BILL LOCKYER
TREASURER
STATE OF CALIFORNIA

October 21, 2008

Honorable Henry Waxman
Chair, Oversight and Government Reform Committee
2204 Rayburn House Office Building
Washington, DC 20515

Dear ~~Chairman~~ Henry Waxman:

I commend your Committee for investigating the credit rating agencies' role in helping cause the current crisis in our nation's economy and financial markets. As you convene this crucial probe, I thought you might find instructive the perspective of the nation's largest issuer of municipal bonds.

Without doubt, the rating agencies too freely assigned their highest ratings to structured investment products backed by mortgages and the debt of financial institutions, many of which have now collapsed. Some evidence suggests the agencies may have cut corners and violated their own standards in doling out these ratings. At the same time, they have for decades held municipal issuers to a higher standard than corporate issuers. That discriminatory treatment has harmed taxpayers, misled investors and undermined the efficient functioning of the market.

Governmental issuers almost never default on bonds issued to finance infrastructure and other crucial public services. Statistics abound to demonstrate this, but I'll mention just one: From 1970 to 2007, only one state and local government general obligation bond rated by Moody's Investors Service (Moody's) defaulted. Nonetheless, only three percent of local government general obligation bond issuers carry the highest rating of Aaa.

The irrationality of the dual system the agencies employ in rating municipal and corporate bonds might best be illustrated by some recent actions of Standard & Poor's (S&P). At the beginning of June, that agency rated both the State of California's general obligation bonds and Lehman Brothers' debt the same: A+. Yet, how could any rational person believe that a long-term investment in Lehman Brothers was as safe as a long-term investment in California? Even S&P acknowledged, in a report entitled "Why Was Lehman Brothers Rated 'A'?," that Lehman "appeared on many 'Who's next?' lists" after Bear Stearns' near collapse in March. So, even after the unraveling of financial institutions became a reality, S&P couldn't shake its hide-bound

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commitment to the idea that the full faith and credit of the largest state in the country was just as risky as a highly-leveraged investment bank with a huge portfolio of sub-prime mortgages.

Since March of this year, I have led an effort to convince the rating agencies to change the way they rate municipal bonds. (My 2008 Debt Affordability Report, available at http://www.treasurer.ca.gov/publications/2008dar.pdf, details the problem and my efforts to address it.) Moody's and Fitch Ratings (Fitch), to their credit, acknowledged they rated municipal bonds by a stricter scale than other bonds. Both have pledged to take corrective action. Over the summer, Moody's announced it would recalibrate municipal ratings beginning this month. The recalibration would result in a rating increase of one to three notches for many issuers. Fitch announced a proposal to do the same and sought comment from municipal bond market participants.

S&P, in contrast, remains in a state of denial. Despite the kind of evidence cited above, S&P consistently has claimed it utilizes exactly the same standards in rating municipal bonds and corporate bonds alike.

Earlier this month, Moody's and Fitch both announced they were postponing implementation of their recalibration plans. They cited the financial market turmoil. I believe this is a huge mistake and am very disappointed.

The delay by Moody's and Fitch raises questions about whether the agencies are, in fact, committed to addressing the inequities and inaccuracies in their rating of municipal bonds. Rather than being a reason not to make changes, the economic crisis points out more than ever the importance of ratings reform. As investors lose trillions of dollars in the stock market, and have justifiable fears about investing in corporate bonds, the rating agencies have an even greater responsibility to assign accurate ratings that inform investors of the relative safety of municipal bonds. Pulling back from taking the first tentative steps to correct rating inequities sends exactly the wrong signal to the market.

While economic developments may place stress on government issuers, the stress will be far more acute on corporations. The possibility that bankruptcies, reorganizations and distress sales inflict losses on corporate bondholders is much greater than the negative consequences municipal bondholders face because of budget stress. For one thing, municipalities almost never go out of business. Even in the rare cases that municipalities default, investors rarely lose any money. In most cases, the worst they suffer is a short delay in getting their payments.

Unjustifiably low ratings have imposed billions of dollars of increased borrowing costs on taxpayers in the form of higher interest rates and bond insurance premiums. Accurate ratings are more important than ever now in today's market, where investors are seeking high credit quality. Capital is scarce for municipal borrowers, and the burden of unjustifiably low ratings makes it more difficult and more expensive to borrow.

Nowhere is this truer than in the short-term market. The reason is the interplay between municipal bond ratings and the Securities and Exchange Commission's Rule 2(a)-7. That rule requires that money market funds only hold investments that have ratings in the double-A category or higher.

Many issuers of variable rate bonds relied on bond insurance or letters of credit to secure such ratings when their own ratings came up short. Those strategies generally are ineffective today. The agencies downgraded most of the bond insurers, and the credit crisis is making banks very reluctant to provide letters of credit. While the serious problems in the municipal short-term market are varied and complex, there is no doubt that they have been exacerbated by a rating system that unnecessarily forces issuers to rely on such credit enhancement to be money-market eligible.

Both Moody's and Fitch acknowledged that their municipal rating scale created problems under Rule 2(a)-7 that would be partially remedied by rating recalibration. But as noted above, just when the short-term market has become more challenging and costly than ever for municipal issuers, both have decided they no longer want to help address the problem.

I hope your investigation increases our understanding of the economic crisis, and brings greater accuracy to credit ratings and strengthens accountability for the rating agencies whose failures have contributed greatly to this country's financial troubles.

Sincerely,

Bill

BILL LOCKYER
California State Treasurer

cc: Barney Frank, Chair
Financial Services Committee

Christopher Davis, Investigations Unit
Oversight and Government Reform Committee