Direct Bank Placements

Credit Implications
Special Report

Over the last 12−18 months, Fitch Ratings has noted an increasing use of direct bank placements (DBPs) as part of an overall plan of finance used by a wide range of municipal and not-for-profit issuers. DBPs provide municipal issuers with increased funding option flexibility and often have been used to refund publicly offered variable-rate demand bonds (VRDBs). Fitch views the risks inherent in DBPs to be similar to the risks assumed by issuers in VRDB structures as discussed in Fitch's report "High Demand/Diminished Supply," dated Dec. 8, 2010, available on Fitch's Web site at www.fitchratings.com. In that report, Fitch briefly discussed DBPs, and this report expands on those comments.

The following are the material credit issues, both positive and negative, associated with DBP financing structures that issuers and investors should be aware of:

No Disclosure Requirement: While most DBPs are structured as a separate bond issue, they are privately placed with the lender (generally a commercial or investment bank) and do not have public disclosure requirements despite being on parity with the issuer's outstanding debt. If Fitch is not requested to provide a rating, it is imperative that issuers promptly notify Fitch of the issuance of DBPs. Moreover, Fitch believes timely and detailed disclosure of a DBP financing to all market participants to be a management best practice.

Unique Performance Covenants: Similar to bank reimbursement agreements utilized in VRDBs supported by bank letters of credit (LOCs) or standby bond purchase agreements, the documents for DBPs may contain more stringent performance covenants and event of default triggers that are broader than events of default in documents for parity debt. In addition, VRDBs and DBPs have a shortened amortization schedule (or in some cases for DBPs, a hard put) at the end of the bank commitment period.

Refinance Risk: As with VRDBs issued with bank liquidity support, issuers may be vulnerable to potential refinancing risk at the end of the commitment period, which generally runs between three to seven years.

Elimination of Counterparty Risk: Unlike VRDBs, DBPs do not have support facilities and therefore do not expose issuers to the risk of a rating downgrade to the bank counterparty.

No Remarketing Risk: Floating-rate DBPs are usually priced based on a formula that uses an index rate (such as 30-day LIBOR) plus a credit spread. Because of this formulaic pricing, issuers are not subject to placement and pricing risks. DBPs may also be structured as fixed-rate bonds.

Related Research

High Demand/Diminished Supply, Dec. 8, 2010

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Background

DBPs are typically issued as a separate series of bonds that are directly placed with a commercial or investment bank for a set commitment period, typically three to seven years, although it may be up to 10 years for higher rated borrowers. As with VRDBs, DBPs are often structured as multi-modal bonds with an amortization schedule and a long final maturity. The interest rate may be a floating rate that is calculated using an index (e.g., a percentage of 30-day LIBOR) plus a credit spread or may be a fixed rate for the commitment period. At the end of the commitment period there is a mandatory put back to the issuer. Generally speaking, if the issuer is unable to remarket or repurchase the bonds, the bank will continue to hold the bonds at a higher interest rate and the bonds will be subject to an accelerated amortization schedule.

In addition, similar to VRDBs that are held as bank bonds, bank purchasers often have the right to increase the interest rate following a regulatory or tax event or an event of default. Following certain events of default, the issuer may be required to immediately repurchase the bank bonds or DBPs, as the case may be. This acceleration of the bonds upon the obligation to repurchase may be granted to bank bond or DBP holders even when parity bondholders have no similar right to accelerate bonds.

Fitch believes that increased use of DBPs is being driven by changes in the regulatory landscape, as well as current global economic conditions affecting the banking industry. First, with the anticipated implementation of Basel III in 2014, banks that provide LOCs will likely be subject to increased liquidity/capital requirements, which will increase the cost of these facilities. DBPs, on the other hand, are funded assets, with no associated liquidity requirement. Second, bank downgrades as well as the decision by certain banks to exit the market have altered the landscape of the banks that are able to provide LOCs on VRDBs.

Disclosure

Because DBPs are not publicly offered, issuers are not required to post the loan documents to a Nationally Recognized Municipal Securities Information Repository (NRMSIRs) or the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access (EMMA) system. Furthermore, under Rule 15c2-12 of the Securities Exchange Act of 1934, issuance of additional debt is not considered a "material event" requiring notification to the information repositories. Therefore, investors and rating agencies may be unaware of an issuer's use of a DBP until the release of audited financial statements. Even then, any information regarding the terms of the DBP would be subject to the level of disclosure provided by the auditor.

Fitch views detailed and timely disclosure to be a management best practice. Fitch is aware that certain bank purchasers ask issuers to post DBP transaction documents to EMMA. It is imperative that issuers promptly disclose the pertinent details of a DBP to Fitch (and investors). As indicated in all rating letters, it is important to keep Fitch informed of developments that may have an impact on the credit profile of an issuer and its outstanding debt. Consequently, Fitch would like issuers of DBPs with rated debt to provide the copies of the financing documents supporting DBPs to determine the impact, if any, on the bonds rated by Fitch. While not ideal, at the very least, Fitch will be made aware of DBPs through its routine surveillance.

Related Criteria

Revenue-Supported Rating Criteria, June 20, 2011

U.S. Local Government Tax-Supported Rating Criteria, Aug. 15, 2011

U.S. State Government Tax Supported Rating Criteria, Aug. 15, 2011

Impact on Security

DBPs are typically structured as bonded debt that is on parity with the issuer's outstanding senior debt. Similar to bank reimbursement agreements and supplemental indentures, the

covenant package in a DBP may include a unique set of performance covenants not granted to all bondholders. Because the remedies of a covenant default under the DBP are not likely to run to the bond trustee(s) who must act in the interest of all bondholders, Fitch believes this could create a situation where the interests of all bondholders are not being equally addressed.

To accurately assess risk to rated debt, Fitch needs to evaluate documents associated with DBPs. Terms governing DBPs are usually contained in the bank agreement, which is typically a supplement to the bond indenture, and may incorporate or cross reference bond resolutions or indentures under which bonds are issued. Fitch focuses on the representations and warranties, covenants, and events of default governing DBPs, which can include cross-default provisions and acceleration or a mandatory tender or redemption upon certain events. These remedies upon default could have a negative impact on the credit profile of an issuer and possibly cause a rating downgrade if issuers must refinance or repay bonds in an accelerated time frame.

Refinance Risk

Under a DBP, bonds are often structured as multi-modal securities with a long maturity and a mandatory put. At the end of the commitment period, the issuer can remarket the bonds in variety of different modes (e.g., fixed, VRDBs, DBP). DBPs generally have longer commitment periods (3–7 years), compared to shorter commitment periods for LOCs and SBPAs (1−3 years). Regardless, the issuer assumes interest rate and market access risk at the end of the commitment period just as they would in a traditional VRDB.

Fitch assesses refinancing risk by gauging an issuer's market access and ability to absorb an elevated interest rate or accelerated amortization. Clearly, issuers with higher ratings or strong cash positions that could redeem DBPs if necessary have less market access risk. To analyze interest rate risk, Fitch applies the same bank bond stress scenarios as it does with VRDBs *(see Fitch Research on "Revenue-Supported Rating Criteria," dated June 20, 2011, "U.S. Local Government Tax-Supported Rating Criteria," dated Aug. 15, 2011, and "U.S. State Government Tax Supported Rating Criteria," dated Aug. 15, 2011, all available on Fitch's Web site at www.fitchratings.com, for a description of the approach to rating bank bonds).*

Elimination of Counterparty Risk and Remarketing Risk

An advantage for issuers that DBPs have over VRDBs is the elimination of counterparty and remarketing risk. Issuers of VRDBs bear increased costs when holders tender bonds during periods of market dislocation or banking system stress. The resulting failed remarketings lead to bank facility purchase draws, followed by higher bank bond interest rates and accelerated amortization periods.

The formulaic pricing employed for DBPs removes the volatility and risk associated with traditional third-party remarketing agreements. VRDB pricing under a remarketing agreement is influenced by market conditions and investor appetite, as well as the individual remarketing agent's current inventory and capital availability. Issuers with bank-supported VRDBs have been negatively affected by a very wide variation of pricing and put experience on bonds supported by a particular LOC, reflecting the differences in remarketing agents' capabilities, inventories, and capital positions.

Rating Impact

From a credit standpoint, while DBPs provide issuers with another funding option, Fitch's greatest concern is the lack of any required market disclosure under a DBP financing structure. Fitch expects that issuers will provide timely notification of the intention to enter into DBPs, as

well as the related documentation prior to execution of the transaction. When Fitch is informed of a DBP, Fitch evaluates the DBP agreement for the presence of the additional risks discussed in this report.

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