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INVESTORS SERVICE

OUTLOOK

Annual Sector Outlook for U.S. Local Governments

2010 Sector Outlook is Negative

Challenging Credit Environment Will Continue

Most Local Governments Will Meet Credit Pressures Through Cost Controls and Downsizing

Table of Contents:

SUMMARY OPINION 1
OVERVIEW 2
LOCAL GOVERNMENTS CONTINUE TO FACE CONSIDERABLE CHALLENGES 5
LOCAL GOVERNMENT STRESS EXACERBATED BY STRUCTURAL FRAMEWORK 8
CONCLUSION 10
MOODY'S RELATED RESEARCH 10

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Summary Opinion

Moody's outlook on the U.S. local government tax-backed sector remains negative. The negative outlook was originally assigned in April 2009, and while there are signs that the U.S. economy has begun to recover, Moody's expects the local government sector to lag the national economic recovery and remain financially challenged through 2010 and into 2011. The effects of the long and deep recession will linger for local governments, as many will continue to face deteriorating revenues and rising expenditure pressures.

Nonetheless, we expect most local governments to meet the challenges of this difficult credit environment and take the necessary budgetary actions to preserve budget balance without significant credit deterioration. Many have already made difficult spending reduction and revenue raising decisions but more will be needed given the prolonged economic weakness of the nation's economy.

The stress on municipal credit grew significantly in 2009 and is expected to continue in the coming year as a result of key challenges facing local governments:

- Stagnancy in economically-sensitive revenues
- Ongoing cuts to state aid
- Potential losses in real estate tax revenues driven by property value declines
- Increased demands for social services

» Growing fixed expenditures

» Continued exposure to variable rate debt and swaps

» Risks of underperforming enterprises impacting general fund balances

Despite these challenges, the fundamental credit strengths of local governments remain intact, and most have taken steps to achieve budgetary balance. Through these actions, we expect the majority of local government issuers to navigate today's challenging environment, demonstrating the resilience that has long characterized the credits of this sector.

Overview

The challenges that U.S. local governments have confronted due to the severe economic recession of the past two years have become more pronounced in the 2009-2010 fiscal year as revenues continued to weaken and credit stress intensified. We expect these challenges to continue through 2010 and into 2011, even as the U.S. economy appears to be moving into a period of modest recovery.

The recovery is projected to be weak, with sluggish employment growth, limited retail activity, and continued instability in the housing market, as well as more pronounced weakness in certain sectors of the economy. The effects of the downturn on local governments have lagged the rest of the economy and the slow recovery is expected to cause persistent pressure on financial operations for many issuers, as diminished economic activity and the real estate correction continues to filter through to the major local sources of municipal revenues, namely taxes. Additionally, certain states will continue to reduce their aid to localities in order to manage their own financial difficulties. Increases in social service needs and growth in annual pension and health care funding, in addition to already-high demand for basic municipal services, will compound the operating pressure on local governments.

To manage these challenges, we expect that most local governments will use the various financial tools available to them. Many local governments have either unlimited property taxing power or room under their property tax limits to make up for losses in taxable value or other revenue sources. Local governments may also have reserves built up over the boom years that will assist in filling budget gaps while phasing in revenue increases or expenditure reductions to achieve structurally balanced operations. Local governments can often implement or raise non-tax fees to enhance revenues.

Expenditure-side adjustments are also crucial to a local government's ability to manage financial operations, although the amount of fixed costs, such as debt service and pension contributions, can limit spending flexibility. Many local governments have cut or deferred certain discretionary spending, such as pay-go capital outlays, in order to maintain balanced operations, while others have furloughed employees or had layoffs to meet significant reductions in revenues.

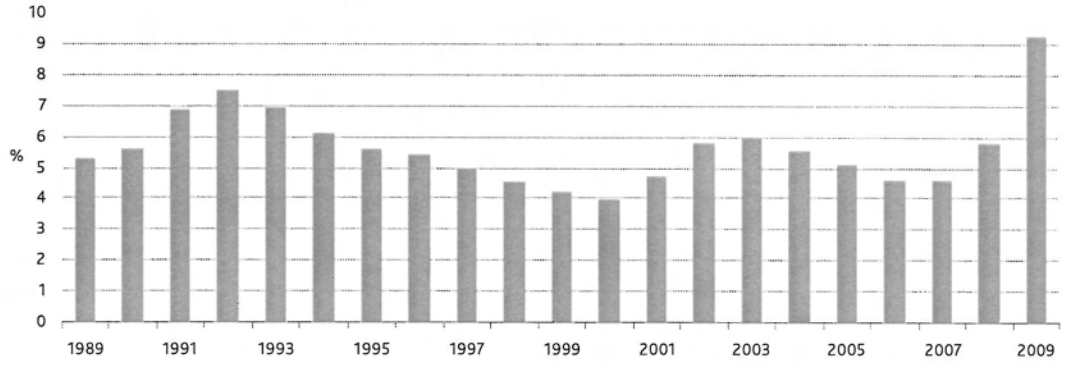
Although many local governments have reserves that will help them effectively bridge this period of financial stress, given the projected weakness of the recovery, revenues are unlikely to return to pre-recession levels for several years. Therefore, those issuers that do not maintain balanced operations and continue to depend on reserves for current expenditures will face significantly reduced financial flexibility as those reserves are depleted. While we anticipate that local governments will remain stressed over the forecast period, and expect to see continued rating downgrades, rating changes will likely be contained to less than 10% of the overall portfolio. Furthermore, we expect very few defaults in this sector given the tools that local governments have at their disposal.

Recession May be Ending but Weak Recovery Ahead

Moody's expects a sluggish recovery to be the most likely global macroeconomic scenario. We believe that the global economy is not going to rebound strongly in 2010 and 2011, but rather return to trend growth rates with persistent unemployment, in line with the "hook"-shaped recovery scenario which Moody's introduced in May 2009. Annual unemployment for 2009 was higher than it had been at any time over the past 20 years by almost 2 percentage points, and while the rate of job loss may have slowed, unemployment is expected to peak at 10.5% in 2010 before declining to 9.6% in 2011 (see Figure 1). The two maps in Figure 2 highlight the rapidity with which joblessness spread across the country. The Federal fiscal stimulus appears to have contributed positively to GDP growth in the latter half of 2009 and according to Moody's Economy.com, the pace of job losses has slowed considerably. The number of people currently receiving unemployment insurance benefits remains exceptionally high, however, and does not appear to be moderating, suggesting that meaningful job creation has yet to materialize. Hiring and job creation will be necessary for a return to economic expansion and will directly affect local government income and sales tax revenues, as well as indirectly affect local aid from the states. For more information on Moody's macroeconomic outlook, please see Moody's Global Financial Risk Perspectives, "Global Macro-Risk Scenarios 2010-2011 on the "Hook" for Some Time Yet," January 2010.

FIGURE 1

U.S. Annual Unemployment Rate, 1999-2009

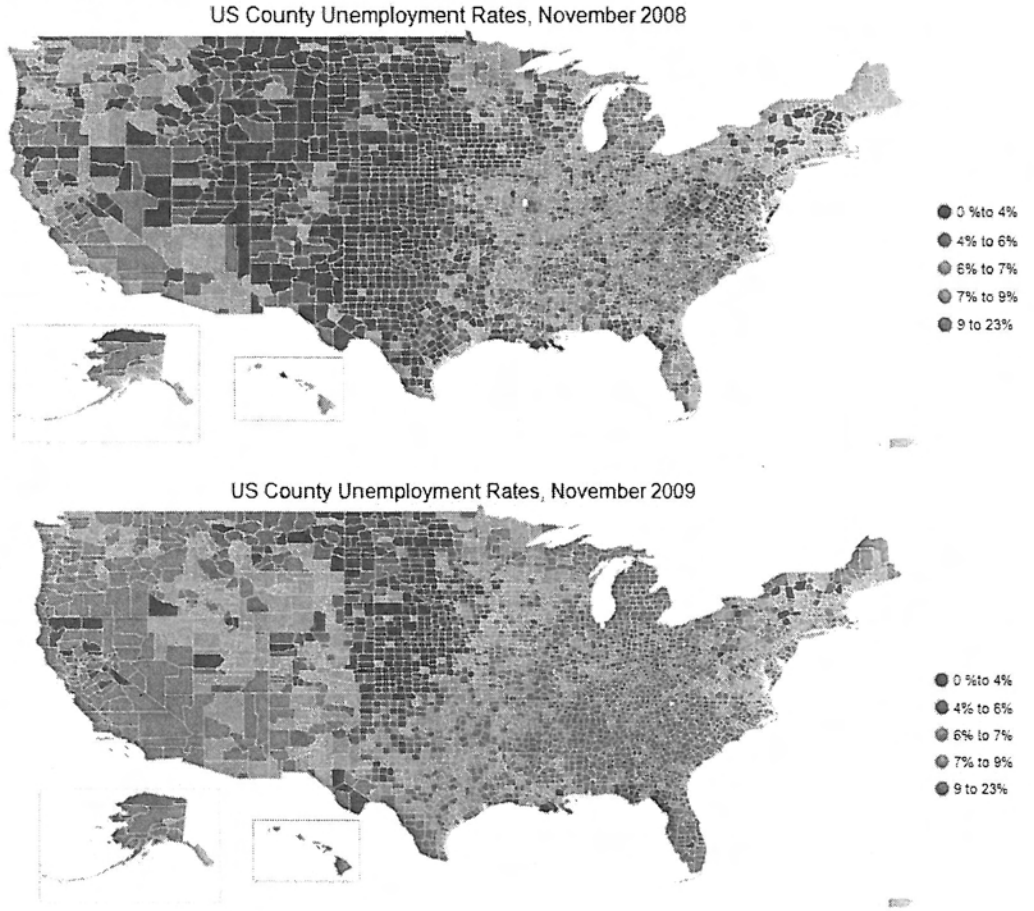


Source: Bureau of Labor Statistics

Certain sectors are expected to rebound more slowly than others and concentration of those industries within a region will create a drag on recovery for some local governments. Moody's Economy.com (a sister company of Moody's Investors Service) projects the financial services sector to be a particularly poor performer in 2010, which could result in sluggish economic activity in the New York City Metro Area, but also in other areas that are regional financial centers, such as Philadelphia, San Francisco, and Atlanta.

FIGURE 2

U.S. County Unemployment Rates November 2008 and November 2009



Source: Bureau of Labor Statistics

Manufacturing is also expected to be a low-performing sector over the next year. Economic recovery in states such as Michigan, whose economy has a concentration in the U.S. automobile industry, will continue to lag due to limited expansion opportunities in the employment base. While homebuilding is expected to improve in 2010, foreclosure activity will continue to weigh down economic and taxable growth in states such as Florida, California, Arizona and Nevada, which benefited strongly from the housing boom.

Favorably, some regional economies have been more stable through the recession and are expected to emerge better-positioned to capitalize on growth when it returns. For example, while the Central Plains States, including North and South Dakota, Iowa and Nebraska, have experienced increased unemployment, rates remain considerably below national levels. These states have not endured as pronounced a downturn in the housing market as most of the country, as they did not experience the growth that other states did during the housing boom. The Central Plain State economies have been further stabilized by continued strength in prices for commodities, such as corn and soybeans, as well as pre-recession expansion in oil production supported by high prices.

Moody's also expects the Washington, D.C. metropolitan area to emerge from the recession well-positioned to capture growth given the employment base provided by the U.S. government, the expansion of Federal spending, and gains from the U.S. military's Base Relocation and Closure (BRAC) process. Similar to these examples, local economies with diversified tax bases, stable housing markets, and strong institutional presence will recover from the recession more rapidly than others.

Local Governments Continue to Face Considerable Challenges

Given the likely weakness of the economic recovery, the pressure of the recession on local governments is expected to intensify and continue through at least 2010 forcing them to continue to make difficult choices about revenue raising and expenditure cutting to balance their budgets. The recessionary effects on financial operations of these issuers tend to lag the overall economy and the severity of this recession suggests that the most challenging period may lie ahead.

Stagnancy Expected in Economically-Sensitive Revenues

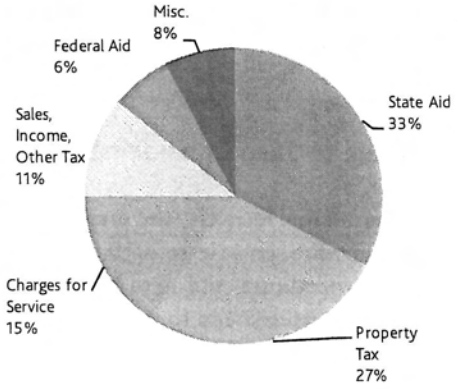
As economic activity slowed in late 2007 and 2008, state and local governments began to see revenue declines from personal and corporate income taxes as well as sales taxes. While Figure 3 shows that these taxes comprise a relatively modest 11% of revenues in the aggregate, local governments in certain states are more dependent on these revenues, sometimes representing as much as one-half of their total revenues. For local governments in states such as Alabama, Ohio, and Kansas, 10-15% declines in these taxes have put a real strain on their budgets as these are their primary revenue streams. Even as the recession is easing, a return to growth will be slow given weak employment growth and subsequent stagnancy in retail activity. Moody's expects that those local governments with a reliance on economically-sensitive revenues will continue to be challenged to balance their budgets.

Declines in State Aid

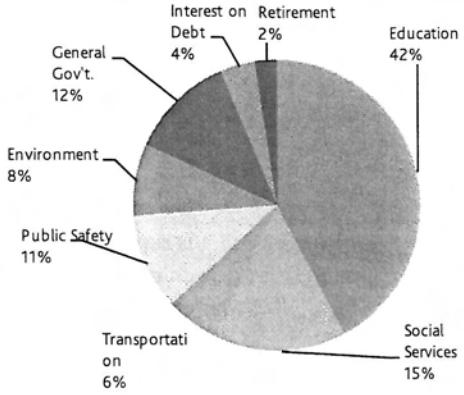
Although state budgets are typically more heavily dependent on economically-sensitive revenues (including capital gains taxes, which fell considerably due to the sharp fall in housing prices and stock market value) than local governments, many states were able to hold aid at least flat in 2008 by cutting other expenses or using rainy day funds and other resources to bridge the revenue loss. As Figure 3 demonstrates, close to 60% of local government revenues are comprised of state aid and property taxes. As state revenues became more stressed in mid-fiscal 2009, some states began to make cuts to localities, although these were mitigated by Federal stimulus funds which alleviated some state budget stress and were only paid to states that maintained certain levels of educational and Medicaid support. As sales and income tax revenues are not likely to experience a meaningful rebound in the next year, state spending growth will be sharply curtailed. In addition, the current Federal stimulus program is scheduled to terminate at the end of calendar year 2010 and it is not clear at this time whether it will be extended. Many local governments are bracing for state aid cuts for fiscal 2011, the magnitude of which will vary across the various states.

FIGURE 3

Local Government Revenues by Type



Local Government Expenditures by Type



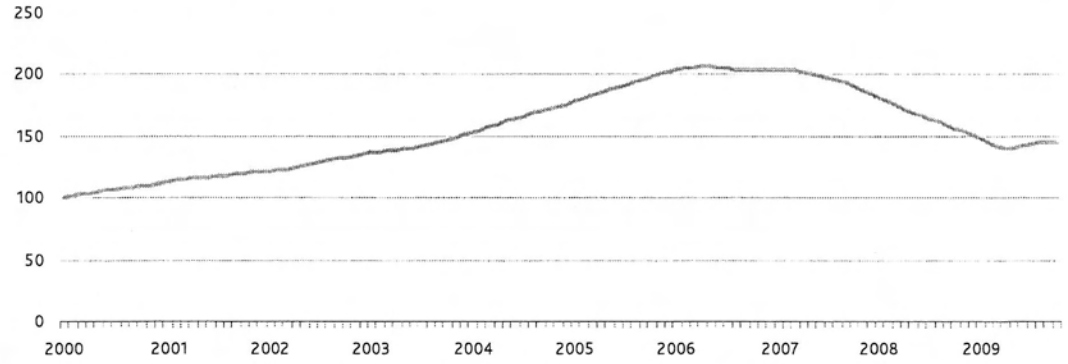
Source: US Census Bureau, State and Local Government Finances by Level of Government and by State, 2006-07

Impact of Home Value Declines Expected to Affect Property Tax Receipts in 2010

Property tax revenue is also beginning to fall for some municipalities as real estate market declines begin to filter through to taxable values. There is generally a delay of at least one year or more in the realization of changes in the market value of real estate as property values for tax purposes are assessed at varying intervals. In addition, some states, including Maryland, Connecticut and Nevada, permit or require local governments to phase in the effects of tax base reassessments over several years, allowing localities to "bank" growth during the real estate boom and therefore softening the near-term effects of rapid market value declines. Thus the effects of the real estate slump on property tax revenues was delayed, but declines in these revenues began in some areas in 2009 and we expect they will continue to decline in 2010. While many local governments are not expected to face drastic drops in taxable value, some will have to manage with unprecedented declines in what had been a stable revenue source for decades. Some that have the legal capacity may elect to increase property tax rates to maintain the overall tax levy.

FIGURE 4

S&P/Case Shiller Home Price Index: 20 Metro Composite



Source: Standard and Poor's and Fiserv, Inc.

Increased Demands for Social Services

At the same time that local government revenues are strained, expenditure pressures will further stretch municipal managers' abilities to maintain financial stability. Demand for social services is expected to increase as unemployment benefits expire and company-provided health insurance is lost. As the private sector has shed significant jobs, a growing portion of the unemployed will largely turn to the public and non-profit sector for safety net services such as health care, housing, and workforce training. Many of these costs are covered by federal and state programs, but as those budgets are strained, counties and cities may be required to deliver some of these services.

Fixed Expenditures Continue to Grow

Figure 3 underscores a growing pressure that local governments face in 2010 and beyond, namely growth in expenses related to pension funding. The Local Government Expenditure chart data is from the fiscal 2006-2007 year, which ended for most local governments on June 30, 2007, when the Dow Jones Industrial Average was close to 14,000. During this period, many municipal pension systems reduced their annual contributions due to the significant growth in investment income over the previous several years. Since then, significant losses in pension fund portfolios are being recognized gradually, a result of multi-year smoothing, and going forward, pension contributions will grow as a percentage of total spending, eroding the ability to fund other expenditure areas and adding to the financial pressure.

Figure 3 also illustrates that the largest share of overall local government spending is for education, an area of particular significance to the public and a service that is generally mandated in state constitutions. Reductions in local education spending in the face of public demand (or statutory obligations) for class-size reduction, Federally-mandated achievement requirements, and pressure from collective bargaining units will remain a challenge for local government financial managers, even as they face cuts in state aid for education.

A significant number of local governments depend on reserves to make up for the rapid loss in revenue while phasing in expenditure cuts or other enhancements to revenue. A prudent use of reserves to mitigate the financial stress will not necessarily erode credit quality if the goal is to use the funds as a temporary measure followed by a return to structural balance and replenishment of reserves. Some local governments, however, have tapped their reserves without making adjustments to their budgets, leaving operating deficits that will carry over into subsequent years. As revenues continue to fall, which is expected through the 2010-11 fiscal year for many local governments, these gaps will become more difficult to close. Add in the additional expenditure pressure discussed above and the challenges grow more pronounced for many localities, especially those that have little or no revenue-raising flexibility or where expenditure-reduction scenarios will be politically difficult and may affect the provision of essential services.

Exposure to Variable Rate Debt Has Improved: Challenges Remain for Some

Many local governments confront the risk of significant exposure to variable rate debt and interest rate swaps. Local governments greatly expanded their use of these tools over the past decade, particularly in states such as Pennsylvania, California and Tennessee where there has been active use of variable rate debt and swaps, even among small local governments. Although many local governments have now fixed interest rates in their debt portfolios and terminated swap contracts (often with significant termination payments), many continue to have considerable variable rate debt and swaps outstanding.

These local governments continue to face interest rate, counterparty and liquidity risk, and they risk significant expenditure pressures due to a swap termination or accelerated repayment of bank bonds.

Enterprise Risk Can Limit the Pace of Recovery

Local governments face additional challenges to financial stability when operating a hospital, nursing home, waste-to-energy plant, or other enterprise that was intended to be mostly self-supporting but has weakened due to economic pressures. While public enterprises that provide essential services, such as water, sewer and electric systems are expected to remain stable overall, the risk related to other government-supported enterprises can result in recourse to a local government's general revenues for the enterprise's operating and debt-related costs.

Underperformance of these operating enterprises resulting in support from the general fund could be absorbed by certain local governments in better financial times. In this challenged economic environment, however, the general financial operations may not be strong enough to continue to support such enterprises, putting strain on the local government. The inability to insulate operating funds from the financial pressure imposed by government-owned enterprises during the economic recovery is a potential challenge to the credit quality of some local governments.

Most local governments have been able to protect general government operating funds from the potential financial pressure of their enterprises by maintaining mostly self-supporting operations. Many local governments do, however, subsidize the financial operations or debt service payments of transit systems, county nursing homes and hospitals, convention centers, solid waste systems, and other enterprises. In many cases, payment of the enterprise debt will be guaranteed by the local government, often with the government's general obligation pledge. If these subsidies escalate, or if the enterprise's operating revenues securing the debt become insufficient to cover debt service, local governments may find themselves with significant expenditure pressure that can be exacerbated in times of economic stress.

While most government-owned or guaranteed enterprise systems will not result in such severe credit deterioration for their parent governments, some governments are exposed to at least moderate risk of struggling enterprises at a time when general government operations are being rigorously tested. Recent examples of this risk include Strafford County (NH), the City of Menasha (WI), and the City of Harrisburg (PA) where a failing enterprise resulted in financial disruption to the general government and severely weakened credit quality.

Local Government Stress Exacerbated by Structural Framework

While U.S. local governments will continue to face a challenging financial environment this coming year, the structural framework in which a municipality operates can further contribute to budgetary strain, beyond economic concerns such as tax base size, growth and diversity. Many states have cut aid to local governments, but the magnitude of those cuts has varied widely and we expect that certain states will continue to make cuts more deeply than others. Many local governments are dependent on economically-sensitive revenues such as sales and income taxes, which, as discussed earlier, are not expected to grow significantly over the next year. In addition, many states impose limits on local property tax increases, capping annual growth in the millage rate, total levy amount, or tax base valuation.

Even in states without local government revenue limitations, there is often political resistance to local tax increases, especially in times of economic uncertainty. Local governments in these states, however, still have the legal ability to raise local revenues, and many will do so to avoid cutting essential services, depending on the political environment in which they operate. There are several states that also impose restrictions on the amount municipalities, especially school districts, can hold in reserves, resulting in limited resources that could supplement revenues during times of stress. Many of these local governments, as well as those that are not restricted but have had lower reserve levels, entered the recession with diminished financial flexibility and will continue to face these challenges without a cushion to help them achieve structural balance.

FIGURE 5

Median General Fund Balance Levels FY04-08

	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Cities					
Aaa	24.3	29.0	28.6	33.8	30.2
Aa	24.8	27.3	28.4	29.8	29.0
A	24.0	27.4	28.2	30.6	30.3
Baa	22.1	25.9	26.5	24.8	22.8
All Cities	**26.2**	**27.1**	**28.1**	**29.8**	**28.8**
Counties					
Aaa	20.4	23.1	25.0	26.9	27.0
Aa	26.7	28.7	29.9	32.7	30.7
A	28.7	27.9	30.9	32.2	30.5
Baa	18.6	21.8	19.2	20.5	23.2
All Counties	**26.5**	**26.8**	**29.3**	**31.4**	**29.8**
School Districts					
Aaa	15.9	21.6	25.8	30.1	28.4
Aa	12.7	12.5	13.9	14.8	15.9
A	11.8	11.7	12.6	13.7	14.3
Baa	15.2	13.1	16.0	17.1	17.4
All School Districts	**13.5**	**12.2**	**13.6**	**14.4**	**15.1**

As Figure 5 demonstrates, median values for General Fund balance as a percent of revenues fell for U.S. cities and counties in fiscal 2008 for the first time in several years. Median values for school districts grew, because most states had yet to cut school funding and property tax revenue remained level. We expect these fund balance levels will fall further in fiscal 2009 and 2010 as the full effects of the recession compel local governments to utilize reserves to balance their budgets. How far these medians will fall is difficult to forecast, but it is clear that many, if not most, local governments will draw on their reserves, resulting in tightened liquidity and financial flexibility.

Conclusion

Over the past two years, most local governments faced economic and financial challenges not experienced in decades. While the economy may be on the road to a weak and sluggish recovery, local governments will continue to experience revenue and expenditure stress over the next 12 to 18 months before relief is in sight. Many local governments will face serious challenges during this difficult period and they will be forced to make difficult choices related to revenues and expenditures to address budget imbalance. We do expect that most issuers will make those hard decisions and the sector will continue to exhibit the resilience that has long characterized local government credit.

Moody's Related Research

Rating Methodology

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Special Comments

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» Greater Washington Region Expected to Weather Recession Better Than Nation, November 2009 (121088)

» U.S. Municipal Bond Defaults and Recoveries, 1970-2009, February 2010 (122579)

Outlooks

» Annual Sector Outlook for U.S. States, February 2010 (123172)

» US State and Local Governments Remain Resilient Despite Growing Pressures, February 2010 (123154)

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