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MUNI MARKET UPDATE

April 5, 2010

INSIDE THIS ISSUE:

A NEW ERA IN MUNICIPAL RATINGS

By Glenn C. Dellinger, CFA

Nearly ten years ago, the Moody's credit rating agency announced that it was in the process of revising their credit rating standards in an effort to adopt uniform standards for all types of debt – municipal, corporate, asset-backed, sovereign – based on measures of expected loss and default risk.

Previously the rating system for municipal credits was largely independent of the rating systems for the other sectors. Each sector was rated on its own standard.

Historic Default Rates for Municipal Bonds Are Lower Than Corporate Bonds

As a result, municipal bonds have historically had much lower default rates than comparably rated corporate bonds. (The cumulative historic default rate for bonds rated invested grade by Moody's is 0.06% for municipals versus 2.50% for corporates. For S&P the percentages are 0.25% and 3.76%, respectively.)

Markets are Merging

As long as the two markets were separate, it wasn't much of an issue, but as the two markets have merged over the years through taxable municipal bonds, cross-over buyers, IDR/PCRs, and revenue bonds backing enterprises similar to for-profit enterprises, the issue has become more pressing.

> *"The cumulative historic default rate for bonds rated invested grade by Moody's is 0.06% for municipals versus 2.50% for corporates. For S&P the percentages are 0.25% and 3.76%, respectively."*

Municipal Authorities' Involvement

Municipal authorities facing stressed finances have been particularly dismayed with the arrangement believing they are paying too much in interest due to ratings that are too low for their low level of default risk.

But that was 2001. In the mean time, nothing much has happened...if you ignore that little thing about the global economy collapsing in large part due to overrated asset-backed securities.

Federal Government's Involvement

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THIS WEEK'S CALENDAR

Date	Amount	Issuer
04/06/10	36,600M	Charles Co, MD
	25,185M	TAX-EXEMPT
	11,415M	TAXABLE - BABS
04/06/10	356,000M	S/O Illinois, IL
	300,000M	TAXABLE - BABS
	56MM	TAXABLE
04/06/10	10,270M	Mahopac CSD, NY
04/06/10	4,348M	Sweedesboro Boro, NJ
04/06/10	17,550M	Springfield Twp, PA
04/06/10	3,470M	T/O Amsterdam, NY
04/06/10	7,050M	Fayetteville Manlius CSD, NY
04/06/10	11,925M	C/O Bethlehem, PA
04/06/10	8,045M	Hempfield SD, PA
04/07/10	4,815M	C/O Kingston, NY
04/07/10	14,500M	Ontario County, NY
04/08/10	6,151M	Little Falls City SD, NY

Click here for calendar updates.

REGULATING DERIVATIVES

The drive to regulate the over $600 trillion over-the-counter derivatives market continues, with two bills being reviewed, and both Mary Shapiro of the SEC and California's State Treasurer weighing in with their opinions.

Dodd's Bill Stalled

Bipartisan talks on Senator Christopher J. Dodd's proposal for regulatory reform in the derivatives market broke down last week, in part because of the end user exemptions.

The two senators on the banking committee whom Dodd had assigned to tackle derivatives oversight, Jack Reed (D-R.I.) and Judd Gregg (R-N.H.), spent months working through the details but recently reached an impasse in their negotiations.

Senate Agriculture Committee's Bill

Senator Blanche Lincoln (D-Ark), the chairman of the Senate Agriculture Committee and Saxby Chambliss (R-Ga.), will soon be releasing that Committee's bill for derivatives legislation. It is anticipated that their version will be more favorable to Wall Street.

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HEALTH REFORM BILL IMPACT ON MUNIS

The good news: The exclusion of income from municipal securities from the new 3.8% Medicare tax makes municipal securities, particularly taxable municipal securities, particularly attractive.

The bad news for states: Overburdened states have had additional obligations imposed upon them as it relates to state-run insurance exchanges.

The bad news for hospitals: with Medicaid providing more coverage, some hospitals may have difficulty providing enough charitable care to qualify for property tax exemptions.

Income from Munis Exempt from the New Tax

The health care plan will levy a 3.8% tax on individuals who earn more than $200,000 annually and joint filers reporting more than $250,000, beginning in 2013. The tax would apply to income from interest, dividends, royalties, capital gains and rents.

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MUNICIPAL MARKET UPDATE

Secondary flows were light in a holiday shortened week as market participants addressed month-end and quarter end issues.

Credit spreads widened and a rise in MMD yields set the tone for the week.

Retail interest moved to the 10-15 year range as selling prevailed in the front end given the low nominal yields in this sector.

With a reduced forward supply of high grade issuance, clients could be compelled to deploy investable funds given the higher yields and cheaper ratios to Treasuries made available as a result of the prior week's sharp adjustment to MMD rates.

Twenty to thirty year tax exempt yields continue to be supported by the lack of supply in this range, given the large proportion of long term Build America Bond issuance. ♣

VISIBLE SUPPLY

The 30-day visible supply of municipal bonds totaled $6.520 billion, up $1.037 billion from the previous session, according to The Bond Buyer.

That comprises $1.686 billion of competitive bonds, which is down $500.7 million and $4.834 billion of negotiated bonds, which is up $0.537 billion.

Week of March 29, 2010

Total supply: $3.04B

Taxable/BABs: $0.69B

Tax-Exempt: $2.35B

Week of April 5, 2010

Total supply: $3.81B

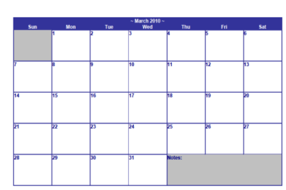
Taxable/BABs: $1.11B

Tax-Exempt: $2.70B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters. 4/1/2010.

ECONOMIC CALENDAR



A NEW ERA IN MUNICIPAL RATINGS (CONT'D)

And now that the federal government is supporting local governments as never before through liquidity pools, transfers, and subsidizing municipal interest expense, the federal government has a vested interest in reducing the burdens on municipalities to provide an impetus for change.

Senator Dodd's recently released draft of a bill to reform financial regulation appears to have lit a fire under the rating agencies. A day after the draft was released, Moody's announced plans to bring its municipal ratings more in line with its ratings for corporate, sovereign and asset-backed securities. They claim that their announcement had nothing to do with a provision in the bill that would require rating agencies to use consistent symbols to rate municipal and other types of debt. The provision also suggests that ratings should be based on the probability of default.

Moody's plans for the ratings to be recalibrated over the course of four weeks beginning in mid-April. Despite the current fiscal struggles facing municipalities, the recalibration of ratings is expected to result in an upward compression of long term ratings on general obligation debt as currently investment grade debt moves up one to three notches and sales tax and special obligation debt move up one notch.

Debt currently rated Aa1 is not expected to move up the rating scale.

Short term ratings are not expected to be affected as Moody's claims that they are already aligned with the ratings of the other sectors, due to a greater emphasis on liquidity.

They further maintain that revenue bonds backing municipal enterprises such as housing, health care, higher ed and public power will not see much in the way of changes as they are already mapped to a global standard. Debt for public enterprise issuers that receive a significant amount of public funding such as public colleges may, however, see a one notch upgrade depending upon their parent governmental body.

Having put off their own effort to establish a global rating standard when they became preoccupied with the collapse of the market in 2008, Fitch recently announced that they expect to re-rate municipal credits to a global scale starting in April as well.

At least one market observer has speculated that the change to a more compressed rating scale will result in less rating volatility and thus lead to a more credit-blind municipal market. If everything is rated Aa, why worry? We would hold that just the opposite is the case.

The market might pay less attention to ratings but it will have to dig beyond the ratings to track down headline risks that might adversely affect market pricing. For the sake of preserving their own relevance, the rating agencies might have been better advised to adopt the granularity of the municipal rating scale for the rest of the market rather than the other way around.

While the change will lead to the incongruous situation of significant upgrades during a period of severe financial stress and a period of uncertainty as the market reestablishes intra-market trading relationships, the change should bring about a much better inter-market integration of the capital markets that is long overdue. ♣

Varied Investor Opinions

In a March 23rd Businessweek article, **Ashton Goodfield**, head of muni-bond trading at **DWS Investments** in Boston, says that because the lowest rating for a muni GO bond will be A1, "Institutional investors have the analytical research tools to be able to discern the quality of various issues, while retail investors will find it harder to differentiate lower- from higher-quality bonds that get the same rating. [The new ratings system] gives a false sense of security about some of these credits."

"The upgrades will also send the wrong message to politicians," according to **Philip Condon**, head of municipal bond portfolio management for retail and tax-exempt advisory clients at **DWS Investments** in Boston, in the same Businessweek article. "Instead of scaring them into improving fiscal management policies with the threat of a credit downgrade, this could encourage them not to tighten their budget belts."

In a March 18th interview with The Philadelphia Inquirer, **Gus Sauter**, chief investment officer at **Vanguard Group,** says the old rating system provided "appropriate differentiation" among high-quality public borrowers. Additionally, there is good reason to differentiate between municipal and corporate bonds. For many municipal issuers "the annual report comes out nine months late," while corporations file quarterly, six weeks after quarter-end.

In an April 2nd Wall Street Journal article, **David Alter**, head of municipal research at **Goldman Sachs Asset Management**, said the effect of the recalibrations will be felt most in the taxable municipal market, and investors will be able to make apples-to-apples comparisons with corporate credits.

REGULATING DERIVATIVES (CONT'D)

The bill is expected to go through the committee soon after Congress returns from its two-week April recess.

The Lincoln-Chambliss bill, if successfully, may help push Dodd's legislation through.

Shapiro's Suggestions for Strengthening the Bill

Mary Shapiro, Chairman of the U.S. Securities and Exchange Commission, in an April 2nd letter to the Washington Post, wrote that Congress should take several key steps to strengthen the bill:

1. Create Clear Lines of Regulation
All securities-based swaps should be regulated as securities; all commodity-based swaps should be subject to commodities laws. As swaps often are economic substitutes for the asset or event underlying a contract, the same regulator can impose similar requirements on similar products.

2. Bring More Transparency to the Market
According to Shapiro, investors and regulators need to know what is being traded, including price and volume. The legislation must provide regulators with the information needed to identify trends and combat abuses; however, the Senate legislation does not empower regulators to require trade reporting.

Ms. Shapiro's remarks did not mention that currently all CDS trades are reported to the DTCC from which regulators receive reports on trading patterns.

3. Maximize the Use of Clearinghouses and Exchanges
A clearing requirement would reduce counterparty risk by substituting the creditworthiness of the clearinghouse for the creditworthiness of the parties to the transaction, helping to stabilize the market and improve transparency and pricing in the process.

4. Eliminate Unnecessary Complications
The arbitrary line based on the number of securities in a swap, possibly leading to the engineering of products to exploit differences in regulation policies.

SEC Task Force on Use of Derivatives by Investment Advisers

On March 26, Andrew J. Donohue, the Director of the SEC's Division of Investment Management, which regulates investment companies and registered investment advisers, announced that he has convened a task force to examine the use of derivatives by all funds registered under the Investment Company Act of 1940 (1940 Act).

Exchange-traded vehicles not subject to the provisions of the 1940 Act, such as exchange-traded commodities funds, are not included.

Temporary Halt in Exemptive Relief for ETFs

On March 25th, the SEC issued a press release relating to Mr. Donhue's Division's temporary halt in considering exemptive relief applications submitted by exchange-traded funds (ETFs) that plan to make "significant investments in derivatives to achieve their investment objectives." (See sidebar.)

California Joins the Swap Debate

California State Treasurer Bill Lockyer reportedly has asked large banks that sell the state's bonds for information about CDSs, including each bank's role in making markets for California and other municipal CDSs, the types of clients, and trading volumes. According to the DTCC, the number of CDS contracts on California has risen from 160 to 422 in the past year.

The growth of taxable muni bonds is expected to increase the use of CDSs for munis because it has opened this market to large, international buyers who also trade CDSs. ♣

SEC EVALUATION OF FUNDS' USE OF DERIVATIVES

The staff generally intends to explore issues related to the use of derivatives by funds, including, among other things, whether:

- current market practices involving derivatives are consistent with the leverage, concentration and diversification provisions of the Investment Company Act
- funds that rely substantially upon derivatives, particularly those that seek to provide leveraged returns, maintain and implement adequate risk management and other procedures in light of the nature and volume of the fund's derivatives transactions
- fund boards of directors are providing appropriate oversight of the use of derivatives by funds
- existing rules sufficiently address matters such as the proper procedure for a fund's pricing and liquidity determinations regarding its derivatives holdings
- existing prospectus disclosures adequately address the particular risks created by derivatives
- funds' derivative activities should be subject to special reporting requirements

The staff also will seek to determine what, if any, changes in Commission rules or guidance may be warranted.

HEALTH REFORM BILL IMPACT ON MUNIS (CONT'D)

The tax would not apply to interest on tax-exempt bonds and other forms of unearned income, such as any gain from the sale of a principal residence, that are excluded from gross income under the U.S. income tax code, according to a footnote in the Joint Committee on Taxation's Technical Explanation of the revenue provisions of the Reconciliation Act of 2010.

Don't Wait Until 2013
The Bush Administration tax cuts enacted in 2003 will expire at the start of 2011, raising the top income bracket to 39.6% from 35%. With the 3.8% increase in the Medicare tax and state taxes, high-income investors will be paying close to a 50% tax rate.

Taxable Munis Are Attractive
While lower yields have made longer-dated munis less attractive to retail investors recently, individual investors should consider buying taxable municipal bonds for their tax-deferred retirement accounts. (See our recent article, *"The Allure of BABs."*)

States' Obligations for Health Reform

The Patient Protection and Affordable Care Act, imposes additional burdens on already cash-strapped states. It provides for the creation of the new state-based insurance exchanges, which are intended to provide more affordable and accessible coverage to individuals and small businesses. Each state must create and administer these individual exchanges.

Although the federal government is responsible, under the new health law, for examining "un-reasonable increases" in premiums, most of the oversight will be in the states' hands.

Tax-Exempt Status of Hospitals

Michael J. Wynne of Reed Smith published an article on March 30th at Mondaq entitled, *"Whither Property Tax Exemptions for Hospitals?"*

In 2014, under the new federal health care legislation, Medicaid coverage will be extended to households with income up to 133% of the federal poverty level and the purchase of insurance from state insurance exchanges for those below 400% of the federal poverty level will be subsidized.

Wynne reports that the extended coverage offered under Medicaid and the insurance exchanges may displace much of the charitable patient care that hospitals have traditionally dispensed.

Federal Taxes
In a 2007 IRS interim report of the Hospital Compliance Project, how much free care is enough for a hospital to qualify for a charitable income tax exemption is noted an area of focus.

The Internal Revenue Code, like the majority of state tax property laws, does not include a specific exemption for hospitals and does not define an exempt purpose to include the promotion of health.

According to Wynne, since the advent of Medicare and Medicaid, the IRS has used a "community benefit" standard to determine whether a nonprofit hospital is exempt. Providing free or below cost services to the poor is a factor that may demonstrate that a hospital promotes health for the benefit of the community.

State Property Tax
The majority of state property tax laws include an exemption for property owned by a not-for-profit entity that is used exclusively for a charitable purpose, and in many states, has been applied to property of non-profits that provide medical care to those unable to afford it.

Many states do not use a "community benefit" standard. It is therefore possible that the federal "community benefit" standard would be met by a not-for-profit, but the ex-

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States Taking the Lead in Healthcare Reform

In **Massachusetts**, the state's Division of Insurance rejected 235 of 274 increases proposed by Massachusetts health insurers for small businesses and individuals.

There is an ongoing legal battle in **Maine** over Insurance Superintendent Mila Kofman's decision last year to reject Anthem Blue Cross and Blue Shield's request for a premium hike of 18.5%. The decision also eliminated a customary 3% margin to cover profits and higher-then-expected costs. Anthem is contesting the state ruling in court, insisting that the state-ordered 10.9 percent rate increase for individual health insurance policies was unfair and too low to make a profit.

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HEALTH REFORM BILL IMPACT ON MUNIS (CONT'D)

empt use requirement would not be satisfied with respect to a specific parcel, reports Wynne.

Possible Outcomes

Wynne proposes several scenarios.

Beginning in 2014, as patients begin to be able to pay for hospital services, state and local governments may seek to deny charitable exempt status to hospital property.

In states not currently providing a specific property tax exemption for hospitals, but rather considers hospital property eligible for the general charitable exemption, a standard similar to the federal "community benefit" standard, modified to require a reasonable connection between the documented community benefit and the specific parcel to be exempted from tax, could be adopted by legislation. This solution may not be feasible in states where the state constitution imposes limits on the types of property tax exemptions that can be granted.

Another legislative option would be to mandate a reduced assessment level for hospitals, instead of creating a new hospital exemption or expanding a charitable exemption, allowing maximum flexibility for the legislature to consider factors other than charity that warrant state support of hospital operations through reduced property tax assessment levels.

Recommendations for Hospitals

In the time leading up to the elimination of the pool of potential charitable care patients, hospitals must take action to understand, mitigate or eliminate the real estate tax bills that will inevitably arrive. Hospitals should be preparing their cases for a reasonable and fair valuation of their property, with supportable data, qualified knowledgeable experts, and experienced counsel. ♣