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October 28, 2008

Ms. Lindsay Valdeon
Deputy Executive Secretary
United States Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC

Submitted via the Federal eRulemaking Portal

Dear Ms. Valdeon,

The Regional Bond Dealers Association (RBDA) and the Education Finance Council (EFC) appreciate the opportunity to present our views on the "Development of a Guarantee Program for Troubled Assets." The RBDA is an association of regional securities firms active in the U.S. bond markets. EFC is the national association of nonprofit and state-based student loan providers. We fully supported enactment of the Emergency Economic Stabilization Act (EESA) when it was being considered by Congress and we commend the Treasury Department for moving so quickly to implement the Act.

We believe that authority provided under EESA can help alleviate stress in two important sectors of the financial markets: auction rate securities (ARS) and variable rate demand notes (VRDNs). The market for ARS has been largely frozen since February. The market for VRDNs, while not as dysfunctional as that for ARS, is also quite stressed; there are indications that the VRDN market could suffer a more widespread breakdown in the coming months. ARS and VRDNs would benefit from a program designed to provide government-supported backstop liquidity for issuers of these products.

Background on ARS and VRDNs

ARS and VRDNs are two forms of long term, variable rate debt financing. Both have been widely used by state and local governments as a substitute for commercial paper by issuing long-term debt with the benefit of short-term interest rates. ARS have also been used extensively by issuers of student loan-backed securities and by closed end mutual funds. At the height of the market in January 2008 there were approximately $330 billion of ARS outstanding. Now, a significant volume of those securities have been restructured or refunded, but nearly $200 billion remain outstanding. There is no reliable source for the volume of VRDNs outstanding; we estimate that approximately $400 billion are currently in the market.

Although both ARS and VRDNs are forms of variable rate financing, they differ in one key area. For ARS, liquidity—the ability for investors to readily sell their securities at par—depends on the success of periodic Dutch auctions. At an auction, which typically occurs weekly or monthly, ARS investors who want to sell their securities provide their order to their broker-dealer who then submits the offer to an auction dealer, a firm contracted by the issuer to manage the auction process. Potential ARS buyers submit bids to the auction, and—at least by design—sellers are matched with buyers. The auction clearing rate becomes the interest rate paid by the issuer until the next auction. Beginning in February 2008 a large number of auctions began to persistently fail—there were insufficient buyers to cover all the offers from ARS sellers. In those cases, investors are unable to sell their securities, and rates paid by issuers on failed ARS increase to a pre-determined maximum, or "penalty," rate. Today, the vast majority of ARS auctions continue to fail on a persistent basis and many thousands of ARS investors are holding securities which offer no liquidity and cannot be sold.

Since February, some state and local government ARS issuers have been able to refund or restructure their outstanding ARS, curing the problems of high penalty rates for issuers and illiquidity for investors. Some closed end mutual funds have taken similar actions. However, many ARS remain outstanding with no liquidity for investors whatsoever. In particular, many municipal and closed end fund ARS and virtually all student loan-backed ARS remain in the portfolios of investors with little prospect for resolution.[1] Although some broker-dealers who sold ARS have reached preliminary agreements with federal and state enforcement agencies that require those dealers to buy back ARS from certain investors at par, only a minority of outstanding ARS are covered by those agreements. Bloomberg estimates that there are $135 billion of ARS outstanding that are not covered by the settlements.[2] Even for those investors who are covered by settlements, the buybacks simply transfer the illiquidity problems from investors to dealers, many of whom may be facing liquidity or balance sheet issues of their own, thus offering little resolution to the financial stress that currently exist within our financial system.

VRDNs do not use an auction process. Instead, each VRDN issue offers investors the opportunity to sell their securities at par, generally on a weekly or daily basis through a designated "remarketing agent," typically a broker-dealer. When a VRDN investor wants to sell their security, he or she submits an offer through their dealer to the remarketing agent. The remarketing agent surveys the market and determines a rate for the VRDNs that would attract sufficient buyers to cover all the offers. That rate then becomes the rate paid by the issuer until the next reset date. Unlike an ARS, however, if there are insufficient buyers to cover all VRDN offers, investors have the right, through the bond trustee, to place the securities with a third-party

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[1] On September 25, 2008 the Brazos Higher Education Service Corporation, Inc., a major servicer and arranger of student loan-backed ARS, announced a tender offer for approximately $6 billion of outstanding student loan-backed ARS. There are significant constraints on the offer, including purchase prices of 92-94 percent of face value for senior notes and a requirement that 95 percent of note holders agree to the offer. Brazos later extended the deadline for responding to the offer to October 31. If successful, this would represent the first major redemption of student loan-backed ARS since the market collapsed in February. See Brazos Higher Education Service Corporation, Inc., "Offers to Purchase or Exchange Commenced in Respect of $6 Billion of Brazos-Serviced Auction Rate Securities," press release, September 25, 2008.

[2] Michael McDonald and Darrell Preston, "Auction-Rate Victims 'Fit to Be Tied' as Accords Ebb," Bloomberg.com, October 24, 2008.

liquidity provider. VRDN liquidity providers, typically banks, have obligations under standby bond purchase agreements (SBPAs), letters of credit (LOCs) or similar contractual arrangements to purchase at par any VRDNs that cannot be resold through the remarketing process. When a VRDN is placed with a liquidity provider, the interest rate paid by the issuer on those bonds increases to a pre-determined maximum. After some defined period, frequently 90 days, VRDNs put to banks require accelerated amortization, forcing issuers to rush to refinance troubled securities at high cost and in difficult market conditions.

While no data are readily available, an inordinate number of VRDN remarketings have "failed" in recent months, *i.e.*, there have been insufficient numbers of VRDN buyers to cover all sell orders. The recent turmoil in the bond insurance area has also been a cause of "failed remarketings" because a large portion of VRDNs carry credit enhancement in the form of bond insurance in conjunction with the SBPA. The confidence crisis which occurred with some money market mutual funds has increased stress in the market and exacerbated the ability to restructure both ARS and VRDNs. As a result, much larger than normal volumes of VRDNs have been put to bank liquidity providers, and those VRDN issuers are now paying high maximum rates on their borrowing.

A key measure of the health of the VRDN market is the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index, an index of rates on certain tax-exempt municipal VRDNs with weekly rate resets. That index rate went to a record high of 7.96 percent on September 24, indicating a drastic market weakening. (By contrast, the average index rate for the first six months of 2008 was 2.21 percent.) The index has fallen back since then, but the market is still unusually constrained. Anecdotal indications suggest that some remarketing agents may be holding VRDNs on their own balance sheets at rates below the maximums in cases where there are insufficient numbers of investors to cover all offers on reset dates in order to prevent bonds from being put to liquidity providers and prevent issuers from facing maximum rates. If this is the case, the market is in a weaker state than improvements in the SIFMA index since September 24 indicate. While problems in the VRDN market are broad, they are particularly pronounced for issues where investors have lost confidence in the particular banks that serve as liquidity providers.

VRDN liquidity facilities have limited terms that are usually shorter than the maturities on the VRDNs they support. This requires issuers to renew SBPAs or LOCs periodically in order to maintain the liquidity backstop for investors. In recent years, some liquidity providers have agreed to SBPA terms as long as five to six years. Recently, however, with banks facing balance sheet constraints and generally retreating from activities that subject them to credit or liquidity risk, the cost of VRDN liquidity facilities has increased significantly and terms offered by banks have shrunk. Some banks previously active in the VRDN market as liquidity providers have retreated from this business entirely. Many of the banks that remain do not offer liquidity facilities longer than one year. We are concerned that continued constrained conditions for banks will make it increasingly difficult for issuers to renew expiring liquidity facilities and will increase the risk of future defaults. This could cause an increasing number of VRDN investors to exit the market, resulting in ever larger volumes of VRDNs being put to liquidity banks.

Difficulties in the ARS and VRDN markets are occurring despite the fact that the credit quality of most ARS and VRDNs has not deteriorated significantly. Many student loan backed ARS are indirectly guaranteed by the federal government since they are backed by federally guaranteed student loans. Many ARS and VRDNs issued by states and localities have lost the benefit of third party bond insurance that may have originally provided them with "triple-A" credit ratings, but the underlying credit quality of the issuers has not deteriorated significantly in most cases. Problems in the ARS and VRDN markets are principally related to illiquidity, deleveraging and dysfunction in the broader financial markets, not to credit deterioration related to these products specifically.

Using Treasury Authority to Address Problems in the ARS and VRDN Markets

The EESA authorizes Treasury to take actions that could significantly improve conditions for ARS and VRDN borrowers and investors and could help avoid a circumstance where liquidity constrained banks are forced to buy a large volume of illiquid securities. Section 101 of the EESA authorizes Treasury "to purchase, and to make and fund commitments to purchase, troubled assets." Section 102 of the EESA requires Treasury to "establish a program to guarantee troubled assets originated or issued prior to March 14, 2008." We believe that either of these authorities, but especially the authority provided in Section 101, allows Treasury to establish a program whereby the Treasury Department would, for a fee, offer the equivalent of SBPAs for VRDN issuers whose liquidity facilities are expiring and for ARS issuers who want to convert their ARS to VRDNs to restore liquidity to investors.

Under the proposed program for ARS Treasury would offer a standby liquidity facility to issuers of ARS originally sold before March 14, 2008 secured by whatever assets are currently supporting outstanding ARS. ARS issuers would pay a commitment fee—in today's market this fee is typically 0.45 to 0.55 percent—for the facility. ARS issuers would exchange new VRDNs backed by the liquidity facilities for outstanding ARS. Many of the new VRDNs would be eligible for investment by money market mutual funds subject to regulation under Securities and Exchange Commission Rule 2a-7, opening up a new source of demand for these issuers whose ARS are generally now not eligible for investment by these funds. The program would operate similarly for current VRDN issuers except there would be no exchange of outstanding securities for new VRDNs. The liquidity facility would be available to issuers of VRDNs originally sold before March 14, 2008 whose bank-provided facilities are expiring. If desired, Treasury could establish a three-year expiration for standby liquidity commitments with the promise of reviewing the effectiveness of the program and the availability of privately negotiated liquidity backstops at the end of that period.

Safe, stable variable rate securities supported by a Treasury-provided liquidity facility would appeal to a broad range of investors. It is unlikely that the facility provided by Treasury would be drawn on to a significant extent, because its mere existence would likely provide confidence to investors and restore normalcy to the market for the affected products. If it did buy assets under the program, Treasury would earn interest at maximum penalty rates that would likely exceed its own cost of funds and would, in that regard, have a "positive carry." In any case, Treasury would earn revenue from commitment fees. As already stated, the credit quality of almost all outstanding ARS and VRDNs is quite high. In the case of ARS backed by federally

guaranteed student loans, the federal government already guarantees defaults and losses on the underlying student loan collateral, so providing a liquidity backstop for these issues would entail no new credit risk at all for the government. Since Treasury would purchase VRDNs only in the case of "failed" remarketings—which would be rare if Treasury were the liquidity provider—it is unlikely that this program would use a significant portion of Treasury's $700 billion asset purchase and guarantee authority under EESA.

In sum, the proposed liquidity would provide several key benefits:

- An orderly market would emerge for hundreds of billions of dollars of assets frozen on the balance sheets of banks, broker-dealers and investors.

- ARS and VRDN issuers would be freed from high penalty and maximum rates on their "failed" securities, and VRDN issuers would be spared from forced accelerations.

- Because Treasury would likely not need to purchase a large volume of securities, the program would provide benefits for many times the volume of outstanding assets than the resources the program actually consumed.

- The assets that would be the target of the program, despite being troubled, are for the most part credit-worthy and soundly performing and would not expose Treasury to undue credit risk. In some cases, the assets are supported by loans that are already federally guaranteed.

- The program would preserve the integrity of the municipal finance and student loan systems and would free up resources for student lenders to make new loans and states and localities to pursue projects that create jobs and enhance services.

We appreciate the opportunity to present our recommendations on implementing the EESA. We would be happy to provide any additional information or perspective as you continue to implement programs under the Act.

Sincerely,

/s/

Michael Decker
Co-Chief Executive Officer
Regional Bond Dealers Association

/s/

Kathleen Smith
President
Education Finance Council

/s/

Michael Nicholas
Co-Chief Executive Officer
Regional Bond Dealers Association