

State of the States / October 2010

This report was developed by Conning's Municipal Research Group in 2007 to rank the state credit quality by measuring factors that we felt are indicative and predictive of long term fiscal health. We felt that the published ratings were (and still are) bunched too closely together and are not forward looking enough. We use these rankings to help us make relative value investment decisions. Having a quantitative forward-looking model to rank state credit quality eliminates any bias we might have. This report provides us with a disciplined approach to managing state exposures for both State GO debt and other credit types within the state.

*The willingness and ability of states to take corrective budget action is a critical strength common to all states, but in our opinion it obscures less controllable, but real credit differences among states. Using the quantitative credit indicators provides us with a truer indication of the economic and fiscal health of the states. **It is important to note that a state's ranking contributes to, but is not a substitute for, our internal Conning rating, which also considers legal protections, debt structure and other factors.***

KEY FINDINGS

- Conning maintains a negative outlook on bonds backed by State General Fund revenues;
- State revenues may have finally begun to improve, although there is a wide variance;
- State revenue growth has historically lagged the end of a recession by between 18 months and 2 years;
- Local tax-backed credits face many of the same credit challenges but lack all the powers that states have over revenues and expenses;
- Unfunded retirement costs pose an increasing threat to improving state and local credit quality;
- State general obligation bond ratings have been recalibrated upward, creating an increased risk of future downgrades;
- The likelihood of a state GO payment default remains remote;
- Conning's proprietary model to rank the states is based on quantitative factors that we believe are predictive of credit quality.

A WEAK RECOVERY – CREDIT CHALLENGES PERSIST

Since our last report in April, all states with June 30 fiscal year-ends have enacted budgets. Whether these budgets are based on sound revenue and expense forecasts remains to be determined. Moody's and Fitch completed their global scale recalibration of municipal ratings in April, which resulted in one to two notch upgrades for most state general obligation bonds not already rated triple A. The intent of the recalibration was to bring municipal bond ratings into line with corporate bond ratings, as municipal bonds had demonstrated lower actual default rates than previously assumed. Moody's state general obligation bond ratings are now all Aa3 or better with the exception of California (A1/A-) and Illinois (A1/A+).

State revenues have begun to inch up with much of the increase associated with prior years' tax increases. Both the US Census Bureau and the Rockefeller Institute of Government reported that total state and local government tax revenues rose 2.3% in the three months ended June 2010 versus the same period a year earlier. It was the second consecutive increase in quarterly tax revenues. It should be noted that in 2005, when the economy was much stronger, state and local governments saw second quarter tax collections rise as much as 14% versus a year earlier.

State revenue collections peaked in the 2008 fiscal year, and only three states —New Hampshire, Oregon and Texas— expect to match that level this fiscal year, according to a survey of the states by the National Conference of State Legislatures. One-third of the states expect revenue to return to their pre-recession levels by the 2013 fiscal year, with the others expecting the return sometime after fiscal 2013. California is projecting its revenue won't return to pre-

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recession levels until 2016, the longest of any state with a forecast, according to the National Conference of State Legislatures. While states have patched together budget solutions for the current fiscal year, longer-term challenges remain. These include building back budget reserves, replacing expiring federal stimulus monies, repaying short term borrowings (and in some cases inter-fund borrowings) and finally meeting growing retirement costs. These needs will consume all available incremental state revenues.

There is a growing dispersion in state credit quality. It is becoming likely that several states may not fully recover from this recession, making them very vulnerable in the next recession. Contributing to this concern is a wide variance among states in both the size of their unfunded liabilities and their proposed solutions. Forthcoming actuarial reports on the funding status of state retirement plans will likely show increased unfunded liabilities due to poor investment returns. Absent federal assistance, there are no easy fixes or short-term solutions to address growing retirement costs which are consuming an ever-increasing share of state expenditures.

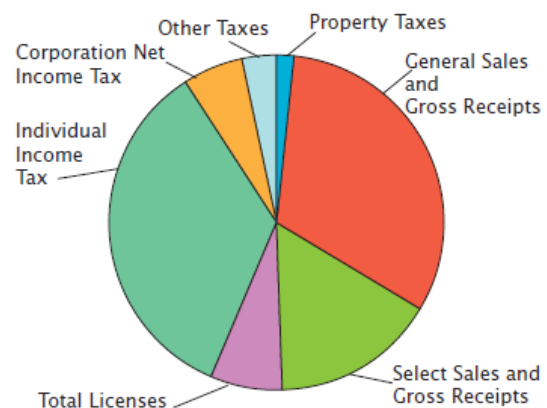
STATE REVENUES ARE BASED ON ECONOMIC ACTIVITY

State budgets are very vulnerable to changes in economic conditions due to their revenue and expenditure mix. Unlike their political subdivisions, which rely more on less volatile property tax revenues, states on average depend on personal and corporate income taxes and sales taxes for almost 90% of their General Fund revenues. Credit problems have historically arisen because of an inverse correlation between revenues and expenditure needs during recessions. States with the highest marginal personal income tax rates, such as California and New York, are the most susceptible to revenue swings based on the level of economic activity. **Good social policy can equate to poor fiscal policy.**

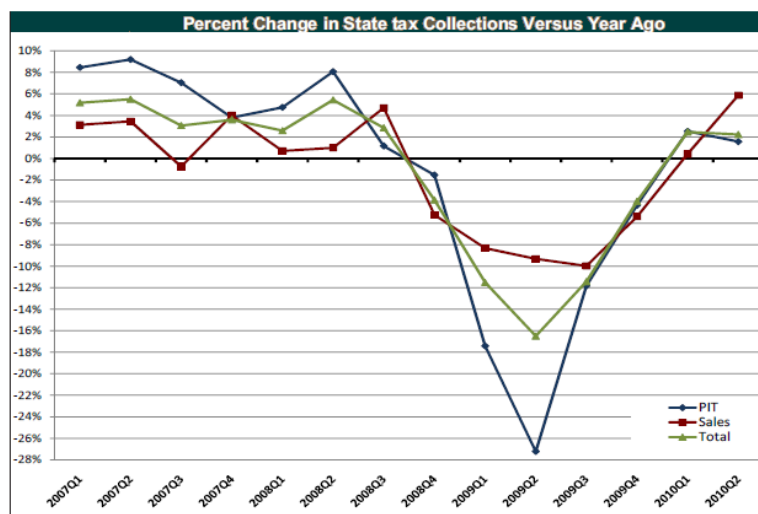
State spending is dominated by education and healthcare, which typically accounts for over 50% of expenditures. Any material cost cutting needs to include reductions to education and health care, which can be politically difficult to reduce.

The chart on the right illustrates the sharp drop that the three state primary revenue sources have had and provides perspective on the time it will take for state revenues to recover to their pre-recession levels. Despite two consecutive quarter of state revenue growth, state revenues are still 14.9% lower in the second quarter of 2010 than in the same period two years ago.

Total State Tax Collections by Category



Source: U.S. Census Bureau, 2009 State Government Tax Collections.



Source: State Revenue Flash Report. The Nelson A. Rockefeller Institute of Government. August 30, 2010

STATE OF THE STATES METHODOLOGY

We have ranked the credit quality of States using 12 indicators. The specific definition and source of the data of our indicators is shown in Appendix A. The selected indicators measure a state's business climate, credit specific metrics, economic and income levels and housing activity. We have periodically changed some of the specific credit indicators within these four broad categories to reflect new priorities.

This year, we added an indicator on economic debt per gross state product, not just stated debt. We define economic debt as stated debt plus borrowed federal funds to make unemployment claims, unfunded pension obligations and unfunded OPEB liabilities. We feel that this is a more comprehensive measure of a state's future obligations than just stated debt alone.

The following tables set forth the indicators and the weightings assigned to arrive at the credit rankings.

Credit Indicator	Weighting	
State Economic Competitiveness	10%	
<i>Laffer State Economic Competitiveness Ranking</i>		10%
State Credit Metrics	34%	
<i>Economic Debt per Gross State Product</i>		10%
<i>FY 2009 General Fund Balance as a % of General Fund Revenues</i>		8%
<i>Debt per capita</i>		8%
<i>Tax Revenue Growth</i>		8%
Economic and Income Measures	40%	
<i>Real State GDP 5 year average growth</i>		8%
<i>Year over Year Employment Growth</i>		8%
<i>Population Growth</i>		8%
<i>Unemployment Rate</i>		8%
<i>Per Capital Income</i>		8%
Housing Indicators	16%	
<i>One Year Home Price Change</i>		8%
<i>Foreclosure Rate</i>		8%
TOTAL	100%	

THE RESULTS

Changes in ranking order were minimal since our last report in April. There was no change in our seven highest ranked states except for some shifting in their rank order. In fact, the top 10 ranked states in April were all ranked 12th or better in this update. For the lower ranked states, eight out of the 12 lowest ranked remained in that grouping. Of note is Conning's own state of Connecticut, which fell from 35 to 47. For Connecticut, high per capita income and wealth levels did not overcome increasing debt levels and low growth.

State	October 2010 Rank	April 2010 Rank	Positions Improved / Declined
North Dakota	1	1	0
South Dakota	2	2	0
Wyoming	3	6	3
Texas	4	4	0
Virginia	5	7	2
Nebraska	6	3	-3
Iowa	7	5	-2
Tennessee	8	16	8
Alaska	9	17	8
Oklahoma	10	9	-1

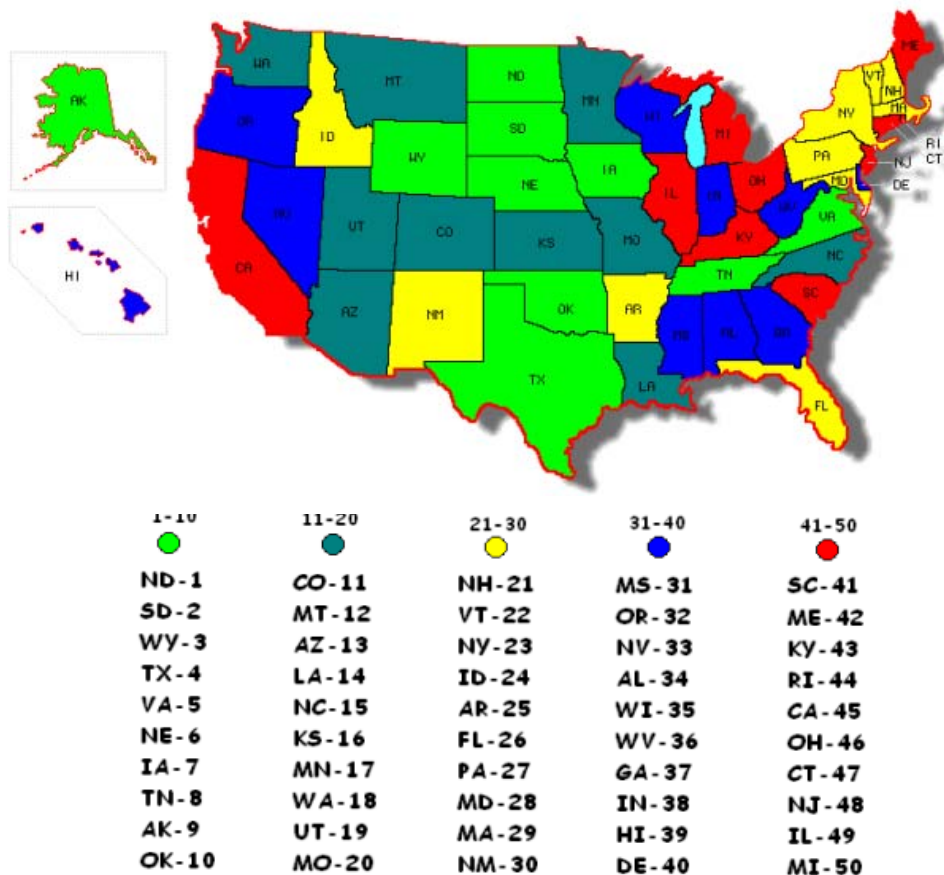
Source: Conning Municipal Credit Group

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State	October 2010 Rank	April 2010 Rank	Positions Improved / Declined
Colorado	11	8	-3
Montana	12	10	-2
Arizona	13	24	11
Louisiana	14	21	7
North Carolina	15	23	8
Kansas	16	11	-5
Minnesota	17	13	-4
Washington	18	28	10
Utah	19	12	-7
Missouri	20	20	0
New Hampshire	21	14	-7
Vermont	22	27	5
New York	23	37	14
Idaho	24	15	-9
Arkansas	25	19	-6
Florida	26	29	3
Pennsylvania	27	25	-2
Maryland	28	26	-2
Massachusetts	29	30	1
New Mexico	30	45	15
Mississippi	31	39	8
Oregon	32	34	2
Nevada	33	22	-11
Alabama	34	33	-1
Wisconsin	35	36	1
West Virginia	36	44	8
Georgia	37	31	-6
Indiana	38	18	-20
Hawaii	39	47	8
Delaware	40	50	10
South Carolina	41	38	-3
Maine	42	32	-10
Kentucky	43	46	3
Rhode Island	44	43	-1
California	45	48	3
Ohio	46	41	-5
Connecticut	47	35	-12
New Jersey	48	42	-6
Illinois	49	49	0
Michigan	50	40	-10

Source: Conning Municipal Credit Group

Ranking Map – October 2010



Source: Conning Municipal Credit Group

IMPROVING STATES

The following states had double digit improvements in their state rankings. The most common ingredients for the improved states were low debt levels and a strong business climate, which included several southeastern and western states.

State	Rank Oct '10	Rank Apr '10	Improvement in Rank	Reasons for Rank improvement
New Mexico	30	45	15	Strong employment, state product and tax revenue growth
New York	23	37	14	State product growth and relatively strong housing activity
Arizona	13	24	11	Low debt levels, tax revenue and state product growth
Delaware	40	50	10	Good GF ending balance and tax revenue growth
Washington	18	28	10	Employment, population and state product growth

Source: Conning Municipal Credit Group

DECLINING STATES

The following states experienced the double digit declines in their ranking. Common factors among lower ranked states include high debt levels and high Medicaid populations and this list includes many eastern and mid-Atlantic states.

State	Rank Oct-10	Rank Apr-10	Decline in Rank	Reasons for Rank Decline
Indiana	38	18	-20	Slow tax revenue, state product and employment growth
Connecticut	47	35	-12	Weak GF ending balance, very high debt levels and slow employment and state product growth
Nevada	33	22	-11	High unemployment, high foreclosure rate and declining home prices
Maine	42	32	-10	Slow population and state product growth with high debt levels
Michigan	50	40	-10	High unemployment, weak growth and declining population

Source: Conning Municipal Credit Group

OUR OUTLOOK FOR CALIFORNIA (#45) AND ILLINOIS (#49) IS CAUTIOUS

Conning has assigned low A internal credit ratings with declining credit outlooks for both California and Illinois. These are also the lowest rated states by Moody's and S&P. Municipal CDS spreads for Illinois and California have been the highest among all states for sometime. Both states are also both major issuers of debt in the municipal marketplace. California is the largest issuer of debt in the municipal marketplace with \$89 billion of outstanding tax-supported debt and Illinois has \$29 billion of outstanding general obligation debt.

Both states have assigned a high priority to the payment of debt service and therefore there is little risk of a payment default. *What concerns us is that the fiscal problems in both Illinois and California show little sign of improvement. Any meaningful recovery in credit quality is not yet in sight.*

Illinois

The state's financial position continues to deteriorate as the backlog of unpaid bills continues to outpace revenue growth. As of September 30, over \$6.4 billion in fiscal year 2011 revenues will be used to pay FY 2010 bills. This represents a staggering 23% of general fund revenues. For the first 3 months of FY 2011, base general fund revenues were flat compared to the same period last year. To eliminate the FY 2010 deficit by year-end, the state needs to realize \$1.2 billion from the securitization of tobacco revenues through a municipal bond deal. In addition, the state needs to complete inter-fund borrowing of \$1 billion and realize tax-amnesty revenues.

The State's funded ratio for its pension plan is less than 50%. As a rule of thumb, an 80% funded ratio is considered the minimum safe level. The budget for the current fiscal year relies on issuance of \$3.7 billion of state general obligation debt to finance statutorily required contributions to the state pension plans. Longer term, the state faces the task of deriving the resources it needs to contribute annually (in keeping with its state law) to achieve a 90% funding ratio by 2045. Even if it manages to reform its budget to allow for these contributions without borrowing, the funded status of the state's pensions may deteriorate further in coming years. The deterioration may be driven in part by weaker-than-assumed investment performance, currently assumed with annual returns of 8.5%.

According to the Comptroller, the state faces the prospect of a \$15 billion budget gap for FY 2012. This represents over 50% of the State expected revenues. The critical issue is the need to raise revenues in the near term to avoid this huge deficit. Political support for an increase in the State's 3% flat personal income tax, currently tepid, will likely be tested following the November election.

California

In October, the State finally passed a budget for its fiscal year starting July 1. The budget package that has been approved closes a \$17.9 billion gap through a combination of expenditure reductions (\$7.5 billion), Federal Funds (\$5.3 billion), additional revenues (\$2.5 billion) and revenue shifts (\$2.8 billion). The budget does not increase any tax rates and implements pension reform for new employees. Reliance on unspecified expenditure cuts and federal funds is uncertain and there is high likelihood that not all these gap closing measures will materialize.

The outlook is for a continuation of California's seemingly endless budget crisis for many years to come. According to the independent State Legislative Analyst's Office, yearly deficits will remain at around \$20 billion through 2015. This equates to an annual 20% budget gap assuming no pay raises. The state reliance on high income tax rates and high sales tax makes its revenue stream very volatile. There is not much political support for raising income taxes and/or sales taxes, which are among the highest in the country. Furthermore, it takes a two-thirds majority vote of each legislative branch to raise taxes, which has proven difficult to obtain.

UNDERFUNDED STATE RETIREMENT SYSTEMS – MYTH VS. REALITY

This year there has been an increased focus on the adequacy of State Retirement Plans to meet promised benefits. Retirement obligations include both defined benefit pension plans and OPEB liabilities, primarily retiree healthcare plans. As a result of new accounting rules, states have to provide more detail on the funding status in their financial statements. They are required to prepare actuarial studies to determine their funding ratio and to calculate their Annual Required Contributions (ARCs) for both their pension and OPEB plans. ARCs include the current employee funding requirements plus an amortization component for already retired workers. Funding levels and ARCs vary widely among states. However, as a result of investment returns being well below the assumed return (between 8 and 8.5%) and the failure by many states to make full ARC payments, many plans are now significantly underfunded.

The credit implication of this is that states will have to make larger ARCs in the future. These payments typically account for between 10 and 15% of General Fund expenditures. There is no legal obligation to make the ARC, and, in fact, many states have not made ARC payments in full or funded them through bond issues. Pension and OPEB ARCs are growing at double-digit rates while revenue growth has been stagnant. The major credit concern is that growing ARC payments are crowding out other discretionary expenditures. As an example, for Connecticut, the pension ARC combined with the pay-as-you-go cost of retiree health care currently equals about 8% of general fund revenues. In 20 years, unless plan changes are made, it is projected that almost 20% of the State of Connecticut's projected expenditures will go towards paying retiree health care and pension benefits.

Increased annual retirement payments can be managed in the short term, but unless difficult choices are made today to curb their growth, they will continue to consume a greater share of state expenditures. Several states, including Michigan and Utah, have already made significant plan changes that will reduce the growth in their retirement costs. ***The funding status of a State's retirement plan is an important distinguishing credit factor. Given that it is both difficult politically (if not legally impossible) to alter an employee's or retiree's vested benefits, taking meaningful steps today is an important credit factor.***

PUBLIC ATTITUDES AND FISCAL POLICIES

A study published by the Pew Center on the States in October titled "Facing Facts – Public Attitudes and Fiscal Realities in Five Stressed States" found a large gulf between what actions residents want their political leaders to take and the fiscal realities. The report found that residents prefer more budget cutting to borrowing. Another key finding was that residents want to protect K-12 public education and health care from spending cuts. Given that these expenditures account for more than 50% of state spending, it is hard square fiscal reality with public opinion. The takeaway for municipal credit quality is that political stalemates are likely to continue. ***The lack of a good understanding of fiscal realities by voters means that legislators will continue to have a difficult job balancing state budgets while keeping their constituents appeased.***

RECENT RATING AGENCY ACTIONS

Recent rating actions since our last report have largely been in-line with our previous rankings and outlooks. Conning assigns ratings to GO debt issued by the states which is incorporated into our State of the States ranking along with other credit factors.

Credit	Agency	Action	Date	October 2010 Rank
CONNECTICUT	Fitch	Downgraded to AA from AA+	6/3/2010	47
ILLINOIS	Moody's	Downgraded to A1 from Aa3	6/4/2010	49
ILLINOIS	Fitch	Downgraded to A from A+	6/11/2010	49
KENTUCKY	Fitch	Downgraded to AA- from AA	6/14/2010	43
WEST VIRGINIA	Moody's	Upgraded to Aa1 from Aa2	7/9/2010	36
ARIZONA	Moody's	Downgraded to Aa3 from Aa2	7/15/2010	13
NEW JERSEY	Moody's	Outlook revised to Negative from Stable	9/22/2010	48
ILLINOIS	Moody's	Outlook revised to Negative from Stable	9/24/2010	49

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FINAL OBSERVATIONS

Since our last report in April, aggregate state revenues have begun a tepid rise, but remain well below pre-recession levels. Furthermore, the credit quality differences among the states have continued to widen. The line of states from North Dakota to Texas continues to be among our highest rated states. These states are starting to see meaningful revenue increases. Many of the mid-western and east-coast states plus California are seeing anemic revenue growth and face a longer revenue recovery period.

In particular, we are most concerned about several large and mid-Atlantic states. Included are California, Illinois, New Jersey, Connecticut, New York and Delaware. These states share many of the same issues including weak business conditions, high economic debt levels, high unemployment, political stalemates and large unfunded retirement costs. Revenue growth in these states is coming from tax increases rather than increased economic activity. These states have all taken numerous one-shot measures to balance their budgets and all face daunting out-year budget gaps. These states may not fully recover from the current recession before the next recession arrives.

At the same time, fundamental state credit quality is under pressure – both Moody's and Fitch implemented global scale ratings for municipal bonds based on historically low municipal bond default rates. This has resulted in one to two notch rating upgrades for all state general obligation bonds that are not already rated AAA. We feel these rating agency recalibrations obscure individual state credit distinctions.

On a positive note, states have cut expenditures, raised taxes and used federal stimulus monies to balance their budgets for the current fiscal year. We do not expect any state payment defaults, but we do see an increased risk of negative rating agency actions. In the current environment, Conning believes essential service revenue bonds and dedicated tax-secured credits offer good value. These credits and structures are recession-resilient and have a stable outlook.

In summary, state credit challenges will be with us for a while to come. Before making investment decisions, it is critical to be knowledgeable of the differences in state credit quality.

Paul Mansour
Jon Rappaport

October 2010

Appendix A - DESCRIPTION OF INDICATORS

Laffer State Competitive Environment (10% weight)

Arthur Laffer, a supply-side economist, developed the Laffer State Economic Competitive Index. His most recent analysis of the states was released in February 2010 and prepared for the American Legislative Exchange Council (ALEC). The report assigns an Economic Outlook Rank based on a state's current standing in 16 state policy variables including top marginal personal and corporate income tax rates, property and sales tax burdens, and state minimum wage.

Economic Debt per Gross State Product (10% weight)

This indicator ranks the states according to their economic debt as a percentage of each state's 2009 Gross State Product (GSP).

$$\text{Economic Debt} = \frac{\text{Net Tax Supported Debt} + \text{State Trust Fund Loans} + \text{Unfunded Pension} + \text{OPEB Liability}}{2009 \text{ Gross State Product}}$$

FY10 General Fund Balance as a percent of GF Expenditures (8% weight)

This indicator ranks the states according to their General Fund balance as a percent of expenditures for their most recent FY, 2010. Each state's ending balance and budget stabilization fund are added together to equal their total funds. Each state's total fund is then divided by that state's expenditures. This data was taken from The Fiscal Survey of States, dated December 2009.

Debt per Capita (8% weight)

This represents total state related debt divided by population. It was obtained from the Moody's 2010 State Debt Medians Report.

Tax Revenue Growth (8% weight)

This indicator ranks the states according to their tax revenue growth. The data was obtained from the U.S Census Bureau and covers the 2nd quarter of 2010 (2Q10) over the 2nd quarter of 2009 (2Q09).

Real GDP Growth by State (8% weight)

This indicator ranks the states according to their 5-year compound annual growth rate in State GDP. This information was taken from a U.S Bureau of Economic Analysis.

Year-over-Year Employment Growth (8% weight)

This indicator ranks the states based on their YoY employment growth (August 2010 vs. August 2009). This data was obtained through the Bureau of Labor Statistics.

Year-over-Year Population Growth (8% weight)

This outlook indicator ranks the states according to their population change from July 1, 2008 to July 1, 2009. This data was obtained from the U.S Census Bureau's Population Division.

Unemployment Rate (8% weight)

This indicator ranks the states by their August 2010 unemployment rate. The unemployment rate is the percentage of the labor force that is unemployed but is actively seeking employment and is willing and able to work. Our data was obtained from the Bureau of Labor Statistics.

Per Capita Income (8% weight)

This indicator ranks the states according to their 2nd quarter 2010 per capita income statistics. This information was taken from the U.S Bureau of Economics and the U.S Census Bureau. Per capita income is the mean income computed for every individual in a particular group. This is calculated by dividing the total income of a group by the total population in that group. In our chart, each state's per capital income is compared to the U.S per capita income.

One-Year change in Home Prices (8% weight)

This indicator ranks the states base on their one-year change in home prices. The data was obtained through the Federal Housing Finance Agency's Monthly HPI Data dated June 30, 2010.

Foreclosure Rates (8% weight)

This indicator ranks the states based on the percentage of homes foreclosed on (as of August, 2010). This data was obtained through RealtyTrac.

ADDITIONAL SOURCES**Wilshire Consulting**

2009 Wilshire Report on State Retirement Systems March 3, 2009

Moody's Investors Service

Various reports

S&P Ratings Direct

Various publications

Center on Budget and Policy Priorities

American Recovery and Reinvestment Act of 2009 February 13, 2009

Center for American Progress**Nelson Rockefeller Institute of Government****Pew Center on the States**

Facing Facts – Public Attitudes and Fiscal Realities in Five Stressed States, October 2010

California Legislative Analyst's Office**National Conference of State Legislators**