MUNICIPALS AND THE STATE BUDGET CRISIS

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Post-Crisis Municipal Performance Issues

- **Lack of Bond Insurance** has "de-commoditized" credit and made high grade paper scarce even as,
- Buyers eschew credit risk, although more to maximize liquidity amid a **general lack of credit research** resources than in fear of sweeping defaults.
- **Periodic media spasms**, which conflate budget with default risk, encouraged fund outflows and have made new investors harder to corral.
- And issuers, dealing with their own budget crises, have held off issuing new bonds; **new issue supply is down by half in 2011**.
- Still, scarcity and demand for high grades have fed **uncharacteristically large boom/bust cycles** and deepened projected illiquidity.

Least Efficient Market in a Generation

- **Bond Insurance (Credit Efficiency)** Discredited and Downgraded
- **Tender Option Bond Programs (Demand Efficiency)** Curbed or Dead
- **Derivatives and VRDOs/ARS (Curve Efficiency)** Distinctly Out of Favor
- Muni Rate Derivatives Have Performed Poorly in the Past
- Muni CDS Have A Different Buyer Base, Poorly Correlated with Credit
- Hedging Difficulties Managed Via Weak Market Making, Thinner Portfolios, Focus on "AAA"

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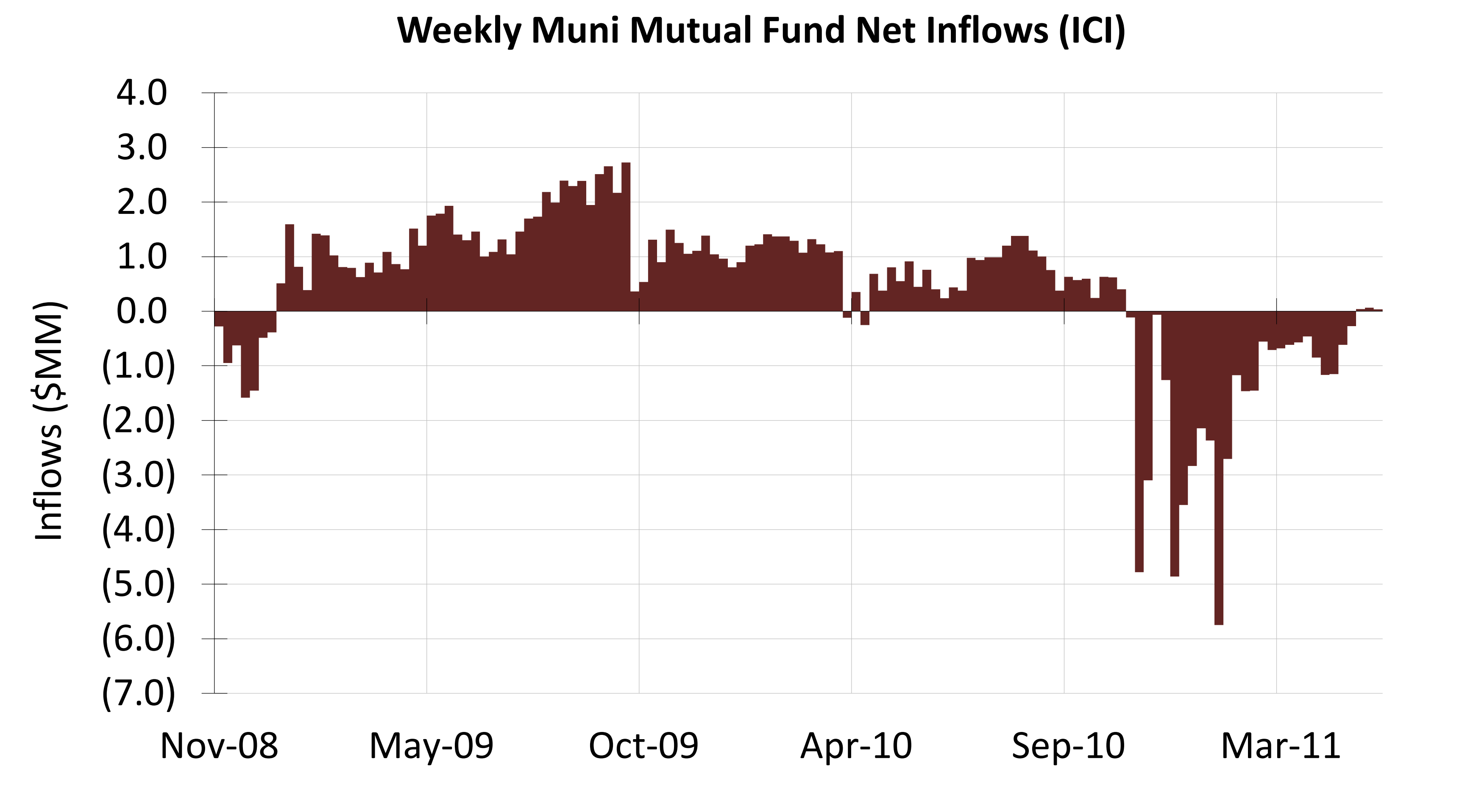
Fund Outflows Were Serious, But Have Become Less Disruptive



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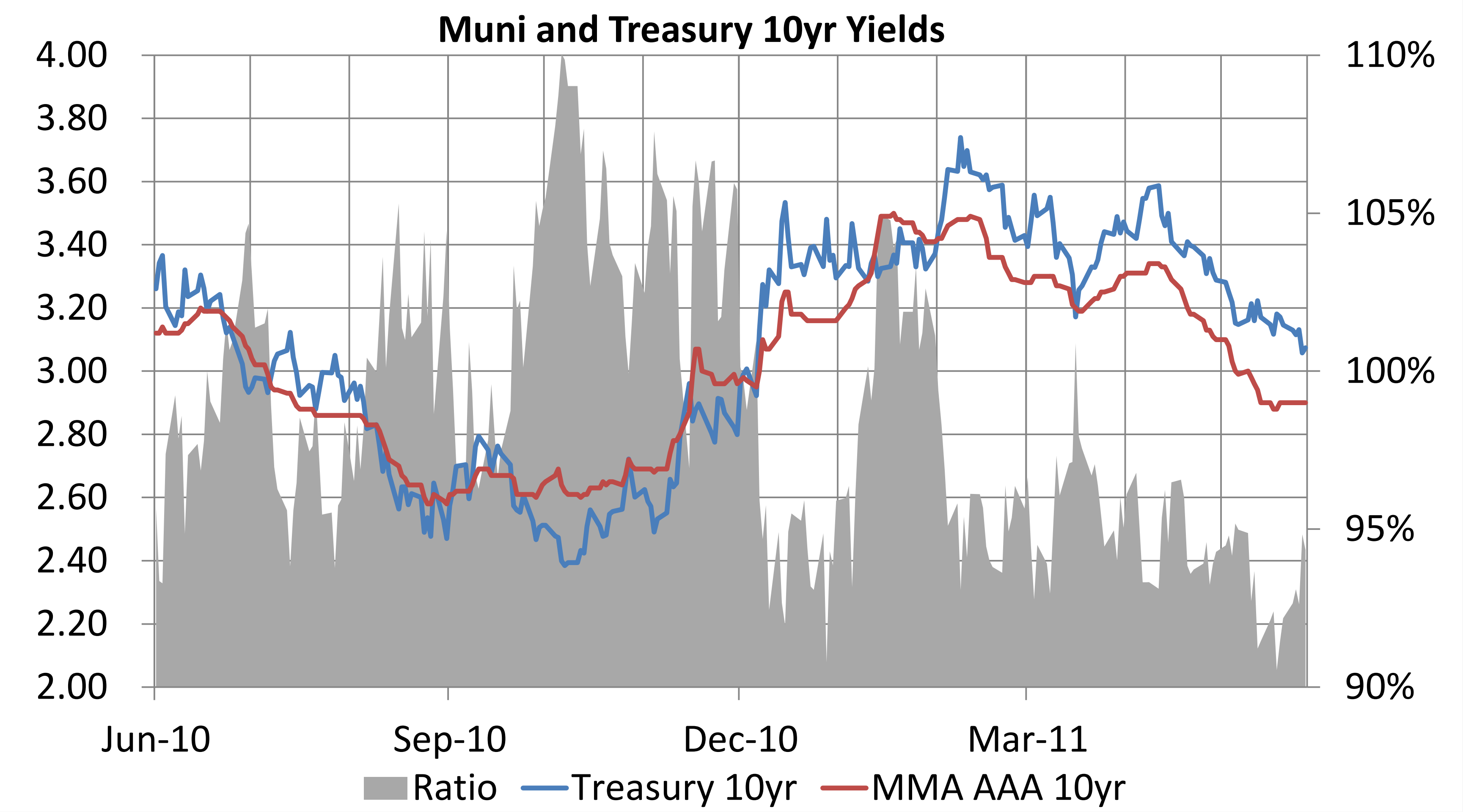
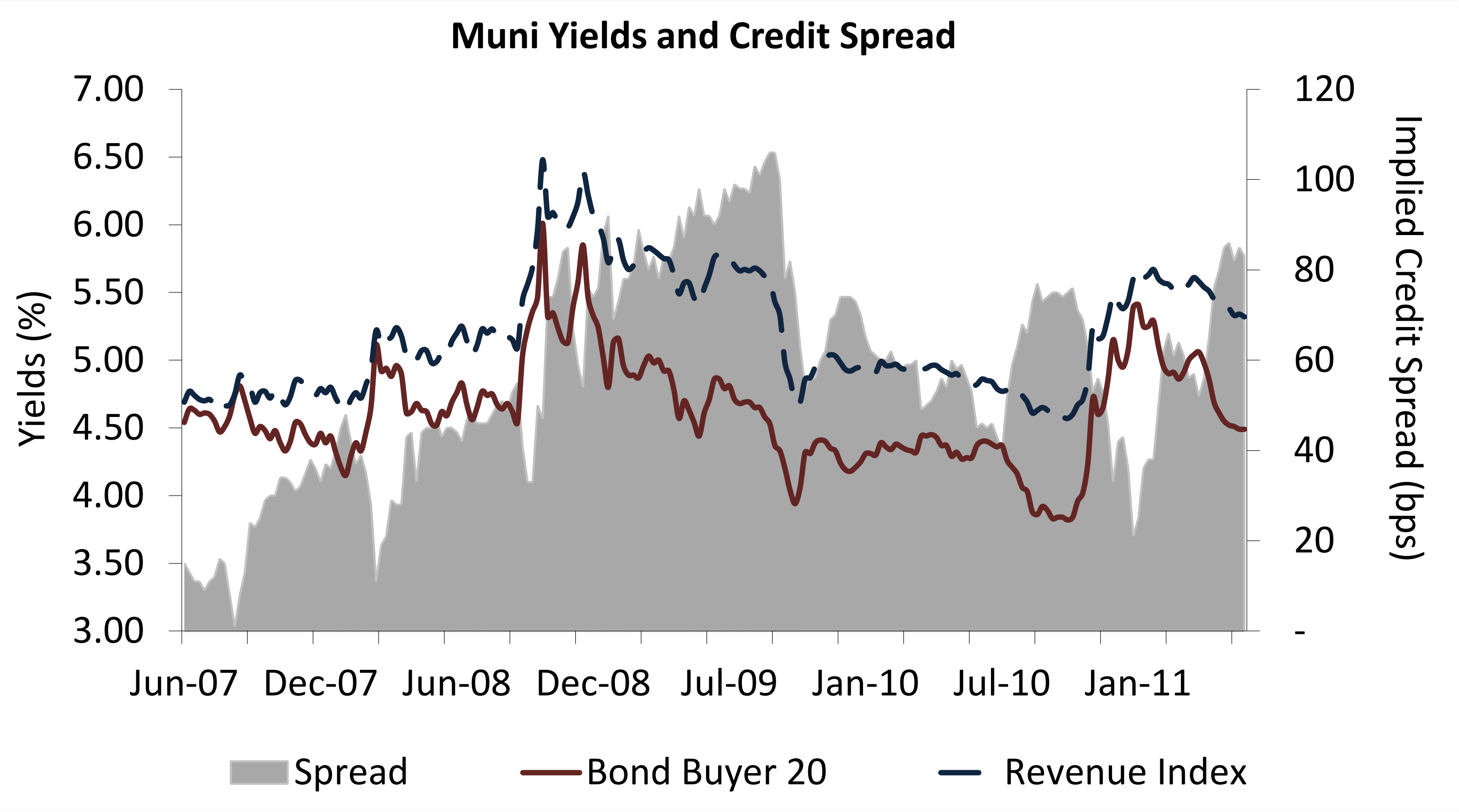
Municipals Have Generally Tracked Treasury Movements



But High Grades Don't Tell The Credit Story



Institutional Bondholder Confidence Because of:

- A General Lack of Refinancing Pressure (which Mitigates Issuers' Vulnerability to a Loss of Market Access).
- Very Manageable Annual Debt Service Expenses.
- The Limited Benefit from, and Lopsided Costs of, Default.
- Close Supervision of Transaction Structuring by Analysts Worried Exclusively over Default Risk.
- Flexibility by States to Set Revenue and Spending Policies and Account for same.
- Steadily Improving Management Sophistication.
- The Exceptional Structural Protections of Bondholders versus Other Government Stakeholders as Granted by State Bond Laws and State Constitutions.

Case Study: Illinois: Budget and Pensions are Bad, But…

- Pursuant to state law, the governor of Illinois has no discretion over whether or not to pay debt service; he or she must appropriate for the full payment of any outstanding general obligation debt.
- Again by state law, the state actually pays debt service by segregating sufficient cash at the end of each month to cover 1/6th of all coming semi-annual interest payments and 1/12th of all principal payments.
- Cash is deposited in the General Obligation Bond Retirement and Interest (GOBRI) Fund, which cannot be tapped for any other purpose. According to the Civic Federation's Institute for Illinois Fiscal Sustainability, "the monthly transfers to the GOBRI fund needed to make the State's debt service payments in FY11 will average between \$230MM and \$250MM … compared to the estimated monthly General Fund receipts and transfers in ranging from \$2.3Bn and \$1.4Bn." This implies minimum five times monthly coverage by revenues, a good portion of which are under the complete and sovereign control of the state itself.
- And, should the General or Road Fund revenues be inadequate, or should the General Assembly not also appropriate for the payment of debt service, state law institutes an, "irrevocable and continuing appropriation of all amounts necessary for that purpose" along with compelling the state treasurer and comptroller to implement these actions as required.

But Bondholders Still Face Credit Risks

- Volatile times can bring out the worst in financial managers.
- Long-term willingness concerns if anti-tax movement continues to gain momentum.
- Reduced credit scrutiny from bond insurers means indentures/loan agreements and the like are only dimly reviewed. Potential for more cohort-based muni credit analysis.
- Outstanding deals that could only have been done with bond insurance are difficult to restructure.
- Even within formal budgetary debate, the inability to raise taxes or make meaningful spending cuts breeds reliance on one-shots, gimmicks, Federal aid, aggressive accounting, and borrowing. Mid-year measures are expensive and can be reckless.
- Swap exposures are still enormous (>$300Bn?); uncollateralized termination amounts have grown again with renewed flight to safety, putting issuers at risk if bank counterparties fail. No attempt by regulators to quantify these risks.
- What if we're wrong? The industry is ill-prepared to manage a missed state debt service payment or even more widespread discussions of such. Prices and rates depend entirely on retail demand remaining intact; this has become far less predictable than in the past now that we've seen how retail can melt over the weekend.

To This Point, Defaults Have Been Concentrated Where They Are Expected: Non-Rated, Risky Sector Bonds

Par (and #) of Outstanding Muni Bonds With an Uncured Default, Reserve Draw, or Other Impairment ($MM)					
Sector	JUNE	All Notices	DEFAULT	Support	Other
ALL	$5,384 (59)	$38,463 (674)	$9,435 (312)	$19,475 (219)	$9,553 (143)
Land Secured	$338 (16)	$5,410 (270)	$2,921 (147)	$2,081 (104)	$409 (19)
Toll Road/Transit	none	$2,923 (6)	$796 (3)	$95 (1)	$2,032 (2)
Tribal	none	$1,220 (7)	$1,193 (6)	none	$27 (1)
Housing	$149 (8)	$1,109 (69)	$887 (50)	$168 (12)	$55 (7)
Retirement	$466 (11)	$2,830 (73)	$1,009 (32)	$539 (11)	$1,281 (30)
Hotel	$43 (1)	$711 (12)	$384 (6)	$229 (5)	$98 (1)
Hospital	$277 (4)	$1,731 (39)	$363 (9)	$299 (7)	$1,068 (23)
Other Risky Sectors	$447 (13)	$14,242 (144)	$1,876 (57)	$11,018 (58)	$1,348 (29)
Safe Sectors (GO,Wtr/Swr,SalesTx)	$3,662 (6)	$8,288 (54)	$7 (2)	$5,047 (21)	$3,235 (31)
Initially Non-Rated Bonds	$1,206 (41)	$11,988 (471)	$6,308 (259)	$3,510 (141)	$2,170 (71)
Initially Insured/LOC Bonds	$3,811 (9)	$14,328 (99)	$720 (7)	$8,409 (48)	$5,199 (44)
Initially Rated, Uninsured Bonds	$366 (8)	$10,913 (57)	$1,579 (18)	$7,290 (23)	$2,044 (16)

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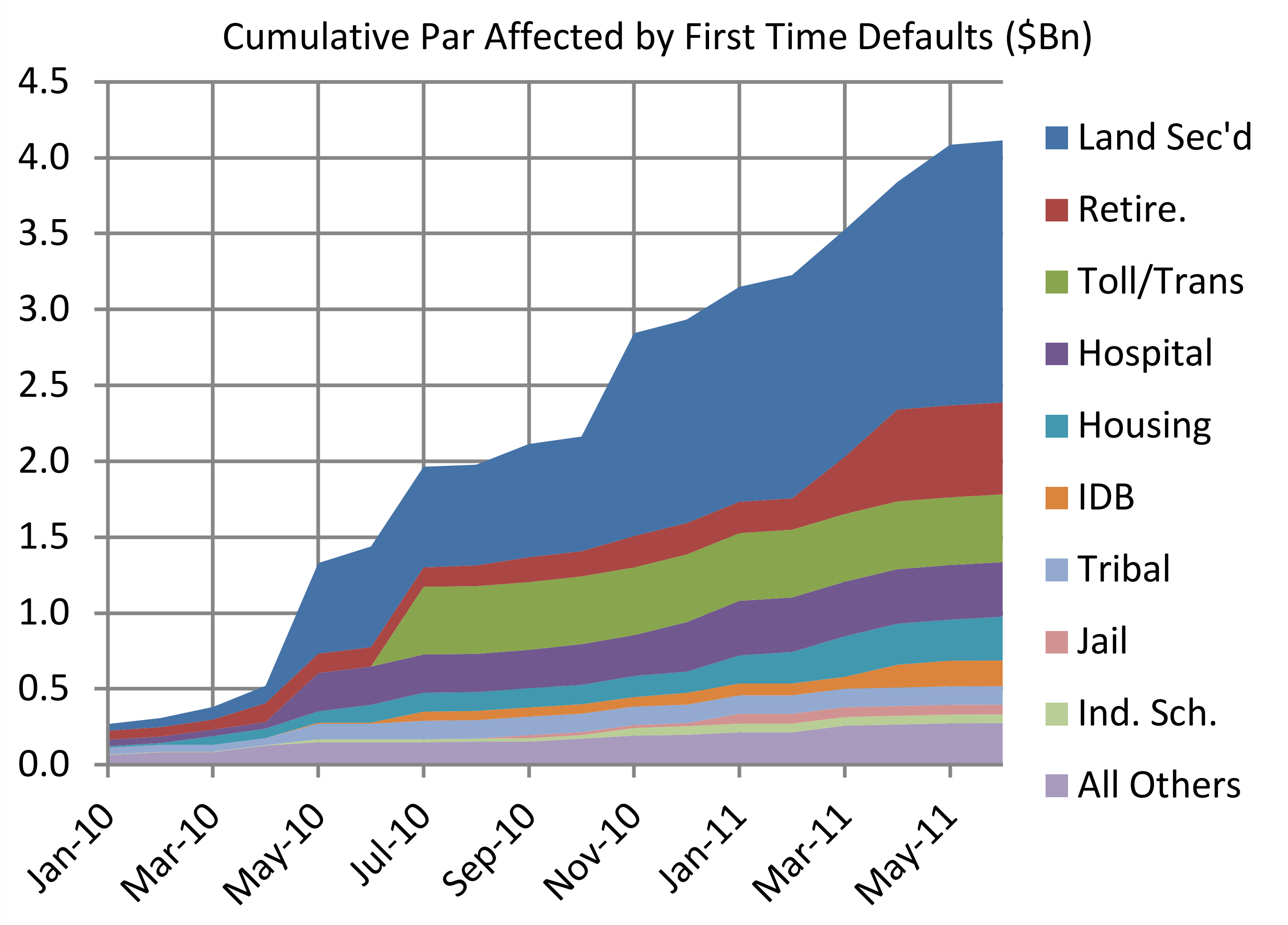
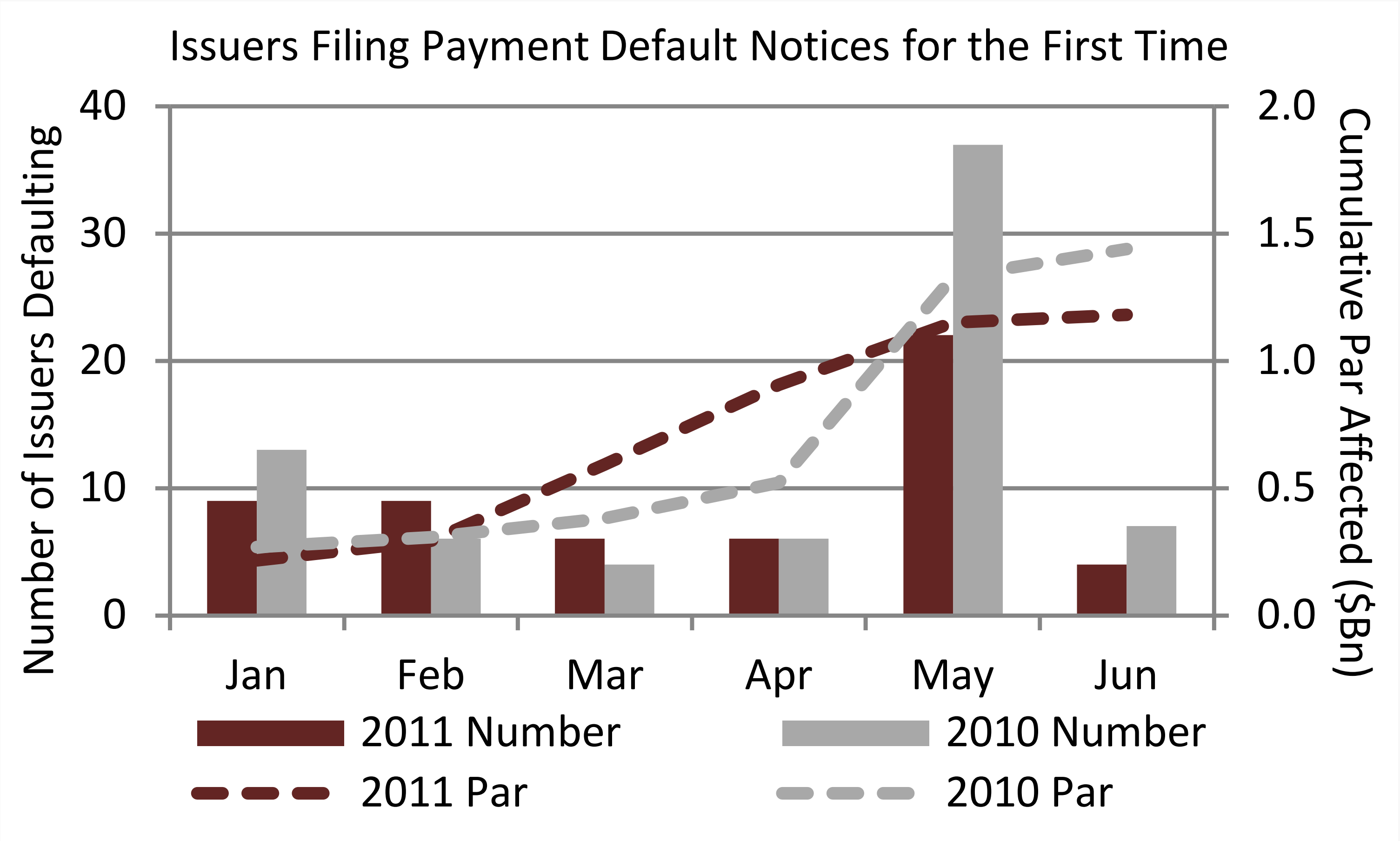
Real Estate Dependent Transactions Issued in Bubble Years Have Inflated Municipal Default “Bubble”



New Default Activity is Slowing, but Gradually



Washington DC - Topics:

- **Illiquidity and Regulation** - Are Investors Appropriately Informed About Their Municipal Holdings? – Credit, Liquidity, Evaluation and Disclosure.
- **Disclosure** - Possible Repeal of Tower Amendment.
- **Pensions** - Greater Political Will and Support to Address Disadvantageous Terms.
- **Build America Bonds** - Democrats Still Explore, Republicans Resistant.
- **Future of the Tax Exemption** – Coming Under Fire from the Right and Left

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