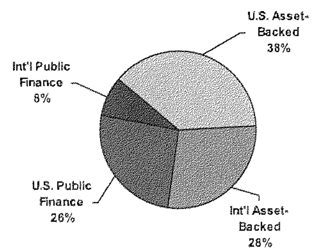
2006 Net Income	$31.0 million
2006 Net Operating Income	$17.7 million
Third Qtr 2007 Net income (Loss)	Not available
Third Qtr 2007 Net Operating Earnings	Not available
Third Quarter 2007 Mark to Market Adjustment for Insured Derivatives	Not available

Share Price

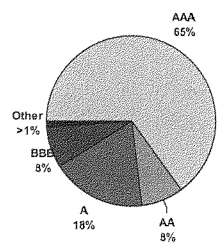
	Date	Amount
52-Week High	00/00/00	Not applicable
52-Week Low	00/00/00	Not applicable
Year-End Market Cap	12/31/07	Not applicable
Recent Market Cap		Not applicable

CIFG Holding, Ltd. (Cont'd)

Net Par Outstanding by Sector



Net Par Outstanding by Rating



Largest U.S. Municipal Risks
(Net Par in $ Millions)

Chicago Board of Education	617,450
New Jersey State General Obligation and Appropriation Credits	598,810
New York City General Obligation	551,883
California State General Obligation	532,085
Miami-Dade County, FL	508,423
New York State General Obligation	501,535
High Speed Railway Funding, Infrastructure Spa (Italy)	479,265
Commonwealth of Puerto Rico General Obligation and Appropriation Credits	458,538
MTA Transportation Revenue Bonds	440,000

As of 9/30/07

CIFG Holding, Ltd. (Cont'd)

Selected Current Exposures (Net Par Outstanding as of 9/30/07)

Vintage and Type	$MM	% of Total Insured Portfolio	Vintage and Type	$MM	% of Total Insured Portfolio
2005 Subprime RMBS	1,453.	1.60	2007 Senior ABS CDO	0.	0.00
2006 Subprime RMBS	361.	0.40	2005 Mezzanine ABS CDO	727.	0.80
2007 Subprime RMBS	0.	0.00	2006 Mezzanine ABS CDO	3,998.	4.39
2005 Senior ABS CDO	400.	0.44	2007 Mezzanine ABS CDO	722.	0.79
2006 Senior ABS CDO	1,198.	1.32			

Financial Guaranty Insurance Company (FGIC)

General Information

Date Established	1983
Headquarters	New York
Other Offices	London, England Sydney, Australia
Ratings	AA Fitch-Rating Watch Negative Aaa Moody's-Review for possible downgrade AA S&P-Credit Watch with developing implications
Ownership Structure	Privately Held
Principal U.S. Regulators	NY State Insurance Dept.; other state insurance regulators For non U.S. subsidiaries: Financial Services Authority in U.K.; Australian Securities & Investments Commission in Australia

Statutory Financial Information (9/30/07)

Statutory Capital and Reserves	$4.0 billion
Total Claims-Paying Resources	$5.1 billion
Guaranteed Net Par Outstanding	$314.8 billion
U.S. Municipal Net Par Outstanding	$224.3 billion

GAAP Financial Information (Holding Company)

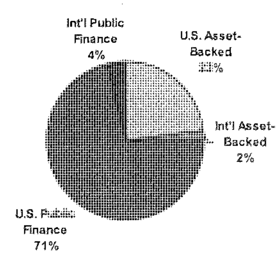
2006 Net Income	$247.8 million
2006 Net Operating Income	$247.1 million
Third Qtr 2007 Net income (Loss)	$(65.3) million
Third Qtr 2007 Net Operating Earnings	$68.7 million
Third Quarter 2007 Mark to Market Adjustment for Insured Derivatives	$(206.2) million

Share Price

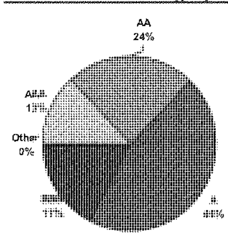
As of 00/00/00	Date	Amount
52-Week High	00/00/00	NOT APPLICABLE
52-Week Low	00/00/00	NOT APPLICABLE
Year-End Market Cap	00/00/00	NOT APPLICABLE
Recent Market Cap	00/00/00	NOT APPLICABLE

Financial Guaranty Insurance Company (FGIC) (Cont'd)

Net Par Outstanding by Sector



Net Par Outstanding by Rating



Ten Largest U.S. Municipal Risks
(Net Par in $ Millions)

California State GO	1,369.9
Jefferson County, AL Sewer Rev	1,196.3
Golden State Tobacco Securitiz Corp, CA Lease	1,150.5
Puerto Rico Commonwealth GO	1,131.8
New Jersey Trans Trust Fund Auth	1,065.6
Massachusetts Commonwealth GO	1,060.2
Miami-Dade County, FL Aviation Rev	1,052.8
Los Angeles USD, CA GO	1,052.0
Port Authority of NY and NJ	1,042.4
Double-Wrap Muni Portfolio(DWMP)	1,041.7

As of 9/30/07

Financial Guaranty Insurance Company (FGIC) (Cont'd)

Selected Current Exposures (Net Par Outstanding as of 9/30/07)

Vintage and Type	$MM	% of Total Insured Portfolio	Vintage and Type	$MM	% of Total Insured Portfolio
2005 Subprime RMBS	3,489.3	1.11	2007 Senior ABS CDO	4,958.3	1.57
2006 Subprime RMBS	414.4	0.13	2005 Mezzanine ABS CDO	289.5	0.09
2007 Subprime RMBS	2,152.4	0.68	2006 Mezzanine ABS CDO	2,224.5	0.71
2005 Senior ABS CDO	1,801.4	0.57	2007 Mezzanine ABS CDO	0	0.00
2006 Senior ABS CDO	1,660.0	0.53			

Financial Security Assurance Inc.

General Information

Date Established	1985
Headquarters	New York
Other Offices	San Francisco, Dallas, Mexico City, London, Madrid, Paris, Sydney, Tokyo, Bermuda
Ratings	AAA Fitch Aaa Moody's AAA S&P AAA R&I
Ownership Structure	Subsidiary of Dexia S.A.
Principal Regulators	NY Insurance Dept.; other state insurance regulators; SEC (for holding co.). For non-U.S. subsidiaries: Financial Services Authority in U.K.; Financial Services Authority in Japan; Secretaría de Hacienda y Crédito Público in Mexico

Statutory Financial Information (12/31/07)

Statutory Capital and Reserves	$5.1 billion
Total Claims-Paying Resources	$6.7 billion
Guaranteed Net Par Outstanding	$426.5 billion
U.S. Municipal Net Par Outstanding	$255.4 billion

The table above does not reflect Dexia's February 2008 contribution of $500 million of additional capital.

GAAP Financial Information (Holding Company)

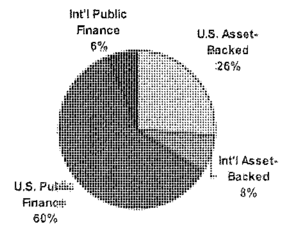
2007 Net Income	$(65.7) million
2007 Net Operating Income	$378.0 million
Fourth Qtr 2007 Net income (Loss)	$(91.9) million
Fourth Qtr 2007 Net Operating Earnings	$94.3 million
Fourth Quarter 2007 Mark to Market Adjustment for Insured Derivatives	$(188.6) million

Share Price

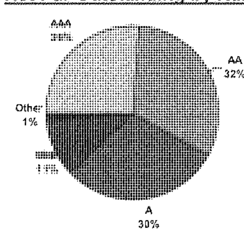
	Date	Amount
52-Week High	00/00/00	NOT APPLICABLE
52-Week Low	00/00/00	NOT APPLICABLE
Year-End Market Cap	12/31/07	NOT APPLICABLE
Recent Market Cap	00/00/00	NOT APPLICABLE

Financial Security Assurance Inc. (Cont'd)

Net Par Outstanding by Sector



Net Par Outstanding by Rating



Ten Largest U.S. Municipal Risks (Net Par in $ Millions)

Commonwealth of Massachusetts G.O.	1,261.6
New York City Municipal Water Finance Authority, Water and Sewer Revenue Bonds	1,253.5
Port Authority of NY and NJ, Consolidated Bonds	1,250.2
Massachusetts School Building Authority Dedicated Sales Tax Revenue Bonds	1,182.9
Los Angeles Unified School District, CA, G.O.	1,113.4
New Jersey Transportation Trust Fund Authority Transportation System Bonds	1,105.9
State of California, G.O.	1,092.0
New York City, NY, G.O.	1,071.2
Metropolitan Transportation Authority, NY, Transportation Revenue Bonds	1,041.6
Houston Combined Utility System, TX, First Lien Revenues	1,038.6

As of 12/31/07

Financial Security Assurance Inc. (Cont'd)

Selected Current Exposures (Net Par Outstanding as of 12/31/07)*

Vintage and Type	$MM	% of Total Insured Portfolio	Vintage and Type	$MM	% of Total Insured Portfolio
2005 Subprime RMBS	579	0.14	2007 Senior ABS CDO	0	0.00
2006 Subprime RMBS	125	0.03	2005 Mezzanine ABS CDO	0	0.00
2007 Subprime RMBS	2,999	0.70	2006 Mezzanine ABS CDO	0	0.00
2005 Senior ABS CDO	300	0.07	2007 Mezzanine ABS CDO	0	0.00
2006 Senior ABS CDO	0	0.00			

* Includes transactions previously wrapped by other monolines.

Radian Asset Assurance Inc.

General Information

Date Established	1985
Headquarters	New York
Other Offices	Philadelphia (Corporate HQ of Parent), London
Ratings	Aa3 (Moody's) AA (S&P) A+ (Fitch)*
Ownership Structure	Subsidiary of Radian Group Inc.
Principal U.S. Regulators	NY Insurance Dept; other state insurance regulators; SEC (for Parent Company). For London: Financial Services Authority

•Fitch currently rates Radian Asset A+ with an evolving outlook.
Radian Group Inc. formally requested that Fitch withdraw its rating
of all Radian Group Inc entities on 9/5/07.

Statutory Financial Information (9/30/07)

Statutory Capital and Reserves	$1.6 billion
Total Claims-Paying Resources	$3.1 billion
Guaranteed Net Par Outstanding	$112.8 billion
U.S. Municipal Net Par Outstanding	$55.1 billion

GAAP Financial Info (Radian Asset Assurance Inc.)

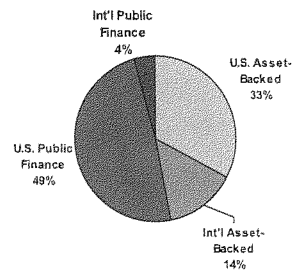
2006 Net Income (FY'06)	$127.3 million
2006 Net Operating Income (FY'06)	$72.5 million
Third Qtr 2007 Net income (Loss)	($152.4 million)
Third Qtr 2007 Net Operating Income	$12.6 million
Third Quarter 2007 Mark to Market Adjustment for Insured Derivatives	($255.6 million)

Share Price (Radian Group Inc. – NYSE: RDN)

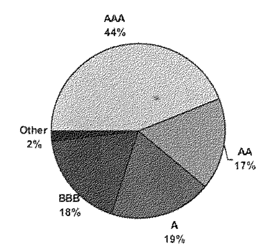
As of 3/6/08	Date	Amount
52-Week High	5/23/07	$63.95
52-Week Low	3/6/08	$5.30
Year-End Market Cap	12/31/06	$4,280.5 million
Recent Market Cap	3/6/08	$458.3 million

Radian Asset Assurance Inc. (Cont'd)

Net Par Outstanding by Sector



Net Par Outstanding by Rating



Ten Largest U.S. Municipal Risks

(Net Par in $ Millions)

New York, NY – G.O.	$ 818
California – G.O.	800
Port Authority of New York & New Jersey	604
Chicago, IL – G.O.	578
Washington – G.O.	450
Massachusetts – G.O.	417
Los Angeles Unified School District, CA	414
Massachusetts School Building Authority	359
New Jersey Transportation Trust Fund Authority	358
Metropolitan Transportation Authority, NY	352

As of 9/30/07

Radian Asset Assurance Inc. (Cont'd)

Selected Current Exposures (Net Par Outstanding as of 9/30/07)—Direct Exposures only

Vintage and Type	$MM	% of Total Insured Portfolio	Vintage and Type	$MM	% of Total Insured Portfolio
2005 Subprime RMBS	0	0.00	2007 Senior ABS CDO	0	0.00
2006 Subprime RMBS	0	0.00	2005 Mezzanine ABS CDO	0	0.00
2007 Subprime RMBS	0	0.00	2006 Mezzanine ABS CDO	0	0.00
2005 Senior ABS CDO	150	0.13	2007 Mezzanine ABS CDO	0	0.00
2006 Senior ABS CDO	510.8	0.45			

Security Capital Assurance

General Information

Date Established	2006
Headquarters	Bermuda
Other Offices	New York; Connecticut; California; London; Singapore; Madrid
Ratings	XLCA and XLFA: AAA by Standard & Poor's Ratings Service A3 by Moody's Investors Service A by Fitch Ratings
Ownership Structure	Holding company of primary financial guarantee insurer (XLCA) and reinsurer (XLFA)
Principal U.S. Regulators	NY Insurance Dept.; SEC (for holding co.). For non-U.S. subsidiaries: Financial Services Authority in U.K

All information current as of February 11,2008

Statutory Financial Information (9/30/07)

Statutory Capital and Reserves	$2.6 billion
Total Claims-Paying Resources	$3.5 billion
Guaranteed Net Par Outstanding	$154.2 billion
U.S. Municipal Net Par Outstanding	$59.6 billion

GAAP Financial Information (Holding Company)

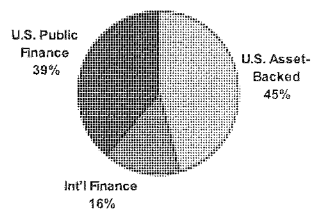
2006 Net Income	$117.4 million
2006 Net Operating Income	$141.9 million
Third Qtr 2007 Net income (Loss)	$(89.9) million
Third Qtr 2007 Net Operating Earnings	$46.0 million
Third Quarter 2007 Mark to Market Adjustment for Insured Derivatives	$(143.0) million

Share Price

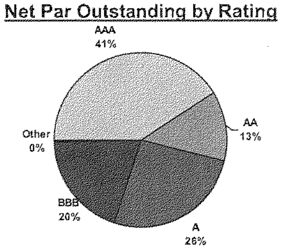
As of 2/11/08	Date	Amount
52-Week High	05/23/07	$ 33.88
52-Week Low	1/18/08	$ 1.65
Year-End Market Cap	12/31/07	$251 million
Recent Market Cap	2/11/08	$ 132 million

Security Capital Assurance (Cont'd)

Net Par Outstanding by Sector



Net Par Outstanding by Rating



Ten Largest U.S. Municipal Risks (Net Par in $ Millions)

State of New Jersey – Ann'l Appr.	858
City of New York - GO	857
State of Texas - GO	833
Jefferson Co., AL – Wtr/Swr Rev.	811
East Bay MUD, CA – Wtr/Swr Rev.	755
State of California - GO	737
State of New York – Ann'l Appr.	721
Commonwealth of Mass. - GO	690
State of Wisconsin – Ann'l Appr.	689
State of Florida – GO	625

As of 9/30/07

Security Capital Assurance (Cont'd)

Selected Current Exposures (Net Par Outstanding as of 9/30/07)

Vintage and Type	$MM	% of Total Insured Portfolio	Vintage and Type	$MM	% of Total Insured Portfolio
2005 Subprime RMBS	307.7	0.20	2007 Senior ABS CDO	6842.9	4.44
2006 Subprime RMBS	0	0.00	2005 Mezzanine ABS CDO	0	0.00
2007 Subprime RMBS	1,366.5	0.89	2006 Mezzanine ABS CDO	0	0.00
2005 Senior ABS CDO	948.6	0.62	2007 Mezzanine ABS CDO	0	0.00
2006 Senior ABS CDO	7095.8	4.60			

United States House of Representatives
Committee on Financial Services

Testimony submitted by Swedish Covenant Hospital, Chicago Illinois at the hearing titled "Municipal Bond Turmoil: Impact on Cities, Towns, and States"
Wednesday, March 12, 2008

Good morning, Chairman Frank and members of the committee.

My name is Mark Newton and I am the President and CEO of Swedish Covenant Hospital, located in Chicago, Illinois. Thank you for the opportunity to speak with you today about a very serious issue, the failing auction market for municipal bonds; and its impact on the not-for-profit hospital industry and more specifically, Swedish Covenant Hospital.

Swedish Covenant Hospital is a 334-bed urban community hospital, the largest remaining independent non-profit hospital serving the culturally diverse north side of Chicago. Founded in 1886 by missionaries of the Swedish Evangelical Covenant Church, the hospital employs more than 2000 staff members, with a demographic composition that mirrors the community we serve. Over 50 different languages are spoken by community members, physicians and staff. More than 550 physicians are on staff at the hospital representing 45 different specialties, and we provide teaching programs in family medicine, internal medicine, obstetrics, critical care and emergency medicine.

Swedish Covenant Hospital is a federal disproportionate share hospital and as such represents a critical safety net for uninsured and underinsured residents. Our community counts on us as a key partner in assuring access to high quality health care services, a commitment to mission which we take very seriously. We consider ourselves your partner in caring for vulnerable populations, and I am thankful to share our story as this Committee considers how best to respond to the crisis in the tax exempt bond markets.

According to a March 2008 report by our financial advisors, Kaufman Hall, the 2007 subprime mortgage crisis has led to a complete meltdown in the auction-rate securities market and now is spilling over into the variable-rate bond market. Because both markets are accessed extensively by healthcare organizations for variable-rate debt, the turmoil represents a significant event risk for hospitals and health systems nationwide.

The risk is made greater because of the cascading nature of the turmoil over the last few months without a predictable fire break on the horizon.

As President and CEO of an urban hospital, I am no stranger to responding to community health risks, to competitive market changes, to the malpractice crisis in Illinois, to nurse staffing shortages and to the ever threatening possibilities of revenue stream cuts to the Medicare and Medicaid programs. Historically, we seemingly have been able to respond in turn to each of these risks to the healthcare system, while continuing to expand our infrastructure and advancing quality outcomes. Key to our ability to respond has been the availability of predictable and efficient capital.

Let me share some details of our story. Since 2000 when I first joined Swedish Covenant Hospital, two hospitals within a few miles have closed, one has stopped obstetrical services and others are for sale. This translates into the loss of approximately 500 hospital beds and 3000 jobs. Swedish Covenant Hospital's best response to our community during the last eight years has been to invest in new facilities, services, technologies and staff while others downsized and curtailed services. Our sense of mission tells us that we must provide both respectful and efficient healthcare to vulnerable people regardless of their economic standing, and to be willing to strategically invest for the long term health of our community.

We now find ourselves responding to a crisis which requires us to reinvent our balance sheet and rethink strategies for capital spending. We are into a refinancing process that will cost over $1 million in transaction fees alone, a dollar amount taken from direct patient care. Our monthly interest costs have historically been in the range of $600,000 per month and increased in early February by an additional $350,000 per month. This increase is tied directly to failed auctions and to the resultant expectations by bondholders of rates of interest of between 10% and 15% for tax exempt insured debt. Clearly, this is not a sustainable scenario.

All of this turmoil has significantly lessened our confidence in financial markets. As concerning, is our new reality that we simply cannot yet tell where this crisis will end, and confidence restored. We now have to be even more alert for unintended consequences as we restructure our balance sheet.

Today, Swedish Covenant Hospital's amount of debt is approximately 150 million with 83% fixed and 17% variable, and is either insured by bond insurance or supported by bank letter of credit for rate enhancement. We are an underlying BBB+ credit. Our fixed rate now is 4.9 % and we expect the cost of fixed rate debt to increase to 6.5%. After refinancing we will have to increase the percentage of variable debt to around 60%. One unintended consequence is even greater reliance on banks letter of credit which is by nature short term. In a period where the Federal Reserve is lowering rates and increasing liquidity, we simply are not seeing carryover to the tax exempt market. The cost of bank credit enhancement (as a replacement for traditional bond insurance) has increased significantly. Credit enhancement capacity has been reduced as we look forward in the next three months to a massive period of debt refinancing by hospitals such as Swedish Covenant.

One other unintended consequence of the unplanned timing of our refinancing is the cost of unwinding existing interest rates swaps which will cost roughly $9.0 million.

What does this all translate into?

Hospitals like Swedish Covenant will face significant cost increases on existing debt and may have very little capacity for access to new capital for the next few years. We are slowing down investments in projects such as implementation of an Electronic Medical Record. We will postpone expansion and renovations of core infrastructure. And we will conserve other spending to maintain needed cash balances as banks tighten other credit terms such as higher minimum levels of cash on hand.

Perhaps my final observation is that organizations such as mine truly need a firebreak in this current cascading crisis. As I noted before, as your partner in providing healthcare services, we really need and want to get back to the basics of caring for people. The fabric of an efficient and effective healthcare system depends on access to stable and predictable sources of capital.

I want to thank the committee for the opportunity to discuss this important issue and welcome any questions.

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.

TESTIMONY
OF

ERIK R. SIRRI
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U.S. SECURITIES AND EXCHANGE COMMISSION

MUNICIPAL BOND TURMOIL: IMPACT ON CITIES, TOWNS AND STATES

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MARCH 12, 2008

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Testimony Concerning
Municipal Bond Turmoil: Impact on Cities, Towns and States

by Erik R. Sirri
Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

Before the Committee on Financial Services, U.S. House of Representatives

March 12, 2008

Chairman Frank, Ranking Member Bachus and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission about the current turmoil in the municipal bond market, its impact on cities, towns and states, and the Commission's responses.

There is no question that the recent dislocations in the municipal bond markets have created unanticipated hardships for municipal issuers and in some cases dramatically increased their borrowing costs. Today I'd like to discuss some of the current problems in the municipal bond markets, with particular attention to problems that have developed in the market for certain short-term municipal securities known as auction-rate securities and variable rate demand notes.

The municipal markets have become much larger, more diverse, and more complex in recent years. There are over $2.4 trillion of municipal securities outstanding. More than $487 billion of new bonds and notes were issued last year. Despite its reputation as a "buy and hold" market, trading volume is also substantial, with over $6 trillion of long and short-term municipal securities traded in 2007. There are more than 50,000 state and local issuers of municipal securities, and two million separate bonds outstanding.

Individual investors are now significant investors in municipal securities, accounting for over one-third of the direct holdings of municipal securities, and that's not counting their indirect holdings through mutual funds, money market funds, and closed-end funds, which account for about another third of the market. And many non-traditional buyers, such as hedge funds, have become active participants in the market.

In addition, issuers of municipal securities have in recent years greatly increased their use of sophisticated financing arrangements, interest rate swap agreements and other derivative financial products in connection with municipal securities offerings. The widespread use of complex products by municipal issuers raises concerns about risks to investors, markets, and taxpayers.

However, at this time I would like to turn my attention to the latest serious problem in the municipal securities markets, auction-rate bond failures. Auction-rate securities are municipal bonds, preferred stocks and other instruments with interest rates or dividend yields that are periodically re-set through auctions, typically every 7, 14, 28, or 35 days. Auction-rate bonds are usually issued with maturities of 30 years, but the maturities can range from 5 years to perpetuity. Auction-rate securities were first developed in 1984, and the market has grown to $325 to $360 billion of securities, with state and local governments accounting for about $166 billion of the outstanding auction-rate debt.

As you know, hundreds of auctions for auction-rate securities issued by municipal issuers recently have failed to obtain sufficient bids to establish a clearing rate. Consequently, issuers who decided to use this type of financing to obtain favorable short-term interest rates are instead paying what are known as "penalty" interest rates as high as 20 percent, at least until the next auction. In addition, investors cannot sell their holdings through the auction process until the next successful auction. The Commission has received many requests to address this market dislocation, from municipal issuers, conduit borrowers, dealers and investors.

Dealers often market auction-rate securities to issuers as an alternative variable rate financing vehicle. Generally, investors buy auction-rate securities as a higher-yielding alternative to money market mutual funds or certificates of deposit. Some smaller investors also have begun participating in the market. Typically, the minimum investment is $25,000.

Auction-rate securities are auctioned at par so the return on the investment to the investor and the cost of financing to the issuer between auction dates is determined by the interest rate set through the auctions. The interest rate is set through a process in which bids with successively higher rates are accepted until all of the securities in the auction are sold. The final rate at which all of the securities are sold is the "clearing rate" that applies to all of the securities of an offering until the next auction occurs. Bids with the lowest rate and then successively higher rates are accepted until all of the sell orders are filled. The clearing rate is the lowest rate bid sufficient to cover all of the securities for sale in the auction.[1] If there are not enough bids to cover the securities for sale, then the auction is said to "fail," the issuer pays a predetermined penalty or default rate that is generally well above-market rates, and all of the current holders continue to hold the securities (except that, in some cases, sellers are allowed to sell on a *pro rata* basis in the event of a "failed" auction). If all of the current holders of the security elect to hold their positions without bidding a particular rate, then the clearing rate is the "all-hold rate," a below-market rate described in the disclosure documents.[2]

The issuer of each security selects one or more broker-dealers to solicit bids for auctions of particular offerings. Investors can only submit orders through the selected broker-dealers, commonly referred to as participating dealers. The issuer also selects an auction agent to collect the orders and determine the clearing rate for the auction.

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[1] For example, suppose $100,000 of securities were for sale and the auction received four buy bids. Bid A was for $50,000 at 1.10%, Bid B was for $50,000 at 1.15%, Bid C was for $50,000 at 1.15%, and Bid D was for $25,000 at 1.20%. Under these circumstances, the "clearing rate" would be 1.15%, meaning all of the securities in the auction would pay interest at a rate of 1.15% until the next auction. Bid A would be allocated $50,000, Bids B and C would receive pro-rata allocations ($25,000 each), and Bid D would receive no allocation.

[2] All hold rates are typically set by formulas, but may sometimes be fixed rates.

For a variety of reasons, including the current lack of dealer support for auctions and frequent auction failures, many holders of auction-rate securities now want to sell them. Recent downgrades of bond insurers have caused many holders to desire to sell bonds insured by companies who have recently been downgraded or who may soon be. In addition, many holders of bonds insured or supported by the credit of insurers whose ratings have *not* been threatened now wish to sell – which may be due to a general loss in confidence in the municipal auction-rate market. As a result of these factors, among others, we understand that sellers of municipal auction-rate securities have often far exceeded buyers in auctions, resulting in auction failures.

Estimates of the value of the recent failures of auctions for municipal auction-rate securities exceed $80 billion. Prior to the current disruption in the municipal auction-rate market, participating dealers retained to solicit bids for the auctions generally supported the liquidity of the municipal auction-rate securities market by placing proprietary bids, as necessary in order that auctions not "fail," and disclosed the fact that they might do so. However, in recent weeks, for a variety of reasons, including liquidity concerns and uncertainty surrounding the monoline insurers, participating dealers have ceased to intervene proprietarily in auctions, with the result that hundreds of auctions have failed.

The current lack of price transparency for auction-rate securities may be exacerbating this situation. Currently, trades of auction-rate securities are reported at par and do not include the "clearing rates" or resulting yields to investors. Reporting of trades at par is not helpful in terms of furthering the availability of pricing information to investors and for issuers. The Municipal Securities Rulemaking Board has been considering rule changes to increase price transparency for this segment of the market, and has been considering requiring dealers to report the resulting yields to investors. The Commission staff now plans to ask the MSRB to consider expanding the scope of this proposal, and consider rule proposals to require dealers in auction-rate securities to report much of the same type of information that is reported in Treasury auctions.

The Commission has an obligation to protect investors in the municipal markets from fraud. Unlike corporate securities, municipal securities are expressly exempted from registration and reporting under the Securities Act of 1933 and the Securities Exchange Act of 1934. Municipal issuers generally do not file any documents with the Commission. There is no mandated line-item disclosure for municipal securities. However, the antifraud provisions of the federal securities laws do apply.

As previously noted in Chairman Cox's letter to the bipartisan leadership of the House Financial Services Committee and Senate Banking Committee last summer, disclosure in the municipal securities market, particularly in the secondary market, is substantially less comprehensive and less readily available than disclosure by public reporting companies. Despite the size and importance of this market, it lacks a variety of the systemic protections found in many other sectors of the U.S. capital markets.

Due to the recent auction failures and resulting higher borrowing costs, we understand that some municipal issuers and conduit borrowers[3] would like to, and in many cases have begun the process to, convert their auction-rate bonds into variable-rate bonds backed by letters of credit or other types of credit enhancement or fixed rate bonds. However, the ability to convert municipal auction-rate securities may be slowed due to heavy demand for such substitute instruments[4] and further overall concerns about the credit markets.

We understand that certain participating dealers may be unwilling to accept bids from issuers in an auction because of questions about the scope of the settlement in a past enforcement action. In May 2006, the Commission instituted proceedings against 15 broker-dealer firms for engaging in violative practices in the auction-rate securities market.[5] The firms consented to the entry of a cease-and-desist order providing for censures, undertakings, and more than $13 million in penalties. The Commission found in that order that, between January 2003 and June 2004, each firm engaged in one or more practices that violated the securities laws. Without adequate disclosure certain respondents bid to prevent auctions from failing. The order does not prohibit broker-dealers from bidding for their proprietary accounts when properly disclosed.

The Commission has received several requests to consider ways to assist issuers with an orderly exit from current market conditions. On February 28, the leadership of this Committee asked the Commission to clarify for the market as quickly as possible that issuers can – within the bounds of applicable laws and regulation – participate in auctions for their own securities. The staff is developing approaches to providing further guidance in this area in light of market developments and the settlement.

Due to the severity and immediacy of the auction-rate market decline and implications for investors, Commission staff is developing appropriate guidance to facilitate orderly markets and continue to protect investors. The guidance would be designed to clarify that, with appropriate disclosures, and compliance with certain other conditions, municipal issuers can provide liquidity to investors that want to sell their auction-rate securities without triggering market manipulation concerns. This may also have the secondary effect of easing the substantial financial burden on municipal issuers and conduit borrowers from unusually high interest rates. It also should facilitate an orderly exit from this market by municipal issuers and conduit borrowers who seek to do so.

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[3] Often, states and local governments issue municipal securities to finance a project to be used primarily by a third party, usually a for-profit entity engaged in private enterprise or a 501(c)(3) organization (referred to as the "conduit borrower"). The security for this type of issue is the credit of the conduit borrower or pledged revenues from the project financed, rather than the credit of the issuer. Many conduit borrowers are non-profit hospitals and private colleges and universities.

[4] According to the Bond Buyer, market sources have said that some banks have already reached their entire yearly capacity for writing letter of credit policies, after just a month and a half; the use of letters of credit increased 244.4% in January over the same month last year, on 66 deals for total volume of $1.55 billion, according to data from Thompson Financial. Dakin Campell, *Interest Rate Swaps Under Scrutiny*," The Bond Buyer, February 20, 2008.

[5] SEC Rel. No. 33-8684, 34-53888 (May 31, 2006).

Enhanced transparency would be a key component of the guidance, as it is to the auction process. For example, if municipal issuers or conduit borrowers want to bid in auctions, they must disclose, among other things, certain facts related to price and quantity. Of course, issuers must comply with their disclosure obligations under the Securities Act of 1933 and the Securities Exchange Act of 1934, as applicable. Staff anticipates that the guidance should remove any hesitancy on the part of broker-dealers and auction agents to allow municipal issuers to bid.

Of course, this guidance cannot modify terms of contracts between buyers and sellers, or contracts between issuers and bondholders, and so municipal issuer bidding could only take place if consistent with the terms of any auction-rate securities as reflected in their respective indentures and governing instruments. The guidance does not address the amendment of the terms of any auction-rate securities in accordance with their governing instruments.

The Commission staff is closely monitoring the potential effects of the developments in the municipal auction-rate securities markets on mutual funds, including money market funds, and closed-end funds. The Commission regulates these investment companies under the Investment Company Act of 1940 and other federal securities laws.

Tax-exempt money market funds, with $465 billion under management, are key investors in municipal securities and part of the $3.3 trillion money market fund industry. Money market funds typically have as their investment objective the generation of income and the preservation of capital. To help meet this objective, they are required by rule 2a-7 under the Investment Company Act to limit the securities in which they invest to high-quality, short-term instruments that the funds' advisers determine involve "minimal credit risks." As a part of this, rule 2a-7 employs NRSRO ratings to determine whether funds may purchase a security.

As much as 30% of the municipal securities currently held by tax-exempt money market funds is supported by bond insurance issued by monoline insurance companies. Some of the securities may be eligible for investment by money market funds because of the insurance that monoline insurers provide. Given the importance of money market funds as investors in municipal securities, some have raised questions regarding the effects of the credit rating conditions in rule 2a-7 on the funds' ability to purchase and hold municipal securities affected by downgrades of monoline insurers.

The Commission staff recognizes that a significant downgrade in a monoline insurer's rating could result in the securities becoming ineligible under rule 2a-7 for investment by money market funds. Also, in the long term, the inability of bond insurers to maintain high credit ratings may restrict the supply of high-quality paper for tax-exempt money market funds.

The credit ratings only create a "floor" below which funds may not invest, however, and constitute one among several risk-limiting conditions of rule 2a-7. Since its adoption in 1982, rule 2a-7 has continued to serve the purposes that the Commission intended. It is notable that, despite the current liquidity crisis, money market funds and their sponsors have not asked the Commission for any changes to the risk-limiting conditions of rule 2a-7, including the credit rating floor.

There are other possible effects that a significant downgrade in a monoline insurer's rating could have on money market funds. The municipal securities they hold include variable rate demand notes ("VRDNs") and tender option bonds ("TOBs") that typically have liquidity backstops, or "puts," that are provided by a financial institution. These liquidity features serve to provide a source of cash to satisfy redemptions by fund shareholders, and also to shorten the municipal bonds' maturities and make them eligible investments for a money market fund.

A significant downgrade could terminate the put, and thus result in money market funds holding long-term securities that would be inappropriate for funds maintaining a stable net asset value. The Commission staff has been in regular contact with fund management companies, which are aware of these risks and have taken steps intended to protect funds and thus fund investors from the loss of these puts.

In addition to money market funds, there are other funds that invest in municipal securities. Most of these are so-called municipal or tax-exempt funds, which are funds that seek to derive most or all of their income from municipal bonds that pay interest that is exempt from federal income tax. The Commission requires funds that call themselves tax-exempt to invest at least 80% of their assets in, or derive 80% of their income from, municipal bonds.

Some tax-exempt funds principally invest their assets in municipal bonds that carry insurance issued by the monolines. These funds generally have the word "insured" in their name and have an investment policy that requires at least 80% of their assets be invested in municipal bonds the payment of interest and principal on which is guaranteed by a AAA-rated insurance company.

Although it is difficult to predict the effect on municipal bond funds of additional rating downgrades of bond insurers, some projections can be made:

- Any overall decline in the value of municipal bonds or insured municipal bonds would be reflected in comparable declines in the value of municipal bond fund shares.
- A more severe downgrade (e.g., from AAA to A) is likely to have a greater effect on the value of municipal bonds and funds than a less severe downgrade (e.g., from AAA to AA).
- A downgrade may present more price risk to an owner of a single municipal bond than to an owner of shares of a diversified municipal bond fund.
- A downgrade may require many insured funds to change their investment policy with respect to the ratings quality of portfolio holdings if those holdings are no longer guaranteed by an AAA-rated insurance company.

Now that I have discussed mutual funds and other investment companies as investors in municipal auction-rate securities, it is important to understand that closed-end funds are also issuers of a particular type of auction-rate securities, called auction-rate preferred securities. The general loss of confidence in the auction-rate markets has spilled over into this market and many of these auctions have failed.

There are important differences in how auction failures have affected municipal and closed-end fund issuers. Although closed-end funds also issue auction-rate securities to obtain financing, they use the financing to leverage their investments in portfolio companies in order to seek higher dividends for the funds' common shareholders. Also, although the funds have been paying penalty rates to their preferred shareholders to compensate them for the illiquidity, the rates are generally much lower than those paid by municipal issuers. In fact, the penalty rates paid by closed-end funds are only slightly higher than the market rates for these securities before the auctions began to fail.

One effect of the relatively lower penalty rates is that the rates are generally not as detrimental to the fund issuers. As long the amount they pay to their preferred shareholders through penalty rates is less than the returns generated from converting the proceeds of the financing, the underlying mechanics continue to work as intended.

That does not necessarily mean that the current status of auction-rate preferred securities will continue, however. Although the closed-end funds pay their preferred shareholders the penalty rate, failed auctions mean that those shareholders may have to continue to hold the securities, which are perpetual, or attempt to sell them on a secondary market at what may be a heavy discount. Preferred shareholders have pressured closed-end fund companies to find solutions to the failed auctions, and the companies have recently begun to contact the Division of Investment Management for guidance.

Due to the special issues raised by the auction failures in the auction-rate preferred securities market, such as those raised by the fiduciary duties owed by funds to both preferred and common shareholders, the staff guidance in the municipal auction-rate securities market may not extend to closed-end fund issuers. The Division of Investment Management continues to assess requests for guidance, however, and to monitor the developments in this area closely.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you might have.

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Statement of

Martin Vogtsberger
Regional Bond Dealers Association

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 $1/10^{th}$ 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.

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

March 12, 2008

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.

Sectoral Breakdown of Moody's-Rated Issuers and Defaulters: 1970-2000

Sector	Number of Issuers	Number of Defaults
General Obligation	14,775	0
Water and Sewer	1,894	0
Public Universities	251	0
Private Universities and Not-For-Profits	580	1
Electric Power	699	2
Not-for-Profit Health Care	1,381	10
Other	8,591	5

Source: Moody's Investors Service

washingtonpost.com

Tax-Exempt Funds Yield a Surprise

By Allan Sloan
Tuesday, March 11, 2008; D02

It's amazing what you can find when you pay attention to detail. For instance, you might discover, as I did, that you can get a higher yield on a tax-exempt money market mutual fund than on a taxable Treasury fund.

Logic would suggest that this would never happen because income on Treasury securities is subject to federal income tax, while income from tax-free securities is . . . duh . . . tax-free. Hence in normal times, tax-exempt money funds yield only about 30 to 35 percent less than Treasury funds do.

But in late February and early March, Treasury fund yields began to fall below those of national tax-exempt funds -- those that own securities from issuers in many states rather than from just one.

As of late last week, according to data from iMoneyNet, a money fund information firm, the average multi-state tax-exempt fund was yielding 25 percent *more* than the average Treasury fund: 2.50 percent to 2.00 percent. The after-tax difference is even higher -- much higher, in fact. This is despite the fact that income from Treasury funds is generally exempt from state and local income taxes, while most income from multi-state tax-exempt funds is subject to them. (In case you're wondering, that's because state and local taxes usually apply to income from tax-exempt securities issued outside the state in which you live.)

Why are tax-frees paying more than Treasurys? I'm glad you asked. It's a reflection of the fear gripping financial markets. Large investors are fleeing to safe-haven Treasurys, driving up their prices and thus decreasing their yield. (Yield, as you may recall from Investing 101, is a security's income divided by its price.) Meanwhile, fear and financial market freeze-ups have driven down the prices of tax-exempt securities. Hence, their yields have risen.

I stumbled on this inversion phenomenon during a bout of insomnia early Friday morning. Instead of raiding the refrigerator, I went for the less-unhealthy option of looking at my portfolio. I was surprised to see my Vanguard tax-exempt money market fund yielding considerably more than my Vanguard Treasury money fund. (Most recent numbers: 3.22 percent and 2.78 percent, respectively.) I promptly transferred most of my Treasury fund balance to the tax-exempt fund.

But now, a warning. There is some risk in doing this because problematic securities keep popping up in parts of the tax-exempt universe. Don't transfer into a tax-exempt fund that owns anything even vaguely risky.

Given my tax bracket and the yield difference, I consider the tiny risk well worth taking. I've still got a majority of my investable assets in stocks, but given my age (63) and the fact that I've been a net seller of stocks since mid-2007, my money fund income matters to me.

Tax-exempt money fund yields were briefly above Treasury yields a few years ago, when yields on short-term Treasury securities were abnormally low because of Federal Reserve Board rate cuts. But after a while, things reverted to normal, with Treasury yields exceeding tax-exempt ones.

Christopher W. Alwine, Vanguard's head of municipal portfolio management, doesn't expect tax-exempt yields to stay above Treasury yields indefinitely this time, either. "We should expect to see volatility [in the tax exempt-Treasury yield ratio] over the next three to six months," he said, "then things will return to their normal condition."

If I were a big enough fish, I'd be out trolling for individual high-quality tax-exempt bonds, some of which seem to offer exceptional values. But buying these securities at a reasonable price -- and buying enough different issues to diversify my holdings -- seems beyond the reach of a small-fry investor like me. So for now, I'll settle for swapping my Treasury money fund shares for tax-frees.

And I'll be paying more attention to money market fund yields than I usually do. This isn't a big-bucks kind of thing. But in a difficult and tricky market like this one, I can use all the breaks I can get.

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MUNICIPAL BOND TURMOIL: IMPACT ON CITIES, TOWNS, AND STATES

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON
FINANCIAL SERVICES

MARCH 12, 2008

Statement of the

MUNICIPAL SECURITIES RULEMAKING BOARD

Statement of the Municipal Securities Rulemaking Board

to the

U.S. House of Representatives
Committee on Financial Services
March 12, 2008

INTRODUCTION AND SUMMARY

The Municipal Securities Rulemaking Board ("MSRB" or "Board") appreciates the opportunity to submit a statement before the Committee addressing current issues concerning the municipal securities market. Part I provides a summary of the Board's structure, authority and rules. Part II provides background on the municipal securities market. Part III is a discussion of the MSRB's regulatory guidance and market initiatives, and specifically our recent initiatives responding to the auction rate securities and short-term municipal market crisis.

I. BACKGROUND ON THE MSRB'S STRUCTURE, AUTHORITY AND RULES

A. MSRB Structure

The MSRB is a self-regulatory organization ("SRO") established by Congress in the Securities Acts Amendments of 1975 to write rules with respect to transactions in municipal securities effected by brokers, dealers and municipal securities dealers (collectively "dealers"). The MSRB stands as a unique SRO for a variety of reasons. The MSRB was the first SRO specifically established by Congress. Also unique is the fact that the legislation, now codified in section 15B of the Securities Exchange Act ("Exchange Act"), dictates that the Board shall be composed of members who are equally divided among public members (individuals not associated with any dealer), individuals who are associated with and representative of banks that deal in municipal securities ("bank dealers"), and individuals who are associated with and representative of securities firms.[1] At least one public member serving on the Board must represent investors and at least one must represent issuers of municipal securities. Further, the MSRB was created as a product-specific regulator, unlike most other securities regulatory bodies.

Members of the Board meet periodically throughout the year to make policy decisions, approve rulemaking, information systems and review developments in the municipal securities market. Day-to-day operations of the MSRB are handled by a full-time professional staff. The operations of the Board are funded through assessments made on dealers for initial fees, annual fees, fees for underwritings and transaction fees.[2]

B. MSRB Authority

The substantive areas of the Board's rulemaking authority are described in Section 15B(b)(2) of the Exchange Act, which lists several specific purposes to be accomplished by Board rulemaking with respect to the municipal securities activities of dealers and provides a broad directive for rulemaking designed to:

> prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons

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1 Under Board Rule A-3, the Board is composed of 15 membership positions, with five positions each for public, bank dealer and securities firm members.

2 These fees are set forth in Board Rules A-12 through A-14.

> engaged in regulating, clearing, settling and processing information with respect to and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

Like other SROs, the Board must file its proposed rule changes with the Securities and Exchange Commission ("SEC") for approval prior to effectiveness.

Although the Board was created to write rules that govern dealers' conduct in the municipal securities market, the Exchange Act directs that inspection of dealers for compliance with, and the enforcement of, Board rules be carried out by other agencies. For securities firms, the Financial Industry Regulation Authority ("FINRA"), along with the SEC, perform these functions. For bank dealers, the appropriate federal banking authorities, in coordination with the SEC, have this responsibility.[3] The use of existing enforcement authorities for inspection and enforcement of Board rules provides for an efficient use of resources. The Board works cooperatively with these enforcement agencies and maintains frequent communication to ensure that: (1) the Board's rules and priorities are known to examining officials; (2) general trends and developments in the market discovered by field personnel are made known to the Board; and (3) any potential rule violations are immediately reported to the enforcement agencies.

While Section 15B of the Exchange Act provides the Board with broad authority to write rules governing the activities of dealers in the municipal securities market, it does not provide the

3 These federal banking authorities consist of the Federal Deposit Insurance Corporation, the U.S. Treasury Department's Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Board of Governors of the Federal Reserve System, depending upon the specific bank dealer.

Board with authority to write rules governing the activities of other participants in the municipal finance market such as issuers and their agents (*e.g.*, independent financial advisors, trustees, bond counsel, etc.). Municipal securities also are exempt from the registration and prospectus delivery requirements of the Securities Act of 1933 and are exempt from the registration and reporting requirements of the Exchange Act.

In adopting Section 15B of the Exchange Act, Congress provided in subsection (d) specific provisions that restrict the Board and the SEC from regulating the disclosure practices of issuers in certain ways. Paragraph (1) of subsection (d) prohibits the Board (and the SEC) from writing rules that directly or indirectly (*i.e.*, through dealer regulation) impose a presale-filing requirement for issues of municipal securities. Paragraph (2) of subsection (d) prohibits the Board (but not the SEC) from adopting rules that directly or indirectly require issuers to produce documents or information for delivery to purchasers or to the Board. Paragraph (2), however, specifically allows the Board to adopt requirements relating to such disclosure documents or information as might be available from "a source other than such issuer." The provisions of subsection (d) commonly are known as the "Tower Amendment."

C. <u>MSRB Rules Overview</u>

The Board has adopted a substantial body of rules that regulate dealer conduct in the municipal securities market. In general, our rules are "principles-based" with specific guidance given where appropriate. We also seek to coordinate our rules with FINRA in cases where similar requirements make sense. MSRB rules address all of the subjects enumerated in Section 15B of the Exchange Act by Congress for Board action, including: recordkeeping, clearance and settlement, the establishment of separately identifiable departments within bank dealers, quotations, the professional qualification of persons in the industry and the arbitration of disputes.[4] The Board also adopted a number of rules in furtherance of the broad purposes of ensuring the protection of investors and the public interest. Among the most important of these are the Board's three primary customer protection measures—Rule G-17, on fair dealing, Rule G-19, on suitability, and Rule G-30, on fair pricing. These rules require dealers to observe the highest professional standards in their activities and relationships with customers.

Maintaining municipal market integrity is an exceptionally high priority for the Board as it seeks to foster a fair and efficient municipal securities market through dealer regulation. The Board engages in an on-going process of reviewing its rules and market practices to ensure that the Board's overriding goal of protecting investors and maintaining market integrity is not compromised by emerging practices.

D. Market Transparency and Surveillance/ Information Systems

In 2005, the MSRB implemented a facility for real-time transaction reporting and price dissemination of transactions in municipal securities (the "Real-Time Transaction Reporting System" or "RTRS").[5] RTRS serves the dual role of providing transaction price transparency to the marketplace, as well as supporting market surveillance by the enforcement agencies. Surveillance data is made available to regulators with authority to enforce MSRB rules, including FINRA and the SEC. The market surveillance function of the MSRB's transaction

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4 The Board's arbitration program was established in 1978. Because of the small number of cases filed with the Board and the agreement of FINRA to handle arbitration cases relating to municipal securities transactions brought by customers involving bank dealers as well as existing FINRA dealer members, the Board discontinued its arbitration program in 1998.

reporting system provides enforcement agencies with a powerful tool in enforcing the Board's fair pricing rules.

In its role as regulator for dealer conduct, the Board also operates information systems to help ensure that dealers can comply with MSRB rules by improving the flow of information in the market about municipal issues, and to ensure that the inspection and enforcement agencies have the necessary tools to do their work. The Municipal Securities Information Library ("MSIL") system collects primary market disclosure documents from underwriters and makes them available to the market and the general public. The MSIL system also accepts and disseminates certain secondary market information provided by municipal issuers and trustees. An improved information service is currently in development and is discussed further below.

II. BACKGROUND ON THE MUNICIPAL SECURITIES MARKET

A. Market Overview

When Section 15B of the Exchange Act was adopted in 1975, yearly issuance of municipal securities was approximately $58 billion. Much of this total represented general obligation debt, which reflected the simple, unconditional promise of a state or local government unit to pay to the investor a specific rate of interest for a specific period of time. The investors in these bonds tended to be commercial banks and property/casualty insurers interested in tax-exempt interest.

(. . . continued)

5 The MSRB's transaction reporting rules require dealers to report transactions in municipal securities within 15 minutes of the time of trade execution instead of by midnight on trade date, as was previously required.

The municipal securities market has grown into a much larger and more complex market. Total municipal debt outstanding as of 2007 is approximately $2.57 trillion. Last year, a total of 12,486 long-term municipal securities issues were issued for a total par value of $249 billion of long-term bonds.

Approximately 47% of the municipal bonds issued in 2007 carried municipal bond insurance. While the market for insured municipal securities and auction rate securities has been impacted by the downgrading of monoline insurers, the credit quality of the underlying municipal securities has generally not been affected. Default rates in municipal securities remain exceedingly low. It should be noted that the municipal ratings scale is more conservative than the corporate ratings scale. The use of such parallel rating scales with different default risk characteristics can obscure the fiscal strength of municipal issuers, as many are strong credits even without insurance.

In the United States, there are approximately 80,000 state and local governments, about 60,000 of which have issued municipal securities. The market is unique among the world's major capital markets because the number of issuers is so large—no other direct capital market encompasses so many borrowers. The issues range from multi-billion dollar financings of large state and city governments to issues less than $100,000 in size, issued by localities, school districts, fire districts and various other issuing authorities. The purposes for which these securities are issued include not only financing for basic government functions, but also a variety of public needs such as transportation, utilities, health care, higher education and housing as well as some essentially private functions to enhance industrial development. In the last two decades debt issuance has become an important management tool for many municipalities, allowing flexibility in arranging finances and meeting annual budget considerations according to local needs and local priorities. The terms and features of municipal securities have evolved over time to meet a multitude of issuer borrowing and investment needs.

Issuers' budgetary and risk management needs have also lead to derivative transactions, especially interest rate swaps, becoming an increasingly common aspect of municipal finance. These derivative transactions are considered to be contractual arrangements and are not transactions in municipal securities, and therefore, MSRB does not have the authority to regulate dealer conduct in connection with derivative transactions. In addition, many non-regulated entities effect derivative transactions with municipal issuers, or advise municipal issuers with respect to these transactions.[6]

The municipal securities market has a significant retail orientation, with approximately 35 percent of municipal debt held by households directly and another approximately 35% through mutual funds. There is great diversity in the types of municipal securities that are issued today. Tax-exempt municipal securities are popular investments that offer a wide range of benefits, including income free from federal and, in some cases, state and local taxes; relative safety with regard to payment of interest and repayment of principal; and a wide range of choices

6 The Commodity Futures Modernization Act of 2000 clarified the status of OTC derivatives and hybrid instruments under U.S. commodities and securities laws. Among other things, it provides that swap agreements are not securities under the federal securities laws. Swap agreements that are based on securities prices, yields or volatilities are, however, subject to specific anti-fraud, anti-manipulation and anti-insider trading provisions of the federal securities laws as if they were securities. Neither the SEC nor the MSRB may, however, impose reporting or record keeping requirements or other prophylactic measures against fraud, manipulation or insider trading with respect to securities-based swap agreements.

to fit an investor's objectives with regard to credit quality, sector, maturity, choice of issuer, type of bond, and geographical location.

There are over 2,000 dealers registered with the MSRB to engage in municipal securities activities. These dealers range from large, securities firms with nationwide presence to small local shops. Approximately 500 of these dealers underwrite new issues.

B. Trading in Municipal Securities

Municipal securities are bought and sold in the over-the-counter market rather than on an organized exchange. Unlike the experience in the over-the-counter market for equity securities, there has been no evolution of firm, two-sided quotations or a formal market maker structure. In fact, a primary characteristic of the municipal securities market is the lack of any core group of issues that trade frequently and consistently over sustained periods of time. One reason for this is the "buy and hold" philosophy of most municipal securities investors. Another reason is that, for most issues, there is a very small or non-existent "float" of securities available to be the subject of trading. Making a market in a conventional sense is difficult, if not impossible, for these issues. In addition, the tax treatment of borrowing tax-exempt securities effectively prevents the "shorting" of an issue. The inability to manage risk in this fashion is a disincentive for making markets even in those issues where "float" might be available.

Another distinction between the municipal securities and the equity markets relates to the frequency of trading. In exchange-listed and NASDAQ markets, the continuous daily pattern of frequent trades in most stocks means that "last sale" transaction prices generally provide reliable information on market values for most stocks. However, "last sale" prices may not provide reliable indicators of market value for most municipal securities. One reason for this is that, even on the heaviest trading days, less than one percent of all outstanding municipal issues trade at all and most of those issues trade only once or twice during the day. Furthermore, MSRB transaction reporting data suggests that only about one-third of the total issues outstanding during a given year are traded even once at any time during that year.

III. REGULATORY PRIORITIES AND GOALS

A. Continuing Vigilance and Market Guidance

The Board continues to review and refine its rules and regulatory guidance in light of new products, changes in marketing practices and other developments. The Board has established as its goal the fostering and promoting of a fair and efficient municipal capital market. To help reach this goal, the Board seeks to exercise market leadership through rulemaking, publishing timely market guidance, providing mechanisms for information flows and adapting to changes in conditions. Recently the Board has taken a number of major actions to further its goal through these priorities and objectives.

B. Market Leadership through Published Guidance

Cognizant of the recent downgrades of municipal bond insurers, ongoing credit agency reviews, the unprecedented number of "failed" auctions in the market for municipal Auction Rate Securities ("ARSs"), and other short-term liquidity concerns that have created extreme volatility in the short-term market, the MSRB has been actively involved in efforts to in efforts to protect investors and promote a fair and efficient market through difficult market conditions. The MSRB has met with federal and state officials and industry stakeholders to lend our expertise and help fashion appropriate responses. The Board reminded dealers that MSRB rules have always applied to ARSs and insured bonds and other short-term instruments and issued timely guidance to remind dealers of their obligations with respect to the investor protection rules applicable to transactions in such instruments.[7]

As discussed above, one of the most important MSRB investor protection rules is Rule G-17, which requires dealers to deal fairly with all persons and prohibits deceptive, dishonest, or unfair practices. A longstanding interpretation of Rule G-17 is that a dealer transacting with a customer[8] must ensure that the customer is informed of all material facts concerning the transaction, including a complete description of the security.[9] Disclosure of material facts to a customer under Rule G-17 may be made orally or in writing, but must be made at or prior to the time of trade. In general, a fact is considered "material" if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor.[10]

As applied to customer transactions in insured municipal securities, the disclosures required under Rule G-17 include a description of the securities and identification of any bond insurance as well as material facts that relate to the credit rating of the issue. The recent MSRB

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7 *See* Bond Insurance Ratings – Application of MSRB Rules, MSRB Notice 2008-04 (January 22, 2008); *See* Application of MSRB Rules to Transactions in Auction Rate Securities, MSRB Notice 2008-09 (February 19, 2008).

8 The word "customer" follows the definition in MSRB Rule D-9, which states that a "customer" is any person other than a dealer acting in its capacity as such or an issuer in transactions involving the sale by the issuer of a new issue of its securities.

9 *See, e.g.*, Notice Concerning Disclosure of Call Information to Customers of Municipal Securities (March 4, 1986), MSRB Manual (CCH) para. 3591.

10 *See, e.g.,* Basic v. Levinson, 485 U.S. 224 (1988).

notices served to remind dealers that disclosures required under Rule G-17 also may include material facts about the credit enhancement applicable to the issue.

MSRB guidance also reminded dealers that, in order to ensure all required disclosures are made under Rule G-17, a dealer must take into consideration information on underlying credit ratings[11] that is available in established industry sources (or information otherwise known to the dealer) and must incorporate such information when determining the material facts to be disclosed about the transaction.[12] The underlying rating (or the lack of an underlying rating)[13] may be relevant to a transaction when the credit rating of the bond insurer is downgraded or is the subject of information from the rating agency about a potential rating action with respect to the insurance company.

11 In addition to the actual credit rating of a municipal issue, "underlying" credit ratings are assigned by rating agencies to some municipal securities issues. An underlying credit rating is assigned to reflect the credit quality of an issue independent of credit enhancements such as bond insurance.

12 *See, e.g.*, Interpretive Notice Regarding Rule G-17, on Disclosure of Material Facts, MSRB Notice (March 25, 2002) (hereinafter "March 2002 Notice"). The March 2002 Notice clarified that, in addition to the requirement to disclose material facts about a transaction of which the dealer is specifically aware, the dealer is responsible for disclosing any material fact that has been made available through sources such as the NRMSIR system, the Municipal Securities Information Library® (MSIL®) system, RTRS, rating agency reports and other sources of information relating to the municipal securities transaction generally used by dealers that effect transactions in the type of municipal securities at issue (collectively, "established industry sources"). The "NRMSIR system" refers to the disclosure dissemination system adopted by the SEC in SEC Rule 15c2-12.

13 The lack of a rating for a municipal issue does not necessarily imply that the credit quality of such an issue is inferior, but is information that should be taken into account when accessing material facts about a transaction in the security.

The MSRB is aware that Auction Rate Securities are often sold to individual investors, who may not have the same sophistication as institutional customers in understanding the features of complex securities. For this reason, the MSRB reminded dealers that it is particularly important for dealers to focus attention on the application of MSRB investor protection rules when effecting transactions in ARSs.

Dealers were reminded that the duty to disclose material facts to a customer in an Auction Rate Securities transaction includes the duty to give a complete description of the security, including features of the auction process that likely would be considered significant by a reasonable investor. Given the variety and complexity of Auction Rate Securities, there are a number of facts that may fall within this duty to disclose, including the duration of the interest rate reset period, information on how the "all hold" and maximum rates are determined, and other features of the security found in the official documents of the issue.[14] In light of recent events, it may be a material fact for an investor that an Auction Rate Security recently was subject to a failed auction. Of course, this does not represent an exhaustive list of facts that a dealer must consider as potentially material, since this may vary with individual securities and transactions.

The MSRB advised dealers to carefully focus on the application of MSRB Rule G-19 on the suitability of recommendations when making recommendations to customers in Auction Rate Securities. Rule G-19 provides that a dealer must consider the nature of the security as well as

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[14] If the maximum rate is a formula linked to a particular securities market indicator, such as the London Interbank Offered Rate (LIBOR), the dealer's disclosure obligations may extend to a description of the material facts concerning the market indicator, as they relate to the Auction Rate Security.

the customer's financial status, tax status and investment objectives, based upon the facts disclosed by or otherwise known about the customer when making recommendations to customers. The dealer then must have reasonable grounds for believing that the recommendation is suitable for that customer.[15] Thus, among other factors, a dealer must consider both the liquidity characteristics of an Auction Rate Security and the customer's need for a liquid investment when making a suitability determination involving Auction Rate Securities.

The MSRB has also worked closely with the SEC to increase transparency in the ARS market and expects to release a notice requesting public comment on the types of information that investors and industry participants may find beneficial.

C. Establishment of EMMA

Consistent with the MSRB's long-standing policy to improve the flow of information in the municipal securities market, the MSRB has been diligently working to establish the Electronic Municipal Market Access system ("EMMA"), with an expected rollout of Summer of 2008. EMMA will be designed to serve as a comprehensive centralized source for primary market and continuing disclosure documents and transaction pricing data for the municipal securities market. EMMA will make such documents and information available on its free publicly accessible Internet website (the "EMMA portal") in a manner specifically tailored to retail investors. The EMMA portal will provide an easily navigable integrated display of

15 In the case when a low maximum rate is set for failed auctions, there may be a high likelihood for continued failed auctions. In this case, dealers were reminded to consider the non-auction secondary market prices when recommending to a customer whether to purchase the Auction Rate Security through an auction or in the non-auction secondary market.

available primary market disclosures, secondary market disclosures and transaction pricing data for a specific security, incorporating detailed user help and investor education information designed to make the information easily understood by retail investors and offering a menu of optional alerts to provide users with notice of updates to posted information. Primary market disclosures, secondary market disclosures and transaction pricing data displayed on the public access portal also will be made available by the MSRB by subscription on terms that promote the broad dissemination of such documents and data throughout the marketplace.

When fully operational, EMMA will consist of three integrated information services:

- a primary market disclosure service for the receipt and dissemination of official statements ("OSs"), preliminary official statements ("POSs"), any amendments thereto, and related documents and information received by the MSRB from dealers acting as underwriters, their agents and other municipal market participants pursuant to MSRB rules and on a voluntary basis;

- a transparency service for the dissemination of real-time transaction price information and related information collected from dealers by the MSRB's RTRS pursuant to MSRB rules; and

- a continuing disclosure service for the electronic receipt and dissemination of continuing disclosure documents, any amendments thereto, and related documents and information to be received by the MSRB from issuers, obligated persons, their agents and other municipal market participants pursuant to continuing disclosure undertakings pursuant to Exchange Act Rule 15c2-12, any other continuing disclosure documents and information provided on a voluntary basis, and advance refunding documents ("ARDs"), amendments thereto, and related information received from underwriters and their agents.

The primary market and continuing disclosure documents and transaction pricing data for the municipal securities market freely available through EMMA will allow for more timely and accurate disclosures, valuations and information regarding municipal securities, which will benefit all industry stakeholders.

CONCLUSION

The MSRB will continue to monitor the municipal securities market as it further evolves to include more diversified and complex new structures and techniques, and as dealers, issuers, investors and others increasingly rely on new technologies. As it has in the past, the Board will remain vigilant and will not hesitate to modify its rules, publish guidance and develop information systems to deal with the ever-changing marketplace.

Government Finance Officers Association
National Association of Counties
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Treasurers
National League of Cities
U.S. Conference of Mayors

March 11, 2008

The Honorable Paul E. Kanjorski
Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2188 Rayburn House Office Building
Washington, DC 20510

Dear Chairman Kanjorski:

Our organizations thank the members of the Committee for your concerns about the current disruptions in the municipal bond marketplace. We appreciate this opportunity to comment on these conditions and their effect on state and local government operations.

State and local governments are suffering the consequences of the bursting of the subprime housing bubble, and the subsequent loss of liquidity and market disruptions in the municipal bond market. As a result, increased bond issuance costs and debt service on municipal bonds are being borne by American taxpayers.

We appreciate the Chairman's statement in announcing this hearing. His remarks make clear the minimal credit risk of municipal debt and summarize well the problems confronting state and local governments. To quote the Chairman:

> "It is now clear that state and local governments have become the innocent victims of the credit crisis and they are being unfairly punished for market conditions far beyond their control. This committee will place a very high priority on this issue," said Chairman Frank. "Cities and states may now be forced to pull back or significantly decrease infrastructure investments and other vital services, which is the wrong thing economically and will leave shortfalls in this critical area . . . Municipal bonds are among the safest—second only to US Treasuries—in terms of losses to investors, and it will be of particular concern to this committee that they not be punished by the worsening credit market and overall economic picture."

Our principal concern is for the taxpayers, who ultimately bear the burden of increased bond issuance and interest costs. These costs are rising for reasons which are completely extrinsic to events in our market.

Municipal bonds remain among the safest securities in the world, and there are no inherent, special or new problems with the securities themselves (see Exhibit One). Despite market turmoil and the increased cost of capital to states and localities, at the end of the day, investors in municipal bonds will not face losses due to defaults, as have some who have invested in the corporate securities market.

State and local governments issue debt to finance public capital improvements and other projects, including new and updated infrastructure facilities. The nation has a vital interest in maintaining appropriate public infrastructure and services to sustain the existing economy and to facilitate economic growth. For example, as the National Surface Transportation Policy and Revenue Study Commission reported last month, $255 billion is needed annually to meet our country's infrastructure needs. A majority of that funding will need to be provided by state and local governments, which require access to the debt market to finance these expenditures.

The recent disruption in the municipal bond market is causing many governments to face new financing costs and expenditures which were not anticipated in their current budgets. This places additional pressure on state and local governments at a time when our budgets are strained, when transfers from the federal government are diminished, and when the needs of our citizens, particularly our most vulnerable constituents, are increased. Almost half the states already report declines in their revenues due to the housing sector slump, and according to some estimates, nineteen states will experience a collective shortfall in projected revenues of $14.6 billion in FY08, and twenty-two states project a collective shortfall of $32.3 billion in FY09.[1]

To continue to revitalize existing infrastructure and to undertake new projects, and to provide public services – especially those which can mitigate the impact of an economic slowdown or recession – states and local governments must be able to access the credit markets in an efficient, prudent, and cost-effective manner.

Concurrent with the downgrading of monoline bond insurers, hundreds of thousands of municipal bond issues have been downgraded, solely because the bond issue is wrapped in insurance. Almost half of the municipal bond market is insured. It is important to note that the insurance may not have been purchased by the issuer, but rather by the underwriter in a competitive sale or in the secondary market. Thus, some issuers may not even be aware that their issue is insured. Compounding this problem, Wall Street, reeling from the credit crisis as a whole, is experiencing constraints on the capital available to support the municipal securities market.

Many issuers obtain bond insurance as an enhancement to their own credit rating. There is growing concern that, without a solid and stable bond insurance platform, some issuers will not have broad market access and will be unable to retain current investors and attract new ones. This dampens bond pricing and raises interest costs. In addition, smaller issuers who are not rated, or whose bonds are not guaranteed by a regular tax or revenue stream (e.g., hospitals), will face even greater difficulties in obtaining bond insurance or other credit enhancements as the costs of these enhancements increase.

A significant amount of current market unrest lies with short-term variable-rate instruments – a consequence directly attributable to the problems faced by municipal bond insurers who also insured other products (e.g., insured asset-backed securities), and the limited ability of capital to support these products.

As a case in point, consider the state of the auction-rate securities and variable-rate demand obligations markets. These are traditional, long-term securities with short-term demand features. The variable-rate demand obligations (VRDO) market sets rates on a short-term basis, which

[1] National Governors Association/National Association of State Budget Officers; *Shortfall Survey*. February 2008.

are supported by some form of liquidity. Bond holders are entitled to demand repurchase of their bonds at par, plus accrued interest, mostly on a daily or weekly basis. Auction-rate securities have no liquidity facility feature; the rates are set at the lowest interest rate at which buyers are willing to purchase all of the potential seller's securities.[2]

When governments first entered the auction-rate and VDRO markets, their main purpose was to save taxpayers' money by securing short-term rates on long-term bonds, and to diversify their debt portfolio by adding variable-rate exposure. For many years, the markets for auction-rate securities and variable-rate demand obligations have been stable, accessible, and liquid. In theory, the average of the short-term rates over the lifetime of the bonds plus fees should be less than issuing fixed-rate debt.[3] This may no longer be the case.

In the current market environment auction rate securities – with interest rates reset on a daily, 7-day, 28-day, 35-day, or longer-term basis – do not have enough investors to purchase the securities that holders of these securities want to sell. The end result is a failed auction, in which case a maximum rate takes effect, pursuant to the terms of the bond indenture. Until recently, a failed auction was an extremely rare event.[4] Today, many governments and obligors are experiencing very high auction rates, due to these failures.

Again, there is no problem with the securities' underlying credit, or with the governments themselves. The negative psychology currently pervading the markets, as well as the lack of liquidity, are responsible for the present volatility, not because states and municipalities are in danger of default. In addition, bankers and hedge funds are liquidating their floating-rate tender-option bond programs which contain insured underlying securities, creating still more liquidity demands on the market. With a tender-option bond, hedge funds, banks and others raise money through short-term borrowings to fund purchase of long-term municipal bonds. Investors, fearing losses, aren't buying, causing bonds worth billions of dollars are piling up at banks and brokerage firms.

Government issuers – and thus taxpayers – are paying the price for the municipal bond market decline in the overall market downturn. Exacerbating the problem are the fees charged by professionals to "unwind" these transactions and convert auction-rate securities into other instruments. Bloomberg News reports that governments are spending over $1 billion in fees as a result of the collapse of the auction-rate securities market.[5] These fees are being paid to the same broker-dealers who have caused the auction failures by refusing to bid on them, in addition to the fees paid for bond counsel and legal fees, financial advisors, swap termination fees, insurance termination fees, and other liquidity providers.

Because many governments are just now being able to convert their auction-rate and variable-rate securities into fixed or less volatile instruments, the extent of these costs are still unknown. As governments complete these conversions, we will provide the Committee with additional information.

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[2] The Bond Market Association, *Fundamentals of Municipal Bonds*. Wiley Press, 2002.

[3] Bloomberg News, 2/28/08. *New York Faces Double Whammy as Swaps Compound Failed Auctions*. Michael Quint.

[4] Bloomberg News, 2/22/08. *Florida Schools, California Convert Auction-Rate Debt*. Jeremy Cooke. "Between 1984 and 2007, only 44 auction rate securities failed. On February 22 alone, 258 out of 386 auctions failed."

[5] Bloomberg News, 3/6/08. *As Housing Suffers Failed Auctions...*, Darrell Preston.

Many in the public finance arena have speculated that increased costs for short-term variable-rate products will spill over to the long-term fixed-rate market, at least in the near future. This means that many issuers may delay capital finance projects, or will pay additional interest costs. While investors seem to be bullish on munis, their appetite is being whetted by the favorable interest rate environment for investors, not for issuers. Indeed, as Bloomberg reported on March 7: "Debt sold by states and local governments suffered the worst monthly slump in at least nineteen years in February, and yields on tax-exempt securities rose to record highs relative to taxable Treasuries."[6]

Possible Solutions

While a "silver bullet" capable of calming the turbulent marketplace is unlikely to appear, a variety of legislative, regulatory, and marketplace changes could ease the pressures on state and local government issuers. The most important way in which the federal government and the marketplace can assist both the municipal bond market and state and local governments is by encouraging investor confidence in the municipal bond market, which would bring more buyers – and resulting liquidity -- to the municipal bond table. We also believe that Congress, regulators, and the marketplace can more concretely help state and local governments. Below is a list of possible solutions that are worth discussing, both within and outside of the Committee's jurisdiction.

Bond Insurance Regulations

State insurance commissioners are considering regulatory changes affecting the bond insurance industry. In addition, bond insurers themselves are looking for ways to secure capital in order to maintain or reclaim their Triple-A rating. The recapitalization of the bond insurers is extremely important in order to stabilize the entire market. All options should be reviewed, including the possibility of the federal government providing a backstop to the bond insurers.

Raise the Bank-Qualified Debt Limit from the Current $10 Million Level to $30 Million, and Index for Inflation Thereafter

Banks have traditionally been significant purchasers of tax-exempt debt, particularly for smaller governments. Since 1986, banks have been able to deduct eighty percent of the costs of purchasing and carrying bonds issued by governments whose annual bond issuance does not exceed $10 million. This adds liquidity to the market and has helped many small issuers place their bonds with community banks, avoiding many of the fees associated with underwriting, and selling these bonds on the open market. However, since 1986, an increasing number of governments have regularly experienced capital needs in excess of $10 million. As a result, governments must often defer projects in order to comply with this unreasonable limit, since inflation and infrastructure costs since 1986 have made the $10 million limit woefully inadequate. Congress has never acted to increase the $10 million limit, nor indexed it to inflation. If adjusted for inflation, the $10 million in 1986 dollars would be worth $19.26 million today.[7] Especially in the current market environment, "bank qualified" financing is an attractive and vastly more efficient debt-issuance vehicle for these smaller entities. If Congress raised the limit to $30 million, smaller governments would be much better able to finance their capital needs.

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[6] Bloomberg, 3/7/8. *Munis Rally as Highest Yields Since 2004 Lure Buyers.* Michael Quint
[7] Bureau of Labor Statistics, Inflation Calculator.

Similarly, few statewide issuers of debt, including debt for non-profit education and health care, are able to issue any bank-qualified debt because the exemption is applied to the issuer, not at the borrower or beneficiary level. We recommend that the law be changed to provide a "small borrower" exemption instead of a "small issuer" exemption.

Increase Private Sector Investment Incentives for Purchasing Tax-Exempt Bonds

Municipal issuers fear that, in the future, banks and other counterparties will seek to insulate themselves from potential credit and valuation risks associated with municipal securities. There are already significant limitations on the amount of bonds which banks, corporations, and property and casualty insurers may hold. The *de minimis* rule allows corporations (other than banks or securities firms) to deduct interest expense, as long as their tax-exempt assets are 2 percent or less of total assets. This ruling means that money cannot be borrowed in order to invest in tax-exempt securities, and thus can be well "traced" per IRS regulations. We would argue that 2 percent is excessively low. If the percentage of allowable tax-exempt assets were increased, corporations would be able to legitimately invest more in bonds, without running afoul of IRS Revenue Procedure 72-18.

In addition, property and casualty insurers (P&Cs) are the single largest corporate investor cateagory in municipal securities holding thirteen percent of the bonds outstanding. However, they are limited in their ability to invest in municipal bonds without penalty. Their holdings of municipal securities are funded entirely from loss reserves, not through borrowing. P&Cs are currently permitted a deduction for contributions to loss reserves, reduced by an amount equal to fifteen percent of their "proration income" which includes tax-exempt bond interest. Thus, P&C's lose fifteen cents on every dollar of municipal securities interest that they earn. This creates a disincentive for P&Cs to purchase municipal securities. If the pro-rata restrictions were lifted, allowing P&Cs to purchase more munis, interest rates could improve, and P&Cs would be more inclined to purchase long-term, fixed-rate municipal bonds.

Allow for an Additional Advance Refunding, On a Limited Basis

Following the example set in response to the 9/11 and Katrina disasters, Congress could enact similar legislation to allow issuers an additional advance refunding if certain criteria are met. The parameters for additional advance refunding might stipulate that a government must already have used its advance refunding opportunity prior to the current market crisis, and that an additional advance refunding could only relate to debt during a certain period of time.

Advance refunding permits refunding an outstanding bond issue before the bonds become due or are callable (usually after 10 years). Under current law, issuers have only one opportunity during the lifetime of the bond issuance to take advantage of favorable market conditions to achieve lower borrowing costs. To allow an additional advance refunding would facilitate restructuring of auction-rate securities obligations, as issuers could view the current high tax-exempt fixed rates as a temporary cost of capital.

Today, 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 governments than the auction-rate market, fixed rates are higher than in recent years. Under current regulations, when the market stabilizes and interest rates are more favorable to issuers, many governments may not be able to take advantage of the more favorable interest rates to refinance their debt, because they have used their advance refunding prior to this crisis.

Permit Federal Home Loan Banks to Offer Letters of Credit

Some tax-exempt bond issuers secure Letters of Credit (LOC) from strongly accredited financial institutions to achieve lower borrowing costs than would be possible if they offered securities through their own credit. (Letters of Credit can be particularly helpful as a source of market access for small issuers who do not have high 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 authorized to offer this guarantee to its member banks, who therefore cannot offer a Triple-A Letter of Credit to issuers. Pending legislation, H.R. 2091 and S.1963, would permit Federal Home Loan Banks to offer Letters of Credit, allowing for more options in the guarantor market. This would be beneficial for issuers and investors alike. We appreciate the support of Chairman Frank and other House Financial Services Committee members who have co-sponsored this legislation.

Allow Governments to Bid on Their Own Auction-Rate Debt on a Temporary Basis

Most governments are currently prohibited from bidding on their own auction-rate securities. Chairman Frank, Chairman Schumer, and Congressman Bachus, as well as a group of California and Massachusetts hospitals and the Securities Industry and Financial Markets Association have called upon the SEC to allow governments to be able to bid on their own auction-rate debt. The current turmoil in the auction-rate securities market has forced some governments to pay exorbitant interest rates on their short-term debt due to a lack of buyers. It would be most helpful if state and local governments – operating under specific conditions addressing the SEC's concerns regarding market manipulation – were allowed to bid on their own auction-rate bonds to save taxpayers' money. Additionally, clarification from the Department of the Treasury on the applicable tax regulations may also be helpful.

Corporate Equivalency Ratings

The three major credit ratings agencies have operated two separate but not comparable ratings systems – one for corporate securities and one for municipal securities. Although municipal issuers have shown historical default rates that are a fraction of similarly or more highly rated corporate bonds, safe muni ratings remain widely dispersed across the investment grade municipal scale. Traditionally, issuers have been forced to rely on the bond insurers (who are rated Triple-A on the corporate rating scale) to satisfy investor regulatory requirements (like SEC Rule 2a-7) and on growing demand from both unsophisticated retail investors (who may not understand the difference between rating scales) and institutional buyers. As was noted during the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee hearing on February 14, *The State of the Bond Insurance Industry*, and again in a letter released on March 4 by the California Treasurer, Bill Lockyer, this double set of standards has hurt issuers, who may have paid unnecessary fees for bond insurance premiums. This double standard adds to the hardships which issuers face in the current marketplace. The creation of an equitable credit rating system would help issuers and investors alike.

SEC Rule 2a-7

Despite the well-known differences between the corporate and municipal ratings scales, the SEC treats the two scales as equivalents under SEC Rule 2a-7, which governs qualified investments in money market mutual funds. This rule effectively requires that money market mutual funds hold investments rated AA or better. As noted above, the standards used to define an AA corporate security are different from the standards used for an 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 are the equivalent 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.

Regulatory Guidance

The Treasury Department released very helpful guidance on reissuance rules for auction-rate securities and variable-rate demand bonds on February 20 of this year. This guidance allows many issuers to convert out of auction-rate securities into different products, such as a fixed-rate bonds, without having to "reissue" the bonds. Governments are seeking this opportunity to convert, to save taxpayer's money without the costly reissuance process, and to limit their exposure in a volatile market. Tax counsel have questions regarding these issues, and we encourage the Treasury Department to continue to respond to their questions and distribute the answers as widely as possible.

Regulatory Oversight

The SEC should continue in its responsibility to maintain fair, orderly and efficient markets. It should review the factors contributing to recent market disruptions, and recommend market instruments which would not place new and unnecessary burdens upon municipal bond issuers.

Student Loans

A very large volume of student loans have been financed through auction-rate securities, and the increased costs of these securities are placing enormous pressure on student loan agencies. Two state student loan agencies have already said that the pressure of added interest costs means that they will not be able to make new loans. College students across the country depend on loans to finance their education, and our country's economic growth depends on the ideas and talents of college graduates. We encourage the Department of Education to work with state student loan agencies quickly, so that they will be able to make loans before the new school year starts.

Federal Reserve Bank Policies

There should be review of policies that would allow the Federal Reserve to purchase auction-rate securities, adding liquidity and price stability to the market during these extraordinary times.

Conclusion

State and local governments face a plethora of challenges in the current market. For many, converting out of auction-rate and variable-rate demand securities is a costly and time-consuming, yet necessary, task. Continued market volatility is causing governments to review their plans for various projects, either scaling back or not starting them. The end result is that taxpayers are paying the price, due to conditions beyond state and local government's control.

But as Andrew Feltus of the Pioneer High Yield Fund noted last week: "These are rock-solid credits."[8] The underlying strength of the municipal bond market cannot be overemphasized.

We understand that markets and market corrections must take their course. But, thousands of state and local governments and millions of their citizens are paying the price for the poor judgments of others in separate markets. We welcome the opportunity to work with the Committee, the Congress, and regulatory bodies to find solutions which would mitigate the harms that governments are facing, and prevent this type of turmoil from happening again in the future.

Sincerely,

Government Finance Officers Association, Susan Gaffney, 202-393-8020
National Association of Counties, Ed Rosado, 202-661-8809
National Association of State Auditors, Comptrollers & Treasurers, Cornelia Chebinou, 202-624-5451
National Association of State Treasurers, Dan DeSimone, 202-624-8595
National League of Cities, Carolyn Coleman, 202-626-3023
U.S. Conference of Mayors, Larry Jones, 202-861-6709

[8] Reuters, 3/6/08. *Big Names are Hopping into Munis, Should You?*

Exhibit One: Courtesy of Municipal Market Advisors

Rating Categories	Cumulative Historic Default Rates			
	Moody's		S&P	
	Munis	Corps	Munis	Corps
Aaa/AAA	0.00%	0.52%	0.00%	0.60%
Aa/AA	0.06%	0.52%	0.00%	1.50%
A/A	0.03%	1.29%	0.23%	2.91%
Baa/BBB	0.13%	4.64%	0.32%	10.29%
Ba/BB	2.65%	19.12%	1.74%	29.93%
B/B	11.86%	43.34%	8.48%	53.72%
Caa-C/CCC-C	16.58%	69.18%	44.81%	69.19%
Investment Grade	0.07%	2.09%	0.20%	4.14%
Non-Invest Grade	4.29%	31.37%	7.37%	42.35%
All	0.10%	9.70%	0.29%	12.98%

Source: Moody's and S&P

Moody's: Average cumulative 10-Year default rate between 1970-2006
S&P Municipals: Average cumulative 19-year default rate between 1986-2006
S&P Corporates: Average cumulative 15-year default rate between 1981-2005

Congress of the United States

Washington, DC 20515

February 28, 2008

The Honorable Charles B. Rangel
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Jim McCrery
Ranking Member, Committee on Ways and Means
U.S. House of Representatives
1106 Longworth House Office Building
Washington, DC 20515

Dear Chairman Rangel and Ranking Member McCrery:

In light of the ongoing problems in our capital markets that are affecting the ability of States, cities, towns, authorities, and other entities to issue bonds to construct roads, build and renovate schools and hospitals, repair bridges, fund college loans, and ease budgeting constraints, we write to request that the Ways and Means Committee schedule a markup of H.R. 2091 as soon as possible. This legislation would amend the Internal Revenue Code of 1986 to allow bonds with credit enhancement by the Federal Home Loan Banks to be treated as tax-exempt bonds.

As you may already know, the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing on February 14 to examine the problems facing the bond insurance industry. The Financial Services Committee also has plans to convene another hearing soon to further explore the impact on State and local governments and other municipal authorities of the current credit crunch, including the consequences of the upheaval currently affecting the bond insurance industry.

In recent years, many bond insurers moved from insuring the timely payment of principal and interest on municipal bonds into insuring structured finance products, including those backed by subprime mortgages. These business decisions and the decline of the value of subprime debt have now resulted in downgrades or the threat of downgrades by credit-rating agencies.

We are very concerned about the effects of these downgrades on municipalities. Municipal markets issue approximately $2.6 trillion in bonds, about one-half of which are insured. The recent downgrades could therefore cause cities and towns to make difficult decisions about whether they can afford to pay more for bond insurance, pay higher interest on bonds issued without insurance, or delay much-needed projects.

The limited availability of bond insurance has also led to hundreds of failures in the offering of auction rate securities in recent weeks. These auction breakdowns have resulted in some municipal issuers paying default penalty rates of 10 percent, 15 percent, or more on their outstanding short-term debts. For example, we learned during the Capital Markets

Subcommittee hearing that the Port Authority of New York and New Jersey has recently experienced a jump from 4 percent to 20 percent on its auction rate bonds. Media outlets have highlighted many similar situations throughout the country in recent days, as well.

During this time of economic uncertainty, we need to work together to help our local communities to lower their borrowing costs in order to move forward with important projects, provide needed services, operate more efficiently, and avoid unnecessary budget cuts. According to the testimony that we received at the Capital Markets Subcommittee hearing, the enactment of H.R. 2091 would help to bring greater stability to the municipal finance market.

Introduced by Congressmen Levin and English and now pending before the Ways and Means Committee, H.R. 2091 would amend Section 149 of the Internal Revenue Code to add the Federal Home Loan Banks to the list of entities that can credit enhance tax-exempt municipal, industrial development, and other private activity bonds. Federal Home Loan Bank letters of credit are already routinely issued through their local bank members on both taxable debt and tax-exempt housing bonds. Unfortunately, the Internal Revenue Service has ruled that the tax code does not permit the Federal Home Loan Banks to credit enhance more traditional tax-exempt bonds. H.R. 2091 would fix this problem.

Adding letters of credit from Federal Home Loan Banks as an option for municipal governments and issuers of tax-exempt bonds for charitable health care facilities and schools will create a new source of credit enhancement and help to fill a void created by the ongoing problems in the bond insurance industry. This legislation will also help to reduce the cost of taxpayers for municipal bond issues aimed at improving water treatment facilities, repairing fire stations, providing long-term care for the elderly, establishing medical clinics, and purchasing school buses, among other things. These reforms are especially important at a time when we have experienced a contraction in the credit enhancement marketplace.

In sum, the current upheaval in the credit markets and the municipal bond insurance industry has increased the need for additional sources of credit enhancement. H.R. 2091 would allow the Federal Home Loan Banks to provide credit enhancements that will reduce the cost of municipal financing and charitable undertakings by raising the rating of the debt. We therefore request that you work to advance this bill through the legislative process and stand ready to support you in these efforts.

Sincerely,

Paul E. Kanjorski
Member of Congress

Deborah Pryce
Member of Congress

Barney Frank
Member of Congress

Spencer Bachus
Member of Congress

Michael N. Castle
Member of Congress

William Lacy Clay
Member of Congress

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Ginny Brown-Waite
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Jim Gerlach
Member of Congress

Steven C. LaTourette
Member of Congress

cc: The Honorable Sander M. Levin
Member of Congress

The Honorable Phil English
Member of Congress

SPENCER BACHUS
6TH DISTRICT, ALABAMA

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January 23, 2007

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-2000

Dear Chairman Cox,

It was a pleasure to speak with you and your staff in my office on January 5. As we discussed during that meeting, I am forwarding you materials about municipal bonded indebtedness in Jefferson County, Alabama. This matter has been of interest to me for a number of years during which I have gathered this file of information about swaps in general and Jefferson County in particular.

Included in these materials is a 1997 letter sent by a local commissioner to then-SEC Chairman Arthur Levitt. Since this letter is now almost ten years old and there have been two chairmen in the interim, I wanted to bring it specifically to your attention.

The SEC has initiated a swaps investigation into transactions that occurred in Jefferson County in the 1990's. Although it is not certain that false representations were made in those transactions, my view is that the cost of water and sewer services in the county has risen as a result of these swaps.

Therefore, this is an issue of significant concern to my constituents and to me. While a primary mandate of the SEC is to protect investors and the integrity of capital markets, I hope damages to the taxpayers and utility rate payers will also be considered as this case moves forward. Penalties are certainly appropriate to send a message to the industry, but disgorgement is also suitable in a case where the damages may not have been to investors, but to taxpayers.

Thank you for your consideration. I look forward to your response and to working with you throughout the 110th Congress. Please have your staff contact Kevin Edgar or Michael Borden if they have any questions.

Sincerely,

Spencer Bachus
Member of Congress

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