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Not All Loans Are Equal: Some Terms and Conditions That Make Disclosure Critical In Evaluating Credit Risk

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Standard & Poor's Ratings Services has commented on the need for U.S. public finance issuers that we rate to provide greater disclosure of their use of alternative financing products such as bank loans and direct-purchase debt. We have focused on our need to be made aware of these transactions so that we can analyze the potential credit risks inherent in them. In this article we highlight some of the actual terms and conditions that may be included in these transactions that, in our view, make disclosure to us essential for our evaluation of an obligor's credit rating.

With greater use of these products and a more diverse group of lenders, we find the terms and conditions less standardized and uniform, creating, in our view, potential for considerable credit risk exposure. In our opinion, this additional risk stems from potential acceleration of principal and interest payments, and the potential for cross–default provisions between alternative financing debt and capital market debt. The documentation under which the lender agrees to purchase the alternative financing often contains events of default or covenants with remedies that, in our view, increase the potential for triggering accelerated repayment of principal and interest. Combined with cross-default provisions, breached covenants and default events could accelerate not only payments under the alternative financing, but also capital market debt, which could create a liquidity crisis for the obligor and potentially have multi-notch negative rating implications.

Therefore, we regard as critical the incorporation of alternative financings into the analysis of an obligor's debt profile. Standard & Poor's typically reviews the events of default set forth in an obligor's debt issuance documents to determine if the remedies can pose stress to an obligor as outlined in our contingent liquidity criteria. If so, we then review the events for consistency with our criteria for analyzing automatic termination events for standby bond purchase agreements (those that permit termination without notice or funding). These typically include what we consider "major" events, e.g., the obligor fails to pay principal of or interest on or repudiates the debt issuance, the obligor fails to make payment on or repudiates any debt on parity with, or senior to, the debt issuance, or the issuer or obligor challenges the validity or enforceability of the debt documents. (For a complete list see USPF Criteria: "Standby Bond Purchase Agreement Automatic Termination Events".)

Our concerns with alternative financing agreements, and our focus from a credit perspective, is whether any "non-major" events, if triggered, could lead to a remedy such as rapid acceleration of debt repayment and in turn, liquidity stress for the obligor. "Non-major" events can cover the spectrum from very broad to very specific events, depending on the obligor.

Examples of "non-major" events we have seen in actual documents leading to immediate acceleration include:

- Failure to perform or observe any term, covenant, agreement, or condition contained in financing agreements related to a liability of more than $1,000,000;
- False statements. Any warranty, representation, or statement made or furnished to lender by borrower or on borrower's behalf, or made by guarantor, or any other guarantor, endorser, surety, or accommodation party under

this note or the related documents in connection with the obtaining of the loan evidenced by this note or any security document directly or indirectly securing repayment of this note is false or misleading in any material respect, either now or at the time made or furnished or becomes false or misleading at any time thereafter;

- An event occurs that could reasonably be expected to have a material adverse effect on the ability of the borrower to perform its obligations under the related documents to which it is a party ;
- Failure to maintain specific debt service coverage ratios;
- Failure to maintain specific debt to capitalization; and
- Insecurity: Lender in good faith believes itself insecure.

Other events leading to acceleration from 30 to 60 days:

- Failure to provide as soon as available, but in any event not later than 120 days after the close of each fiscal year the annual report of the borrower;
- Failure to provide the annual operating budgets for the borrower within 30 days of adoption;
- Failure to promptly give notice to the bank of the occurrence of the commencement of any litigation, proceeding, or dispute affecting the borrower which could give rise to a default;
- Failure to maintain primary banking accounts with the bank;
- Borrower is charged with any environmental violation that would likely have a material adverse effect on borrower; and
- Failure to receive unqualified audit opinion.

As these examples show, the financing documents may allow the obligor a specific cure period before an event of default leading to acceleration is triggered. The combination of the magnitude of potential accelerated debt relative to an obligor's liquidity, and the immediacy of such liquidity calls, will be key to our determining the impact on an obligor's outstanding rating.

Related Criteria And Research

- USPF Criteria: Standby Bond Purchase Agreement Automatic Termination Events, April 11, 2008
- USPF Criteria: Contingent Liquidity Risks, March 5, 2012
- Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance, Feb. 28, 2014
- Credit FAQ: How Standard & Poor's Considers U.S. Public Finance Alternative Financing In Its Rating Process, March 26, 2014