**Testimony of Mary Jo Ochson**

**CIO Federated Investors Municipal Bond and Tax Exempt Money Market Group**

**Before the**

**Committee on Financial Services**
**United States House of Representatives**

**On**

**"Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance"**

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**Hearing of the U.S. House Financial Services Committee**
**"Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance"**

Good morning, and thank you Chairman Frank and members of the Committee for the opportunity to appear here today. You and the Committee are to be commended for your work in this particular area as well as the tremendous efforts you have led over the last months to address the major financial issues confronting us. Federated is vitally interested, as investment adviser for our funds' shareholders, in the health of the municipal markets. We support your initiative to examine, understand and resolve the disruptions to municipal markets, as well as other credit markets, that have occurred in the course of the financial crisis.

My name is Mary Jo Ochson. I am Chief Investment Officer for the Municipal Bond and Tax-Exempt Money Market Investment Group at Federated Investors, Inc. ("Federated"). I joined Federated as a municipal analyst in 1982, and have now been an analyst and portfolio manager investing in municipal securities for over 27 years.

I am a former Chairperson of the National Federation of Municipal Analysts, a member of the Society of Municipal Analysts and a Chartered Financial Analyst. I am also a former member of the Municipal Securities Rulemaking Board.

Federated has been a pioneer and innovator in investing in municipal bonds through its mutual funds, creating funds specifically designed to provide investors the opportunity to invest in municipal markets. Federated created one of the very first mutual funds to invest in municipal bonds in 1976. It was then that federal tax legislation was enacted permitting the flow-through of tax-exempt interest through a mutual fund.

After the regulatory approval of structured municipal securities, such as variable rate demand obligations ("VRDOs"), which enabled money market funds to comply with the requirements (now Rule 2a-7 under the Investment Company Act) for maintaining a stable share price, Federated created the first tax-exempt money market fund in 1979.

Today Federated manages $3.4 billion in 13 municipal bond funds and $36.5 billion in 23 tax-exempt money market funds. Federated trades more than $150 billion in municipal securities annually.

On a broader scale, mutual funds, including both money market and municipal bond funds, are among the largest investors in municipal securities. At the end of 2008, the total municipal market was about $2.7 trillion. Of this amount, approximately $750 billion was short term (one year or less in maturity).

At year-end 2008, mutual funds and other registered investment companies owned approximately $882 billion in municipal securities, over half of which ($491 billion) is in money market funds. Thus, mutual funds own about one-third of all municipal securities and tax-exempt money market funds own approximately two-thirds of the outstanding short-term municipal securities.

## Municipal Money Market Background

The tax-exempt money market provides essential short-term financing to a wide variety of municipal borrowers and an attractive, secure place for investors seeking liquid, high quality, tax exempt investments. The tax-exempt money market fund has been a driving force in the development of the municipal money markets over the past thirty years with favorable impact on the amount and cost of short term-financing available to states, municipal governments, hospitals, school districts and other municipal borrowers. Access to municipal money markets has allowed municipal issuers to pay far lower borrowing costs than would have been available in long-term bond financings. Since the inception of the tax-exempt money market fund in 1979, assets in these funds have grown from nothing to almost $500 billion today, supplying about 65% of the short-term financing needs of municipal borrowers.[1]

The securities in the municipal money market are structured to meet the financing needs of the municipal issuers and the investment requirements of Rule 2a-7. Rule 2a-7 requires money market funds to invest in short-term securities with minimal credit risk in order to value their portfolio securities at amortized cost and thereby maintain a stable share price. The VRDO structure meets these objectives.[2] In fact, the VRDO is one of the most prominent security structures in the municipal money market, enabling municipal money market funds to maintain average maturities of less than the regulatory requirement of 90 days while still investing significant portions of the fund in notes that mature in six months to one year that are often issued to address short-term municipal cash flow needs.

The VRDO structure normally includes credit and/or liquidity enhancement in the form a bank letter of credit, a bank standby purchase agreement or a bond insurance policy coupled with a bank standby purchase agreement.

During the credit crisis, some VRDOs lost their status as eligible investments for money market funds because of the deterioration in credit quality of the liquidity provider, bond insurer, or letter of credit bank. The issuer of the VRDO is hurt in this event because the money market fund is required to tender or "put" the VRDO back to the liquidity provider who then cannot remarket it to another fund. In this instance, the interest rate on the VRDO changes from a short-term rate to a higher rate reflecting the liquidity provider's cost of capital in holding the VRDO. (VRDOs, when not held by money market funds, are referred to as "bank bonds".)

Further, new issuance of VRDOs has decreased substantially since the end of 2008 because fewer banks or other financial institutions are able or willing to provide liquidity facilities.[3] The loss of existing VRDOs and the drop in issuance of new VRDOs hurts municipal issuers by limiting their access to, and increasing their cost, of capital.

[1] Report of the Money Market Fund Working Group, Investment Company Institute, March 17, 2009, p. 19.

[2] VRDOs are nominally long-maturity municipal bonds that have certain features that enable them to be treated as short-term securities by a money market fund. To reduce interest rate risk, the VRDO has a variable or "floating" interest rate resetting on a daily, weekly, monthly or quarterly basis coupled with the ability to "put" or tender the VRDO to a bank or other financial institution for purchase on seven days notice. For example, a VRDO with a floating interest rate resetting on a weekly basis and a seven-day put is treated as having a seven-day maturity for purposes of Rule 2a-7. If the money market fund tenders the VRDO pursuant to the put feature, the VRDO remains outstanding but is simply "remarketed" to another fund buyer.

[3] Issuance of VRDOs fell 20% in the fourth quarter of 2008 and an additional 62% in the first quarter of 2009. In 2009 issuance of VRDOs in the municipal sector is expected to be constrained well below 2008 levels. This is not a problem unique to the municipal market.

The market for cash management notes has stabilized to a greater degree (and in many cases is functioning well) than the market for VRDOs. For example, in 2009 alone, we have purchased over 100 notes including both cash flow borrowings and bond anticipation notes for various issuers, such as school districts. However, a limited number of issuers may face market access concerns.

**Municipal Market Liquidity Enhancement Act of 2009**

It appears that The Market Liquidity Enhancement Act could create a helpful vehicle to preserve the liquidity and lower the cost of capital of two types of issuers: (1) current and any future VRDO issuers struggling with the "bank bonds" problem, and (2) issuers that may be unable to have market access to sell cash management notes. The Act could provide a purchaser of last resort for securities of such issuers. We agree with the approach of letting issuers of cash management notes first come to market, and then if they are not able to sell their notes, invoking the support facility.

More broadly, I applaud the myriad efforts of the Federal Reserve, the Treasury and the other Federal banking regulators to support the credit quality and functioning of the banking system. Steps to support the banks will directly support the functioning of the municipal money markets given the essential role banks play in the VRDO structure. That said, many municipal issuers report a decline in the availability and an increase in the cost of such bank facilities. I would encourage the Committee and the Federal banking regulators to consider steps that would motivate banks to provide such facilities to sound borrowers at reasonable cost, perhaps by reconsidering the regulatory capital treatment of such bank facilities or other measures.

**The Municipal Bond Fairness Act of 2009**

The Municipal Bond Fairness Act instructs the SEC to require that all Nationally Recognized Statistical Rating Organization ("NRSROs") use a uniform and consistent standard for assigning ratings on any security or money market instrument based on the likelihood that the investor "may not receive payment in accordance with the terms of issuance of such securities and instrument."

I assume the effect of this requirement is to require that municipal bonds be rated on the same ratings scale as corporate bonds and other fixed income obligations. A shift from a municipal-specific ratings scale to one "global scale" (as Moody's Investors Service has labeled the unified scale concept) is intended to facilitate accurate investor comparisons across various bond markets about the risk of nonpayment (default) and recovery in the event of nonpayment. We suggest that this second consideration, namely recovery in the event of default, be specifically added to Section 1A of the bill.

I do not oppose the shift toward one global ratings scale; however, I have the following suggestions. Credit ratings are meant to indicate the risk of default and recovery in event of default. Default and recovery are concepts that apply to all bond obligations, regardless of whether the issuer or borrower is a government, a corporation or a hospital, and regardless of whether the bond is taxable or tax-exempt. Many of the factors that have been offered to explain the persistence of a separate and more stringent municipal ratings scale—namely the lesser liquidity of municipal bonds, differences in the investor base between municipals and other bonds and the short-comings in municipal disclosure—are not appropriate considerations in a credit rating.

Factors such as weaker disclosure or lesser liquidity are critically important to an investor when making investment decisions. For example, investors need timely and efficient access to accurate and comprehensive information about municipal securities to perform credit analysis, make informed investment decisions, monitor their securities portfolios, and otherwise protect themselves. Those factors, however, should be addressed by more stringent disclosure rules on municipal borrowers or by better information regarding the trading and markets in municipal bonds. I respectfully would direct the Committee to the comments of the Investment Company Institute on enhancing municipal securities disclosure.

As for the rating scales, in my opinion, the differences that exist now between the municipal and corporate rating scale likely reflect the historical evolution of the two separate rating scales at the NRSROs, the historic separation between the staffs at NRSROs and the historic differences between investors in municipal versus taxable bonds. Because such differences are fading, as illustrated by the recent warm market reception of Build America Bonds by non-traditional municipal investors, they do not justify maintaining separate ratings scales. The NRSROs themselves have acknowledged the benefits of greater consistency and comparability across bonds sectors and some have already begun to revise municipal ratings with that goal in mind. Over many years, the municipal market has become more and more integrated into other fixed income markets.

I urge the Committee and the NRSROs, however, not to rest on an oversimplified approach to making municipal ratings more consistent with corporate ratings. Relying solely on comparative default statistics of municipal and corporate securities over the last 20 to 40 years is not sufficient. Although defaults are admittedly rare, the default rate is not zero. In addition, in periods of great economic stress, including the Great Depression and, to a lesser degree, the early 1970s, municipal defaults or the risk of municipal defaults, rose sharply. The information inherent in such historical stress events should be considered when making municipal ratings more consistent with taxable bond rating standards.

In addition, even outside of periods of sharp economic stress, qualitative or forward-looking factors that have material effects on municipal credit quality--such as the wide variation in budget processes, the impact of political considerations on budget outcomes, and the growing strains on municipal governments from underfunded pension and healthcare obligations — cannot be ignored. Such factors must be included when assigning the credit rating to an individual borrower. In general, these factors are not adequately captured in relatively short historic data sets on municipal defaults.

The bill specifically allows for the introduction of historical, qualitative or forward-looking factors in Section 2A when it states that NRSROs are not prohibited from using "additional credit factors…that have a demonstrated impact on the risk an investor…will not receive repayment in accordance with the terms of issuance" or in section 3 where it states the SEC cannot prevent the NRSROs from establishing "ratings that are complementary" that are created to measure a "discrete aspect of the security's or instrument's risk." I urge the Committee and ultimately the NRSROs not to simply realign municipal credit ratings based solely on default and recovery statistics since 1970, but to use the latitude the existing bill provides to consider the historical stress events and the importance of qualitative and forward-looking factors in determining credit ratings and, perhaps, complementary ratings.

**The Municipal Bond Insurance Enhancement Act of 2009**

We support the objective of the Municipal Bond Insurance Enhancement Act to increase the capacity of insurers to offer bond insurance to the municipal bond market.

Enabling lower rated issuers to raise their credit quality should generally improve the functioning of the municipal market. The availability of insurance will reduce borrowing costs for these issuers.

Further, the bill could enable some issuers to create VRDOs that are eligible to be purchased by money market funds. Presumably the federal government reinsurance provided by the bill will be structured to enable a money market fund to treat the bond insurance as federal insurance. Federally reinsured bond insurance will attract liquidity providers by eliminating the liquidity provider's fear of losing the ability to remarket the VRDO due to loss of Rule 2a-7 eligibility.

While we endorse the notion of insurance support for municipal bonds, we also emphasize the private market is already responding to the need and strong demand from municipal issuers for insurance. We are concerned that the bill may not be necessary or may interfere with the various private market efforts already occurring to respond to this need.

**The Municipal Advisers Regulation Act of 2009**

As an investor in municipal securities, I am deeply interested in municipal borrowers receiving sound financial advice that does not unduly increase their financial risk profiles. To the extent that regulatory requirements described in the Act may help foster high standards for Municipal Financial Advisors and reduce situations where unsound advice may have harmed a municipal entities creditworthiness, I support the spirit of the proposed legislation.

Thank you again, Mr. Chairman. We stand ready to help you as you strive to restore and maintain the vibrancy of this very important market.