



Written Testimony
of
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Good morning, Chairman Frank, Ranking Member Bachus and Members of the Committee. My name is Bernard Beal and I am Chief Executive Officer of M.R. Beal & Company¹ and Vice Chair of the Securities Industry and Financial Markets Association (SIFMA)². Thank you for the opportunity to testify before you on behalf of SIFMA on these important pieces of legislation that address critical issues for the municipal securities market and its participants.

We applaud your ongoing leadership and the bold steps you are taking to help stabilize this vital sector of the financial markets. When SIFMA last addressed the Committee regarding municipal securities matters in September 2008, the focus was on the effect of the collapse of the auction rate securities (ARS) market on municipal securities issuers. While much of the dust from that breakdown has settled and many market sectors are regaining health, some parts of the municipal bond market have been unable to regain their footing and seek assistance accessing the capital markets. Many lower-rated state and local government issuers are facing a critical need for reliable liquidity facilities and long-term credit enhancement, and the lack thereof is making it difficult for them to bring some transactions to market. This delays important infrastructure projects, such as schools, healthcare facilities, and bridges and roads, which create jobs and revitalize communities.

The legislation that is the subject of today's hearing offers constructive solutions to assist state and local issuers gain access to the capital markets and addresses important regulatory and ratings matters that have persisted for years. With regard to market access issues, the legislation is consistent with recommendations that SIFMA advanced in a letter to this Committee in February and, therefore, we support these measures and offer suggestions to ensure efficiency in restoring and spurring market activity with the least amount of direct federal involvement. We also support the provisions regulating unregulated financial advisors, which, generally, are consistent with the Municipal Securities Rulemaking Board (MSRB) rules that govern our regulated broker-dealer members, who engage in the same financial advisory activities today. I will address each of the proposed bills with a focus on what benefits they will provide for market participants. I look forward to answering any questions the members may have.

¹ M.R. Beal & Co. was founded in 1988, and is the nation's oldest minority-owned investment bank. The firm consistently ranks among the top-20 national underwriters of municipal debt transactions and among the top-100 underwriters of corporate equity and debt. M. R. Beal is a directed broker for major institutions and an approved broker for most major public and private pension plans. The firm also offers advisory services and proprietary research. Headquartered on Wall Street in Manhattan's financial district, M.R. Beal also has offices in Chicago, Dallas and Sacramento. The firm's equity trading group is based in Chicago.

² SIFMA brings together the shared interests of more than 600 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. SIFMA's members account for about 90% of the nation's municipal bond underwriting and trading activity by volume, which represented an estimated \$5 trillion of municipal bonds in 2008. It has offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. More information may be found at our website: <http://www.sifma.org>.

“Municipal Bond Insurance Enhancement Act of 2009”

SIFMA supports the proposal to establish a temporary federal government reinsurance program for transactions covered by a primary credit enhancement policy from a private market participant. This model provides the most benefit to the issuing community and investors alike without direct federal involvement in state and local debt issuance. Moreover, the program does so in a carefully defined manner: after providing reinsurance for five years (which will last for the life of the underlying insured debt), the Secretary of the Treasury is obligated to provide a privatization plan to Congress.

SIFMA strongly endorses creating an Office of Public Finance within the Department of Treasury as proposed under this legislation. This office will provide a point of contact for the municipal securities industry for non-regulatory matters. This office will help foster communication among state, local and federal governments and serve as a point of information for municipal securities market stakeholders.

It is important to note that federal involvement in this area is not a poor reflection of the municipal securities market. Rather, it stems from the fact that most of the municipal bond insurance companies suffered catastrophic losses from their exposure to products and markets not related to municipal securities, such as secured subprime mortgages. As a result, most of the bond insurers lost their highly esteemed AAA and AA ratings, which had been in place since the industry began 30 years ago.

Municipal bond insurance serves a valuable function in the municipal securities market as it provides comfort to investors that a third party will make timely principal and interest payments on their bonds should the need arise, in addition to reducing an issuer's borrowing costs. The lack of AAA- and AA-rated companies has negatively impacted the market access of smaller issuers and those lesser-rated issuers whose purchase of insurance wraps for their debt offerings helps lower borrowing costs and makes their debt eligible for purchase by money market funds.

For example, in 2007 the percentage of municipal securities that were enhanced by bond insurance was 46.7 percent, while in 2008, the percentage declined substantially to 18.5 percent. During the first four months of this calendar year, only 12.5 percent of municipal bonds were insured. Municipal issuers rated A and BBB rely heavily on insurance to save on issuance costs. Of municipal securities rated A and BBB, 57.8 percent were insured in 2007, 44.8 percent in 2008 and 20.7 percent in the first quarter of this year.

“Municipal Market Liquidity Enhancement Act of 2009”

SIFMA supports the initiatives taken in this bill as they provide a method for the federal government to target assistance to a specific sector of the market. My testimony with respect to this piece of legislation is the synthesis of conversations among the members of SIFMA, in particular, broker dealers that underwrite and distribute municipal securities, some of whom are affiliated with entities that provide letters of credit and other liquidity facilities as part of their day-to-day business.

While, in general, the municipal markets are functioning properly, there are important sectors that are in need of affordable liquidity facilities. Injecting liquidity into the municipal securities market is a complex undertaking; doing so will affect the sector in need and each of the market participants in that sector differently. Because it is directed to serve the needs of those market sectors in greatest need, the facility can play a critical role in reinvigorating those sectors.

From a policy perspective, SIFMA is of the view that there are many ways for the federal government to inject liquidity into the municipal securities market, each of which has distinct policy ramifications. We would like to offer some alternative approaches and the potential market effects of each approach. It is our intention to work constructively with Congress and the Administration to assure that whatever federal liquidity facility is implemented is an efficient vehicle for troubled sectors while being the least disruptive to the markets that are functioning well.

The proposed legislation authorizes the Federal Reserve Bank to lend money to a special purpose vehicle that will be used to purchase three classes of variable rate demand obligations (VRDOs): (i) those that have already been issued by the date the legislation is enacted (new-money VRDOs are not included); (ii) those issued to refund auction rate securities (regardless of when they are issued); and (iii) short-term notes issued to assist a government with its short-term borrowing needs. The legislation also specifies that the special purpose vehicle can act as the liquidity facility of last resort only for those VRDOs and short-term notes that have been the subject of a public offering. Finally, the liquidity facilities to be made available by the special purpose vehicle will bear interest rates to be established by the Federal Reserve Bank and approved by the Federal Reserve Board, will be secured by the VRDOs that are being purchased.

Previously Issued VRDOs. VRDOs are municipal bonds with a long-term maturity, usually 30 years, and a coupon that is calculated periodically, be it daily, weekly, monthly or other short-term frequency. The purchasers of these instruments have the irrevocable right to sell them back to the issuer, which almost always has a liquidity facility issued by a bank that provides cash in the event an investor wants to sell them and another buyer cannot be found (some issuers use their own liquidity). Historically, issuers have used this product to manage their debt as it allowed them to borrow money for a long term while paying short-term rates. In the current market, issuers are trying to obtain liquidity facilities to replace ones that are expiring by their terms so they can keep their VRDOs in that mode. The cost of liquidity facilities, however, has increased dramatically for the entire market and especially for lower-rated credits and the healthcare sector, preventing some issuers from accessing the market. In 2007, VRDOs represented 11.7 percent of all municipal securities. In 2008, that figure jumped to 29.7 percent as issuers used VRDOs to refund auction-rate securities, which experienced a tremendous spike in rates. During the first four months of this year, VRDO issuance stood at 9.7 percent of all municipal securities.

The prohibitive cost of liquidity facilities also means that VRDOs, for which purchasers could not be found during the credit crunch, may still be held in the form of bank bonds by the banks that issued letters of credit, investors or broker dealers. Most of these entities would sell these securities if at all possible. Given this market stasis, SIFMA supports the legislation targeting previously issued VRDOs for purchase.

While the legislation describes the *instruments* that may be purchased by the federal facility, it does not provide any guidance with respect to the *market sectors* that will receive such support. It is well accepted that the not-for-profit sector, which includes health care, higher education, and the housing sector, now require the most help. Another sector of the market that should not be ignored are the lower-rated issuers, which have considerable difficulty accessing the markets. Significantly, these issuers enjoy investment grade ratings and, in a well-functioning market, could access the markets at will. In the current market, though, that is not the case.

On the other end of the need scale are higher-rated credits, including general obligation bonds, revenue bonds and private-activity bonds, that are functioning well.

Short-Term General Obligations. While certain large state and city issuers have experienced cash-flow shortfall due to economic conditions in general, it is not clear to us that general obligations as a class of debt are in dire need of assistance. Nonetheless, we do not oppose the inclusion of short-term general obligations in this legislation because some state and local governments should be assisted during this difficult economic time.

Liquidity Facility Provider of Last Resort. By establishing the special purpose vehicle as the liquidity facility provider of last resort for the three classes of municipal bonds noted above, the legislation creates an entity that will become a direct player in the municipal markets. While the appearance of a new player in the market can assist the smaller and lesser-rated credits, we have some concerns with this provision. Potentially, this entity can alter the dynamics of the market at the same time that it tries to revive it: issuers will know that they do not have to pay market prices for liquidity because the federal government will be willing to provide a liquidity facility to purchase all of the permitted unremarketed VRDOs and short-term notes. The potential for this type of disruption, of course, will depend on the pricing of the liquidity facility offered by the special purpose vehicle.

While creating a liquidity facility of last resort is one way to address the need to provide liquidity facilities to the market, other structures exist.

Federal Backstop — In this model, the federal liquidity facility will serve as a backstop to letters of credit issued by banks, so that the facility will make a payment if the letter of credit bank does not. This structure would give the banks another tool to mitigate the risks in the current marketplace without the need for direct government involvement. Such a structure could be similar to a Federal Home Loan Bank program, which also backs existing letters of credit in housing transactions. Banks funded by the federal liquidity facility should share the risk of the underlying credit by posting collateral equal to a portion of the loan.

Federal Participating Liquidity Facility — This structure includes the federal government as a minority partner with private letter of credit banks that are sourcing their own transactions. The federal government would increase the size of the private bank's letter of credit by a percentage, perhaps in the range of 20 percent to 40 percent. So, for example, if a bank is issuing a \$200 million letter of credit, the federal participating liquidity facility could add an additional 30 percent — or \$60 million — to the size of the letter of credit. The advantages of this model are that the federal

government does not have to assess credit as it can piggyback on the credit decisions of the majority bank. The 30 percent multiplier of the federal facility would allow the majority bank to increase its capacity and issue more letters of credit. Finally, the transaction could be structured so that investors would look to the federal facility for 30 percent of the transaction. This would allow a 2a-7 fund investor with concentration limits to dilute its exposure to majority banks, as they would take on exposure to the federal facility.

Pricing of Liquidity Facilities. We believe that the special purpose vehicle should price its federal liquidity facilities in such a way that it helps issuers who otherwise could not obtain a letter of credit without discouraging private sector market participation. As I noted earlier, if the pricing undercuts the market, there will be the risk that issuers will look to the federal facility and not to the usual market participants. At the same time, we recognize that the special purpose vehicle cannot price the liquidity facilities too high because doing so would undermine its main purpose. One way to address this situation is for the special purpose vehicle to offer pricing that will increase over time, as this would create a strong incentive for the issuer to return to the functioning markets and its traditional investor base.

Size of the Liquidity Facility. The size of the liquidity facility, of course, will depend on the scope of the program. The legislation provides that VRDOs issued prior to enactment of the legislation may be purchased with loans provided by the facility, which is a finite number. The inclusion of VRDOs for refunding ARS and short-term debt obligations, however, has the potential to require a much larger facility as various issuers assess their borrowing needs.

Term of the Liquidity Facility. Although it is not addressed in the proposed legislation, the federal liquidity facility, in SIFMA's view, should be a safe harbor for the troubled sectors of the municipal market until those sectors stabilize. It is impossible, though, for anyone to predict when that stabilization may occur or what the term stabilization means. For our purposes today, I will define stability as the point in time at which the markets will be able to function without the need for federal intervention. Having said that, we believe the federal facility should be in place for a term of not more than three years.

“Municipal Advisors Regulation Act”

SIFMA supports the proposed legislation to regulate independent municipal financial advisors, who have not been subject to any regulatory scheme and operate unfettered in the markets. SIFMA has held this view for many years, as the unregulated financial advisors have taken advantage of gaps in the industry's regulatory structure. This legislation will fill in that regulatory gap, protect issuers and investors alike and help to restore confidence in the municipal securities markets. The legislation will also help level the playing field for market participants who offer financial advisory services to state and local governments, by holding currently unregulated financial advisors to the same high standards for registration, examinations and fair dealing as well as limiting potential conflicts of interest caused by unregulated provision of political contributions, gifts and entertainment.

Under the proposed legislation, the Securities and Exchange Commission (SEC) would be the entity responsible for such standards, which includes training, experience, competence and other qualifications the SEC deems appropriate for protecting investors. While we agree that there should be one body responsible for registering and regulating municipal financial advisors, we caution against duplicative regulatory regimes. Currently, the MSRB is the body that drafts the rules for municipal securities based on its deep understanding of the products and practices of municipal securities dealers with FINRA responsible for enforcing those rules and regulations. At the same time, the SEC is responsible for monitoring and enforcing compliance with antifraud and other provisions of existing legislation, such as the Securities Act of 1933 and the Securities and Exchange Act of 1934. SIFMA recommends that, in defining the SEC's role in regulating financial advisors, the committee recognize the role of the MSRB in the regulatory framework and consider this existing division of responsibilities.

We believe the crucial purpose of this bill is to require currently unregulated municipal financial advisors be held to the same high standards to which regulated broker dealers currently adhere. In early April of this year, the MSRB³ found that 73 percent of financial advisors that participated in at least one primary market transaction in 2008 were not subject to MSRB regulatory rules. Of the total \$453 billion in par value of municipal bonds that were sold in 2008, roughly 70 percent — or about \$315 billion — were issued with the assistance of a financial advisor. Only 38 percent of those financial advisors were MSRB-registered broker dealers. These statistics and the amount of municipal securities for which unregulated entities provide advice clearly show the need for regulation over these market participants.

In a municipal bond transaction, the municipal financial advisor sits next to the issuer and advises its client on a range of topics, including the size and form of the transaction, how to invest the proceeds and whether to hedge some of the risks involved in issuing municipal debt. The municipal financial advisor also participates in the pricing call when the debt is sold to the market. Based on this very close relationship with the issuer, we agree, in principle, that municipal financial advisors should be held to a fiduciary standard of care, and we look forward to a dialogue with lawmakers and regulators to discuss what such a standard should entail.

While a fiduciary standard of care is defined under various state laws, the municipal finance market is a national one in which lawyers, bankers, advisors and trustees from all 50 states can work on transactions in all 50 states. Thus, a single standard of care under federal law will regulate municipal financial advisors and, at the same time, establish a uniform standard that will apply throughout the country regardless of the jurisdiction or the home state of the advisor. This clarity will simplify compliance and enforcement. Correctly, the new regulations would not cover bond attorneys serving in an accepted legal capacity or registered broker-dealers (acting the capacity of underwriters), who are already well regulated under the MSRB.

“Municipal Bond Fairness Act”

³ The Municipal Securities Rulemaking Board report, “Unregulated Municipal Market Participants: A Case for Reform,” April 2009.

A move to global scale ratings — either by unilateral action on the part of the rating agencies or as a result of federal law — would represent a sea change to the municipal bond industry. Like any market, the municipal bond market can be disrupted if such changes are introduced too quickly. We would like to offer our views on the advantages of such a move, as well as raise some constructive suggestions on areas of concern.

Advantages

Fairness to the Municipal Markets. The first advantage of moving to global scale ratings is that it would be more consistent with the municipal market's history of an extremely low default rate coupled with a high rate of expected recovery in defaults. It would seem fair, as suggested by the title of this legislation, to acknowledge the historic safety of investing in municipal bonds and have them rated on the same scale that is used to rate all other debt securities.

Consistency Across Asset Classes. For about 90 years, Moody's Investors Service has used a single scale to rate the debt of all corporations, financial institutions, sovereigns, structured products as well as sub-sovereigns in the international markets — with the only exception being municipal securities. As more municipal bonds are purchased by non-traditional investors (such as, most recently, those who have gobbled up vast amounts of Build America Bonds), it is in the interests of all stakeholders in the markets to have all asset classes rated on the same scale. Doing so will bring greater uniformity to the markets in general and make it easier for all investors — institutional, retail and individual — to make informed investment decisions.

Issuer Benefits. If a transition is made to the global scale ratings, many municipal issuers would enjoy higher ratings, which would have several important benefits. Higher ratings, of course, mean less risk, which translates into lower borrowing costs. Lower borrowing costs for issuers will have a direct positive financial effect on the budgets of states and cities, resulting in more revenue and lower debt service payments that will benefit taxpayers. Another advantage is more limited but no less important — for those issuers that are moved from AA to AAA, it will mean that they will not need credit enhancement to achieve the highest ratings, which will translate into another cost savings. Finally, the transition will mean that the debt of more entities will become eligible for purchase by the 2a-7 money market funds, which have become an increasingly large percentage of municipal bond purchasers.

Credit Rating Agency Benefits. The credit rating agencies would also benefit from a transition to the global ratings scale as it would give them greater flexibility to adjust to the current economic environment, which is different from that of the past 30 years for many reasons, including the pressure on municipal issuers' due to reduced tax receipts and increasing other post employment benefits (OPEBs). While we cannot predict with any certainty what will take place in the future, it would not be surprising if there are more defaults of municipal bond issuers in the next 30 years than there were in the past 30 years.

Disadvantages

Effect on the Individual Investor. Perhaps the most profound effect of the shift to the global ratings scale will be on individual investors. Currently, municipal issuers are spread across the range of ratings from below investment grade to AAA, with fewest in the top categories, a distribution that has been the norm for all investors in municipal bonds. A transition to the global ratings scale could result in a dramatic upgrading of some municipal issuers — either overnight or spread over time — that would mean that more issuers would be moved into highest ratings categories. Institutional investors, on the one hand, that are quite sophisticated and have greater resources, will be able to discern between the AAA credits that have been so rated because of their ongoing credit quality versus those that, historically, have been AA credits and are simply enjoying the benefits of the recalibration. Individual investors, though, lack the resources of these institutions and may not be as able to easily discern the difference. Rather than resulting in greater transparency for the individual investor, the change could make credit assessment more opaque for that market segment.

Another overall concern is that regardless of what action the committee and the Congress take on this matter, it is essential that the market participants view the rating agencies as regulated, but independent entities, responsible for the ratings they assign to debt instruments.

Greater Homogenization of Credits. The issue noted above should also be considered from the issuers' perspective as well. With the sudden increase of AAA credits, those issuers that historically have been AAA credits would share that rating with others. This reclassification of the AAA together would, in effect, reward the newly classified AA credits at the expense of the legacy AAA credits and place downward pressure on the legacy AAA credits.

Moral Hazard. As noted earlier, converting municipal issues to the global ratings scale may result in upgrading of a significant number of issues and the lowering of borrowing costs for those issuers as well as a downgrading of some issuers and the increase of their borrowing costs. There is, however, the risk of a moral hazard in such an action as the sudden change in ratings — in either direction — may remove the market's incentive to distinguish between credit-driven ratings and those informed by federal legislation.

Thank you, Mr. Chairman, for allowing me to present SIFMA's views. We hope to continue the dialogue on this important part of the credit market and stand ready to assist this Committee with any of these matters.