NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
STATE AND LOCAL GOVERNMENT FINANCE DIVISION
AND THE LOCAL GOVERNMENT COMMISSION

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MEMORANDUM

TO: Local Government Commission Executive Committee

FROM: Vance Holloman
Secretary, Local Government Commission

SUBJECT: Qualified Institutional Buyers and Recovery Zone Facility Bonds

DATE: April 26, 2010

On the May 4 agenda, there is a discussion item concerning a request for staff guidance regarding the types of institutions permitted to purchase Recovery Zone Facility Bonds in a private placement sale. Please consider the following background information in preparation for the Committee's discussion on May 4.

As part of the American Recovery and Reinvestment Act of 2009, Congress approved $15 billion of private activity tax-exempt debt authorization in the form of Recovery Zone Facility Bonds. Facility bonds are a type of traditional tax-exempt private activity bond that may be used by private businesses to finance a broad range of capital projects in designated recovery zones. North Carolina counties and large cities received $627 million in direct allocations of the facility bond allocation from the U.S. Treasury. The local units were required to declare their intent to use the initial allocation, and the unused allocation reverts to the State to be administered by the State's Tax Reform Allocation Committee (TRAC). Local units initially declared their intent to use approximately $111 million of the total allocation, and the TRAC has reallocated approximately $287 million of these bonds as of April 19.

As with most bonds, the LGC must approve facility bond financings by evaluating each project's financial feasibility. The standard for financial feasibility in this case is the same standard applied to other types of private activity bonds (such as industrial development bonds, solid waste disposal bonds, and 501(c)(3) bonds issued by local Authorities). That is, the LGC must determine:

> "Whether the proposed operator and obligor have demonstrated or can demonstrate the financial responsibility and capability to fulfill their obligations with respect to the financing agreement. In making such

> determination, the Commission may consider the operator's experience and the obligor's ratio of current assets to current liabilities, net worth, earnings trends and coverage of fixed charges, the nature of the industry or business involved and its stability and any additional security such as credit enhancement, insurance, guaranties or property to be pledged to secure such bonds." 159C-8(b)(1) and 159D-8(b)(1)

Historically, the LGC has found projects to meet this feasibility standard in one of the following ways:

1) The bonds have an investment grade rating (*i.e.*, BBB or better) from at least one rating agency;

2) The bonds are supported by a letter of credit from a bank or other financial institution that has an investment grade rating;

3) A bank, insurance company or "similar financial institution" commits to purchase and hold the bonds in a private placement transaction.

These feasibility standards have allowed the staff to utilize the credit evaluation of banks and other similar entities when conducting our own feasibility analysis. National default rates for tax-exempt private activity bonds are generally estimated at one to two percent which is similar to commercial loan default rates.

Following the recent recession, banks have tightened their lending requirements. This tightening has, in turn, limited the number of projects meeting LGC's financial feasibility standards. Our staff, as well as the staff of the TRAC, has received requests from legislators, bond lawyers, and economic developers to loosen the feasibility standards regarding the types of institutions that can purchase the facility bonds in a private placement. These representatives contend that the State's facility bond allocation has been underutilized and that loosening the standard will allow entities in the State to make full use of these bonds. Specifically, these parties have requested that the LGC permit "Qualified Institutional Buyers" (QIBs) to purchase facility bonds in private placement sales.[1]

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[1] The concept of sales to "Qualified Institutional Buyers" or "QIBs" is taken by analogy from another concept under the federal securities laws. SEC Rule 144A provides a safe harbor from the registration requirements of the Securities Act of 1933 for certain private resales to QIBs of unregistered securities that were sold to initial investors in a private placement (and not registered with the SEC). The Rule indicates a willingness by the SEC to acknowledge that investors meeting the requirements of a QIB are capable of making sophisticated investment decisions without the additional protections the securities laws give to the public in general for securities that are subject to SEC registration and periodic reporting requirements. Facility bonds are already exempt from registration by virtue of their status as municipal bonds, thus the concept is taken by analogy.

Under Rule 144A, QIBs are institutions that manage at least $100 million in securities, including banks, savings and loans institutions that have at least $25 million in assets, insurance companies, investment companies, employee benefit plans, or an entity owned entirely by qualified investors. Also included are registered broker-dealers owning and investing, on a discretionary basis, $10 million in securities of non-affiliates. QIBs include mutual funds that meet these criteria.

High yield mutual funds are one of the primary types of QIBs that purchase unrated municipal bonds. A typical high yield fund will invest in a mix of investment grade, barely investment grade, sub investment grade and unrated bonds, ranging from hospital debt to charter schools to full faith and credit pledges from governments with weaker credits. The QIB investors are experienced in financing non-rated projects. They use a variety of tools to determine the projects' financial feasibility and to enhance the credit of the project, including the requirement for vertical financing, special assessment payments, conservative LTV ratios, standby letters of credit for a portion of the payments or operating costs, large funded debt service reserve funds, and similar financial covenants and restrictions.

Over the past several weeks, our staff has met with several bond attorneys about allowing QIBs to purchase facility bonds. The attorneys with whom we spoke expressed no reservations about allowing QIB purchasers in this limited context. In addition, we have reviewed the reports generated by QIBs in their analysis of several economic development deals in other states and have spoken to underwriters who analyze, evaluate and place bond issuances with QIBs. We have been impressed by the depth of the QIBs' due diligence efforts and believe that their analysis is thorough and would be reasonable for the LGC to rely upon as the basis for the required finding of feasibility. However, staff believes that the default rates for QIB-purchased, unrated facility bonds could be higher than the average one to two percent.

It is important to note that this would not be the first time the Commission has approved unrated bonds without additional credit enhancement. The LGC has, in very limited circumstances, approved unrated bonds where the private entity was essentially serving a public purpose. For example, the Commission has authorized the sale of unrated bonds for a private company providing recycling services and for a rental housing facility for senior citizens.[2] In addition, recent bond sales for the Medical Care Commission and the N.C. Capital Facilities Finance Agency have allowed banks

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[2] Furthermore, the Commission has approved the sale of unrated bonds for two project development financing projects (TIFs) in which investment grade ratings were not achievable. In these two cases, these bonds carried credit enhancements in the form of minimum assessment agreements that guaranteed the payment of debt service from additional property taxes levied on property in the financing district.

purchasing unrated bonds to transfer the bonds to QIBs to satisfy banking requirements associated with a new financing structure connected with these facilities.[3]

Staff recommends that the Commission consider Qualified Institutional Buyers as acceptable purchasing institutions for facility bonds. We recommend that this allowance only apply if the QIB agrees to limit the secondary market sale of the facility bonds to banks, insurance companies, other QIBs and similar financial institutions. Beginning as early as the Commission's second May meeting, these QIB-placed bonds would be on the agenda. At this point, we only anticipate this policy shift with respect to the facility bonds. This will allow a "trial" implementation of these lowered credit requirements and allow for evaluation at a future date.

[3] For these financings, the agencies privately place bonds with a bank for an initial fixed term, usually five years. At the end of the period, the bank may choose to renew the financing for another five-year period or may choose to terminate the financing and require the bonds to be paid in full. If the bank chooses not to renew the financing, the bond documents require the bank to offer a taxable loan to the borrower in the amount of the outstanding bonds so that the initial bonds issued by the Agency or the Medical Care Commission can be paid off. For these financings, the banks have the option to transfer the bonds to QIBs in order to satisfy internal banking requirements, but it is unlikely that a QIB would have an interest in purchasing the taxable bonds.