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The Recession's Impact On U.S. State And Local Government Credit Risk

Primary Credit Analysts:

James Wiemken
Chicago
(1) 312-233-7005
james_wiemken@
standardandpoors.com

Secondary Credit Analysts:

Robin Prunty
New York
(1) 212-438-2081
robin_prunty@
standardandpoors.com

Reports of persistent unemployment, falling property values, widespread mortgage delinquencies, and sales and income tax declines not seen in decades are frequently in the news these days. Given the historical lag between economic conditions and their effect on state and local government revenues, Standard & Poor's Ratings Services expects that the economic difficulties that the U.S. is experiencing will likely influence government issuers for the next 12-24 months, even if the economy recovers in 2010.

While we think that state and local governments are, and will continue to come, under pressure that will cause them to make tough fiscal choices, we do not expect defaults or downgrades to be as frequent as they have been in the corporate sector. This is not to say that we believe the credit quality of all government issuers will remain unchallenged, but by and large we expect that governments' relatively superior (but not unlimited) ability to make structural adjustments should allow most of them to weather the current downturn even if the recovery is weak. That said, governments' actions during this downturn as well as the strength and shape of the subsequent recovery and how governments react to that are important ingredients in an equation that we believe could have more significant consequences in the future. This article examines the most common questions we are receiving regarding Standard & Poor's state and local government ratings in the context of the current economic environment.

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Frequently Asked Questions

From a credit perspective, what makes U.S. state and local governments less vulnerable to economic fluctuations than the corporate sector?

As dramatic as current revenue declines may seem for governments when compared to recent history, based on our observations, most dominant government revenue streams remain relatively stable. While we believe that all are vulnerable to economic fluctuations, we think the diverse economic bases of most governments result in relative stability compared to corporate profits driven by demand for a specific line of products, which are generally more susceptible to consumer tastes and competitor actions. Governments have the option of cutting services and raising fees or taxes, although such actions are unpopular. While some taxpayers may move out of a community in response to a government's austerity measures, as a general proposition, the frequency of such reactions pales in comparison to the demand elasticity of most consumer products.

Furthermore, governments are generally ongoing entities serving a public purpose. We believe the absence of a clear profit motive influences their risk-taking willingness, as does the fact that many are precluded by law from filing for bankruptcy. We believe history reflects this relative stability, not only in recent times but also over longer periods including more stressful times, which our ratings take into consideration. The default rate for state and local governments was 16.2% during the Great Depression, according to George Hempel's study, "The Postwar Quality of State and Local Debt." Even with criteria-based rating adjustments, 'AAA' rated entities currently make up less than 6% of our tax-secured ratings universe.

Then why do state and local governments keep talking about the dire straits they are in?

In terms of having to maintain current or growing government service levels, we agree that state and local governments are facing challenges in this area, and it is important that they communicate this so that the public understands the need for budget adjustments or responses. In our view, such public awareness facilitates the enactment of difficult measures, which we believe, in turn, supports credit quality.

Governments have faced and, we expect, will continue to face budget gaps that will force them to make tough choices that will be felt by many stakeholders. The choices present themselves in the form of "crowding out" or trade-off type of decisions. We believe governments will make these hard choices to weather the downturn both because of state laws requiring balanced budgets and out of the need to continue to function. As this all plays out, we think that new headlines will likely capture elected officials' and others' efforts to make the public aware of the circumstances of their austerity measures and what they think will be the consequences of inaction. We believe that state requirements for balanced budgets actually increase headline activity as governments are forced to deal with the full extent of budget gaps on an annual basis.

As stated above, we expect some governments to face meaningful challenges. Governments as large as the city of Detroit (BB/Stable general obligation rating) and as small as Littlefield, Texas (B/Negative general obligation rating) have seen the recession cause additional stress on already significant

imbalances that we believe pose more immediate liquidity threats absent further assistance from outside sources. But, based on our observations, these are exceptions rather than the norm. Both cities were in our view vulnerable to adverse circumstances going into the recession whereas most state and local governments had what we consider to be good or even strong reserve levels when the downturn began.

Your quarterly ratings roundup reports show a sustained level of upgrades. How can you be upgrading credits at a time like this?

Our upgrades of certain municipalities in the past 12-18 months have been almost entirely related to criteria changes. Our revised criteria is designed to place more weight on management and less weight on population size and whether a town or city is located in a metropolitan area. These criteria changes apply only to local general obligation credits and to water and sewer municipal utilities. State ratings, special tax ratings, and more purely land-backed ratings are not affected. We believe that, generally speaking, smaller and more-rural governments with otherwise similar liquidity, management, and leverage characteristics are nearly as adept in managing through the downturn as their larger, more metropolitan counterparts. That said, the revenue decline resulting from the economic downturn will likely test local governments' liquidity and their willingness to make adjustments — either structural or temporary. To the extent that their liquidity suffers beyond what we expect or their response to fiscal imbalances is less than we think is required, credit quality will likely suffer. We are also seeing a number of credits where fiscal imbalances, declining liquidity, or increasing leverage have offset adjustments resulting from our criteria for small and rural credits. In these cases, there have been only slight upgrades or no upgrades at all. For many states and local governments that we believe have been more susceptible to declining conditions or haven't made structural adjustments to their budgets, we have lowered ratings or revised our outlooks to negative.

Still, aren't you concerned that you might have to "undo" some upgrades?

No. We began this downturn with the majority of government credits rated in the 'A' and 'AA' categories, and this remains the case today. The sustained period of upgrades that continues to the present day reflects a case-by-case analysis of the relative credit quality of each issuer, rather than a general approach that does not consider governments' individual characteristics. We would also note that such rating changes are being made with consideration to our previously published commitment to explicitly recognize credit stability as a rating factor (see "Standard & Poor's To Explicitly Recognize Credit Stability As An Important Rating Factor," published Oct. 15, 2008, On RatingsDirect). If we believe that a credit is likely to transition beyond the rating levels outlined, we assign a lower rating. Again, however, if credit conditions deteriorate beyond what we expect, we may make downward adjustments.

What about state ratings in particular?

Our research shows that states have a long history of managing through volatile economic periods (including the Great Depression) and have continuously repaid their debt. We believe many entered this downturn well prepared to continue this good performance with what we consider to be generally strong reserve levels and broad authority to enhance revenues, adjust spending, and manage disbursements. We have also observed many improvements to budget structure, reserve policies, and debt management in prior periods of budget volatility that, in our view, have generally enhanced states'

ability to manage through cycles. Thus far, stimulus funds aside, in our view most states have been actively managing their budget gaps through more structural solutions, rather than debt issuance. We have already lowered ratings or revised our outlooks on states whose management of budget deficits we considered to be less permanent and less proactive.

What about local governments?

Although our research shows that states in general maintain a credit profile that is somewhat above that of local governments, we believe most municipalities will likely experience less revenue volatility than states despite their more-limited economic bases and more direct experience with home foreclosures. While municipalities may be reliant on property tax revenues, we have seen that declines in this revenue source tend to be less severe than other sources. Also, these local governments have more time to plan for such downturns. We have observed that assessed value declines are generally less severe than sales and income tax declines, and when assessed value declines do occur, property tax rate increases (however unpopular) are still more common than broad-based sales and income tax increases at the state level. Conditions do vary. Our observations show that local governments in the heart of overbuilt areas — particularly in the Sunbelt states — may fare worse than their resident states, and local governments heavily dependent on state-shared revenues will likely share in the state's pain. Local governments in states with less state oversight and state statutes that authorize municipal bankruptcies may carry a higher risk of not addressing problems quickly enough or may be tempted to pursue a Chapter 9 filing instead of pursuing structural reform without a bankruptcy filing. Nevertheless, we expect such instances to be limited.

We hear a lot about rising and deferred pension and OPEB costs. Legacy costs have been a problem for some industries. What about state and local governments?

We expect that many governments will face pressure to make higher mandatory contributions to pension funds to offset the funds' falling values, but, in our view, that won't likely have an immediate impact on state and local credit quality. That's because accounting rules allow them to "smooth" funding following a market decline over several years, rather than absorb the losses in one year. About 88% of public pension plans have a smoothing period of four years or longer, with five years being the most common. Although we expect the fact that many of the first contribution increases will occur just as federal stimulus money is running out, thus creating some pressure, we believe this pressure should be manageable in the near term. In our opinion, governments generally do not need to fully resolve their pension and other postemployment benefit (OPEB) funding issues in the next several years to avoid a crisis. However, we think that not deciding on a solution or delaying the implementation of a solution could significantly compound the problem in five to 10 years as the number of retired baby boomers mushroom.

What is your outlook for 2010 and beyond?

Standard & Poor's expects a subdued recovery in 2010. We believe this weak improvement, combined with additional potential risks and uncertainties, such as another collapse in financial markets or surge in oil prices to \$100 or more a barrel, could dent investor confidence and leave the country vulnerable to another recession. As we have stated, we believe that in the current environment, governments' debt positions, liquidity levels, and pension and OPEB requirements do not pose an immediate threat to

credit quality for most issuers. We believe this is the case even with additional budget gaps, assuming that governments continue to resolve them with prudent actions. However, were governments to consistently rely heavily on debt and other one-time measures in the coming years and ignore pension and OPEB costs (in the hope that future economic growth will bolster their finances sufficiently), we believe this could set the stage for something far more difficult.

In our view, the most likely scenario under which debt, other liabilities, and structural imbalances could lead to material deterioration of credit quality would be one in which governments avoid taking on the hard issues and making the difficult decisions over the next two to four years. At that point, we would expect governments could still function financially and operationally, but they would be more vulnerable to adverse economic conditions to the point where their ability to weather another significant downturn through further adjustments and continued market access could be compromised. In our assessment, such a scenario would most likely also involve a series of consecutive events over a four- to six-year period (encompassing a prolonged weak recovery followed by another significant recession), most of which we view as unlikely. Aside from the fact that this scenario is beyond our outlook horizon, we believe the combined likelihood of such a series of events is not yet sufficient to warrant movement in most governments' ratings. Should we observe both economic conditions and government actions moving in a direction that we believe makes such a scenario more likely, we would then determine that rating changes may be appropriate. Our current expectation, however, is that most governments, at least in part, will take structurally prudent steps, thus lowering the likelihood of such a deterioration scenario.

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