Fitch Ratings

Presentation to the Municipal Advisory Council of Michigan

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Outline

Fitch's State Ratings Universe

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2012 State Ratings Outlook

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State Ratings Universe

Fitch's states group currently rates 43 states as well as the District of Columbia, Puerto Rico, and the U.S. Virgin Islands

- Five state ratings currently carry a Negative Outlook
  - Florida
  - Maine
  - Kentucky
  - Pennsylvania
  - Washington
- Two state ratings currently carry a Positive Outlook
  - Michigan
  - New York
- California (rated 'A-') and Illinois (rated 'A') are the only states with ratings below the 'AA' category

2011 State Ratings Outlook Recap

- Fitch's 2011 State Rating Outlook - assigned in January 2011 - was Negative
- The rationale for the Negative Outlook was that budgets for fiscal 2012 would be in many ways the most difficult of the downturn
  - Revenue recovery generally not robust enough to offset loss of federal stimulus
  - Elevated funding demands for state services, particularly Medicaid
  - Reduced financial flexibility, as reserves drawn down and more palatable budget management actions already taken
  - Anti-tax environment; many new governors as well as significant changes in the political composition of state legislatures
- 2011 ratings activity recap
  - Three states were downgraded by one notch (Hawaii, Minnesota, and New Jersey)
  - Two states were put on Positive Outlook (Michigan and New York) while one state's Outlook was revised to Stable from Negative (Rhode Island)
  - One state was upgraded (West Virginia)

2012 Outlook for State Ratings

- In December 2011, Fitch Revised the Outlook for the State Sector to Stable from Negative
- Factors contributing to the Stable Outlook for 2012:
  - Budget gaps projected for states' fiscal 2013 budgets (which for most states begins on July 1) were smaller than those faced in the fiscal 2012 budget season, as the bulk of state solutions employed for balancing in 2012 were structural in nature
  - The Stable Outlook also reflected an expectation of slow economic and revenue recovery, which through the first three-quarters of fiscal 2012 has largely held true
  - Budget balancing for fiscal 2013 was expected to remain challenging given the extent of action that has already been taken
    - States clearly have lower reserves and fewer cost-cutting options than they did before the downturn
    - Nonetheless, the demand for state services remains elevated and increased required contributions to pension systems are an additional pressure for many states.

2012 Outlook for State Ratings

- **From December 2011 Report: What Could Change the Outlook?**
  - Evidence that states have reached a legal or practical limit on the ability to further restrict spending
  - A sharp decline in economic conditions that weakened state financial positions to levels that impacted credit quality
  - Steep reductions in federal spending or tax policy changes that were not accompanied by time for states to react to such events

Current State of the States

- Economic and Revenue Performance
  - State tax collections have grown for eight straight quarters based on analysis from the Rockefeller Institute.
  - Fiscal 2011 revenues were on or ahead of budget in most places, with surpluses not uncommon.
  - Revenue recovery has continued in fiscal 2012, albeit at a slower pace, and most state budgets assume sustained, slow economic and revenue gains.
  - For income-tax dependent states, April revenue results, which include final payments, will be an important indicator. Those states that saw some of the strongest revenue performance last year – high income states with progressive income taxes – remain particularly vulnerable, given the volatility of capital gains-related tax revenue.
- Impact of Federal Deficit Reduction
  - Uncertainty regarding the impact of federal action in numerous areas continues.
  - Given fiscal challenges at the federal level, Fitch believes that states remain significantly exposed to the possibility of federal funding cuts. However, we expect that states will have time to react to federal plans.
  - Medicaid, which accounts for the majority of federal aid to the states, is not affected by the first phase of cuts and protected from the automatic cuts scheduled to take effect in January 2013.

Current State of the States

- Health Care Spending
  - Fitch expects that Medicaid, which demands an increasingly large percentage of state spending, will present the biggest budget challenge for states in the coming years.
  - States' options to reduce Medicaid costs at present are limited. These include lowering rates of payment to healthcare providers, reducing benefits, tightening eligibility rules, and cost sharing with enrollees. Each of these options presents its own challenges given federal mandates, including those related to health care reform, as well as the already comparatively low healthcare provider reimbursement rates for Medicaid.
  - Many states needed federal approval for some of their budget solutions in this area in their fiscal 2012 budgets, and their experience in receiving these approvals has varied considerably.
  - Provider rates have been a big focus for virtually all the states, and managed care is part of the discussion for many.
  - The potential impact of federal health reform, which remains a significant area of uncertainty for states, increases the exposure of the states to decisions on the federal level. The forthcoming Supreme Court decision on the legislation will provide some clarity, but federal election results also will be significant.

“Hot Topic”: Pensions

- Last year, Fitch added several steps to its analysis of state and local government pension obligations
- Pensions are reviewed in the analysis of debt and other long-term liabilities
- Consider factors in combination -- analysis of pensions focused on trends in:
  - Magnitude of the liability
  - Funded ratio
  - Resource base from which funding is derived
  - Amount of government's budget needed to make pension contributions
  - Government’s pension contribution history
  - Actuarial assumptions
- Management plays an important role
- Fitch believes that the vast majority of governments will withstand the pressures they face from their pension obligations, although for many this will mean taking difficult steps to adjust contributions and/or benefits
- For governments with poorly-funded systems, the need to act to ensure a more sustainable footing is pressing

“Hot Topic”: Pensions

- Earlier this year, Fitch added a new liability metric which measures each state’s net tax-supported debt combined with the UAAL of its major pension systems against the state’s wealth base (personal income)
  - The metric considers direct pension obligations – inclusive of direct state obligations and their proportionate share of the UAAL of multi-employer systems
- Applying the new metric to states rated by Fitch shows that the median combined net tax-supported debt and adjusted pension UAAL equals 6.9% of personal income
  - The combined figure is more than double the 3.1% median figure for net tax-supported debt alone. The range for the combined metric is wide, from 2% (Tennessee) to 25.8% (Hawaii).
  - Fourteen of the 43 states rated by Fitch have a combined liability greater than 10% of personal income.
  - Michigan’s ranks relatively low among states, with its ratio totaling 3.9% of personal income
- The new liability metric is intended to supplement, not replace, existing state debt and pension metrics and provide greater comparability for states’ overall long-term liability burden. Because analysis of debt and pensions has long been incorporated into Fitch’s analysis, the new metric, in and of itself, is not expected to result in any rating changes.

Focus on Michigan

- **Key Rating Drivers:**
  - ECONOMIC IMPROVEMENT EVIDENT: Michigan's economy has begun to rebound following a decade of employment losses largely related to declining state's automotive sector employment. Economic recovery is expected to lag that of the nation and an above-average dependence on cyclical manufacturing is still expected.
  - SOUND FINANCIAL MANAGEMENT: Fiscal 2012 operations were balanced without the use of one-time measures and for the first time the budget included projections for the following fiscal year as well. Monies have been budgeted to begin to replenish the state's rainy day fund in the current fiscal year, and an additional deposit is contemplated for fiscal 2013.
  - LOWER-MODERATE DEBT LEVELS: State debt levels have been and are expected to remain in the lower moderate range. The state's pension system funding has declined in recent years, though a commitment to funding is evident and legislation has recently been passed that will reduce the state's other post employment benefits liability.

State of Michigan GO Rating History

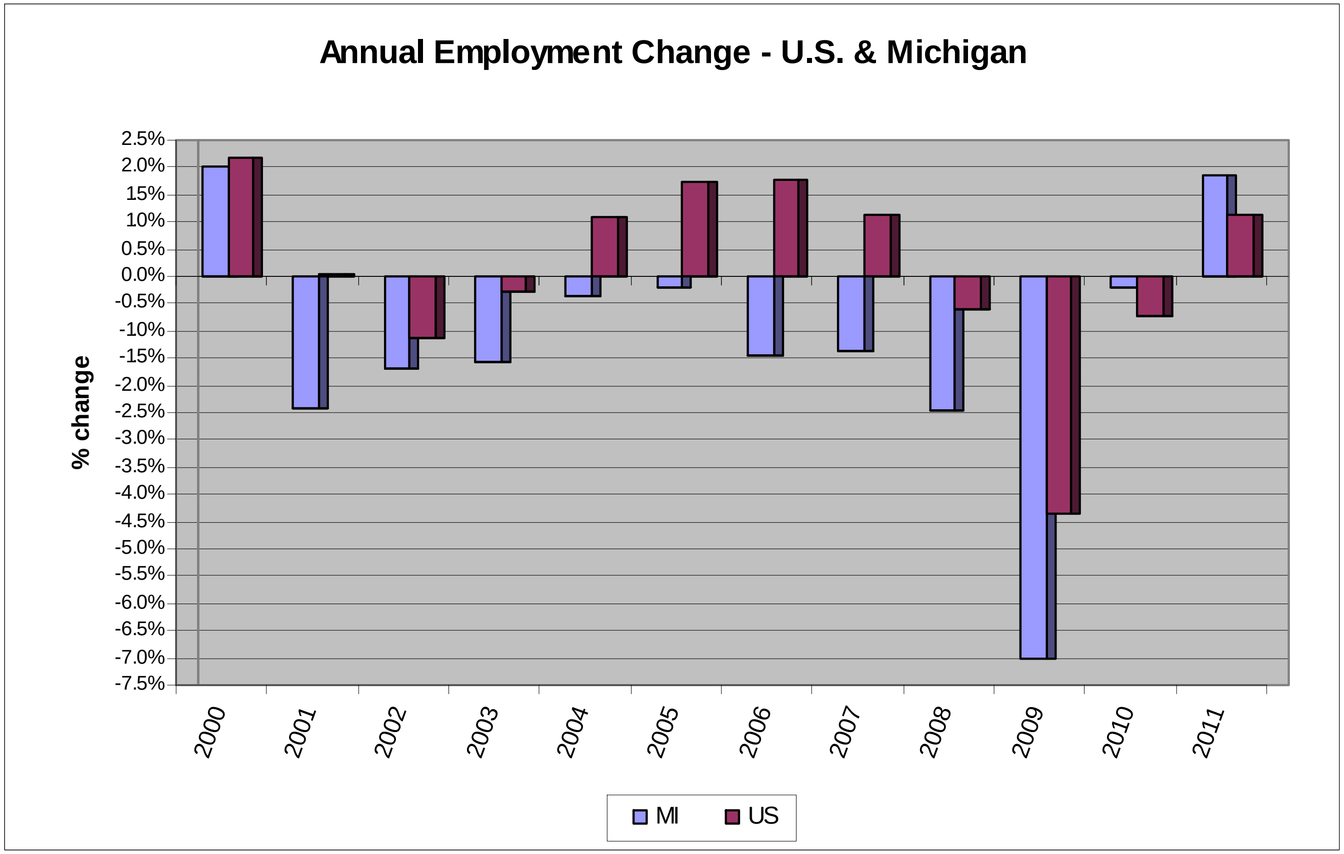
Rating	Action	Outlook/ Watch	Date
AA-	Affirmed	Positive	3/27/12
AA-	Affirmed	Positive	7/27/11
AA-	Revision	Stable	4/5/10
A+	Downgrade	Stable	7/10/09
AA-	Affirmed	Negative	4/26/07
AA-	Downgrade	Stable	1/26/07
AA	Affirmed	Negative	4/13/06
AA	Downgrade	—	12/14/04
AA+	Upgrade	—	4/15/98
AA	Affirmed	—	5/26/95

Focus on Michigan

- **What Could Trigger A Rating Action:**
  - CONTINUED EVIDENCE OF STRUCTURAL BALANCE: Rating improvement is likely with evidence of continued structurally balanced operations as enacted tax code changes are phased in.
  - RESERVE FUND GROWTH: Attainment of intended progress toward reserve fund replenishment will be indicative of improved credit quality.
  - SUSTAINED ECONOMIC RECOVERY: Continued employment recovery and improvement in the high unemployment rate will be important for credit improvement.

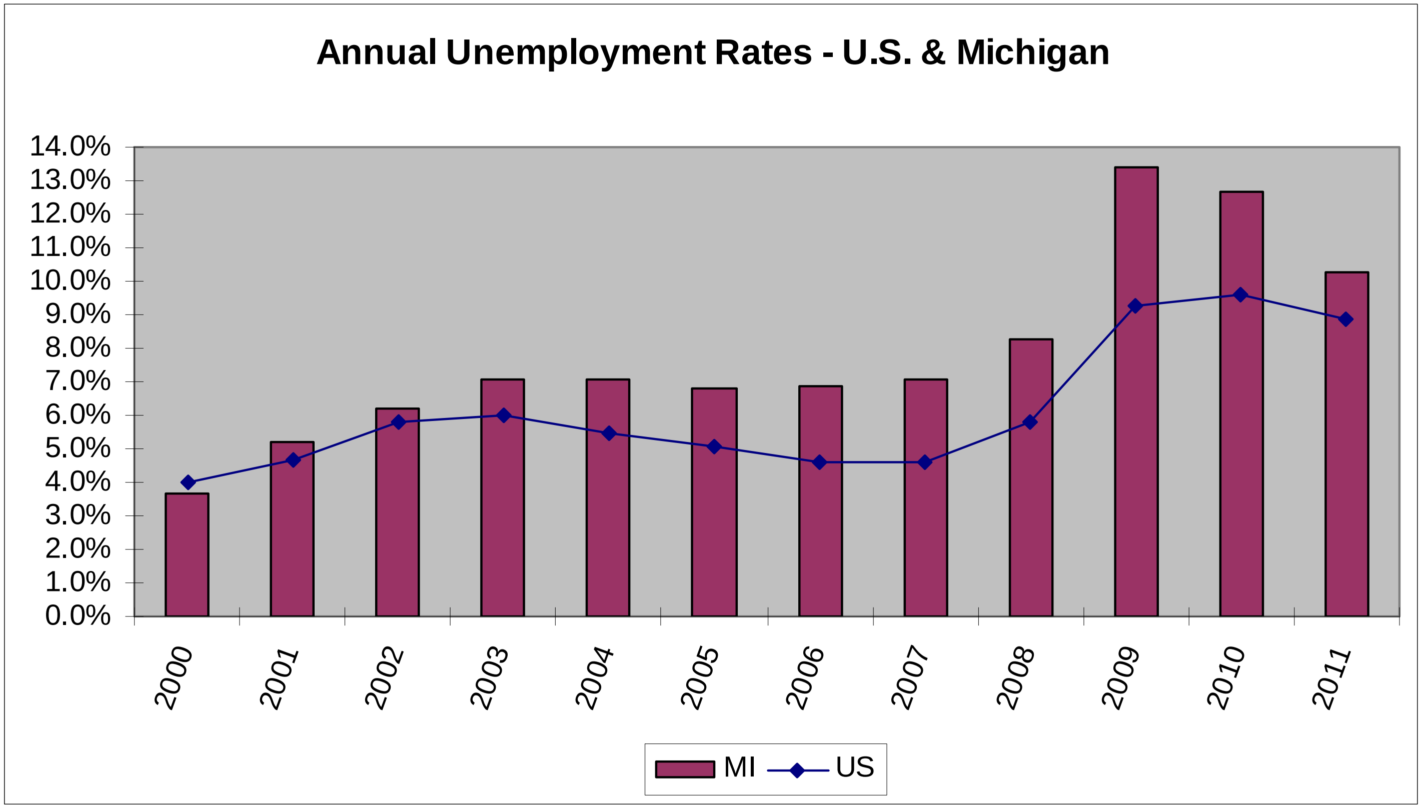
Focus on Michigan

- Employment growth in Michigan has returned after a long history of decline
  - Global Insight is projecting a 1.7% growth rate for calendar 2012, versus 1.6% for the U.S.
  - As of March 2012, year-over-year employment is up 1.5%, on par with the U.S. rate for the same month



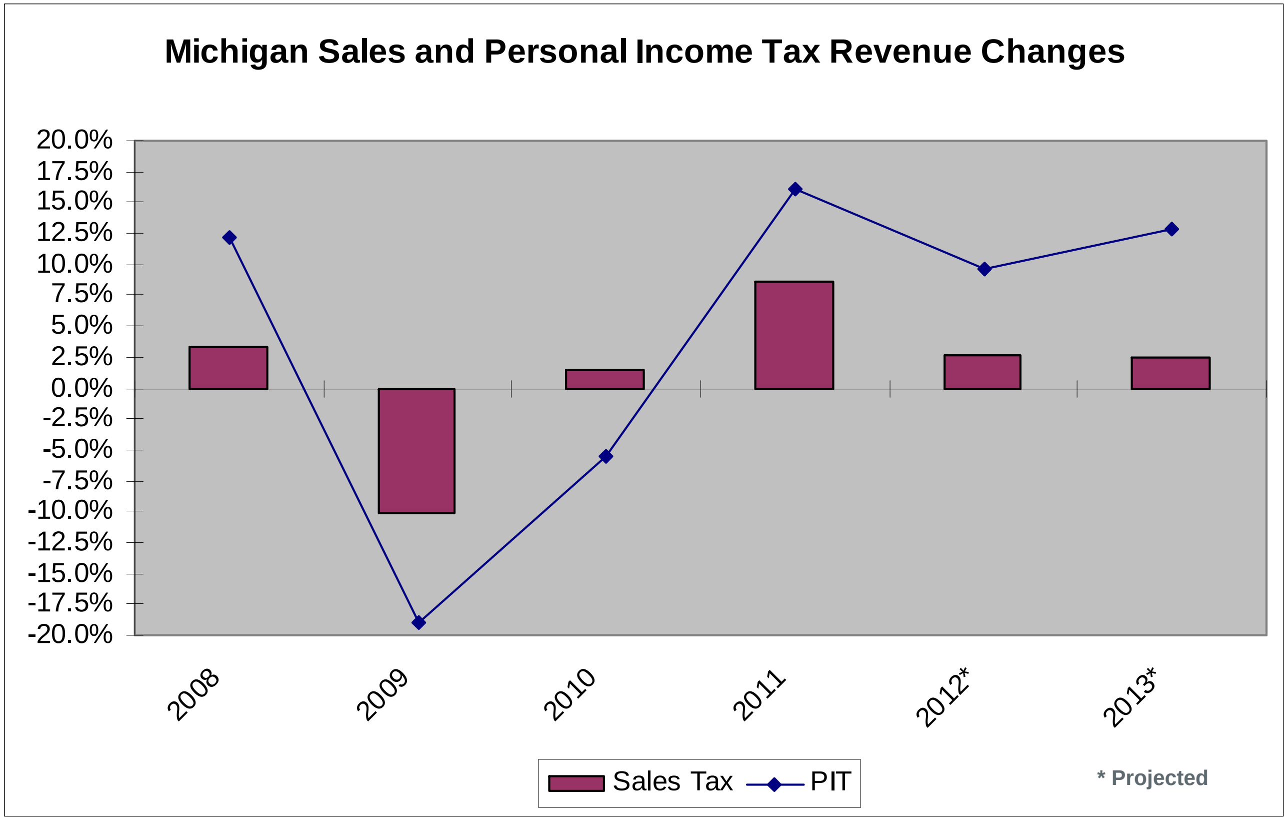
Focus on Michigan

- Unemployment levels have been declining – spread to the national rate has declined
- As of March 2012, MI's unemployment rate of 9% was just ahead of the 8.4% national rate



Focus on Michigan

- With economic recovery underway, revenue performance has improved following steep declines seen during the recession
- Through March 2012, MI's sales tax revenues are up 5.4% while net PIT revenues are up 7.4%



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