Security Structures Beyond GOs

Municipal Analysts Group of NY luncheon

Amy Laskey, Managing Director

September 8, 2017

Fitch Ratings

Agenda

- Explain the relationship between the Issuer Default Rating (IDR) and security ratings
- Discuss the limited circumstances under which an entity’s securities can be rated either notched or distinct from its IDR.

The Issuer Default Rating

- Fitch assigns IDRs to state and local governments with operating risk.
- The IDR considers the issuer's ability to meet all of its financial obligations (timely performance of commercial obligations is not included).
- It is an expression of Fitch's opinion of the likelihood of insolvency of the entity and the consequent bankruptcy proceeding.
- An issuer that does not meet its financial obligations when due is by definition insolvent.
- Except for sovereign-like credits (i.e. states), insolvency is assumed to lead to the initiation of bankruptcy proceedings.

Default Ratings on Securities Capped at the IDR, with Exceptions

- Fitch strives to consistently evaluate the legal basis for rating securities differently from the IDR. The goal is to provide consistent and complete information to investors to assist them in making informed decisions.
- General rule for Chapter 9 entities: Because of the automatic stay provisions, as a general rule any securities of a municipal issuer should be capped at the IDR.
- General rule for states: As we cannot know what obligations a state will pick to perform in advance of its general insolvency, all securities of a state payable out of its general funds should also be capped at its IDR, even though there is no available bankruptcy process.
- Exceptions to the general rules can be justified if there is a reasonable basis in law to support the analytical conclusion that the general insolvency of the issuer will not prevent continuing payment, collection and enforcement of bondholder remedies.
- The nature of the legal basis differs between states and municipalities as they have different frameworks for default.

States

- U.S. states cannot file for bankruptcy, thus there is no framework for restructuring state debts.
  - There is no concept of automatic stay to prevent litigation to enforce state obligations or lien rejections.
- Dedicated tax bonds may be rated distinct from the state IDR if the flow of pledged revenue is structurally protected from general operations, e.g. through provisions in the state's constitution, statutes or bond documents.
- Although contract clause protections under federal and state constitutions restrict the ability of a state government to impair its dedicated tax bond obligations, they do not impose an absolute constraint when there is a fiscal emergency.
- Therefore, rating uplift from the IDR is tempered by the risk that the state could exercise its sovereign powers to the detriment of bondholders in the event of extreme stress.
- Fitch does not apply explicit notching.
- In Fitch's view, the more narrow the dedicated tax source and the more limited its impact on a state budget, the less likely the state could successfully argue that impairment is reasonable in an emergency.

Example: Illinois Department of Employment Security Bonds Rated Above the IDR

- The Illinois Department of Employment Security Unemployment Insurance Fund building receipts revenue bonds are secured by a first lien on a 0.55% assessment levied on all contributing employers in the state against a statutorily set wage base.
- The fund building rate, set at 0.55% for the life of the bonds, is a separate levy, charged to contributing Illinois employers at the same time and in the same manner as the state's other, longstanding unemployment assessments.
- Pledged revenues are deposited in a segregated account, controlled by the Department of Employment Security, separate and distinct from funds of the state.
- Strong non-impairment language limits the ability of the state to reduce either the fund building rate or the wage base upon which it is levied.
- Rating: AA+/Stable
- IDR: BBB/Negative

Example: Louisiana Broad Constitutional Pledge Does Not Support a Distinct Rating Above the IDR

The Pledge is essentially a gross revenue pledge of all revenues; impairment in broad state distress would be more readily justified. Excerpt from Official Statement:

State Treasury and Bond Security and Redemption Fund

The Bonds, together with other general obligations of the State, are payable from monies pledged and dedicated to and paid into the Bond Security and Redemption Fund created and established in the State Treasury, have a first lien and privilege upon all State money deposited into the Bond Security and Redemption Fund, are payable on a parity with all other outstanding general obligation bonds heretofore and hereafter issued by the State under and pursuant to the State Constitution, and are secured by the monies pledged and dedicated to and paid to the Bond Security and Redemption Fund, subject to prior contractual obligations as provided in Article VII, Section 9 of the State Constitution.

Article VII, Section 9(B) of the State Constitution gives constitutional status to the Bond Security and Redemption Fund and further provides that, subject to contractual obligations existing on the effective date of the State Constitution (January 1, 1975), all State money deposited in the State Treasury is to be credited to the Bond Security and Redemption Fund, except money received as the result of grants or donations or other forms of assistance when the terms and conditions thereof or of agreements pertaining thereto require otherwise.

Other Exceptions to the IDR Cap for Security Ratings

- Ratings linked to/notched above the IDR
  - Recovery Ratings (Statutory Liens)

- Ratings distinct from/without consideration of the IDR
  - Securitizations
  - Intercepts
  - Special Revenues

Recovery Ratings

- Most Fitch security ratings reflect full and timely payment of debt service.
- We have adopted a framework to incorporate recovery in limited circumstances, most notably where a statutory lien is present.
- Bonds secured by a statutory lien on revenues are rated two notches above the IDR.
- A **statutory lien** is defined in Section 101(53) of the Code as a lien arising by force of statute on specified circumstances or conditions.
- It is in contrast to a **consensual lien** (defined in Section 101(51)), in which a lien is created by agreement between parties to a financing.
  - Most Fitch-rated municipal bonds are backed by a **consensual lien**.
- The statutory lien preserves bondholder rights to tax revenues securing bonds in a bankruptcy, whereas the consensual lien ends with respect to subsequently collected taxes once the bankruptcy proceedings begin.
- Neither exempts the debt from the automatic stay, so **default risk remains present**.

Statutory Lien Examples

- **Yes**: Rhode Island – GO ratings are two notches above the IDR

  45-12-1 of the Rhode Island General Laws provides for a statutory lien on ad valorem taxes and general fund revenues for the benefit of general obligation debt of cities and towns such that the statutory lien has a priority in a bankruptcy. The faith and credit, ad valorem taxes and general fund revenues of each city and town are pledged for the payment of [P&I], whether or not the pledge is stated in the bonds and notes or in the proceedings authorizing their issue and the pledge constitutes a first lien on such ad valorem taxes and general fund revenues.

- **No**: Illinois (from IL Debt Reform Act)

  Any such pledge made by a governmental unit shall be valid and binding from the time such pledge is made. The revenues, moneys and other funds so pledged and thereafter received by the governmental unit shall immediately be subject to the lien of such pledge without any physical delivery thereof or further act; and, subject only to the provisions of prior agreements, the lien of such pledge shall be valid and binding as against all parties having claims of any kind in tort, contract or otherwise against the governmental unit irrespective of whether such parties have notice thereof. Pursuant to any such pledge, a governmental unit may bind itself to impose rates, charges or taxes to the fullest extent permitted by applicable law. No ordinance, resolution, trust agreement or other instrument by which such pledge is created need be filed or recorded except in the records of the governmental unit.

Intercept Mechanism

- Many states have adopted laws that create a mechanism to intercept revenues that would otherwise be transferred from a state government to a municipality.
- These funds are instead remitted to a bond trustee directly from the state, effectively monetizing future intercept revenues.
- The funds belong to the state in support of the municipality and do not become property of the municipality until after bonds are paid.
- To rate distinct from the IDR, legal analysis must support the conclusion that moneys subject to the intercept are not property of the municipality.
- The intercept scheme must:
  - Be clearly established in a state law and not by the municipality;
  - Require no consent or authorization of the municipality.

- Security devices such as direct deposit of funds into a lock box do not provide a basis for ratings distinct from the IDR as the revenues remain subject to the automatic stay.

Two Examples of Trustee Intercepts

Yes: Detroit Distributable State Aid Bonds

- The bonds will be payable from the Distributable State Aid the City expects to receive from the state…The Distributable State Aid received or to be received by the Trustee for the purpose of paying debt service on the…bonds is subject to a statutory lien and trust for the benefit of Bondowners that is perfected without delivery, recording, or notice. The Distributable State Aid held or to be held by the Trustee is held in trust for the sole benefit of the Bondowners and is exempt from being levied upon, taken, sequestered, or applied towards paying the debts or liabilities of the city other than for payment of debt service on the Series 2010 bonds. Pursuant to Act 80, the Bondowners are provided a lien on such Distributable State Aid that is paramount and superior to all other liens and interests of any kind that arise or are created after the issuance of the…bonds.

No: New York Health and Hospitals Corporation General Obligation Bonds

- The Bonds are general obligations of the Corporation, secured by a pledge of (i) Health Care Reimbursement Revenues that are deposited, on a daily basis, into Lock Boxes…that must be used first for each month's accrued debt service on the bonds before such funds can be applied to operating expenses or other uses by the Corporation; and (ii) the amounts on deposit in certain funds and accounts established under the Resolution…

Pledged Special Revenue Bonds

- A feature unique to Chapter 9
- Creates a legal fiction treating debt secured by special revenues as if issued by a separate entity.
- Provisions work together to exempt special revenue debt from the automatic stay on remedies and to preserve the lien on the revenues post bankruptcy.
  - Section 902 (2) (Definitions)
  - Section 922 (Automatic Stay)
  - Section 927 (Limited Recourse)
  - Section 928 (Post Petition Lien Continues)
- Why special revenues?
  - Per the legislative history: “[a continuing lien] should make it easier for troubled municipalities to obtain needed financing of public projects.” (- Collier on Bankruptcy).

Special Revenue Definitions

Five categories of special revenues

A. Receipts derived from the ownership…of projects…used primarily to provide transportation, utility, or other services…;
B. specific excise taxes imposed on particular activities or transactions;
C. Incremental tax receipts…;
D. Other revenues or receipts derived from particular functions of the debtor…;
E. taxes specifically levied to finance one or more projects or systems, *excluding receipts from general property, sales, or income taxes…levied to finance the general purposes of the debtor.*

The first four categories are fairly intuitive. Fitch does not believe specific legal advice is generally required to evaluate the application of paragraphs (A) to (D).

Fitch View on Special Revenues Under Fifth Definition (902(2)(E)

Fitch believes the fifth category poses the most risk in application and has very specific requirements for assessing whether it will support a distinction from the IDR.

Each of the following elements is necessary for Fitch to provide a rating based on the pledged revenues' status as special revenues under 902(2)(E) of the Code:

- A statutory scheme limiting the authority to levy a specific tax to the financing of capital projects.
- A statutory prohibition on use of the tax revenues for operations, unless not subordinated to operating expenses in a bankruptcy.
- A ballot initiative or a resolution limiting use of debt proceeds to identified capital projects.
- Bondholders do not have a claim on general revenues of the municipality; bonds are solely secured by a dedicated tax.
- A statutory requirement that a governmental official outside the municipality collects and remits the tax revenues to the paying agent.
- Clarity that the pledged taxes are property of the municipality, not of the entity collecting and remitting the tax revenues.

The Application of 902(2)(E) : Chicago Board of Education

- The board's IDR is 'B+'/Negative.
- Fitch rated its $500 million dedicated capital improvement tax bonds, series 2016 'A'/Stable.
- The bonds are secured by a first priority lien on revenues from the capital improvement tax (CIT), a district-wide property tax.
- The features of the bonds meet Fitch's high bar for rating special revenue obligation debt without consideration of the IDR.
  - State statute limits the permitted uses of CIT revenues to include construction, acquisition and equipping of school and administrative buildings, and site improvements.
  - The board has identified specific capital projects in the bond resolution that may be funded either by bond proceeds or by residual CIT revenues. Any amendments to the project list must be passed by board resolution.
  - The revenues legally cannot be used for general operations of the board.
  - Bondholders do not have a claim on the board's general revenues.
  - Revenues are collected by Cook and DuPage Counties, and transmitted directly to an escrow agent, who transfers daily revenues for debt service to the bond trustee.
  - The 'A' rating is based on the structure's resilience through economic cycles.

How Special Revenues Played Out in the Detroit Bankruptcy

- **GO debt** not backed by a state aid intercept was considered ‘unsecured’ and impaired
- **The state intercept debt** was not interrupted, and paid throughout the proceeding
- **Utility revenue bonds** were unimpaired and not subject to the stay. The lien continued in bankruptcy, and a cram-down was successfully avoided.

Securitizations

- Allow a “true sale” of the future revenues of an issuer to support debt.
- Future revenues conveyed to an SPV or a trust that issues the related security.
- Legal opinion and analysis would need to conclude that the revenues would not be property of the municipality in its bankruptcy.
- The municipality may have benefit of residual flows, much like a shareholder of an SPV would in a structured finance transaction.
- New York City Transitional Finance Authority is an example.
- New Illinois legislation provides for a new, similar vehicle.

Examples from Fitch Ratings for Chicago

- **Motor fuel tax bonds:** The rating is distinct from the city's IDR because motor fuel taxes fall under special revenue definition B.
  - Since the bonds are subject to state appropriation, the rating is capped at the state appropriation rating.
- **Airport and water and sewer bonds:** Distinct from the city's IDR because the pledged revenues in each case are special revenues under definition A. The ratings reflect operating risk of each enterprise, with notching for senior and subordinate lien levels.
- **Sales tax bonds:** since they are payable from local and state sales taxes levied for operating purposes, no special revenue definition fits and the rating is capped at the city's IDR.
- **Potential new financing structure authorized by the state of IL:** The legislation allows for the establishment of an SPV to which revenues in support of debt could be irrevocably transferred. If properly constructed, bonds would be rated as a securitization, without regard to the transferring unit's IDR.
  - Chicago's IDR would incorporate any increase in the debt burden resulting from the SPV issuance on the city's operating costs and the economic resource base.

New York
33 Whitehall Street
New York, NY 10004

London
30 North Colonnade
Canary Wharf
London, E14 5GN

fitchratings.com

@fitchratings

FitchRatings