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INVESTORS SERVICE

SPECIAL COMMENT

US Municipal Rating Revisions Through the Great Recession

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Summary Opinion

The vast majority of US public finance ratings have held their ground in the wake of the Great Recession. Since January 2010, less than 6% of the nearly 18,000 municipal credits we rate have been either upgraded or downgraded. The bulk of these movements have been downgrades, as downgrades have outpaced upgrades in this market for 10 consecutive quarters. This trend is likely to continue, given our continuing negative outlook on all municipal sectors.

However, most downgrades have been limited to one or two notches. Downgrades of more than two notches remain relatively rare occurrences, are heavily concentrated in extremely economic-sensitive sectors and are often driven by a confluence of factors.

Over the past 18 months, there have been 102 downgrades of more than two notches, accounting for 0.6% of the Moody's-rated universe. What most of these downgrades have in common are rapid and steep credit deterioration, often coupled with limited financial resources to mitigate such pressure.

There have been no large multi-notch downgrades (which we define as downgrades of more than two notches) at the state level. At the local government level, which accounts for the largest percentage of the Moody's-rated universe, only 22 counties, cities and school districts experienced multi-notch downgrades. Many localities have limited revenue sources and can therefore be prone to sharp declines in credit quality when a primary source is impaired through cuts in state aid or property tax declines.

Of the 102 large multi-notch downgrades, 59 were housing-related credits, and more than half of those have been multi-family affordable housing projects. This concentration is a reflection of the severity of the housing downturn in some regions. Furthermore, most multifamily affordable housing is limited recourse projects that are significantly affected by poor rental market conditions, investment problems, and/or counterparty downgrades.

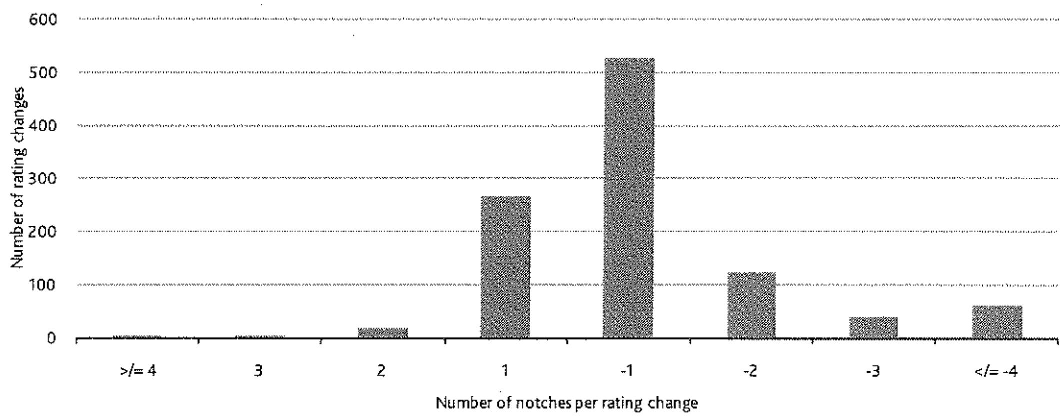
Weak Economic Recovery Keeps Pressure on Munis

Throughout the Great Recession, the municipal sector has faced unprecedented credit stress which has been reflected by an elevated level of rating downgrades relative to upgrades[1]. Even so, the total number of rating changes has been relatively modest. Our negative outlook on all major public finance sectors[2] expresses our expectations for fundamental credit conditions over the next 12 to 18 months. While it does not necessarily speak to expectations for individual rating changes during the outlook period, we do expect downgrades to continue exceeding upgrades for at least the next year. Though the Great Recession officially ended in July 2009, financial strains on municipal credits are likely to persist on a backdrop of high unemployment, anemic GDP growth, high fixed costs, and growing off-balance sheet liabilities. Economic growth has stayed positive in 2011, but downside risks have increased due to waning confidence about the health of the global and U.S. economies, and a corresponding spike in capital market volatility. Moody's Analytics estimates that the odds of a renewed recession over the next 12 months are now one in three.

In addition to weak economic dynamics, public finance credits in all sectors are confronted with a depletion of stimulus funds that were provided by the American Recovery and Reinvestment Act of 2009. Finally, federal deficit reduction efforts portend looming budget cuts that will impact and challenge a wide array of credits.

EXHIBIT 1

Since January 2010, Most rating changes have been one or two notches. Very few were large multi-notch.



Drivers of Large multi-notch Rating Changes

Since the start of 2010, the vast majority of Moody's rating revisions were one or two notch changes (Exhibit 1). However, given a sharp deterioration in their financial profile, a small number of credits were downgraded by more than two notches. Over the last 18 months there were 102 large multi-notch downgrades of public finance credits.

1 For additional statistics please refer to our quarterly rating change reports. The latest report is Credit Stress Continues for U.S. Public Finance: Downgrades Outpaced Upgrades by 3.0 to 1 in the Second Quarter, July 2011

2 The outlook for higher-education sector is split. Higher rated market-leading universities have a stable outlook, but the majority of other, mostly lower rated universities, have a negative outlook.

Large multi-notch downgrades are often driven by issuer-specific factors, but there are some common themes for such rating actions, as follows:

» Issuers that were highly susceptible to a sharp deterioration in credit quality given a confluence of precipitous declines in core revenues which may have been driven by a spike in unemployment, a deep and sustained decline in real estate values, or other abrupt weakening of their financial profile.

» Inadequate financial tools or resources to weather financial disruptions, and slow response by governance or management to mitigate new strains. These credits often had rapidly deteriorating liquidity that quickly exhausted available financial reserves, and their governance/management did not enact sufficient and timely longer-term measures to handle current and future financial difficulties.

Of the 102 large multi-notch downgrades over the last 18 months, 59 were housing-related credits (Exhibit 2). The prevalence of large multi-notch downgrades of housing bonds is a testimony to the severity of the housing downturn in some regions and the associated impact on multi-family housing project financings and single family state Housing Finance Agencies (HFA).

More than half of the large multi-notch downgrades of housing credits relate to multi-family affordable housing projects. Most of these credits are limited recourse projects that are significantly affected by poor rental market conditions, investment problems, and/or counterparty downgrades. Overhanging supply spurred concessions that lowered housing projects' rental revenue and hence their debt service coverage. Moreover, since these projects are typically small, dips in occupancy can precipitate a downgrade.

Counterparty exposure was a problem for many multi-family housing projects and state HFA programs. The 2008 financial disruption led to material downgrades of many Guaranteed Investment Contract (GIC) providers to the extent that Housing bond ratings were downgraded by multiple notches because they were no longer considered enhanced by GICs provided by institutions rated below a certain level.

The low interest rate environment also had a significant effect on the credit quality of housing bonds. Many housing issuers invest bond fund proceeds in GICs where a rate of return is guaranteed by a qualified financial institution for the term of the bond issue. However, given the trajectory for very low interest rates, our methodology assumes 0% investment earnings on any funds not in a GIC. Additionally, the very low interest rates on conventional mortgages have reduced the demand for HFA loans, and in turn reduced the financial margins of the HFA business model.

The impact of the housing downturn is also reflected in the regional distribution of large multi-notch downgrades of housing credits. Eight housing-related credits in Florida had large multi-notch downgrades; Florida is one of the states' hardest hit by real estate devaluation.

Second to housing credits, cities, school districts and counties had a combined 22 large multi-notch downgrades, due mostly to rapid and significant declines in state aid, property tax revenues, and liquidity. Many localities have limited revenue sources, and can therefore be prone to sharp declines in credit quality when their predominant source of revenue is impaired. For example, in November 2010, we downgraded Atlantic city's general obligation and guaranteed bonds by three notches from A1 to Baa1, largely due to the repercussions of its heavy reliance on a declining gaming industry. Atlantic City's gaming industry came under significant pressure from the legalization of gambling in neighboring Pennsylvania, Connecticut and New York. Eleven casinos account for approximately 74% of the city's tax base.

EXHIBIT 2

Of the large multi-notch rating changes, housing-related bonds had the highest

Number of large multi-notch downgrades since January 2010, by original rating Category

Sector	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Non Inv. Grade	Total
Housing	33		2	1	1	1	1	1	2	5	12	59
City			1		8			1			3	13
School District				1	3	3						7
Utility		1	1		2			1			1	6
Gas Prepay			4			1						5
County			1	1								2
Higher Ed											2	2
Other			1								1	2
Special District		1							1			2
Transportation									1		1	2
Health Care								1				1
Other NFP								1			0	1
Total	33	2	10	3	14	5	1	5	4	5	20	102

Drivers of All Rating Changes

The key distinctions between credits that experienced a one or two notch downgrade and those that had a large multi-notch downgrade are the speed and severity of credit deterioration, and the availability of financial resources to mitigate a weakening of their financial position. Regardless of the number of notches that a rating is moved, downgraded credits across the various municipal sectors have been faced with a multitude of challenging undercurrents:

» State governments have been challenged by declining revenues, rising fixed costs and the elimination of federal stimulus funds to buffer the revenue declines. Total state government tax revenues in 2010 were 10% lower than in 2008 because of recessionary forces that led to high unemployment, low consumer confidence, and reduced business activity. Revenues nudged higher in 2011, but are still materially below pre-recession levels. States also confronted growing difficulties paying required contributions to public pension funds. Pension funding ratios declined significantly because of declines in asset values, demographics of baby boomers retiring, and failure of state and local governments to pay their full Annual Required Contributions (ARC). According to a report by the PEW Center on the States, state pension funding gaps grew by 26% in fiscal 2009[3]. Going forward, certain states will endure both rising pension costs and deficit-induced federal cutbacks. Despite these pressures, there have been no large multi-notch state rating changes since January 2010, which reflects the underpinning strength of the sector. State's economies are broad-based and diverse, and governance has a variety of powerful fiscal management tools at their disposal. Moreover, states cannot file for bankruptcy, and their debt burdens are relatively low compared to other sectors.

[3] The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs, April 2011

» Many local governments continue to face a combination of declining aid from states and lower property tax revenues due to declines in home values. This trend is expected to continue over the medium term as states push federal budget cuts downstream to local governments, and housing prices continue to tumble. Where possible, localities have combated financial strain by raising property tax rates, by cutting costs, and by utilizing available reserves. However, some credits have less legal and political headroom to raise property tax rates, some have depleted reserves, and others have growing pension expenses. Additionally, several local governments have exposure to financially unstable enterprises that drain general funds away from their core missions. For example, in December 2010, the Pollution Control Financing Authority of Camden County, New Jersey (PCFACC) narrowly avoided default on the $26.2 million balloon maturity of its solid-waste disposal and resource recovery bonds because state and local government support became less reliable and subject to the unpredictability of the political process.

» Not-for-profit hospitals that are susceptible to downgrades have dealt with lower patient volumes, a weaker payer mix, and increased competition. For some hospitals in economically impaired regions, the spike in unemployment over the last three years resulted in higher bad debt expenses, and an increase in uncompensated care. Going forward, hospitals will confront declining reimbursements from all payers, which include Medicare, Medicaid and private insurers. Additionally, the cost and uncertainty surrounding provisions of healthcare reform, and the likelihood of federal cutbacks to Medicare and Medicaid, are sources of potential financial strain that could lead to rating downgrades.

» Most higher education institutions that were downgraded have significant tuition resistance, weak fundraising results, and declining state aid[4]. These institutions are typically lower rated and have a more regional student draw, weaker pricing power, and less diversified revenues. Conversely, market leading universities with large endowments and multiple revenue streams have been much more economically resilient and therefore are less likely to be downgraded. These market leading institutions are mostly rated in the Aa or Aaa categories and represent a minority of universities nationwide. We expect these dynamics to continue over the next year.

» The key driver of rating downgrades of housing-related bonds is the continued weakness in the U.S. housing market which has negatively affected local multi-family housing financings and pooled mortgage finance programs operated by state HFAs. As described previously, multi-family housing projects are contending with a glut of supply, waning rental prices, investment challenges, tenuous counterparty exposure, and reduced occupancy. Demand for single-family HFA loans has decreased because of competition with conventional mortgages that have been offered at extremely low interest rates. Furthermore, some HFAs deteriorated because of scarce liquidity, and counterparty credit deterioration. These pressures are not projected to abate in the near term, and will continue to put pressure on housing issuers.

[4] See 2011 Outlook for U.S. Higher Education, January 14, 2011

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