TESTIMONY OF ROBIN PRUNTY

MANAGING DIRECTOR, RATINGS SERVICES,

STANDARD & POOR'S FINANCIAL SERVICES LLC

BEFORE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 15, 2011

Mr. Chairman, Mr. Ranking Member, Members of the Committee, good afternoon. My name is Robin Prunty. I serve as a managing director in Standard & Poor's Ratings Services business ("S&P"), and I am an Analytical Manager for the State Ratings Group at S&P. S&P is a credit rating agency, and, as such, conducts analysis and forms forward-looking opinions about the creditworthiness of debt and debt issuers, including, among others, states and municipalities. Our core mission is to provide the markets with quality, independent analysis, and we publish our opinions broadly to the world. I am pleased to appear before you today, and intend to cover two main topics: (i) the significant financial and budget challenges faced by states and municipalities, and (ii) our views on the general credit outlook for states and municipalities we rate.

Background on the Municipal Market and Credit Quality

The diversity of the municipal bond market defies easy generalization. There are a wide variety of issuers ranging from fire districts to state governments. In addition, there are many different security pledges supporting debt issued by state and local governments. We rate over sixty different security types ranging from the more common general obligation pledge to narrowly based revenue or tax pledges. S&P maintains ratings on approximately 17,500 distinct state and municipal issuers, but these ratings do not encompass the entire municipal market. There are nearly 90,000 local government entities in the U.S. and many are authorized to issue debt. Municipal issuers tend to be self-selecting: that is, municipal issuers of lower credit quality tend not to seek credit ratings. Correspondingly, the universe of rated municipalities is, as a general proposition, more creditworthy and generally less likely to default than non-rated issuers.

In light of this, in assessing the difficulties faced by states and municipalities in the aftermath of the recent economic recession, it is important to distinguish the nature of the challenges they face. S&P believes the difficulties faced by states and municipalities will give rise to tough policy decisions, but not defaults for our rated universe in the overwhelming majority of cases. This is because debt obligations are secured either by a specific pledge of the government's full taxing authority or dedicated taxes, user revenues or fees, and there is often a priority status for debt relative to other obligations. We have generally seen a very strong commitment by governments to their debt obligations over time, despite difficult economic cycles. Because states and in many cases local governments, are required to balance their budgets rather than finance budget deficits through debt issuance, they are annually making choices to align revenues and expenditures. Since the onset of the recession, we have seen many U.S. states and local governments making difficult policy and budget choices in an effort to balance their budgets. These actions, along with federal stimulus funding, contributed to relative credit stability for most U.S. public finance issuers. While credit downgrades have increased over the past two years and we expect there could be further credit deterioration in 2011, 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. Over the past twenty five years, there have been 42 defaults for non-housing issues in U.S. Public Finance at S&P; 40 were rated non-investment grade immediately before the default ("U.S. Public Finance Defaults and Rating Transition Data: 2010 Update"). There has been one observed default by a state in more than one hundred years. Although the number of defaults has been, relatively speaking, low, we do believe securities issued by rated municipalities can still face meaningful default risk.

Difficulties faced by States and Municipalities

Because of the slow progress of recovery from the recession, S&P believes that continued flat or slow revenue growth trends for state and local governments may add to fiscal strain on budgets and liquidity, especially in the short term. We expect the difficult budget environment to continue for many rated state and municipal issuers in 2011.

The severity and duration of the recent recession suggests to us that economic recovery could continue to be slow. Standard & Poor's forecasts U.S. economic growth of 3.1% 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; “U.S. Economic Forecast: A More Prosperous 2011?” published on Jan. 5, 2011; and “U.S. Economic Forecast: Pouring Water On Troubled Oil” published on March 8, 2011, available on S&P’s Global Credit Portal). Reduced spending, be it from lower incomes or from saving more, translates to lower overall demand, employment, and tax revenues.

We believe the housing market is likely to continue to provide an additional source of economic pressure. 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 were to take hold, we expect that state and local government revenues may continue to demonstrate a muted response to the recovery owing to the end of federal stimulus funding 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. Revenue recovery is underway for most states, but remains below pre-recession levels for most. According to the U.S. Census 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.

In addition to the effects of the recession and the subsequent slow recovery, we believe that pensions and other post-employment benefit obligations represent material long-term risks to governments and have long been factored into our criteria for rating state and local governments. Recent investment performance of the assets in most pension trust funds are well below historic trends, and negative in many cases, calling into question certain assumed rates of return on these assets. As voters face economic pressures and market losses in their retirement accounts, taxpayers' and legislators' willingness to guarantee pension benefits for public employees may waiver. Actuarial projections of future contributions necessary to fund the benefits or to restore funding levels to pension funds depict potential tradeoffs that taxpayers -- and voters -- may be unwilling to accept. Governments that are not funding their annual required contributions risk the most significant changes in budget capacity.

Such concerns have given rise to pension reform movements in certain states. Some states are re-examining the fundamental nature of the governments' obligations, while others are focused on containing the growth of existing liabilities by reducing benefits levels for all newly hired government employees. While we believe that liabilities to public employees present genuine long-term pressures on government credit quality, they generally are not immediately competing for most governments' capacity to fund their debt service or meet their other priority payment obligations. History strongly suggests that the majority of governments can and will make the needed adjustments. Prior to accounting changes in the 1980's that required governments to report pension liabilities in their financial statements, there were limited assets to fund liabilities and many changes and reforms were made to public plans to improve funding levels. In general, we believe worst-case scenarios regarding pensions will likely occur only if governments are unable or unwilling to use their powers of adjustment.

Impact of Budget Gaps

If the economic recovery staggers in combination with revenue reductions, we think that fiscal strain can evolve into outright budget crises for particular locales that have low reserves and thin financial liquidity.

Most U.S. states and many local governments are required by law to balance their annual budgets, which can necessitate difficult service cuts or tax increases when resources are insufficient to fund baseline spending trends. If this occurs, policymakers may face difficult decisions representing zero-sum tradeoffs for stakeholders, many of whom may 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. Notwithstanding the difficult policy choices facing state and local governments, S&P continues to expect that most issuers we rate will retain strong or even very strong capacity and willingness to meet their debt obligations. Moreover, there is little incentive for them to allow their debt obligations to default. This is in part because the funds required for debt service are relatively low; the median debt service among U.S. states was 3.0% of total expenditures for 2009. Foregoing or canceling debt payments would therefore yield relatively little in terms of budget savings. 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 been a significant 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 disbursement 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.

We have observed that governments have made many improvements to budget structure, reserve policies, and debt management during prior periods of budget stress, which, in our view, have generally enhanced their ability to manage through downturns. 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 suggest that the discussion may continue in earnest during 2011. The new law requiring Illinois to produce public multi-year financial forecasts is an example of the reform efforts.

Outlook for Municipal Markets

We anticipate greater market volatility in the prices for municipal securities in 2011. In our view, rating downgrades, instances of severe fiscal problems and a generally softer environment for municipal credit could well occur. But we also believe that fundamental credit performance of states and municipalities we rate -- as measured by default rates relative to debt outstanding in the market -- will likely remain mostly stable with the possibility for a modest up-tick, in light of the difficult economic and revenue environment.

State and local governments could be faced with the prospect of selling bonds to a narrower investor base in 2011 compared to 2009 and 2010 due to the expiration of the Build America Bond ("BAB") program, which had temporarily reduced their cost of borrowing. Without that program, 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 bonds in the market could result in higher interest rates for issuers in need of financing.

Although noteworthy for the municipal market, expiration of the BAB 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.

Government Response Is Key

The recent recession revealed common challenges faced by many state and local governments, and we believe such governments will be facing the lagging effects for at least the next couple of years. Effective financial management will be key and governments have strong powers of adjustment, which in our view means they generally have an ability to withstand what we consider to be extreme stress scenarios that could otherwise lead to default. However, we believe that if governments consistently rely heavily on debt and other one-time solutions and continue to ignore or postpone service provision, revenue enhancement, pension and other post-employment benefit funding needs in the hope that economic growth will balance their budgets, they could be setting themselves up for greater hardship in the near future.

While we expect there may be an increased number of public finance rating downgrades in 2011, we believe the majority of state and local government issuers we rate will likely retain solidly medium-to-high investment grade ratings. Throughout difficult economic periods, including during and after this most recent 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, governments' management of cash and their commitment to debt obligations has remained largely apolitical in our view. If we were to observe a change to this, the credit implications could be significant. While there are vulnerabilities in the public finance sector, our expectation based on our analysis is that the threat of default is generally not widespread among the state and municipal issuers we rate. Moreover, whatever budget or political crises the recession has caused, and whatever doubts may be held about the wisdom of public policy directions or the priorities of the public sector, we expect the overwhelming majority of rated U.S. state and municipal governments will survive the recession without defaulting.

Conclusion

I thank you for the opportunity to participate in this hearing, and I would be happy to answer any questions you may have.

Committee on Oversight and Government Reform
Witness Disclosure Requirement – "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name: Robin Prunty

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1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2008. Include the source and amount of each grant or contract.

None

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2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

I am testifying on behalf of Standard & Poor's Ratings Services.
I am a managing director in the Public Finance Ratings Group within Standard & Poor's Rating Services

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3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2008, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

S&P has entered into contracts in connection with ratings of debt and issuers of debt in which the Federal Government has an interest.

I certify that the above information is true and correct.
Signature: Robin L Prunty Date: 3/14/11