If the Muni Market Falls, Will Anyone in Washington Hear It?

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They say misery loves company.

They're wrong.

Conditions in the municipal bond market have qualified as miserable since at least February. But with crises boiling over in almost every other front in the financial markets, the public finance community has struggled to gain a place on Washington's radar screen.

It's been a lonely year.

If the municipal market was suffering alone, there is no question that the federal government would have taken action to bolster the ranks of buyers and facilitate capital flows to states and local governments. But because leaders perceive bigger problems elsewhere, munis rarely enter the conversation.

That is inexcusable and could turn into a tragedy for the nation. Set aside the obvious benefit that tax-exempt borrowing has historically provided: long-term financing, at some of the lowest interest rates in the world, practically on demand. The stakes are even higher right now - with other sources of economic activity drying up, it's more crucial than ever that state and local governments maintain, and potentially increase, their capital-spending outlays.

But the implications run deeper than governmental balance sheets and monthly economic data. Without a vibrant and deep tax-exempt bond market, federalism doesn't work. You cannot ask state and local governments to provide critical public services without a mechanism to channel capital funds to them. And you can't expect that system to work flawlessly without a mechanism to provide fiscal oversight. For at least the last 50 years, the municipal market has done both on a massive scale.

For all the criticism of the market's structures, from rating agencies to bond insurance, tax-exempt finance professionals are often the only voices playing a watchdog role, monitoring the fiscal policies of tens of thousands of governmental units and their elected leaders, and passing judgment on the financial viability of billions of dollars in public works projects.

In the short-term, the Treasury and Federal Reserve need to take the advice offered by Rep. Jim

Moran, D-Va., at a promising House Appropriations Committee meeting last week and act to establish the same kind of liquidity and credit backstops they've offered to the mortgage and money markets.

NEEDED: MORE BUYERS

A longer-term public policy discussion also needs to start now. With leveraged accounts like tender-option bond programs forced to scale back, there is an imbalance between supply and demand for tax-exempt bonds, and Congress needs to realize that, through the tax code, it controls the demand.

As noted in these pages by Loop Capital's Christopher Mier and the Regional Bond Dealers Association, raising the bank deductibility limit to allow banks to buy municipal bonds directly is a crucial first step. The Government Finance Officers Association has promoted a plan to raise the limit to include issuers who sell less than $30 million of bonds per year. That should be the floor, not the ceiling.

While commercial banks have their own issues, they also have the Federal Reserve's help, and have been crucial sources of liquidity for some classes of creditworthy borrowers - just ask the nation's student-loan borrowers, for whom depository institutions were saviors this fall.

Moving the smaller borrowers into the bank-lending market and would free the rest of the market to focus on placing bonds from the larger, more complex borrowers.

And that's where the industry has to look inward. It's a clichÃ© to say munis are sold, not bought. Investment bankers need to remember that, and they need to work with their issuer clients to respond with more transparency, more aggressive marketing campaigns of individual bond issues and issuers, and a commitment to improved disclosure practices.

The Municipal Securities Rulemaking Board's EMMA system looks like a major step forward in simplifying access to information, but at the end of the day, it's only a utility and will only be as useful as the information fed into it.

It's easy to pick on Wall Street, and in cases where complex deals have performed badly - most notably in Jefferson County, Ala.- there is plenty of blame to go around. It's much harder to identify the ranks of issuers who might have faced fiscal crises if not for the restructuring efforts undertaken by their investment bankers, financial advisers, and attorneys - often at very low compensation levels - but those stories are out there, too.

It seems a given that the new year will bring new regulations and regulators who will be tasked with finding the balance between encouraging innovative problem-solving and preventing deals that merely mask risk. But the process of sorting the wheat from the chaff will only be possible if the short-term liquidity crunch is resolved. Actions to stabilize the municipal bond market must be part of the stimulus bill.

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