National Federation of Municipal Analysts

A COMMENT ON THE CURRENT MARKET DIALOGUE REGARDING MUNICIPAL BOND RATINGS

The National Federation of Municipal Analysts (the "NFMA"), chartered in 1983, is a not-for-profit association formed with the goals of promoting professionalism in municipal credit analysis and providing an informed perspective in the formulation of legal and regulatory matters relating to the municipal finance industry. Currently the industry is facing several serious challenges, one of which is the evolving meaning and usage of credit ratings as they are applied by various participants. While the NFMA does not take a position on proposed changes to municipal ratings schema, the purpose of this comment is to encourage all market participants to conduct the debate in a reasoned and thoughtful manner.

Over the past year, volatility in the fixed income market has profoundly destabilized the municipal bond market. Specifically, the downgrades of several bond insurers have resulted in a tremendous loss of liquidity across the yield curve as well as the essential collapse of the municipal auction-rate market. Members of the NFMA have a special interest in ending this disruption and restoring a functioning, efficient market.

On behalf of its members, the NFMA is releasing this paper to express concerns that recent statements by public officials advocating radical and sudden changes to the municipal rating scale could threaten the restoration of a smoothly functioning market. Specifically, some public officials have openly and forcefully argued that municipal bond ratings should mirror corporate ratings, based primarily on the historically low rate of municipal bond defaults. The NFMA is concerned that the rhetoric and tactics of these officials have been misleading and, at times, inaccurate.

The NFMA finds it troubling that such advocacy is being driven by a relatively small group of state, local and national political officials, issuers and non-traditional niche investors who seek to seize on the recent turmoil in order to push for broad scale rating upgrades. The NFMA is concerned that this advocacy has the effect of intimidating rating agencies and others to achieve short-term and narrowly focused goals. In recent weeks, we have read news reports of threatened proxy battles and boycotts, ostensibly on behalf of investors whose "paramount concern...is the risk of default". The NFMA does not believe that these statements accurately represent broadly held investor perspectives or that these tactics are beneficial to the market.

While the community of analysts represented by the NFMA does not share a unanimous opinion about changes to the existing rating scales for municipal bonds, our members strongly favor a more thoughtful dialogue and gradual process. We fear that rushed implementation of this change could muffle necessary debate among the broad market participants who have, for many years, used ratings as a factor in the pricing of municipal bonds and the preservation of strong market liquidity.

While we agree that municipal default rates are extremely low by corporate standards, the municipal market has, for many years, used its own rating scale to provide qualitative indicators in a market that is substantially larger (by number of issuers and types of repayment), more heterogeneous and opaque than the corporate bond market. This rating scale, in conjunction with independent credit decisions made by our members and others, has imposed a fiscal discipline on issuers that has helped the municipal market function efficiently by keeping default rates low and investor confidence high. Furthermore, many users of municipal ratings understand that municipal defaults are low compared to corporate defaults because of the intervention of supervising governmental entities that frequently intervene to manage or assist local issuers that have experienced financial distress (i.e., Nassau County, NY; Buffalo, NY; Oakland Unified School District, CA; Springfield, MA, as a few examples).

Many NFMA members fear that a rapid change may result in unintended consequences that have negative long-term effects. We believe it is necessary to engage the broad group of market participants in a thoughtful dialogue to discuss some key questions regarding the short and long-term impact of such changes. For example:

- Recent developments in the structured securities markets have shown that many market participants, including the rating agencies, overestimated the ability of models based on historical data to assess credit risk. Are the potential changes to municipal bond rating methodologies, which would be based on quantitative analysis of historical default data, similar to those formerly used to evaluate structured securities?

- Should municipal issuers be rated similar to corporate issuers when disclosure requirements are far looser in the municipal market? Fixed income analysts in the corporate bond market have the opportunity to conduct more frequent analysis of corporate bond issuers due to SEC requirements for quarterly financial filings. Most municipal issuers file only annually and then not for 180-270 days after fiscal year end.

- Given the economic challenges many issuers will face in the coming days and years, is this an appropriate time to see rating standards weakened?

- Some have argued that the rigorous municipal credit rating system has contributed to the strong management and fiscal discipline. If this is valid, will these strong municipal credit practices erode under a more lenient rating system? Would the erosion of such widely held and accepted standards consequently result in higher default rates?

The NFMA believes that municipal bond ratings should not become the focus of short-sighted agendas. These ratings are very important to the successful functioning of our market and the abilities of issuers to raise capital for essential public projects. The stakes of this debate are extremely high and the NFMA believes that the loudest voices should not be permitted to drown out those that have yet to be heard. We encourage other market participants to make their voices heard regarding this issue.