Gimme Some Credit!

A Status Report on Credit Conditions for State and Local Governments

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A Grand Slam of Financial Challenges

Rising Demand for Services

Pension Underfunding

Declining Tax Revenues

Expensive Credit
Impacts of the Recession

- Housing decline hampers property values, property taxes, and transactions fees
- Consumption decline hampers sales tax receipts, especially for big ticket items
- Corporate cutbacks limit the tax base
- Stock market slump widens pension shortfalls
  - Role of alternative investments
- Demand for community services rises dramatically

- Balanced budget requirements enforce procyclicality
All About Housing?

Property Tax Comprises Majority of Local Government Tax Revenue

Source: US Census Bureau, State and Local Government Finances by Level of Government and by State: 2005-06
Current Yield Curves
A Reversal of the Norm

AAA 30 Year Municipal G.O. Yield as a Percentage of Swaps

Source: Bloomberg
Flight to Quality

Spread Between AAA and A Municipal Bond Yields

2008 2009
Reasons for the Reversal

- Poor fiscal outlook
- General trend toward risk aversion
- Stress on collateral value and liquidity
- General concern over the integrity of ratings
- Instability of municipal bond insurers
Municipal Bond Insurers
Credit Default Swap Quotes

<table>
<thead>
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<th>Basis Points</th>
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<tbody>
<tr>
<td>8000</td>
</tr>
<tr>
<td>7000</td>
</tr>
<tr>
<td>6000</td>
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Jan '07 | Jul '07 | Jan '08 | Jul '08 | Jan '09

MBIA | AMBAC

State and Local Government Credit Conditions, May 2009
The Downward Spiral for Investors

- Credit Concerns
- Downgrades
- Price Declines
- Risk Limits
- Sales

• Models accelerate the process
## Mark to Market Accounting

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<td>• Transparency: an external view of value</td>
<td>• Performs poorly in illiquid environments</td>
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<td>• Early warning signal</td>
<td>• Very pro-cyclical (on the way up, too)</td>
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<tr>
<td>• The rule of thumb for securities markets (collateral)</td>
<td>• Not reflective of the way that all investors manage</td>
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The Rise of ARS, VRDNs, TOBs
Short-Term Structured Products

- Issuers liked the combination of term liquidity and short-term costs
- Investors liked the combination of tax preference and short-term liquidity
- Sponsors liked the fees
- Ultimately, everyone was disappointed
  - Auctions failed
  - Issuer costs skyrocketed
  - Investors were locked in
  - Sponsors had to provide support to preserve reputation
Why No TALF?

- Securities are very heterogeneous
- Unclear resolution procedures
- Long maturities not consistent with desired exit strategies
- Providing a first-loss component
- State/local governments benefit directly from fiscal stimulus plan
Muni Bond Issuance

Not much dropoff for YTD 2009
Summary

- Municipal debt issues are getting done…
- …but costs are significantly higher than they have been historically
- Shallow, heterogeneous markets play to investor fears about transparency
- Competition from other debt issues will be significant
- Other fixed income sectors may recover earlier