The Great Credit Shift

US Public Finance Post Crisis

21 SEPTEMBER 2011

How did public finance credit shift over the last four years? Where is credit going now? These 12 articles discuss some of the credit and structural shifts affecting municipal bond investors in the wake of the Great Recession.

CONTENTS

» Weak Economy Will Prolong Municipal Credit Pressure 2

» Municipal Investors' Insurance Safety Blanket Has Been Unwrapped 4

» Less Reliance on Floating-Rate Issuance: a Good Shift for Municipal Issuers 6

» States Add to Credit Risk by Increased Reliance on Volatile Taxes 8

» Property Tax Revenue Still a Drag for US Local Governments and their Bondholders 11

» Enterprise Risk Is a Growing Problem for US Local Governments 14

» Municipal Defaults to Remain Rare Amid Continuing Credit Stress 16

» Revenue Pressures Will Drive Further Hospital Consolidation, a Credit Positive for Bondholders 19

» Not-for-Profits Face Growing Tax Risk 22

» Housing Finance Agencies Are Stressed, but Federal Support Is Credit Positive 26

» Municipal Disclosure Practices Show Improvements, but Major Shortcomings Remain 28

» Non-Profit Hospital and University Disclosures Are Better, but Far from Perfect 30

OVERVIEW

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Weak Economy Will Prolong Municipal Credit Pressure

Fiscal pressure across most municipal sectors increased throughout the Great Recession. Over the next year, we expect credits to remain pressured against a backdrop of weak economic growth, high fixed costs, capital market volatility and growing off-balance-sheet liabilities. Issuers have addressed these challenges in various ways and many mitigated, but did not eliminate, this unprecedented confluence of risks.

Weaker credit fundamentals. The sharp collapse of municipal bond insurers in 2008, together with the recent economic recession, sparked the transformation of the municipal bond market to one focused on underlying credit fundamentals from one predominately driven by benchmark interest rates.

Though the recession officially ended in third-quarter 2009, economic drags continue to hinder credits in all public finance sectors. Municipal issuers received a temporary boost from federal government stimulus, but most of these funds are depleted and additional federal budget cuts will ensue, leaving issuers little choice but to cut expenditures or identify new revenue sources to shore up their finances. At all levels of government and across other municipal sectors, budget cuts have been a common way to close deficits or limit losses, but the drag on economic growth caused by associated reductions in employment will perpetuate myriad strains on public finance credits, including, but not limited to the following:

- We expect state government revenue growth to remain lackluster and more susceptible to capital market volatility given added reliance on more volatile personal income tax revenue, which is sensitive to the level of capital gains.
- There is increased risk that the federal and/or state governments will retract certain tax benefits received by higher-education institutions, not-for-profit hospitals, and other not-for-profit organizations.
- Local governments will continue to suffer the brunt of the housing market downturn, which is a problem exacerbated by lags in property assessments and the legal inability or political unwillingness to raise property tax rates.
- Default risk is expected to increase, but occurrences will be segmented and isolated.
- Increased strain on some enterprises will negatively affect local governments that have a direct or moral incentive to support failing enterprises. Local governments will be less financially capable of supporting enterprises given demands on their own core finances.
- Housing finance agencies will remain strained given continued weakness in the housing market and competition from conventional mortgage providers that are offering loans at all-time low interest rates.

Efforts to mitigate credit risks. As fundamental risks increased and investors shifted toward more of a credit focus, many issuers, and some regulators instituted structural and operational changes to moderate credit deterioration, reduce market risks, and maintain accessibility to the bond market. Many of these measures include reducing fixed costs, raising revenue, streamlining operations, and other changes, including these:

- Many issuers have switched from issuing municipal floating-rate debt to predominately fixed-rate debt, a shift that reduced associated risks of these instruments and mitigates potential systemic effects. We expect sophisticated borrowers to continue to use floaters to effectively diversify their debt exposures.

OVERVIEW

» Modest strides at improving the financial disclosure and availability of other market information of keen interest to investors have been made by regulators, governments, not-for-profit hospitals and higher-education institutions. Regulators are pining for more changes on the back of investor sentiment, which provides impetus for ongoing efforts.

» Consolidation over the past several years of not-for-profit hospitals among peers has been a popular, and mostly credit-positive trend that will likely continue as these institutions navigate operational pressures.

» Housing financing agencies have, and are likely to continue, benefiting from extraordinary measures undertaken by the federal government to support these institutions.

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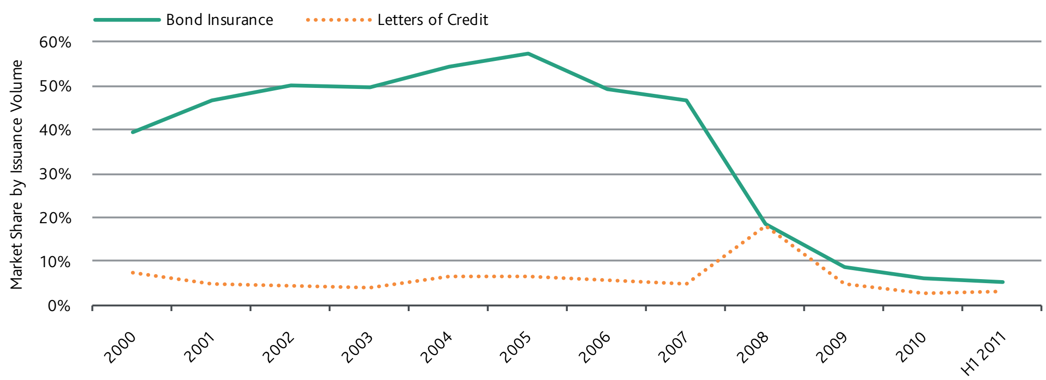
Municipal Investors' Insurance Safety Blanket Has Been Unwrapped

The financial crisis hit bond insurers hard, leaving insurance penetration in the US municipal market at less than 10%, down from a peak of over 50% before the crisis (Exhibit 1). For municipal investors, the decline of bond insurance and the associated multi-notch downgrades of insurers with outstanding policies has been a negative development that has necessitated bondholders' more thorough understanding of municipal credit fundamentals.

Since the collapse of most bond insurers in 2008 and 2009, only Assured Guaranty (Aa3 negative) is underwriting new municipal bond policies. It is also the only source of bond insurance that increases the value of the underlying bonds in arm's-length transactions. Bonds wrapped by other beleaguered bond insurance companies such as Ambac (rating withdrawn) or National Public Finance Guaranty Corp (Baa developing) trade at values consistent with the issuer's underlying credit quality, indicating that investors attribute no value to these insurance policies.

EXHIBIT 1
Insurance Penetration Remains Low



Sources: Company regulatory filings, Bond Buyer

The bond insurance sector's decline was not precipitated by stress in their municipal guarantee portfolio, but instead by their exposure to structured products. In the five years preceding the financial crisis, guarantors gradually increased their exposure to structured finance and other sectors in response to the limited growth prospects of their core municipal franchise. Their foray into the mortgage and ABS collateralized debt obligation (CDO) market proved devastating. Guarantors' high operating leverage coupled with significant losses stemming from RMBS and ABS CDOs exposed to RMBS caused most guarantors to dismantle and/or restructure in the face of multi-notch downgrades or withdrawn ratings. Some guarantors settled claims with their ABS CDO counterparties, sometimes as part of a broad restructuring.

Given that most bond insurers are now either bankrupt, restructured, unrated or carry low ratings (see Exhibit 2), it's clear that, relative to the years preceding the financial crisis, there is now a higher risk that investors' insurance claims will not be fully recovered. From the few high-profile large bankruptcies or issuer defaults of insured municipal bonds, we infer two investor repercussions. First, the legal resolution of bankruptcies can be a protracted and costly process for uninsured and insured bondholders. Second, the resolutions offered in bankruptcy proceedings can subject investors to large haircuts from the original par value of their insured holdings. For example, Las Vegas Monorail (LVM) declared bankruptcy in January 2010, and the amount of reimbursements to be paid by

Ambac, which was itself under bankruptcy protection, weighed on the outcome of LVM's bankruptcy proceedings and on a workout plan developed by the Wisconsin insurance commissioner. Though the outcome of these dealings are far from final, if a workout plan between the insurance commissioner, bondholders and Ambac is approved, bondholders would receive $111 million in cash on the $451 million of insured bonds outstanding in addition to surplus notes.

EXHIBIT 2

Most Bond Insurers Are Unrated or Low Rated

Insurer	Rating
ACA Capital Holdings	Not rated
Ambac Assurance Corp	Withdrawn
Assured Guaranty	Aa3 negative
Berkshire Hathaway Assurance Corp	Aa1 stable
CIFG Assurance	Withdrawn
Financial Guaranty Insurance Company	Withdrawn
Assured Guaranty Municipal Corp	Aa3 negative
National Public Finance Guaranty Corp	Baa1 developing
Radian	Ba1 stable
Syncora	Ca developing

Source: Moody's

While LVM's situation will likely prove very costly to investors, other cases indicate that insurers, especially the healthier ones such as Assured Guaranty, are better able to fully pay claims, particularly in smaller value defaults. For example, Assured Guaranty has about $165 million of net par exposure to the City of Harrisburg, Pennsylvania, and has paid all of the $4.5 million in net claims to date. Similarly, MBIA's National Public Finance Guarantee Corp honored 100% of default insurance claims on $4.8 million of debt issued by the bankrupted City of Vallejo, California.

While we do not expect wide-scale municipal defaults, sustained economic weakness and related municipal credit stress will likely increase the volume of defaults over the next two or three years, testing the efficacy of the guarantees that wrap many outstanding municipal bonds. In an effort to cordon their risks, MBIA has separated their municipal portfolios from their respective legacy structured finance book[1], and Assured Guaranty Municipal (AGM) is winding down its structured exposure to focus on municipal bonds. Both these efforts are positive developments for the prospect of a revival of healthy bond insurers. Additionally, there have been inklings of entrants in the bond insurance business, such as a proposal by the National League of Cities to create a not-for-profit bond insurance cooperative. As it stands, we don't expect a meaningful increase in the market penetration of healthy bond insurers over the next two or three years, which leaves investors without the blanket of safety they enjoyed prior to 2008.

[1] The separation of the municipal portfolio of National Public Finance Guarantee from MBIA is currently being challenged in court

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Less Reliance on Floating-Rate Issuance: A Good Shift for Municipal Issuers

One of the more profound influences the financial crisis exerted on state and local government credit was the way municipalities simplified their debt structures with fewer and more easily understood risks. The post-crisis shift to conventional fixed-rate structures and away from pre-crisis variable-rate securities has been good for investors.

Historically, the vast majority of long-term municipal debt has been fixed-rate bonds structured to amortize over their life. In the years leading up to the peak of the financial crisis of 2008, a variety of alternative debt structures were widely used in the public finance sector. Common alternative structures included variable-rate demand obligations (VRDOs) and auction-rate securities (ARS). While exploiting the considerable demand for short-term and variable-rate municipal debt, these structures incorporated interest rate risk, credit risk and market access risk, none of which are borne by the issuer of traditional fixed-rate self-amortizing debt. Most of these financings were hedged with fixed-payer interest-rate swaps, which introduced a variety of additional risks not found in conventional fixed-rate financing. From 2001-08, more than a quarter of municipal issuance was variable-rate instruments (see Exhibit 1).

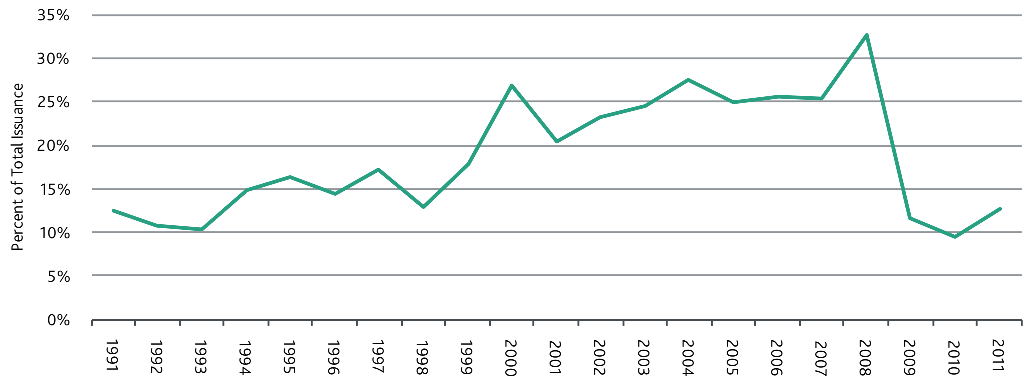
The financial crisis brought these products' inherent risks to the surface. Beginning in February 2008, the market for ARS failed en masse, stranding investors in securities that they had considered cash equivalents and, in many cases, imposing exorbitant penalty interest rates on issuers. The deep-freeze in the ARS market forced many issuers to convert to VRDOs supported by bank letters of credit and liquidity facilities. In the fall of 2008, the widespread deterioration of bank credit resulted in a collapse of the market for bank-supported variable-rate debt, widespread tenders of VRDOs, failed remarketings and draws on support facilities. As a result, issuers were subjected to accelerated amortization of principal, and high penalty rates. These added strains were particularly burdensome to issuers that were already fundamentally weak.

One example is Jefferson County, Alabama (Caa1 negative), which defaulted on $3.5 billion of sewer and general obligation debt in 2008 when its ARS froze and investors tendered their VRDOs to banks, triggering penalty rates and accelerated amortization. The biggest default in municipal history had much less to do with Jefferson County's financial condition than with the structure of its debt.

Since 2010, about 90% of municipal debt has been issued with fixed rates with very few derivative overlays, no counterparty or basis risk, and no need to remarket debt or renew bank facilities at regular intervals. Much of this shift reflects issuers' desire to insulate themselves from the risks that accompany bank facilities and associated interest-rate derivatives. Reduced substitution of variable-rate financing hedged with derivatives and use of unhedged variable-rate financing in amounts consistent with issuers' variable-rate revenues is a significant credit positive for the municipal sector as a whole, and particularly for lower-rated credits that have fewer tools to mitigate risks.

EXHIBIT 1

Municipalities Issued More Variable-Rate Debt Before the Financial Crisis



Sources: The Bond Buyer

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States Add to Credit Risk by Increased Reliance on Volatile Taxes

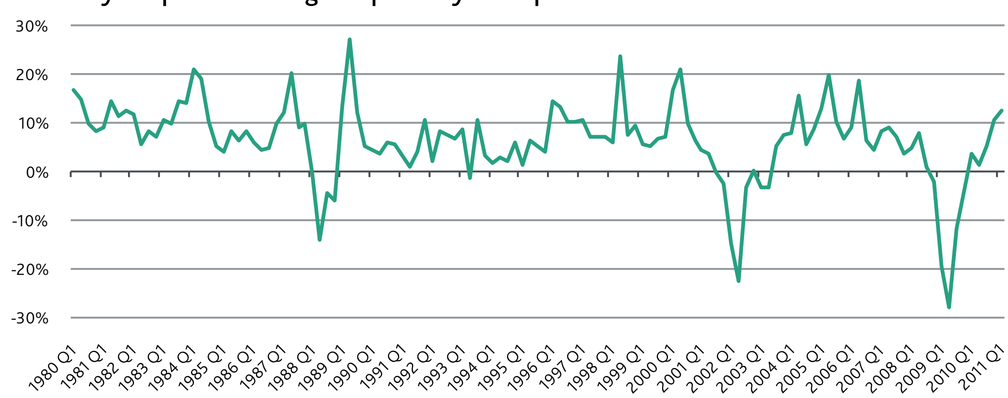
State tax revenues declined more severely over the past four years than in prior economic downturns. This is partly because states have become reliant on taxes with volatile proceeds such as personal income tax. Additionally, many tax revenue streams exhibited more instability in the recent downturn than ever before, and did not rebound swiftly, as they did in prior recessions. States' increased dependence on volatile tax revenues is one factor contributing to their increased credit risk over the past four years, and it will likely continue to be a factor if the economy and capital markets remain weak and unstable. Moreover, the shift reinforces the importance of leverage constraints and stress tests in assessing potential debt-service coverage of revenue sources.

Volatility and personal income tax. State tax revenues have become more unpredictable because states increased their reliance on personal income tax (PIT) and away from sales and other more stable taxes. Because PIT is susceptible to changeable capital-gains income, it fluctuates with the ebbs and flows of investment valuations. Reliance on PIT for state tax revenue has grown quite dramatically: PIT increased from 19% of total state tax revenue in 1970, to 29% in 1980, and to 33% in 2011.

Between 1980 and 2008, the largest quarterly year-over-year decline in PIT was in second-quarter 2002, when PIT fell by 22%. The greatest consecutive number of quarterly declines (on a year-over-year basis) was four. In this downturn, PIT fell for five consecutive quarters, including a year-over-year decline of 27.7% in second-quarter 2009 (see Exhibit 1).

EXHIBIT 1

Personal Income Tax Revenues Dropped Sharply in the Recession
Year-over-year percent change in quarterly state personal income tax revenue



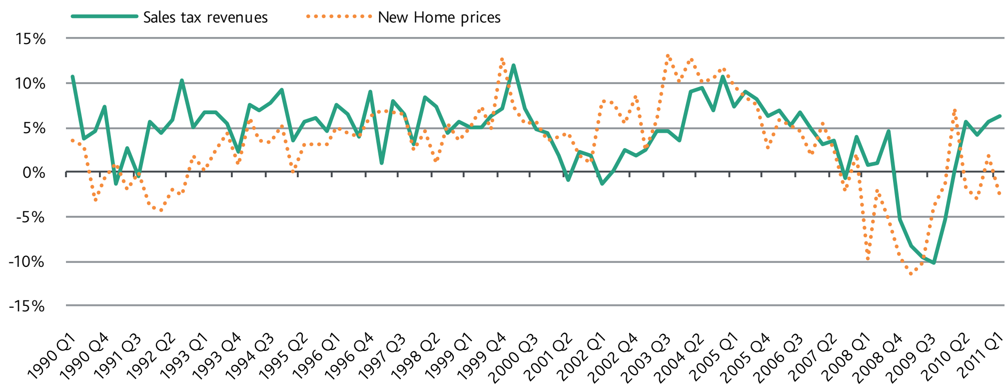
Sources: US Census Bureau, Quarterly Summary of State Tax Revenues

Volatility and sales tax. In addition to PIT, the other major revenue source for states, sales tax, was more volatile in this downturn than in the past. The decline in sales tax revenue during the Great Recession was not only steeper, but longer lasting, and without the swift rebound experienced in previous cycles. Because the recession was sparked by the collapse of the housing market, and because home furnishings and related sales are a large portion of sales tax receipts, the housing downturn had a relatively large effect on sales tax revenues (see Exhibit 2). Declining sales of materials used in new construction and renovation also lowered sales tax revenues. Finally, the decline in housing wealth decreased homeowners' consumption and led to a decline in sales tax revenues from goods and services.

Between 1980 and 2008, the largest quarterly year-over-year decline in sales tax revenue was 11.3% in fourth-quarter 1988. Though the steepest one-year decline was in 1988, the declines in this most recent downturn were longer lasting; sales tax receipts fell for an unprecedented five consecutive quarters starting in the fourth quarter of 2008 (see Exhibit 2).

EXHIBIT 2

As the Housing Market Plunged, So Did Sales Tax Revenue
Year-over-year percent change in quarterly sales tax revenue and new home prices



Source: US Census Bureau, Quarterly Summary of State Tax Revenues , Bureau of Census Construction Review

Examining sales tax revenue data in certain states can be even more revealing. In California, for example, sales tax revenue fell a mere 1.8% in 2002 before rebounding in 2003 and 2004. When the state's economy fell into recession in 2008, year-over-year state sales tax revenues declined by 1.9% that year and by about 10% in 2009.[2] The severe decline in the state's sales tax revenues sharply lowered debt service coverage on bonds secured by those revenues.

In Nevada, which receives two-thirds of its tax revenue from sales- and gaming-related taxes (the state does not have PIT), tax revenue declines were unexpectedly steep (see Exhibit 3). In fiscal year 2002, gaming taxes declined modestly from the previous year and sales taxes receipts were flat. In the Great Recession, however, gaming and sales tax revenue sources had three years of declines, including double-digit declines in 2009.

[2] California's Comprehensive Annual Financial Report, page 260-261

EXHIBIT 3

Nevada's Two Main Revenue Sources Soared in the Boom, then Plummeted
Year-over-year percent change in Nevada gaming and sales tax revenues

Source: Nevada Comprehensive Annual Financial Report, Statistical Section

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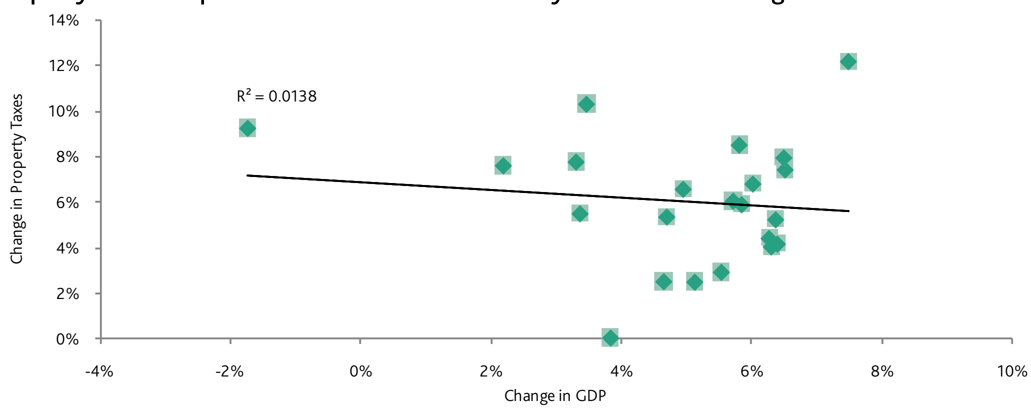
Property Tax Revenue Still a Drag for US Local Governments and Their Bondholders

US local governments were significantly strained by the Great Recession, and although many revenue sources are likely to recover in fiscal 2012,[3] we expect property tax revenue to remain weak through at least 2012. The weak revenues will exert further negative credit pressure on local governments, leaving bondholders worse off than before the financial crisis. Property tax receipts are the main revenue source for the vast majority of US local governments, and usually exhibit little sensitivity to economic cycles (Exhibit 1). Until 2010, property tax revenues consistently increased annually for 40 years because of steadily rising property prices, growing tax bases, and property tax rate hikes.

EXHIBIT 1

Property Tax Receipts Have Shown Little Sensitivity to Economic Change



Source: US Census Bureau, Bureau of Economic Analysis

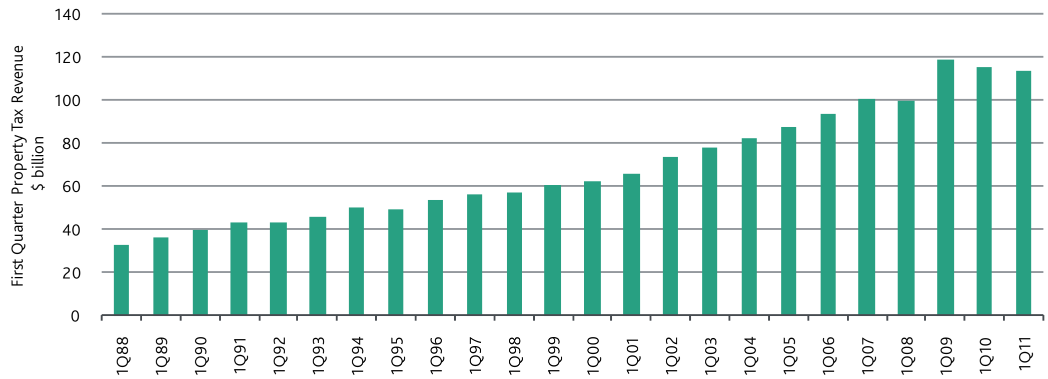
However, on the heels of the Great Recession, property tax revenues have been unstable. Aggregate receipts declined in the first two quarters of 2011, the first consecutive quarter decline on record.

According to the US Census Bureau, local governments collected $111.3 billion of property tax revenue in the first quarter of 2011, a 1.7% decline from first-quarter 2010 (Exhibit 2). Conversely, other sources of state and local government revenue in first-quarter 2011 increased appreciably. For example, state and local individual income tax revenue increased 11.9%, general sales taxes increased 5.8%, and corporate income taxes increased by 6.3%.

[3] Most local government fiscal year's start July 1

EXHIBIT 2

Year-Over-Year First-Quarter Property Tax Revenue



Source: US Census Bureau, quarterly summary of state and local property tax revenues

Property tax revenues are a function of a simple equation: the assessed value of real property in the jurisdiction multiplied by the tax rate. Still, in the current economic climate, the result is anything but simple because of significant challenges to both variables in the equation: continued weakness in the housing market suppresses assessment values, and political, legal and economic factors that make tax hikes difficult to enact.

We expect sales of distressed homes to accelerate in the second half of 2011 because of large foreclosure inventories, which weigh on existing-home prices and dampen new home sales. In July 2011, the National Association of Realtors reported that distressed homes account for a hefty 31% of home sales. Against this backdrop, Moody's Economy.com expects national home prices to fall by 3% through 2011, before stabilizing in 2012.[4]

Property tax assessments are often based on the property's market value two to three years prior to the date taxes are levied. Therefore, declines in the real estate market values can affect revenues up to three years after the market stabilizes.

In addition, property tax appeals are a growing problem for local governments because many homeowners argue that tax assessments are unfairly based on the higher market values of previous years. In many cases, successful appeals tend to have an immediate effect on budgets since the local government is required to provide a refund or tax credit to the property owner in the current fiscal year.

For example, property tax appeals have been an ongoing credit issue for White Plains City School District in New York (Aa2 no outlook) over the past three years. The school district paid $9 million in tax certiorari[5] claims in fiscal 2010 and $7 million in fiscal 2011 through a combination of drawing from reserves and issuing bonds.

Raising property tax rates has often been the strategy to mitigate assessment value declines. However, it is generally not politically palatable to raise taxes in an environment of sharp anti-tax sentiment and high unemployment. For instance, Florida's Miami-Dade County Mayor Carlos Alvarez was recalled in March 2011, partly because of his decision to raise property taxes 40%.

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4 See Moody's Analytics Monthly Housing Monitor Report, 15 August 2011.

5 Tax Certiorari: the legal process of challenging real estate tax assessments

The difficulty in raising property tax rates often leads localities to utilize other revenue-raising options. The National Association of Counties in June 2010 published a survey of 108 counties from 33 states that found 64% of counties expected a revenue shortfall in 2011. Only 10% supported increasing property taxes to address their budget shortfalls. Conversely, 67% of respondents favored freezing government salaries, 66% preferred to delay capital investments, and 64% were partial to a hiring freeze.

Legal limits on property tax rates imposed on many jurisdictions spur the preference for non-tax budget solutions. Property tax cap rules vary significantly from region to region. However, caps usually consist of various combinations of a rate limit based on a percentage of assessed value, a levy limit based on a determined measure of owners' income, or a limit on the annual increase in assessment value. Additionally, in only a few cases, municipalities will be subject to a rule of full disclosure/truth in taxation that requires them to provide certain notices to property owners before raising levies.

Despite the historical stability of property tax revenues, we expect declining property tax revenues over the next two years given continued weakness in the housing market. Additionally, the unwillingness and/or inability to raise tax rates, and a growing volume of tax appeals will exacerbate governments' revenue pressures.

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Enterprise Risk Is a Growing Problem for US Local Governments

In the wake of the Great Recession, financial strain on public enterprises has increased the potential risks they pose to their local government parents, which often have a legal or political responsibility to ensure these enterprises remain solvent and meet their obligations. However, given local governments' own weakened financial condition, many are less able to withstand financial shocks stemming from ailing enterprises than they were prior to the financial crisis that began in 2007, which leaves bondholders of those local governments worse off now than before the financial crisis.

High-profile public enterprises that severely affected the financial stability of the corresponding local governments in recent years include a waste-to-energy facility in Harrisburg, Pennsylvania, a steam plant in Menasha, Wisconsin, and a nursing home in Strafford County, New Hampshire, among others. These and other troubled enterprises illustrate the risks that public enterprise operations impart to local governments. One common thread among these troubled enterprises is that they all operate in sectors that have ample competition from non-public organizations.

Public enterprises fall into a wide range of sectors but consist mostly of essential services such as water, sewer, and other utilities that are not affordably provided by the private sector. These organizations usually operate as monopolies that inherently lack competition. Some are publicly owned and/or supported, but even these are largely self-supporting and, in some cases, generate additional revenue that is transferred to the parent government's general operating funds. However, they sometimes need a subsidy from the parent government in order to meet their operating and debt obligations, and might require extraordinary support when facing material financial difficulty.

Other types of municipal-supported enterprises provide services widely offered by private entities, making their business model more volatile than traditional public services because of competitive pressures. These enterprises include golf courses, ski resorts, water parks, public power generators, cable or telecommunication services, waste-to-energy plants, and healthcare facilities. The fragile economy and precarious fiscal condition of the federal government will continue to exert financial pressure on enterprises, especially those that provide non-essential services. For example, reduced consumer confidence can result in decreased spending on recreational services offered by government-supported enterprises, and looming federal spending cuts will likely reduce the Medicare and Medicaid revenues of healthcare providers.

The extent of local government support for enterprises varies, but may come in the form of annual operating subsidies, loans, or general obligation guarantees of debt. The type and magnitude of support has not changed significantly since 2007, but persistent economic weakness increases the likelihood that some of these organizations will fail and become financial burdens to associated local governments.

In addition to heightened enterprise risk, municipalities face reduced revenues from sources ranging from state aid, sales and income taxes and property taxes. They also confront rising fixed costs related to employee benefits, and their constituencies often exert considerable pressure to limit tax increases and expenditure cuts. These combined forces tighten fiscal constraints of local governments, which reduces their capacity to withstand exogenous challenges posed by enterprises.

In some extreme cases, the strain of supporting a failing enterprise will force a local government to make drastic decisions, such as choosing between honoring enterprise debt-service guarantees or meeting payroll. Harrisburg, for example, declined to make full payments on debt issued by the Harrisburg Authority that it guaranteed (originally issued to refurbish a waste-to-energy plant), but it continues to make debt service payments on direct general obligation debt, albeit with assistance from the Commonwealth of Pennsylvania.

Even under less severe scenarios, support for non-essential public enterprises can pressure already diminished municipal resources. Going forward, anemic economic growth and fiscal cutbacks by federal and state governments will likely increase the risks that strained public enterprises pose to local governments and their bondholders.

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Municipal Defaults to Remain Rare Amid Continuing Credit Stress

Despite unprecedented credit pressure on state and local governments since the financial crisis, municipal debt defaults have been rare and are likely to remain infrequent and isolated, although we expect defaults to increase from current levels.

The financial crisis of 2008 and ensuing recession changed the way many people think about municipal defaults. As the efficacy of bond insurance waned, the municipal bond market morphed from an interest-rate product to a credit-spread product (Exhibit 1).

EXHIBIT 1

Current Credit Spreads Are Much Wider than Pre-2008
Baa spread minus Aaa spread in basis points

Source: Moody's

While municipal rating downgrades have outpaced upgrades for 10 consecutive quarters, since the onset of the Great Recession, only two local government issuers defaulted among our 8,500 rated counties, cities and school districts. Since 1970, 59 Moody's-rated municipal entities have defaulted. Of those, only seven have been a city, town, school district, or county. Just three have been general obligation defaults. We expect a modest increase from historical levels, but that has yet to occur.

We see three broad reasons municipal defaults are likely to remain rare:

1) **Municipal issuers face low rollover risk.** In contrast to corporate issuers or sovereignties, municipalities seldom expose themselves to refinancing risks. The bulk of municipal debt is long-term with gradual amortization, meaning most municipal governments do not rely on market access to repay their debt through rollovers. There are major exceptions: plenty of issuers (in particular California and Texas) use short-term notes to smooth revenues, and issuers with variable-rate products need to renew bank facilities every few years. But municipal issuers generally are better equipped to survive the types of market freezes that would threaten debt repayment by many companies or nations.

2) **Most municipalities have little to gain by defaulting.** Debt service typically represents a low percentage of municipal expenditures, often in the 5%-7% range. A municipality whose expenses are overwhelming its revenues would probably still be in trouble even without debt expenses.

3) **Most municipalities have a lot to lose by defaulting.** Missing debt service can be a costly decision for a municipality. Losing market access would likely result in being shut out from short-term note and bank-lending markets that can help municipalities bridge cash flow gaps and/or facing much higher borrowing rates. In almost all cases, it is more cost-effective to meet debt service and cut other expenses, and that is exactly what municipalities have been doing.

One issuer illustrating the unfavorable cost/benefit tradeoff of defaulting is Baldwin County (AL), which for 15 days in 1988 was in default on $8 million of debt. That brief default, with 100% recovery, prompted Moody's to drop the county's rating to B from A. The county would not return to an investment-grade rating for more than five years.

The adage that municipalities often can't solve their problems by ignoring their debt is still true today and has bolstered bondholder security for several issuers facing insolvency. The City of Central Falls, Rhode Island (Caa1, review for downgrade), facing a hopeless mountain of unfunded pension and health care liabilities, filed for Chapter 9 bankruptcy protection in August. The city raised property tax rates, cut salaries, laid off workers, proposed annexing itself to a neighboring city, and tried to renegotiate its union contracts. One solution it did not publicly contemplate was missing debt service on its roughly $20.8 million of bonds. Why? The city's net annual debt service costs are about $2 million, which against a $6.3 million structural deficit means that ignoring debt service payments wouldn't bring the city to solvency. In fact, the State of Rhode Island passed a law over the summer sanctifying the seniority of bondholders over all other creditors in a municipal bankruptcy.

EXHIBIT 2

Rated Local Government Defaults

Issuer	Defaulted Amount (millions)	Date	Reason
Belfield, North Dakota	$2.4	1987	Insufficient property taxes
Baldwin County, Alabama	$8	1988	Insufficient funds on hand
Polk County, Iowa	$39	1991	Bankrupt racetrack
Orange County, California	$110	1994	Investment losses
Cicero Local Development Corp., New York	$15.3	2003	Insufficient revenue from recreation center
Jefferson County, Alabama (two defaults)	$3,470	2008	Penalty rates on failed auctions/remarketing

Source: Moody's

Instances when municipalities default are usually isolated. The City of Bell, California (unrated), for example, last year defaulted on a $35 million lease-revenue bond after a judge ruled the city failed to conduct sufficient environmental review on purchased land intended to be leased to a railroad. The Orange County, California (Aa1 stable) default in 1994, caused by the county treasurer leveraging the county investment pool in interest rate derivatives that lost value, was similarly anomalous. These defaults arose from atypical factors not reflective of the broader landscape for municipal credit.

Although Vallejo, California (unrated) defaulted on some of its bank-held debt through a bankruptcy workout approved over the summer, retail bondholders suffered no losses because all the city's debt was either insured or backed by a letter of credit. New Jersey's Camden County Pollution Control Financing Authority paid off the last of its debt last year with help from the state. Pennsylvania's Harrisburg (unrated) has so far avoided default, although last year it did default on $242 million of incinerator debt the city had guaranteed.

None of this is to ignore the substantial credit pressures facing municipal issuers, which are confronted with significant challenges that include but are not limited to the lagging effects of the Great Recession, the rising risk of a double-dip recession, and federal cutbacks. Nonetheless, we still expect municipal defaults to stay sparse and infrequent, to have high recovery rates, and to affect mostly smaller issuers that infrequently access debt markets.

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Revenue Pressures Will Drive Further Hospital Consolidation, a Credit Positive for Bondholders

Over the next three to four years, revenue pressures that began during the 2008 financial crisis will continue to drive consolidation in the not-for-profit hospital sector.[6] In most cases, hospital consolidation is credit positive for bondholders as mergers or acquisitions often lead to debt repayment or guarantees by higher-rated systems. But, when mergers fail to produce strategic operating benefits, credit deterioration can result.

Unlike most industries, hospitals largely operate under a reimbursement payment model that requires them to deliver much of their service before being paid. There are four main sources of revenue pressure facing not-for-profit hospitals, three of which stem from expected lower or stagnant reimbursement rates paid by government or commercial payers. They are the following:

1) Medicare rate reductions by federal government

2) Medicaid rate reductions by state governments

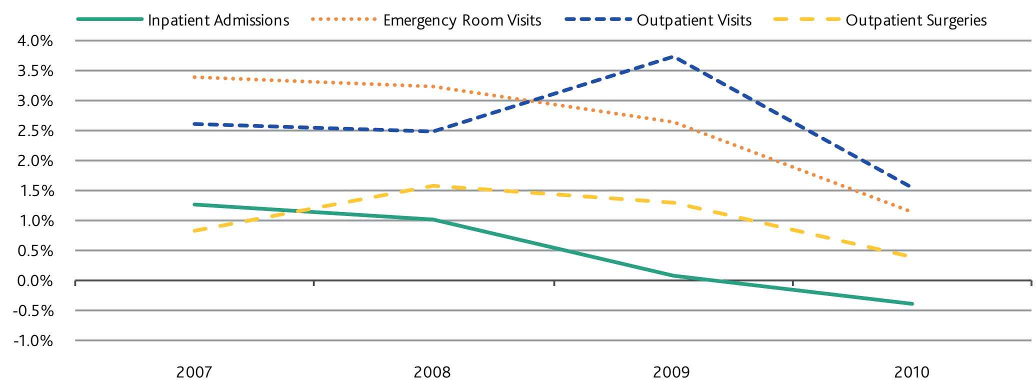
3) Commercial rate reductions by health insurance companies

4) Patient volume declines caused by persistent high unemployment

Ongoing cuts or stagnant funding for Medicare, the largest single source of revenue for most hospitals, are all but inevitable given the large scale of the federal deficit. Many hospitals in numerous states are already absorbing the effects of 2011 Medicaid rate reductions. Also, many hospitals report lower rate increases from commercial payers that have historically enabled providers to subsidize losses incurred from governmental payers. Finally, depressed patient volumes, owing largely to the loss of employee health coverage (see Exhibit 1), have combined with the weakened payor funding to cause the lowest hospital revenue growth rates in over a decade[7] (see Exhibit 2).

EXHIBIT 1

Median Volume Growth-Rate Slump Continues

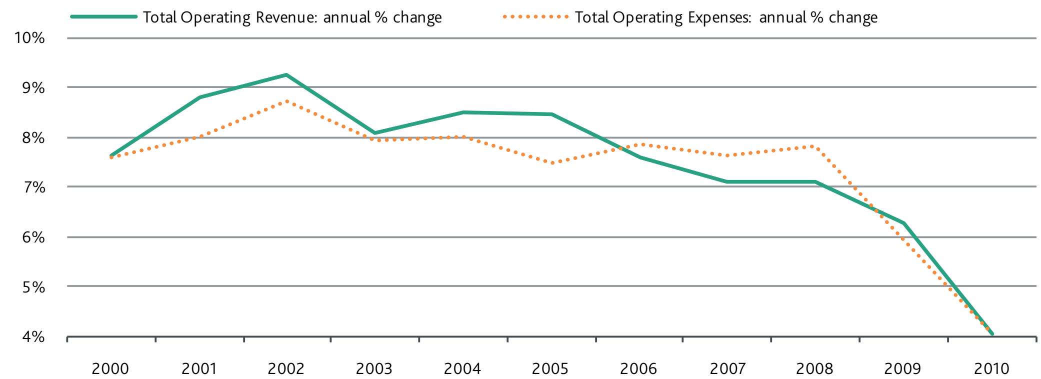


Source: Moody's

[6] See Major M&A Activity Among Not-for-Profit Hospitals Is Favorable, 11 October 2010, and For-Profit Investment in Not-for-Profit Hospitals Signals More Consolidation Ahead, April 2010.
[7] See Hospital Revenues in Critical Condition; Downgrades May Follow, 10 August 2011.

EXHIBIT 2

Median Hospital Revenue Growth Rate Reaches Low Point of 4% in 2010*



*The data prior to 2007 are from different sample sets, however the 10 years of data still accurately reflect the trend in the industry over this period

Source: Moody's

Revenue contraction is credit negative for hospitals. On average, Medicare contributes 43% to a hospital's revenue, making Medicare reductions painful. Changes to Medicare rates have been strong contributors to past rating downgrades. For example, change to Medicare's reimbursement methodology in the mid 1980s resulted in numerous downgrades as many hospitals were unable to adapt to a new payment scheme. Likewise, the Balanced Budget Act of 1997 froze inpatient Medicare rates to hospitals, and contributed to an increased number of downgrades. In both 1999 and 2000, downgrades outpaced upgrades by over 4-to-1. Most recently, rate reductions that began on 1 October 2010 led to an increase in rating downgrades through first-half 2011 with downgrades outpacing upgrades 2.3-to-1.0.[8]

Looking ahead, the August 2011 Budget Control Act will inevitably lead to more Medicare changes, with hospitals in the crosshairs of future cuts. These cuts will be on top of the Medicare rate reductions already hardwired into healthcare reform that begin on 1 October 2011.

Hospitals are now challenged to examine all facets of their operations since they cannot count on much revenue growth in coming years. Cutting spending is now a strategic imperative, but much of the "low-hanging" fruit of expense reductions has already occurred. Most hospitals will now focus on gaining operating efficiencies through in-depth process redesign that touch all areas, from patient care to corporate office functions.

In view of the strategic imperative to become more cost effective and productive, we expect increased industry consolidation over the next one to two years. Smaller, independent hospitals that cannot absorb the rate reductions or access the capital markets will look for larger hospital partners. Some hospitals may be acquired by for-profit hospital companies, while others will merge into large not-for-profit health systems. In either case, the consolidation usually provides an exit strategy for bondholders as outstanding bonds are typically redeemed or guaranteed by a stronger credit.

We expect that the larger not-for-profit health systems, such as regional systems or multi-state systems, will look to gain size and scale through merger and acquisitions. Many have already

[8] See US Not-For-Profit Healthcare Quarterly Ratings Monitor: Sharp Increase in Downgrades in Second Quarter 2011, 15 July 2011.

commenced such strategies with acquisitions of other hospitals that are contiguous to their service area or represent new service areas.

For-profit hospital companies have strong access to multiple forms of capital (debt, stock, and bank lines) and are looking for growth opportunities as a means to drive shareholder value. Additionally, new interest by private-equity firms that heretofore have not invested in hospital operations are now surfacing with greater investment in the hospital industry.

Strategic refocusing on physician alignment, often in more consolidated organizations, will allow many not-for-profit hospitals to achieve some revenue growth. A key goal will be solidifying volume referrals from independent physicians practicing in their communities. This strategy mainly takes on the form of the hospital employing key physicians and is another form of industry consolidation. Hospitals attempted physician employment in the mid 1990s, often to disastrous financial results. Many hospitals ended up privatizing or divesting physician practices to curb losses. We expect hospitals will improve their financial planning with this new wave of physician employment.

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Not-for-Profits Face Growing Tax Risk

Since the onset of the Great Recession, investors face a higher risk that not-for-profit higher education institutions, hospitals, and other organizations will encounter negative tax law changes. These risks are likely to remain elevated over the next two years as local, state and federal governments seek solutions to budgetary challenges. Because the not-for-profit sector is diverse, the credit implications of tax risk will vary according to the unique fundamental credit characteristics of an organization. Tax risk is evident across other municipal sectors, but not-for-profits have unique exposures to this risk partly because of their 501c(3) status under the Internal Revenue Service Code, from which they derive their tax exemption.

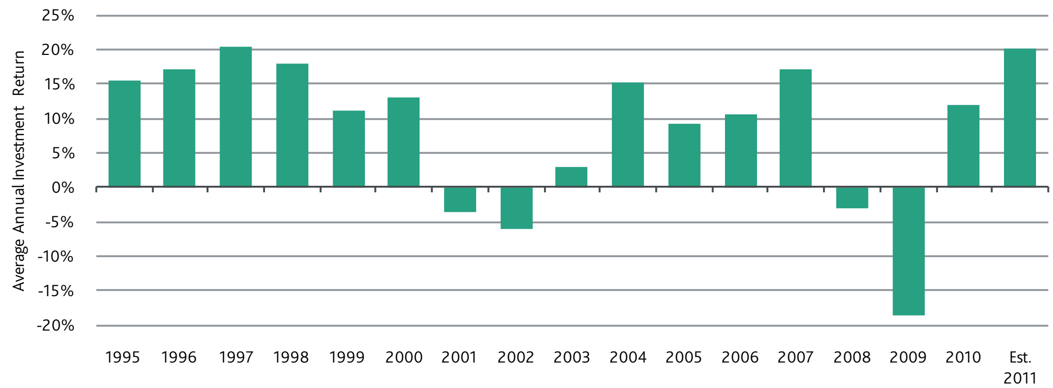
Not-for-profit organizations derive significant benefits from the current tax code, including exemptions from taxes on investment income, property values, and sales/revenue. The organizations are also permitted to issue tax-exempt debt. While modifications to the tax code could negatively affect the not-for-profit sector, the changes that would have the most severe effect are also those least likely to occur. We expect the not-for-profit sector to successfully manage the more modest tax risks, such as altered benefits that donors receive for giving to not-for-profit organizations, or political pressure from localities to contribute to shared services in lieu of property tax.

The most severe federal tax changes are least likely to occur. Federal tax code benefits for not-for-profit organizations have been a political issue in recent years, but material change that would severely affect the sector seems remote. Not-for-profit organizations primarily derive three benefits from the US federal tax code: tax-free earnings on investment income, the ability to issue tax-exempt debt, and tax benefits for donors. We expect the political and public scrutiny of these benefits to continue, but expect not-for-profit organizations to manage the modest modifications to the federal tax code that are likely to occur.

Federal tax-free earnings on investment income is one of the most highly politicized tax benefits not-for-profit organizations receive. In 2007, following a period of robust investment earnings, some US senators questioned whether the nation's wealthiest universities were spending enough from their endowments to serve the public good and their not-for-profit missions. As a result of these inquiries, many wealthy universities increased financial-aid budgets and, in some cases, elevated spending from their endowment. Two years of investment losses sparked by the 2008 financial crisis quieted the political outcry on this topic, but it could resume if multiple years of positive investment earnings resume. The most affluent organizations that rely heavily on investment earnings to support operations would be most vulnerable.

EXHIBIT 1

College Endowments Benefit from Tax-Exempt Earnings on Investment Income



Source: NACUBO Endowment Study and Moody's estimate for fiscal 2011

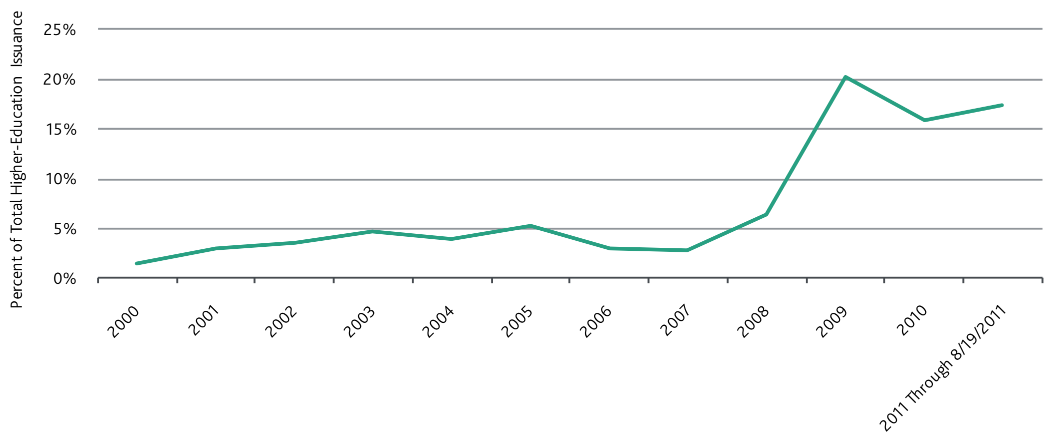
The risk associated with an organization's ability to issue tax-exempt debt to finance capital needs is tied to investment earnings in several respects. Not-for-profit organizations historically earned more on investing assets than they paid in interest, calling into question this benefit. A Congressional Budget Office report[9] published in 2010 found a majority of bonds issued by colleges and universities earned arbitrage profits on tax-exempt debt issuance, a far greater proportion than not-for-profit hospitals. Because of recent investment losses, concern over arbitrage has been greatly reduced. The potential credit implications of removing a not-for-profit organization's ability to issue tax-exempt debt would depend on the size and frequency with which it borrows and the cost and availability of alternative financing options. Currently, the cost and flexibility of issuing taxable debt, instead of tax-exempt debt, has become attractive to colleges and universities, and taxable borrowings were an increasingly larger share of debt in 2009, 2010, and the first eight months of 2011. Taxable debt grew from an average of less than 4% between 2000 and 2008, spiking to 18% in 2009 and staying in the double digits ever since (see Exhibit 2).

[9] Tax Arbitrage by Colleges and Universities, Congressional Budget Office, April 2010

EXHIBIT 2

Taxable Debt Comprises Growing Share of Higher Education and Not-for Profit Borrowing

(not factoring for Build America Bonds)

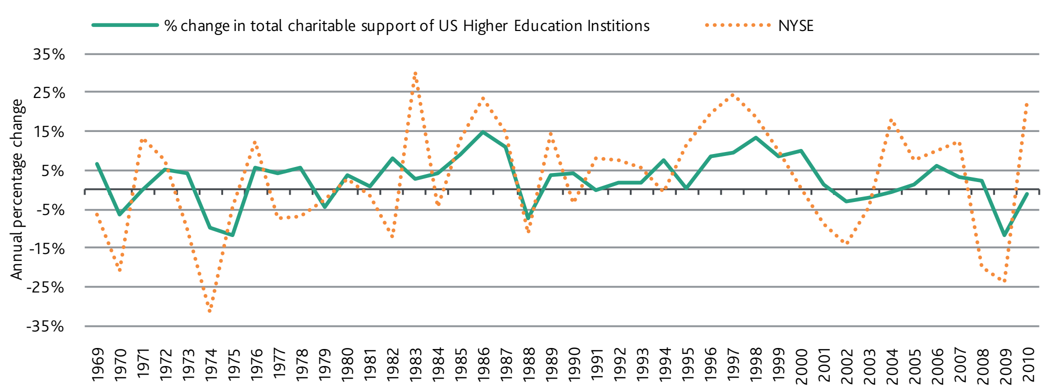


Source: SDC and Barclays Capital

Modifications to the tax code have resulted in periodic reductions to the tax benefits donors can claim for philanthropic support of not-for-profit organizations. Reductions in tax benefits donors derive from giving, particularly for the wealthiest individuals, are more likely as the federal government looks to generate additional revenue. Exhibit 3 illustrates that changes in the tax benefit for charitable giving has a high correlation to stock market valuations—which we use as a proxy of household wealth. This is one indication that the impact of changes to tax rules on the level of donations has been modest because a donor's motivation to give to a not-for-profit organization extends beyond tax benefits.[10]

EXHIBIT 3

The Level of Charitable Donations to US Higher Education Institutions Has Been Highly Correlated to Stock Market Valuations



Inflation adjusted

Source: Council for Aid to Education, 2011

[10] President's Perspective: Give and Take - Is there a connection between philanthropy and taxes?, Council for Advancement and Support of Education, September 2011.

State and local governments pursue revenue. Prolonged budgetary pressure has prompted state and local governments to pursue revenue from not-for-profit organizations, including denying their tax-exempt status. We expect governments to explore such strategies during periods of continued economic strain. Colleges, universities, and not-for-profit hospitals have been targeted because they tend to be large landholders, with their real estate not subject to taxation.

While exempt from property taxes, not-for-profit organizations have made payments in lieu of taxes (PILOTs) to contribute to services provided by local governments and maintain good town-gown relationships. In recent years, local governments including the cities of Boston, Pittsburgh, and Providence, Rhode Island, searching for additional revenue, have asked not-for-profit organizations to increase their payments. In other instances, some non-profits have voluntarily increased contributions. We expect governments to exert continued pressure on these organizations to maintain or increase PILOTs. However, non-profits will likely manage these requests as governments balance the need for immediate revenue against the negative credit implications of creating a burden for the large employers and economic engines, such as universities and hospitals.

In August 2011, the State of Illinois (A1 negative) denied three not-for-profit hospitals property-tax exemptions, citing insufficient charity and community-care programs. The cash-strapped state continues to review the tax-exempt status of other hospitals and healthcare systems. Losing tax exemption could be devastating for individual hospitals, with increased costs triggering workforce reductions or the need to merge with a larger tax-exempt system.

A less-common strategy local governments use to address budgetary challenges is to try to tax some of a not-for-profit organization's revenue. In 2009, Pittsburgh proposed taxing college and university tuition.[11] The measure was unsuccessful, and it was highly likely that the additional costs would be passed directly to students. Given continued concern about affordability and access to higher education and healthcare, this approach seems to be less of a threat to the industry.

[11] Pittsburgh's Tuition Tax Proposal May Be Sign of Rising Government Conflict with Universities, November 2009

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Housing Finance Agencies Are Stressed, but Federal Support Is Credit Positive

The 2008 financial crisis significantly changed the economics of housing finance agencies (HFAs). In an effort to mitigate damage to the real estate market, the federal government provided unprecedented support to HFAs, including the New Issue Bond Program (NIBP) and the Temporary Credit and Liquidity program (TCLP), among other measures. Investors of bonds that participate in NIBP and TCLP are exposed to less risk than holders of bonds issued prior to the establishment of these programs in 2010, and are safer than holders of bonds issued prior to the housing market crisis. Though investors of bonds issued outside of NIBP and TCLP benefit from other federal support programs, the significant deterioration in HFA credit quality over the past four years outweighs the benefits, owing to the decline of the housing market.

Housing finance agencies' mission is to help low- and moderate-income individuals purchase or rent homes at affordable prices. Traditionally, HFAs offer mortgages to eligible borrowers at rates below conventional mortgages, which HFAs fund with tax-exempt mortgage revenue bonds. Prior to the financial crisis, demand for HFA mortgages was strong, which helped HFAs maintain high profitability. However, demand for HFA loans has waned in recent years because of competition with conventional mortgages, whose interest rates are at historic lows.

The effect of the financial crisis. Although HFA programs and loans securing those programs performed well during the financial crisis relative to the subprime market, investors concerned about rising delinquencies of home mortgages began demanding higher interest rates to compensate them for potential risks. As a result, HFAs' borrowing costs rose considerably, forcing them to offer mortgages at higher rates in order to maintain profitability. Compounding the HFAs' problem was that the Federal Reserve's mortgage-backed securities (MBS) purchase program pushed conventional mortgage rates to historic lows, making it difficult for HFAs to compete and continue making loans to low- and moderate-income borrowers.

Meanwhile, HFAs' counterparties experienced severe credit stress that added to HFAs' woes. Indeed, we downgraded all private mortgage insurance (PMI) companies to low investment grade or speculative grade. As a result, most HFAs ceased offering PMI as an insurance option and instead only accepted mortgage insurance from federal government mortgage insurers such as the Federal Housing Administration, the US Department of Veterans' Affairs and the USDA-Rural Department. In addition, we downgraded many banks that provided liquidity to HFAs for their variable rate debt, which resulted in higher borrowing costs and/or increased risk of mandatory acceleration of principal repayments on bank bonds.

Increased federal support is the new normal. In an effort to stabilize their programs and continue their mission, HFAs turned to several federal government programs for support, including the following:

- NIBP, under which the US Treasury purchases up to 60% of an HFA's debt at below-market interest rates, providing capital at a cost that allows HFAs to offer competitive mortgage rates. HFAs cannot issue variable rate debt under indentures of bonds issued in the NIBP, and the ability to withdraw funds from the indenture is limited. Combined, these two program attributes eliminate exposure to variable-rate debt risk and limit the potential dilution of the bond indenture.
- The TCLP enables HFAs to utilize federal credit and liquidity guarantees for their variable-rate bonds, which were saddled with high costs and less-widely available credit facilities offered by banks and other financial institutions. The federal credit and liquidity facilities are offered through Fannie Mae and Freddie Mac to participating HFAs with variable-rate debt, lowering the cost of

outstanding variable-rate debt and mitigating the counterparty risk and the risk of mandatory accelerated principal repayment.

» Increased use of MBS in HFA programs over whole-loan programs. This switch had three objectives: alleviate pressure from declining home values, stem higher losses resulting from increases in delinquencies and foreclosures, and mitigate the decline in PMI credit quality. MBS provides the highest quality collateral for HFA bonds because Ginnie Mae, Fannie Mae and Freddie Mac guarantee the full and timely payment of principal and interest, regardless of the underlying mortgage loans' performance. To date, nine state HFAs have switched to purchasing MBS instead of whole loans, joining 15 other HFAs that already use MBS programs. The MBS program is typically less risky but also less profitable since HFAs have to pay a guarantee fee to an MBS guarantor.

» Increased reliance on government mortgage insurance. As discussed earlier, the downgrade of PMIs has resulted in HFAs only accepting government mortgage insurance for their loans.

» Receiving funds from the Hardest Hit Funds (HHF) program. In support of the mortgage market, the federal government pledged $7.6 billion to the HHF, which 19 HFAs can use to develop housing-related programs to help families in their respective states.

On the margin, all the federal support mechanisms outlined above are credit positive for the HFAs. From a risk perspective, federal programs have made some HFA investors better off now than they were prior to the housing market debacle. In particular, investors of HFA bonds that participate in NIBP and TCLP have less risk than investors of bonds issued prior to the establishment of these programs. Investors in bonds issued before the NIBP and TCLP programs are worse off now than they were prior to the housing market downturn given that they are exposed to relatively more credit and liquidity risks. Although these investors do benefit from the other federal support mechanisms such as government mortgage insurance and MBS guarantees, these benefits are outweighed by the weakening of the intrinsic credit strength of HFAs over the past four years.

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Municipal Disclosure Practices Show Improvements, but Major Shortcomings Remain

The 2008-09 recession spotlighted US state and local governments' financial disclosure practices, spurring investor demand for timely and more uniform information. To the benefit of investors, some issuers have improved their disclosure practices, and we expect further progress in coming years, partly as a result of more stringent regulatory requirements. But major disclosure shortcomings remain, and sector-wide progress will be limited given the broad range of size and other traits among our approximately 12,000 rated US state and local government entities.

Among the challenges to improving disclosure is that state and local governments do not have set reporting deadlines, financial statements sometimes lag the fiscal year-end by 12 months and there is no current project addressing this lack of timeliness. The Electronic Municipal Market Access (EMMA) system has made access to some information easier, but disclosure hasn't improved markedly as a result. That said, high-profile enforcement actions by the Securities and Exchange Commission (SEC) have led to additional pension disclosure by some issuers and the Governmental Accounting Standards Board (GASB) has undertaken accounting standard revision projects to improve transparency.

Online financial disclosure mechanisms facilitate information flow. The EMMA system, which the Municipal Securities Rule Making Board (MSRB) launched in 2008, is a web-based mechanism allowing easier disclosure of offering statements, comprehensive annual financial reports (CAFRs) and material-event notices. It also provides price and yield information from trades, which improves market transparency. EMMA's usefulness to investors can be limited, given that material-event notice triggers cover situations such as payment default and bond calls. To provide more forward-looking information useful for credit analysis, many large issuers have launched their own investor-oriented websites. These sites can provide access to bond offering documents and CAFRs, as well as budgetary projections and other more current information. The state of Illinois (A1 negative), for example, recently launched a "Capital Markets" website that provides links to recent investor presentations, official statements, CAFRs, and debt-related statutes. Many of the other largest state debt issuers, including California, Florida, New Jersey and New York, maintain similar sites.

Despite these online communication mechanisms, timeliness remains an issue. In many cases, CAFRs are published with substantial delays compared with private-sector standards, often lagging fiscal year end by six to 12 months. Both the SEC and GASB have cited the lack of timely CAFR publication as problematic, but no regulatory body has tried to impose strict reporting deadlines.

Pension liability disclosures are likely to improve. Perhaps the most significant disclosure enhancements among municipal debt issuers relate to pension liabilities. Illinois, for example, expanded its pension disclosures to 24 pages in the offering document from 12 pages in a sale document published the preceding summer. The state added a broad range of illustrations and text covering its projected pension-funded status, projected statutorily required contributions, actuarial assumptions, components of change in the pensions' unfunded liability, historical state contributions, pension rates of return, and other matters. It also expanded its description of pension reforms enacted in 2010. Other states that are enhancing or expanding pension disclosures in official statements include Kansas (Aa1 negative) and Minnesota (Aa1 negative). The state of Kansas will be adding more than 25 pages of pension-related information to official statements. Minnesota will increase its pension information to more than 20 pages, from four previously.

Earlier this year, the National Association of Bond Lawyers (NABL) published a draft document entitled "Considerations in Preparing Defined Benefit Pension Plan Disclosure in Official Statements." The NABL intends to devise pension-disclosure guidelines that outline how contributions affect current and future budgets, and provide information on measures the plan has taken to address future payments.

Regulators are encouraging improved pension disclosure practices. Steps towards improved pension liability disclosure followed actions by the SEC to admonish or probe states over misleading or incomplete bond sale document disclosures. In August 2010, the SEC sanctioned New Jersey (Aa3 stable) for material misrepresentations of pension-related disclosure in official statements from prior years. In September 2010, the SEC contacted Illinois regarding its reporting of benefits expected from pension reforms enacted that year. No violation of securities law has been indicated in the Illinois case. Other states have sought to emulate the Illinois pension disclosure practices, given the possibility of further SEC sanctions. Municipal issuers are exempt from the SEC registration and disclosure requirements that apply to public companies, but the SEC and MSRB do have some oversight through bond issuance rules and interpretive releases applicable to municipal securities underwriters and broker-dealers. Section 15(d) of the Exchange Act, commonly known as the Tower Amendment, limits the SEC's direct authority over the municipal market.

New accounting standards may also support enhanced pension reporting. In the summer of 2011, GASB issued an exposure draft of new pension reporting rules that, if implemented, will require state and local governments to provide more uniform measurements of retiree benefit liabilities. We expect the board's standard will take several years to implement fully. Apart from the pension reporting exposure draft, GASB has been active since 2008 with other large projects. Because of one effort focused on liquidity, governments will be required to present fund balance information in five classifications (non-spendable, restricted, committed, assigned, and unassigned), replacing the four traditional categories of reserved, unreserved, designated, and undesignated. Additionally, a GASB derivatives project will mean that governments involved in derivative contracts have to record the fair value of these instruments in audited financial statements.

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Non-Profit Hospital and University Disclosures Are Better, but Far from Perfect

The 2008-09 financial crisis provided impetus for not-for-profit healthcare and higher-education issuers to tangibly, albeit modestly, improve disclosures. Driven by investor and regulatory demand and new accounting standards, disclosure by some of these organizations is more timely and detailed than it was prior to 2008, but remains far from optimal and neither as timely nor as robust as for-profit corporations.

Not-for-profit health care and private higher-education debt issuers are covered by the same SEC rule 15c2-12 as are other municipal market borrowers. This rule requires publishing financial statements and ongoing public disclosure of some basic data on the organization. However, virtually all other municipal debt issuers report their financials under the Government Accounting Standards Board (GASB) guidance, whereas most hospitals and universities report under the Financial Accounting Standards Board (FASB) rules.

Since the early 1990s, FASB reporting rules required increasing disclosure about investment valuations, details on cash flow, net investment in plant, donations receivable and pension/OPEB liabilities. FASB guidance that relates to health care specifically includes disclosure about charity care and the reclassification of bad debt from an expense to a revenue deduction. Hospitals, continually evaluating their bondholder relationships, have increasingly committed to the dissemination of quarterly, unaudited financial statements and operating data.

Since the market disruption of 2008, some hospitals and universities including the University of Pittsburgh Medical Center, the Reading Hospital and Medical Center, and Baylor University voluntarily release information pertaining to liquidity, which is not captured in financial statements. These aspects alone have long made non-profit disclosure better than the GASB-based disclosure state and local governments and public college and universities provide. However, most non-profit statements still lack useful liquidity information and a detailed Management Discussion & Analysis (MD&A) section. And, timeliness is a challenge because non-profit financial reports are often released with a significant lag after the end of the fiscal year, unlike their for-profit corporate counterparts.

Disclosure by not-for-profit universities. Best practices for disclosure in the higher-education sector are not as highly evolved as in the healthcare sector because the business model for healthcare is intrinsically more risky and traditionally more dependent on capital market access. For higher-education institutions, current best practices include an annual release of audited financial statements, which sometimes include a limited MD&A that summarizes the financial results and corresponding drivers as well as the entity's strategic plans.

The best-managed universities have developed management dashboards that track debt and financial metrics, and make comparisons to peers and competitors. A handful of investor-oriented universities including Indiana University, Stanford University, University of Texas, and Vanderbilt University have posted these dashboards and other comprehensive disclosure on their university web sites. A few have even added significant liquidity and other pertinent information that is more current than the data provided in the annual financial statement.

Many colleges and universities believe that timelier reporting is not necessary because their finances are stable and based on an annual business cycle. In their view, quarterly statements would not, therefore, provide material insight into their financial condition and would bring unwarranted focus to volatile short-term investment results. As a result, it is rare for colleges or universities to prepare external quarterly reports. It is even uncommon for them to prepare internal quarterly statements, although this is changing.

The 2008-09 crisis highlighted disclosure practices, and investors and regulators have sought more timely and thorough information on investment volatility, liquidity and swap counterparty risks, and covenant test compliance. Investor demand for this information is especially acute when colleges and universities have issued variable-rate debt and entered swap transactions.

Gradually, not-for-profit issuers are responding to the demands for more timely and accessible financial information. More institutions are utilizing web sites as a platform to provide direct access to financial statements and other continuing disclosure, and a few have created dedicated investor portals on their websites to make it easier to find information.

Disclosure by not-for-profit hospitals. Disclosure in the healthcare sector improved greatly after the National Federation of Municipal Analysts released disclosure guidelines for hospital debt transactions in August 2000. The guidelines called for quarterly disclosure of operating data, financial information, and MD&As. Best practices suggest that operating data be posted 60 days after the close of any quarter and that financial statements be available within 120 days of each quarter's end. While most healthcare organizations meet this timing standard, audits are sometimes released up to six months after fiscal year-end. Updated information may be difficult to find on a hospital's web site, but it can be retrieved easily from the MSRB website, www.emma.mrsb.org.

Disclosure practices beyond annual audit filings vary widely among not-for-profit healthcare providers. Many smaller issuers limit updated disclosure to posting annual audited financial statements and selected utilization data. Other issuers elect to go beyond that simple disclosure to include information similar to that found in official statements. These updates are shown against the year-ago period, and compared to financial budgets. In the best case, both the balance sheet and income statements provide similar detail as the audited statements.

Typically, an MD&A provides brief explanations for key year-over-year variances. In addition to quarterly disclosure and limited MD&As, management provides more detailed notification of any strategic changes made throughout the year, including potential merger, acquisition or sale activity, key management turnover, public news releases, and other major events.

As the US government grapples with the federal budget, it is likely that there will be material changes to the Medicare and Medicaid programs. Together, these programs account for approximately 60% of hospital revenues. As the reimbursement paradigm shifts, investors will likely demand access to timely disclosure in order to make investment decisions. Without adequate disclosure, investors may be increasingly reluctant to lend to health care institutions.

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