

Testimony of Robert Brooks, Ph.D., CFA
Wallace D. Malone, Jr. Endowed Chair of Financial Management
The University of Alabama
before the
United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises
July 20, 2012
The Impact of the Dodd-Frank Act on Municipal Finance

Chairman Garrett, Ranking Member Waters and Members of the Committee:

Good morning. I am Robert Brooks, a finance professor at The University of Alabama. My area of academic work is financial derivatives and financial risk management, including municipal derivatives. Thank you for the privilege of participating in this event. It is an honor for me to be here.

I would like to make eight brief points regarding the impact of the Dodd-Frank Act on municipal finance. Beforehand let me offer a unique perspective on the Jefferson County, Alabama financial crisis to help understand my point of view.

Synopsis of the Jefferson County, Alabama financial devastation

Since 1998 I have used the 1997 swap transaction between Jefferson County, Alabama and J. P. Morgan to train my students on how *not* to do a swap transaction. The 1997 swap idea, promoted by Raymond James Financial, Inc., was to refinance an existing variable rate bond with a fixed rate bond and then enter a swap transaction to create a synthetic variable rate bond. The Raymond James Financial, Inc. pitch book suggested significant savings in the form of lower interest costs.

After millions of dollars of transaction costs and fees, the synthetic variable rate paid by Jefferson County was dramatically higher than the original variable rate bonds. I am not aware of any financial institution that would refinance their own variable rate to a higher synthetic variable rate and take on more risks. Raymond James Financial, Inc. brokered the swap on behalf of J. P. Morgan and Jefferson County had no independent advisor acting in a fiduciary capacity for Jefferson County. Although there were many independent advisory firms available to provide this service, Jefferson County officials did not want it.

Later relying on the advice of other financial institutions, Jefferson County officials then proceeded to enter over \$5 billion notional amount of swaps tied to other failed strategies based on a heavy debt burden. Although there have been several prosecutions in Alabama, there has not been much apparent consequence to the financial institutions that facilitated this financial devastation. Remember that at the time of this activity (1997 through 2003), Jefferson County as well as financial institutions that facilitated this financial devastation were heavily regulated entities.

I would now like to offer eight brief points regarding the impact of the Dodd-Frank Act on municipal finance.

1) Regulatory burden must be reasonable

The compliance burden placed on municipal advisory firms must be reasonable and every effort should be made to avoid duplication and unintended consequences. We would not want to drive the highly ethical and skilled professionals out of this industry. For example, if a derivatives advisory firm provides quality services to a variety of entities, at this moment it is unclear under the Dodd-Frank Act whether the derivatives advisory firm would have to register with the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC) and/or the Municipal Securities Rulemaking Board (MSRB). One unintended consequence might be that other registrants, such as registered investment advisors and commodity trading advisors, would now be able to offer municipal derivatives advisory services regardless of their competency in that arena.

2) Regulatory ambiguity promotes tyranny

Ambiguous laws and regulations may result in tyrannical enforcement where particular regulators arbitrarily bring enforcement actions. Since I live in Alabama, I would like to use the local university rivalry to emphasize this important point. Suppose you encountered the following speed limit sign on an Alabama interstate, "Drive At A Reasonable Speed." This ambiguous law instantaneously creates the potential for the Alabama highway patrol to arbitrarily bring enforcement actions.

There is the potential that on Alabama's west side of the state, cars with The University of Alabama vanity tag would receive fewer speeding tickets and on the east side of the state, cars with Auburn University vanity tag would receive fewer speeding tickets. If you have a University of Tennessee vanity tag, you might think twice about driving on that Alabama interstate at all!

On the more serious side, every effort should be made to make legal compliance crystal clear, such as "Speed Limit 70." In that way, law abiding firms will have certainty regarding their compliance. The present high level of ambiguity in the Dodd-Frank Act might result in enforcement actions against innocent or unsuspecting parties. This risk is a strong deterrent for young finance professionals entering municipal finance.

3) Regulations need to improved transparency

Every International Swaps and Derivatives Association (ISDA) confirmation letter that I can recall contains explicit language related to representations, specifically non-reliance, evaluation/understanding, and status of parties. In essence, this portion of the derivatives documents state that each counterparty has made their own independent judgment or is relying on its own advisors. Most importantly, there is an explicit denial of a fiduciary relationship between the two counterparties.

In reality, often derivatives ideas emanated from financial institutions pitching the transaction. The idea was "sold" to the municipality based on some sort of convincing pitch book where benefits are emphasized and well-known risks are omitted. Due to other demands, the municipal

representatives rely on and trust the financial institution. From the municipality's perspective, there is a practical fiduciary relationship.

The municipal officials trust the representations of the financial institution's professionals. Ultimately, finance is and has always been a trust business. Historically, banks often had the word "trust" in their corporate name. The solution may lie more in financial institutions re-embracing their ancient fiduciary responsibilities, rather than the rule of law attempting to place layer upon layer of complex and ambiguous regulations.

At a minimum, financial institutions should embrace transparency by clearly documenting the services they are providing, providing clear identification of conflicts of interest, written documentation of all their compensation sources and strongly recommend that municipalities find their own independent, capable advisor who is willing to act as their fiduciary.

4) Important role of municipal finance industry demand

The municipal finance industry historically has demanded transaction-driven financial consulting services. Commission hungry and ethically questionable derivatives salespeople are not the best source of ideas for creative and innovative solutions to complex municipal finance problems. It should be suspect that often the very idea promoted by a financial institution would never be done at that same financial institution. The municipal entity's leaders should demand a vibrant set of municipal advisory firms that embrace their fiduciary duty to the municipal entities they serve.

Consider the following analogy: Suppose I am experiencing heart problems (say pressure from appearing at a congressional hearing) and have the choice of two different cardiologists. Dr. Red Cuttem only receives compensation if he conducts open-heart surgery. Dr. Green Soy is paid for whatever services are provided, including her time for routine office visits. Who is more likely to provide the unbiased advice that diet and exercise will solve my heart problems?

The municipal professional associations should be at the forefront of leading a cultural change. The municipal finance advisory providers will adapt their business model to whatever their customers demand.

5) Important role of self-enforcement

Like most communities, self-enforcement is an excellent deterrent for criminals. Remember I live in Alabama where hunting is very popular, giving pause to many would-be intruders. For example, if a large financial institution is found to have ravaged a specific municipality through malicious derivatives advice, then through industry-wide self-enforcement, that particular financial institution should find itself unable to create demand for their services. This loss of market share, coupled with severe regulatory enforcement action, would provide a healthy deterrent. The municipal industry, perhaps through its professional organizations, should provide a clear message to those institutions that instigate harm on municipalities.

6) If regulators frame financial risk management, then systemic risk increases

Many concepts within financial risk management are not well defined and hence, not well understood. Remember that finance is a social science, not a physical science. For example,

market participants' beliefs about how certain financial instruments should be valued will influence their value.

Most finance practitioners have a general understanding of “hedging,” but it is surprisingly difficult to pin down. For example, the 1997 Jefferson County swap transaction was promoted as a hedge of interest rate risk. Within a year, the 1997 swap transaction was terminated. If entering the swap was hedging, what was terminating the swap?

As another example, consider two general approaches to interest rate risk management, view-driven and needs-driven. Interestingly, financial institutions seek to balance out their interest rate risk using asset liability management techniques (needs-driven). These financial institutions do not attempt to manage interest rate risk by guessing where rates are going. Surprisingly, these same financial institutions will place a derivatives salesperson on a plane to pitch a view-driven derivatives transaction on an unsuspecting municipal official. It seems reasonable that the financial institution pitching the derivatives deal should be willing to do it themselves if they were facing similar circumstances. Clearly, there are a wide variety of ways to frame the interest rate risk management task.

Therefore, if regulators are allowed to forcefully frame the context of financial risk management, then systemic risk is actually increased and not decreased.

7) Hedging is ill-defined due to the lack of benchmarks specified in advance

The Dodd-Frank Act documents the following permitted activity for banks. “Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings” are permitted and hence referred to as a bona fide hedge in the Act.

Most banking entities have hundreds of positions with exposures to numerous market risks. These same firms have multiple stakeholders with different goals and objectives. There is no requirement in the Act, or for that matter in any other related regulations, for firm-wide financial performance benchmarks to be clearly defined in advance. Therefore, almost any financial derivatives transaction arguably can be deemed a “bona fide hedge.” All one must do is identify some existing exposure in the firm with the appropriate empirical correlation and voila, a derivatives transaction is a “bona fide hedge.” But from almost any ethical framework, such as the CFA Institute’s Code of Ethics and Standards of Practice, many financial derivatives transactions today do not pass as a “bona fide hedge;” they would be deemed deceitful and in bad faith. Because finance falls in the social sciences, ethics is primary and analysis is accidental. Unfortunately, for many in finance – especially academic finance, analysis is primary and ethics is accidental.

For students of the human condition, it would come as no surprise that corporate as well as municipal executives today assert that the activities of their entities are “bona fide hedges” in the Dodd-Frank Act sense. If these executives, however, were asked to justify their hedging transactions to their aging parents, they would struggle to do so without blushing. Without any

preconceived and clearly stated financial risk management benchmarks, whether a municipal entity is on course or not is meaningless.

8) Municipal finance career need to be attractive

It is a given that the regulatory environment governs how municipal finance is practiced day-to-day, but what may not be obvious is that it also influences who chooses to enter this vocation. If the municipal finance landscape resembles a prison environment, then we should not be surprised that many highly ethical, competent, creative professionals opt for an alternative finance profession. If the financial landscape instead encourages innovation and creativity where self-enforcement is reliable, then we will observe more highly ethical professionals opting for the municipal finance profession.

In summary, the municipal finance industry historically has been regarded as dubious by many finance professionals, there appears to be little downside risk for criminals and no real representation of interests of the tax paying public. We must resolve the numerous existing structural problems in municipal finance so there exists an attractive environment for highly ethical, innovative and creative professionals to enter and serve the municipal finance industry. There are many young professionals today interested in this type of public service. We should create an attractive environment for them to flourish.