CITY OF OAKLAND
CITY COUNCIL

LEGISLATIVE ANALYST MEMORANDUM

To:	Rules and Legislation Committee
From:	Sabrina Landreth, Legislative Analyst
Date:	May 29, 2008
Re:	**Resolution Supporting Reform of the Bond Rating System to Eliminate Discrimination Against Municipal Bonds**

SUMMARY

On April 17, 2008 the League of California Cities board of directors unanimously endorsed a nationwide campaign to persuade the agencies that rate municipal and corporate bonds to reform their rating system. The League argues these companies discriminate against municipal bonds, and this practice has cost taxpayers billions of dollars over the years through higher interest rates and bond insurance purchases. The League board urges individual cities to support this effort by adopting a resolution to that effect, and to communicate their position to the bond rating agencies.

BACKGROUND

The recent downgrades of several bond insurers, and the higher costs that are imposed on many municipalities with variable rate bonds backed by those insurers, has led to calls for rating agency reform. Currently, higher standards are imposed by the three major rating agencies in rating municipal bonds compared to corporate bonds, mortgage-backed securities and other debt instruments. California State Treasurer Bill Lockyer has been working on a nationwide campaign to end this practice. He was recently joined by 10 other state treasurers and financial officers from a number of local agencies, including the City of Los Angeles, in calling on the three major rating agencies to treat municipal bonds on par with corporate bonds with an equivalent level of risk to investors. The Treasurer also testified before the House Financial Services Committee in March about the need for this reform.

In many cases public agencies seek bond insurance to secure higher ratings, thereby equalizing the differences between how municipal and corporate bonds of comparable risk are rated. This creates an added cost to compensate for the different rating criteria for municipal bonds. California state officials estimate they have spent $102 million between 2003-07 on bond insurance for $9 billion of bonds to secure higher bond ratings (and lower interest rates as a result).

The three main rating agencies have mixed responses to the calls for reform. Standard & Poor's objects to a review of current practice, claiming they have one consistent rating scale. Fitch acknowledges the existence of two scales and has announced it is undertaking a review of whether they should continue using two scales or move to a single scale. Moody's has announced that it will assign a corporate-equivalency rating (what it calls a global scale rating) alongside the traditional municipal rating to any municipal bond at the issuer's request.

CONCLUSION/ RECOMMENDATION

The League urges individual cities to join the campaign by adopting the attached resolution, urging the rating agencies to treat taxpayers the same as corporations and rate municipal bonds based on their risk, thereby better serving taxpayers and investors.

APPROVED AS TO FORM AND LEGALITY

DRAFT

______________ City Attorney

INTRODUCED BY COUNCIL MEMBER ______________

OAKLAND CITY COUNCIL

RESOLUTION NO. ______________ C. M. S.

A RESOLUTION SUPPORTING REFORM OF THE BOND RATING SYSTEM TO ELIMINATE DISCRIMINATION AGAINST MUNICIPAL BONDS

WHEREAS, City Council of the City of Oakland recognizes that the recent turmoil in the municipal bond markets has brought into focus the higher standards imposed by the three major bond rating agencies in rating municipal bonds compared to corporate bonds, mortgage-backed securities and other debt instruments; and

WHEREAS, issuers of municipal bonds rarely default on the bonds they sell to finance streets and roads, public buildings, bridges, flood protection and water systems, and other critical infrastructure, yet municipal bond ratings fail to reflect that fundamental fact; and

WHEREAS, the rating agencies even acknowledge this disparity, but they ignore it in their ratings. Standard & Poor's, for example, acknowledges that the historic rate of defaults of A-rated municipal bonds is 0.23 percent, while that of corporate bonds is 2.91 percent - or 13 times greater; and

WHEREAS, despite the relative default rates shown by their own data, the rating agencies continue to discriminate against municipal issuers, requiring public agencies to secure expensive bond insurance in order to secure bond ratings comparable to those of private corporations; and

WHEREAS, the rating agencies base their ratings of corporate bonds on the risk the issuer will default. Their ratings of municipal bonds, in contrast, have little relationship to the risk of default. This difference provides a substantial economic benefit at the expense of taxpayers across the nation; and

WHEREAS, a coalition of state and local public agencies, led by California State Treasurer Bill Lockyer, has called on the three major rating agencies to examine their practices and treat municipal bonds on par with corporate bonds that expose investors to the same level of risk. The Treasurer also testified before the House Financial Services Committee on March 12 about the need for reform.

WHEREAS, the response by the rating agencies to the call for reform has been uneven. Moody's has taken the greatest strides, announcing it will assign a corporate-equivalency rating (what it calls a global scale rating or GSR) alongside the traditional municipal rating to any municipal bond at the issuer's request; and

WHEREAS, the City Council determines that the current double-standard by rating agencies: (1) drains billions of dollars from taxpayers' pockets in the form of unfairly high interest rates; (2) forces taxpayers to pay even more money to buy bond insurance – insurance they would not have to purchase if municipal bond ratings accurately reflected the slight risk of default; (3) misleads investors by grossly inflating the risk of buying municipal bonds; and (4) undermines the effective functioning of a transparent market; and now, therefore, be it

RESOLVED, that the City Council of the City of Oakland calls on the major municipal bond agencies to end the double standard in the treatment of municipal and corporate bonds; to treat taxpayers the same as corporations and rate municipal bonds based on the risk of default; and to create a unified, global rating approach that treats all issuers equally, and better serves taxpayers and investors.

FURTHER RESOLVED, that the City Clerk is hereby directed to notify the municipal bond rating agencies by letter of the adoption of this resolution, with a copy to California State Treasurer Bill Lockyer and to register the City as a member of the coalition of public agencies supporting the nationwide effort to reform how bond rating agencies grade state and local bonds.

FURTHER RESOLVED, that this Resolution shall take effect immediately upon its passage.

IN COUNCIL, OAKLAND, CALIFORNIA, ______________________, 2008

PASSED BY THE FOLLOWING VOTE:

AYES: - BRUNNER, KERNIGHAN, NADEL, QUAN, BROOKS, REID, CHANG, AND PRESIDENT DE LA FUENTE

NOES -

ABSENT –

ABSTENTION –

ATTEST:

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LATONDA SIMMONS
City Clerk and Clerk of the Council
of the
City of Oakland, California