# Bond Case Briefs

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## Swift Descent to Junk Shows Buried Risk as Municipal Loans Surge.

In a routine review of Lawrence, Wisconsin's credit rating last month, Standard & Poor's analysts discovered something troubling.

The 4,600-person town eight miles (13 kilometers) south of Green Bay had borrowed $4.6 million, about three times its annual revenue, from local banks, and tucked into the agreements was a potentially costly clause: The banks could demand immediate repayment if they decide the town has turned into a mounting financial risk. The finding triggered an eight-level downgrade to Lawrence's rating, which went from the third-highest grade to junk.

"Anyone could have these deals," said Geoffrey Buswick, a managing director at S&P in Boston. "Until it's disclosed or someone reads the documents and considers the credit risk, you don't know if you're holding double A paper or double B plus paper."

How many Lawrence's are there in the $3.7 trillion U.S. municipal-bond market? It's impossible to know.
The proliferation of such loans since the credit-market crisis seven years ago has added fresh uncertainty to the state and local-government debt market, where the financial disclosure rules are already more lax that those that apply to businesses. Because the loans aren't securities, states and cities aren't immediately required to disclose them — despite the risks they may pose to bondholders if a government is pushed toward default.

"Nobody knows how many loans there are, nobody knows the total volumes of those loans, nobody knows the terms of those loans," said Lynnette Kelly, executive director of the Municipal Securities Rulemaking Board, the industry's regulator. "I'm frustrated by it."

The loan terms can favor banks over bondholders and add to a city's financial risk, credit-rating companies said. For example, banks can demand accelerated principal and interest if a payment is skipped or a government's cash falls below a specific target, which could push the borrower into a liquidity crisis if it can't cover the bills.

"Most local government bond investors don't have the right to be paid back upon default," said Tom Jacobs, a senior vice president at Moody's Investors Service. "A private financing can jump to the head of the queue when it matters."

**Financial Wreckage**

The municipal bank-loan business rose from the wreckage of the financial crisis, when cities and states used them to escape from floating-rate bond deals that turned costly when credit markets seized up. The business has continued to grow because hospitals, universities and others can borrow at rates comparable to those in the bond market, without the fees tied to a public-debt offering.

The push has made U.S. banks a growing presence in local-government finance. They held about

$477 billion, or 13 percent, of the municipal debt outstanding by the end of June, twice what they had five years earlier, according to Federal Reserve data.

S&P estimates that loans account for as much as one-fifth of municipal borrowing. In 2014, S&P evaluated 404 direct loans of about $16 billion. Of those, 13 credit ratings were affected by them.

Lawrence, Wisconsin, followed on Sept. 17, when S&P cut its rating from AA to BB+.

Jennifer Messerschmidt, the town's finance director, criticized the decision. She said one of its banks said it rarely, if ever, has invoked the ability to demand repayment by deeming itself "insecure," a clause that protects a lender if a borrower's finances deteriorate. She said the town is working with its banks to remove the provision in an effort to have its previous rating restored.

"S&P wouldn't even give me a day to talk to the bank,"' she said.

While states, cities and non-profits disclose the amount of bank loans in their annual financial statements, those reports often aren't released until months after the year's end and don't reveal key terms.

Even though municipal issuers are required under federal securities rules to disclose all material information when they sell bonds, it's up to them to decide whether the loans fit that bill, said Kelly, the MSRB director. The regulator has encouraged issuers to voluntarily disclose key details about the loans on its online repository, where bond documents for investors are now posted.

**Full Picture**

Lawrence hasn't publicly sold debt since 2012. Instead, it borrowed $4.6 million from local lenders The Business Bank and Greenleaf Wayside Bank. The loans account for more than 60 percent of the town's debt.

"If there was an acceleration how would they be actually be able to cover that?" said S&P's Jane Ridley, a senior director. "Without a requirement to disclose, we can't get a full picture of what the rating looks like."

Messerschmidt, the Lawrence finance director, said the size and interest rates on the loans are disclosed in its annual financial reports. She said Lawrence is in a better financial position than when it last issued debt in 2012, when many cities' tax collections were still being squeezed by the effects of the housing-market collapse and the recession that followed.

"I don't think it was handled properly," she said of the downgrade.

Caroline West, an S&P analyst, said the company can't give a city such as Lawrence advice or help it structure documents or deals.

"We have to proceed with evaluating the information we have at hand," she said. "That's what we did."

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