

Rate Resets for Out-of-the-Money Loan Commitments

Discussion Outline

October 25, 2019

1 OTMLC Definition and Scale in 2018-2019 Cohorts

The 2018-2019 WIFIA portfolio cohorts have significant out-of-the-money loan commitments (OTMLCs) due to Treasury rate levels at time of loan execution. An OTMLC has a fixed rate that has become materially higher than rates on the borrower’s likely current alternative tax-exempt (TE) bond financing. As such, absent other factors (e.g. limited bond capacity), a borrower is unlikely to draw an OTMLC unless rates on their alternatives rise.

Most WIFIA borrowers have both long-term and short-term TE alternatives for permanent and construction financing, respectively.

Currently seven of the oldest loan commitments in the 2018-2019 cohorts are likely to be OTMLCs, aggregating slightly more than half of total cohort commitment amount.

	<u>Name</u>	<u>Closing Date</u>	<u>Est. Closing</u> <u>UST30 Rate</u>	<u>Commitment</u> <u>Amount</u>	<u>Est. Bond</u> <u>Rating</u>	<u>BVAL AAA</u> <u>Spread</u>	<u>Alternative</u> <u>Bond Rate</u>	<u>YTM 20</u> <u>BVAL AAA</u> <u>2.40%</u>	<u>Drawn</u> <u>Amount</u>
1	King Co. (Wash)	20-Apr-18	3.01%	135	Aa1/AA+	110%	2.64%	0	0
2	Omaha City	21-Jun-18	2.96%	70	Aa1/AA+	110%	2.64%	0	0
3	SF PUC	30-Jul-18	3.05%	699	Aa3/AA-	110%	2.64%	0	0
4	Orange Co. WD	1-Aug-18	2.99%	135	Aa1/AA+	110%	2.64%	0	0
5	SD PFFA	27-Nov-18	3.22%	614	Aa3/AA-	120%	2.88%	0	0
6	St. Louis MSD	20-Dec-18	2.88%	48	Aa1/AA+	110%	2.64%	0	0
7	Baltimore City	25-Feb-19	2.90%	202	Aa3/AA-	120%	2.88%	0	0
8	Miami-Dade Co.	5-Apr-19	2.78%	100	Aa3/AA-	120%	2.88%	1	100
9	SVCW	17-Jul-19	2.40%	218	Aa2/AA	115%	2.76%	1	218
10	Tulatin - Hills	20-Aug-19	1.87%	640	Aa1/AA+	110%	2.64%	1	640
11	NBC	22-Aug-19	1.92%	269	Aa3/AA-	120%	2.88%	1	269
12	IFA	6-Sep-19	1.78%	436	AAA/AAA	105%	2.52%	1	436
	Totals			3,566					1,663

2 Possible Program Issues with a High Level of OTMLCs

Although OTMLCs do not pose credit or compliance issues per se, a high aggregate and persistent level of OTMLCs may be detrimental to the Program:

- **Misleading indication of Program performance:** In reality, even if never drawn, a WIFIA loan commitment provides interest rate management benefits to the borrower and the project itself will comply with policy objectives regardless of ultimate financing. However, the ‘soundbite’ perception of a successful loan program includes drawn loans. Undrawn OTMLCs may be mischaracterized (intentionally or unintentionally) as a failed product.
- **Change in borrower’s intended use:** Since a WIFIA rate is fixed at Treasury flat, a loan commitment is in-the-money for almost all borrowers at execution and likely intended to be drawn, at least for permanent term financing. However, if the commitment becomes a persistent OTMLC, the borrower may begin to view it as a secondary option and focus on developing bond alternatives as the primary financing plan.
- **Increased Program exposure to interest cost re-estimate risk:** If the borrower views the loan commitment as a secondary option, this increases the chance the loan will only be drawn at the last possible time in a rising rate environment, resulting in greater mismatch between Treasury funding cost and loan rate. The full PV of this will be reflected in the final FCRA interest subsidy cost re-estimate. Although the re-estimate is an off-budget item (Permanent Indefinite Authority), it is an indicator of a true cost to federal taxpayers.

3 OTMLC Rate Reset – Legal and Budget Aspects

In theory, to reset an OTMLC to current rates, a borrower can simply unilaterally cancel its existing loan commitment and re-apply for the same project in the next open Solicitation. In practice, for both the borrower and the Program, this approach is uncertain, wasteful of resources and likely to be poorly perceived. A bilateral agreement to reset at current Treasury rates would be far more efficient and provide benefits to both sides.

Since the Program was intended to provide in-the-money loan commitments at current Treasury rates, such a bilateral reset appears to be fundamentally consistent with Congressional intent. However, resets were not anticipated in specific Program legislation or budget protocols.

- **Legal:** USC 33§3908(b)(4) is explicit that the loan rate is fixed “on the date of execution of the loan agreement”. This suggests that a reset will require a new execution of the loan agreement. It is a legal question to what extent the approval and execution a major amendment (e.g. a new Effective Date) of an existing loan agreement can be considered a new execution for the statute.
- **Budget:** If a reset can simultaneously be viewed as a “new execution” for statutory purposes and a “modification” or “re-estimate” per OMB A-11§185.3(s) for FCRA purposes, then budget protocols may be straightforward. If not, a reset may require a cancellation of the existing commitment and a new allocation of budget resources, a process that is likely to be much more complex and raise other issues (e.g. whether the allocation must occur in the competitive context of a currently open Solicitation).

4 OTMLC Rate Reset Structural Options

Assuming legal and budget clarifications provide the necessary scope, there are various structural options for a reset transaction that can achieve borrower and Program objectives:

- a) **Unconditional reset:** The only significant change to the existing loan commitment is a current Treasury rate as of the new Effective Date. No other conditions are imposed.
- b) **Reset with minimum required construction draws:** For the new rate, the borrower agrees to make minimum draws on the commitment during the construction period (corresponding to a conservative schedule of Eligible Asset expenditure) regardless of cheaper short-term financing alternatives. The agreement would make clear that any modification of the schedule that reduced or delayed draws would require approval on a sole discretion basis that (absent force majeure etc.) would be denied.
- c) **Reset with full draw into escrow:** For the new rate, borrower would agree to fully draw the loan shortly after closing and deposit unused amounts into SLGS escrow. Future draws from escrow would be subject to same conditions as existing agreement but the timing could be relatively flexible (e.g. a single draw within one year after construction completion would be permitted).
- d) **Reset with full draw into escrow and minimum required construction draws:** All the conditions of both option 2 and 3 above.

4a Unconditional Reset

An unconditional reset is the simplest and most attractive option for the borrower. For the Program, an OTMLC is replaced by a loan commitment that is more likely to be drawn. However, there may also be significant downsides for the Program with this option:

- Most importantly, an unconditional reset would establish a precedent of ‘ratcheting down’ initial loan commitment rates. This could change many borrowers’ view of a WIFIA loan: from an intended source of financing to a complex mechanism wherein the loan’s original rate is simply a cap and the primary purpose is to reset the loan rate at the lowest point during a lengthy construction period. Larger borrowers (and their advisors) would seek to maximize the value of such an unusual mechanism, possibly in innovative ways that were inconsistent with Program objectives.
- The lower reset rate would increase the chance of ultimate loan draw, but the ‘mechanism mindset’ could encourage the same borrower behavior that makes an OTMLC a source of interest rate risk for the Program – waiting until the last possible time to draw in a rising rate environment – but with an even lower WIFA rate.
- An unconditional reset will *at best* not improve the Program’s position. This would raise questions of justification and equity about why a one-sided deal is being offered. These issues will likely make resolution of any legal and budget issues more difficult.

4b Reset Requires Minimum Future Construction Draws

Since a downward reset is intrinsically valuable to a borrower, the Program can require conditions that improve its own position while reducing reset value to some extent. A simple condition is to require a minimal schedule of loan draws during construction. This will mitigate some issues arising from either doing nothing with OTMLCs or offering an unconditional reset.

- Requiring financing draws will characterize the WIFIA product more as a ‘loan’, less as an ‘option’. In addition, drawn construction loans have a positive impact on federal tax revenues.
- Depending on the drawdown schedule, the Program will still be exposed to interest cost risk if rates rise rapidly from the reset point, but the exposure is at least partially hedged.
- For a borrower that otherwise would have used short-term TE financing for construction, the minimal draw schedule will cost the difference between short-term TE rates and long-term WIFIA rate.

Results	Undiscounted		PV @ W-Rate	
	\$ Amt	% Cost	\$ Amt	% Cost
Negative Arbitrage	0.0	0.0%	0.0	0.0%
WIFIA vs. ST TE Rates	10.0	1.6%	9.3	1.5%
Total	10.0	1.6%	9.3	1.5%
Federal Tax Rev. Impact	4.9	0.8%	4.6	0.7%

Borrower Cost Example

Using \$614M San Diego PFFA OTMLC 5-year construction schedule, total cost (full 5 years; unchanged rates after reset) for construction draw requirement is about 1.5% of project cost. Federal tax increase about \$4.9 million.

From: Reset escrow cost estimate SD PFFA 10252019.xlsm

4c Reset Requires Full Draw to Escrow Only

A more complex condition would require full draw of the loan commitment into escrow shortly after closing but relative flexibility thereafter.

- This condition would effectively eliminate Program interest cost risk for the loan (full disbursement would establish FCRA Single Effective rate at closing rates) and firmly anchor the product as permanent (and possibly construction) financing for the infrastructure project.
- Depending on rates, the borrower may still elect to use short-term financing for construction and do a single-draw from escrow at completion. This would have a neutral effect on federal tax revenues.
- The borrower will incur negative arbitrage in the escrow due to the difference between short-term and long-term Treasury rates. This is functionally equivalent to the cost incurred in hedging a bond, but the rate differential is lower as no credit spreads or arbitrage restrictions are involved. In addition, the borrower will likely reset at least a few years after initial close, further reducing total negative arbitrage amount.

Results	Undiscounted		PV @ W-Rate	
	\$ Amt	% Cost	\$ Amt	% Cost
Negative Arbitrage	19.3	3.2%	18.1	3.0%
WIFIA vs. ST TE Rates	0.0	0.0%	0.0	0.0%
Total	19.3	3.2%	18.1	3.0%
Federal Tax Rev. Impact	0.0	0.0%	0.0	0.0%

Borrower Cost Example

Using \$614M San Diego PFFA OTMLC 5-year construction schedule, total cost (full 5 years; unchanged rates after reset) for full escrow only requirement is about 3.0% of project cost. Single-draw; no federal tax increase.

From: Reset escrow cost estimate SD PFFA 10252019.xlsm

4d Reset Requires Full Draw to Escrow and Minimum Future Construction Draws

The Program could require *both* full draw into escrow *and* minimum future construction draws from escrow, effectively combining conditions of 4(b) and 4(c) above.

- Other than to intensify the characterization of WIFIA as a source of financing (not just interest rate management), the main Program benefit is the increase in federal tax revenues during construction as the WIFIA loan replaces tax-exempt construction financing. This may be especially relevant in a standard CBO/JCT ‘pay-for’ 10-year budget scenario.
- From the borrower’s perspective, the marginal cost of combining both conditions may be slight, since the rate differential in escrow negative arbitrage is about the same as between short-tax exempt financing and the reset WIFIA loan rate. There may also be minor counterbalancing benefits from ‘one-stop’ simplification and improved perception of WIFIA facility as an immediately useful source of financing.

Results	Undiscounted		PV @ W-Rate	
	\$ Amt	% Cost	\$ Amt	% Cost
Negative Arbitrage	11.4	1.9%	10.9	1.8%
<u>WIFIA vs. ST TE Rates</u>	<u>10.0</u>	<u>1.6%</u>	<u>9.3</u>	<u>1.5%</u>
Total	21.4	3.5%	20.2	3.3%
Federal Tax Rev. Impact	4.9	0.8%	4.6	0.7%

Borrower Cost Example

Using \$614M San Diego PFFA OTMLC 5-year construction schedule, total cost (full 5 years; unchanged rates after reset) for full escrow and construction draw is about 3.3% of project cost. Federal tax increase about \$4.9 million.

From: Reset escrow cost estimate SD PFFA 10252019.xlsm

5 Recommendations and Next Steps

Rate resets are apparently unprecedented in infrastructure loan programs. A series of sequential steps will be required to determine if they are a practical tool.

Legal and Budget Framework

- 1) Establish specific legal requirements of “date of execution” meaning for statutory purposes.
- 2) Based on minimally-required legal form, establish whether a rate reset transaction will be a (1) modification or re-estimate per OMB A-11§185.3(s) definition, or (2) a new transaction.

Borrower Interest

- 3) Borrowers have expressed general interest in resets, but they may or may not be interested if conditions were required. Establish informally if they would consider a conditional proposal.
- 4) Estimate in further detail approximate cost and Program BCA of various conditions.

Transaction Development

- 5) Bearing in mind that any proposal will set a precedent, develop transaction proposal for most interested borrower. Recommended: Start with 4(d), all conditions included.
- 6) If rate resets seem practical and effective to improve both borrower and Program position, develop and approve standard Program policies.