CDIAC

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

13TH Annual Pre-Conference at
The Bond Buyer's 24TH Annual
California Public Finance Conference

ALTERNATIVE FINANCING IN THE MUNICIPAL MARKET:

FINANCIAL AND POLICY CONSIDERATIONS

OCTOBER 8, 2014 SAN DIEGO, CA

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SESSION FIVE: POLICIES AND PROCEDURES – HOW TO CONNECT THE DOTS

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Private Financing Arrangements Increase Risk to Muni Sector

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Presentation to CDIAC Pre-Conference, October 8, 2014

Private Financing Arrangements – Not Just Bank Loans

TYPES OF FINANCINGS

- Private bank loans
- Operating lines of credit
- Other private placements
- Swaps and other derivative contracts
- Guarantees of other entities using any of the above structures (contingent liabilities)

THEY'RE NOT JUST PRIVATE…THEY OFTEN INTRODUCE GREATER CREDIT RISK

- Private financings generally use legal structures similar to commercial lending world; different than typical fixed-rate muni structures but often similar to Variable Rate Demand Bonds (VRDBs)
  - Issuers may be less familiar with transaction terms – requires specialized expertise
  - Lack of public disclosure becomes a bigger concern for investors
- Traditional muni financing documents don't contemplate full range of financing products now used by issuers
  - Rights of current investors may not be protected
- Growing issue as private financing arrangements spread down-market to smaller issuers

Private Financings, like VRDBs, Can Introduce Risks Not Found in Fixed Rate Fully Amortizing Debt

Potential Risk	Private Financings	VRDBs	Fixed Rate Amortizing Debt
Acceleration Risk	YES	YES	NO
Remarketing Risk	NO	YES	NO
Renewal/Refinancing Risk	YES	YES	NO
Interest Rate Risk Associated with Short-Term Market Conditions	YES	YES	NO
Interest Rate Risk Associated with Credit Quality of Support Provider	NO	YES	NO
Interest Rate Risk Associated with Credit Quality of Issuer/Obligor	YES	YES	NO

Acceleration Risk: Many-Faceted; "Cutting in Line"

- Private lenders often have acceleration provisions, and remedies upon default, that are not available to existing bondholders.

- Events of default that can lead to acceleration include:
  - Payment default on the loan or any parity obligation
  - Initiation of bankruptcy proceedings or other evidence of insolvency
  - Invalidity or repudiation of the obligation
  - Decline in rating below a threshold
  - Failure to maintain a specified amount of liquidity
  - Failure to generate a specified amount of revenues relative to debt service
  - Breach of another financial covenant
  - A material adverse change
  - Failure to provide timely financial reports or notifications to the lender

- Existing debt may lack cross-default provisions, leaving their investors "second in line."

Excerpt from Moody's report on Yeshiva U, 3/21/14

Heightened reliance on liquidity facilities increases debt structure risk

Increased use of external liquidity facilities enables Yeshiva to manage cash flow requirements, but also introduces new credit risks for the university. These risks include short-term note maturities; covenants with limited headroom; some collateral requirements; and the potential for acceleration. At the B3 rating, market access will likely require additional collateral which would place bondholders in a subordinate position to the banks. Yeshiva's ability to access external liquidity will be vital to its near-term viability, barring extraordinary gifts or asset sales.

Yeshiva's short-term facilities include covenants that, if tripped, could lead to the acceleration of both the JP Morgan line of credit and the Bank of America note given cross-default provisions. The covenants include a liquidity ratio, maintenance of at least an A3 or A- rating at either Moody's or Standard & Poor's, and timely audit reporting (defined by JP Morgan as 150 days after the end of the fiscal year). Yeshiva has fairly narrow headroom on all of these covenants. While the liquidity ratio as defined in the agreements is currently met, with coverage of 0.9 times versus required coverage of 0.5 times, we expect it will deteriorate. The near-term expiration of the Bank of America note on June 1, 2014 also exposes the university to liquidity risk if this note cannot be extended or replaced.

Effective subordination for bondholders as market participants request collateral also increases credit risk. Since Yeshiva's rated bonds are unsecured (except for a secured interest in pledged revenues equal to Maximum Annual Debt Service for the Series 2004 bonds), any new leverage that requires collateral would take priority over bondholders. Though the university has few unrestricted resources available, we believe its expansive real estate holdings in Manhattan and the Bronx would likely provide full recovery for bondholders. However, additional future leverage – especially if it has a secured pledge – could weaken unsecured bondholders' recovery rate.

Moody’s Perspective on Disclosure Issues

Types of Disclosure:

- Audited financial statements:
  - Scrutinize footnotes for disclosure of private financings
  - Generally withdraw rating if no audit within 1 year of fiscal year end
  - Still, audits lag after end of fiscal year; could be 18+ months after date of private financing
- EMMA filings: inconsistent
- New California requirement: promising if compliance is high
- Issuer Surveys used in some muni sectors
- Voluntary Disclosure: extremely helpful; common among larger issuers

Completeness of Disclosure:

- Transparency varies: “Series 2014B” may be a private bank loan
- Analysts generally ask for core financing documents

Bank Loan Agreements	Swap Documents
Lines of Credit	Inter-Creditor Agreements
Compliance Certificates & accompanying worksheets	Private Placement Agreements

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California Debt and Investment Advisory Commission

Alternative Financing

Using an Asset Liability Management Model to Establish Debt Issuance Policies

October 8, 2014

Conservative Liability Management

- **Liabilities should be sold as long-term fixed rate**
  - **- no interest rate risk**
  - **- “permanent” financing**

Conservative Asset Management

- **Assets should be invested conservatively**
  - **Short-term**
  - **High Quality**

Balance Sheet Risk

- **Assets should be invested conservatively**
  - **Short-term**
  - **High Quality**

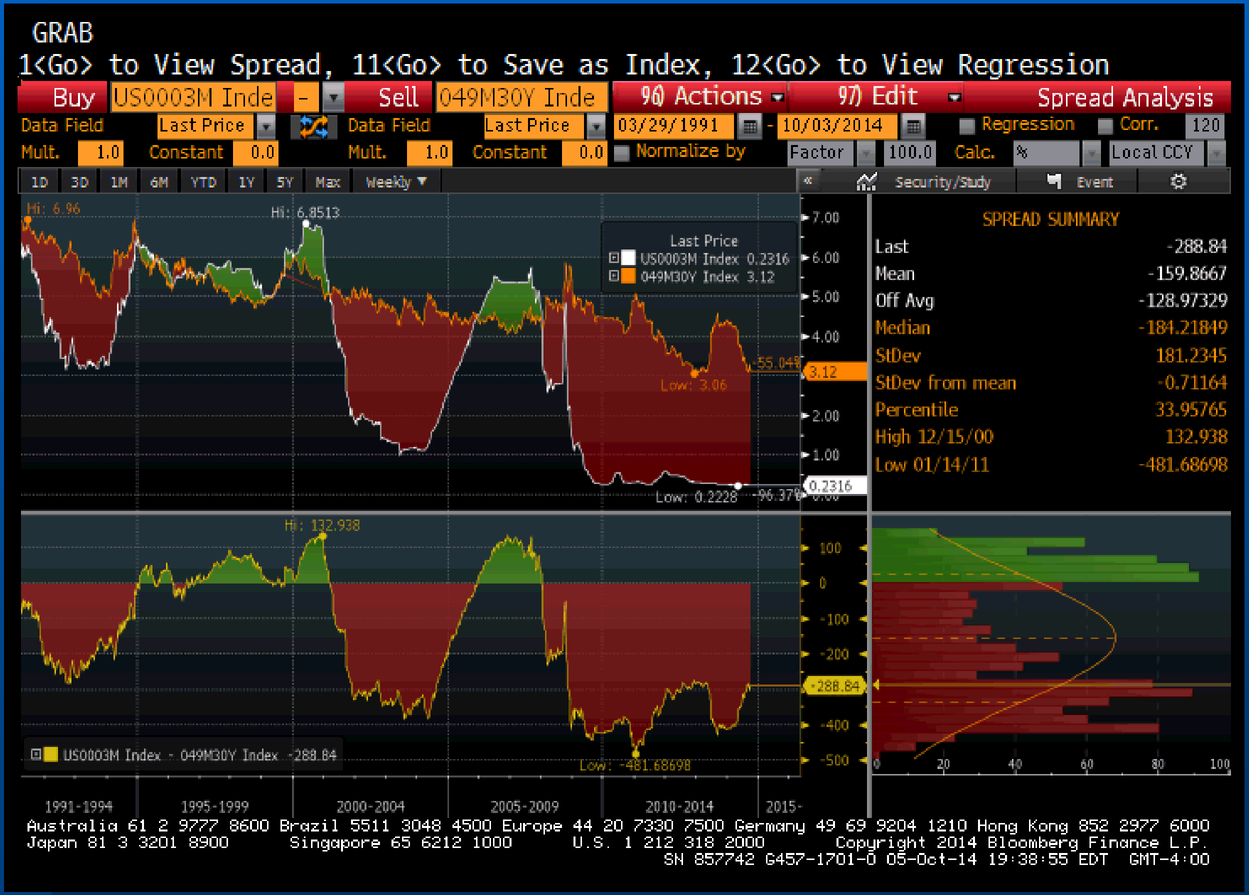
- **Liabilities are typically sold as long-term fixed rate**
  - **no interest rate risk**
  - **“permanent” financing**

This combination produces interest rate risk

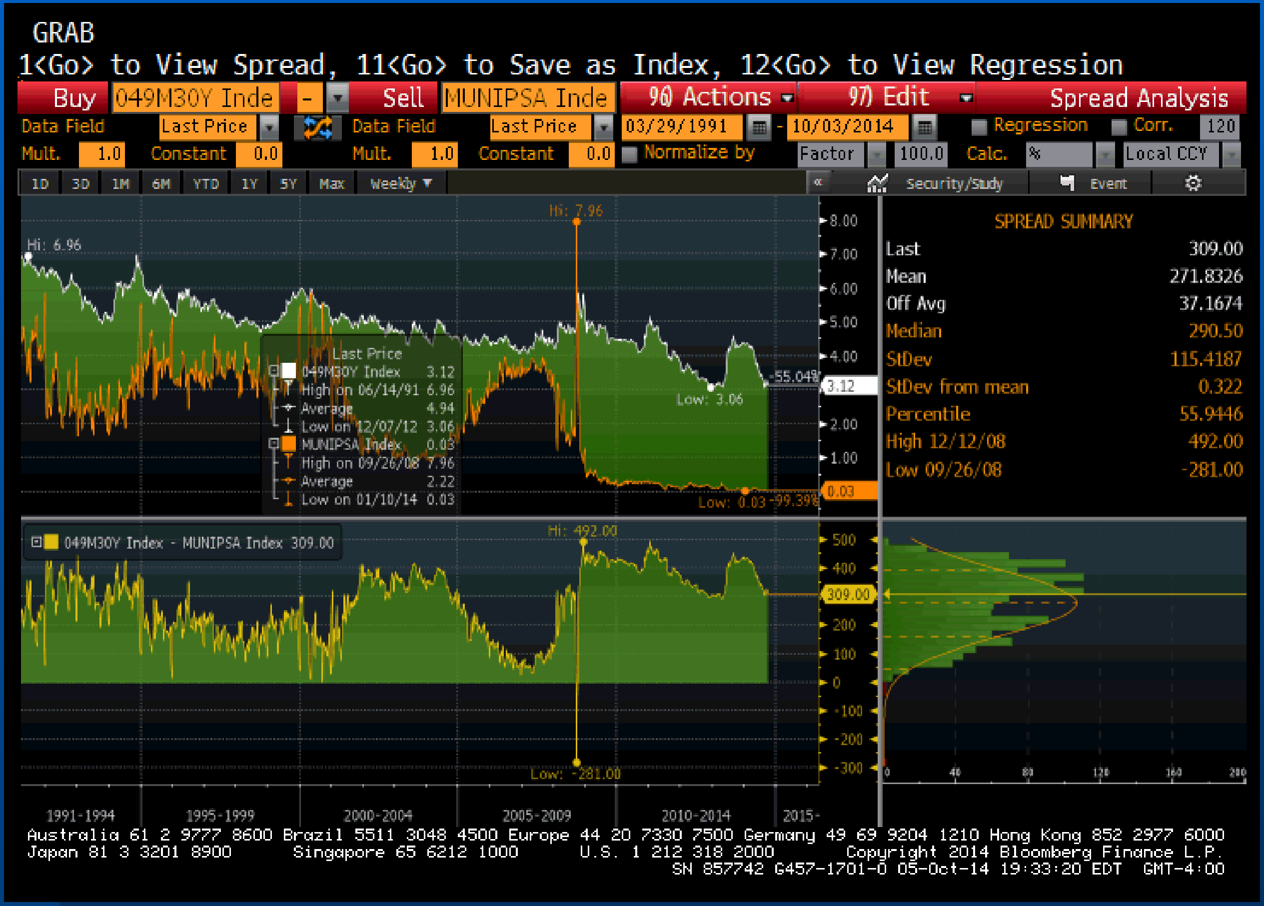
Implicit “Bets” by not using ALM

- **Short-term and long-term rates will rise**
- **Short-term rates will follow the forward curve**
- **Over the long run, short-term rates will average more than current long-term rates**

Historical Taxable Short vs. Tax-Exempt Long Interest Rates



Historical Tax-Exempt Short vs. Tax-Exempt Long Interest Rates



Asset Liability Management

- ALM is the process of managing assets, liabilities and other financial risks <u>together</u> to limit cash flow variance (i.e. risk).
  - Counterintuitive that adding variable rate debt will reduce interest rate risk

Steps to achieve ALM policy

- Ability to quantify asset/liability mismatch
- Establish ALM targets
  - Perfect offset is impractical

* Design Variable Rate Financing Strategy
  - Market Access
  - Diversification guidelines across products
  - Manage “roll” risk
  - Avoid “acceleration” risk
  - ALCO
  - Reporting

Benefits of Additional Variable Rate Debt

- Reduce interest rate risk by hedging assets with liabilities
- Diversify capital structure
- Diversify investor base
- Increase flexibility and optionality
- Reduce borrowing costs due to:
  - Historically steep tax-exempt yield curve
  - More efficient pricing at front end of the curve