S&P: Bank Loans Pose Potential Credit Risks, But For Now Issuers' Liquidity Positions Help Support Most Ratings.

Standard & Poor's Ratings Services continues to scrutinize the credit impact of bank loans assumed by issuers and their potential effects on Standard & Poor's rated debt. This commentary updates our Jan. 28, 2015. report on bank loans (see "Standard & Poor's Maintains Its Focus On Direct Loans After Evaluating $15.8 Billion In 2014") to include our 2015 year-to-date experience. Through Sept. 25, 2015, and including all prior years, we have reviewed 513 bank loans totaling approximately $20 billion in par by applying the methodology detailed in our 2012 contingent risk criteria.

The overwhelming majority of these bank loans we have evaluated have not, for the most part, negatively affected the credit quality of the obligors' debt rated by Standard & Poor's. This is because in our view (1) the parties to the transactions negotiated terms that we consider to be consistent with existing credit quality and current liquidity positions vis-à-vis the direct purchase terms under which acceleration could occur, (2) the financing structures do not present material contingent liquidity risks, and (3) the loans do not explicitly or implicitly subordinate other liens but the loan documents often provide preferential rights to the bank, in the event of a covenant default, which may result in a credit concern if liquidity is insufficient.

Overview

- So far in 2015, Standard & Poor's evaluated the impact of 109 bank loans totaling $4.22 billion on the obligors' public debt ratings. Of that total, six loans negatively affected the credit quality of Standard & Poor's rated parity obligations due to lenient covenants and inadequate liquidity levels to handle a potential acceleration event.
- The overwhelming majority of bank loans generally haven't negatively affected U.S. public finance issuers' credit quality when the financing structures mitigate contingent liquidity risks and where liquidity is sufficient per our criteria.
- We continue to stress the importance of loan disclosures in our written analysis and communications with issuers as direct purchase debt is often not subject to disclosure rules like rated securities.

Often, the bank loan financing documents contained provisions that introduced additional risks that the obligors' current liquidity position may or may not fully have mitigated. If liquidity were to erode in our view, credit quality and ratings could be negatively affected and the magnitude of the rating decline could be greater than it would be absent these loans.

Looking at 2015 exclusively, Standard & Poor's evaluated the impact of 109 bank loans with a par amount totaling $4.22 billion on the obligors' public debt ratings. The loans ranged from less than $287,000 to $300 million. To date, the ratings or outlooks of six obligors have been negatively affected by bank loans. The 109 loans evaluated thus far in 2015 include:

- 19 loans totaling $641 million and an average par of $33.8 million secured by universities, independent schools, and not-for-profit institutions;

- 35 loans totaling $1.89 billion and an average par of $54 million secured by hospitals and other health care providers;
- 40 loans totaling $589.9 million and an average par of $14.7 million secured by a variety of special taxes, general obligation and appropriation pledges, and
- 15 loans totaling $1 billion and an average par of $73.1 million secured by transportation and utility systems.

Measuring the U.S. public finance bank loan market remains a challenge for various reasons, most notably because bank loans are not explicitly required to be disclosed as they are not deemed to meet the legal definition of securities. Nevertheless, Standard & Poor’s observes that issuers across the municipal finance market continue to meaningfully use bank loans as an alternative financing product to manage their debt profiles for various reasons, including cost of capital, ease of issuance, and often to avoid the put features of various bonds.

Although the instances where we have adjusted ratings as a result of issuers’ use of bank loans have been limited, Standard & Poor’s continues to emphasize that disclosure of the loans and their terms is critical to identifying those cases where the loans do affect credit quality. Moreover, loan disclosure promotes transparency for all market participants, including the retail and institutional investors that use Standard & Poor’s ratings. In our view, reviewing the loans is critical because each transaction is separately negotiated, the terms are not uniform, disclosure of the loans can be inconsistent, and the potential for contingent liquidity exposures or altering the relative priority of creditors’ claims can be significant even for fixed-rate instruments. Consequently, we continue to underscore with issuers that carry Standard & Poor’s ratings the importance of providing us with bank loan documents, irrespective of whether we assign ratings to the issuers’ loans. Our view is that bank loans lacking the protections outlined in our criteria have the potential to meaningfully affect the credit quality of rated capital market instruments largely because of covenants that can trigger acceleration even in fixed-rate instruments.

06-Oct-2015