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Statement of the Regional Bond Dealers Association

Committee on Appropriations
United States House of Representatives

Hearing on the Economic Recovery Bill and State and Local Governments

December 11, 2008

The Regional Bond Dealers Association (RBDA) appreciates the opportunity to submit this statement for the record in connection with the hearing of the Committee on Appropriations on the economic recovery bill and state and local governments. The RBDA is the association of regional securities firms active in the U.S. bond markets. The majority of RBDA's member firms are active participants in the municipal bond market, underwriting and trading the bonds of state and local governments.

States and localities have suffered as a result of the global credit crisis, and many state and local governments are facing significant fiscal constraints. Tax revenues collected by state and local governments have fallen as a result of the recession, and demands for public services have risen. Borrowing costs for states and localities have gone up sharply, and many investment projects have been postponed because governments are unwilling to lock in interest rates at the current unfavorable terms. These issues are vital, and we commend Chairman Obey and Ranking Member Lewis for conducting this timely hearing. State and local governments need assistance, and while direct cash transfers from the federal government to states and localities would help significantly, Congress and the administration should also provide other forms of assistance to help revive debt financing for state and local investment projects. In particular, we urge that the following steps be taken to help address acute problems in the municipal bond market:

- Congress should enact H.R. 6333, the Municipal Bond Market Support Act of 2008, and its companion bill in the Senate, S. 3518.

- The Department of the Treasury should use its authority provided in the Emergency Economic Stabilization Act (EESA) (PL 110-343) to provide liquidity facilities to support variable rate debt issued by state and local governments.

Background

The municipal bond market represents an outstanding example of a partnership among the federal government, state and local governments and the private sector in financing investment in our nation's vital infrastructure. States and localities borrow from private investors in the capital markets to finance investment in schools, roads, airports, public and charitable hospitals, water and sewer systems, colleges and universities, waste disposal facilities, public buildings, parks and a variety of other public works projects. The federal government assists in financing these projects by exempting most municipal bond interest paid to investors from federal income tax. This results in significantly lower borrowing costs for states and localities than if municipal bond interest were taxable. The federal tax exemption on municipal bond interest saves states and localities hundreds of billions of dollars every year in interest expense and results in significantly more investment in public infrastructure than if municipal bond interest were taxable and is one of the most important forms of federal investment in public works.

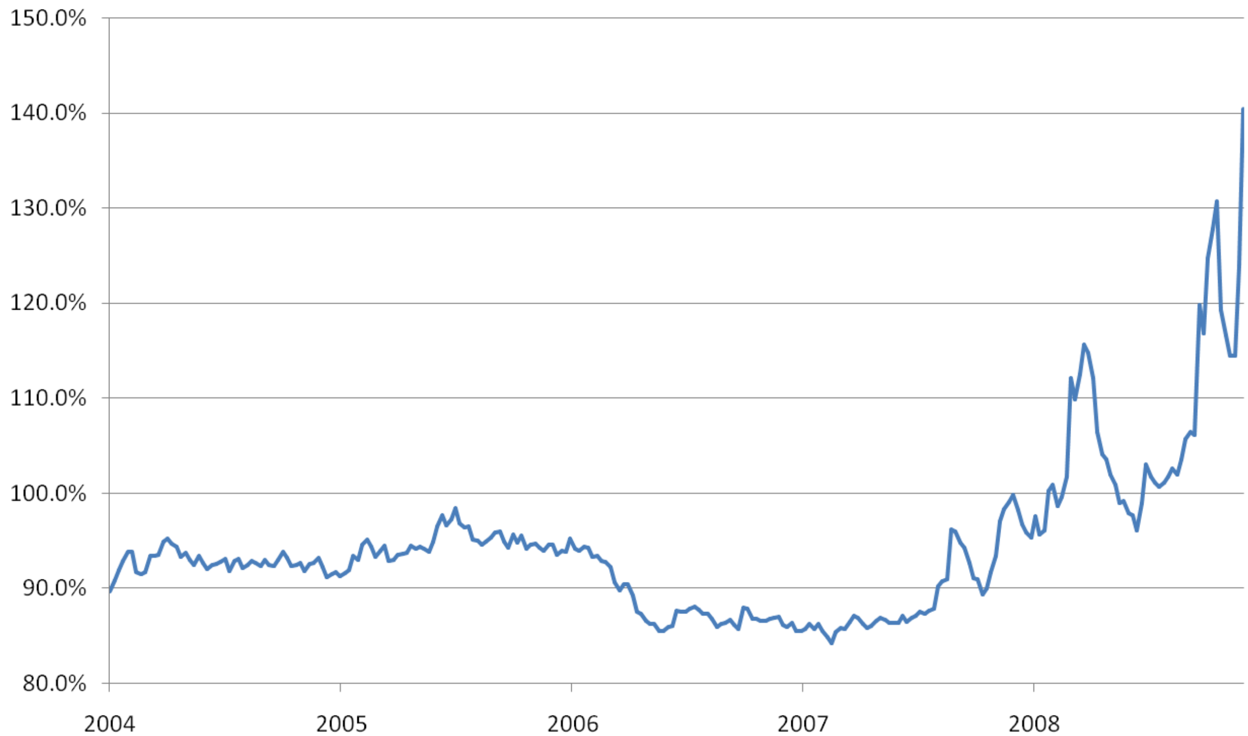

Figure 1. 20-year AA-rated municipal bond yields to 20-year constant maturity Treasury yields. Data source: Federal Reserve.

The municipal bond market has been acutely affected by the broader crisis in the world's credit markets. Throughout 2008 state and local borrowing rates have risen significantly. Figure 1 above illustrates the ratio of yields, or interest rates, on state and local borrowing in relation to yields on Treasury securities. This ratio is an important benchmark indicator of the health of the municipal market. The lower the ratio, the cheaper it is for states and localities to borrow. Historically, this ratio has hovered around 85-90 percent. Today, the ratio is at around 140 percent. (A higher ratio indicates weaker municipal market conditions.)

The spike in the municipal-Treasury yield ratio is in part attributable to lower Treasury yields and in part to higher municipal bond yields. Figure 2 below illustrates the absolute yields on

Treasury securities and municipal bonds and demonstrates that while yields on Treasuries have fallen, yields on municipals have risen. This trend represents a broad "flight to quality" among bond investors globally. Investors are shunning products that carry credit risk—the risk of loss associated with a debt default—in favor of credit risk-free Treasury securities.

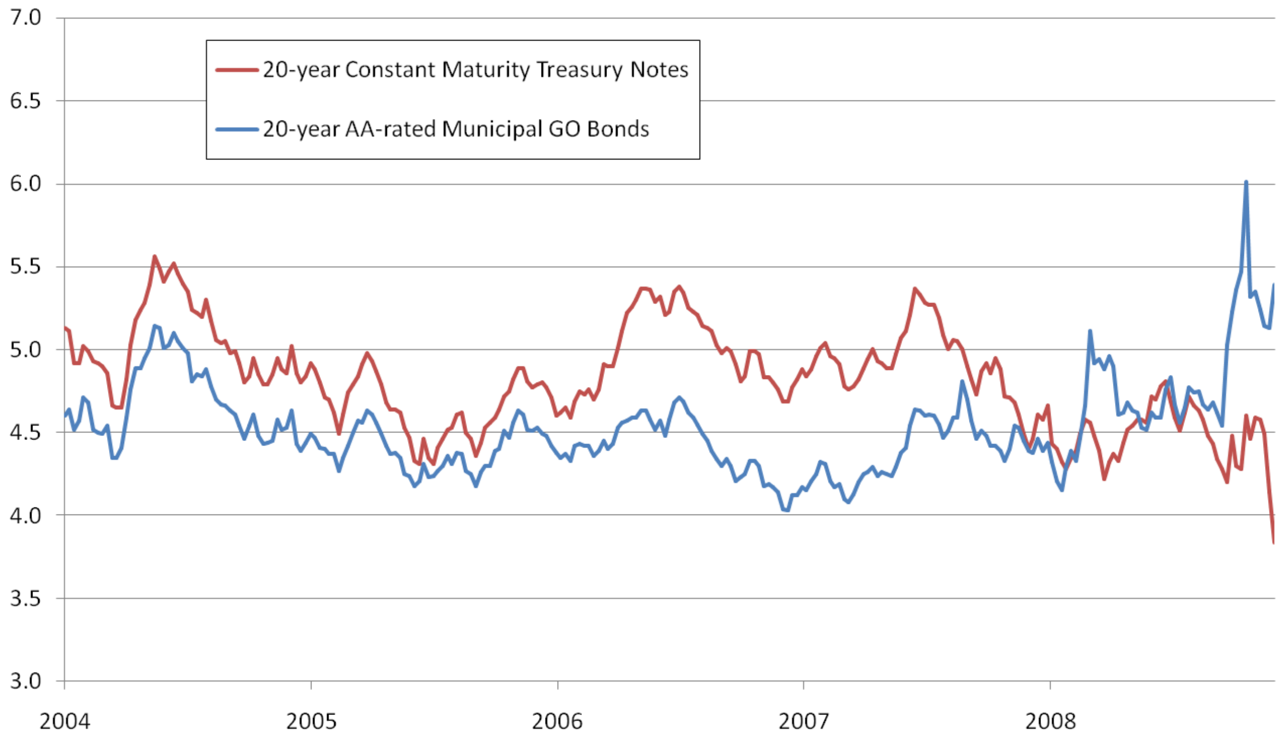

Figure 2. Treasury and municipal bond yields. Data source: Federal Reserve.

The retreat from the municipal bond market among investors is in some important respects without a fundamental basis. The historic default rate among municipal bonds issued for governmental purposes—either general obligation bonds backed by a state or local full faith and credit pledge or revenue bonds issued to finance traditional governmental services—is close to zero. After bonds backed by the federal government, municipal bonds are the safest investment in the U.S. capital markets. The withdrawal from the municipal bond market by key groups of institutional investors reflects two trends. First, certain investors that previously were important marginal buyers of municipal bonds, like hedge funds, have been forced to deleverage, eliminating an important source of demand. Second, investors in general have been shunning any assets that carry the risk of default, no matter how remote.

As a result of the downturn in the municipal market, state and local governments have postponed a significant number of financings because of a reluctance to borrow at unfavorable terms or an inability to access the market altogether. By some estimates as much as $100 billion of state and local financing that would have come to market were conditions more favorable have been postponed or cancelled. As an anecdotal indicator, the Port Authority of New York and New Jersey, a prominent municipal bond issuer, tried to sell $300 million of bonds by competitive auction on December 3, 2008. The offering was cancelled when the Port Authority received no bids for its bonds.[1]

Restoring institutional demand for state and local bonds

One of the primary factors affecting negative conditions in the municipal market has been the loss of demand for municipal bonds among institutional investors like property and casualty insurance companies, hedge funds, tender option bond programs (a type of leveraged municipal investment fund) and others. For reasons outlined above, these investors have significantly reduced their activity in the municipal market, resulting in weakened market conditions.

One source of institutional demand that has been largely absent from the municipal bond market for the last 22 years has been commercial banks. Before 1986 commercial banks were active buyers of municipal bonds. However, provisions of the tax reform act of 1986 imposed negative federal income tax consequences on banks, savings institutions and securities firms that earn tax-exempt income. In particular, before 1986, the tax code imposed a 20 percent pro rata interest expense disallowance for banks that earned tax-exempt interest from municipal bonds. The 1986 tax act raised this disallowance to 100 percent for most tax-exempt bonds. The only exceptions were bonds held at the time the 1986 law was enacted and bonds issued by states and localities that sell $10 million or less of bonds annually, known as "bank qualified" bonds.

As a result of the 1986 tax act, banks divested much of their municipal bond portfolios. Banks and securities firms went from holding $255 billion of municipal bonds, or around 30 percent of total outstanding volume, at the end of 1985 to just $107 billion, or eight percent of outstanding volume, at the end of 1996. More recently, total investment by banks had risen to $255 billion of municipals by the end of last year, but that represented just ten percent of the total $2.6 trillion outstanding.[2] The vast majority of bank investment in municipals is concentrated in bank qualified bonds.

To gauge the importance of bank investment in the municipal market, it is useful to examine the effect of bank purchases on the bonds of bank qualified issuers. Generally, interest rates paid by issuers of bank qualified bonds are 25-40 basis points (0.25-0.40 percentage points) lower than comparable bonds that are not bank qualified. This benefit is entirely attributable to increased demand for these bonds among banks. Being a bank qualified issuer also reduces transaction costs associated with bond issuance, since it is often possible to place an entire bond issue with a bank without offering the bonds publicly.

The $10 million bank qualified issuance limit established in 1986 has not been increased or indexed for inflation in the last 22 years. In real terms, the $10 million limit is worth approximately half of what it was at the time the 1986 tax law was enacted. Also, some state and local issuers sell bonds on a "pooled" basis or they issue through financing authorities. Often the total pooled issuance volume in these cases exceeds $10 million even though the borrowing of an

[1] Maurna Desmond, "A Bond Too Far," Forbes.com, December 3, 2008.
[2] All data on bank and securities firm investment in municipal bonds are from the Federal Reserve.

individual community or other issuer is under the $10 million limit. Because the $10 million issuance test is applied at the level of the issuer, not the borrower, these bonds are not bank qualified.

The penalty on banks and securities firms associated with earning tax-exempt interest does not apply in the same way to non-financial companies. The Internal Revenue Code generally prohibits all investors from deducting the interest cost associated with borrowing to finance the purchase of tax-exempt bonds. Under tax law and regulation banks and securities firms—financial companies—that earn tax-exempt interest (other than on bank qualified bonds in the case of banks) are automatically disallowed a pro rata portion of their total interest expense deduction. Non-financial companies who earn tax-exempt interest and take an interest expense deduction must be able to trace the source of funds used to acquire its municipal bond portfolio and demonstrate that the bonds were not purchased with borrowed funds. However, a 1972 Internal Revenue Service Revenue Procedure (Rev. Proc. 72-18) in many cases permits non-financial companies to hold up to a *de minimis* two percent of their total assets in tax-exempt bonds without a loss of interest expense deduction as a simplification measure.

Bringing banks back to municipal bond market as significant investors would help restore the market to normalcy, reduce interest expenses for states and localities, and allow state and local governments to finance investment projects that would help stimulate the economy. H.R. 6333, introduced earlier this year by Rep. Barney Frank and cosponsored by Reps. Michael Capuano, Emanuel Cleaver, Paul Kanjorski and Richard Neal (and its companion bill in the Senate, S. 3518) is designed to address the loss of institutional demand for municipal bonds by removing some of the tax code barriers to bank investment in tax-exempt municipal bonds.

H.R. 6333 would raise the annual bank qualified issuance limit from $10 million to $30 million, index that amount annually for inflation, and establish for banks a statutory two-percent *de minimis* rule similar to the one included in Rev. Proc. 72-18 for non-financial companies.

By bringing banks back to the municipal bond market and increasing demand for municipal bonds, H.R. 6333 would directly address problems experienced by states and localities as a result of the credit crisis. The bill would establish a solid base of institutional demand for municipal bonds and lower interest rates for states and localities. New investment projects ready to be built could obtain financing, and moving forward on these projects would help stimulate the economy. By eliminating barriers to bank investment in municipal bonds, H.R. 6333 would help direct a portion of the funds allocated under the EESA's Troubled Asset Relief Program (TARP) to bank recapitalization to benefit state and local governments.

Under H.R. 6333 banks would be active buyers of municipal bonds, which fit well with the investment objectives of many banking institutions. Municipal bonds are low credit risk investments that generally entail low regulatory capital charges for banks. Eliminating the tax code barriers to bank investment would draw banks to the municipal market and directly benefit states and localities.

Helping states and localities obtain variable rate financing

While H.R. 6333 would help address problems associated with traditional long-term, fixed-rate financing for states and localities, the Department of the Treasury can take other, immediate steps to address problems associated with variable rate financing. We believe that authority provided under EESA can help alleviate stress in two important sectors of the financial markets: auction rate securities (ARS) and variable rate demand notes (VRDNs). The market for ARS has been largely frozen since February. The market for VRDNs, while not as dysfunctional as that for ARS, is also quite stressed; there are indications that the VRDN market could suffer a more widespread breakdown if credit market conditions worsen. State and local governments with outstanding ARS and VRDNs would benefit from a program designed to provide government-supported “backstop liquidity” for issuers of these products.

<u>Background on ARS and VRDNs</u>

ARS and VRDNs are two forms of long term, variable rate debt financing. Both have been widely used by state and local governments as a substitute for commercial paper by issuing long-term debt with the benefit of short-term interest rates. ARS have also been used extensively by issuers of student loan-backed securities and by closed end mutual funds. At the height of the market in January 2008 there were approximately $330 billion of ARS outstanding. Now, a significant volume of those securities have been restructured or refunded, but nearly $200 billion remain outstanding. There is no reliable source for the volume of VRDNs outstanding; we estimate that approximately $400 billion are currently in the market.

Although both ARS and VRDNs are forms of variable rate financing, they differ in one key area. For ARS, liquidity—the ability for investors to readily sell their securities at par—depends on the success of periodic Dutch auctions. At an auction, which typically occurs weekly or monthly, ARS investors who want to sell their securities provide their order to their broker-dealer who then submits the offer to an auction dealer, a firm contracted by the issuer to manage the auction process. Potential ARS buyers submit bids to the auction, and—at least by design—sellers are matched with buyers. The auction clearing rate becomes the interest rate paid by the issuer until the next auction. Beginning in February 2008 a large number of auctions began to persistently fail—there were insufficient buyers to cover all the offers from ARS sellers. In those cases, investors are unable to sell their securities, and rates paid by issuers on failed ARS increase to a pre-determined maximum, or “penalty,” rate. Today, the vast majority of ARS auctions continue to fail on a persistent basis and many thousands of ARS investors are holding securities which offer no liquidity and cannot be sold.

Since February, some state and local government ARS issuers have been able to refund or restructure their outstanding ARS, curing the problems of high penalty rates for issuers and illiquidity for investors. Some closed end mutual funds have taken similar actions. However, many ARS remain outstanding with no liquidity for investors whatsoever. In particular, many municipal and closed end fund ARS and virtually all student loan-backed ARS remain in the portfolios of investors with little prospect for resolution.[3] Although some broker-dealers who sold ARS have reached preliminary agreements with federal and state enforcement agencies that require those dealers to buy back ARS from certain investors at par, only a minority of outstanding ARS are covered by those agreements. Bloomberg estimates that there are $135 billion of ARS outstanding that are not covered by the settlements.[4] Even for those investors who are covered by settlements, the buybacks simply transfer the illiquidity problems from investors to dealers, many of whom may be facing liquidity or balance sheet issues of their own, thus offering little resolution to the financial stress that currently exist within our financial system.

VRDNs do not use an auction process. Instead, each VRDN issue offers investors the opportunity to sell their securities at par, generally on a weekly or daily basis through a designated "remarketing agent," typically a broker-dealer. When a VRDN investor wants to sell their security, he or she submits an offer through their dealer to the remarketing agent. The remarketing agent surveys the market and determines a rate for the VRDNs that would attract sufficient buyers to cover all the offers. That rate then becomes the rate paid by the issuer until the next reset date. Unlike an ARS, however, if there are insufficient buyers to cover all VRDN offers, investors have the right, through the bond trustee, to place the securities with a third-party liquidity provider. VRDN liquidity providers, typically banks, have obligations under standby bond purchase agreements (SBPAs), letters of credit (LOCs) or similar contractual arrangements to purchase at par any VRDNs that cannot be resold through the remarketing process. When a VRDN is placed with a liquidity provider, the interest rate paid by the issuer on those bonds increases to a pre-determined maximum. After some defined period, frequently 90 days, VRDNs put to banks require accelerated amortization, forcing issuers to rush to refinance troubled securities at high cost and in difficult market conditions.

While no data are readily available, an inordinate number of VRDN remarketings have "failed" in recent months, *i.e.*, there have been insufficient numbers of VRDN buyers to cover all sell orders. The recent turmoil in the bond insurance area has also been a cause of "failed remarketings" because a large portion of VRDNs carry credit enhancement in the form of bond insurance in conjunction with the LOC or SBPA. The confidence crisis which occurred with some money market mutual funds has increased stress in the market and exacerbated the ability to restructure both ARS and VRDNs. As a result, much larger than normal volumes of VRDNs have been put to bank liquidity providers, and those VRDN issuers are now paying high maximum rates on their borrowing.

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[3] On September 25, 2008 the Brazos Higher Education Service Corporation, Inc., a major servicer and arranger of student loan-backed ARS, announced a tender offer for approximately $6 billion of outstanding student loan-backed ARS. See Brazos Higher Education Service Corporation, Inc., "Offers to Purchase or Exchange Commenced in Respect of $6 Billion of Brazos-Serviced Auction Rate Securities," press release, September 25, 2008. On December 4, 2008 Brazos announced that the conditions of its tender offer had not been met and that no securities would be redeemed. See Brazos Higher Education Service Corporation, Inc., "Brazos Announces Expiration of Auction Rate Security Tender Offers," press release, December 4, 2008.

[4] Michael McDonald and Darrell Preston, "Auction-Rate Victims 'Fit to Be Tied' as Accords Ebb," Bloomberg.com, October 24, 2008.

A key measure of the health of the VRDN market is the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index, an index of rates on certain tax-exempt municipal VRDNs with weekly rate resets. That index rate went to a record high of 7.96 percent on September 24, indicating a drastic market weakening. (By contrast, the average index rate for the first six months of 2008 was 2.21 percent.) The index has fallen back since then, but the market is still unusually constrained. Anecdotal indications suggest that some remarketing agents may be holding VRDNs on their own balance sheets at rates below the maximums in cases where there are insufficient numbers of investors to cover all offers on reset dates in order to prevent bonds from being put to liquidity providers and prevent issuers from facing maximum rates. If this is the case, the market is in a weaker state than improvements in the SIFMA index since September 24 indicate. While problems in the VRDN market are broad, they are particularly pronounced for issues where investors have lost confidence in the particular banks that serve as liquidity providers.

VRDN liquidity facilities have limited terms that are usually shorter than the maturities on the VRDNs they support. This requires issuers to renew SBPAs or LOCs periodically in order to maintain the liquidity backstop for investors. In recent years, some liquidity providers have agreed to SBPA terms as long as five to six years. Recently, however, with banks facing balance sheet constraints and generally retreating from activities that subject them to credit or liquidity risk, the cost of VRDN liquidity facilities has increased significantly and terms offered by banks have shrunk. Some banks previously active in the VRDN market as liquidity providers have retreated from this business entirely. Many of the banks that remain do not offer liquidity facilities longer than one year. We are concerned that continued constrained conditions for banks will make it increasingly difficult for issuers to renew expiring liquidity facilities and will increase the risk of future defaults. This could cause an increasing number of VRDN investors to exit the market, resulting in ever larger volumes of VRDNs being put to liquidity banks.

Difficulties in the ARS and VRDN markets are occurring despite the fact that the credit quality of most ARS and VRDNs has not deteriorated significantly. Many student loan backed ARS are indirectly guaranteed by the federal government since they are backed by federally guaranteed student loans. Many ARS and VRDNs issued by states and localities have lost the benefit of third party bond insurance that may have originally provided them with "triple-A" credit ratings, but the underlying credit quality of the issuers has not deteriorated significantly in most cases. Problems in the ARS and VRDN markets are principally related to illiquidity, deleveraging and dysfunction in the broader financial markets, not to credit deterioration related to these products specifically.

Using Treasury authority to address problems in the ARS and VRDN markets

The EESA authorizes Treasury to take actions that could significantly improve conditions for ARS and VRDN borrowers and investors and could help avoid a circumstance where liquidity constrained banks are forced to buy a large volume of illiquid securities. Section 101 of the EESA authorizes Treasury "to purchase, and to make and fund commitments to purchase, troubled assets." Section 102 of the EESA requires Treasury to "establish a program to guarantee troubled assets originated or issued prior to March 14, 2008." Section 103(7) of the

EESA requires Treasury to consider in implementing the law "the need to ensure stability for United States public instrumentalities, such as counties and cities, that may have suffered significant increased costs or losses in the current market turmoil." We believe that these authorities and requirements taken together, especially the authority provided in Section 101, allows Treasury to establish a program whereby the Treasury Department would, for a fee, offer the equivalent of SBPAs for VRDN issuers whose liquidity facilities are expiring and for ARS issuers who want to convert their ARS to VRDNs to restore liquidity to investors.

Under the proposed program for ARS Treasury would offer a standby liquidity facility to issuers of ARS originally sold before March 14, 2008 secured by whatever assets are currently supporting outstanding ARS. ARS issuers would pay a commitment fee—in today's market this fee is typically 0.45 to 0.55 percent—for the facility. ARS issuers would exchange new VRDNs backed by the liquidity facilities for outstanding ARS. Many of the new VRDNs would be eligible for investment by money market mutual funds subject to regulation under Securities and Exchange Commission Rule 2a-7, opening up a new source of demand for these issuers whose ARS are generally now not eligible for investment by these funds. The program would operate similarly for current VRDN issuers except there would be no exchange of outstanding securities for new VRDNs. The liquidity facility would be available to issuers of VRDNs whose bank-provided facilities are expiring or as a liquidity "wrap" that would be a backstop to existing bank LOCs or SBPAs. If desired, Treasury could establish a three-year expiration for standby liquidity commitments with the promise of reviewing the effectiveness of the program and the availability of privately negotiated liquidity backstops at the end of that period.

Safe, stable variable rate securities supported by a Treasury-provided liquidity facility would appeal to a broad range of investors. It is unlikely that the facility provided by Treasury would be drawn on to a significant extent, because its mere existence would likely provide confidence to investors and restore normalcy to the market for the affected products. If it did buy assets under the program, Treasury would earn interest at maximum penalty rates that would likely exceed its own cost of funds and would, in that regard, have a "positive carry." In any case, Treasury would earn revenue from commitment fees. As already stated, the credit quality of almost all outstanding ARS and VRDNs is quite high. In the case of ARS backed by federally guaranteed student loans, the federal government already guarantees defaults and losses on the underlying student loan collateral, so providing a liquidity backstop for these issues would entail no new credit risk at all for the government. Since Treasury would purchase VRDNs only in the case of "failed" remarketings—which would be rare if Treasury were the liquidity provider—it is unlikely that this program would use a significant portion of Treasury's $700 billion asset purchase and guarantee authority under EESA.

Key state and local officials have called for similar federal actions to shore up the short-term and variable rate municipal bond market.[5]

[5] See letter from Bill Lockyer, California State Treasurer and 19 other California state and local officials to Reps. Nancy Pelosi and Barney Frank and Sens. Dianne Feinstein and Barbara Boxer, November 21, 2008. Also see Andrew Ackerman, "Student Lenders Urge Liquidity Facilities," *The Bond Buyer*, October 31, 2008.

In sum, the proposed liquidity would provide several key benefits:

- An orderly market would emerge for hundreds of billions of dollars of assets frozen on the balance sheets of banks, broker-dealers and investors.

- State and local ARS and VRDN issuers would be freed from high penalty and maximum rates on their "failed" securities, and VRDN issuers would be spared from forced accelerations.

- Because Treasury would likely not need to purchase a large volume of securities, the program would provide benefits for many times the volume of outstanding assets than the resources the program actually consumed.

- The assets that would be the target of the program, despite being troubled, are for the most part credit-worthy and soundly performing and would not expose Treasury to undue credit risk. In some cases, the assets are supported by loans that are already federally guaranteed.

- The program would preserve the integrity of the municipal finance and student loan systems and would free up resources for student lenders to make new loans and states and localities to pursue projects that create jobs and enhance services.

Conclusion

The global credit crisis has affected every corner of the financial markets. Despite the extraordinary safety and stability of bonds issued by states and localities, the crisis has resulted in significant market disruption for state and local borrowers and investors and has increased costs for state and local governments who are already fiscally strained by the recession. Moreover, construction projects that could be contributing to an economic stimulus have been put on hold by states and localities unwilling to borrow at unattractive terms or unable to obtain financing at all. The federal government could help by implementing targeted, low-cost policies designed to provide direct benefit to state and local borrowing and thaw the frozen municipal bond market.

First, Congress should enact H.R. 6333. This legislation would almost immediately restore demand for municipal bonds among banks and would lower capital financing costs for states and localities. Second, the Treasury Department should dedicate a small portion of its authority under the EESA to providing backstop liquidity facilities to state and local governments and agencies with outstanding ARS and VRDNs. Together, these policies would help restore order to a market that has been caught in the tornado of the global credit crisis.

The RBDA appreciates the opportunity to submit this statement for the hearing record. Please do not hesitate to call on us if we can provide any assistance in the Committee's consideration of economic recovery policies.