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Are Muni Bonds Being Replaced by Direct Loans?

Municipalities and banks are getting friendlier, and it's starting to irk credit rating agencies.

Earlier this year, Wisconsin pulled off a fancy financing maneuver designed to avoid an expected increase in interest rates. Rather than waiting until next year to go to the municipal market and refinance a certain set of bonds, the state got a $278 million loan secured directly from a bank. In doing so, Wisconsin locked in 2014's lower interest rates and can pay off bondholders next year with the proceeds.

This particular refinancing tool, called a delayed draw term loan, is complex and likely only to be used by more sophisticated issuers like large municipalities or states that are very accustomed to selling bonds. But it's one of many examples in recent years where a government has skipped issuing debt in the municipal market and just borrowed the cash instead.

Sometimes, said Cook County, Ill., CFO Ivan Samstein, the best deal is through a bank. "It's the ability to do a lower-cost transaction because of lower fees and a cost of capital," he said. "I think that's what driving issuers to work directly with banks." In recent years, Cook County has refinanced most of its floating rate bonds through banks instead of the market, moving from about $130 million a few years ago to $370 million with banks today.

In fact, over the last five years, banks in general have nearly doubled their municipal holdings to $425 billion in securities and loans, up from $225 billion at the end of 2009, according to a recent Moody's Investors Service report. The practice is becoming so prevalent that muni analysts say it's contributed to the slower pace of new bond issuance over that same five-year period.

The increased borrowing by municipalities has irked credit ratings agencies, leading Moody's and Standard & Poor's to call for better uniform disclosures of bank loans to governments. S&P even warned issuers that a delay in providing the information could have "negative rating implications."

Obviously people secure bank loans all the time, so why the fuss when governments do it? The main reason has to do with transparency — like credit analysts and investors who are assessing a government's risk exposure need to know where that government's money is going. Large issuers like Wisconsin have already made a habit of notifying the public of any private financings. But as direct loans and other private structures have become more prevalent among smaller, less frequent issuers, credit analysts are often learning about them from year-end audits rather than from the borrower at the time of the loan. That means that, thanks to the lag time in issuing these reports, the full details of a bank deal may not be publicly known until a year after the fact.

And that's a problem. Ratings agencies aren't just looking at governments' comprehensive debt positions but also at the terms associated with these deals, said S&P analyst Henry Henderson. "That's probably our biggest concern with the direct purchase sector," he said. "If there are different terms [than a typical loan agreement], we feel that it's important that's disclosed to the public."

Rating agencies are not alone. Like Wisconsin, Cook County is one of the experienced issuers that voluntarily reports its bank deals with the Municipal Securities Rulemaking Board, the body that sets rules for the municipal market and its users. The board doesn't require governments to disclose bank deals, but two years ago it published guidance on doing so. And starting next year, California is requiring higher standards for disclosing these types of direct loans. The law speeds up the deadline to file loan disclosures to 21 days. (It requires alternative forms of financing be included in existing bank loan transparency regulations.)

It could be a game changer. Not only will it make for a more informed market, Municipal Market Advisors' Matt Posner points out it could actually reduce California's borrowing costs because of this more complete picture for investors. And if that happens, other states will likely follow.

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