

**TESTIMONY OF DAN BUDOFSKY
DAVIS POLK & WARDWELL LLP
ON BEHALF OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
PENNSYLVANIA SENATE FINANCE COMMITTEE
HEARING ON
SENATE BILL 1277 AND SENATE BILL 1278
MAY 5, 2010**

Chairman Browne, Vice Chair Earll, Democratic Chair Ferlo and members of the Committee:

My name is Dan Budofsky. I am a partner of the law firm Davis Polk & Wardwell LLP. I am appearing today on behalf of the Securities Industry and Financial Markets Association (“SIFMA”)¹ and its members. Thank you for your invitation to testify today.

The membership of SIFMA is diverse and includes financial firms of different sizes that are active in different parts of the financial services business. Certain of SIFMA’s members have built successful derivatives businesses, including in municipal derivatives, by offering products that meet the important needs of their customers. Certain of SIFMA’s members specialize in underwriting municipal debt and, in that capacity, are extremely familiar with the use of swaps by municipalities. It is therefore in our interest to support legislative and regulatory measures that will improve the integrity

¹ The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

and soundness of the municipal derivatives markets. Such measures serve the interests of all market participants and the American public.

Accordingly, SIFMA is pleased to have the opportunity through our testimony today to serve as a resource for the Pennsylvania Senate Finance Committee as you consider bills that would repeal the authority granted to local governmental units (LGUs) under Act 23 to enter into derivatives known as “qualified interest rate management agreements” (QIRMAs).

At the outset, we would like to state emphatically that SIFMA and its members recognize the severe hardships that are being experienced by municipalities, school districts and communities in Pennsylvania and across the United States as a result of the financial crisis. In addition, SIFMA takes very seriously the concerns highlighted in Auditor General Wagner’s report regarding potentially inappropriate conflicts of interest, lack of disclosure and excessive fees embedded in municipal swap transactions. SIFMA believes that fair, arm’s-length and transparent derivatives markets are essential to the American economy, and, as a result, SIFMA supports sensible legislative and regulatory efforts to address such concerns.

In particular, SIFMA supports federal financial regulatory reform and has been working with federal legislators and agencies to put in place new laws and regulations for derivatives. As we speak, the U.S. Senate is debating the details of a strong bill to reform the derivatives markets, and the U.S. House has already passed such a bill. These bills are designed to reduce systemic risk, make derivatives markets more transparent and enhance investor protections. If such a bill were to become law (which appears quite likely), derivatives would become subject to new mandatory clearing and exchange trading requirements. Under the bills, the key players in the derivatives markets, swap dealers and so-called “major swap participants,” would become subject to comprehensive new requirements in areas including registration, reporting, capital, margin, disclosure and business conduct.

Both the House and Senate bills would, for the first time, require non-dealer financial advisors and other market intermediaries who advise on and sell municipal derivatives to register with and come under the oversight of the Securities and

Exchange Commission (SEC). The Senate bill would subject them to rulemaking by a strengthened Municipal Securities Rulemaking Board (MSRB). The MSRB's enhanced powers would include regulating the advice given to municipalities by financial advisers, requiring continuing education for financial advisers, imposing penalties for violations of its rules and assisting the SEC and Financial Industry Regulatory Authority (FINRA) in examinations and enforcement actions. To address potential conflicts of interests, the MSRB would be reconstituted with a majority of board members unaffiliated with broker-dealers, municipal dealers or municipal advisors. Another provision of the bill would double the minimum financial requirements for a municipality to be eligible to enter into a derivative with a swaps dealer. Under the new rule, a municipality would have to own and invest at least \$50 million in discretionary investments to be eligible to enter into swaps with a dealer.

I would now like to turn to explain SIFMA's views that (a) QIRMAs are an essential tool for municipalities to gain access to financing at the lowest possible cost and with manageable risks; (b) the serious losses experienced by municipalities that entered into derivatives are in large part attributable to the extraordinary effect of the financial crisis on financial insurers, liquidity providers and other providers of credit enhancement; and (c) additional regulation, along the lines of that which is currently being debated in the U.S. Senate, is preferable to an outright ban.

QIRMAs include interest rate swaps, forwards and options. Municipalities use them to reduce their debt costs, to minimize fluctuations in the amount of interest they have to pay and to help them manage their debt portfolios. QIRMAs are not the exotic instruments featured in the financial crisis. They are not credit default swaps (CDSs). They are not collateralized debt obligations (CDOs). Nor are they CDO squared, collateralized loan obligations (CLOs) or residential mortgage-backed securities (RMBS).

To illustrate the use of a QIRMA, let's look at a typical strategy employed by many municipalities, including the Bethlehem Area School District: issuing variable rate debt combined with entering into a fixed-for-floating rate swap to achieve a lower rate of financing than it could through the issuance of a straight fixed rate bond. Why not just issue fixed rate bonds as some suggest? For one thing, there are times when bond

buyers will not buy fixed rate municipal debt at reasonable terms, so a fixed rate option is not available in the market. At the same time, these bond buyers will not buy variable rate bonds from a less-than-stellar municipal credit without an associated swap in place because they are concerned about the borrower's ability to meet its interest obligations if rates rise in the future.

Even if the municipality were able to issue long-term bonds at a fixed interest rate based on its own credit, under certain interest rate environments, it still minimizes its interest expense by using a swap. A swap allows a municipality to issue bonds with a variable coupon, supported by a "credit enhancement provider" (such as a financial insurer, liquidity provider or letter of credit issuer), and enter a fixed-for-floating rate swap with a swap dealer. In this way, the municipality pays the dealer a fixed rate of interest on a notional amount equal to the amount of debt it has issued and, of key importance, *this fixed rate is lower than the rate it would have paid to issue fixed rate bonds.*

In return, the dealer pays to the municipality a variable rate of interest on the same notional amount. So, if the variable rate of interest on the debt the municipality has issued equals the variable amount of interest it receives on the swap, the net payment the municipality must make will be equal to the fixed payment it must make to the swap dealer. Said differently, if interest rates were to go up on the variable rate bond it issued, the municipality's loss would be offset by gains on the swap. Conversely, if interest rates were to fall on the variable rate bond, the municipality's savings would be offset by its losses on the swap. In this way, the swap permits the municipality to achieve lower effective funding costs while avoiding gambling on which way interest rates may move. Until the financial crisis, this worked very well for many years for many municipalities.

Yet, theory and experience tell us that there are risks and rewards at work in this arrangement. One risk that became quite important in the financial crisis was the risk of a serious fall in the creditworthiness of the credit enhancer of the variable rate bond. The variable rates payable by the swap dealer on the fixed-for-floating swap, such as LIBOR or the SIFMA Municipal Swap Index, reflect interest rates of creditworthy issuers.

Under normal circumstances, the variable rate payable by the municipality on its bond is based on the strength of the credit enhancement provider. Therefore, if that credit deteriorates significantly, as it did in the financial crisis, the variable amount of interest owed by the municipality on its variable debt would move at a different rate—or even in a different direction—than the variable rate it received from the swap.

This is exactly what happened during the financial crisis when credit enhancement providers came under severe pressure. Without the benefit of the credit enhancement, the rate on municipalities' variable debt spiked and exceeded the variable rate they were receiving on their associated swaps. Caught in an unmanageable situation, these municipalities unwound their swaps to stop the financial bleeding, incurring large unbudgeted termination charges based on the value of the swap from counterparties who lost money terminating their own market hedges. So, a strong argument can be made that the serious losses experienced by municipalities were not due to innate riskiness of the interest rate derivatives; rather, they were a by-product of the meltdown of the credit enhancement providers. In contrast, municipalities with strong credit enhancement providers did not experience the same losses. Instead, their positions recovered, and a large number of these transactions continue to perform largely as expected.

Nonetheless, the very real losses of many municipalities show undeniably what the Pennsylvania Legislature understood when it passed Act 23 and what SIFMA has long stated: that financial arrangements involving variable rate bonds and derivatives do carry risks. One reaction to this has been to say that municipalities should not be allowed to use swaps to gamble with public funds! That all derivatives are too risky! That municipalities should conduct only risk-free public finance! We all wish this were possible. But, there are risks involved in every financial transaction—including issuing fixed rate bonds. Interest rate swaps have been used for decades to reduce these risks and have become a valuable financing tool well understood by participants in the financial markets. Yet, even the simplest derivative can involve risks that must be carefully considered.

Therefore, SIFMA believes that municipal entities must arm themselves with the skills, training and knowledge necessary to evaluate the benefits and risks of each contemplated financing, including any derivative transaction. Rather than ban the use of interest rate derivatives by municipalities, the Legislature should consider ways to provide additional support to municipalities using these swaps, and added protections and enhanced transparency in the use of QIRMAs. In line with states like Louisiana, Tennessee and Texas which have rejected an outright ban, some market participants have suggested a range of ideas, including: enhanced education on derivatives and interest rate management; state-level support to smaller issuers to help them analyze swaps; limitations on the permitted swap exposure of municipalities to a stated percentage of its borrowing capacity; preventing municipalities with a yearly budget or total debt outstanding below a certain threshold amount from being permitted to enter into swaps; disclosure of fees in actual dollars, rather than basis points; contract review; and mandating the use of registered and regulated of financial advisers with minimum qualifications. SIFMA believes that these and other ideas may have merit and should be fully considered in lieu of a ban. Moreover, close consideration should be given to federal legislation affecting municipal derivatives and the benefits and protections that a better regulated and more transparent derivatives market will provide to local governments.

In conclusion, SIFMA does not support a repeal of Act 23 and a ban on the use of QIRMAs by LGUs. Instead, we support preserving access of LGUs to QIRMAs as a means of reducing their cost of capital, minimizing interest rate volatility and gaining flexibility in structuring and managing their debt portfolios.

We appreciate the opportunity to testify today and welcome the opportunity to answer your questions.