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Preparing for a Possible US Treasury Rating Downgrade

Implications of Current Debt Ceiling Debate

Background

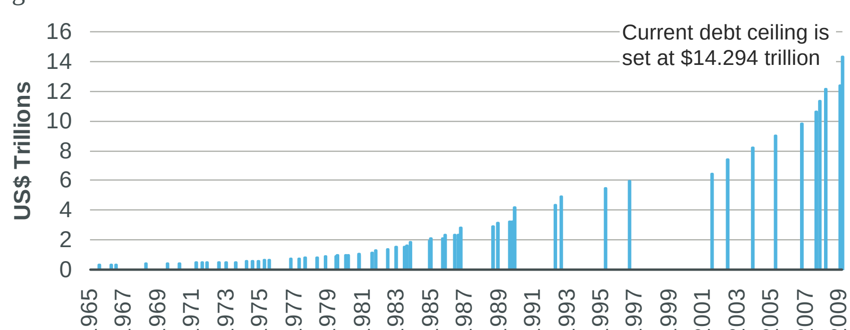
The debate currently taking place in Washington over the US debt ceiling (ie the amount of money that the federal government is legally allowed to borrow) could have major implications for the global economy. Republicans and Democrats are using the ceiling limit as a key reference point in a wider philosophical debate over the best way to keep the US budget deficit under control. Put simply, Democrats favour tax increases to raise revenue, while Republicans prefer the option of cutting expenses. The debate has become a litmus test of party values, especially for those newcomers to the House of Representatives who are aligned with the conservative 'Tea Party' movement, which strongly advocates lower taxes and reduced public spending. Given the magnitude of the gap between the two parties, the long-term solution will probably involve both revenue increases and spending cuts; however, it has been difficult to agree on the details, and any significant delay in reaching that agreement could jeopardise the credit rating attached to US sovereign debt.

The US government will be forced to make difficult decisions in preparation of the debt ceiling being reached. According to Treasury Secretary Timothy Geithner, if the ceiling is not raised by 2 August 2011 (or earlier, since the legislation has to be drafted, reviewed, passed, reconciled and subsequently signed), the US will begin to default on some of its obligations. Examples of these obligations include Social Security checks, government employee salaries and interest payments on Treasury bonds. While all government debts would not default at once, certain obligations would need to be met.

What the rating agencies are saying

For the past few months, the rating agencies have been warning the US government that failure to raise the debt ceiling and create a credible proposal to cut deficits may result in credit downgrades from the current AAA level. Standard and Poor's (S&P) warned on Thursday 14 July that there is a 50% chance that it will cut the US AAA credit rating if a $4 trillion deficit reduction plan is not reached soon, indicating that "there is a substantial

Figure 1: Historical US debt limits



Source: White House Office of Management and Budget; most recent debt ceiling was set on 12 February 2011

Peter R. Fisher, Senior Managing Director, is head of BlackRock's Fixed Income Portfolio Management.

Barbara Novick, Vice Chairman, is head of Government Relations and Public Policy.

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likelihood of it taking a rating action within the next 90 days, or in response to events presenting significant uncertainty to the creditworthiness of an issuer".

Similarly, if the US misses a payment on debt, **Moody's has stated that it is likely to downgrade the sovereign debt rating to AA**, with the assumption that the missed payment would be temporary in nature, and may not restore the rating even if the default is "fixed". By contrast, **S&P would likely downgrade US debt to a Selective Default rating**, while Fitch told Reuters, "if [we] reach the second of August without a lifting of the debt ceiling, **Fitch would assign a rating watch negative to the US sovereign** ratings" – illustrating the varied approach being taken by the major ratings agencies.

It is extremely difficult to project how the market would react to an actual downgrade of the US Treasury to below AAA. There is sufficient revenue coming into the federal government daily to ensure that no actual default would occur on any US Treasury security as we believe the Treasury would prioritise payments to ensure that all payments of principal and interest are paid when due. However, delaying Congressional action risks a loss of confidence in a recovering market. A temporary default or downgrade would be likely to create considerable uncertainty, and thus probably increase the risk premium, which could mean higher borrowing costs for the government and US banks.

If US debt is downgraded: unintended consequences relevant to investors

Collateral management

Currently, when using derivatives in an over-the-counter transaction, parties in the financial markets post a percentage of the deal size for collateral commonly in the form of US Treasuries or agency debt. In the case of a US Treasury downgrade, it is possible that Treasuries would sell off and hence drop in value. Were this to happen, parties in the transaction will require additional funding.

Furthermore, a downgrade or default could affect whether counterparties continue to accept US Treasuries as collateral or increase the applicable haircut. If US Treasuries are downgraded, they may be perceived as riskier assets. Therefore, the haircut associated with collateral posted in US Treasuries may increase.

Money market funds

A brief, contained, technical default is not expected to implicate the overall rating of most money market funds. However, an erosion in client confidence could stress their liquidity, and as a result, most funds are building extra liquidity. Additionally, many funds have 'barbelled' their holdings to avoid Treasury securities that mature in August.

Sovereign ceiling rule

The sovereign ceiling rule says that, with few exceptions, the private sector cannot have a higher credit rating than the government. S&P, for example, would downgrade all domestic AAA-rated companies in the event of a sovereign downgrade. However, Moody's has a more flexible approach, and under their system firms rated AAA would not necessarily be downgraded.

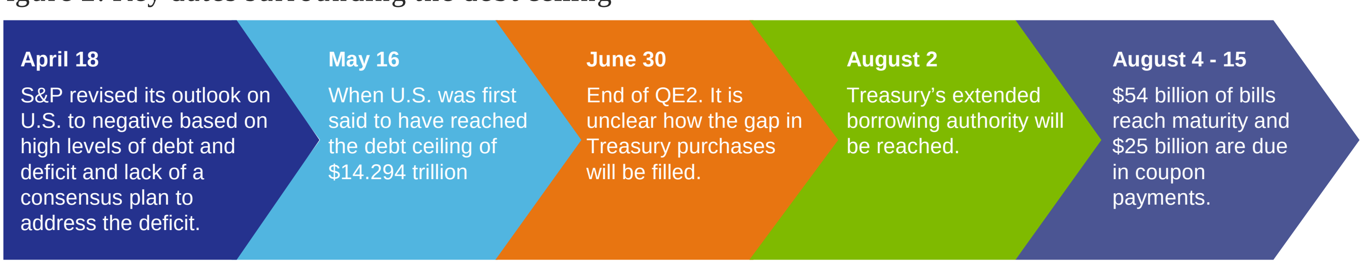
Government-sponsored debt

Ginnie Mae (GNMA) mortgages and debt are explicitly guaranteed by the federal government, and Fannie Mae (FNMA) and Freddie Mac (FNMC) were placed under conservatorship by the US Treasury in September 2008 (and therefore are implicitly guaranteed by the government). Due to these guarantees, GNMA, FNMA, and FNMC are all treated as government-quality securities. They would therefore likely be downgraded in tandem with US Treasuries.

Municipal debt: state and local governments

In the case of a US debt downgrade, there are implications for state and local governments. While Moody's announced that in the beginning they will focus on AAA-rated states and local governments for possible downgrades, lower-rated municipalities are ultimately put in a much worse position if federal payments are delayed. This effort seems to be an exercise in calibration – if the US provides at least 25% of funding to AAA-rated states, then these states should no longer be rated AAA – rather than an action that speaks to state debt default risk across the board. The agency would also focus on federal procurement contracts as a percent of GDP. For local governments, Moody's will look

Figure 2: Key dates surrounding the debt ceiling



primarily at those owning hospitals and/or nursing homes, or which are directly responsible for Medicaid. This would affect primarily AAA-rated counties and large cities rather than modest sized governments and school districts.

Another portion of the municipal bond market that would be directly affected by a US downgrade is pre-refunded (escrowed) bonds. Pre-refunded bonds are municipal bonds that have been legally defeased and are secured by the proceeds of an escrow account. The account is typically invested in a unique type of US Treasury obligation known as State and Local Government Series securities, or “SLGS”. Pre-refunded bonds are no longer obligations of the local government issuer, but are instead secured solely by the contents of the escrow account. The rating would move in lock-step with any future rating action taken on the US government.

Developing a plan in the event of a US debt rating downgrade

Given the nature of the situation, BlackRock is currently undertaking a broad review of portfolio guidelines, and recommends that investors conduct their own examination of those guidelines to determine if limitations on debt rated below AAA should be revised, whether the guidelines have an inconsistent definition between government securities and AAA-rated securities, and if strict sell-down requirements in the case of downgrades are appropriate.

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