Stephen Hopkins Center for Civil Rights

FOR IMMEDIATE RELEASE 5/16/2013:

Moody's Feigns Neutrality
Raimondo takes sides: Wall Street comes first
Ghosts of Watergate haunt debate over 38 Studios subsidy

Despite* No Obligation*, Raimondo pushing Constitutional end-run on bonds.
Hopkins Center calls for comprehensive debate focused on public interest to shed light on these sham bonds originated by Watergate conspirator John Mitchell

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This week the Hopkins Center received a response to their April 18th criticisms from Moody's professing neutrality over the public policy question of state subsidy for the 38 Studios bonds.

"Given that Moody's doesn't seem to miss an opportunity to highlight the states so-called 'moral obligation', despite municipal bond texts emphasizing the rating of these bonds as based on the creditworthiness of the underlying borrower[1], it is hard to see their contributions to date as neutral", observed Matthew Fabisch, President and General Counsel of the Stephen Hopkins Center. "Indeed, their initial assessment of the 38 Studios Issues observes in all caps: "STATE MORAL OBLIGATION PLEDGE PROVIDES ULTIMATE SECURITY FOR BONDS"!

"It is one thing to focus on the state's endorsement of this arrangement after the bankruptcy of 38 Studios, but Moody's initial rating focuses more on the state's creditworthiness than on 38 Studios'. This epitomizes an industry trend questioned by academics and policymakers[2] since John Mitchell dreamt up this sham to evade constitutional safeguards.

Careful study of state statutes and investor disclosures reveals ***No Obligation*** whatsoever for Rhode Island to make up shortfalls to 38 Studios bondholders. 'Moral obligation' is in the minds of wall street analysts, not in the laws and documents of the state of RI. The commitment is limited to consideration, which means that the state can as freely -- and without moral failing – refuse to bailout bondholders as to mount a rescue." Fabisch concluded.

"We shouldn't have to defend the state from Mitchell's ghost, that should be the job of General Treasurer Gina Raimondo, who, to date, has thrown the citizen's and the constitution under the bus in this fight, standing up for wall street instead," Hopkins researcher Brian Bishop observed.

"The Hopkins Center calls on Treasurer Raimondo to distance herself from her previous embrace of this finance industry double speak, and to inform the legislature and the public that the state has ***No Obligation*** to 38 Studios bondholders. Once that is established, then the state can debate whether to appropriate money for 38 Studios bondholders just as it does for all purposes, as a reflection of our priorities and appropriate public policy.

“Since we can’t get neutral analysis from Moody’s, one source we ought to be able to depend on for comprehensive analysis of the state’s full range of legitimate options is the state’s elected executive of public finance, the General Treasurer, who ought to act more like a financial professional in appraising credit risks to the state rather than a cheerleader for wall street.

The Treasurer may have reasons for believing that 38 Studios subsidies are good policy, but she should advance those arguments instead of falling into the Wall Street trap of calling them obligations”, Bishop suggested.

“Indeed, the General Treasurer should be intimately aware, as an architect of pension reform, of what is an obligation and what is not. Treasurer Raimondo, of all people, ought to understand that the legislature has no more power to promise future payments to bondholders without a referendum than to promise future payments to pension holders without a referendum. Ms. Raimondo had no problem dismissing the idea of ‘moral obligations’ to state workers and has no business advancing them here”, Bishop maintained.

“ ‘Moral Obligation’ not only has no legal meaning,” Bishop continued, “it doesn’t fairly describe the state’s ethical responsibilities. This is wall street speak for ‘we win, taxpayers lose’ dreamt up by Watergate conspirator John Mitchell. We don’t seek to tarnish Mitchell’s public finance career by simply mentioning this criminal chapter. Mitchell himself did that when an interviewer posed that “Critics of moral obligation bonds say they are a form of political elitism that bypasses the voter's right to a referendum or an initiative”, and Mitchell responded, “That's exactly the purpose of them.[3] Who can’t see how this echoes the Nixonian attitude during Watergate that it was all right to ignore the law in pursuit of what the elite lawbreakers deemed to be the interest of the people?

“It is well past time to hold public finance accountable to a higher standard than John Mitchell set. It is one thing for the Governor to be taken in by Wall Street threats but the General Treasurer as a financial professional should know better. Apparently Ms. Raimondo wishes to perpetuate Mitchell’s disdain for the voter instead of vindicating the Rhode Island Constitution.

“Rather than advocating for an end run around the constitutional rights of Rhode Island taxpayers, The Hopkins Center respectfully suggests that the General Treasurer’s time and expertise would be better spent explaining to her friends at Moody’s that there is no rational basis for any negative impact to the state’s credit rating when the state clearly and explicitly has ***No Obligation*** to bail out 38 Studios investors and when they have given positive response to our cutting pension payments that had been a statutory part of the budget as well”, Bishop suggested.

“We would hope that the days of grossly abusive corporate welfare, where the government takes all the risk and allows Wall Street to reap all of the rewards, are far behind us.” Fabisch and Bishop agreed.

Addendum:

The text of the response from Moody's to Stephen Hopkins Center is reproduced below. For copies of our letter and study forwarded to Moody's please contact Hopkins legal researcher, Brian Bishop at riwiseuse@cox.net or by phone at 401-439-7877.

Dear Mr. Fabisch:

We have received and reviewed your letter of April 18 regarding our May 23rd, 2012 Special Comment, "Rhode Island's Moral Obligation Supports 38 Studios Economic Development Bonds." Thank you for your inquiry.

Attached is a copy of that report and a copy of the press release announcing our initial assignment of a rating to the RIEDC job Creation Guaranty Taxable Revenue Bonds in 2010.

Moody's role in the financial markets is as an independent observer and analyst of credit risk. We are prohibited from providing advice on structuring debt and we do not make recommendations on public policy matters. Since we are market observers, our opinions are intended to promote dialogue and debate amongst market participants about the relative credit risk of bonds issued in the public finance marketplace. Our ratings are intended to augment -- not replace -- independent credit analyses by sophisticated investors and other market participants.

Moody's views on credit risk are predictions about the future determined by rating committees based on published methodologies. We are constantly monitoring the credit environment (including underlying assumptions), and if appropriate, a rating committee may decide that credit circumstances warrant a change in the credit rating. In those cases, we will revise the rating and communicate those views to the market.

Sincerely yours,

Marcia Van Wagner
Vice President/Senior Analyst

Robert Kurtter
Managing Director -- Public Finance

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[1] *See*, *e.g.*, O'hara, Neil, The Fundamentals of Municipal Bonds, 6th Edition, John Wiley and Sons, Hoboken, NJ, 2012:

> The moral obligation bonds issued by states present a special situation for analysts. While the full backing of the state is implied for these bonds, there is no legal obligation for the state to pay debt service. Thus, there is always some doubt as to how readily states will rescue troubled moral obligation issues. **Analysts concentrate, therefore, on the degree to which these bonds are self-supporting**. (emphasis added)

[2] *See*, *e.g.*, Griffith, Janice C., "Moral Obligation" Bonds: Illusion or Security?, 8 Urb. Law. 54 (1976) citing New York State comptroller Arthur Leavitt's "criticism of the credit rating agencies' practice of rating revenue bonds of a state agency . . . on par with the bonds backed by the full faith and credit of the state". The 38 Studios Bonds issued in Nov. 2010 were rated 3 notches lower than RI General Obligation (GO) debt. The 10 yr. maturity coupons had a yield of 7.75%. 10 yr. RI GO bonds issued Oct. 2010 yielded 3.69%. Adding a 1.1% premium for taxability status, we calculate a comparable rate of 4.79%, meaning the premium paid to bondholders was 62%. This is significant, but it is absurd to argue that this represents the underlying credit of 38 Studios that was reportedly unable to find private financing. The real risk was whether the state would choose to provide subsidy in the event of underlying default, a risk that was arguably compensated, thus undercutting the implication of state obligation.

[3] Bond Buyer magazine, Nov. 1984.