Municipalities and Their Hidden Debt Risks: Direct Bank Loans

When Riverside, California, was ironing out a municipal bond offering recently to expand its performing-arts center, several banks pitched a radical idea: Why not take out a loan instead? The City scrapped the bond plan and borrowed $25 million from City National Bank in Los Angeles. The City saved hundreds of thousands of dollars in issuance costs, says the assistant finance director. Plus, he says, the interest rate is 3.85% versus at least 5% if it had floated a public offering. The term is slightly lower—21 years versus perhaps 30 years in the bond market. Riverside now intends to seek a bank loan for a conference center that it had planned to build with bonds. It could find a robust reception for its business. Banks are now aggressively courting municipal borrowers with conventional loans for capital projects. This effort, known as direct lending, is partly directed at borrowers like Riverside that need money to build, and have relatively good credit ratings.

U.S. financial regulators are examining the rising use of private loans to state and local governments that allow public officials to take on added debt without disclosing it to municipal bond investors. Direct bank purchases — private loans to a municipal bond issuer — have increased rapidly in number over the past 12 to 24 months. A precise amount is difficult to determine because few borrowers disclose deals in a timely manner. Because these deals are private, the issuer is not bound by public disclosure requirements, and does not have to submit loan documents to the Municipal Securities Rulemaking Board's online EMMA system.

Officials with the MSRB, which writes regulations for the $2.9 trillion tax-exempt bond market, have discussed the issue with the Securities and Exchange Commission. The MSRB said in August that private loans could fall under some securities rules. It is urging the SEC to weigh in on the matter. The loans may leave investors unaware about rising debt obligations that could affect municipal credit ratings. Another concern is that in some cases bank loans may in fact be municipal securities.

Specifically, municipal issuers are not required to disclose bank loans publicly, unless they later sell public debt, according to the MSRB. Then, if the bank loan is "material" to the issuer's finances, which is decided by the issuer and its lawyers, the issuer must disclose it. Private bond placements usually have to be disclosed if a broker is involved, and brokers cannot trade existing municipal bonds unless all material information is available to the purchasers.

Many private deals are in the healthcare and higher education sectors, which can also raise money with municipal offerings. Some issuers see opportunity in the lack of disclosure requirements. When American University needed $75 million for construction costs last June, it found that weaker disclosure requirements meant it could put together the transaction more quickly and with less paperwork. The University tapped JPMorgan Chase for a 10-year bullet issue — a longer duration than most retail buyers of bonds prefer — and attained cheaper financing than what was offered via the capital markets. The single-A borrower paid a 4.19% interest rate, payable monthly and due in June 2021. "Part of the benefit to us was that there was less disclosure requirement," Laura McAndrew, the University's senior director of treasury management, reported. "The banks can't require the disclosure, at this point. It may come in the future, but the benefit to us was the limited disclosure." American University's fiscal year ends April 30. When it published its annual financial report in August, it included details of the June transaction in a "subsequent events" footnote so

investors and rating agencies would be fully aware of its situation. McAndrew feels that disclosure is sufficient, as the transaction is private and so does not require a rating.

Rating agencies often do not hear about these private placements until after they are complete, and have expressed reservations about the lack of communication. Standard & Poor's in July estimated that municipalities may borrow as much as $75 billion from banks this year. The agencies call it imperative that issuers promptly notify them when they take on new debt.

S&P has warned about a possible credit downgrade to "junk" status for Oaklawn Hospital in Michigan related to new private debt deals that included certain default triggers that could force the Hospital to repay almost all its $79 million of debt at an accelerated pace. S&P also lowered ratings on a school board in Orange County, Florida, and some refunding bonds issued by Puerto Rico related to terms in private deals.

Most credit analysts and market participants are worried that the deals are adding another layer of opacity to a market that has already been criticized for poor transparency. The loans could contain terms that affect the borrower's ability to pay its other debts, some of which are publicly issued, and fund operations. The issuer could be facing the possibility of accelerated payments on this debt and the rest of the market may not necessarily know the trigger for that, or the terms.

Aside from disclosure issues, from a municipality's perspective, there are several benefits about the growing private placement sector. Municipalities that have taken out direct loans say interest rates are typically lower than they would pay in the bond market, and they do not have to pay underwriters and lawyers to prepare a public offering. Direct purchases increase issuers' access to credit and liquidity, and they represent an alternative to variable-rate demand bonds. This is due to the fact that they eliminate counterparty and remarketing risks, and limit refinance risk. Many of these private debt deals have replaced a type of public debt that was previously issued with bank guarantees. The guarantees have become more expensive because many are expiring at once this year, and new international regulations would make them less attractive for banks. That has prompted the switch to direct loans or direct purchases. Moody's estimated that about $13 billion in direct loans or private placements had occurred in the past 18 months to refinance debt with bank guarantees.

Municipal borrowers are finding the banks quite eager to lend to them: JPMorgan Chase is devoting billions of dollars to direct loans this year to both refinance deals and for new projects. Last year, the bank made a few hundred million dollars of direct loans to municipalities. Now, the bank would consider making a single loan for hundreds of millions of dollars, a bank official said. It also is dispatching teams to explain the concept to wary public borrowers. Citibank also is courting municipal borrowers with direct loans, according to several bond issuers. This used to be unheard of, but for banks, this is a potentially lucrative business at a time when they are sitting on cash that is not earning substantial interest, and are reluctant to make loans for mortgages and other areas they see as risky. In the past, banks would occasionally loan a municipality less than $1 million to finance projects too small for a bond offering. For bigger loans, they would form a syndicate with other lenders.

It remains to be seen what land mines may be lurking for lenders and borrowers. Some municipalities are going through significant struggles, raising questions about whether they will prove good credits. And direct loans are less liquid, meaning banks cannot sell them as easily as bonds. For borrowers, many of these loans must be paid back more rapidly than a bond. So the loans could prove something of a time bomb for borrowers.

In the event of a bankruptcy, analysts say, it is unlikely that a bank extending a direct loan would be given priority over bondholders. It is more likely that the bank and bondholders would be on equal footing in laying claims to recover their money, though it would depend on what each lender negotiated.

U.S. municipal borrowers are increasingly turning to private debt deals for funding, raising fears over hidden risks in public debt. Direct loans from banks and direct purchases of municipal securities by banks have enabled local borrowers to refinance billions of dollars of debt as public issuance has dropped. MTAM believes that borrowers should make the details of private loans known to the broader market so investors and rating agencies have an accurate picture of an issuer's outstanding debt. Direct purchases represent additional debt or a change in debt structure, and that can have an effect on outstanding credit parameters. Municipal market participants need to be informed when such a transaction occurs so they can analyze if there is any impact on existing credit conditions.