

Discussion on Municipal Bond Market Issues

California Treasurer Bill Lockyer has identified several issues critical to public finance worthy of discussion among the group. These items are:

1. The economic stimulus program includes several bond-related tax proposals – many designed to increase the demand and marketability of municipal bonds. These include changes to the “de minimus” rule, bank deductibility and alternative minimum tax treatment.
 - a. De Minimus Rule: The “de minimus” rule allows companies, other than banks, to deduct interest on their own debt, up to 2% of their assets, to buy municipal bonds. In contrast, banks can deduct interest only if the borrowing is used to buy bonds of issuers issuing less than \$10 million annually. The proposed change would apply the “de minimus” rule to banks and increase the exempt threshold from \$10 million to \$30 million for bonds purchased by banks in 2009 and 2010. This would increase the demand for these bonds and reduce the cost of capital for smaller municipalities.
 - b. AMT: Currently, interest earned on private activity bonds (non-housing and non-501(c)3 bonds) are not exempt from the AMT. The proposed change would make interest earned on these bonds issued in 2009 and 2010 tax-exempt from AMT – thereby increasing the demand for these bonds and lowering the interest rates issuers must pay.
2. Troubled Asset Relief Program (TARP): There is considerable uncertainty about how the Obama Treasury Department will use its TARP authority to help the municipal bond market. Former Treasury Secretary Paulson insisted TARP didn’t apply to municipal bonds, but Obama has said he believes it does. TARP amendments passed by the House (but not taken up in the Senate) have clarified that the municipal bond market is an allowable use for TARP funds. Municipal bond issuers will need to press Treasury for quick application of TARP once Secretary Geithner appoints the deputies who will have that responsibility. Here are some options under consideration:
 - a. Federal guarantee as a substitute for bond insurance companies such as MBIA and AMBAC which no longer have AAA ratings. Bond insurance has become very expensive or unavailable in the current market.
 - b. Federal funds to provide liquidity to support short term debt markets, perhaps modeled after the Commercial Paper Funding Facility the Federal Reserve created for corporate CP.
3. Rating agency reform: Rating agencies use a different method for rating municipal debt vs. corporate debt. The method makes municipal bonds appear more risky than they actually are and therefore increases the cost to states issuing debt.

Key issues for discussion:

1. Which of these should the Treasurers work together on? What will make the biggest difference?
2. What needs to be done to lay further ground work for working together?