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## Feature

by Tanya K. Hahn

## Letters of Credit and How They Work

A letter of credit issued by a commercial bank is an irrevocable obligation to make bond payments if a borrower cannot. With that support, a borrowing organization can issue bonds backed by the bank's credit strength. This credit enhancement can make borrowing more affordable for organizations that wish to issue bonds, but have limited credit strength putting other forms of enhanced or unenhanced bonds out of their grasp.

When a borrower purchases a letter of credit, a bank with better credit agrees to make all of the principal and interest payments on the bonds and be reimbursed by the organization. Bondholders generally feel more comfortable with this situation; a bank has guaranteed they will be getting their money, and because of this guarantee they are willing to accept a lower interest rate for purchasing the bonds. A diagram of this complex network is included at the end of this article.

The cost of a letter of credit is largely driven by the perceived credit risk of the borrower and typically includes a one-time fee along with an annual service charge. Letters of credit usually are issued for three- to five-year terms and can be renewed or substituted throughout the life of the bonds.

**Key Benefits and Considerations**

A letter of credit-enhanced bond offering gives the borrower the ability to tailor its debt structure to reduce the organization's exposure to changing interest rates. Most letter of credit bonds use short-term or variable inter-

est rates. The interest rate is closely associated with the SIFMA (formerly the Bond Market Association) index, which has averaged 2.82 percent over the last 15 years.

Flexibility is a major benefit of a letter of credit. The debt can be paid off whenever the borrower desires without penalty. In addition, it is relatively easy to negotiate changes with a letter of credit bank; most changes do not require the authorization of the bondholders. It may be possible to leverage existing bank relationships to issue supplemental or additional debt.

The process for obtaining a letter of credit is also generally shorter than that of other enhancement options. Obtaining a letter of credit-enhanced bond structure typically takes about 12 weeks and occurs in three phases: internal financing, external financing analysis, and closing.

**Phase I: Gathering and Analyzing Internal Information**

The organization's need for funds must be accurately determined before any action is taken. It is less expensive to issue bonds once to cover all needs than to borrow too little and be forced to look for additional financing. The organization and its underwriter or financial adviser should compare the letter of credit option to other financial structures during this initial phase.

The organization's finances must be evaluated to identify qualitative and quantitative credit strengths and weaknesses and the ability of the borrower

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to repay the planned debt. Creditors want to be sure the loan will be repaid, and that the borrowing organization is not taking on more debt than it can handle. The higher they perceive the credit risk of the borrower, the higher the letter of credit fee will be.

## Requesting the Enhancement

If the letter of credit route is chosen, these detailed credit strength elements become part of a "Credit Enhancement Request Package," an application to a bank or banks for a letter of credit. The goal is to outline the organization's financial strengths, both qualitatively and quantitatively, which in turn should reduce the risk associated with it. Less risk translates to lower fees and less stringent covenants -- financial targets the organization must hit consistently or risk default.

The credit enhancement request package should include what is being requested from the bank, how the funds from the bonds will be used, collateral offered, and the organization's financial statements. It is important to describe the details of the bonds being issued as well as the benefits the organization will receive by issuing them.

A good credit enhancement request package should highlight strengths and explain any potential issues. Collateral needs to be specified, and any other potential business opportunities for the bank that may arise as part of the transaction. After the package is submitted, banks usually will respond within two weeks.

## Phase II: Analysis of Bank Responses

Each bank can offer different terms, fees and collateral than originally offered. Fees are easily compared, but covenants and collateral must also be carefully considered. These can include maintaining ratios or other financial guarantees, pledges not to take on additional debt, or maintenance covenants. All terms need to be negotiated and finalized once a bank's proposal is chosen.

## Phase III: Document Revision and Bond Issuance

During the final phase of the letter of credit-enhanced bond issuing process, all documents may go through several rounds of revision. These documents include:

- Trust or master trust indenture: Drafted by bond counsel, this provides the terms of the bonds and specifies the mechanics of how they are paid. Rights, duties, and remedies are included in the indenture, as well as the necessary funds and accounts created as part of the financing.
- Loan agreement (sublease): This specifies prepayment provisions, provisions required by state law,

and may also include business covenants.

- Reimbursement agreement: This contains many of the specifics of when and what the borrower will repay to the letter of credit bank, including all fees, and it contains the primary business covenants for the borrower while the bonds are outstanding. It also may contain any extension provisions and any other guarantees. The reimbursement agreement, created by the bank's counsel, is the most important document to review from the perspective of the borrower.
- Tax compliance documents: These deal with any tax issues connected with the issuance of the bonds, including possible limitations on the cost of issuance and reimbursement issues. All tax-exempt bond issues require this document.
- Bond purchase agreement: Drafted by the underwriters counsel, it sets out all the terms and conditions under which the underwriter will buy the bonds from the borrower, including the provision of a letter of credit by a highly rated bank. The borrower and bank are a party to this document.
- Remarketing Agreement: Document between the borrower and the firm serving as the remarketing agent, usually the underwriter, outlining the duties of the remarketing agent for setting the periodic interest rates on the bonds while outstanding and remarketing any bonds subsequently to the initial sale.
- Preliminary & official statement or offering circular: Prepared by both the bond and underwriter's counsel, it summarizes all of the documents, terms of the financing, and use of proceeds. It is the document used to solicit orders from investors, much like a red herring for public stock sales.

A trustee is chosen at this point, and will act as a hub for future debt service payments. Ratings must be acquired from a ratings agency, such as S&P, to ensure the bond rating will receive the current letter of credit bank's rating. The bonds are registered, then issued, and funds are transferred. All future debt service payments are made by the trustee to investors, with reimbursement by the borrower.

While the enhancement is complex, a letter of credit can usually help a borrower access the capital markets at better interest rates than other financing structures. It is one of several tools available to weaker credits, and due consideration should be given to all financial options.

# The Capital Issue: Letter of Credit Players

