Stephen Hopkins Center for Civil Rights

April 18th, 2012

Stephen Hopkins Center for Civil Rights
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Marcia J Van Wagner
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Moody's Investors Service, Inc.
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Ms. Van Wagner,

We are writing pursuant to your firm's May 23rd, 2012 Special Comment (announced May 24th) on the 38 Studios Economic Development Bonds issued by the Rhode Island Economic Development Corporation. We feel a duty to point out that Moody's analysis, to the extent that it does not contemplate the legitimate range of policies available to the state legislature provides neither state officials, nor investors, with adequate guidance.

Moody's is by no means the only party ignoring such due diligence, and state policymakers, notably Governor Chafee and General Treasurer Raimondo, have made precipitous statements which make it appear to the public that state subsidy of the 38 Studios Bonds should be the kind of *fait accompli* required as a matter of law rather than policy. These statements further seem to imply that any decision to pay the 38 Studios guarantees are left to the executive will of the Governor with the mere concurrence of legislative elites. Your analytical summaries, however, comport almost identically with these inaccurate representations and worse, appear designed to secure an outcome rather than predict the risk of several legally available outcomes.

The May 24th announcement condenses your relevant comment on the state role to the following quote attributed to you personally: "[a]nd the state's highest officials have also given their assurances that the moral obligation commitment based on the state's credit for the bonds issued on behalf of 38 Studios will be honored".

Of course, the conclusory nature of this statement might result from its condensed summary of the note's contents, but it must not escape notice that the "state's highest officials" are without the power to make such an assurance. Indeed, it appears you acknowledge this in the Special Comment itself where local reporter, Ted Nesi, reports on his Nesi's Notes blog that you explain: "Once the appropriation request is submitted [by the governor] to the legislature, the state's legal obligation has been met and the legislature may decide not to appropriate the funds."

We write to you to highlight what this note apparently fails to address: why, and to what extent, if the state lives up to that legal obligation, its overall credit rating might be at risk if the legislature chooses not to appropriate the funds. This glaring omission, otherwise known as the 'contagion' question, appears to trouble our elected officials and should be put to rest. We can find no logical reason why an agency that gave positive guidance on the state's debt when legislators reversed statutory pension 'promises' could possibly allow the implication to fester that failing to back statutory 'promises' to bondholders that are not legal obligations should not be similarly regarded.

The state's highest officials do not have a reputation for a particularly high degree of acumen in their due diligence, and their failure to distinguish the axiomatic tarnish on moral obligation bonds likely to result from a failure to subsidize 38 Studios bonds from the effect of an event of true default on the state's general obligation or revenue backed issues is no surprise. It is, however, a great surprise that a firm that is all but synonymous with due diligence seems to ignore this critical distinction insofar as future guidance related to the state's other credit ratings is concerned.

To the extent that you do distinguish this grey market borrowing your characterizations of the institution in Rhode Island are, we think, unprofessionally imprecise and designed to magnify the apparent impact on public policy of failure to subsidize the 38 Studios issue.

Yesterday, a spokesman suggested that you might issue additional guidance if the legislature acts, which we believe evades your responsibility to markets given the special status awarded to yours and a spare handful of other firms to make meaningful comments relied upon by the regulated public finance community, including legislators acting on behalf of states participating in the municipal bond market.

We don't anticipate that it is Moody's responsibility to meticulously chart the effects of any and every vagary of state policy or proposed legislation. But the paucity of precedent in this particular arena leave this realm uncharted in a way we do feel Moody's has a duty to rectify.

It seems equally appropriate that Moody's comments are not always of the nature of mathematical precision or crystal ball prediction of particular quantitative results or outcomes either to the states 'credit rating' or the rating of any particular issue. But, it has not escaped our notice the Moody's regularly issues qualitative guidance for public participants in these markets indicating the measures of credit worthiness being stressed by the agency. Thus ample options seem to exist for you to respond in comment to the legitimate policy options now being debated in the legislature: barring appropriations or EDC funded subsidies of the 38 Studios bonds (H-5888), barring the subsidy of interest for the 38 Studios Bonds (H-5643), barring subsidy with the bondholders being identified (H-5639).

We note one further obligation in this particular regard. Ratings agencies generally have responded to early criticism of treatment of this grey market financing as equivalent in risk to legal state obligations, *see*, *e.g.*, Griffith, Janice C., *Moral Obligation Bonds: Illusion or Security?,* 8 Urb. Law 54 (1976). Indeed you recognize in your comment that these 38 Studios bonds were rated "three notches lower" than the states traditional borrowing. At least some of the approximately 100% interest premium gained by 38 Studios bond purchasers must reflect an expectation that states may not always subsidize underlying defaults. Your firm must think this legitimate in some circumstances, or it could not in good conscience offer a rating for these bonds. So it owes participants in this market an explanation of what kind of circumstances could justify a state's refusal to subsidize an arrangement it has endorsed, for instance the kind of economic distress that could lead a state to unilaterally reduce its pension payments?

It is our hope you might think it prudent to rectify this lack of guidance and we await a reply at your earliest convenience.

To inform ourselves and our citizens, the Stephen Hopkins Center has prepared a more thorough memorandum posing these questions and tracking the legal and policy context for moral obligation or appropriations backed issues in Rhode Island. In the hopes that it may illuminate your further analysis, it is appended hereto.

Best Regards,

Matthew Fabisch, Esq.
President and General Counsel