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Outlook: U.S. State And Local Governments Must Navigate Turbulent Conditions To Maintain Credit Stability

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Outlook: U.S. State And Local Governments Must Navigate Turbulent Conditions To Maintain Credit Stability

Many U.S. state and local governments have been making difficult policy and budget choices in an effort to balance their budgets. These actions, along with federal fiscal support, helped credit quality for most U.S. public finance issuers to remain stable in 2010. But because of the slow progress of recovery from the Great Recession, we believe that continued revenue decreases for state and local government may increase fiscal strain on budgets, and monitoring of liquidity will be especially important in 2011.

Throughout difficult economic periods, including during and after the Great Recession, we have generally seen on the part of state and local governments what we consider to be a very strong commitment to their debt obligations, which for us has been an important credit consideration over time. Although we view budgets as inherently political documents, liquidity and cash management has remained largely apolitical in our view. If we were to observe a change to this or a weakening of issuers' commitment to their debt obligations, we think the credit implications could be significant.

Overview

- State and local governments will likely continue to operate in a constrained revenue environment, with many issuers having to make difficult policy choices.
- Managing liquidity will likely be key for many state and local government issuers.
- Municipal bond market volatility may increase in 2011, creating a more difficult interest rate environment.
- A majority of state and local government issuers rated by Standard & Poor's will likely remain medium to high investment grade.

The diversity of the municipal market defies easy generalization. Standard & Poor's maintains ratings on approximately 17,500 distinct municipal issuers, but this does not encompass the entire municipal market, which tends to be self-selecting. That is, municipal issuers of lower credit quality tend not to request ratings. Correspondingly, the universe of rated municipalities is, as a general proposition, more creditworthy and, of course, less likely to default. In terms of credit performance, in the majority of cases, we believe general obligation and other types of direct debts of state and local governments we rate will continue to be retired as scheduled. These debt types frequently hold a legally advantaged status compared to other obligations of these governments.

As an exception to the usual general obligation situation, we occasionally observe that local governments have issued or guaranteed debts intended to finance projects less directly related to traditional core municipal services. Depending upon the structure or the additional budgetary pressure these debts can represent, we have seen examples of these debts coming under material credit pressure.

A significant amount of municipal debt is repaid from the revenues of essential service enterprises; for example, those that provide water or wastewater treatment services. In general, we have observed that the issuers of these essential service revenue bonds typically enjoy a strong market position. In addition, revenue bond issuers often have

strong rate-raising authority, enhancing repayment capacity.

Another form of municipal debt includes various types of land-backed bonds, many of which are unrated by Standard & Poor's. These bonds, typically repaid from assessments on properties in a residential development, are often intended to finance infrastructure for incomplete residential development projects. Unrated debt issued for incomplete property developments may, as in recent years, continue to exhibit higher rates of distress, in our view.

We expect that there may be an increased number of rating downgrades in 2011, yet we believe the majority of state and local government issuers we rate will likely retain solidly medium-to-high investment grade ratings. Setting the stage for 2011 is the presence of several notable conditions that, in our view, almost all state and local government issuers will confront. Among these are:

- An economic recovery that will likely continue to be weak generally;
- The persistence of budget gaps requiring difficult policy decisions;
- The potential for a more challenging bond market for issuers;
- The heightened role of financial liquidity as a credit quality bellwether among municipal issuers, particularly for those with severe structural budget misalignments and issuers of certain types of variable-rate debt;
- A new regulatory regime as a result of the Dodd-Frank Financial Reform legislation; and
- An increased focus on issuer pension and other retiree benefits packages.

A Weak Economic Recovery May Continue To Depress Revenues

We expect the difficult economic environment to continue for many municipal issuers in 2011. The severity and nature of the recent recession suggests to us that economic recovery could be slow. Standard & Poor's forecasts U.S. economic growth of 3.0% during 2011, below the average 5.0% GDP gain observed during the last eight economic recoveries from recession dating to the early 1960s (see "Economic Research: U.S. Risks To The Forecast: Ring Out The Old Recession, Bring In The... ?" published on Dec. 21, 2010 and "U.S. Economic Forecast: A More Prosperous 2011?", published on Jan. 5, 2011 on RatingsDirect on the Global Credit Portal). The current economic growth forecast for 2011 of 3%, if it were to materialize, may not be sufficient to have an appreciable effect on the unemployment rate. According to our baseline economic forecast, the national unemployment rate is only projected to decline to 9.4% in 2011 from 9.7% in 2010. Reduced spending, be it from lower incomes or from saving more, translates to lower overall demand, employment, and tax revenues.

We believe that the housing market is likely to continue to provide an additional source of economic pressure. According to the 20-city S&P/Case-Shiller Home Price Index, as of October 2010, home prices remain 29.6% below their July 2006 peak. Standard & Poor's believes further deterioration is possible, if not likely, and could rival the April 2009 trough of 33% below the peak (see "U.S. Weekly Financial Notes: Doubling-Up On A Double Dip" published on Dec. 29, 2010). With the lag between market prices for real estate and the assessment process relevant to property tax revenues, in our view, home price trends offer further evidence of a relatively long and slow recovery for state and local government finances.

Even if a more robust economic recovery takes hold, we expect that state and local government revenues may continue to demonstrate a muted response to the recovery owing to reduced federal aid and the expiration of previously adopted temporary tax increases. This is in addition to the typical historical lag between economic growth and improved state and local government tax revenues. On the other hand, according to the U.S. Census

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Bureau, third quarter state tax receipts increased 4.8% ($7.6 billion) and combined state and local tax revenues grew 5.2% ($284.3 billion) compared to the same period last year. Year-to-date total state tax revenue, which was up 1.26% through September 2010, posted the first annual increase since 2008.

Ongoing Budget Gaps And Difficult Policy Decisions Continue To Challenge Municipal Issuers

If the economic recovery staggers in combination with the above-mentioned revenue reductions, we think that fiscal strain may evolve into outright budget crises for particular locales that have low reserves and thin financial liquidity. Most U.S. states and local governments are required by law to balance their annual budgets, which can necessitate, in the absence of extraordinary federal support, difficult service cuts or tax increases when resources are insufficient to fund baseline spending trends. If this occurs, policymakers face difficult decisions representing zero-sum tradeoffs among stakeholders, many of whom will have contradictory objectives. We have seen that cuts to certain government services in favor of others can be contentious, and ongoing high rates of unemployment place pressure on states' social service infrastructure networks. Some governments may (for example) underfund contributions to their pension systems rather than cut, say, current public safety services in an attempt to defer the most difficult of decisions.

Because these decisions reflect an issuer's financial management, even if the issuer who makes such decisions does not face immediate, severe credit challenges, we could see an erosion of long-term credit ratings among state or local governments that choose to adopt what we consider to be short-term measures that carry longer-term credit implications.

Even with difficult policy choices, Standard & Poor's continues to expect that most issuers that we rate will retain strong or even very strong capacity and willingness to meet their debt obligations. The bulk of most states' general funds are spent on education and human services, including health care and the funding of federal matching requirements for Medicaid. Considering that the median debt service among U.S. states was 3.0% of total expenditures (as a portion of governmental funds in fiscal 2009), redirecting these funds away from debt service would yield relatively little in freed up cash flow.

Beyond achieving relatively little savings, we believe that a defaulted debt service payment would likely result in a loss of access to the capital markets, which has predominantly been the source of funding for capital and infrastructure projects for state and local governments.

For some governments, capital market access can also be critical for funding operations. Many governments' cash receipts do not align with their disbursements schedules. Governments often manage this mismatch by issuing short-term notes to smooth their annual cash flow cycles. For these governments there is a strong incentive to retain the creditworthiness necessary to sell cash flow notes in order to sustain even the most basic of functions.

Some of the states with the most severe projected budget gaps, notably California and Illinois, have structural budget reform on their agendas for the upcoming legislative sessions. Reconciliation of structural revenue and spending misalignments may not be achieved in one fiscal year, but initial indications in some states suggests that the discussion may continue in earnest during 2011.

Debt Markets: A Changed Landscape With Limited Credit Implications

We expect the possibility of greater market volatility in the prices for municipal securities in 2011. We believe that notable rating downgrades, specific instances of severe fiscal problems, and a generally softer environment for municipal credit could occur. We also believe, however, that fundamental credit performance throughout the market -- as measured by default rates relative to debt outstanding in the market -- will likely remain mostly stable with the possibility for a modest uptick, in light of the difficult economic and revenue environment. In 2010, the S&P/Investortools Municipal Bond Index, which includes $1.27 trillion of municipal debt outstanding, saw newly defaulted bonds of $2.65 billion, or 0.21% of the index. This is actually somewhat of a decline compared to 2009, in which there was $2.9 billion of new defaults. Overall, the balance of defaulted bonds in the index rose to $6.89 billion (0.54% of the index) from $5.14 billion in 2009 (0.42%). Of the defaulted bonds in the index, 75% are conduit revenue bonds that actually reflect corporate credit quality (such as certain industrial development revenue bonds), land-secured financings, or health care related issuers. None of the defaulted bonds are of traditional general obligation debts of states or localities. There was only one default among issuers with Standard & Poor's ratings in 2009 (a non-investment grade housing issue) and three in 2010 (all were non-investment grade).

Municipal issuers could face selling bonds to a narrower investor base in 2011 compared to 2009 and 2010. The Build America Bond (BAB) program expired at the end of 2010, and without it, we expect issuers to revert to selling traditional tax-exempt debt, which tends to appeal only to investors subject to U.S. federal income taxes. We believe an increased supply of tax-exempt paper in the market could result in higher interest rates for issuers in need of financing.

Although noteworthy for the municipal market, expiration of the BABs program has little direct bearing on the credit quality of most issuers in our view. By allowing issuers to sell federally subsidized bonds to taxable investors, the BAB program broadened the municipal investor base. If the ability to issue taxable debt siphoned the overall supply of debt away from the tax-exempt market, it likely benefited issuers in the form of lower tax-exempt yields during the last two years.

Late in 2010 municipal tax-exempt rates ('AAA'; 30-year) edged higher and surpassed those of 30-year Treasury bonds, according to Bloomberg data. In our view, any number of factors has likely been causing the yield curve to steepen; among them could be the extension of the Bush-era federal income tax rates, anticipated expiration of the BAB program, or concerns about credit risk in the municipal market. Straightforward supply and demand dynamics could also be a factor. Toward the end of 2010, total municipal issuance reached $431 billion, surpassing the previous record in 2007 when $429.9 billion was issued. A more sanguine interpretation of market rates is that longer-term Treasury rates are higher in response to investor optimism about the economy, and municipal rates are simply tracking the Treasury market.

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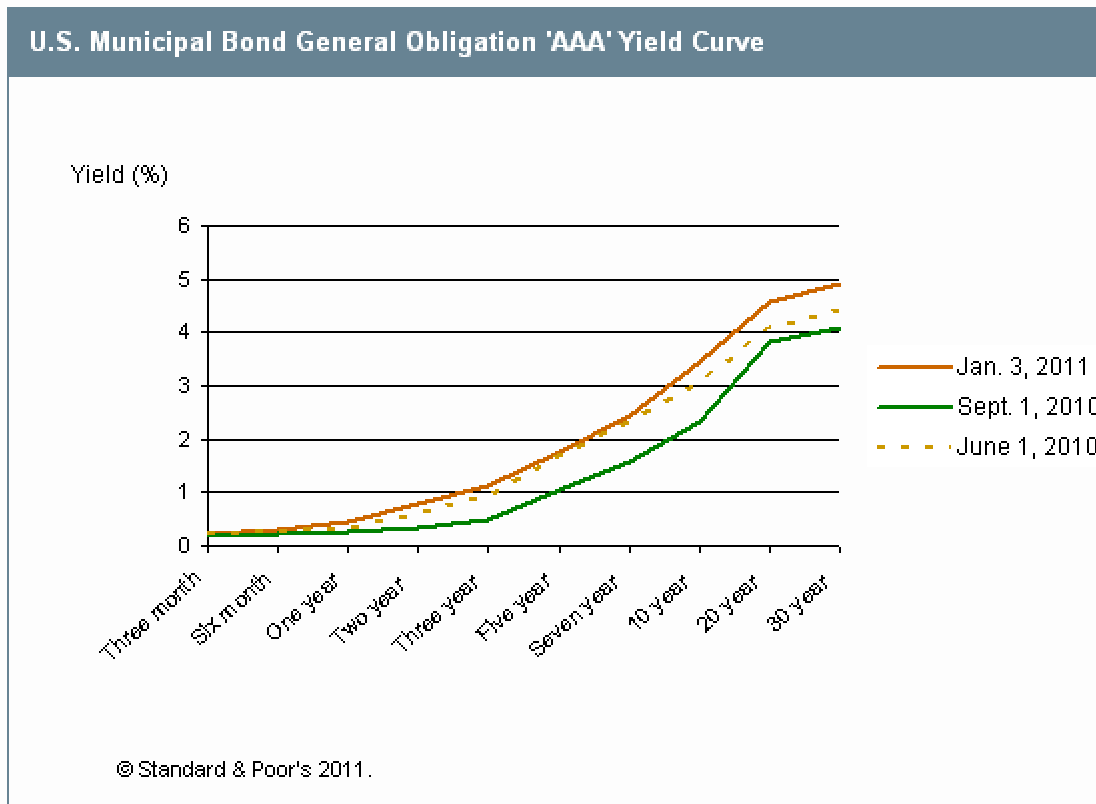

Adequate Financial Liquidity Is A Key To Credit Stability; Refinancing Risk Is Possible

Potential for inadequate liquidity serves as a bellwether to the risk of immediate and potentially severe credit deterioration, particularly for those with significant budget misalignments and issuers of certain types of variable-rate debt, in our view. Ultimately, the possibility of having insufficient cash to meet debt obligations is at the heart of our credit analysis. In 2011, we believe there is a heightened risk among some issuers that protracted multi-year structural budget deficits may culminate in insufficient cash flow for operations. We observe that credit pressure can become acute when, facing a significant budget gap, there is incomplete fiscal adjustment coupled with inadequate access to cash. Such a predicament could fit the profile of -- and be a precursor to -- an issuer facing a rating downgrade.

For states, budgets provide the legal mechanism by which funds are appropriated. Unless budgeted spending is reduced or taxes are increased in the face of underperforming revenue, states tend to tap reserves, engage in internal cash borrowing, or defer certain disbursements to sustain operations mandated by budget laws. Depending upon their starting cash positions, some states (and local governments) have fewer of these options than others. For many states, fiscal 2012, which for most states begins on July 1, is the fourth consecutive budget year in which a sizeable budget gap must be closed. Our initial analysis suggests that total state projected budget gaps may exceed $100 billion and could approach as much as 20% of total state budgets. Fiscal 2012 could be the fourth consecutive year in which total state budget gaps are projected at $100 billion or more. States that fail to make the necessary budget

adjustments and whose sources of liquidity approach depletion could face downgrades.

We have seen states occasionally generate fiscal and cash flow relief by withholding payments to (or extracting payments from) local agencies. State transfer payments are an important source of revenue for many local governments around the country, particularly school districts. When state liquidity is sufficiently stressed, we have observed that state governments occasionally defer disbursements to local agencies, even when those disbursements are budgeted. As a result, cash and liquidity management, including scenario analyses, can be an important part of credit stability at the local level during the current phase of the economic cycle.

Insofar as state governments withhold expected funding or shift service mandates to local levels of government, budget pressures at the local level could be compounded. We believe that local governments, with a relatively greater reliance on property tax revenues, could particularly experience losses from the real estate downturn of the past two to three years in 2011, given the lag in assessment processes. If this coincides with state funding reductions or increased service delivery responsibilities, we believe there is a potential for greater budget stress among some local governments. Those in this predicament could, in our view, face among the most difficult budget choices going into fiscal 2012.

Another type of liquidity-based credit risk we see for 2011 relates to variable-rate debt exposure. When the dismantling of the approximately $200 billion auction-rate securities (ARS) market occurred in 2008, many issuers restructured these debts into variable-rate demand obligations (VRDO). The VRDOs typically require third-party liquidity support, which is frequently sold to issuers by banks in three-year agreements. As 2011 approached, Bloomberg data indicated that more than $100 billion in bank liquidity facilities are estimated to expire. Given the higher cost of bank liquidity, some issuers have refinanced their obligations into alternative variable-rate structures. These alternatives generally have a blend of traits from bond anticipation notes (BANs), extendible commercial paper, and traditional VRDOs. We are also seeing a trend toward direct purchase of obligations by banks subject to the terms of some form of purchase agreement. Under some of these structures, the potential for accelerated repayment causing sudden and significant demands on an issuer's liquidity could have credit implications. (Please see the article "Credit FAQ: Changes And Challenges In The Variable-Rate Debt Market," published March 10, 2010). We anticipate this will likely be a prevalent analytic factor for issuers with this exposure in 2011.

Financial Reform: A Continuation Of Existing Trends In The Municipal Sector

We saw the financial crisis begin a shift in the relationship between municipalities and banks, as bank liquidity and credit availability became more limited throughout the economy. We believe the Dodd-Frank financial reform legislation will likely encourage this trend because we expect higher capital requirements for banks in the future. During the crisis, we saw a number of municipalities maintained portions of their debt in short-term instruments and confronted reduced access to low-cost bank liquidity support. In response, governments began to utilize versions of the aforementioned new variable-rate debt structures. These structures frequently sell in the market as short-term securities to be retired from the proceeds of remarketing offerings. Instead of depending on external bank liquidity to backstop a market disruption, the new structures tend to depend on sustained investor confidence. Consistent with this evolution in the municipal market, Dodd-Frank appears to facilitate a longer-term change in the relationship between municipal issuers and investors by giving investors more prominence on the Municipal Securities Rulemaking Board. (Please see the article, "U.S. Financial Regulations: Positive Change Amid Uncertainty And Missed Opportunities", published on Aug. 5, 2010). In general, we believe that use of these debt structures

increases an obligor's market confidence sensitivity and the importance of financial liquidity in its credit profile.

Pension Scrutiny To Continue And Intensify

Significant market losses in 2008 weakened state and local government pension funding levels. We have seen the steep losses in asset values and large unfunded estimated pension liabilities receive considerable attention and have led some commentators to express concern about governmental solvency. In light of asset market volatility and as the public dialogue concerning off-balance-sheet liabilities has progressed, underlying pension plan assumptions, such as rates of return on invested plan assets, have come under scrutiny (please see "Pension Funding And Policy Challenges Loom For U.S. States" published July 8, 2010).

Several states have embarked on pension reform initiatives, including or considering steps such as increasing employee contributions to pension asset trusts, raising retirement ages for benefits eligibility, or outright benefits reductions. Reform efforts of various governments are at different stages and, in some cases, we believe the implications of the initiatives are mixed. For example, a re-examination of, and potential downward adjustment to, a particular pension plan's assumed rate of return could have the effect of magnifying the estimated unfunded pension liabilities. Even reform that contains the growth of long-term pension liabilities through the creation of new benefit plan tiers or the introduction of partially defined-contribution plans for employees hired after a certain date could, in our view, entail risk to the sponsoring government's budget. Although restructured pension plans that include new tiers or hybrid (partially defined contribution) arrangements could make pension benefits more affordable in the longer run, we believe that the new structures could in some cases deprive existing pension plans of additional needed contributions in the near-to-medium term. Once new benefit plan tiers are created, current contributions are typically deposited in the asset trust funds of the new plans and are legally not available to the closed plans.

In our view, governments' overall liability profile encompasses pension and other long-term liabilities as well as bonded debt. We believe that pension and other retirement liabilities may represent a source of material credit pressure in the years to come but, in most cases, are not immediately jeopardizing the debt-paying capacities of the governments we rate. However, our analysis also considers whether governments are funding the actuarial-based annual required contributions (ARCs). We believe that those that are not may preserve budget capacity in the near-term while possibly establishing the groundwork for compromised credit quality in the future.

Fiscal Pressure Does Not Necessarily Imperil Debt Payment

Despite a difficult economic and revenue environment, Standard & Poor's believes that very few governments are likely to repudiate their debt obligations. Indeed, we continue to believe that most governments are likely to make the difficult tradeoffs in a limited-resource environment precisely so they may preserve funding for important (sometimes legally required) programs and to protect their credit and market access.

In short, several state and local governments may endure fiscal strain and even budget crises during 2011, but we view these as different from debt crises. Even if headlines occasionally conflate the two, governmental budgets are not necessarily synonymous with debt paying capacity. In our view, budgets and fiscal positions reflect issuers' financial management and are, thus, incorporated into their credit profiles, but they do not tell the whole story.

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