ABOUT US
PRESIDENT'S LETTER

Omnes viae Romam ducant.

Tutte le strade portano a Roma.

All roads lead to Rome…or should we say, to Washington?

For that will be the exact route for state and local governments to travel to raise capital for local infrastructure projects if Representative Barney Frank's proposal of creating a federally guaranteed program for insuring municipal bonds gains any traction. Such a proposal, according to Mr. Frank, "would cost the federal government zero."

Let's not mince any words here: Mr. Frank is dead wrong. Such a program will cost all of us plenty. It will cost us in terms of dollars. Did we not learn our lesson from the dual financial disasters of the federally guaranteed Fannie Mae and Freddie Mac programs?

Such a program will also cost us in terms of a loss in our local economic freedom. The ability of municipal and state governments to raise capital independent of Washington is a critical component of ensuring local decision making. That is a primary reason why the municipal bond market developed as a tax exempt market many, many decades ago. McCulloch vs. Maryland, 17 U S 316(1819) was a landmark decision that has helped ensure this independence for the past 190 years ("the power to tax is the power to destroy"). If local governments want independence from Washington, then they need access to an independent capital source. Introducing the federal government in any meaningful way as a participant in local, municipal finance issues threatens this independence. A federal government guarantee of municipal bond issues would be a significant departure from the past and a serious misstep.

There are always strings (implicit and explicit) attached when funds are received from or secured by a third party. In the case of federal government involvement, the so called metaphorical strings will more resemble the cables stretching across the Golden Gate Bridge. If you have any doubts, query the enfeebled powers at Citibank, General Motors and AIG to name three current examples.

Do we want to encourage a system where bureaucrats in Washington are dictating how much money our local school district can spend on a construction project or how much the local water utility can charge for use of the system's resources? Those are local decisions best made by the local citizenry whose lives are directly affected by the decisions made. Introduce a federal guarantee on the funding of these local projects and people in Washington will then claim some level of ownership in the decision making process. That is a recipe for economic inefficiency and loss in our freedom to make decisions.

As was the case for most of the entire financial world, the final months of 2008 were terrible months for municipal and state governments. Revenues declined and borrowing costs increased significantly for most issuers. Many municipalities were unable to borrow at interest rates they felt were reasonable so they delayed capital projects. In many instances, they reduced staff and cut expenditures. Most continue to do so. These were painful choices, but needed ones. The more desperate governments in need of cash issued debt at very high interest rates. These too were painful and expensive choices that will help achieve needed balance as these issuers are forced by the market to recognize that profligate spending leads to higher borrowing costs. Certain, highly leveraged issuers, were completely shut out from the market during this period. These instances were few.

The municipal bond marketplace is a good governor of economic behavior if it is allowed to function independent of national political agendas. Quite simply, the bond market charges higher interest rates when profligate spenders come to market. In extremely volatile markets, as we experienced in late 2008, interest costs tend to skyrocket and the weakest credits are shut out altogether.

Let's examine what happened in California last fall: As tumultuous as markets were, the State of California was able to borrow $ 5 billion in October at the nadir of the market. It paid a dear price (4.25 % for 8 month paper) and it was able to access the market in spite of the fact it has racked up a multi billion dollar deficit. Understandably, elected officials in California were upset with this high interest rate. The fact of the matter is, its borrowing costs would have been lower if the State legislature had not approved such significant expenditures over the past several years. The State needed to issue notes last fall in order to pay for its prior largesse. The financial crisis of 2008 accelerated California's plight, but it did not cause it. California has been living beyond its means for many years and it paid a dear price to borrow last fall when it needed to borrow. But the fact is, it was able to borrow because the municipal market was functioning.

Municipal governments that have been living from paycheck to paycheck and that have relied on financing to fund operating expenses were severely challenged last year. This was the case for many issuers last year and those that borrowed paid high interest rates. The most desperate were shut out of the market completely for a very brief period. Solvent, well run issuers that issued debt borrowed at more reasonable rates; many in this group, sensibly, decided to postpone issuance altogether.

Isn't that appropriate economic behavior? Should all issuers have equal access to capital and at the same price? If one believes that, what possible incentive does an issuer have to live within a budget it can afford? A federal guarantee of any sort on municipal bond debt service will only serve to dumb down this market dynamic that has worked very well for decades in the municipal finance sector.

Should taxpayers in parts of the country that have lived within their means be forced to underwrite California's runaway spending habits and incompetence? It is an injustice to the prudent and responsible taxpayer and municipality, if that is allowed to occur. That is exactly what will result from any federal government guarantee of municipal debt. It will serve only to reinforce bad economic behavior in places like California and, I suspect, will encourage prudent issuers to act less responsibly. After all, why should a Virginian official, who has acted fiscally responsibly deny his citizenry a "needed" project even though it's unaffordable? He or she knows that approving a popular project will serve short term political interests and, if it cannot be paid for locally, well then the federal government (us taxpayers) will cover the debt service. This is a recipe for financial disaster. I remind you again to revisit the Fannie Mae and Freddie Mac bailout.

The final months of 2008 were difficult ones for municipal issuers, but credit is again available to most issuers at reasonable levels. The period of high anxiety was short lived and most municipal issuers are now able to access the credit markets by issuing either tax exempt or taxable build America bonds. Investors are returning in great numbers. An illustration of this is that the period ending May 13th recorded the eighth heaviest cash inflow of money into the municipal bond mutual funds since 1992. In the grand scheme, a 3-4 month period of market turmoil is not that long and certainly is a short enough period during which a well run, efficiently managed issuer should be able to navigate around without having to issue debt. After all, well run businesses and households across the country by the thousands managed themselves in this manner in the latter part of 2008.

Certain issuers need help and some form of federal assistance should be offered until a private or issuer sector solution is plausible. A federal government guarantee of their debt is not the answer, however. That possible solution is a slap in the face to the residents, elected officials and administrators of well run municipal and state governments. And it threatens our collective independence from the federal government.

If places like California need a federal lifeline, then, of course, one should be offered; a very short, taut lifeline.

Consider this as a possible solution for desperate issuers like California: provide California with a federal loan (not a guarantee) for a 12-24 month period. This period could cover two fiscal budget years. In return for the loan, the borrower must commit to legitimately balancing its budget within the same time period. If the elected officials of the issuer cannot agree to a restructuring plan, then the terms of the federal loan requires across the board cuts of all departmental expenditures. No departments or areas are spared other than honoring outstanding debt service requirements. The rights of bond investors cannot be trampled, if a functioning municipal bond market is to exist. The federal government needs to dictate these terms and passes any needed legislation to ensure the success of this solution.

The result: desperate issuers like California receive the short term assistance needed to get them through its current crisis with strings, the past behavior of healthy issuers is recognized as proper, taxpayers across the nation are not forced to underwrite California's past largesse and the independence of municipal market is preserved.

Barney Frank recently justified federal intervention in the municipal bond market because issuers "are paying more than is justified for building things." I am astounded by such a declaration and wonder who selected Barney Frank as the arbiter of interest rates? Make no mistake, this is a very slippery slope we are starting to descend. If Mr. Frank believes interest rates are too high and a federal guarantee of municipal bonds is the remedy, isn't it a logical extension for him to dictate what local financing project or locale should qualify for this federal guarantee? Under that scenario, I envision local economics and preferences having less to do with funding decisions of local projects than Washington politicians rewarding local constituents for favorable votes. There will be a loss of local decision making power as the economic decision making for local projects moves from city hall to faraway Washington.

Omnes viae Romam ducant.

Tutte le strade portano a Roma.

All roads lead to Rome…or should we say, to Washington?

Ronald P. Bernardi
President and CEO
Bernardi Securities, Inc.
May 2009