City of Woodland

REPORT TO MAYOR AND CITY COUNCIL

AGENDA ITEM

TO: THE HONORABLE MAYOR
AND CITY COUNCIL

DATE: June 10, 2008

SUBJECT: Campaign to Save Tax Funds by Reforming the Municipal Bond Rating Practices Used in the Grading of Municipal Bonds

Report in Brief

Although municipal bonds carry a very low default risk for investors, their ratings are subject to higher standards (*than corporate bonds, mortgage-backed securities and other debt investments)*resulting in public agencies paying a higher interest than private corporations with similar default exposure.

The California State Treasurer is leading a nationwide campaign calling for reform to the municipal bond rating system. Ten other state treasurers and local agency financial officers, including the City of Los Angeles, have joined in this effort.

The Board of the League of California Cities voted unanimously to support this campaign because of the importance to the fiscal vitality of cities; and is strongly urging cities to support this campaign by adopting the attached resolution and sending letter to the rating agencies urging them to end the double standard in treatment of municipal and corporate bonds.

Staff recommends the Council adopt Resolution No. _______ supporting the campaign to reform municipal bond rating practices and authorize issuance of the attached letter (Exhibit 'A') to the three major rating agencies (Standard & Poors, Fitch, and Moody's).

Background

The turmoil in the municipal bond markets has brought into focus the higher standards imposed by the three major rating agencies in rating municipal bonds compared to corporate bonds, mortgage-backed securities and other debt instruments.

The downgrades of several bond insurers, and the higher costs imposed on many municipalities with variable rate bonds backed by those insurers, has led to calls for rating agency reform. In many cases, public agencies seek bond insurance to secure higher ratings, thereby equalizing the differences between how municipal and corporate bonds of comparable risk are rated. This added cost to compensate for the discrimination against municipal bonds is staggering. California state officials estimate they have spent $102 million between 2003-07 on bond insurance. As most investors know, state and local government entities rarely default on their bonds, yet, municipal ratings fail to reflect that fundamental fact.

California State Treasurer Bill Lockyer has been leading a nationwide campaign to end discrimination in municipal bond ratings. He was recently joined by ten other state treasurers and financial officers from a number of local agencies, including the City of Los Angeles, in calling on the three major rating agencies to examine their practices and treat municipal bonds on par with corporate bonds.

The Treasurer testified before the House Financial Services Committee on March 12th about the need for reform stating that the rating agencies own studies show governmental, or municipal issuers default much less than corporate issuers.

- Municipal bonds rated Baa by Moody's have experienced a default rate of only 0.13 percent, while corporate bonds rated Aaa by Moody's have defaulted at four times that rate, or 0.52 percent.
- Corporate bonds rated AAA by S&P have defaulted at almost twice the rate of municipal bonds rated BBB (0.60 percent and 0.32 percent, respectively). Standard & Poor's acknowledges that the historic rate of defaults of A-rated municipal bonds is 0.23 percent, while that of corporate bonds is 2.91 percent - or 13 times greater.
- Of all general obligation municipal bonds rated by Moody's between 1970 and 2006, only one issuer defaulted.
- For a tax-backed bond rated BBB or better by S&P, the likelihood of default over a 20-year period is only 0.03 percent.

Recently, the governing Board of the League of California Cities unanimously endorsed the call for reform, and sent letters to the major rating agencies urging them to examine this practice that has cost taxpayers billions of dollars in higher interest and bond insurance costs over the years.

The rating agencies are aware of this campaign and have mixed views:

- Standard & Poor's objects to the call for reform, claiming they have one consistent rating scale, despite the evidence of their own default studies to the contrary.
- Fitch acknowledges the existence of two scales and has announced it is undertaking a review of whether they should continue using two scales or move to a single scale.
- Moody's has taken the greatest strides. The firm announced that it will assign a corporate-equivalency rating (what it calls a global scale rating or GSR) alongside the traditional municipal rating to any municipal bond at the issuer's request.

Discussion

The Board of the League of California Cities voted unanimously to support this campaign because of the importance to the fiscal vitality of cities; and is strongly urging cities to support this campaign by adopting the attached resolution and sending letters to the rating agencies urging them to end the double standard in treatment of municipal and corporate bonds.

Other agencies and individuals supporting the reform effort are listed on a website established by Treasurer Lockyer for this purpose at http://www.treasurer.ca.gov/fairbondratings/index.asp

Fiscal Impact

The City Council's approval of the attached resolution will have no impact on the General Fund or other City funds. A change in practice for rating of municipal bonds, could lead to significant savings on future municipal financings.

Public Contact

Posting of the City Agenda

Staff Recommendation

Staff recommends the Council adopt Resolution No. _______ supporting the campaign to reform municipal bond rating practices and authorize issuance of the attached letter (Exhibit 'A') to the three major rating agencies (Standard & Poors, Fitch, and Moody's).

Prepared by: Joan Drayton
Finance Director

____
Mark G. Deven
City Manager

EXHIBIT 'A'

TO: Blank Rating Agencies

SUBJECT: Ending Double Standard in Ratings of Municipal & Corporate Bonds

Gentlemen:

The current system of assigning credit ratings to bonds issued by governmental entities which provide essential services to the public leads to indefensible market discrimination against state and local municipal issuers. The rating agencies own studies show that the likelihood of default by municipal borrowers is much lower than for corporate borrowers with similar ratings. Ratings should be based primarily on an evaluation of the likelihood investors will suffer a loss due to default. Unfortunately, for municipal bonds, they are not. This practice costs taxpayers enormous amounts of money that could be invested in public programs and infrastructure.

The City Council of Woodland recently adopted a resolution (copy enclosed), urging your companies to end the double standard in the treatment of municipal and corporate bonds. The City Council urges you to treat taxpayers the same as corporations and rate municipal bonds based on the risk investor loss due to default. Finally, we urge you to do this by creating a unified, global rating approach that treats all issuers equally, thereby better serving taxpayers and investors.

Thank you.

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF WOODLAND SUPPORTING REFORM OF THE BOND RATING SYSTEM TO ELIMINATE DISCRIMINATION AGAINST MUNICIPAL BONDS

WHEREAS, the City Council of the City of Woodland supports reform of the Bond Rating System to eliminate discrimination against municipal bonds ; and

WHEREAS, the recent turmoil in the municipal bond markets has brought into focus the higher standards imposed by the three major bond rating agencies in rating municipal bonds compared to corporate bonds, mortgage-backed securities and other debt instruments; and

WHEREAS, issuers of municipal bonds rarely default on the bonds they sell to finance streets and roads, public buildings, bridges, flood protection and water systems, and other critical infrastructure, yet municipal bond ratings fail to reflect that fundamental fact; and

WHEREAS, the rating agencies even acknowledge this disparity, but they ignore it in their ratings. Standard & Poor's, for example, acknowledges that the historic rate of defaults of A-rated municipal bonds is 0.23 percent, while that of corporate bonds is 2.91 percent - or 13 times greater; and

WHEREAS, despite the relative default rates shown by their own data, the rating agencies continue to discriminate against municipal issuers, requiring public agencies to secure expensive bond insurance in order to secure bond ratings comparable to those of private corporations; and

WHEREAS, the rating agencies base their ratings of corporate bonds on the risk the issuer will default. Their ratings of municipal bonds, in contrast, have little relationship to the risk of default. This difference provides a substantial economic benefit at the expense of taxpayers across the nation; and

WHEREAS, a coalition of state and local public agencies, led by California State Treasurer Bill Lockyer, has called on the three major rating agencies to examine their practices and treat municipal bonds on par with corporate bonds that expose investors to the same level of risk. The Treasurer also testified before the House Financial Services Committee on March 12 about the need for reform.

WHEREAS, the response by the rating agencies to the call for reform has been uneven. Moody’s has taken the greatest strides, announcing it will assign a corporate-equivalency rating (what it calls a global scale rating or GSR) alongside the traditional municipal rating to any municipal bond at the issuer's request; and

WHEREAS, the current double-standard by rating agencies: (1) drains billions of dollars from taxpayers’ pockets in the form of unfairly high interest rates; (2) forces taxpayers to pay even more money to buy bond insurance – insurance they would not have to purchase if municipal bond ratings accurately reflected the slight risk of default; (3) misleads investors by grossly inflating the risk of buying municipal bonds; and (4) undermines the effective functioning of a transparent market.

RESOLUTION NO: _______________

RESOLVED, by the City Council of the City of ____________________ that it calls on the major municipal bond agencies to end the double standard in the treatment of municipal and corporate bonds; to treat taxpayers the same as corporations and rate municipal bonds based on the risk of default; and to create a unified, global rating approach that treats all issuers equally, and better serves taxpayers and investors.

RESOLVED FURTHER, that the city manager/finance officer is hereby directed to notify the municipal bond rating agencies by letter of the adoption of this resolution, with a copy to California State Treasurer Bill Lockyer and to register the City as a member of the coalition of public agencies supporting the nationwide effort to reform how bond rating agencies grade state and local bonds.

ADOPTED this _____ day of ________, 2008.

NOW, THEREFORE, THE CITY COUNCIL OF THE CITY OF WOODLAND DOES HEREBY RESOLVE AS FOLLOWS:

The above recitals are true and correct.

STATE OF CALIFORNIA)
COUNTY OF YOLO)ss.
CITY OF WOODLAND)

I, _________________________________, City Clerk of the City of Woodland, County of Yolo, State of California do hereby certify that the foregoing Resolution No. ___________ was regularly adopted by the City Council of said City of Woodland at a regular meeting of said council held on the __________ day of _______________, 2008, by the following vote:

AYES:	Council members:	________________________________
NOES:	Council members:	________________________________
ABSENT:	Council members:	________________________________
ABSTAIN:	Council members:	________________________________

____
Mayor, David M. Flory

Attest:

_______________________________________,
City Clerk, Sue Vannucci

EXHIBIT A

____________, 2008

Mr. Robert Grossman
Group Managing Director
U. S. Public Finance
Fitch Ratings
33 Whitehall Street, 27th Fl.
New York, NY 10004

Ms. Gail Sussman
Group Managing Director
Public Finance
Moody's Investors Service
250 Greenwich Street
New York, NY 10007

Mr. William Montrone
Head
U.S. Public Finance Dept
Standard & Poor's
55 Water Street
New York, NY 10041

SUBJECT: Ending Double Standard in Ratings of Municipal and Corporate Bonds

Dear Mr. Grossman, Ms. Sussman and Mr. Montrone,

The current system of assigning credit ratings to bonds issued by governmental entities which provide essential services to the public leads to indefensible market discrimination against state and local municipal issuers. The rating agencies' own studies show that the likelihood of default by municipal borrowers is much lower than for corporate borrowers with similar ratings. Ratings should be based primarily on an evaluation of the likelihood investors will suffer a loss due to default. Unfortunately, for municipal bonds, they are not. This practice costs taxpayers enormous amounts of money that could be invested in public programs and infrastructure.

The City Council of ________________ recently adopted a resolution (copy enclosed), urging your companies to end the double standard in the treatment of municipal and corporate bonds. The City Council urges you to treat taxpayers the same as corporations and rate municipal bonds based on the risk investor loss due to default. Finally, we urge you to do this by creating a unified, global rating approach that treats all issuers equally, thereby better serving taxpayers and investors.

Thank you.