MOODY'S
INVESTORS SERVICE

SPECIAL COMMENT

U.S. State and Local Governments Remain Inherently Resilient, Despite Growing Pressures

Fundamental Credit Strengths Remain Intact; Severe Stress Expected to be Selective and Idiosyncratic

Table of Contents:

EXECUTIVE SUMMARY 1
U.S. STATES ARE INHERENTLY RESILIENT CREDITS 3
SIGNIFICANT GAPS IN STATE BUDGETS FOR 2010 AND 2011 4
HOW WILL STATES ADDRESS BUDGET GAPS? 5
A ROAD TO RECOVERY FOR STATES WILL INCLUDE MIX OF RECURRING AND NON RECURRING SOLUTIONS 7
LOCAL GOVERNMENT REVENUES LESS VOLATILE THAN STATE REVENUES 8
LOCAL GOVERNMENTS FACE LESS BUDGETARY FLEXIBILITY, CONTINUED TAX REVENUE DECLINES 9
MANAGEMENT RESPONSES WILL DRIVE LOCAL GOVERNMENT CREDIT QUALITY 11
DESPITE GROWING PRESSURES, VERY FEW LOCAL GOVERNMENTS RATED IN SPECULATIVE GRADE 12
MUNICIPAL BANKRUPTCIES EXPECTED TO BE RARE; DEFAULTS MAY INCREASE 13
CONCLUSION 14
MOODY'S RELATED RESEARCH 14

Analyst Contacts:

NEW YORK 1.212.553.1653

Anne Van Praagh 212.553.3744
Group Credit Officer – U.S. Public Finance
Anne.VanPraagh@moodys.com

Bart Oosterveld 212.553.7914
Team Managing Director
Bart.Oosterveld@moodys.com

Edith Behr 212.553.0566
Vice President-Senior Credit Officer
Edith.Behr@moodys.com

Geordie Thompson 212.553.0321
Vice President-Senior Analyst
Geordie.Thompson@moodys.com

Gail Sussman 212.553.0819
Group Managing Director
Gail.Sussman@moodys.com

» contacts continued on the last page

Executive Summary

While there are signs that the U.S. economy has begun to recover, Moody's expects the state and local government sectors will lag the national economic recovery and remain financially challenged through 2010 and into 2011. The effects of the long and deep national recession will linger for state and local governments as many will continue to face credit pressures due to deteriorating revenues, increasing spending pressures and weakened balance sheets. Most state and local governments have begun responding to the weaker economy and reduced revenue by cutting spending and adjusting to the changed fiscal reality. This report provides an overview of the size and scope of U.S. state and local budget gaps and presents our views on how state and local governments are positioned to respond to credit stress.

» Sector's Overall Credit Strength Will Remain Intact. The credit profile of the U.S. state and local government sectors is very strong, and we fully expect that, under our baseline scenario for the macroeconomy, the vast majority of municipal governments will make timely debt service payments, consistent with the remarkably low default experience seen in this sector over the last sixty years. We expect the majority of state and local governments will remain pressured over the next 12-18 months, but will manage through with minor credit impact. We anticipate severe credit stress to be selective and idiosyncratic. We anticipate that downgrades will continue to outpace upgrades in the public finance market in 2010.

» Defaults Expected To Be Rare, But Could Be Higher than Historical Norm. While we expect that local government defaults and bankruptcies in the Moody's-rated universe will continue to be very rare, we also believe it is possible that there could be an increase in defaults in the future. In our opinion, it is extremely unlikely that there will be a cultural shift in the market towards increased use of Chapter 9 bankruptcies or a wholesale erosion of investor appetite sufficient to threaten liquidity to this market.

» Sizing the State Budget Gap. Lagging recovery in volatile income and sales tax revenues has caused a significant gap in U.S. state budgets for the current 2010 fiscal year, as well as the projected 2011 fiscal year budgets. In the aggregate, our estimate based on published reports of the shortfall for 2010 and 2011 stands at close to $200 billion, or 15% of all combined state budgets.

» Fiscal Management Tools of the States. States enjoy significant budgetary flexibility and have a wide range of policy tools to address budget shortfalls. All but one state has some sort of balanced budget requirement, and in most states, the governor is required to submit a balanced budget. In the aggregate, we anticipate states will rely first on direct spending cuts to mitigate budget shortfalls, but some will also pursue tax and revenue increases, one-shots, and reserve drawdowns.

» Local Governments Supported by Less Volatile Revenues. Lower levels of U.S. municipal government—counties, cities/towns, school districts—provide a few basic services and rely on less volatile property taxes revenues. These inherent credit strengths counterbalance their lack of deep balance sheets and limited access to broad-based taxes and other revenues. They also have less budgetary flexibility than states because their basic services, such as police, fire and education, are not as easily cut. In addition, states can sometimes shift part of their budget gaps to lower levels of government by cutting intergovernmental funding or mandating local funding of program obligations.

» Local Governments Nevertheless Face New and Difficult Financial Decisions. We anticipate that property taxes, which account for 72% of local government tax revenues on average, will remain less volatile than sales and income taxes that are so critical for state governments. However, property tax revenue will likely decline in some jurisdictions for the first time in decades as reduced tax assessments and lower revenues catch up with declining property values. While the decline will be modest in most cases, we anticipate a number of local governments will face significant budgetary pressures in the current and coming fiscal years.

» Credit Stress Is Already Evident

- In our sector outlooks: Moody's annual sector outlooks for U.S. state and local governments were negative for 2009 and remain negative for 2010.
- In our rating actions: The ratio of U.S. municipal upgrades-to-downgrades weakened considerably in 2009, resulting in the lowest annual and quarterly ratio of municipal upgrades-to-downgrades in over 20 years. On an annual basis, the ratio declined in 2009 to 0.7-to-1 from 2.4-to1 in 2008, reflecting pressure on all major municipal sectors, including state and local governments, health care, higher education, housing, and airports.
- In select bankruptcy filings: In 2009 two Moody's rated local government issuers filed for bankruptcy or defaulted on their general obligation bonds. This continues the trend of very limited municipal default experience over the period 1970-2009.

» Outlooks Assume Modest Economy Recovery. Our sector outlooks for U.S. states and local governments are predicated on our base-line forecast for the U.S. economy, which calls for a durable economic recovery, albeit at a modest pace. 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. If the economy deviates adversely from this baseline and experiences a relapse into recession, the level of public sector distress will be considerably greater than that contemplated in our current state and local government sector outlooks and our current rating levels.

U.S. States Are Inherently Resilient Credits

U.S. state net-tax supported debt equaled $417 billion at the end of 2008, or 14% of nominal par outstanding in the public finance market. The states are inherently resilient from a credit perspective, and for a variety of reasons we do not expect that states will default on general obligation debt, even under the most stressed economic conditions. Most states are required to begin each fiscal year with a balanced budget, which does not guarantee that large deficits will not develop during a year and does not forbid use of temporary "one-shot" solutions. But the balanced budget requirement does tend to prevent a systemic accumulation of multi-year deficits and eventually forces states to confront the need for revenue or spending solutions. Many states have an established constitutional or statutory prioritization for payment of general obligation debt service. States also benefit from broad powers similar to sovereign credits, particularly those united in a monetary union. In general, states:

» Cannot file for bankruptcy or be filed against;

» Provide essential government services (public health and safety, education), although they delegate some of these to lower levels of government;

» Have largely unconstrained powers to raise taxes and to determine spending and benefit levels;

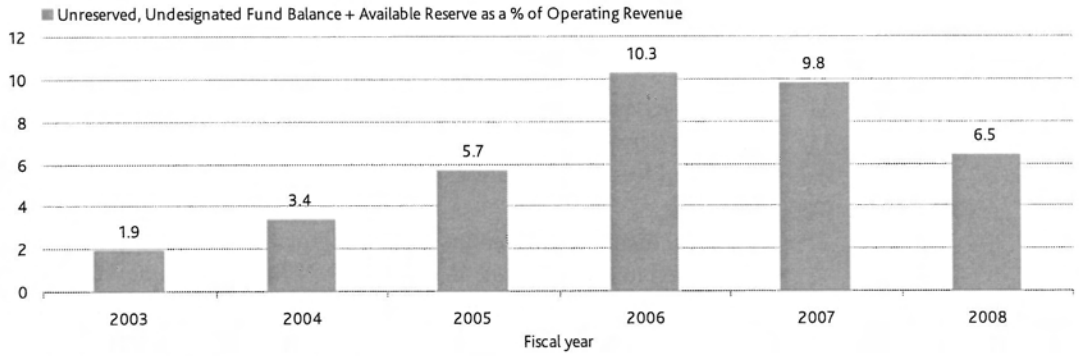
» Can push problems down on local governments; and

» Can create lower levels of government and empower them to tax.

Heading into the recession, states also had several strengths that have helped to mitigate the impact of the recession on their credit ratings. States had record reserve levels heading into the recession, and many states used all or a portion of their reserves and "rainy day funds" to help balance their budgets in fiscal 2009 and 2010. States also had access to a large infusion of federal stimulus dollars that were deployed in fiscal 2009 and 2010 to help offset Medicaid and other expenses. However, many states have utilized much of these reserves, as would be expected in this stressed economic environment.

FIGURE 1

States Headed into the Recession with Healthy Reserves



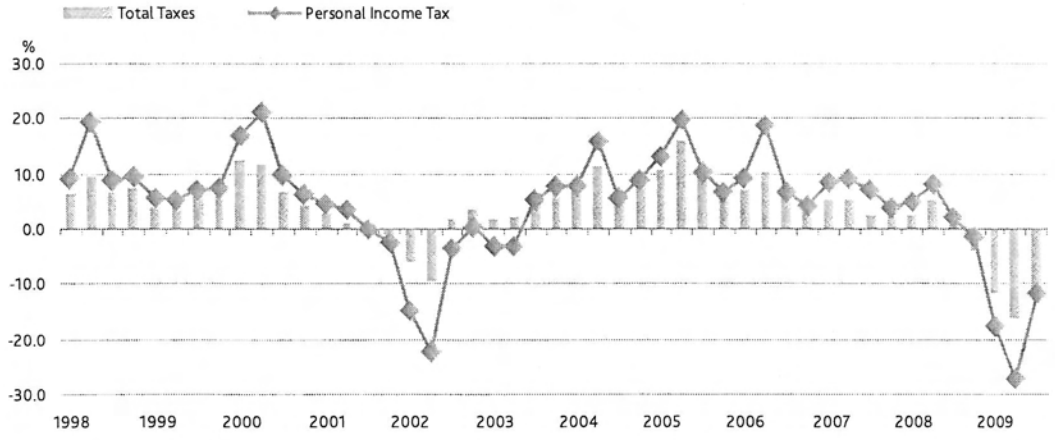
Source: Moody's Municipal Financial Ratio Analysis

Significant Gaps in State Budgets for 2010 and 2011

As has been noted in our sector outlooks and other research publications, U.S. states continue to experience severe financial stress as the recession has negatively affected revenues and states remain pressured to increase spending for social services and other critical programs. Unlike past recessions, this downturn is broad-based and deep and the recovery path remains uncertain. According to the National Conference of State Legislatures, states solved a cumulative $100 billion budget gap in fiscal year 2009 and have already addressed $145 billion of budget gaps in fiscal year 2010. States will face further gaps in state budgets for the remainder of the current (2010) fiscal year as well as for the 2011 fiscal year. In the aggregate, the shortfall stands at close to $200 billion for the two years, representing 15% of estimated state general fund operating budgets. It is worth noting that the budgetary problems are not distributed evenly. More than half of the states do not report a budget gap in the current fiscal year, either because a) they addressed a gap that emerged in the first half of the year, b) they have not formally updated their view since the formal budget adoption at the beginning of the fiscal year, or c) their revenues are performing close to projected levels.

FIGURE 2

Year-Over-Year Quarterly Percentage Change in State Tax Collections



Source: Rockefeller Institute of Government

In the aggregate, more than two-thirds of the revenues for U.S. states come from two main sources of income: personal income taxes (40%) and sales taxes (33%), with the balance accounted for by other taxes and fees. Both sources of revenues have declined sharply in the current downturn:

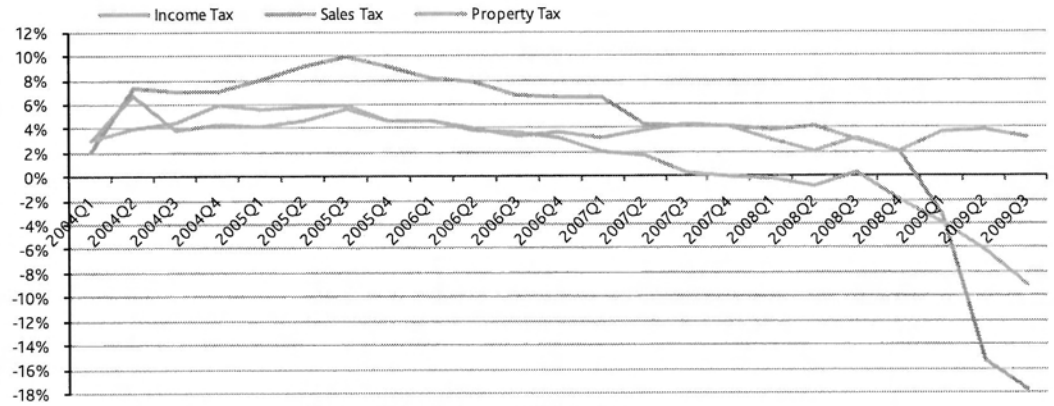
Personal income tax revenues started a dramatic decline early in 2008 and dropped by more than 25% compared to the prior year in early 2009. While the declines have slowed, we anticipate that the highly progressive tax systems in many states will prevent a full recovery for some time to come.

Sales taxes, which by definition vary with GDP, similarly started to decline early in 2008 and fell by up to 10% during certain quarters in 2009, exceeding the drop in GDP due to the reduction in real estate upon which consumers had tapped home equity to fund purchases. This revenue is the most directly sensitive to the overall economic environment and we anticipate that the end of the recession will trigger a rebound in these taxes in the aggregate later in 2010, although the benefits will be unevenly distributed.

FIGURE 3

Both Income Tax and Sales Tax Declined Sharply

Year-Over-Year Percent Real Change in Major Taxes
Four-Quarter Average of Percent Change



Source: U.S. Census Bureau (tax revenue) and Bureau of Economic Analysis (GOP price index).
Notes: (1) 4-quarter average of percent change in real tax revenue; (2) No adjustments for legislative changes.

How Will States Address Budget Gaps?

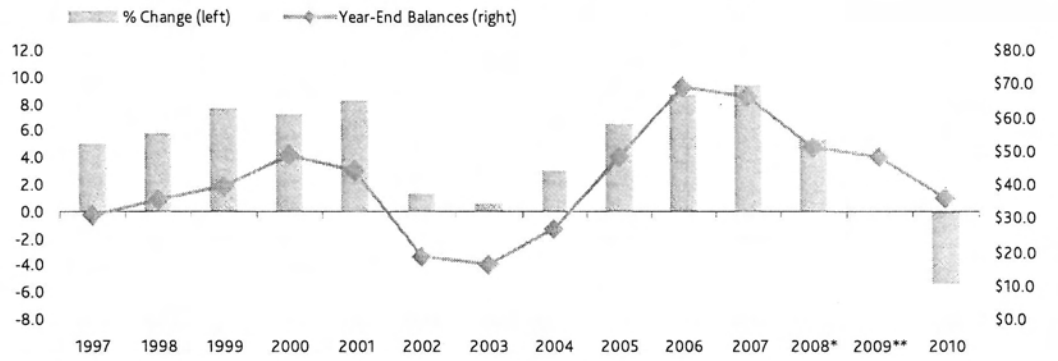
Against the background of significant market attention to budget gaps and proposed solutions, we anticipate the shortfalls in the remainder of 2010 and 2011 at the state budget level will be resolved in the aggregate by:

Spending cuts: These can take the form of reduced direct state services, deferrals or cuts in state aid to lower levels of government, and deferral of maintenance and other longer term spending. States also may cut payroll and benefits, and while these cuts tend to make top news headlines, states typically have limited capacity to generate significant budget savings through payroll cuts within a given fiscal year. That said, steps to reduce pension and other employee benefits have the potential to generate significant savings, although the impact is often not felt until many years into the future. More than half of states reduced their general fund expenditures in fiscal 2009, and over two-thirds of states adopted budgets for fiscal 2010 with spending below fiscal 2009 levels. Based on experience to-date, we anticipate this will be the most prevalent method of addressing budget gaps.

Tax and revenue increases: New and higher taxes are unattractive to enact in many states even in an up-cycle and are politically challenging in the current economic environment. To our knowledge, very few states implemented significant tax increases in fiscal 2009, and we did not see increases in broad-based taxes until fiscal 2010 budget discussions when a number of states realized that the magnitude of their gaps would require a more significant gap closing measure. Several states, including New Jersey, California, and New York, put in place temporary personal income tax increases that helped mitigate weak revenue performance in fiscal 2010.

FIGURE 4

State's Year-Over-Year GF Expenditure Changes vs. Year End Balances



Source: National Association of State Budget Officers

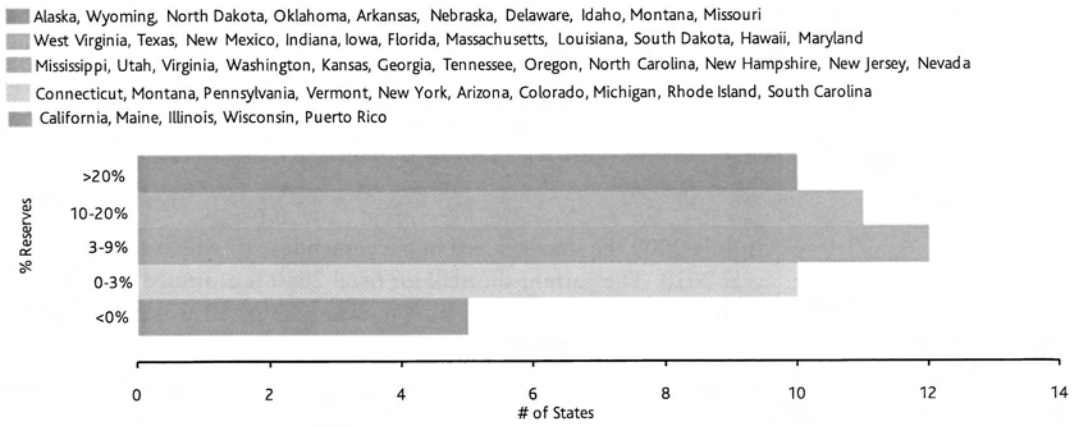
» Use of federal fiscal stimulus aid: States have relied heavily on federal aid payments to help stave off budget cuts, tax increases or use of reserves that otherwise would have been required earlier to balance budgets. Federal aid paid directly to states for operations will amount to $141 billion in aggregate over the 27 months through December 2010, or roughly 6% of state monthly spending plans over that time period. Federal stimulus aid has helped state finances in other ways, including to boost overall liquidity levels and to address gaps that emerged earlier than expected in fiscal 2010. As fiscal year 2011 approaches, states face the challenge of budgeting without this aid or with a reduced amount of additional federal fiscal stimulus, depending on whether the President's proposal to provide an additional $25 billion to states through June 2011 is adopted into law.

» Application of reserves and rainy day funds: States entered the down-cycle with record reserves. While some states are statutorily limited as to the amount of money they can hold in reserve and twelve states have no reserves at all, there are other state governments that hold very strong reserve levels. At the end of fiscal 2008, states had median combined unreserved, undesignated fund balances and available reserves equal to 6.5% of operating revenues. There is wide variation around this median level, with 21 states at greater than 10% (and many well above 20%), while nearly as many states were below 3% of revenues. Five states were poorly positioned with negative balances heading into the recession, with all of these states experiencing stress earlier, and in the cases of California and Illinois, more severely than the sector as a whole. Many states have drawn down reserves fully to balance operations in fiscal 2009, while other states will exhaust remaining reserves in fiscal 2010. Only very few states, such as Texas, expect to preserve fund balance heading into fiscal 2011. The types of solutions, including one-time solutions, recurring spending and revenue adjustments, or a combination thereof, will determine how quickly states restore structural budget balance, which in turn will influence which states will preserve their credit standing.

» Deficit financing: Only a handful of states have the constitutional ability to deficit finance. However, in fiscal 2009 and 2010 roughly half of the states issued refunding bonds that were structured to provide budget relief in the current fiscal year. Likewise, more than a dozen states issued cash flow notes in fiscal 2009 and / or 2010 signaling weakened liquidity or cash flow timing issues primarily related to weak revenue performance and reduced balance sheet strength.

FIGURE 5

Unreserved, Undesignated Fund Balance + Available Reserves as a % of Operating Revenue



Source: Moody's Municipal Financial Ratio Analysis

A Road to Recovery for States Will Include Mix of Recurring and Non Recurring Solutions

To date many states have relied on a combination of revenue and spending adjustments to close gaps in fiscal 2009 and the first half of 2010. Some of the solutions have been one-time in nature; that is, the actions address a budget gap in a single year or over a biennium, but do not provide a recurring revenue or spending adjustment over a longer period. Examples of common one-shot solutions during this credit cycle include one-time cuts to discretionary spending, use of reserves, deficit financing, debt refinancing that is structured to refinance principal coming due in the current year, sale or lease of an asset for an upfront payment, and other accounting changes or gimmicks. In fiscal 2009 and 2010, states also relied heavily on federal stimulus funds to help close their gaps. All of these actions help to create a balanced budget, but they do not address the underlying structural imbalances that have resulted from the recession.

We estimate that in the aggregate states relied on non-recurring solutions for one-third of their gap closing measures in fiscal 2009 and the first half of 2010, with recurring solutions accounting for the balance. States adopted a wide variety of solutions, with some states more or less dependent on one-shots. For example, California (rated Baa1/Stable) closed a combined $64 billion budget gap, or 35% of its combined fiscal 2009 and 2010 operating budget. In doing so the state relied on one-shots (primarily in the form of payment deferrals to lower level governments) to solve roughly 45% of its budget gap (see additional details in sidebar) and on recurring revenue and spending adjustments for the balance.

California Continues to Rely Heavily on One-Shot Budget Solutions

The State of California (rated Baa1/Stable) continues to struggle with very large budget gaps, liquidity pressures (including the need to issue IOUs instead of cash payments in July 2009), political difficulty coming up with solutions, and the reliance on one-time solutions, which in turn exacerbate out-year budget gaps. We expect the upcoming budget cycle (for fiscal year 2011) will likely have a lot of the same characteristics as the last one, including political squabbles, delayed budget action, and resulting liquidity strain.

In July 2009 the state enacted budget amendments which solved a gap of almost $23 billion for fiscal year 2010. The current shortfall for fiscal 2010 is projected at $6 billion, or 7% of the General Fund budget of approximately $85 billion. The gap for 2011 is projected to be approximately $13 billion. The governor's proposed budget, released in early January, solved the total 18-month gap of almost $20 billion, primarily with spending cuts (40% of solutions) and additional federal funds not yet appropriated (35%). Failure to receive the proposed federal funds would trigger significant additional spending cuts.

When the governor released the proposed budget, he also declared a fiscal emergency in the state, which brings the legislature into special session to solve the problem. The legislature has 45 days to solve the problem and, if they fail to do so, would be precluded from conducting other business until the budget gap is closed. We expect the legislature to solve the gap with a combination of cuts, accounting maneuvers, and revenue enhancements, such as closing tax loopholes. The state has no rainy day fund, issued $8.8 billion of short-term cash flow notes in fiscal 2010 and expects to borrow up to $10 billion in short-term cash flow notes in 2011. The state cannot issue deficit bonds without voter approval.

As states address gaps for the remainder of fiscal 2010 and deliberate on budget proposals for fiscal 2011, we expect more states will begin to consider a package of solutions that in the aggregate are more heavily weighted toward recurring revenue and spending adjustments, and less reliant on one-shot solutions.

Local Government Revenues Less Volatile Than State Revenues

Compared to states, local government finances and credit quality tend to be more stable, but they do not possess all the diverse credit strengths of states and are rated lower on average with an A2 median rating level. Local governments typically provide essential services with a limited scope of operations and the costs of services are generally not economically sensitive, as is the case with states. Most local governments derive the majority of revenues from real property taxes, and historically these revenues have been less volatile than the income tax and sales tax revenues that support state budgets.

Local governments face a number of key credit challenges in the current environment. Local governments, including counties, cities, towns, school districts and other special districts, usually lack the depth of resources that states have. They generally have less budgetary flexibility than states. They do not have access to the variety of broad based taxes, fees and other revenues that states have, and they also generally have a higher percentage of services that are not easily eliminated or downscaled. In addition, states may pass on their budget gaps to lower levels of government by cutting funding for health care and other social service programs, passing down service mandates, or both as a way to manage their own credit stresses. Our credit analyses of local governments remains focused on the

four fundamental rating factors, including tax base, financial strength, management and debt, which are standard elements of our existing rating methodology. In light of the particular challenges of the current economic environment, we are placing additional focus on certain aspects of these four key rating factors. These important considerations include each local government's exposure to:

» Declining tax revenues, particularly property tax and sales tax

» Cuts in state aid, and

» Enterprise and operating risks

Individual local governments that have 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;

» Management's demonstrated willingness and ability to make swift, mid-year budget adjustments as needed to restore budget balance;

» Conservative budgeting as demonstrated in a history of actual revenues and expenses that outperform budgeted results; and

» Identification of recurring solutions that allow for restoration of structurally balanced operations.

Local Governments Face Less Budgetary Flexibility, Continued Tax Revenue Declines

Property Tax Collections. In contrast to state issuers, the vast majority of local government credits are backed by property taxes. Local governments rely primarily on real property taxes, which in the aggregate account for 72% of revenues. The history of housing market appreciation and depreciation for the last 10 years compared to housing market assessed valuation shows that while there are lags and timing differences between market value and assessed valuation, these differences have not impacted assessed valuations in prior downturns. The downturn in housing prices has been so dramatic in some jurisdictions, with little prospect of recovery for a long period, that prices may now be equal to or lower than the level of assessed valuation.

Declines in underlying housing values are now beginning to affect assessed valuations and property tax collections. We are also seeing the weakness in the residential housing market spread to the commercial real estate sector. Many local governments have budgeted for property tax revenue declines in 2010 and are reporting that they expect declines in 2011 as well. Property tax revenue declines are expected to be most significant for local governments that are constrained by state statute to either a flat annual tax rate or a limit on annual tax rate increases.

The magnitude of the revenue decline is expected to vary widely by state and by region, and our evaluation of local government credits will focus on the reliance on property taxes (which range from a low of 35% to over 95% of total tax revenues), delinquency rates, the pace of foreclosures and tax appeals. We will also look for mitigating factors such as statutory or other legal provisions that may help stabilize assessed values or stave off declines in property tax revenues for a period of time. To the extent that a local government's property tax revenues are declining faster than statewide or regional

trends, or faster than can be offset by spending adjustments needed to achieve a structurally balanced budget, individual ratings may be affected.

State Aid Cuts. Most local governments in the current environment are susceptible to state aid cuts, although we think some states including California, Michigan, New Jersey, Ohio, Minnesota, New York and Virginia are states where local governments may be more vulnerable to state aid cuts because of the general reliance on state aid among these municipalities as well as the proposed scope of cuts. As state credits remain pressured by weak tax revenue performance, continued spending pressures, and the expiration of federal stimulus funds at the end of 2010, states may look to solve a portion of their budget gaps through state aid cuts or deferrals that impact local government cash flow, reserve levels and overall credit quality.

Our analysis of local government credits incorporates our assessment of their ability and willingness to respond to potential state aid cuts through mid-year revenue and spending adjustments as needed, as well as the impact on liquidity and reserve levels. To the extent that local government aid cuts are proposed as part of a state gap closing solution for the remainder of fiscal 2010 or proposed for fiscal 2011, we will assess the ability to withstand various levels of cuts in state aid.

Enterprise and Operating Risks. Through the current economic cycle, we are monitoring closely the financial performance of local government issuers that have financial exposure to riskier enterprises, such as nursing homes, hospitals or utilities. An enterprise fund is typically a component unit of the local government and is included in the local government's audited financial statement. Many times these enterprises are self-supporting in that the revenues generated from their operations (patient revenues in the case of health care institutions, or user fees in the case of utilities) are sufficient to cover costs, and the local government's General Fund is well-insulated from the operating risks. However, these enterprises may also experience operating pressures as a result of the recession that can spillover to the local government and require financial contributions from a General Fund to support operations and debt service.

General obligation and revenue bond credits also may be exposed to project risk and construction risk. When a local government undertakes a large, multi-year capital program to fund projects that are expected to generate revenues and those revenues are required to support debt service on the project, the issuer is exposed to construction risk (see sidebar on Menasha, WI). Our analysis of these issuers incorporates stress tests on key underlying assumptions including project cost overruns related to schedule delays, project complexity, untested technology, interest costs, refinancing risks, and the overall affordability of the proposed projects should they require support from the local government's general revenues. Those local government credits with outsized capital projects or debt issuance plans that make them susceptible to cost overruns and debt affordability challenges may have their ratings adjusted down if the proper risk mitigation strategies are not in place.

Menasha, WI's Default Highlights Enterprise, Project Risks

The City of Menasha, WI defaulted on $24.16 million in Steam Utility Revenue Bond Anticipation Notes that came due on September 1, 2009, following construction cost overruns on the conversion of a steam plant, permitting problems, and schedule delays that prompted the city to abandon the steam plant. Moody's downgraded the ratings on the city's steam revenue notes to SG and we downgraded the rating on the city's GO bonds to B1, due to risks related to project cost overruns, the high debt burden associated with the additional bond issuances, and the expected distress on the city's general fund. Moody's downgraded the general obligation rating of the city to B1 with a negative outlook from Ba2 on watchlist for possible downgrade in August 2009, primarily due to the city's failure to honor its appropriation pledge or sell refunding bonds to pay the maturing notes. The city is current on its general obligation bond debt service.

Rating actions on the BANs as well as on the city's other debt have been occurring since 2006 as performance issues with the steam plant and its financing developed and worsened. We understand that the city is in discussions with holders of the BANs and is attempting to reach an agreement on forbearance. City officials have told us that a number of work-out scenarios are being contemplated, but ultimate recovery prospects for noteholders remains unclear.

Management Responses Will Drive Local Government Credit Quality

Our increased focus on the risks outlined above will be matched with equal focus on a set of possible risk mitigants. In the near-term, we will look for mitigants to include 1) above average reserve levels, and 2) spending flexibility that allows for mid-year budget adjustments to offset revenue declines, and 3) conservative budgeting and strong performance of budgeted revenues and spending relative to actual results.

Reserve Levels. In aggregate, local governments built up reserves during the economic expansion, and reserve levels for cities and counties remained very strong at the end of fiscal 2008, despite a modest drop off from the peak levels reached in fiscal 2007. School district fund balances on average also grew, but remain somewhat weaker given that many states limit the amount of reserves that can be accumulated before requiring a commensurate tax reduction in the subsequent fiscal year. In contrast to cities and counties, median reserves of school districts grew in fiscal 2008 because most states had yet to cut school funding and property tax revenue remained healthy. Many local governments have reported to us that they relied on reserves to balance general fund budgets in fiscal 2009 and also budgeted to draw down reserves further in fiscal 2010 and we expect the audited financial results for fiscal 2009 will demonstrate this decline. How far these medians will fall is difficult to project, but it is clear that in the aggregate reserves could fall well below even fiscal 2004 levels. Those local governments that demonstrate a temporary or strategic use of reserves as a bridge to shift toward a more structurally balanced budget will be better positioned than their current peer group as they emerge from the recession

FIGURE 6

Median Fund Balance Levels FY04-08 (% of General Fund Revenues)

	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
Cities	26.2	27.1	28.1	29.8	28.8
Counties	26.5	26.8	29.3	31.4	29.8
School Districts	13.5	12.2	13.6	14.4	15.1

Source: Moody's Municipal Financial Ratio Analysis

Spending Flexibility. Following a long and deep economic recession and uncertainty about the economy's near term growth prospects, local governments with a high degree of expenditure flexibility are likely better positioned to maintain their financial health. In an environment of declining tax revenues and cuts to state aid, we are focused on evaluating local government's ability to react swiftly to reduce spending. Those governments with greater expenditure flexibility will have an easier time adjusting to a new economic reality.

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.

Like states, local governments have experienced a broad deterioration in funding levels for public sector pensions. The reduction in funding levels is largely driven by significant investment losses in pension plans throughout 2008 and early 2009 – losses which for certain local governments came on top of longer-term demographic pressures. In order to restore pension funding levels to pre-recession levels or to improve on those levels, the challenge for local governments is to resist the decision to defer pension contributions during this period of budgetary stress. While many governments may view this as a source of budget flexibility, perennial underfunding of annual pension contributions, as well as other post-employment benefits, over time only adds to fiscal pressure that could contribute to negative rating actions for select issuers in the next several years.

Despite Growing Pressures, Very Few Local Governments Rated in Speculative Grade

Notwithstanding growing pressure, we believe the credit fundamentals of local governments will continue to support strong investment grade ratings for the majority of local governments through the current economic cycle. The universe of speculative grade ratings remains very small, with roughly 50 ratings below Baa3 on the municipal scale. Roughly one-third of these ratings were downgraded directly as a result of credit pressures that emerged in the last year. The majority of speculative grade municipal credits have experienced chronic budget stress over many consecutive years, due to structural economic weaknesses, lack of political will to adjust spending and revenues, mismanagement or in many cases a combination of these factors. Below we summarize the general characteristics of speculative grade local government credits, although we acknowledge that these credits are highly idiosyncratic and the rationale for the rating on each government rests largely on credit factors that are unique to the issuer:

- Many are very small and have weak prospects for economic growth or diversification
- Many exhibit significant financial stress, with recurring operating deficits of 5% - 20% of revenues and negative GAAP fund balances that range from 15 - 30%
- Many have some reliance on cash flow borrowing and some are also dependent on market access for note repayment; some have issued deficit financing bonds
- Many have weak management with no credible plans for restoring budget balance

Municipal Bankruptcies Expected to Be Rare; Defaults May Increase

As the universe of speculative grade rated local government credits has increased over the last year, a very small but growing number of municipalities have been rumored to consider filing for municipal bankruptcy protection. We take seriously statements by public officials related to potential bankruptcy and media reports of rumored bankruptcies and will quickly follow with a review of the issuer's financial position and assess the likelihood of bankruptcy and probability of a payment default and adjust the rating accordingly.

High Legal Hurdles To Municipal Bankruptcy Filing. In contrast to corporations, municipalities face significant restrictions to filing for bankruptcy. Municipalities are ineligible to file for chapter 11, and many of the benefits that typically come with a corporation's chapter 11 case are not applicable in a chapter 9 municipal filing. State law must authorize municipalities to seek chapter 9 protection. Many states limit which municipalities can file and under what circumstances, or require special approval of state authorities to permit a filing. Twenty-six states prohibit bankruptcy filings, and a municipality in those states would have to seek enactment of a specific statute that authorizes such a filing if it wanted to pursue that option. State governments cannot file for bankruptcy.

Municipal Bankruptcy Court Has Limited Powers. Those municipalities that have the option to pursue a bankruptcy filing often lack the same incentives that would compel a corporation to file. In chapter 11 cases the bankruptcy judge has significant powers over the debtor during the course of the case. In contrast, the court plays a very limited role in a municipal bankruptcy case: it cannot take over the municipality's operations, require change in governance or management, direct the actions of a governing board or appoint a receiver to run the affairs of the municipality. Similarly, the court cannot permit the municipality to override state laws such as those requiring voter approval for new taxes. The court cannot require a municipality to sell or lease assets to meet its obligations to creditors or impose an adjustment plan; the creditors and debtors need to work out a plan. If the municipality fails to produce a workable plan, the case is dismissed and the municipality exists with all of its problems and claims as it did before bankruptcy.

Potential For Contagion, But Risk is Remote. Given the high legal hurdles and limited opportunities to use the courts as a third party arbiter, we expect limited use of municipal bankruptcies. We acknowledge that in the current environment there is a risk of bankruptcy contagion among municipalities, although we think that risk is remote. While there is limited case law on municipal bankruptcies, reputable law firms have argued that the bankruptcy court will observe state law restrictions on municipalities and how they use their funds. We think this likely provides significant protection for bondholders in cases where revenues pledged to repay the bonds are restricted for debt service. In the case of Sierra Kings Health District, CA, which filed for bankruptcy in September 2009, we understand that the District is restricted from using its tax levy for general obligation bonds for any purpose other than general obligation debt service. Subsequent to its chapter 9 filing, the District made full and timely general obligation debt service due on February 1, 2010, and we expect timely payments will continue.

Defaults Expected to Be Rare But Could Increase. While we expect that municipal defaults will continue to be very rare, we also believe that in the current environment it is possible that there could be an increase in municipal defaults in the future. Moreover, we would expect an increase in technical defaults – that is, failure of the issuer to meet a particular bond covenant. Technical defaults may not necessarily lead to non-payment of debt service or losses to bondholders, but often signal credit stress that if continued uncured for a period could eventually lead to non-payment. We also generally expect

to see somewhat higher rates of default among the non-rated universe than the Moody's-rated universe. Defaults may occur when the political process breaks down, and where a crisis that we expected to be averted, is not. It may not always be possible to predict in advance which entities will fail to avert a crisis, leaving the potential that a small number of ratings could move down quickly and in multi-notch increments. Nonetheless, we expect that the aggregate default experience for rated municipal credits will remain low.

Conclusion

As we have noted throughout this report, the credit profile of the U.S. state and local government sectors is very strong, and we fully expect that, under our baseline scenario for the macroeconomy, the vast majority of municipal obligors will make timely debt service payments, consistent with the very low default experience seen in this sector over the last sixty years. Having said that, the unprecedented stress in these sectors is likely to produce defaults at a higher rate than we have seen in the past. In the normal course of our credit reviews, we will adjust ratings when credit characteristics are no longer consistent with a given rating level. We will not downgrade the sectors as a whole – which includes roughly 14,500 unique state and local government credits – because of the elevated default risks of a few. In the aggregate, we continue to believe that the U.S. state and local government sectors remain strongly positioned within the investment-grade category.

Moody's Related Research

Special Comment:

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

Outlooks:

» Annual Sector Outlook for U.S. State Governments is Negative for 2010, February 2010 (123172)

» Annual Sector Outlook for U.S. Local Governments Remains Negative for 2010, February 2010 (122849)

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.

PAGE INTENTIONALLY LEFT BLANK

* contacts continued from page 1

Analyst Contacts:

NEW YORK 1.212.553.1653

Robert A. Kurtter 212.553.4453
Senior Managing Director
Robert.Kurtter@moodys.com

Jack Dorer 212.553.1332
Senior Managing Director
Jack.Dorer@moodys.com

Thomas J. Keller 212.553.7210
Senior Managing Director
Thomas.Keller@moodys.com

Report Number: 123154

Author
Anne Van Praagh

Production Associates
Diana Brimson
Wing Chan

© 2010 Moody's Investors Service, Inc. and/or its licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ARE MOODY'S INVESTORS SERVICE, INC.'S ("MIS") CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MIS DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. CREDIT RATINGS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

MIS, a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MIS have, prior to assignment of any rating, agreed to pay to MIS for appraisal and rating services rendered by it fees ranging from $1,500 to approximately $2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moodys.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

MOODY'S
INVESTORS SERVICE