

Agenda

Review of Recent Rating Actions

Revenue and Spending Trends

Sound Reserve Levels

Willingness to Pay

Recent Bankruptcy and Default Cases

State Intervention Programs

Review of Recent Rating Actions

- Average local government general obligation rating remains 'AA' but trending towards 'AA-'
- 12% downgrade rate YTD
- Upgrades scarce
- Multiple downgrades
- Increasing divide between strong and weak credits
- Expect more isolated cases of default, bankruptcy

Revenue vs. Spending Trends

- Moving in opposite directions
- Flat to declining recent revenue performance
 - Property tax
 - Sales tax
 - State aid
- Natural spending growth
 - COLAs, step increase
 - Inflationary growth
 - Pension, health care increase

Mixed Economic and Revenue Outlook

- Housing market bottomed out in some places, not others
- Property tax receipts are lagged
- Consumption-based taxes have shown improvement
- State aid cuts have abated
- Unemployment rates still elevated; job growth slow
- Income levels stagnant

Labor Environment

- Averages around two-thirds of total spending for most local governments
 - Some as high as 80% or more
- Fitch is refining analysis
 - Enhance predictive qualities of the labor environment
 - Fixed cost burden
- Legal vs. practical constraints
- Value of cooperation and shared goals
- Range of decision-making constraints
 - From unilateral decision by management to impartial third party
 - Local example of breakdown in process: Chicago Public Schools

Potential Mitigants to Labor Constraints

- Layoffs accompanied by severance payments so financial benefit is delayed
- Shared services
- Arbitrator decisions incorporate market conditions
- Pension plan adjustments are continuing despite some challenges
- Other state actions to constrain labor costs have had mixed results and uncertain future
 - Wisconsin
 - Ohio
 - Michigan

Sound Reserve Levels

- Reserves remain strong for most local governments despite some declines during the downturn
- Once the prolonged nature of the downturn became clear most managers turned to recurring budget solutions
- Unrestricted reserves at the end of fiscal 2011 average well over 20% of spending for governments rated in the 'AA' category

Willingness to Pay

- Cases in California and elsewhere raise questions about local governments' commitment to repaying debt
- Willingness to pay has been a hallmark of the municipal market
- Incentives to continue to pay
 - Market access needs
 - Control and autonomy
 - Reputational risk
- Traditional measures of willingness
 - Financial flexibility to pay all obligations
 - Ongoing payment of lease and other obligations
 - Bankruptcy threats, regardless of strategic reasons

Recent Bankruptcy and Default Cases

- Defaults can be triggered by inability to repay debt on large project
 - Jefferson County, AL
 - Harrisburg, PA
- Central Falls, RI reduced pension payments and avoided default
- Vallejo, CA bankruptcy resulted in reduced labor as well as debt service costs
- Are Stockton and San Bernardino a new breed?
 - Factors that led to bankruptcy reflected general credit deterioration rather than a particular factor or event
 - Harder to pinpoint when/whether bankruptcy became inevitable
 - Bondholders identified as an object of potential spending reductions

State Intervention Programs

- Can be positive for deteriorating credits
- Benefit must be demonstrated to be incorporated into credit analysis
- Programs have varying levels of strength and effectiveness
- Examples:
 - California
 - Pennsylvania
 - Michigan
 - North Carolina

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