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## Bank Loans Grow In Municipal Market While Bond Issues Shrink.

Significant developments in the way municipal entities borrow money are under way. Last year, issuances of new municipal bonds in traditional municipal bond markets dropped to near historic lows and the outlook for 2014 is similarly weak. According to the Municipal Bond Credit Report, Fourth Quarter 2013, prepared by the Securities Industry and Financial Markets Association (SIFMA), new capital markets municipal offerings in 2013 totaled $315.2 billion, a 13% decline from 2012. Of this amount, $266.7 billion represented tax-exempt issuances. The SIFMA 2014 Municipal Issuance Survey forecasts the 2014 total issuances to be $309.5 billion, of which $265 billion is expected to be tax-exempt, marking another decrease in volume.

Of great interest to commercial banks is the fact that, in contrast to this downturn in offerings of traditional municipal bonds, there is a marked increase in the amount of direct lending by banks and other financial institutions to municipal borrowers. While exact numbers are difficult to come by, Standard & Poor's has estimated that direct bank loans to muni issuers may account for as much as twenty percent (20%) of new municipal borrowings.[1] While there is no single factor that explains this rather dramatic change in landscape, there are a number of significant reasons why this may be occurring.

First, interest rates have been at or near historically low levels for the last five or so years. This low interest rate environment has offered unique opportunities to refinance outstanding bond debt on more favorable terms by enabling banks to offer very competitive interest rates to municipal borrowers on both tax-exempt and taxable debt. This has proven to be true even after factoring in the full or complete loss of a corresponding interest expense deduction that financial institutions may incur to carry tax-exempt debt pursuant to Sections 265 and 291 of the Internal Revenue Code.

The "all in" cost of direct bank loans is also made more competitive by the absence of certain bond-related costs of issuance that are generally not part of a direct bank loan structure, such as the underwriter's discount, rating agency fees, costs of preparing and printing an Official Statement, underwriter's counsel fees, remarketing agent fees, liquidity provider or other credit enhancement fees, bond trustee fees and bond trustee counsel fees.

In addition to the obvious purpose of lowering debt service and the costs of issuance, municipal borrowers are taking advantage of bank loan refinancings to reduce their mix of fixed and variable rate debt, to restructure debt amortization, to shed burdensome bond document covenants and to reduce liquidity risk that may exist under outstanding variable rate demand bonds (VRDBs).

For example, direct bank loans seem to have become the vehicle of choice to refinance outstanding VRBDs by effectively converting those letter of credit obligations and risks into direct loan obligations, often in refinancing transactions with the former letter of credit bank.

Such a direct loan may also be preferred by financial institution lenders over letters of credit, standby bond purchase agreements or other liquidity facilities due to the evolving capital adequacy

rules and standards under Dodd-Frank (and its progeny) and because the treatment of credit-enhancement facilities remains unsettled for risk-based capital computation purposes.

Another advantage presented by direct bank loans over traditional capital market issuances is flexibility, both in negotiating credit terms and in the administration of the debt relationship going forward. A muni borrower may be able to more flexibly negotiate the terms of a borrowing by dealing one on one with a single lender rather than by negotiating with an underwriter based on what the underwriter believes to be necessary to sell the bonds in the capital markets. Further, the trust indenture that governs a borrower's ability to issue additional debt over time may lock the municipal borrower into a fixed, common set of covenants and documentation requirements, making it potentially more difficult to address special debt needs that may arise.[2]

Flexibility in credit administration is achieved because it is much easier to obtain the consent of a single lender to modifications or waivers of credit documents than having to work through a bond trustee and DTC to locate and obtain consents from a disparate set of bondholders.

On the regulatory front, direct bank loans presently have an advantage over capital market issues involving an underwriter because the regulatory burden on the borrower is substantially reduced. With no underwriter in the deal, the bond issue is not subject to many of the regulatory compliance requirements imposed on underwriters of municipal securities by the Municipal Securities Rulemaking Board (MSRB) and the Securities and Exchange Commission (SEC). The requirements that come along with an underwritten deal include: the underwriter must obtain a continuing disclosure agreement with the municipal borrower pursuant to SEC Rule 15c2-12 and determine whether the municipal borrower is presently in compliance with all of its other continuing disclosure undertakings as a condition to selling the bonds; an official statement or placement document must be used in connection with the bond offering and filed and supplemented on the SEC's Electronic Municipal Markets Access System (EMMA); and mandatory continuing disclosure filings must be made on EMMA by the municipal borrower.

You should be aware, however, that these so-called regulatory advantages are currently under close scrutiny by the MSRB and various other regulators. There is a growing belief by the regulators that the use of such direct bank loans creates something of a shadow market that deprives the capital markets of essential information regarding muni bond issuers, including information which would otherwise be available if an underwriter were involved in the financing.

To illustrate, the MSRB has published Notice 2012-18 that strongly urges state and local governmental issuers to voluntarily file with EMMA the same types of information and disclosures that would be applicable if the issue was publicly underwritten. Notice 2012-18 summarizes the MSRB's concerns as follows:

"The increased use by state and local governments of bank loans to meet funding needs has raised concern among market participants about the level of disclosure about such loans. Because, as described below, bank loans generally do not require the same level of disclosure as public offerings for municipal securities, holders of an issuer's outstanding debt, as well as potential investors and other market participants, may not become aware of such bank loans or their impact on the issuer's outstanding debt until the release of an issuer's audited financial statements. Thus, for example, bondholders may not be aware of the terms and conditions of a bank loan that may require the acceleration of debt repayment if the borrower encounters financial stress. In other circumstances, where bank loans are on parity with or senior to other outstanding debt, the bondholders' security position could be diluted."

Because of these expressed concerns, it would not be surprising if future legislative or

administrative initiatives were to impose increased disclosure requirements on direct bank loans to municipal entities. Perhaps that is even to be expected in this era of concern for municipal market transparency and full disclosure.

Finally, the rating agencies are beginning to take a much harder look at outstanding bank debt when doing their rating analysis of municipal issuers. Standard and Poor's, in its commentary noted above, has indicated that it is concerned with the increasing use of such facilities by municipal borrowers and the liquidity and other credit risks presented by direct bank loans. According to S&P's commentary, these risks are increasing as a more diverse group of banks enters this lending arena and the terms and covenants within the bank agreements are less clearly defined and uniform. In S&P's view, this creates the potential for considerable credit risk exposure. These risks are, or will be, part of the ratings analysis and could be the basis for a negative credit action or outlook change.

In summary, direct lending to municipal entities presents a lending opportunity for Pennsylvania banks and other financial institutions that should continue until at least the current interest rate climate changes in an adverse direction. However, as these direct bank loans become even more widely used, they are moving onto the regulators' and rating agencies' radar screens in significant ways. There is no doubt more to come on these evolving fronts.

[1] Source: Standard & Poor's commentary, Alternative Financing: Disclosure is Critical to Credit Analysis in Public Finance, February 18, 2014
[2] It should be noted that for active issuers, using a uniform set of documents and covenants may provide other benefits that should not be overlooked, such as not having to comply with several different, and potentially conflicting, covenant regimes. Such an arrangement would also have the benefit of serving as a convenient vehicle for achieving parity of covenants and security among bondholders without having to negotiate and execute intercreditor agreements each time that new parity debt is issued.

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