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World of Tax-Exempt Bank Direct Purchases is Changing.

Over the past decade, tax-exempt bank direct purchases became an increasingly popular form of financing in the municipal market as an alternative to traditional public bond offerings. The trend was initially driven by several factors including the demise of some bond insurance providers, punitive bank capital charges for variable rate demand bond credit support products, and bank appetite for loan growth. Issuers compelled by the lower costs of issuance and ease of execution further fueled this trend. Per the Federal Deposit Insurance Corp., bank municipal debt holdings (separately categorized from municipal "securities") totaled $62 billion as of December 2009. By December 2017, reported holdings had more than tripled to $190 billion.

Post the U.S. Tax Cuts and Jobs Act of 2017, the trend in total bank holdings and the makeup of the universe of bank participants (national versus regional banks) is starting to evolve with holdings dropping to $185 billion as of the end of the first quarter in 2019. This is showing the first signs of a slow down since 2009.

Several of the largest holders have experienced a decrease in their portfolios by over 10%. Drivers for the decrease include borrowers experiencing increased costs for yield adjustment provisions in their bank direct purchase structures and reduced benefit to banks due to the drop in the corporate tax rate to 21%. Further, many borrowers have elected to move back to public markets structures to capitalize on favorable trends driven by increased demand in the market – municipal bond funds have seen over $25 billion dollars in net cash inflows since the beginning of 2019 per TM3. In addition to driving low tax-exempt rates, the strong market conditions are helping deliver more favorable covenant and security structures, particularly for borrowers rated in the lower and sub-investment grade categories.

While some borrowers have restructured their bank-held issues, many borrowers still have not. Reasons for this include having initially negotiated out increased cost language due to tax reform, bank partners temporarily waiving or renegotiating the increased cost rate, or the bonds being in a fixed rate mode, making it difficult to implement a higher rate without triggering a tax "re-issuance" event. Many borrowers will eventually need to revisit their deals with their bank partners as they approach the end of their commitment period, which is typically well within the final bond maturity.

As borrowers continue to revisit their bank structures, there are several considerations as they potentially make changes by moving to the capital markets or another bank partner that is willing to absorb some or all of the increased cost for holding tax-exempt debt.

The potential transition includes multiple documentation and cost considerations, primarily driven by the ability to convert modes within the existing documents or the need for a full refunding of the bonds. While many of the bank deals were completed with "multi-modal" indentures, the ability to convert modes may be more complex than anticipated. Additionally, to the extent existing bonds are transferred, there are documentation concerns some bank partners may have dealing with their determination of ability to book the debt as a "loan" or "security" based on the initial documents that were utilized. Lastly, many of the bank deals are structured in a LIBOR indexed mode, which may create challenges as LIBOR is phased out.

Separate from documentation considerations, new requirements to disclose other debt obligations under the SEC Rule 15c2-12 will also lessen the difference between public and private deals on an ongoing disclosure basis. While the new disclosure rule may not drive any borrower decision between the structures, it is an additional consideration for which borrowers need to be prepared.

As the market continues to evolve after tax reform and the banks and borrowers adjust, the most common pros and cons of private versus public debt will remain mostly the same. While bank direct purchases will continue to be a popular alternative for many borrowers, given the structuring flexibility, ease of execution, and cost benefits, the market and documentation standards will continue to evolve. Borrowers may be well served to revisit their deals sooner than later to best understand their options and start planning to achieve their institutional goals.

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