



THE SECRETARY OF TRANSPORTATION
WASHINGTON, D.C. 20590

September 22, 2008

The Honorable James L. Oberstar
Chairman, Committee on Transportation
and Infrastructure
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

This letter responds to the requirement found in 49 U.S.C. 5323(d), as amended by the Safe Accountable, Flexible, and Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU; P.L. 109-59) to establish a debt service reserve fund pilot program under 49 U.S.C. 5323(d). The Act directs the Secretary of Transportation to implement the program and to transmit a report to the House and Senate Committees on the status and effectiveness of the pilot program.

To date, no applicants have applied for the Debt Service Reserve Pilot Program; therefore, there is no information to provide on the status and effectiveness of the program. Enclosed for your reference is supporting information on the provision included in SAFETEA-LU, reports on implementation efforts, and identification of possible reasons for the lack of interest in the program.

An identical letter has been sent to the Ranking Member of the House Committee on Transportation and Infrastructure and the Chairman and Ranking Member of the Senate Committee on Banking, Housing and Urban Affairs.

Sincerely yours,

/S/ original signed by

Mary E. Peters

Enclosure

Debt Service Reserve Pilot Program Supporting Information

Background

The Debt Service Reserve Pilot Program (DSRPP) seeks to provide credit support and reduce overall project expenses by providing public transportation project sponsors that plan to issue bonds in the capital markets with the additional flexibility to use Federal grants to establish and maintain a debt service reserve fund. A debt service reserve fund provides a supplementary source of revenues that may be used to meet debt service payments owed to bondholders. It is particularly useful in the event that the issuer encounters a future financial shortfall during the debt repayment period that may jeopardize the scheduled payments to the bondholders. If this occurs, the funds in the reserve account would be used to make the scheduled payments in full and on time, a requirement that is important to credit rating agencies that evaluate the creditworthiness and financial strength of bonds for the investing public. Credit rating agencies increase the ratings of bond issues that provide contingent payment arrangements, such as reserve funds that may be used to meet the obligations of the bond indenture.

Program Implementation Efforts

Implementation of the DSRPP commenced with a notice placed in the *Federal Register* on December 28, 2006, alerting potential applicants to the availability of the pilot program and the application procedure. The limitations included restricting the program to not more than ten participants. The program was also listed on the Federal Transit Administration (FTA) Web site and articles were placed in *Innovative Finance Quarterly*, an electronic publication produced by the Federal Highway Administration that is delivered to an audience consistent with the goals of the program. FTA also contacted prospective program stakeholders in order to ascertain the interest in the program and to identify potential impediments to implementation.

Description of the Bond Market

A bond is an interest bearing security that obligates the issuer to repay borrowed funds by a specific date and pay interest at a specified rate. Interest paid by the issuer to municipal bond holders is often exempt from Federal income tax, as well as State or local income tax depending on the State in which the issuer is located, subject to certain restrictions. Consequently, municipal bonds offer a slightly lower rate to investors to account for the higher after-tax yield relative to a taxable corporate bond with the same coupon rate.

According to the Municipal Securities Rulemaking Board:

“There are over 80,000 governmental units that may issue municipal securities.¹⁴ These issuers include not only States and local governments, but also many “authorities” that are created to carry out special functions and to issue municipal debt. These issuers have outstanding approximately 1.4 million different municipal securities, ranging from simple, non-callable general obligation debt to conduit financings involving complicated credit structures and multiple call features. Characteristics such as these distinguish

municipal securities from U.S. treasuries and corporate bonds, in which far fewer types of securities are issued and the securities have more standardized features.”

A typical transit bond may rely exclusively on Federal grant revenues for debt repayment (e.g., those issued by the Chicago Transit Authority) and may utilize bond insurance to guarantee timely payments to bond holders.

Program Implementation Progress

As of May 5, 2008, no applications were submitted for this pilot program. Several reasons may explain the shortage of interested participants, and are summarized and explained in greater detail below:

1. The size of the potential applicant pool;
2. Competing financial products that accomplish a purpose similar to a debt service reserve fund at a competitive price;
3. The indifference of credit rating agencies to debt financed versus grant financed debt service reserve funds; or
4. Competition with broker commissions.

The size of the potential applicant pool may limit interest in this program because only transit agencies that issue debt will be able to benefit from a debt service reserve fund. Debt issuance involves certain fixed costs that limit or restrict the use of this type of financing to large dollar purchases. Consequently, the program may only appeal to specific transactions that meet specific cost thresholds.

Alternative competing products exist in the financial services marketplace that may duplicate, mimic or accomplish a purpose that is identical or very similar to the goals of this program. For example, bond issuers may choose to protect the integrity of their payment schedule and the corresponding credit rating by purchasing bond insurance. Bond insurance guarantees the payment of principal and interest in full and on time, even in the event of fraud. The issuer is free to negotiate the terms of the insurance with an underwriter and may find that it is less expensive to pay a bond insurance premium rather than maintain a debt service reserve fund. Debt service reserve funds may involve additional resources such as fund management that may encumber a bond program. Special tax code compliance requirements, such as arbitrage rebate calculations and reporting requirements, may encourage a preference for the relatively simple services provided by bond insurance.

One of the reasons to use credit enhancement features such as a debt service reserve fund or bond insurance is to reduce repayment risk and thereby improve the credit rating of a bond issue, thereby reducing the interest expense to the issuer. Lower repayment risk represented by a higher credit rating may augment the appeal of an issue to the investing public. Many issuers strive to attain and sustain an investment grade rating in order to expand the market appeal of their issue. In fact, some investors such as pension funds are restricted by investment risk management policies or strategies to securities that have investment grade ratings and must refrain from purchasing any issues that do not have or maintain an investment grade rating.

However, rating agencies are indifferent in their assessment of how a particular issue achieves an improvement in its overall creditworthiness and will give the same incremental rating upgrade to an issue that relies on bond insurance, as one that utilizes a debt service reserve fund to ensure timely payments to bondholders. Therefore, the relative costs associated with these two credit enhancement strategies will influence the issuer's preference for these products.

Bond insurance firms are able to tailor a policy to an issuer's individual needs and may therefore displace the need for a less flexible Federal debt service reserve fund program. Nevertheless, issuers must be mindful of several unidentified costs of bond insurance. First, premiums paid to an insurer will never be available to support a public transportation project in the future, unlike the funds deposited in a debt service reserve account, which combined with accrued interest over the life of the fund will be returned to the issuer and may be used for future public transportation projects. Second, a bond insurer may demand establishment of a reserve fund as a condition of providing the insurance. Third, bond insurance does not excuse an issuer from reimbursing the insurer for the costs of making scheduled payments.

Most bond insurance policies require the issuer to repay the insurer for making timely payments to bondholders. If the issuer fails to do so, the insurer will cancel coverage for the issuer and will not provide coverage for any future debt. In this case, the bonds will enter into a default condition, which is an extremely rare event in U.S. capital markets. Finally, it is important to note that bond insurance may not be available to all issuers, since bond insurance firms may refuse to insure bonds that they consider to have a speculative risk level.

The financial services industry often provides services on a commission basis. For bond issuers, it is important to note that an increase in the size of a debt issue may positively correlate to an increase in the size of an underwriter's commission. Consequently, there is little incentive for a financial services firm to recommend a reserve fund financing mechanism that involves substituting Federal grant funds for funds that are borrowed as part of an overall debt issue.

Conclusion

Due to the lack of interest in this program to date, FTA recommends no further action to expand the program. Sufficient private sector products exist that appear to adequately meet the needs of the intended program recipients. However, it may be useful to continue to permit the option to use grant funds for debt service reserve requirements in the future. Recent volatility in the credit markets including the restructuring of the private firms that provide bond insurance may indicate a future benefit for debt service resources. Therefore, we do not recommend eliminating the authority to use Federal transit grant funds for a debt service reserve fund; credit enhancement options and their associated costs may change in the future and stimulate an increase in the use of this authority.