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January 11, 2005

Steven J. Murphy
Standard & Poor's Rating Services
55 Water Street – 38th Floor
New York, NY 10041-0004

Dear Steve:

The Bond Market Association (the "Association"¹) appreciates the opportunity to comment on the Debt Derivatives Profiles ("DDP") program developed by Standard & Poor's ("S&P"). These comments were developed and are being presented by the Association's Municipal Financial Products Committee (the "Committee"). The Committee, which consists principally of dealers in the market for derivatives in which the end-user is a borrower of the proceeds or an issuer (each, an "issuer") of tax-exempt debt (e.g., U.S. governments and non-profits), applauds the efforts by S&P to increase disclosure regarding municipal derivatives and conduct a constructive dialogue regarding the implications of the DDP scoring system.

The Committee indicated at its meeting with your representatives on December 3, 2004 that it would provide written commentary to you addressing several articulated concerns. The purpose of this letter is for the Association to set forth both its support for S&P's comprehensive approach to analyzing the derivatives exposures of issuers and its considered view that S&P should eliminate the publication of the DDP numeric scoring system. In addition, the Association concurs with and endorses the comments on the DDP provided in a separate letter by ISDA.

Our concerns about the DDP scoring system are multifaceted. The Committee's membership includes some of the derivative market's most seasoned participants and its members, as structurers and marketers of derivatives in the tax-exempt market, deal on a daily basis with the complexities and challenges raised by market, legal, regulatory and rating agency developments. Members of the Committee are uniquely positioned to assess both wholesale and subtle ramifications of market-impacting developments. The introduction of the DDP scoring system has had, what we believe, are unintended, but potentially serious consequences for the tax-

¹ The Bond Market Association represents securities firms and banks that underwrite, distribute and trade debt securities, both in the United States and abroad. More information about The Bond Market Association may be obtained from its website located at www.bondmarkets.com.



exempt market. To the extent DDP scoring continues, we believe that issuers, investors and dealers will all continue to be adversely affected.

We have sought to state our concerns as briefly as possible:

Derivatives exposures do not warrant special treatment for tax-exempt issuers.

Exposure to derivatives does not typically constitute a uniquely significant component of the financial position of issuers in the tax-exempt market and should not be singled-out for scoring. Debt-related derivatives frequently present a relatively minor financial exposure for an issuer, in the context of an issuer's overall ability to meet its debt service obligations. Other components of an issuer's financial position (*e.g.*, the composition of its investment portfolio, its ability to access bank letters and lines of credit, etc.) typically constitute a significantly greater portion of its overall financial profile. We believe that highlighting derivatives activities with a separate numeric score in and of itself materially overstates the importance of these activities in an issuer's overall credit picture.

The scoring system adds little value to carefully worded textual analysis. The complex issues raised by an issuer's use of derivatives are not readily reduced to a simplified numeric score. ISDA has provided in a separate letter specific comments with respect to the various components of the DDP score. It is clear to us, as providers of derivatives and as professionals working daily with issuers and their advisors and counsel, that a standard application of the complex DDP scoring criteria across all issuers in all circumstances, for all products, does not produce a fair and accurate measure of all issuers' exposures.

Investors may place too much emphasis on an issuer's DDP score. Several of the Committee's members have informally surveyed the investor community and have found that buy-side analysts are giving perhaps too much weight to the DDP score when considering an investment in an issuer's bonds. We believe that investors are distinguishing between bonds which have the same rating, where one has a DDP score of, say, "2," and the other a DDP score of, say, "3." We believe that the scoring system is having the unintended effect of reducing the buy-side analyst's emphasis on S&P's comprehensive descriptive commentary in favor of the short-hand score. We are concerned that this may ultimately have the effect of reducing market liquidity for an issuer's bonds, to the extent that investors make decisions on the basis of both an issuer's rating and the DDP score and, possibly, of creating trading differentials for issuers' bonds with the same ratings but different DDP scores. Furthermore, we believe that since the release of S&P's DDP program, there may have, already, been instances in which issuers have foregone or delayed sound hedging opportunities with derivatives for fear of the uncertain impact a derivatives transaction would have on their DDP score.

The scoring system has created confusion among issuers. Issuers are unclear as to the significance of scoring a "1." Scores of "1," "2" or "3" are a neutral to



moderate credit factors and, as such, raise the question as to what distinction S&P is drawing by issuing such scores.

The DDP score may reduce liquidity for derivatives in the tax-exempt markets.

Dealers in the tax-exempt market have sought to enhance liquidity by, among other things, making market transactions reflect products and practices in the derivatives markets at large. We have found that issuers' desire to score a "1" is leading issuers to insist upon deviations from standard, and prudent, established market practices. We believe that this may have the unintended result of reducing market liquidity for tax-exempt market derivatives, as fewer dealers may be able and willing to participate on the terms now demanded by issuers. Likewise, the DDP scoring system may only exacerbate the credit imbalance (as between dealers and issuers) in tax-exempt market derivatives agreements through non-symmetrical or one-way collateral provisions. Similarly, the scoring system biases issuers towards using monoline insurance rather than collateral for credit support for their obligations; many dealers do not have an unlimited credit appetite for direct exposure to monoline insurers.

The DDP Scoring System should not apply uniquely to issuers in the tax-exempt market. Tax-exempt market issuers do not have relatively greater exposure to derivatives, as compared with general corporate end-users. It is no more appropriate to score the use of derivatives in the tax-exempt market than in other markets. Indeed, while the use of derivatives in the tax-exempt markets has expanded significantly in recent years, these products have been used in the corporate market for a long time, and the tax-exempt markets have benefited from lessons learned from the broader corporate markets. On the other hand, use of derivatives is by no means new to the tax-exempt markets. As a result, standards and practices have become well-established in the tax-exempt market -- among other things, the vast majority of issuers (certainly moreso than in the general corporate end-user market) engage professional advisors to assist in their derivatives activities, adopt authorizing resolutions for derivatives transactions, and cause their counsel to deliver opinions and, where appropriate, analyze the tax implications of transactions. Documentation in this market is timely and careful.

Derivatives transactions in the tax-exempt market are no more complex or exotic than in other markets. The bulk of the market consists of relatively straightforward debt or asset interest rate hedges, designed to, among other things, reduce an issuer's borrowing costs, optimize the relationship between fixed and floating rate exposures or assets, or synthetically access favorable market rates when tax or other regulatory restrictions would prohibit cash market financings. In many instances, state statutory and federal tax constraints severely limit the scope of an issuer's derivatives activities.

Differences among tax-exempt market issuers (i.e., differences among governments and differences generally between governments and non-profits) render unhelpful a

Steven J. Murphy

January 11, 2005

Page 4



“one size fits all” scoring system. Non-profit tax-exempt market borrowers are subject to FASB’s Statement 133/138 which places derivatives on the balance sheet, but does not include a detailed description of the transaction. On the other hand, governmental tax-exempt market borrowers are subject to GASB’s Technical Bulletin 2003-1 which establishes comprehensive financial statement disclosure regarding derivatives activities (trade terms, security provisions, mark-to-market valuation, issuer objectives, etc.) that exceeds the disclosure requirements that apply to general corporate market end-users.

In conclusion, the Association supports S&P’s publication of detailed, comprehensive analyses of issuers’ derivatives exposures in the tax-exempt markets. However, for the reasons stated above, we believe that the scoring component of the DDP program poses troublesome concerns for the tax-exempt derivatives market. We have sought to devise modifications to the scoring system to alleviate those concerns, but have come up empty-handed. The plain fact is that it is the scoring in and of itself that is the source of the problem. We respectfully request that S&P eliminate the scoring system. Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact me at 646.637.9230 or via email at lnorwood@bondmarkets.com.

Sincerely,

Leslie M. Norwood
Vice President and
Assistant General Counsel

cc: Peter Block, *Standard & Poor’s Rating Services*
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