From: Hennessy, Elizabeth [ehennessy@williamblair.com]
Sent: Wednesday, August 10, 2011 5:17 PM
To: Hennessy, Elizabeth
Subject: S+P Rating Downgrade of US Debt
Attachments: StateAndLocalGovernmentRatingsAreNotDirectlyConstrainedByThatOfTheUSSovereign 8 8 11.pdf; SP Bond Buyer Article.pdf

Attached please find two articles on the recent downgrade of the US credit rating by Standard and Poor's and how this may affect the district's bond rating. The good news is that unless the district is dependent on federal revenues, there will be very little impact on the district's bond rating. Because Illinois local governments are mostly property tax supported, they are viewed as somewhat immune to the credit difficulties at the federal level.

Now more than ever, it is important to keep the district's financial house in order. The rating agencies are being more diligent in their reviews of local credits. William Blair & Company assists issuers with rating agency presentations and rating reviews and would be happy to put our expertise in this area to work for your district.

Please don't hesitate to call us with any questions.

Sincerely,

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State And Local Government Ratings Are Not Directly Constrained By That Of The U.S. Sovereign

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State And Local Government Ratings Are Not Directly Constrained By That Of The U.S. Sovereign

Despite Standard & Poor's Ratings Services' downgrade of the U.S. sovereign debt rating to AA+/Negative/A-1+, we may still assign a 'AAA' rating to some state and local governments.

We do not directly link our ratings on U.S. state and local governments to that of the U.S. sovereign debt rating for reasons outlined in our criteria. However, we recognize generally that U.S. state and local governments'economic performance is frequently similar to the nation and they share responsibility for some spending items with the federal government. Yet individual state and local governments' funding interdependencies with the federal government vary considerably. A minority of state and local obligors rated by Standard & Poor's have achieved the highest long-term rating of 'AAA'. We expect that many of these obligors, particularly those with relatively low levels of funding interdependencies with the federal government or those that, in our view, are likely to manage declines in federal funding without weakening their credit profile, should be able to retain ratings above the U.S. sovereign rating if we would otherwise assign ratings above the U.S. sovereign rating based on our view of other rating factors. However, in light of the potential for common economic and credit environments between the U.S. and state and local governments, we expect that in most instances in which state and local governments have ratings above that of the U.S., the differential will be limited to one notch.

Overview

- It is possible for state and local governments to have higher ratings than the U.S. sovereign rating, most likely by no more than one notch.
- We derive our credit ratings by evaluating a borrower's individual credit factors based on our credit rating criteria.
- A factor in rating a state or local government above the U.S. is whether it is insulated from negative federal intervention in fiscal management.

Our credit rating criteria allow for a higher rating on a state or local government than on the sovereign if, in our view, the state or local government demonstrates the following characteristics:

- The ability to maintain stronger credit characteristics than the sovereign in a stress scenario,
- An institutional framework that is predictable and that is likely to limit the risk of negative sovereign intervention, and
- The projected ability to mitigate negative sovereign intervention by a high degree of financial flexibility and independent treasury management.

Pursuant to our criteria, the fiscal autonomy, political independence, and generally strong credit cultures of U.S state and local governments can support ratings above that of the U.S. sovereign.

Ability To Maintain Stronger Credit Characteristics Than The Sovereign In A Stress Scenario

A central feature of our U.S. public finance criteria is the independence of individual state and local governments from the federal government. In part, this is based on our view of the Tenth Amendment to the U.S. Constitution, which provides that rights not expressively given to the federal government remain with the states. Although our ratings reflect the role of the federal government in state and local finances and economies, we believe that this decentralized governmental structure in the U.S. suggests that we also analyze state and local government credit quality independent of the federal impact.

When viewing credits on a standalone basis, we expect that some state and local governments in the U.S. are capable of maintaining relatively consistent credit quality even through a period of stress at the sovereign level. Compared with many of their peers on a global basis, U.S. state and local governments function with a high level of revenue independence. Specifically, most state revenues (including almost all discretionary revenue) are derived within the states themselves, i.e., they do not come from the federal government. Revenues are even less linked to the federal government at the local level (although some state-shared revenues originate with the federal government). In addition, historically we have found that state and local governments generally have distinct credit cultures backed by well-established frameworks that provide for enforcement of important public finance laws. We view this to be important in the U.S. public finance setting because we predominantly assign issue ratings as opposed to issuer credit ratings. Debt issues in the U.S. municipal market tend to be backed by dedicated taxes, revenues, or fees and include specific protections that are legally enforceable in the U.S. context.

Given the depth and magnitude of the U.S. economy, state and local governments operate within a wide range of disparate economic bases throughout the country. We have found that some state or local economies regularly perform differently from that of the U.S. as a whole. Our criteria describe how we analyze the attributes of state and local economies and incorporate our analysis into our ratings. Beyond analyzing economies in isolation, however, we have observed that some state or local governments have more favorable balances between resources and responsibilities (i.e., they may be less leveraged) than the federal government. We believe that certain state and local governments have historically shown a greater commitment to fiscal discipline or a more resilient local economy, which may be reflected in ratings higher than that of the U.S. government. In a minority of cases (3.9% of U.S. public finance ratings), state and local governments currently demonstrate what we consider to be particularly strong credit characteristics consistent with our highest rating and, thus, are rated 'AAA'. Because we have assigned these ratings based on our view of individual rating factors pursuant to our criteria, we believe these ratings are appropriate notwithstanding the downgrade of the U.S. sovereign debt rating.

A Predictable Institution Framework, Financial Flexibility, And Independent Treasury Management

In our view, the institutional framework for U.S. public finance is among the most stable and predictable in the world. We believe this is primarily a result of the constitutional separation of power between the central and sub-national levels of government that is intended to restrain intervention in state and local government administration.

U.S. state and local governments enjoy considerable financial autonomy from federal intervention. State—and in many cases local--governments have authority to establish and maintain laws pertaining to tax rates and collections, as well as the ability to add new taxes and other forms of revenue generation. In practice, receipt of federal funding typically requires a state or local government to satisfy various mandates, such as providing certain levels of service. And yet, participation in some of the programs for which federal funding is provided is voluntary. This includes Medicaid, the largest federal-state jointly financed social service.

In addition, U.S. state and local governments' treasury management is independent from the U.S. federal government. Although we consider stress scenarios in which federal disbursements could be delayed or reduced, thereby inflicting cash flow disruptions, state and local government obligors with 'AAA' ratings have, in our view, strong access to liquidity, likely allowing them to bridge such episodes.

Criteria Support Possibility Of 'AAA' State And Local Government Ratings

Participation in the U.S. economy and legal system provides a platform in which state and local governmental obligors can generally manage their finances and debt portfolios with considerable independence and without material risk of negative sovereign intervention. In light of this independence, our ratings largely reflect our view of local economic characteristics or state-level laws that may impede or strengthen state and local credit quality to varying degrees. Credit implications from these factors are detailed in our relevant criteria documents.

Related Criteria And Research

- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- Methodology: Rating A Regional Or Local Government Higher Than Its Sovereign, Sept. 9, 2009
- Where U.S. Public Finance Ratings Could Head In The Wake Of The Federal Fiscal Crisis, July 21, 2011
- U.S. State Ratings And Outlooks: Current List

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To Market's Relief, S&P Keeps Credits Independent

BY PATRICK MCGEE

When Moody's Investors Service warned of a possible downgrade to the United States' sovereign credit last month, it said hundreds of triple-A muni credits — including five of the 15 states it rates Aaa — could likely follow.

Moody's affirmed the sovereign credit and assigned it a negative outlook on Aug. 2, and then assigned negative outlooks on the five U.S. states and 303 other public finance issuers it sees as "indirectly linked" to the federal government.

Standard & Poor's walked a different path, deciding to downgrade the United States. But to the relief of many observers, it says it sees no reason for an automatic downgrade of its AAA muni credits as a result.

After stripping the sovereign credit of its gilt-edged rating last Friday, the agency has since defended the notion of munis carrying better-than-sovereign ratings. It called public finance credits "among the most stable and predictable in the world" and said the decentralized structure of the governmental system allows for state and local government credits to be analyzed independently.

Standard & Poor's grants the coveted AAA rating to 13 states, or 26% of all state ratings, according to a July 15 credit report. And no state ratings have been changed yet.

"Compared with many of their peers on a global basis, U.S. state and local governments function with a high level of revenue independence," the agency said late Monday, noting most state revenues do not stem from the federal government, and local government revenues are even less linked.

Stressing the independence of state and local governments makes sense, according to **Dick Larkin**, director of credit analysis at **Herbert J. Sims**, because the federal government is unique in having been created by the states, rather than the other way around.

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"States still retain all powers that are not specifically granted to the U.S. federal government," Larkin wrote to clients Tuesday. "You have 'sovereign states' — the 50 U.S. states — within a global 'sovereign state,' the U.S. government. ... That's why they are making an exception to their sovereign ceiling rule in the U.S."

One thing Standard & Poor's pointed to as they downgraded the sovereign credit was a lack of real cuts to the federal budget.

Rob Williams, director of fixed income at **Charles Schwab**, points out that's a credit positive for state and local issuers, insofar as it doesn't restrict the trickle down of cash flow. "The credit quality for the broad array of municipal credits hasn't changed dramatically," Williams said. "And most of those states and municipalities have been anticipating a reduction in federal funding. So we don't see a major change in credit quality... Unlike Moody's, S&P has been a little bit less aggressive in saying they might take immediate action on ratings of AAA state and local government issuers."

Williams concluded that any widening of spreads versus Treasuries could very well be a buying opportunity.

That seems to be the response retail investors had Tuesday.

While muni yields were steady across the curve Tuesday, retail appetite for tax-exempt paper strengthened, according to data compiled by **BondDesk**.

BondDesk pegs itself as "the voice of retail" — data collected from its electronic trading platform reflects aggregate moves from retail investors and their financial advisors across the country.

Data from this week indicates retail investors were frightened to the sidelines Monday, but with Standard & Poor's defending the muni market late that evening, coupled with the equity market picking itself up Tuesday morning, retail investors jumped back into the game.

BondDesk data showed retail investors buying munis midday Tuesday at a buy-to-sell ratio of 3 to 1, the inverse of Monday.

"Retail is fickle," BondDesk's Senior Market Strategist Chris Shayne said. ☐