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CALIFORNIA
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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 ONE: THE MAKEUP OF ALTERNATIVE FINANCING IN THE MUNICIPAL MARKET

DAVID DOYLE

12TH DISTRICT CREDIT RISK COORDINATOR
BANKING, SUPERVISION & REGULATION
FEDERAL RESERVE BANK OF SAN FRANCISCO





The Makeup of Alternative Financing in the Municipal Market

California Public Finance Conference
San Diego, California
October 8, 2014

David Doyle

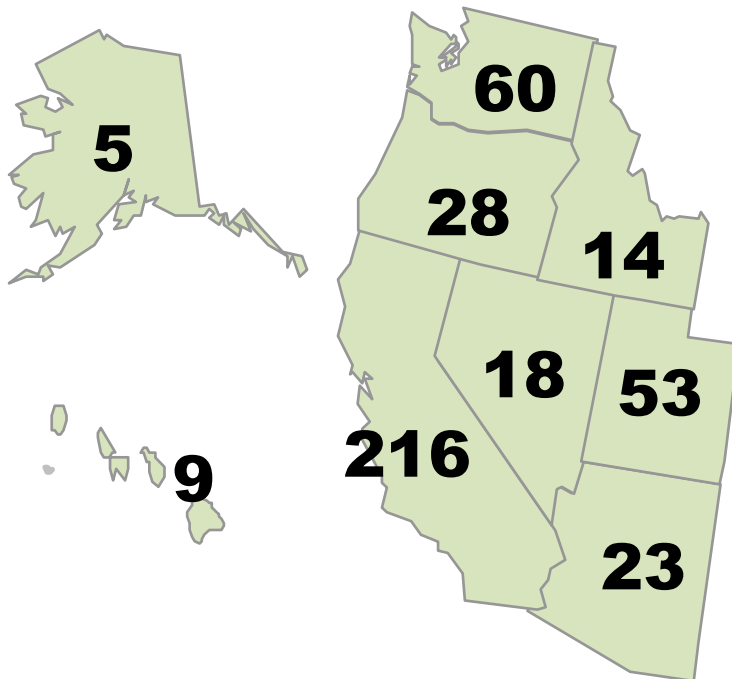
12th District Credit Risk Coordinator
Banking Supervision and Regulation
Federal Reserve Bank of San Francisco

Views expressed are those of the presenter and are not necessarily those of the Federal Reserve Bank of San Francisco or the Board of Governors.

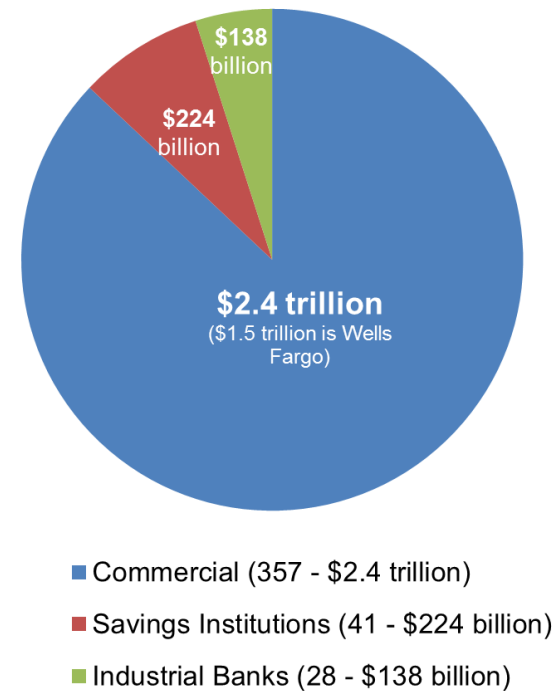


Banking Profile in the West

Number of Financial Institutions



Banking Assets

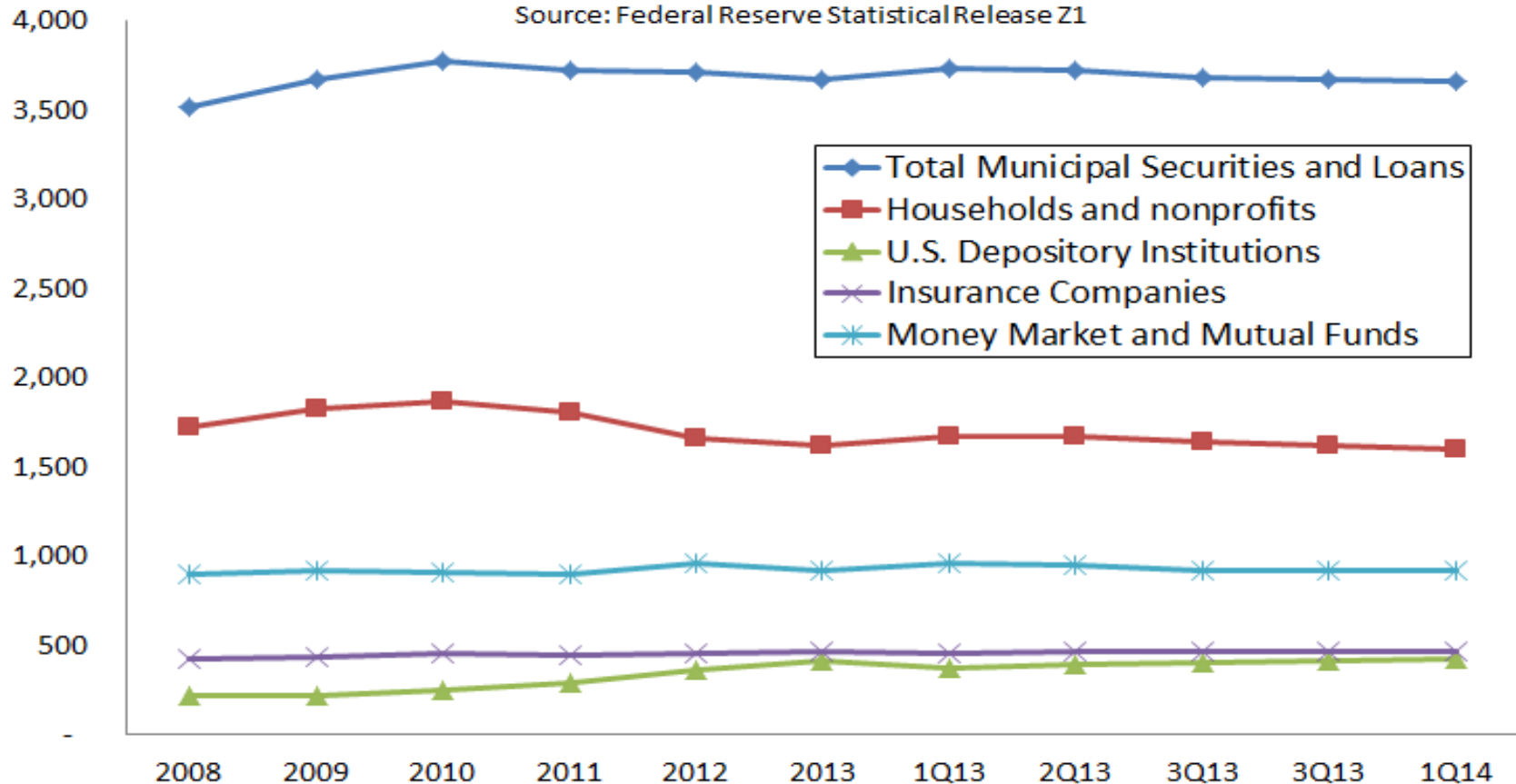




Municipal Securities and Loans

Aggregate Outstanding Municipal Securities and Loans (\$ in Billion)

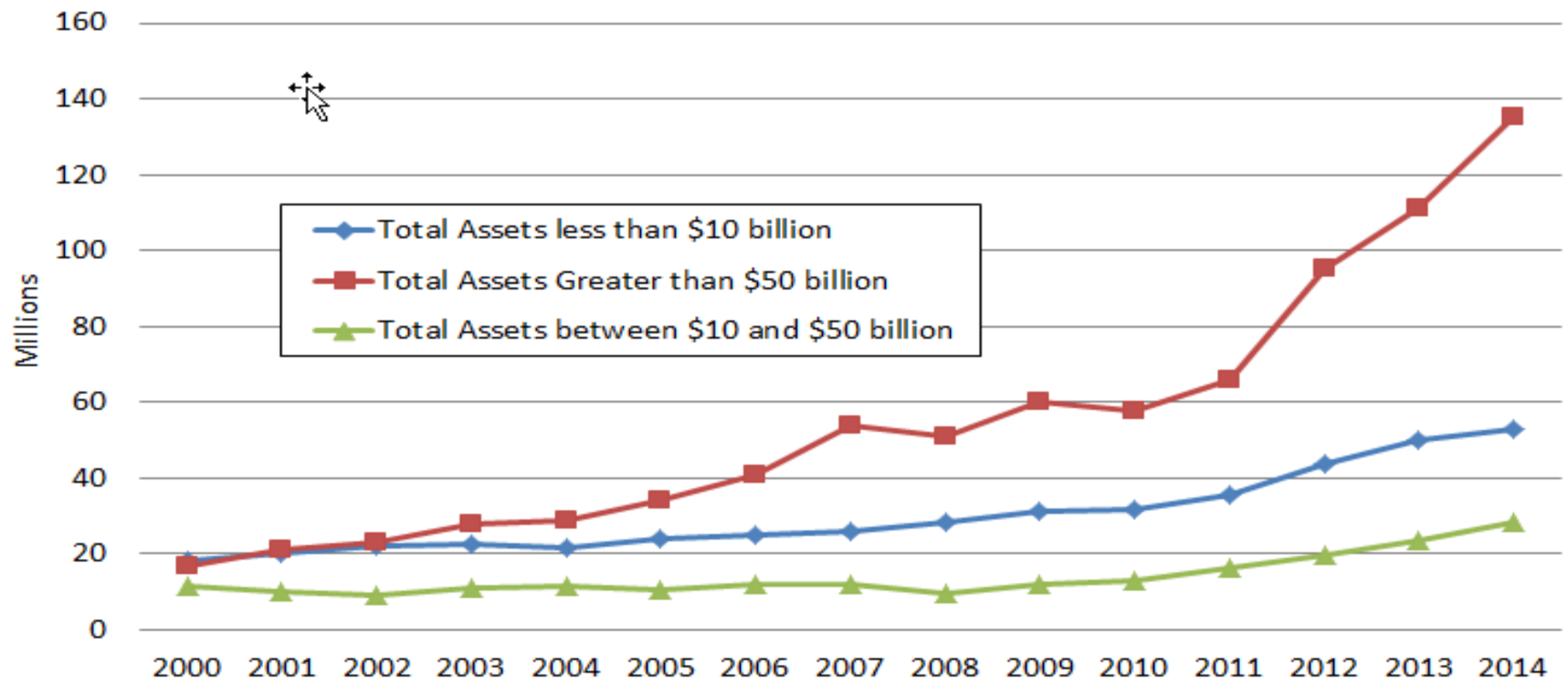
Source: Federal Reserve Statistical Release Z1





Financial Institutions

**Aggregate Municipal Securities Outstanding
As of June 30th of each Year**

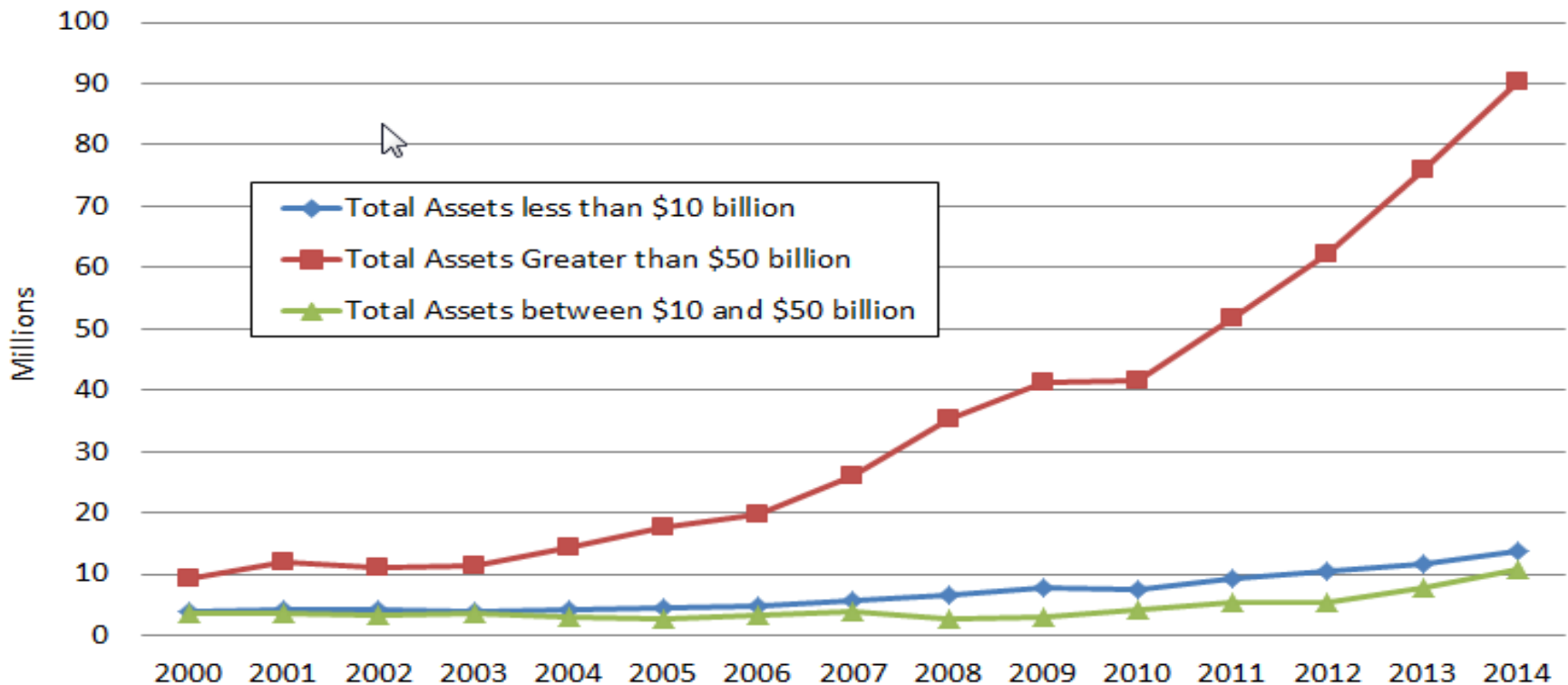


Source: CALL Report



Financial Institutions

**Aggregate Municipal Loans Outstanding
As of June 30th of each Year**



Source: CALL Report



CDIAC Question

What are the trends driving alternative lending?

Capital market challenges facing Issuers

- Availability of bond insurance
- Risk of bank rating downgrade of support facilities
- Liquidity/remarketing risk
- Capital market appetite for infrastructure needs vs new economy and small or weaker issuers
- Recent events: Detroit and Puerto Rico
- Future: Rising rates and pension costs



CDIAC Question

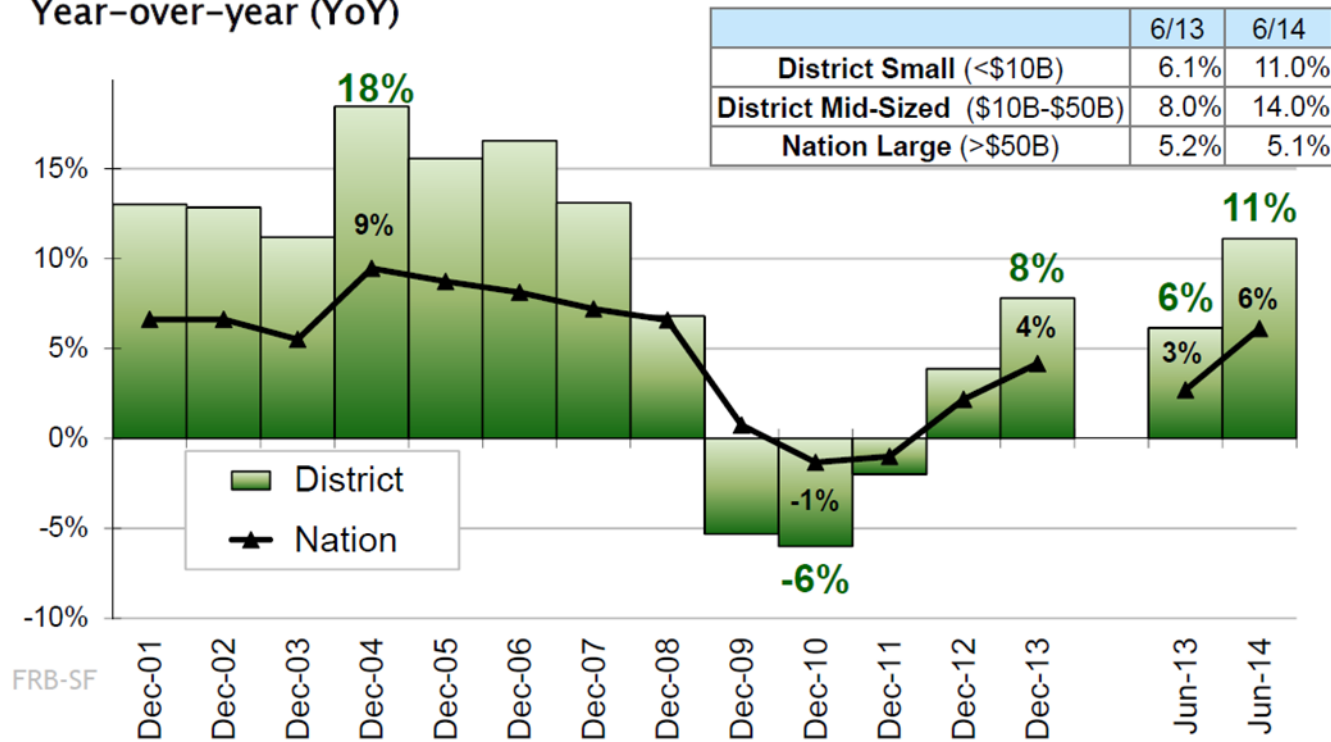
Why are lenders encouraged to provide funding to municipalities?

Factors contributing to renewed interest from financial institutions:

- Direct lending more profitable than providing support facilities to municipal issuers
- Municipal defaults and recoveries compare well to corporates
- Loan growth targets/budgets
- Heightened investment purchase due diligence (DFA)



Net Loan & Lease Annual Growth Rates
Year-over-year (YoY)





CDIAC Question

Direct Lending: what are the benefits to municipal borrowers?

Issuer friendly instruments

- New loans can be closed quickly and without need for public documentation, ratings, bond counsel, advisory or underwriting
- All in cost of direct loans made more competitive by absence of bond-related costs
- Direct loans do not rely on bank LC or require remarketing agent
- Issuer not required to provide ongoing disclosure to market
- Competition between banks has provided attractive rates and terms
- Flexibility dealing with one lender versus set of bondholders



Municipal Issuer

Other direct lending considerations

- Banks of all sizes offering the product, resulting in terms and covenants less clearly defined and less uniform
- Lack of disclosure to market. Investors may not know about the credit and/or terms of a new direct loan
- Liquidity implications of reliance on direct lending
- Need to understand regulatory expectations for banks that offer direct lending



Direct Lending ----

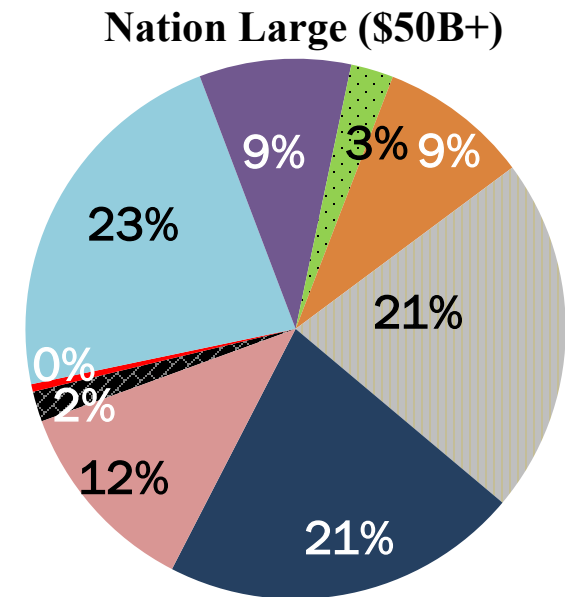
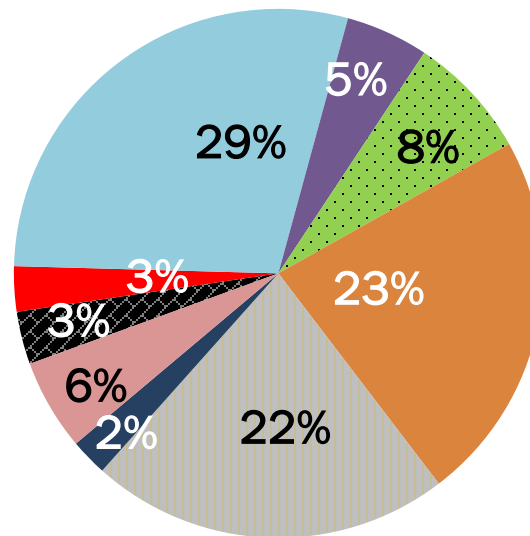
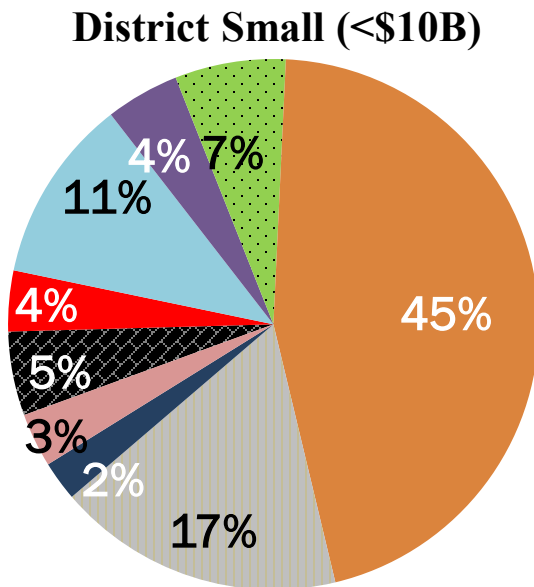
Bank Regulator Concerns

- **Section 939A of the Dodd-Frank Act -----> Securities**
 - Banks can no longer rely *solely* on external credit ratings. Historically banks very reliant on external credit ratings for municipal securities and loans.
 - DFA “investment grade” test:
 - (1) the risk of default by the obligor is low and
 - (2) the full and timely repayment of principal and interest is expected.
- **Financial Statements**
 - Obtain and maintain current financials to assess municipal’s *ongoing ability to repay*
 - Sometimes difficult for bankers to get good quality and current financials
- **Expertise**
 - Banks must have the resources to do the analytical work internally or may choose to engage third parties.
 - The depth of the due diligence should be a function of the municipals credit quality, the complexity of the structure, and the size of the transaction.



12th District Loan Mix (%) by Asset Size

District Mid-Sized (\$10-50B)



- Construction & Land Development
- 1-4 Family First Lien
- Multifamily
- Commercial & Industrial
- Other
- Ag + Farmland Secured
- HomeEquity + Jr Lien
- Nonfarm Nonresidential (NFNR)
- Consumer



Municipal Loan Concentrations

-- Top 12 in Nation

06/30/14 Bank & Thrift Loan Growth Rates

Bank & Thrift Information				
- CLICK ANY COLUMN HEADER TO RE-SORT -		Loan Mix (%)		% of RBC
ID RSSD	Name	Total Assets (\$000)	Oblig (other than securities & leases) of US States & Political Subs	Oblig (other than securities & leases) of US States & Political Subs
		A	A	A
377908	CENTURY BANK AND TRUST COMPANY	3,550,059	42.18	228.78
472858	HOUSTON COMMUNITY BANK, NATIONAL ASSOCIAT	319,996	16.71	109.08
2963547	LANDMARK COMMUNITY BANK	277,977	13.21	98.98
529958	TIB THE INDEPENDENT BANKERSBANK	2,251,411	31.61	95.73
503453	BREMER BANK, NATIONAL ASSOCIATION	731,143	12.06	95.01
3138146	WESTERN ALLIANCE BANK	9,892,546	12.34	93.86
78559	SUMMIT NATIONAL BANK	61,513	14.51	92.14
623454	BANK AND TRUST, SSB, THE	420,818	13.91	87.78
3476192	CARTER BANK & TRUST	4,653,337	13.06	83.88
750341	HASTINGS CITY BANK	283,174	14.51	83.06
926342	STATE BANK	22,561	35.94	81.07
245276	ORIENTAL BANK	7,649,578	12.96	80.69



Bank Liquidity Coverage Ratio

Topic of fierce debate

- September 3rd Final Rule issued which excludes debt issued by municipalities from high quality liquid assets (HQLA)

Opponents of the exclusion warn that municipalities will face higher borrowing costs

- Banks will have less incentive to buy municipal bonds

Proponents of the exclusion argue that the rule is aimed at preventing a repeat of financial crisis liquidity crunch

- Expect minimal impact because market dominated by retail investors
- “Municipalities are notorious for having unreliable and opaque financials that come out only once a year....these type of securities can hardly be considered high quality.” *American Banker*, September 4, 2014, Mayra Rodriguez Valladares



Bank Liquidity Coverage Ratio

Federal Reserve Governor Tarullo:

- Most municipal bonds are not sufficiently liquid to serve the purposes of HQLA during stressed periods.
- Analysis suggests that the liquidity of some municipal bonds is comparable to that of the very liquid corporate bonds that can qualify as HQLA.
- FRS Staff working on criteria for determining which municipal bonds fall into this category...may be considered for inclusion as HQLA at a later date.



Questions?



<http://www.frbsf.org/banking-supervision/>

Banking Supervision Highlights

[Supervisory Spotlight: September 2014](#)

Posted September 16, 2014

Federal Reserve supervision of community banks continues to evolve, as we undertake new initiatives in response to changing and emerging risks. The latest *Supervisory Spotlight* highlights changes to the Fed's community bank supervision program, risks of bank-owned life insurance, the accounting implications of improving asset quality, and cybersecurity.

[Asia Focus: Priority Sector Lending in Asia](#)

Posted September 15, 2014

This *Asia Focus* discusses Asia's experience with priority sector lending, reviews the current state-level priority sector lending policies in several Asian economies, assesses the implications for the respective domestic banking systems, and examines potential alternative mechanisms to encourage lending to priority sectors.

[Outlook Live – Frequently Asked Questions on the TILA-RESPA Integrated Disclosures Rule](#)

Posted September 11, 2014


On October 1, the Federal Reserve is hosting a webcast by the Consumer Financial Protection Bureau, *Frequently Asked Questions on the TILA-RESPA Integrated Disclosures Rule*. The event will address specific questions related to interpretation and implementation challenges and focus on questions about how to complete the loan estimate and closing document.

[First Glance 12L: Second Quarter 2014](#)

Posted September 11, 2014

The 2Q14 issue of *First Glance 12L* shows that conditions in the District continued to improve. Though trends are positive, a return to "normalcy" by pre-crisis standards has not yet materialized.

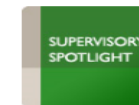
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Publications



Supervisory Spotlight

Observations on current banking and regulatory issues by the Division Director of Banking Supervision and Regulation



First Glance 12L

Quarterly reports highlighting key indicators of 12th District banking conditions



Banks at a Glance

These quarterly reports highlight key indicators of banking conditions within each of the nine states comprising the 12th Federal Reserve District.



<http://www.federalreserve.gov/bankinforeg/default.htm>

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Banking Information & Regulation

Features



[Frequently Asked Questions](#)

Implementation of Regulation YY Enhanced Prudential Standards for Foreign Banking Organizations (Released June 26, 2014)



[Stress Tests and Capital Planning](#)

The Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Act (DFA) stress tests are regulatory tools the Federal Reserve uses to ensure that financial institutions have robust capital planning processes and adequate capital.

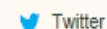


[Basel Coordination Committee \(BCC\) Bulletins](#)

BCC Bulletins provide examination guidance relating to the implementation of the advanced approaches risk-based capital rule. [View All >>](#)

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SESSION TWO: PUBLIC AGENCY DEBT PORTFOLIOS AND NEW SOURCES OF CAPITAL

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VICE PRESIDENT,
CAPITAL STRATEGIES
WELLS FARGO SECURITIES

JAY M. GOLDSTONE
MANAGING DIRECTOR,
PUBLIC FINANCE
MUFG UNION BANK, N.A.

PETER LUCHETTI
PARTNER
TABLE ROCK CAPITAL LLC

HECTOR E. NEGRONI
PRINCIPAL
FUNDAMENTAL ADVISORS

BREAK

WE WILL RECONVENE AT 10:30 AM



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SESSION THREE: FINANCIAL MANAGEMENT – RISK ANALYSIS AND ALLOCATION

ANNA SARABIAN, MODERATOR
SENIOR VICE PRESIDENT
FIELDMAN, ROLAPP & ASSOCIATES

MATT COVINGTON
MANAGING DIRECTOR
CONWAY MACKENZIE

MATT REINING
SENIOR DIRECTOR AND
ANALYTICAL MANAGER
STANDARD AND POOR'S

ALEX WALLACE
MANAGING DIRECTOR AND
HEAD OF PUBLIC FINANCE
US BANCORP MUNICIPAL
SECURITIES GROUP

LISA WASHBURN
MANAGING DIRECTOR,
MUNICIPAL MARKET ADVISORS/
TREASURER, NATIONAL
FEDERATION OF MUNICIPAL
ANALYSTS

The Best Portfolio Mix

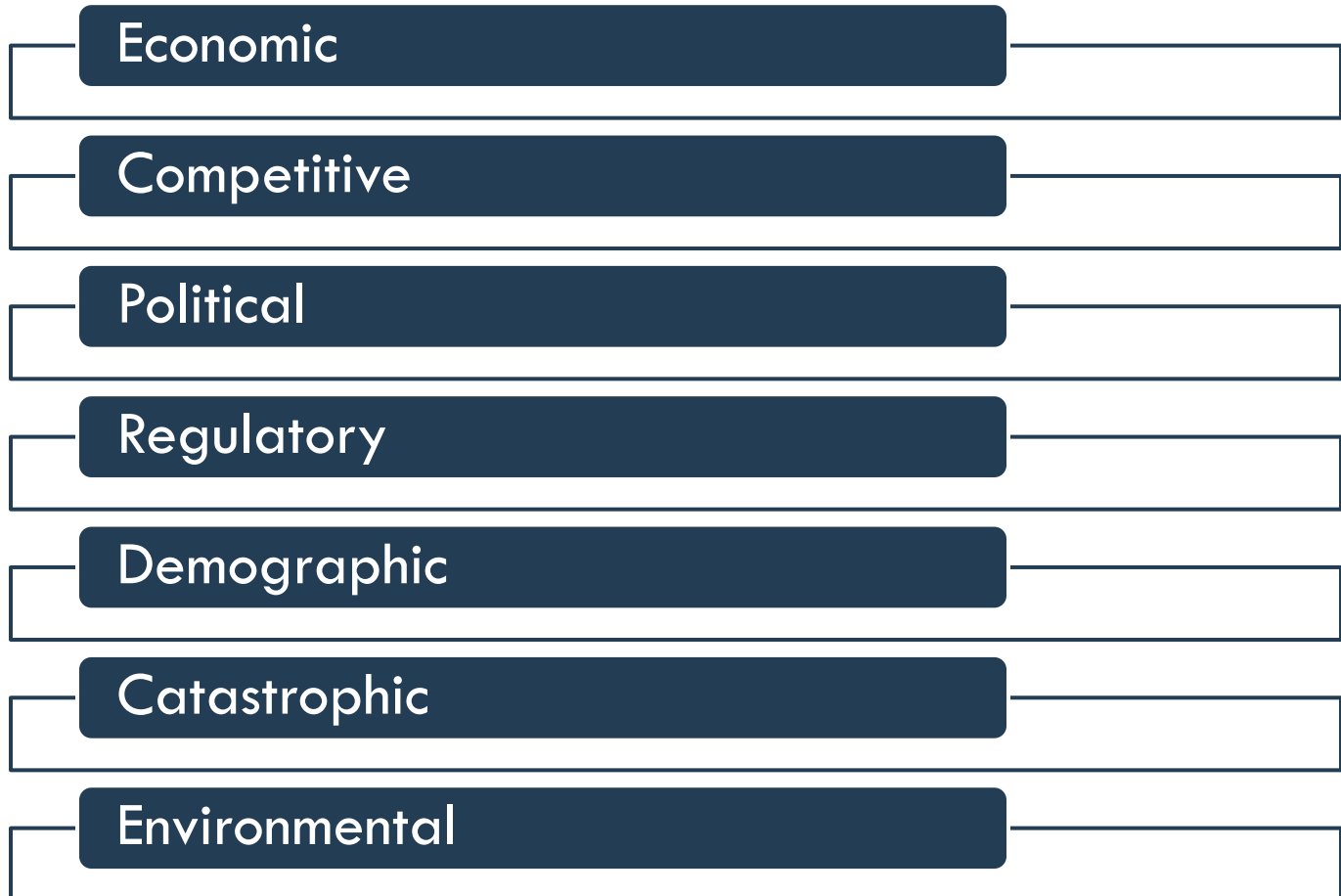
25

- There isn't one
- Economic, political, demographic, regulatory, etc. factors matter
- Risk-centric approach to debt policy might help reduce cost and limit risks
 - ❑ Traditional fixed rate debt and risk aversion
 - Certain benefits
 - Opportunity cost – the foregone lower costs of other alternatives – focus on hidden costs of decisions
 - Exchange of one set of risks for another
 - Commitment risk – lack of flexibility to respond to future risks

Portfolio Restructuring

26

Long-Term Risks



Asset-Liability Matching

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- A balance sheet risk management approach that links the interest rate sensitivity of liabilities and assets
- Rule of thumb: variable rate debt = 100-150% of cash
 - ❑ More if revenues are economically sensitive
- If revenues and expenses are economically sensitive, then even issuers without significant cash balances might find fixed rate debt quite risky

Debt Policy

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- Flexible, risk-centric approach might be beneficial for certain issuers
- Cost/Benefit Analysis of alternative debt products
 - ❑ Ask the “right” questions
 - ❑ Fully understand proposed structures, what assets are pledged and decisions being made
 - ❑ Be mindful of potential impacts and interdependency
 - ❑ Think about budget and operational performance
- Holistic analysis of the commitments being undertaken both financially, legally and politically

Risk Analysis of Alternative Structures

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- How does this product differ from TFRD?
- What are the key benefits and risks?
- How does this product fit into/impact my current debt portfolio and/or asset liability management?
- What is the current market for this product? Size? Investors? What types of issuers have used it?
- Has it been tested in an adverse situation? What was the outcome and impact on the issuer?
- What transaction features are most attractive to investors? Do they come with a certain cost for the issuer?

Risk Analysis of Alternative Structures (Cont'd)

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- What structural features are investors most concerned about?
- What are the accounting and disclosure requirements? What is required and what do investors expect in terms of disclosure?
- What is the rating agencies' view on the product and impact on credit quality?
- Does the product require expert knowledge of finance products or monitoring of markets, counterparties, etc.?
- Is there a risk that the issuer could be responsible to cover a payment of another party such as the U.S. government that is relied upon for repayment of the debt?
- What is the worst theoretical outcome for an issuer that uses this product?

Keep Focused

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- Think about your own mission, not what capital market creditors want from you



"We've considered every potential risk except
the risks of avoiding all risks."

Risk Analysis: Recent Periods in the Municipal Markets

2008 – 2010 “Stimulus Period”	2011 – 2012 “Stabilization Period”	2013 - 2014 “Recovery and Growth Period?”
Themes <ul style="list-style-type: none"> ▪ Auction rate market collapses ▪ Federal stimulus programs aids issuance (ARRA) ▪ Bank and bond insurer downgrades ▪ Taxable/crossover buyer participation ▪ Short-term market alternatives emerge 	Themes <ul style="list-style-type: none"> ▪ Banks emerge as 3rd largest Muni bond holders ▪ Short and long-term rates dip to historical lows ▪ Credit spreads stabilize ▪ FRN and DP markets continue to grow ▪ Tax-exempt/ taxable ratios above 100% 	Themes <ul style="list-style-type: none"> ▪ Inconsistent views on recovery leads to volatility on the long-end ▪ Credit events (e.g. Detroit) ▪ Volume decline ▪ Convergence continuing between FRN and DP markets ▪ Clients exploring all markets (direct purchases, tax-exempt, taxable and swap market)
Issuer Behavior <ul style="list-style-type: none"> ▪ ARS and VRDNs restructured to fixed rate ▪ Taxable and private placement markets readily accessed ▪ Focus on counterparty risk/exposure (Credit enhancement substitutions Swap terminations) ▪ New money projects accelerated before ARRA sunset 	Issuer Behavior <ul style="list-style-type: none"> ▪ Refundings ▪ Fixed rate bias (95% of issuance volume) ▪ Taxable and private placement markets continued to be viable alternatives ▪ Other alternative markets tested Counterparty fatigue (credit and swap) 	Regulation & Legislative Impacts <ul style="list-style-type: none"> ▪ Dodd-Frank ▪ Muni Advisor Rule ▪ Volcker Rule ▪ Basel III ▪ Tax Reform

Examples of Alternative Structures

Public Market	Private Market
Floating Rate Notes <ul style="list-style-type: none">- SIFMA based or Libor based- Hard / Soft Put Callable Commercial Paper Century Bonds	Direct Purchases <ul style="list-style-type: none">- Fixed rate and floating rate Drawdown Facilities
P3's Synthetic Structures	

Macro Risks to Alternative Structures

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Regulatory

- Dodd-Frank
- Basel III (HQLA)
- Muni Advisor Rule
- Volcker Rule
- Tax Reform

Political risk

- Recent credit events (Detroit, P.R., pensions)

Disclosure

- Possibility of two-tiered disclosure system

Liquidity

- Market depth and flexibility

Micro Risks to Alternative Structures

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Counterparty risk

- Bank products (credit enhancement, direct purchases, swaps) and Dealer/Remarketing Agent risk

Tax risk (SIFMA vs. LIBOR)

- Change in corporate tax rate can change deal economics

Renewal risk

- Bank appetite for exposure to certain credits can change just as market liquidity

Structural risk

- Acceleration, transfer risk, etc.

Rating Agency Perspective

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- Alternative products might provide benefits
- Less standardized and uniform terms and conditions/lack of transparency create potential for considerable risk exposure
- S&P analyzes an obligor's comprehensive debt position, so even if there is no legal requirement, exposure to alternative products should be disclosed
- Covenants which could lead to acceleration, create demands on liquidity, or cross-default other debt, could have credit implications

Rating Agency Perspective (Cont'd)

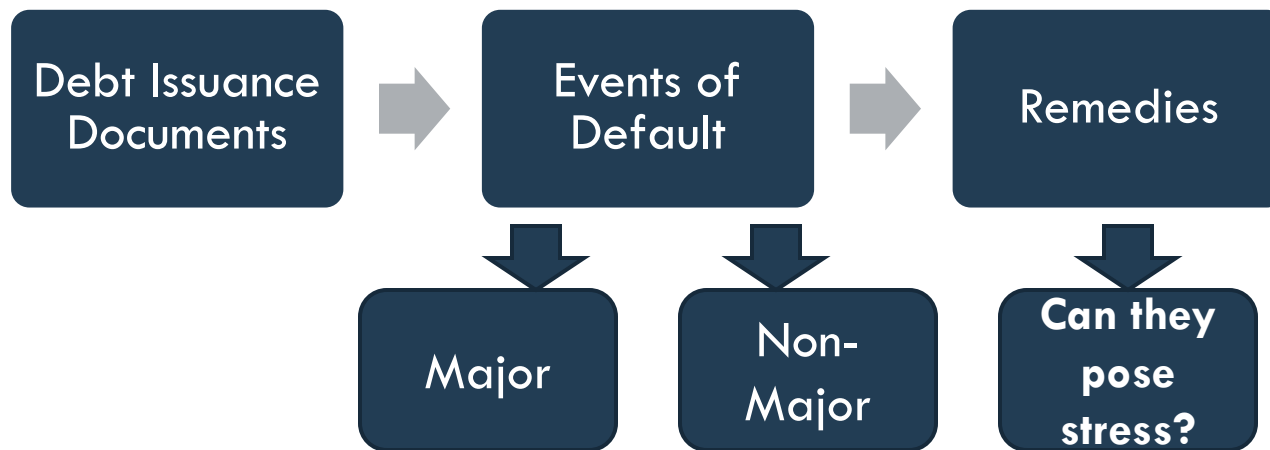
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- The credit impact on an obligor's portfolio is considered holistically: all introduced risks are analyzed regardless of the financing vehicle
- Additional risk from alternate structures stems from:
 - ❑ Potential Acceleration of P&I payments
 - Events of Default
 - Covenants and remedies
 - ❑ Cross-default provisions between alternative financing debt and capital market debt
 - ❑ Breached covenants and default events could lead to a liquidity crisis for the obligor

Rating Agency Perspective (Cont'd)

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- Incorporation of alternative financings into the analysis of an obligor's debt profile is critical



- 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

Rating Agency Perspective (Cont'd)

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- Acceleration provisions that favor private lenders:
 - ❑ Subordinate the claims of the issuer's capital market lenders
- Even if the events of default do not include acceleration as a remedy, they could still cause the acceleration of other parity debt through:
 - ❑ Cross-default provisions or
 - ❑ Most favored nation clauses
- Most favored nation clauses pose a particular risk to credit quality because the events of default may change in unknown ways

Rating Agency Perspective (Cont'd)

40

- Repayment Risk tied to VRDBs, alternative financing products, and other debt instruments:
 - ❑ Predictable
 - ❑ Event-driven
- Where event-driven risk exists, evaluation of:
 - ❑ Likelihood of triggering acceleration, termination payment, or collateral posting requirements
 - ❑ Assessment of management's capacity to respond to these liquidity demands through available balance sheet liquidity, capital market access, or lines of credit
- Debt Management and Investment Policies Critical

The Risk of Distress

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- The strength of the municipal market is based on mutual trust
- Detroit, San Bernardino, Stockton, Puerto Rico – no sizable municipal distresses as expected
- Distressed focused hedge funds
- Predatory participants introduce a far more adversarial perspective
- Political leaders facing fiscal pressure are vulnerable to the “easy” options

The Risk of Distress (Cont'd)

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- Uncertainty in how things will be restructured
- Uncertainty in how the various parties will be treated
- Conflicting short-term and long-term interests
- There are some opportunities in distressed markets
 - ❑ Yield-hungry lenders

Case Study

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Summary of Proposed Creditor Treatment Stockton Plan of Adjustment (*\$ in Millions*)

Detroit Plan of Adjustment (*\$ in Millions*)

Class	Name	Impaired / Unimpaired I / U	Claim \$	Recovery (%)
1A, 1B	2003 Police/Fire/Library Certificates (Ambac)	I	\$12.6	106.4%
2	2006 SEB Bonds (NPFG)	U	12.1	100.0%
3	2004 Arena Bonds (NPFG)	I	45.1	96.7%
4	2004 Parking Structure Bonds (NPFG)	I	31.6	83.9%
5	2007 Office Building Bonds (Assured)	I	40.4	53.9%
6	Pension Obligation Bonds (Assured)	I	124.3	51.9%
8	SCC 16 Claims	U	0.5	100.0%
10	Restricted Revenue Bond and Notes Payable	U	n/a	100.0%
11	Special Assessment and Special Tax Obligations	U	n/a	100.0%
12	General Unsecured Claims (incl. Franklin and OPEB)	I	579.8	0.9%
13	Convenience Class Claims (<\$100)	U	n/a	100.0%
14	General Liability Tort Claimants	I	n/a	0.9%
15	CalPERS Claim for Pension Obligations	U	289.2	100.0%
17	Workers Compensation Claims	U	51.1	100.0%
18	Stockton Police Officers' Claims	I	8.5	13.0%
19	Price Claims	I	1.4	n/a
20	Golf Course Secured Claim	I	4.1	100.0%
Pro-Forma Treatment of Retirees (Pension and Retiree Health)				
12, 15	City Retirees (combining retiree health and pension treatment)	I	\$551.0	53.4%

Class	Name	Impaired / Unimpaired I / U	Claim \$	Recovery (%)
1A, 1B,	Water and Sewer District Bond Claims	I	\$5,779.9	100.0%
2A-F	Secured General Obligation Claims	U	485.0	100.0%
3	Other Secured Claims	U	8,855.5	100.0%
4	HUD Installment Note Claims	U	90.1	100.0%
5	COP Swap Claims	I	85.0	30.0%
6	Parking Bond Claims	U	8.1	100.0%
7	Limited Tax GO Claims	I	163.5	11.5%
8	Unlimited Tax GO Claims	I	388.0	74.0%
9	COP Claims	I	1,473.0	10.0%
10	Police and Fire Retirement System	I	1,250.0	59.0%
11	General Retirement System	I	1,879.0	60.0%
12	OPEB Claims (<i>includes both Safety and General</i>)	I	4,303.0	11.5%
13	Downtown Development Authority	I	33.6	11.5%
14	Other Unsecured Claims	I	150.0	11.5%
15	Convenience Claims (<\$25,000)	I	n/a	25.0%
16	Subordinated Claims	I	n/a	0.0%
Pro-Forma Treatment of Retirees (Pension and Retiree Health)				
10, 11, 12	City Retirees (combining retiree health and pension treatment)	Impaired	\$7,432.0	31.8%

Source: Respective Plans of Adjustment, Amended Plans of Adjustment, Disclosure Statements and Amended Disclosure Statements for Stockton and Detroit

Questions & Answers

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LUNCHEON

WE WILL RECONVENE AT 12:30 PM





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SESSION FOUR: DISCLOSURE AND REPORTING – EXPOSING THE INTERSECTION BETWEEN MUNICIPAL SECURITIES AND OTHER FORMS OF DEBT

LISA WASHBURN
MANAGING DIRECTOR,
MUNICIPAL MARKET ADVISORS/
TREASURER, NATIONAL
FEDERATION OF MUNICIPAL
ANALYSTS

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DISCLOSURE GAPS FOR DIRECT BANK LOANS

How did we get here?

Lisa Washburn, Managing Director

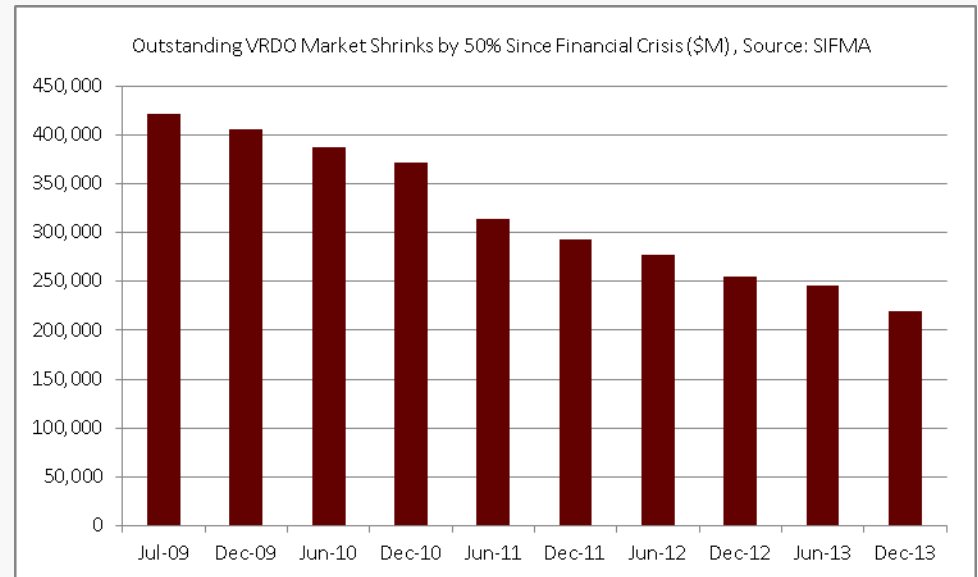
October 8, 2014

Gaps in disclosure become clearer during the financial crisis

- **During the crisis the municipal market experienced**
 - Collapse of the bond insurance industry
 - ARS market failure
 - VRDO tenders
- **Bank bonds, high max rates, accelerated repayments**
 - Counterparty troubles causing issuer credit strains
 - Incomplete disclosure of terms, lack of public documents
- **Issuer credit critical; no longer masked by insurance**
- **Greater investor appreciation of “hidden risks”**

MSRB implements changes to SHORT system

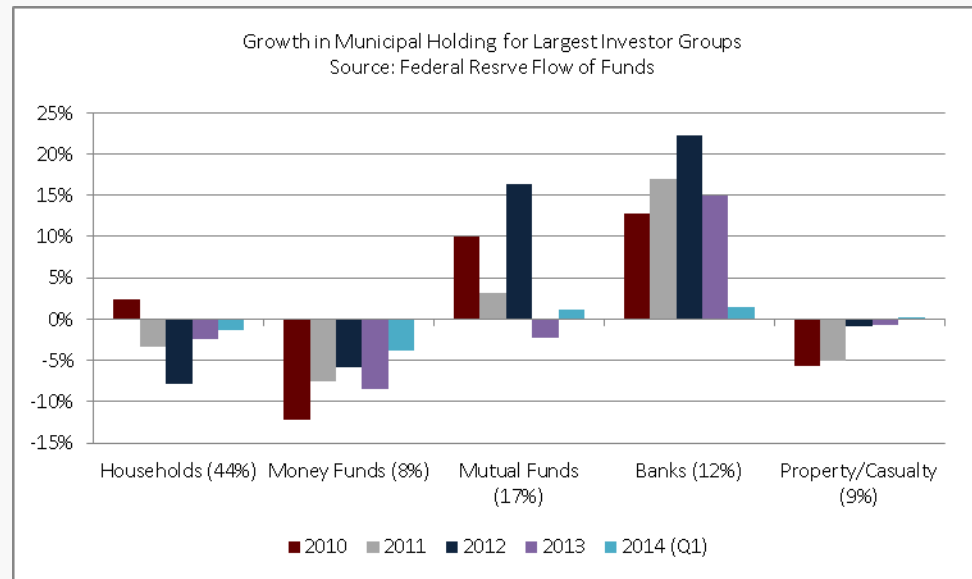
- Additional terms, documents
- Did not become effective until 2011, after financial crisis
 - Dramatically shrinking VRDO market
- Less available credit and liquidity and higher cost
 - Some providers exit market
 - Others no longer effective counterparties for Rule 2a-7
- And, issuer avoidance of structure



But as VRDO market declines, similar risks emerge in growing bank loan market

- Issuers left with non-performing VRDOs need solution
- Downgraded banks need an alternative to stay in market
- ***Direct bank loans fill the gap***

- At first, good fix for broken VRDOs
- Other benefits accelerate product growth



Direct loans have advantages for issuers

- Access to an alternate source of capital and new lenders
- Customized arrangement between issuer and lender
- Familiar structure (VRDO-like) but without the counterparty (bank and remarketing risk)
- Less costly; typically no ratings, no offering document
- *No required disclosure under 15c2-12, yet direct loan typically poses similar credit and liquidity risks to issuers as VRDOs*

Although not required existing bondholders need disclosure

- **Dodd-Frank mandate to remove reliance on rating agencies**
 - Investors required to make independent credit assessment
- **Entering into a new bank loan can impact credit and/or liquidity profile**
 - Increase debt outstanding
 - Potentially different covenants and remedy triggers
 - Assets previously available may have been pledged to bank
 - Structural risks, such as a balloon payment
- **Lack of/delayed disclosure impairs investor ability to make timely assessment of the loan's impact on the issuer's credit profile and impedes**
 - Ability to assess whether to hold or sell bonds
 - Assess impact of rating deterioration (asymmetrical information)
 - Valuation of the bonds

Industry recognition that better direct loan disclosure is needed

- **Bank Loan Disclosure Task Force published white paper “Consideration Regarding Voluntary Secondary Market Disclosure”**
 - American Bankers Association (ABA), Bond Dealers of America (BDA), Government Finance Officers Association (GFOA), Investment Company Institute (ICI), National Association of Bond Lawyers (NABL), National Association of Health and Educational Facilities Finance Authorities (NAHEFFA), National Association of Independent Public Finance Advisors (NAIPFA), National Federation of Municipal Analysts (NFMA), Securities Industry and Financial Markets Association (SIMFA)
- **MSRB Notice 2012-18 encouraging voluntary disclosure**
- **S&P published on requirement to disclose bank loans to them and ramifications for failure to do so**
- **GFOA published “Best Practice Understanding Bank Loans”**

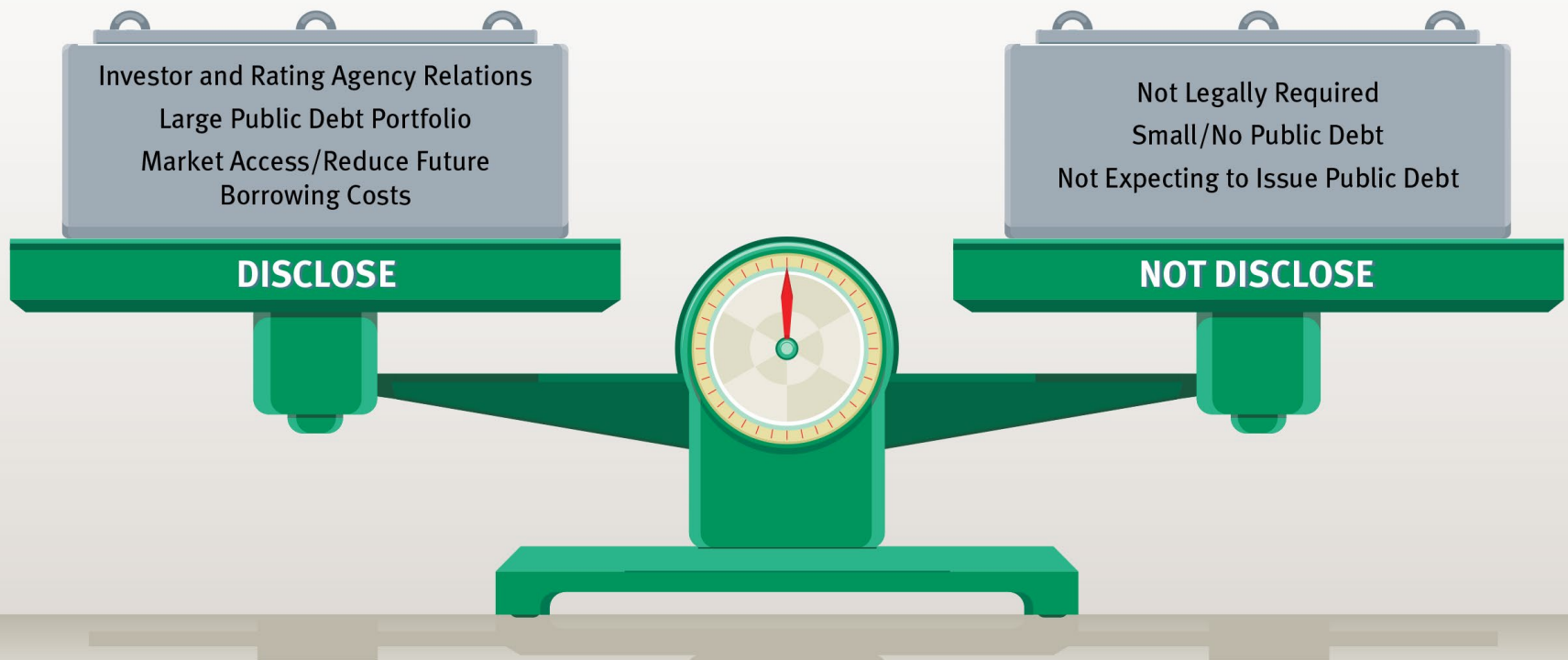


Disclosure Rules for Direct Purchases: What Disclosure is Legally Required?

Presented by:
Jenna Magan, Partner
Orrick, Herrington & Sutcliffe

October 8, 2014

To Disclose...or Not to Disclose... That is the Question



Two Main Disclosure Rules

Federal Securities Laws (Securities Exchange Act of 1934)

1. Rule 15c2-12
2. Rule 10b-5

Both Rules apply to “securities”

- » If the direct purchase is considered a “loan” instead of a “security” under the federal securities laws, it is not subject to these rules
- » Hard to conclude if the instrument being purchased is called a “note” or “bond” -- even if the purchaser is willing to book it as a loan for its internal accounting purposes

Rule 15c2-12

- Broker-dealer may not underwrite an issue of municipal bonds unless the underwriter has been able to:
 - » obtain and review an official statement that the issuer deems final as of its date; and
 - » obtain agreement of the issuer to provide continuing disclosure (annual reports and notices of specified “material events”)
- There are certain exemptions

Rule 15c2-12: Exemptions

- No official statement is required in typical direct purchase because:
 - » Issues with denoms of \$100,000 or more are exempt if sold to no more than 35 sophisticated investors who do not have intent to resell
 - » May conclude that Rule 15c2-12 does not apply because:
 - there is no underwriting
 - there is no “municipal security”
- Bottom Line for Issuers: Rule 15c-12 applies to underwriters, not issuers, so reasonable to defer to direct purchaser or another party to determine whether transaction is subject to Rule 15c2-12

Rule 15c2-12: Reporting of Incurrence of Additional Debt Not Required



- No material event notice is required for incurrence of additional debt because:
 - » Rule 15c2-12 does not require that an issuer notify the market any time something “material” happens; and
 - » Rule 15c2-12 only requires notice of specified “material events”
- Best Practice for Issuers: Consider voluntary disclosure of incurrence of additional debt in direct purchase transaction if outstanding public debt



Rule 10b-5

“It shall be unlawful for any person . . .

a) To employ any device, scheme or artifice to defraud,

b) To make any untrue statement of a material fact or to omit to state a *material* fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading”

Must be “in connection with the purchase or sale of any security”

The “Materiality” Standard

- “[w]hether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest”
- Materiality is determined in context of all the facts and circumstances, but usually on a retroactive basis
- Guidance comes primarily from court decisions and SEC enforcement cases

Rule 10b-5: In Direct Purchases

- No exemption from Rule 10b-5 for direct purchases
 - » Note that Rule 10b-5 only applies to “securities”
- Practice in direct purchase deals is that Issuer addresses 10b-5 issues without need to provide disclosure document to investor by:
 - » Disclosing material facts to the investor;
 - » Allowing investor to ask issuer questions and do its diligence; or
 - » Obtaining investor letter

When Does Rule 10b-5 Apply?

- There is no requirement under federal securities laws for issuers to continuously update investors
- Rule 10b-5 applies whenever an issuer is “speaking to the market”
 - » New offerings
 - » Annual Report under Rule 15c2-12
 - » Voluntary Filings
 - If issuers choose to voluntarily disclose direct purchase or post redacted documents, keep in mind that Rule 10b-5 applies

Bank Loans - What are the Applicable GASB Accounting and Disclosure Requirements?

GASB Chair David A. Vaudt
October 8, 2014

The views expressed in this presentation are those of Mr. Vaudt. Official positions of the GASB on accounting and financial reporting matters are determined only after extensive due process and deliberation.

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GASB Accounting Requirements

- Propriety Fund (Business-Type Activities) Financial Statements
 - *Account for bank loans directly related to, and expected to be paid from, proprietary funds as liabilities in the proprietary fund financial statements*
 - Bonds, notes and other long-term liabilities of proprietary funds are specific fund liabilities, even though the full faith and credit of the government may be pledged as further assurance
 - GASB Codification 1500.102

GASB Accounting Requirements

■ Governmental Fund Financial Statements

- *Account for non-proprietary fund bank loan amounts due and payable, if any, as liabilities in the governmental fund financial statements*
- Due and payable – matured, but unpaid principal and interest
- Generally unmatured non-proprietary fund long-term indebtedness should not be recorded in governmental funds
- GASB Codification 1500.103, 1500.121-.123, and 1600.120-.122

GASB Accounting Requirements

- Government-Wide Financial Statements

- *Report bank loans related to proprietary funds as liabilities in the “business-type activities” column of the government-wide financial statements*
- *Report all other bank loans as liabilities in the “governmental activities” column of the government-wide financial statements*
- GASB Codification 1500.102 and 1500.121

GASB Disclosure Requirements

- Note Disclosures about Long-Term Liabilities
 - *Include all bank loans on the schedule of long-term liabilities in the notes to the financial statements*
 - *Beginning- and end-of-year balances*
 - *Increases and decreases*
 - *Portions of each item that are due in one year*
 - Long-term liabilities – such as bonds, notes, loans, and leases payable
 - GASB Codification 2300.120
 - See GASB Statement 34, Appendix C, for an illustration of a schedule of long-term liabilities

GASB Disclosure Requirements

- Note Disclosures about Debt Service Requirements
 - *Include the principal and interest requirements on all bank loans in the notes to the financial statements*
 - *Principal and interest requirements to maturity*
 - *Presented separately for each of the five subsequent fiscal years and in five-year increments thereafter*
 - *The terms by which interest rates change for variable-rate debt*
 - GASB Codification 2300.120
 - See GASB Statement 38, Appendix C, Illustration 7 for an example disclosure of debt service requirements

GASB Disclosure Requirements

- Note Disclosures about Significant Violations of Legal or Contractual Provisions
 - *Include disclosure of significant violations of bank loan related covenants, and actions taken to address such violations, in the notes to the financial statements*
 - GASB Codification 1200.112
 - See GASB Statement 38, Appendix C, Illustrations 5 and 6 for example disclosures of legal or contractual provision violations



Voluntary Disclosure of Bank Loans

Lynnette Kelly, *MSRB Executive Director*

Background

- State and local governments increasingly using bank loans as a municipal financing tool
- Banks have long played a role in municipal finance, for example through liquidity facilities and letters of credit to support variable rate demand obligations
- Like bank loans, VRDOs not initially covered under existing disclosure framework
- Emerging products and practices raise questions about disclosure

MSRB Resources on Bank Loans

- Determining whether a bank loan is a security ([MSRB Notice 2011-52](#))
- Providing voluntary disclosure on bank loans on EMMA ([MSRB Notice 2012-18](#))

Voluntary Disclosures on EMMA

- Issuers may provide additional information to market participants on a voluntary basis via **EMMA**® including:
 - Information about bank loans
 - Pre-sale information such as preliminary official statements or investor and rating agency presentations
 - Information about the timing of and accounting standard used to prepare annual financials
 - Investor website address

Disclosure Resources for Issuers

- “Putting EMMA to Work for You” outreach campaign
- MSRB Education Center
 - <http://www.msrb.org/EducationCenter.aspx>
- Email reminders for recurring financial disclosures
- Customizable display of issuer information on EMMA’s issuer homepages



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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

Naomi Richman

Managing Director, Local Government Ratings

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 & Private Placement Agreements
 - accompanying worksheets

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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

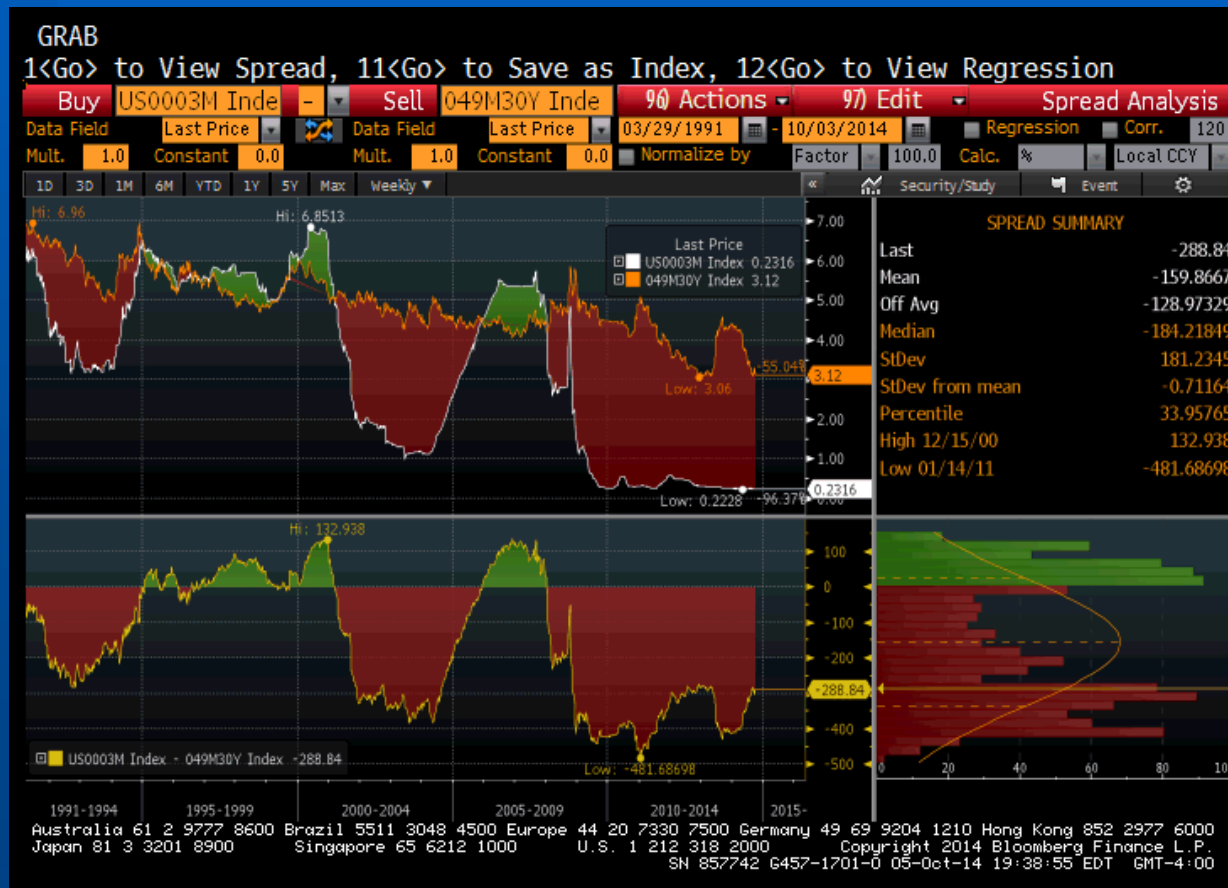
- **Assets should be invested conservatively**
 - Short-term
 - High Quality
- **Liabilities are typically sold as long-term fixed rate**
 - no interest rate risk
 - “permanent” financing

This combination produces interest rate risk

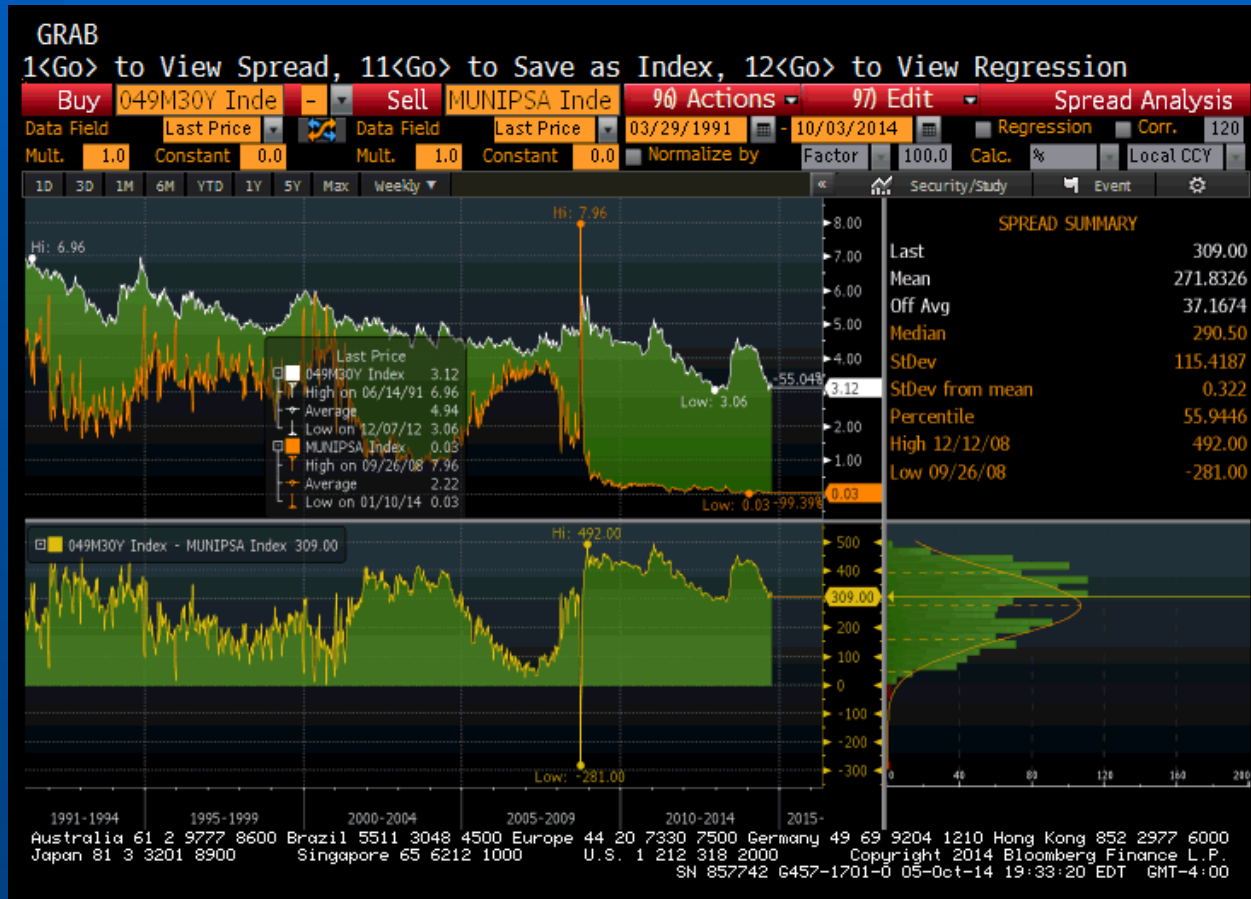
Implicit “Bets” by not using ALM

- 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 together 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**



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

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Thank You for Participating

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