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Reuters: As U.S. Municipalities Turn More to Bank Loans, Market Races to Catch Up.

Private bank loans are riding a wave of popularity among cities, counties and other U.S. local governments, leaving the \$3.7 trillion municipal bond market racing to assess and contain any risks they may pose, a white paper said on Wednesday.

“Bank loans provide issuers with access to capital, supply needed cash flow...and can be easier and less costly to obtain for an issuer than a public debt issuance,” a task force that included members of nine major banking, investing, trading, and bond organizations said in the white paper.

But a loan could “introduce potential risks that may impact a bondholder’s willingness to continue to hold the issuer’s bonds, affect bond ratings or impact pricing in the secondary market.”

The climb in borrowing, either by selling bonds to banks or through direct loans, has been swift and steep. U.S. banks held a record high level of municipal bonds and loans in the final quarter of 2012, \$363.1 billion, according to the Federal Reserve, one of the few sources of data on the loans.

The public is often in the dark about the details of the borrowing, with investors and regulators sometimes having to wait for annual statements to learn loans even exist.

“I think it’s great that there’s again another opportunity, another tool for state and local governments to tap, but I do think we do need to be vigilant about some of the pitfalls in that private funding market,” Municipal Securities Rulemaking Board (MSRB) Executive Director Lynnette Kelly said last month.

“What are the terms of those bank loans and do state and local governments really understand the risks involved with bank loans? Are those loans being disclosed? Is there a refinancing risk in five years, seven years, 10 years – whenever these great loans come due?” she added in a speech to a meeting of state treasurers.

The MSRB is a self-regulatory organization that writes the rules for the market that the Securities and Exchange Commission enforces. In a statement on Wednesday, Kelly commended the task force for assisting issuers by laying out possible ways to disclose the loans.

Issuers do not have to provide offering documents when they take out the loans, and they do not have to tell traders in the secondary market about them. Last year, though, the MSRB began pushing for voluntary disclosure.

The task force, which included representatives from the American Bankers Association and the Securities Industry and Financial Markets Association, suggested disclosing bank documents such as the financing agreements or providing summaries that cover the loan’s terms. It emphasized that issuers should promptly post the information.

Banks have long made tax-exempt and taxable bank loans to issuers, but since 2009, they have been

more willing “to make an increasing amount of tax-exempt bank loans to issuers as an alternative to publicly offered tax-exempt bond issues,” according to the white paper.

The 2009 federal stimulus plan raised the amounts of “bank-qualified obligations” that banks could hold, as part of a grander scheme to thaw a municipal credit freeze. In 2009 and 2010, issuance of the obligations doubled.

Essentially, the obligations are exceptions to part of the tax code that prevents banks from deducting the carrying cost of municipal bonds from their taxes. By doing so, the tax code eliminates the appeal of most tax-exempt debt for banks.

When the stimulus plan expired issuance of the qualified obligations slowed, but the public sector continued relying on banks in general, the task force found.

“Contrary to the expectations of many participants in the municipal market, however, banks have continued to make a substantial amount of bank loans on a non-bank-qualified basis since Jan. 1, 2011,” according to the white paper.

Many loans are being used as substitutes for the liquidity facilities and letters of credit that banks provide to back variable-rate demand bonds, according to Thomas Jacobs, who tracks products related to municipal bonds as a vice president for Moody’s Investors Service.

Direct borrowing is less expensive for both issuers and banks than selling variable-rate bonds with support facilities, according to the rating agency.