

# **STAFF SUMMARY RE CHFFA/CEFA INVESTMENT GRADE PUBLIC OFFERED BOND GUIDELINE CONSIDERATION**

September 30, 2010

## **Short Summary**

The attached resolution and appendices thereto comprise staff's recommendation for a new review process for investment grade public offerings. The resolution recites the essential history to the development of the process, as well as the specific elements of the process staff will follow from inception to conclusion when analyzing a revenue bond transaction.

## **Background**

The Authorities established the written bond-issuance guidelines attached as Exhibit A to the resolution in 2000. Since their inception, borrowers have occasionally requested and been granted various exceptions to the guidelines. Coinciding with the auction, variable rate and insurer challenges over the course of the last 24 months, top borrowers from both Authorities have increasingly asked for exceptions to the guidelines.

Given the increasing number of requests for exceptions to the guidelines and the near decade of time that had passed since the guidelines were originally implemented, staff from both Authorities formed a working group to carefully consider whether any amendments to the guidelines might be merited. The working group was composed of representatives from the following: (1) both Authorities' rank and file, (2) counsel routinely serving as bond counsel to the Authority, (3) counsel from the Treasurer's office, (4) counsel from the Attorney General's Office, (5) the Authorities' financial advisor, Public Financial Management, and (6) the State Treasurer's Office Public Financial Division.

Members of the working group engaged in a variety of activities to help evaluate the guidelines. Staff talked with and reviewed the policies of other statewide, as well as other national conduit issuers to get a sense of what other conduit issuers are doing. Staff developed mission statements for both Authorities to help tether the evaluation of the guidelines around the key tenets of the organizations. Staff also researched and identified the most recent ratings for the top borrowers of each Authority. The Attorney General's office reviewed the legislative history behind both organizations, the statutes in place for both Authorities and specifically, the statutes spelling out the requirements for both Authorities whenever an application for bond approval is submitted to the Authorities. Representatives from Public Financial Management researched statewide and national default rates for healthcare transactions and provided the knowledge needed to more clearly understand the various credit ratings assigned by rating agencies and how these ratings are construed by the market. Bond counsel helped the working group to identify the business and legal risks faced by conduit bond issuers, as well as how conduit bond issuers might best mitigate these risks through appropriate disclosures, covenants, representations and indemnities.

Grounded to the Authorities, respective missions to provide ready access to capital for their borrowers, the working group has worked to balance the mission against the need to minimize various risks to each Authority, including legal, financial and reputational risks. Considering the unprecedented market conditions of the past few years, the working group recognizes that further changes that cannot be predicted are inevitable.

### **Proposed New Process for Investment Grade Rated Transactions**

Bond issuance guidelines for both Authorities are currently prescriptive; various covenants and security measures are required. If a borrower does not completely meet the requirements, a formal exception is required. To avoid the challenge with distinguishing factual circumstances that might qualify for an exception (or not) and to respond to the changes in the market over the last decade, the working group focused on developing a system of staff diligence and investigation in reviewing what each finance team puts together as an appropriate credit package. The new process brings flexibility to the table and the working group believes will likely be more responsive to future market conditions than the previous “yes/no” style inherent to the prescriptive guidelines.

The required rating threshold has been modified to mirror the market distinction between Investment Grade and Non-Investment Grade securities. The working group duly considered the presentations from Brad Spielman of Moody’s Investors Service and John Bonow of Public Financial Management which reflected their research of past transactions nationwide indicating that adjusting CHFFA’s prior cut-off for additional sale restrictions below BBB+ to the new public offering requirement for all ratings above BBB- does not raise the risk of default. The working group also acknowledged a seemingly arbitrary difference between CEFA and CHFFA in that CEFA has a cut-off at the BBB level rather than CHFFA’s BBB+. The working group placed priority on having consistent demarcations based on objective criteria.

Accordingly, the attached resolution memorializes the review process staff recommends for all future CEFA and CHFFA publicly offered investment grade rated bond transactions.

# Exhibit A

## CEFA BOND ISSUANCE GUIDELINES PER BOND RATING CATEGORY

The following are the Authority's bond issuance guidelines. These guidelines describe what CEFA would expect to see given a transaction with a particular rating (or no rating). The Authority reserves the right to use its discretion as necessary. However, each financing must be reviewed individually and exceptions to these guidelines may be considered if the applicant demonstrates that such exception is a necessary part of a cost-effective and prudent borrowing strategy; conversely, the Authority has the flexibility to add additional requirements as circumstances warrant. Appendix A provides a written summary of these guidelines.

BOND RATING (1)	LOAN SECURITY PROVISIONS	BOND COVENANTS
<b>I. A/A or higher rated debt (public offering)</b>	<ul style="list-style-type: none"> <li>General Obligation Pledge</li> </ul>	<p><u>Reporting Covenants:</u></p> <ul style="list-style-type: none"> <li>Annual submission of Certificate of Compliance with CEFA Statute, Continuing Disclosure, financial and other covenants.</li> <li>Annual submission of Arbitrage Reports to Authority</li> <li>Annual Audited Financial Statements</li> <li>Interim internal financial information, if requested</li> </ul>
<b>II. BBB/BBB/Baa (public offering)</b>	<ul style="list-style-type: none"> <li>General Obligation Pledge</li> <li>Revenue Pledge</li> <li>Debt Service Reserve Account (must be funded at all times with internal cash, bond proceeds, letter of credit or surety bond)</li> <li>Secured with real property or other assets with an appraised value of at least 100% of bond size (with appropriate release conditions), dependent on the overall asset base and financial strength of the applicant</li> </ul>	<p><u>Reporting Covenants:</u></p> <ul style="list-style-type: none"> <li>Annual submission of Certificate of Compliance with CEFA Statute, Continuing Disclosure, financial and other covenants.</li> <li>Annual submission of Arbitrage Reports to Authority</li> <li>Annual Audited Financial Statements</li> <li>Interim internal financial information, if requested</li> </ul>
<b>III. Less than BBB/BBB/Baa rated debt or unrated debt</b>	<ul style="list-style-type: none"> <li>Must be privately placed (in both primary and secondary markets) with a "Qualified Institutional Buyer" as defined by SEC Rule 144A, promulgated under the Securities Act of 1933</li> <li>Minimum denomination of \$100,000</li> </ul> <hr/> <ul style="list-style-type: none"> <li>General Obligation Pledge</li> <li>Revenue Pledge</li> <li>Debt Service Reserve Account (must be funded at all times with internal cash, bond proceeds, letter of credit or surety bond)</li> <li>Secured with real property or other assets with an appraised value of at least 100% of bond size (with appropriate release conditions), dependent on the overall asset base and financial strength of the applicant</li> </ul>	<p><u>Other Covenants</u></p> <ul style="list-style-type: none"> <li>Financial and other covenants as appropriate</li> </ul>
<b>IV. Unrated debt for Equipment Program (for equipment purchases generally \$5 million or less)</b>  <b>Private placements for colleges with current debt ratings of BBB/BBB/Baa or higher.</b>	<ul style="list-style-type: none"> <li>Must be privately placed (in both primary and secondary markets) with a "Qualified Institutional Buyer" as defined by SEC Rule 144A, promulgated under the Securities Act of 1933</li> <li>Minimum denomination of \$100,000</li> </ul>	<p><u>Reporting Covenants:</u></p> <ul style="list-style-type: none"> <li>Annual submission of Certificate of Compliance with CEFA Statute, Continuing Disclosure, financial and other covenants.</li> <li>Annual submission of Arbitrage Reports to Authority</li> <li>Annual Audited Financial Statements</li> <li>Interim internal financial information, if requested</li> </ul>

(1) Refers to broad rating categories used by Standard & Poor's/Fitch/Moody's, irrespective of rating modifiers (i.e. - 1/2/3 or +/-)

Revision: 9/30/99

## APPENDIX A

### **CEFA BOND ISSUANCE GUIDELINES PER BOND RATING CATEGORY**

The Authority will generally expect to see the following security provisions and bond covenants given a transaction with a particular rating (or no rating), as specified below, and reserves the right to use its discretion as necessary. Each proposed financing will be reviewed individually and exceptions to these guidelines may be considered if the applicant demonstrates that such an exception is a necessary part of a cost-effective and prudent borrowing strategy; conversely, the Authority has the flexibility to add additional requirements as circumstances warrant.

The ratings shown are the respective categories of Standard & Poor's, Fitch and Moody's. The guidelines relate to the broad rating category and do not distinguish whether a rating includes a numerical (1, 2 or 3) or another ("+" or "-") modifier.

#### **I. A/A/A or Higher Rated Debt (public offering)**

##### **1. Loan Security Provision: General Obligation Pledge**

##### **2. Reporting Covenants:**

- a. Annual submission of Certificate of Compliance with CEFA Statute, Continuing Disclosure, financial and other covenants
- b. Annual submission of Arbitrage Reports to Authority
- c. Annual Audited Financial Statements
- d. Interim internal financial information, if requested (e.g. – budgets, comparison of actual financial results to budget, projections, etc.)

#### **II. BBB/BBB/Baa (public offering)**

##### **1. Loan Security Provisions:**

- a. General Obligation Pledge
- b. Revenue Pledge (Lien perfected at closing, enforceable by Trustee, in the event of notice of default by Borrower)
- c. Debt Service Reserve Account (must be funded at all times with internal cash, bond proceeds, letter of credit or surety bond)
- d. Secured with real property or other assets with an appraised value of at least 100% of bond size (with appropriate release provisions), dependent on the overall asset base and financial strength of the applicant

## **CEFA BOND ISSUANCE GUIDELINES PER BOND RATING CATEGORY**

### **2. Reporting Covenants:**

- a. Annual submission of Certificate of Compliance with CEFA Statute, Continuing Disclosure, financial and other covenants
- b. Annual submission of Arbitrage Reports to Authority
- c. Annual Audited Financial Statements
- d. Interim internal financial information, if requested (e.g. – budgets, comparison of actual financial results to budget, projections, etc.)

- 3. Financial and other covenants** as appropriate, the specific terms of which would be at the discretion of the Authority and the credit enhancer, if credit enhancement is utilized.

### **III. Less than BBB/BBB/Baa Rated Debt or Unrated Debt**

#### **1. Loan Security Provisions:**

- a. Must be privately placed (in both primary and secondary markets) with a “Qualified Institutional Buyer” as defined by SEC Rule 144A, promulgated under the Securities Act of 1933
- b. Minimum denomination of \$100,000
- c. General Obligation Pledge
- d. Revenue Pledge (Lien perfected at closing, enforceable by Trustee, in the event of notice of default by Borrower)
- e. Debt Service Reserve Account (must be funded at all times with internal cash, bond proceeds, letter of credit or surety bond)
- f. Secured with real property or other assets with an appraised value of at least 100% of bond size (with appropriate release provisions), dependent on the overall asset base and financial strength of the applicant

#### **2. Reporting Covenants:**

- a. Annual submission of Certificate of Compliance with CEFA Statute, Continuing Disclosure, financial and other covenants
- b. Annual submission of Arbitrage Reports to Authority (including periodic construction spending progress reports, if applicable)
- c. Annual Audited Financial Statements
- d. Interim internal financial information, if requested (e.g. – budgets, comparison of actual financial results to budget, projections, etc.)

- 3. Financial and other covenants** as appropriate, the specific terms of which would be at the discretion of the Authority and Qualified Institutional Buyer of the bonds.

## **CEFA BOND ISSUANCE GUIDELINES PER BOND RATING CATEGORY**

### **IV. Unrated debt for Equipment Program (for equipment purchases generally \$5 million or less) and Private Placements for colleges with current debt ratings of BBB/BBB/Baa or higher.**

The guidelines in section “I” through “III” are based on the rating of the bonds to be issued. However, this is a special category where the guidelines relate to the type of transaction. The Authority will give special consideration to *small equipment private placements* and to *private colleges with current debt ratings of BBB/BBB/Baa or higher* that want to privately place their bond offerings. For these particular types of transactions, the loan security provisions and bond covenants are streamlined as outlined below.

#### **1. Loan Security Provisions:**

- a. Must be privately placed (in both primary and secondary markets) with a “Qualified Institutional Buyer” as defined by SEC Rule 144A, promulgated under the Securities Act of 1933
- b. Minimum denomination of \$100,000

#### **2. Reporting Covenants:**

- a. Annual submission of Certificate of Compliance with CEFA Statute, Continuing Disclosure, financial and other covenants
- b. Annual submission of Arbitrage Reports to Authority
- c. Annual Audited Financial Statements
- d. Interim internal financial information, if requested (e.g. – budgets, comparison of actual financial results to budget, projections, etc.)

# Exhibit B

## CALIFORNIA EDUCATIONAL FACILITIES AUTHORITY INVESTMENT GRADE PUBLIC OFFERINGS

### Revenue Bond Application Review Process

#### I. INVESTMENT GRADE RATING REQUIRED

- (A) Borrower must obtain an Investment Grade Rating from at least 1 nationally recognized rating agency on bonds to be issued; BBB-/BBB-/Baa3 or better from S&P/Fitch/Moody's
- (B) For Variable Rate Bonds that may be Converted to Fixed Rate Bonds without further CEFA action, Indenture provisions shall require confirmation prior to the Conversion that an Investment Grade Rating will apply to the bonds following Conversion
- (C) If proposed bonds have more than one rating, the highest rating shall be used to determine compliance except when one of the ratings falls below BBB-/BBB-/Baa3, regardless of the higher rating CEFA will not treat the requested bonds as having an Investment Grade Rating

#### II. CEFA STAFF EVALUATION PROCESS

- (A) Staff Diligence Pursuant to § 94142 (link)
- (B) Work Compiled in Staff Report
  - (1) Sample Staff Report Form (link)
  - (2) Draft Report will be provided to Borrower, UW, BC, CEFA's Financial Analyst and AG for review and comment
  - (3) Final Report Sent to Authority Members 7 Days Prior to Meeting
  - (4) Deference to Cal Mortgage Loan Committee credit review process
- (C) Staff Makes Recommendation but Authority retains discretion

#### III. CONSIDERATION OF COVENANTS AND SECURITY FOR BONDHOLDERS

- (A) Borrower and CEFA Analyst to compile list of key provisions; CEFA does NOT require particular covenants
- (B) Clarify which entities' finances secure repayment of CEFA loan, e.g. single Borrower corporation, Obligated Group, Guarantors

- (C) Sample Covenants/Security (#1 is required; ## 2-4 are strongly preferred; remaining ones are examples of what is often seen in various financings depending on credit strength and market conditions)
- (1) Unconditional Promise to Pay
  - (2) Gross Revenue or Gross Receivables Pledge
  - (3) Negative Pledge Against Prior Liens
  - (4) Limited Permitted Encumbrances
  - (5) Debt Service Reserve Fund
    - (a) Would one be funded with bond proceeds or equity
    - (b) If it is a springing funding requirement, what is the trigger
    - (c) How is the reserve requirement sized
    - (d) Is a surety or letter of credit permitted in lieu of a cash deposit
    - (e) Are there circumstances where all moneys in the reserve may be released
  - (6) Debt Service Coverage Requirement
    - (a) Maximum Annual Debt Service or Annual Debt Service to be covered; what is the required ratio; how low can it be before default?
    - (b) Is a Consultant review required if the ratio falls below a threshold?
    - (c) Steps and Timing Before Event of Default
  - (7) Additional Debt Limitation
  - (8) Disposition of Cash and Property Limitations
  - (9) Cash or Liquidity Requirements
  - (10) Debt to Capitalization Requirement
  - (11) Security Interest in Designated Property
  - (12) Mortgage or Deed of Trust
  - (13) Other



# Exhibit C

## CALIFORNIA EDUCATIONAL FACILITIES AUTHORITY INVESTMENT GRADE PUBLIC OFFERINGS

### Revenue Bond Application Resources and Review Process

#### OUTLINE

- I. CEFA MISSION STATEMENT (link)
- II. CEFA COMMITMENT TO “CUSTOMER” SERVICE
- III. CEFA ACT (link)
  - (A) Qualifying Borrowers; Definition of “Participating Private College” (link)
  - (B) Qualifying Projects; Definitions of “Project,” “Cost,” and “Private College” (link)
  - (C) Financed Projects must comply with CEQA (link to § 94212 and required documentation)
  - (D) State Treasurer (STO) acts as agent for sale for CEFA (link)
- IV. CEFA MEETINGS/HEARINGS/AGENDA REQUIREMENTS
  - (A) Transactions are set for hearings and approvals after receipt of an application (see Article VI below)
  - (B) Under Regulations Section 9006, Regular Meetings are held the fourth Thursday of each month, unless otherwise ordered by the Authority. By resolution, Regular meetings are ordered for the last Thursday of every month at approximately 1:30 pm at CEFA offices in Sacramento (link)
  - (C) Special Meetings are possible in extraordinary circumstances
  - (D) Agenda Deadlines (CEFA must distribute each meeting agenda at least ten days in advance of meetings unless there is an extraordinary situation meeting legal requirements for shorter notice; link to public meeting law)
  - (E) TEFRA Hearing Arrangements
    - (1) A single public hearing covers projects throughout the State
    - (2) CEFA’s custom is to hold hearings at its offices on the Wednesday preceding each regular monthly meeting at 10:00 a.m.; Borrowers are not required to attend; alternative days and times available upon request

- (3) Bond Counsel arranges publication of hearing notices and provides affidavits of publication to CEFA at least 2 business days prior to the hearing
- (4) STO provides issuer approval certificate within 10 days after hearing (link to model certification language)
- (F) Single Meeting Approval via Resolution (link to model resolution)

#### V. SELECTION OF FINANCE TEAM

- (A) Underwriter(s) may be designated by Borrower from STO approved Underwriter Pool (link)
- (B) Borrower selects its own Counsel
- (C) Borrower may select Bond Counsel with CEFA consent
- (D) CEFA represented by Attorney General's (AG) Office or a designated outside attorney, acting as issuer counsel
- (E) CEFA/ Financial Advisor is PFM
- (F) STO is Agent for Sale (following approval, pricing and bond sale are to be coordinated through CEFA with STO)
- (G) Trustee/Paying Agent May Be Selected by Borrower with CEFA consent
- (H) CEFA will designate an Analyst for each Financing as Primary Contact
- (I) CEFA Analyst will provide contacts for CEFA/STO/AG participants
- (J) Credit or Liquidity Enhancer Identified by Borrower

#### VI. APPLICATION SUBMISSION

- (A) Staff Assistance Available Prior to Formal Application
  - (1) Discuss Project/Borrower Eligibility
  - (2) Consideration of Corporation an appropriate Applicant and Borrower
  - (3) Resources for Municipal Borrowing Information (links to STO resources; CDIAC Primer and materials gathered by CEFA)
- (B) On-Line Application Form (link)
- (C) Timing – Due by first business day of month in which approval is sought

- (D) Application Fee ([link](#)); Issuance Fee Information ([link](#))
- (E) Borrower Documents Requested with Application
  - (1) Latest Audited Financial Statements
  - (2) Latest Unaudited Financial Information
  - (3) Previous Official Statement (if any)
  - (4) Evidence of CEQA Compliance or Exemption
  - (5) Draft of CEFA Resolution
  - (6) Master Indenture or other document containing Borrower or existing covenants
  - (7) Latest Rating Agency Reports of Borrower
- (F) Bond Documents
  - (1) Substantially Final Drafts Due No Later than 10th of the month in which approval is sought; further refinements of the documents may continue to be submitted to CEFA staff
  - (2) Standard Provisions of CEFA Loan Agreements and Indentures to be Used ([link](#))
    - (a) Recitals
    - (b) Representations
    - (c) Reporting Requirements
    - (d) Indemnification
    - (e) California Choice of Law
    - (f) Venue in Sacramento County
    - (g) CEFA Named as “Additional Insured”
    - (h) Signature Block format
  - (3) Tax Agreement Provisions, including rebate reporting ([link](#))
  - (4) CEFA Closing Certificate Forms ([link](#))

(G) Underwriting Documents

- (1) Substantially final drafts due no later than 10th of the month in which approval is sought; further refinements of the documents may continue to be submitted to CEFA staff
- (2) Standard provisions of CEFA Bond Purchase Agreement and Official Statement (link)
  - (a) CEFA disclosure/disclaimers
  - (b) Required Legal Opinions
    - (i) Issuer Counsel
    - (ii) Bond Counsel (validity opinion and supplemental opinion including SEC Act § 10b(5) opinion)
    - (iii) Underwriters' Counsel
    - (iv) Borrower Counsel (must cover SEC § 10b(5) opinion on full OS with very limited exclusions)
- (3) Authority 15c-2(12) Certificates (link to model and process and timing for obtaining from CEFA)

VII. INVESTMENT GRADE RATING REQUIRED

- (A) Borrower must obtain an Investment Grade Rating from at least one nationally recognized rating agency on bonds to be issued; BBB-/BBB-/Baa3 or better from S&P/Fitch/Moody's
- (B) For Variable Rate Bonds that may be Converted to Fixed Rate Bonds without further CEFA action, Indenture provisions shall require confirmation prior to the Conversion that an Investment Grade Rating will apply to the bonds following Conversion
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  - (1) Sample Staff Report Form (link)

- (2) Draft Report will be provided to Borrower, UW, BC, CEFA's Financial Analyst and AG for review and comment
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  - (5) Debt Service Reserve Fund
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    - (b) If it is a springing funding requirement, what is the trigger
    - (c) How is the reserve requirement sized
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    - (a) Maximum Annual Debt Service or Annual Debt Service to be covered; what is the required ratio; how low can it be before default?
    - (b) Is a Consultant review required if the ratio falls below a threshold?
    - (c) Steps and Timing Before Event of Default

- (7) Additional Debt Limitation
- (8) Disposition of Cash and Property Limitations
- (9) Cash or Liquidity Requirements
- (10) Debt to Capitalization Requirement
- (11) Security Interest in Designated Property
- (12) Mortgage or Deed of Trust
- (13) Other

X. CONTINUING DISCLOSURE

- (A) Comply with SEC Rule 15c2-12
- (B) Authority Standard Provisions ([link](#))