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Chairman Frank, Ranking Member Bachus, and members of the Committee, thank you for the opportunity to comment on issues related to the markets for municipal debt. In my testimony today, I will provide some background on the structure of the municipal debt market, focusing particularly on the role of municipal bond insurance and the use of variable rate demand obligations by some municipalities. I will then discuss current stresses in the municipal bond market and conclude with some comments on policy considerations.

Background

The market for municipal debt is very large and diverse. At the end of 2008, investors held about $2.7 trillion of municipal securities issued by more than 50,000 entities. The vast majority of municipal debt is issued by state and local governments. A relatively small amount of municipal debt is issued by government authorities on behalf of qualified nongovernmental entities such as hospitals, private colleges, and some private companies. Households own a large amount of municipal bonds either directly or through mutual funds and other investment vehicles. Commercial banks and insurance companies are also significant investors in these securities.

Approximately one-half of municipal debt outstanding has credit enhancement in the form of insurance from financial guarantors; these firms are often called bond insurers or monolines. In exchange for a fee, financial guarantors agree to make timely payment of principal and interest on insured bonds if the municipality cannot. Before the financial crisis, most financial guarantors were rated AAA by the major credit rating agencies, and this rating was essentially transferred to insured securities. In effect, issuers of municipal securities rented the presumed balance sheet strength of the financial guarantors, thereby typically reducing their net borrowing costs. Banks also provide credit enhancement to municipalities as part of letters of credit.

Most municipal bonds have long maturities, reflecting the long lives of the municipal projects the debt is typically used to finance. However, municipalities do issue some short-term debt, primarily as a cash-management tool to bridge gaps between expenses and revenues. In addition to these "true" short-term securities, municipalities also have issued securities that combine long maturities with floating short-term interest rates that are reset on a weekly, monthly, or other periodic bases. Some of these floating-rate securities explicitly have what is known as liquidity support or a liquidity backstop, which is typically provided by a commercial or investment bank. Liquidity support ensures that bondholders are able to redeem their investment at par plus accrued interest even if the securities cannot be successfully remarketed to other investors. Securities that have this type of explicit contractual liquidity support often are referred to as variable rate demand obligations (VRDOs). Auction rate securities (ARS)--another form of floating-rate debt--do not have an explicit contractual liquidity backstop. VRDOs have much greater market share, with roughly $400 billion to $500 billion currently outstanding, as compared with less than $80 billion for municipal ARS.

Recent Developments and Current Market Conditions

The financial crisis has strained the market for municipal debt, as it has so many other markets. One source of this strain has been that losses on a range of nonmunicipal credit exposures have greatly diminished the capacity of financial guarantors to write new policies and have reduced the perceived value of previously written policies. The share of newly issued municipal bonds that are insured has fallen from about 50 percent in the fall of 2007 to about 10 percent in the first quarter of this year, and the market for reinsurance for such bonds is largely closed. Another source of strain has been that liquidity support for VRDOs has become more expensive while support for ARS has essentially disappeared. Yet a third source of strain has been that the recession has significantly reduced the revenues collected by many municipalities, in some cases by enough to raise concerns about their ability to service their debt.

Despite these stresses, the market for traditional fixed-rate municipal debt appears to be functioning fairly well for many issuers. Gross issuance of long-term municipal bonds has been fairly solid in recent months. For example, total gross issuance of long-term municipal bonds averaged about $30 billion per month during the first four months of 2009, in line with issuance during the first four months of both 2006 and 2007, before the crisis hit the municipal market. Moreover, although the spread between the yield on traditional fixed-rate municipal debt and comparable-maturity Treasury securities remains quite high by historical standards, it has narrowed notably in recent months. That said, lower-rated municipalities are facing higher-than-usual costs of issuing debt relative to the rates paid by higher-rated issuers. For example, the credit spread between municipal bonds rated AA and A is very high by historical standards.

Although the market for fixed-rate municipal debt is currently functioning fairly well, the markets for floating-rate municipal debt are in more serious condition. Auctions of ARS began to fail en masse in mid-February of last year. Many municipalities have reportedly succeeded in refinancing ARS into VRDOs or traditional fixed-rate debt, bringing down substantially the volume outstanding in the ARS market.

Strains in the market for VRDOs began to emerge in late 2007, largely in response to increasing concerns about the financial strength of guarantors that insured many of these bonds, and came to a head in September 2008. One commonly used measure of the interest rates paid on high-quality VRDOs skyrocketed from less than 2 percent on September 10 to almost 8 percent in just two weeks.[1] Since then, however, this measure has reversed its September spike and, indeed, has fallen with other short-term rates to below 1 percent. Nonetheless, market participants report that the cost of liquidity support from banks has risen sharply. As in the market for long-term fixed-rate debt, higher-rated municipalities are reportedly able to issue new VRDOs, but many lower-rated issuers appear to be either unwilling or unable to issue debt in this market at the prices that would be demanded of them.

Demand for some VRDOs has reportedly been so weak that the securities have been put to their liquidity providers, turning them into what are called "bank bonds." Under the terms of issuance, bank bonds typically carry penalty interest rates and can eventually be subject to accelerated amortization. The combination of these two factors can cause a sudden and substantial increase in the debt service payments required of the municipality that issued the bond. One market observer estimated that the value of VRDOs that are bank bonds may be about $50 billion, but precise estimates are not available.

The municipalities that issued the securities that have become bank bonds potentially face significant financial difficulties. As noted, if they do not refinance the bank bonds, they must pay higher interest rates and confront the possibility of having to

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[1] The measure referred to in the text is the seven-day swap index published by the Securities Industry and Financial Markets Association.

amortize the debt over a much shorter period. But refinancing is not an easy option either, partly because VRDOs are often paired with interest rate swaps that would be quite costly to unwind in current market conditions and partly because banks have significantly increased the fees they assess for new liquidity support, especially for lower-rated issuers.

Policy Considerations

Thus, the strains in some segments of the market for municipal debt remain significant. These strains reflect the weakened fiscal position of the issuing jurisdictions, the pressures on the providers of liquidity support, and the weakened condition of the financial guarantors.

Some policy actions that have already been taken are helping--and should continue to help--address these strains. For example, over the first 15 months of the financial crisis, the Federal Open Market Committee brought the federal funds rate down to its current target range of 0 to ¼ percent, an adjustment that was historically aggressive both in speed and scale. In addition, the Congress has enacted two large stimulus packages. The monetary easing and the fiscal stimulus will continue to provide important support to the overall level of economic activity in coming months--a critical determinant of the fiscal condition of state and local governments. The second stimulus bill also included authorization for Build America Bonds, which give issuers of taxable municipal bonds a 35 percent federal rebate on interest costs.

The Federal Reserve also has created a wide range of facilities aimed at improving the functioning of financial markets. And indeed, these facilities have achieved some success. For example, the spread of the London interbank offered rate, or

Libor, over the overnight index swap rate, a spread commonly interpreted as a measure of strains in the interbank market, has diminished markedly from its peak last fall. Similarly, the spreads on asset-backed commercial paper and on lower-rated nonfinancial commercial paper have narrowed over the same period. Moreover, the benefits of the Federal Reserve's facilities have been felt not only in the markets that were directly targeted, but also in financial markets more generally.

The recently concluded Supervisory Capital Assessment Program (SCAP) should also provide some indirect help to municipalities, because the institutions subject to the SCAP are among those that provide liquidity backstops for VRDOs. The SCAP provided a thorough, consistent, and forward-looking examination of the 19 U.S. bank holding companies with more than $100 billion of assets. By assuring that these 19 institutions will have a capital buffer in place sufficient to allow them to withstand even a worse-than-expected macroeconomic environment over the next two years, the SCAP and the Treasury's related Capital Assistance Program should help bolster banks' willingness to provide liquidity backstops and investors' confidence in those backstops.

If the Congress chooses to address more directly the strains in the municipal bond market, the most productive actions would likely be ones that address the stress points noted above--the weakened fiscal condition of the issuing municipalities, the diminished financial strength and capacity of the financial guarantors, and the reduced availability and higher costs of liquidity backstops and credit enhancement from banks and other financial institutions. Many of these potential policy responses likely would require fiscal action--such as grants to municipalities or the creation of new federal insurance or reinsurance programs to address the current problems in the markets for municipal bond insurance--and thus are properly in the realm of the fiscal authorities.

A threshold question for us, of course, is whether the Federal Reserve should play a more direct role in supporting the market for municipal debt. As Chairman Bernanke has noted before, the Federal Reserve has important misgivings about assuming such a role in light of the potential for decisions about the provision of credit to states and municipalities to assume a political dimension.[2] Indeed, this consideration is one reason that the Federal Reserve Act imposes limits on the ability of the Federal Reserve to purchase municipal debt, including a six-month maturity limit. The Federal Reserve believes that such a role is better suited to elected officials and the Administration than to the central bank.

In addition, it is important to note three key characteristics of the Federal Reserve's responses to the financial crisis thus far. First, the statutory authority under which the Federal Reserve has taken many of its policy actions sets a high bar for the exercise of extraordinary powers. In particular, before lending can be extended under section 13(3) of the Federal Reserve Act, the Board of Governors must find that "unusual and exigent circumstances" prevail. This provision assures that the Federal Reserve will not be involved in financial markets in these extraordinary ways unless market functioning is significantly impaired. Second, the Federal Reserve has been mindful of the need to protect both it and federal taxpayers from credit losses. In the case of the Term Asset-Backed Securities Loan Facility, or TALF, for example, private investors are in the position of taking the first loss on any given security, by dint of the haircut that we

[2] For example, see Ben S. Bernanke (2008), letter to Paul E. Kanjorski, October 28, http://kanjorski.house.gov/images/stories/08_10_28%20credit%20crisis%20muni%20fed%20reply.pdf.

apply to the value of the security when determining the amount that we will lend. In addition, the Treasury has provided the Federal Reserve with a layer of credit protection. We judge that these two features taken together provide us with a robust protection against credit risk. Third, Federal Reserve programs have been designed carefully to allow a clear exit strategy, thereby helping ensure our ability to raise the federal funds rate from its current level once the Federal Open Market Committee determines that such a move is necessary to promote the mandate given to us by the Congress to foster maximum sustainable employment and price stability. Credit protection, balance sheet control, and a clear exit strategy exist in the Federal Reserve's current facilities and are, indeed, consistent with the joint statement on the role of the Federal Reserve issued on March 23 by the Treasury and the Federal Reserve.[3] We believe these features are critical to achieving the dual monetary policy mandate and preserving the central bank's independence.

One issue that the Congress may wish to bear in mind as it considers whether future action is warranted is the degree to which government involvement in this market is appropriate in the long term. One effect of the current financial crisis has been to expose some important vulnerabilities of the VRDO market. For example, because contracts for liquidity support are typically of short duration, municipalities face significant " rollover" risks for their VRDOs that raise serious questions about whether these securities should remain a significant vehicle for municipal finance in the long term. If the Congress determines that other financial structures will likely be more robust

[3] Board of Governors of the Federal Reserve System and U.S. Department of the Treasury (2009), "The Role of the Federal Reserve in Preserving Financial and Monetary Stability: Joint Statement by the Department of the Treasury and the Federal Reserve," joint press release, March 23, www.federalreserve.gov/newsevents/press/monetary/20090323b.htm.

under adverse market conditions, then the Congress may choose to tailor any government intervention in the municipal bond market relatively narrowly, aiming, for example, to encourage market participants to seek private-sector solutions, if possible, and to facilitate the government's exit from the market.

Conclusion

Thank you for the opportunity to testify on conditions in the municipal bond market and potential policy responses. We look forward to working with the Congress to assist in your deliberations on these matters. In addition, the Federal Reserve will continue to work aggressively to restore normal functioning to the financial markets and the flow of credit in the economy. I would be pleased to answer any questions you may have.