November 21, 2008

Honorable Dianne Feinstein
United States Senate
331 Hart Senate Office Building
Washington, D.C. 20510

Honorable Barbara Boxer
United States Senate
112 Hart Senate Office Building
Washington, D.C. 20510

Honorable Nancy Pelosi
Office of the Speaker
235 Cannon House Office Building
Washington, D.C. 20515

Honorable Barney Frank
United States House of Representatives
2252 Rayburn Building
Washington, D.C. 20515

Re: Solution to critical problems in the short-term municipal bond market

Dear Senator Feinstein, Senator Boxer, Speaker Pelosi, and Congressmember Frank:

The undersigned representatives of major California municipal bond issuers respectfully request you support creation of Federal Reserve program to correct serious problems in the short-term municipal bond market caused by the current financial crisis. These problems are burdening taxpayers with substantial costs, worsening state and local governments' budget woes, further destabilizing our banking and financial system, and hindering financing of infrastructure projects needed to help put us on the road to economic recovery.

Summary

We believe that the Federal Reserve should establish a program to provide much-needed liquidity to the short-term municipal bond market. Historically, that market has functioned because banks provide liquidity to guarantee investors a market in which to sell their bonds. Unfortunately, current financial disruptions have interrupted this market. Banks are less willing or unable to use their balance sheet to provide liquidity. Further, investors, worried whether weakened banks will provide the liquidity when needed, are selling their bonds as a precaution. The result is higher interest rates for many municipal issuers, the risk their debt will be accelerated, the possibility they will be forced to convert to a fixed rate in a very expensive and generally unaffordable market, and increased pressure on the banking system as banks use precious liquidity to purchase these bonds.

The solution is for the Federal Reserve to provide direct support to the market. This can be through either:

1. The direct purchase of municipal variable rate bonds sold back to the banks; or

2. Direct loans made to the banks so they can buy municipal variable rate bonds.

This program has benefits for all parties:

1. This is neither a bank bailout nor a municipal subsidy. These variable rate bonds need a temporary home while remarketing agents look for new buyers. In exchange, banks and the federal government will receive market rate interest payments.

2. Investors will gain confidence that liquidity support will always be there – eliminating the artificial pressure to sell their bonds back.

3. Issuers will benefit from a more stable market, lower interest rates and the ability to deliver critically needed infrastructure projects. This will help taxpayers by keeping down the cost of the municipal debt they support. And, it will help the economy by maintaining public works spending.

4. Finally, it will provide liquidity and balance sheet relief to banks that are at the center of the financial market crisis.

We believe this solution is consistent with the assistance the Federal Reserve is providing corporate debt issuers through the Commercial Paper Funding Facility (CPFF). We request your assistance in working with the Federal Reserve to make that program, or a program like it, applicable to the municipal short-term market.

The Municipal Variable Rate Market

The problem affects both variable rate demand bonds (VRDBs) and tax-exempt commercial paper (CP). While CP is the short-term funding of choice for corporations, municipal issuers rely heavily on VRDBs. Between 1999 and 2007, they issued approximately $420 billion of VRDBs.

Both CP and VRDBs are bought primarily by money market funds. Interest rates are re-set periodically and investors can sell back, or "put", their bonds at each re-set date. The market relies on investment banks (in the role of remarketing agent) to re-set the rate and find new buyers for bonds that are put, and commercial banks (in the role of liquidity provider) to guarantee the repurchase of any bonds that are put and cannot be re-sold.

This guarantee is one of two requirements imposed by the Securities and Exchange Commission for money market funds to hold VRDBs or CP. The other, required by SEC Rule 2(a)-7, is that the bonds have ratings at least in the double-A category from at least two rating agencies. This requirement is sometimes satisfied by a bank letter of credit (LOC) that guarantees both debt service payments and the put. Alternatively, an issuer can guarantee the put with a liquidity facility and provide the necessary rating by purchasing bond insurance or maintaining a sufficient unenhanced rating.

Until this year, remarketing agents rarely failed to remarket bonds. Rather than put bonds to the bank, they would temporarily hold bonds in inventory to maintain demand and keep interest rates low. Banks rarely had to use capital to buy and hold bonds (known as "bank bonds").

This is no longer true. The credit crisis has raised costs to municipal issuers and imposed stress on the balance sheets of both remarketing agents and liquidity providers. Unable to find buyers for many VRDBs, remarketing agents hold huge inventories and have put billions of dollars of bonds to liquidity banks. While interest rates on bonds with strong bank ratings have declined from their peaks of a few weeks ago, bank bonds and those backed by weak banks still carry excessively high interest rates. While all VRDBs used to carry about the same interest rates, we now see some at 2% and others as high as 16%.

The Problem

There are three manifestations of the problem:

- **Ratings** – In recent years, bond insurance has been less expensive than letters of credit to secure the necessary ratings for money market eligibility. Accordingly, a great many issuers used bond insurance or their own bond rating, supplemented by a liquidity bank to guarantee the put. When several insurers suffered rating downgrades below double-A earlier this year, some issuers were able to secure LOCs to replace the insurance, though the availability of LOCs has now dried up. The current problem is that many issuers are at risk their VRDB ratings will drop below Rule 2(a)-7 requirements. For some, this will occur because their LOC bank or bond insurer is under stress (e.g., FSA or Dexia). For others – those who meet the SEC rating requirement on the basis of their own credit – the slow economy may trigger rating downgrades that push them below the 2(a)-7 threshold. If the money market funds are no longer able to own these bonds, remarketing agents could end up holding billions of dollars of VRDBs on their balance sheets and, eventually, put the bonds to liquidity banks.

- **Weak Liquidity Banks** – As banks came under stress, several that were major providers of liquidity facilities for VRDBs and CP suffered downgrades. Fearing that such banks may not honor puts, investors began putting their bonds back to the issuer. The result was either substantially higher interest rates or bonds put to the liquidity banks. Such bank bonds carry significantly higher interest rates and require the municipal issuer to amortize principal payments over an accelerated period of time, generally five years. Issuers whose revenues can support a 30-year repayment schedule may not be able to repay their debt in five years. Further, the banks that have had to devote capital to buy and hold bonds are the very banks already struggling with the stresses that led to their rating downgrades. Among the larger liquidity providers who have fallen from favor with investors are Depfa, Fortis, Dexia, and Helaba.

- **Liquidity Rollover Risk** – In today's market, strong and weak banks alike are reluctant to extend credit. This includes providing liquidity facilities for VRDBs. Accordingly, as these facilities expire (most are in effect for just a few years), municipal issuers are finding it difficult, if not impossible, to renew. This means many issuers will be forced to convert their bonds to a fixed rate in a market where fixed rates are the highest they have been since the early 1990s, pay significantly higher fees for credit facilities, and risk the possibility that their bonds will convert to bank bonds and be subject to acceleration.

The Solution

All of these problems can be addressed by the federal government providing liquidity to the short-term municipal market as we work through this crisis. As described above, this can be done either by providing liquidity to banks so they can support the market, or by direct purchases of bank bonds by the Federal Reserve. Each has its advantages and disadvantages, and we would appreciate the opportunity to engage in detailed discussions with Federal Reserve officials to determine the optimal approach.

For the program to restore proper functioning to the market, there are several essential elements to its design that will need to be worked out. We note a few key ones:

- The program's design should ensure the continued tax-exemption of the bonds. The Federal government would not be making any payments to bondholders. It would provide liquidity, not a guarantee of principal and interest. Furthermore, it would provide the liquidity to the banks, not to the issuer or to investors.

- The program must provide issuers with sufficient time to address the problems created by the market – either to secure new liquidity/credit enhancement arrangements to remain in a variable rate mode, or to convert to a fixed rate in an orderly fashion. The rates paid on bank bonds and the timing to clear bank bonds must not be onerous.

- The program must accommodate issuers whose bonds are no longer money-market eligible because, though their bonds remain investment grade, their ratings drop below the Rule 2(a)-7 threshold.

- The program must not force an acceleration of bank bonds. Liquidity banks that borrow from the Fed to buy bank bonds must agree not to accelerate. Bonds owned by the Fed must amortize pursuant to the original documents, not as if they are bank bonds.

Attached is a list of the specific problems each of us signing this letter has experienced. We appreciate your attention and support as we address this very serious issue. Please feel free to contact any one of us for further information.

Sincerely,

Bill Lockyer
State Treasurer, California

Nadia Sesay
Public Finance Director, City & County of San Francisco

Brian Mayhew
Chief Financial Officer, Bay Area Toll Authority

William E. Noland
Finance Director & Treasurer, City of Oakland

Quentin Wilson
President and Chief Executive Officer, Access to Loans for Learning Student Loan Corporation

Scott Lay
President & Chief Executive Officer, Community College League of California

Theresa A. Parker
Executive Director, California Housing Finance Agency

Scott Haggerty
President, County of Alameda Board of Supervisors

Paul McIntosh
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Chief Operations Officer, County of Sacramento

Gary M. Breaux
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General Manager, Eastern Municipal Water District

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Paul D. Jones II
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Gary L. Gallegos
Executive Director, San Diego Association of Governments

Terry Matsumoto
Executive Officer, Los Angeles County Metropolitan Transportation Authority

John L. Martin
Airport Director, San Francisco International Airport

Jeff Kightlinger
General Manager, Metropolitan Water District of Southern California

Bill Carnahan
Executive Director, Southern California Public Power Authority

Attachments

Summary of Short-Term Market Exposures

State of California

Problems with weak credit enhancers or liquidity providers
The State has approximately $6.5 billion of credit facilities from 22 different liquidity providers for its General Obligation (GO) and Economic Recovery Bond (ERB) programs. The credit rating downgrade to Depfa in particular has caused the State to incur extremely high interest costs on $1.3 billion of outstanding commercial paper (CP) notes. Since October 2' 2008, the State has had to pay 7-10.0% on almost all of the rollover notes that have been issued as a result of Depfa being a member of the nine-bank syndicate that provides liquidity to the program. The State currently has over $52.5 million of CP "bank notes" that the State's dealers cannot find buyers for despite the extremely high rates. Additionally, $91.25 million of the State's $98 million of GO VRDOs backed by a Depfa letter of credit are "bank bonds."

Problems renewing liquidity facilities or letters of credit
The State has over $1.75 billion of letters of credit (LOC) that come up for renewal in the second half of 2009. At this point, it is unknown if the banks will be willing to renew the LOCs and if so, at what price.

Bank bonds (including amounts, rates, acceleration provisions)
As of October 27' 2008, the State had $91.25 million of VRDO bank bonds and $52.5 million of CP bank notes.

Under the terms of the Depfa LOC, bank bonds carry a rate of the greater of (1) the Fed Funds rate (currently 1%) or the Prime rate (4.5%), whichever is greater; or (2) 1-month LIBOR+125 basis points (4.42%). Also under the terms of the LOC, any bonds held by the bank for 30 days convert to a term-loan. The rate on the term loan is the lesser of the maximum rate (11%) or 1-month LIBOR+250 basis points (5.67%). A term-loan also triggers an acceleration of the principal repayment. The principal is required to be repaid over five years with payments due quarterly.

Under the terms of the CP Standby Note Purchase Agreement, any notes held by the banks carry a rate of Prime (currently 4.5%) or Fed Funds+50 basis points (1.5%), whichever is greater. The term-loan provisions for the bank notes kick in when notes have been held by the bank for 180 days. The principal on a term note is due four and a half years after the term notes are issued. The term-loan rate is 150 basis points over the greater of Prime or Fed Funds+50 basis points.

Problems maintaining long-term ratings necessary for money market eligibility
The downgrade of Depfa has caused the $98 million of VRDOs to become ineligible for purchase by money market funds and has caused investors to demand extremely high rates on the State's $1.3 billion of outstanding CP notes.

Problems with interest rate swaps tied to variable rate bonds
The State of California does not have any interest rate swaps in connection with its General Fund supported debt.

Summary of Short-Term Market Exposures

California Department of Water Resources (DWR)

General comments
In response to the energy crisis in 2001, legislation authorized the establishment of the DWR Power Supply Program. Under the program, DWR entered into short-term and long-term contracts to purchase power from wholesale suppliers and supply electricity to retail customers. The Power Supply Program authorized the issuance of $13.423 billion of bonds which are payable from charges imposed by the CPUC to ratepayers. DWR has $9.524 billion of power supply bonds outstanding as of November 1, 2008.

Problems with weak credit enhancers or liquidity providers
Earlier this year, DWR was required to refund $500 million insured auction rate bonds and $1.325 billion insured variable rate demand bonds (VRDBs) to address the weakening credit rating of the insurers.

Currently, DWR has approximately $5.41 billion of outstanding VRDBs. The primary concern at this time is the Dexia letter of credit and FSA/Dexia liquidity facility. These bonds have been difficult to remarket over the past few weeks. Total FSA and Dexia exposure is about $1.61 billion.

Problems renewing liquidity facilities or letters of credit
The letter of credit and liquidity facilities supporting $575 million of the Power Bonds are scheduled for renewal on December 1, 2008. Three of the four providers will not renew their commitment with DWR. As a result, DWR will convert $425 million of VRDBs into fixed rate bonds. The next renewal date for about $3.63 billion of VRDBs is November 1 and December 1, 2010.

Bank bonds (including amounts, rates, acceleration provisions)
DWR has $60.82 million of bank bonds as of November 2, 2008.

Under the terms of the Master Credit Agreement, the bank bond interest rate is the greater of (1) the Fed Funds rate plus 0.50% or (2) the Prime Rate for the first-90 days with an increment of 1.00% on the second-90 days. After 180 days, there is a 2.00% increment during this term out period. The principal is required to be repaid over five years with payments due quarterly during the term out period.

Problems maintaining long-term ratings necessary for money market eligibility
The underlying ratings of DWR Power Bonds are Aa3, A, and A+ by Moody's, S&P, and Fitch, respectively. At this time, there is no immediate concern about money market eligibility for Power Bonds. One of the liquidity facility providers, Fortis Bank, however, is under review for possible downgrade. If the ratings of Fortis Bank are further downgraded by the rating agencies, the bonds backed by its liquidity will no longer be eligible for purchase by the money market funds. Total Fortis Bank exposure is $150 million.

Problems with interest rate swaps tied to variable rate bonds
DWR has $3.94 billion in interest rate swaps and $1.01 billion in basis swaps with 10 counterparties. One of the swap providers, Depfa, is close to the rating requirement that triggers termination of the swap. If a termination with Depfa occurs, under the current interest rate environment, DWR may pay a termination fee to Depfa. DWR has $286.80 million of interest rate swaps with Depfa.

DWR has already re-allocated many of their swaps as a result of converting to fixed rate bonds. If this continues to occur, DWR may pay additional costs on their swaps.

Summary of Short-Term Market Exposures

<u>City and County of San Francisco</u>

General comments
The City currently has approximately $1.9 billion in outstanding debt and long-term obligations consisting of $1.1 billion in issued and outstanding general obligations bonds backed by voter approval *ad valorem* property taxes and $0.8 billion in issued and outstanding long-term obligations backed by the General Fund.

In July 2008, the City refunded its general obligation bonds (Laguna Honda Hospital, 1999) Series 2005B, 2005C, and 2005D which were the only general obligation bonds in variable rate mode and replaced such bonds with fixed-rate Series 2008-R3. All outstanding general obligation bonds are in fixed-rate mode and the City's debt service payments on outstanding general obligation bonds are not directly impacted by current credit market turbulence.

In September 2008, the City, through the Finance Corporation, refunded and restructured its variable rate lease revenue bonds (Moscone Expansion Center) Series 2000-1, 2000-2, and 2000-3 bonds outstanding of $144.3 million credit enhanced by bond insurance and backed with a standby bond purchase agreement with the Series 2008-1 and 2008-2 bonds credit enhanced by a direct pay letter of credit. The interest rate on these bonds reset weekly. The refunding and restructuring addressed concerns regarding the credit enhancement provided by the bond insurer of 2000-1, 2000-2, and 2000-3 bonds.

Problems with weak credit enhancers or liquidity providers
The City has $144.3 million in letters of credit (LOC) from Bank of America and State Street Bank. At this point, it is unclear if the banks will renew the LOC once it expires, and if so, at what price.

Summary of Short-Term Market Exposures

County of Sacramento

General comments:
County has outstanding $71,025,000 tax-exempt bonds and $134,000,000 taxable bonds, both in weekly reset variable rate mode.

Problems with weak credit enhancers or liquidity providers:
Both of the letters of credit that back-stop these bonds are with Bayerische Landesbank. Even though this entity has maintained an AAA rating, related German bank entities have experienced financial stresses such that bond purchasers are backing sway from purchasing bonds with this letter of credit backing.

Problems renewing liquidity facilities or letters of credit:
The County's letters of credit for our variable rate bonds are due for renewal in about a year, and if general market liquidity does not improve we will likely be paying substantially more in annual fees. In addition, our Airport terminal modernization program has not been successful in obtaining letter(s) of credit at a reasonable cost for a commercial paper program, which has historically been a cost-effective tool in the financing of large projects that is not currently available.

Bank bonds (including amounts, rates, acceleration provisions):
The County has had as much as $20 million in tax-exempt bank-owned bonds and $10 million in taxable bank-owned bonds at any one time, but currently all have been remarketed. During the time a letter of credit bank owns our bonds, we must pay interest at a rate of prime plus 1%, and must begin paying back the principal within 3 months, and over a period of 5 years, greatly accelerating the anticipated principal payments of the bonds.

Problems maintaining long-term ratings necessary for money market eligibility:
The County's credit rating alone is not money market eligible, and we depend on letters of credit to maintain eligibility for our variable rate bonds.

Problems with interest rate swaps tied to variable rate bonds:
The County's $134,000,000 taxable variable rate bonds were hedged with an interest rate swap agreement with Lehman Brothers. Due to the Lehman bankruptcy, the County terminated the Lehman swap, which was no longer performing. We financed a $23 million swap termination payment to Lehman through an up-front payment from Deutsche Bank when entering into a replacement swap with Deutsche. The terms of the new Deutsche swap are not as favorable, and will increase County costs by an estimated $8 million over the length of the swap.

Summary of Short-Term Market Exposures

Eastern Municipal Water District (EMWD)

General comments
We support this proposal and believe that there are significant benefits to be derived by municipal issuers from the additional security that could be provided. This is not to be interpreted as a "bailout" program or loan, but rather a temporary liquidity support program that can result in stable costs for the issuer and its rate payers.

Problems with weak credit enhancers or liquidity providers
EMWD has $385 million in VRDBs that are backed by three different liquidity providers. The cost of this liquidity has been magnified when the market is unwilling to invest in such securities due to constraints that may be self-imposed by the buyer due to rating issues. The downgrades have resulted in bonds being put to the liquidity banks at rates that are well above "reasonable." As a consequence, EMWD's interest rates have reached levels between 6% and 9% and, at the recent peak, resulted in an additional interest expense of $60,000/day. Currently, these same bonds are trading below 1.0%.

Problems renewing liquidity facilities or letters of credit
EMWD will need to renew $154 million in Standby Agreements for liquidity prior to July 2009 and we are uncertain if banks will be willing to provide this support and if so, at what price. Ultimately, the rate payer is at risk if these bonds are required to be converted to fixed rates due to the volatility of the market. A shift of these bonds to fixed rates could result in much higher interest costs of two to three times higher than what is being paid by municipal issuers today.

Summary of Short-Term Market Exposures

Los Angeles County Metropolitan Transportation Authority

General comments

We currently have $1.07 billion in outstanding auction rate and variable rate bonds, plus an additional $184 million in outstanding commercial paper. We are facing significantly higher debt service on the majority of our auction rate and variable rate debt, at the same time that we are trying to find replacement liquidity from a shrinking pool of highly rated banks. The bond insurers on all of our short-term bond issues have been downgraded, resulting in downgrades for each of these issues. As a result, our interest rates have increased while we search for a solution to the decrease in liquidity available to us.

Problems with weak credit enhancers or liquidity providers

Of our total auction rate and variable rate bonds, all but our most recent variable rate issue – issued in September 2008 – has bond insurance from Ambac, MBIA or FGIC. We have liquidity from Dexia on approximately $325 million of our variable rate bonds and $60 million of our commercial paper, and another $36.6 million with Bayerische Landesbank (BLB). Our remaining liquidity ($132 million) is with Bank of America, which is not experiencing any problems with the market. Of all the other credit enhancers or liquidity providers for these variable rate and auction rate bonds, each of them have experienced downgrades or negative trends, affecting both the long-term and short-term ratings on the debt. Concerns with the liquidity providers have also caused the rates on the bonds to be set at either the maximum rate or a rate well in excess of current market rates. Nearly $560 million of our auction rates securities were insured by Ambac, and the most recent downgrading has caused our maximum rate on failed auctions to increase to 250% of LIBOR for one issue and 225% of LIBOR for the other.

Problems renewing liquidity facilities or letters of credit

In early 2008, the auction rate securities market began to significantly deteriorate, in large part because of the sub-prime mortgage crisis and the downgrade of bond insurers. This caused our rates on the auction rate securities to go from rates of about 3.5%, to rates as high as 12%. Given the problems with auction rate securities, we began the restructuring of the ARS to variable rate debt, which would be secured by liquidity from a bank in the form of a letter of credit or standby bond purchase agreement. While we were able to complete $263 million of ARS restructurings, all of the remaining issues cannot be restructured at this time as we attempt to obtain liquidity from a much smaller pool of banks.

Dexia was to provide approximately $300 million in liquidity but in September, 2008 they put any new issues on hold. For the issue that was restructured with Dexia as the liquidity provider, we are paying the maximum rate (12%) due to the bonds being put to the bank by purchasers, showing the lack of demand for issues secured by Dexia. The majority of other banks from which we were planning to obtain liquidity have cancelled or put commitments on hold (or there is a market penalty for those banks, making them much less desirable for us to use).

We continue to look for liquidity, but the rates charged by the banks are increasing at the same time that it is becoming much harder to obtain liquidity.

Bank bonds (including amounts, rates, acceleration provisions)
We restructured auction rate securities in September 2008 with $132 million in variable rate bonds secured with liquidity from Dexia. Those bonds are all bank bonds (with Dexia). We currently pay 12% on the bank bonds (versus a rate of less than 1% on the variable rate bonds for the other portion of the bond issue not with Dexia). The rate will decrease to the base rate (higher of Prime Rate or the Federal Funds rate plus one half of one percent) plus 1% for the third month, then increase to the base rate plus 2% beginning in the fourth month. If term out funding is required (generally after the bonds have been with the bank for six months), the principal repayment is accelerated and has to be repaid over five years instead of the scheduled 23-year repayment. Our other two variable rate issues have been with the banks (Dexia and BLB) on and off over the last several months.

Currently, virtually all of the 1992 issue with liquidity provided by BLB is with the bank and is paying 6%. The rates on the bank bonds for those issues are at a lower rate than the Dexia portion of the 2008 variable rate bonds but are still much higher than the market rate on the Bank of America portion.

Problems maintaining long-term ratings necessary for money market eligibility
The insured ratings on all of our auction rate and variable rate debt are now lower than the underlying rating on those issues from at least one of the rating agencies. For two of our auction rate issues and one variable rate issue, we no longer have at least a double-A rating from two of the rating agencies because of an underlying rating in the single-A category.

Problems with interest rate swaps tied to variable rate bonds
We have seven interest rate swaps tied to five different variable rate/auction rate bond issues. Because of the problems in the market and the downgradings of FGIC, Ambac, and MBIA, all of our swaps have significant negative basis variance. The current termination values for all of these issues is approximately $50 million. These large termination values make it very difficult for us to refund our auction rate and variable rate issues to fixed rate bonds without incurring a large upfront payment. Additionally, because of the downgrading of Ambac, we may have to post collateral on at least one of our issues, causing us further expense.