BACKGROUND:

States, cities, counties and other governmental entities such as transportation authorities and school districts issue municipal bonds, which are debt obligations designed to raise funds to finance public infrastructure projects. Investors in municipal bonds lend money to the issuer who in turn pays interest and returns the principal when the bond matures.

Municipal bonds can be categorized as either general obligations (GO) or revenue. GO bonds are backed by the taxing power of the issuing government and revenue bonds are backed by, for example, the ratepayers of public water and sewer utilities or hotel tax, etc.

Estimates are that the municipal securities market in the U.S. is comprised of some 55,000 issuers and $2.6 trillion in outstanding debt. While the rate of municipal defaults have historically been low, less than 0.1% over the past 37 years, the municipal securities market is currently under severe stress. Municipal bankruptcies are a concern given that many municipalities are one step away from insolvency and "have underfunded pensions as well as healthcare liabilities they can't afford." ("Lawyers See Wave of Municipal Filings on Cities' Shortfalls," The Associated Press, Jan. 9, 2006)

Because of an amendment to the Securities Exchange Act of 1934, municipalities issuing bonds are not subject to the same reporting requirements as corporations issuing bonds. The Tower Amendment of 1975 prohibits the SEC and the Municipal Securities Rulemaking Board (MSRB) from requiring issuers of municipal securities, either directly or indirectly through their underwriters, to file any document prior to the sale of securities by the issuers. It also prohibits the MSRB from directly or indirectly requiring any document or information to be furnished by an issuer to prospective purchasers after the securities have been sold.

Municipal bonds have historically earned a lower investment rating than comparable corporate bonds due in part to the amount of information made available in evaluating each type of bond. Moody's Investor Services, for example, bases its municipal bond rating on the fiscal strength of the municipality that issues the bond while it bases its corporate bond ratings on risk of loss.

Bottom line

- There are over 55,000 issuers of municipal securities, including towns, cities, counties, and states, as well as other state and local government agencies and authorities—like hospitals and colleges—that issue securities for special purposes. No other direct capital market has such a surfeit of borrowers. By way of comparison, there are only 5,500 issuers of corporate debt.

- The terms and features of some municipal securities have evolved over time into highly complex structures. The extensive variation in the laws among the fifty state, as well as in local ordinances and codes among the tens of thousands of localities—which affect borrowing authority, lending of credit, powers to impose

taxes and special assessments, contracting powers, budgeting restrictions, and many other matters—results in an enormous diversity of financing structures.

- Mandating a "one-size-fits-all" approach to rating different categories of financial instruments is not wise. After-all, different kinds of investors have different risk-appetites.

- Some investors are intolerant of any reduced value or liquidity that might result from financial distress. Bond values and liquidity can decline even if actual default is a remote probability.

- Consequently, municipal investors look to the rating agencies not only to determine the likelihood of default, but also for an opinion on whether the municipal bond issuer will experience financial stress.

- It's not the role of the government to tell rating agencies how to determine their ratings. We should be encouraging LESS reliance on government involvement in the rating agencies, rather than dictating their work product.

- Even if we passed a bill that mandated a AAA rating for every municipal bond, the market knows that certain municipalities have their houses in order, while others, obviously, do not. In addition, it would give investors false comfort that does not exist, thereby perpetuating even more reliance on ratings. If the government is forcing the rating, it would make the designation of "AAA" meaningless.

- Under this proposal, if the municipality hasn't defaulted, it should have AAA rating – does this mean that a distressed municipality with a declining tax base or declining public services rate base should have a AAA rating on its sewer bonds?

- Rather than forcing certain filing or reporting requirements onto municipalities, the Hensarling amendment simply preserves rating agencies' ability to take a comprehensive look at a municipality – including financial management (or mismanagement), reliance on risky revenue sources, declining population coupled with rising per capita costs, changes to economic base, natural/manmade disasters, political factors, and ineffective leadership.

- State and local governments have $2.6 trillion in outstanding debt, but they are subject to less stringent debt-disclosure rules than private businesses are. State and local issuers don't have to follow accounting rules as set out by the Government Accounting Standards Board — even though private companies must adhere to the rules developed by the Financial Accounting Standards Board.

- The Hensarling amendment also directs the SEC to conduct a study of the treatment of different classes of bonds (municipal versus corporate) by the nationally recognized statistical rating organizations.