Chapter 1

OVERVIEW OF A DEBT FINANCING

CREDIT RATING AGENCIES

Credit rating agencies are firms that analyze the probability of the debt instrument returning all of the principal to the investor. Municipal credit ratings are opinions of the investment quality of issuers and issues in the municipal and tax-exempt markets. The municipal bond market has slightly different rating criteria from the corporate debt market owing to the unique characteristics inherent in public debt. Municipal debt ratings are viewed in relation to the general state of the state and national economy, debt levels and mix, revenue and expense cash flows, and the issuer's management strategies.

The credit rating agencies (principally Moody's Investors Service, Inc., Standard & Poor's, and Fitch Ratings) provide, for a fee customarily paid by the issuer, an independent appraisal of the credit quality and likelihood of timely repayment of a bond issue. Normally, when the financing structure is designed and the documents are close to final form, the financial advisor or underwriter will provide all of the documents to the rating agency or agencies selected by the issuer (with advice from the financial advisor or underwriter) and will provide any other additional information (such as cash flow data or other financial calculations) requested by the rating agency. Rating agency representatives will discuss the financing directly with the issuer. Representatives of the rating agency also may visit the issuer or the project being financed. In the alternative, a financial advisor or underwriter may recommend that representatives of the issuer meet with the rating agency in their offices in San Francisco or New York.

Underwriters and investors rely upon the credit quality judgment made by the rating agencies (expressed as a credit rating). Some mutual funds, institutions, and investment trusts are restricted by law or by the terms of their organizational documents to buying securities at or above specified credit rating levels. Other investors may apply such criteria informally. Investors generally demand higher interest rates with respect to lower-rated bonds. Generally speaking, the credit rating is the most important factor in determining the interest rate on bonds relative to other issues sold at the same time. Tables 1-1 and 1-2 below describe the various credit ratings for Moody's, Standard & Poor's, and Fitch.

Bonds are generally not legally required to be rated. However, in most cases issuers find it to their advantage to obtain bond ratings because of the difficulty of selling unrated bonds. One important exception is land-secured financings, such as assessment or Mello-Roos Bonds, for districts where development has not been substantially completed at the time of the issuance of the bonds, which are commonly issued as unrated bonds. Some conduit issuers require a minimum rating in order to issue bonds as a matter of policy. For example, California's Educational Facilities Authority and Health Facilities Financing Authority require a minimum "A" rating—either through credit enhancement or on a "stand-alone" basis, although on a case-by-case basis they will permit a "BBB" or "Baa" rating if additional collateral (such as a deed of trust) is posted.

Each major rating agency maintains separate rating scales for long-term debt (generally debt with a maturity of greater than one year) and short-term debt (generally debt with a maturity of less than one year). It is possible for an issuer's short-term rating to be of a different category than its long-term rating.

Ratings are reviewed periodically by the rating agencies whether or not requested by the issuer. A review may result in the up- or downgrading of an existing rating. To perform their reviews, rating agencies expect periodic financial and other reports relating to the status of a bond issue. In the absence of such reports, they may suspend the rating of an issue.

Finally, although ratings are generally assigned only in response to a request from the issuer, the rating agencies reserve the right to assign a rating without such a request. The following tables are condensed from the rating descriptions published by each rating agency. More detailed descriptions of the ratings categories for each major rating agency are available on the rating agencies' websites. (See **Appendix B – Resources and Contacts**.)

Table 1-1
Short-Term Tax-Exempt Debt Credit Rating Definitions

<table>
<tr><th>Rating</th><th>Moody's</th><th>Rating</th><th>S&P</th><th>Rating</th><th>Fitch Ratings</th></tr>
<tr><td rowspan="2">MIG-1/
VMIG-1</td><td rowspan="2">MIG-1 - Superior credit quality. Excellent protection afforded by established cash flows, highly reliable liquidity support, or demonstrated broad-based access to the market for refinancing.

VMIG-1 – Superior credit quality. Excellent protection afforded by the superior short-term credit strength of the liquidity provider and structural and legal protections that assure the timely payment of purchase price on demand.</td><td>SP-1</td><td>Strong capacity to pay principal and interest. An issue determined to possess a very strong capacity to pay debt service is given a plus (+) designation.</td><td rowspan="2">F1</td><td rowspan="2">Highest credit quality. Indicates the strongest capacity for timely payment of financial commitments.</td></tr>
<tr><td>A-1</td><td>Degree of safety regarding timely payment is strong. Those issues determined to possess extremely strong safety characteristics are denoted by a plus (+) sign.</td></tr>
<tr><td rowspan="2">MIG-2/
VMIG-2</td><td rowspan="2">MIG-2 -Strong credit quality. Margins of protection are ample although not as large as in the preceding group.

VMIG-2 – Strong credit quality. Good protection afforded by the strong short-term credit strength of the liquidity provider and structural and legal protections that ensure the timely payment of purchase price on demand.</td><td>SP-2</td><td>Satisfactory capacity to pay principal and interest, with some vulnerability to adverse financial and economic changes over the term of the notes.</td><td rowspan="2">F2</td><td rowspan="2">Good credit quality. A satisfactory capacity for timely payment of financial commitments, but the margin of safety is not as great as in the case of the higher ratings.</td></tr>
<tr><td>A-2</td><td>Capacity for timely payment on issues with this designation is satisfactory. However, the relative degree of safety is not as high as for issues designated 'A-1.'</td></tr>
<tr><td rowspan="2">MIG-3/
VMIG-3</td><td rowspan="2">MIG-3 - Acceptable credit quality. Liquidity and cash flow protection may be narrow, and market access for refinancing is likely to be less well-established.

VMIG-3 – Acceptable credit quality. Adequate protection is afforded by the satisfactory short-term credit strength of the liquidity provider and structural and legal protections that ensure the timely payment of purchase price on demand.</td><td>SP-3</td><td>Speculative capacity to pay principal and interest.</td><td rowspan="2">F3</td><td rowspan="2">Fair credit quality. The capacity for timely payment of financial commitments is adequate; however, near-term adverse changes could result in a reduction to noninvestment grade.</td></tr>
<tr><td>A-3</td><td>Issues carrying this designation have an adequate capacity for timely payment. However, they are more vulnerable to the adverse effects of changes in circumstances than obligations carrying the higher designations.</td></tr>
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(Table 1-1 continued on next page)

Table 1-1
Short-Term Tax-Exempt Debt Credit Rating Definitions (continued)

Speculative Grade (SG)	**MIG–SG** Speculative grade credit quality. May lack sufficient margins of protection. **VMIG–SG** Speculative grade credit quality. Demand features rated in this category may be supported by a liquidity provider that does not have an investment grade short-term rating or may lack the structural and/or legal protections necessary to ensure the timely payment of purchase price upon demand.	B	Only speculative capacity for timely payment.	B	Speculative. Minimal capacity for timely payment of financial commitments, plus vulnerability to near-term adverse changes in financial and economic conditions.
		C	Doubtful capacity for payment.	C	High default risk. Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon a sustained, favorable business and economic environment.
		D	Default.	D	Default. Denotes actual or imminent payment default.

Table 1-2
Long-Term Tax-Exempt Debt Credit Rating Definitions[1]

Rating	Moody's	Rating	S&P	Rating	Fitch Ratings
Aaa	Demonstrates the strongest creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	AAA	Highest rating. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.	AAA	Highest credit quality. Assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
Aa	Demonstrates very strong creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	AA	Differs from the highest rated obligation only in small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.	AA	Very high credit quality. Very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A	Present above-average creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	A	Somewhat more susceptible to the adverse effects of change in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.	A	High credit quality. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
Baa	Demonstrates average creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	BBB	Adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.	BBB	Good credit quality. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category.

(Table 1-2 continued on next page)

[1] Moody's appends the numerical modifiers 1,2, and 3 to each generic rating category from Aa through Caa. Modifier 1 indicates that the issuer or obligation ranks in the higher end of its generic rating category; modifier 2 indicates a mid-range ranking; and modifier 3 indicates a ranking in the lower end of that generic rating category. Standard & Poor's and Fitch use a +/- or no modifier much in the same way.

Table 1-2
Long-Term Tax-Exempt Debt Credit Rating Definitions (continued)

Rating	Moody's	Rating	S&P	Rating	Fitch Ratings
B	Demonstrates weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	B	More vulnerable to nonpayment than obligations rated 'BB,' but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.	B	Highly speculative. Indicates significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
Caa	Demonstrates very weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	CCC	Currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.	CCC	High default risk. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments.
Ca	Demonstrates extremely weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	CC	Currently highly vulnerable to nonpayment.	CC	Default is probable.
C	Demonstrates the weakest creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues.	C	Subordinated debt that is highly vulnerable to nonpayment. Bankruptcy petition may have been filed, but payments are being continued.	C	Imminent default.
		D	Default.	DDD DD D	Default. The ratings of obligations in this category are based on their prospects for achieving partial or full recovery in a reorganization or liquidation of the obligor.