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Local Governments' Hidden Reason to Oppose Tax Cuts: Bank Loans.

- **Tax cuts could trigger 'yield maintenance provisions' in loans**
- **Officials ' may not appreciate all the risks,' analyst says**

Some local governments have a hidden reason to root against President Donald Trump's tax-cutting agenda: It could make their bank loans more costly, according to Municipal Market Analytics.

Municipalities have borrowed billions from banks to skirt the expenses associated with public bond offerings. But banks often include provisions enabling them to raise the interest rates if legal or regulatory changes diminish their returns. A cut in the corporate tax rate, for example, would likely result in a lower after-tax yield on a tax-exempt loan, potentially triggering "yield maintenance" provisions, wrote analysts at MMA, a Concord, Massachusetts-based independent research firm.

"Given the current administration's focus on tax-reform and/or tax cuts, borrowers that have these yield maintenance provisions could see their debt service costs rise," MMA wrote.

Direct lending by banks has proliferated in the $3.8 trillion municipal market because states, local governments and non-profits can borrow at rates comparable to those on bonds, without the fees or disclosure requirements associated with securities sales.

Because loans aren't classified as securities, states and cities aren't immediately required to disclose them, despite the risk they can pose to bondholders and taxpayers. 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.

MMA estimates that some $180 billion of such loans have been made. But given the lack of disclosure, it's impossible to know how many borrowers might be subject to rate increases if federal taxes are cut, MMA wrote.

The Securities and Exchange Commission in March proposed requiring state and local governments provide information about significant bank loans within 10 days.

A borrower with a $20 million loan could pay an additional $50,000 in annual interest if the rate is increased 0.25 percentage point to compensate for the reduced after-tax return a lower corporate levy would bring, MMA said. By contrast, when municipalities issue fixed-rate debt the risk of future tax changes is shifted to bondholders. President Trump has proposed reducing corporate taxes to 15 percent from the current 35 percent.

Many municipalities that used derivatives such as interest-rate swaps in the mid-2000s to lower borrowing costs weren't aware of the risks and had to pay billions of dollars to get out of the contracts when investors dumped certain types of municipal bonds en masse during the financial crisis.

“Banks that provided interest-rate swaps to municipalities found themselves in a firestorm of negative media stories detailing how they profited on the backs of municipal borrowers, costing taxpayers billions of dollars,” MMA wrote. As with interest-rate swaps, “many municipalities may not fully appreciate all the risks inherent in bank loans.”

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