

### Credit FAQ:

## Changes And Challenges In The Variable-Rate Debt Market

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Based on a review by Standard & Poor's Ratings Services, issuers of variable-rate debt in U.S. public finance continue to feel the effects of the credit market dislocation of 2008. Debt managers and investors have had to cope with the fallout of the dislocation, including the deterioration of the monoline bond insurers and reduced liquidity available from the banking sector, in the past 18 months. We believe that significant challenges and risks remain in the market. The following responses to some frequently asked questions provide some insight regarding our views on several current issues relating to variable-rate debt issuance.

## Frequently Asked Questions

### **What are some of the key changes you have observed since 2008?**

With the credit market disruptions, investor demand for auction-rate securities (ARS) contracted dramatically, contributing to the dismantling of the approximately \$200 billion ARS market. Issuers of ARS typically restructured their outstanding ARS into variable-rate demand obligations (VRDOs), which require third-party liquidity, most typically in the form of liquidity or credit facilities, such as letters of credit (LOCs) and standby bond purchase agreements (SBPAs). When combined with the substantially larger universe of outstanding variable-rate debt, the demand for liquidity support started to exceed available supply. Like any other market, the dynamic of increased demand and constrained supply pushed up prices on bank liquidity. Given the overall weakening of bank credit quality, the municipal market now faces new pressures. These pressures are seen most easily in higher bank fees and weaker bank commitments and provisions that reallocate risks to the issuers and obligors.

### **What is your view of the impact of this reduced availability and increased cost of bank liquidity?**

We think the higher cost of liquidity comes at a bad time for governments and enterprises due to the recession and the difficult budget environment for most. Some issuers have reported that costs of liquidity facilities have increased as much as 10 times from before the crisis. We see the availability of liquidity as a significant risk and challenge due to the high volume of bank facility expirations facing the sector. Market-wide, more than \$103 billion in bank liquidity facilities are estimated to expire in 2010 and another \$101 billion in 2011, according to Bloomberg data. We believe that issuers will need to actively manage and plan for these expirations given the current market dynamics. Failure to react in a timely manner could substantially increase debt service costs.

### **Do you think that variable-rate debt will continue to be part of a government's debt portfolio?**

Variable-rate debt is attractive to many obligors due to the lower costs associated with short-term rates. Some issuers chose to hedge their variable-rate debt with swap agreements. If it is costly to terminate the swap, there is a significant incentive to keep the associated debt obligation in variable-rate mode. We have seen a significant conversion to fixed-rate debt by obligors uncomfortable with the costs of VRDOs, bank counterparty risk, remarketing risk, or bank facility rollover risk.

### **What do you think will happen if an issuer cannot refinance outstanding VRDOs?**

Municipal obligors who are not able to extend or replace an existing LOC or SBPA may face accelerated repayment of their debt due to bank bond term-out provisions. The compressed time frame for funding debt service could cause

significant budget or liquidity pressure and, in our view, ultimately lead to credit deterioration, particularly if the agreements contain "accelerated payment provisions" exercisable by the liquidity provider.

**What does the term "accelerated payment provisions" mean?**

This term will be used throughout the article to refer to an investor's ability to require early repayment of principal that is not scheduled based on certain events, with repayment required on a compressed time frame, generally less than 180 days.

**Have you seen new solutions emerge to address some of these challenges?**

We have seen a range of new structures and options as obligors look for alternatives to bank liquidity. These alternatives generally have a blend of traits from bond anticipation notes (BANs), extendible commercial paper, and traditional VRDOs. We are also seeing a trend toward direct purchase of obligations by banks subject to the terms of some form of purchase agreement. We expect the range of options to expand over the next year but they will ultimately be subject to investor and obligor acceptance.

**What key features of these alternatives have you seen?**

We have observed that each of the financings have unique terms, conditions, and maturities. The common feature is eliminating the bank or other third party as the source of liquidity and in its place the obligor assumes a more significant role in the overall structure compared to traditional VRDOs, including accepting accelerated payment provisions that are not covered by third-party liquidity in some cases.

**What credit risks do you see in the structures?**

We have observed a migration of risk to obligors in many of these structures but the degree of this risk transfer depends largely on the structure. We think that the primary risk is tied to the obligor's willingness to accept the potential liquidity pressures derived from accelerated repayment provisions, particularly related to events outside of its immediate control and potentially unrelated to its own credit, such as covenants and a range of other conditions. Based on our observations, very few obligors in the public finance universe maintain sufficient liquid assets to meet accelerated payment provisions. Our primary focus, therefore, relates to our assessment of liquidity and timing. If there are any accelerated payment provisions that would require an obligor to pay a bondholder on short notice (generally less than 180 days), we will assess the quality and sufficiency of the obligor's liquidity reserves in accordance with our self-liquidity criteria.

Standard & Poor's believes that a period of 180 days is generally sufficient to allow for access to other sources of liquidity, including market access, and that accelerated payment provisions requiring payment in this time horizon pose manageable risks. In addition, we believe that accelerated payment provisions based solely on the obligor's failure to timely pay principal and interest on the bonds, or the obligor's bankruptcy, pose less of a liquidity risk for highly rated credits.

**What role would management play in your assessment of the structure and credit implications?**

Standard & Poor's expects that obligors are able to fully discuss the rationale, benefits, risks, and risk mitigation related to entering into any type of debt transaction. Our Financial Management Assessment methodology and other management assessments incorporate our assessment of this ability. We will also review the details of a transaction and assess how they fit within the overall debt profile. This would include a review of how much debt is subject to accelerated payment provisions relative to the total debt of the obligor. We will request information on the administrative process or policies in place to manage the refinancing and liquidity risk if applicable. This includes information on the range of options to refinance, the time frame involved, what approvals would be necessary, and

other issues that we think could affect the timing of market access.

**What do you see as the credit implications of this type of structure?**

We understand that these structures are providing a cost-effective financing option for obligors that may also be minimizing risks in other areas such as bank counterparty risk or remarketing risk. However, in structures with accelerated payment provisions, we think it would be important to understand the tradeoff between liquidity risks and potential interest-rate savings. Depending on the magnitude of the risk determined by our analysis, rating actions could occur.

**Why do you view these differently from structures typically found in letter of credit reimbursement agreements or standby bond purchase agreements?**

In our view, the fundamental difference between these transactions and obligations incurred under LOC reimbursement agreements or SBPAs is that these provisions are current instead of contingent. Once these issues are marketed, the accelerated repayment provisions can occur if any of the events are triggered. In LOC or SBPA-backed bond issues, there typically not only needs to be a trigger event but also the purchase of the bonds by the LOC or SBPA provider for the accelerated repayment provisions of the LOC reimbursement agreement or the SBPA to be triggered.

**What rating symbols are used for these types of transactions?**

The rating symbols used by Standard & Poor's reflect the structure of the obligation. Variable-rate debt with the ability of the investor to put the obligations to the issuer within 13 months will receive a dual rating. If there is a mandatory tender date within 13 months, only a short-term rating will be assigned (see "Credit FAQ: Application of Dual Ratings In U.S. Public Finance," published Aug. 19, 2008, on Ratings Direct). If the debt maturity or mandatory tender dates are beyond 13 months and there are no accelerated payment provisions, only a long-term rating will be assigned.

Related Research

- USPF Criteria: Commercial Paper, VRDO, And Self-Liquidity, July 3, 2007
- Criteria: Methodology And Assumptions: Approach To Evaluating Letter Of Credit-Supported Debt, July 6, 2009
- USPF Criteria: Standby Bond Purchase Agreement Automatic Termination Events, April 11, 2008

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