

**FINANCIAL INSTITUTIONS
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Debt Market / Infrastructure Component

**CREDIT ENHANCEMENT STRATEGIES
FOR US MUNICIPAL GOVERNMENTS:
FUNDAMENTAL CONCEPTS**

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Credit Enhancement Strategies for US Municipal Governments

Introduction

This query is divided into three separate parts (I) general background on infrastructure finance issues relevant to the discussion, (II) the major and most effective forms of credit enhancement, and (III) the impact of credit enhancement. Section one serves to introduce the reader to types of revenue streams that can benefit from credit enhancement in different types of infrastructure financings. The second section describes the purpose, action required and principal steps taken by the municipal issuer to gain access to the major and most effective types of credit enhancement. Emphasis is placed on the methodology used by states to support or enhance an issuing entity's debt. Section three describes the impact of the credit enhancement process.

I. Infrastructure Financing

The term **infrastructure finance** covers the issuance of debt related to **transportation** including ports, highways, toll roads and mass transit, **utilities** including water, wastewater, power, solid waste, natural gas, and **general purposes** encompassing school districts, traffic lights and other capital needs of municipalities. Financings for stadiums and convention centers are also included when they are secured by dedicated ticket sales, occupancy charges or similar taxes. Any debt held by a state entity that is secured by revenues and dedicated taxes falls into this category as well.

Infrastructure debt can be issued by a municipality or by a duly authorized entity that serves one or more municipalities. As a result, infrastructure financings often cover many different jurisdictions. An example in the first instance is a city that issues school district bonds to improve the physical plant of its schools. An example of the second instance is a regional water authority that issues water revenue bonds that are secured by the payments of municipalities within the region.

Security for infrastructure debt can vary considerably but is typically a single, dedicated revenue stream directly related to the services provided. For example, in the second scenario above, revenues from the sale of water can secure or pay back bonds that were issued to build a water supply system. There are different types of revenue which can strengthen this single dedicated stream, among them sales tax, "*full faith and credit*" taxing power of the locality, and other specific taxes such as property taxes.

II. Major and most effective forms of credit enhancement

Credit enhancements are methods which secure or increase the strength of a municipal bond obligation to investors by: (I) enhancement of the **security** or the **revenue stream**, (ii) enhancement of the **structure**, and (iii) a combination of (I) and (ii). Generally speaking, credit enhancement

vehicles seek to accomplish the objective of shifting the credit risk from the issuer of securities to the entity that is providing the credit enhancement. Typically the entities that may provide credit enhancement include the state or federal government, banks, and corporations. This has the net effect of enhancing the marketability of the bonds to investors.

Credit enhancement may be broken into three distinct categories: (i) public enhancements, (ii) private credit enhancements, and (iii) structural enhancements. **Public credit enhancements** generally involve the support of a superior governmental unit. For example, in the U.S., a city may lend credit support to a duly authorized authority within the city, such as a water authority. A state may lend credit support to a city in a similar manner. **Private credit enhancement** methods of increasing the credit worthiness of an issue seek to shift the credit risk from the issuer of securities to a private entity that is providing the credit enhancement. Examples of private entities that provide credit enhancement services include, municipal bond insurance companies, letter of credit banks, and corporations. **Structural Enhancements** involve the utilization of legal provisions and financing tools to augment the creditworthiness of an issue. An example of a legal structural enhancement is the placement of project revenues in a "lock box" over which an authorized representative has dominion. Another example of a financing tool that augments the marketability of an issue is the establishment of a debt service reserve fund. Any deficiency in principal and interest payments can be covered by such a fund. All three of these methods of credit enhancement have the net effect of lowering borrowing costs by enhancing the marketability or investor interest in the security.

Public Credit Enhancements

There are generally six mechanisms for credit enhancement that states have implemented to support issuers of debt within their jurisdictions: (i) the automatic withholding and use of state aid to pay debt service, (ii) United States Governmental agency or state guarantees, (iii) Revenue Sharing, (iv) "Lock Boxes", (v) "Double Barreled" bonds, and (vi) Moral Obligations. There are many possible permutations of these credit enhancements. The terms which are defined and discussed below are only the most common. Creativity is a critical ingredient in the development of new and innovative approaches to the credit enhancement process.

- **Withholding of State Aid.** State aid withholding programs are the most common type of public credit enhancement mechanisms in the United States. Typically, these programs are designed to benefit school systems within a state. This form of enhancement is a very low cost and effective way for states to assist localities within their jurisdictions by improving the credit quality of bonds issued with the additional security. The programs use state aid entitlements as a form of guarantee that debt service obligations will be met. If a local unit cannot meet its repayment obligation on a qualified bond, the state withholds sufficient aid to meet debt service. Important factors related to the evaluation of this type of program include the status of the state laws governing municipal autonomy. An example of state aid withholding program follows.

Section 15.1225 of the Code of Virginia authorizes the governor of the State of Virginia to immediately intercept state aid appropriated for municipalities in order to pay principal and interest on certain bonds in the event of default. The statute makes provision for the default to be remedied within one day.

Under the state statute that enables municipalities to take advantage of the Virginia guarantee program's minimum bond rating of "A", there are two general conditions that must be satisfied: (I) the municipality must demonstrate that state aid for each of the previous five years was at least 1.25 times maximum annual debt service, (II) each bond issue must have a paying agent, trustee, or similar fiduciary representative to promptly inform the state of a default.

The rating for bonds issued under the auspices of the program reflects the State of Virginia's credit worthiness. This is a direct result of the fact that Virginia's withholding program is based upon the state governor's authority to withhold payments.

- **U.S. Governmental Agency or State Guarantees.** The issuer may seek a U.S. government agency or state to issue a guarantee of the payment of the principal and interest on the bonds. This shifts the credit risk from the issuer to the U.S. governmental Agency or State. The guarantee may be structured to provide payment to the bondholders in much the same way as a **Letter of Credit**. For example, the guarantee may be a **direct pay** guarantee or **standby** guarantee. A direct pay guarantee pays defaulted principal and interest in the event of a default. In the case of a standby guarantee, the guarantee provides protection for bondholders in the event of bankruptcy of the project. The guarantee must be a primary, absolute and unconditional, continuing and irrevocable guarantee of payment. An example of a state guarantee program follows.

Under New Jersey Statute 18A.2993, the state treasurer is authorized to intercept a portion of city, township, and other local municipality qualified state aid to pay debt service on certain types of obligations directly to the trustee. To qualify for the state's guarantee, a municipality must receive state approval for the planned capital improvements and the scheduled debt service. Also, as part of the requirement for the minimum debt rating, revenues from the state must be equal to or greater than maximum debt service requirements.

- **Revenue Sharing.** State revenue sharing programs typically collect a statewide tax, surcharge or fee in order to redistribute the tax, surcharge or fee back to an individual cities, municipalities or regions. Typically these revenue sharing programs redistribute the collected fee on the basis of population. States have used this redistribution of revenues to provide credit enhancement for local projects. An example follows.

This program, authorized in 1990 under California Assembly Bill 1375, permits cities and counties to guarantee payment of General Obligation bonds or lease obligations through their allocation of motor vehicle license fees. Upon notification to the state from a trustee that a community's payment was not made from other sources, the California State Comptroller is

directed to make the payment from the community's share of license fee revenues. When requested, the rating agencies will assign a minimum rating of 'A' to the debt of qualified issuers that choose to participate in the program.

To qualify for the minimum rating, the financing must be structured to

- (i) Account for the monthly distribution of license fee revenues,
- (ii) Account for the timing and notification requirements,
- (iii) Provide for monthly lease or sinking fund payments,
- (iv) Include a fully funded debt service reserve, and
- (v) Have a paying agent, trustee, or similar representative act in a fiduciary capacity to promptly notify that state of a locality's failure to make the required payment.

Given the historical volatility of statewide license fee revenues and the distribution formula's direct link to populations, only cities and counties with a population of at least 2,500 are eligible to participate in the program. The local unit also must demonstrate that its allocation of license fee revenues in each of the five preceding years will cover maximum future debt service of the project at least 2.5 times. This 2.5 times coverage must cover all of the outstanding debt service for all of the issuers under the program.

- **“Lock Boxes”.** A project's revenues are “lock boxed” when a state appointed or approved trustee manages the process of collecting revenues of the project. This gives comfort to investors that the revenue from the project will be used to pay debt service.
- **“Double Barreled” Bonds.** Double barreled bonds are typically secured by a project's revenues, such as water and sewer user charges and the full faith and credit pledge of a state government or locality. This full faith and credit taxing power is only used if project's revenues are insufficient. Depending on the accounting system used, a well run project can enhance the general government's credit by making substantial financial contributions to the general fund. In contrast, a weak project can threaten the creditworthiness of the supporting governmental entity.
- **Moral Obligation Pledge.** A moral obligation pledge occurs when an issuer relies on another entity to make up any deficiency in the debt service reserve fund. The pledge is nonbinding and most often given by a state to the debt of its agencies or authorities. The promise of a state government to appropriate money to the debt service reserve fund is the usual form of this type of guarantee.

Private Credit Enhancements

Private sector methods of enhancing the credit worthiness of an issue seek to shift the credit risk from the issuer of securities to the entity to which it is providing the credit enhancement. There are four general types of private credit enhancement (i) Letters of Credit, (ii) Municipal Bond Insurance, and (iii) Corporate Guarantees.

- **Letter of Credit.** The purpose of a bank letter of credit is to completely shift the credit risk from the issuer of the bonds to the bank that issues the letter of credit. To accomplish this purpose, letter of credit financing must be structured so that any failure by the issuer to make any payment will be covered by timely payment by the bank. The two most common types of letters of credit are **direct pay** letters of credit and **standby** letters of credit. A direct pay letter of credit pays defaulted principal and interest in the event of a default. In the case of a standby letter of credit, the letter of credit provides protection for bondholders in the event of bankruptcy of the project. The rating of the bond issue typically reflects the rating of the bank that provides the letter of credit.
- **Municipal Bond Insurance.** Financial guarantee insurance in the form of municipal bond insurance is the oldest rating enhancement mechanism for providing third-party support or security for the guaranteed payment of principal and interest. The major insurers of municipal bonds are MBIA corporation, Financial Surety Association, Capital Guaranty and Financial Guaranty Insurance Corporation. Insurance from each of these companies provides a AAA rating from the rating agencies.
- **Corporate Guarantees.** The issuer may seek a corporation to issue a guarantee of the payment of the principal and interest on the bonds. This shifts the credit risk from the issuer to the corporation in exchange for fees, profits from participation, or other benefits to the corporation. The guarantee may be structured to provide payment to the bondholders in much the same way as a letter of credit. For example, the guarantee may be classified as **direct pay** or **standby**. A direct pay guarantee pays defaulted principal and interest in the event of a default. In the case of a standby guarantee, the guarantee provides protection for bondholders in the event of bankruptcy of the project. The rating for the bond issue reflects the rating of the guarantee provider.

Structural Enhancements

Structural enhancements involve the utilization of legal provisions and financing tools to augment the creditworthiness of an issue. An example of a legal structural enhancement is the placement of project revenues in a "lock box" that a trustee has dominion over. An example of a financing tool that augments the marketability of an issue is the establishment of a debt service reserve fund from which deficiencies in principal and interest payments are made up from the debt service reserve fund.

III. Impact of Credit Enhancement

In the U S , the mechanism used to determine the impact of credit enhancement on an issuer's debt is a process that generally evaluates two criteria (I) the underlying rating or creditworthiness of the entity that provides the credit enhancement and (ii) the structure of the credit enhancement While rating agencies primarily assess the issuer's likelihood of full and timely payment of debt service, the structure of the credit enhancement has a direct impact on the value of the credit enhancement If the credit enhancement completely shifts the risk to the provider of the credit enhancement then the rating will reflect this and the issue will have the same rating as the provider These enhancements add strength to an issuer's credit quality and can function as complete credit substitutions In such cases, the strength of the **legal structure** and the availability of financial resources to satisfy shortfalls in debt service payments provide the basis for the rating determination The stronger the legal relationship, the stronger the tie to the rating of the credit enhancement provider

Assessing the impact of credit enhancement on the state credit enhancement provider's finances and budget is a complicated process A municipality's ability to pay or support a project today does not necessarily demonstrate its ability to pay in the future Therefore, a wide range of factors are considered in assessing the impact of credit enhancement on the issuance of debt A key factor in making such an assessment is the degree to which the state is directly responsible for debt service payments Another factor is the agreed-upon time period for which a state must set aside reserves to cover its commitments under such credit enhancements Other factors include the state's socioeconomic base, income levels, rate of income growth, employment mix analysis and population growth

The measure of credit enhancement impact on a project's cash flow is directly related to the cost of the enhancement to the issuer in both up-front and ongoing fees Very specific financial analysis tools exist that allow the issuer to evaluate credit enhancement as an economically viable strategy The purpose of such an analysis is to determine whether the yield differential between the credit enhanced issue and the non-credit enhanced issue justifies the cost of credit enhancement

IV. Conclusion

These tools of credit enhancement should be viewed as a means to securing the lowest possible debt service so that a project is able to meet all of its operating costs These tools may be mixed and matched in order to ensure the most cost effective financing This, in simple terms, means that if a municipality wishes to issue debt, it must first compare the cost of securing a higher credit rating through credit enhancement strategies to the cost of paying higher interest rates to the holders of their debt over the life of the debt issue Credit enhancement methods should only be pursued if the cost of securing an enhancement is less than the cost that paying higher interest rates would entail

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THE FIRE(D) PROJECT

The objective of the Indo-US Financial Institutions Reform and Expansion (FIRE) project, funded by the U.S. Agency for International Development (USAID), is to support the Government of India in its efforts to strengthen domestic capital markets to enable them to serve as efficient sources of development finance. One of the components of the FIRE project seeks to expand the debt market through the financing of commercially viable urban environmental infrastructure projects, defined as those which result in the provision of affordable urban services on a full cost-recovery basis by their sponsoring municipal corporations and authorities. This Debt Market/Infrastructure component, (FIRE-D), is under the auspices of the Union Ministry of Urban Affairs and Employment with USAID support targeted to the National Institute of Urban Affairs (NIUA), the Housing and Urban Development Corporation Limited (HUDCO) and the Infrastructure Leasing and Financial Services Limited (IL&FS) as well as to selected local entities.

The FIRE-D Project is designed to foster the development of a commercially viable infrastructure finance system by channelling USAID Housing Guaranty (HG) funds to selected demonstration cities and states to assist in the financing of urban environmental infrastructure projects. HUDCO and IL&FS, acting as financial intermediaries, make loans to selected municipal corporations, state boards and authorities and private enterprises which have formed partnerships with municipal entities. Eligible projects include water supply, sanitation, solid waste management, and integrated area development schemes. NIUA acts as the advocate for policy change and the coordinator for delivery of technical assistance and training directed at the development of local government capacity in the areas of identification, development and management of commercially viable urban environmental infrastructure projects; pricing and cost recovery for urban services; and financial management systems to support accessing of capital markets. It is expected that the participating institutions will be able to replicate the policy changes and project development initiatives beyond the demonstration states and municipalities to other areas throughout India.

This USAID-funded program will make available up to \$125 million from US capital markets in loans, combined with grant funds for management support, technical assistance and training. Loan guarantees must be matched with capital investment raised in the Indian debt market through FIRE's creation of innovative financial instruments.

Technical assistance, training and research support is provided by a consortium of US firms led by Community Consulting International (CCI) in association with Technical Support Services (TSS). Principal partners in the consortium include the Wall Street investment banking firm of Grigsby Branford and Company (GB&C) and the Government Finance Officers Association (GFOA) of the USA and Canada.

For more information on the FIRE(D) Project, contact the project office at the address mentioned above.

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