Bond Case Briefs

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The Hidden Risks of a Growing Way to Pay for Infrastructure.

More and more, governments are turning to bank loans rather than bonds. But too often the terms of the loans — and who is first in line to collect — are secret.

A perilous new financial risk may be hiding in the fine print of loan agreements in state capitals, county seats and city halls across the country. The cost could be high for millions of individuals whose investment dollars help finance the public schools, water systems, bridges and roads that we all rely on and which in many cases are in desperate need of repair.

Investment in the nation's infrastructure has long been a partnership between state and local governments and retail investors. State and local governments prioritize public projects, investment bankers provide products to help spread costs over the life of the project, investors buy in to earn reliable, often tax-free interest income, and then taxpayer dollars repay the bonds. Today, more and more communities are opting for alternatives to this traditional municipal-bond model in the form of direct loans from banks. Estimates are that the bank financing of public projects has ballooned to more than $155 billion with another $25-$30 billion being added each year.

Borrowing funds from a bank to build a bridge is not inherently problematic. The problems arise when the extent of the borrowing — and the precise terms of the loans — are a secret. For municipal-bond financings, states and communities have obligations under federal law to publicly disclose material information to investors at the outset. But no such disclosure requirements exist at the time they receive loans from banks. Investors who hold a city's outstanding bonds may have no idea that the city has taken on more debt or that the bank making the loan has made sure it will be first in line to collect if the city runs into financial troubles.

That's just what happened in Lawrence, Wis. The small town borrowed heavily from local banks, and it agreed to put the banks before the bondholders in the event it someday couldn't cover all of its financial obligations. When a major ratings agency learned of the unfavorable terms for bondholders, it quickly downgraded Lawrence's bonds to junk status. Bondholders who thought they were holding investment-grade paper are now left with a far riskier asset.

No one knows how many other Lawrences are out there. A few states, counties and cities voluntarily make information about their bank loans publicly available on the Municipal Securities Rulemaking Board's Electronic Municipal Market Access website (EMMA), the official public archive for financial documents and other information for municipal bondholders. But the vast majority of bank-financed public projects remain a mystery to municipal bond investors, taxpayers and securities regulators.

As the national regulator charged with protecting municipal bond investors, the MSRB is advocating for expanded disclosure of the amounts and material terms of these alternative financings by state and local governments. Since 2012, the MSRB has encouraged states and communities to take advantage of EMMA to make bank loan information available to the public, something several industry groups support.

This year, the MSRB is escalating its call for improved bank loan disclosure. We are now collecting public input on how the MSRB might exercise its regulatory authority over the financial professionals who work with state and local governments to require more transparency around these loans. Because state and local governments have legal protections against federal oversight, the MSRB cannot simply mandate bank-loan disclosure on their part. Any future action by the MSRB must also take into consideration the fact that bank-loan documents may contain proprietary information that would need to be redacted prior to public dissemination.

Despite these constraints, the MSRB believes it is imperative to address the risks that undisclosed bank loans pose to bondholders and the broader financial health of communities nationwide. Until the amount and terms of these loans are understood, there's no way to assess the likelihood of a crisis in the making, one that could result in thousands of bank-leveraged bridges and millions of burned bondholders.

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