Agenda Report

TO: CITY COUNCIL June 2, 2008

THROUGH: FINANCE COMMITTEE

FROM: CITY MANAGER

SUBJECT: ADOPTION OF A RESOLUTION SUPPORTING REFORM OF THE BOND RATING SYSTEM TO ELIMINATE DISCRIMINATION AGAINST MUNICIPAL BONDS.

RECOMMENDATION:

It is recommended that the City Council adopt a Resolution:

1- Supporting reform of the bond rating system to eliminate discrimination against municipal bonds;

2- Authorizing the Mayor to notify the municipal bond rating agencies by letter of the adoption of the 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..

BACKGROUND:

The turmoil in the municipal bond markets has brought into focus the higher standards imposed by the three major rating agencies in rating municipal bonds compared to corporate bonds, mortgage backed securities and other debt instruments. As most investors know, state and local government entities rarely default on their bonds. Yet municipal ratings fail to reflect that fundamental fact.

The rating agencies own studies show governmental, or municipal issuers default much less than corporate issuers.

- Municipal bonds rated Baa by Moody's have experienced a default rate of only 0.13 percent, while corporate bonds rated Aaa by Moody's have defaulted at four times that rate, or 0.52 percent.

- Corporate bonds rated AAA by Standard and Poor's (S&P) have defaulted at almost twice the rate of municipal bonds rated BBB (0.60 percent and 0.32 percent, respectively). S&P acknowledges that the historic rate of defaults of A-rated municipal bonds is 0.23 percent, while that of corporate bonds is 2.91%, or 13 times greater.

- Of all general obligation municipal bonds rated by Moody's between 1970 and 2006, only one issuer defaulted.

- For a tax-backed bond rated BBB or better by S&P, the likelihood of default over a 20-year period is only 0.03 percent.

The 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. 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 related. This added cost to compensate for the discrimination against municipal bonds is staggering. 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).

California State Treasurer Bill Lockyer has been leading the campaign nationwide to end discrimination in municipal bond ratings. 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 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 where widespread concern was expressed about this discriminatory practice.

Standard & Poor's objects to the call for reform, claiming they have one consistent rating scale, despite the evidence of their own default studies to the contrary. 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 taken the greatest stride. The firm announced that 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.

Recently the Board of Directors of the League of California Cities unanimously endorsed the call for reform in the municipal bond rating system to end the historic discrimination against municipal issuers that has cost taxpayers billions of dollars in higher interest and bond insurance costs over the years. The League sent a letter to the three rating agencies, endorsing the reform of the bond rating system. Other agencies and individuals supporting the reform effort are listed on the website established by Treasurer Lockyer for this purpose.

FISCAL IMPACT:

There is no fiscal impact by adopting the recommended resolution. Were the rating agencies to reform the municipal bond rating system, the savings to local governments including the City of Pasadena could be significant

Respectfully submitted,

Bernard K. Melekian
City Manager

Prepared by:

Vic Erganian
Acting Deputy Director of Finance

Approved by:

Steve Mermell
Director of Finance