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Political Credit Risk in New York State

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Summary

- The recession and the troubled financial services industry hit New York State's finances hard, and exacerbating the problem is a dysfunctional political process. The state's deteriorating ability to balance its budget has forced it to delay aid payments to local governments.
- We believe there is downgrade risk in New York State general obligation debt, currently rated Aa3/AA/AA- with a stable outlook from all three rating agencies.
- We are concerned about New York State credits with political credit risk, and have a preference for New York State credits that are structured to ameliorate this risk.

Background

Last year was a tumultuous time for New York State. As with neighbors Connecticut and New Jersey, the financial situation deteriorated as the national recession reduced revenues, and expenditures rose as the government-financed safety net came to the aid of more struggling citizens.

But New York's political situation was especially troublesome in 2009, resulting in major budgetary and capital disruptions. In July, the New York State Senate was effectively shut down by two dissident Democrats as the party first lost and then regained control. The shenanigans delayed important financial legislation such as sales tax changes, pension funding, and an increase and extension of debt caps. The Senate remains closely divided, so we cannot rule out a recurrence of this type of disruption.

This year, the entire Assembly, Senate, and all statewide officials are up for election, increasing the chances of grandstanding (and therefore disruption) yet further. As candidates pander to various constituencies, we are concerned that they will avoid making difficult but necessary fiscal decisions. In a census year with control of the legislature critical to redrawing electoral district lines, the parties may be especially frantic. Delays in addressing the structural budget imbalance could ultimately lead to downgrades in the current New York State general obligation bond ratings of Aa3/AA/AA- (from Moody's, Standard & Poor's, and Fitch, respectively). Currently, all three agencies maintain a stable outlook.

Economic Outlook

Although New York's economy is improving and Wall Street is strengthening, their recovery is not enough to solve the state's near-term fiscal problems. Western New York's dependence on manufacturing employment in declining industries and unfavorable demographic trends lead us

to expect a recovery weaker than the nation's as a whole and continuing job losses throughout 2010. Lower taxes from consumer spending and increased costs in social services will thus deepen the New York State budget shortfall.

The financial services sector accounts for about 20% of tax revenues and its troubles have added significantly to the state's fiscal problems. For 2010, low interest rates, significant government intervention, and reduced operating budgets may help certain financial firms generate strong profits – probably higher than expected. Bonuses at investment and commercial banks may be up over 40% from last year, according to the State Comptroller. Government pressure to force firms to pay more in stock options and less in cash would mute the impact on state tax revenues, however.

Fiscal Outlook

The timing of tax collections and various programs' funding needs is placing further pressure on the state's cash flow. According to the Comptroller, New York's tax revenue was down nearly 16% for the first six months of this fiscal year. Resistance to further cuts to schools or healthcare, which comprise most of the budget, will limit the state's flexibility in closing the deficit.

For FY2010, the budget gap was \$17.9 billion. To close it, the state used over \$11 billion in non-recurring (available one-time) or temporary fixes (such as federal stimulus monies, payment deferrals, and temporary tax increases). These gimmicks will make closing the FY 2011 gap even more challenging. The State Comptroller estimates that the 3-year cumulative gap in the general fund through FY2012 could reach \$27.5 billion.

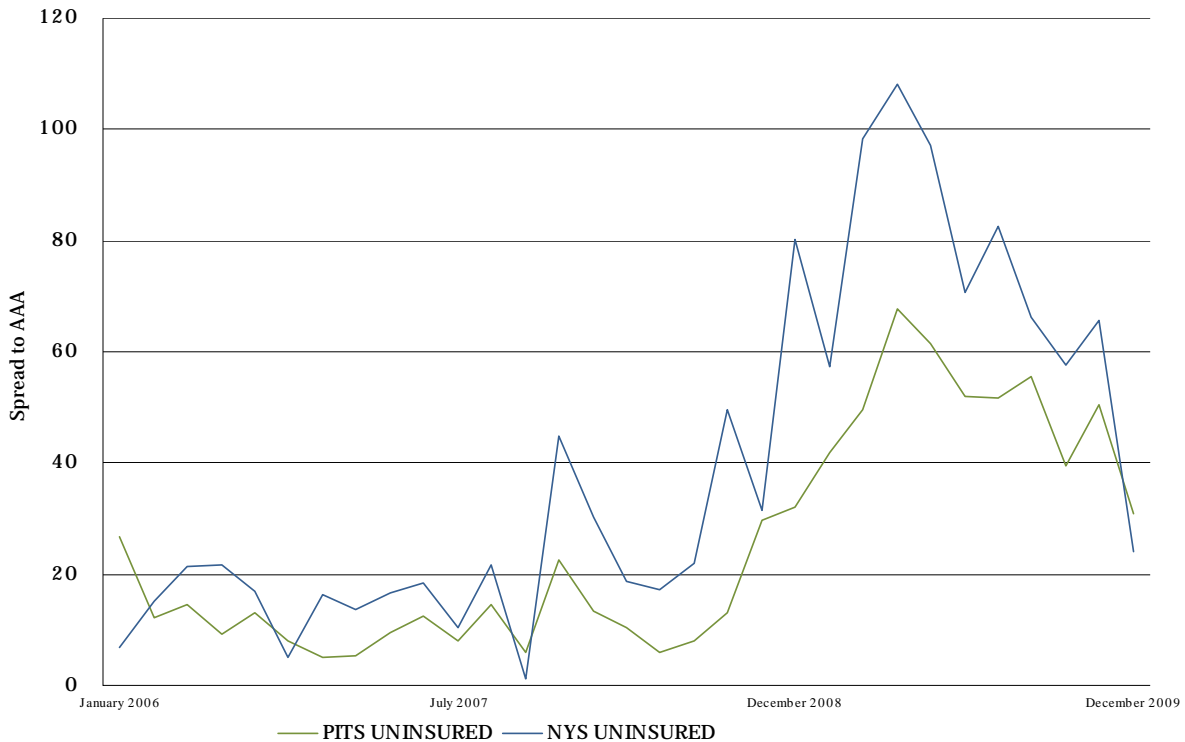
Potential cash shortfalls are another major issue. Barring a major influx of tax receipts in the last few days of December, the State's General Fund may have ended the month with its first-ever deficit, according to the State's comptroller. If there is a shortfall, the General Fund would need to borrow from other funds in the State's Short-Term Investment Pool. Once the last financial cushion is depleted, the riskier and scarier it will be if there is an unanticipated further downturn.

Other Debt Examples

For New York State debt issues, our biggest concern is political risk, and ultimately downgrade risk. Credits where political risk is high include General Obligation issues as well as credits that require the legislature to appropriate funds and that carry ratings determined by the state's fiscal restraints. We prefer more structured credits, such as NYS Personal Income Tax (PIT), NYS Local Government Assistance Corporation or NYS Environmental Facilities Corporation bonds. In this case, "structured" means a flow of funds or a "trap" mechanism that avoids political tampering.

At this time, we believe that the market is not pricing enough risk into general obligation bonds and that structured bonds such as the Personal Income Tax bonds represent better value. When NYS General Obligation bonds yield less than PIT bonds, we have found an opportunity to sell NYS bonds and buy dedicated revenue-backed bonds such as PITs.

Comparison of NYS Uninsured GO's to Uninsured PITs Spread to AAA Scale



Data from Loop Capital based on actual trades.

The advantages of NYS PIT bonds include the following:

- Revenues from the tax are set aside with a “poison pill” mechanism, whereby excess monies cannot be used by the State until receipts are appropriated for debt service;
- Significant set-aside receipts accumulate in the fund until they reach \$6 billion or 25% of the PIT, whichever is greater;
- To prevent overleveraging, there is a 2X additional bonds test that limits debt issuance in relation to this revenue stream; and
- Despite the economic downturn, income tax receipts have decreased but not precipitously, thanks to an additional surcharge on high-income earners:
 - FY 2008 was \$36.6 billion, FY 2009 was \$36.9 billion, FY 2010 Department of Budget estimate is \$35.0 billion including recent income tax surcharge;
 - Debt service coverage is approximately 6X (\$8.8 billion, which is 25% of the estimated F2010 expected \$35.0 billion collection)

Besides the New York State Personal Income Tax Bonds, we find several other New York State credits attractive relative to NYS general obligation bonds:

- New York State Local Government Assistance Corporation: Secured by the statewide sales tax, with a funding mechanism that prevents the use of the remaining sales tax receipts until money is appropriated for debt service;
- State University of New York Lease Revenue Bonds: A systemwide pledge of revenues supporting dormitory debt. Finances have been stable, with potential cuts in state appropriations somewhat mitigated by increases in demand and enrollment. Fund-raising is also increasing with the growth of the alumni base.

- New York State Power Authority: Very strong wholesale electric system with cheap hydro power and good transmission access ensuring a steady customer base throughout the State. It also has independent rate-setting abilities.
- New York State Environmental Facilities Corporation: State revolving loan program, with a broad array of participants, mostly investment grade or above. Significant reserves bolster its high demonstrated default tolerance. There is also an underlying general obligation or revenue pledge and, for each individual borrower, a state intercept mechanism that allows the State to withhold appropriations in order to make debt service payments directly to the trustee.

New York State Key Facts

- Current Ratings, General Obligation Bonds: Aa3/AA/AA- all with stable outlooks for Moody's, S&P, and Fitch, respectively.
- Total Debt with Contingent and Guaranteed Debt:

○ General Obligation Debt	\$53.6 billion
○ State Supported Lease Purchase	\$3.3 billion
○ Personal Income Tax Bonds	\$26.1 billion
○ Local Govt Assistance Corp.	\$13.7 billion
○ Sales Tax Asset Receivable Corp.	\$3.8 billion
○ Contingent and Guaranteed Debt	\$2.4 billion
	\$4.3 billion
- New York ranks fifth in the nation in net tax-supported debt per capita (Moody's)
- Unemployment Rates, November 2009: New York, 8.6%; United States, 10.0%
- Total Estimated Receipts FY 2010, State Comptroller:

○ Personal Income Tax	\$64.1 billion
○ Consumer Taxes and Fees	\$34.2 billion (53.3%)
○ Business Taxes	\$13.8 billion (21.5%)
○ Other Taxes Including MTA Payroll	\$7.6 billion (11.8%)
○ General Fund Misc. Receipts	\$2.8 billion (4.4%)
○ Lottery	\$3.1 billion (4.9%)
	\$2.6 billion (4.1%)

Howard joined Evercore Wealth Management with over 23 years of experience in analyzing tax-exempt municipal securities. He can be contacted at Cure@evercore.com.

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