

State Debt Ratings

Council of State Governments' Southern Legislative
Conference

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Topics to Cover

- **Ratings in General**
- **State Debt Ratings**
- **Impact of GASB 45**
- **State Debt Levels**
- **Bond Insurance**

S&P Rating Definition

ISSUE CREDIT RATING DEFINITION

A Standard & Poor's issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program (including ratings on medium-term note programs and commercial paper programs). It takes into consideration the creditworthiness of guarantors, insurers, or other forms of credit enhancement on the obligation and takes into account the currency in which the obligation is denominated. The opinion evaluates the obligor's capacity and willingness to meet its financial commitments as they come due, and may assess terms, such as collateral security and subordination, which could affect ultimate payment in the event of default.

A Rating Is Not -

The issue credit rating is not a recommendation to purchase, sell, or hold a financial obligation, inasmuch as it does not comment as to market price or suitability for a particular investor.

Long-Term Issue Credit Ratings

Issue credit ratings are based, in varying degrees, on the following considerations:

- **Likelihood of payment—capacity and willingness of the obligor to meet its financial commitment on an obligation in accordance with the terms of the obligation;**
- **Nature of and provisions of the obligation;**
- **Protection afforded by, and relative position of, the obligation in the event of bankruptcy, reorganization, or other arrangement under the laws of bankruptcy and other laws affecting creditors' rights.**
- **Issue ratings are an assessment of default risk, but may incorporate an assessment of relative seniority or ultimate recovery in the event of default. Junior obligations are typically rated lower than senior obligations, to reflect the lower priority in bankruptcy, as noted above. (Such differentiation may apply when an entity has both senior and subordinated obligations, secured and unsecured obligations, or operating company and holding company obligations.)**

Investment Grade Ratings

AAA

- An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

AA

- An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

A

- An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

BBB

- An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

Plus (+) or minus (-)

The ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

Outlooks and CreditWatch

Rating Outlook Definitions

- A Standard & Poor's rating outlook assesses the potential direction of a long-term credit rating over the intermediate term (typically six months to two years). In determining a rating outlook, consideration is given to any changes in the economic and/or fundamental business conditions. An outlook is not necessarily a precursor of a rating change or future CreditWatch action.
- Positive means that a rating may be raised.
- Negative means that a rating may be lowered.
- Stable means that a rating is not likely to change.
- Developing means a rating may be raised or lowered.

CreditWatch

- CreditWatch highlights the potential direction of a short- or long-term rating. It focuses on identifiable events and short-term trends that cause ratings to be placed under special surveillance by Standard & Poor's analytical staff. These may include mergers, recapitalizations, voter referendums, regulatory action, or anticipated operating developments. Ratings appear on CreditWatch when such an event or a deviation from an expected trend occurs and additional information is necessary to evaluate the current rating. A listing, however, does not mean a rating change is inevitable, and whenever possible, a range of alternative ratings will be shown. CreditWatch is not intended to include all ratings under review, and rating changes may occur without the ratings having first appeared on CreditWatch. The "positive" designation means that a rating may be raised; "negative" means a rating may be lowered; and "developing" means that a rating may be raised, lowered, or affirmed.

Municipal Ratings on a Global Scale

- **S&P's ratings opinions and analyses are designed to bring transparency to the global credit markets to help facilitate access to capital. Our ratings also help investors determine which bonds and issuers might meet their individual risk tolerance and investment objectives.**
- **The global credit markets benefit from standards and benchmarks that are understood by all, *which is why we use the same scale across all sectors.***

S&P Municipal Ratings and Default Rates

S&P has been systematically reviewing and upgrading a large number of U.S. public debt instruments over the last several years in response to their generally lower default rates. The result has been higher ratings for those bonds that truly deserve it.

- In 1986, only about 20% of municipal bonds rated by S&P held AAA or AA ratings; by 2007, more than 35% were rated that highly.**
- More than 99% of rated municipal issuers are investment grade, compared with less than 20% of corporate issuers that S&P has rated in recent years.**

Standard and Poor's Rating Distributions

US Public Finance		
Rating	Count	%
AAA	376	3.07%
AA	3818	15.95%
A	5998	48.93%
BBB	1920	15.66%
BB	112	0.91%
B	24	0.20%
CCC	4	0.03%
CC	1	0.01%
C	4	0.03%
D	1	0.01%
Grand Total	12258	100.00%

US Public Finance Housing		
Rating	Count	%
AAA	1377	58.17%
AA	684	28.90%
A	222	9.38%
BBB	35	1.48%
BB	20	0.84%
B	15	0.63%
CCC	7	0.30%
CC	3	0.13%
C	1	0.04%
D	3	0.13%
Grand Total	2367	100.00%

US Corporate Finance		
Rating	Count	%
AAA	5	0%
AA	23	1.26%
A	202	11.05%
BBB	386	21.12%
BB	387	21.17%
B	764	41.79%
CCC	52	2.84%
CC	4	0.22%
D	5	0.27%
Grand Total	1828	100.00%

Municipal Bonds Are Not Risk Free

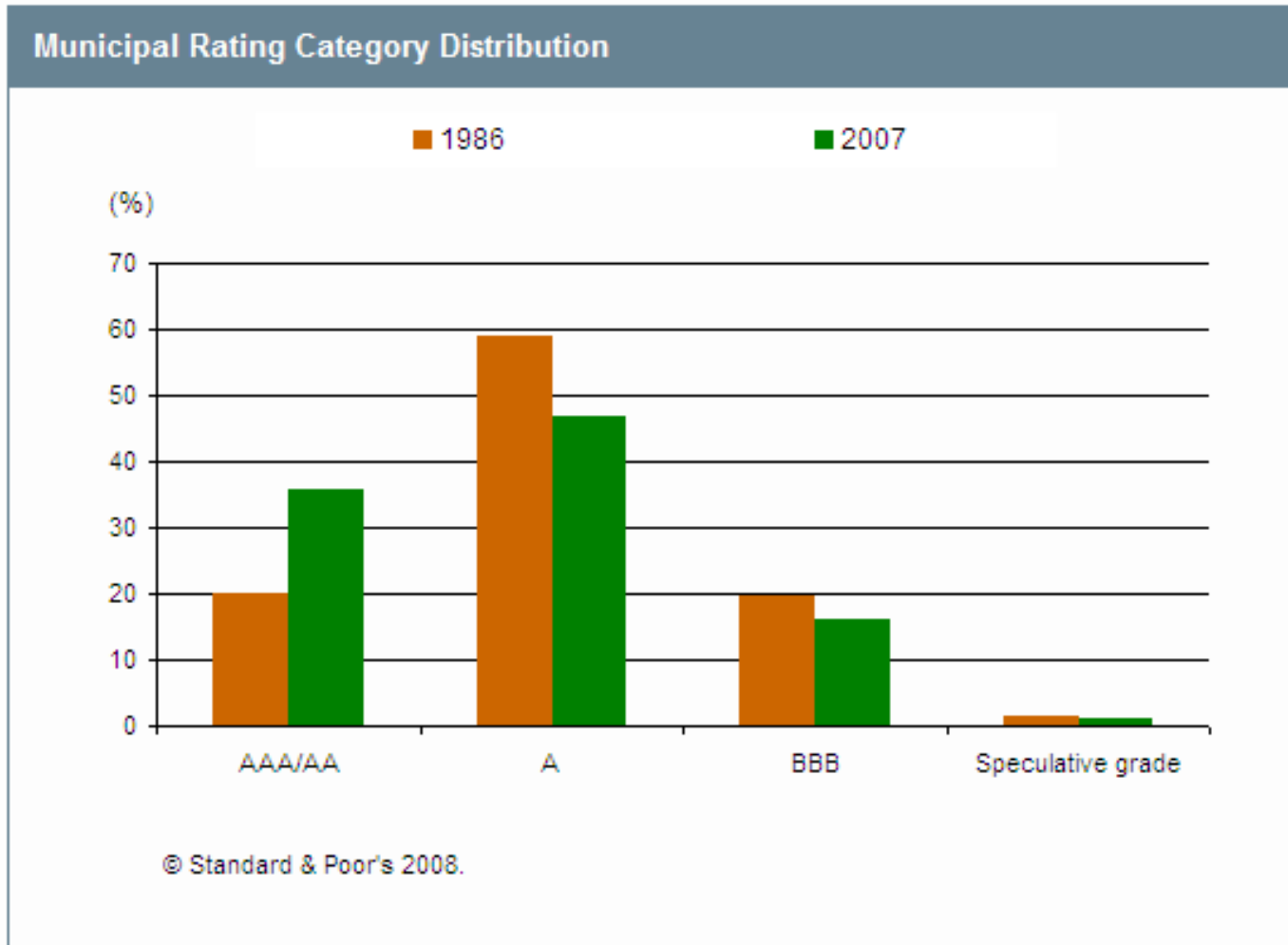
Our recent municipal transition and default study shows 34 defaults by issuers rated by S&P between 1986 and 2006. And just recently, two municipal entities -- Jefferson County, Ala., and Vallejo, Calif. -- have been downgraded substantially due to increased financial uncertainty that they can meet their debt obligations.

Officials in Jefferson County recently stated that they could "provide no assurance that net revenues ... will be sufficient to permit the county to continue to meet its debt obligations," and revenue shortfalls in Vallejo have led that city to consider filing for bankruptcy.

Municipal Bonds Are Not Risk Free

- **Municipal bond market tends to be self-selecting. Higher-risk municipalities that are more likely to default often choose not to have their bonds rated at all.**
- **During 2007, for example, S&P rated only about 40% of the municipal bonds coming to market.**
- **Information obtained by S&P Securities Evaluations confirms that there were more than 1,100 municipal issue defaults between 1986 and 2007, but only 167 of those -- about 15% -- were rated by any rating agency.**

S&P Municipal Ratings Reflect Credit Strength



S&P Ratings Continue to Evolve

- **S&P will revise and refresh criteria as appropriate to best reflect rating performance.**
- **We anticipate further migration up the rating scale in the USPF sector, assuming that creditworthiness, particularly of governmental credits, remains strong.**
- **It is distinctly possible that, over time, much of the public finance-rated universe will be weighted to the 'A' category or better.**
- **We would not expect the same trend in housing, health care, toll roads, or other sectors that exhibit more risk characteristics.**
- **A more incremental understanding of the factors driving credit stability adds value to the market.**

Rating State Debt

- **Economy**
- **Financial performance and flexibility**
- **Debt burden**
- **Administration/Management**

State sector performance through Fiscal 2007

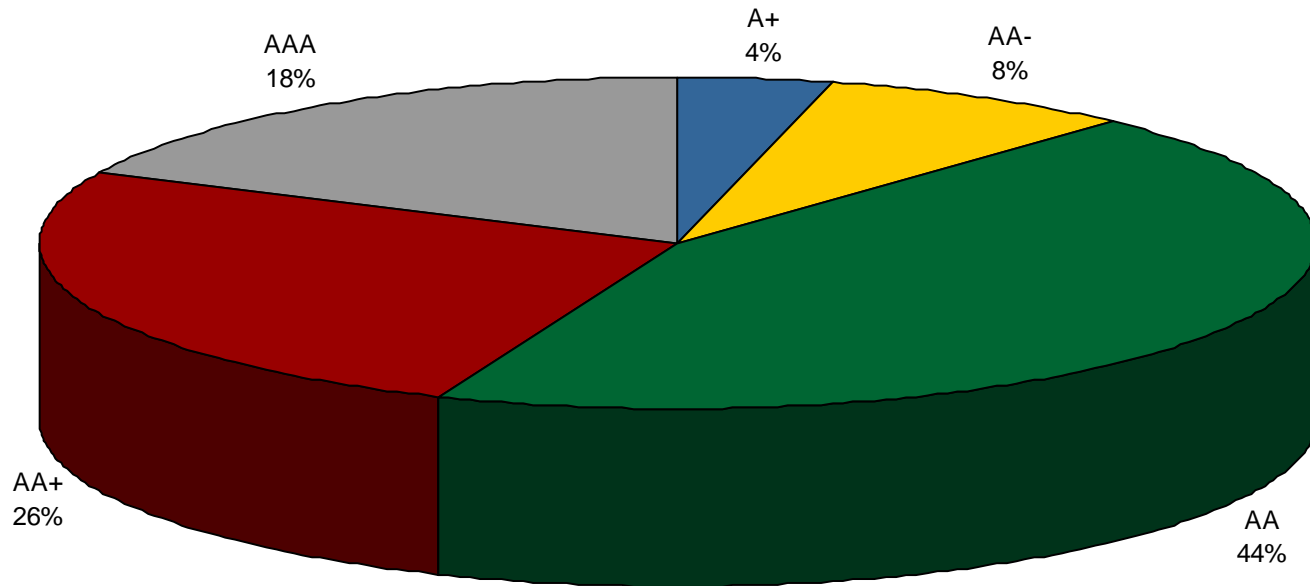
- **State credit sector through fiscal 2007 was strong**
- **Dramatically improved budget conditions for most states through 2007**
- **Some targeted tax reduction measures were implemented**
- **Positive revenue performance through fiscal 2007 increased financial reserves across the sector**
- **Targeted spending initiatives that had been restrained from 2001-04**
- **Medicaid was still a major pressure point but had been easing slightly**
- **Pensions and Other Post Employment Benefits a major focus**

State credit trends through 2nd Quarter 2008

- **11 state ratings were upgraded from 2006 through June 2008 (California, Hawaii, Indiana, Maine, Nevada, Oregon, Tennessee, Washington, Alaska, Wyoming, and Montana) and one state rating was downgraded (Michigan)**
- **One state rating has a positive outlook (Kentucky)**

Distribution of State Ratings as of 7/12/2008

State Rating Distribution¹



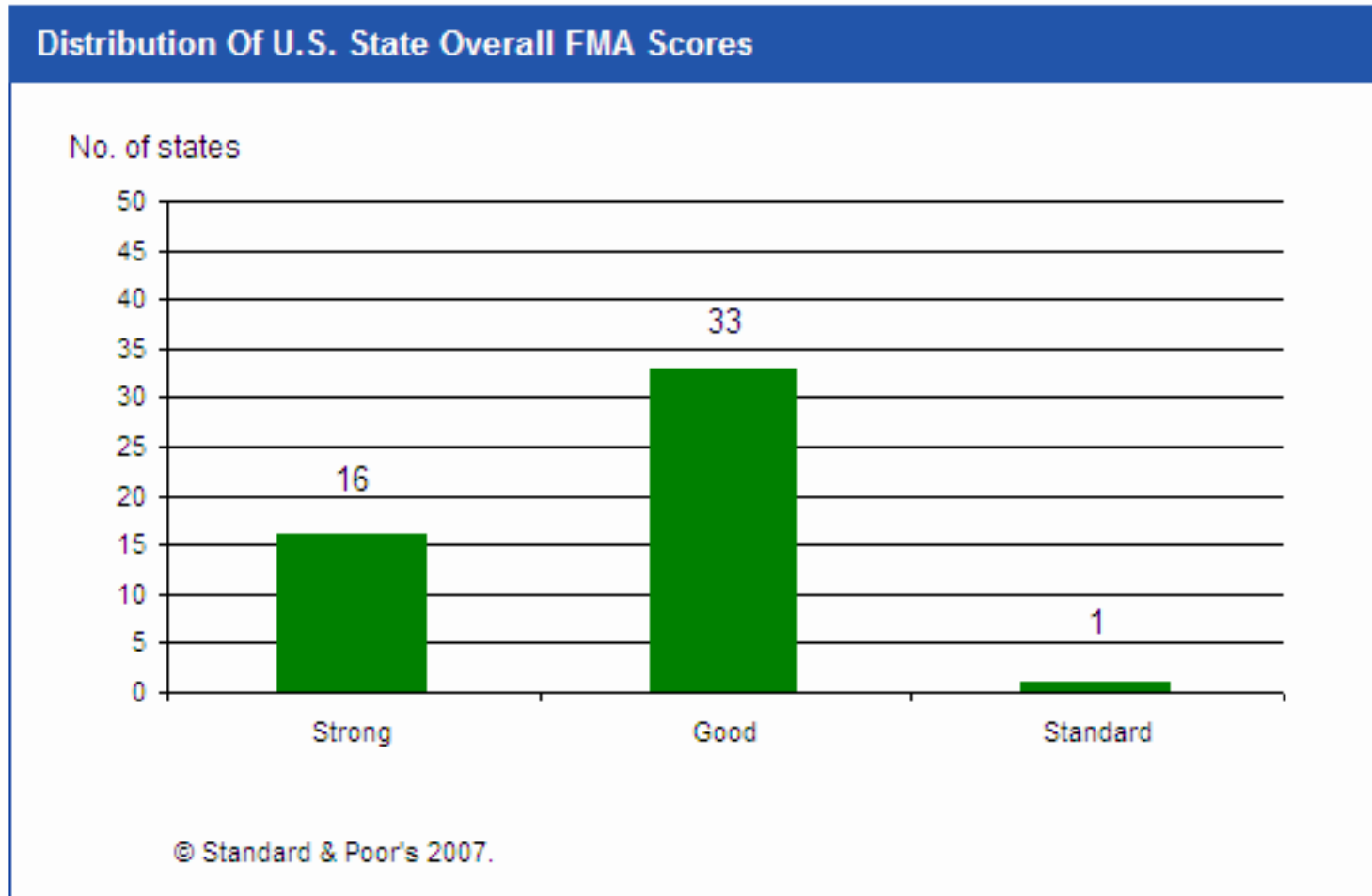
Financial Management Assessment - FMA

- **Introduced by S&P as a criteria enhancement in June of 2006**
- **Better transparency to aspects of the analysis that have existed all along**
- **Better communication and disclosure of the environment in which financial decisions are made**
- **Highlights in a consistent manner the most transparent aspects of management that are common to most governments**

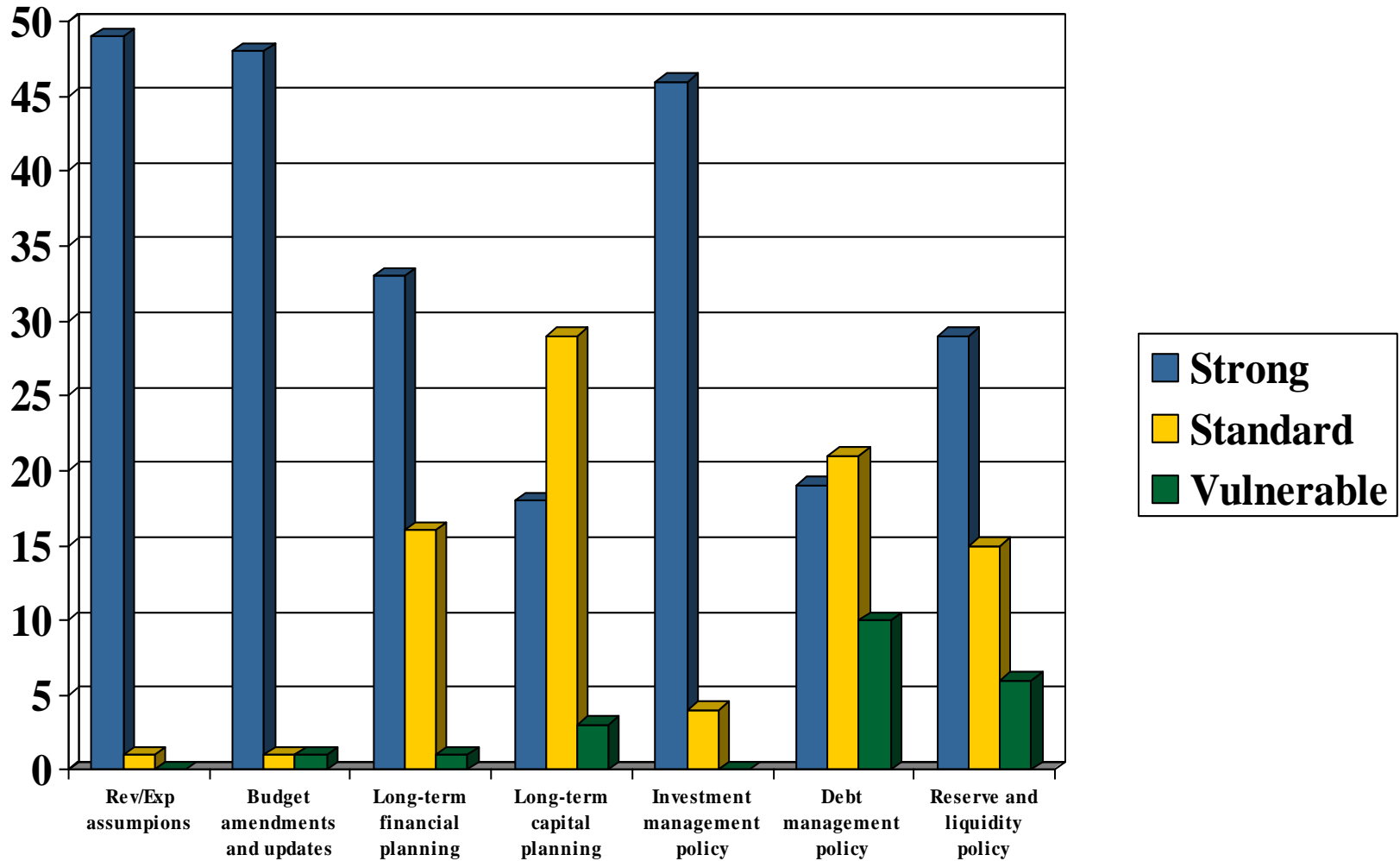
State FMA Scores

- **Distribution mirrors above-average general crediworthiness of the sector**
- **Compared to entire Public Finance sector, FMA distribution is extremely favorable**
- **Overall, state governments have well-developed policies in nearly all areas incorporated into score**
- **Distribution of FMA scores:**
 - **16 strong**
 - **33 good**
 - **1 standard (California)**

State FMA's Reflect Above Average Credit Profile



Distribution of U.S. State Individual FMA Scores Per Contributing Factor



Fiscal 2008: What a difference a year makes...

- **Economic climate weakened considerably in many states and shortfalls have been identified**
- **Economic uncertainty is leading mid-year revenue revisions for the current year as well as fiscal 2009 and beyond**
- **Spending in certain program areas is above budget and spending reduction measures are accelerating in an effort to restore balance**
- **Reserves will likely be less than fiscal 2007**
- **Restructuring of Auction Rate Securities**

Top 10 Fiscal 2009 Budget Trends

Standard & Poor's released report on March 25th, 2008: A Weak Economy Will Tax U.S. States' 2009 Budgets

- **Budget gaps for fiscal 2009 were formidable**
- **Economic weakness and uncertainty permeate revenue forecasts**
- **Broad-based taxes are unlikely; gaming revenues remain popular**
- **Reserves are dwindling**
- **Spending reductions are substantial across many areas**

Top 10 Fiscal 2009 Budget Trends...

- **Tax relief remains a major theme**
- **Federal stimulus is not considered a major factor for state revenues**
- **Accelerated bonding is in the works**
- **State economic stimulus proposals creep into budget proposals**
- **Sales of assets and privatization initiatives are under consideration**

*****Key challenge is fiscal health of local governments*****

Fiscal 2009: Credit Outlook

- **Fiscal 2008 is proving to a challenge from a budget balance standpoint which spills into fiscal 2009**
- **State revenues will continue to decline well after the economic downturn reverses**
- **States tend to have well developed budget and revenue monitoring processes**
- **Early action on budget shortfalls optimal**
- **States with healthy reserves will have broader flexibility to manage revenue volatility**
- **The magnitude of economic decline and the pace of any recovery will ultimately be the key to credit stability**

Status of US State Pensions

- **S&P's Report "Market Volatility Could Shake Up State Pension Funding Stability" – 2/20/08 shows the following:**
- U.S. state pension funding levels fell slightly in fiscal 2006
- The mean funded ratio for the principal state pensions was 81%, compared with 81.8% in fiscal 2005 and 83.5% in fiscal 2004
- Total gross unfunded actuarial accrued liability (UAAL) for the 50 states in 2005 is \$371 billion, up from \$330 billion a year earlier
- The average U.S. state has a UAAL of \$7.2 billion, or \$1,664 per capita, and has a funded ratio of 81%
- Cumulative pension liabilities exceed tax supported debt for 2006

Status of US State Pensions

Best and Worst Funded States, By Funding Ratio			
	Funding Ratio (%)	Total UAAL (\$ millions)	PC UAAL (\$)
Top 3			
Oregon	110.5	(5,364)	(1,449)
North Carolina	106.1	(3,029)	(351)
Florida	105.6	(6,182)	(342)
Bottom 3			
West Virginia	52.7	5,268	2,897
Rhode Island	53.4	4,925	4,613
Connecticut	56.4	14,801	14,801
Data for each state is an aggregate of that state's major pension systems. Data is from 2006. "Market Volatility Could Shake Up State Pension Funding Stability" – 2/20/08			

S&P's Report: **States Are Quantifying OPEB Liabilities And Developing Funding Strategies As The GASB Deadline Nears** – 11/12/07 shows the following:

- 40 of 50 states have completed valuations
- Based on the reports done to date, OPEB liabilities total \$357 billion to \$394 billion for the states (the range reflects valuations that show the a liability with and without pre-funding);
- Range of liabilities is enormous -- \$52 for North Dakota to \$58.1 billion for New Jersey
- Median liability: \$3.2 billion-\$4.1 billion
- Average Liability: \$9.2-\$10.1 billion

OPEB Status

- Comparisons between states are very difficult because there is broad differences in what is measured/included for each state and there is significant variation in the actuarial methods and assumptions used to calculate the liability.
- About 15 states have taken steps to begin to formally address the liability. This would include establishing a trust; implementing benefit changes or providing resources to begin to fund the liability.

State OPEB Solutions

- States have embraced a range of strategies to begin to address liability
- Actions to date include the following:
 - Establishing trust funds
 - Reducing benefits
 - Health care cost containment
 - Increasing contributions
 - One state has moved to ARC funding (Utah)

Liabilities Conclusion

- **Pensions and OPEB represent a \$700+ billion (and counting) liability**
- **Action to address liabilities is underway but will move forward at a slow pace**
- **Flexibility to limit or reduce benefits will be less than the private sector experience due to legal, political or practical constraints**
- **States need to be aware of local liability in this area**

Significance of GASB from a credit standpoint

- Consistency and transparency of financial information is important from a credit standpoint
- Standard & Poor's criteria for GO debt financial analysis includes the following passage from the 2007 Public Finance Criteria book:

"The first important variable in judging financial performance is the method of accounting and financial reporting. Based on the guidelines of Generally Accepted Accounting Principles (GAAP), Standard & Poor's assesses an entity's financial reports."

Significance of GASB from a credit standpoint

- GASB interpretations of accounting rulings are considered by S&P in evaluating the organization of funds, accruals, and other financial reporting methods.
- Generally Accepted Accounting Principles (GAAP) reporting is considered a credit strength by S&P.
- Lack of an audited financial report prepared according to GAAP could have a negative impact on an issuer's credit rating, since questions about reporting will be raised.

How OPEB/GASB 45 fits into the rating process

OPEB touches ratings in in three key areas:

- **Management,**
- **Finances, and**
- **Debt**

OPEB Rating Factors: Management

- Are the OPEB obligations fully understood by management?
- If liabilities are material, what are the options to manage the liability and is there a clearly articulated strategy in place?
- Where does the OPEB problem rank in relation to other planning priorities?
- How conservative (or aggressive) are the methods and assumptions being used to determine OPEB liabilities and plan for the future?

OPEB Rating Factors: Financial

- While there is no requirement to fund OPEB under GASB, how do the commitments impact the overall cost structure?
- Can the budget afford the OPEB ARC or an escalating PayGo scenario?
- Will total carrying charges of bond debt service, pension contributions, plus OPEB contributions be sustainable given existing (or projected) resources?
- Legal and practical ability to manage OPEB costs

OPEB Rating Factors: Debt

- What is the legal obligation of the employer (how “debt-like”) to meet retiree healthcare obligations?
- How does OPEB alter the total long-term liability landscape for the employer: bonded debt + pension liabilities + OPEB liabilities?

NOT a good response to GASB 45



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<u>Date Published</u>	<u>Article Title</u>
January 30, 2008	OPEB Liabilities Pose Some Risk For State And Local Governments
November 14, 2007	U.S. States Are Quantifying OPEB Liabilities And Developing Funding Strategies As The GASB Deadline Nears
June 26, 2007	California's OPEB Liabilities Are Prompting A Review Of Future Funding Decisions
June 5, 2007	New Texas Law Affecting State And Local OPEB Reporting Will Have No Immediate Rating Impact
February 27, 2007	Improved U.S. State Pension Funding Levels Could Be On The Horizon
December 4, 2006	Credit FAQ: OPEB Liabilities Pose Minimal Near-Term Rating Risk For Public Finance Credits
September 26, 2006	An Aging Population Challenges U.S. State Budgets And Renews Interest In Health Care Reform
August 11, 2006	How Big U.S. Cities Are Faring With The Pension Fund Meltdown
June 15, 2006	Accounting for OPEB Liabilities: Can State & Local Governments Cope?
May 3, 2006	Funding OPEB Liabilities: What It Means For Minnesota's Local Governments
December 15, 2005	Funding OPEB Liabilities: Assessing The Options
November 16, 2005	Public Employers Are Exploring A Switch To Defined Contribution Pension Plans
April 21, 2005	Are OPEB Obligation Bonds A Viable Option To Fund Liabilities?

State Debt Issuance

- **More than \$10 billion of state-related debt has been restructured**
 - ARS has increased from about 1% of total public debt issued (1998) to more than 10% (2004)
- **A weak economy could lead to significantly higher debt issuance in order to meet budget requirements**
- **Discretionary resources to fund capital requirements have evaporated**
- **Unfunded pension liabilities**
- **Pressure to continue to fund infrastructure improvements**
- **Total debt issued by states and state authorities has increased from roughly \$110 billion in 1998 to about \$180 billion in 2007**

Measuring State Debt

- **Debt per capita**
- **Debt as a percentage of personal income**
- **Debt amortization**
- **Fixed rate versus variable rate**
- **Debt Derivative Profile (DDP)**

State Debt Ratios (Fiscal 2007)

- **For states with debt outstanding:**
 - Total debt outstanding ranged from \$38 million to more than \$57 billion
 - Total debt per capita ranged from \$21 to more than \$4,200
 - Debt as a % of personal income ranged from 0.1% to more than 9%
- **A new State Debt Report Card should be available this week**

Bond Insurance

- **Remember:**
 - States have very high ratings on their own
 - States are not major users of bond insurance
 - The market at large is utilizing bond insurance at levels well below historical norms

Municipal Bond Issuance: First Quarter 2008

	<u>Total Issuance</u>		<u>Insured</u>		
Issuer Type	Number of Transactions	Amount (\$MM)	Number of transactions	Amount (\$MM)	Percent Insured Penetration of Par
STATE	32	8,762.580	3	1,048.120	12%
STATE AUTH	294	24,106.144	37	4,481.825	19%
All Other	2030	50,741.082	719	16,733.997	33%
Total	2356	83,609.806	759	22,263.942	26%

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