After the S&P Downgrade of U.S. Debt to 'AA+', Are Any Municipalities Worthy of Triple-A Status?

MTAM Says Yes

Last Friday, Standard & Poor's Ratings Services lowered its long-term sovereign credit rating on the United States of America to 'AA+' from 'AAA'. S&P faulted the nation's political process and criticized lawmakers for failing to cut spending or raise revenue enough to reduce record budget deficits. S&P also said that the outlook on the long-term rating is 'negative' as it becomes less confident Congress will end Bush-era tax cuts or tackle entitlements. The rating may be cut to 'AA' within two years if spending reductions are lower than agreed to, interest rates rise, or "new fiscal pressures" result in higher general government debt.

The $2.9 trillion municipal bond market is preparing for thousands of downgrades as S&P will be cutting its ratings on municipal debt secured by the federal government, such as pre-refunded bonds, tax-exempts backed by U.S. agencies, and credits that are most dependent on federal spending. Overall, municipal credits are deemed more vulnerable to the U.S. downgrade than corporate credits given their reliance on federal funding. Those with greater reliance are the most vulnerable.

S&P is expected to immediately downgrade pre-refunded bonds. When municipal bonds are refunded, investors typically are repaid from Treasuries held in escrow. Any defeased bonds backed by U.S. agency securities are also considered vulnerable. MTAM believes that pre-refunded bonds are still an excellent credit, and are just likely to be slightly less liquid than usual.

Next on the list of the most at-risk municipal credits are the billions of dollars of debt issued by public housing authorities secured by federally guaranteed mortgages. Today, S&P downgraded Fannie Mae and Freddie Mac, the two main government-sponsored enterprises used by state or local public housing authorities.

The biggest long-term threat to municipal credits is the possibility that the federal budget will be cut more deeply. MTAM anticipates that the lawmakers in Congress will react to this downgrade by cutting more spending over time. States that rely heavily on government spending -- such as Virginia and Maryland, which are home to many federal employees and defense contractors -- could suffer. States, counties, cities, school districts, and hospitals might have to borrow more to make up for cutbacks in federal programs. Hospital credits could be weakened further if the federal government slashes healthcare programs.

Anticipated state and local government downgrades from S&P may be similar to potential ratings cuts Moody's mapped out last month. Moody's on July 13 said a possible U.S. downgrade would affect 7,000 municipal credits totaling $130 billion that are directly linked to U.S. credit. Moody's also said it would review indirectly linked credits, and last month put five of the 15 states it rates 'Aaa' on review for a potential downgrade because of their vulnerability to cuts in federal spending. Moody's wound up reaffirming those top ratings last week, assigning a negative outlook.

The University of Washington, with $1.3 billion of debt, was singled out by Moody's as being especially impacted due to the University's unusually large share of revenues derived from federal research

grants and Medicare and Medicaid reimbursements. The University's maintenance of a triple-A rating will focus on management's ability to maintain balance sheet reserves and operating cash flow, while reducing expenses or increasing revenues in response to potentially significant federal funding cuts.

The downgrading of the U.S. rating might have had more impact on municipals in previous years, when there was an expectation that the U.S. federal government might ride to the rescue of beleaguered states or cities. Since it is widely believed that the federal government is not in any position to bail out states, most municipal market participants recognized that the notion of the federal government as a backstop was unrealistic, and has been largely discounted.

In addition, the immediate market impact of the U.S. downgrade might be somewhat muted by the municipal market's traditional strengths. Many of the tens of thousands of tax-exempt issuers, from states to counties and school districts, raise revenue from their own taxes and fees, independently of the federal government.

S&P said the downgrade of the U.S. could "disrupt the capital markets, making it more challenging for some public issuers to get financing…" On the other hand, it is also possible that investors would view U.S. public finance issues as a safe haven. State governments should be evaluated in light of the flow of federal funds, and the potential impact of fiscal contraction on a state's economy. Liquidity and financial flexibility should be key considerations. What happens to state and local government bond ratings will depend to a large degree on how they manage with less federal funding.

MTAM does not expect sector-wide rating actions. Local governments will be evaluated on a case by case basis, but widespread rating actions are not anticipated. Higher interest rates as a result of the U.S. downgrade might potentially pressure financially weaker governments, especially those with variable-rate exposure. Not-for-profit healthcare ratings will depend on various factors, including the still unfolding healthcare reform rules. Higher education and not-for-profit corporations could see a modestly negative impact. Public utilities will likely not be affected, but some outlooks could be revised to negative. In the transportation sector, the outlook for Garvee bonds — secured by federal transportation grants — could be changed to negative, as all federal budget priorities will be uncertain. Most other transportation group ratings would not be affected. Public housing issues with federal guarantees will generally move in lockstep with the sovereign rating. Factors weighing on specific housing credits include high levels of government mortgage insurance, and high delinquency and foreclosure rates.

At this time, an important question to ask is: *if the U.S. is no longer triple-A, can any municipal credit still be triple-A?* The rating agencies may decide to say no, but MTAM points out that state and local governments for the most part are required to balance their budgets, unlike the federal government. And they have been doing so, for the most part, despite the ravages of the recession and declining tax revenues. The federal government, meanwhile, has been footing the bill for costly wars, entitlements, and economic stimulus programs.

A credit rating compresses an enormous amount of diverse information into a single symbol. Credit quality embraces relative default probability, loss severity, financial strength, and transition risk (referring to the uncertainty with respect to the levels and timing of credit events). Bonds with the same credit rating, therefore, may be comparable with respect to overall credit quality, but may differ with respect to specific credit quality characteristics. MTAM believes that in order to have a credible rating scale that is topped by triple-A, at least some municipal credits must be deemed worthy of that designation. When determining a municipal bond's credit rating, MTAM uses it own proprietary credit research team to compare several numerical measures to sector medians. Those credits that meet and exceed the highest medians, and have other top-notch security features, are deemed triple-A by MTAM, independent of the rating agencies. Even during a recession, when those overall medians are

lower than in times of economic prosperity, triple-A credits must still exist as states are compared with other states; and school districts are compared with other similarly-sized school districts.

The State of Utah, for example, remains a triple-A rated state determined by MTAM's comparison with other U.S. states. Utah's conservative debt and fiscal policies have kept debt levels moderate and quickly amortizing, and have allowed for successful and timely action when addressing budgetary imbalances. The state has a history of taking action to close budgetary gaps and has prioritized building reserves. The state's debt profile is strong with rapid amortization, moderate debt burden despite an increase in debt for transportation needs, and adequately funded pension system. The state also benefits from a growing and diversifying economy, and has successfully managed associated operating and capital spending pressures, especially for education and transportation.

The Massachusetts Institute of Technology also remains a triple-A rated university, besting all of MTAM's medians for similarly-sized private universities. MIT enjoys a global market position as an elite science and engineering university with a preeminent research profile; exceptionally large balance sheet providing strong coverage of debt and operations; history of extraordinary philanthropic support; expendable financial resources of $7.2 billion; and consistently healthy operating performance expected to continue due to strong oversight and fiscal stewardship.

Both the State of Utah and MIT would be impacted to some degree by a decrease in federal spending; but would remain triple-A credits even under the most stressed scenarios.

In assessing the impact of the U.S. downgrade on a municipal credit, MTAM will evaluate the strength of the sovereign linkages to each affected credit, including direct and indirect reliance on federal spending, sensitivity to deteriorating macroeconomic conditions, and vulnerability to disruptions in the financial markets. MTAM will also consider positive credit attributes of each issuer such as financial position, operating flexibility, and management responsiveness.