



## BASEL III - WHAT A TOWN WITHOUT PITY CAN DO

BY DAN WILES, PRINCIPAL

**“No** *it isn't very pretty what a town without pity can do.”*

-Gene Pitney, “Town Without Pity” 1961

Variable rate debt has been a staple of public finance since the 1980s. While each decade has seen permutations, the standard variable rate demand bond backed by a bank letter of credit or standby bond purchase agreement has endured. Prices for liquidity support came down in the mid 2000s with the bubble bursting at the Lehman bankruptcy.

Just as the costs of bank support are receding from the post Lehman highs comes the new Basel III standards for bank capitalization and liquidity. The Bank for International Settlements, based in Basel, Switzerland, released its second set of revisions to bank standards.

The new standards are a response to the worldwide financial crisis in which banks were overleveraged and undercapitalized. Bank failures were based in part on their inability

to absorb lending and investing losses. In the United States, the Fed's stress tests demonstrated some weakness in the banking system. The new standards are aimed to correct those areas of weakness.

If Basel has any pity, it isn't for bank credit customers. The Basel III standards are aimed at overall bank financial health, but are not aimed at the interests of bank credit customers. Under the new standards, banks need to accumulate more Tier I capital, actual honest to goodness equity. Banks are no longer allowed to depend as heavily on leverage. This results in a safer, but a bit more “expensive” banking system.

For banks that provide credit support in the public finance markets, reserves (cash and security equivalents) need to be equal to 100% of the amount that can be reasonable estimated to be payable in the next 30 days. While this is still subject to a level of interpretation, what is crystal clear is that banks will be required to maintain significantly

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## SOME IMPACTS OF DODD-FRANK ACT ON MUNICIPAL ISSUERS

BY THOMAS G. JOHNSEN, PRINCIPAL

In July 2010 Congress approved and the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”). Portions of the Act require that municipal advisors register with the Securities and Exchange Commission (“SEC”) and be subject to professional standards such as testing, continuing education and supervisory rules. The Act also provides that “no municipal advisor may engage in any act, practice or course of business which is not

consistent with a municipal advisor's fiduciary duty...” to its clients. Other portions of the Act seek to address rating agency matters related to accountability, conflict of interest, rating accuracy and disclosure of information used to determine a rating.

The Act defines municipal advisor as any person (not an employee of a municipal entity) that “provides advice to or on behalf of a municipal entity or obligated party with respect to municipal

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## AMENDMENTS TO DISCLOSURE RULES

BY JOSHUA J. LENTZ, ASSISTANT VICE PRESIDENT

On May 26, 2010, the SEC issued new rules and amendments to municipal disclosure Rule 15c2-12 (the “Rule”). The new provisions include (a) new disclosure requirements for public offerings of variable rate demand obligations (“VRDOs”); (b) new significant events; (c) removal of the materiality requirement for certain significant events; and (d) requiring a ten business days reporting notification for significant events. The changes will apply to primary public offerings occurring on or after December 1, 2010.

Originally under the Rule, continuing disclosure requirements did not apply for VRDOs. Continuing disclosure requirements for fixed rate debt obligations will now apply to VRDOs. The new changes and amendments to the Rule will not apply to VRDOs outstanding as of November 30, 2010 so long as they meet certain denomination requirements and remain subject to tender at least every nine months.

The Rule currently states that reporting of significant event notices be filed in a timely manner. Under the new changes and amendments, reporting of significant event notices will be required to be filed within 10 business days of the occurrence.

In addition, the amendments added the following significant

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# ANOTHER SUCCESSFUL YEAR FOR SCHOOL DISTRICT G.O. BONDS

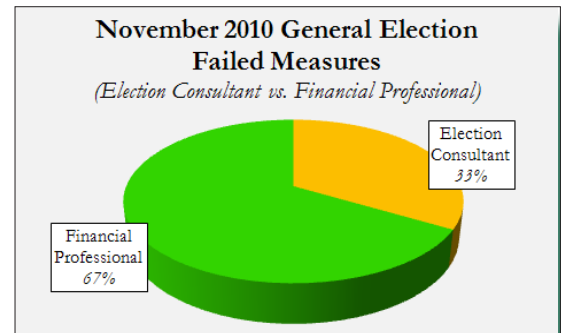
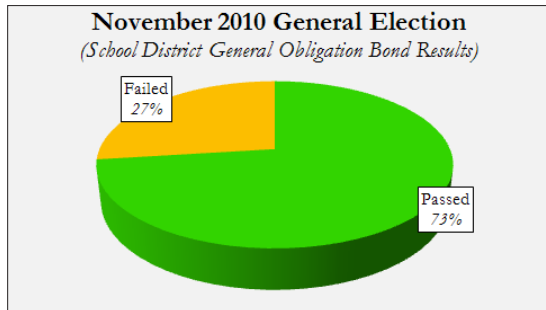
BY ADAM BAUER, PRINCIPAL

Despite a difficult economy and a gubernatorial race that did not excite many, Californians continue to support school district General Obligation (GO) Bond Measures. There are many reasons school districts have experienced success with GO Bond Measures. One of the more significant reasons for school districts' success at the ballot box has been the passage of Proposition 39. Proposition 39, which passed

in 2000, lowered the voter approval threshold from 66% to 55%. Prior to Proposition 39, the passage rate for school GO Bond Measures was typically below 60%. On the 2010 November 2nd general election ballot there were sixty-three Proposition 39 GO Bond Measures on the ballot. It appears that forty-six have passed, two still too close to call, resulting in a passage rate of 73%. While this represents a lower passage rate compared to the immediately prior years, it is still a high success

rate when compared to elections prior to Proposition 39. In the pie chart to the left is a summary of the GO Bond Measure successes and failures on the November 2, 2010 ballot.

For more information contact Adam Bauer, Principal at Fieldman, Rolapp & Associates.



## DISCLOSURE RULES

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events, bringing the total to 15:

- Tender offers
- Bankruptcy, insolvency, or other similar proceedings
- Mergers, consolidations, and acquisitions and sales of assets
- Appointment of a successor or additional trustee

Prior to the amendments, the Rule stated that any of 11 significant events were to be reported if deemed "material." Under the revised Rule, occurrence of any of the following nine significant events must be reported, regardless of whether such events are determined to be material:

1. Principal and interest delinquencies
2. Unscheduled draws on debt service reserve funds reflecting financial difficulties
3. Unscheduled draws on credit enhancements reflecting financial difficulties
4. Substitution of credit or liquidity providers or their failure to perform
5. Adverse tax opinion
6. Tender offers
7. Defeasances
8. Rating changes

9. Bankruptcy, insolvency, or other similar proceedings

Under the amendments, the following significant events will remain subject to "materiality" determination:

10. Non-payment related defaults
11. Modifications of rights of security holders
12. Bond calls
13. Release, substitution or sale of property of property securing repayment of the securities
14. Mergers, consolidations, and acquisitions and sales of assets
15. Appointment of a successor or additional trustee

The new changes and amendments have expanded and clarified the "Adverse tax opinion" significant event regardless if it is material. The following are types of events which may trigger an "Adverse tax opinion" significant event: (a) issuance by the IRS of proposed or final determinations of taxability, (b) IRS Form 5701-TEB or (c) other significant notices or determinations with respect to the tax statutes of municipal securities.

Municipal securities issued on or after December 1, 2010 will require continuing disclosure documentation to include the new significant events and state that all significant events will be filed with the MSRB within ten (10) business days of such occurrence. ♦

# A LOOK BACK AT BOND INSURANCE

BY JOSHUA J. LENTZ, ASSISTANT VICE PRESIDENT

There was a time, not too long ago, that it was relatively easy to obtain AAA rated insurance for municipal bonds and there were few worries that a bond insurer would lose its stellar ratings. Well, the bond insurance scene

has dramatically changed since the end of 2007 and now there are no longer any bond insurers with an AAA rating. Below is comparison of the bond insurers' ratings as of November 1, 2007 to November 1, 2010. ♦

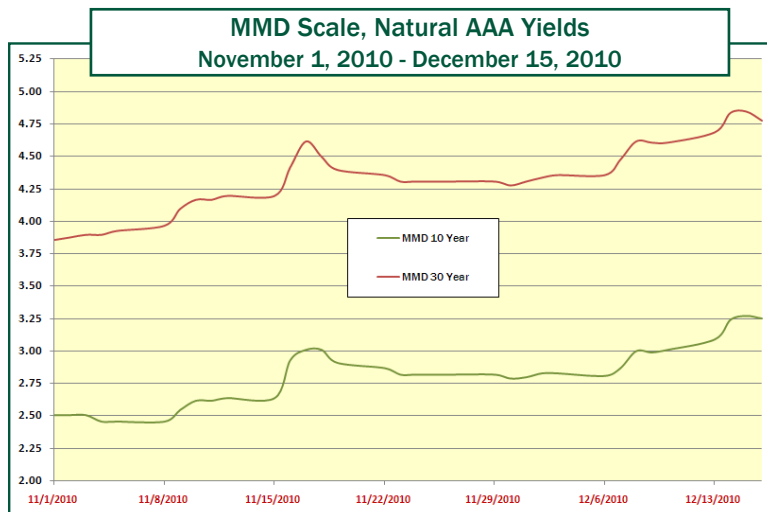
## INSURED FINANCIAL STRENGTH RATINGS AS OF NOVEMBER 1, 2007

BOND INSURERS	MOODY'S	S&P	FITCH
Ambac Assurance Corporation	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook
Assured Guaranty Corp.	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook
CIFG Assurance North America, Inc.	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook
Financial Guaranty Insurance Company	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook
Financial Security Assurance Inc.	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook
MBIA Insurance Corporation	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook
Radian Asset Assurance Inc.	Aa3, Stable Outlook	AA, Stable Outlook	AA, Negative Watch
XL Capital	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook

## INSURED FINANCIAL STRENGTH RATINGS AS OF NOVEMBER 1, 2010

BOND INSURERS	MOODY'S	S&P	FITCH
Ambac Assurance Corporation	Caa2, Positive Outlook	R*	Not Rated, Withdrawn
Assured Guaranty Corp.	Aa3, Negative Outlook	AA+, Stable Outlook	Not Rated, Withdrawn
Assured Guaranty Municipal Corp. (formerly FSA)	Aa3, Negative Outlook	AA+, Stable Outlook	Not Rated, Withdrawn
Berkshire Hathaway Assurance Corporation	Aa1, Stable Outlook	AA+, Stable Outlook	Not Rated
CIFG Assurance North America, Inc.	Not Rated, Withdrawn	Not Rated, Withdrawn	Not Rated, Withdrawn
Financial Guaranty Insurance Company	Not Rated, Withdrawn	Not Rated, Withdrawn	Not Rated, Withdrawn
National Public Finance Guarantee Corporation (formerly MBIA)	Baa1, Developing Outlook	A, Developing Outlook	Not Rated, Withdrawn
Radian Asset Assurance Inc.	Ba1, Stable Outlook	BB-, Negative Outlook	Not Rated, Withdrawn
Syncora Guarantee Inc. (formerly XL Capital)	Ca, Developing Outlook	Not Rated, Withdrawn	Not Rated, Withdrawn

\* R rating is when an obligor is subject to regulatory supervision owing to its financial condition. Please contact S&P for further information with respect to the "R" rating category.



## MUNICIPAL MARKET UPDATE BY TOM JOHNSEN, PRINCIPAL

A strange combination of positive economic news, decreasing cigarette sales and a rush to sell bonds before December 31st led to increasing yields on tax-exempt municipal bonds from early November to mid December. A strong payroll report indicating higher than anticipated job growth started bond market yield increases in early November. This was followed by the downgrading of over \$20 billion of tobacco bonds, based on decreasing tobacco sales in some states. The tobacco downgrade forced the sale of bonds by market funds holding those bonds to meet cash withdraws from frightened investors. The bond market has also seen extremely heavy supply due to issuers wanting to complete transactions prior to the expiration of Build America Bonds on December 31, 2010. From December 1 to the middle of the month, 174 BAB transactions with \$13.7 billion were issued. Recent stock market advances have also helped to push yields higher. ♦

## BYE BYE BABs? BY THOMAS G. JOHNSEN, PRINCIPAL

At least for now, Build America Bonds (“BABs”) will expire on December 31, 2010. BABs were authorized in early 2009 by the American Recovery and Reinvestment Act to provide economic stimulus and to lower borrowing costs for issuers of municipal bonds. BABs provide issuers a direct payment, by the federal government, of a 35% subsidy on interest costs.

On Wednesday, December 15th, the Senate approved tax package did not include provisions for an extension of BABs. The House approved version also excluded an extension of BABs. The incoming chairman of the House Transportation and Infrastructure Committee, however announced plans to attempt to “reincarnate” BABs next congressional session.

A report by the Center on Law and Public Finance stated that over \$137 billion of BABs have been issued in 1,774 separate transactions. BABs were issued in every state but Montana. Other sources state that as of December 2nd there had been over 2,000 BABs with \$174 billion in proceeds. California’s share is reportedly 7% of transactions and 32% by bond volume. For December 2010, it appears municipal

issuance of BABs will exceed issuance of tax-exempt municipal bonds. ◆

## BASEL III CONTINUED FROM FRONT PAGE

higher reserves to support letters of credit and SBPAs.

The new rules are imposed by each national banking regulator, but are expected to be in force by January 1, 2015. Basel III’s impact on the costs to banks is clear. What remains unclear is how all of this comes out in the wash. For example, we don’t know if there will be any impact on pricing for credit that expires by January 1, 2015. However, banks are expected to be on a trajectory to enforcement before that date. Moreover, investment bankers, in response to the collapse of the auction rate market, have been developing non bank variable rate products, like SIFMA floating rate notes and extendable commercial paper. At present, these remain mostly “boutique” products with application limited to a few large issuers and a handful of purchasers.

Which force is stronger on variable rate debt, the upward price pressure from Basel III or the downward pressure from the non bank alternatives. Stay tuned, it’s going to get interesting. ◆

## DODD-FRANK CONTINUED FROM FRONT PAGE

financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters,” or undertakes a solicitation of a municipal entity. Specifically included are financial advisors, guaranteed investment contract brokers, third party marketers, placement agents, solicitors, finders and swap advisors. Attorneys offering legal advice or providing traditional legal services are exempt from registration as are engineers providing engineering advice. It is not yet clear if service providers such as feasibility consultants or other like participants involved in the bond issuance process will be subject to provisions of the Act.

Though the effective date of the Act was October 1, 2010, professional standards and other applicable rules are yet to be written by the Municipal Securities Rulemaking Board (“MSRB”) and approved by the SEC. Rule writing could take as long as two years. The Act required registration of municipal advisors, under interim rules, prior to October 1, 2010. Permanent registration will be required in the near future. About 750 registered nationally with the SEC as municipal advisors prior to the October 1 deadline.

The potential impacts of municipal advisor regulation on issuers of municipal securities are not yet known. It will take time for the benefits and costs to be realized. Already in effect though, as of October 1, is the prescription of fiduciary duty. This means that municipal advisors have a duty of loyalty and duty of care to clients. In short, a fiduciary relationship means putting the other party’s interest above your own. In many instances the obligation of fiduciary duty already applied between municipal advisors and their clients. Prescription within the Act however makes it universal and

will lead to more even application around the country.

Rulemaking for municipal advisors along with the application of fiduciary duty will likely exact influence over the activities of municipal advisors. This could impact issuers. Municipal advisory activities will be subject to currently unknown standards. These standards and practices will effect municipal advisor actions and could indirectly impact, to various degrees, issuer actions. Much like issuers are impacted by disclosure procedures that underwriters must statutorily follow, issuers and their transactions will likely be effected by municipal advisor regulation and the rules that must be followed.

The Act also likely changes the relationship between the issuer and a rating agency. New procedures separating rating evaluations from sales and marketing efforts were mandated by the Act as were stricter internal controls, and differences in corporate governance. Recently some issuers have been presented with, previously unseen, letters of engagement or indemnification requirements from rating agencies. As with other provisions of the Act, the actual and final impact on the rating agency/ issuer relationship will not be known for some time, but that relationship has and will continue to evolve.

Those providing municipal advisory services are now subject to rulewriting by the MSRB and enforcement through the SEC. Fiduciary duty of the advisor has also been prescribed by the Act. Oversight of the rating agencies has also been mandated. It will be some time before all the rules are written, reviewed and provisions of the Act interpreted. The full extent of provisions of the Act is not yet known and will likely not be known for some time. How the direct costs of increased regulation will be paid and who pays them is only starting to be discussed. Only with time will the benefits, costs and impacts of municipal advisor regulation be known. ◆