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State Treasurer

Fall 2008

The LOCAL View

Local Option Capital Asset Lending

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LOCAL – From Concept to Success!

by **Mike Murphy**
State Treasurer

It shouldn't be news to most of you that I will retire on January 14, 2009, at the end of my third term as State Treasurer. That will make this my final article for our newsletter and I want to take this opportunity to thank you all for your support during my tenure in office. The Office of the State Treasurer has had some great successes through the years, but not many have been as successful as the LOCAL program.

In 1989, my predecessor had started the lease-purchase program and required state agencies to participate: if they were buying over time, they had to come through OST. The Treasurer had the infrastructure in place for personal and real property purchases. While serving as Thurston County Treasurer, I recognized that we did not have the staff at the county to help out the junior taxing districts. The lease-purchase program provided a great opportunity for a new local government program at the state level.

When I was elected as State Treasurer I was determined to expand the lease-purchase program to local government. In 1998, I sponsored executive request legislation to extend the use of the state's Lease/Purchase program to local governments. The selling point to the Legislature was that there would be no cost to the State as we incorporated two "paying" features: one eighth of a percentage point of the borrowed amount, and payment 30 days before it was required to be sent on to the bond holders.

I'm happy to say that, since 1998, the LOCAL program has proven itself a success. It has worked very well and LOCAL participants have seen big benefits over the years: low tax-exempt interest rates, a Moody's rating of Aa2, standardized documentation, and consistent debt service payment dates. The program allows pooling of financing requests from state and local agencies and both benefit from economies of scale. In many cases, state and local agencies would be unable to achieve transaction sizes large enough to attract substantial market interest. For smaller issuers, the increased issue size from pooling financing requests from various agencies makes it possible to finance smaller ticket items - items which might be difficult to finance otherwise. Local agencies are also able to benefit from the state's experience with the issuance of public debt - the state is one of the largest issuers in the Great Pacific Northwest. We routinely access the municipal securities marketplace for the sale of bonds and certificates of participation (COP).

Pooling state and local equipment financing transactions and financing them in individual COP issues via the LOCAL program enables local agencies – in most instances – to receive the lowest interest rates possible. For example, Fire Districts, particularly those with volunteer and part-time staff, make up our largest customer base. With fire trucks selling at $500,000 or more, LOCAL offers a very good (and usually less expensive) alternative to vendor financing.

It is a GREAT program! In the first year of operation we had 15 leases with 13 participants totaling $1,340,246; by 2007 we were

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Concept to Success continued

up to a total of 461 leases with 250 participants and a total of $126,522,529. This year we have issued over $10,150,581 for an up-to-date total of $136,673,111 with 492 leases and 271 participants.

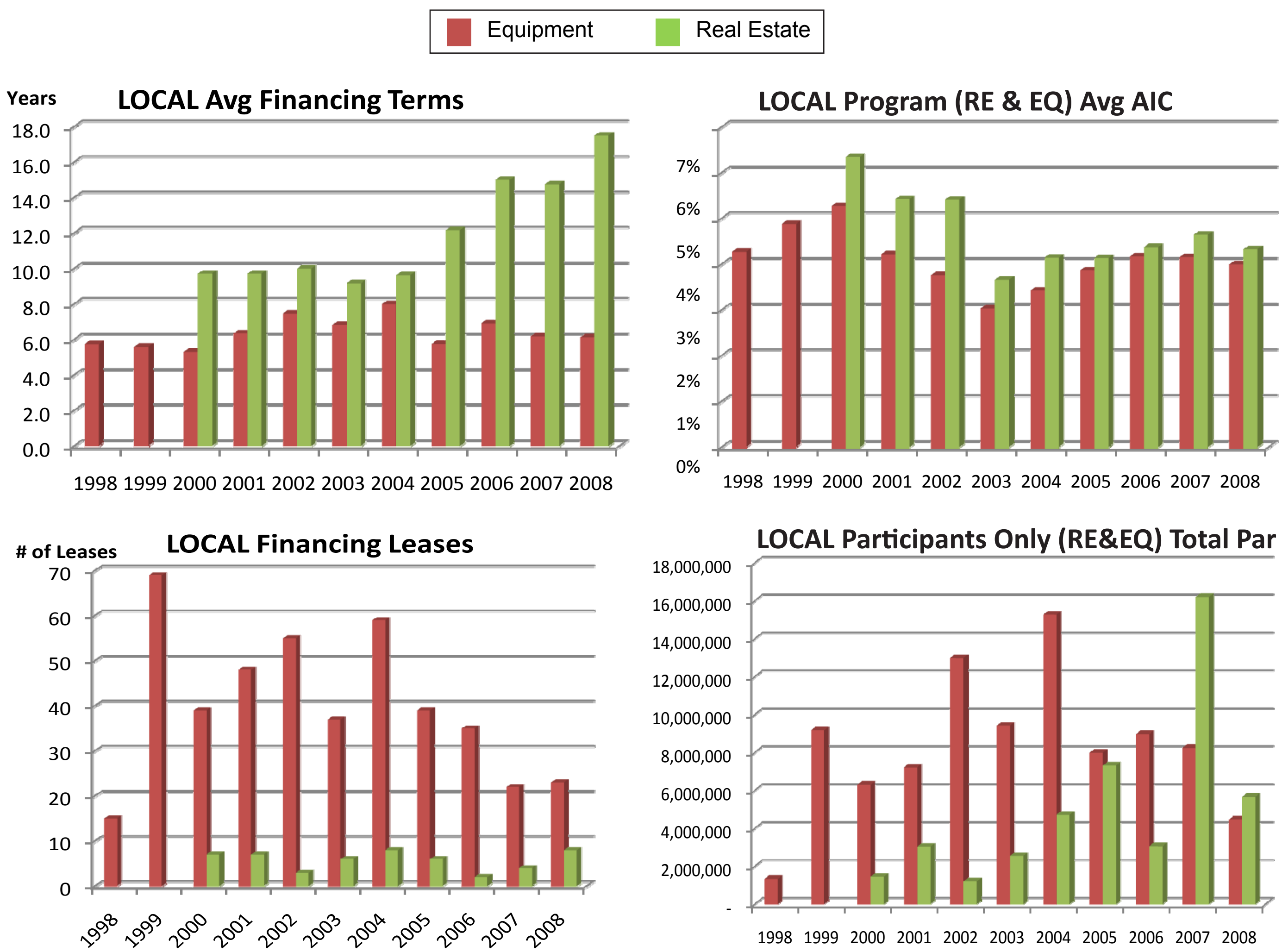
I count the LOCAL program as one of my proudest accomplishments and I expect that it will remain a vital tool for LOCAL participants in the foreseeable future. Again, thank you for your participation and thank you for a great 12 years! ■

Michael J. Murphy

Ten years of LOCAL Success

by Noah Crocker

Over the ten years of the LOCAL Program we have seen significant participation and realized savings through low borrowing rates for LOCAL governments. Sizable borrowing amounts have helped maintain successful pools – providing for economics of scale for all participants. To date we have financed over 441 equipment leases and 51 real estate leases for local governments totaling 492 leases with a total par amount of $136,673,111. In the same ten year period, the average all-inclusive cost (“AIC”) rate for equipment has been 4.104% with an average term of 6.49 years. Real estate has had an average AIC rate of 4.715% with an average term of 11.76 years. Over the last 4 years the average AIC rate for equipment has been 4.045% and for real estate 4.371%. While the interest rate environment during this 4 year period has been historically low, these are still remarkably low rates for an all inclusive cost borrowing. With continued LOCAL government financings we look forward to another ten years of success for the LOCAL Program. ■



Bond Insurance – The Changing Landscape

by Darlene DeRose, Montague DeRose and Associates, LLC

The bond insurance industry ("monoline insurers") has experienced unprecedented disruption since December 2007. Prior to 2007, no monoline insurer had ever been downgraded or defaulted. However, after having built their reputations on maintaining AAA ratings, the highest possible bond rating, it appears that many of the insurers made business decisions that essentially unraveled their financial stability in a matter of months. The changing landscape of bond insurance has had an impact on nearly every sector of the U.S. economy, including businesses and consumers.

While many people are aware of the impact of the "sub-prime mortgage" fallout on the economy and the financial condition of some banks, few people outside of the municipal bond industry understand how real estate defaults and foreclosures have had a major effect on the monoline bond insurers. Over the past few years, rapidly rising real estate values, coupled with historically low interest rates, made home sales skyrocket. During this period, a significant number of mortgages were made to borrowers using lower credit standards ("sub-prime mortgages") and low "teaser" rates set for a brief introductory period. These sub-prime mortgages were packaged together ("securitized") and sold to investors as collateralized debt obligations (CDOs). To make the rates on the CDOs more attractive to investors, bond insurance was purchased. The insurers invested in CDOs because backing them required little capital and they were profitable.

In late 2007, the rating agencies downgraded thousands of CDOs in recognition of higher default risk. Initially, market analysts believed that bond insurer health was not a concern, because insurance is generally paid out over the term of the debt and not in one lump sum. However, since the bond insurers' fiscal health and AAA-level ratings depend on the value of the assets which they insure, the CDO rating downgrades meant that the insurers were forced to raise capital if they wanted to keep their AAA ratings. Some of the insurers were unable or unwilling to raise such capital, which resulted in multiple downgrades, some of which have been to below-investment grade levels.

Prior to the sub-prime mortgage crisis, seven AAA-rated bond insurers actively wrote new business. These seven included Ambac, Assured Guaranty, CIFG, FGIC, FSA, MBIA and XL Capital. The percentage of new issuances which were insured exceeded 50%. As of the end of July 2008, five have been downgraded to levels that make it impossible to write new business, essentially forcing them to focus on reinsurance, finding a different market niche or operating in run-off mode. Only two bond

Monoline Bond Insurer Ratings as of July 31, 2008

	Moody's		S&P		Fitch	
	Current Rating	Current Outlook	Current Rating	Current Outlook	Current Rating	Current Outlook
AMBAC	Aa3	Negative	AA	Negative	Not Rated	
Assured Guaranty	Aaa	Under review for downgrade	AAA	Stable	AAA	Stable
Berkshire Hathaway Assurance	Aaa	Stable	AAA	Stable	Not Rated	
CIFG	Ba2	Under review with direction uncertain	A-	Negative Watch	CCC	Evolving
FGIC	B1	Negative	BB	Negative Watch	CCC	Evolving
FSA	Aaa	Under review for downgrade	AAA	Stable	AAA	Stable
MBIA	A2	Negative	AA	Negative Watch	Not Rated	
XL Capital	B2	Negative	BBB-	Negative Watch	CCC	Evolving

Source: Rating Agency Websites

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insurers (FSA and Assured Guaranty) currently hold AAA-level ratings. For the past several months, these two insurers have essentially controlled the market, with the ability to selectively insure transactions at premium levels up to three times the levels from the past few years. However, on July 20, 2008, Moody's put the ratings of both insurers on review for possible downgrade. The accompanying chart details the ratings of the monoline insurers as of July 31, 2008.

The impact of the sub-prime mortgage crisis has been far-reaching. Bond insurer downgrades have negatively affected fixed rate bonds, variable rate bonds, available credit, market liquidity, and guaranteed investment contracts used for municipal bond proceeds. The stock market continues to decline, as the stability of major financial institutions is questioned. Credit has been more difficult to get, including mortgages, student loans and letter of credit.

In addition to the monoline insurance downgrades, there are several interesting outcomes arising from the sub-prime mortgage crisis. One is the heightened debate on the value and accuracy of municipal bond ratings, with issuers (and Congress) urging (or legislating) the rating agencies to change their bond rating standards, thereby minimizing the role played by the bond insurers. Historic evidence has repeatedly revealed that municipal bond default rates are strikingly low, much lower than corporate default rates, supporting the call for change to the municipal rating standards. Moody's has been at the forefront of the dialogue, with its proposed Global Scale Ratings. On July 31, Fitch Ratings published an exposure draft entitled "Reassessment of Municipal Ratings Framework" which explains the agency's proposed methodology for recalibrating municipal ratings. Municipal bond investors have also begun to focus more on the underlying credit of an issuer, regardless of the published bond ratings, thereby minimizing the importance of the rating agencies. Also of interest is the formation of new bond insurance companies, such as Berkshire Hathaway and Infrastructure Bond Assurance Corp., seeking new, more viable business models in the municipal insurance industry. ■

Darlene DeRose is Senior Managing Director of Montague DeRose and Associates and a financial advisor serving Washington State. The preceding article is an updated summary of a presentation Darlene gave to the Local Advisory Group last fall.

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Annual LOCAL financing schedules

Real estate Cutoff	Fund date	Equipment Cutoff
Jan. 1	March	Feb. 1
April 1	June	May 1
July 1	September	Aug. 1
Oct. 1	December	Nov. 1