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SPECIAL COMMENT

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Growth of Bank Loans and Private Placements Increases Risk and Reduces Transparency in the Municipal Market

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Analyst Contacts:

NEW YORK +1.212.553.1653

Thomas Jacobs +1.212.553.0131
Senior Vice President
thomas.jacobs@moodys.com

Geordie Thompson +1.212.553.0321
Vice President - Senior Credit Officer/Manager
geordie.thompson@moodys.com

Timothy Blake +1.212.553.4524
Managing Director - Public Finance
timothy.blake@moodys.com

Summary

Banks currently hold $425 billion of municipal securities and loans, up from $225 billion at the end of 2009.[1] A large and growing portion of those holdings are direct loans and privately placed securities which are not subject to the full and timely disclosure requirements of financings done in the public bond market.

» Direct bank loans and private placements can increase bondholder credit risk and inconsistent disclosure of their terms reduces transparency.

» Material risks associated with private bank financings are typically very similar to those associated with publicly-issued debt backed by bank credit and liquidity facilities, such as commercial paper (CP) and variable rate demand bonds (VRDBs).

» Bank financing and related risks are not new to the municipal sector, but a recent increase in private financing by issuers of all sizes and across sectors has increased potential risk for bondholders.

Increased Private Financing Increases Risk and Reduces Transparency

Banks have doubled their exposure to the US municipal sector since 2010. Much of the growth has come in the form of privately placed securities and direct loans. As discussed below, private financings sometimes include provisions that can adversely affect the issuer and its other creditors. In addition, issuers have not provided consistent disclosure of the details of private financings. Even in cases in which a private financing does not include provisions that increase risks to other creditors, absence of disclosure undermines proper risk assessment.

[1] Federal Reserve Flow of Funds

Large and frequent issuers generally provide timely disclosure of private financings, both to rating agencies and via the MSRB's EMMA web site that is available to all investors. As direct loans and other private structures have become more prevalent among smaller, less frequent issuers, credit analysts are often learning about them from year-end audits rather than from the borrower at the time of the loan. In addition to the standard lag in the filing of annual financial statements, audit disclosures do not include full details of the financing terms needed to assess potential impact on the issuers' credit and other creditors. Upon learning of a private financing through our review of audited financial statements or from any other source we ask the issuer for detailed information and documentation. Investors' understanding of an issuer's credit position will be more complete after reviewing the documents..

Beginning in January 2015, California will become notable for stronger disclosure due to recent state legislation that will require timely and full terms disclosure of all private financings by public sector entities in the state.[2] California's new law is clearly a step in the right direction. Prior to implementation it is difficult to know for sure whether the law will provide a standard of disclosure that achieves timely and effective incorporation of private financings into assessments of all California municipal credits.

Private Financing Exposure in Public Finance Sector

In the broad local government sector, where Moody's rates the public debt of approximately 10,000 issuers of all sizes, our annual review of 2013 audits filed to date has identified over 100 bank loans and other private financings that are large enough to be considered material relative to the rated issuer's resources. While a number of these loans and their terms were disclosed voluntarily at the time of borrowing, many were not. We consider this information essential to our ability to maintain ratings on an issuer's related public debt and expect it to be disclosed as close to the completion of the financing as possible.

As a result of the proliferation of direct loans and other private financing structures, the US municipal market has become less transparent. Transparency is essential for consistent credit analysis and, ultimately, liquid and efficient markets. If issuers increase and improve disclosure for direct loans and private financings so that they are consistent with the industry standards for public financings, both investors and obligors will benefit.

Material Potential Risks Are Parallel To Those Found In Public VRDBs and CP

From a risk perspective, many recent muicipal private financings are very similar to publicly-offered VRDBs and CP supported by liquidity facilities (Exhibit 3). Both direct loans and VRDBs can introduce a range of risks to obligors' debt structures that are absent in the fixed rate, amortizing debt structures that have long been the mainstay of US municipal sector debt.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

[2] See California's New Law Requiring Disclosure of Bank Loans Will Benefit Investors published 31 July 2014 on moodys.com for more complete discussion of California's legislation.

EXHIBIT 1

Direct Bank Loans Introduce Risks Similar to VRDBs; Often Not Found in Fixed Rate Fully Amortizing Debt

Potential Risk	VRDBs	Direct Bank Loans	Fixed Rate Fully Amortizing Debt
Acceleration Risk	Yes	Yes	No
Remarketing Risk	Yes	No	No
Renewal/Refinancing Risk	Yes	Yes	No
Interest Rate Risk Associated with Short-term Market Conditions	Yes	Yes	No
Interest Rate Risk Associated with Credit Quality of Support Provider	Yes	No	No
Interest Rate Risk Associated with Credit Quality of Obligor	Yes	Yes	No

In a direct bank loan or other private financing, a lender sometimes has stronger rights and remedies than are available to holders of publicly offered debt. Exercise of these rights and remedies can affect the issuer's credit and the availability of resources to meet the claims of other creditors in an event of default on the loan. An acceleration right in a private financing, for example, can drain the issuer's financial resources, increasing the probability of default on other debts. Given the wide range of terms found in direct loans and other private financings, which tend to be highly negotiated rather than based on standard documents, there is no substitute for careful review of each agreement. Understanding how a private financing can affect an issuer's credit profile requires review of its terms and the issuer's other financing agreements to see how they fit together.

Some direct bank loans expose borrower to acceleration risk

Lenders in all sectors of the credit markets seek to reduce credit risk by negotiating the right to demand immediate or accelerated repayment in the event that an issuer's credit deteriorates. In direct loans to municipal issuers, events of default that can lead to acceleration sometimes include:

» Payment default on the loan or any parity obligation;

» Initiation of bankruptcy proceedings or other evidence of insolvency;

» Invalidity or repudiation of the obligation;

» Decline in rating below a threshold;

» Failure to maintain a specified amount of liquidity;

» Failure to generate a specified amount of revenues relative to debt service;

» Breach of another financial covenant;

» A material adverse change; and

» Failure to provide timely financial reports or notifications to the lender.

We evaluate acceleration risk on a case-by-case basis. In addition to headroom, i.e. the degree of weakening in the issuer's financial profile needed to give a lender the right to accelerate, we review cure periods for non-payment defaults, whether cross default provisions gives other lenders the right to accelerate if the loan under review accelerates or is not paid upon acceleration, and whether the issuer's

liquid resources would be sufficient to meet a demand for immediate repayment. Acceleration provisions seen in direct loans and other private financings are often very similar to those often seen in standby bond purchase agreements and letters of credit supporting publicly-issued variable rate demand bonds. Although lenders may defer acceleration to protect business interests with the issuer or in the issuer's sector or region, particularly in cases in which it deems ultimate repayment likely, our credit assessments reflect the expectation that acceleration will be used as a remedy when available.

Remarketing risk associated with VRDBs is not present in direct bank financing

Unlike VRDBs, direct loans do not incorporate remarketing risk over the term of the loan. VRDBs are puttable at par by investors at regular intervals, usually daily or weekly. Puts are often supported by credit or liquidity facilities (support facilities) provided by highly rated commercial banks, which are drawn upon in the event that tendered bonds cannot be remarketed to new investors. Under direct loans, the bank does not have the option of putting the loan back to the issuer during the term of the loan.

Direct loans often expose issuer to refinancing risk

Direct loans are often structured with bullet maturities or mandatory tenders that cannot be met out of cash flow but require refinancing. In the long-term fixed rate debt structures most commonly used by US municipal issuers, debt is amortized over the life of the financing out of annual cash flow. There is generally no requirement that the issuer access the market to repay the debt. In contrast, failure by the issuer to arrange extension of its loan or alternative financing can result in depletion of liquidity and severe cash flow pressure.

Refinancing risk in direct loans is parallel to support facility renewal risk seen in public VRDBs. If a VRDB issuer is unable to extend or replace an expiring support facility it may be required to repay the debt immediately or within an accelerated timeframe and to pay interest at an elevated penalty rate. It is also parallel to refinancing risk found in floating rate notes, long-mode put bonds and other structures with effective maturity dates that are shorter than the anticipated life of the financing. The need to extend or refinance a loan or support facility can compound challenges faced by an issuer under stress.

Interest rate risk in direct loans is similar to that found in VRDBs

Many of the direct bank loans to public finance issuers that we have observed during the past 18 months are structured with variable interest rates and have been used as alternatives to VRDBs. Interest on VRDBs floats at rates set by the remarketing agent on each reset date. Interest on variable rate direct loans is typically indexed to either the London Interbank Offered Rate (LIBOR) or the Securities Industry and Financial Markets Association (SIFMA) rate. In either case, should interest rates rise to levels above those for which the issuer has budgeted, the additional interest expenditures could cause the issuer's cash flow, liquidity, and credit quality to weaken, particularly if interest rates are elevated for an extended period. Rates on direct bank loans can rise as a result of increases in the market rate to which the loan is indexed. In addition, the spread to the market index at which many floating rate direct loans reset can change if the obligor's credit rating changes.

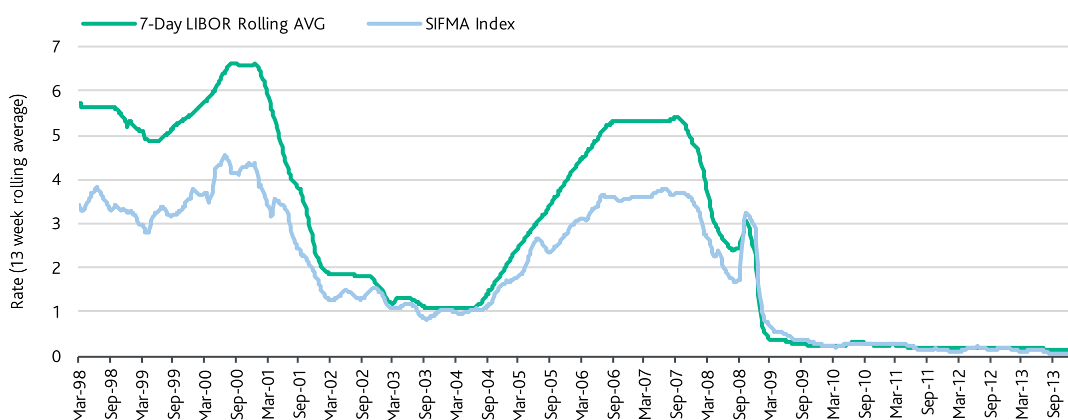
In our review of issuers with variable rate debt, we consider their ability to withstand extended periods of elevated interest rates. We take into account the responsiveness of the issuer's revenues, particularly short-term investment income, to changes in interest rates, as well as the effectiveness of any interest rate hedges and the issuer's access to alternative financing.

Banks Shifting Municipal Exposure from Public VRDB Support Facilities to Direct Loans and Securities

As shown in Exhibit 2 below, since the 2007-2008 financial crisis banks' funding cost has been extremely low, making direct bank financing competitive with bank-supported public VRDB financing.

EXHIBIT 2

Extraordinarily low bank funding cost since 2010 has made on balance sheet financing attractive relative to bank supported VRDBs



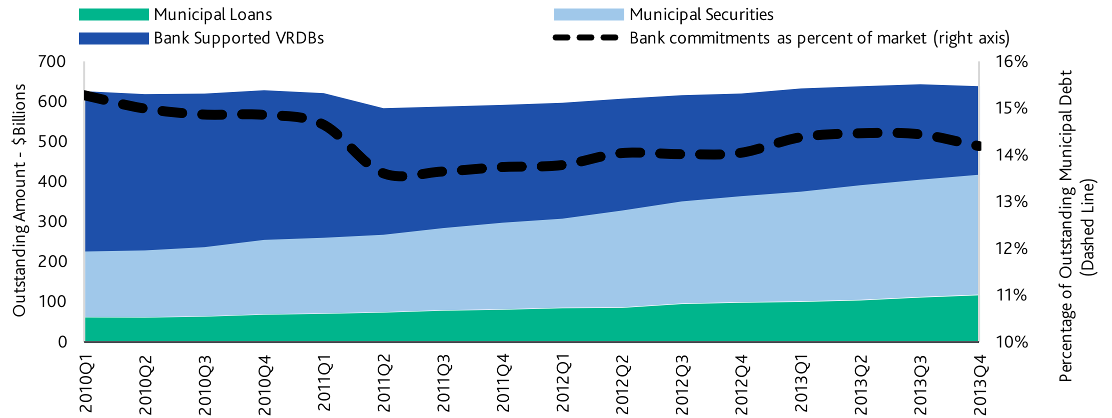
Sources: British Bankers Association and SIFMA

As banks have sought to deploy their low cost funding, the municipal market has been a reliable source of assets. Banks have converted VRDB support facilities into direct loans, have made new direct lending commitments, and have increased their holdings of publicly offered municipal securities. As shown in exhibit 3, from the beginning of 2010 through the end of 2013, bank holdings of municipal bonds and loans increased by approximately $200 billion to $425 billion. Over the same period the outstanding balance of bank supported variable rate demand bonds declined by a similar $186 billion, as many of these were restructured as direct private placements that have added to banks' bond holdings. From the beginning of 2010 through the middle of 2011 aggregate bank and bank supported financing declined from 15.25% to 13.6% of the $3.7 trillion US municipal market. Since then, it has climbed back to 14.6%. Although banks' share of the market has remained similar, the proportion that is subject to public market disclosure requirements has shrunk significantly in a relatively short period of time.

EXHIBIT 3

Bank Commitments to the US Municipal Market Have Shifted from VRDB support Facilities to Direct Loans and Securities Since 2010 Title

Chart Subtitle



Sources: FDIC, Federal Reserve, SIFMA and the Bond Buyer

Moody's Related Research

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Sector Comments:

» Californiua's Passage of Law Requiring Municiplities to Disclose Bank Debt Will Benefit Investors, July 2014 (173822)

» Bank Regulators Rule Munis Can't Be Used as Liquidity Cushion By Banks; A Credit Negative, September 2014 (175329)

» Fed Proposes Munis Not Be Used as Liquidity Buffer by Banks; a Credit Negative Published November 2013 (159977)

Special Comments

» Municipal VRDB Market Continues Slow Contraction, March 2014 (165633)

» Direct Bank Loans Carry Risks Similar to Variable Rate Demand Bonds for Public Finance Issuers, September 2011 (135849)

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Report Number: 176392

Author
Thomas Jacobs

Production Specialist
Cassina Brooks

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