

STAFF SUMMARY RE CHFFA/CEFA BOND GUIDELINES

June 24, 2010

Background

The Authorities established the written bond-issuance guidelines currently in place in 2000. Since their inception, borrowers have occasionally requested and been granted various exceptions to the guidelines. Coinciding with the auction, variable rate and insurer challenges over the course of the last 24 months, top borrowers from both Authorities have increasingly asked for exceptions to the guidelines. Examples include borrowers asking for a lower debt service coverage ratio requirement because of their master indenture mandates and in some instances, because unrealized investment losses lowered proforma debt service coverage calculations below CHFFA's minimum 1.25x requirement. Other borrowers have asked to enter the market with lower denominations and some have asked permission to go out to the market for a public offering despite a guideline requirement for a private placement.

Given the increasing number of requests for exceptions to the guidelines and the near decade of time that has passed since the guidelines were originally implemented, staff from both Authorities believed it prudent to form a working group to carefully consider whether any amendments to the guidelines might be merited. Staff formed a working group composed of representatives from the following: (1) both Authorities' rank and file, (2) counsel routinely serving as bond counsel to the Authority, (3) counsel from the Treasurer's office, (4) counsel from the Attorney General's Office, (5) the Authorities' financial advisor, Public Financial Management, and (6) the State Treasurer's Office Public Financial Division.

Since the formation of this working group, members have engaged in a variety of activities to help evaluate the guidelines. Staff talked with and reviewed the policies of other statewide, as well as other national conduit issuers to get a sense of what other conduit issuers are doing. Staff developed mission statements for both Authorities to help tether the evaluation of the guidelines around the key tenets of the organizations. Staff also researched and identified the most recent ratings for the top borrowers of each Authority. The Attorney General's office reviewed the legislative history behind both organizations, the statutes in place for both Authorities and specifically, the statutes spelling out the requirements for both Authorities whenever an application for bond approval is submitted to the Authorities. Representatives from Public Financial Management researched statewide and national default rates for healthcare transactions and provided the knowledge needed to more clearly understand the various credit ratings assigned by rating agencies and how these ratings are construed by the market. Bond counsel helped the working group to identify the business and legal risks faced by conduit bond issuers, as well as how conduit bond issuers might best mitigate these risks through appropriate disclosures, covenants, representations and indemnities.

Tethered to the Authorities respective missions to provide ready access to capital for their borrowers, the working group has worked to balance the mission against the need to minimize various risks to each Authority, including legal, financial and reputational risks. Considering the unprecedented market conditions of the past few years, the working group recognizes that further changes that cannot be predicted are inevitable.

Proposed New Process for Investment Grade Rated Transactions

Bond issuance guidelines for both Authorities are currently prescriptive; various covenants and security measures are required. If a borrower does not completely meet the requirements, a

formal exception is required. To avoid the challenge with distinguishing factual circumstances that might qualify for an exception (or not) and to respond to the changes in the market over the last decade, the working group focused on developing a system of staff diligence and investigation in reviewing what each finance team puts together as an appropriate credit package. The new process brings flexibility to the table and the working group believes will likely be more responsive to future market conditions than the previous “yes/no” style inherent to the prescriptive guidelines.

The required rating threshold has been modified to mirror the market distinction between Investment Grade and Non-Investment Grade securities. The working group duly considered the presentations from Brad Spielman of Moody’s Investors Service and John Bonow of Public Financial Management which reflected their research of past transactions nationwide indicating that adjusting CHFFA’s prior cut-off for additional sale restrictions below BBB+ to the new public offering requirement for all ratings above BBB- does not raise the risk of default. The working group also acknowledged a seemingly arbitrary difference between CEFA and CHFFA in that CEFA has a cut-off at the BBB level rather than CHFFA’s BBB+. The working group placed priority on having consistent demarcations based on objective criteria.

Accordingly, the review process attached hereto as Exhibit 1 is staff’s recommended approach for all future CHFFA investment grade rated bond transactions. Please note this is an excerpt from a much longer recommended application and review process, the entirety of which is attached hereto as Exhibit 2 for your review and consideration and which staff recommends adding to the Authority’s website where appropriate. Staff plans to expand upon Exhibits 1 and 2 during the board meeting to impart meaning and appropriate context. If the board approves of this new methodology or some reasonable permutation thereof, staff recommends the guidelines be removed from the Authority’s website so that Exhibits 1 and 2 appropriately govern the review and processing of future bond transactions.

If this proposed process is palatable to the board, the working group will also prepare an Investment Grade approach for CEFA similar to Exhibit 1 and 2 for CHFFA. In addition, the following topics remain for the working group’s continued effort:

- Complete development of diligence and approval process for less-than-Investment Grade offerings and private placements for CHFFA and CEFA
- Continue development of model documentation identified in Exhibits 1 and 2
- Insure that recently adopted more stringent SEC continuing disclosure requirements (under SEC Rule 15c-2(12)) are included in all financings
- Review form of existing application to comport with new diligence process
- Continue exploration of making greater use of Federal Home Loan Bank Board capacity to “wrap” their AAA rating around community and regional bank letters of credit for nonprofit borrowers
- Continue efforts to make expanded allowance for “Bank Qualified Bonds” to be of use to nonprofit borrowers
- Continue efforts to enhance and expand CHFFA’s private equipment financing program (formerly referred to as the GE program).
- Review presentation of STO and CHFFA/CEFA in official statements to avoid any possible confusion as to the role of the State of California; make cover more consistent with other State Authorities and I-Bank

**CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY
INVESTMENT GRADE PUBLIC OFFERINGS**

Revenue Bond Application Review Process

I. INVESTMENT GRADE RATING REQUIRED

- (A) Borrower must obtain an Investment Grade Rating from at least 1 nationally recognized rating agency on bonds to be issued; BBB-/BBB-/Baa3 or better from S&P/Fitch/Moody's
- (B) For Variable Rate Bonds that may be Converted to Fixed Rate Bonds without further CHFFA action, Indenture provisions shall require confirmation prior to the Conversion that an Investment Grade Rating will apply to the bonds following Conversion
- (C) If proposed bonds have more than 1 rating, the highest rating shall be used to determine compliance

II. CHFFA STAFF EVALUATION PROCESS

- (A) Staff Diligence Pursuant to § 15437(b) (link)
- (B) Work Compiled in Staff Report
 - (1) Sample Staff Report Form (link)
 - (2) Draft Report will be provided to Borrower, UW, BC, CHFFA's Financial Analyst and AG for review and comment
 - (3) Final Report Sent to Authority Members 7 Days Prior to Meeting
 - (4) Deference to Cal Mortgage Loan Committee credit review process
- (C) Staff Makes Recommendation but Authority retains discretion

III. CONSIDERATION OF COVENANTS AND SECURITY FOR BONDHOLDERS

- (A) Borrower and CHFFA Analyst to compile list of key provisions; CHFFA does NOT require particular covenants
- (B) Clarify which entities' finances secure repayment of CHFFA loan, e.g. single Borrower corporation, Obligated Group, Guarantors

(C) Sample Covenants/Security (#1 is required; ## 2-4 are strongly preferred; remaining ones are examples of what is often seen in various financings depending on credit strength and market conditions)

- (1) Unconditional Promise to Pay
- (2) Gross Revenue or Gross Receivables Pledge
- (3) Negative Pledge Against Prior Liens
- (4) Limited Permitted Encumbrances
- (5) Debt Service Reserve Fund
 - (a) Would one be funded with bond proceeds or equity
 - (b) If it is a springing funding requirement, what is the trigger
 - (c) How is the reserve requirement sized
 - (d) Is a surety or letter of credit permitted in lieu of a cash deposit
 - (e) Are there circumstances where all moneys in the reserve may be released
- (6) Debt Service Coverage Requirement
 - (a) Maximum Annual Debt Service or Annual Debt Service to be covered; what is the required ratio; how low can it be before default?
 - (b) Is a Consultant review required if the ratio falls below a threshold?
 - (c) Steps and Timing Before Event of Default
- (7) Additional Debt Limitation
- (8) Disposition of Cash and Property Limitations
- (9) Cash or Liquidity Requirements
- (10) Debt to Capitalization Requirement
- (11) Security Interest in Designated Property
- (12) Mortgage or Deed of Trust
- (13) Other

**CALIFORNIA HEALTH FACILITIES FINANCING AUTHORITY
INVESTMENT GRADE PUBLIC OFFERINGS**

Revenue Bond Application Resources and Review Process

OUTLINE

- I. CHFFA MISSION STATEMENT (link)
- II. CHFFA COMMITMENT TO “CUSTOMER” SERVICE
- III. CHFFA ACT (link)
 - (A) Qualifying Borrowers; Definition of “Participating Health Institution” (link)
 - (B) Qualifying Projects; Definitions of “Project,” “Cost,” and “Health Facility” (link)
 - (C) Savings Pass-Through Requirement (link to § 15438.5 and CHFFA policy)
 - (D) Community Service Assurance; Access Requirements (link to §§ 15459 through 15459.4)
 - (E) Financed Projects must comply with CEQA (link to § 15455 and required documentation)
 - (F) State Treasurer (STO) acts as agent for sale for CHFFA (link)
- IV. CHFFA MEETINGS/HEARINGS/AGENDA REQUIREMENTS
 - (A) Transactions are set for hearings and approvals after receipt of an application (see Article VI below)
 - (B) Regular Meeting Schedule is typically the last Thursday of every month at approximately 1:30 pm at CHFFA offices in Sacramento (link)
 - (C) Special Meetings are possible in extraordinary circumstances
 - (D) Agenda Deadlines (CHFFA must distribute each meeting agenda at least 10 days in advance of meetings unless there is an extraordinary situation meeting legal requirements for shorter notice; link to public meeting law)
 - (E) TEFRA Hearing Arrangements
 - (1) A single public hearing covers projects throughout the State

- (2) CHFFA's custom is to hold hearings at its offices on the Wednesday preceding each regular monthly meeting at 10:00 a.m.; Borrowers are not required to attend; alternative days and times available upon request
 - (3) Bond Counsel arranges publication of hearing notices and provides affidavits of publication to CHFFA at least 2 business days prior to the hearing
 - (4) STO provides issuer approval certificate within 10 days after hearing (link to model certification language)
- (F) Single Meeting Approval via Resolution (link to model resolution)

V. SELECTION OF FINANCE TEAM

- (A) Underwriter(s) may be designated by Borrower from STO approved list (link)
- (B) Borrower selects its own Counsel
- (C) Borrower may select Bond Counsel with CHFFA consent
- (D) CHFFA represented by Attorney General's (AG) Office or a designated outside attorney, acting as issuer counsel
- (E) CHFFA/STO Financial Advisor is PFM
- (F) STO is Agent for Sale (following approval, pricing and bond sale are to be coordinated through CHFFA with STO)
- (G) Trustee/Paying Agent May Be Selected by Borrower with CHFFA consent
- (H) CHFFA will designate an Analyst for each Financing as Primary Contact
- (I) CHFFA Analyst will Provide contacts for CHFFA/STO/AG participants
- (J) Credit or Liquidity Enhancer Identified by Borrower

VI. APPLICATION SUBMISSION

- (A) Staff Assistance Available Prior to Formal Application
 - (1) Discuss Project/Borrower Eligibility
 - (2) Consideration of Corporation or Obligated Group as an appropriate Applicant and Borrower
 - (3) Resources for Municipal Borrowing Information (links to STO resources; CDIAC Primer and materials gathered by CHFFA)

- (B) On-Line Application Form ([link](#))
- (C) Timing – Due by 1st business day of month in which approval is sought
- (D) Application Fee ([link](#)); Issuance Fee Information ([link](#))
- (E) Borrower Documents Requested with Application
 - (1) Latest Audited Financial Statements
 - (2) Latest Unaudited Financial Information
 - (3) Previous Official Statement (if any)
 - (4) Evidence of CEQA Compliance or Exemption
 - (5) Draft of CHFFA Resolution
 - (6) Master Indenture or other document containing Borrower or Obligated Group existing covenants
 - (7) Latest Rating Agency Reports of Borrower or Obligated Group
- (F) Bond Documents
 - (1) Substantially Final Drafts Due No Later than 10th of the month in which approval is sought; further refinements of the documents may continue to be submitted to CHFFA staff
 - (2) Standard Provisions of CHFFA Loan Agreements and Indentures to be Used ([link](#))
 - (a) Recitals
 - (b) Representations
 - (c) Reporting Requirements
 - (d) Indemnification
 - (e) California Choice of Law
 - (f) Venue in Sacramento County
 - (g) CHFFA Named as “Additional Insured”
 - (h) Signature Block format
 - (3) Community Service Assurance Form ([link](#))

- (a) Physician List
 - (b) Certification
 - (c) Annual Notices
- (4) Tax Agreement Provisions, including rebate reporting (link)
- (5) CHFFA Closing Certificate Forms (link)
- (G) Underwriting Documents
 - (1) Substantially final drafts due no later than 10th of the month in which approval is sought; further refinements of the documents may continue to be submitted to CHFFA staff
 - (2) Standard provisions of CHFFA Bond Purchase Agreement and Official Statement (link)
 - (a) CHFFA disclosure/disclaimers
 - (b) Required Legal Opinions
 - (i) Issuer Counsel
 - (ii) Bond Counsel (validity opinion and supplemental opinion including SEC Act § 10b(5) opinion)
 - (iii) Underwriters' Counsel
 - (iv) Borrower Counsel (must cover SEC § 10b(5) opinion on full OS with very limited exclusions)
 - (3) Authority 15c-2(12) Certificates (link to model and process and timing for obtaining from CHFFA)

VII. INVESTMENT GRADE RATING REQUIRED

- (A) Borrower must obtain an Investment Grade Rating from at least 1 nationally recognized rating agency on bonds to be issued; BBB-/BBB-/Baa3 or better from S&P/Fitch/Moody's
- (B) For Variable Rate Bonds that may be Converted to Fixed Rate Bonds without further CHFFA action, Indenture provisions shall require confirmation prior to the Conversion that an Investment Grade Rating will apply to the bonds following Conversion
- (C) If proposed bonds have more than 1 rating, the highest rating shall be used to determine compliance

VIII. CHFFA STAFF EVALUATION PROCESS

- (A) Staff Diligence Pursuant to § 15437(b) (link)
- (B) Work Compiled in Staff Report
 - (1) Sample Staff Report Form (link)
 - (2) Draft Report will be provided to Borrower, UW, BC, CHFFA's Financial Analyst and AG for review and comment
 - (3) Final Report Sent to Authority Members 7 Days Prior to Meeting
 - (4) Deference to Cal Mortgage Loan Committee credit review process
- (C) Staff Makes Recommendation but Authority retains discretion

IX. CONSIDERATION OF COVENANTS AND SECURITY FOR BONDHOLDERS

- (A) Borrower and CHFFA Analyst to compile list of key provisions; CHFFA does NOT require particular covenants
- (B) Clarify which entities' finances secure repayment of CHFFA loan, e.g. single Borrower corporation, Obligated Group, Guarantors
- (C) Sample Covenants/Security (#1 is required; ## 2-4 are strongly preferred; remaining ones are examples of what is often seen in various financings depending on credit strength and market conditions)
 - (1) Unconditional Promise to Pay
 - (2) Gross Revenue or Gross Receivables Pledge
 - (3) Negative Pledge Against Prior Liens
 - (4) Limited Permitted Encumbrances
 - (5) Debt Service Reserve Fund
 - (a) Would one be funded with bond proceeds or equity
 - (b) If it is a springing funding requirement, what is the trigger
 - (c) How is the reserve requirement sized
 - (d) Is a surety or letter of credit permitted in lieu of a cash deposit
 - (e) Are there circumstances where all moneys in the reserve may be released

- (6) Debt Service Coverage Requirement
 - (a) Maximum Annual Debt Service or Annual Debt Service to be covered; what is the required ratio; how low can it be before default?
 - (b) Is a Consultant review required if the ratio falls below a threshold?
 - (c) Steps and Timing Before Event of Default
- (7) Additional Debt Limitation
- (8) Disposition of Cash and Property Limitations
- (9) Cash or Liquidity Requirements
- (10) Debt to Capitalization Requirement
- (11) Security Interest in Designated Property
- (12) Mortgage or Deed of Trust
- (13) Other

X. CONTINUING DISCLOSURE

- (A) Comply with SEC Rule 15c2-12
- (B) Authority Standard Provisions ([link](#))