Bond Accountability
Commission 2, Inc.

Municipal debt financing

A guide to the basic elements of bond sales, Issue 14 practices of the Cleveland Metropolitan School District

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Overview

This report is provided to help members of the Bond Accountability Commission and others understand the basic elements of how the Cleveland Metropolitan School District funds its construction and renovation program through municipal debt financing.

The report will attempt to explain how bond and note sales work and the respective roles of the players. Although by no means definitive or exhaustive, it should provide a start for understanding any further analyses that might be undertaken.

Municipal bonds

A bond is a debt security, similar to an IOU. The U.S. government, local governments, water districts, companies and many other types of institutions sell bonds. When an investor buys a bond, the investor is lending money to a government, municipality, corporation, federal agency or other entity known as the issuer.

In return for the loan, the issuer promises to pay the investor a specified rate of interest during the life of the bond and to repay the face value of the bond (the principal) when it "matures," or comes due.

Since most governmental bonds are tax-exempt, bondholders are generally willing to accept a correspondingly lower rate of return on their investment than they would expect on a comparable commercial bond. Bond financing, therefore, can often provide state and local governments with low-interest capital.

Some state and local governments are required by law to seek voter approval for certain types of bond issues. In a public vote on May 8, 2001, residents of the Cleveland Metropolitan School District authorized the District to issue up to $335 million in bonds for capital improvements to the District's schools and to levy property taxes to pay off the debt with interest.

Bonds are issued for a period of more than one year. Similar debt instruments, called notes, are issued for periods of one year or less. A particular bond issue may be structured to include bonds of various maturities, ranging from a few years to 30 or more, resulting in a variety of interest rates (generally, the longer the term, the higher the interest rate).

An issuer, such as the School District, sells bonds to an underwriter, a financial institution or syndicate of institutions that then resells the bonds to investors – both institutional, such as pension funds, and retail, such as individual.

Typically, the rate at which interest is paid and the amount of each payment is fixed at the time the bond is offered for sale. That's why bonds are known as fixed-income securities, one reason a bond seems less risky than an investment whose return might change dramatically in the short-term.

A bond's interest rate generally reflects the credit rating of the issuer, enhancement of that credit rating through issuer purchase of insurance for a particular bond issue, and the general market appetite for bonds of that credit rating at the time the bonds are sold. Generally speaking, the longer the term, the higher the interest rate that is offered to make up for the additional risk of tying up the investor's money for so long a time.

The interest rate for bonds is also related to the cost of borrowing in the economy at large, so when mortgage rates are down, for example, bond rates also tend to be lower.

As a rule of thumb, bonds of like size, credit rating and maturity sold on a given day should have comparable interest rates.

Bonds sold by state or local governments are known as municipal bonds, or munis. The proceeds of the bond sale go to either support a government's general financing needs or for special projects, such as the Cleveland District’s school construction and renovation program.

Standard municipal bonds are federally tax-exempt, meaning that the investor pays no federal income tax on the accrued interest. They are also free from state and local taxes if they are issued in the investor’s state of residence. For example, a resident of Ohio who buys a municipal bond issued by the Cleveland Metropolitan School District will not pay Ohio state or local taxes on it. However, if the same resident of Ohio buys a municipal bond from a school district in Connecticut, he or she will pay Ohio state and local taxes on the accrued interest.

A municipality may also choose to issue taxable bonds, and the options for doing so have been expanded as part of the federal stimulus legislation approved in February 2009. However, to date the Cleveland District’s notes and bonds issued to pay for the facilities program have been of the tax-exempt variety.

There are many types of municipal bonds. They are: General Obligation Bonds, Limited and Special Tax Bonds, Industrial Revenue Bonds, Housing Bonds, Moral Obligation Bonds, Double Barreled Bonds, Tax Anticipation Notes, Bond Anticipation Notes, and Revenue Anticipation Notes. Those relevant to the Cleveland Metropolitan School District’s facilities program to date are:

General Obligation Bonds (GO's). These bonds are backed by the full faith and credit of the issuer for prompt payment of principal and interest.

Many bonds issued by cities, counties or school districts also have the added security that they can raise property taxes to assure payment. This guarantee is of an unlimited nature. The issuer can raise taxes as high as it wants to pay the bonds. If the property tax is not paid, the property can be sold at auction, giving the bondholder a superior claim above mortgages, mechanical liens, and other encumbrances. General Obligation bonds are regarded as very safe investments.

The Issue 14 bonds are of this type. The Board of Education resolution authorizing a $55 million bond issue in 2009 contains this excerpted language:

“There shall be levied on all taxable property in the School District … a direct tax annually during the period the Bonds are outstanding in an amount sufficient to pay the debt charges on the Bonds when due. … The tax shall be unlimited as to amount or rate. … This Board determines that … the full faith and credit and general property taxing power … of the School District and Board are pledged for the timely payment of the debt charges on the Bonds; …”

Bond Anticipation Notes (BAN’s). These are interim short-term tax-exempt obligations used to provide funds for construction. The proceeds of a future bond issue are pledged to pay the note at maturity. To avoid poor market conditions or for other reasons, an issuer might delay a bond issue. Eventually, a tax-exempt bond issue provides permanent financing, and the bond anticipation notes are retired. An issuer may also use available cash to pay off the notes.

The Cleveland District has frequently issued such notes to finance the facilities program.

The Board of Education resolution authorizing a $55 million bond issue in 2009 contains this language:

"WHEREAS, on December 30, 2008, the School District issued its $15,000,000 School Improvement Notes, Series 2008 (the "Series 2008 Notes"), in anticipation of the issuance of a portion of the aforesaid bonds, which notes will mature on September 30, 2009; …"

Financial adviser, bond counsel

Many issuers, including the Cleveland District, hire a financial adviser to assist in developing financial strategies, among them formulating and executing a debt-financing plan. The District's financial co-advisers are Fifth Third Securities, based in Columbus, Ohio, and represented by John Adams, vice president and Ohio public finance manager, and SBK-Brooks Investment Corp., based in Columbus and Cleveland and represented by William E. Matlock, Jr., managing director.

The Government Finance Officers Association (GFOA) recommends in its paper "Recommended Practice -- Selecting Financial Advisors (2008)" that issuers select financial advisors on the basis of merit using a competitive process and that issuers review those relationships periodically. A competitive process using a Request for Proposals (RFP) process allows the issuer to compare the qualifications of proposers and to select the most qualified firm based on the scope of services and evaluation criteria outlined in the RFP.

SBK Brooks and Fifth Third Securities were selected in 2002 after a competitive review process, including proposals and interviews, according to the School District.

Regarding fees paid to financial advisors, the GFOA recommends that they "should be on an hourly or retainer basis, reflecting the nature of the services to the issuer. Generally, financial advisory fees should not be paid on a contingent basis to remove the potential incentive for the financial advisor to provide advice that might unnecessarily lead to the issuance of bonds. GFOA recognizes, however, that this may be difficult given the financial constraints of many issuers. In the case of contingent compensation arrangements, issuers should undertake ongoing due diligence to ensure that the financing plan remains appropriate for the issuer's needs. Issuers should include a provision in the RFP prohibiting any firm from engaging in activities on behalf of the issuer that produce a direct or indirect financial gain for the financial adviser, other than the agreed-upon compensation, without the issuer's informed consent."

According to the District, Fifth Third Securities and SBK-Brooks are not on retainer but are paid on a contingent basis per transaction: $0.50 per $1,000 financed plus $25,000 per regular bond issue, $35,000 for a refunding bond issue (a refinancing such as the one proposed but abandoned in 2007), and $7,000 per note issue. The total fees are split evenly between the two firms.

Issuers of municipal debt also need to have a bond counsel, a lawyer or law firm that delivers a legal opinion on the issuer's authorization to issue bonds and the tax-exempt nature of the bond and performs other duties, such as coordinating execution of closing documents and acting as liaison to bond insurers. The Cleveland Metropolitan

School District's bond counsel is the firm Squire, Sanders & Dempsey, represented by Richard D. Manoloff.

Bond ratings

When an issuer prepares to sell bonds, it obtains a bond rating on the issue. Bond ratings are assessments made by investor advisory companies, also known as rating agencies, of credit quality or, conversely, the risk that the borrowing government will not make scheduled payments of principal and interest. Rating agencies base their ratings on a number of economic, debt, financial, and governmental factors. These ratings significantly influence the interest rate that a borrowing government must pay on its bond issues. Stated another way, a rating helps prospective investors determine the level of risk.

The agencies rate a bond issue according to systems that designate a letter or a combination of letters and numerals. The three main ratings companies for municipal bonds are Moody's Investors Service, Standard and Poor's Ratings Services, and Fitch Ratings. Moody's uses a modifier of 1, 2 or 3 to show relative standing within a category. Standard and Poor's and Fitch Ratings use a modifier of plus or minus.

The agencies may also periodically change their ratings of particular municipal bonds in the years after they are issued but before they mature. Such adjustments are primarily of interest to those investors who buy or sell the bonds among themselves.

Credit Risk	Moody's	Standard and Poor's	Fitch Ratings
Investment Grade			
Highest Quality	Aaa	AAA	AAA
High Quality	Aa	AA	AA
Upper Medium	A	A	A
Medium	Baa	BBB	BBB
Not Investment Grade			
Lower Medium	Ba	BB	BB
Lower Grade	B	B	B
Poor Grade	Caa	CCC	CCC
Speculative	Ca	CC	CC
No Payments / Bankruptcy	C	D	C
In Default	C	D	D

Credit enhancement

An issuer that does not merit, based on its own financial situation, a top credit rating (its *underlying* rating), may elect to have a bond issue insured in order to improve the issue's rating (its *insured* rating). A better rating serves to attract more buyers and lower the interest rate that the District must pay to bondholders.

The insurance is a legal commitment by an insurance company to make scheduled payment of interest and principal of a bond issue in the event that the issuer is unable to make those payments on time. The cost of insurance is usually paid by the issuer in case of a new issue of bonds, and the insurance is not purchased unless the cost is more than offset by the lower interest rate that can be incurred by the use of the insurance.

The Cleveland District's current underlying bond rating from Moody's is Baa1, and from Fitch it is BBB+.

The District in the past has purchased bond default insurance – from the Financial Guaranty Insurance Company (FGIC) for its 2002 issue and from Financial Security Assurance Inc. (FSA) for its 2004 issue. The current Moody's insured rating for the 2002 and 2004 bonds is Aa2. Fitch's insured rating for the 2002 bonds is BBB+ (note no improvement from the underlying rating) and for the 2004 bonds, AA+.

The collapse of the housing speculation bubble and ensuing crisis in the credit markets reduced the effectiveness of customary bond default insurance. That's because the main insurers of municipal bonds -- Ambac, MBIA, and FGIC – also engaged in the business of guaranteeing collateralized debt obligations and other mortgage-backed debt, instruments at the heart of the financial crisis. That, in turn, led to serious questions about the insurers' own ability to make good on promises to pay if, say, a school district could not meet the principal and interest payments on its bonds. (**See the Kiplinger article "Why Municipal Bonds Are Stumbling" below.**)

However, the Cleveland District also has another avenue for improving the rating of its bonds, the Ohio School Credit Enhancement Program, under which the District essentially pledges its basic state foundation assistance allotment as collateral in case of default on its bonds. The Cleveland District participates in this program.

The Fitch rating agency announced on Jan. 29, 2009, that it would give an AA rating to school district debt backed by the Ohio program. Moody's assigns an enhanced rating of Aa2 to the District's 2002 and 2004 issues.

Moody's has a different system for rating note issues. All of the Cleveland District's note issues to date have received Moody's top rating, MIG 1.

Issuer expenses

In addition to the costs of insurance and interest payments, an issuer's expenses in a municipal-securities sale may include legal fees (including bond counsel), trustee's fees, printing costs, discounts from sales of bonds at below face value, cost of credit ratings, fees and charges for execution, and filing and recording fees. On the other hand, expenses can be offset by a premium, which is received when a security sells at more than face value.

The interest rate effectively paid by the issuer (as opposed to a security's face-value interest rate, known as the coupon rate) is calculated by including the above costs of issuance and the coupon rate, offset by any premiums. The resulting calculation produces what is known as an "all-in" rate, a reflection of an issuer's actual costs.

For example, the School District sold $15 million in nine-month Bond Anticipation Notes to PNC Capital Markets in December 2008 at a face-value interest rate of 2.5%. However, PNC paid a premium, resulting in an all-in rate calculated by the District and its advisers at 2.216%.

Methods of sale

The methods of issuer bond sale are classified as either competitive or negotiated.

In a competitive deal, bonds are advertised for sale. The advertisement includes both the terms of the sale and the terms of the bond issue. Any underwriter or syndicate of underwriters may bid on the bonds at the designated date and time. The issuer sells its bonds to the bidder the best bid according to guidelines in the notice of sale (chiefly, the lowest interest cost).

In a negotiated deal, an issuer selects an underwriter or group of underwriters according to qualifications criteria specified in a Request for Proposal, also known as a Request for Qualifications (RFQ), and then negotiates the bond price to be paid to the issuer and the maximum price at which the underwriter(s) will then offer the bonds to its investor customers. The terms of the bonds are negotiated to meet the demands of the underwriter's investor clients, as well as the needs of the issuer. Negotiated sales also involve a process known as a presale in which underwriters seek customer indications of interest in the issue before establishing final bond pricing.

The primary role of the underwriter in a negotiated sale is to market the issuer's bonds to investors.

Assuming that the issuer and underwriter reach agreement on the pricing of the bonds at the time of sale, the underwriter purchases the entire bond issue from the issuer and resells the bonds to investors. In addition, negotiated-sale underwriters are likely to provide ideas and suggestions with respect to structure, timing and marketing of the bonds being sold.

All of the Cleveland District's bond sales under Issue 14 have been negotiated.

Negotiated vs. competitive

The question of whether issuers of tax-exempt municipal bonds benefit more from competitive sales or from negotiated sales has long been the subject of debate.

According to the GFOA, "State and local government bond issuers should sell their debt using the method of sale that is most likely to achieve the lowest cost of borrowing while taking into account both short-range and long-range implications for taxpayers and ratepayers. Differing views exist among issuers and other bond market participants with respect to the relative merits of the competitive and negotiated methods of sale. Moreover, research into the subject has not led to universally accepted findings as to which method of sale is preferable when taking into account differences in bond structure, security, size, and credit ratings for the wide array of bonds issued by state and local governments."

The School District's financial advisor John Adams of Fifth Third Securities had this to say about the advantages of a negotiated deal in a December 2008 memo:

"The benefits of the negotiated process include:

- Based upon market volume, economic announcements, actions by the Federal Reserve, etc., the underwriters can more easily adjust when to bring the issue to market.
- Small structural changes can be made the day of the bond sale to respond to specific demand by investors, which result in lower net borrowing rates.
- The marketing period for the bonds can start several weeks in advance of the sale date, rather than the typical two or three days for competitively bid issues.
- Negotiating underwriters have agreed to buy the issuer's debt, even if it cannot all be immediately sold to investors.
- And an issuer can be certain that any interested investors within the issuer's district will have access to the issuer's bonds."

Mr. Adams cited a potential drawback of a negotiated deal as "the concern that the interest rates received from the negotiating underwriter(s) are not on-the-market." He said the risk of that is mitigated for the School District "by having independent Financial Advisors in place to review the rates proposed by the underwriters. The Financial Advisors receive the same compensation whether the District's debt is negotiated or bid, so the only motivation is obtaining the lowest all-in costs of borrowing for the District."

Mr. Adams correctly noted that about 86% of tax-exempt bond deals are now done on a negotiated basis.

Nonetheless, numerous studies have concluded that competitively bid bond deals save money for the issuer, the latest being a study, "Persistent Underwriter Use and the Cost of Borrowing," in the Winter 2008 issue of the Municipal Finance Journal, written by Mark D. Robbins and Bill Simonsen of the University of Connecticut.

They concluded that competitively bid sales saved issuers an average of 17 to 48 basis points (a basis point is 0.01 percent), or enough to save $1.7 million to $4.8 million in interest costs for taxpayers on a $100 million debt over 10 years.

The financial advisory firm WM Financial Strategies reports: "According to data from The Bond Buyer, with only one exception, the average weighted gross underwriting spread for negotiated issues exceeded the spread for competitive issues every year since 1987. For 2007 the average spread for negotiated sales was $5.38 per $1,000 of bonds compared to $4.05 per $1,000 of bonds for competitive bond sales."

Mr. Adams makes the point that "negotiated debt tends to be comprised of issues which are more difficult to sell and/or have relatively low credit ratings, and it is this profile which adds to the average underwriter fees, not just the fact that the issue is negotiated."

He added: "Negotiating underwriters frequently provide pre-sale services, such as assisting with rating presentations, providing amortization options, etc. Some issuers have their Financial Advisor provide these services, but not all issuers use an FA, so they ask the negotiating underwriter to do some of this work, and compensate them for doing more than just selling the debt.

"Simply comparing fees for negotiated versus competitive issues is not an apples-to-apples comparison."

In addition, studies of past sales may not accurately reflect the unprecedented realities of the bond market in today's extremely fragile economy. (**See Bloomberg article "Schwarzenegger Debt Defies Academics …" below.**)

In any case, competitively bid deals avoid the chance to steer underwriting business to firms for political reasons, such as campaign contributions, rather than give the work to the firm offering the best deal for the taxpayers.

No-bid deals represent "an irresistible invitation to political corruption," Bloomberg News recently quoted Christopher Taylor as saying. Taylor, who was executive director of the Municipal Securities Rulemaking Board from 1978 to 2007, has called for ending negotiated transactions (**See "Palm Beach Scandal …" article below**.)

The GFOA is relatively ambivalent on the question of competitive vs. negotiated sales. It says that the presence of the following factors may favor the use of a competitive sale:

- "The rating of the bonds, either credit-enhanced or unenhanced, is at least in the single-A category.
- The bonds are general obligation bonds or full faith and credit obligations of the issuer or are secured by a strong, known and long-standing revenue stream.
- The structure of the bonds does not include innovative or new financing features that require extensive explanation to the bond market."

Similarly, the GFOA says that the presence of the following factors may favor the use of a negotiated sale:

- "The rating of the bonds, either credit-enhanced or unenhanced, is lower than single-A category.
- Bond insurance or other credit enhancement is unavailable or not cost-effective.
- The structure of the bonds has features such as a pooled bond program [a municipal bond offering in which a sponsor sells an issue of bonds with proceeds used by a number of cities or other tax-exempt organizations – does not apply here], variable rate debt [interest rates are periodically adjusted based on current market conditions – does not apply here], deferred-interest bonds [pays no interest until a date specified in the future -- CMSD's planned $55 million sale does include Capital Appreciation bonds, which do not pay accrued interest until the maturity date], or other bonds that may be better suited to negotiation.
- The issuer desires to target underwriting participation to include disadvantaged business enterprises (DBEs) or local firms.
- Other factors that the issuer, in consultation with its financial advisor, believes favor the use of a negotiated sale process."

Perhaps reflective of the debate over negotiated vs. competitive, the District's planned bond sale meets all three of the above criteria favoring a competitive sale, but also at least three of the criteria favoring a negotiated sale.

Among the GFOA's recommendations for cases in which a negotiated sale is deemed best are these:

- Openly disclose public-policy issues such as the desire for DBEs and regional firm participation in the syndicate and the allocation of bonds to such firms as reason for negotiated sale; measure and record results at the conclusion of the sale.

- Prepare a post-sale summary and analysis that documents the pricing of the bonds relative to other similar transactions priced at or near the time of the issuer's bond sale, and record the true interest cost of the sale and the date and hour of the verbal award.

Mr. Adams acknowledges "it is fair to say that in many instances, if you have essentially identical issues, and those issues have wide market acceptance, that the competitive format has some interest rate advantages."

However, he said recently, "there are very good reasons why the vast majority of issuers choose not to negotiate. This is particularly true in difficult markets, like the ones currently being experienced. The District's combination of relatively low stand-alone credit ratings, and well-known economic challenges, leads me to continue to recommend using the negotiated format for its bond issues. The less complex short-term note issues should continue to be competitively bid, in my opinion."

Underwriter selection

If an issuer decides that it wants to pursue a negotiated sale, it must select an underwriter or group of underwriters. The Cleveland District, on the advice of its financial advisers, has elected to pursue a negotiated sale of its $55 million issue in 2009.

Its adviser said an RFP was issued to 15 underwriting firms active in the Ohio tax-exempt market. The responses were evaluated according to the District's criteria, and five underwriters were selected with which to negotiate terms of the deal: Huntington Investment, JP Morgan, KeyBank Capital, Loop Capital, and National City/PNC Capital Markets. (**See the School District's weighted evaluation chart below**.)

In cases of a group of underwriters, one or more of them is designated as the lead or managing underwriter or co-managers, while the others are designated as members of the selling group. The manager(s) distributes the bonds among members of the selling group for marketing. Typically, the lesser members of the selling group have no direct obligation to the issuer to buy the bonds, whereas the managers do.

According to the last information received from the Cleveland District, the managing underwriter(s) for the $55 million issue had not yet been designated.

The issuer's goal in a negotiated bond sale is to obtain the highest possible price (lowest interest cost) for the bonds. To maximize the potential of this occurring, the issuer's goal in the underwriter selection process is to select the underwriter(s) that has the best potential for providing that price. Those underwriters are typically the ones that have demonstrated both experience underwriting the type of bonds being proposed and the best marketing/distribution capabilities.

The underwriter in a negotiated sale is compensated in the form of an underwriter's discount or "spread", which consists of the negotiated difference between the amount the underwriter pays the issuer for the bonds and the amount the underwriter expects to receive selling the bonds to investors.

The underwriter's discount includes up to four components: the management fee (the amount paid to the senior manager and/or co-managers for handling the affairs of the syndicate), takedown (normally the largest component of the spread, similar to a commission, which represents the income derived from the re-sale of the securities), expenses (costs incurred by the underwriter on behalf of the issuer for such expenses as

travel, underwriters' counsel, printing and mailing, and closing costs) and underwriting fee (compensation for risk based on the relative number of bonds each syndicate member has agreed to sell). To the extent that the initial offering prices are subsequently lowered by the selling syndicate**,** the full amount of the spread may not be realized by the syndicate**.** The spread is usually expressed in dollars or points per bond.

The only component of spread that can be fixed in an RFP is the management fee. However, proposers may be required to list maximum amounts for other elements of the spread, setting the stage for negotiating the final terms.

Compared to a competitive sale, pricing bonds in a negotiated sale requires much greater issuer/adviser involvement if the issuer is to be confident that pricing results reflect prevailing market conditions at the time of sale. The key items typically negotiated during the pricing process include bond yields, coupons, the underwriter's discount, and optional redemption provisions.

The GFOA, in its "Recommended Practice -- "Selecting and Managing the Method of Sale of State and Local Government Bonds (1994 and 2007)," says **"**Concerns have been raised about the lack of a competitive Request for Proposals (RFP) process in the selection of underwriters in a negotiated sale and the possibility of higher borrowing costs when underwriters are appointed based on factors other than merit. As a result, issuers have been forced to defend their selection of underwriters."

The Municipal Securities Rulemaking Board (MSRB), an independent self-regulatory organization established by the Securities Acts Amendments of 1975, is charged with primary rulemaking authority over bond dealers, dealer banks and brokers. In response to "pay to play" complaints that issuers were steering lucrative underwriting work to underwriters who donated to the campaigns of municipal officeholders, the MSRB in the late 1990s adopted its Rule G-37, prohibiting such contributions. It declined, however, to approve a proposal to extend the prohibition to donations to municipal bond referenda campaigns, such as that for Issue 14 in 2001.

According to various reports, the MSRB considered the referenda prohibition again in April 2009, after letters from executives of Citi, J.P. Morgan and Morgan Stanley suggested that contributions to bond referenda campaigns could cause an underwriter to be selected and that a level playing field was needed for all underwriters. However, the MSRB again chose not to ban contributions for bond referenda, saying it had "determined that, based on the information it has been able to gather, there is not adequate evidence to suggest that bond ballot campaign contributions have a negative effect on the integrity of the municipal marketplace." The MSRB said it would continue to research any link between contributions and questionable practices.

According to the GFOA in "Recommended Practice -- Selecting Underwriters for Negotiated Bond Sales (2008), "It is appropriate to ask the proposer for a firm management fee quote, although its weighting in the evaluation criteria should be low."

Note that the formula used by the District gives "fees and expenses" the highest single weight among the criteria.

The GFOA continues: "The remaining components of spread, as noted below, should be determined through the negotiation process.

1. Expenses – includes various fees and overhead expenses and also should not be part of the RFP evaluation criteria. However it is important to note that all underwriter

expenses be clearly identified and defined at the appropriate time during the bond negotiation.

2. Takedown – is the "sales commission" of the deal. Current market levels of takedown can be determined by the issuer or its financial advisor just prior to the time of negotiation. The takedown is the principal component of the potential profit to an underwriter in a bond sale. The issuer must weigh the impact of takedown on the resulting true interest cost to the bond issuer. An inadequate takedown may result in less aggressive marketing of the bonds and a higher interest cost to the issuer. A fair balance must be struck between a "market rate" takedown and the cost to the issuer in future interest costs.

3. Underwriting Fee – is almost never part of the final underwriter's discount and should not be part of the discussion at the RFP stage. Discussion of the payment of an underwriting fee may occur during pricing negotiation, but only to the extent the underwriter agrees to underwrite a substantial amount of unsold bonds."

The CMSD formula also gives more combined weight to underwriters with a local presence in the District which are deemed to have performed well on previous District bond issues than it does to ability to distribute, or market, tax-exempt debt. The best marketer would theoretically be able to get the highest prices for the bonds, which should lead to the best interest rate for the District.

Cleveland MSD Underwriter Services Evaluation			
Criteria	**Weighting**	**Rank (1-5)****	**Score**
Fees and expenses*	25%	0	0
Ability to distribute tax-exempt debt (total):	20%		
To retail buyers in the District and Ohio	5%	0	0
To Institutional buyers nationally	10%	0	0
Experience selling Ohio school district debt	5%	0	0
Commitment to/ ownership by minority groups	20%	0	0
Corporate presence in the District	20%	0	0
Performance on previous District bond/note issues	15%	0	0
Total	100%	-	-

* National average approximately $5.75
Range in Ohio is $6.00 to $4.00 per $1,000 issued
** 1 is good - 5 is Exceptional

According to the evaluation chart, an underwriting firm with no local office and no previous experience with the District would appear to stand little chance of being selected even if had superior ability to distribute tax-exempt debt.

Indeed, the criteria for underwriter selection appear to have been changed since the District's last proposed (but not executed) bond sale, a refunding in the spring of 2007, to further favor firms with a corporate presence in the District – now 20%,

previously 10% -- and performance on previous CMSD bond and note issues – now 10%, previously 5%.

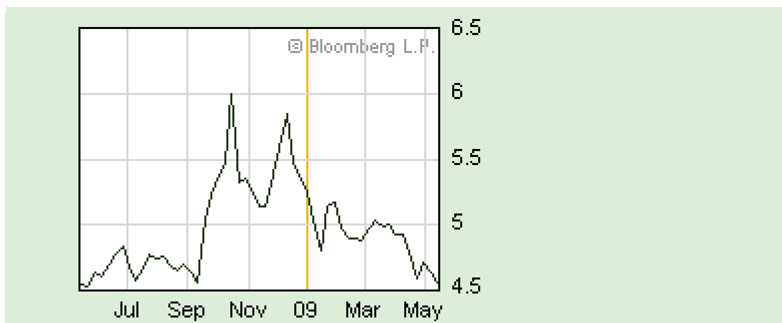
The importance of a firm's commitment to or ownership by minority groups was also increased, to 20% from 15%. Meanwhile, the importance of experience selling Ohio school district debt was reduced to 5% from 20%, of ability to distribute tax-exempt bonds to retail and institutional buyers to 15% from 20%.

Mr. Adams of Fifth Third Securities explained the changes this way: "In the last few years, the number of firms providing underwriting services has decreased, and the remaining firms have not all shown the same level of commitment to continue to provide those services. Other factors, such as corporate presence in the District, etc., now take on additional value as firms are selected, particularly for a transaction which could take a long time period to come to market."

Market factors

The bond markets became virtually frozen in the second half of 2008 as investors attempted to assess their own financial positions and the financial health of issuers and even debt insurers (See Bloomberg article "Muni Bond Yields Rise …" below.)

Now, after government bailouts of financial institutions and other measures to ease the burden of toxic debt, the credit markets have thawed, particularly for highly rated municipal debt. Bloomberg quotes: (AAA-rated, 20-year maturity): 4.34% on May 14, 2009; 4.50% week earlier; 4.68% month earlier; 5.14% 6 months earlier. Bloomberg also reported on May 15 that municipal bond rates were at an eight-month low:



Weekly yields, Bond Buyer 20 G.O Bond index, 20-year maturity, Moody's rating Aa2

Obviously the recent decline in interest rates bodes well for the District's plan to issue $55 million in bonds. Indeed, the District chief financial officer reported to the BAC on March 18 that the District planned to delay completion of the sale pending possible further rate improvements and other developments. The sale once had been anticipated to occur in April or May 2009.

Another factor that could influence the District's plans could be federal issuance of rules and development of viable markets for new, taxable Qualified School Construction Bonds (QSCBs) and Build America Bonds (BABs) authorized by the federal stimulus legislation enacted in February 2009.

These new bonds reduce or eliminate an issuer's interest expenses, because the federal government foots the bill through tax credits. In the case of the planned $55 million issue, the savings to local taxpayers would be approximately $20 million for an issue of QSCBs.

Other factors, however, such as a 13-year maturity limit on QSCBs instead of the District's usual 20 to 25-year maximum bond maturity, could make them unsuitable for the District's purposes.

However, the District might also elect to issue a combination of conventional tax-exempt bonds and QSCBs or BABs, according to its chief financial officer, James Fortlage.

Meanwhile, unease remains in the debt markets over the reliability of credit ratings, especially after mortgage-related securities that had been stamped AAA ended up being nearly worthless. Such uneasiness can tend to cause higher interest rates on long-term debt. The concern extends to ratings of municipal issuers (**See Bloomberg article "Flawed Credit Ratings …" below**).

Remaining factors that could affect the District's underlying credit rating are the deterioration of the area's property tax base and a continuing decline in the rate of tax collections. However, Dennis Kubick of the District's Finance Department had this to say on May 15 regarding the 2009 county-wide valuation update: "It is estimated by Cuyahoga County that residential valuations will decrease 11% from $3.2 billion to $2.8 billion while commercial valuations will remain the same. This change in valuations will affect the second-half collections in FY10 and beyond. The District does not believe this will have a material effect and will continue to collect 6.1 mills for all voted debt issued by the District."

In addition, pledging the District's basic state operational subsidy to pay off bonds through Ohio's credit-enhancement program could place the District in a tenuous position, given the large operational deficits in the District's five-year forecast. It remains to be seen whether the State of Ohio's own precarious financial circumstances will have an impact on credit ratings. (**See New York Times article "Bonds May Face Downgrade" below**)

Issue 14 securities sales

05/08/2001
Cleveland Municipal School District voters approve issuance of $335 million in bonds and bond anticipation notes and the levying of taxes to support same.

11/07/2001
Bond Anticipation Notes: $35 million
Competitive
Purchaser: Banc One Capital Markets
Term: 1 year
Coupon Rate: 3.0%
Net Premium: $28,545

10/24/2002
Bonds: $124.92 million Various Purpose Improvement and Refunding Bonds
Negotiated

Lead Underwriter: National City. Co-managers: Loop Capital Markets and Banc One Capital Markets.
Maximum Term: 25 years
Coupon Rates: various, 1.45% to 5.0%
Cost of issuance: $268,665
Underwriter's discount: $192,778 (allocable to Issue 14 portion)
Explanation: $27,405,000 of the grand total, "together with other available money was used to retire the $35 million in 2001 notes due Nov. 6. An additional $40 million of the grand total represented "new" Issue 14 bond issuance. The rest of the bond issue refinanced previous District debt unrelated to the current school construction program.

<u>7/8/2004</u>
Bonds: $125 million School Improvement Bonds
Negotiated
Lead Underwriter: National City. Co-manager: KeyBank.
Maximum Term: 23.4 years
Coupon Rates: various, 2.0% to 5.25%
Cost of issuance: $299,400
Underwriter's discount: $342,500

<u>12/22/2005</u>
Bond Anticipation Notes: $30 million
Competitive
Purchaser: First Albany Capital
Term: 7 months
Coupon Rate: 3.75%
Cost of issuance: $50,500
Underwriter's discount: $11,000
Net Premium: $26,100
Explanation: These notes were paid off in full at maturity (July 27, 2006) "with available property tax proceeds."

<u>3/6//2007</u>
Bond Anticipation Notes: $30 million
Competitive
Purchaser: A.G. Edwards & Sons
Term: 9 months
Coupon Rate: 4.0%
Cost of issuance: $53,600
Underwriter's discount: $7,000
Net Premium: $27,000

<u>12/5/2007</u>
Notes: $20 million School Improvement Notes
Competitive
Purchaser: J.P. Morgan Securities

Term: 7 months
Coupon Rate: 4.0%
Cost of issuance: $38,100
Underwriter's discount: $3,800
Net Premium: $43,600
Explanation: $5 million of this is "new" Issue 14 money. The remaining $15 million, along with "available property tax proceeds," went to paying off the previous $30 million issue. "Available property tax proceeds" retired the full $20 million issue at maturity July 30, 2008.

9/23/2008
Bond Anticipation Notes: $70 million
Competitive
Sale withdrawn
Explanation: The District in late 2007 and early 2008 had outlined plans for this note issue, which would exhaust the balance of Issue 14 authorization. The idea at the time was that the District could request and receive voter authorization in November 2008 for additional funding needed (said to be $217 million) to complete the facilities program. Any debt remaining from the $70 million issue would be rolled into a new bond issue in 2009, combining the remainder of Issue 14 authorization and part of the new one.

The fall-back strategy was that if voter approval was not received, the District could still issue long-term bonds under Issue 14 sufficient to retire the outstanding balance from the $70 million note issue.

As it turned out, the District decided not to put a request for additional bonding authority on the November ballot. The reason is not entirely clear, although it may have stemmed partly from the lengthy delays in devising a new Master Plan for the program. The Ohio School Facilities Commission approved the plan in late November.

Then, a few days before the planned issue date for the $70 million in notes, the gathering financial crisis exploded with the Lehman Bros. bankruptcy and similar developments, causing a general freeze in the credit markets. The District and its advisers elected to withdraw the planned issue

However, by this time the District needed additional cash in order to hire architects for Segment 5. Hence the following note issue.

12/30/2008
Bond Anticipation Notes: $15 million
Competitive
Purchaser: PNC Capital Markets
Term: 9 months
Coupon Rate: 2.5%
Cost of issuance: $27,200
Underwriter's discount: $46,450
Net Premium: $31,950
Explanation: This smaller issue was deemed by the District's financial advisers to be more digestible by the still-shaky credit market than the $70 million. In fact, only PNC submitted a bid. The actually offering price was set at 100.704% of par value, or a total of

$15,105,600, resulting in a net premium to the District of $31,950 after deductions for costs of issuance and the underwriter's discount.

However, the $15 million was still insufficient to pay the District's total share of Segment 5 costs. The OSFC, in a departure from normal practice, said the District could proceed with Segment 5 architectural planning with the understanding that the OSFC would provide no matching funds until the District had enough cash to complete the entire Segment. Hence the plans for the following bond issue.

Spring/Summer 2009
Bonds: $55 million
Negotiated
Underwriter: Lead not determined, from District-selected pool of Huntington Investment, JP Morgan, KeyBank Capital, Loop Capital, National City/PNC Capital Markets.
Term: circa 20 years, maximum of 25 years
Coupon Rate: To be determined.

Contact us: James G. Darr, BAC administrator; (216) 987-3309; bondaccountability@hotmail.com

Additional reading

Why Municipal Bonds Are Stumbling

These usually safe, tax-exempt investments have become unlikely victims of the subprime mortgage fallout.

By Jeffrey R. Kosnett
Kipplinger.com

December 4, 2007

Municipal bonds generally keep a safe distance when financial firestorms threaten to wreak havoc in other areas of the bond marketplace. But now some triple-A rated tax-exempts are getting thrown into the dreaded subprime mortgage inferno.

The problem isn't that falling real estate values or growing default rates among mortgage holders are causing fiscal problems for state and local governments or school or public utility districts. Municipalities have plenty of ways to cope with budget shortfalls before they get remotely close to defaulting on their debt.

If you're a buy-and-hold, income-oriented investor who owns individual tax-exempts rated single A or better, there's no reason to sell. And there's no reason to avoid new issues.

But total-return investors and holders of bond funds, especially the leveraged kind, do have something to worry about. Municipals are the second-worst-performing class of bond in 2007, barely ahead of corporate junk bonds, and things could get worse.

The problem. The weak performance is tied to concerns about the health of bond insurance companies, relatively obscure entities that go by such acronyms as Ambac, FGIC and MBIA. These companies insure roughly half of all the tax-exempt bonds outstanding for the eventual repayment of principal and any missed interest payments.

On their own, these bonds would typically merit a triple-B or single-A rating, perhaps occasionally, a double-A rating. The insurance upgrades them to triple-A status in the eyes of the market. This allows state and local issuers to pay less interest on their bonds.

Saving money on interest, not compensation for potential defaults, is the real purpose of muni-bond insurance. Claims are rare, and what few there are usually stem from embezzlement and other forms of fiscal chicanery, not general financial market risks.

Because defaults are rare, the "financial guaranty" industry is enormously profitable -- or at least the bond part of it. But bond raters Moody's, Standard & Poor's, Fitch Ratings and A.M. Best, as well as some bond analysts, are now examining the bond insurers closely.

They want to know to what degree the insurers could be exposed to losses from their secondary business of guaranteeing collateralized debt obligations and other pools of asset or mortgage-backed securities.

If the insurers lose their triple-A status because of losses in these assets, the municipal bonds they guarantee will also lose their top rating. Prices of those bonds would drop because their yields would reset to the higher level of a lower-rated bond.

It is this prospect that explains why many insured munis have been losing value even as prices of Treasury bonds seem to rise almost every day.

The situation still may not deteriorate enough to force the ratings agencies to cut anyone's triple-A status. But "this has become a credit story and there's significant fear in the markets whenever there's a credit story. That's a fact," says John Miller, a municipal bond manager for Nuveen Investments.

Another bond trader, who asks to remain anonymous, says insured municipal bonds are trading for 5% less than they should be worth because of a belief, which he shares, that Ambac and MBIA will need to raise new capital or suffer a notch or two cut in their ratings.

The stocks of both Ambac and MBIA, which issue the bulk of the municipal bond insurance, have plunged. That means they can't easily raise money by selling new shares or convertible bonds. In a pinch, they might be pressed to copy Citibank and find a rich partner.

The ratings agencies are caught in the middle. S&P and Moody's took all sorts of grief for being too slow to downgrade subprime mortgage securities. They're in no mood to wink at another fiasco, but they also don't want to send the municipal bond market into a needless downward spiral.

Both S&P and Moody's offer their analyses of the bond insurance situation on their public Web sites. That tells you this is serious because such reports are usually only available to paying subscribers and the press.

The market speaks. Bond investors are weighing in. Their conclusion appears to be that the insurers' problems are serious. As a result, the cost to bond holders is mounting.

Normally, Miller says, the difference in yield between a bond that's rated AAA (S&P) or Aaa (Moody's) on its own merits and an insured bond is 0.08 to 0.12 percentage point. Over the past couple of months, as the insurers' condition has become an issue, this spread has widened to as much as 0.45 percentage point.

To put it another way, that means that an insured, triple-A highway or sewer bond is being priced as if it were an uninsured muni rated between single-A and double-A.

This stealth downgrade doesn't affect the security of the principal or interest payments. But it's a significant loss of value for bondholders.

Currently, there are about $2.5 trillion to $3 trillion in municipal bonds, half of which are insured. The average yield now for a 20-year insured bond is 4.3%. Assume that those bonds would yield 4% if there were no questions about the health of the insurers. The difference in price works to about 4 cents per dollar on a bond due in 2027.

That may not seem like a lot, but it's a big loss in such a stable category, and the losses could get bigger if the ratings agencies turn up their rhetoric or actually downgrade the insurers.

Another sign of pressure is the action in leveraged closed-end municipal bond funds. Although these funds don't invest exclusively in insured bonds, the discounts between the funds' share prices and their net asset values are widening -- a sign that investors see extra risk.

Discounts for four leveraged and insured funds--- Insured Muni Income Fund **(**PIF), Nuveen Premier Insured Muni **(**NIF), Morgan Stanley Insured Muni **(**IIM) and BlackRock Insured Muni Income Trust **(**BYM) -- have widened considerably since last summer. Their share prices are down by 7% to 12% in six months.

By the standard of a bear market in stocks, these losses aren't horrific. There may even be a bright side to the insurers' travails: More munis may come to market without insurance, meaning higher costs for taxpayers but better yields for bond buyers.

Still, this is about the worst performance spell for muni bonds since 1999. That it came out of left field and

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Palm Beach Scandal Helps Bids After Official Negotiated Favors

By Joe Mysak

March 10 (Bloomberg) -- After losing the third county commissioner to scandal since 2006, some officials in Palm Beach County, Florida, may become exceptions in the $2.67 trillion municipal bond market by requiring more transparency in public debt sales.

Mary McCarty, 54, an 18-year commissioner who resigned Jan. 8, faces federal charges of helping to steer public underwriting business to firms that employed her husband, Lawrence Kevin McCarty. She is scheduled to plead guilty on March 27, court documents show. Kevin McCarty, who has pleaded guilty to concealing his wife's alleged crime, is to be sentenced the same day. The couple made almost $300,000 from the deals, the government alleges.

In Palm Beach County, whose $55,311 per-capita income in 2006 was 51 percent higher than the national average**,** the push for transparency may end a practice whereby each elected commissioner chooses an underwriting firm, such as Citigroup, Inc.

"Astounding," said J.B. Kurish, a finance professor and associate dean at Emory University's Goizueta Business School and former director of the Government Finance Officers Association's Government Finance Research Center. "It is just not the right thing to do. You don't give these out like patronage jobs. You have to analyze these firms and have a process to do so."

'Strict Controls'

Mary McCarty was charged in a criminal information on Jan. 9. That was four days after New Mexico Governor Bill Richardson removed his name from consideration as U.S. secretary of commerce amid a federal grand jury investigation into whether his chief of staff helped a political contributor win bond work in the state. The probes, along with a broader federal examination of how municipal issuers reinvest proceeds from bond sales, spurred a former top regulator, Christopher Taylor, to call for more openness when public agencies go to market.

After the McCartys were charged, Palm Beach County Clerk and Comptroller Sharon R. Bock began studying local debt practices. She recommends a new policy that includes "strict controls to prevent opportunities for abuse," according to a letter she sent to commissioners.

The commission will look at adopting a selection process that reflects "best industry practices," Jeff Koons, the panel's chairman, said in a telephone interview.

In October, the Government Finance Officers Association issued a white paper recommending "the use of a Request for Proposal process when selecting underwriters in order to promote fairness, objectivity and transparency." RFPs should include descriptions of the contemplated transaction and the evaluation and selection process, as well as questions on compensation, fees and references, according to the GFOA.

'Invitation to Corruption'

"There ought to be a process that assures the administrators that you're getting the best financing available, and doing it economically," said Arlin Voress, 84, a Palm Beach County taxpayer. He served as mayor of Highland Beach, a small city in Palm Beach County, in the 1990s, he said.

Since 1991, Palm Beach County, one of 48 counties rated Aaa by Moody's Investors Service, has issued all

its bonds through negotiated sales rather than competitive bids, said John Long, the county debt manager. The municipality has almost $2 billion in debt outstanding, according to Bock.

No-bid deals represent "an irresistible invitation to political corruption," said Taylor, who was executive director of the Municipal Securities Rulemaking Board from 1978 to 2007. Taylor has called for ending negotiated transactions.

Most Choose Negotiations

In 2008, U.S. state and local politicians chose negotiations over bids for more than 85 percent of the $392 billion in tax-exempt bonds sold.

Competitive bond offerings force banks to line up and submit the lowest interest-cost bid to win underwriting business. In a negotiated sale, states and cities decide in advance which banks will market the bonds. Banks have promoted the no-bid method, saying it allows them to get the best prices for issuers by tailoring the debt to specific types of investors.

Bid sales saved issuers 17 to 48 basis points, "on average and all else equal," according to a study published in the Winter 2008 issue of the Municipal Finance Journal. A basis point is 0.01 percentage point.

On $100 million of debt, the savings mean $1.7 million to $4.8 million less interest over the life of a 10-year bond. The research by Mark Robbins and Bill Simonsen of the University of Connecticut in West Hartford cited "almost all studies on this issue."

McCarty's Charges

Mary McCarty is charged with voting to approve more than $150 million in county housing finance authority bonds for which Raymond James & Associates of St. Petersburg, Florida, was an underwriter from 1998 to 2000. After 2002, when her husband had moved from that firm to **Bear Stearns & Co.**, she helped arrange for the firm to underwrite $506 million in county school district bonds.

Mary and Kevin McCarty, who are free on bonds of $200,000 and $100,000, respectively, couldn't be reached for comment. The telephone number published for their home in Delray Beach, Florida, has been disconnected. J. David Bogenschutz, a lawyer who represents Mary McCarty, didn't respond to repeated telephone calls seeking comment.

Tammy Eitel, a spokeswoman for Raymond James, said the firm "has been fully and voluntarily cooperating with the U.S. Attorney's office since being alerted to this situation." Justin Perras, a spokesman for JPMorgan Chase & Co., which acquired Bear Stearns last year, declined to comment.

Third to Resign

U.S. Attorney R. Alexander Acosta noted "the outstanding cooperation provided by the bond underwriting firms" in a news release.

McCarty is the third commissioner since 2006 to resign after corruption charges in Palm Beach County, where the value of taxable real property per capita is $172,173, about $100,000 higher than the national median, according to Moody's. Former commissioners Tony Masilotti and Warren Newell are both serving five-year prison terms after pleading guilty to receiving secret payments on land deals.

The commission's problems have some Palm Beach taxpayers calling for more open government.

"I come from a background in construction, where we put out bids for work," said Chris Harmon, 72, who retired and moved from New York to Boca Raton, Florida, 15 years ago. "They ought to take bids" on bond issues, he said.

Harmon was walking around Town Center at Boca Raton, a shopping mall where one circuit equals one mile -- "if you do all the nooks and crannies," he said.

No Transparency

All the bonds in McCarty's case were sold "without the use of transparently objective criteria" for choosing the underwriter, such as an official Request for Proposals, Acosta wrote in the criminal information filed in federal court. Prosecutors use informations to charge defendants who waive their right to a grand jury indictment.

Underwriters "served at the discretion of a particular county commissioner," and were confirmed by full

commission vote, the criminal information says.

In Palm Beach, each of the seven commissioners selects a firm to go into a pool. Bond work rotates among the chosen underwriters, Robert Weisman, the county administrator, said in an e-mail. Bond counsel work is awarded in the same fashion, he said.

Commissioners' Choices

Long, the debt manager, said the current pool includes Raymond James; Jackson Securities, a minority-owned firm based in Atlanta; Merrill Lynch & Co., now a unit of Bank of America Corp.; Citigroup in New York; Loop Capital Markets, another minority-owned firm in Chicago; Wachovia Securities LLC of St. Louis; and Goldman Sachs Group Inc. of New York, which was appointed by Burt Aaronson, the commission's vice chairman, on Dec. 2.

Koons, the chairman, said he usually consults with the county's Office of Financial Management and Budget before voting on underwriters or bond lawyers.

"I ask, 'Who are we missing?'" he said.

While the firms that receive work have to be qualified, "the selection was strictly by choice of the individual commissioners with input from staff on qualifications," said Weisman, who has been administrator since 1991.

Shelley Vana, who was elected to the commission in November, said she hasn't selected an underwriter yet.

"I'm waiting for the review" that comptroller Bock is conducting, she said.

Bock declined to comment.

Inclusive System

Aaronson said in an interview that he'd be "open to an RFP process, if that's a better system."

Commissioner Addie Greene, who was quoted in the Palm Beach Post newspaper in January as saying that she favors the current system because it allows for the inclusion of minority-owned firms, announced on Friday that she was resigning for health reasons. She, along with commissioners Karen Marcus and Jess Santamaria, didn't respond to repeated messages seeking comment.

Officials developed the rotation idea in the early 2000s, Weisman said.

"When companies heard we were going to do issues, they would lobby, or if they had refinancing ideas like swaps to reduce interest costs, they would come to us to claim first dibs on the idea," he said. "This led to arguments as to whether refinancings were premature or if their idea was nothing special."

Staff Recommendations

Since then, the finance staff has occasionally offered advice to commissioners on selections, said Long. The debt manager obtains the latest list of top underwriters and bond lawyers nationally from Thomson Reuters and the Bond Buyer newspaper, and also names "firms that the county had used in the past that I felt did outstanding work," and passes them on to commissioners who ask, he said.

"If an underwriter appointed by an individual commissioner did not actually sell bonds, we recommend to the commissioner that the firm be replaced," he said.

He declined to specify any such instances.

The case against Mary McCarty is USA v. McCarty, 9:09-cr- 80004-DMM. The case against Lawrence Kevin McCarty is USA v. McCarty, 9:09-cr-80003-KLR. Both are in U.S. District Court, Southern District of Florida (West Palm Beach).

To contact the reporter on this story: **Joe Mysak** in New York at **jmysakjr@bloomberg.net**.

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Muni Bond Yields Rise to 6-Year High Amid Variable-Rate Squeeze

By Jeremy R. Cooke

Sept. 24 (Bloomberg) -- Tax-exempt bonds fell for the 10th day this month, driving 30-year benchmark yields to the highest in more than six years, as fallout from upheaval in the financial industry roiled the U.S. municipal market.

Variable interest rates on tax-exempt debt soared to a record, higher than long-term, fixed-rate yields, boosting concern that investors who borrow to finance bond holdings are being forced to sell amid weak demand.

Issuers have postponed more than $7 billion in planned borrowing, after Lehman Brothers Holdings Inc**.** sought bankruptcy protection Sept. 15, sparking a shakeup that's reshaped Wall Street and led the U.S. government to propose a $700 billion rescue. State and local governments also face costs as high as 9 percent on variable-rate demand notes amid outflows from money- market mutual funds that continued yesterday.

``Current conditions arguably represent the most stressed fixed income market in our lifetimes,'' Mike Nicholas, co-chief executive of the Regional Bond Dealers Association, said in a statement. The Alexandria, Virginia-based trade group canceled a conference in Dallas this week because of the market turmoil.

Average yields on the highest quality 30-year municipal bonds have risen 42 basis points, or 0.42 percentage point, since Sept. 11 to 5.24 percent today, based on an index compiled by Concord, Massachusetts-based Municipal Market Advisors.

Average seven-day yields for tax-free and municipal money funds almost tripled to 3.67 percent from 1.36 percent, a record one-week jump, according to the Money Fund Report from iMoneyNet Inc. of Westborough, Massachusetts, which has tracked tax-free funds since 1981.

`High Rates'

Average weekly rates on variable-rate demand notes rose more than fourfold in two weeks to 7.96 percent, traders said, the highest since the group now known as the Securities Industry and Financial Markets Association started the index in 1989.

``High rates for variable-rate demand notes, heading up to 8 percent after being put back to dealers by tax-free/muni money funds, were behind that boost in 7-day yields,'' Mike Krasner, editor at iMoneyNet, said in an e-mail today.

Tax-free money-fund investors have pulled out more than $30 billion in cash since Sept. 15, or almost 6 percent of assets in the funds, data from iMoneyNet show.

Daily tax-free outflows narrowed yesterday to $1.1 billion from $9.4 billion on Sept. 18, according to iMoneyNet. The past three days, investors have added to taxable money-fund assets after they pulled a record $81 billion from them Sept. 17 as the Reserve Primary Fund exposed holders to losses on Lehman debt.

Municipal borrowers unable to put off their fixed-rate offerings the past two weeks are competing with variable-rate securities for buyers' attention.

No Choice

Lorain, Ohio, yesterday sold 20-year general obligation bonds rated Baa2 at a price to yield 7 percent, more than 2 percentage points higher than Aaa bonds at that maturity tracked by Municipal Market Advisors.

``We didn't have a choice,'' said Ron Mantini, auditor for Lorain, a city of about 70,000 west of Cleveland. ``If there was any way, I would have pulled it off the market, given everything that has happened with the

economy. We had to come up with $4.8 million to pay off'' short-term debt coming due next week.

Tax-exempt bonds have dropped 3.63 percent since Sept. 12, the most since February, while U.S. government debt declined just 0.35 percent, according to Merrill Lynch & Co.'s total- return Municipal Master and Treasury Master indexes.

To contact the reporter on this story: **Jeremy R. Cooke** in New York at **jcooke8@bloomberg.net**.

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Schwarzenegger Debt Defies Academics as Negotiations Trump Bids

By Joe Mysak

April 13 (Bloomberg) -- Utah and Georgia saved money for taxpayers by selling AAA-rated bonds in the first quarter through private negotiations with banks, even though more than a dozen studies show such transactions may increase costs.

While 75 percent of Utah's sales since 2000 involved competitive bids, the latest $394 million sale in March was negotiated with New York-based Morgan Stanley. Georgia offered $614 million in fixed-rate bonds in February, its first no-bid offering, and Virginia issued $270.8 million in AAA-rated general obligation bonds in November through a similar process.

In a market battered by underwriter departures, insurer downgrades and flagging institutional demand, each no-bid sale produced yields further below the Municipal Market Advisors AAA median yield curve than the states' most recent competitive offerings.

The worldwide freezing of credit since August 2007 and the longest economic slowdown since the Great Depression "may have further emboldened bankers to press even harder for negotiated" offerings, said Patrick P. Born, chief financial officer for Minneapolis. "This pressure is likely to be even greater with the threat of job losses among the pinstriped set."

Boosted by New York City's sale of $883 million of general obligation bonds last week, the volume of no-bid sales in 2009 has reached 86 percent of $91.8 billion in issues, according to Thomson Reuters. For all of last year, they made up about 85 percent of $391.5 billion.

'Insurmountable Problems'

California, which negotiated the sale of $6.5 billion in bonds last month, paid higher yields than in the past. Yet the offering found enough demand for officials to increase it by 64 percent from a planned $4 billion. Similarly, New York officials issued $400 million more than initially scheduled last week after first selling $454 million to individual investors.

The Georgia, Utah and Virginia results differ from the conclusions of a study, "Persistent Underwriter Use and the Cost of Borrowing," in the Winter 2008 issue of the Municipal Finance Journal. The paper by Mark D. Robbins and Bill Simonsen of the University of Connecticut was the most recent academic analysis showing that competitive bidding saves issuers money in the $2.69 trillion municipal bond market.

At the same time, a growing number of local-government issuers have seen interest payments increase significantly after engaging in negotiated bond sales that included interest-rate swaps. Jefferson County, Alabama, was singled out last week in a report by Moody's Investors Service as having "insurmountable problems" related to variable-rate debt. The county, home to Birmingham, is facing insolvency after interest rates on $3 billion of adjustable-rate sewer debt surged last year.

'Market Forces'

Federal Reserve Chairman Ben Bernanke, in a March 31 letter to Congress, noted that variable-rate debt tied to swaps, along with the failure of the auction-rate securities market "are causing fiscal strains for a number of municipalities."

Highly rated states pursued negotiated sales because markets were "anything but normal," said Dave Andersen, managing director and head of municipal bond trading and syndicate for Bank of America-Merrill Lynch, the nation's leading tax-exempt underwriter for competitive and negotiated sales. The unit is the investment-banking arm of Charlotte, North Carolina-based Bank of America Corp.

"Market forces have been behind the trend towards negotiated deals," Andersen said in an e-mail from New York. "Retail order periods have been critical to the success of most deals, and you can't run a retail order period during a competitive deal."

The bank, which led a group of underwiters on the sales in Georgia and Virginia, participated in 14 competitive transactions this year totaling $2.3 billion and 108 negotiated ones amounting to $13.7 billion.

California's Issue

California's record sale last month produced yields that were further above the MMA AAA curve than those from the state's last competitive sale. Yet bankers marketed the bonds to individuals successfully, allowing state Treasurer Bill Lockyer to expand the offering, Andersen said. Underwriters can't employ such advertising to retail investors in auctions, he said.

"California would not have been able to get the size it did, or the pricing, if it had done a competitive deal," he said.

Republican Governor Arnold Schwarzenegger's state paid an average of 111.6 basis points over the yield curve. The last time it sold bonds competitively, in February 2007, it was rated A1 and A+, five maturities out of 22 were insured and it paid an average 5.64 basis points over the curve. A basis point is 0.01 percentage point.

'We All Lose'

The March 24 deal offered a top yield of 6.10 percent on $1.2 billion of securities maturing in 2038, 82 basis points more than the Municipal Market Advisors' index at that maturity.

Las Vegas paid the same yield on the same day in an auction of $31 million of 30-year bonds rated AA by Standard & Poor's and Aa2 by Moody's Investors Service, Andersen said.

The trend away from bidding may cost borrowers in the long run, said **Ken Rust**, director of the Bureau of Financial Management for Portland, Oregon.

"If you believe, as I do, that competitive sales produce the best sale results, then issuers pricing bonds in a negotiated sale need competitive sale results to serve as market leading comparables," Rust said in an e-mail.

Unless issuers bargain harder with banks, "negotiated sale results move further away from market results that could have been realized in a competitive sale," Rust said. "Ultimately we all lose."

Individual Investors

Competitive debt offerings force banks to submit the lowest interest-cost bid to win business. In a negotiated sale, issuers decide in advance which banks will market the bonds. Underwriters say the no-bid method lets them get better prices by tailoring the debt to specific types of investors.

Georgia had planned to sell its recent debt by auction last year, "but the **market** wouldn't cooperate," said Lee McElhannon, director of bond finance at the state Financing and Investment Commission. Mutual funds and hedge funds stopped buying municipal bonds after the onset of the credit crunch, leaving only individual investors, he said.

"We're back to a much more limited investment base in the municipal market, and we needed a mechanism to reach out to that base," he said.

The state's first negotiated sale of new general obligation bonds Feb. 2 drew yields on its 5-year instruments that were 51.8 basis points less than the Municipal Market Advisors' AAA median yield curve. At auctions last year, Georgia's 5-year bonds yielded an average of 11.6 basis points below the median.

Beating the Curve

"We could not have been more pleased," McElhannon said.

For 20-year bonds, the state paid almost 41 basis points less than the median in February, down from an average of 7.4 basis points below it last year.

Concord, Massachusetts-based Municipal Market Advisors, an independent research firm, produces its median curve by surveying dozens of bond dealers and professional money managers daily on where they think AAA yields should be.

Utah paid an average of 17.5 basis points under the MMA AAA yield curve on its $394 million negotiated sale on March 2. Its last competitive issue, $75 million in June 2007, yielded 3.7 basis points above the curve. Virginia paid an average of 29.7 basis points beneath the curve for its negotiated sale of Nov. 10, after paying 22.8 basis points below it for a June 4 auction of $98 million.

"The benefits of transparency and the reassurance of fair pricing are lost when governments use negotiated sales," said Robbins, one of the authors of the recent study. "In the long run, you have to hope that competitive sales return."

Volatile Markets

Bid sales saved issuers 17 to 48 basis points "on average and all else equal," the researchers said in the study.

"Highly volatile markets are times when issuers worry about getting too few bids to have a successful competitive sale," Robbins said in an interview. "If there ever is a day when negotiated sales are warranted, days without bidders are the ones."

After credit markets froze in September, dozens of issuers postponed or canceled bond sales, according to data compiled by Bloomberg. By December, municipalities were **paying** a record 2.2 times the federal government's costs. Top-rated issuers now pay 1.18 times, still above the average 0.86 percent.

In Idaho, "we actually sold bonds at auction in November and breathed a sigh of relief" afterward, said Liza Carberry, executive director of the Idaho Bond Bank Authority and state investment manager.

May Trend Back

Idaho paid an average of 16.3 basis points below the AAA median in its Nov. 6 sale of $27.8 million in revenue bonds rated Aa2 by Moody's Investors Service. At its Jan. 26 negotiated sale of $48.8 million, it paid an average of almost 4 basis points over it.

Georgia may sell new general obligation bonds this quarter, McElhannon said. The state hasn't decided which method to use. There are signs that demand is perking up. Institutions led by mutual funds purchased about $3.2 billion of California's issue, roughly half the total.

"It depends upon the market," McElhannon said. "If we continue to see improvement, and if an issuer has a history of selling competitively, I think you can see more issuers trend back to competitive sale."

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Flawed Credit Ratings Reap Profits as Regulators Fail (Update1)

By David Evans and Caroline Salas

April 29 (Bloomberg) -- Ron Grassi says he thought he had retired five years ago after a 35-year career as a trial lawyer.

Now Grassi, 68, has set up a war room in his Tahoe City, California, home to single-handedly take on

Standard & Poor’s, Moody’s Investors Service and Fitch Ratings. He’s sued the three credit rating firms for negligence, fraud and deceit.

Grassi says the companies’ faulty debt analyses have been at the core of the global financial meltdown and the firms should be held accountable. Exhibit One is his own investment. He and his wife, Sally, held $40,000 in Lehman Brothers Holdings Inc**.** bonds because all three credit raters gave them at least an A rating -- meaning they were a safe investment -- right until Sept. 15, the day Lehman filed for bankruptcy.

“They’re supposed to spot time bombs,” Grassi says. “The bombs exploded before the credit companies acted.”

As the U.S. and other economic powers devise ways to overhaul financial regulations, they have yet to come up with plans to address one issue at the heart of the crisis: the role of the rating firms.

That’s partly because the reach of the three big credit raters extends into virtually every corner of the financial system. Everyone from banks to the agencies that regulate them is hooked on ratings.

Debt grades are baked into hundreds of rules, laws and private contracts that affect banking, insurance, mutual funds and pension funds. U.S. Securities and Exchange Commission guidelines, for example, require money market fund managers to rely on ratings in deciding what to buy with $3.9 trillion of investors’ money.

‘Stop Our Reliance’

State regulators depend on credit grades to monitor the safety of $450 billion of bonds held by U.S. insurance companies. Even the plans crafted by Federal Reserve Chairman Ben S. Bernanke and Treasury Secretary Timothy Geithner to stimulate the economy count on rating firms to determine how the money will be spent.

“The key to policy going forward has to be to stop our reliance on these credit ratings,” says Frank Partnoy, a professor at the San Diego School of Law and a former derivatives trader who has written four books on modern finance, including Infectious Greed: How Deceit and Risk Corrupted the Financial Markets (Times Books, 2003).

“Even though few people respect the credit raters, most continue to rely on them,” Partnoy says. “We’ve become addicted to them like a drug, and we have to figure out a way to wean regulators and investors off of them.”

AIG Downgrade

Just how critical a role ratings firms play in the health and stability of the financial system became clear in the case of American International Group Inc., the New York-based insurer that’s now a ward of the U.S. government.

On Sept. 16, one day after the three credit rating firms downgraded AIG’s double-A score by two to three grades, private contract provisions that AIG had with banks around the world based on credit rating changes forced the insurer to hand over billions of dollars of collateral to its customers. The company didn’t have the cash.

Trying to avert a global financial cataclysm, the Federal Reserve rescued AIG with an $85 billion loan -- the first of four U.S. bailouts of the insurer.

Investors, traders and regulators have been questioning whether credit rating companies serve a good purpose ever since Enron Corp. imploded in 2001. Until four days before the Houston-based energy company filed for what was then the largest-ever U.S. bankruptcy, its debt had investment-grade stamps of approval from S&P, Moody’s and Fitch.

In the run-up to the current financial crisis, credit companies evolved from evaluators of debt into consultants.

‘Abjectly Failed’

They helped banks create $3.2 trillion of subprime mortgage securities. Typically, the firms awarded triple-A ratings to 75 percent of those debt packages.

“Ratings agencies just abjectly failed in serving the interests of investors,” SEC Commissioner Kathleen Casey says.

S&P President Deven Sharma says he knows his firm is taking heat from all sides -- and he expects to turn that around.

"Our company has always operated by the principle that if you do the right thing by the customers and the market, ultimately you'll succeed," Sharma says.

Moody's Chief Executive Officer Raymond McDaniel and Fitch CEO Stephen Joynt declined to comment for this story.

"We are firmly committed to meeting the highest standards of integrity in our ratings practice," McDaniel said in an April 15 SEC hearing.

"We remain committed to the highest standards of integrity and objectivity in all aspects of our work," Joynt told the SEC.

Ratings and Rescue

Notwithstanding the role the credit companies played in fomenting disaster, the U.S. government is relying on them to help fix the system they had a hand in breaking.

The Federal Reserve's Term Asset-Backed Securities Loan Facility, or TALF, will finance the purchase by taxpayers of as much as $1 trillion of new securities backed by consumer loans or other asset-backed debt -- on the condition they have triple- A ratings.

And the Fed has also been buying commercial paper directly from companies since October, only if the debt has at least the equivalent of an A-1 rating, the second highest for short-term credit. The three rating companies graded Lehman debt A-1 the day it filed for bankruptcy.

The Fed's financial rescue is good for the bottom lines of the three rating firms, Connecticut Attorney General Richard Blumenthal says. They could enjoy as much as $400 million in fees that come from taxpayer money, he says.

S&P, Moody's and Fitch, all based in New York, got their official blessing from the SEC in 1975, when the regulator named them Nationally Recognized Statistical Ratings Organizations.

Conflict of Interest

Seven companies, along with the big three, now have SEC licensing. The regulator created the NRSRO designation after deciding to set capital requirements for broker-dealers. The SEC relies on ratings from the NRSROs to evaluate the bond holdings of those firms.

At the core of the rating system is an inherent conflict of interest, says Lawrence White, the Arthur E. Imperatore Professor of Economics at New York University in Manhattan. Credit raters are paid by the companies whose debt they analyze, so the ratings might reflect a bias, he says.

"So long as you are delegating these decisions to for- profit companies, inevitably there are going to be conflicts," he says.

In a March 25 report, policy makers from the Group of 20 nations recommended that credit rating companies be supervised to provide more transparency, improve rating quality and avoid conflicts of interest. The G-20 didn't offer specifics.

52 Percent Profit Margin

As lawmakers scratch their heads over how to come up with an alternative approach, the rating firms continue to pull in rich profits.

Moody's, the only one of the three that stands alone as a publicly traded company, has averaged pretax profit margins of 52 percent over the past five years. It reported revenue of $1.76 billion -- earning a pretax margin of 41 percent -- even during the economic collapse in 2008.

S&P, Moody's and Fitch control 98 percent of the market for debt ratings in the U.S., according to the SEC. The noncompetitive market leads to high fees, says SEC Commissioner Casey, 43, appointed by President George W. Bush in July 2006 to a five-year term. S&P, a unit of McGraw-Hill Cos., has profit margins similar to those at Moody's, she says.

"They've benefited from the monopoly status that they've achieved with a tremendous amount of assistance

from regulators," Casey says.

Sharma, 53, says S&P has justifiably earned its income.

'People See Value'

"Why does anybody pay $200, or whatever, for Air Jordan shoes?" he asks, sitting in a company boardroom high over the southern tip of Manhattan. "It's the same. People see value in that. And it all boils down to the value of what people see in it."

Blumenthal says he sees little value in credit ratings. He says raters shouldn't be getting money from federal financial rescue efforts.

"It rewards the very incompetence of Standard & Poors, Moody's and Fitch that helped cause our current financial crisis," he says. "It enables those specific credit rating agencies to profit from their own self-enriching malfeasance."

Blumenthal has subpoenaed documents from the three companies to determine if they improperly influenced the TALF rules to snatch business from smaller rivals.

S&P and Fitch deny Blumenthal's accusations.

'Without Merit'

"The investigation by the Connecticut attorney general is without merit," S&P Vice President Chris Atkins says. "The attorney general fails to recognize S&P's strong track record rating consumer asset-backed securities, the assets that will be included in the TALF program. S&P's fees for this work are subject to fee caps."

Fitch Managing Director David Weinfurter says the government makes all the rules -- not the rating firms.

"Fitch Ratings views Blumenthal's investigation into credit ratings eligibility requirements under TALF and other federal lending programs as an unfortunate development stemming from incomplete or inaccurate information," he says.

Moody's Senior Vice President Anthony Mirenda declined to comment.

Sharma says it's clear that his firm's housing market assumptions were incorrect. S&P is making its methodology clearer so investors can better decide whether they agree with the ratings, he says.

'Talk to Us'

"The thing to do is make it transparent, 'Here are our criteria. Here are our analytics. Here are our assumptions. Here are the stress-test scenarios. And now, if you have any questions, talk to us,'" Sharma says.

The rating companies reaped a bonanza in fees earlier this decade as they worked with financial firms to manufacture collateralized debt obligations. Those creations held a mix of questionable debt, including subprime mortgages, auto loans and junk-rated assets.

S&P, Moody's and Fitch won as much as three times more in fees for grading structured securities than they charged for rating ordinary bonds. The CDO market started to crash in mid- 2007, as investors learned the securities were jammed with bad debt.

Financial firms around the world have reported about $1.3 trillion in writedowns and losses in the past two years.

Alex Pollock, now a resident fellow at the American Enterprise Institute in Washington, says more competition among credit raters would reduce fees.

'An SEC-Created Cartel'

"The rating agencies are an SEC-created cartel," he says. "Usually, issuers need at least two ratings, so they don't even have to compete."

Pollock was president of the Federal Home Loan Bank in Chicago from 1991 to 2004. The bank was rated triple-A by both Moody's and S&P. He says he recalls an annual ritual as he visited with representatives of each company.

"They'd say, 'Here's what it's going to cost,'" he says. "I'd say, 'That's outrageous.' They'd repeat, 'This is what it's going to cost.' Finally, I'd say, 'OK.' With no ratings, you can't sell your debt."

Congress has held hearings on credit raters routinely this decade, first in 2002 after Enron and then again each year through 2008. In 2006, Congress passed the Credit Rating Agency Reform Act, which gave the SEC limited authority to regulate raters' business practices.

The SEC adopted rules under the law in December 2008 banning rating firms from grading debt structures they designed themselves. The law forbids the SEC from ordering the firms to change their analytical methods.

Role of Congress

Only Congress has the power to overhaul the rating system. So far, nobody has introduced legislation that would do that. In a hearing on April 15, the SEC heard suggestions for legislation on credit raters. Some of the loudest proponents for change are in state government and on Wall Street. But no one's agreed on how to do it.

"We should replace ratings agencies," says Peter Fisher, managing director and co-head of fixed income at New York-based BlackRock Inc., the largest publicly traded U.S. asset management company.

'Flash Forward'

"Our credit rating system is anachronistic," he says. "Eighty years ago, equities were thought to be complicated and bonds were thought to be simple, so it appeared to make sense to have a few rating agencies set up to tell us all what bonds to buy. But flash forward to the slicing and dicing of credit today, and it's really a pretty wacky concept."

To create competition, the U.S. should license individuals, not companies, as credit rating professionals, Fisher says. They should be more like equity analysts and would be primarily paid by institutional investors, Fisher says. Neither equity analysts nor those who work at rating companies currently need to be licensed.

Such a system wouldn't be fair, says Daniel Fuss, vice chairman of Boston-based Loomis Sayles & Co., which manages $106 billion. An investor-pay ratings model may give the biggest money managers a huge advantage over smaller firms and individuals because they can afford to pay for the analyses, he says.

"What about individuals?" he asks.

Eric Dinallo, New York's top insurance regulator, proposes a government takeover of the rating business.

"There's nothing wrong with saying Moody's or someone is going to just become a government agency," he says. "We've hung the entire global economy on ratings."

'Like Consumer Reports'

Insurance companies are among the world's largest bond investors. Dinallo suggests that insurers could fund a credit rating collective run by the National Association of Insurance Commissioners, a group of state regulators.

"It would be like the Consumer Reports of credit ratings," Dinallo says, referring to the not-for-profit magazine that provides unbiased reviews of consumer products.

Turning over the credit ratings to a consortium headed by state governments could lead to lower quality because there would be even less competition, Fuss says.

"I would be strongly opposed to the government taking over the function of credit ratings," he says. "I just don't think it would work at all. The business creativity, the drive, would go straight out of it."

At the April 15 SEC hearing, Joseph Grundfest, a professor at Stanford Law School in Stanford, California, suggested a variation of Dinallo's idea. He said the SEC could authorize a new kind of rating company, owned and run by the largest debt investors.

'Greater Discipline'

All bond issuers that pay for a traditional rating would also have to buy a credit analysis from one of these firms.

SEC Commissioner Casey has another solution. She wants to remove rating requirements from federal

guidelines. She also faults investors for shirking their responsibility to do independent research, rather than simply looking to the grades produced by credit raters.

"I'd like to promote greater competition in the market and greater discipline," she says. "Eliminating the references to ratings will play a huge role in removing the undue reliance that we've seen."

Sharma, who became president of S&P in August 2007, agrees with Casey that ratings are too enmeshed in SEC rules. He wants the SEC to either get rid of references to rating companies in regulations or add other benchmarks such as current market prices, volatility and liquidity.

"Just don't leave us the way it is today," Sharma says. "There's too much risk of being overused and inappropriately used."

'Hurt Now'

Sharma says that even with widespread regulatory reliance on ratings, his firm will lose business if investors say it doesn't produce accurate ones.

"Our reputation is hurt now," he says. "Let's say it continues to be hurt; it never comes back. Three other competitors come back who do much-better-quality work. Investors will finally say, 'I don't want S&P ratings.'"

S&P will prove to the public that it can help companies and bondholders by updating and clarifying its rating methodology, Sharma says. The company will also add commentary on the liquidity and volatility of securities.

S&P's New Steps

S&P has incorporated so-called credit stability into its ratings to address the risk that ratings will fall several levels under stress conditions, which is what happened to CDO grades. The company has also created an ombudsman office in an effort to resolve potential conflicts of interest.

Jerome Fons, who worked at Moody's for 17 years and was managing director for credit policy until August 2007, says investors don't have to wait for a change in the rating system. They can learn more about the value of debt by tracking the prices of credit-default swaps, he says.

The swaps, which are derivatives, are an unregulated type of insurance in which one side bets that a company will default and the other side, or counterparty, gambles that the firm won't fail. The higher the price of that protection, the greater the perceived risk of default.

'More Accurate'

"We know the spreads are more accurate than ratings," says Fons, now principal of Fons Risk Solutions, a credit risk consulting firm in New York. Moody's sells a service called Moody's Implied Ratings, which is based on prices of credit swaps, debt and stock.

In July 2007, credit-default-swap traders started pricing Bear Stearns Cos. and Lehman as if they were Ba1 rated, the highest junk level. They pegged Merrill Lynch & Co. as a Ba1 credit three months later, according to the Moody's model.

Each of those investment banks was stamped at investment grade by the top three credit raters within weeks of when the banks either failed or were rescued in 2008.

Lynn Tilton, who manages $6 billion as CEO of private equity firm Patriarch Partners in New York, says she woke up one morning in August 2007 convinced the banking system would collapse and started buying gold coins.

"I predicted the banks would be insolvent," Tilton says. "My biggest issue was credit-default swaps. When the size of that market started to dwarf gross domestic product by six or seven times, then my understanding of what defaults would be in a down market became clear: There's no escaping."

'Collective Wisdom'

Investors like Tilton watched as the financial firms tumbled while credit raters held on to investment-grade marks.

"If the ratings mandate weren't there, we wouldn't care because the credit-default-swap markets can tell us basically what we want to know about default probabilities," NYU's White says. "I'm a market-oriented guy,

so I'm more inclined to be relying on the collective wisdom of the market participants."

While credit-default-swap traders lack inside information that companies give to credit raters, swap traders move faster because they're reacting to market changes every day.

San Diego School of Law's Partnoy, who's written law review articles about credit rating firms for more than a decade and has been a paid consultant to plaintiffs suing rating companies, says raters hold back from downgrading because they know the consequences can be dire.

In September, Moody's and S&P downgraded AIG to A2 and A-, the sixth- and seventh-highest investment-grade ratings. The downgrades triggered CDS payouts and led to the U.S. lending AIG $85 billion. The government has since more than doubled AIG's rescue funds.

'Basically Trapped'

"When you get into a situation like we're in right now with AIG, the rating agencies are basically trapped into maintaining high ratings because they know if they downgrade, they don't only have this regulatory effect but they have all these effects," Partnoy says.

"It's all this stuff that basically turns the rating downgrade into a bullet fired at the heart of a bunch of institutions," he says.

Sharma says S&P has never delayed a ratings change because of potential downgrade results. He says his firm tells clients not to use ratings as triggers in private contracts.

"We take action based on what we feel is right," Sharma says.

While swap prices may be better than bond ratings at predicting a disaster, swaps can also cause a disaster.

AIG, one of the world's biggest sellers of CDS protection, nearly collapsed -- taking the global financial system with it - - when it didn't have enough cash to honor its swaps contracts. Loomis's Fuss says relying on swap prices is a bad idea.

'Not Always Right'

"The market is not always right," he says. "An unregulated market isn't always a fair appraisal of value."

Moody's was the first credit rating firm in the U.S. It started grading railroad bonds in 1909. Standard Statistics, a precursor of S&P, began rating securities seven years later.

After the 1929 stock market crash, the government decided it wasn't able to determine the quality of the assets held by banks on its own, Partnoy says. In 1931, the U.S. Treasury started using bond ratings to analyze banks' holdings.

James O'Connor, then comptroller of the currency, issued a regulation in 1936 restricting banks to buying only securities that were deemed high quality by at least two credit raters.

"One of the major responses was to try to find a way -- just as we are now with the stress tests and the examination of the banks -- to figure out how to get the bad assets off the banks' books," Partnoy says.

Since then, regulators have increasingly leaned on ratings to police debt investing. In 1991, the SEC ruled that money market mutual fund managers must put 95 percent of their investments into highly rated commercial paper.

Avoiding Liability

Like auditors, lawyers and investment bankers, rating firms serve as gatekeepers to the financial markets. They provide assurances to bond investors. Unlike the others, ratings companies have generally avoided liability for errors.

Grassi, the retired California lawyer, wants to change that. He filed his lawsuit against the rating companies on Jan. 26 in state superior court in Placer County.

The white-haired lawyer discusses his case seated at a tiny wooden desk in his small guest bedroom, with files spread over both levels of a bunk bed. Grassi says in his complaint that the raters were negligent for failing to downgrade Lehman Brothers debt as the bank's finances were deteriorating.

The day Lehman filed for bankruptcy, S&P rated the investment bank's debt as A, which according to S&P's definition means a "strong" capacity to meet financial commitments. Moody's rated Lehman A2 that day,

which Moody's defines as a "low credit risk." Fitch gave Lehman a grade of A+, which it describes as "high credit quality."

'Without Merit'

"We'd like to have a jury hear this," Grassi says. "This wouldn't be six economists, just six normal people. That would scare the rating agencies to death."

The rating companies haven't yet filed responses. They've asked the federal court in Sacramento to take jurisdiction from the state court.

S&P and Fitch say they dispute Grassi's allegations. "We believe the complaint is without merit and intend to defend against it vigorously," S&P's Atkins says.

Fitch's Weinfurter says, "The lawsuit is fully without merit and we will vigorously defend it."

Mirenda at Moody's declined to comment.

S&P included a standard disclaimer with Lehman's ratings: "Any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision."

'On Your Own'

Grassi isn't deterred.

"They're saying we know you're going to rely on us and if you get screwed, you're on your own because our lawyers have told us to put this paragraph in here," he says.

The companies have defended their ratings from lawsuits, arguing that they were just opinions, protected by the free speech guarantees of the First Amendment to the U.S. Constitution.

McGraw-Hill used the First Amendment defense in 1996 after its subsidiary S&P was sued for professional negligence by Orange County, California. S&P had given the county an AA-rating before the county filed for the largest-ever municipal bankruptcy.

Orange County alleged in its lawsuit that S&P had failed to warn the government that its treasurer, Robert Citron, had made risky investments with county cash.

Not Liable

The U.S. District Court in Santa Ana, California, ruled that the county would have needed to prove the rating company's "knowledge of falsity or reckless disregard for the truth" to win damages.

The court found that the credit rater couldn't be held liable for mere negligence, agreeing with S&P that it was shielded by the First Amendment.

Sharma says rating companies shouldn't be responsible when investors misuse ratings.

"Hold us accountable for what you can," he says. He compares the rating companies to carmakers. "Look, if you drove the car wrong, the manufacturer can't be held negligent. But if you designed the car wrong, then of course the manufacturer should be held negligent."

Sharma subsequently stated that his use of the car manufacturer analogy and the words "negligent" and "Negligence" during an interview was a misstatement and does not reflect his or S&P's position.

'Regulatory Process"

"The point I was trying to convey is that the appropriate approach to accountability is through a regulatory process that requires NRSROs to adopt relevant policies and procedures and oversees their application," Sharma said.

The bigger issue is whether the credit rating system should be changed or even abolished. From California to New York to Washington, investors and regulators are saying it doesn't work. No one has been able to fix it.

'Like a Cancer'

The federal government created the rating cartel, and the U.S. is as dependent on it as everyone else. So far, the legislative branch hasn't cleaned up the ratings mess.

“This problem really is like a cancer that has spread throughout the entire investment system,” Partnoy says. “You’ve got a body filled with little tumors, and you’ve got to go through and find them and cut them out.”

As the U.S. has spent, lent or pledged about $12.8 trillion in efforts to revive the slumping economy, and as President Barack Obama and Congress have worked overtime to find a way out of the deepest recession in 70 years, no one has taken steps that would substantially fix a broken ratings system.

If the government doesn’t head in that direction, all of its efforts at financial reform may be put in jeopardy by the one piece of this puzzle that nobody has yet figured out how to solve.

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Bonds May Face Downgrade

By MARY WILLIAMS WALSH
New York Times

Moody’s Investors Service assigned a negative outlook to the creditworthiness of all local governments in the United States, the agency said Tuesday, the first time it had ever issued such a blanket report on municipalities.
The report signaled how severely the economic downturn was affecting towns, counties and school districts across the nation.
While Moody’s regularly reports on the financial strength of various sectors of private industry, its analysts have in the past considered America’s tens of thousands of towns and local authorities too diverse for generalizations.
The report suggests that the ratings of many governments could be downgraded in the coming months, something that would make it more expensive for them to borrow money to finance their operations.
In the most extreme cases, municipalities might default on some of their obligations, as Jefferson County, Ala., has been threatening to do for a number of months.
Vallejo, Calif., declared bankruptcy last year and is being closely watched to see if it will set a legal precedent that other towns could follow.
Moody’s did not report on individual cities or towns, but its overview offered a general note of caution for investors who have bought municipal bonds seeking a safe stream of income in difficult financial markets.
In a special report made public on Tuesday, the agency cited revenues that are falling almost everywhere as a result of the economic downturn. But it also discussed the problems some municipalities had created for themselves by using complex financial products that seemed to be saving money at first, only to send costs soaring during the credit crisis.
In former boom states like California and Florida, the sharp decline in housing prices is translating into falling property-tax revenue, while in towns in Michigan, Indiana and Ohio, revenues are off because of the collapse of the auto industry. Many local governments in New York, New Jersey and Connecticut will lose significant revenue because they rely on the banking and financial services sectors for their tax bases.
Moody’s said any municipality relying heavily on tourism, gambling or manufacturing was probably at risk of feeling a pinch.
The report suggested conflicts ahead between taxpayers struggling to keep their own households afloat and elected officials charged with balancing budgets, making their payrolls and protecting their credit ratings.
“Taxpayers, worried about their own financial condition, are more resistant than ever to increasing property or other local taxes,” the report observed.
The report’s publication coincided with the downgrading by Moody’s of the credit of the State of Illinois to the A level from double-A. Moody’s said Illinois was having difficulty managing its cash, and in recent weeks

had been trying to push its scheduled pension contributions into the future. The state pension fund is already seriously underfunded.
The Federal Reserve chairman, Ben S. Bernanke, warned that local governments had probably lost their ability to lower their borrowing costs by linking their bonds to derivatives. Such bond packages had become popular in the last few years because they appeared to offer cities both the lower borrowing costs of variable-rate bonds and the predictability of fixed-rate bonds. But the structures broke down during last year's market turmoil, leaving some municipalities staggering under more debt than they can afford.
Mr. Bernanke said he was aware that some governments with low credit ratings were completely shut out of the short-term financial markets, while others were stuck with a type of derivative called interest-rate swaps that no longer made sense for them.
Mr. Bernanke offered his remarks in a letter to members of Congress who had asked the Fed to create a facility to breathe new life into segments of the municipal bond market that were still paralyzed. But Mr. Bernanke said municipal debt had "unique characteristics" that made it "unlikely" that the Fed could be of much help.
He suggested that instead, Congress could consider setting up some other form of assistance for municipalities unable to restructure or refinance their debt, like a federal bond reinsurance program.
The bond markets took the Moody's report in stride on Tuesday, apparently because institutional investors were already familiar with the problems described. New York City brought bonds to market on Tuesday and ended up selling much more than initially planned.
"New York City is potentially a poster child for economic woe, but that didn't seem to bother investors," said Thomas G. Doe, president of Municipal Market Advisors.
The Moody's report "creates headline risk and a lot of confusion for investors," he said, "but it's not a sounding of the alarm for default."