November 18, 2008

Honorable Dianne Feinstein
United States Senate
331 Hart Senate Office Building
Washington, D.C. 20510

Honorable Nancy Pelosi
Office of the Speaker
235 Cannon House Office Building
Washington, D.C. 20515

Honorable Barbara Boxer
United States Senate
112 Hart Senate Office Building
Washington, D.C. 20510

Honorable Barney Frank
United States House of Representatives
2252 Rayburn Building
Washington, D.C. 20515

Re: Solution to critical problems in the short-term municipal bond market

Dear Senator Feinstein, Senator Boxer, Speaker Pelosi, and Congressmember Frank:

We, the undersigned representatives of major municipal bond issuers, respectfully request your assistance in addressing the serious and costly problems the nation's financial crisis has imposed on the short-term municipal bond market.

Summary

As major California issuers of short-term municipal bonds, we are writing to request your assistance in addressing serious problems that are costing taxpayers and ratepayers millions of dollars, while contributing to the destabilization of our banking and financial system.

We believe that the Federal Reserve should establish a program to provide much-needed liquidity to the short-term municipal bond market. Historically, that market has functioned because banks provide liquidity to guarantee investors a market in which to sell their bonds. Unfortunately, current financial disruptions have interrupted this market. Banks are less willing or unable to use their balance sheet to provide liquidity. Further, investors, worried whether weakened banks will provide the liquidity when needed, are selling their bonds as a precaution. The result is higher interest rates for many municipal issuers, the risk their debt will be accelerated, the possibility they will be forced to convert to a fixed rate in a very expensive and generally unaffordable market, and increased pressure on the banking system as banks use precious liquidity to purchase these bonds.

The solution is for the Federal Reserve to provide direct support to the market. This can be through either:

1. The direct purchase of municipal variable rate bonds sold back to the banks; or

2. Direct loans made to the banks so they can buy municipal variable rate bonds.

This program has benefits for all parties:

1. This is neither a bank bailout nor a municipal subsidy. These variable rate bonds need a temporary home while remarketing agents look for new buyers. In exchange, banks and the federal government will receive market rate interest payments (usually the prime rate plus .50% or more).

2. Investors will gain confidence that liquidity support will always be there – eliminating the artificial pressure to sell their bonds back.

3. Issuers will benefit from a more stable market, lower interest rates and the ability to deliver critically needed infrastructure projects. This will help taxpayers by keeping down the cost of the municipal debt they support. And, it will help the economy by maintaining public works spending.

4. Finally, it will provide liquidity and balance sheet relief to banks that are at the center of the financial market crisis.

We believe this solution is consistent with the assistance the Federal Reserve is providing corporate debt issuers through the Commercial Paper Funding Facility (CPFF). We request your assistance in working with the Federal Reserve to make that program, or a program like it, applicable to the municipal short-term market.

The Municipal Variable Rate Market

The problem affects both variable rate demand bonds (VRDBs) and tax-exempt commercial paper (CP). While CP is the short-term funding of choice for corporations, municipal issuers rely heavily on VRDBs. Between 1999 and 2007, they issued approximately $420 billion of VRDBs.

Both CP and VRDBs are bought primarily by money market funds. Interest rates are re-set periodically and investors can sell back, or "put", their bonds at each re-set date. The market relies on investment banks (in the role of remarketing agent) to re-set the rate and find new buyers for bonds that are put, and commercial banks (in the role of liquidity provider) to guarantee the repurchase of any bonds that are put and cannot be re-sold.

This guarantee is one of two requirements imposed by the Securities and Exchange Commission for money market funds to hold VRDBs or CP. The other, required by SEC Rule 2(a)-7, is that the bonds have ratings at least in the double-A category from at least two rating agencies. This requirement is sometimes satisfied by a bank letter of credit (LOC) that guarantees both debt service payments and the put. Alternatively, an issuer can guarantee the put with a liquidity facility and provide the necessary rating by purchasing bond insurance or maintaining a sufficient unenhanced rating.

Until this year, remarketing agents rarely failed to remarket bonds. Rather than put bonds to the bank, they would temporarily hold bonds in inventory to maintain demand and keep interest rates low. Banks rarely had to use capital to buy and hold bonds (what become known as "bank bonds").

This is no longer true. The credit crisis has raised costs to municipal issuers and imposed stress on the balance sheets of both remarketing agents and liquidity providers. Unable to find buyers for many VRDBs, remarketing agents hold huge inventories and have put billions of dollars of bonds to liquidity banks. While interest rates on bonds with strong bank ratings have declined from their peaks of a few weeks ago, bank bonds and those backed by weak banks still carry excessively high interest rates. While all VRDBs used to carry about the same interest rates, we now see some at 2% and others as high as 16%.

The Problem

There are three manifestations of the problem:

- **Ratings** – In recent years, bond insurance has been less expensive than letters of credit to secure the necessary ratings for money market eligibility. Accordingly, a great many issuers used bond insurance or their own bond rating, supplemented by a liquidity bank to guarantee the put. When several insurers suffered rating downgrades below double-A earlier this year, some issuers were able to secure LOCs to replace the insurance, though the availability of LOCs has now dried up. The current problem is that many issuers are at risk their VRDB ratings will drop below Rule 2(a)-7 requirements. For some, this will occur because their LOC bank or bond insurer is under stress (e.g., FSA or Dexia). For others – those who meet the SEC rating requirement on the basis of their own credit – the slow economy may trigger rating downgrades that push them below the 2(a)-7 threshold. If the money market funds are no longer able to own these bonds, remarketing agents could end up holding billions of dollars of VRDBs on their balance sheets and, eventually, put the bonds to liquidity banks.

- **Weak Liquidity Banks** – As banks came under stress, several that were major providers of liquidity facilities for VRDBs and CP suffered downgrades. Fearing that such banks may not honor puts, investors began putting their bonds back to the issuer. The result was either substantially higher interest rates or bonds put to the liquidity banks. Such bank bonds carry significantly higher interest rates and require the municipal issuer to amortize principal payments over an accelerated period of time, generally five years. Issuers whose revenues can support a 30-year repayment schedule may not be able to repay their debt in five years. Further, the banks that have had to devote capital to buy and hold the bonds are the very banks already struggling with the stresses that led to their rating downgrades. Among the larger liquidity providers who have fallen from favor with investors are Depfa, Fortis, Dexia, and Helaba.

- **Liquidity Rollover Risk** – In today's market, strong and weak banks alike are reluctant to extend credit. This includes providing liquidity facilities for VRDBs. Accordingly, as these facilities expire (most are in effect for just a few years), municipal issuers are finding it difficult, if not impossible, to renew. This means many issuers will be forced to convert their bonds to a fixed rate in a market where fixed rates are the highest they have been since the early 1990s, pay significantly higher fees for credit facilities, and risk the possibility that their bonds will convert to bank bonds and be subject to acceleration.

The Solution

All of these problems can be addressed by the federal government providing liquidity to the short-term municipal market as we work through this crisis. As described above, this can be done either by providing liquidity to banks so they can support the market, or by direct purchases of bank bonds by the Federal Reserve. Each has its advantages and disadvantages, and we would appreciate the opportunity to engage in detailed discussions with Federal Reserve officials to determine the optimal approach.

For the program to restore proper functioning to the market, there are several essential elements to its design that will need to be worked out. We note a few key ones:

- The program's design should ensure the continued tax-exemption of the bonds. The Federal government would not be making any payments to bondholders. It would provide liquidity, not a guarantee of principal and interest. Furthermore, it would provide the liquidity to the banks, not to the issuer or to investors.

- The program must provide issuers with sufficient time to address the problems created by the market – either to secure new liquidity/credit enhancement arrangements to remain in a variable rate mode, or to convert to a fixed rate in an orderly fashion. The rates paid on bank bonds and the timing to clear bank bonds must not be onerous.

- The program must accommodate issuers whose bonds are no longer money-market eligible because, though their bonds remain investment grade, their ratings drop below the Rule 2(a)-7 threshold.

- The program must not force an acceleration of bank bonds. Liquidity banks that borrow from the Fed to buy bank bonds must agree not to accelerate. Bonds owned by the Fed must amortize pursuant to the original documents, not as if they are bank bonds.

Attached is a list of the specific problems each of us signing this letter has experienced. We appreciate your attention and support as we address this very serious issue. Please feel free to contact any one of us for further information.

Sincerely,

Attachment: Summaries of Short-Term Market Exposures

ATTACHMENT
SUMMARY OF SHORT-TERM MARKET EXPOSURES
(TO BE FILLED OUT BY EACH SIGNATORY)

Name of Issuer:

General comments

Problems with weak credit enhancers or liquidity providers

Problems renewing liquidity facilities or letters of credit

Bank bonds (including amounts, rates, acceleration provisions)

Problems maintaining long-term ratings necessary for money market eligibility

Problems with interest rate swaps tied to variable rate bonds