Transparency Problems in the Municipal Debt Markets and Their Effect on Fiscal Condition

Kelly Shea

Cities across the country have mounting obligations and often chose to offer bonds to address capital needs or provide services. While many cities in the U.S. are in trouble financially, the true state of their fiscal affairs is often hidden.This paper attempts to explain how current problems in the capital market—including problems with credit rating agencies and bond insurers—directly affect municipal bond offerings by cities and states and how proposed changes could be made to increase transparency in this sector.

INTRODUCTION

Municipal bonds, also referred to as "muni bonds," are debt securities issued by states, cities, counties, and other government entities as a way to finance large infrastructure projects or to raise cash for other purposes.[1] The $2.7 trillion muni bond market is, in many ways, under-regulated. While muni bonds have in the past been classified as safe investment vehicles, questions are now being raised regarding the financial health of cities across the United States and their ability to repay their municipal debts.

A number of cities are overextended in their obligations and are hurting due to the current financial crisis. Sales tax revenue for cities and states is down, as is revenue coming specifically from property tax. Such liabilities on cities and states often force these entities to either buy bond insurance to increase their bond rating, or face increasingly high rates of interest on the bonds issued. While this bonding system has worked in the past when municipal bond insurers were only insuring one kind of product, the entry of these insurers into the world of more risky financial products—such as mortgage backed securities, collateralized debt obligations, and other complex financial products—has placed municipal bonds, and their investors, in a dangerous situation. The municipal bond market, not immune to the problems in the larger capital markets, has suffered from the effects of the past two years.

Also contributing to the overall problem is the fact that cities and states are not subject to the same disclosure requirements of specific financial information before offering bonds publicly, this due to a 1975 amendment to the Securities and Exchange Act of 1934 known as the Tower Amendment. This Tower Amendment effectively limits regulation by the Securities and Exchange Commission and other federal oversight authorities. In some cases, this allows

---

[1] "Municipal Bonds". *Securities and Exchange Commission (SEC)*. http://www.sec.gov/answers/bondmun.html

municipalities to simply not disclose important financial obligation information before a bond offering.

Many cities around the country have mounting obligations coupled with a need to offer bonds to address capital needs or provide services. Many cities in the U.S. are in trouble financially, but the true state of their fiscal affairs is often hidden. This paper attempts to explain how current problems in the capital market—including problems with credit rating agencies and bond insurers—directly affect municipal bond offerings by cities and states across the U.S., and how proposed changes could be made to increase transparency in this sector.

I. BACKGROUND ON MUNICIPAL BONDS

General Obligation bonds (GOs) are used to raise immediate capital and are supported by the taxing power of the issuer. Revenue bonds are issued to fund specific projects and are supported by revenue generated by those projects.[2] Muni bonds are generally thought of as extremely safe investment instruments due to the assumed ability by an issuer to tax citizens should a revenue repayment shortfall occur. While GO bonds pay back investors through taxes, revenue bonds are ordinarily paid back from revenue streams associated with the projects funded by the revenue bonds. In some cases these are more risky because it is possible the designated revenue stream could slow down or stop entirely. Municipal securities are attractive to many investors due to their generally exempt status from federal and, in some cases, state and local taxes.[3] Municipal bonds are a $2.7 trillion market, more than twice the size of all discretionary federal government spending every year.[4] More than 50,000 state and local issuers issued more than $430 billion in new bonds and notes in 2008.[5]

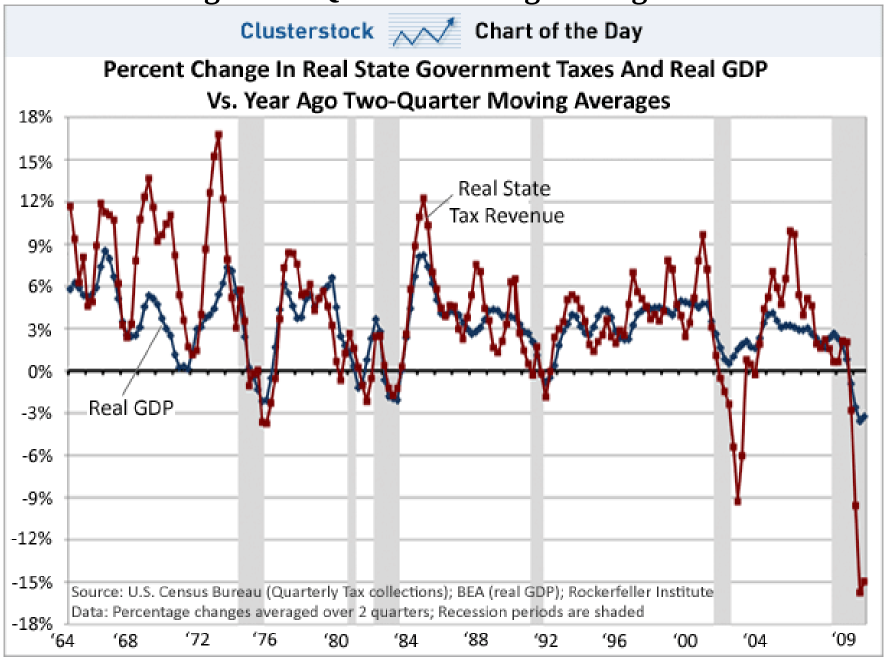
---

[2] "Revenue Bonds". *Investopedia*. http://www.investopedia.com/articles/bonds/05/022805.asp
[3] "Municipal Bonds"
[4] "Discretionary Appropriations Status." *Congressional Budget Office*. www.cbo.gov/budget/approps.shtml
[5] Securities and Exchange Commission. *Disclosure and Accounting Practices in the Municipal Bond Market (White Paper).* 7 June 2007. p4.

II. CURRENT ISSUES FACING MUNICIPALITIES

While muni bonds have traditionally been seen as safe investments, there are new concerns in the muni bond market. Specifically, some cities are financially overextended in their obligations, and those shortages are felt even more due to the current financial crisis. City and state revenue is down, as is property tax due to the negative impact of the subprime housing market collapse (see Chart 1). Experts expect the default rate for these bonds to continue to increase from a quarter of 1 percent to 1 percent.[6]

Chart 1: Percentage Change in Real State Government Taxes and Real GDP vs. Year Ago Two-Quarter Moving Averages[7]



In addition, cities and states are not held to strict disclosure standards before offering muni bonds due to the Tower Amendment, which will be discussed later in this paper. The Securities and Exchange Commission (SEC) has noted a number of cities and states that have not

[6] "More Investors Turn to Municipal Bonds." New York Times: Dealbook. 21 May 2009. http://dealbook.blogs.nytimes.com/2009/05/21/more-investors-chastened-by-stock-losses-settle-for-municipal-bonds/

[7] Weisenthal, Joe. "Chart of the day: Cash-Strapped States Hope Salvation is Right Around the Corner." Business Insider, www.businessinsider.com/chart-of-the-day-state-tax-revenue-vs-gdp-2010-1.

accurately disclosed their liabilities and has suggested improvements to the muni bond offering process.[8] The SEC is monitoring several municipal entities. For this paper we will look at two case studies: California and the City of San Diego.

California

In May 2009, the California State Legislature attempted to shore up a $21 billion budget gap.[9] Many believe California's fiscal problems began in 1978 with the passage of Proposition 13, which rolled property assessments back to their 1975 levels and capped both the annual increase in assessed value and the tax itself.[10] Thereafter, the California state budget ballooned as the state assumed more liability for programs that were covered before Proposition 13 passed. In 1988, Proposition 89 passed, sponsored by the California Teachers Association, to give schools a guaranteed 40-plus percent portion of the state's revenues.[11] In 2000, the ".com" bubble burst left the state with a $14 billion operating deficit, a condition which seems to have plagued it ever since. By 2009, the state's annual deficit was at $40 billion, and the state was expected to run out of cash in late July.[12] On July 28, Governor Arnold Schwarzenegger signed the 2009-2010 California budget that closed the budget shortfall but caused him to invoke line-item vetoes, slashing $500 million in government programs, primarily in the health care and education budgets.[13]

To add to California's budget woes, in 2008 the California Employees Retirement System (CALPERS) actuary assumed higher rates of return for the state's pension fund. Soon thereafter, risky investments and the collapse of the stock market caused CALPERS to lose a

[8] SEC White Paper 1.
[9] *The Economist.* "No Gold in State". 21 May 2009.
[10] Carey, Pete. "California Budget Crisis Brings Critics of Prop 13 to the Fore". *Mercury News.* 24 July 2009.
[11] Walters, Dan. "30 Years of Budget Problem Mileposts". *The Sacramento Bee.* 22 June 2009.
[12] *Ibid*.
[13] Woo, Stu. "Schwarzenegger Signs California Budget After Making More Cuts". *The Wall Street Journal.* 29 July 2009.

third of its value.[14] The system owed benefits of more than $10 billion a year to over 400,000 state employees, and the losses forced the state to cover a more than $3 billion shortfall. This coming year the state is facing paying even more to CALPERS to fund another massive shortfall.

It can be argued that if it were legally possible to do so, California would be closer to declaring bankruptcy than any other state has ever been, including New York in 1975. Currently, there is no federal provision for states to file for bankruptcy.[15] As of February 2009, California had $59 billion in outstanding GO bonds and was currently the lowest rated U.S. state by all three major credit rating agencies.[16] When asked in June 2009 of the chances of California defaulting on their GO bonds, Martin Weiss of Weiss Research—most recently known for his early warnings about the collapse of Bear Stearns and Lehman Brothers—stated that "it's unavoidable."[17] As the world's eighth largest economy and the largest U.S. issuer of muni bonds, the prospect of California defaulting has far-reaching consequences. Should California default, how would that financial shortfall be addressed? Who covers bond payments if a municipality declares bankruptcy or defaults, as Vallejo, California, did earlier this year?

It is easy to see how municipal bonds tie into city and state pension fund liabilities: If a city cannot pay for city services due to huge annual pension system obligations, it may be unable to issue bonds or otherwise raise capital. In the current financial climate, investors may be wary of investing in muni bonds issued by cities and states with large unfunded liabilities and dwindling revenues. This problem is not going away any time soon and is threatening to affect many more cities and states around the country unless something is done to clean up the financial mess.

---

[14] PBS Newshour."Billions in Pension Payments Loom for State Budgets". 25 Dec 2009. http://www.pbs.org/newshour/bb/business/july-dec09/pensions_12-25.html
[15] Cohen, Marilyn. "Municipal Bonds: Armageddon or Opportunity?". *Forbes.* 19 Jan 2009.
[16] Petruno, Tom. "California's Credit Rating Cut to Lowest of All 50 States". *Los Angeles Times.* 3 Feb 2009.
[17] Birger, Jon. "A Warning Bell on California Muni Bonds". *Fortune.* 25 June 2009.

Weighed down by pension obligations, the city of Vallejo, California, filed the largest municipal bankruptcy since Orange County, California, filed in 1994.[18] In the instance of Vallejo, muni bond debt payments were assumed by banks that had backstopped the debt, and bondholders have continued to receive regular payments, though it is unclear how much and when the banks will recoup.[19] Many cities and states are facing the same problems as California and Vallejo: rising revenue shortfalls, soaring pension liabilities, and a host of other fiscal issues making issuing, buying, and paying back muni bonds a more risky endeavor for all involved.

Because of a lack of accurate financial information, the municipal bond market has not yet reflected these risks. Cities and states are not held to the same financial disclosure standards as corporations when issuing bonds, an issue that will be discussed later in this paper. The lack of consistency and transparency in state and municipal financial disclosures has caused the municipal bond market to become more risky than most investors believe. Due to this lack of transparency, it is impossible to accurately gauge to what extent cities and states are misstating their financial health until it is too late.

Problems in large governments often do not lend themselves to sequential staging: fiscal concerns are routinely postponed and go unaddressed until they present themselves cataclysmically all at once. In California's case, past increases in state spending and pension entitlements put in place during periods of fiscal growth are difficult or impossible to change in times of fiscal compression. Since California requires taxpayer approval in advance for general tax increases, during times of fiscal constraint the prospect of timely revenue increases is virtually impossible. The result is that continued obligations are accrued and paid out at high levels until the state literally runs out of money. California was in this exact situation last year,

[18] Wooley, Scott. "Beware of Defaulting Munis". *Forbes.* 16 March 2009.
[19] *Ibid*.

when the State Treasurer was forced to issue warrants (IOUs)—a form of debt default—instead of tax refunds to entitled California taxpayers.[20] School and other special districts are likewise restricted by limitations on raising taxes without a vote, and when they fail financially, the state has the ability to force those entities into receivership. Obviously, such resort is far more difficult in times when the state is itself in fiscal imbalance.

While a subdivision of a state can file for Chapter 9 Bankruptcy to restructure its financial condition, such decisions face strong resistance from politicians who worry about being held responsible for financial problems. Political implications make government officials much more likely to elect to liquidate public assets or discontinue essential public services in order to survive until term limits force the problem onto the next officeholder. Although the U.S. bankruptcy code was extended in 1934 to include municipalities, states do not have the right to file for Chapter 9 bankruptcy under existing federal law.[21]

City of San Diego

San Diego has experienced some especially egregious miscalculations by those in charge of its finances. These missteps, both purposeful and otherwise, have caused the city much stress in the areas of the city's credit rating and access to the capital markets.

In September 2003, a board member of the San Diego City Employees Retirement System (SDCERS) found outdated and incorrect information regarding the city's financial situation in a city sewer bond prospectus. The $505 million bond prospectus neglected to mention the city's underfunding of its pension fund that had, over time, generated an unfunded liability of over $1.15 billion.[22] The pension fund was referred to in only four paragraphs in a

---

[20] Woo, Steve and Sabrina Shankman. "California Lays Plans To Issue IOUs To Creditors". *Wall Street Journal.* 2 July 2009.

[21] "Bankruptcy Reform Act". 1978. (P.L. 95-598)

[22] Broder, John. "San Diego Finds Itself being Viewed as a Kind of Enron-By-The-Sea". *New York Times*. 7 Sept 2004.

bond prospectus that generally mentioned the deficit but not the scope of the practice of intentional underfunding. The prospectus stated that the deficit's recent spike was due to "less than anticipated investment returns."[23]

Once the pension liability was discovered, the sewer bond sale was postponed. Four months later the city was forced to admit it had misstated its financial condition for the last several years and submitted changes to its financial disclosure documents.[24] The new report stated that by 2011 the city might have to pump as much as $306 million into the pension system, up from the $85 million required in the year of the bond offering.[25] The amended reports also projected a $2.4 billion shortfall in the pension fund by 2011. Eight days after the city filed its report, rating agencies began to downgrade the city's credit rating, reducing its ability to issue bonds. At the same time, the SEC opened an investigation into the former city auditor and the U.S. Attorney's office announced that it had launched an investigation into possible fraud and corruption within the city related to the bond offering.[26] By the end of 2003, the retirement system's debt had swelled to $1.3 billion and the city had yet to produce a certified financial statement for the year.

In September 2004, the *New York Times* dubbed San Diego "Enron-by-the-Sea."[27] In April 2008, the SEC alleged that five former San Diego city officials had misled bond investors and Wall Street analysts in borrowing $262 million in 2002 and 2003.[28] It stated that city officials knew the unfunded pension liability would balloon out of control by 2009, but chose not to stop it. City officials responded that they had received bad advice from other city officials and

---

[23]LaVelle, Phil. "City Pension Woes Called 'Significant". *San Diego Union Tribune*. 4 Feb 2004.
[24] Broder
[25] LaVelle
[26] Strumpf, Daniel. "San Diego's Pension Scandal for Dummies". *San Diego City Beat.* 15 June 2005.
[27] Broder
[28] Hall, Matthew. "Ex-City Officials Charged with Fraud". *Union Tribune.* 8 Apr 2008.

private advisers.[29] In a separate case, the SEC also charged pension board members with various related charges.[30]

The scope of the pension deficiency was bracing. The allure of pension underfunding devices are all based on the same premise: that it will be easier to backfill pension deficits in later years than to pay them in full in the year required. This is almost never true and the later funding almost never happens. Once the underfunding practice begins, the combination of compound interest on deficits and the precedent set for sending unfunded pension debt to undefined later generations is too attractive an approach to abandon—until it is discovered or fails.

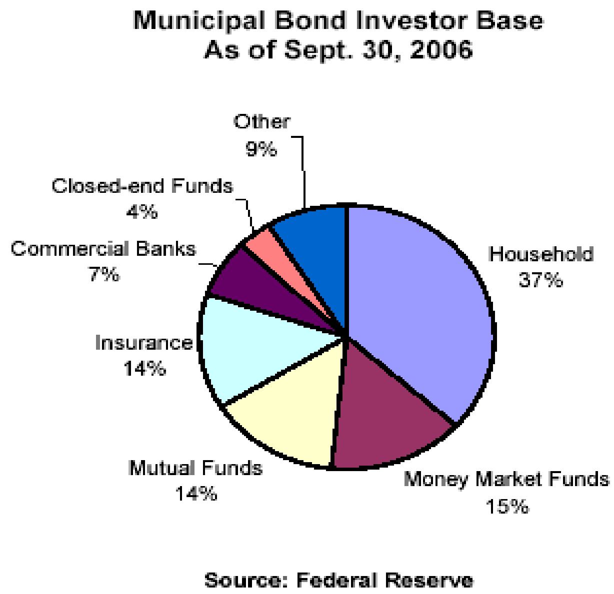
The cases against the city of San Diego were the SEC's strongest current enforcement action in the municipal bond area. In the mid-1990s, city officials from the County of Orange, California, misled investors in order to sell $2.1 billion in bonds. The SEC issued a cease-and-desist letter but did not levy fines or take further action. In San Diego, the SEC has pursued both the city and public officials.[31] By charging city officials with civil penalties, the SEC seems to be sending a signal to other municipalities, putting them on notice.

This strong stance by the SEC runs parallel to the increased interest in the municipal bond market by individuals, especially investors looking for safe investments. According to the San Diego *Union Tribune*, individual investors own about 70 percent of all municipal securities, either directly or through mutual funds (see Chart 2).[32] Municipal bonds are generally perceived to be the second safest investment next to U.S. Treasury notes.

---

[29] *Ibid*.
[30] *Ibid*.
[31] Gustafson, Craig. "SEC Flexing its Muscle in San Diego Case". *Union Tribune.* 13 Apr 2008.
[32] *Ibid*.

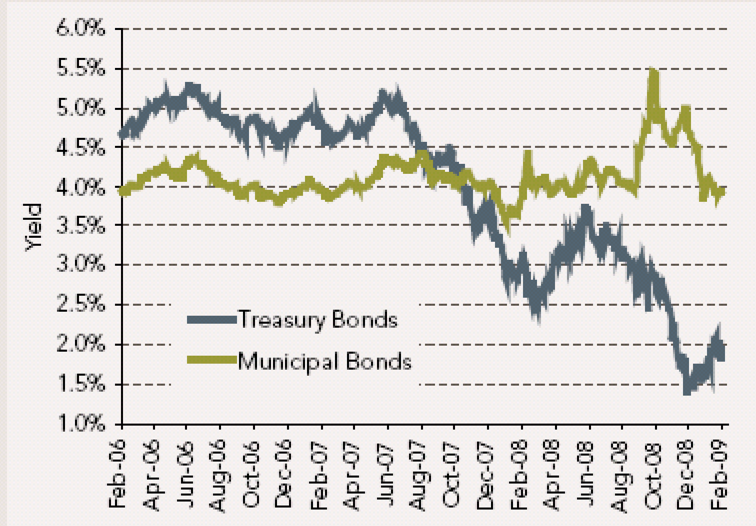
Chart 2: Municipal Bond Investor Base[33]



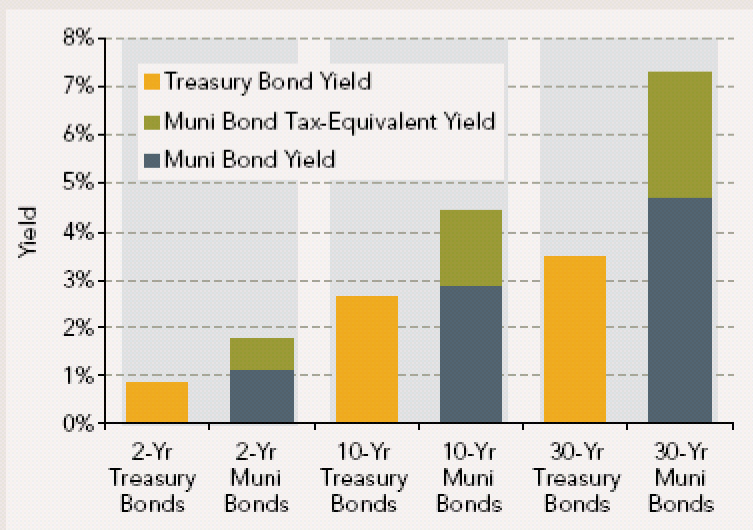
Because municipal bond yields are higher than Treasury bond yields (see Chart 3), they may be more attractive to investors who are looking for a safe investment product with a reasonable return. However, if municipalities and states fail to disclose all relevant financial information, the safety of these products must be questioned.

[33] PIMCO. "Bond Basics." March 2007.
http://www.pimco.com/LeftNav/Bond+Basics/2007/Muni+Bond+Basics.htm

Chart 3: Municipal Bond Yields vs. Treasury Bond Yields[34]



Yields represented by the following indices: Treasury Bonds - Barclays Capital® (BC) Treasury Index; Municipal Bonds - BC Municipal Index. Source: Barclays Capital, FMRCo (MARE) as of 2/18/09.



Tax-equivalent yield calculated using top federal income tax rate (35%). Source: Municipal Market Data - Thomson Financial Services, Bloomberg, FMRCo (MARE) as of 2/17/09.

(www publications.fidelity.com)

[34] Fidelity. "Municipal bonds: Yielding more as high-quality credits are tested." 23 Feb 2009. https://news.fidelity.com/news/article.jhtml?guid=/FidelityNewsPage/pages/mare-yielding-more-as-high-quality-credits-are-tested

Other Cities

San Diego is not the only city experiencing huge pension liabilities on its balance sheet. Other cities and states, like Houston and Illinois, are facing shortfalls similar to San Diego's. In Houston, to prevent a mass retirement of 5,000 experienced city employees, the city implemented a plan where city employees who agreed to stay would receive both their salary and their pension, which would be credited with a minimum annual interest of 8.5 percent.[35] The Houston pension fund was, as of 2004, running a deficit of $1.9 billion.

In Illinois, state employees have exploited the state pension system by using a practice known as "spiking," which effectively increases final salaries before retirement in order to collect more in pension benefits.[36] These employees would, just before retirement, move into a higher paying position for a short period of time. Since pensions are usually determined by one's final salary, the workers in Illinois were able to collect higher benefits without having been in a senior position long. By artificially increasing benefits, state workers effectively put more strain on an already strained pension system. The pension plans covering the 630,000 Illinois state workers and retirees were, as of 2004, collectively underfunded by $35 billion—the worst pension deficit in the country.[37] Illinois's problems date back to the early 1980s, when legislators began to limit contributions to the pension funds in order to balance tight general fund budgets. By the mid-1990s, the assets in Illinois's state pension funds plummeted to below 55 percent of liabilities, at which point the state government mandated huge payments until the fund ratios were restored.

Pension plans covering the nation's 16 million state and local government employees—about 12 percent of the total U.S. workforce—collectively owe $366 billion more to their

---

[35] Revell, Janice. "The $366 Billion Outrage All Across America". *CNNMoney.com*. 31 May 2004.
[36] *Ibid.*
[37] *Ibid.*

pension systems than is actually funded.[38] In 2003, Illinois offered $10 billion in pension obligation bonds with the proceeds earmarked to go toward the state's five pension systems.[39]

While borrowing money may help in the short-term, bond offerings do not make the long-term problem go away. Cities and states have tried converting to 401K-style contribution plans, but have been met with huge resistance by state and local workers. In both New York and Massachusetts, such conversion plans have been postponed indefinitely.[40]

III. CAPITAL MARKET PROBLEMS AND EFFECTS

Some may think that because the municipal bond market funds public projects, it is a market immune to the problems plaguing the capital markets in general. This could not be further from the truth. The subprime housing market collapse, the collapse of certain brokerage firms, and the government intervention in the business of American International Group, Inc., all affect the muni bond market directly and indirectly. Apart from the obvious direct concerns when investing in municipal bonds, which arise from a deficiently funded pension system, muni bond insurers were also insuring subprime mortgages, causing certain munis to be downgraded due to poor decisions by these monoline insurers. These downgrades directly affected investors and municipalities alike. As is easy to see, everything traded on the capital markets is connected, and muni bonds are no exception.

Rating Agency Problems

Both subprime mortgage instruments and muni bonds have been affected by the problems inherent in credit rating agencies. It is difficult to fully parse out the similarities and distinctions reflected in the failures by credit rating agencies (CRAs) in assessment of municipal bonds and housing-related derivative products—at first look they appear unconnected. While this paper will

---

[38] *Ibid.*
[39] *Ibid.*
[40] *Ibid.*

not delve deeply into this, one shared trait stands out: both were either legally entitled, or market allowed, to self represent unwarranted and inflated financial conditions and images of solvency. In the case of non-pension related products, the nature of the products being developed were new, relatively unknown, and supported by market assurances and guarantees from third parties such that closer scrutiny seemed unnecessary. In the case of municipalities, accounting practices were legally non-uniform, allowing for every sort of inspired creativity (which rating agencies found unnecessary to investigate more thoroughly because of how historically safe muni bonds had been). Subsequent exposure of monoline insurers to the subprime mortgage market was unrecognized by CRAs as a liability and was ignored, causing many muni bonds to be downgraded when the subprime market imploded.

Credit rating agencies analyze a bond issuer's ability to meet its debt obligations and then issue a rating based on the issuer's perceived strength and risk. The scale for rating both public and private debt is: AAA, AA, A, BBB, BB, B, CCC, CC, C, and D, with AAA being the highest and anything below representing increasing risk for investors. The best-known rating agencies are Fitch, Moody's Investors Service, and Standard and Poor's. CRAs have been a feature of the securities market since the nineteenth century and predate the federal regulation of capital markets.[41]

Before the collapse of the capital markets in 2008, all three CRAs were active in rating mortgage-backed securities. As an example, by 2006, mortgage-backed securities accounted for 43 percent of all of Moody's revenue.[42] It is clear now that the CRAs failed in accurately assessing the possibility of a collapse of the subprime mortgage market. All three companies highly rated many mortgage-backed securities offerings, only to later downgrade them after the

---

[41] Seitzinger, Michael and Gary Shorter. "Credit Rating Agencies and Their Regulation". *Congressional Research Service*. 29 May 2009.

[42] *Ibid*. 5.

collapse became apparent. The scope and magnitude of the downgrades caused concern among investors that the CRAs do not review offerings thoroughly enough on the front end and do not downgrade companies quickly enough as adverse information becomes available, leaving their ratings not to be trusted.[43] One prominent example when discussing the failure of the CRAs is the Enron case, in which the CRAs kept Enron's rating at investment grade until just four days before the company went bankrupt.[44]

There are a number of key reasons, identified by the Congressional Research Service, that CRAs have failed in doing their job:

- ***Issuer-Pays Model:*** Because issuers pay the CRAs to rate bond offerings, a potential bias is created toward providing overly favorable ratings, which can encourage "ratings shopping" and engender a "race to the bottom";
- ***Existence of Quasi-Regulatory License:*** In 1975, the SEC recognized the "big three" CRAs as Nationally Recognized Statistical Rating Organizations (NRSROs). As a result, there is little competition outside of the big three, which has led to an oligopoly;
- ***Flawed Models and Assumptions:*** The agencies used flawed models and presumptions in their rating processes;
- ***Inability to Handle a Voluminous Amount of Structured Securities Business:*** CRAs were overwhelmed by the sophistication of some of the financial products they were rating;
- ***Challenges from High Levels of Fraud and Lax Mortgage Underwriting:*** Lax underwriting and underwriting fraud for many of the subprime mortgages that were

[43] *Ibid*. 6.

[44] Borrus, Amy. "The Credit-Raters: How They Work and How They May Work Better". *Business Week.* 8 April 2002.

bundled within structured securities is said to have undermined the rating process for these securities;

- ***Insufficient CRA Regulation:*** The advent of new, more strict regulation suggests that the previous regulatory guidelines were inadequate;
- ***Potential Conflicts of Interest in Designing Some Securities:*** CRAs were often involved in both designing and rating securities. These relationships with issuers is thought to have undermined their ability to provide unbiased ratings;
- ***Limited Liability Under the First Amendment:*** CRA ratings are often categorized as having First Amendment rights similar to those of journalists, in that they are immune from liability, absent actual malice.[45]

In July of 2008 the SEC released a study on CRAs recommending changes in the way the agencies currently operate. In response, the big three CRAs have voluntarily adopted a number of reforms, which include reforming the review of due diligence conducted by underwriters; improving their analytical methodologies; promoting objective measurement of ratings performance; adopting measures to improve investors' understanding of the attributes and limitations of credit ratings; rotating analysts; and establishing an ombudsman to help manage potential conflicts of interest.[46] In June of 2008 all three CRAs reached a settlement with the Attorney General of New York that requires increased independence from issuers/clients. However, the settlement does not appear court enforceable, so CRAs are still, in many ways, on their own. The SEC is continuing to look into more stringent rules in order to better align investors' interests with the rating agencies' practices.

Municipal Bond Insurer Problems

---

[45] Seitzinger 6-8.
[46] *Ibid.* 11.

Municipal bond insurance was introduced in the U.S. in 1971 with the establishment of American Municipal Bond Assurance Corporation (AMBAC). Three years later, the Municipal Bond Insurance Association (MBIA) was created. By 1979, both companies had achieved AAA ratings by CRAs and by 1988, 25 percent of all muni bonds issued carried insurance.[47]

By paying a premium to insurance companies, muni bond issuers are able to increase issue ratings, which both increases investor demand and lowers the interest cost. Initially these insurers, also known as monoline insurers, were solely involved in insuring municipal bonds.[48] Gradually, and as a way of increasing profits, monoline insurers became involved in insuring mortgage-backed securities, collateralized debt obligations (CDOs), and other similarly structured financial products. In 2006-2007, when the housing market failed, these insurers were heavily exposed. In January of 2008, AMBAC became the first bond insurer to lose its AAA status when Fitch reduced its rating to AA.[49] The downgrade of AMBAC triggered a downgrade in the ratings of $500 billion of municipal bonds covered by AMBAC from over 100,000 municipalities and institutions.[50]

The CRAs rate muni bonds as well as the bond insurers who insure the bonds. These insurers insured unsafe structured financial products and transferred their AAA rating onto those financial products. These risky investments were thought of and bought as safe. In the collapse of the subprime market, municipal bonds were not spared in the uncertainty associated with the solvency of the insurers. It is easy to see how bond insurers' exposure to subprime and CDO markets resulted in a downgrade in billions of dollars worth of municipal bonds.

---

[47] "Municipal Bond Insurance". *Investopedia*. http://www.investopedia.com/articles/bonds/08/municipal-bond-insurance.asp

[48] *Ibid*.

[49] Richard, Christine. "Ambac Insurance Loses AAA Rating at Fitch". *Bloomberg*. 8 Jan 2009.

[50] "Bond Insurance". *Wikipedia*. http://en.wikipedia.org/wiki/Bond_insurance

In the aftermath of the market collapse, regulators and bankers were considering a division of bond insurers: one for insuring municipal debt and one for insuring riskier products, like mortgage-related securities.[51] In February of 2008, MBIA split its muni bond business away from other insurances and created an indirect subsidiary called National Public Finance Guarantee, Corp. In June of 2009, Standard and Poor's lowered the new subsidiary's rating from AA- to A due to "uncertain business prospects."[52] At the time of MBIA's split and downgrade, only AMBAC was writing new bond insurance. Warren Buffet's company, Berkshire Hathaway, entered the monoline insurance market by creating Berkshire Hathaway Assurance Company (BHAC), hoping to take advantage of the hole left by MBIA. [53] However, in October of 2009, Berkshire Hathaway unilaterally exited the municipal bond market, citing a questions and uncertainties in the municipal bond area.[54]

The Tower Amendment

The 1975 Tower Amendment to the Securities and Exchange Act of 1934 limits both the SEC and the Municipal Securities Rulemaking Board (MSRB) from requiring municipal issuers to file comprehensive and accurate financial materials before selling bonds.[55] This amendment allows the financial disclosures offered by cities and states to be varied and inconsistent compared to the standards required of the private sector bond market.

Former SEC Chairman Arthur Levitt believes that municipal bond issuers should follow "effective and consistent" accounting standards issued by an independent board backed by SEC jurisdiction and enforcement.[56] Levitt also believes that all disclosure requirements that apply to

[51] Bajaj, Vikas. "A Split-Up of Insurers of Bonds Is Considered". *New York Times.* 16 Feb 2008.
[52] Harrington, Shannon and Jody Shenn. "MBIA Splits Off Municipal Bond Insurance Business". *Bloomberg.* 18 Feb 2009.
[53] Ellis, David. "Buffet Offered to Help Ailing Bond Insurers". *Fortune.* 12 Feb 2008.
[54] Freehling, Bill. "Berkshire Hathaway Pulls Out of Municipal Bond Insurance". *GuruFocus.com*. 4 Oct 2009.
[55] Mysak, Joe. "U.S. Muni Issuers Prepare to Debate Tower Amendment". *Bloomberg.* 2 May 2007.
[56] Daley, Gemma. "Levitt Urges Stricter Muni Bonds Oversight in WSJ". *Bloomberg.* 9 May 2009.

the private sector bond market should equally apply to the municipal bond market: "The opacity of this market is unrivaled and thus presents a significant threat to our economy … We need major reform, beginning with industry-wide oversight."[57]

Municipal bond issuers are expected to resist any change to the Tower Amendment, as increased emphasis on disclosures would require extra time and possible exposure of financial weaknesses, causing interest costs to rise. It is arguable that investors and underwriters would favor more accurate and complete disclosure, especially underwriters who have long felt the burden of questionable official statements from bond issuers.[58] Disclosure consistent with corporate bond offerings could potentially mitigate the problems found in cases like San Diego, where city financial liabilities were not fully stated.

IV. SOLUTIONS

Municipal Securities Rulemaking Board (MSRB)

The MSRB is tasked by Congress with making the rules that regulate broker-dealers and banks that deal in municipal bonds and notes.[59] While the MSRB is responsible for making the rules, it has no power to enforce these rules as a result of the Tower Amendment.

In June of 2009, the MSRB created the Electronic Municipal Market Access System (EMMA) that plans to provide documents related to state and local government bond offerings online.[60] This system is 13 years behind the SEC-operated parallel system for corporate bonds known as EDGAR, or Electronic Data Gathering Analysis and Retrieval. While EMMA is a step in the right direction in improving disclosure to muni bond investors, muni bond issuers are still shielded by the Tower Amendment and are still be able to disclose less than is required of

---

[57] *Ibid.*
[58] *Ibid.*
[59] "Municipal Securities Rulemaking Board". *Wikipedia*.
http://en.wikipedia.org/wiki/Municipal_Securities_Rulemaking_Board
[60] Preston, Darrell. "Muni Bonds Lag 13 Years Behind Corporate Disclosures". *Bloomberg.com.* 12 June 2009

corporate bond issuers. According to a study done in September of 2008 by DPC Data, Inc., a quarter of municipal issuers failed to file documentation for three or more years, and muni borrowers with the greatest default risk led these non-disclosers. [61] This lack of disclosure, coupled with rising defaults of $7.6 billion in 2008—up from $329 million in 2007—underscores a clear flaw in the municipal bond disclosure system as it stands today. The rise in defaults has been led by Jefferson County, Alabama, which faces bankruptcy after interest on $3 billion of adjustable-rate debt surged to 10 percent when their bonds lost top ratings. The county was unable to refinance because the ratings on its bonds were below investment grade, and the Alabama state legislature refused a plan for new revenue to back the mounting debt.[62] As of November 2009, Jefferson County's situation was still uncertain.[63] Concern over the possibility of the county declaring bankruptcy—where bond investors might only get back cents on the dollar—has many watching closely to see how this city's financial problems unfold.

Financial Industry Regulatory Authority (FINRA)

FINRA, a regulatory organization established by the Securities and Exchange Act of 1934, is responsible for regulating all securities firms that do business with the public.[64] In June of this year, FINRA began conducting sweeps to gather information on firms that underwrite securities tied to derivatives related to small municipal bond offerings.[65] The collapse of the $330 billion auction-rate securities market in early 2008 left investors unable to sell bonds they were initially told were as safe as cash.

Many banks and bond insurers like AIG, who guaranteed payment on the bonds, experienced huge exposure to the auction-rate securities failures and were unable to support their

[61] *Ibid.*
[62] *Ibid.*
[63] Burnsed,Brian. "Bond Debacle Sinks Jefferson County." *Business Week*. 8 Nov 2009.
[64] "Financial Industry Regulatory Authority". *Wikipedia*. http://en.wikipedia.org/wiki/FINRA
[65] Preston, 30 June 2009.

insurance on these once they were given reduced credit ratings. Many small municipalities invested bond capital in these derivative products, in expectation of better returns with no increase in risk. Instead, many were left with the inability to repay their own bondholders, and municipal bond defaults rose last year to their highest levels. About $211 billion of the auction-rate securities market involved municipal securities.[66] Lynette Hotchkiss, head of the MRSB, stated earlier this year: “It would be very easy to say, muni securities, forget it, it doesn’t matter … Nobody knew what kind of exposure municipalities had to AIG.”[67]

National League of Cities Proposal

In May of 2009, the National League of Cities (NLC) requested start-up capital from the U.S. Treasury Department to create the first ever mutual bond insurance company, called Issuers Mutual Bond Assurance Company (IMBAC).[68] By creating this new bond insurer, NLC hopes it will assist in financing municipal projects by reducing state and local borrowing costs. Membership would be limited to state and local government agencies, and the company will not insure securities that lead to the downgrade of other bond insurers. NLC has requested $3 billion in initial capital and another $2 billion in call capital if there is a strong demand.[69] NLC’s request has coincided with the Treasury’s push to help cities obtain money at cheaper rates. Congressman Barney Frank, Chairman of the House Financial Services Committee, has championed NLC’s idea, calling it the “ideal solution” to bring much needed liquidity to the municipal bond market.[70]

Government Accounting Standards Board (GASB)

---

[66] Preston, Darrell. “SEC Approves Expanding Muni Bond Market Disclosure Requirements”. *Bloomberg.com.* 15 July 2009.
[67] Braun
[68] Spain, Cathy. “NLC Seeks Treasury, Industry Support for New Municipal Bond Insurer”. *Nation’s Cities Weekly.* 25 May 2009.
[69] *Ibid.*
[70] Etzkorn, Lars. “Rep. Frank Highlights NLC Plan During Municipal Bond Hearing”. *Nation’s Cities Weekly.* 25 May 2009.

The GASB is an independent organization established in 1984 that establishes standards of accounting and financial reporting for U.S. state and local governments.[71] It is recognized as setting the Generally Accepted Accounting Principles (GAAP) by which state and local governments operate. GASB is not a government entity; rather, it operates as a component of the Financial Accounting Foundation (FAF), a private-sector and non-profit entity.

While GASB has issued a white paper on "Why Governmental Accounting and Reporting Is—and Should Be—Different," and is working on a project regarding public sector pension disclosures, the organization lacks the authority to enforce any rules or regulations on local and state governments. Without a regulatory arm, either through GASB or the SEC, states and municipalities are able to use, or not use, any or all of GASB's recommendations regarding financial reporting. This is a key issue for GASB and for municipal bond investors. While cities and states may say they are following GASB policies, often they do not. Due to the Tower Amendment, GASB has been left somewhat powerless. While the SEC has stated it is looking into congressional intervention to set standards for cities and states, it remains to be seen whether this Congress will pass legislation on this particular issue.

Securities and Exchange Commission Actions

Due to the continued problems in the municipal bond market, the SEC is seeking congressional action to require improved disclosure requirements for securities dealers issuing municipal bonds. The SEC voted unanimously to propose changes to SEC Rule 15c2-12, which prohibits brokers and municipal securities dealers from purchasing or selling municipal securities unless they reasonably believe the state or local government issuing the securities has agreed to disclose annual financial statements and notices of certain events, such as payment defaults,

[71] Governmental Accounting and Standards Board. "Facts About GASB". http://www.gasb.org/facts/facts_about_gasb_2009-2010.pdf

rating changes, and prepayments.[72] The proposed amendments would expand the Rule 15c2-12 to cover additional municipal securities; improve disclosure of tax risk; strengthen and expand disclosure of certain events; establish a more specific filing deadline; and propose additional guidance regarding interpretations of the rule.[73]

In December 2008, through the SEC, MSRB established the EMMA system whereby individuals can access specific financial documents relating to municipal bond offerings.[74] While this modestly helps remove the veil of secrecy often surrounding municipal disclosures, it does not achieve full transparency, as there is still no law that compels municipalities' data to be uniform.

The SEC unanimously approved changing the rules that currently apply to securities dealers, and Mary Shapiro, the new Chair of the SEC, has said that she plans to work with Congress to further expand the SEC's authority over municipal securities.[75] While the SEC's rule changes regarding the dealers of municipal bonds are a step in the right direction, federal law still limits SEC authority over issuers of municipal securities.

Federal Involvement

The House Financial Services Committee, led by Congressman Barney Frank, spearheaded the effort to legislatively correct problems within the capital markets. In January 2009, Chairman Frank suggested that the second half of Troubled Asset Relief Program (TARP) funds should include aid for municipal bond issuers hurt by the credit crisis.[76] Many in Congress have pushed for federal assistance, through TARP and otherwise, to help state and local governments jumpstart state infrastructure projects.

---

[72] "SEC Votes to Propose Rules Enhancing Municipal Securities Disclosure". SEC Press Release. 15 July 2009.
[73] *Ibid.*
[74] Preston, Darrell. "Muni Bonds Lag 13 Years Behind Corporate Disclosures". *Bloomberg.com.* 12 June 2009.
[75] *Ibid.*
[76] Schmidt, Robert. "U.S. House's Frank Says TARP Funds Should Aid Muni-Bond Insurers". *Bloomberg.com.* 8 Jan 2009.

Due to the compression in the credit markets after the collapse of the subprime and other market sectors, municipalities have found it increasingly difficult to sell municipal bonds. President Obama has also expressed support for the muni bond market and has proposed a system within the U.S. Treasury to guarantee municipal debt.[77] As part of the American Reinvestment and Recovery Act (ARRA), President Obama has created Build American Bonds (BABs), taxable municipal bonds that carry special tax credits and federal subsidies for bond issuers and bond holders.[78] This program has given some relief to the municipal bond market; however, BABs do not guarantee the entire amount of the bond.[79] The program is expected to sunset at the end of 2010.

Currently, there are four draft bills released by Chairman Frank during the 111th Congress that deal with the municipal bond market.

- **H.R. 2549 – The Municipal Bond Fairness Act** would ensure uniform and accurate credit rating of municipal bonds;
- **H.R. 2550 – The Municipal Advisors Regulation Act** would amend the Securities and Exchange Commission Act of 1934 to require the registration of municipal financial advisors;
- **H.R. 2551 – The Municipal Market Liquidity Act** would amend the Federal Reserve Act to provide for lending authority for certain securities purchases;
- **H.R. 2589 – The Municipal Bond Insurance Enhancement Act** would establish the Office of Public Finance within the Department of the Treasury, which would provide federal reinsurance for municipal-only primary bond insurance.[80]

---

[77] Schmidt
[78] "Build America Bonds". *Wikipedia*. http://en.wikipedia.org/wiki/Build_America_Bonds
[79] McTague, Tim. "BABs In Bond Land". *Baron's.* 6 July 2009.
[80] Etzkorn

All of these bills are currently referred to either the House Financial Services Committee or the Ways and Means Committee. None of the draft bills contain a federal guarantee for general obligation bonds; however, Chairman Frank has said he will consider such a provision.

V. CONCLUSIONS

In studying the problems in the capital markets, the recurring deficiency with respect to municipal bonds is one of disclosure. Due to the Tower Amendment, cities and states are not required to fully disclose accurate financial information. While this may have been acceptable when the Tower Amendment was passed in the 1970s, it seems no longer appropriate in the current market. Structured financial products are far more complicated than ever before, and the municipal bond market is not immune to the hazards created by under-regulation of complicated products. Since municipal bond products are directly and indirectly tied to the larger capital markets, it seems prudent that municipalities should be required to disclose the same type of information as is required in corporate bond offerings and be regulated by the SEC to the same extent as private sector offerings.

MSRB, FINRA, GASB, and the SEC need greater oversight authority in regulating credit rating agencies, bond insurers, and bond issuers. This past year all these entities were needed in ways not appreciated before the market collapse. To gain oversight authority, the Tower Amendment would need to be repealed through legislative action. Based on this clear need, federal government involvement is inevitable and is, in fact, already underway.

More must be done to protect both municipal bond investors and the cities and states that issue them, in order to continue to provide necessary financing for city and state projects. City and state governments must be open to increased disclosure. Uniformity and increased transparency is the only way to stabilize municipal securities.

Many critical aspects of American life depend on the municipal financing of capital projects. The problems in the municipal bond market must be carefully watched and regulated in order to avoid the disaster that transpired in 2007 with the collapse of the housing market. It is a new era for municipal bond offerings, and the federal government must be vigilant in securing these products for cities, states, and investors in the future.

BIBLIOGRAPHY

Bajaj, Vikas. “A Split-Up of Insurers of Bonds Is Considered.” *New York Times.* 16 Feb 2008.

“Bankruptcy Reform Act.” 1978. (P.L. 95-598)

Birger, Jon. “A Warning Bell on California Muni Bonds.” *Fortune.* 25 June 2009.

“Bond Insurance.” *Wikipedia*. http://en.wikipedia.org/wiki/Bond_insurance

Borrus, Amy. “The Credit-Raters: How They Work and How They May Work Better.” *Business Week.* 8 April 2002.

Broder, John. “San Diego Finds Itself being Viewed as a Kind of Enron-By-The-Sea”. *New York Times*. 7 Sept 2004.

“Build America Bonds.” *Wikipedia*. http://en.wikipedia.org/wiki/Build_America_Bonds

Burnsed,Brian. “Bond Debacle Sinks Jefferson County.” *Business Week*. 8 Nov 2009.

Carey, Pete. “California Budget Crisis Brings Critics of Prop 13 to the Fore.” *Mercury News.* 24 July 2009.

Cohen, Marilyn. “Municipal Bonds: Armageddon or Opportunity?” *Forbes.* 19 Jan 2009.

Daley, Gemma. “Levitt Urges Stricter Muni Bonds Oversight in WSJ.” *Bloomberg.* 9 May 2009.

“Discretionary Appropriations Status.” *Congressional Budget Office*. www.cbo.gov/budget/approps.shtml

Ellis, David. “Buffet Offered to Help Ailing Bond Insurers.” *Fortune.* 12 Feb 2008.

Etzkorn, Lars. “Rep. Frank Highlights NLC Plan During Municipal Bond Hearing.” *Nation’s Cities Weekly*. 25 May 2009.

Fidelity. "Municipal bonds: Yielding more as high-quality credits are tested." 23 Feb 2009. https://news.fidelity.com/news/article.jhtml?guid=/FidelityNewsPage/pages/mare-yielding-more-as-high-quality-credits-are-tested

“Financial Industry Regulatory Authority.” *Wikipedia*. http://en.wikipedia.org/wiki/FINRA

Freehling, Bill. “Berkshire Hathaway Pulls Out of Municipal Bond Insurance.” *GuruFocus.com*. 4 Oct 2009.

Governmental Accounting and Standards Board. “Facts About GASB.” http://www.gasb.org/facts/facts_about_gasb_2009-2010.pdf

Gustafson, Craig. “SEC Flexing its Muscle in San Diego Case.” *Union Tribune.* 13 Apr 2008.

Hall, Matthew. “Ex-City Officials Charged with Fraud.” *Union Tribune.* 8 Apr 2008.

Harrington, Shannon and Jody Shenn. “MBIA Splits Off Municipal Bond Insurance Business.” *Bloomberg.* 18 Feb 2009.

McTague, Tim. “BABs In Bond Land.” *Baron's.* 6 July 2009.

“More Investors Turn to Municipal Bonds.” New York Times: Dealbook. 21 May 2009. http://dealbook.blogs.nytimes.com/2009/05/21/more-investors-chastened-by-stock-losses-settle-for-municipal-bonds/

“Municipal Bonds.” *Securities and Exchange Commission (SEC)* definition. http://www.sec.gov/answers/bondmun.html

“Municipal Bond Insurance.” *Investopedia*. http://www.investopedia.com/articles/bonds/08/municipal-bond-insurance.asp

“Municipal Securities Rulemaking Board.” *Wikipedia*. http://en.wikipedia.org/wiki/Municipal_Securities_Rulemaking_Board

Mysak, Joe. “U.S. Muni Issuers Prepare to Debate Tower Amendment.” *Bloomberg.* 2 May 2007.

LaVelle, Phil. “City Pension Woes Called ‘Significant”. *San Diego Union Tribune*. 4 Feb 2004.

PBS Newshour.“Billions in Pension Payments Loom for State Budgets.” 25 Dec 2009. http://www.pbs.org/newshour/bb/business/july-dec09/pensions_12-25.html

Petruno, Tom. “California's Credit Rating Cut to Lowest of All 50 States.” *Los Angeles Times.* 3 Feb 2009.

PIMCO. "Bond Basics." March 2007. http://www.pimco.com/LeftNav/Bond+Basics/2007/Muni+Bond+Basics.htm

Preston, Darrell. “Muni Bonds Lag 13 Years Behind Corporate Disclosures.” *Bloomberg.com.* 12 June 2009

Preston, Darrell. “SEC Approves Expanding Muni Bond Market Disclosure Requirements.” *Bloomberg.com.* 15 July 2009.

Revell, Janice. “The $366 Billion Outrage All Across America.” *CNNMoney.com*. 31 May 2004.

“Revenue Bonds.” *Investopedia*. http://www.investopedia.com/articles/bonds/05/022805.asp

Richard, Christine. “Ambac Insurance Loses AAA Rating at Fitch.” *Bloomberg.* 8 Jan 2009.

Schmidt, Robert. “U.S. House’s Frank Says TARP Funds Should Aid Muni-Bond Insurers.” *Bloomberg.com.* 8 Jan 2009.

“SEC Votes to Propose Rules Enhancing Municipal Securities Disclosure.” SEC Press Release. 15 July 2009.

Securities and Exchange Commission. *Disclosure and Accounting Practices in the Municipal Bond Market (White Paper).* 7 June 2007. p4.

Seitzinger, Michael and Gary Shorter. “Credit Rating Agencies and Their Regulation.” *Congressional Research Service*. 29 May 2009.

Spain, Cathy. “NLC Seeks Treasury, Industry Support for New Municipal Bond Insurer.” *Nation’s Cities Weekly.* 25 May 2009.

Strumpf, Daniel. “San Diego’s Pension Scandal for Dummies.” *San Diego City Beat.* 15 June 2005.

The Economist. “No Gold in State.” 21 May 2009.

Walters, Dan. “30 Years of Budget Problem Mileposts.” *The Sacramento Bee.* 22 June 2009.

Weisenthal, Joe. "Chart of the day: Cash-Strapped States Hope Salvation is Right Around the Corner." Business Insider. www.businessinsider.com/chart-of-the-day-state-tax-revenue-vs-gdp-2010-1

Woo, Stu. “Schwarzenegger Signs California Budget After Making More Cuts.” *The Wall Street Journal*. 29 July 2009.

Woo, Steve and Sabrina Shankman. “California Lays Plans To Issue IOUs To Creditors.” *Wall Street Journal.* 2 July 2009.

Wooley, Scott. “Beware of Defaulting Munis.” *Forbes.* 16 March 2009.