February 22, 1979

Senator William Proxmire, Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Proxmire:

This is in response to your request for an answer to Senator Stewart's question. Senator Stewart mentioned that in my testimony before your Committee I appeared to state that the City needs three years of budget balance according to GAAP before it can be "self-financing" in the bond market.

You may recall that my comments were in response to questioning by Senator Javits, and although neither of us went into detail with respect to accounting standards, my answer was not intended to take into account GAAP. Rather, I was referring to a balanced budget of New York City based upon the Uniform System of Accounts, as adjusted. Thus, the three years of budget balance to which I alluded could be achieved within the context of the four year plan (by June 30th, 1982) if the City succeeds in achieving its budgetary goals.

Very truly yours,

GDG:rmc

George D. Gould
Chairman

cc: Marilyn Friedman
Mr. Chairman, Members of the Committee:

Governor Carey has asked me to comment on the status of the program developed by MAC and numerous other parties to provide the City with financing during the four-year period ending June 30, 1982.

In its report accompanying the New York City Loan Guarantee Act of 1978, this Committee stated its belief that "the primary responsibility for meeting New York City's financing needs for the next four years and restoring the City to fiscal and financial health rests at the local level -- with City and State officials and with the various local sources of financing." MAC's efforts over the past year, as well as the efforts of all of the other parties I will mention, have been directed toward seeing that this responsibility is fulfilled.

From June through November of 1978, representatives of the United States Treasury Department, New York State, New York City, MAC, the Financial Control Board, 11 commercial banks, 35 savings banks, 10 insurance companies, 4 New York City pension funds and 2 New York State pension funds directed their attention to negotiating the long and complex agreements required to implement the financing program. As implemented on November 17, 1978, in one of the largest financings ever undertaken, the financing program consists of the following elements:
1. The sale to certain New York State and New York City pension funds of bonds of the City guaranteed by the Federal government in the amount of $750 million, during fiscal years 1979 and 1980.

2. The issuance of MAC bonds in the amount of $2.8 billion, of which up to $1.8 billion are to be sold to the financial institutions and City pension funds during the four city fiscal years 1979 through 1982, $500 million are to be sold to the public this fiscal year and $500 million are to be sold to the public in fiscal year 1980. On November 17, 1978, MAC sold to the institutions and pension funds $401 million of the Corporation's bonds, comprising the scheduled sales to those purchasers for the current fiscal year. Also on November 17, 1978 MAC sold to an underwriting group $250 million of its bonds as part of the public sales. I intend to discuss with MAC's Finance Committee a recommendation that the Corporation issue the remaining $750 million of bonds to be sold to the public on a quarterly basis of approximately $125 million each quarter.

3. The public sale of unguaranteed bonds of the City in the amount of $950 million, in fiscal years 1981 and 1982. If the City is unable to sell its bonds publicly on reasonable terms and conditions, up to $950 million of MAC bonds are to be sold publicly. If MAC is unable to sell its bonds on reasonable terms and conditions, $900 million of bonds of the City guaranteed by the
Federal government are to be sold to certain New York State and New York City pension funds.

4. The sale to the commercial banks and City pension funds of up to $750 million notes of the City, during fiscal year 1979, to the extent the City or MAC do not fill such needs in the public markets. As you know, the City's needs for this facility has been reduced substantially as a result of the City's recent successful note sale.

The commitments to purchase bonds and notes, like the commitment to issue the guarantees, were not unconditional. Out of the many months of negotiations, we achieved a package which both protected the assets pledged and enabled, indeed required, the City to take the steps necessary to gain re-entry to the credit markets to meet its future financing needs. Those steps have begun to be taken. The City has reduced, and by the end of the City's 1979 fiscal year is expected to eliminate, its need to obtain an $800 million annual advance from the State. This will have the effect of decreasing its seasonal borrowing requirements substantially. Further, the timetable for elimination of expense items from the City's capital budget has been accelerated and the City has been able to go forward with plans for capital construction and rehabilitation of the City's infrastructure. Finally, the market has been advised that a specified amount of obligations will be marketed by the City and MAC during the next several years. This should
improve our ability to market our obligations.

We believe that we have accomplished what we set out to do thus far. We have provided a financing structure within which the steps referred to by the Governor can be taken and budgetary decisions can be made by the City toward the end of achieving a budget balanced under generally accepted accounting principles. All of this can now be done without the sense of urgency and desperation so destructive of the decision-making process. We expect to review with this Committee, in the context of its oversight hearings and in informal staff discussions, the progress being made by the City in these respects and the overall status of the financing program.
My name is George Gould. I am a member of the Board of Directors and the Chairman of the Finance Committee of the Municipal Assistance Corporation For The City of New York. I am also President of the Madison Fund, Inc., a closed end investment company.

I am here today representing MAC because MAC believes that its recent experience with the rating of its bonds by Moody's Investors Service may be a useful case study for consideration by the Committee in determining whether legislation is necessary to insure responsible, professional behavior on the part of rating agencies in their rating of municipal bonds, and if so the form such legislation should take.

On May 26, 1976, Moody's Investors Service, without prior discussion with MAC, abruptly announced that it had reduced its rating of those MAC bonds which it had previously rated, from A, its third highest rating, to B, its sixth highest rating. Moody's assigns its A rating to bonds which are of "upper medium grade," while it assigns a B rating to bonds which "generally lack characteristics of a desirable investment" and as to which "assurance of interest and principal payments ... over any long period of time may be small."

Moody's drastic downgrading of the MAC bonds was an event which is virtually unprecedented in the financial community. MAC believes that the circumstances surrounding Moody's action raise substantial questions concerning the practices of bond rating agencies as they apply not only to MAC but
to all municipal and corporate issuers and we believe that these are questions which should be addressed by your Committee.

In MAC's judgment, Moody's action was reckless and irresponsible, an action taken without consultation and with no basis in fact. Something went wrong at Moody's and it cost MAC and its bondholders dearly. We do not yet know what went wrong. Until we do, it is very difficult to propose, and we do not now propose, any specific regulatory solutions. We propose instead that this Committee study not only what went wrong at Moody's, but also why Standard & Poors and Fitch's did not go wrong and did not follow Moody's precipitous and erroneous change in their ratings of MAC bonds.

The Committee should be aware of several of the facts surrounding Moody's action:

Moody's informed MAC of its adverse rating change only minutes prior to releasing the decision to the public and to the wire services. Although MAC representatives offered to meet with Moody's immediately on being informed of the decision, Moody's refused to participate in such a meeting, termed it unnecessary and insisted on going forward with its public announcement as planned.

When Moody's made its decision public and announced its reasons for its downgrading, it was immediately apparent that Moody's had not gathered the relevant information, all
of which was publicly available and widely disseminated, that was necessary to make a professional decision of the quality which issuers and the investing public have the right to expect. In addition, as amply evidenced by its rating change report, Moody's based its decision on a series of gross misinterpretations of disclosed facts and misunderstandings or misreadings of available documents.

To cite but a few examples:

1. **Moody's reported** that MAC was now "proposing a restructuring of its bonds held by banks, pension and sinking funds, and that such restructuring "raise[s] serious questions as to the security of" MAC bonds.

   In fact, the restructuring was agreed to by MAC, the banks, and the pension and sinking funds, and widely reported in the press and discussed in detail in a generally circulated official statement of MAC on November 26, 1975, six months before the Moody's action; and, in fact, the restructuring has no detrimental effect whatsoever on the security of MAC's bonds.

2. **Moody's reported** that "without [the restructuring and the amendments for which consents were solicited] MAC would not have sufficient revenues to meet its coverage requirements and comply with debt limits. . . ."

   In fact, MAC has ample revenues and adequate coverage to meet its debt service requirements with or without the restructuring. The restructuring merely reduces the MAC debt service requirements over the life of the bonds by up to $753,000,000, in order to free desperately needed cash for New York City. All of the relevant revenue and coverage figures were set out in the Additional Information section of the publicly available Notice to
MAC bondholders relating to the proposed restructuring. It is difficult to understand how Moody's could have reached the conclusions they reached if they had examined these figures.

3. Moody's reported, quoting entirely out of context from the Notice to Bondholders issued in connection with the restructuring and the proposed amendments, that "Without such amendments, [MAC] could not carry out certain terms of the [Amended and Restated Agreement of November 26, 1975] without being in default under the [General Bond Resolution]."

In fact, as the Notice made clear, (i) consent of only two-thirds of the holders of bonds issued under the General Bond Resolution is required, (ii) the banks, pension and sinking funds that are signatories to an agreement with MAC, and the State of New York, together hold two-thirds of such bonds, and (iii) MAC had no reason to expect that all of those holders would not give the requested consents, and the necessary formal consents have now been received. Obviously, MAC would not have attempted to implement the November 26, 1975 agreement if that would have caused a default under its General Bond Resolution. Thus, Moody's misunderstood the facts and its statement was at the very least misleading in its omission of these critical facts.

4. Moody's reported that "there have been suggestions by governmental officials in the City and MAC that bankruptcy is a desirable alternative for the City."

In fact, no such suggestion has ever been made by any MAC official and MAC officials have been widely quoted as opposing bankruptcy.

5. Moody's reported that the prospect of bankruptcy action by the City "would certainly involve the MAC financing."
In fact, MAC is not dependent upon the New York City government or budget for its revenues. Rather, its revenues are derived entirely from State sources, principally State sales and use taxes which are appropriated to MAC by the State Legislature, not the City. The New York Supreme Court has upheld the constitutionality of the legislation imposing such State sales and use taxes within the City, and has directed the State Tax Commissioner to collect the sales and use taxes and remit the proceeds to MAC as required by such legislation. Thus, City bankruptcy would not deprive MAC of the revenue sources which are the security for its bonds.

Moody's could not have made these mistakes if they had been familiar with, or had talked with anyone familiar with, MAC's affairs. Which leaves us with the as yet unanswered question: With whom did they talk; on what basis did they discharge their responsibilities?

After several meetings with MAC representatives in the days immediately following the announcement of the downgrading, Moody's issued a new report which corrected many of the factual and legal mistakes contained in its first report but nonetheless reaffirmed the B rating. This reaffirmation seems to have been based on an entirely new reason not even referred to in the first report, Moody's conclusory reading of "the whole history of municipal financial difficulties in the United States..." and their crystal ball gazing as to what the New York State legislature might do at some unspecified time in the future.

In April of 1975 Standard & Poor's suspended its rating of New York City bonds. Moody's did not downgrade
its New York City bond rating until October of 1975. MAC believes that Moody's unwarranted downgrading of MAC bonds is an ill-conceived attempt to compensate for its prior misjudgments.

The consequences of Moody's action were immediate and severe, causing grave damage to MAC and the holders of its bonds. First, on the day immediately following Moody's announcement, the market prices of rated MAC bonds dropped by approximately $\_\_\_\_\_\_ per $100, for an aggregate drop of approximately $\_\_\_\_\_\_ on such bonds.

Second, MAC had at the time of Moody's action and still has outstanding an offer to holders of certain New York City notes to exchange such notes for MAC bonds. Moody's reckless action clearly frustrated this exchange offer and jeopardized its success to the detriment of the holders of such notes of the City and to the detriment of the City itself.

Third, MAC's credit standing has been impaired by Moody's and consequently MAC's usefulness as a vehicle to help New York City emerge from its current fiscal crisis may be seriously undermined.
In considering our recent experience with Moody's and the disastrous consequences of Moody's action to MAC, the City and the investment public, there are lessons to be learned from our experience of wider applicability beyond MAC to all municipal issuers.

We therefore offer the following two proposals:

First, we propose that the law require that prior to any substantial adverse change (as for example, any change of two or more grades or any change that would shift a security from investment grade status to a non-investment grade status) rating agencies inform the issuer in advance that such a change is under consideration and consult with the issuer to determine whether or not the factual and legal bases of the proposed change are correct.

I have mentioned that Moody's announcement downgrading MAC contained numerous errors. Had Moody's been required to notify MAC that such a drastic change was under consideration, MAC representatives would have had the opportunity to correct such erroneous assumptions and Moody's would have had a chance to reconsider its proposed rating change before making it public. I am confident that if such a practice were followed, Moody's precipitous action would not have occurred and orderly markets would have been maintained. Obviously, after its public announcement the embarrassment of admitting its error publicly
and the possible legal consequences of such a public admission made it very difficult for Moody's to change its position. But MAC bondholders, City noteholders and the City itself are paying the price for Moody's mistakes. Moody's remains unaccountable.

We understand that Moody's takes the position that notification to an issuer of a proposed change in rating of that issuer's securities prior to any public announcement of such change would be a violation of the Federal securities laws with respect to the dissemination of inside information. No other rating agency takes this position. Furthermore, MAC's counsel has advised us that such notification would not in itself give rise to any such violation by Moody's. Obviously, if any officer or employee of an issuer, or someone "tipped" by him, traded upon knowledge of such information, the securities laws would be violated by such person. But responsible corporate officials live within these rules regularly, and Moody's should not presume that these rules would be violated.

We simply propose that prior to making a final decision on a major adverse change in a rating, the rating agency be required to notify the issuer in order that the issuer be given a chance to check that the factual and legal bases of the proposed change are correct and to inform the rating agency of any errors. Our proposal avoids any misuse of inside information
because the rating agency would not be communicating any final decision but only would be required to communicate a proposed course of action which may or may not become final in the form proposed.

Second, we propose that, in order to protect the public interest, consideration be given to establishing a mandatory right of review of such rating changes. The mechanism suggested in HR 675 for the filing of complaints with the SEC by any person aggrieved by any action of a bond rating agency is one approach. Another approach would be to provide a specific statutory cause of action to municipal bond issuers damaged by reckless actions by rating agencies. MAC has made no determination as to what approach is best. We advocate the consideration and adoption of some review mechanisms in order to provide a check on the significant but currently unsupervised powers of the bond rating agencies.

We generally favor the goals of HR 675 to ensure high standards in the bond rating field and to provide some mechanism for reviewing the decisions of bond rating agencies.

We are not, however, at this time advocating general regulation of rating agencies and do not wish to dictate or limit the criteria which rating agencies may responsibly employ in arriving at their determinations.
Congressman Murphy and other members of the Committee, etc.

My name is George Gould. I am a member of the Board of Directors and the Chairman of the Finance Committee of the Municipal Assistance Corporation For The City of New York. I am also President of the Madison Fund, Inc., a mutual fund.

I am here today representing MAC because MAC believes that its recent experience with the rating of its bonds by Moody's Investors Service may be a useful case study for consideration by the Committee in determining how better to insure responsible, professional behavior on the part of rating agencies in their rating of municipal bonds.

On May 26, 1976, Moody's Investors Service announced that it had reduced its rating of those MAC bonds which it had previously rated from A, its third highest rating, to B, its sixth highest rating. Moody's assigns its A rating to bonds which are of "upper medium grade," while it assigns a B rating to bonds which "generally lack characteristics of a desirable investment" and as to which "assurance of interest and principal payments ... over any long period of time may be small."

Moody's drastic downgrading of the MAC bonds was an event which is virtually unprecedented in the financial community. MAC believes that the circumstances surrounding Moody's action raise substantial questions concerning the practices of bond rating agencies as they apply not only to MAC but
to all municipal and corporate issuers and we believe that these are questions which should be addressed by your Committee.

Something went wrong at Moody's and it cost MAC and its bondholders dearly. We do not yet know what went wrong. Until we do, it is very difficult to propose, and we do not now propose, any specific regulatory solutions. We propose instead that this Committee study not only what went wrong at Moody's, but also why Standard & Poors and Fitch's did not go wrong and did not follow Moody's precipitous and erroneous change in their ratings of MAC bonds.

The Committee should be aware of several of the facts surrounding Moody's action:

Moody's informed MAC of its adverse rating change only minutes prior to releasing the decision to the public and to the wire services. Although MAC representatives offered to meet with Moody's immediately on being informed of the decision, Moody's refused to participate in such a meeting, termed it unnecessary and insisted on going forward with its public announcement as planned.

When Moody's made its decision public and announced its reasons for its downgrading, it was immediately apparent that Moody's had not gathered the relevant information necessary to make a professional decision of the quality which issuers and the investing public have the right to expect. In addition, as amply evidenced by its rating change report, Moody's based its decision on a series of gross misinterpretations
of disclosed facts and misunderstanding or misreadings of available documents.

To cite but a few examples:

1. **Moody's reported** that MAC was now "proposing" a restructuring of its bonds held by banks, pension and sinking funds, and that such restructuring "raise[s] serious questions as to the security of" MAC bonds.

   In fact, the restructuring was agreed to by MAC, the banks, and the pension and sinking funds, and widely reported in the press and discussed in detail in a generally circulated official statement of MAC on November 26, 1975, six months before the Moody's action; and, in fact, the restructuring has no detrimental effect whatsoever on the security of MAC's bonds.

2. **Moody's reported** that "without [the restructuring and the amendments for which consents were solicited] MAC would not have sufficient revenues to meet its coverage requirements and comply with debt limits, and would not be able to carry out its agreement with New York City."

   In fact, MAC has ample revenues and adequate coverage to meet its debt service requirements with or without the restructuring. The restructuring merely reduces the MAC debt service requirements into order to free desperately needed cash for New York City.

3. **Moody's reported**, quoting entirely out of context from the Notice to Bondholders issued in connection with the restructuring and the proposed amendments, that "Without such amendments, [MAC] could not carry out certain terms of the [Amended and Restated Agreement of November 26, 1975] without being in default under the [General Bond Resolution]."
In fact, as the Notice made clear, (i) consent of only two-thirds of the holders of bonds issued under the General Bond Resolution is required, (ii) the banks, pension and sinking funds that are signatories to an agreement with MAC, and the State of New York, together hold two-thirds of such bonds, and (iii) MAC had no reason to expect that all of those holders would not give the requested consents. Thus, Moody's misunderstood the facts and its statement was at the very least misleading in its omission of these critical facts.

4. Moody's reported that "there have been suggestions by governmental officials in the City and MAC that bankruptcy is a desirable alternative for the City."

Indeed, no such suggestion has ever been made by any MAC official.

5. Moody's reported that the prospect of bankruptcy action by the City "would certainly involve the MAC financing."

In fact, MAC is not dependent upon the New York City government or budget for its revenues. Rather, its revenues are derived entirely from State sources, principally State sales and use taxes which are appropriated to MAC by the State Legislature, not the City. The New York Supreme Court has upheld the constitutionality of the legislation imposing such State sales and use taxes within the City, and has directed the State Tax Commissioner to collect the sales and use taxes and remit the proceeds to MAC as required by such legislation. Thus, City bankruptcy would not deprive MAC of the revenue sources which are the security for its bonds.

We cannot believe that Moody's would have made these errors if they had been familiar with, or had talked with anyone familiar with, MAC's affairs. Which leaves us with the as yet unanswered question: With whom did they talk; on what basis did they discharge their responsibilities?

After several meetings with MAC representatives in the days immediately following the announcement of
the downgrading, Moody's issued a new report which corrected many of the factual and legal mistakes contained in its first report but nonetheless reaffirmed the B rating. This reaffirmation was seemingly based on an entirely new reason not even referred to in the first report. Although Moody's stated that it would review its B rating, such rating is still in effect.

The consequences of Moody's action were immediate and severe, causing grave damage to MAC and the holders of its bonds. First, on the day immediately following Moody's announcement, the market prices of rated MAC bonds dropped by approximately $\_\_\_\_\_\_\_\_\_\_\_\_ per $100, for an aggregate drop of approximately $\_\_\_\_\_\_\_\_\_\_\_\_ on such bonds. I should add that, although this price drop was severe, it was not really so severe as might have been expected had the market fully accepted the accuracy of Moody's assessment of the security of MAC bonds.

Second, MAC had at the time of Moody's action and still has outstanding an offer to holders of New York City notes subject to the moratorium enacted by the New York State Legislature an offer to exchange such notes for MAC bonds. Moody's action clearly frustrated this exchange offer and jeopardized its success to the detriment of the holders of such notes of the City and to the detriment of the City itself.

Third, MAC's credit standing has been impaired by
Moody's and consequently MAC's usefulness as a vehicle to help New York City emerge from its current fiscal crisis has been seriously undermined.

In considering our recent experience with Moody's and the disastrous consequences of Moody's action to MAC, the City and the investment public, there are lessons to be learned from our experience of wider applicability beyond MAC to all municipal issuers.

We therefore offer the following two proposals:

First, we propose that the law require that prior to any substantial adverse change (as for example, any change of two or more grades or any change that would shift a security from investment grade status to a non-investment grade status) rating agencies inform the issuer in advance that such a change is under consideration and consult with the issuer to determine whether or not the factual and legal bases of the proposed change are correct.

I have mentioned that Moody's announcement downgrading MAC contained numerous errors. Had Moody's been required to notify MAC that such a drastic change was under consideration, MAC representatives would have had the opportunity to correct such erroneous assumptions and Moody's would have had a chance to reconsider its proposed rating change before making it public. I am confident that if such a practice were followed, Moody's precipitous action would not have occurred and orderly markets
would have been maintained. Obviously, after its public announcement the embarrassment of admitting error publicly and the possible legal consequences of such a public admission made it less likely that Moody's would change its position.

We understand that Moody's takes the position that notification to an issuer of a proposed change in rating of that issuer's securities prior to any public announcement of such change would be a violation of the Federal securities laws with respect to the dissemination of inside information. No other rating agency takes this position. Furthermore, MAC's counsel has advised us that such notification would not in itself give rise to any such violation by Moody's. Obviously, if any officer or employee of an issuer, or someone "tipped" by him, traded upon knowledge of such information, the securities laws would be violated by such person. But responsible corporate officials live within these rules regularly, and Moody's should not presume that these rules would be violated.

We simply propose that prior to making a final decision on a major adverse change in a rating, the rating agency be required to notify the issuer in order that the issuer be given a chance to check that the factual and legal bases of the proposed change are correct and to inform the rating agency of any errors. Our proposal avoids any misuse of inside information
because the rating agency would not be communicating any final decision but only would be required to communicate a proposed course of action which may or may not become final in the form proposed.

Second, we propose that, in order to protect the public interest, consideration be given to establishing a mandatory right of review of such rating changes. The mechanism suggested in HR 675 for the filing of complaints with the SEC by any person aggrieved by any action of a bond rating agency is one approach. There may be others. MAC has made no determination as to what approach is best. We merely advocate the consideration and adoption of some review mechanisms in order to provide a check on the significant but currently unsupervised powers of the bond rating agencies.

We do not purport to have made an exhaustive study of municipal bond rating agencies and consequently we are not at this time advocating general regulation of rating agencies.

Furthermore, we do not wish to dictate or limit the criteria which rating agencies may employ in arriving at their determinations. Finally, we are not prepared at this time to endorse specifically HR 675 or any other particular bill, although we do generally favor the goals of HR 675 to ensure high standards in the bond rating field and to provide some mechanism for reviewing the decisions of bond rating agencies.