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U.S. Municipal Market – The View From the Markets

Presentation to the Federal Reserve Banks of Chicago, New York and Philadelphia

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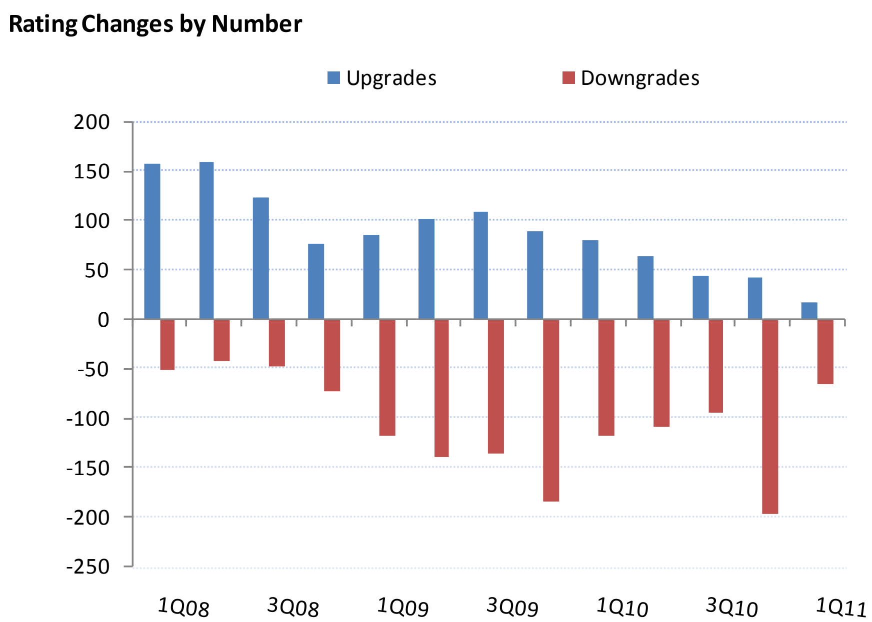
Unprecedented financial stress across municipal sectors

- Municipal market is broad and has diversity of credit risks
- Economic recession is tepid – state and local governments are lagging in recovery
- End of federal stimulus makes 2011 an even more stressful year for state and local governments
- Moody's has had negative outlooks on state and local governments for 3 years
- Downgrades have outpaced upgrades for 9 consecutive quarters



Source: Moody's

Very few rated municipal bonds have defaulted

- From 1970 to 2009, 54 Moody's rated municipal issuers defaulted
  - Nearly 80% were in non-profit hospital or housing project sectors
- Average recovery on defaulted municipal bonds has been 59% of par, compared to 37% for defaulted corporate bonds

Default Counts by Purpose

Purpose	Ratings Outstanding	Defaults
Housing	1,041	21
Health Care	650	21
Electric, Water or Sewer Enterprise	1,645	3
Higher Education	843	1
Recreation	93	1
City, Town, County – Non-General Obligation	2,342	4
General Obligation	8,610	3
Total	15,224	54

Source: Moody's

Defaults are higher among unrated bonds

- Only 2 Moody's rated municipal issuers defaulted in 2010
- No rated defaults year to date in 2011

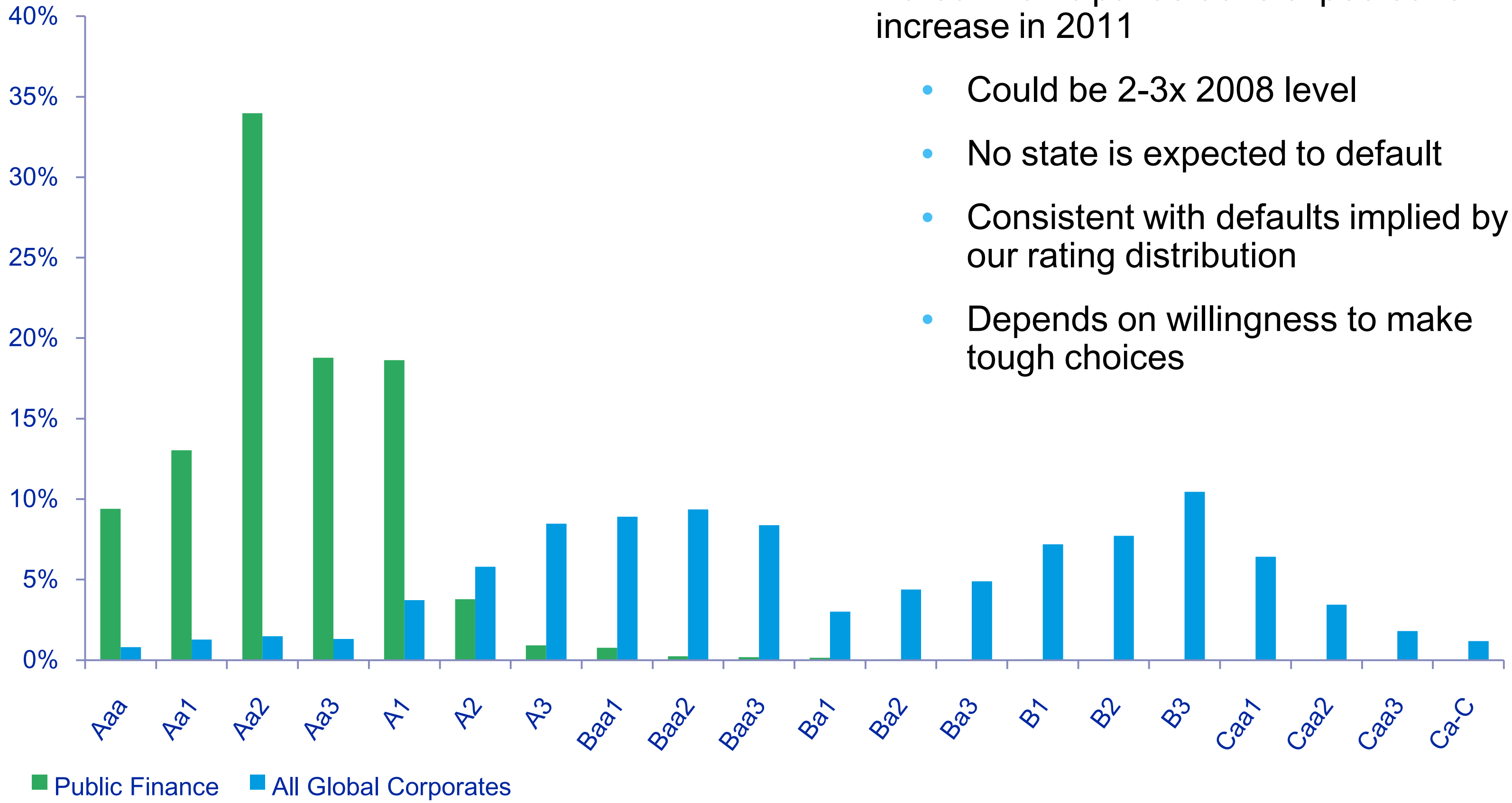
Recent US Municipal Defaults

	2008	2009	2010	2011 YTD
Issuers (#)				
Rated by Moody's	5	1	2	0
Unrated and Rated by Moody's	167	207	82	14
Volume ($millions)				
Rated by Moody's	$ 3,678	$ 24	$ 40	$ -
Unrated and Rated by Moody's	$ 8,518	$ 1,688	$ 3,233	$ 605

Source: Moody's and Income Securities Advisor, Inc.

Rated defaults expected to increase in 2011

Municipal vs. Corporate Ratings

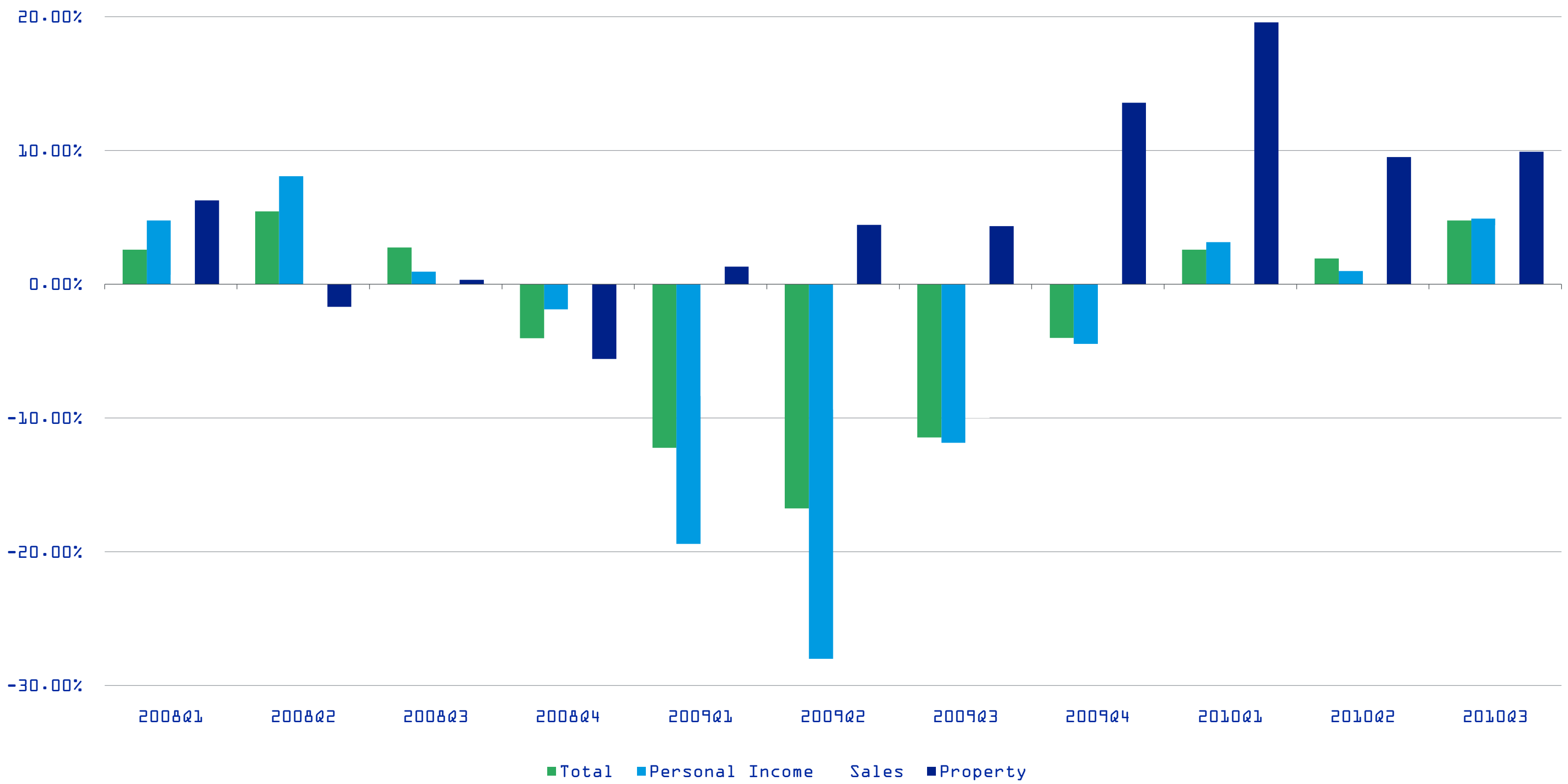


- Rated municipal defaults expected to increase in 2011
  - Could be 2-3x 2008 level
  - No state is expected to default
  - Consistent with defaults implied by our rating distribution
  - Depends on willingness to make tough choices

Source: Moody's

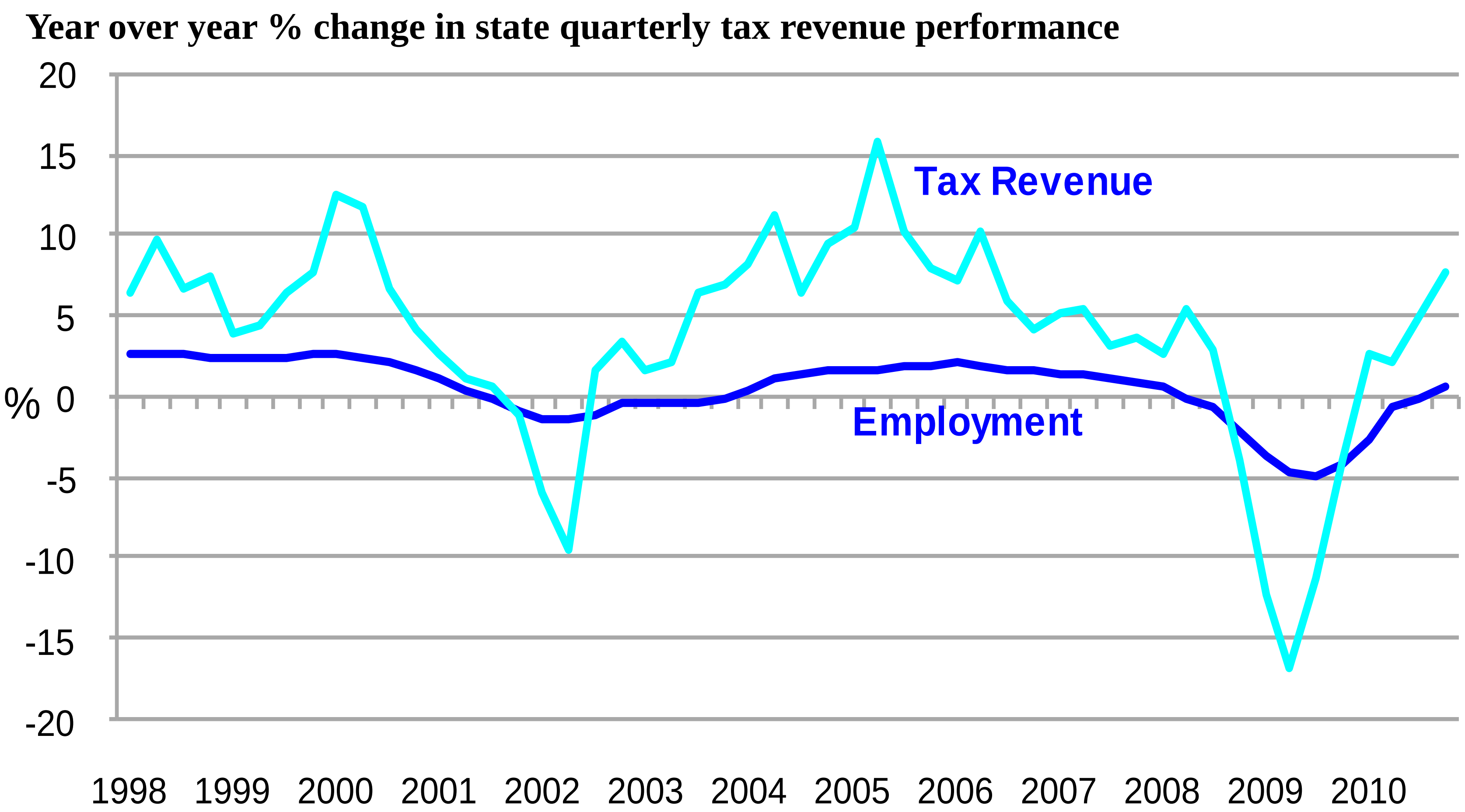
States face a revenue and spending crisis, not a debt crisis

State and local government quarterly tax revenue performance



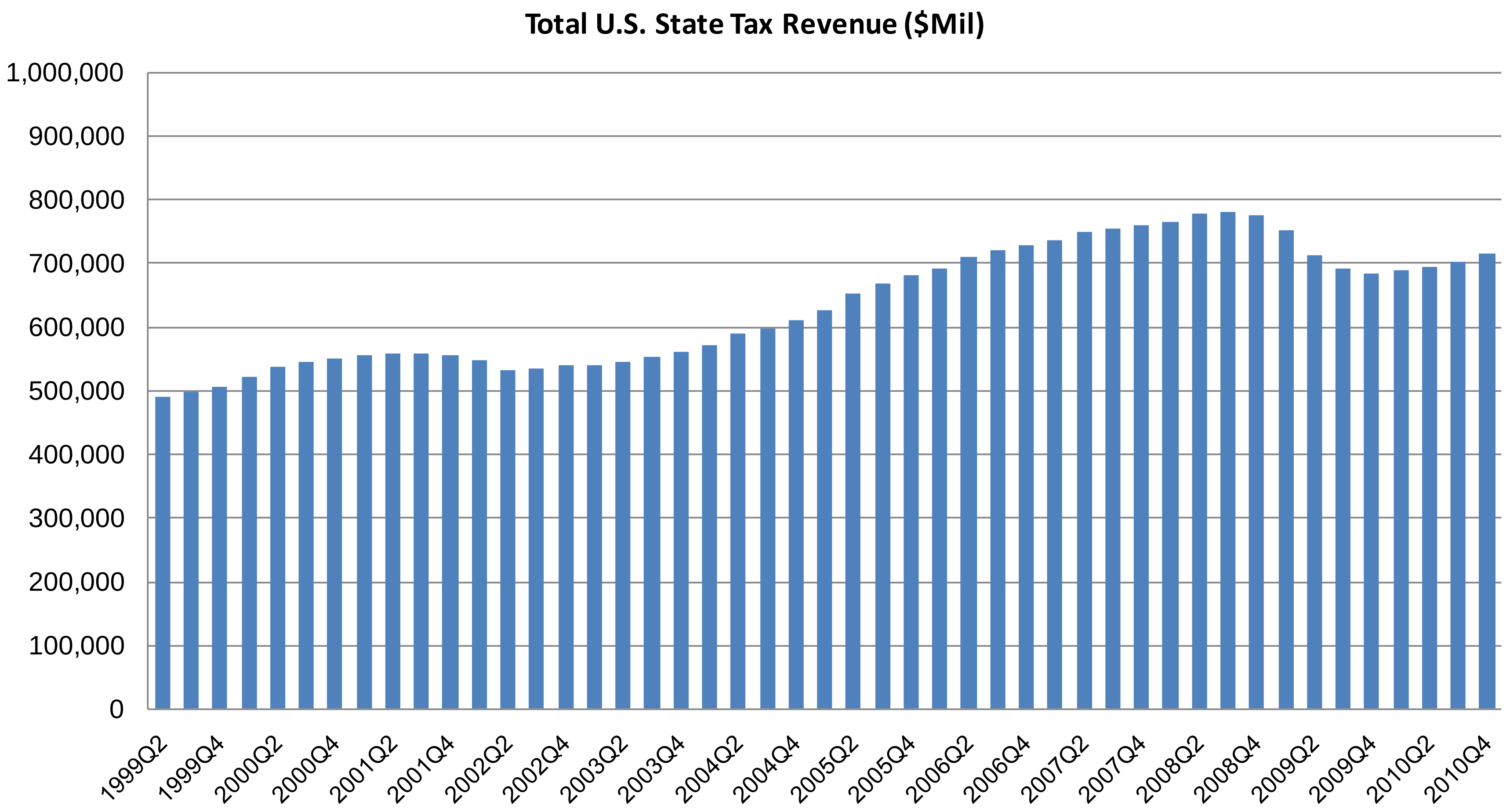
Source: Bureau of Census

State revenues improving, but will not solve problem alone



Source: U.S. Bureau of Census, Bureau of Labor Statistics

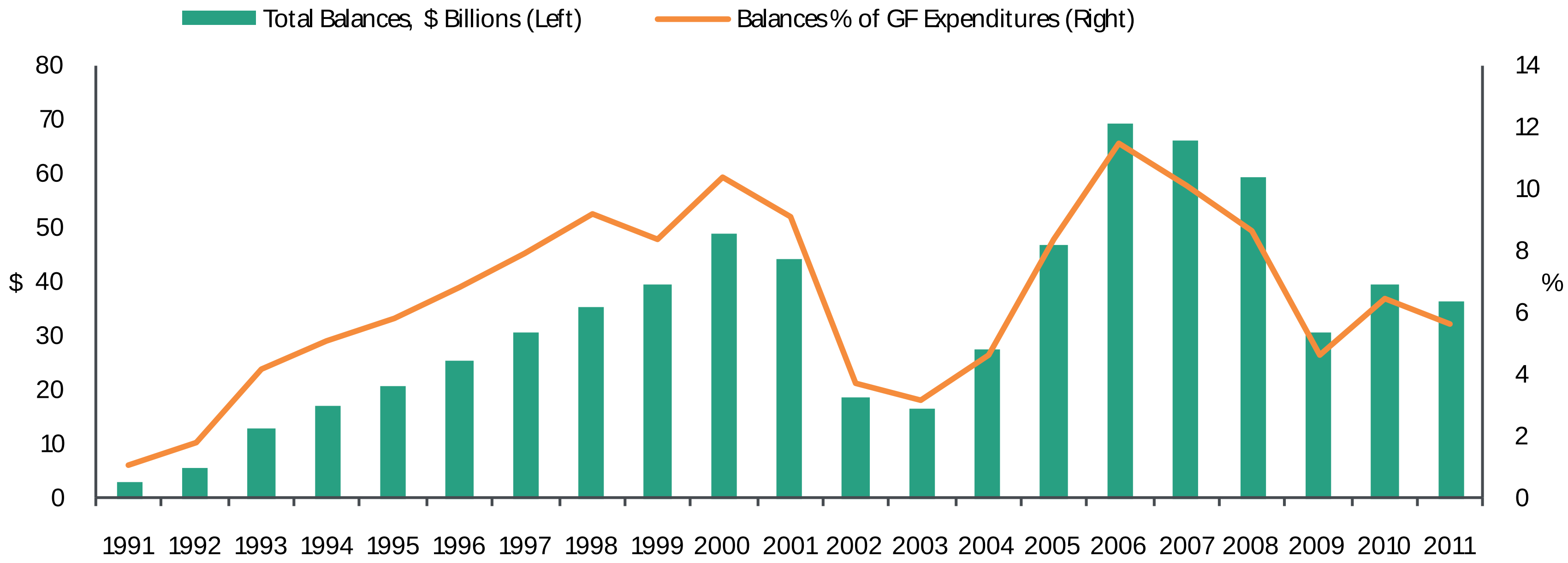
State revenues still below pre-recession peak



Source: Bureau of Census

State reserves are half of pre-recession levels

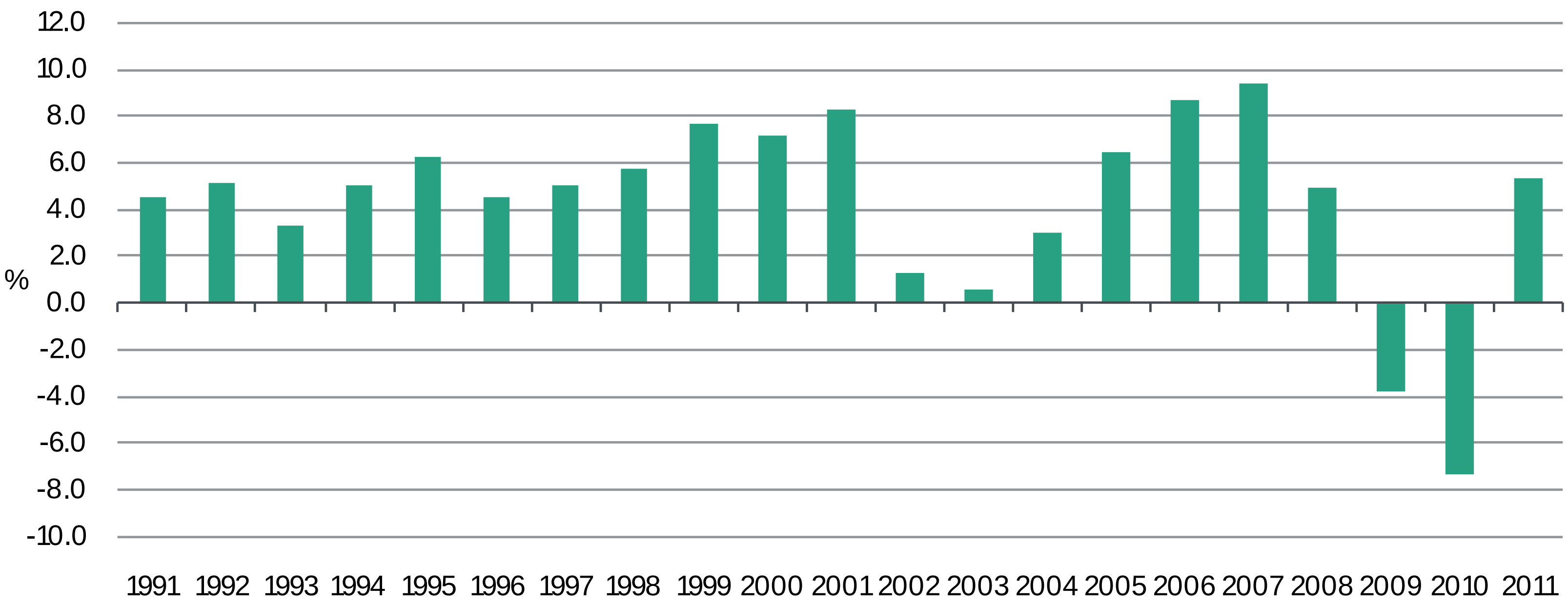
Fiscal Year-End Balances+Reserves as Percentage of General Fund Expenditures



Source: National Association of State Budget Officers

States face difficult choices

Annual Percentage Change in State General Fund Spending by Fiscal Year



Source: National Association of State Budget Officers

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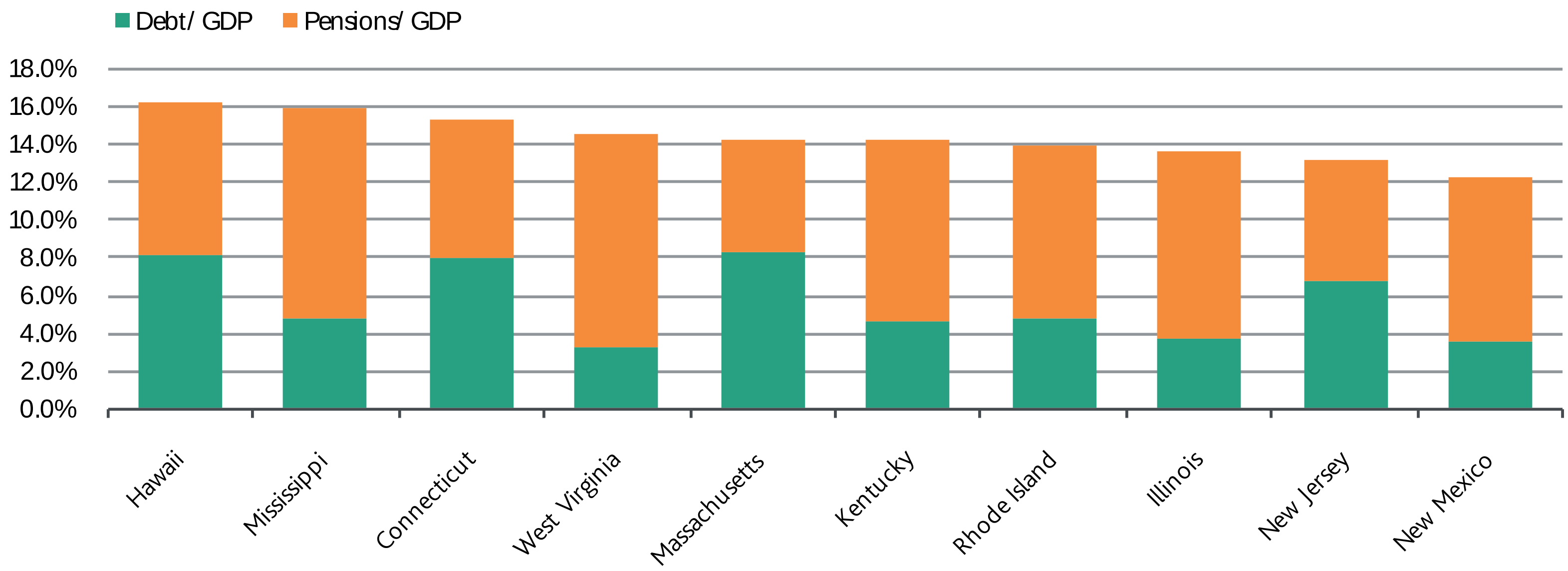
Pensions are growing problem, but not a short-term issue for most

Combined Liabilities as Share of GDP – Top 10 States



Source: Moody's Investors Service

Despite credit pressures, state and local governments have inherent strengths

- Governments exist in perpetuity
- Federal monetary policies benefit state and local economies
- State economies and those of some large cities are broad-based and diverse
- State and local governments have strong incentives to pay bond debt
- Debt service, even when combined with unfunded pension liabilities, is a small share of expenses
- State and local governments have a variety of powerful fiscal management tools at their disposal

Moody's views are based on certain assumptions

- State and local governments will:
  - honor their contractual obligations to make bond payments because of strong incentives to do so
  - be able to continue accessing financial markets on roughly the same terms currently available
  - continue to have sufficient budget flexibility to meet the contractual obligations associated with their bonds (e.g., cutting costs and/or increasing revenues)
- Bankruptcy laws will not change
- The economic recovery will not be derailed by, e.g., an oil price shock

What are we watching? What could change?

- **States:** Revenues still below pre-recession levels. Most will manage by adjusting revenues and spending, and using reserves and any remaining federal stimulus money
  - Risks:
    - Expiration of federal stimulus funds in June 2011 creates large gaps
    - Entitlement spending for pension, OPEBs, Medicaid continues to grow
    - Material shift in market confidence
    - Economic recovery is fragile
    - Impact of federal debt ceiling / deficit reduction plans

- **Local Governments:** Small, weaker issuers will be most stressed, some distressed
  - Risks:
    - Further state aid cuts
    - Some have exposure to enterprise risk with outsized debt levels
    - Exposure to financial institutions, liquidity and credit facilities expiring
    - Breakdown in political process that results in failure to pay debt, bankruptcy filing
    - Impact of federal debt ceiling / deficit reduction plans

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