National Association of Bond Lawyers

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August 4, 2006

Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: Preliminary Views of the Governmental Accounting Standards Board on Major Issues related to Accounting and Financial Reporting for Derivatives

Ladies and Gentlemen:

The National Association of Bond Lawyers (NABL) respectfully submits the enclosed response to the Governmental Accounting Standards Board (GASB) solicitation for comments on the Preliminary Views of the Governmental Accounting Standards Board on Major Issues related to Accounting and Financial Reporting for Derivatives, dated April 28, 2006 (PV). In the PV, GASB describes possible changes to generally accepted accounting principles for governmental entities that affect accounting for derivatives contracts. The NABL comments were prepared by an *ad hoc* Securities Law subcommittee, chaired by Fredric A. Weber, Fulbright & Jaworski L.L.P., Houston, Texas. NABL exists to promote the integrity of the municipal market by advancing the understanding of and compliance with the law affecting public finance. A professional association incorporated in 1979, NABL has more than 3,000 members and is headquartered in Chicago.

As noted in the enclosed response to the PV, NABL limits its comments to the area in which its members are most knowledgeable: the possible impact of the described changes on compliance with outstanding bond covenants.

National Association
of Bond Lawyers

If you have any questions concerning the comments, please feel free to contact me at 617/239-0389 (wstonge@eapdlaw.com), or Fredric A. Weber at 713/651-3628 (fweber@fulbright.com), or Elizabeth Wagner, Director, Governmental Affairs at 202/682-1498 (ewagner@nabl.org).

Thank you in advance for your consideration of these comments.

Sincerely,

Walter J. St. Onge III

Enclosure

cc: Fredric A. Weber
Kristin H.R. Franceschi
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COMMENTS
OF THE
NATIONAL ASSOCIATION OF BOND LAWYERS
regarding
PRELIMINARY VIEWS OF THE GOVERNMENTAL ACCOUNTING STANDARDS BOARD
ON MAJOR ISSUES RELATED TO
ACCOUNTING AND FINANCIAL REPORTING FOR DERIVATIVES

The following comments are submitted on behalf of the National Association of Bond Lawyers (NABL). The comments relate to the Preliminary Views of the Governmental Accounting Standards Board (GASB) on Major Issues related to Accounting and Financial Reporting for Derivatives, dated April 28, 2006 (PV). The comments were prepared by an ad hoc subcommittee of the NABL's Securities Law Committee. The members of the ad hoc subcommittee are listed below.

NABL members provide legal advice to state and local governments as well as users of their financial statements. NABL members are not themselves compilers or users of the financial statements. Accordingly, NABL defers to other organizations for comments on the usefulness and efficacy of the accounting and financial reporting changes described in the PV. NABL limits its comments to the areas in which its members are most knowledgeable: the possible impact of the described changes on compliance with outstanding bond covenants, including both financial covenants and continuing disclosure obligations.

Background

Bond Covenants. Many state and local governments have issued (and in the future will issue) substantial amounts of revenue bonds to finance municipal utilities, airports, convention centers, and other important public infrastructure. In doing so, they typically enter into covenants to set and collect rates for goods or services sufficient to pay annual operating expenses and debt service on the revenue bonds (and parity and senior obligations) with a specified cushion. In addition, state and local governments typically enter into covenants that condition their right to issue additional parity or senior revenue bonds (or to take certain other actions) on realizing or projecting adequate annual net revenues to pay annual debt service requirements with a similar or higher cushion. In contrast to typical corporate financings, governmental revenue bond covenants seldom refer to capitalization ratios or other balance sheet items, except for occasional liquidity covenants.

Rationale for Covenants. Unlike private business enterprises, governments do not exist to maximize the value of their organizations, and they may face political resistance to increasing rates for essential public services. Accordingly, revenue bond rate covenants (and additional bond tests) are designed to assure that the government will have adequate annual revenue to operate and maintain its revenue-producing assets and to pay debt service on the bonds (and parity and senior obligations). On the other hand, bondholders typically are less concerned by the data reflected in a government's balance sheet and, except for occasional liquidity covenants, seldom require covenants based on measures reflected in a balance sheet. This is true because (i) the pledged revenues are usually generated by enterprises performing essential governmental functions for which there is no effective competition, permitting the government to raise rates as necessary to pay debt service, (ii) most of the government's assets are required to perform its governmental functions and, accordingly, are not available for trade or sale, and (iii) governments are not subject to liquidation proceedings in bankruptcy.

Effect of GAAP on Covenant Compliance. In revenue bond covenants, descriptions of net revenues are typically similar to earnings of for-profit enterprises before income tax, depreciation, and amortization (commonly referred to as "EBITDA"), but they vary greatly among states, government and enterprise types, and specific governmental issuers. The definitions of net revenues (or the measures used in the definitions) are sometimes stated to be governed by generally accepted accounting principles (GAAP). In these cases, to minimize divergence between financial and legal accounting over time, the operative provisions sometimes refer to GAAP as in effect from time to time, rather than to GAAP as in effect when the bonds are issued. Even when the definitions of net revenues (or the measures used in the definitions) are not stated to be governed by GAAP, GAAP may be referenced in resolving ambiguities presented by the definitions. Accordingly, changes in the principles used to determine a governmental unit's changes in net assets or other similar change statement measures could affect state and local government compliance with outstanding revenue bond covenants.

Permanence of Covenants. State and local government revenue bonds often are not callable for a period of years and, under federal income tax rules, often may not be refunded with other tax-exempt obligations until they are or soon will be subject to redemption at the option of the issuer. Consequently, the bonds often may not be economically refunded to modify or terminate burdensome covenants. In addition, governmental revenue bonds typically are widely sold and held. Accordingly, consent solicitations to secure bondholder agreement to modify covenants are generally infeasible or, at least, very expensive and time-consuming. As a result, if the contemplated changes to GAAP sometimes require greater gross revenues for state and local governments to comply with bond covenants, the governments may be forced to increase their rates and charges to do so or may be forced to pursue expensive, uneconomic refundings or consent solicitations in order to obtain covenant relief. Similarly, if the contemplated changes enable governments to comply with bond covenants with less gross revenue than otherwise required, the creditworthiness of outstanding bonds may be adversely affected until the bonds mature, with consequent loss to bondholders who trade the bonds before maturity or suffer a resulting default.

Disclosure to Investors. Governmental issuers almost universally publish their financial statements as part of the disclosure documents they use to market their bonds to investors. In addition, to enable the underwriters of public offerings of their bonds to comply with Rule 15c2-12 adopted by the United States Securities and Exchange Commission (SEC), governmental issuers regularly undertake to file annual financial statements with nationally recognized information services during the term of the bonds. Both to comply with state and federal securities laws and to be fair to investors (many of whom are often constituents of the government), governments take great care to avoid misleading statements when they publish or file their financial statements or other data in a manner accessible to investors.

Comments

1. Impact on Bond Covenants. Under the changes to GAAP contemplated by the PV, unless a derivative contract is a qualified hedge, changes in the value of the contract during a government's fiscal year likely would be taken into account in calculating its enterprise net revenues, to the extent that term is governed or influenced by GAAP. In addition, if a derivative contract loses its status as a qualified hedge during its term, deferred changes in its value from inception would be taken into account. Unlike most other components of net revenues, the change in value would result in current year recognition (as gain or loss) of the present value of expected net payments or receipts over the entire remaining term of the contract. Accordingly, a change in current or expected interest rates or commodities prices could result in an impact on net revenues in the current year that is many times the actual current cash flow impact on the government. For valid governmental purposes, governments often enter into derivatives contracts (such as interest rate "basis" swaps and fixed receiving interest rate swaps) that do not qualify as hedging derivatives contracts, and under the contemplated changes to GAAP, even qualified hedging contracts may lose their qualification as such over time. Unless all of a government's derivatives contracts are qualified hedges, the contemplated change in GAAP could affect a government's ability to comply with rate covenants and additional bonds tests in years in which the values of its non-hedging derivatives contracts change much more substantially than the annualized impact of the changes in prevailing interest rates or commodities prices. This result could adversely impact either bondholders or governments, depending on the circumstances, and could defeat the expectations of both governmental issuers when they issued bonds and entered into the derivatives contracts and investors when they purchased bonds.

For example, suppose a local government has issued variable rate bonds and entered into a fixed paying interest rate swap agreement to effectively fix its net interest liability, but, due to changes in federal income tax laws, market conditions, or other causes, the swap is no longer an effective hedging contract under the contemplated changes to GAAP. Suppose, also, that the government's bond covenants use (or are influenced by) GAAP in defining net revenues. If, due to a possibly modest change in either prevailing interest rates or the slope of the yield curve, the value of the swap were to decline substantially in a year, the government's net revenues in that year would be reduced by an amount far greater than the expected impact on recurring net annual cash flow available to pay current or future debt service. As a result, the government might breach its rate covenant for that year or lose its ability to issue additional parity revenue bonds to finance needed public improvements, even though its actual ability to meet debt service requirements annually is not materially affected. In contrast, if, due to a comparably modest, but opposite change in prevailing interest rates, the value of the swap were to increase materially in a year, the government's net revenues in that year would be increased by an amount far greater than the expected improvement in the government's recurring annual revenue available to pay current or future debt service. As a result, the government might comply with a rate covenant that it would otherwise have breached or be able to issue additional parity revenue bonds that it otherwise may not be able to issue in compliance with bond covenants.

NABL recommends that GASB explore alternative accounting treatments for non-hedging derivatives contracts that would not have a disproportionate impact on the net revenues used by governments in measuring bond covenant compliance, at least where the government's intent is to hold the derivative contract for its term. For example, GASB could consider a proposal to modify GAAP so that (1) if a government intends and is able to hold a derivative contract to maturity, fluctuations in the fair value of the contract would not be reflected in its change statements, but rather would be deferred, or (2) a government would recognize only the annualized impact of the change in value of a derivative that is not a qualified hedging contract. Alternatively, GAAP could elect not to propose a change to existing GAAP principles. If GASB chooses to propose a change to the principles for accounting for derivative contracts and does not take steps to reduce the disproportionate impact on change statements from the principles contemplated by the PV or the frequency with which those principles would apply, GASB should at least consider treating all pre-effective date derivatives contracts as qualified hedging contracts.

2. Hedging Contract Exception. Under the contemplated change in GAAP, to qualify a derivative contract as a hedging contract, a government would have to declare that it entered into the contract to hedge a hedgeable liability or asset. It is not clear from the PV whether the government may declare its intent after it has entered into the derivative contract if the hedged liability or asset already existed at that time. The changes to GAAP are proposed to be applied retroactively from the beginning of the earliest reported year. Accordingly, the changes could apply to derivatives contracts executed before the changes become effective (or were even described in the PV or proposed). GASB should therefore clarify that a government may declare its hedging intent to enter into previously executed derivatives contracts at any time prior to the issuance of the first financial statements reflecting the proposed accounting change, in addition to the other times described in the PV. Otherwise, many outstanding derivatives contracts could be treated as non-hedging contracts (with consequent impact on compliance with revenue bond covenants), even when governments have the intent to hedge a hedgeable asset or liability and have, therefore, entered into effective hedges.

3. Disclosure Risks. If a government were to recognize a derivative contract's full change in value in its current year change statement, the change statement might overstate or understate the annualized impact of the value change on the government's overall financial performance, which (based on covenants negotiated with investors) appears to be the data of most interest to investors. Given the importance of financial statements in making disclosure to investors, applying GAAP should result in financial statements that make fair disclosure without the need for explanatory or pro forma supplemental statements.

Summary

1. Avoid Unexpected Impact on Covenant Compliance. If the value of a state or local government's non-hedging derivatives contracts were to increase or decrease substantially in a year, the contemplated changes in accounting for the contracts could affect, positively or negatively, that government's compliance with outstanding revenue bond covenants, in each case to an extent not contemplated by the government when it entered into the covenants or outstanding derivatives contracts or by investors when they purchased the government's bonds. GASB should consider this impact in determining whether to propose the contemplated changes in GAAP for comment. If appropriate, GASB should explore alternative accounting treatments that would avoid or reduce this potential effect on covenant compliance.

2. Grandfather Outstanding Derivatives Contracts. If GASB proposes the contemplated change in GAAP for comment, it should clarify that a state or local government may declare its hedging intent (in entering into previously executed derivatives contracts) at any time prior to the issuance of the first financial statements reflecting the proposed accounting change, in addition to the other times described in the PV.

August 4, 2006

Members of the Ad Hoc Subcommittee Regarding the Preliminary Views of the Governmental Accounting Standards Board on Major Issues Related to Accounting and Financial Reporting for Derivatives:

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