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[Treasury's Hiteshew Warns of Heightened Scrutiny for Munis.]

CHICAGO – Bankruptcies in Jefferson County, Ala. and Detroit, as well as regulatory and enforcement actions, have garnered increased scrutiny of the bond market in Washington, D.C. and market participants need to better understand the policymaking process, a key Treasury Department official told bond lawyers on Wednesday.

Kent Hiteshew, director of Treasury's State and Local Finance Office, made the remarks at the opening session of the National Association of Bond Lawyers' Bond Attorneys' Workshop, which is in session here until Friday. He discussed municipal bankruptcies, the Municipalities Continuing Disclosure Cooperation Initiative, the new liquidity coverage ratio rule, and other current topics in the market to illustrate how the perception of the muni market have changed in ways that market participants should be aware of.

Also during the session, Kevin Guerrero, a senior counsel at the Securities and Exchange Commission's enforcement division's muni and pensions unit, warned that that the SEC will likely seek financial penalties against issuers who have violations and do not participate in the MCDC. Issuers have until Dec. 1 to self-report failures to disclose noncompliance with continuing disclosure obligations for bonds issued during a five-year period.

Hiteshew began his remarks by talking about the tremendous growth of the municipal market. "When I started my career in the early 1980s, total municipal debt outstanding was just $575 billion." he recalled. Today the $3.7 trillion muni market is unique in the world as it provides low cost, easy capital market access to state and local governments large and small to finance our nation's critical infrastructure needs. But, the system's advantage of de-centralized capital planning and execution is also its challenge: there are over 50,000 issuers with more than 1.5 million distinct CUSIPs issued under more than 50 separate legal frameworks and state income tax exemptions."

"Notwithstanding remarkably low historic default experience," he continued, "the recent bankruptcies of Jefferson County, several California local governments and Detroit, and bid-rigging and swap scandals, while isolated, have increasingly captured headlines."

"These events have increased attention and focus on the municipal market, particularly in the regulatory community," he said.

Hiteshew urged a close reading of the Securities and Exchange Commission's 2012 comprehensive muni market report, and said that understanding the SEC's view that muni market is "opaque, illiquid and fragmented," is important to understanding why bank regulators did not include munis as high-quality liquid assets in its liquidity coverage rule. Hiteshew acknowledged market fears that the exclusion of munis as HQLAs could hamper banks' appetite for them and hurt the market, and said his office will be monitoring the situation to understand what impact the new rule is having on the market.

"My point here is that there is significant focus on the municipal market in Washington today," Hiteshew said. “Whether you agree with these developments or not, the municipal bond industry should be more cognizant of how it is perceived by policymakers and work to better understand the policymaking process.”

Hiteshew also challenged NABL to perform an analysis of the legal treatment of “special revenues” during and after municipal bankruptcy. Recent municipal bankruptcies have brought increased attention to the treatment of bonds backed by a user or service fee versus general obligation bonds in bankruptcy proceedings. Hiteshew said recent NABL papers on other topics have been helpful.

Hiteshew also touted the Obama administration’s proposal to create a permanent America Fast Forward Bond program. This proposal was included in the president’s fiscal 2015 budget proposal.

The AFF bond program “would attract new sources of capital for infrastructure investment and provide significant benefits for both issuers and the overall municipal market,” he said.

AFF bonds would be similar to Build America Bonds in that they would be in the direct-pay mode, but the subsidy rate would be 28% instead of 35%. AFF bonds could be used for the same types of projects as BABs as well as current refundings and 501(c)(3) financings. They could also be used for projects that could be financed with private-activity bonds.

Starting in 2013, the subsidy payments to issuers have been reduced because of federal spending cuts known as sequestration. But the Obama administration’s proposal precludes subsidies for AFF bonds from being reduced because of sequestration.

Hiteshew noted that AFF bonds would be a supplement, rather than a substitute, to tax-exempt bonds. The program would “make the tax-exempt market more efficient and actually bolster support for tax-exempt bonds among federal policymakers,” he said.

Hiteshew said it is important that the AFF program be permanent in order to “incentivize investors to make a longer-term commitment to the municipal bond market and more effectively broaden the taxable investor base for infrastructure investment in our country.” When BABs were being marketed, potential investors, particularly foreign investors and U.S. pension funds, told Treasury that they found the fact that BABs could only be issued for a short time period to be a disincentive to developing credit expertise and portfolio management systems for the bonds, he said.

“Overall, a new large class of institutional investors could be a healthy addition to the municipal market – enhancing both market liquidity and promoting improved disclosure standards,” he said.

Additionally, AFF bonds would be helpful to the market because they “would provide issuers with an effective alternative when tax-exempt market supply-demand technicals turn negative and the value of tax exemption cheapens,” Hiteshew said. “[AFF] Bond issuance could be used to reduce tax-exempt supply, thereby improving tax-exempt pricing — particularly on the long end of the curve where traditional tax-exempt demand is more limited.”

Furthermore, “for larger issuers, America Fast Forward Bonds would provide an important additional source of demand when their traditional tax-exempt investors reach capacity limits,” he said.

Hiteshew invited NABL members to give a new working group suggestions about innovative financing approaches to infrastructure.

The group, called the Interagency Infrastructure Finance Working Group, is co-led by Treasury Secretary Jack Lew and Transportation Secretary Anthony Foxx. It is supposed to submit to

President Obama by mid-November recommendations about how to increase collaboration between the public and private sectors on infrastructure development and promote awareness and understanding of innovative infrastructure financing programs.

Guerrero said the SEC enforcement division's muni and pensions unit of roughly 30 attorneys will spend the coming months combing through underwriter self-reports under MCDC, which were due earlier this month. Under the terms of the initiative, the enforcement division will recommend to the commission favorable settlement terms for both underwriters and issuers who self-report instances in the past five years in which the participated in deals where official statements falsely claimed compliance with continuing disclosure obligations.

Guerrero said that when evaluating MCDC submissions, the SEC may ask follow-up questions of the self-reporting entities and will contact them if the commission thinks enforcement is warranted. Guerrero urged issuers, who still have until Dec. 1 to report, to use their best judgment in deciding to do so.

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