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PRESENTATION TO HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM, SUBCOMMITTEE ON HEALTH CARE, DISTRICT OF COLUMBIA, CENSUS AND THE NATIONAL ARCHIVES

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THE DISTRICT OF COLUMBIA: CURRENT CREDIT QUALITY ASSESSMENT

Thank you for giving me the opportunity to speak on the District of Columbia's credit quality and rating prospects. Before I begin my remarks, let me state that Municipal Market Advisors ("MMA") is a fully independent research company without any trading, investing, or underwriting interests. We produce a range of research and commentary on the municipal bond market, and our subscribers include dealer firms, mutual fund companies, regulators, issuers, and even a few retail investors.

DISTRICT'S CREDIT PROFILE IS STRONG: While MMA comments extensively on general market dynamics, we also provide research opinions on individual bond issuers. Our analytic focus is weighted strongly on a bond's security structure, meaning the constitutional and statutory procedures, the legal indentures, and the loan agreements that provide the framework by which revenues are collected and bondholders are paid. Through this lens, the District of Columbia provides a solid credit profile. The security pledges to bondholders under its two main borrowing programs are well made and carefully tended. These bonds should, and do, qualify for above average bond ratings as the risk of payment default is very small.

GENERAL OBLIGATION BONDS: The District's bonding programs include general obligation ("GO") bonds, which are specifically paid out of a special district-wide property tax levied and collected for this purpose only. That tax, which is set each year to cover the amount of debt service coming due, is deposited into a separate debt service fund set off from the District's other financial operations and can only be spent for general obligation debt service. Should tax collections be insufficient, bonds must be paid out of all other District funds not otherwise committed. Payment of GOs does not require District or Congressional approval. The District has approximately $2.96Bn of GO debt outstanding, currently rated Aa2/A+/AA- by Moody's, S&P, and Fitch, respectively. Both Moody's and Fitch sharply raised their ratings on the District's GOs in 2009 (from A1 and A+, respectively) as part of a sector-wide recalibration of their municipal ratings to the global rating scales already being used for corporate, structured, and international sovereign credits. These recalibrations were not upgrades per se, but instead recognitions of the historically lower default and loss risk characterized by municipal borrowers.

INCOME TAX BONDS: The second principal program used by the District of Columbia is its Income Tax Secured program, under which $2.89Bn of debt is currently outstanding: very close to this program's $2.92Bn limit. This is a new program, launched in 2009, that carries much higher bond ratings (Aa1/AAA/AA+) because of its structure, whereby income taxes are collected by an outside agent and transmitted to the bond trustee daily for periodic payment of debt service. Again, no appropriation or District action is required to ensure debt service is paid. Projected coverage of peak debt service by collected revenues is greater than 5 times, although the District's borrowing capacity is somewhat higher, permitting projected peak debt service coverage to fall to 2 times by pledged revenues.

STRONG FINANCIAL MANAGEMENT BENEFITS CREDIT QUALITY: Because of its history of being subjected to a financial control board, the potential for re-imposition of the board should District management stray, and a likely interest in minimizing incremental Congressional rulemaking, the District operates itself in a highly conservative manner. Importantly, while the District has greatly benefitted from the current management team, many of the procedures they follow are institutionalized in statute or regulation. This means subsequent management teams are less likely to stray from current policies than would be the case in other jurisdictions where similar practices are not codified. Specifically, the District CFO estimates revenues four times a year and completes five year revenue projections. Congress requires the maintenance of two financial reserves that together equal 6% of annual expenditure. The District recently passed legislation to require two additional working capital reserves that, when fully

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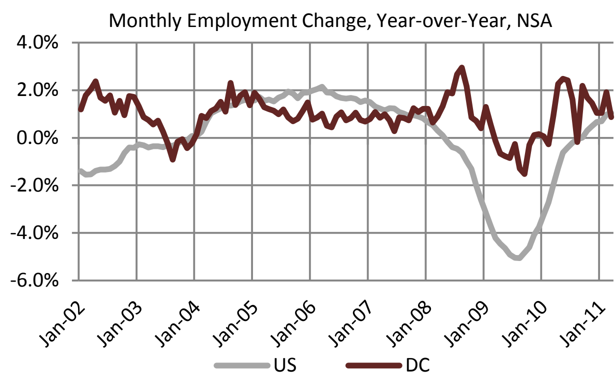
built up, will push total financial cushion to 16% of expenditures: similar to peak reserve levels maintained prior to the financial crisis. Finally, all District reserves feature strong replenishment provisions: a best practice for a governmental issuer.

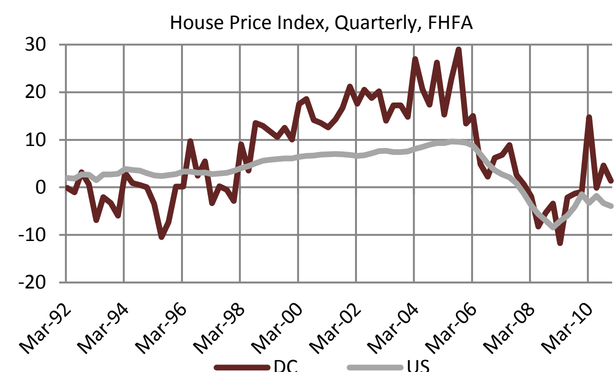
We note two recent management successes:

- The District-led imposition of a stricter debt cap than that allowed under the Home Rule Act, which itself addressed only GO debt and permitted near extreme levels (at 17% of annual revenues) of GO debt service. The District's new Debt Cap Law instead limits all tax-supported debt, including the income tax bonds, to 12% of annual expenditures. Current tax-supported debt service is 10.2% of annual expenditures. The District had some difficulty remaining within the debt cap during the financial crisis as expenditures were steadily cut in response to falling revenues. In general, the District's higher debt levels make its regular financial operations less flexible than similar credits. However, this debt cap is broadly appreciated by the rating agencies; its imposition bolstered their opinions of the District's strong financial management.
- The District's aggressive and successful restructuring of its variable rate debt portfolio which, in 2008, amounted to 22% of the District's total debt burden. Variable rate bonds employing interest rate swaps were 12% of the District's total debt. Following the flight to quality in US Treasury bonds that started in mid-2007, monoline bond insurer downgrades that began in -December 2007, the auction rate market collapse in February 2008, and the crisis in confidence in bank counterparties that continued into 4Q08, interest rates spiked across the entire municipal bond sector, and many municipal issuers with variable rate debt and related swaps found themselves facing much higher near-term debt service costs. In large part, the District used its new, highly-rated income tax bond program to restructure these troublesome positions into fixed or new floating debt, reducing its variable rate debt exposure to just 9% at present. Interest rate swaps are now attached to only 5% of the district's bonds. It is unclear to what extent the rating agencies value the District's success in mitigating the large risks it faced; however, investors in the District's bonds are now much better insulated from contingencies or shocks that might develop from the banking sector.

THE RECESSION AND FINANCIAL CRISIS WILL CONTINUE TO POSE CHALLENGES: In addition to its debt portfolio, the District has faced stiff challenges from the financial crisis as economic weakness undermined revenues. In response to both initial and mid-year budget gaps, the District relied heavily on a mix of reserve fund draws, spending cuts, ARRA cash and other one-time measures, and to a limited extent, new revenues. The general fund balance has fallen from its 2005 peak of $1.6Bn to $0.9Bn in FY10. And pressure continues: absent additional ARRA funds, the FY11 budget draws another $186MM from the fund balance, leaving end of period cash resources at 11% of planned appropriations. To arrest this trend, the District is proposing a new budget with zero reserve draws through 2015 and the transfer of unrestricted reserve amounts into more formally maintained working capital balances, as noted above, which should help protect against reserve fund draws in the future. This will be an important safeguard as, should economic growth slow again, District revenues will reasonably come under renewed financial pressure. The District's proposed income tax rate increase is also a strong credit positive if approved. The municipal market is currently rewarding issuers willing to use all means of structural solutions, in particular tax increases which have been removed by consideration by a great number of issuers, to create lasting budget balance.



ECONOMY HAS STRUGGLED, BUT DC IS FAR BETTER OFF THAN MOST OTHER CITIES AND STATES: The District of Columbia's great credit weakness is its inability to tax non-resident commuters or governmental buildings, which together represent the large majority of economic activity within the District. Absent a change in this rule, it is unlikely the District's GO rating will ever achieve AAA status on its own. However, the location of the Federal government and related organizations and businesses has meant above average employment and income trends over the last five years. In addition, house prices are rising briskly, and long term, very favorable trends for Federal government-related employment, should encourage further development within the District itself, implying an improving ability to pay across the entire tax base. Still, the economic is consistent with other large urban areas, has structurally higher poverty and unemploy-



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ment rates. District investment in its schools is an offset here, but, long-term service provision costs will be a higher burden on taxpayers and keep both tax and debt levels elevated.

RATING AND DEMAND OUTLOOK IS STABLE TO POSITIVE: While Moody's and Fitch have taken a far more conservative stance than S&P toward municipal ratings in the last year—downgrades outpacing upgrades—both agencies have recently written highly positive reports on the District's GO security, with notable risks being erosion of current financial practices and a potential retrenchment of the Federal government. Neither of these appear likely in the near or medium-terms, implying more rating upside than down. Further, S&P's more conservative A+ rating has been restrained by the District's modest use of fund balance over the last few years, its above average debt levels, and its inability to tax commuters or government buildings. Should the District be able to rebuild reserves as planned, rating upside does exist—although this is limited. A credit upgrade would be an important factor for the District's market access costs. The municipal bond market has been deeply affected by the collapse of the AAA bond insurers, which effectively removed about 50% of the "high grade" supply from the market. Yet individual investors, who represent the backbone of demand for municipal bonds, continue to strongly favor bonds rated AA and better, paying a far higher premium for these kinds of credits than in the past. Thus, were the District's GO security to garner at least AA-category ratings from all three agencies, market acceptance should improve, meaning markedly lower borrowing costs for new bond issues.

INCREMENTAL RULEMAKING NOT WARRANTED, FOR NOW: With the improvements made over the last few years, MMA sees little need for additional reserve requirements, borrowing caps, or management processes at the current time. In MMA's opinion, the District has maintained a very reasonable balance between conservatively managing its finances and leveraging its resources to maximize services. However, with recent threats over a Federal government shutdown potentially threatening the District's ability to pay its $240MM certificates of participation (COPs) outstanding, not to mention many of its day-to-day functions, Congress should consider loosening Federal oversight requirements to allow somewhat greater District autonomy so long as financial metrics are being met.

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