Bond Case Briefs

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Big Banks Got Huge Tax Cuts, Then Hiked Cities' Interest Rates.

- **Tax cut triggers loan provisions that protect banks' returns**
- **Muni bank-loan market may be as much as $180 billion**

As U.S. banks were tallying up the billions of dollars in extra profits they'll reap from the sweeping tax cuts signed into law by President Donald Trump, they were quietly delivering unwelcome news to local governments: The interest rates on their loans were about to go up.

That's because banks often include clauses in contracts when they lend to states and cities giving them the right to trigger the increases if legal changes lower the returns on their investments.

The tax cut did just that. Slashing the corporate rate made the tax-exempt loans less valuable than before compared with other assets, once federal taxes are taken into account. So companies including Wells Fargo & Co., U.S. Bancorp and SunTrust Banks Inc. demanded more interest to make them whole.

The impact is being felt across the country by governments and non-profits that borrowed through loans, a loosely regulated niche of public finance that took off after the end of the last recession. Municipal Market Analytics estimates that there are about $180 billion of such loans outstanding. That could translate into tens of millions of dollars in extra costs each year for local agencies that Trump is pushing to boost spending on roads, airports and other projects.

"It takes away from money that would help the state's reserve, or it takes away from money the state may appropriate for other statewide public purposes," said David Erdman, the capital finance director for Wisconsin, whose payments on a $279 million loan will jump by about $750,000 next year. He declined to name the lender.

Direct lending 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. They also offered a way for borrowers to refinance floating-rate bond deals that unraveled after the 2008 credit crisis.

Because loans aren't classified as securities, states and cities aren't immediately required to disclose them, making it impossible to know how many borrowers might be subject to rate increases. Banks may also decide to waive the provision to preserve other business with municipalities, like investment work, and governments may opt to refinance, though interest rates in the bond market have been on the rise.

But several banks have been alerting borrowers that their interest rates are going to increase. Tennessee, the Metropolitan Atlanta Rapid Transit Authority, and Portland, Oregon, are among those whose payments are set to rise, according to public officials.

"We've heard underwriters are dealing with it in different ways," said Emily Brock, federal liaison for the Government Finance Officers Association, which represents local government officials. “One things for sure, not all issuers understand clearly how that gross-up provision is going to impact them.”

Gross-up, or rate-hike provisions, are common for loans that are pegged to the London Interbank Offered Rate. A standard formula calls for multiplying the interest rate by 1.22 if corporate tax rates decline to 21 percent. For bonds bearing a fixed rate with a 5 percent coupon, the increase would be more than a full percentage point.

Tennessee will pay an extra $300,000 a year on a $70 million credit line with Wells Fargo and U.S. Bancorp, said Sandra Thompson, director of the state comptroller’s Office of State and Local Finance. The increase is significant “considering it wasn’t a cost that we incurred before Jan. 1 of this year,” she said.

Wells Fargo has informed its clients the rate increase is automatic, but borrowers can try to negotiate new terms, said Adam Joseph, the head of Public Finance Capital Strategies at the San Francisco-based bank. He said the increases haven’t come as a surprise.

“The existence of the factor was very much known to the client at the time of the deal,” he said.

SunTrust “is working through” the rate adjustment with clients, said Thomas Crosson, a spokesman for the bank. Dana Ripley, a U.S. Bancorp spokesman, declined to comment.

The San Francisco County Transportation Authority is paying 0.45 percentage point more in interest on its $72 million revolving credit facility to State Street Corp. than it did last month because of an increase in Libor and the effect of the gross-up. State Street informed the transportation authority in advance that its borrowing cost would rise, said Cynthia Fong, the authority’s deputy director for finance. The credit facility expires in June. Julie Kane, a State Street spokeswoman, didn’t return a call and email seeking comment.

While larger borrowers will likely be able to handle the impact of the rate increases, small non-profits may find it more of a burden. One non-profit client of Michael Wiener, a bond lawyer at Holland & Knight in Lakeland, Florida, could pay an extra $100,000 a year in interest on $27 million in variable-rate debt, he said.

“One hundred thousand dollars a year is still a decent amount of money for a lot of these borrowers,” said Wiener, who declined to name the client.

Some are getting a break. First Republic Bank has told California non-profits that it won’t trigger the clause in their loans, said Cathy Martin, treasurer and chief financial officer of Guide Dogs for the Blind, in San Rafael, California. If it hadn’t, its costs on a $30 million loan would have jumped by $100,000 a year. Greg Berardi, a spokesman for First Republic, declined to comment.

“I can’t tell you how grateful I am because it would have been fairly significant money for us,” said Martin.

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