Governments Are Turning to Banks for Easy Money.

States and localities say direct loans aren't as much of a hassle as issuing bonds. That may be true, but they're also riskier.

In the years since the Great Recession, state and local governments have increasingly borrowed money directly from banks instead of issuing public bonds. The loans, they say, come with lower costs and can be more convenient than going through the cumbersome public debt process. But observers worry that the terms around these loans aren't transparent enough, obscuring an important part of a government's financial health.

Now, a new Stanford University study of these loans in California concludes that more than half of the municipalities there that have borrowed from banks have put themselves at "financial risk" thanks to stringent terms in the loan. Alarmingly for bondholders and ratings agencies, those terms often mean their investment takes a back seat to the bank's loan in the event of a default. What's more, the terms are so broad in some cases that the bank can recall the loan more easily. That, says Sylesh Volla, one of the paper's co-authors, makes direct loans riskier than bonds.

In a review of 41 direct loans to California governments between 2010 and 2016, the terms all defined a missed debt payment and a bankruptcy filing as a default. That's standard, but some terms went further. More than 60 percent said a nonpayment on any of the issuer's debt would also count as a default and require immediate repayment of the loan. One-quarter said that any "material adverse change" in a government's operations or financial prospects — as interpreted by the bank — could trigger a default. And one-tenth said a credit rating downgrade would prompt a repayment.

The findings of the study, prepared for the Volcker Alliance, which promotes government accountability and performance, sheds light on what is becoming a highly controversial area in state and local finances. California is the only state that requires governments to disclose the terms around all types of debt, thanks to a law that went into effect in 2015.

That has been very frustrating for those whose job it is to assess state and local governments' financial health. Since 2009, banks have more than doubled their municipal holdings to $536 billion in securities and loans, according to the Federal Reserve. Not much is known about these deals — a fact that angers credit rating agencies and many industry trade groups such as the Government Finance Officers Association, the National Federation of Municipal Analysts and the Municipal Securities Rulemaking Board.

A recent S&P report estimates that as much as $50 billion to $60 billion in deals are made privately with banks each year. That's significant, considering that last year $450 billion in total debt was issued publicly in the municipal bond market.

While noting most of the deals haven't changed a government's credit quality, S&P's report went on to warn "that the lack of uniformity in timely disclosure of bank loan agreements remains a potential risk to the functioning of the municipal marketplace."

The Securities and Exchange Commission seems to agree. After being lobbied for years to do so, the commission in February proposed a rule that would require governments to disclose their direct loans from banks no more than 10 days after closing. If approved, it would be a major step forward for disclosure. But Volla notes California's experience shows that simply requiring disclosures doesn't guarantee that all governments will comply. The Stanford research notes that — despite its disclosure rule — the California Debt and Investment Advisory Commission doesn't actually know how many direct loans it is capturing in its database. A representative of the commission emailed researchers that trying to put a number on that "would simply be a wild guess."

Rather than relying on a regulatory body, Volla says governments likely need more of a stick than a carrot to comply with bank loan disclosure requirements. He says municipal market forces — such as more favorable interest rates on public debt for governments that provide more data — are more likely to encourage compliance.

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