**STATEMENT OF RICHARD P. LARKIN**

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**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,**

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**REGARDING**

**"THE STATE OF THE BOND INSURANCE INDUSTRY"**

**WRITTEN TESTIMONY**

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I would like to thank Chairman Kanjorski, ranking member Pryce and other members of the Capital Market Subcommittee of the House Financial Services Committee for inviting me to testify on the State of the Bond Insurance Industry. My name is Richard Larkin, and I am a Senior Vice President for Herbert J. Sims & Co., Inc., headquartered in Southport, Connecticut. H.J. Sims has allowed me to assist this committee with my testimony. In preparing this testimony, I have also had the assistance of some members and staff of the Securities Industry and Financial Markets Association (SIFMA), an organization that represents more than 650 member firms of all sizes, in all financial markets in the U.S the world. The opinions and information that I will share with you is mine, and not necessarily that of H.J. Sims or SIFMA. It may help the committee to know that my prior experience includes 26 years as a senior rating executive and analyst at two Nationally Recognized Statistical Rating Organizations (NRSROs), and 2 years as an independent financial advisor to state and local governments that access the tax-exempt bond market to finance essential infrastructure.

The crisis in the bond insurance industry is already having an impact on the municipal bond market, and appears to be affecting credit markets beyond municipals. It is important for this committee to understand the dynamics, events, and implications of this crisis; it is also important to solicit possible solutions to ameliorate the current crisis, and strengthen credit markets after the crisis has abated. I will attempt to do both today.

The Aaa/AAA ratings assigned to insured municipal bonds have been extremely useful tools, for both debt issuers and investors. State and local governments that have used bond insurance have been able to lower their interest costs. Investors have benefited from the perceived safety against default that bond insurance provides, which in turn has improved the liquidity of their investments if they needed to sell their investment prior to maturity.

Threatened and actual downgrades of the insurers' bond ratings have already had dramatic effects on the municipal bond market. Interest rates and yields on municipal bonds have remained high relative to Treasury bonds, despite dramatic cuts in borrowing rates by the Federal Reserve. Fed cuts usually have a stimulating effect on local government bond issuance for new capital and to refinance previously issued higher cost debt. In the last two months, however, issuance is down dramatically from the prior year's record volume of issuance.

For years, bond insurance backed about 50% of all new debt issuance. In the last two months, only 30% of new debt carries insurance. It is unclear as to whether the drop is a function of issuers' belief that insurance is not as necessary as it has been in the past, or investors' belief that the credit safety and liquidity value of insurance has weakened. One thing that is clear is that investors do not want debt that loses value because of imminent rating downgrades.

It is also clear that the bond insurance crisis is rating-driven. The disruptions to the insured municipal bond market are precipitated by the rating agencies' threats of downgrades of those insurers. These downgrades are also precipitated by the increasing downgrades on structured subprime mortgage securities. Most observers believe that these securities provide the greatest risk to bond insurer capital adequacy. While bond insurers can take responsibility for extending their guarantees into this suddenly volatile and increasingly risky sector, they could not have maintained their Aaa/AAA ratings unless the rating agencies also believed that exposure in this sector would not weaken those ratings. Going forward, any solutions to this crisis will require actions by the NRSROs, or changes to the NRSRO system. In the last week, the three major NRSROs have announced reforms or proposed revisions to facets of their rating process. Because of their newness, it remains to be seen whether these proposals will help prevent the recurrence of a crisis such as the one we are witnessing right now.

The last time the tax-exempt market faced a crisis as large as this was in 1975, when the threat of bankruptcy by New York City rattled the credit markets. That event was of historical proportions, and I believe that the bond insurance crisis is comparable in its enormity. Yet, the lessons of the New York City crisis strengthened the capital formation process for the tax-exempt credit market:

- Adoption of Generally Accepted Accounting Principles as the standard for governmental financial accounting and reporting;

- Improved disclosure for municipal bonds, at the time of issuance, and in the secondary market;

- Increased hiring, stronger rating criteria, and improved transparency by NRSROs that are so important to the efficient operation of credit markets.

I am optimistic that the current crisis will also result in new structural improvements to the capital formation process, as we all cooperate to solve this crisis and enact safeguards for the future.

## IMPACT ON MUNICIPAL MONEY MARKET FUNDS

While investors are concerned that insured municipal debt may lose value because of rating downgrades, of most immediate concern are holdings by municipal money market funds subject to rule 2a-7 of the Investment Company Act of 1940. The rule requires minimum ratings for investment in these money market funds. The collateral used for investing by those funds must be rated in the highest two categories by an NRSRO in order to comply with 2a-7. Insured bonds with Aaa/AAA ratings are a significant component of those investments. Downgrades to those securities may require liquidation and replacement of those investments in order to comply with rule 2a-7.

It is estimated that money market funds hold about $500 billion of highly rated municipal securities. If 50% of those securities are insured (which is the historical proportion of insured debt to total debt in the municipal market), downgrades of insured debt below the Aa/AA category could prompt a short-term sell-off of an estimated $200 billion of municipal securities. In a market that sees average daily trading volume of only about $11 billion, a sell-off of this magnitude would result in a flood of supply, which would reduce the prices of these securities, and increase tax-exempt interest rates. The effects would be felt both by issuers and investors. Reporting by the Bond Buyer indicates that this may already be happening, as money market funds try to anticipate downgrades before their holdings lose value.

In conversations with other market professionals, this appears to be the most immediate concern in the tax-exempt market. Downgrades of insured debt may also require capital adjustments to banks and insurance companies, but I will leave that phenomenon to others that may appear before this panel.

## THE BOND INSURANCE CRISIS' IMMEDIATE EFFECTS ON STATE AND LOCAL GOVERNMENT ISSUERS

Related to the dislocations in the municipal money market funds, state and local governments that have issued debt with variable interest rate terms are already experiencing significant increases to the interest costs, which could reduce available funds for essential services in the current fiscal year.

> On Tuesday February 12, Reuters reported that "U.S. municipal bond issuers were hit with "multiple" failures of auctions of their paper on Tuesday, ….. as investors were concerned about the safety of the bond insurers backing the debt…..Rates for auction-rate paper are reset

periodically, and an auction fails when no buyer can be found and the dealer does not take it back."

The immediate impact to these borrowers is that new interest rates have to be set high enough to attract investors to be willing to assume real or perceived risk that the bond insurers may not be able to honor their guarantees. The market also seems to be developing two tiers:

- one for issues that are not tainted by the bond insurance crisis, whose credit is strong and highly rated on its own; and
- one for credits whose ratings are dependent on the rating from bond insurance.

To demonstrate the volatility of the market because of the current crisis, it was reported that the State of California's recent issue of debt is trading with yields on their one-year maturity of only 0.96% per year, because of the strong demand by money market funds for highly rated municipal short-term debt. On the other end, another creditworthy issuer, the Port Authority of New York and New Jersey, saw their interest rate reset from 4.3% to an annualized rate of 20% in one week's time, on February 12th.

## RECENT TRENDS IN THE USE OF BOND INSURANCE

In the brief time since the raters first announced downgrades and negative watch and outlook assignments to the ratings of the bond insurers, there has been a dramatic reduction in the use of bond insurance, and a market share shift among the companies that provide insurance. In a market where bond insurance was used for 50% of new debt issuance, that penetration has dropped to 30% in the last two months.

In addition, FSA and Assured Guaranty, the two bond insurers that have not had negative rating actions, are capturing over 65% of new bond insurance business in the last two months, as compared to a combined market share of only 26% for all of 2007.

In November, several firms in the market reminded their clients that downgrades of the bond insurers would not necessarily lead to defaults on insured municipal bonds, pointing out the strong credit strength provided by the underlying issuers of those bonds. Studies of default rates by rating agencies and other observers point out that default rates on traditional tax-backed and utility revenue bonds are lower than those for Aaa/AAA corporate taxable debt.

The bond insurance crisis has highlighted this safety record, a fact well-known by municipal bond professionals, but not as widely known to the average person. In recent weeks, issuers that regularly used bond insurance for some or all of their normal issuance (e.g., Wisconsin, California and the City of New York) have all successfully sold large bond issues without purchasing bond insurance. Although the trend is recent, it is my opinion that as more people are educated to the history of infrequent municipal bond defaults, future demand for municipal bond insurance may be less robust than has been the case for the last 20 years.

## CONTROVERSY: MUNICIPAL VS. GLOBAL/CORPORATE SCALE RATINGS

The default studies performed since 1999 by Fitch, Moody's and S&P all point to the long track record of safety against default for most municipal bond issuers. In particular, the long-term default rates on the universe of state, city, county and school district tax-backed debt is as low as or lower than that of Aaa/AAA rated corporate debt. Default rates for water/sewer revenue bond debt are lower still. Yet median ratings for these combined classes of municipal debt are only in the single 'A' category. The raters, in varying degrees, have begun to factor this history of safety into their bond rating systems.

In 2000, Fitch Ratings overhauled their rating criteria, in order to review and produce bond ratings that were more in line with default rates measured in its study. In particular, Fitch put more positive weight on issuers that implemented financial management best practices. As a result, about 26% of Fitch's tax-backed ratings and nearly 50% of water/sewer revenue bond ratings were upgraded. After that review, median ratings for this debt was higher than single "A" yet still below the "AA" category.

Standard & Poor's has done several default studies since 2001. S&P has revised some of its rating criteria and ratings in some sectors, but has not seen a need to alter its current rating scales, which they believe are indicators of default risk.

Since at least 2002, however, Moody's has recognized that their traditional municipal rating scale does not produce ratings that are indicative of actual default rates. In March 2007, Moody's clearly enunciated that their municipal scale ratings were not indicators of default and loss, as were all of its other ratings (which Moody's termed "Global Scale Ratings"). Moody's municipal scale ratings were said to be indicative of the willingness and ability of an issuer to pay debt service. The difference is significant.

In the 2007 report, Moody's also published a "map" to show what the differences would be between municipal and global scale ratings for various classes of tax-exempt debt. The most visible examples of rating differentials between the two scales are for general obligation bonds and water/sewer revenue bonds. The map indicates that these bonds, rated as low as Baa3 on their municipal scale, would be rated no lower than Aa3 on their Global Scale. The implications of this differential are tremendous, in light of the pressures on money market funds to maintain securities rated in the top two categories under rule 2a-7.

The raters' default studies, capped by Moody's March 2007 report, all corroborated what finance professionals and academics have said for years: that municipal bonds are the second safest investment against default after US Treasury obligations.

It is clear, however, that the custom of using more conservative municipal scale ratings with a median of single "A" play a large part in the usage of municipal bond insurance. That is because the difference in the issuer's borrowing costs between single "A" underlying ratings and "Aaa/AAA" insured rated debt. It is that differential that is the economic basis for bond insurance in the first place.

**It is my firm belief that ratings which truly reflect low municipal bond defaults ("Global Scale"-type ratings) would allow significantly more debt to carry ratings of Aa/AA and Aaa/AAA, consistent with rule 2a-7. This might negate the need for costly bond insurance to qualify as money market fund investments, and reduce borrowing costs for local governments. Using this scale for retroactive assignments of underlying ratings on insured debt would also allow more securities to be retained by money market funds, in the event that bond insurer ratings are downgraded below Aa/AA.**

That said, there is still a case to be made for maintaining the more conservative scale of municipal bond ratings. State and local government finance is regulated only at the state level, and not consistently regulated or monitored from state to state. The SEC's purview and enforcement powers in the municipal sector are limited to securities-related transactions, and only when there is apparent fraud in issuance or transactions. The NRSROs are, for all practical purposes, "regulators" of public financial management, through their debt rating process. Rating agencies will deny that this is their role in the market, and they are correct. Municipal ratings are not, and never were, intended to regulate or influence public financial management for state and local governments.

After 33 years in the public finance sector, I believe that the history of rare municipal bond defaults can be partly attributed to the rigorous ratings and systems employed by the NRSROs. The bond raters are leading proponents of management best practices, by their incorporation into municipal bond rating criteria and standards. Good government organizations, such as the Government Finance Officers Association (GFOA), promulgate rating agency standards and practices which can result in higher ratings in their educational programs. In the 1980's, the industry's push to expand local governments' use of Generally Accepted Accounting Principals (GAAP) was aided immeasurably by rating agency positions that bond ratings would be lower for issuers that failed to adopt GAAP as their accounting standard. State and local government budgeting practices have been improved when issuers seek higher bond ratings, and negative financial "gimmickry" has been reduced when an issuer is faced with a downgrade. There is a clear relationship: issuers that see their stronger bond ratings enjoy lower interest costs, while downgrades result in higher borrowing costs. Again, the raters will state that these results are not intended consequences of their rating actions, and they are correct. It is the bond market's reactions to ratings that provide this cause and effect. With no official regulator for state and local governments, the bond raters have been an effective tool for public financial management, and are a significant factor in the history of rare bond defaults and investor losses in the municipal bond sector.

One last observation on the prospects for "Global Scale" ratings versus traditional municipal scale ratings: there are many classes of municipal bonds where there would be little or no increase in ratings if "Global Scale" ratings were employed by all bond raters. These classes include organizations that are still vulnerable to competitive pressures that lead to higher rates of default, despite governmental participation in their financial operations. In varying degrees, these entities (in no particular order) are hospitals, long term care providers and nursing homes, toll roads, private colleges, ports and airports, and local government-sponsored convention centers and sports facilities. In my opinion, these entities would get significant value from a strong and stable bond insurance industry. These issuers, in my opinion, have the greatest need for a viable bond insurance industry, and are likely to most feel the impact of the bond insurance crisis, through higher interest costs and greater difficulty borrowing in the tax exempt market.

## POTENTIAL SOLUTIONS TO ALLEVIATE THE IMMEDIATE CONSEQUENCES OF RATING DOWNGRADES ON BOND INSURERS

I take no position on whether financial assistance, either by the private sector or the government, should be provided to bolster the capital positions of bond insurers vulnerable to increased defaults in the structured debt markets. Nor am I taking a position on increased regulation of either the bond insurers or the rating agencies, whose Aaa/AAA ratings supported the creation and expansion of the bond insurance sector. Those issues and answers are being taken up by others with far more experience and knowledge about such matters than I. To me, the current crisis is primarily bond-rating driven, and as a former bond rating executive, I'd like to offer several ideas that might provide the most immediate relief for issuers and investors affected by downgrades to the bond insurers.

- **Increased availability of underlying bond ratings for insured debt.**

Underlying ratings are debt ratings that would be assigned if there were no credit enhancement from bond insurance. In short, it is the rating based on the financial strength or weakness of the issuer. Underlying ratings are not issued automatically. The issuer must separately request one when the bond issue is insured. Although many large issuers carry underlying bond ratings on other debt which is on parity for repayment, there are many more, particularly small infrequent issuers, for which no underlying rating is assigned or published. If underlying ratings were assigned as standard procedure, there could be significantly more bonds that keep ratings of Aa/AA or higher after an insurer's downgrade, allowing them to be retained by the money market funds under rule 2a-7. This proposal would also dramatically increase the transparency of NRSRO bond ratings.

This solution is not without its problems. Because the issuer-pay rating agency model assigns ratings only upon request, rating agencies may not be permitted or required to assign underlying ratings if the issuers want to keep those ratings suppressed. In addition, it is unknown whether the rating agencies have adequate information on which to assign accurate underlying ratings for every insured bond issue rated Aaa/AAA. While raters monitor the underlying quality of an insurer's book of business, they may not have full information on each and every insured issue, despite having been paid a fee to assign a rating. The rating fee paid when a bond was issued with insurance in many cases was for assigning a rating based on the insurance "wrap" of the bond insurer, and did not cover the assignment of an underlying rating.

- **Rating agency adoption of "Global Scale" or Corporate Equivalent ratings that are indicators of default and loss.**

As I stated earlier, the Moody's "map" of Global Scale" bond ratings is far less conservative than their traditional municipal rating scale. If this system were in place, there would be a large increase in "Aa" & "Aaa" rated securities that would be eligible for money market fund investment under rule 2a-7, and could reduce the amount of bonds that would need to be sold-off by those funds if bond insurers were downgraded. This kind of action, however, assumes that the raters were willing or able to increase the number of underlying ratings where they currently do not exist. It would also require Moody's to reverse its stance that market participants have indicated that maintenance of "municipal scale" ratings is preferred to the more liberal "Global Scale" ratings. In addition, it is unclear as to whether S&P and/or Fitch believe that there should be a different rating scale from their current system, or whether they are in a position to implement such a dramatic change from current custom. And while Moody's took the lead in publishing their municipal and corporate equivalents "map", there is no indication that Moody's would automatically assign "Global Scale" equivalents in exactly the manner envisioned by the map. Implementation could result in exceptions to the mapped correlations. Finally, there is the risk that adoption of higher ratings under a "Global Scale" system could result in a weakening of the financial discipline and strong financial management practices that have evolved in state and local government financial management as a result of the current system of assigning municipal bond ratings.

- **Application of a Rating by Maturity Approach to Insured Bond Ratings**

There are very few instances where the NRSROs assign different debt ratings solely on the basis of a maturity date. All three NRSROs use different symbols for specific types of short-term debt (e.g., commercial paper, tax/revenue anticipation notes, bond anticipation notes, variable rate demand bonds) with maturities of three years or less. But for the most part long-term bond issues are usually assigned only one bond rating, whether that debt matures in 2 years or 50 years.

Bond market professionals realize that although bond insurers and raters agencies are estimating higher losses and potential insurance payments on structured Collateralized Debt Obligations (CDOs) and Residential Mortgage-Backed Securities (RMBS), the obligation of a bond insurer to immediately pay for all losses is remote. Bond insurance is designed so that payments on defaults are required only when stated principal and interest payments are due, usually on an annual or semi-annual basis. So, even if it was projected for an insurer to pay $20 billion on loss claims, those payments are stretched out over the stated maturities of the debt, according to the original maturity schedule.

In order to provide some immediate relief to money market funds facing large liquidations of insured bonds after a rating downgrade, the raters might consider a bifurcated approach by maturity. As a hypothetical example, take an instance where the bond raters have made their most conservative estimate of claims faced by a bond insurer. Using that "worst-case" scenario, the rating agencies could analyze maturities of projected defaults, and estimate the time period for which current claims-paying reserves could totally cover projected losses according to the maturity. The raters could have a legitimate basis to maintain "Aaa/AAA" ratings on the earlier maturities of outstanding insured debt, while downgrading the remaining maturities of projected structured debt to reflect remaining capital shortfalls. As with the other suggestions, this would require an elemental change in the manner and process by which the NRSROs assign long-term bond ratings. The process would also have to be tested for its rating impact, and an assumption would need to be made about a "worst-case" loss scenario in the subprime CDO/RMBS sectors. In the past few months, those "worst case" scenarios have been moving targets, and it remains unclear as to when a "worst-case" scenario estimate will prove reliable.

## FEDERAL HOME LOAN BANKS AS LETTER OF CREDIT PROVIDERS TO ENHANCE STATE AND LOCAL GOVERNMENT DEBT

One repercussion from the downturn of the bond insurers is that credit enhancement is exceedingly hard to obtain for state and local bond issuers. This problem is particularly acute in the current market environment because many bond issuers are attempting to restructure or refinance outstanding bonds where the interest rates have climbed to ridiculously high levels. A potential source for credit enhancement are the Federal Home Loan Banks (FHLBs). However, Section 149 of the Internal Revenue Code prohibits federal guarantees of tax-exempt bonds, and letters of credit from FHLBs are treated as de facto federal guarantees, despite the fact that the federal government does not directly back the obligations of the FHLBs. Bipartisan legislation introduced last year (H.R. 2091) would correct this problem by specifying that credit enhancement provided by the FHLBs would not cause bonds to be treated as federally guaranteed. This would create a new source of credit enhancement for states and localities suffering as a result of the bond insurers' troubles. I urge members of this committee to support this important legislation.

## IRS REISSUANCE REGULATIONS AS AN OBSTACLE FOR ISSUERS THAT NEED TO RESTRUCTURE THEIR DEBT BECAUSE OF BOND INSURER DOWNGRADES

Another problem faced by states and localities as a result of the bond insurers' problems arises from IRS rules that govern when a tax-exempt bond is "reissued." When a state or local issuer, in agreement with bondholders, materially changes the terms of a bond issue, tax regulations specify that the bond under the new terms be treated as a newly issued bond rather than an extension of the outstanding bond.

This can trigger negative tax consequences for both issuers and investors. Today, many states and localities face conditions where, through no fault of their own, their outstanding bonds are carrying interest rates far in excess of reasonable market rates due to problems with the bond insurers. Some states and localities are prevented by the IRS's reissuance regulations from negotiating new terms with their bondholders. Market participants have been talking with the Treasury and the IRS to address these problems, and we are hopeful that a reasonable solution can be reached.

I would like to thank the committee for the invitation to appear on this important problem facing the credit markets, and I invite your questions to the extent that I am able to answer.