

Pledge Adequacy - What Is It And Why Is It Important?

Guidance

Always consult the bond covenants or loan agreement to determine the specific definition for pledge requirements related to the obligation. This may or may not involve consultations with your Financial Advisor and or bond counsel.

Definition

The specific definition of the “pledge” is usually included in the bond covenants or loan agreement. The concept is both a legal requirement, and an economic requirement. The legal requirements define what is involved (e.g. a “revenue pledge”). The economic component is defined by a calculation based on the legal requirement. Also note that definitions of key terms provided in bond covenants or loan agreements often provide additional and clearer definition of important terms.

In short, either the actual pledge results are adequate (meets minimum standard as defined in the associated legal documents) or the actual pledge results are inadequate (noncompliance is indicated, and corrective actions may be appropriate).

Importance

The existence of “*pledge inadequacy*” is important for several reasons, among them:

- It indicates that a state of noncompliance with the legal documents (the agreement) existed and may still exist.
- It indicates that adequate economic resources are not being generated in a timely manner to support debt service requirements. A default risk is higher than desired as a result.
- It indicates that action is warranted to return to compliance with agreed upon requirements in legal documents

Types of Pledges

Pledges would include the following:

- Tax Pledge – A borrower has pledged the full faith and credit of the property taxes generated by the taxing authority, such as a City or a District, to pay debt service.
- Revenue Pledge – A borrower has pledged a revenue source such as the revenue of a water system to pay debt service. The legal documents provide more explicit definition of what is (or is not) pledged based on the agreement made by the lender with the borrower.

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- **Combination Pledge** – A borrower has pledged a combination of a Tax Pledge and a Revenue Pledge. The legal documents provide more explicit definition of what is (or is not) pledged based on the agreement made by the lender with the borrower.

Compliance Calculations

The determination of compliance is merely a mathematical calculation based on the type of pledge defined in the bond covenants or loan agreement. The calculation will determine whether the economic resources pledged are adequate (meet minimum threshold requirements) and can continue to provide adequate resources to meet outstanding obligations.