BOSTON (S&P Global Ratings) May 2, 2018--In March 2018, the Government Accounting Standards Board (GASB) released Statement No. 88, new accounting guidelines that detail disclosure requirements for a variety of financial instruments. S&P Global Ratings believes GASB 88 will help improve disclosure for direct purchase transactions, private placements, and bank loans (hereafter, bank loan structures), as well as other transactions that could present contingent demands on issuers' liquidity or alter the relative rights of lenders to public finance borrowers.

The document's introduction cites "improve[d] financial reporting," as GASB's purpose for introducing the disclosure guidelines. Similarly, S&P Global Ratings has viewed inconsistent disclosure and the asymmetric information associated with many bank loan structures as being detrimental to the market, and have called for improved disclosure requirements for years. As such, we view the GASB 88 release as an important and favorable development that facilitates transparency.

Markets function most efficiently when all stakeholders have symmetrical or equal access to material information. Although the release speaks to required disclosures, not all public finance issuers comply with GAAP standards or
adopt all GASB statements. Consequently, we believe the municipal market is not functioning as effectively as it could around a bank loan structure. Nevertheless, this release is a significant positive development that signals even to those who have not adopted GASB statements that the marketplace is developing higher expectations about disclosures. Adopting the statement could also have credit implications for our view of management teams, which is a component of our credit analysis and which we have found often have misunderstanding about these concepts.

GASB 88

Released in March 2018, GASB 88, "Certain Disclosures Related to Debt including Direct Borrowings and Direct Placements," cites improved information disclosure as the primary objective. GASB states that there is "essential information" that should be disclosed to all of an issuer's stakeholders when entering into bank loan structures due to "significant events of default ... and termination event with finance-related consequences..."

S&P Global Ratings agrees that these structures have financial implications that could affect credit quality and encourage all obligors to disclose these items, in addition to the audited statements, when entering these structures. Statement 88 will be effective for reporting periods beginning after June 15, 2018, so it is unlikely that we will see the associated improved reporting in audits until fall 2019. The statement, however, "encourage[s]" earlier application of the new standards. Although the improved disclosure might not be evident until late next year, we continue to ask about and assess all bank loan structures.

Historically, the question of, or perhaps the aversion to, whether to disclose these bank loan structures has centered on two points: whether there is a regulatory obligation to do so, and whether these bilateral financing arrangements constitute debt. To the first point, the Municipal Securities Rulemaking Board and SEC are still considering whether they need to clarify regulations regarding bank loans. But Statement 88 directly addresses the status of these financings as debt. Paragraph number 4 of the statement explicitly says:

"For purposes of disclosures in notes to financial statements, debt is defined as a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount that is fixed at the date the contractual obligation is established. For disclosure purposes, debt does not include leases, except for contracts reported as a financed purchase of the underlying asset, or accounts payable."

Paragraphs no. 5 and 6 outline the specific information to be included in the notes to the financial statements with respect to these instruments. They include "significant (1) events of default with finance-related consequences, (2) termination events with finance related consequences, and (3) subjective acceleration clauses." The statement further specifies that notes to financial statements address these matters in a separate section to promote clarity or,
dare we say, avoid confusion. The word significant leaves open the potential that covenants and remedies some investors or rating agencies deem meaningful could be left undisclosed. As such, S&P Global Ratings encourages a liberal interpretation of significant and believes that improved transparency better serves the market.

Furthermore, we agree with the GASB, as they state in the Appendix B of Statement 88, that the overall public benefit in implementing this change outweighs the costs to the individual issuers.

FEDERAL TAX CHANGE IMPACT
Our focus on the provisions of bank loan structures calls to mind some of their hidden hazards. As we did in the summer of 2017, we continue to bring to light the issue of the margin rate factor clause, or "gross-up covenant." The clause was included in bank loans to municipalities in the 1980s, leading up to the 1986 federal tax reform, but has been less consistently included since. It allows the bank the right to increase the interest rate the borrower pays if there are tax law changes that reduce the lender's tax rate or remove the municipal interest income tax exemption. These clauses hedge lenders' exposure to potential erosion of the value of the loan's stated interest rate.

Since December 2017's tax reform, the clause has been triggered regularly in first-quarter 2018. The adjusted rate is not stressing ratings because the nominal value of affected loans tends to be small relative to issuers' overall debt portfolios. However, the clause is raising credit risks. First, we have heard from bond counsel that issuers have been surprised that the margin rate factor clause was in the documents. Whereas the lawyers believe that the clause is typically discussed with clients before document execution, many issuers had not fully understood the potential costs associate with that language. This continued lack of complete understating of the provisions in these documents by the obligors augments the risk to the market. We assess management as part of our analysis, and have repeatedly found that many teams have misunderstandings about provisions such as the margin rate factor and other provisions of bilateral loan agreements, which reflects negatively on them and the issuer's credit quality.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information that helps to support the growth of transparent, liquid debt markets worldwide.