

Rhode Island and the 38 Studios Financing

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Moral Obligation Generally Viewed as Connected to State but Opinions can Vary

- Typical use of the moral obligation is to backstop financings that otherwise rely on a more speculative security pledge
- Implication is that the sponsoring government:
 - Strongly believes in the value and economics of the project
 - Will undertake regular oversight/surveillance of operations, perhaps as part of a larger program of lending or investment
 - May provide additional economic support for the project being financed
 - Will pay debt service if the underlying security can not
- Most municipal lenders expected to see a connection between moral obligation and State
 - Traditional view blurs the line between all state general fund securities: general obligation, appropriation, moral obligation; allows little latitude for state not to pay if it is able
 - Some market participants believe the moral obligation to be of little value besides demonstrating state's "vote of support" for a project
- Rating agency approaches can vary; Some generally notch ratings down from sponsor government, some typically notch ratings up from underlying security of the project
- Finally, market or dollar impact of these opinions also varies, but largely based on current market conditions

Some Ambiguity in the 38 Studios Financing Structure

- Solid investment grade underlying ratings obtained (A2, A) were not feasible without strong belief of Rhode Island's support for its moral obligation debt
- Municipal bond insurer participation would not have happened without State's backing
 - Beneficiary of bond insurance is the bondholder not the State
 - Bond insurer can be expected to seek reimbursement of amounts owed from State
- But, some evidence suggests that buyers may have only partially appreciated the moral obligation pledge or bond insurance on the transaction
 - Relatively high yields (7.75% for 2020 maturity)
 - Taxable buyers are unused to valuing either non-recourse securities or bond insurance
 - Private placement provides limited secondary market liquidity
 - Several possible reasons for private placement, including risk level, disclosure requirements
 - Continuing disclosure not required under 15c2-12 but agreements voluntarily entered into by Issuer and 38 Studios
 - 38 Studios agreed to update certain information included PPM (but no financials were in PPM) as well as other enumerated events

Marketing of 38 Studios Transaction Does Suggest State Support to Payment

- Private Placement Memorandum (PPM) contains language that the bonds do not constitute a debt, obligation or liability of the State
 - Not atypical – moral obligations and appropriation-backed bonds often include disclaimers
 - Bondholders have few, if any, remedies to pursue should the State choose not to pay
- Also, inclusion of some information on the 38 Studios project implies bondholders should consider project risk
- But, nearly 200 (of 330) pages in the PPM devoted to the financial and economic condition of Rhode Island as Appendix A: a strong signal to investors on what security to rely
 - Information on other Capital Reserve Account indebtedness and discussion of moral obligations
- Financial statements for 38 Studios not included
 - Reference to a “going concern” opinion from PricewaterhouseCoopers LLP in July 2010
- Issuance by RI Economic Development Corp under Job Creation Guaranty Program
 - Program to provide support for loans or bonds to encourage lending to facilitate job growth
 - The Act authorizing the Program included as Appendix E to PPM
- Capital Reserve Account and “certain appropriations made by the State” listed as security
 - PPM outlines the functioning of the Capital Reserve Account and replenishment feature
 - History of Capital Reserve Indebtedness (moral obligation) includes a discussion of a troubled transaction that required and received state support (Alpha Beta Technologies, Inc.)

State Default on 38 Studios Debt Likely to Affect Ratings, Yields

- Non-payment on a moral obligation bond by Rhode Island would be a troubling market development, in particular because State is choosing not to pay
 - States considered the most sophisticated and reliable municipal issuers
 - In the past, willingness of states to make bond payments has not been questioned
 - For many investors, any worry over underlying project performance represents a dramatic change in practice
 - Precedent would likely lessen the value of moral obligations as a financing tool/security
- States, including Rhode Island, use several security pledges to access the capital markets including appropriation-backed debt and moral obligation debt
 - Both types require state action (willingness), one routine and one episodic
 - Most market participants link the two, even if they don't necessarily like either
 - Implies a negative response to all non-GO bonds of Rhode Island, ratings and yield/spread
- An issuer that decides to take an action that results in a bond default will face questions of willingness to pay in all other transactions
 - Rating agencies, market observers, investors all taking far more serious view over willingness
 - Negative rating actions on some, or all, of their debt will reasonably follow
 - Yields prone to rise (spreads widen) for debt of the issuer, but market context will dictate
- Reputational and financial impacts may not be to the same degree

Negative Rating Actions Likely but Fundamentally Unpredictable

- Rating agency views on willingness have grown far more serious but inconsistencies noted
 - Recent, more severe rating actions suggest greater concern over the issue
 - Spokane, WA and Cicero, NY (2001) to Vadnais Heights, MN and Moberly, MO (2012)
- No precedent for rating actions following state moral obligation default
 - But, the Vadnais Heights and Moberly set chilling examples the state should consider:
 - Vadnais Heights' transaction presented as a lease obligation for a sports complex with City responsible for payments as tenant (8-notch downgrade of general obligation rating)
 - Moberly included "annual appropriation" in its bond description, although pledged security is arguably weaker than a moral obligation (9-notch downgrade of its issuer credit rating)
- Factors considered in rating actions likely include
 - Whether moral obligation is rated by the agency (rating status may amplify negative response)
 - Marketing of debt (how it was presented to market and the rating agencies)
- Moral obligation bond default would reasonably cause pressure on the issuer's other ratings
 - Other classes of non-recourse securities (specifically, appropriation-backed) would be viewed more skeptically because of the weakened willingness (bottom up ratings process substituted for top down methodology); strong potential for non-investment grade ratings
 - General obligation ratings could also be lowered but non-investment grade ratings very unlikely
 - Widening of distance (notching) between general obligation and other pledges could occur

Financial Impact Dependent on Market Context but Higher Costs Much More Likely

- Principal concern of state in considering default should be the impact on new issuance. On average, state and local issuers have sold about \$800MM in new bonds annually, about half of which by the State itself across various securities
- While there are scenarios under which penalties would not exceed the value of the default, more reasonable expectation is for some hike in interest rates paid, eroding all or most of the potential savings from not paying the 38 Studios debt
 - Financial penalty could last for multiple years and would vary by security type:
 - State appropriation security would be the most impacted: reasonable potential for non-investment grade ratings implies much smaller universe of investors and suitability concerns for individuals. Bonds henceforward would likely need to show credible underlying security and would likely be valued and purchased primarily based on that underlying security; State should assume much reduced use of this mechanism to finance development projects
 - GO security also likely to become more expensive for the State to use; Worst case scenarios imply interest rates substantially (+50-100bps) higher; Best case scenarios show smaller hit
 - Moral obligations no longer a tenable security although these are less important to the State
 - Other State issuers could feel a smaller but still negative effect, as would local governments; locals more reliant on state aid likely to feel more market reluctance
 - If downgrades and/or penalties are steep enough, State may no longer be able to achieve savings through current refunding transactions (recently generated about \$5MM per year)
 - And Rhode Island residents holding the ~\$2.0Bn of outstanding State-issued bonds would see their portfolios fall in value, very reasonably by more than \$100MM

Reputational Risks Should Not Be Disregarded

- Reputational impacts could last far longer than financial impacts; That the State is able but chooses not to pay is the critical and precedent-setting development here
- Even in what we see as less likely scenarios, where default-related savings exceeds financial penalty, there would almost surely be a change in market perception about the State
- By many investors, Rhode Island would be seen as “getting away with” bad behavior, similar to current views of Illinois, Alabama, Puerto Rico; Some investors likely to intentionally portray State as a bad actor to push yields higher; unlikely this is the view State is cultivating
 - Comes after several years of successful marketing of the state and bolstering of capital market access for local governments: a particular disappointment for some observers
- Could be an historic event for the municipal market (for example, market participants continue to cite Arkansas’ default in the Great Depression; Rhode Island repudiation could be first in over a century)
- Moral obligation bonds issued in other states may similarly lose market access
- Should the State actually choose to consider defaulting, we strongly recommend a more tempered approach that includes robust market study of the potential reputational and financial impacts, with consideration of potentially shifting market contexts and future infrastructure/development needs
- Market-based or creditor-oriented debt restructuring options should be considered as well to preserve hard gained reputation while reducing total State costs

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