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Private Lending Takes Root in Muni Market.

Private sales of debt from state and local governments spiked during pandemic's market stress and have grown over past decade

A pandemic surge in privately sold municipal bonds is highlighting how private deals have become a mainstay of the $4 trillion market for state and local debt—and a go-to in times of stress.

During the three months ended in May 2020, the amount of municipal debt sold privately spiked to 13.4%, the highest share in 13 years on record, according to a report this week by the Municipal Securities Rulemaking Board. It has since retreated to about 8%, or around $36 billion—up from 4% in 2012 but in line with its average for the past decade, according to data from the board and Refinitiv.

"We're fielding more and more calls from nonprofit traditional public-markets issuers who are looking into borrowing in the private markets," said Jonathan Mondillo, head of North American fixed income at Edinburgh-based Abrdn, with $1.5 billion in muni debt under management.

Mr. Mondillo said his firm has considered or bid on privately placed deals with a combined total value of more than $1 billion, often for utilities or healthcare- or higher-education-related projects. He said Abrdn typically purchases investment-grade debt issuances ranging from $50 million to $400 million for clients such as insurance companies and pension funds.

In so-called private placements, borrowers bypass public markets where individuals, mutual funds, insurers and others compete for bonds. Instead, they sell debt straight to banks or money managers.

In rocky markets, towns, universities and other small borrowers like not having to worry about how retail buyers will behave on the day of a public bond sale. At the same time, broker-dealers may want to avoid holding bonds they have purchased from borrowers in case investors don't feel like buying. Privately placed debt goes straight to the buyer, without an intermediary putting capital at risk.

One possible explanation for the increase in private placements early in the pandemic could be that "underwriters didn't want to take a principal position during the market volatility," said Municipal Securities Rulemaking Board chief economist Simon Wu, the lead author of the board's report.

Before the Covid-19 pandemic, the biggest uptick in private placements occurred in 2013, when bond prices tanked following Detroit's bankruptcy and amid fears that the Federal Reserve would start dialing back easy-money policies.

Some investors and analysts worry that private placements put investors at a disadvantage by keeping them in the dark about the full scope of a borrower's debt. Though a 2019 rule generally requires issuers to disclose private placements, a January study by two scholars from the Federal Reserve and one from the University of Cologne concluded that compliance is poor and "private debt disclosure remains largely voluntary."

Private placements generally fall into two categories, according to borrowers and their attorneys and advisers. Banks typically buy tax- or fee-backed debt from small school districts or towns in quantities that can be as little as a few million dollars. In contrast, money managers often purchase more risky higher-yielding debt from nonprofits or one-off economic-development projects.

“They want 7% to 8%, so they’re not buying [the debt of a large city]; they’re buying this weird private placement that’s been designed for them,” said Amanda Stephens, a public-finance partner at Orrick, Herrington & Sutcliffe LLP.

Competition can be fierce for muni debt, which pays interest that is typically exempt from federal taxes, and often state taxes too. For a household or company in the top tax bracket, a 7% tax-exempt yield is equivalent to a taxable yield of 11.8%, according to data from Nuveen LLC.

One draw for both banks and asset managers is the ability to purchase a large chunk of debt wholesale, without competing with other buyers. Another perk: They don’t have to negotiate with other creditors if the deal goes sour.

Borrowers, for their part, avoid the labor and cost typically involved in bringing a deal to market, including seeking an opinion from a credit-rating firm. They also may have reduced disclosure requirements over the life of the bond.

The repayment period for private debt also tends to be much shorter than the 30-year period standard in public markets, typically around five to 10 years, reducing the amount of time borrowers are locked into current interest rates, according to attorneys and advisers.

Contra Costa County, Calif., built an emergency-services center and an administrative building and refinanced old debt with about $200 million in muni debt sold privately to a bank in 2017.

“We were seeing rate proposals very close to what we thought we would get in the public market, and the cost of issuance is substantially less,” said chief assistant county administrator Timothy Ewell.

Still, guidance on direct sales to banks from the Government Finance Officers Association trade group notes that borrowers may lose the opportunity to find out whether they could get lower interest rates in the open market. The group hasn’t taken a position on placements with asset managers.

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