February 2020 Discussion Memorandum:
The Indiana Finance Authority (IFA) Water Infrastructure Finance and Investment Act (WIFIA) Loan

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Background

In October 2019, the U.S. Environmental Protection Agency (EPA) announced a $436 million Water Infrastructure Finance and Innovation Act (WIFIA) loan to the Indiana Finance Authority (IFA), representing the largest initial disbursement under WIFIA to date. IFA will use the proceeds of the loan, together with monies in the State Revolving Fund, to fund 23 water projects. IFA manages Indiana’s Wastewater and Drinking Water State Revolving Fund Loan Programs. According to an EPA press release, “Combining state resources, annual federal capitalization grant dollars and its WIFIA loan, Indiana’s State Revolving Fund (SRF) will be able to lend nearly $900 million to support water infrastructure projects throughout the state. EPA’s WIFIA program will finance nearly half of that figure – up to $436 million. The WIFIA loan will save IFA an estimated $20 million compared to typical bond financing. This loan marks the first time EPA has provided WIFIA financing directly to an SRF program.”

WIFIA Loan

The loan between EPA and IFA is pursuant to a loan agreement dated September 6, 2019. Loan terms are as follows:

- **Final Maturity:** 2054 (35 years)
- **Amortization:** See Exhibit G of loan agreement
- **Interest rate:** Bond A (principal amount $349 million)-1.78%
  Bond B (principal amount $87 million)-1.99%
- **Security:** 23 existing SRF loans were carved out and pledged to the WIFIA loan. Those loan repayments must first be used to pay IFA’s WIFIA loan obligation. If tests for permitted transfers pass, any excesses will then be transferred to the Clean Water/Drinking Water SRF programs for use to make new loans, pay debt service, etc. A flow of funds is shown as Figure 1.

Proceeds from the EPA loan were used to purchase the Series A and Series B bonds issued by IFA. Fitch has rated these bonds “AA”. Fitch’s rating report is shown as Figure 2.
Flow of Funds Dedicated by Indiana Finance Authority (IFA) WIFIA Alternative Trust Indenture

(1) denotes 38 specified loans pledged under the WIFIA Trust Estate, of which:
- 22 are existing SRF loans and 9 are SRF loans anticipated to be closed over the next 2 years, payments on which will flow back (but only as Permitted Transfers) to the Primary Trust Estate after being applied to the WIFIA Loan payment obligation; and
- 7 are existing IFA Supplement Fund loans, payments on which will flow back (but only as Permitted Transfers) to the IFA's Supplement Fund, not to the Primary Trust Estate;
- Each only after being applied to the WIFIA Loan payment obligations.

(2) denotes the 7 existing IFA Supplement Fund loans pledged under the WIFIA Trust Estate.

(Red dashed lines) denotes only if there is excess under terms of WIFIA Loan Agreement will this flow occur (see multiple references to Permitted Transfers therein).

Source: Indiana Finance Authority
Fitch Ratings-Austin-06 September 2019: Fitch Ratings has assigned a 'AA' rating to the following bonds issued by the Indiana Finance Authority (IFA or the authority):

--Approximately $349 million taxable WIFIA alternative program revenue bond, series 2019-1;
--Approximately $87 million taxable WIFIA alternative program revenue bond, series 2019-2.

Proceeds from the Environmental Protection Agency's (EPA) Water Infrastructure and Innovation Act (WIFIA) loan program will be used to purchase the series 2019-1 and 2019-2 bonds. The bonds, in turn, will finance certain eligible water quality and drinking water projects in the state. The remaining source of project funding is expected to come from a combination of state revolving fund (SRF) bond proceeds and SRF program equity. The 2019-1/2 bonds are expected to close on Sept. 6.

The Rating Outlook is Stable.

SECURITY

The WIFIA alternative program bonds are secured by WIFIA participant loan repayments and by other accounts pledged under the WIFIA alternative indenture.

KEY RATING DRIVERS

ADEQUATE FINANCIAL STRUCTURE: Fitch's cash flow modeling demonstrates that IFA's WIFIA alternative program (the program) can continue to pay bond debt service, even with loan defaults in excess of the 'AA' liability rating stress hurdle, as produced by Fitch's Portfolio Stress Model (PSM).

SIGNIFICANT POOL CONCENTRATION: Pool concentration is significant, with the CWA Authority, Inc. (CWA; wastewater system revenue bonds rated 'A+/Stable) accounting for 59% of the pool. To account for this, programs with higher concentration are assessed at higher stress levels in Fitch's PSM.

HIGHLY RATED BORROWER POOL: Approximately 94% of the program's loan portfolio is investment grade. Loan provisions are strong, with all loan principal secured by borrowers' net system revenue pledges.

STRONG PROGRAM MANAGEMENT: IFA adheres to consistent, conservative underwriting policies and loan monitoring procedures.

RATING SENSITIVITIES

REDUCTION IN MODELED STRESS CUSHION: Significant deterioration in aggregate borrower credit quality, increased pool or single-borrower concentration or increased leveraging resulting in the program's inability to
pass Fitch's 'AA' liability rating stress hurdle would put downward pressure on the rating. The Stable Outlook reflects Fitch's view that these events are unlikely to occur.

CREDIT PROFILE

IFA is responsible for the administration and management of the SRF's (IFA SRF program rated 'AAA'/Stable) and now also the newly created WIFIA program. The WIFIA loan program was established by EPA to help fund a massive gap in capital spending for infrastructure needs across the country. WIFIA was conceived as a complementary source of federal funding to the Clean Water and Drinking Water SRFs. SRFs, funded as state grants through annual congressional appropriations, are geared toward smaller projects with less access to capital markets. In contrast, WIFIA is designed to handle complex and large water and wastewater projects. Originally a five-year pilot program, WIFIA was designated a permanent program, subject to annual appropriation, in 2018.

The program's participant loan pool consists of highly-rated borrowers, but concentration is significant with CWA and Evansville accounting for 59% and 19% of the pool, respectively.

FINANCIAL STRUCTURE EXHIBITS ADEQUATE DEFAULT TOLERANCE

Fitch calculates the program's asset strength ratio (PASR), which includes total scheduled primary loan repayments and any additional pledged funds divided by total scheduled bond debt service, to be adequate at 1.6x. The PASR is slightly weaker than the 1.9x median level for comparable municipal pools rated by Fitch but considered to be supportive of Fitch's 'AA' rating. The model inputs used to calculate the default tolerance and PASR are based on forecast cash flows provided by the issuer's financial advisor.

Cash flow modeling demonstrates that the program can continue to pay debt service, even with hypothetical loan defaults of 43%, 100% and 100% in the first, middle and last four years of the program's life, respectively (per Fitch criteria, a 90% recovery is also applied in its cash flow model when determining default tolerance). This is in excess of the program's 'AA' liability rating stress hurdle of 36%, as produced by Fitch's PSM. The rating stress hurdle is calculated based on overall program credit quality as measured by the ratings of underlying borrowers, borrower size, loan term and concentration.

In accordance with its criteria, Fitch applied a lower recovery rate of 50% to CWA-- the largest program participant -- to test the effect such a recovery could have on program bond payment. With a minimum default tolerance of 43%, the program passes Fitch's 'AA' liability stress hurdle of 36% with a 7% cushion. The rating is limited to 'AA' not only based on model-implied results, but also because of the program's significant concentration and inherent single-borrower risk.

POOL EXHIBITS SIGNIFICANT BORROWER CONCENTRATION

The loan portfolio is composed of 30 participants; 100% of the portfolio consists of loans secured by water or sewer revenue pledges. The largest borrower, CWA, accounts for about 59% of total outstanding loan principal. The City of Evansville's wastewater system is the pool's second largest borrower at around 19%, and the city of Greenwood's wastewater system is the pool's third largest loan participant at 7%. The pool's next seven largest borrowers account for 3% or less of the total pool.

In aggregate, the top-10 borrowers represent approximately 97% of the participant loan pool, which is well-above Fitch's 'AAA' median level of 56%. Inclusive of one credit opinion assigned by Fitch, approximately 94% of the rated pool is 'A-' or better; the remaining 6% does not carry a public rating. In accordance with Fitch criteria, the unrated portion of the pool was conservatively estimated to be of speculative-grade credit quality ('BB') in the analysis.
In aggregate, pool credit quality is weaker than that of similar municipal pools rated by Fitch, as reflected by an ‘AAA’ PSM liability stress hurdle of 46% versus Fitch’s ‘AAA’ median level of 31% (higher liability stresses correlate to lower credit quality). Furthermore, the high single-borrower concentration adds pool credit risk. Nevertheless, the strong loan security pledges, which consist primarily of water/wastewater net system revenues, mitigate some concern.

**LOSS PROTECTION PROVIDED PRIMARILY BY OVERCOLLATERALIZATION**

Loss protection to bondholders is primarily provided by annual loan repayments that are in excess of bond debt service payments. Under the program structure, if any WIFIA loan participant having an aggregate original loan amount of at least $100 million (currently, CWA and Evansville), fails to make a required loan payment, IFA will retain these program surplus funds until a reserve equal to the maximum annual WIFIA debt service has been funded. Additionally, as of July 31, 2019, the SRF equity balance totaled $390 million. While equity is not pledged for payment of SRF or WIFIA debt service, IFA may use assets held in equity to pay for SRF or WIFIA alternative revenue bonds.

**STRONG PROGRAM MANAGEMENT**

IFA manages the CWSRF, DWSRF, and WIFIA programs using strong underwriting practices. Among other factors, IFA takes into consideration in its borrower assessment the creditworthiness of the borrower and environmental goals of the programs. Participant WIFIA loans secured by system revenue pledges are also required to create a local debt service reserve fund equal to 1.0x maximum annual debt service.

Annual loan monitoring is conducted on outstanding borrowers and includes verification of local reserves and a review of financial statements. No loan defaults have occurred within the IFA SRFs to date.

**Notes**