Statement of Christopher A. Taylor, Ph.D., CFA

Committee on Ways and Means

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One of the great achievements of this country is its extensive infrastructure. For those of us that live here, we take it for granted that we can drive on roads to work, take our children to schools, turn on our faucets and get clean water, and know that there are police and courts to protect us. Yet for visitors, especially those from governmental agencies of developing nations, our infrastructure is a marvel that they wish to emulate.

This infrastructure was put in place over decades largely (1) based on decisions made at the state and local level and (2) financed by the issuance of debt at the same state and local level. Few countries in the world give such freedom to political subdivisions below the national level.

Yet, this achievement has a darker side, an unhealthy aspect of the municipal debt market, which may make it harder for states and localities to address their needs in the future. Future growth may be threatened if issuers of municipal debt do not have the confidence that their financing decisions are being made in the most economical manner and if investors question the integrity of market where they buy and sell that debt.

It is this darker side that I wish to discuss with you today. This aspect of the municipal debt market took shape in the wake of the Tax Reform Act of 1986 coupled with trends developing in the business models of dealers. And it centers on the difference between tax-exempt and taxable rate – arbitrage.

I want to state emphatically at this point that no one should construe my remarks as criticism of that tax reform effort. Rather I want to share my observations of the municipal debt market as an economist and as the regulator of the municipal dealer community from 1978 to 2007. Changes in the tax law invariably change markets; policy makers must decide whether those market changes are worthwhile or need to be addressed further in some way.

Prior to the Tax Reform Act of1986, the investor groups were banks of all sizes, property/casualty insurance companies, and individuals. All of these groups were in the higher, if not the highest tax brackets at the time so the availability of investments producing a return exempt from those taxes was preferable. In fact, banks and property/casualty (p/c) companies were much larger investors than individuals.

The business model of almost all dealers in municipal debt was based on profits from buying and selling debt to the banks and p/c companies. Profits from underwriting new debt (bringing to market new debt issues) and selling securities to individuals were dwarfed by profits from trading.

The Act changed the groups that invested in municipal debt. It changed them overnight – not gradually as would have occurred by normal market forces. Banks were almost eliminated as an investor group. Property/casualty investments in municipal debt were sharply limited. Individuals suddenly became the primary investor group.

The structure of the muni market abruptly went from one dominated by institutions to one that now had to focus on individuals. Coincidently, the Act also eliminated many tax-advantaged investments – tax shelters – that competed for the investment dollar of individuals in upper income tax brackets. This change only heightened the importance of individuals in the muni market.

This change in market structure effectively destroyed the business models of the dealer community. Trading munis was no longer a profit center as individuals are mainly buy-and-hold investors unlike institutions which tend to constantly adjust their investment portfolios. Numbers of dealer firms who specialized in institutional trading went out of business or were forced to merge with firms that had some sort of underwriting capability and/or individual client business.

Dealers had to adapt to survive and, unfortunately, those adaptations led to the dark side of muni finance. The new business model for dealers by necessity placed an emphasis on profitability from underwriting new issues of municipal debt. Underwriting new issues means the dealer or group of dealers buy the whole new debt issue of the state or local government. If a community wants to issue $50 million to build and renovate a number of schools, it typically sells all the debt at one time to a dealer or group of dealers – the underwriter or underwriting group. The underwriter then turns around and sells the debt to investors.

There are two basic forms of underwriting – competitive and negotiated. In a competitive sale, the issuer announces that it will be selling its debt – the $50 million in my example – on a specified day at a specified time. Underwriters then submit bids and the issuer accepts the bid that results in its paying the lowest interest cost. The winning underwriter then bears the risk of any adverse subsequent changes in market interest rates, not the issuer.

A negotiated sale is much different. An issuer requests proposals from underwriters, asking them to submit their qualifications to serve as underwriter and to specify what management fee they will charge. In exchange for the management fee, the underwriter works with the issuer to set the terms of the issue so that investors will find it attractive. The issuer effectively bears the interest rate risk, not the dealer, as the terms of the issue are usually adjusted to the point that almost all the debt is pre-sold.

So the muni dealer community moved from a business model that involved risk-taking in both trading and underwriting to a model essentially based on underwriting fees. The only "competition" occurred in the RFP process where dealers touted their qualifications; it was not a competition for producing the lowest interest cost for the issuer. It is a model with low-risk – most of the bonds are pre-sold, sharply lowering the risks and costs of carrying inventory as well as reducing the capital necessary to be held by the dealer. Moreover, for the underwriter there was now a source of product for the broker distribution system to individuals – another source of profit.

The move to fee-based profits versus risk-taking profits had been occurring in other parts of the financial services industry. It was slowly moving into the muni arena prior to the Tax Reform Act of 1986 but the Act certainly hastened its adoption.

Muni dealers quickly learned, however, that the shift to negotiated underwriting had its downside. Intense competition developed for the awarding of negotiated underwriting. The competition took place throughout the country and, in short order, management fees declined sharply. Dealers began to search for ways to protect their profits and the flow of deals to their respective firms as the deal flow was necessary to justify employee compensation levels.

In a first reaction, dealers engaged in pay-to-play practices whereby campaign contributions were made to public officials in exchange for the dealer being awarded a negotiated underwriting. Pay-to-play had become so pervasive that in 1993 the Municipal Securities Rulemaking Board enacted Rule G-37 banning a firm from any negotiated business with an issuer to whom political contributions. The rule was challenged on Constitutional grounds but upheld by the courts.

A second reaction was the move to seek profits from "the other side" of debt issuance– the reinvestment of bond proceeds. In the example above, after the issuer has sold all the bonds to an underwriter or underwriting group, it has $50 million (less expenses) to invest until the funds are expended for the actual construction and renovation of the schools. Of course, issuers would like to invest all these funds, borrowed at a tax-exempt rate, at a higher taxable rate – arbitraging between the rates.

An issuer's ability to earn arbitrage was limited by provisions of the Tax Reform Act of 1986 and attendant IRS regulations. Nonetheless, many in the dealer community devised a way to earn outsize profits by selling issuers US Treasury securities at above-market prices thereby lowering their yield supposedly to a level that met IRS restrictions; this practice was called "yield burning." After SEC and IRS investigations, fines and penalties exceeding $250 million were levied against a substantial number of the dealer community in 1996.

In the following decade leading up to the financial crisis, muni dealers devised several ways to generate fees. Issuers were encouraged to move away from long-term fixed rate financings into short-term "auction-rate" securities, supposedly to capture the benefit of lower short-term rates. From a dealer profit perspective, just doing yet another deal generated underwriting and distribution profits.

Subsequent to the initial issuance of these short-term securities, dealers were paid by the issuer to hold auctions weekly or monthly to reset the rates to reflect current market rates. Unfortunately, the auctions were not really auctions as we know them and dealers often colluded with each other to determine the reset rates. The SEC settled with the large dealer banks for less than $10 million, requiring them only to inform issuers that the resetting process did not involve true auctions.

From an economist's point of view, even without any collusion, the auction process was not one that would yield a competitive market rate as each dealer individually reoffered the securities to

select customers. There was no central marketplace where the rates would be set by the interaction of potential investors with the full field of available securities. In other words, it was a series of temporal monopolies with informational inefficiencies limiting investor choice.

Issuers were sold interest rate swaps for the supposed purpose of protecting them from rising short-term rates. These swaps were quite lucrative for dealers who were able to do them – essentially the largest financial institutions. Municipal issuers were told that such interest rate swaps had been used successfully by corporations for more than a decade. What muni issuers were not told was the length of corporate swaps rarely exceeded five years while the great majority of muni interest rate swaps were more than 20 years in length. By the legal nature of interest rate swaps, muni issuers were "locked" into a long-term relationship with the swap provider and the only way out of that relationship was to "prepay" all the interest payments that were due over the remaining term of the swap. In other words, it would be like having to make all the payments on your current mortgage at once if you wanted to refinance or sell your home.

It should also be noted that muni issuers and many market participants assumed that these interest rate swaps were covered by US securities laws. In fact, they were not; Congress had passed the Commodities Modernization Act of 2000 exempting them from any regulation except private contract law. What looked like a duck, walked like a duck, and squawked like a duck, was declared not to be a duck. Moreover, almost all swaps were based on LIBOR rates which we have come to learn were manipulated through collusive practices.

The risks of using auction rate securities and swaps came home to roost in 2008 as the financial crisis unfolded. These risks and the harm caused to municipal issuers were the subject of hearings held by the House Financial Services Committee at that time.

In the decade following the yield-burning settlements with the IRS and SEC, a number of unregulated entities moved into the muni arena as swap advisors and financial advisors. Like the dealers before them, these parties moved into the "other side" of debt issuance and they, too, sought to evade IRS regulations governing the reinvestment of bond proceeds.

The activities of these unregulated parties and their interaction with the dealer community become the subject of an extensive investigation by the IRS, SEC, and Justice Department. I believe the current totals are 13 persons have either pled guilty or been convicted and fines totaling more than $650 million levied against major investment banks and firms for price-fixing, bid rigging, conspiracy, and the like. The Justice Department has indicated that its probe is continuing.

This statement has focused on some of the reactions of the market to the Tax Reform Act of 1986. It does not address such issues as the greater concentration of underwriting in the largest banks, the lack of national, centralized mechanism for price discovery, or the lack of standards and effective enforcement mechanism for disclosure by issuers. This statement does not discuss the broad policy issue of what projects and activities should be allowed to be financed in the tax-exempt market. Nonetheless, I would be glad to share my views with the Committee on these topics if you choose.

As the Committee considers what, if any, actions it wishes to take with regard to the tax-exemption of municipal securities, it may wish to consider what conditions it wishes to impose on those who are granted the privilege to raise funds at a preferential rate. It is critical for the economic well-being of this country that there is a broad, competitive market with integrity in which municipal entities can raise funds for infrastructure purposes.