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Rating Agencies Reviewing Certain Housing and Healthcare Bond Issues with an Eye Toward Potential Ratings Downgrades

Over the past several months, Moody's Investors Service (Moody's) and Standard & Poor's Rating Services (S&P) have been reviewing certain single family housing, multifamily housing and health care revenue bonds issues to determine if rating downgrades are appropriate in light of the prolonged period of historically low investment rates on trustee-held funds. Specifically, Moody's and S&P have been looking at FHA insured/GNMA-collateralized bond issues, Freddie Mac credit-enhanced fixed-rate bond issues and Fannie Mae credit-enhanced fixed-rate bond issues in which the trustee-held funds have not been invested in Guaranteed Investment Contracts (GICs). In those transactions, the bond trustee receives mortgage payments on a monthly basis and retains the money in the bond fund until bond debt service is due, which is typically on a semi-annual basis. Between interest payment dates on the bonds, the mortgage loan payments are invested in short-term investments and, in some transactions, these additional earnings (float earnings) are needed to pay bond-debt service and program expenses.

When the float earnings are used to pay debt service and/or program expenses, they typically account for a small differential between the mortgage loan revenue and bond debt service. When the bonds being examined were first issued (generally from 1997 through 2008), certain assumptions were made under the then-current accepted rating criteria with respect to reinvestment rate on the

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mortgage loan payments and the corresponding float earnings. At the time, Moody's and S&P permitted borrowers to assume that those funds not invested in a GIC would be invested in instruments that would provide a presumed return, often as high as 2.5 percent.

In light of the earnings environment over the past several months, the bond issues are now assumed to have a zero-percent reinvestment rate if there is no GIC in place for the remaining life of the issue. To maintain the "Aaa" or "AAA" rating Moody's or S&P, respectively, originally assigned to these bond issues, the bonds must not have a cash shortfall or "parity break" for the next 15 years.

Moody's is examining more than 250 issues on which it maintains ratings, and S&P is examining more than 600 issues on which it maintains ratings. Several issuers have been advised by Moody's of a potential downgrade if additional cash deposits are not made to the bond trustee, and S&P indicated in a May 12, 2010 release that all of the issues it has rated "are being placed on CreditWatch with negative implications at this time, unless cash flows have been previously analyzed based on a zero rate of earnings. The magnitude of any rating changes that [S&P] might make will depend on whether [S&P] think[s] the cash flows demonstrate sufficiency under [S&P's] stress assumptions."

A rating downgrade could have serious implications for transaction documents if the documents require a certain rating level to be maintained, or provide a tender right for holders if a rating falls below a certain level. These factors should be taken into account in deciding how to respond to rating agency requests for updated verified cash flow projections.

For more information on this topic, please contact your principal Squire Sanders lawyer or one of the individuals listed in this *Alert*.

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