FitchRatings

Public Finance
Municipal Structured Finance
U.S.A.

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

Sector-Specific

Scope

This report outlines Fitch Ratings' criteria for assigning short-term ratings to new and existing U.S. variable-rate demand obligations (VRDOs) and commercial paper (CP) issued with the support of external liquidity facilities, as well as for the surveillance of existing ratings assigned pursuant to these criteria. External liquidity facilities are dedicated third-party facilities provided by banks or other entities that are available to the trustee and paying agent for the benefit of debtholders and exclusively for the repayment of specified short-term debt. Fitch considers the liquidity provider's ability to honor its liquidity commitments when assigning a short-term rating to obligations backed by these liquidity facilities.

Under the terms of the debt instrument documentation, holders of VRDOs are entitled to receive a purchase price equal to the principal of and accrued interest on their bonds upon the exercise of a tender option or any mandatory tender of the bonds. If tendered bonds cannot be remarketed, another source of funds, typically a liquidity facility, must be readily available to pay tendering bondholders.

CP is a short-term instrument that matures in 1-270 days and is assigned a short-term rating. Purchasers of CP issued with the benefit of external liquidity rely on that support as a source of payment as notes mature.

The criteria outlined in this report are used in conjunction with the criteria listed under Applicable Criteria. References to "banks" throughout these criteria means banks, financial institutions, or other entities providing short-term liquidity.

Key Rating Drivers

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

Role of Liquidity Facilities: Liquidity facilities, such as standby bond purchase agreements, are frequently used by the more highly rated public finance debt issuers in connection with the issuance of VRDOs and CP. These dedicated third-party facilities provide a source of liquidity to ensure payment of the purchase price of tendered VRDOs in the event of a failed remarketing or to pay CP at maturity. The short-term rating of the bank providing the liquidity facility is the most direct driver of the short-term rating assigned to the VRDOs and CP.

Likelihood of Liquidity Termination: The long-term ratings for VRDOs, which are assigned using the relevant public finance sector criteria, represent an evaluation of the degree of risk associated with scheduled principal and interest payments. The short-term rating for VRDOs and CP reflects the Short-Term Issuer Default Rating (IDR) of the bank providing external liquidity capped by the issuer's long-term rating.

This linkage represents an evaluation of the risk associated with the purchase demand feature for VRDOs, plus the likelihood of immediate termination of the bank's obligation to provide liquidity without first effectuating a final purchase of the VRDO, or payment at maturity for CP, due to certain credit events related to the debt issuer.

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This report replaces the Fitch criteria report titled "U.S. Public Finance Variable-Rate Demand Obligations and Commercial Paper Issued with External Liquidity Support Rating Criteria," dated Dec. 23, 2020.

Applicable Criteria

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

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Facility's Sizing Reviewed: The full purchase price at the maximum possible interest rate should be covered in the intended interest rate modes in VRDOs, with provisions to protect investors upon conversion to uncovered rate modes. External support for CP may either provide for the payment of principal and interest due on maturing CP or only the payment of principal with the issuer obligated to pay accrued interest on maturing CP.

Revocability of Facility: Early and immediate termination of the facility may occur if triggered by events that indicate a material deterioration of the debt issuer's credit. For example, if the issuer Long-Term IDR falls below investment grade or is withdrawn by Fitch, the liquidity facility would terminate. Any other termination of the facility is accompanied by a prior takeout and full payment to investors with the support of the facility.

Legal Opinion Addresses Enforceability: Fitch reviews legal opinions that provide assurance of the facility's enforceability since the facility is the source of payment in a failed remarketing and the short-term rating is based directly on its presence.

What the Ratings Address

By utilizing external liquidity facilities issued by banks and other financial institutions, municipal issuers are able to shift the primary source of payment for ongoing tender obligations and maturing CP from themselves to the liquidity provider. This allows them to provide a third-party source of funds on particular VRDOs and CP issuances as a means of more efficiently managing their liquidity position.

VRDOs with external liquidity facilities are assigned long- and short-term ratings, with the long-term component representing an evaluation of the degree of risk associated with principal and interest payments, and the short-term component representing an evaluation of the risk associated with the purchase demand feature and the likelihood of termination of the bank's revocable obligation to provide liquidity without first effectuating a final purchase of the VRDO. Consequently, the long-term component of the VRDO rating is based on the creditworthiness of the issuer, reflecting continued reliance on the issuer for payment of principal and interest.

The short-term component of the rating is based on the short-term rating of the liquidity support provider, that is, the ability of the bank to provide timely payment of purchase price upon an optional or mandatory tender in the event of a failed remarketing of the bonds, but is capped by the long-term rating assigned to the debt issuer's obligations that rank senior to, or on parity with, the bonds, in a manner described below.

In rating CP supported by revolving credit agreements (RCAs), which are also revocable obligations of the bank, Fitch likewise caps the short-term rating of the CP at the long-term unenhanced rating assigned to the CP issuer's obligations that rank senior to, or on parity with, the CP notes. While liquidity facilities may also be called standby note purchase agreements and even standby letters of credit by certain banks, these facilities do not cover credit risk and function as revocable liquidity facilities and are quite distinct from irrevocable direct-pay letters of credit.

Ratings for banks providing liquidity are assigned by Fitch's Financial Institutions group, which continually monitors the banks' credit and liquidity strength. Any rating action on the short-term rating of the financial institution will be reflected in the short-term component of the rating assigned to the bonds or CP.

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

Relationship Between Long- and Short-Term Ratings

Long-Term Rating	Short-Term Rating
BBB+	F2
BBB	F2 or F3
BBB–	F3

Source: Fitch Ratings.

Fitch determines the appropriate short-term rating for the VRDO or CP transaction based on the table above. A short-term rating based on a bank liquidity facility may never be higher than the short-term rating, as indicated in the table, which is related to the long-term rating of the debt issuer since the liquidity provider's obligation to fund the purchase price for tendered bonds or CP is conditioned on the issuer's ability to meet its debt obligations. When the debt issuer's long-term rating is on a rating cusp (A+ or A–, for example) with a Stable Rating Outlook, Fitch will generally assign the higher of the two short-term ratings shown in the table above. When the debt issuer's long-term rating is on a rating cusp and on Rating Watch Negative, 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 liquidity facility, as described later in this report.

Accordingly, as the risk of termination increases, the short-term rating is adjusted downward to reflect this, even if the liquidity bank's own short-term rating remains unchanged. For example, if the issuer is downgraded to 'A', the short-term rating for the VRDO or CP would not reflect this risk at the highest short-term rating, 'F1+', even if the liquidity bank's own short-term credit rating remains at 'F1+'. The short-term rating will be lowered to 'F1' to reflect the increased risk of a termination event occurring and the resultant loss of liquidity.

Sufficiency of Funds

Fitch assesses whether the documents governing VRDO or CP transactions work together sufficiently to permit full and timely payment to holders of VRDOs and CP.

External liquidity facilities are dedicated, third-party bank facilities available to the trustee and paying agent for the benefit of holders and exclusively for the repayment of specified short-term debt. They generally cover the full amount of the purchase price of tendered bonds. Fitch reviews the liquidity documents to determine that facilities provide for full principal plus the maximum amount of interest that would accrue during the longest rated interest accrual period. Interest is calculated at the maximum rate allowable under the bond documents.

For CP issued with the support of an external liquidity facility, the RCA may either provide for the payment of principal and interest due on maturing CP or the payment of principal when the issuer is obligated to pay accrued interest on the maturing CP. When the RCA only supports principal, the rating assigned to the CP reflects the external support of the RCA and may be adjusted downward to take into consideration the ability of the issuer to cover interest due on maturing CP.

When a liquidity facility is sized to cover only certain interest rate modes for VRDOs, conversion to modes with longer interest accrual periods is preceded by one of the following in order to maintain the rating: a mandatory tender; a substitute liquidity facility or an increase in the interest component of the liquidity facility, either of which may be accompanied by receipt of notice from Fitch that the conversion will not result in a reduction or withdrawal of the short-term rating on the bonds; or, in the case of a conversion of only a portion of the bonds, segregation of funds drawn on the liquidity facility for the benefit of the holders of the bonds supported by such facility.

The documentation authorizing and governing the issuance and terms of the CP determines the sizing of the interest component, which can be expressed either as a given dollar amount or determined using a formula of a given number of days of interest coverage at a set interest rate. Additionally, the RCA may provide for a specific dollar amount of coverage that includes both principal and interest, or break out principal and interest coverage as separate components.

Where the external support covers principal only, the facility is sized to reflect the maximum principal amount of the CP being issued.

In most CP programs, the issuing and paying agent (IPA) is the entity responsible for authenticating, issuing and, upon maturity of the notes, paying the CP noteholders. Fitch reviews the IPA agreement to evaluate how this document provides for a mechanism or a formula by which the IPA is able to control the issuance of CP and prohibit the issuance of CP in excess of the maximum amount covered by the RCA. Fitch examines this formula to determine its sufficiency, and, if applicable, whether it includes advances or loans provided under the RCA that would reduce the aggregate principal and interest amount available.

CP programs may be authorized in an amount greater than that reflected in the RCA. This is frequently done when the issuer does not have an immediate need to issue the full authorized amount and chooses to limit issuance to the lesser amount covered by the RCA. Any increase in the amount of CP above the coverage of the RCA is contingent upon an amendment by the bank providing the external support that would provide coverage for the increased amount of CP.

Early Termination and Replacement of Liquidity Facilities

Liquidity facilities are revocable and subject to termination (without a prior mandatory purchase in the case of VRDOs, or payment at maturity for CP) when the credit of the debt issuer deteriorates materially. The following credit-related events permit immediate termination and/or suspension of the liquidity facility:

- Voluntary bankruptcy (or other form of insolvency) of the VRDO or CP issuer, or involuntary bankruptcy that remains uncured for a specified period.
- Payment default on the VRDO being rated or on debt ranking on parity with or higher than the VRDO (which may include net swap payments but not swap termination payments). Payment default on any CP liquidity advance made under the terms of the RCA or on any parity debt of the CP issuer. However, since CP is structured such that the liquidity facility provides funds if there are insufficient rollover proceeds or issuer funds to pay CP notes, the liquidity facility should remain available, even if there is a nonpayment by the issuer on the CP or on any parity CP. Failure to make payment on CP is not viewed as an indication of the issuer's credit but, rather, its liquidity.
- Moratorium on the payment of the debt declared by the debt issuer or a governmental authority with appropriate jurisdiction.
- Lowering to below investment grade or withdrawal of the issuer's long-term rating by Fitch.
- Failure by the debt issuer to pay, or stay the enforcement of, a final, non-appealable judgment for a specified amount within a specified, reasonable time frame.
- The debt issuer contests the validity of or repudiates the debt being rated or debt rated on parity or higher.
- The debt being rated or debt rated on parity or higher is ruled to be unenforceable or invalid by a court with jurisdiction in a final, non-appealable judgment.
- A governmental authority or court with jurisdiction rules in a final, non-appealable judgment that the liquidity facility or essential transaction documents are not valid or binding on the issuer.

There may be other immediate termination events depending on the nature of the issuer. Fitch will review these on a case-by-case basis. It is essential that these events can be monitored by Fitch and tied to the issuer's credit quality.

Termination events typically appear as events of default in the liquidity facility. However, in some cases, liquidity facilities may specify, as a condition precedent to the bank's obligation to fund, that none of these events have occurred. In either case, the effect is the same: a loss of liquidity.

Some VRDO liquidity facilities have attempted to incorporate by reference any terms from other liquidity agreements subsequently entered into by the issuer and other banks that are more favorable to the bank than those written into the liquidity facility by having the issuer agree by covenant in the liquidity facility that those terms will be incorporated. Other facilities have contained language permitting amendments to the facility and the events of default upon consent of the issuer alone.

The rating concern is that there may be additional events of default that result in immediate termination of the facility but are not readily apparent and cannot be monitored. In instances where such other terms are referenced or amendments permitted, the liquidity facility documents have made the inclusion of those other events subject to confirmation by the rating agencies then rating the bonds that there would not be a reduction or withdrawal of the rating assigned to the VRDO as a result of their inclusion. Absent that provision, Fitch may be unable to provide a rating for the transaction.

Termination events, other than those described above that relate to the credit of the debt issuer, are accompanied by notice of a mandatory tender to holders of all outstanding VRDOs. This mandatory tender assures that the holders are paid in full prior to the termination of the liquidity facility. Similarly, a mandatory tender and a draw on the liquidity facility occur to pay the purchase price to bondholders prior to the facility's stated expiration date. The typical remedy for CP involves the bank giving a notice of stop-issuance and directing the IPA to cease issuing notes. Following the issuance of this notice, no new or rollover notes are issued, and the RCA remains in place to pay off the outstanding notes as they mature.

Prior to substitution of a liquidity facility, VRDOs are typically subject to mandatory tender, unless Fitch determines that the replacement will not result in a reduction or withdrawal of the existing short-term rating. It is standard market practice that bondholders be given prior notice of the substitution, even if the rating will not be affected. When the effective date of a substitute liquidity facility coincides with a mandatory tender date, the draw for the payment of the purchase price due on such date should be made on the facility being replaced and not on the new substitute liquidity facility.

Substitution of the RCA provider is ordinarily permitted under the terms of the documents that authorize or otherwise govern the issuance of the CP. Fitch evaluates how the documents handle the replacement of the support provider since CP notes, unlike VRDOs, are not subject to tender. CP, once issued, remains outstanding until its maturity date. Since Fitch rates the CP on the basis of the external support, it is essential that the original support facility remains in place until all notes issued under the original support facility have matured so that the basis of the rating is maintained. If a new RCA is put in place before all outstanding CP has matured, Fitch will review the documentation to ensure that it supports the new notes without changing the support structure of outstanding notes.

Investment of Funds

Bondholders and CP holders depend on the continued availability of funds drawn on a liquidity facility. As a practical matter, given the short-term nature of these obligations and the very short time during which these funds are held (generally less than one business day), such funds are either held uninvested or invested only in direct U.S. government obligations maturing when needed, in a separate and segregated account with no commingling with other funds, and free of any liens or encumbrances as set forth in the bond documents.

Legal 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. If the liquidity provider is a U.S. bank, it is important that the enforceability opinions are based on the laws of the state under which the liquidity facility is, by its terms, governed. If the provider is a non-U.S. entity, enforceability opinions from both non-U.S. and domestic counsel are reviewed.

Surveillance

Liquidity provider ratings are central elements in determining the rating of the VRDOs and CP benefiting from their support. VRDOs will carry over the long-term rating of the issuer, and the short-term rating is derived from the bank providing liquidity support capped by the long-term rating of the issuer. CP will likewise have the capped short-term rating of the liquidity support provider. 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 bond and CP ratings.

Rating Assumption Sensitivity

The short-term rating reflects the short-term rating that Fitch maintains on the bank providing liquidity support and will be upgraded or downgraded in conjunction with the Short-Term IDR of the bank and, in some cases, the long-term rating of the bonds or bond obligor, or issuer of the CP notes. The long-term rating is exclusively tied to the creditworthiness of the bond obligor and will reflect all changes to that rating. Changes to the structure made subsequent to our review may have an effect on the rating and must be re-evaluated.

Data Sources

The key rating assumptions used in these criteria and the data used to assign the ratings are based on the legal precedent of relevant instrument and program documentation, which contractually obliges a third party to provide liquidity for VRDOs and CP 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 liquidity 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 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 Rating Definitions page at www.fitchratings.com.