

California Debt and Investment Advisory Commission

Municipal Market Disclosure: Applications to Pension Disclosure

A Financial Advisor's Perspective on Disclosure

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My Personal Path to Understanding Disclosure

- An inexperienced issuer with the City of Los Angeles
- An experienced issuer with the City of Los Angeles
- A rating analyst during the Orange County bankruptcy
- A rating analyst after the passage of Proposition 218
- A financial advisor observing the City of San Diego
- A financial advisor “going home again” to work on the City of Los Angeles’s disclosure

Minimal Definitive Guidance is Available

- Municipal bonds have historically been a minimally regulated industry, the downside of which is that there are minimal written regulations
- The old “Bible”, GFOA’s *Disclosure Guidelines for State and Local Government Securities*, last published in 1991
 - Out of print, and does not reflect the last 20 years of experience
 - GFOA has published “Making Good Disclosure,” helpful, but far from definitive
 - Is GFOA really the right authority?
- National Federation of Municipal Analysts (NFMA.org) has published a series of “Recommended Best Practices in Disclosure,” which provide good guidance, but are not heavily relied on by drafters of disclosure documents
- NABL white paper on pension disclosure
- Best guidance comes from reading SEC actions and drawing conclusions

Good Disclosure is an Art, Not a Science

- There is not a “one-size-fits-all” standard
 - Depends on the transaction, its complexities and risks
 - Depends on the personalities in the room
- Disclosure has become the job of lawyers, who don’t necessarily have particular insight into what is material in the eyes of potential and actual investors
 - Does disclosure counsel listen to the rating presentation?
 - Do they listen to investor briefings?
- Good judgment is more important than learning a fixed set of rules
- Written disclosures for policies and procedures are helpful, but there is no substitute for the right culture

The Disclosure Dashboard: Some “Idiot Lights”

- Cognitive dissonance
 - Pay attention to things that you don’t personally understand (this is equally true for issuers and outside professionals)
 - Don’t simply assume that investors know more than you do, especially in the discussion of legal and governmental factors
- Inaccuracies
 - Pay attention to language that seems to not quite get it right
 - The act of “due diligence” includes fact checking
- Things that might make you look bad
 - If you think that information might negatively effect an investor’s decision to invest or result in a lower bond rating, and
 - You think that would be a reasonable reaction, then
 - That is precisely the kind of information that is probably “material,” and should be included in the disclosure document

More “Idiot Lights”

- Things that you don’t think are relevant
 - Irrelevant disclosure is in itself misleading in that it distracts the reader, and should be deleted
- Boilerplate
 - Always suspect to me, because often not carefully read by preparers or reviewers of the document
 - A real life example: two full pages on how one calculates the Gann limit, but no information on the specific issuer’s limit and its appropriations subject to the limit
 - A disclosure document is like my garage: things keep getting added, and every once in a while you have to clean it out
- Consistency
 - Does the Official Statement (OS) agree with the CAFR?
 - Are there other official documents with conflicting information or messages floating around?

Listening to Investor Feedback

- Since most issuers don't actually talk with investors, the rating agencies and bond insurance companies are often your best proxy
- Consider incorporating in your disclosure document information that you have provided to the rating agencies and insurance companies that is not in your OS
 - Projections
 - Details on assumptions (often best handled as footnotes to tables)
 - Financial information that is more current than your last audit
 - Preliminary debt service numbers
 - The answers to (relevant) rating agency questions
 - Facts or observations included in a rating agency credit report that weren't included in your OS

Thoughts on Audits

- *In theory*, the CAFR is itself a principal disclosure document
- What is the relationship between the CAFR and the Official Statement?
 - Is the role of the OS to summarize or repeat CAFR disclosure?
 - Does the CAFR undergo the same level of due diligence as the OS (and visa versa)?
 - Do the debt people understand the CAFR (se habla GAAP?)
 - Do the people who prepare the CAFR (staff and outside auditors) participate in the preparation of the OS?
 - What about the actuaries and staff who prepare the pension disclosure?
- Should the auditor's consent be reinstituted to help protect the issuer?

More Thoughts on Audits

- Audits are never fully satisfying to the experienced analyst
- Good disclosure supplements the audit. Some examples:
 - Analysts want more information on the types of “tax” revenues (audits often consolidate property tax, sales tax and other taxes into a single “taxes” line item)
 - Detailed information on transfers in and out
 - Translating between budget (the language of managers) and GAAP (the language of analysts), especially when discussing budget “reserves” and fund balance
 - What items are in the various fund balance categories?
- Sobering fact: the risks relating to pre-bankruptcy Orange County were in the fiduciary funds section of the audit (and who reads *that?*)

Other Thoughts

- The issuer's lead staff person should not shoulder full responsibility for the accuracy of the official statement
 - Create a process where multiple eyes share responsibility for the accuracy of what is written
 - Circulate sections to appropriate peers for review and comment (e.g., the budget officer, the pension manager, etc.)
 - I'm a big fan of "real" diligence meetings
- Despite the crises of Orange County, San Diego and New Jersey, there is still great resistance to "hard thinking"
 - Is your finance team leading you forward, or serving as an "enabler" of bad habits?

Final Observations

- Remember that the biggest risks are to the public agency, and the staff that works there
- Think of the OS less of a sales document and more as your defense if you are ever sued or investigated
 - In a securities action, the OS is Exhibit 1. Think about what you wish it would have said
 - There is little downside to good disclosure; there is a lot of downside risk to bad disclosure
- Strive for a culture that identifies what is missing and needs to be added
- Like all processes of self-knowledge, it is never done
 - I have never seen a perfect OS. There is always room for improvement

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OVERVIEW: SEC REGULATIONS AND THE DISCLOSURE PROCESS

Relevant Laws and Regulations

Best Practices

Views of the SEC

**Lessons from Orange County and
San Diego**

Outline

Key Laws

Preliminary Official Statement/Official Statement

Suggested Disclosure Processes and Policies

Posting of Preliminary and Final Official Statements and Other Information

Continuing Disclosure: Rule 15c-12

SEC White Paper and Recent Speeches

Lessons from Orange County and San Diego

Personal Liability of Staff and Legislators

Key Laws — *Securities Act of 1933*

Generally requires registration of securities with SEC

Exempts most municipal securities from registration

Prohibits fraud in offer or sale of securities (Section 17(a))

- ▣ Municipal securities are not exempt from Section 17(a)

Key Laws — *Securities Exchange Act of 1934*

Anti-Fraud provisions

- Section 10(b): prohibits fraud in purchase or sale of securities
- Rule 10b-5: communications to “marketplace” cannot contain untrue statement of material fact or omission of material fact “necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading”
- “Material”: a fact is material if there is a substantial likelihood that, under all the circumstances, the fact would have actual significance in the deliberations of the reasonable investor

Key Laws — *Securities Exchange Act of 1934*

Rule 15c2-12: directly regulates underwriters (and indirectly governmental issuers)

- ▣ Regulates

- Initial disclosure
- Continuing disclosure (see Appendix A)

Key Laws — *Securities Exchange Act of 1934*

Rule 15c2-12: New Issue Disclosure

■ Preliminary Official Statement (POS)

- Must contain
 - Information concerning the terms of the securities
 - Financial information or operating data material to an evaluation of the securities
- Must be reviewed by underwriter before it bids for, offers/purchases/sells bonds
- Must be “deemed final” by the issuer

■ Official Statement (OS)

- Same as the POS except it includes pricing-related information
- Delivered to underwriter within 7 business days after pricing and in time to accompany buyer confirmations

Preliminary Official Statement/Official Statement

■ Preliminary Official Statement (POS)

- Used to market the securities by the underwriter and, in the case of a competitive sale, is used by bidders to determine its bid for the securities
- Prepared by financing team and approved by governing board of issuer
- As it is the issuer's document, it is ultimately the issuer's responsibility to assure the accuracy and the completeness of the POS

Preliminary Official Statement/Official Statement

■ Official Statement (OS)

- Completed upon the sale of bonds
- In most cases, only changes to POS is to include final pricing information
- Occasionally, between the printing/posting of POS and preparation of final OS, an event occurs that requires updating the final OS (e.g., updated State budget information or the release of an issuer's CAFR)

Suggested Disclosure Processes and Policies

Establish Internal Controls and Systems

- ▣ Identify “disclosure documents”: information that is reasonably expected to reach investors/trading markets
 - Initial disclosure
 - Continuing disclosure
 - Other information (such as press releases and web site postings)
- ▣ Identify who is responsible for what
- ▣ Establish checks and balances

Suggested Disclosure Processes and Policies

Establish Internal Controls and Systems (continued)

- Define process for drafting and reviewing disclosure
- Require brainstorming sessions to discuss “big picture”
 - Financial problems and other issues
 - Scrutinize disclosure documents: could average investor read the disclosure documents and understand the issue?
- Give legislative body time to review the POS
- Transmit the POS to the legislative body with a cover letter highlighting security for bonds, repayment risks

Suggested Disclosure Processes and Policies

Hire competent auditors and other professionals

Disclose bad news

Provide practical training to officials and employees (from council/board members to staff members)

- Disclosure requirements of federal securities laws
- GASB financial reporting provisions
- Each person's role in disclosure/financial reporting process

Posting of Preliminary and Final Official Statements and Other Information

Now customary to post Preliminary Official Statements and print few, if any, copies

When first proposed, concerns over staleness of information if POS not promptly removed following sale

Final Official Statements now commonly posted on issuers' websites

Posting of Preliminary and Final Official Statements and Other Information

Concerns regarding staleness of final Official Statements and other information

- Disclaimers regarding final Official Statements being accurate and complete only as of their date
- Need to monitor other information on issuer website that is “reasonably expected to reach investors and trading markets”

Key Laws — *Securities Exchange Act of 1934*

Rule 15c2-12: Continuing Disclosure

- ▣ Applies only to issues of \$1 million+
- ▣ Underwriter may not purchase/sell primary offering of securities unless issuer or an “obligated person” undertakes to provide continuing disclosure
- ▣ “Obligated person”: person, including issuer, generally or through an enterprise, fund or account committed by contract or other arrangement to support payment of all or a part of the obligations on the municipal securities

- ▣ Two types of reporting

- Annual report**

- Financial information or operating data of the type included in the OS
 - Audited financial statements, when and if available

- Listed event disclosure**

- Failure to file annual report
 - 14 material events

Key Laws — *Securities Exchange Act of 1934*

Rule 15c2-12: Continuing Disclosure

▣ 14 Material Events

- Principal and interest payment delinquencies
- Non-payment related defaults, if material
- Unscheduled draws on debt service reserves reflecting financial difficulties
- Unscheduled draws on credit enhancements reflecting financial difficulties
- Substitution of credit or liquidity providers, or their failure to perform
- Adverse tax opinions or events affecting the tax-exemption
- Modifications to rights of security holders, if material
- Bond calls, if material, and tender offers
- Defeasances
- Release, substitution, or sale of property securing repayment of the securities, if material
- Rating changes
- Bankruptcy or insolvency of Issuer
- Merger or consolidation, if material
- Appointments of successor or additional trustee, if material

Key Laws — *Securities Exchange Act of 1934*

Rule 15c2-12 primary exemptions:
securities with \$100,000+ denominations
and-

- ▣ Private placement: securities are sold to no more than 35 sophisticated investors who buy for investment and not distribution
- ▣ Short-term bonds:
 - Bonds maturing in 9 months or less: exempt from all requirements
 - Bonds maturing in 18 months or less (e.g., TRANS): subject only to material event disclosure

Key Laws — *Securities Exchange Act of 1934*

Recent Rule 15c2-12 Amendments

- Effective July 1, 2009, all continuing disclosure filings must be filed with MSRB through its Electronic Municipal Market Access (“EMMA”) system.
- Amendments effective for deals closing after December 1, 2010:
 - **Removed the exemption from primary offering disclosure for variable rate tender bonds**
 - Removed the materiality determination from most listed event disclosure
 - Added new events to the listed event disclosure
 - Listed event notices now must be filed within 10 business days after the event occurs

Key Laws — *Securities Exchange Act of 1934*

Rule 15c2-12 - Enforcement

- ▣ Imposes liability for secondary market statements
 - Continuing disclosure reports
 - Statements “reasonably expected to reach investors and trading markets”
 - Press releases
 - Web site postings

SEC White Paper

Asks whether nature of municipal marketplace still justifies less regulation than corporate market

- ▣ Highlights size/nature of municipal market
- ▣ 50,000+ municipal issuers nationwide
- ▣ \$2.4 trillion of securities outstanding (2 million bond issues)
 - Individuals own 36% directly
 - Individuals own 33% indirectly, e.g., mutual funds
 - Median trade: \$25,000
- ▣ \$430 billion issued in 2006

SEC White Paper

Concerns

- ▣ Municipal disclosure less comprehensive than corporate disclosure
- ▣ Issuers lack policies or procedures adequate to ensure accurate/full disclosure
- ▣ Legislative body often approves disclosure with little or no review
- ▣ Issuer not required to certify the accuracy of disclosure
 - Contrast CEO/CFO certifications of quarterly/annual reports under Sarbanes-Oxley (which imposes civil and criminal penalties)
- ▣ Professionals are often hired on a transaction-by-transaction basis and lack factual knowledge derived from ongoing relationship with issuer

SEC White Paper

Concerns (continued)

- Lack of Generally Accepted Accounting Standards
 - GASB funded with voluntary payments
 - GASB compliance is voluntary
- Some issuers include audited financial statements in disclosure documents without consent of auditor (or without disclosing that consent has not been obtained)*
- Underwriters disclaim responsibility for statements
 - SEC believes underwriters should review OS and have “reasonable basis for belief in accuracy and completeness”

* See GFOA “Recommended Practice: Auditor Association with Financial Statements....” 2/24/06

Steps that should be taken

- EMMA for free access to offering documents, periodic reports
 - New rule effective July 1, 2009
 - Only Cox initiative that does not require Congressional action
- Mandatory generally accepted governmental accounting standards

Steps that should be taken (continued)

- Issuers of municipal securities should establish policies/procedures for disclosure appropriate for the particular issuer
- Legal responsibilities of issuer officials for disclosure documents they authorize should be clarified
 - Miami Cease and Desist Order: “The City Manager actually admitted he wasn’t familiar with disclosure requirements ... and dismissed importance of bond offering documents” (citing reliance on ratings)
 - Dauphin County: legislators “read little, if any,” of POS before approval.
 - Ira Weiss case (finding bond counsel liable for securities law violation for failing to disclose incorrect tax-exemption opinion): school district business manager “had no understanding” of contents of arbitrage certificate

Post-White Paper

October 23, 2008 - SEC testimony to
Committee on Oversight and
Government Reform (House of
Representatives)

2009/10 - Obama Administration
Initiatives

Lessons from Orange County — *Background*

- **1993-94:** \$1.3 billion of notes issued to invest in County Pools
- County's financial condition closely tied to financial condition of the County Pools
- **December 1994:** County Pools' \$20.6 billion investment portfolio suffers market value loss of approximately \$1.5 billion (\$600 million loss on liquidation)
- **December 6, 1994:** County petitions for bankruptcy under Chapter 9, U.S. Bankruptcy Code
- **January 24, 1996:** County, the County Flood Control District and Board of Supervisors consent to entry of SEC Cease and Desist order

Orange County — *SEC Action*

SEC Report: issued “to emphasize the responsibilities under the federal securities laws of local governmental officials...”

- ▣ Supervisors were aware of County financial condition and budgetary reliance on investment returns generated by County Pools
- ▣ Supervisors knew that the investment strategy was tied to debt issuance
- ▣ Supervisors failed to take “steps appropriate under the circumstances” to assure that the County's financial situation was being adequately disclosed to potential investors
 - “Public official who approves issuance of securities and related disclosure documents may not authorize disclosure that the public official knows to be materially false or misleading”
 - “Public official may not authorize disclosure while recklessly disregarding facts that indicate that there is a risk that the disclosure may be misleading”

Lessons from Orange County

- Legislative body has duty to take steps appropriate under the circumstances to assure accurate disclosure is made to investors regarding material information
- Legislative body should be familiar with disclosure documents
- Legislative body may need to question officials, employees, agents regarding disclosure of material information

Lessons from San Diego — *Background*

- Issued \$260 million in 5 issues in 2002 and 2003
- City staff and legislative body knew the City had huge unfunded liabilities for pensions, retiree health care
- Violation of anti-fraud rules: City did not adequately disclose the issue in disclosure documents, rating agency presentations, continuing disclosure reports

Lessons from San Diego

- ▣ Adopt written disclosure policies and procedures
- ▣ Provide appropriate training to everyone involved in the disclosure process (legislative body and staff)
- ▣ Focus on big picture issues facing the local agency
- ▣ Disclose the good with the bad
- ▣ Hire auditors with the skills and resources necessary to adequately audit local agency's financials in connection with its securities offerings

Personal Liability of Legislators and Staff

Orange County

- ▣ **Treasurer:** SEC cease and desist order; 6 years in jail, \$100K fine
- ▣ **Asst Treasurer:** SEC cease and desist order; 3 years in jail; \$10K fine

Personal Liability of Legislators and Staff

San Diego (April 7, 2008):

SEC filed securities law charges against San Diego officials (City Manager, Auditor & Comptroller, Deputy City Manager for Finance, Assistant Auditor & Comptroller, City Treasurer) under Section 17(a) of 1933 Act, Section 10(b) of 1934 Act and Rule 10b-5

- ▣ Seeking permanent injunction and civil penalties (four former city officials ultimately settled and paid fines ranging from \$5,000 to \$25,000)
- ▣ Challenged actions: OS failed to disclose looming financial crisis and the officials, with knowledge of material facts -
 - Signed closing certificate as to accuracy of OS
 - Participated in rating agency presentations
 - Reviewed misleading financial statements and allowed their publication

Questions

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Disclosure: The Good, The Bad and The Ugly

Jennifer Johnston, Franklin Templeton



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Franklin Municipal Bond Department

As of February 29, 2012

- Over \$77 Billion Under Management
- 34 Funds
- Long-term, Intermediate-term, Limited-term, Money Market, Investment grade—national and state specific, Insured, High-Yield¹
- **12** Portfolio Managers
- **17** Analysts
- Average Tenure: **16 Years**

1. High-yield bonds, also known as “junk bonds,” are subject to additional risks such as the increased rate of default.



Good disclosure benefits everyone!

Issuers, the market and investors



Disclosure in Public Finance:

The Good, the Bad and the Ugly

- The Good: What a difference a decade makes! How 15c2-12 has worked. The benefits of EMMA, technology and the web.
- The Bad: Where has the system failed? Will the analyst community ever be happy? Move to direct lending/bank loans.
- The Ugly: The market has changed dramatically over the past several years. We continue to suffer from ongoing economic weakness. Municipalities are doing more with less.



It's a New World

- 2008: Meltdown of the auction rate market, bank and insurer collapse.
- 2010: Bank analyst Meredith Whitney is featured on *60 Minutes* predicting “hundreds of billions” in local government defaults.
- 2012: First two California municipalities enter AB506 process. There are municipalities not appropriating for “essential” leases.
- Local governments nationwide continue to struggle from economic weakness and unprecedented budget pressures.
- Budget battles often take place in the press. Pensions are headline making news.



What does this mean for issuers?

- Issuers no longer have it as good as they used to.
- Analysts will be asking new and different questions that require more in-depth answers.
- Timely release of information is now more important than ever.
- Renewed interest by SEC, GAO, GASB.



The Bonds f.k.a Insured

- Most insured bonds trade differently today then a year ago.
- All bonds should have a public underlying rating. Period.
- How do credit analysts look at insured bonds? This can be a good or bad thing for an issuer.
- What about the bonds that don't have underlying ratings?
- What could this mean next time you issue bonds?



“Are issuers rewarded for good disclosure?”

- Who is the “market?”
- How are bonds priced in the primary?
- How are bonds priced in the secondary or on an ongoing basis?
- Large versus small issuers
- Real world examples



Types of Disclosure

- Primary Market
- Secondary Market
- Surveillance



Primary Market Disclosure

- Primary market disclosure is generally very good and has improved over the past few years.
- How do credit analysts look at deals in the primary?
- Continuing Disclosure Agreements
- Do issuers benefit from good primary market disclosure after the deal prices?



Secondary Market/Surveillance

- Why disclosure is important even *after* bonds are sold.
- We are required by law to price bonds daily and any bond can trade at any time.
- Disclosure timing



So what do we want?

Timely and complete disclosure of the financial and operating information needed to assess the credit quality and risk of a municipal debt issue.

- Historical financial results (audited)
- Current financial snapshot (interim reporting, unaudited is fine)
- We need taxes broken out. Chances are while property taxes are declining, sales taxes are increasing. We want to give you credit for that.
- Tax Base, Demographic profile, Economic snapshot
- Liquidity
- Other long term obligations
 - Long Term Debt
 - Pensions, OPEB
 - Direct Lending/Bank loans



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Example of how issuers can benefit from interim disclosure

Let's set the stage..

- Today is May 3, 2012.
- I have two secondary market opportunities on my desk.
- Both are California cities with a 6/30 fiscal year end.



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City A

- FY10 results are the most recent posted. It shows that general fund revenues for FY10 are down 8% from FY09.
- “Taxes” are all grouped together and are down 11.2%
- Fund balance has declined in each of the last three years and in FY10 fund balance was negative.
- When I call the finance director I get the run-around and never get a return call.

City B

- FY 11 results show general fund revenues are flat.
- Property taxes are down 4% and sales taxes are down 2%
- I can see that this is the third year of property tax declines, but sales taxes have declined less in FY10 and FY11.
- City B has posted mid-year unaudited results for the first 6 months of FY12. I see that property taxes are still down, but sales taxes have increased 10%.

What do I do?



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What if City A actually had timely disclosure...

- What if FY11 results actually showed that revenues increased? What if taxes were flat, but sales taxes increased and helped make up for ongoing property tax declines? Because the city doesn't break up taxes, this is hard to deduce.
- What if FY12 sales taxes are improving even more and as a result a surplus is expected for FY12 due to better-than-expected sales taxes?
- You want me to know this!
- What happens next time that city comes to the market?



Where do institutional investors get information?

- Offering Statements
- Continuing Disclosure filings
- Issuer websites
- Calls to management
- Sometimes we have to get creative



For more information

- National Federation of Municipal Analysts

www.nfma.org



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Good Disclosure Benefits Everyone!

- Improves transparency
- Improves access to capital
- Improves pricing
- Increases liquidity





THANK YOU!



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Bonds 101

Finance Team Roles, Responsibilities: Who's Involved?

Mark D. Blake
Deputy City Attorney
San Francisco City Attorney's Office

Who's On Your Team?

- Once Issuer determines to debt finance capital project, team of competent professionals is assembled to successfully access capital markets in an efficient and cost effective manner
- Professional services include:

Who's On Your Team?

- **FINANCIAL ADVISOR** - financial consultant retained by the issuer to provide expert advice to structure, manage and execute a debt financing plan
- **BOND COUNSEL** - law firm that provides legal advice regarding financing plan, and renders critical unqualified opinion that bonds are valid and binding obligations, and that interest on bonds is exempt from federal and state taxes

Who's On Your Team? (cont.)

- **DISCLOSURE COUNSEL** - law firm that assists issuer with the preparation of disclosure document, and assists issuer with the conduct of due diligence. Renders “10b-5” opinion to issuer to provide negative comfort on disclosure document
- **TRUSTEE** - a commercial bank or trust company that performs administrative trust duties relative to the bond issue, holds funds and accounts on behalf of bond holders, exercises remedies, if necessary, on behalf of bondholders

Other Professionals

- In addition to professional services the issuer retains, other professionals who will participate in accessing capital markets, including:
 - **UNDERWRITER** - investment bank or banks that purchases bonds from issuer and resells bonds to investors. For negotiated sales, issuer will select underwriter who will assist issuer structure, market and sell bonds. For competitive sales, underwriter bids on bonds at time specified by issuer. Underwriter may be represented by counsel

Other Professionals (cont.)

- **RATING AGENCIES** - credit rating agencies provide an independent analysis of the credit quality and likelihood of timely repayment of a bond issue. Investors use rating analysis, among other things, in determining whether to purchase
- **CREDIT ENHANCEMENT PROVIDERS** - banking facilities that provide, in various forms, assurance that funds will be available to pay bonds upon certain circumstances. Examples are bond insurance, letter of credits, or lines of credit