# U.S. Public Finance Tender Option Bond Rating Criteria

## Sector-Specific

## Scope

Tender option bond (TOB) programs were developed to create synthetic short-term paper with a put feature that makes it eligible for money market funds. In a typical TOB structure, a fixed-rate bond or note, or other financial instrument with similar characteristics to a bond, is deposited into a trust. The trust issues two new securities: receipts that bear interest at a variable rate and often have a tender option; and an inverse floating-rate or residual interest receipt with no tender option (residual receipt). The original issuer of the deposited securities plays no role in issuing the TOB; the transaction occurs in the secondary market.

This criteria report describes Fitch Ratings' approach to rating new and existing TOB programs in the U.S. It outlines the general framework of our analytical approach, which considers the credit risks of the legal structure and the quality and sufficiency of the liquidity support. The criteria set out in this report supplement, and are applied in conjunction with, the applicable criteria reports.

## Key Rating Drivers

The assignment of a rating is conditioned on the presence of each of the following factors. As such, there is equal weighting among the key rating drivers.

**Securities Deposited into a Trust:** Principal and interest payments made to receipt holders are derived from regularly scheduled debt service payments on the securities held by the issuing trust.

**Ratings Linked to Deposited Securities:** The long-term rating for the floating-rate receipts and residual receipts is equal to the Fitch rating of the deposited securities, unless such securities are otherwise credit enhanced, in which case, the rating is capped at the rating of the credit enhancer. The short-term rating is based on the bank providing liquidity support for the floating-rate receipts, but may never be higher than the short-term rating level that corresponds to the long-term rating of the deposited securities, in accordance with the table on page 3.

**Calculation of Maximum Interest Rate:** The variable interest rate on the floating-rate receipts is adjusted periodically by the remarketing agent. The maximum rate payable on the floating-rate receipts is calculated by the remarketing agent so that the total dollar amount of income paid on the underlying securities is adequate to pay interest on all floating-rate receipts. The interest payable on the inverse floating-rate or residual receipts is the difference between the total amount of money available to pay interest and the amount payable to floating-rate receipt holders and agents receiving fees.

**Termination of Tender Rights for Floater Holders:** Holders may have the right to tender their floating-rate receipts periodically, as described in the legal documents. Third-party liquidity support facilities provide payment of the purchase price for tendered receipts. A tender option termination may occur as a result of a material deterioration in the credit quality of the deposited securities, or their taxability.

### Table of Contents



This report replaces the prior criteria report entitled "U.S. Public Finance Tender Option Bond Rating Criteria," dated March 25, 2020.

### Related Criteria

U.S. Public Finance Structured Finance Rating Criteria (February 2021)

U.S. Public Finance Variable-Rate Demand Obligations and Commercial Paper Issued with External Liquidity Support Rating Criteria (December 2020)

U.S. Public Finance Letter of Credit-Supported Bonds and Commercial Paper Rating Criteria (February 2021)

### Analysts

Joseph Staffa
+1 212 908-0829
joseph.staffa@fitchratings.com

Richard Park
+1 212 908-0289
richard.park@fitchratings.com

Ronald McGovern
+1 212 908-0513
ronald.mcgovern@fitchratings.com

Linda Friedman
+1 212 908-0727
linda.friedman@fitchratings.com

Mario Civico
+1 212 908-0796
mario.civico@fitchratings.com

## Creation of the Trust — Deposit of Securities

Because the deposited securities' cash flow is the TOB purchaser's ultimate security, Fitch reviews the trust structure to determine that the deposit of the securities is irrevocable, in the form of a grant and free and clear of any liens of the depositor. This mitigates the risk that the securities would be characterized as assets of the estate of the depositor of the securities in the event of the depositor's insolvency. The programs provide for multiple series of receipts issued under a set of master documents. Each series in the program is governed by both the master documents and the series supplements, which create separate series trusts.

## Maximum Floating-Rate Calculation

Deposited securities often bear interest at a fixed rate, while the variable interest rate set on the floating-rate receipts by the remarketing agent is capped at a maximum rate. Fitch reviews the documents to determine that the maximum rate payable on the floating-rate receipts will be calculated so that the total dollar amount of income paid on the underlying securities is adequate to pay interest on all floating-rate receipts. In addition, when periodic fees owed to the remarketing agent, liquidity provider and trustee are subtracted from the pass through of income prior to payment of interest on the floating-rate receipts, the maximum floating rate must be reduced accordingly.

Fitch also reviews the maximum rate formula as set out in the program documents to ensure that an interest shortfall caused by "non-accrual days" and "odd-lot redemptions" will not occur. Non-accrual days may result when interest on the bonds is calculated on the basis of a 360-day year of 12 30-day months and interest on the receipts is calculated on the basis of the actual number of days elapsed in a 365- to 366-day year. The mismatch in accrual methods raises concerns if bonds are redeemed on a date other than an interest payment date. Unless the maximum rate formula addresses the possibility that the floating-rate interest accrual period could exceed the interest accrual period for the deposited bonds by adjusting the maximum floating rate down, an interest shortfall may occur on the floating-rate receipts.

Interest shortfalls may also occur if deposited bonds are partially redeemed and the amount of bonds redeemed is not equal to an authorized denomination of the floating-rate receipts. If the program does not permit the issuance of odd-lot receipts or there is a requirement to maintain a proportional relationship between floating-rate and residual receipts, the aggregate amount of receipts outstanding may exceed the principal amount of bonds remaining in the trust. Interest will continue to accrue on the amount of receipts outstanding. The trustee will hold the bond redemption proceeds in excess of the amount of receipts that could be redeemed in the trust, uninvested, in an odd-lot subaccount until the amounts on deposit are sufficient to redeem receipts in authorized denominations.

To determine that there is no shortfall in the interest available to pay floating-rate receipt holders, the program documents may provide that the parties agree on procedures for the issuance of receipts not in authorized denominations. In cases where an odd-lot amount may exist, the maximum rate definition takes into account the possibility of odd-lot amounts by reducing the rate to reflect the possibility that a principal amount of bonds may be redeemed but cannot be passed through because the redemption amount does not aggregate to the authorized denomination of receipts.

## Tender Option

Floating-rate receipts have many of the same characteristics as primary market variable-rate demand obligations (VRDOs), such as interest rate determination methods, put provisions, third-party liquidity support to provide a purchase price for tendered but unremarketed floating-rate receipts, and types of interest rate modes. While the receipts bear interest in various modes, the floating-rate receipt holders may have the option to tender their securities on any business day following required notice. Recent programs have provided for a mandatory tender at the end of term periods of 90–366 days in duration, with no optional tender. Whether optional or mandatory, funding for the tender is provided by the third-party liquidity support provider.

Fitch's analysis of the tender feature is similar to the analysis of tender features of VRDOs supported with liquidity facilities (see "U.S. Public Finance Variable-Rate Demand Obligations and Commercial Paper Issued with External Liquidity Support Rating Criteria") Fitch reviews the liquidity facility and other documents governing the TOB program to ensure the following:

- The liquidity facility provides coverage for the full principal amount of the floating-rate receipts plus the maximum amount of interest that can accrue during the longest interest period at the maximum interest rate, unless the facility is terminated prior to the tender date.
- The party authorized to draw under the liquidity facility has clear instructions to draw upon the facility, in accordance with its terms in the event remarketing proceeds are insufficient to pay the purchase price for tendered receipts, unless the facility is terminated prior to the tender date.
- Funds drawn under a liquidity facility and other funds provided for purchases are generally held uninvested since they are on hand for no more than 1-2 days and to protect against investment risks, and will remain free from agent liens.

Floating-rate receipts are also subject to mandatory tender upon occurrence of specified events, including substitution or scheduled termination of the liquidity facility and conversion of the interest rate determination mode. Fitch's review includes the determination that liquidity facilities will remain available to provide funds in the event of a failed remarketing following all mandatory tender events.

## Risk of Termination of Tender and Liquidity

Holders of TOBs are exposed to the risk that the tender option will terminate and the liquidity facility supporting payment of tender price will terminate without notice following one of the events described on the next page.

The risk that a downgrade to below investment grade or other termination event occurs during the relevant tender period (daily to 366 days) is reflected in the assignment of a short-term rating linked to the long-term rating of the relevant municipal security. When the underlying security's long-term rating is on a rating cusp (A+ or A−, for example), Fitch will generally assign the higher of the two short-term ratings shown in the table at the right, unless the underlying security's long-term rating is on a rating cusp (A+ or A−, for example) and on Rating Watch Negative, in which case, Fitch will generally assign the lower of the two short-term ratings shown in the table. A lower short-term rating reflects the increased possibility of the occurrence of one of the events that can immediately terminate the tender option and the liquidity facility. The table provides the relevant mapping and corresponds to mapping used by Fitch when assessing external liquidity support.

### Relationship Between Long- and Short-Term Ratings

| Long-Term Rating | Short-Term Rating |
|---|---|
| AAA | F1+ |
| AA+ | F1+ |
| AA | F1+ |
| AA– | F1+ |
| A+ | F1+ or F1 |
| A | F1 |
| A– | F1 or F2 |
| BBB+ | F2 |
| BBB | F2 or F3 |
| BBB– | F3 |

Source: Fitch Ratings.

Following termination of the liquidity facility by the bank, Fitch will withdraw the short-term rating, as the liquidity support that forms the basis of the rating is no longer in place. The long-term rating assigned to the floating-rate and residual receipts will be withdrawn upon the resulting termination of the trust and payment to holders of what is due them or a distribution of the deposited securities.

Although synthetic floating-rate receipts are similar to VRDOs, additional liquidity risks are associated with secondary market synthetic structures. Floating-rate receipt holders can lose the right to tender their receipts upon the occurrence of certain events related to the credit quality or taxability status of the securities deposited. These events are called tender option termination events and include the following:

- Payment default by the issuer of the deposited securities or, if the security is credit enhanced, default by the credit enhancer.
- Act of bankruptcy by or against the issuer of the deposited securities or, if the security is credit enhanced, by or against the credit enhancer.
- The rating of the deposited securities is lowered to below investment grade (below BBB–).

- A determination of taxability with respect to the deposited securities.

Fitch reviews the trust documents to determine that there is no possibility that the default or bankruptcy of an unrated security issuer can cause a tender option termination event.

In the event of a tender option termination event, floating-rate receipt holders lose their tender option rights and receive either the proceeds of the sale of the securities, provided that such proceeds are sufficient to pay the holders the par amount of receipts plus accrued interest and all fees to the agents, or their pro-rata share of the deposited securities.

## Rating the Residual Receipts

While some TOB programs do not provide for the residual receipt to be rated, many program sponsors request a rating on the residual receipt. Generally, the residual holder is entitled to only those funds that remain after all agents have been paid their fees and all floating-rate holders have received full principal and accrued interest on their receipts. Fitch can assign a long-term rating to the residual receipts based on the rating of the deposited securities if the program is structured so that the residual holder's right to receive the principal amount of the residual receipt or its pro-rata share of the deposited securities ranks pari passu with the right of the floater holders to receive the principal amount of their floater receipts or their pro-rata share of deposited securities upon the occurrence of a tender option termination event or the termination of the trust.

## Legal and Tax Issues

The legal analysis for TOB programs concentrates on enforceability and taxability issues. Fitch reviews legal opinions provided by the liquidity provider's counsel to determine that the liquidity facility has been duly authorized, is enforceable in accordance with its terms, and is a legal, valid and binding obligation of the provider. When the liquidity provider is a foreign entity, enforceability opinions from both foreign and domestic counsel are reviewed. A tax opinion addressing the classification of the trust and stating that there is no tax at the entity level for federal and state purposes is also reviewed. In addition, unlike most direct obligations of states, local governments and other public instrumentalities, TOBs are not automatically exempt from requirements to register securities offerings with the Securities and Exchange Commission. Consequently, TOBs are sold to institutional investors qualifying for exemptions from the registration requirements of the securities laws. A legal opinion addressing the exemption from registration is also reviewed as failure to register the securities may result in monetary penalties at the trust level and possibly interfere with the cash flow of the deposited securities.

As TOB structures evolve and new products and structures are developed, Fitch may request additional opinions. These opinions may include true sale or security interest opinions. True sale opinions have not been requested by Fitch to date, as we have been comfortable with the structure since the deposit of the securities is irrevocable, in the form of a grant, and free and clear of any liens of the depositor. In most structures, the parties are independent of each other and transact at arm's length, and in those cases where the sponsor depositor owns a portion of the certificates, that portion is a de minimus amount. Fitch will evaluate the need for any additional opinions on a case-by-case basis.

## Multiple Bonds Deposited in the Trust

Some secondary market derivative programs provide for the deposit into the trust of multiple bonds of the same credit quality of a single security issued by the same credit issuer. Since the interest rate on each of the bonds deposited in the trust may be different, the maximum amount of interest due to the floating-rate receipt holders on each interest payment date should not exceed the aggregate amount of interest accruing on the bonds during that period. The maximum rate definition may provide for a calculation using the lowest interest rate borne by the bonds in the trust. This will ensure that the cash flow generated by the bonds will be sufficient to pay interest on the floating-rate receipts, even if bonds bearing interest at higher rates are redeemed.

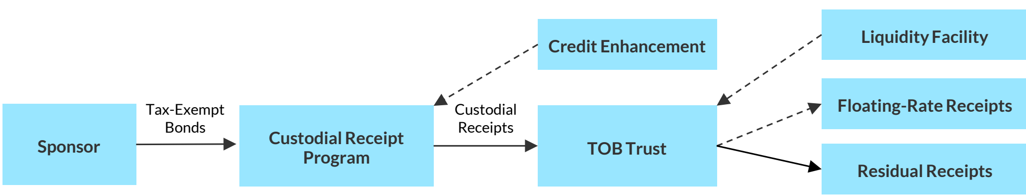
## Custody Receipts

A similar secondary market product, referred to as a custody receipt, is created when securities are deposited with a custodian pursuant to a custody agreement. The custodian issues receipts that represent individual interests in the deposited securities. Credit enhancement is usually added to these custody receipts, which essentially raises the credit quality of the deposited security. The receipts may be marketed on their own or used as the asset to be deposited into a TOB trust. As with TOBs, the original issuer has no role in the issuance of the custody receipt, and the securities deposited with the custodian may be only a portion of the original issuance. The custodian draws on the credit enhancement directly or after a failed payment on the deposited securities whenever principal and interest is due on the deposited securities to make payment on the custody receipts. When deposited as the asset in a TOB trust, these payments are passed through to make payment on the TOB receipts. Generally, the long-term rating of the credit enhancer of the custody receipts will be the basis of the long-term rating for the TOB receipts, except in instances where the long-term rating of the underlying security is higher than that of the credit enhancer.

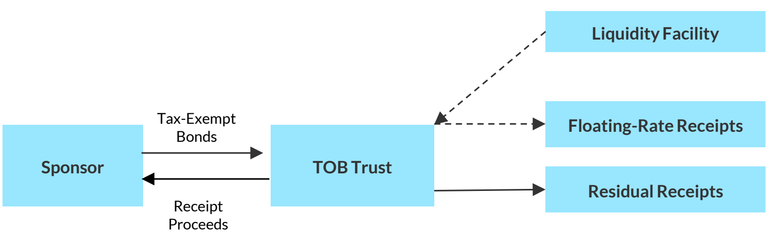
Fitch's analysis of the custody receipts focuses on similar issues found in the creation of a TOB trust, as described: the free and clear deposit of the bonds into the custody arrangement, exemption from registration under the securities laws and the enforceability of the credit support. Examination of the credit support, usually a letter of credit (LOC), involves many of the analytical issues important for the rating of LOC-supported bonds (see ”U.S. Public Finance Letter of Credit-Supported Bonds and Commercial Paper Rating Criteria”).

The following charts depict the TOB structure with and without custodial receipts.

**Custodial Receipts**




**Tender Option Bonds**




Source: Fitch Ratings.

## Surveillance

The ratings of third-party credit enhancement providers or relevant underlying assets are central elements in determining the rating of the TOBs. TOBs will carry over the long-term rating of the underlying asset, or the long-term rating that Fitch maintains on the bank providing credit enhancement for the underlying asset. The short-term rating is derived from the bank providing the liquidity support, capped by the long-term rating of the underlying asset. Ratings for these entities are monitored by the sector analysts in accordance with their respective surveillance schedules. Any direct support counterparty rating changes will be reflected in the TOB ratings.

## Rating Assumption Sensitivity

The long-term rating is tied to the creditworthiness of the underlying securities deposited in the trust. Changes to this rating may affect the long-term rating assigned to the TOBs.

The short-term rating is tied to the short-term rating that Fitch maintains on the bank providing the liquidity facility, capped by the long-term rating of the underlying asset.

## Data Sources

The key rating assumptions and the ratings analysis used in these criteria are based on the legal precedent of relevant instrument and program documentation, which contractually obliges a third party to provide credit and/or liquidity support for securities within certain terms and conditions. Sources can include issuers and legal counsels' explanations to Fitch and their program public offering documents' disclosure of documentation terms and conditions, which confirms the understanding of the contractual support mechanisms and any limitations.

## Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating where appropriate.

A variation can be approved by a ratings committee where the risk, feature or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

## Limitations

Ratings, including Rating Watches and Outlooks, assigned by Fitch are subject to the limitations specified in Fitch's Ratings Definitions page at www.fitchratings.com.