

Outlook

Moody's U.S. Public Finance

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Moody's Assigns Negative Outlook to U.S. Local Government Sector

Challenging Credit and Economic Environment Focuses Credit Review Spotlight on Select Rating Factors

The outlook for US local government ratings is negative. This outlook expresses Moody's expectation for the fundamental credit conditions in the sector over the next 12 to 18 months

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Summary

Moody's has assigned a negative outlook to the U.S. local government tax-backed and related ratings sector. This is the first time we have assigned an outlook to this extremely large and diverse sector. This negative outlook reflects the significant fiscal challenges local governments face as a result of the housing market collapse, dislocations in the financial markets, and a recession that is broader and deeper than any recent downturn.

With the past year's relentless stream of negative economic and financial news, the current economic environment will clearly pose significant challenges for many if not most local governments. Sharply falling property values, contracting consumer spending, job losses, and limited credit availability lead the long list of developments that will make balancing budgets in the coming year particularly difficult. The negative outlook assigned to the U.S. local government sector encapsulates our view of this challenging environment and the strains that will be evident in credit for issuers across the industry.



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This Special Comment outlines the key challenges facing local governments in the current environment and highlights the components our credit analysis that will likely drive rating decisions in the next twelve to eighteen months. These are standard elements of our existing rating methodology that, in light of the particular challenges of the current economic/credit environment, have taken on increased importance. These important considerations include each local government's exposure to:

- Market volatility, particularly the potential liquidity implications of failed remarketings of variable rate debt;
- Industries particularly at risk in the current economic downturn, including, among others, real estate development, auto manufacturing, and financial services;
- Volatile and declining revenue sources, like sales and real estate transfer taxes, that are particularly sensitive to economic fluctuations, and;
- Expenditures that are legally mandated and/or effectively fixed in the near-term.

Individual local governments that stand out as having relatively high exposure in one or more of these areas could be, in the absence of clear credit mitigants, subject to downward rating pressure. The nature of such mitigants will vary according to the particular weakness being considered, but would generally include:

- Above average reserve levels
- Demonstrated willingness and ability of management to make rapid, if not multiple, mid-year budget adjustments; and
- Consistently conservative budget assumptions.

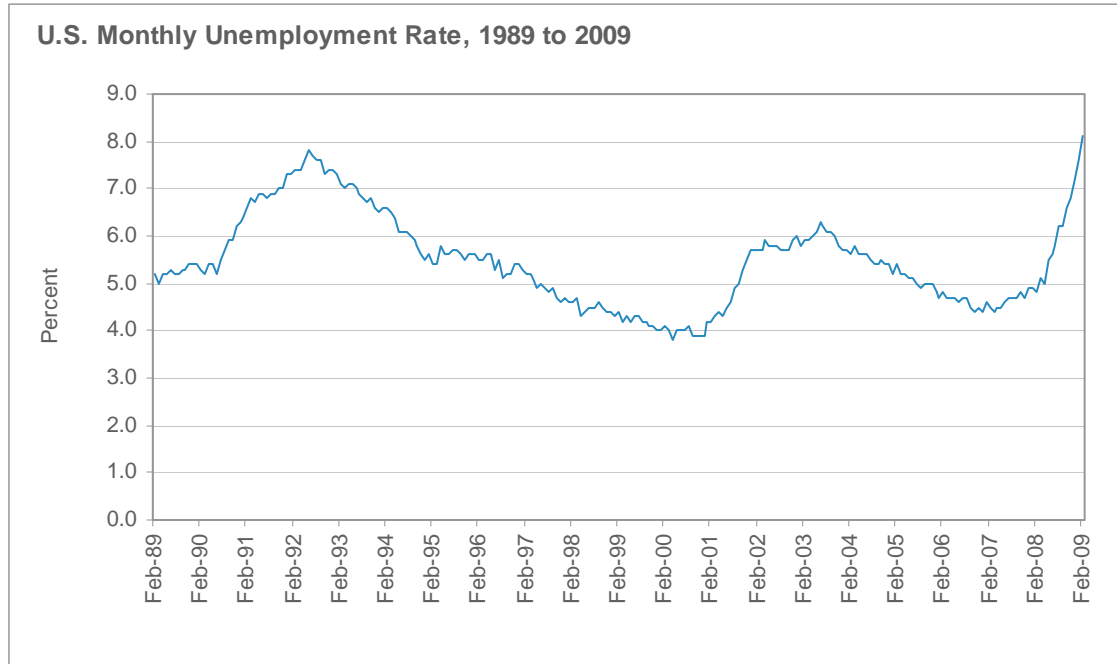
The negative sector outlook does not suggest that the prospects for local government credit ratings are uniformly negative. Its meaning is distinct from our rating outlooks for individual credits, which are predictive of future rating direction for that particular credit. The sector outlook characterizes the prevailing operating environment and the challenges issuers in the local government sector will face in the coming 12-18 months.

Credit pressures faced by local governments and their responses to these pressures will vary significantly across and within states due to uneven economic conditions, differing revenue mixes and service mandates, inconsistent property assessment practices, and different levels of revenue raising authority. The governance strength of individual issuers and the behaviors which demonstrate their willingness and ability to adapt to that environment will determine the overall trend in individual ratings.

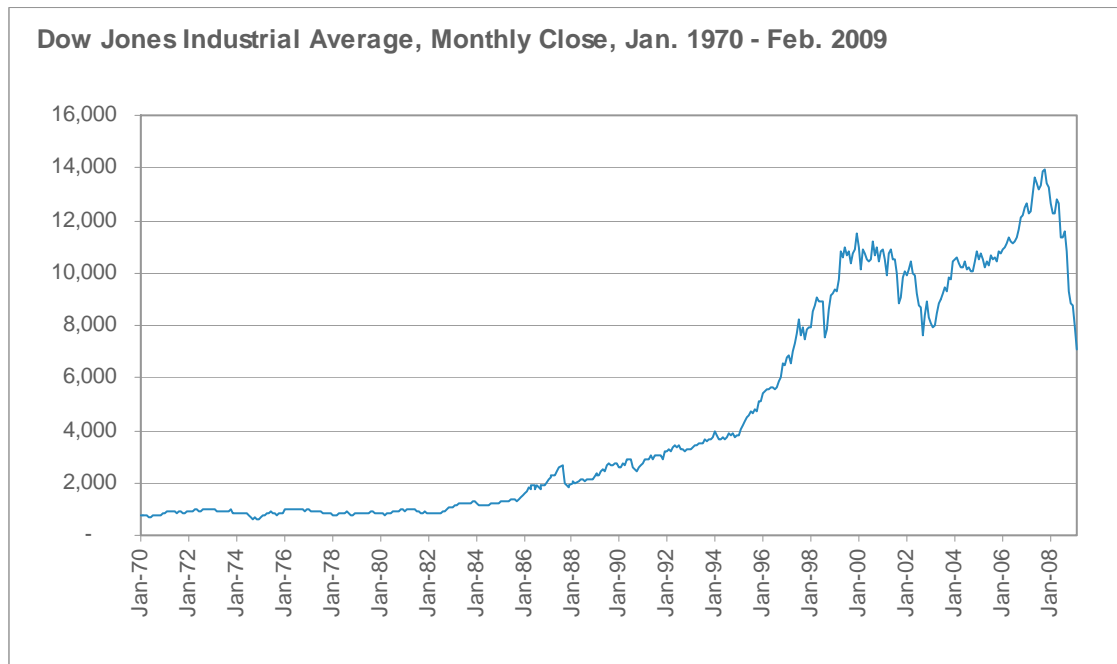
Unprecedented Fiscal Challenges Drive Negative Outlook for Local Government Ratings

The current U.S. recession, which began in December 2007, has already lasted longer than the prior two recessions in 2001 and 1990-91. Unemployment spiked to 8.1% in February 2009, a 3.3 percentage point increase from a year ago and its highest level in 20 years. Some economists report that it may increase to 10% by 2010.

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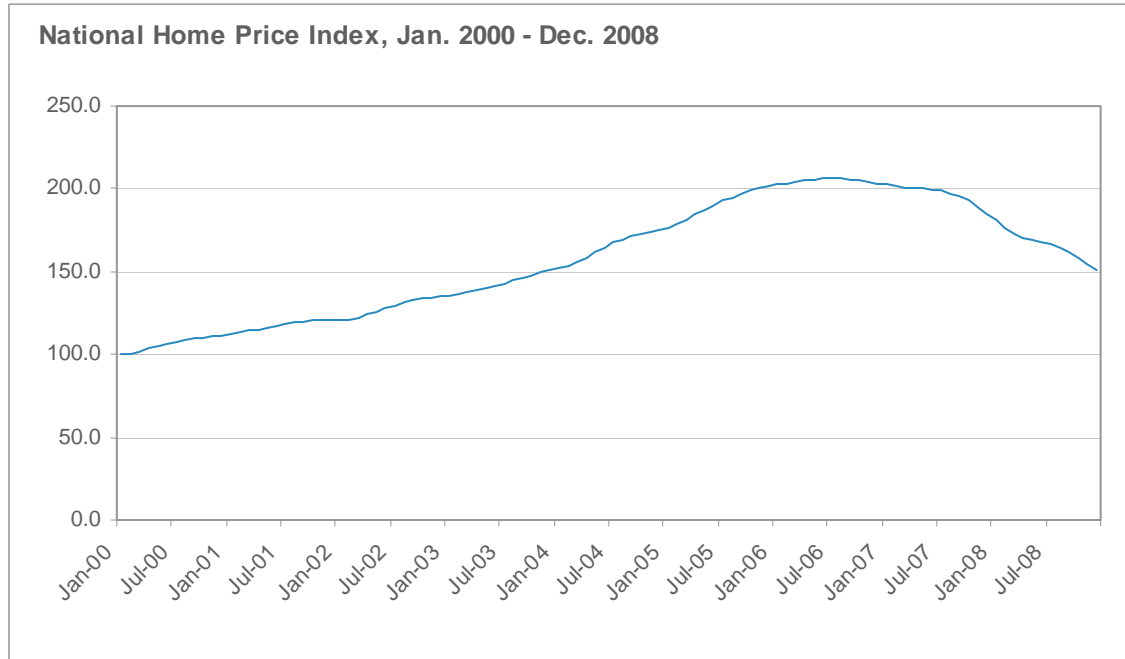
Stock prices are 49% off their peak in October 2007, the worst decline since the Great Depression.



Nationally, home prices have fallen on average 25% from their peak in July 2006¹ and some predict another 20% decline before this recession is over.

¹ Case-Shiller Home Price Index, 20 metro area composite, July 2006 to December 2008.

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In late 2008, credit markets suffered an unprecedented collapse, shutting down access to the capital markets at various times even for the most highly rated issuers. These are challenging times for the economy, if not unprecedented in the post-war era.

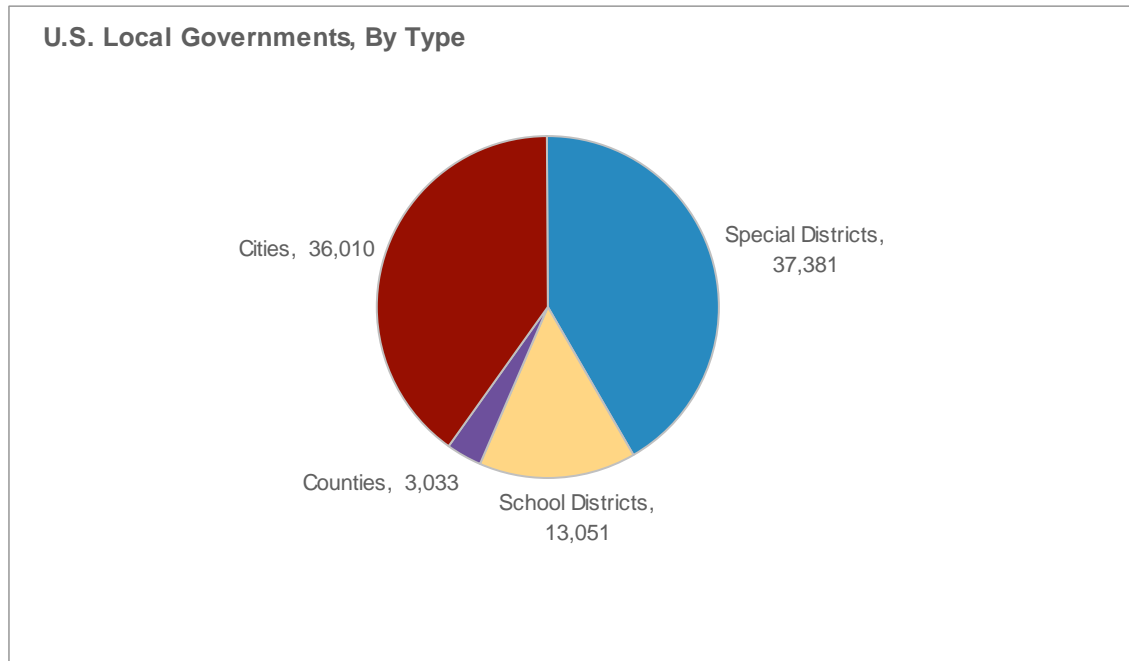
This environment is placing unprecedented pressure on local governments. Declining home values will in many cases translate into lower assessed values and lower property tax collections in the absence of compensating, and potentially significant, tax rate increases. Decreased consumer spending will depress sales tax revenues. Higher unemployment will weaken income tax collections while increasing demand for social service expenditures. Disruptions in the financial markets may result in liquidity problems for local governments with variable rate debt exposure or those that need to access the markets for annual cash flow borrowings. Taxpayers, worried about their own financial condition, are more resistant than ever to increasing property or other local taxes.

The pressures will not affect all local governments equally. The sector is exceedingly diverse in size--about 52,000 cities, counties and school districts²--and scope of service provision, as well as in resources and revenue raising authority, making any generalization challenging.

² These figures exclude special districts, which alone number about 37,000. Special districts include a wide variety of entities dedicated to specific rather than general governmental purposes, including for example, water and sewer districts, flood control districts, library districts, and fire districts. The "city" count is broadly defined to include municipalities, cities, towns, and townships.

Source: U.S. Census Bureau, Census of Governments, 2007.

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Assessment practices in many states, for example, will limit the impact of home price declines on assessed values and property tax revenues. Many municipalities are well managed and will be able to take action needed to counter revenue losses. Many bolstered their reserve positions during the recent expansion, and many even took a cautious approach to the windfall revenues generated from soaring home prices. The use of variable rate debt and the need to access the capital market for cash flow needs are not widespread in the sector.

While fiscal management in this environment will undoubtedly be challenging, our ratings are intended to withstand some level of stress due to normal business cycles and we would not necessarily expect rating changes due to temporary weakening. However, rating actions will be taken when we see a shift in the absolute or relative credit quality among individual local governments, as well as circumstances when a credit outperforms or underperforms its peers at a given rating level.

However, few if any local governments will be entirely immune from the impact of the current environment given the widespread nature of this economic downturn. Even if the only challenge that a particular local government encounters is slowed revenue growth, the inexorable demand for improved governmental services will heighten the challenge of maintaining healthy finances. Credit market access will undoubtedly be more expensive than in recent years, if not denied outright to some potential borrowers. Our assignment of the negative outlook to the entire U.S. local government sector reflects the pervasive nature of these challenges.

This Special Comment describes the fiscal pressures facing local government and highlights specific areas that, in light of this negative outlook, will be of particular focus for our credit analysts in determining ratings over the next twelve to eighteen months. These are standard elements of our existing rating methodology that have taken on increased importance in the current environment. Broadly speaking, they include each local government's exposure to 1) the short-term credit market, 2) particularly at-risk sectors of the economy, 3) economically-sensitive revenues, and 4) fixed/mandated expenditures.

Market Volatility

After the unprecedented collapse of the auction rate and insured-variable rate credit markets in 2008, it became clear that the market access mitigants issuers previously relied on to manage fiscal problems were no longer available in the ways they were before. Conversion of variable rate bonds to a fixed rate and the ability to easily access the capital markets for short term borrowing have been more challenging in the past year. Consequently Moody's analyses had to be adapted to consider the changed environment and the impact on

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local governments' ability to manage certain short-term market challenges. We utilize a robust, quantitative tool to evaluate the impact of volatile interest rates, non-remarketed tenders for variable rate demand obligations and the liquidity challenge of amortizing bonds that are being held by the liquidity bank because they could not be remarketed ("bank bonds"). Explicit measures of interest rate risk, term-out risk, and counterparty risk are defined and compared to similarly rated credits. The counterparty risk analysis includes both liquidity providers and swap counterparties. Various stress scenarios are considered and compared.

To date we have found that most local government's exposure to this market risk has been relatively modest and manageable, with a few exceptions. Most local governments had little or no variable rate risk exposure and only a few had significant risk. Of those with significant risk, only one issuer emerged with insurmountable problems, Jefferson County, Alabama. For the other issuers with significant variable rate exposure, most have been actively restructuring their debt. Typically, they have refunded their variable rate debt with more conventional fixed rate structures. We continue to monitor this risk for all local government issuers. As the market continues to evolve and the credit and liquidity position of issuers change, additional rating actions may be taken. We will monitor continued credit deterioration and consolidation of global financial institutions providing local governments with the financial products related to variable rate debt and assess ratings accordingly. At a minimum, with failed remarketings and bank bond conversions having morphed from largely theoretical risks to very real events, a local government's exposure to the short-term market will be more heavily weighted in our long-term credit analysis than it had been in the past.

Key Ratios & Metrics

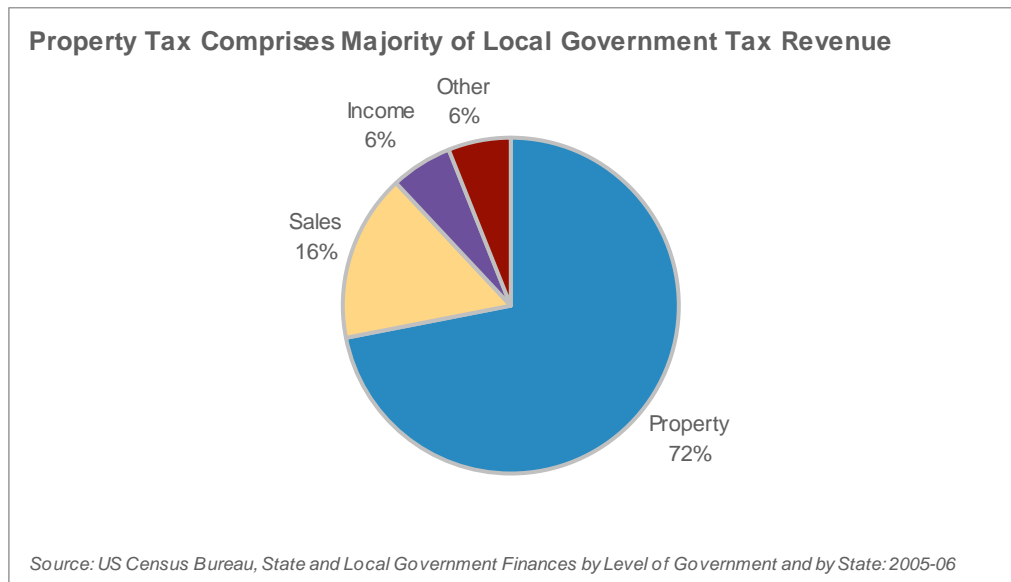
Moody's looks at a number of different ratios to gauge the extent of a local government's exposure to market risk. Two of the most common are: (1) **Variable Rate Debt as a Percentage of Total Debt**, and (2) the **Ratio of Variable Rate Debt to Cash and Other Liquid Resources**. In general, if variable rate debt represents more than 25% of total debt or the amount of variable rate debt exceeds the amount of liquid resources, Moody's will conduct a more detailed analysis of that potential risk. There are no fixed thresholds for these ratios that would automatically lead to a rating downgrade. Instead, each local government's exposure is looked at on a case-by-case basis, since all variable rate debt does not present the same risks. For example, debt with a put option back to an issuer which can turn into bank bonds with an accelerated term-out can pose a greater liquidity risk to a local government than other variable rate debt without a put option or puttable debt not subject to an accelerated term-out. Moody's also considers mitigating factors such as revenue flexibility or a government's demonstrated ability to access the markets when needed.

At-Risk Industries

Significant economic concentration has always been a heavily weighted, negative factor in Moody's local government rating analysis. Conversely, high diversity in employment-base and taxpayers has been a hallmark of local governments' economic strength and is positively reflected in current ratings. While the current economic downturn has been very broad-based, certain industries have suffered significantly more than others. The real estate development slowdown could impact areas with recent high growth levels such as certain areas of Florida and California. Troubles in the auto manufacturing industry may well affect many governments in Michigan, Indiana and Ohio, while the turmoil in the financial services industry is affecting issuers in New York, New Jersey and Connecticut. Tourism, gaming, and manufacturing generally, may also be disproportionately affected by the current downturn. Local governments with above average exposure to these particular industries could well experience significant downward rating pressure in the near-term.

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Volatile and Declining Revenues



Similar to the industry concentration risk discussed above, a local government's revenue concentration in sources that are particularly sensitive to economic fluctuations has always been a carefully considered rating factor. The higher the revenue concentration, the higher the risk. High revenue concentration has often been mitigated by very high reserves or well above average expenditure flexibility. That is the case now, with many local governments having prudently built up reserves in anticipation of the end of the housing boom. The sharpness of the housing downturn and speed of the general economic contraction will likely test the sufficiency of those reserve cushions. The extent to which a local government relies on its accumulated reserves to help balance its current budget may well determine its future, relative credit standing.

The origin of the current downturn in the housing market bubble and its widespread impact on consumer spending has potentially expanded the meaning of "economically-sensitive revenues". Previously independent revenue sources now appear to be moving in tandem with the economy. In the past, the U.S. economy typically experienced recessions without there being a simultaneous decline in property tax revenues. Sales taxes might have declined without a similar drop in, for example, hotel occupancy taxes. Tourism related revenues might have declined, but utility user taxes might have been immune. Now virtually all local government revenues are simultaneously experiencing weakness, if not outright declines compared to last year.

A local government's revenue dependence on a higher level of government--typically the state--is another source of revenue concentration that will likely receive increased scrutiny. Cases of high dependence and significant stress at the higher level of government could lead to near-term local government rating revisions. A number of states currently have negative outlooks. The U.S. state government sector also has a negative outlook, reflecting the serious financial and budgetary pressures that states face. The state and local rating relationship has been built into our existing local government ratings, but the severity of the current downturn and the states' own budget balancing choices may drive individual local government rating outcomes.

Key Ratios & Metrics

The key ratio used to measure both a local government's revenue loss and the extent to which it has offset this loss with expenditure cuts and new revenues is the trend in **General Fund Balance as a Percent of Revenues**. To the extent this ratio significantly declines for a particular local government compared to its peer group--for example, if this ratio for the government was historically greater than 125% of the median for its peer group and it declined to less than 75% of the median--a rating downgrade may result. A government that depletes its fund balance entirely or experiences a fund deficit may be subject to a multiple notch downgrade

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although mitigating factors will also be considered. For example, if a decline in fund balance was due to a recurring structural deficit it is more likely to lead to a rating downgrade than if it was a planned drawdown for one-time purposes. The composition of General Fund Balance is also important—if total Fund Balance declines, but Unreserved and Unreserved, Undesignated Fund Balance remain stable, a downgrade may not be warranted. Moody's will also consider the availability of unrestricted reserves in other funds and a government's plans to rebalance its budget and restore fund balance. For reference, median values for General Fund Balance as a Percent of Revenues are shown in Table 1.

Table 1

	FY 2004	FY 2005	FY 2006	FY 2007
Median Values for General Fund Balance as % of Revenues				
Cities				
Aaa	24.3	29.0	28.6	33.8
Aa	24.8	27.3	28.4	29.8
A	24.0	27.4	28.2	30.6
Baa	22.1	25.9	26.5	24.8
All Cities	26.2	27.1	28.1	29.8
Counties				
Aaa	20.4	23.1	25.0	26.9
Aa	26.7	28.7	29.9	32.7
A	28.7	27.9	30.9	32.2
Baa	18.6	21.8	19.2	20.5
All Counties	26.5	26.8	29.3	31.4
School Districts				
Aaa	15.9	21.6	25.8	30.1
Aa	12.7	12.5	13.9	14.8
A	11.8	11.7	12.6	13.7
Baa	15.2	13.1	16.0	17.1
All School Districts	13.5	12.2	13.6	14.4

Fixed and Legally Mandated Expenditures

With the relative sharpness of the current economic contraction and a significant, lingering uncertainty about the economy's near-term future, local governments with high degrees of expenditure flexibility may well be significantly better positioned to maintain their financial health than previously expected. In an economy of severely strained liquidity, an ability to rapidly reduce expenditures may prove a better indicator of credit quality than the traditional measures of municipal credit risk. A large, diverse economy, high revenue diversity, or, for example, an above average socioeconomic profile—all components of our traditional local government credit analysis—may provide little benefit in a liquidity crisis. Certainly, those governments with greater expenditure flexibility will have an easier time adjusting to a new economic reality. Evaluation of the degree to which a local government's costs are fixed or its service provision legally mandated takes on a greater importance in this environment. Evaluations of what qualifies as a "fixed cost" in the near-term and the extent to which legally mandated service provision may be trimmed without violating state law are also important considerations. Beyond basic public health and public safety services, most municipal service provision is variable, at least to the extent compatible with labor agreements and local political will. State labor laws and employee contracts can vary widely and provide governments with significantly different levels of implicit, near-term expenditure flexibility. In the current environment, this flexibility may be more important than ever.

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Compensating Credits Strengths: Cash, Flexibility, and Foresight

As in the past, the risks highlighted above will be considered in the context of the local government's overall credit profile. Our increased scrutiny of these particular risks will be matched with deeper dives into a government's possible mitigants. In the near-term, local governments may not be able on their own to mitigate the economic threats from concentration in a particularly hard hit industry, but the federal stimulus bill holds some promise of near-term relief. More concrete, traditional mitigants would include: 1) a demonstrated willingness and ability to make mid-year budget adjustments; 2) assiduously conservative budgeting of economically-sensitive revenue sources; and 3) a demonstrated understanding of the detailed terms and conditions of variable rate transactions.

Proactive development of detailed contingency plans would help counter the uncertainties of what-if scenarios, and stepped up monitoring of at-risk revenues and credit exposures would likely lessen the rating impact of related, emergent risks. As always, a healthy reserve position would also serve to mitigate some of the risks identified above. But to the extent we believe relative or absolute credit risk has increased as a result of the recent economic and credit market developments, reserves would also likely have to have been increased to be truly offsetting. While many local governments have added to their reserves in recent years, the near-term trend is highly likely to be negative.

Conclusion

Moody's evaluates each U.S. local government's individual strengths and weaknesses on a case by case basis. Though the outlook for the local government sector is now negative, this individual analysis will continue. The methodology used for these individual reviews also remains the same. But the past year's economic and credit market developments have necessitated emphasis on particular elements of that methodology. While we expect most local governments' ratings will be maintained, the emphasis on the elements discussed above may well result in increased rating revisions for U.S. local governments.

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Moody's Related Research

- Impact of the Credit Crisis and Recession on Local Governments (112225)
- Tighter Municipal Market Leads to Enhanced Review of Bond Anticipation Notes (112389)
- Outlook Remains Negative for U.S. States: Federal Fiscal Stimulus May Moderate Recession's Effects on U.S. States; Impact from Recession Will Not be Equal (114526)
- Credit Implications of U.S. Fiscal Stability Plan and Stimulus Act (114769)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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