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S&P: Disclose Bank Loans or Risk Rating.

Standard & Poor's, citing concern over hidden debt exposure in the municipal bond market, sent letters this month warning issuers they could lose their ratings if they don't disclose their direct loans.

S&P told issuers that it now requires notification and documentation of any private debt they owe, including bank loan financings, whether or not that debt is rated by S&P.

"We are concerned about the undisclosed terms in the loans, or simply the magnitude of these loans," Steve Murphy, the head of public finance at S&P, said in an interview.

The letters were sent out on May 6 to all of the roughly 24,000 issuers S&P rates, Murphy said. Direct loans' impact on issuers' credit quality has been on S&P's radar awhile. These letters "fall in line with S&P's commentary regarding issuers' direct loans," a spokesman for S&P said in an interview.

S&P's primary concern is bank loans, whether called direct purchases or direct loans, a spokesman for S&P wrote in an email. Broadly, the term direct loans refers to alternative financings, meaning non-traditional placement in the public market.

Direct loans occur when issuers choose to raise capital by selling municipal securities to a select number of investors instead of making the bonds available to the public. Direct loans have increased to offset a decline in variable-rate demand bond issuance in recent years, S&P wrote in a report released on March 26.

Direct loans are attractive because they are less costly to issue than VRDOs, Matt Fabian, managing director at Municipal Market Advisors, said in an interview..

"There is no bond counsel, there is no legal fee, there is no paying a remarketing fee, which VROS pay," he said. "You don't have to disclose the purchase. Any bond going to one investor has very limited disclose requirements."

VRDO balances have fallen by about half in five years, MMA wrote in an April 14 report.

The amount of direct loans outstanding is difficult to determine because banks are not obligated to report these purchases. Murphy said that bank loans do not have to be disclosed with the Securities and Exchange Commission, or with any other regulator.

"There is no way of knowing the amount [of direct loans] occurring in aggregate," Murphy said. "That's part of the issue we have with this."

Fabian said that for official private placement there is very limited disclosure, and that for bank's direct purchases there is none.

"Direct loans would be disclosed in financials, but muni financials lag by nine months or so," he said.

“You have a nine month window and if they are done earlier in the fiscal year, somewhat longer.”

MMA cited industry estimates that direct purchases totaled \$40 billion to \$50 billion in 2013, and that projections show similar volume in 2014. MMA said those numbers understate the full amount of direct purchase activity, which it estimated at as much as \$55 billion.

One of the major risks of direct purchases is that they reduce public municipal supply available at a time when the buy-side is starved for more issuance. Supply this year has remained low, totaling only \$89.34 billion as of April 30 this year compared to \$122.72 billion for the same period in 2013, according to data provided by Ipreo and The Bond Buyer.

“As DPs replace a greater amount of new money projects — that, in the current market, might otherwise go into fixed rate bonds — they will incrementally reduce the income available to traditional lenders,” MMA wrote in the report.

A second major risk is that there could be terms in a direct loan covenant that harm investors holding public bonds released by the same issuer.

“[These direct loans] could have credit annexes and credit terms that could force the loan to be accelerated,” Fabian said. “They could have a covenant like a cash covenant or a credit covenant, where if the issuer were to violate it, the covenant could be immediately payable. If you are a bond holder of an issuer that has a direct loan, if that direct loan is forced to accelerate it could eat up all the issuers’ cash. It could push them into default or restructuring.”

Direct loans undermine investors’ confidence in the disclosed materials available and makes them more gun-shy, because weaker issuers may be closer to their debt limit than investors believe, Fabian said.

S&P described the disclosure requirements related to direct loans as “eccentric at best”. Murphy said that if issuers do not comply with sending S&P the documents they will be downgraded.

“We have a very specific sequence we follow in terms of credit ratings,” he said. “We contract the obligor to request documents not just for bank loans, but for any additional information requested when performing surveillance. If we do not receive anything in 15 days, a second request is sent and 10 days after that request is received, if we are not sent any documentation a third request is sent out and the issuer is placed on credit watch for an additional 15 days.”

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