Testimony of Robert Kurtter
Managing Director, U.S. Public Finance
Moody's Investors Service

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Hearing on State and Municipal Debt

I. Introduction

Good afternoon Mr. Chairman, Congressman Quigley and members of the Subcommittee. My name is Robert Kurtter, and I'm a Managing Director in the U.S. Public Finance Group at Moody's Investors Service ("**Moody's**"). Thank you for inviting Moody's to participate in today's hearing and share our views on the creditworthiness of state and local government bonds as part of the Subcommittee's inquiry into the financial situation of these entities.

In my testimony, I will explain what Moody's opinions on U.S. public finance bonds address and the key factors we consider in our credit analysis before turning to our current outlook on state and local government issuers. As part of that discussion, I will outline the assumptions that underpin our views on the U.S. public finance market and describe how we have taken and continue to take pension liabilities into account. At the outset, however, I would like to highlight the following:

- The U.S. public finance sector encompasses a large and very diverse universe of issuers.
- Different types of issuers face different pressures and have different tools to deal with the challenges they may face.
- Issuers in this sector are experiencing severe stress from the worst recession since the Great Depression.
- While many states and local governments are facing revenue and spending challenges, we believe it is very unlikely that any states will default on their bonds in the next 12-18 months and we expect only a relatively small increase in bond defaults by Moody's-rated local governments. This is because state and local governments have very strong incentives to meet their bond payment obligations.

I also want to emphasize that there are a significant number of unrated U.S. public finance bonds. Therefore, my comments should not be generalized to the entire universe of public finance bonds because, historically, unrated issuers and bonds have demonstrated greater levels of credit risk and may continue to have quite different risk characteristics in the future.

II. WHAT MOODY'S OPINIONS ADDRESS – AND WHAT THEY DO NOT

Next I would like to explain what Moody's opinions on the U.S. public finance market address – and what they do not address. There has been a lot of attention paid recently to the debt levels of states and local governments. The term "debt" can refer to many things. When Moody's uses the word "debt", we are referring specifically to "bond debt". We are not referring to any other obligations of the government, such as utility payments, salaries due to employees or pension liabilities. Our opinions speak only to the likelihood that a government-issued bond is likely to be paid in full on a timely basis, according to the contractual terms of that bond. This is what bond investors want to know. Therefore, when we use the term "default", we are referring specifically to the failure to make payments to bondholders. We do not rate and are not referring to the default on any other type of obligation to any other person or entity.

Similarly, the term "credit risk" can mean different things to different people. When Moody's uses the term "credit risk", we are referring to the risk that an issuer will not pay the obligations due on its bonds when those obligations come due. As I explain below, we take into account all of an issuer's major financial obligations as part of our analysis so that we can assess both the issuer's ability and its willingness to meet its bond payment obligations.

We're market observers and intend for our opinions to promote dialogue and debate among market participants about the relative credit risk of bonds issued in different regions and by different types of issuers. If people choose to consider our opinions, we expect them to use those opinions to supplement, and not replace, their own credit analysis.

III. KEY FACTORS IN OUR ANALYSIS

A. Overview

Against that backdrop, I will now provide an overview of the key factors we consider in our credit analysis of the U.S. public finance sector. By way of example, I will describe our analytical approach to the states. We focus on four broad factors:

1. *Economy*: We look at the breadth and diversity of the affected economy, including growth trends and comparative economic position to other, similar issuers.

2. *Finances*: We analyze information contained in financial statements as well as current budget information and compare this information to sector statistics for comparable issuers.

3. *Debt Ratios*: Debt ratios are calculated to adjust for size (debt per capita) and wealth (*e.g.*, debt to personal income) and compared to sector medians.

4. *Governance/Management*: We assess the type of governance, including legal powers to manage finances and any legal constraints on taxing, borrowing or spending.

All of these factors are important to our assessment of the state's degree of financial flexibility to meet the specific obligations it faces with respect to its bonds. We also look at each factor's impact on the other factors.

B. States' Pension Liabilities

Many commentators have been focusing lately on states' pension liabilities. These liabilities have long been part of our analysis and are factored into our opinions. We recognize that growing, unfunded pension obligations are creating challenges that these issuers must address, and we are monitoring the situation closely. We have taken, and will continue to take, rating actions where we believe an issuer's credit profile warrants it.

From an analytical perspective, pensions are a type of long-term debt obligation, and therefore they are incorporated into our debt ratio analysis. Ongoing contributions to the pension fund also represent a current budget cost, which we consider in our analysis of an issuer's finances. And finally, our governance analysis incorporates the way a state responds to developments regarding its pension obligations.

There are three main reasons why unfunded pension liabilities have been growing in recent years. First, the economic downturn significantly diminished the value of pension funds' assets. Second, at the peak of the stock market, some states enhanced benefits and/or reduced employer contributions. Third, demographic factors, including the retirement of Baby Boom generation employees and the increasing life expectancy of beneficiaries, are adding to liabilities. These increasing liabilities have resulted in a situation where states have needed to increase their pension contributions at a time when declining revenues are also requiring them to impose budget cuts.

These developments have also drawn the public's attention to some other issues relating to pension finance. Specifically, many funds are not fully funded on an actuarial basis. Governmental accounting standards are different and give states more flexibility than corporations with respect to pension reporting.

Recently, because of market participants' interest in pension liabilities, we provided an additional perspective on these liabilities by publishing a report that combined unfunded pension liabilities with outstanding bond indebtedness. This combined debt and pension burden highlights different credit characteristics when compared to economic and revenue measures. For example, a comparison of combined liabilities to GDP, population and personal income shows the economic and demographic base that a state can draw on to meet its obligations over time. This approach also provides a basis for comparison with other sectors, such as hospitals and corporations.

IV. OUR OUTLOOK FOR THE STATES AND LOCAL GOVERNMENTS

There is unprecedented financial strain on the U.S. public finance sector and this is reflected in the negative outlooks we have on all major sub-sectors in this market. For state and local governments, we hold this view for various reasons, including:

- A recovering but still fragile overall economy;
- Increased liabilities, such as pension and healthcare costs;
- Lingering fiscal pressures, which have required severe budget cuts, use of reserves, and other nonrecurring solutions to solve budget gaps; and
- Strained revenue sources because of persistent high unemployment and sagging real estate prices, along with attendant drags on taxes.

A. Our Outlook for the States

There continue to be significant financial challenges for the states. While the fundamentals of the state sector remain strong (from the perspective of credit risks for bondholders), states face more credit pressure than they have in decades. While revenues have begun to stabilize, risks still remain in the economic outlook that could further strain state finances. For example, employment is slowly improving but unemployment is still very high and risks remain relating to housing and oil prices. The recovery is still fragile and it is uncertain when sustained revenue growth will take hold. This means that in the near future, states probably will not be able to grow their way out of budget gaps. This might be the most difficult budget season of the downturn. For example, the end of most federal stimulus funding in June likely will require many states to make tough decisions as they adopt their fiscal 2012 and 2013 budgets, and this likely will cause reduced aid to local governments and public universities, as well as other significant cuts.

Future state budgets also will be increasingly challenged by rising pension and retiree health benefit costs. While many states have largely protected public services such as K-12 education and Medicaid from budget cuts to date, reductions in or other changes to those services are now more likely.

Despite these credit pressures, from the perspective of bondholders, bonds issued by the states continue to reflect a variety of credit strengths, including the following:

- State economies are broad-based and diverse.
- States have a variety of powerful fiscal management tools at their disposal, including balanced budget requirements, sovereign taxing authority to raise revenues, the ability to cut expenditures without reducing revenues (although large-scale state employee layoffs might depress economic growth), and the ability to cut or delay aid to local governments.
- Governments exist in perpetuity.
- Federal monetary policies benefit state economies.
- Bond debt, on its own or combined with unfunded pension liabilities, represents a relatively small proportion of states' total liabilities compared to other sectors, such as corporates. For example, debt owed to bondholders generally accounts for only 5-8% of state budgets and annual bond debt costs remain a relatively small share of expenditures. This means that governments have less incentive to default on these payments because non-payment would do little to solve major budget gaps.

- States have strong incentives to pay bond debt. General obligation bonds are backed by the state's full faith and credit pledge, which an investor can take to court to enforce. The states also are motivated to treat other bond debt the same way so that they can continue accessing the markets to finance initiatives such as the construction of schools, roads and hospitals. For the same reasons, in the extremely unlikely event of a state default on general obligation bonds or related debt, we expect that investors' rate of recovery on their bonds would be very high.

B. Our Outlook for the Local Government Sector

Our outlook for the local government sector remains negative for various reasons, including the following:

- *Ripple effect due to the states' fiscal problems*: States are cutting or delaying aid to local governments in significant numbers, transferring costs from themselves to their cities, counties and K-12 schools. Some states are also passing laws that limit the local government's ability to raise taxes.
- *Ramifications of the lag between house price declines and property tax assessments*: The main revenue source for most local governments is property taxes. For many local governments, property value assessments lag changes in house prices. Because of this timing lag, the revenue impact of the sharp decline in U.S. housing prices is only being felt severely now by many local governments. Furthermore, we expect that the taxable value of housing will continue to decline through the fall of 2011 before starting to show modest improvement.
- *Tougher budgetary choices*: Many expenditure cuts already have been made, leaving mostly reductions in services that will be felt by the public, including cuts to K-12 education and police and fire services. The growth rate of employee costs, such as pensions and health spending, will pose additional challenges when local government finances are already strained. Raising revenues through tax increases is unpopular. To avoid tax increases, some governments are expected to turn to asset sales.

C. Financial Stress Not Expected to Lead to Widespread Defaults on Rated Bonds

While states are facing a revenue and spending problem, Moody's does not see debt in the form of obligations to bondholders as the source of credit strain for most states. As noted above, annual bond debt costs remain a relatively small share of expenditures. In addition, most states do not face refinancing or material rollover risks. We could see a few more states turn to deficit financings to fund operating expenses, or restructurings to produce budget savings in 2011, but we expect those states to be the exception rather than the rule. For these reasons and because of the strong incentives states have to pay their bond debt, we do not expect any states to default on their bond obligations in the next twelve to eighteen months.

In the Moody's-rated local government sector, we expect a relatively small increase in defaults from historically low levels, but we do not expect a wave of defaults. One reason for the expected increase in bond defaults is that the states can reduce or delay their aid to local governments or cut programs so that local governments have to step in and fill the resulting funding gap. This is likely to exacerbate problems at the local government level. But we also expect that the majority of individual local governments will make the tough choices and painful budget cuts needed to continue making timely payments on their bonds. As a credit rating agency, we do not have views on which choices these issuers should make. Rather, we focus on whether the choices they make increase or decrease the likelihood that they will meet the contractual obligations under their bonds.

While we do not expect a wave of actual bond defaults by rated state and local governments, there have been situations in the past, for example in Harrisburg, Pennsylvania, where the risk of bond default seemed imminent but was averted. We expect there will likely continue to be selective instances of severe credit stress.

D. Assumptions

Moody's views on credit risk are predictions about the future and, as such, they are based on certain assumptions, or expectations, about what is likely (but not guaranteed) to happen. I have set out below a number of the assumptions we have incorporated into our outlook for the next twelve to eighteen months. We expect that:

- State and local governments will honor their contractual obligations to make bond payments because there are such strong incentives for them to do so.
- State and local governments will be able to continue accessing financial markets on roughly the same terms that are available to them now.
- State and local governments will continue to have sufficient budget flexibility, *e.g.*, to cut costs and/or increase revenues, to meet the contractual obligations associated with their bonds.
- Bankruptcy laws will not change.
- The economic recovery will not be derailed by, for example, an oil price shock.

We recognize that a number of the assumptions above currently are the subject of debate. We constantly monitor the environment in which state and local governments operate, seeking information that is relevant to these assumptions. If at any time during our ongoing analysis, we were to begin seeing shifts that might call into question the appropriateness of these assumptions, we would re-consider those assumptions and, if we believe the facts and circumstances warranted it, revise and communicate our views to the market.

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Thank you again for inviting me to testify on this important matter, and I look forward to answering your questions.