Comments Delivered to the SEC Field Hearing

Panel on "Distressed Communities"
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Good Morning. I am pleased to be with you today and to share a few of my thoughts on the topic of distressed communities. Before beginning I want to thank Chairman Shapiro and Commissioner Walter for scheduling this hearing in Alabama. I also want to commend Congressman Bachus for his leadership as Chair of the House Committee on Financial Services, and his long term interest in addressing the problems in the municipal marketplace in a practical way.

Ever since I was asked to do this and was pondering what I was going to say about distressed communities, I kept thinking back to a 20 year old golf story that I will tell on myself. I was playing in a best ball tournament with Bill Easterling, the former and now deceased sports editor of the Huntsville Times. I was hitting the ball pretty well that day, but unfortunately, my iron play was a little off and I found myself in a lot of greenside bunkers. After about the 12th hole, I was muttering something probably off-color about my sand game and how I needed to practice that more and Easterling stopped me in mid-sentence and said, "Dotts, you don't need to practice coming out of the sand, you need to practice not hitting into the sand." And so it is with state and local governments—the key is staying out of the sand.

- Communities don't become distressed overnight. Distress is the result of both internal and external factors that accumulate over time—sometimes rapidly due to sudden and uncontrollable changes in economic conditions; sometimes over many years of mismanagement, internal weaknesses, and consciously or unconsciously choosing to ignore reality. I refer to it as "not knowing what they do not know".

- In some ways it is analogous to the so-called epidemic of bank failures over the past few years, which in theory were run by sophisticated financial professionals that had risen up the ranks over the years based largely on their ability to produce successful results.

- Leading up to the great recession, I think it's safe to say that most banks did not think they were heading for trouble by loading up their balance sheets with concentrations in commercial real estate loans or by continuing to make residential development loans as prices continued to inflate. Just as state and local governments saw increased revenues from inflated real estate values and sales taxes, the banking industry saw increased profits from those activities until the shockwaves of 2007-2008 hit and the recession led to declines in income and sales tax receipts that were the steepest since the Great Depression. In Alabama, both state budgets were cut by approximately 20% before the current administration took office, rainy day funds were exhausted and stimulus funds were used to prop up operations, all of which are not available for the 2012 budget. Local governments were effected in a similar way.

- But, back to the bank analogy for a minute. In hindsight, I think it's fair to say that banking regulators also failed to anticipate the impact of the economic collapse. In fact, bank profitability was soaring, or so they thought, and this after extensive annual examinations and scrutiny by their examiners.

- To put things in context, over the past 3 years there have been 356 bank failures with a cost to the FDIC of over $80 billion, to say nothing of the loss of market value by shareholders and employees in the failed institutions—and, in spite of an economy that by most accounts is strengthening, there will be other institutions that might now be considered distressed and will no doubt fail and add to the totals cited previously.

- Let's contrast that with state and local government debt and its overall performance. As you know, there are a lot of metrics out there in this space and the old adage about "Lies, damned lies, and statistics" probably holds true here as well, but nonetheless, I am going to try to add some numbers to the discussion also.

- Overall, the municipal market is approximately $2.9 trillion and there are almost 17,000 rated credits within that universe. The record year for defaults was 2008 (totaling approximately $8.1 billion in par value) which was largely fueled by a large number of "dirt bond" defaults and, of course, Jefferson County.

- For the first half of 2011, defaults totaled 24 or $746 million down from 60 during the first half of 2010 totaling $2.29 billion and 144 during the first six months of 2009 totaling $4.89 billion.

- According to a recent Moody's report, the ten year cumulative default rate in the municipal market was .09% compared to 11.06% for corporate debt and most of the defaults were in the non-profit healthcare and housing sectors.

- I am not trying to suggest that there aren't a lot of distressed communities out there; just about every client we have has had to deal with a lot of stress over the past few years and many are continuing to work through the effects of the recession. But I think the numbers do suggest that defaults are rare in spite of the press attention on Jefferson County, Harrisburg, Meredith Whitney, and elsewhere.

So the questions in my view are:

1. **How severe is the problem of distressed communities?**
   I think for certain communities the answer is very severe and almost without a solution short of a debt compromise.

2. **Are the problems isolated or widespread?**
   I think the evidence and the numbers suggest that the worst of the distress, that is to say the kind that leads to default, is isolated and not of epidemic proportions.

3. **But either way – what can or should the SEC do about the problem or problems?**
   In my view, and as a practical matter, there really are only a few initiatives or approaches for the SEC to consider unless they are suddenly given the resources to conduct on-site examinations of public debt issuers by a staff of highly trained examiners similar to the FDIC. To me, that seems to be something that would be both impractical and may fall into the category of overkill, and much like the bank example, might not lead to heading off future problems anyway - be they isolated or widespread.

There are a few added roles for the SEC that I do think may be worth considering.

- Promote the benefits of disclosure and the tools that are increasingly available to make the task of disclosure even easier. In practice, many public issuers provide financial information on their websites and routinely file the required reports. On the other hand, some have not even heard of EMMA or the new voluntary disclosure options. Issuers should be encouraged to provide more voluntary information or mid-year results or commentary. Added visibility by the SEC at state and national GFOA meetings, for example, would be helpful over time.

- There really should be some matters of disclosure that if ignored, lead to sanctions beyond a notice for 5 years in the POS that filings were late. There really is no reason that I can think of, for annual audits not to be completed within 180 or 270 days.

- Focus oversight on municipal advisors and underwriters on things that matter. I may be a rarity, an independent FA that thinks added SEC and MSRB regulatory oversight is a good thing for the industry. I also think that it is overdue and necessary even if there had only been one event of abuse or self-dealing. The substance of the new regulations does not alarm me at all and I encourage the SEC and the MSRB to focus on substance and not form as the regulations are finalized—all of which should begin with an assumption of fiduciary duty.

- Lastly, and perhaps most germane to the discussion today, the SEC should attempt to focus the States to encourage better debt management policies by the public issuers within their respective borders. The benefits to the issuers of debt in North Carolina for example which has a Local Government Commission are obvious and show up in lower rates and the ability to access "best practices" for issuers that are less sophisticated. Even for those issuers with capacity, access to information and assistance in reviewing whether or not a new financing concept makes sense or not is a valuable resource. Or, even if it does make sense, a realistic assessment of the potential downside if the unforeseen happens and the issuer's ability to withstand such an event. States should also be encouraged to adopt legislation providing them the ability to intervene in some manner into distressed situations. Some states, such as Pennsylvania and Michigan have such mechanisms – in my view, all states should. Perhaps a collaborative approach with each state's Securities Commission would be a good place to start.

There are clear examples of bad management, corruption, and significant external factors (for example, national economic recessions and the demise of the monoline insurers) that have led to some pretty major dust-ups in the municipal finance space over the years. Who would have ever expected, for example, Moody's placing 7000 issuers under review for a downgrade as a result of the impasse related to the federal debt limit negotiations? But, in my view, and maybe it's because most of our traditional public finance practice is in this region, I see this as a period of transition to new economic realities, and not the beginning of a municipal apocalypse. Lower debt issuance is a sign of the transition, as is the right-sizing of the workforce in the public sector, a process that has trailed the private sector. All issuers will be affected by national and regional economic conditions – some will muddle through better than others. I guess you can call those either communities under pressure or distressed – in general it's a matter of semantics, but without a doubt, those with the best internal practices and that value their credit standing and market access will do better than those that don't exhibit those characteristics irrespective of external factors. As conditions improve, and they will, some of the concern will go to the back page or to increasingly more obscure blogs. On the one hand, that is a good thing, but not if it lessens the objectives of better disclosure, effective oversight of municipal advisors and underwriters and having the states take a more active role in encouraging better debt and financial management policies by issuers located within their jurisdictions.

Thank you again for allowing me to be a part of this committee today. I am also looking forward to some additional discussion.

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