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CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

Alternative Financing in the Municipal Market: Financial and Policy Considerations for Municipal Borrowers

Standard & Poor's (S&P) defines "alternative financing" as:

> "(D)ebt other than traditional long-term fixed-rate debt, notes, variable-rate demand bonds, and commercial paper commonly sold in the U.S. municipal market. Alternative financing typically includes bank loans, direct purchase bonds, and other types of privately placed debt."[1]

S&P recognizes that this type of financing has grown in response to the decline in variable-rate demand bonds, which were supported by letters of credit or other bank liquidity facilities. But the rise of alternative lending reflects other structural changes in the capital markets as well. These include:

- Liquidity facilities becoming less economical causing banks to move to restructure their auction rate securities and variable rate demand obligations (VRDOs) to fixed-rate loans;
- Deepening of the Great Recession and increasing importance of counterparty risk as a critical factor, leading borrowers to substitute credit enhancement or terminate swap agreements whenever possible;
- Dips in short and long-term rates and credit spread stabilization, precipitating borrowers refunding outstanding debt, including variable-rate obligations; and
- Experation of federal supports for new money issuance under ARRA, inducing borrowers to accelerate projects and their search for capital.

The increasingly limited capital base resulting from structural changes in the market expanded the menu of financing options available to public borrowers to include floating rate notes (FRNs), callable debt, extendable debt, century bonds, municipal guaranteed bonds, and vendor financing.[2] This also included more creative financing approaches like privately placed debt and direct loans from new market participants including hedge funds and private investors. Some borrowers were attracted by lower issuance costs or the absence of disclosure obligations provided by these new products. But as the debt market further fragmented with the introduction of alternative products, the debt portfolios of borrowers took on additional complexities. To manage this risk, borrowers need to exercise levels of due diligence not present in a traditionally structured debt portfolio that has relied on long-term, fixed rate borrowing.

ISSUER CONSIDERATIONS–ASSESSMENT OF RISK

The emergence of the alternative lending market undoubtably provides benefits to issuers by offering diversification and, often times, new sources of capital. But issuers should recognize that the structural character of these loans may differ from the traditional forms of borrowing they have used in the past. Specifically, many of these loans contain covenants that lead to acceleration, create demands on liquidity, or contain cross-default provisions for other outstanding debt of the borrower.[3] These claims may subordinate the claims of other lenders even if those lenders negotiated terms with the borrower prior to the latter borrowing in the alternative market.

Issuers' debt management policies should be updated to account for changes in the municipal market. Issuers should conduct a cost/benefit analysis for alternative debt products. They should also fully understand the proposed debt structure, what assets are pledged, the potential impacts and interdependencies, as well as how it will affect budget and operational performance. Different debt structures do not eliminate risks but they allocate them differently. In issuing any type of debt, issuers should be aware of what risks they are retaining and how those risks might be realized.

When considering alternative financing options, municipal issuers should contemplate the following:

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[1] Standard & Poor's Ratings Services, *RatingsDirect: How Standard & Poor's Considers U.S. Public Finance Alternative Financing In Its Rating Process*, March 26, 2014.

[2] FRNs are a debt instrument with a variable interest rate tied to a benchmark. Callable debt can be redeemed by the issuer prior to maturity, usually by paying a premium to the bondholder. Extendable commercial paper and bonds give the issuer or investor the option to extend the maturity date. Century bonds mature in 100 years whereas traditionally bonds mature within 40 years of issuance. With municipal guaranteed bonds, the municipality guarantees the debt of a third party. Vendor financing consists of a vendor providing a new service that is paid for by the issuer through regular rates over the life of the service.

[3] Acceleration provisions require full payment of the debt on default or give private lenders priority in default and repayment (commonly called "most favored nation" clauses).

- How does this product differ from traditional fixed-rate debt?
  - What is the rate structure?
  - How is the interest rate reset?
  - How often is the interest rate reset?
  - Are there counterparties involved?
  - How often do counterparties need to be replaced?
  - Are there any early payment provisions outside of maturity, including an acceleration or tender option?
  - Are there future burdens such as low initial costs that build over time?
- What are the key benefits and risks?
- How does this product fit into and impact the current debt portfolio and asset/liability management?
- 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 is the current market for this product?
  - Is the investor base broad?
  - Are there any limitations to the investor base?
- What transaction features are most attractive to investors?
  - Do they come with a certain cost for the issuer?
  - Do these costs outweigh the benefits?
- 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 are the rating agency's views on the product and the likely impact on credit quality?
- Does the product require expert knowledge of financial products or more intensive work to monitor markets and counterparties?
- 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?

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

Rating agencies have expressed concerns about alternative financing, in particular the structural risks associated with direct loans. The terms and conditions of these loans or obligations are often different from other forms of municipal debt and they tend to be less transparent. This fact raises concerns among credit analysts who are unable to ascertain the nature of risk pertaining to the whole portfolio of a borrower's obligations precisely because it may not be fully disclosed.[4] The increased focus on disclosure for alternative financing is, in part, due to the financial crisis during which the near total collapse of the bond insurance industry revealed the underlying credit quality of borrowers. A delay in or lack of disclosure of bank loans impairs the bond investor's ability to make a timely assessment of the loan's influence on the borrower's credit profile, hold-sell decisions, rating deterioration, and appropriate bond valuation.

In addition to increased investor interest in and demand for disclosure of alternative financings, municipal borrowers may find it prudent to disclose for the sake of transparency and in order to maintain strong relationships with investors and rating agencies. Although there are no securities laws compelling such disclosure for alternative financings, there is widespread support of voluntary disclosure by the municipal market, as evidenced in part by the creation of the Bank Loan Disclosure Task Force.[5] The Task Force published "Considerations Regarding Voluntary Secondary Market Disclosure about Bank Loans."[6] Additionally, municipal market agencies have published guidelines and briefs in support of voluntary disclosure.[7] Issuers may file disclosure documents with the market through the MSRB.[8]

The application of federal securities laws as they relate to initial disclosure of an alternative financing hinges on whether it is considered a "loan" or a "security." Loans

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[4] S&P, *Not All Loans Are Equal: Some Terms and Conditions That Make Disclosure Critical in Evaluating Credit Risk*, July 23, 2014, *available at* www.treasurer.ca.gov/cdiac/seminars/2014/20141008/risk.pdf; Moody's Investors Series, *Direct Bank Loans Carry Credit Risks Similar to Variable Rate Demand Bonds for Public Finance Issuers*, Sept. 15, 2011, *available at* www.treasurer.ca.gov/cdiac/seminars/2014/20141008/loans.pdf.

[5] The Bank Loan Disclosure Task Force is comprised of: 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), and Securities Industry and Financial Markets Association (SIMFA).

[6] SIFMA, *White Paper: Considerations Regarding Voluntary Secondary Market Disclosure about Bank Loans*, May 1, 2013, *available at* www.sifma.org/issues/item.aspx?id=8589943360.

[7] S&P, *Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance*, Feb. 18, 2014, *available at* www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1260447&SctArtId=215585&from=CM&nsl_code=LIME&sourceObjectId=8463571&sourceRevId=1&fee_ind=N&exp_date=20240219-21:48:41; MSRB Notice 2012-18, *Notice Concerning Voluntary Disclosure of Bank Loans*, Apr. 3, 2012, *available at* http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2012/2012-18.aspx; GFOA, *Understanding Bank Loans*, Sep. 2013, available at www.gfoa.org/understanding-bank-loans.

[8] MSRB's Electronic Municipal Market Access (EMMA) system is used for most debt, but the Short-term Obligation Rate Transparency (SHORT) system can be used for securities bearing interest at short-term rates, such as auction rate securities (ARS) and VRDOs.

are not subject to the disclosure rules, while securities are.[9] However, this distinction is not always clear in the language of the financing documents, and the accounting treatment of the debt is completely separate from its securities treatment. As to continuing disclosure, there are several instances where it is inapplicable to privately placed debt. First, if the issue is sold to 35 or less sophisticated investors with no intent to resell no continuing disclosure is required. Second, Rule 15c2-12 is inapplicable where there is no underwriting or no "municipal security." Because Rule 15c2-12 applies directly to underwriters – who obtain a commitment from the borrowers to provide continuing disclosures – borrowers may reasonably defer to the direct purchaser or another party in determining whether continuing disclosure is required.[10]

Borrowers may also consider whether to report a direct purchase or direct loan as part of the continuing disclosure for a previous issue. Rule 15c2-12 requires issuers to report specified "material events." However, taking on new debt is not a specified material event. As a result, issuers are not required to report it. As a best practice, an issuer should consider voluntarily disclosing when they take on additional debt if the issuer has outstanding public debt.

Issuers may also consider reporting their alternative financings on the basis of Rule 10b-5 which makes it unlawful to make a material misstatement or omit a material statement in the purchase or sale of a security. Again, where such a financing is not deemed a security, the securities laws will not apply. A fact is material where "there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest."[11] Common practice is for issuers to address Rule 10b-5 concerns absent a disclosure document. This is generally accomplished by disclosing material facts to the investor, allowing investors to ask questions and perform their due diligence, or obtaining an investor letter. Rule 10b-5 applies when issuers are speaking to the market; there is no requirement for issuers to continuously update investors. Generally, the rule is applicable upon a new offering, annual filings, material events notices, and any voluntary filing.

Alternative financing should also be disclosed in audited financial statements. The Governmental Accounting Standards Board (GASB) has particular accounting requirements for bank loans.[12]

POLICIES AND PROCEDURES – HOW TO PROTECT THE INTERESTS OF BORROWERS AND THE MARKET ALIKE

Municipalities can incorporate alternative financings into their debt policies to diversify their portfolios, access capital, or merely decrease overall market risk. However, it is critical for issuers to understand the terms of alternative financings and communicate that information to rating agencies and, at their discretion, to the market. Even with these precautions, alternative financings present a number of challenges that may not be present in more traditional borrowing. To address the challenges, borrowers may consider the following points.

First, municipalities may wish to evaluate their debt and investment management policies and ensure that alternative financings are properly addressed. Public investment managers and their counterparts on the debt side commonly structure their portfolios conservatively, but independently. As a result, the management approach used for debt issuance may be incompatible with the approach used for investing. For example, the agency may have only long-term, fixed rate debt but be invested in short-term, variable rate securities. To the extent that they make conflicting assumptions about changes in interest rates, borrowers may not be capturing the benefits of diversification or they may be taking on unrecognized market risk.

Borrowers should be aware of the terms of their obligations and avoid provisions that expose them to unknown or unreasonable risk. Alternative financings generally use legal structures similar to those used in commercial lending. Issuers may be less familiar with the transactional terms, requiring specialized expertise from bond counsel or a financial advisor. Even absent this support, a borrower is free to negotiate the terms of the financing contract. Borrowers should be wary of acceleration provisions, regulatory gross-up requirements, corporate tax change gross-up requirements, and even downgrade provisions that increase the rate.[13]

Public borrowers should also keep in mind the potential consequences that exist when they fail to disclose privately held debt or direct loans. Rating agencies rely on audit reports to review a borrower's credit position and in each review factor in the issuance of new debt and its priority with respect to other liabilities. A borrower that does not release an audit in a timely fashion may receive a ratings downgrade. Because audit reports are often late, issuers are encouraged

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9 The distinction was established in *Reves v. Ernst & Young, Inc.*, 494 U.S. 56 (1990). *See also* MSRB Notice 2011-52, *Potential Applicability of MSRB Rules to Certain "Direct Purchases" and "Bank Loans"*, Sep. 12, 2011, *available at* http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-52.aspx.

10 "Borrower" is used here in the context of a loan, but securities laws refer to a borrower who issues debt as an "issuer." As a result, we may use them interchangeably.

11 *In the Matter of the City of Miami, Florida, Cesar Odio, and Manohar Surana*, A.P. File No. 3-10022, Initial Decision Release No. 185 (June 22, 2001).

12 GASB Statement 34, Appendix C illustrates a schedule of long-term liabilities. GASB Statement 38, Appendix C, Illustration 7 is an example of disclosure of debt service requirements. Illustrations 5 and 6 of the same appendix are examples of disclosures of legal or contractual provisions violations.

13 A gross-up requirement usually appears as a provision of a loan agreement that obligates the issuer to pay a higher loan rate upon the occurrence of a specified event, such as a change in municipal regulations or tax law that would negatively affect the bank's after-tax yield.

to voluntarily disclose the terms of new debt when it is issued.

The existing alternative financing practices also have the potential to hurt bondholders, both through unfair pricing and because bondholders may have a lower priority to alternative lenders in the distribution of cash flow. Because bondholders do not currently have full and timely information about alternative financing, the pricing for traditionally financed debt may not have been fully risk-adjusted.

The current state of the municipal market leads to inconsistencies in how alternative financings are considered and disclosed. There are several approaches that may be taken to address the current discrepancies in disclosure.

1. Market-based reform;
2. State-based reform;
3. Revision of 15c2-12; or
4. Repeal of the Tower Amendment

While some market-based reforms are beginning to appear, to be truly effective the market has to reward and penalize borrowers who fail to fully disclose other obligations to bondholders. At present, there are no formal penalties for borrowers who fail to disclose. The fact that the audited financial statements of most borrowers are significantly delayed remains a concern to many investors. Market-based reform would be more effective if investors insisted on fair pricing based on full disclosure of all debt issuance. In the absence of disclosure requirements regarding alternative financing, it falls on the market to establish standards. Investors could identify the relevant information they would like borrowers to disclose. For example, issuers could be asked to develop a one-page summary of each alternative financing stating the events that could cause rates to increase or cause the debt to be due and payable immediately, any covenants that differ from the issuer's bonds, and the priority of debtholders. Alternately, investors could require issuers to provide links to proprietary documents – redacted if necessary – to allow interested parties to assess the importance and impact of new debt.[14] Both methods are in line with the voluntary disclosure guidelines published by MSRB and GFOA.[15]

There has been little state-based reform. The passage of AB 2274 (Chapter 181, Statutes of 2014) in California clarifies that loans are to be considered a "reportable" form of debt by the California Debt and Investment Advisory Commission. There is no requirement, however, that borrowers disclosure their alternative loans to EMMA where it may be more readily accessible to investors. Further, it is unknown whether other states will adopt similar measures. Absent widespread adoption of these standards disclosure will remain inconsistent from state to state.

The third approach is to revise SEC Rule 15c2-12 to deem the issuance of any new debt a material event. This is the most straightforward means of addressing investor concerns and ensuring uniform disclosure of alternative financings. While the SEC is currently seeking comment on Rule 15c2-12 in conformity with federal regulations, it is unclear whether and at what time any substantive changes will be made to the Rule.

Finally, full and complete disclosure may only be achievable if municipal issuers are required to conform to the rules that apply to corporations. This is only possible if Congress moves to overturn the protections provided by the Tower Amendment, an unlikely scenario and one that has great adverse implications for the market.

This issue brief was written by Lauren Herrera of CDIAC's Research Unit and edited by Mark B. Campbell.

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[14] Voluntary disclosure of alternative financings should include the core financing documents: bank loan agreements, lines of credit, compliance certificates and accompanying worksheets, swap documents, intercreditor agreements, and any other private placement agreements.

[15] *See* supra note 7.