STANDARD & POOR'S
RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance

Primary Credit Analyst:
David N Bodek, New York (1) 212-438-7969; david.bodek@standardandpoors.com

Secondary Credit Analysts:
Geoffrey E Buswick, Boston (1) 617-530-8311; geoffrey.buswick@standardandpoors.com
Jeffrey J Previdi, New York (1) 212-438-1796; jeff.previdi@standardandpoors.com
Robin L Prunty, New York (1) 212-438-2081; robin.prunty@standardandpoors.com
Valerie D White, New York (1) 212-438-2078; valerie.white@standardandpoors.com
Horacio G Aldrete-Sanchez, Dallas (1) 214-871-1426; horacio.aldrete@standardandpoors.com

Secondary Contact:
Steven J Murphy, New York (1) 212-438-2066; steve.murphy@standardandpoors.com

Table Of Contents

Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance

Standard & Poor's Ratings Services continues to see U.S. public finance issuers using alternative financing products such as bank loans and direct-purchase debt. We have commented about the use of these products and the potential credit risks inherent in them (see "The Appeal of Alternative Financing Is Not Without Risk For Municipal Issuers," published May 17, 2011 on RatingsDirect, and "Contingent Liquidity Risks In U.S. Public Finance Instruments: Methodology And Assumptions," published March 5, 2012). We recognize there are benefits to some of the alternative financing products, such as direct-purchase bonds, that are being offered to municipal obligors. However, we believe it is important to highlight the risks of these new products, and reiterate the need for transparency when issuers incorporate these types of financing vehicles into their debt profile.

Overview

- Standard & Poor's analyzes an obligor's comprehensive debt position, so exposure to alternative financing instruments should be disclosed to us, even if there is no legal requirement to do so.
- Covenants which could lead to acceleration, create demands on liquidity, or cross-default other debt, could have credit implications.
- The optimal time for disclosure is while alternative financing agreements are being planned and finalized, so that credit impacts can be assessed.
- Failure to disclose, or delayed disclosure, could color our assessment of management and have negative rating implications.

It is our understanding that use of direct-purchase bonds was initially generally limited to replacements of expiring letters of credit (LOCs) and standby bond purchase agreements (SBPAs) in support of variable-rate demand obligations (VRDO), typically placed with large national banks. Currently though, we are seeing variable- and fixed-rate direct-purchase bonds being used not just for variable rate structures but for new money needs as well as the refunding of existing fixed-rate debt. Additionally, banks of all sizes are offering the product. These obligations could contain terms that may be similar to VRDOs, however we consider the credit impact of an obligor's portfolio holistically and analyze all risks introduced regardless of the financing vehicle. With greater use of these direct-purchase obligations and a more diverse group of banks entering into these types of financings, the terms and covenants within the agreements are less clearly defined and less uniform, creating, in our view, the potential for considerable credit risk exposure. Standard & Poor's ratings are assigned and surveilled based on information provided to us by issuers, and so disclosure to Standard & Poor's (and more broadly the lack of transparency in the capital marketplace) of the existence of these types of vehicles is critical. Of particular concern to us is the frequent absence of disclosure to us of these agreements' existence and their terms, notwithstanding whether privately placed debt carries legal disclosure obligations. Standard & Poor's believes that the optimal time for disclosure is while alternative financing agreements are being planned and finalized, so that credit impacts can be assessed.

Standard & Poor's has reviewed or rated 173 direct-loan deals totaling about $10.4 billion from 2011 through February of this year. Overall, we estimate that direct loans might account for as much as 20 percent of municipal issuance. Private placements or direct-purchase obligations can have substantial implications for the credit quality of an obligor's capital market debt, irrespective of how large or small the alternative financings might be relative to the balance sheet. Implications can include, but are not limited to, acceleration and the potential for cross–default provisions between privately placed debt and capital market debt. Some documents contain events of default provisions or covenants that, in our view, favor the lender over existing capital market bondholders, and increase the potential for triggering the financing's remedies. Combined with cross-default provisions, breached covenants and default events could accelerate not only the privately placed obligations, but also capital market debt, which could create a liquidity crisis for the issuer and potentially have multi-notch negative rating implications. Also, acceleration provisions that favor private lenders essentially subordinate the claims of an issuer's capital market lenders relative to those of the private placement lender. Finally, even when the events of default contained in these documents might not have acceleration as a remedy, they could cause acceleration of other parity debt through either cross-default provisions or most favored nations clauses. The presence of such provisions could have negative implications for our ratings on an issuer's capital market debt. Moreover, the presence of what are known as "most favored nation" clauses that incorporate by reference the terms of future agreements that the obligor may enter into can be particularly deleterious to credit quality because the events of default may change in unknown ways.

We request comprehensive disclosure to Standard & Poor's to facilitate review of these products' latent demands on the obligor's liquidity in order to assess the potential impact on both the issuer's direct placement financings and its capital market debt. If in our view the likely demand on liquidity is high and available liquidity is inadequate to cover repayment risk, in general, we could consider a negative rating action or outlook change. We assess the relationship of the current rating to rating triggers in the covenants, cure periods, and the financing's other specified terms that define default events. Standard & Poor's does not believe that the potential absence of legal or regulatory disclosure requirements, or the fact that ratings are not being sought, eliminates the need for market transparency. So that ratings reflect, among other factors, the range of exposures that issuers' liquidity faces, we request disclosure of the existence and terms of all instruments that could have a bearing on the issuer's financial risk profile. And beyond liquidity considerations, disclosure to us of any debt obligations is important to assess an obligor's overall liability and liquidity profile. Use of additional debt instruments has the potential to alter our view of an obligor's debt burden. The extent to which management demonstrates an understanding of the risks that direct-purchase bonds and loans could present, and has plans or policies to mitigate them, plays an important role in our assessments of the credit quality implications of these types of financings.

Two Types Of Repayment Risk

In general, we believe that there are two primary types of repayment risk tied to VRDOs, alternative financing products, and other debt instruments. The first is risk that is predictable or likely to occur. We consider these risks predictable as the potential timeline for these events occurring is known. Therefore, management usually has adequate time to address payment obligations associated with such risks. These circumstances could include:

- Known expiration dates and the resulting expected termination of bank facilities;
- Maturing commercial paper;

- Outstanding bank lines or bank bonds that need to be repaid according to term-out provisions;
- Debt that is to be redeemed;
- Guarantees that have already been triggered; and
- Upcoming mandatory tenders with known tender dates.

The second is event-driven risk. This type of risk presents an analytical challenge because the circumstances that could require repayment or additional liquidity are uncertain. Payment obligations associated with event-driven risk that could require liquidity typically include VRDOs supported by LOCs and SBPAs, interest-rate swaps, bank debt that might come due as a result of covenant violations or events of default, third-party guarantees, and new market-based variable-rate products. Event-driven risks could also include:

- Unexpected acceleration;
- Failed remarketings causing obligor payments;
- Interest-rate swap and other instruments' collateral posting requirements;
- Swap termination payments; and
- Cross-default provisions under financing agreements.

Ratings Incorporate Event-Driven Risk

We believe that, in general, the lower an obligor's credit rating the more likely it is that event-driven risk could occur. We also believe that the shorter the period identified to respond to the latent liquidity demands financing documents provide, the more likely it is that an obligor could have difficulty if triggering events occur. The longer the period for curing a default, the greater the opportunity for accessing capital markets, accessing less-liquid assets on the balance sheet, or making other financing arrangements to meet extraordinary liquidity demands. In the criteria article, "Contingent Liquidity Risks In U.S. Public Finance Instruments: Methodology and Assumptions," we discuss the benefits of a longer cure period: "A longer time period between the triggering event and the date when the obligor must pay the resulting claim provides some protection against potential market disruptions. Because suddenness is frequently an attribute of contingent claims and because capital market access requires some planning and coordination, the criteria usually assume no ability to fund claims through capital market access within 180 days."

Some factors could necessitate extending the 180-day threshold, including:

- A rapid deterioration of the credit in question,
- An already noninvestment-grade rating,
- Additional potentially difficult actions required before an issuance could occur, such as passage of a difficult budget; rate or fee adjustments; or completion of adequate disclosure where audit completion is significantly delayed, or
- Widespread market disruptions or closures that are expected to continue.

Conversely, the criteria allow for the assumption that some obligors may be able to gain market access in less than 180 days. Assuming that none of the conditions in the previous paragraph exist, obligor characteristics that may lead to this assumption are:

- Characteristics consistent with a market risk profile score of 'low' as calculated in "Bond Anticipation Note Rating Methodology", published Aug. 31, 2011 (the BAN criteria) or,

- A long-term credit rating in one of the highest two categories, no recent history of late budget adoption, and characteristics consistent with at least a neutral market risk profile score as defined in the BAN criteria.

Disclosure of privately placed debt is critical to the ratings process because where event-driven risk exists, we evaluate the likelihood of the issuer triggering acceleration, termination payment, or collateral posting requirements. We further assess management's capacity to respond to these types of liquidity demands, whether through available balance sheet liquidity, capital market access, or lines of credit. If in our view the available liquidity is inadequate to cover repayment risk, in general, we could consider a negative rating action or outlook change.

For obligors with a high degree of event-driven risk, our view as to the magnitude of these risks being realized over the near term will also likely inform our view of the obligor's overall liquidity position and whether we include these risks in our traditional analysis of liquidity. It should be noted that, based on our observations, local governments (cities, counties, and school districts) frequently have lower levels of operating liquidity and more-seasonal cash flow patterns than other public finance and tax-exempt obligors.

Information Needs

Whether or not banks or municipal entities are required to disclose direct financing agreements' covenants, we nevertheless believe it is critical, as part of our routine surveillance of obligors, to explore whether issuers have entered into any such agreements and to have management:

- Quantify the amount of predictable and event-driven liabilities outstanding;
- Articulate the circumstances under which they might be exposed to extraordinary calls on liquidity;
- Be able to identify assets or strategies to respond to extraordinary calls on liquidity; and
- Disclose all relevant financing documents.

We expect obligors to provide information on covenant thresholds, potential acceleration periods, and expiration dates of various liquidity facilities and/or bank loans and letters of credit. We also expect obligors to provide summary information on compliance with various covenants. If particular liabilities require potentially rapid repayment, we would expect obligors to demonstrate the steps they would take to meet repayment terms. Also, we will expect obligors to notify us of plans for using alternative financing products before entering into such agreements. Whereas the "Contingent Liquidity Risks In U.S. Public Finance Instruments: Methodology and Assumptions" extends the principles cited in this article to all U.S. public finance debt, sector specific criteria pieces discuss specific exposure risks in debt and liquidity sections or in discussions of financial policies.

Standard & Poor's also believes that the optimal time for disclosure to rating agencies and capital markets is while alternative financing agreements are being planned and finalized. Specifically, in regard to entities rated by Standard & Poor's, we request that all documents associated with the transaction be shared, regardless of whether the financing is being rated by Standard & Poor's. We believe that delayed disclosure of any financing does not serve the market well, particularly where the financing's covenants could pressure liquidity, potentially leading to negative rating implications. Failure to disclose, or delayed disclosure, could color our assessment of management and have negative rating implications or lead to rating withdrawals due to what we regard as insufficient information having been disclosed to us.

To facilitate the flow of information concerning these transactions, please send any alternative financing documents to USPF_Review@standardandpoors.com.

Related Criteria And Research

- The Appeal Of Alternative Financing Is Not Without Risk For Municipal Issuers, May 17, 2011
- Credit FAQ: Procedures For Suspending Ratings In U.S. Public Finance Due To Insufficient Information, Aug. 25, 2011.
- Bond Anticipation Note Rating Methodology, Aug. 31, 2011
- Contingent Liquidity Risks In U.S. Public Finance Instruments: Methodology And Assumptions, March 5, 2012
- Credit FAQ: Bank Loans And Bond Ratings: What To Disclose?, June 17, 2013
- U.S. Local Governments General Obligation Ratings: Methodology And Assumptions, Sept. 12, 2013
- Request For Comment: U.S. Not-For-Profit Acute-Care Stand-Alone Hospitals -- Methodology And Assumptions, Dec. 5, 2013
- Mass Transit Enterprise Ratings: Methodology And Assumptions, Dec. 18, 2013