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STATE OF CALIFORNIA

March 4, 2008

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Dear Mr. Belsky, Ms. Sussman, and Mr. Montrone:

We, the undersigned representatives of major municipal bond issuers, urge the rating agencies you head to create new rating standards for U.S. municipal debt. For years, municipalities have been held to a higher standard than corporate issuers. This differential treatment undermines the functioning of an efficient and transparent capital market, a goal shared not just by investors and issuers, but rating agencies as well. For investors, the current system greatly inflates the risk of investing in municipal bonds relative to alternative investments, leading to investment decisions that are not based on the best information. For municipalities, the dual standard has cost our taxpayers and ratepayers billions of dollars in increased interest costs and bond insurance premiums.

Recent events in the debt markets have highlighted the problem. Many collateralized debt obligations (CDOs) and structured investment vehicles (SIVs) that your agencies rated triple-A have become insolvent or are at risk of insolvency. As a result, your agencies have been forced to downgrade those securities, as well as the ratings of some of the bond insurers who guaranteed them. Meanwhile, the vast majority of municipal issuers have not shown strains that would suggest they may default on their bonds. Nonetheless, many strong municipal issuers continue to carry much lower ratings than our corporate counterparts, in some cases even lower than the bond insurers about whom the market has understandable concerns. To illustrate this point, we note recent credit default swap levels for bond insurers with triple-A ratings have been many times higher than the levels for many of the biggest and most stable – but lower-rated – municipal issuers.

The ratings services your agencies have provided historically have been critical to the smooth functioning of the municipal bond market. Given the myriad state and local issuers of tax-

exempt debt, your agencies have served an important role in helping investors choose and price municipal bonds. That function will remain critical in the future. But we believe your rating scale bears too little relationship to most investors' paramount concern: the risk that issuers of the bonds they buy will default.

Across the country, for decades, the evidence has been clear and convincing. State and local governments almost never default on the bonds they issue. The safety of municipal bonds is grounded in a fundamental fact: a city or a state simply is not going to go out of business during the life of its bond issue. That possibility is much more likely in the case of a bank or bond insurer, or a special-purpose entity created simply to issue CDOs or SIVs.

The lack of foundation for the differential rating standards applied to corporate and municipal issuers has been demonstrated by your agencies' own default studies. Municipal bonds rated Baa by Moody's have had a default rate of only 0.13%, while corporate bonds rated Aaa by Moody's have defaulted at four times that rate, or 0.52%. Corporate bonds rated AAA by S&P have defaulted at almost twice the rate of municipal bonds rated BBB (0.60% and 0.32%, respectively).

We do not advocate that all municipal bonds should be rated triple-A. Certainly some deserve lower ratings, based on their unique circumstances. But bonds with an exceedingly low risk of default should be rated accordingly, whether issued by governmental entities or corporations. If some investors want fine rating distinctions among such bonds, perhaps gradations within the triple-A scale could serve that purpose. Some bonds could be Aaa1 or AAA+, while others could be Aaa3 or AAA-. But the triple-A rating on all those bonds would tell investors the truth: The risk of default is minimal.

We applaud some agencies' growing acknowledgement of the dual scale that exists today. Moody's, for example, will assign a "global scale rating," but only to taxable bonds. It simultaneously requires the assignment of a municipal scale rating. When the State of Oregon in 2003 sold $2.1 billion in taxable general obligation bonds to fund its pension liabilities, Moody's assigned two ratings to the same bonds: Aaa global scale and Aa3 municipal scale. Similarly, when California sold taxable general obligation bonds in 2007, Moody's assigned ratings of "Aaa" global scale and "A1" municipal scale. These distinctions reflected both states' substantial credit strength compared to most corporate issuers, and helped attract new buyers for the taxable bonds. But they also created confusion because the very same bonds carried two different ratings. Such confusion does not serve investors well. Investors increasingly function in a worldwide capital market where the trading of credit risk is not isolated to distinct taxable and tax-exempt cash markets. Municipal credits are compared to corporate credits in a great number of markets, including the interest rate swap and credit default markets. An integrated, global capital market requires an integrated, global rating scale.

This dual rating scale burdens taxpayers and ratepayers with substantial, added costs. Taxpayers pay a higher interest rate when municipal bonds have a rating lower than triple-A. Consider, for example, the State of California, which never has defaulted on its bonds and ranks as the largest municipal issuer in the nation. The difference between triple-A and single-A interest rates in today's market is about 0.38 percentage points. [1] California plans to issue $61 billion of general obligation bonds for infrastructure projects already approved by voters. Over the 30-year life of those bonds, a 0.38% difference in interest rates would save taxpayers, and the state's General Fund, more than $5 billion. While a sudden recalibration of your agencies' rating scale likely would not produce the full amount of those savings, even a portion would provide welcome relief to California taxpayers. Similar examples abound in states, cities and counties throughout the country, resulting in hundreds of billions of dollars in unnecessary costs to American taxpayers.

Taxpayers incur other costs imposed by the bond insurance industry, which exists in large part because of your municipal rating scales. Municipal issuers have paid enormous sums to buy bond insurance that – at least in the past – brought their ratings up to the level they would have been on a corporate, or global, rating scale. For example, the State of California, with a global scale rating from Moody's of Aaa, nonetheless paid $102 million from 2003-07 to buy triple-A bond insurance on its general obligation bonds. Those purchases allowed the state to sell the bonds at a lower interest rate. But it would have been unnecessary to spend $102 million of taxpayers' money for a triple-A rating if the bonds had been rated by the same criteria as non-municipal debt.

Further, what California actually bought when it paid for bond insurance was not a triple-A municipal rating, but a triple-A global scale rating. Moody's has stated, "Like other financial institutions and insurance companies, the financial guarantors are rated on the global scale." (*Mapping of Moody's Municipal Ratings to the Global Scale: Frequently Asked Questions, June 2007*) Now consider: As noted above, Moody's gave a triple-A global scale rating to taxable bonds California issued in 2007. Applying that rating to all general obligation bonds the state insured from 2003-07, including tax-exempt issues, means that when taxpayers spent $102 million to insure those bonds, they effectively spent $102 million to put an Aaa rating on top of the Aaa rating the state already possessed.

The recent problems of municipal bond insurers, ignited by their exposure to securities based on sub-prime mortgages, have imposed serious, additional costs on numerous municipal issuers. The short-term municipal bond market has been built on the triple-A status of bond insurers. In part, the insurers' ratings have been used to satisfy regulatory requirements. But over time, the homogenizing nature of a market based on triple-A ratings meant that even issuers whose debt could be issued without bond insurance frequently found it useful to purchase insurance.

[1] Municipal Market Data yield differential between Aaa/AAA and A/A 30 year bonds as of February 25, 2008.

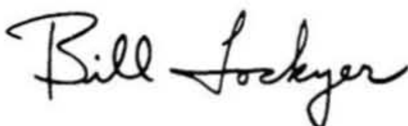
Under U.S. Securities and Exchange Commission Rule 2a-7, money market funds generally are allowed to buy securities only if they have long-term ratings of at least double-A. To provide that, many municipal issuers purchased bond insurance on their variable rate demand bonds (VRDBs). Of course, this would not have been necessary if municipal issuers were rated on a corporate scale. Corporations of much weaker credit quality comply with Rule 2a-7 without credit enhancement such as bond insurance.

The current turmoil in the tax-exempt variable rate market was sparked by the rating agencies' reassessment or downgrading of bond insurers. The agencies' actions caused many investors to worry that the insurers' ratings may drop below 2a-7's required levels. Already, insurer-backed VRDBs are costing much more than in the past. More troublesome, the liquidity facilities guaranteeing the demand feature of VRDBs can drop away if the bond insurer faces difficulties, at a time when the banks that remarket the bonds are facing their own sub-prime induced balance sheet problems. As a result, many issuers of VRDBs are finding that remarketing agents are putting their bonds to the liquidity banks, which in turn require issuers to pay them high taxable rates specified in the bond documents.

The fallout from the bond insurance upheaval also has hit the auction rate securities (ARS) market. Rating agencies' downgrades or reassessments of insurers – and the possibility of further downgrades in the future – have driven away many of the typical ARS buyers, including corporate money managers and wealthy individuals. Corporate money managers often have minimum rating requirements for the bonds they own. They relied on bond insurance for such ratings, since the underlying securities carried lower ratings assigned on a municipal rating scale. The well-publicized problems of failed auctions caused by insurer downgrades are imposing substantial costs on municipalities. Many issuers have found themselves paying interest rates as high as 15%-20% on debt that cost a fraction of that amount just a few weeks earlier.

We believe you share our desire to strengthen the municipal bond market that funds the infrastructure necessary to secure America's future. We respectfully request that you work with market participants – including issuers and investors – to develop a new, unified global rating approach that achieves that goal, and better serves investors and taxpayers.

Thank you.



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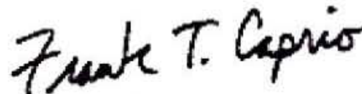

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