

To: Board Members and David Bean
From: Randy Finden, Jialan Su, and Christian Jones
cc: GASB Staff and Meeting Observers
Date: July 10, 2017
Re: Research Memorandum: Conduit Debt

I. INTRODUCTION AND BACKGROUND

Conduit debt financings represent a significant part of the municipal bond market. According to a comprehensive report on the municipal securities market issued by the Securities and Exchange Commission (SEC) in July 2012,¹ there were about 44,000 state and local government-issuers with a total face amount of \$3.7 trillion municipal securities outstanding. The SEC staff estimated that conduit bonds represented approximately 10 percent of municipal principal issued.² In 2011, a research firm, estimated that conduit bonds represent roughly 20 percent of all municipal bonds but 70 percent of all defaults in the municipal bond market.³

The GASB has addressed conduit accounting and reporting in Interpretation No. 2, *Disclosure of Conduit Debt Obligations*, issued in 1995. Interpretation 2 describes conduit debt obligations as follows:

The term *conduit debt obligations* refers to certain limited-obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing capital financing for a specific third party that is not a part of the issuer's financial reporting entity. Although conduit debt obligations bear the name of the governmental issuer, the issuer has no obligation for such debt beyond the resources provided by a lease or

¹ "Report on the Municipal Securities Market," U.S. Securities and Exchange Commission, July 31, 2012, accessed June 22, 2017, <https://www.sec.gov/news/studies/2012/munireport073112.pdf>, page 1.

² *Ibid.*, footnote 30.

³ Nathaniel Popper, "Conduit Muni Bond Defaults Draw Scrutiny," *Los Angeles Times*, June 14, 2011, accessed June 22, 2017, <http://articles.latimes.com/2011/jun/14/business/la-fi-risky-municipals-20110614>.

loan with the third party on whose behalf they are issued. [Paragraph 2, footnote omitted.]

Conduit financings generally are tax exempt, provided that they conform to relevant portions of the Internal Revenue Code. Thus, these financings are a way for not-for-profit organizations—for example, hospitals, nursing facilities, and educational institutions—to secure financings at tax-exempt rates. Third-party borrowers also may be other governments. This structure is popular when the issuer is considered to have financing expertise and economies of scale (for example, a state bond bank). Finally, some borrowers may be for-profit corporations. Many issuers receive a fee for arranging conduit financings and some are government agencies solely organized to issue conduit debt. A third-party borrower generally is identified in bond documents, such as offering statements.

In December 2016, pre-agenda research to study conduit debt was approved by the Board. The research objectives were (1) to evaluate the effectiveness of Interpretation 2 and (2) to consider the need for revisions to existing standards. To achieve these objectives, the GASB staff conducted the following research activities:

- Reviewed relevant GASB literature, as well as literature from other standards setters
- Reviewed rules, regulations, and reports issued by federal and state governments
- Reviewed studies and media reports from various sources
- Examined the results of other research projects regarding note disclosures related to conduit debt in governments' annual financial reports
- Conducted telephone interviews with government-issuers of conduit debt and users of government financial statements.

This memorandum presents the results of that research. Four sections follow. The first section summarizes the relevant literature review. The second section provides the key research questions that were presented in the research proposal. The third section provides an overview of the research approach and the methodologies employed, as well as the limitations of the research design. The final section presents the results of the research and the GASB staff's analysis of those results.

II. LITERATURE REVIEW

The GASB staff reviewed current GASB literature and looked for literature from other standards-setting bodies related to conduit debt. We found that conduit financings represent significant public policy issues. Several federal and state agencies have issued reports addressing conduit debt. The findings of those reports are included in this review. Rating agencies also have issued reports that consider the effects of conduit debt, moral obligation, and appropriation-backed debt. Finally, the GASB staff reviewed existing research, including a study funded by a Gil Crain Memorial Research Grant, and various news reports on conduit debt.

Literature Review Objectives

As with other pre-agenda research activities, the GASB staff examined the relevant literature of other standards-setting bodies, including:

- Canadian Public Sector Accounting Board (PSAB)
- Federal Accounting Standards Advisory Board (FASAB)
- Financial Accounting Standards Board (FASB)
- International Public Sector Accounting Standards Board (IPSASB).

None of these organizations has issued comparable accounting guidance because the entities their standards address do not have similar conduit financing structures. The U.S. conduit financing structure appears to be unique in that it allows for governments other than the national government to issue tax-exempt debt.

In the auditing literature, the American Institute of Certified Public Accountants' audit guide, *State and Local Governments*, addresses conduit debt. Much of the material reiterates GASB Interpretation 2.

Conduit financings have significant public policy implications. Several federal agencies have issued reports that are summarized in this paper. The GASB staff also examined relevant rules and regulations from the following agencies:

- Government Accountability Office (GAO)
- Internal Revenue Service (IRS)
- Municipal Securities Rulemaking Board (MSRB)
- Securities and Exchange Commission (SEC).

Likewise, state-level agencies have issued several reports, including the following:

- California Debt and Investment Advisory Commission
- California State Auditor
- New York State Comptroller.

All four rating agencies have addressed conduit debt or attendant issues such as moral obligation or appropriation-backed debt.

Finally, the National Federation of Municipal Analysts (NFMA) has published guidelines for disclosures.

Current GASB Guidance on Conduit Debt

Interpretation 2 describes what constitutes conduit debt. Paragraph 3 describes the disclosure requirements for conduit debt transactions and paragraph 4 highlights that those entities - reporting conduit debt on their balance sheets at that time may continue to do so. These paragraphs from Interpretation 2 follow:

2. This Interpretation clarifies the application of paragraph 158 of NCGA Statement 1, as amended by paragraph 63 of GASB Statement No. 14, *The Financial Reporting Entity*, to conduit debt obligations. The term *conduit debt obligations* refers to certain limited obligation revenue bonds, certificates of participation, or similar debt instruments issued by a state or local governmental entity for the express purpose of providing capital financing for a specific third party that is not a part of the issuer's financial reporting entity. [Footnote omitted.] Although conduit debt obligations bear the name of the governmental issuer, the issuer has no obligation for such debt beyond the resources provided by a lease or loan with the third party on whose behalf they are issued. This Interpretation applies to all state and local governmental entities.

3. Conduit debt obligations should be disclosed in the notes to the financial statements of the issuing entity.² The disclosures should include:
 - a. A general description of the conduit debt transactions.
 - b. The aggregate amount of all conduit debt obligations outstanding at the balance sheet date.³
 - c. A clear indication that the issuer has no obligation for the debt beyond the resources provided by related leases or loans.
4. Some issuers of conduit debt obligations currently report them as liabilities on their balance sheets along with related assets. This Interpretation does not alter that reporting or the reporting of future conduit debt obligations that are substantially the same as those already reported.

² If a component unit (for example, an industrial development authority) that issues conduit debt does not publish separate financial statements, the disclosures required by this paragraph should instead be included in the reporting entity's notes to the financial statements. If the component unit does publish separate financial statements, the reporting entity should apply the disclosure guidance in paragraphs 62 and 63 of Statement [No.] 14 [*Defining the Reporting Entity*].

³ If the aggregate amount outstanding is not determinable or cannot reasonably be estimated, issuers may provide the aggregate original issue amount for conduit debt obligations issued prior to the implementation of this Interpretation. In this case, the information required should be segregated between conduit debt obligations with the original issue amount provided and those with the outstanding balance provided.

GASB Concepts Statements

Since the issuance of Interpretation 2, the GASB has addressed notes to financial statements and financial statement elements (Concept Statements No. 3, *Communication Methods in General Purpose Financial Reports That Contain Basic Financial Statements*, and No. 4, *Elements of Financial Statements*, respectively). Note disclosures provide information essential to a financial statement user's understanding of a government's financial statements. One reason that information may be disclosed in notes is that it provides additional insight into financial position and inflows or outflows of resources but does not meet the criteria for recognition (Concepts Statement 3, paragraph 35). Liabilities are present obligations to sacrifice

resources that a government has little or no discretion to avoid. Generally, liabilities cannot be avoided because they are legally enforceable (Concepts Statement 4, paragraphs 17 and 18).

Other GASB Literature

Some cities and counties sponsor special assessment transactions. Special assessment districts are organized with a government's jurisdiction to construct capital assets. Examples are construction of sidewalks and extending water and sewer lines to unserved parts of a government's service area. Typically, a government sponsors the construction activities and makes assessments to property owners or customers. When assessments are to be collected over time, long-term financing may be arranged by the government, with the government collecting periodic payments and making debt service to retire the financing. Statement No. 6, *Accounting and Financial Reporting for Special Assessments*, addresses under what circumstances a sponsoring government should report these long-term financings as liabilities.

[A] government may be primarily liable for the debt, as in the case of a general obligation issue; it may have no liability whatsoever for special assessment debt; or it may be *obligated in some manner* to provide a secondary source of funds for repayment of special assessment debt in the event of default by the assessed property owners. A government is obligated in some manner for special assessment debt if (a) it is legally obligated to assume all or part of the debt in the event of default or (b) the government *may* take certain actions to assume secondary liability for all or part of the debt—and the government takes, or has given indications that it will take, those actions [paragraph 16]

Statement 6 was issued in 1987, well before Concepts Statements 3 and 4, and has not been reevaluated since its issuance. Statement 6, therefore, may not be a suitable analog.

Literature of Other Accounting Standards Setters

The notion of one non-national entity issuing conduit debt on behalf of another appears to be unique to the U.S. municipal market. We considered the literature of the FASB, FASAB, IASB, IPSASB, and PSAB. In some cases, we contacted the staff of these organizations to determine whether they have relevant guidance or comparable financing structures. We did not identify any relevant literature relating to an issuer of conduit debt.

The FASB's guidance is limited to conduit debt transactions in which an entity is a conduit debt borrower (for example, *FASB Accounting Standards Codification*[®] Topic 855, "Subsequent Events," 855-10-25-1A). Apart from the guidance relevant to third-party borrowers that are not governments, the FASB does not address conduit debt transactions. However, some users believe that asset-backed securities have similar characteristics. That is, for example, a variable interest entity (VIE) may be created by a bank. The VIE holds income producing financial instruments. Similar to conduit debt financings, where debt service payments from third-party borrowers are collected by trustees and forwarded to conduit bond holders, debt service payments from mortgage debtors are pledged to make debt service payments to investors. The relevant aspect of these financings is under what circumstances would the VIE be consolidated into the financial statements of the loan originator? The FASB literature, in summary, provides that a VIE should be consolidated with a reporting entity when that reporting entity has a controlling financial interest. In this case, that is when the reporting entity has an obligation to absorb losses of the VIE (FASB Topic 810, "Consolidation," 810-10-05-8A).

Academic Research

As mentioned earlier in this paper, conduit financings are of keen interest to stakeholders as public policy matters. Consequently, little of the academic research related to conduit debt has focused on accounting and financial reporting. The GASB's interest in most of this academic literature, therefore, is limited as to whether researchers can get the information they need and the sources of that information. Annual financial reporting is one such source. The following research specifically is relevant to conduit debt financing in financial reporting.

Crain grant research

Two academics were engaged as part of the GASB's Crain research grant program to study conduit debt. Their research report is dated December 2016. Their report is divided into two parts: evaluation of issuer financial statements and interviews of financial statement users.

Archival research. The researchers evaluated the display and disclosure of conduit debt in the financial statements of issuers. They examined the financial statements of (1) all state

governments and (2) 41 local government-issuers within the state of California.⁴ Regarding state governments, they concluded that, overall, states provide disclosure of conduit debt obligations either by explicitly providing total outstanding amounts or by referring a user to the complete financial statements of component units and related organizations. (The latter receive limited visibility within a state’s comprehensive annual financial report.) Their research indicated that the degree of transparency into conduit debt activity of public authorities varied both across and within state comprehensive annual financial reports. The researchers concluded that, in general, the local governments in California with conduit debt activity consistently disclosed obligations in accordance with Interpretation 2.

Interviews of users

The researchers interviewed six financial statement users—two individuals serving legislative or oversight bodies and four municipal bond analysts (one rating agency representative, one bond insurer, and two buy-side analysts).⁵ The legislative/oversight users were primarily concerned about the potential for a conduit debt borrower to adversely affect the issuer’s reputation of competent management or its credit rating. The municipal analysts interviewed evaluate conduit debt in terms of the actual issuance itself, considering the credit quality of the borrower. The focus on credit risk and the likelihood of repayment means that the revenue sources and the project details are key. One interviewee noted they had never thought about the finances of conduit issuers. If there is no recourse to the government-issuer, these municipal bond analysts generally are not concerned that conduit debt will impact the issuer.

The interviewees who were interested in analyzing an issuer’s financial health indicated that conduit debt is not viewed as very important to their analysis. This was because they recognized that the issuer is not the borrower. These users also expressed uncertainty about whether state

⁴ The researchers focused on California governments because a list of local government conduit debt issuers was readily available from the CDIAC.

⁵ Although the interviews provide some insight into how users perceive conduit financings, these findings are not necessarily generalizable to other users given the small number of interviewees.

and local government-issuers might step in if a borrower defaulted on conduit debt. This uncertainty exists even in the absence of legal requirements to do so. They believe that, at a minimum, discussion of conduit debt obligations in financial statements should clearly delineate the borrower and any guarantees that exist from the issuer.

Finally, the interviewees viewed conduits not just in terms of decision-making from a public finance standpoint, but in terms of an accountability and a transparency viewpoint. Three interviewees raised the larger policy question of why conduit debt is being used in the first place. One commented that the activity has implications for accountability and transparency when governments use conduit issuers to borrow and potentially avoid voter approval requirements. Another interviewee said that they would like to have additional information about conduit debt including disclosure on why a conduit issuer is being used (instead of directly issuing debt), why the selected conduit issuer is being used (rather than other available conduit issuers), what ongoing role is played by the conduit issuer (for example, some conduits perform annual surveillance of their issuers), and a default history of the conduit issuer's financings.

Reports Issued by Federal and State Agencies

Most conduit financings are tax-exempt, and some issuances are within a state government's cap on private-activity bonds. Accordingly, conduit financings are of keen interest to the federal government.

Securities and Exchange Commission

As previously noted, in 2012, the SEC issued "Report on the Municipal Securities Market."⁶ This report described the municipal market and in the SEC's view its infirmities. The SEC described the conduit debt market as follows:

Conduit revenue bonds are issued by a municipality or an agency or instrumentality of a municipality on behalf of a third party (often called a "conduit borrower" or "obligated person"). If certain requirements in the federal Internal

⁶ See footnote 1.

Revenue Code (“IRC”) and Internal Revenue Service (“IRS”) regulations are met, conduit revenue bonds may be tax-exempt. Tax-exempt conduit revenue bonds include industrial development bonds on behalf of private entities, as well as financings for both non-profit and for-profit borrowers: such as hospitals; colleges and universities; power and energy companies; resource recovery facilities; multi-family housing projects; hotels; and sports stadiums. In a conduit revenue bond financing, the bondholder cannot look to the municipal issuer for payment of the bonds but rather must rely on payment from the conduit borrower. As discussed later, reports indicate that a majority of defaults in the municipal securities market are in conduit revenue bonds issued for non-governmental purposes, such as multi-family housing, healthcare (hospitals and nursing homes), and industrial development bonds (for economic development and manufacturing purposes). [Page 7, footnotes omitted]

The SEC research noted studies that addressed conduit debt borrowers that default:

Municipal bond default rates also vary considerably depending on the types of bonds issued, ratings on the bonds, and whether the ultimate obligor is a municipal entity or a non-municipal entity (i.e., a conduit borrower). In the S&P study of municipal bond defaults in the 1990s, non-rated bonds accounted for 85% of all defaults. That same study noted that bonds for the three major types of conduit bond issues (healthcare, multifamily housing, and industrial development) accounted for more than 70% of defaulted principal. More recent reports have also indicated that non-governmental conduit borrowers account for more than 70% of municipal bond defaults. A similar conclusion was reached in a 2011 report that stated that the largest share of modern era defaults consists of industrial development revenue bonds, followed by bonds supporting health care and housing. The report states that these three sectors accounted for 67% of all defaulting issues during the period 1980 to 2011. [Page 24, footnotes omitted]

The SEC’s legislative recommendations only extended to conduit debt *borrowers*:

Amend the municipal securities exemptions in the Securities and Exchange Act to eliminate the availability of such exemptions to conduit borrowers who are not municipal entities under Section 3(a)(2) of the Securities Act, without differentiation based on the size of the financing due to the continuing availability of other exemptions, including those available for small businesses, private offerings, and non-profit entities that take into account different types of offerings and issuers. [Page viii]

However, the SEC report did comment on disclosure practices of conduit debt issuers:

Moreover, partly as a result of open government laws and similar public accountability measures, state and local governmental bodies routinely make publicly available a large amount of information about issuers of municipal securities. The practices of market participants in voluntarily providing such additional information to investors are not, however, consistent. Large repeat issuers generally have more comprehensive disclosure than small, infrequent or **conduit issuers**, who may voluntarily provide little ongoing information to investors. [Page 58, footnotes omitted, bold font added for emphasis]

On March 1, 2017, the SEC proposed to amend Rule 15c2-12⁷ to require filings with the MSRB for events related to (1) incurrence of a financial obligation of the obligated person, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material; and (2) default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, any of which reflect financial difficulties. Although this proposed amendment did not specifically address conduit debt obligations of issuers, it would apply to all issuers.

Finally, on occasion the SEC has brought enforcement actions against issuers. The SEC enjoined a conduit bond issuer for failing to disclose to the market (in a 15c2-12 filing) the planned departure of a major tenant from an office building being financed with a municipal bond issue.⁸ (The Rule applies to dealers that act as underwriters of municipal securities with an aggregate principal amount of \$1,000,000 or more. The requirements of this Rule also are addressed by the MSRB, discussed later in this memorandum.)

⁷ “Proposed Amendments to Municipal Securities Disclosures, Rule 15c2-12,” *Federal Register: The Daily Journal of the United States*, 17 CFR 240, March 15, 2017, accessed May 1, 2017, <https://www.federalregister.gov/documents/2017/03/15/2017-04323/proposed-amendments-to-municipal-securities-disclosure>.

⁸ See *Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, DC Cir. 2008; Exchange Act Release No. 54143, “*In the Matter of Dolphin and Bradbury, Incorporated and Robert J. Bradbury*,” July 13, 2006, accessed June 30, 2017, www.sec.gov/litigation/opinions/2006/33-8721.pdf.

Internal Revenue Service

In 2011, the IRS's Advisory Committee on Tax Exempt and Government Entities issued a report on "The Role of Conduit Debt Issuers in Tax Compliance."⁹ The report describes the roles that issuers and third-party borrowers play in a conduit financing as follows:

PARTIES TO CONDUIT BOND ISSUE

An issuer of conduit bonds is generally not obligated to pay debt service on the conduit bonds from its revenues -- the true obligor is the conduit borrower. The conduit issuer is not directly receiving the tax benefits relating to the conduit bonds. However, the conduit issuer is treated as the "taxpayer" for certain federal income tax purposes and procedures.

A conduit borrower is generally responsible for the payment of debt service on the conduit bonds and is often contractually obligated to maintain the tax status of the bonds.

The bondholder receives the tax benefits and bears the tax liability if there is a failure to meet the requirements of the Code applicable to maintain the tax status of the bonds.

The bondholder relies on the conduit issuer and the conduit borrower to maintain the tax status of the bonds.

In general, the conduit issuer and the conduit borrower are responsible for tax compliance. The division of responsibility, between the parties to maintain compliance, is defined in the bond documents for the particular bond issue. [Pages B5 and B6]

Some conduit financings are supported by leases as follows:

BONDS SUPPORTED BY TRUE LEASES

Certain bonds issued by state or local governments are not used to make loans to other entities. Nevertheless, such issues (e.g., certain airport bonds) may be used to finance facility leases to another entity for the entire term of the bonds. While

⁹ Michael Bailey, David Cholst, and George T. Magnatta, "The Role of Conduit Issuers in Tax Compliance" in *General Report of the Advisory Committee on Tax Exempt and Government Entities*. 2011, Internal Revenue Service Publication 4344 (Rev.6-2011), Catalog Number 38578D, Internal Revenue Service, Washington, DC, accessed June 22, 2017, https://www.irs.gov/pub/irs-tege/tege_act_rpt10.pdf.

such issues are not conduit bonds, the lessee of such facilities often is responsible for many of the compliance requirements, and such bonds may be treated as conduit bonds for many purposes. Accordingly, many of the issues described herein apply to issuers of such bonds. [Page B6]

The IRS describes the responsibilities of issuers as follows:

Post-Issuance Compliance – There are certain core elements of reasonable bond compliance procedures that should be considered by a conduit issuer for adoption and implementation to demonstrate a favorable record retention policy. These core elements are: (1) reasonable procedures for assignment of compliance responsibilities; (2) reasonable procedures for the establishment and maintenance of books and records; (3) reasonable procedures for compliant investment of gross proceeds; (4) reasonable procedures for the review and allocation of bond proceeds; (5) reasonable procedures for periodic monitoring of use of financed property; and (6) reasonable susceptibility to audit.

A “one size fits all” approach is not workable, and a conduit issuer should consider tailoring its procedures in order to meet these core elements. [Page 30]

The IRS report surveyed market participants. From that survey, the IRS made the following observations that are relevant to our research:

b. Types of respondents

Issuers of conduit bonds fall into many categories. These include operating entities such as cities, as well as special purpose entities that serve no purpose other than as a bond issuer. Our survey asked various questions about the nature of the respondents. The purpose of these questions was not to determine the percentage of issuers that fell into each of these categories, but rather to allow the other responses to be interpreted fairly. For example, there are many issuers with virtually no staff, no permanent offices and no activity except when requested to act by a conduit borrower. Our survey appears not to have reached this class of issuers. The issuers surveyed fell into the following categories:

Operating entity – 67%
Full time Staff – 92%
Other respondents had part time staff.

Respondents varied on the types of issues they issued. Types of issues included governmental bonds, qualified 501(c)(3) bonds, and private activity bonds (non-qualified 501(c)(3)). Few of the respondents issued over 50 conduit bond issues, but a majority issued over 10. Qualified 501(c)(3) issues appeared to be the biggest

category of bonds issued by the respondents. The respondents were relatively large issuers. 70% of the respondents issued over \$500,000,000 of conduit bonds for 501(c)(3) borrowers. None issued under \$5,000,000 in any category (unless they issued none in that category). [Page 15]

The survey asked participants to describe handling of investments and recordkeeping:

g. Investment control

Most of the respondents indicated that investment decisions were treated as the responsibility of the conduit borrowers, not the conduit issuer. This matches the experience of the [Advisory Committee on Taxation] members and also reflects the recognition that in most conduit transactions the investments are treated as property of the conduit borrowers. However, a significant minority indicated that either the conduit issuer controlled the investment, or that a party hired by the conduit issuer controlled the investment. Thus, a significant number of conduit issuers appear to consider investment of bond proceeds as a function meriting conduit issuer control. Over 90% of the respondents indicated that proceeds were held by a bond trustee prior to expenditure. Bond trustees usually do not, however, have independent discretion over the investment of funds they hold. [Page 16]

k. Recordkeeping

A minority of respondents considered themselves as keepers of comprehensive records. However, only a third of respondents indicated that they did not keep records at all. The types of records kept by the conduit issuer respondents was varied, with less than 10% keeping expenditure records, private use records, or remedial action records. Less than 20% kept investment records. Evidently the responding conduit issuers considered recordkeeping to be primarily the responsibilities of the conduit borrowers. Of those who stated that they kept records, a large majority were committed to keeping records for at least three years after the payment in full of the bond issue. Many kept records for considerably longer periods. [Page 17]

Government Accountability Office

In 2012, the GAO issued “Municipal Securities: Options for Improving Continuing Disclosure.”¹⁰ The focus was on the municipal market in general. It does, however, describe the size of the municipal market:

Municipal securities are debt instruments that state and local governments issue to finance transportation, housing, hospitals, education, and other diverse public projects. The value of municipal securities outstanding was an estimated \$3.7 trillion as of March 31, 2012, with individuals (also known as retail investors) holding 50 percent of the total outstanding directly, such as through purchases from broker-dealers, and up to another 25 percent indirectly through investment funds. There are approximately 51,000 state and local government-issuers of municipal securities and the number of separate outstanding municipal securities is estimated to be more than 1.3 million, according to information cited by the Securities and Exchange Commission (SEC). State and local governments account for 80 percent of the total outstanding. Of the remaining 20 percent, corporate conduit borrowers (public and privately held companies) account for approximately 13 percent and nonprofit conduit borrowers (such as schools, health care providers, and nonprofit housing developers) account for approximately 7 percent.⁵ [Except for footnote 5, footnotes omitted.]

⁵ Corporate and some nonprofit borrowers access the municipal market through governmental issuers that act as conduits to the market. [Page 2]

The GAO’s numbers suggest that in 2012, the amount of conduit debt outstanding would have been an estimated \$740 billion (20 percent of \$3.7 trillion). When the report addresses conduit debt, it focuses on the need for more information from third-party borrowers. One recommendation was to require borrowers to comply with corporate disclosure requirements (page 31). The context of this recommendation implies this would include timely annual reports and quarterly reports.

¹⁰ “Municipal Securities: Options for Improving Continuing Disclosure,” United States Government Accountability Office, Washington, DC, accessed June 21, 2017, <http://www.gao.gov/products/GAO-12-698,2012>.

Municipal Securities Rulemaking Board

The MRSB defines conduit financing as follows:

The issuance of municipal securities by a governmental unit (referred to as the “issuer” or “conduit issuer”) to finance a project to be used primarily by a third party, which may be a for-profit entity engaged in private enterprise, a 501(c)(3) organization, or another governmental entity (referred to as the “conduit borrower”). In a conduit financing, the conduit borrower is liable for making debt service payments on the bonds. Industrial development bonds, multi-family housing revenue bonds and qualified 501(c)(3) bonds are common types of conduit financings.¹¹

The MSRB also addresses an issuer’s obligations for continuing disclosure:

What is continuing disclosure?

... Continuing disclosure generally consists of disclosures of financial information or operating data for the issuer or obligated person and disclosures of specific events that can have an impact on the securities.

The goal of continuing disclosure obligations is to make available to the municipal securities market, on a timely basis, information on entities who are responsible for repayment of the municipal securities, known as obligated persons. Thus, if an obligated person for whom financial information and operating data is presented in the official statement (for example, the conduit borrower) enters into a contract to provide the required continuing disclosure, **the conduit issuer may not have any continuing disclosure obligations of its own.** However, conduit issuers should consult with their legal professionals to ensure that any continuing disclosure obligations pertaining to their specific issuances are satisfied.

Who Is Subject to Continuing Disclosure Obligations?

SEC Rule 15c2-12 requires a continuing disclosure commitment, typically contained in a separate continuing disclosure agreement, **from the issuer** or an obligated person for whom financial information and operating data is presented in the official statement. Since an obligated person is generally a person who agrees to pay all or a portion of the obligations on the municipal securities, the continuing

¹¹ Glossary definition of “conduit debt,” MSRB, accessed June 22, 2017, <http://www.msrb.org/Glossary/Definition/CONDUIT-FINANCING.aspx>.

disclosure agreement would typically include the conduit borrower in a conduit issuance...

How Do Conduit Issuers Fulfill Any Continuing Disclosure Obligations?

The parties to the continuing disclosure agreement, often — although not necessarily — may include the conduit borrower, **the conduit issuer**, the trustee (on behalf of the bondholders) and a designated agent or dissemination agent, which is a person or entity that agrees to submit the actual disclosures to the MSRB. The agreement will typically describe the actions that each party agrees to take to ensure compliance with the relevant continuing disclosure obligations. **Conduit issuers should note that, even if they do not have any obligations to submit continuing disclosures related to their own financial and operating data, the continuing disclosure agreement may impose other requirements on them**, such as a duty to notify the other parties to the agreement that an event triggering a continuing disclosure filing has occurred.¹² [Bold font added for emphasis]

California Debt and Investment Advisory Commission

The California Debt and Investment Advisory Commission (CDIAC), organized within the state treasurer’s office, has studied conduit financings. The Commission provides information, education and technical assistance on debt issuance and public fund investments to local public agencies and other public finance professionals. In 2015, it issued “A Preliminary Review of the Initial Disclosure Practices of California’s Conduit Borrowers.”¹³ Much of the focus of this report was an evaluation of risk disclosures by issuers in a conduit financing’s offering statements. There was, however, an effort to understand ongoing risk disclosures of outstanding conduit financings in the context of SEC Rule 15c2-12.

¹² “The Conduit Issuer’s Guide to Continuing Disclosures,” MSRB, <http://www.msrb.org/msrb1/pdfs/Conduit-Issuers-Guide-to-CD.pdf>, accessed June 22, 2017.

¹³ “A Preliminary Review of the Initial Disclosure Practices of California’s Conduit Borrowers,” California State Treasurer, 2015, accessed June 30, 2017, <http://www.treasurer.ca.gov/cdiac/issuebriefs/201509.pdf>.

California State Auditor: conduit fees

In 2012, the California State Auditor issued a report, “Conduit Bond Issuers.”¹⁴ The report studied three conduit issuers in California. Some conduit issuers engage consultants to assist in bringing issuances to market. The report considered the public policy concerns of fees paid to those consultants. What is significant to standards setting about this report is that it indicates that California law requires conduit issuers to report the following information in their audited financial statements:

1. Dollar amount of fees imposed on borrowers
2. Dollar amount of expenditures related to the fees imposed on borrowers
3. Bonds the board approved that remained unsold at the end of the audit period
4. Bonds issued during the audit period and bond amounts still outstanding. (Page 38)

New York State: public authority debt

In January 2017, the New York State Comptroller issued a report¹⁵ indicating that New York public authorities have \$68 billion in outstanding conduit debt.

¹⁴“Conduit Bond Issuers,” California State Auditor, 2012, accessed June 23, 2017, <https://www.bsa.ca.gov/pdfs/reports/2011-118and2011-613.pdf>.

¹⁵ “Public Authorities by the Numbers,” New York State Comptroller, January 2017, accessed June 22, 2017, <http://www.osc.state.ny.us/pubauth/reports/pub-auth-num-2017.pdf>).

State and Local Public Authority Debt
(in millions)

	State	Local	Total
State - Issued for State purposes	\$ 51,118	\$ 7,453 *	\$ 58,571
Authority - Issued for authority purposes	66,653	74,008	140,660
Conduit - Issued on behalf of other entities	40,886	27,472	68,358
Total	\$ 158,657	\$ 108,933	\$ 267,590

* Local public authority debt issued for State purposes primarily comprises certain New York City Transitional Finance Authority debt, which is categorized as Other State-Funded Debt.

Note: See the Debt Glossary (Appendix C) for components of public authority debt.

Totals may not add due to rounding.

[Page 9]

Note that this report includes debt that is secured by a pledged revenue stream—characterized as a collateralized borrowing:

Conduit Debt – Bonds or notes issued to finance a project for a specific third party, excluding New York State. The security for such bond or note is the credit of the third party rather than the issuer, and the issuer has no obligation to repay the debt beyond the resources provided by that third party. Also considered conduit debt is New York State collateralized borrowing, where the security for such debt is the pledge of a future revenue stream, and the issuer has no obligation to repay the debt beyond the resources provided by the pledge of such future stream of revenues. [Page 43]

Rating Agencies

Publications available from the rating agencies describe the default experience with certain debt. Unlike the SEC report described above, the materials from the rating agencies do not distinguish conduit debt from other debt. Nevertheless, in the GASB staff’s view the experience with municipal defaults discussed by the rating agencies generally is consistent with the SEC’s analysis. The materials from the ratings agencies also address housing finance agencies (mortgage pass-through bonds), debt that carries an issuer’s moral obligation, and a commitment to make appropriations.

Fitch Ratings

The relevant Fitch Ratings materials the GASB staff was able to obtain focus on housing finance agencies (HFAs). In its publication, “U.S. State Housing Finance Agencies: MBS Pass-Through Bond Rating Criteria,”¹⁶ Fitch evaluated the mortgage securities supporting an HFA’s bonds. Of note is that Fitch also considers whether the bankruptcy of the HFA has the potential to negatively affect the trust estate of the mortgage-backed bonds.

[T]he primary assets securing the bonds are the MBS [mortgage backed securities]. Consequently, Fitch examines bond documents to determine whether the legal structure ensures that bondholders will receive the expected security. MBS and associated revenues should be validly pledged to bondholders and held in a separate segregated trust fund for the benefit of bondholders...

In addition, Fitch assesses whether the trust estate is sufficiently shielded from the risk of bankruptcy of the bond issuer...

Factors that Fitch may consider in its rating could include, in appropriate cases, **the conduit nature** of the bond issuer and the nonrecourse nature of the bonds (as opposed to general obligation debt that could create an increased risk of insolvency or an increased incentive to seek reorganization); whether applicable statutes or bond documents restrict the use of the trust estate and revenues solely to the bonds; the limited nature of the issuer’s operations and the issuer’s inability to become subject to an involuntary bankruptcy filing (as confirmed in a legal opinion); the existence of reserve funds if required to support payments temporarily on the bonds; and whether a risk of an issuer bankruptcy may be reduced based on a close nexus between the bond issuer and its municipal or state parent, which could effectively align the bankruptcy risk of the issuer with its municipal or state parent.

A bankruptcy filing concerning such an issuer or events that could materially increase the risk of such a filing could lead to a downgrade of the rating.¹⁷ [Bold font added for emphasis]

¹⁶ “U.S. State Housing Finance Agencies: MBS Pass-Through Bond Rating Criteria,” Fitch Ratings, last modified May 18, 2017, accessed June 20, 2017, <https://www.fitchratings.com/site/re/897797>.

¹⁷ Ibid., pages 2 and 3.

Fitch has separate ratings criteria for pooled multifamily housing bonds¹⁸ Although these criteria are similar to the criteria for other forms of debt, it is notable how pledges from “a municipal entity related to the pool” are addressed:

Pledges

Fitch will consider the presence of additional support or a guarantee from a municipal entity related to the pool on a case-by-case basis. In addition to pledged assets in the indenture, there are bond programs in which a state or municipality provides a moral obligation (MO) pledge, typically to replenish the debt service reserve fund of the indenture if it is tapped.

Fitch believes the MO pledge can potentially add strength to the credit. However, the degree of additional credit enhancement that it provides is dependent on several factors: the mechanics of the MO provision, including the notification of a reserve tap and timing and details of a replenishment, the essentiality and breadth of public benefit provided by the housing developments being financed, and the strength of the state entity providing the MO, including its financial flexibility and liquidity, its selectivity in assigning its MO and the disclosure of its MO exposure (*for more information, see Fitch Research on “U.S. Tax-Supported Rating Criteria,” dated April 2016, available on Fitch’s website at www.fitchratings.com*).

Fitch’s view of debt that is secured by a moral obligation by the issuer is that the issuer may fail to honor its commitments. A moral obligation is considered “a nonbinding legislative mechanism,” and a failure to honor a moral obligation is a negative.¹⁹

¹⁸ “Ratings Criteria for Pooled Multifamily Housing Bonds,” Fitch Ratings, last modified December 22, 2016, accessed June 22, 2017, <https://www.fitchratings.com/site/re/891719>, page 14.

¹⁹ “U.S. Public Finance Tax-Supported Rating Criteria,” Fitch Ratings, last updated May 31, 2017, accessed June 22, 2017, <https://www.fitchratings.com/site/re/898466>, pages 45–47.

Standard & Poor's Financial Services

S&P's description of its process of evaluating debt issued in the U.S. public finance sector²⁰ states that whether a government's debt is subject to appropriation or secured by a moral obligation is a factor :

Debt statement analysis

3. When Standard & Poor's examines the debt burden of a municipality it starts by looking at all direct debt, and any other analytic obligations of the entity. Debt types included in gross direct debt include:

- General obligation bonds...
- Authority, certificate or other capital lease obligations that are secured by lease rental or contract payments subject to appropriation;
- Moral obligation secured debt...

5. With this aggregation of direct debt, Standard & Poor's measures the full burden of debt on the population in relation to wealth. After this evaluation, deductions are made from the debt statement for self-support of certain types of debt...

6. Self-support is an analytic judgment and will not necessarily match statutory calculation of self-support. The following are typically deducted:...

- Moral obligation debt that has not required any contribution to the debt service reserve fund from the morally obligated party...

When debt service is being covered by a third party borrower, that borrower should be identified.

15. The debt statement should include a listing of obligations of both long- and short-term debt and maturity dates should be provided. Furthermore, the nature of the security should be concisely, but accurately defined. If the entity paying the debt service is different from the security, that should be defined as well. In terms of lease obligation, there is often a conduit authority set up to issue the debt for the obligor, therefore the debt statement should include this debt and indicate the appropriate authority for debt issuance.

²⁰ "Debt Statement Analysis," Standard and Poor's Ratings Services, last modified March 2, 2017, New York

Kroll Bond Rating Agency

In “U.S. State Annual Appropriation Rating Methodology,” the Kroll Bond Rating Agency (KBRA) addresses how it evaluates (1) debt that carries the moral obligation of a state-issuer and (2) debt for which a state-issuer agrees to make appropriations.²¹ If debt service reserves need to be replenished, the issuer agrees to seek an appropriation of funds. But the issuer is not obligated to do so. In KBRA’s view, revenue bonds and annual appropriation obligations were introduced to avoid debt limits and voter approval requirements. They observe that state courts generally do not view revenue and annual appropriation obligations to be debt for debt limit and voter approval purposes. Because KBRA believes moral obligation debt is an indirect obligation of the issuer, it considers moral obligation debt to be lower quality than state appropriation-backed debt.

KBRA evaluates annual appropriation risk by considering the legal environment, political environment, and project essentiality. The legal environment is comprised of a state’s unique statutes, case law, and constitutional provisions. Included is an evaluation of whether a legal challenge is likely. The political environment is an evaluation of whether annual appropriation financing is controversial. In KBRA’s view, an appropriation for debt service associated with an essential project is more likely, though they indicate that this is not a critical element of their evaluation.

Moody’s Investors Service

In its study of municipal defaults, “US Municipal Bond Defaults and Recoveries, 1970–2015,”²² Moody’s Investors Service indicates that “non-GO bonds” have a significant potential

²¹ “U.S. Annual Appropriation Obligation Rating Methodology,” Kroll Bond Rating Agency, last modified February 5, 2014, available for download after registration at www.krollbondratings.com.

²² “US Municipal Bond Defaults and Recoveries, 1970–2015” Moody’s Investor Service, last modified May 31, 2016, accessed June 22, 2017, https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_1017170, page 2.

for default. Some of this debt carries the moral obligation of the issuer or a commitment of the issuer to make appropriations.

Nearly half of all rated municipal bonds are not backed by a GO pledge. Non-GO bonds—predominantly revenue bonds—are repaid from revenues generated from an enterprise such as a water and sewer system, a hospital, a housing or infrastructure project, or from special taxes such as sales, gasoline, hotel taxes, etc. Non-GO bonds also include governmental debt backed by operating funds without a specific pledge, including lease revenues, appropriations and moral obligations. Since 1970, 90 of the 99 Moody's-rated municipal defaults were defaults on non-GO debt. The majority of Moody's-rated defaults have occurred in the last two decades; only 15 occurred before 1996...

Cumulative Default Rates

Only 99 Moody's-rated municipal issuers defaulted on their bonded debt or related guarantees during the period 1970-2015. . . . The vast majority of defaults were in the housing (with one-year default rate of 0.09% for all ratings and 4.64% for speculative-grade only) and healthcare sectors (with one-year default rate of 0.09% for all ratings or 1.60% for speculative-grade only). Only nine GO bond issuers defaulted on GO bonds in the 46-year study period (the one-year default rate for GO bonds is 0.003% and 0.20% for speculative-grade GO bond issuers)... [Page 10]

In the report's listing of defaults, one issuer failed to make appropriations:

[The issuer], a conduit agency that issues debt supported by appropriations of [the] central government (Caa3 negative),...defaulted on four series of bonds for which [the] Assembly had failed to appropriate payments. This was the first payment default of any of [this government's] various debt issuing arms, all of which are rated in the deep speculative ranges...Confronted by a growing liquidity and debt crisis, the legislature in June 2015 had approved a budget lacking the required \$93.7 million for the...bonds' fiscal 2016 debt service, even though the executive branch...had included this amount in budget bills it submitted to the legislature. [Page 79]

Moral obligation debt. One government extended its moral obligation to cover debt service payments of a third-party borrower. It ultimately agreed to cover those payments:

The bonds were secured by loan payments made by [the start-up company] and **featured a moral obligation from the [state government] to appropriate funds** to cover deficiencies in the capital reserve fund and debt service on the bonds. The company struggled financially, [and] . . . eventually

declared bankruptcy. Politically, the once-positive sentiment over job creation in connection with the venture was replaced with frustration over the agreement terms and [the state government's] exposure to the outstanding debt. However, the state has continued to appropriate **funds to meet its moral obligation pledge** without interruption. [Page 80, bold font added for emphasis.]

Failure to appropriate. The following example involved a lease and a city government's commitment to appropriate funds if a lessee fails to pay:

The [city's] action to renege on an appropriation pledge is an example of how the failure to support the operations or debt service of struggling enterprises can have serious ramifications for a local government's general obligation rating. Some will experience severe deterioration in credit quality. For example, [this city] made an appropriation pledge to support a lease revenue transaction (unrated) used to finance a sports complex. City management expected net revenues of the facility to fully fund debt service, but when net revenues were insufficient, the city faced an unexpected call on its appropriation pledge. City officials chose to terminate the lease payments, a decision that led to our September 2012 downgrade of the city's general obligation rating to Ba1 from Aa2. A key factor in our rating action was the city's unwillingness to honor its pledge on publicly-issued debt. [Page 81]

National Federation of Municipal Analysts

The NFMA has published a number of best practices that address various types of municipal debt issuances. Housing revenue bonds, hospital debt, long term care facilities, and private college and university transactions are specifically addressed.²³ Recommended disclosures for land-secured debt are bond principal outstanding; amounts in reserve, construction funds, and debt service funds; delinquencies; foreclosures and tax lien sales; and building and occupancy activities.²⁴

²³ "Best Practices in Disclosures," NFMA, accessed June 29, 2017, <http://www.nfma.org/best-practices-in-disclosure>.

²⁴ "Recommended Best Practices in Disclosure for Land Secured Debt Transactions, NFMA, June 2000, accessed June 29, 2017, <http://www.nfma.org/assets/documents/DG.BP.landsecuredpractices.doc.pdf>.

News Articles

Conduit financings are routinely covered in the news media. The GASB staff's review indicates that articles about conduit financings often involve issuances for large dollar amounts, financings of projects that are of public interest, and touch upon issues such as private activity bonds and caps, defaults, and commitments extended by government-issuers.

III. RESEARCH QUESTIONS

The aim of this pre-agenda research activity was to collect information to help the Board assess whether there is a need to revise the existing GASB literature that addresses conduit debt. The research proposal identified the following questions to be considered:

- How useful has information about conduit debt been for making decisions and assessing accountability?
- Considering the Concepts Statement 4 definition of a liability, under what circumstances, if any, do conduit debt obligations constitute a liability of the government issuing the debt?
- If conduit debt is a liability of the issuing governments, is the amount owed by third-party entities an asset (receivable) of the government?
- If conduit debt has been defeased, how should it be reported or disclosed?

As described in the Results and Analysis section of this paper, our research gathered information on conduit debt transactions—the identity of participants in the transactions, the characteristics of conduit debt transactions, the risks assumed by conduit debt issuers, and the information needs of financial statement users. The GASB staff concluded, however, that whether conduit debt represents a liability, asset recognition, and defeasance accounting are issues that need to be addressed by the Board. The GASB staff believes that our pre-agenda research has assembled the information that the Board will need to consider whether a conduit debt project should be added to the Board's current technical agenda.

IV. METHODOLOGY AND LIMITATIONS

In addition to the literature review, two research methods were employed to gather information on conduit debt—archival research and telephone interviews.

Archival Research

Archival research for conduit debt derived from two separate research efforts: (1) the Crain grant research discussed in the literature review section and (2) the pre-agenda research conducted by the GASB staff for the Note Disclosure Reexamination project.

As previously noted, the Crain grant research was designed to study financial reporting practices for conduit debt. The researchers reviewed all 50 state government annual financial reports for disclosures related to conduit debt obligations. In addition, the researchers used a data set of municipal bond issuance activity in California from the CDIAC covering 2004–2013. That data set included debt issued both by dedicated conduit issuers and local governments reporting conduit debt.

The Note Disclosure Reexamination research reviewed 494 annual financial reports of various types of governments for fiscal year 2015, including 49 states, 125 counties, 125 cities, 100 school districts, 75 special districts, and 20 colleges and universities.

Interviews

Two rounds of telephone interviews were conducted by the staff in May and June 2017. The interview questions, protocols, and procedures were developed in accordance with the provisions of the GASB's Research and Technical Activities (RTA) Manual. (The interview questions can be found in Appendices A through C of this memorandum.)

Interview objectives

The first round of interviews was conducted with individual in various capacities with respect to conduit financings (such as buy-side analysts, news media, and state-level policy analysts). These interviews focused on understanding the conduit debt market. Specific aspects included:

- Interviewees' views on no-commitment debt, moral obligation debt, limited-obligation debt, and appropriation-backed debt, as well as their relationship with conduit debt
- Interviewees' understanding of conduit debt market participants, their roles in those transactions, transaction structures, and cash flows.
- Interviewees' understanding of the issuers' activities, including the selection process, monitoring activities, commitments made, and debt service payments made, if any.

Incorporating the results of the first round of interviews, a second round of interviews was conducted with users and individuals representing government-issuers. These interviews were designed to achieve the following objectives:

- User interviews:
 - How users currently use financial information about conduit debt
 - What additional information they need for their decision-making process and assessment of governments' financial health but currently do not see in governments' financial statements
 - Their information sources other than governments' financial statements
- Government-issuer interviews:
 - What commitment government-issuers make, if any, when issuing conduit debt
 - Whether any of their third-party borrowers has defaulted and, if so, whether the government-issuer has made any debt service payments
 - What screening process and monitoring activities, if any, they have been engaged in related to their conduit debt
 - Whether and how often they receive information from the trustee regarding third-party borrowers' payment status.

Selection of interviewees

The GASB staff obtained names of potential interviewees from the following sources:

- Governmental Accounting Standards Advisory Council (GASAC) members

- GASB stakeholder database
- News media articles and reports, reports from rating agencies, and academic research papers
- Other interviewees.

Potential interviewees were invited to participate by email, with follow-up telephone calls if necessary. Interviewees were provided materials in advance of the interview date that included a description of the objectives of the pre-agenda research and the questions that would be asked during the interview.

The staff conducted 11 interviews in the first round. Interviewees included:

- Two municipal bond market advisors
- A bond counsel
- A buy-side analyst
- An information service provider focusing on municipal bond defaults
- Two academics who coauthored a research paper on conduit debt
- An official in a state controller's office that oversees the terms and conditions for that state's conduit debt sales
- An official in a state treasurer's office that approves debt transactions
- An auditor with clients in conduit debt transactions
- An official from an independent commission chaired by a state treasurer that collects annual reports from state conduit issuers and provides information, education, and technical assistance on debt issuance to the public.

The staff conducted 12 interviews in the second round—7 with users and 5 with government-issuers. The five government-issuer interviewees were from different states or designated debt issuance agencies of a state government, such as a financing authority. The user interviewees included:

- An official from a state finance oversight office

- Two state legislative fiscal officers (single interview)
- A state bond review board official
- Three buy-side analysts
- An analyst from a rating agency.

Limitations to the Methodologies

There are limitations to the methodologies used in this research. For the literature review, though the GASB staff reviewed 61 news media reports, 6 academic studies/research reports, 4 rating agencies reports, and the 3 federal reports discussed earlier, there likely are articles and reports about conduit debt that we did not identify. Those articles and reports may have provided different perspectives and insights to the staff. Therefore, the issues presented in the literature review may not include all relevant stakeholder concerns.

For the telephone interviews, although a variety of stakeholders were interviewed, there are other types of stakeholders—and other stakeholders of the types included—who are interested in this research subject. Those stakeholders, as well the stakeholders who were invited to participate but declined or did not respond, may have different views from those interviewed. Finally, the interviewees were not selected using a random process, nor were the findings statistically tested. Therefore, the results of the telephone interviews may not be generalizable.

V. RESULTS AND ANALYSIS

This discussion is organized by the source of the information—archival research and telephone interviews.

Archival Research

As discussed earlier, the archival research consists of reviews of government annual financial reports from two separate research efforts. The Crain grant research examined 13 dedicated conduit debt issuers, 40 local governments in California, and the 50 states. The researchers concluded that the conduit debt obligation disclosures they examined generally were in

compliance with GASB guidance. Given the different governments examined, there were differences in compliance. Of the 13 dedicated conduit issuers, 12 (92 percent) were compliant. For the 40 local governments in California, however, 10 (25 percent) either presented no disclosures or did not properly disclose the outstanding conduit debt amount. For state-level compliance the researchers found that state governments either made the required disclosures or referred a reader to the separately issued financial statements of component units or related organizations. However, as noted in this paper, California currently has a law requiring the disclosure of most of this information.

Of the 494 annual financial reports reviewed as part of the GASB's Note Disclosure Reexamination, 88 (18 percent) included disclosures related to conduit debt. All 88 provided a general description of their conduit debt transactions. Regarding the two remaining disclosure requirements in Interpretation 2, 66 of the 90 governments (73 percent) disclosed the aggregate amount of all conduit debt outstanding at the date of the statement of net position, and 79 (90 percent) provided a clear indication that an issuer has no obligation for the debt beyond the resources provided by the related leases or loans. This suggests that 27 percent did not disclose the aggregate amount of all conduit debt outstanding and 10 percent did not provide a clear indication that an issuer has no obligation for the debt beyond the resources provided by the related leases or loans.

Telephone Interviews

The results of both rounds of interviews are grouped into eight topics: definition of conduit debt; understanding of the transaction and market; government-issuer's risk exposure; availability to government-issuers of information about the status of the borrower's payments; use of conduit financing disclosures by users; other information about conduit financings users need; accountability for conduit financings; and housing finance agencies.

Definition of conduit debt and its relationship with other debt terms

When asked how they define conduit debt, almost all interviewees described conduit debt as debt issued by a government on behalf of a third party that the government-issuer has no

obligation to repay. The source of debt service payments is limited to resources provided by the borrower.

The GASB staff asked about the relationship between conduit debt and four terms that often are mentioned in the discussion of conduit debt: (1) no-commitment debt, (2) moral obligation debt, (3) limited-obligation debt, and (4) appropriation-backed debt. The general understanding among the interviewees was that conduit debt is equivalent to no-commitment debt. On the other hand, the other three terms refer to different types of debt in which a government-issuer has some type of obligation to repay and are not the same as how the interviewees described conduit debt.

Understanding conduit debt transactions and the conduit debt market

The GASB staff asked interviewees to describe their understanding about aspects of conduit debt transactions and the conduit debt market. The answers to each aspect are presented separately below.

Initiation of an issuance may be from any participant. Many interviewees stated that a conduit financing transaction may be initiated by a government-issuer, a third-party borrower, or a financial advisor to a third party, depending on the purpose of the debt. In many cases, third-party borrowers initiate the transaction (such as by applying to a conduit financing program) because they need to access capital markets or because it would be cheaper for them to issue tax-exempt bonds than taxable bonds. Sometimes a government-issuer tries to encourage a third-party organization to take on a project that would benefit the local community. In that case, the government-issuer actively seeks qualified third-party borrowers and offers conduit debt financing as an incentive. Some interviewees indicated that some government financing agencies are very active in locating third-party borrowers and offering conduit debt financing. Those financing agencies are established as agencies of governments. Although some are organized and staffed like any other government agency, some are entirely staffed by employees of for-profit organizations.

Selection process and criteria used by government-issuers. The GASB staff asked about processes and criteria that government-issuers apply when entering conduit financings with third-party borrowers. The responses varied. Some government-issuers have rigorous policies and procedures that not only check the credibility and financial health of third-party borrowers, but also evaluate the nature of the projects the debt intends to finance. Some issuers go through an informal process. Finally, some issuers do not go through any selection process.

Typical cash flows. Interviewees noted that the bond trustee typically handles all cash flows, including disbursement of bond proceeds to and collection of debt service payments from the third-party borrowers. Except for the fees that issuers receive for providing conduit financing, issuers generally do not handle any cash inflows or outflows in conduit debt transactions.

Legal and financial documents that describe the structure and obligation. Commonly available documents include public offering statements, bond indentures, loan and lease agreements, tax documents proving tax-exempt qualification of the conduit bond, and issuer resolutions. Some interviewees believe that offering statements are of limited value. Those interviewees indicated that the critical terms and conditions of conduit debt transactions are in bond indentures and loan agreements.

Knowledge of conduit debt structured as leases. Some interviewees indicated that debt service payments by third-party borrowers may be characterized as lease payments. In their description, the government-issuers are lessors, the third-party borrowers are lessees, and the transactions usually are structured as lease-purchase-type arrangements in which there is a capital asset being acquired or constructed and the conduit debt is issued to finance that asset. There would be a lease associated with that asset for the third-party borrower to use. At the conclusion of the lease, there usually is a provision that returns the asset to the government-issuer or transmits the asset to the borrower. The bond indenture generally would require the lessee-borrower to make all lease payments directly to the trustee.

Government-issuer monitoring of borrower debt service payments. Interviewees stated that the extent of government-issuer monitoring of third-party borrower debt service payments

varies significantly. Many interviewees said that monitoring efforts by issuers are minimal, if any. On the other hand, some government-issuers that were interviewed described having a vigorous monitoring policy and process, but pointed out they do not know whether other issuers conduct the same extensive monitoring activities.

Commitments and debt service payments made by government-issuers. When asked what commitments, if any, government-issuers make, interviewees indicated that commitments are limited to compliance with tax-exempt status. Interviewees said that government-issuers do not have commitments to cover debt service payments of defaulting borrowers. In answer to follow-up questions, some interviewees pointed out that when a government extends a moral obligation or explicitly expresses a willingness to make annual appropriations, that in their opinion, the debt is no longer conduit debt.

When asked whether they were aware of any circumstances in which a government-issuer made actual debt service payments for a defaulting borrower, no interviewees had such knowledge. Some interviewees referred to a well-known case of a conduit financing in which a state government stepped in to make debt service payments. However, they indicated that this was not conduit debt. That was because the bond indenture included a provision that the state promised to make annual appropriations to cover debt service payments in the event of default by the borrower. The specific commitment was as follows:

The 20XX bonds and the interest thereon do not constitute a debt, liability or obligation of the state or any political subdivision thereof (other than a special or limited obligation of the issuer) and neither the faith and credit nor the taking or taxing power of the state or any political subdivision or municipality thereof is pledged to the payment of the 20XX bonds or the interest thereon. The issuer has no taxing power. The obligation of the state to make payments for deposit into the capital reserve fund is subject to annual appropriation by the state general assembly. [Text in offering statement was all caps.]

Government-issuer risk exposure

User interviewees generally believe there is a reputation risk or “headline risk” for government-issuers. One interviewee did not believe there is any risk to the government-issuer unless there

is a guarantee. Some interviewees believe that if a government-issuer enters a conduit debt financing and the borrower defaults, it would be more difficult (or even impossible) for that government-issuer to issue conduit debt in the future. Some interviewees also believe there is a credit risk to the issuer because of the potential negative publicity when there is a default.

Some interviewees believe litigation risk exists even though the government-issuer is not liable. If a borrower goes into a bankruptcy proceeding or a foreclosure proceeding, these interviewees believe the government-issuer may be sued as a party of the transaction and be subject to depositions.

Finally, losing a conduit financing's tax-exempt status is another risk. Government-issuers generally are responsible to comply with federal and state securities laws. If there is a material omission or a material misstatement in the transaction, the issue is not exempt from federal or state taxes and the government-issuer could be sued for fraud and misrepresentation.

Availability to government-issuers of information on debt service payment status

Government-issuers were asked whether they periodically receive information from the conduit debt trustee regarding the status of a borrowers' payments. Government-issuers who answered yes stated that a provision is included in their debt agreements that requires trustees to provide monthly payment statements. Government-issuers who answered no stated that this information was not always automatically provided by the trustee. But all government-issuers interviewed indicated that the information was easily accessible if they made a request to the trustee.

Use of existing conduit financing information disclosures

During the second round of interviews, users were asked to describe what information about conduit debt they typically see in the notes to the government-issuers' financial statements and how they use that information for their decision-making process or assessment of the financial health of the government-issuers. The state legislative staff indicated that they saw in the notes what conduit debt has been issued, but not much more than that. That information does not

enter into their analysis of the issuer or decision-making, because issuers are not obligated to pay. One state bond review board official stated that the review board would look at individual transactions but does not necessarily review an issuers' financial statements. Because the review board needs to have intimate knowledge about issuers, the review board performs detailed analysis using an issuer's overall financial information. That analysis is not necessarily limited to conduit debt information.

The three buy-side analysts and one credit analyst generally see conduit debt in the notes. They use this information if they believe that information could impact a government-issuer's financial health or credit standing, especially if there is a moral obligation attached to the debt. However, they generally are more interested in information about borrowers and not issuers.

Information needs of users that are not currently available in the notes to financial statements

Although this question was not explicitly asked during the first round of interviewees, many of the users interviewed indicated a need for additional information beyond what is in the notes. During the second round of interviews, the staff asked users what information they need that cannot be obtained from the notes. Some users said there should be a brief (perhaps two-sentence) description of the status of the projects associated with a financing. Examples included: "the project is paying the debt service as per the agreement" and "the project is or is not subject to a tax-exempt status inquiry by the Tax-Exempt Bond office of the IRS." Some users said government-issuers should disclose (1) whether a conduit debt satisfies the financial needs of the program or project it is financing, (2) whether taxpayers are getting benefits from the debt, and (3) whether conduit debt is the lowest cost of borrowing and most expeditious way to finance a project.

Some users believe government-issuers should be required to disclose the status of their outstanding conduit debt, such as whether the debt service payments are current, in arrears, or in default. They view this information to be very useful to investors, because it provides them with indications about any potential headline risks or coming problems.

Conduit debt and government accountability

Many interviewees voiced concerns about conduit debt. Some interviewees believe conduit debt is being used to avoid voter approval requirements. Some interviewees believe that because government-issuers are not obligated to pay, they have little or no incentive to do due diligence in selecting qualified borrowers or to monitor a financing's payment status. Some interviewees think that there are problems and abuse in the conduit debt sector due to a lack of oversight, which could account in part for the higher default rate compared to non-conduit-debt obligations.

Some interviewees that expressed certain concerns about conduit debt noted above, also stated those problems may not be the GASB's problem to solve. Finally, some users stated that even though the SEC's continuing disclosure requirements require issuers to disclose defaults, investors do not have easy access to that information.

Housing finance agencies

A unique segment of the conduit debt market is debt issuances made by housing finance agencies (HFAs). To better understand conduit financing provided by HFAs, the GASB staff interviewed two HFAs from different states.

HFA financings may be associated with single-family mortgages or multifamily mortgages. In both cases, the mortgages are securitized. The issuance of the securitized mortgages is an HFA's source of funds for the HFA's underwriting mortgages. When the securitized mortgages are associated with single-family homes, they generally are reported on an HFA's statement of net position. On the other hand, when associated with multifamily mortgages, the securitized mortgages generally are considered conduit debt and presented as a note disclosure. In both cases, offering statements should indicate that the HFA's responsibility for repayment is limited to debt service payments made by mortgagees.

The explanation for this difference varied. One explanation was that in a single-family financing, the HFA owns the mortgages. The implication in that case is that mortgages for multifamily

financings are owned by the bond's trust estate. (See the earlier discussion of trust estates in the section on Fitch Ratings' criteria.) One of the HFA officials interviewed, however, indicated that the difference is that in a multifamily financing, the third-party borrower is identified in official documents; in the case of single-family financings, there may be hundreds of mortgages or more that are swept up into one securitization. The GASB staff's review of offering statements is consistent with the latter explanation.

Summary: Characteristics of Conduit Debt

In summary, the research suggests that a conduit financing generally has the following characteristics. Responsibilities of participants are defined in official documents, such as offering statements or bond indentures.

- The government-issuer:
 - May be a general-purpose government, but often is a government specifically organized to issue conduit debt
 - Indicates that it is not responsible for debt service payments beyond what third-party borrower has paid—"no commitment" debt
 - Does not recognize a capital asset, but may report a lease receivable
 - Generally receives a fee for an issuance followed by annual fees while the debt is outstanding
 - Is responsible for federal tax compliance.
- The third-party borrower:
 - May be another government, a not-for-profit organization, or a for-profit entity
 - Is identified in bond documents, such as in an offering statement and bond indenture
 - Agrees to be responsible for debt service
 - Receives bond proceeds directly from the bond trustee and spends those proceeds
 - Generally makes debt service payments directly to the bond trustee.
- The bond trustee:
 - Receives bond proceeds and disburses them directly to third-party borrower
 - Generally receives debt service payments directly from third-party borrower

- Is aware of whether a third-party borrower is current in its debt service obligations and can share this information with the issuer.

Conduit debt generally is tax exempt, but there are exceptions. Some conduit financing transactions are characterized as leases, with “lease payments” rather than “debt service.” Finally, conduit debt may affect a state’s cap on private activity bonds.

APPENDIX A

First-Round Interview Questions

GASB Research on Conduit Debt: Understanding the Market

The objectives of this interview are to seek the following:

1. Your understanding of conduit debt market participants, their roles in these transactions, transaction structures, and cash flows.
2. Your views on no-commitment debt, moral obligation debt, limited-obligation debt, and appropriation-backed debt, as well as their relationship with conduit debt.
3. Your understanding of the issuers’ activities, including any monitoring, commitments made, and any debt service payments.

Please prepare to answer the following interview questions:

If you don’t want to answer any of these questions, we will skip it and move to the next one.

1. What is your role in conduit debt transactions?
2. How do you define conduit debt?
3. In your view, what is the relationship, if any, between conduit debt and the following?
 - a. No-commitment debt
 - b. Moral obligation debt
 - c. Limited-obligation debt
 - d. Appropriation-backed debt.
4. What is your understanding about transaction structures and cash flows, including the following aspects?
 - a. Who initiates the potential issuance?
 - b. How does an issuer select potential third-party borrowers? What are the criteria for the selection?

- c. What are typical cash inflows and outflows?
 - d. What commitments, if any, do issuers make for conduit debt?
 - e. What legal or financial documents describe the details of structures and obligations?
5. Are you aware of any conduit debt structured as a lease between the issuer and the third-party borrower? If so, please describe these transactions, including the roles of market participants in these transactions.
 6. What risks, if any, do you believe government-issuers are exposed to? Is there any risk to the reputation of government-issuers?
 7. In your experience, have any issuers covered any debt service payments? If so, what were the circumstances?
 8. In your experience, how do issuers monitor debt service payments made by third-party borrowers?
 9. What additional thoughts do you have, if any, regarding conduit debt transactions?

APPENDIX B

Second-Round Interview Questions

Questions for Issuers

The objectives of this interview are to understand your role and activities as a government-issuer of conduit debt and the information available to you. Please prepare to answer the following interview questions.

1. When issuing conduit debt, some governments make limited commitments.
 - a. What commitments, if any, has your government made?
 - i. Has your government issued conduit debt that indicated it was a moral obligation of your government?
 - ii. Has your government issued conduit debt that was backed by annual appropriation of your government if a third-party borrower defaults?
 - b. Has your government ever made a payment if a third-party borrower has defaulted? If so, what were the circumstances?
2. Please answer the following questions related to your conduit debt transactions.
 - a. Do you have a screening process and selection criteria before you agree to issue conduit debt on behalf of a third-party borrower? If so, please describe the process and the criteria.
 - b. What monitoring activities of third-party borrowers do you conduct, if any, after the conduit debt has been issued?
 - c. Does your government handle any of the debt proceeds or debt service payments related to conduit debt transactions? If so, what does it do?
 - d. Do you receive information from the trustee regarding whether the third-party borrowers are current in their debt service payments or lease payments periodically?
 - i. If yes, how often do you receive that information?
 - ii. Do you actively request that information or is it automatically provided to you?
3. Would your answers to Questions 2a-2d differ if your government considers the conduit debt to be its moral obligation or backed by its annual appropriation?
4. What additional thoughts do you have, if any, regarding conduit debt transactions?

APPENDIX C

Second-Round Interview Questions

Questions for Financial Statement Users

The objective of this interview is to understand your information needs regarding conduit debt. Please prepare to answer the following interview questions:

1. How do you define conduit debt?
2. How is conduit debt relevant to you—in analyzing government-issuers, in analyzing third-party borrowers, or both?
3. Do you analyze government-issuers?
 - a. What information about conduit debt do you typically see in the notes to a government-issuers' financial statements (if any)?
 - b. How do you use that information for your decision-making or assessment of the financial health of the government-issuer?
4. Do you analyze third-party borrowers that also are governments?
 - a. What information about conduit debt do you typically see in the notes to a third-party borrower's financial statements (if any)?
 - b. How do you use that information for your decision-making or assessment of the financial health of the third-party borrower?
5. What information about conduit debt do you need for your decision-making or assessment of the financial health of a government-issuer or a third-party borrower that is not available in the notes to financial statements? Are you able to find this information elsewhere?
 - a. If yes, where do you find that information and how do you use it?
 - b. If no, what would you do with that information if you could obtain it?
6. Would your answers to Question 5a and 5b be different if the transactions are conduit debt with a moral obligation of the issuer or backed by the issuer's annual appropriation?
7. What additional thoughts do you have, if any, regarding conduit debt transactions?