

Risky Business: Bank Loans to Local Governments

By **Benji Nguyen, Sylesh Volla, and Annabel Wong**

Local governments across California — and the U.S. — are increasingly borrowing from commercial banks instead of issuing public bonds. These loans can be problematic for financial markets and for local governments themselves, risking a lack of transparency and poor terms including accelerated or immediate repayments for events such as a ratings agency downgrade.

Our research, based on California Debt and Investment Advisory Commission (CDIAC) data from 2010 to 2016, found that more than half of California municipalities that borrowed directly from banks are at such financial risk.

Historically, local governments have raised funds through issuing public bonds, a process regulated by the Municipal Securities Rulemaking Board (MSRB), a regulatory agency focused on municipal financing and subject to oversight of the Securities Exchange Commission (SEC).

The process is highly transparent, informing citizens and financial market participants alike.

Recently, local governments have begun to borrow directly from banks, primarily using “private placements,” which are bonds purchased by banks directly from local governments.¹ The private bank loan market in California is now \$91 billion, compared to only \$49 billion four years ago.²

Why should this trend worry us? For starters, federal law does not require issuers to disclose these

loans.³ Second, local governments with limited staff may not fully comprehend loan risks. Finally, because banks generally have first access to assets when local governments default, public bondholders may be increasingly reluctant to invest, reducing government’s access to public capital.

This policy brief characterizes the municipal bank loan market in California, examines concerns for issuers, investors, and the market in general and offers policy recommendations to address those concerns. We relied on interviews with relevant stakeholders, conducted empirical analysis using CDIAC data, and reviewed direct loan agreements available from CDIAC.

Local Government Funding Sources

Local governments raise funds from a variety of sources, including taxes and fees, or borrowing via public bonds and bank loans. Local governments may issue bonds to raise funds for specific projects, general funding, or funding budget deficits, among others. An underwriter buys the bonds and sells them to investors, such as individuals, mutual funds, banks, or

About the Authors

The authors recently graduated with Master in Public Policy degrees from Stanford. They conducted research in conjunction with the Volcker Alliance, a nonprofit, nonpartisan organization that was launched in 2013 to address the challenge of effective execution of public policy and rebuild trust in government. Their advisors were **Joe Nation**, a SIEPR researcher, and **Christine Pal Chee**, a lecturer in the Public Policy Program.

1 National Federation of Municipal Analysts (NFMA). (2015). “Recommended Best Practices in Disclosure for Direct Purchase Bonds, Bank Loans, and other Bank-Borrower Agreements,” http://www.nfma.org/assets/documents/RBP/rbp_bankloans_615.pdf, retrieved Nov. 30, 2016, p. 2.

2 California Debt and Investment Advisory Commission. (2017). *CDIAC All Data*. (February 2017) [data file] <https://data.debtwatch.treasurer.ca.gov/Government/CDA-All-Data/yn6-vaxy>.

3 California is in fact the only state requiring disclosure of all private bank loans.

corporations. In all states, SEC Rule 15c-12 requires dealers to ensure local governments enter continuing disclosure agreements to disclose public bond information to EMMA, the Municipal Securities Rulemaking Board’s disclosure website.

In contrast, bank loans, a “catch-all” term that refers to direct loans, private placements, and other alternative private financing methods used by municipalities, have no such national disclosure requirement. However, as discussed below, disclosure is now required in California.

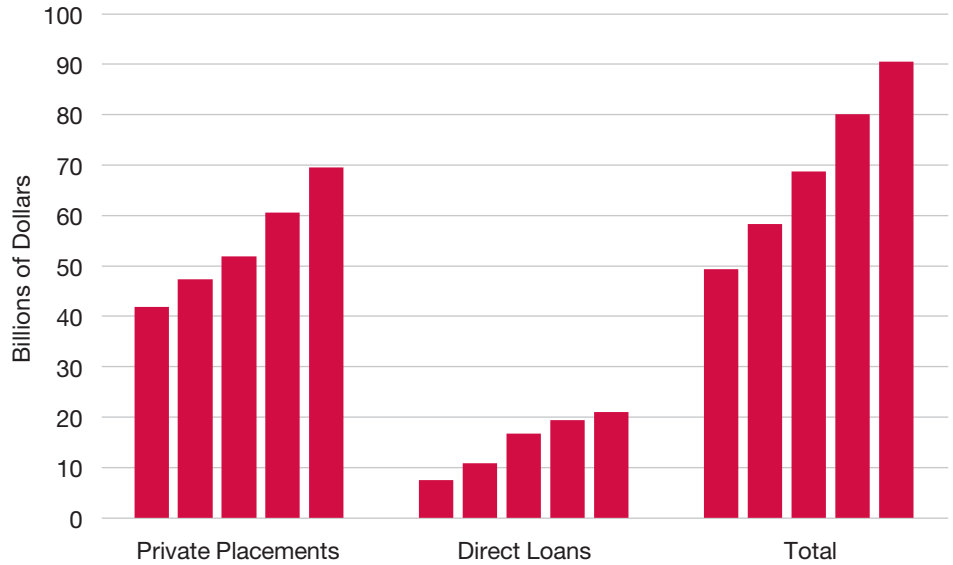
Bank Loans Are Increasing

Bank loans — both direct loans and private placements — to local governments increased at a rapid rate across the U.S. and in California from 2012 to 2016. In California, bank loans increased 83.5 percent, from \$49.5 billion to \$90.6 billion (Figure 1). Direct loans nearly tripled, from \$7.5 billion to \$21.0 billion. Private placements, which include the sales of bonds to a select group of investors, increased 66.3 percent, from \$41.8 billion to \$69.6 billion.⁴

In addition to this substantial increase in volume, the number of private placements rose from 688 in 2012 to 1,761 in 2016, a more than 150 percent

⁴ Bank loans rose 49.9 percent in the U.S. over this same period, including a 39 percent increase in private placements and a 79.5 percent rise in direct loans.

Figure 1. California Bank Loans
Municipal securities owned by banks and direct loans made and outstanding, 2012-2016



Source: Municipal Market Analytics & BankRegData

increase.⁵ Part of the increase in 2014 resulted from a CDIAC clarification that broadened required reporting; however, the increase in private placements appears independent of this clarification. Notably, during this same period, the number of public bond offerings was generally flat, increasing only 6.3 percent (Figure 2). Multifamily housing projects and residential energy conservation are the most common uses for private placements.

Additional details on private placements indicate lower issuance costs, but higher interest rates than

⁵ Data on the number of direct loans in California are not available.

public offerings (Table 1). Private placement issuance costs, albeit unadjusted for varying risk and type, are consistently about one-third of the issuance costs for public offerings. In contrast, the interest rate for private placements is 23 percent higher than that of public offerings in 2016, excluding residential energy issuance.

More than likely, lower issuance costs for private placements make them appealing to local governments. In addition, based on our interviews and literature review, the following are seen as advantages:

- Fewer disclosure requirements and issuance costs;
- Faster execution process;
- Competitive interest rates.

In light of the Great Recession, private placements and direct loans have been appealing to banks for the following reasons:

- Higher profits when banks loan to municipal governments;⁶
- Regulatory changes that encourage banks to invest in municipal debt;^{7,8}
- Ease at converting existing letters of credit to bank loans.⁹

Bank Loan Risks

Despite these advantages, bank loans introduce risks to local governments and bondholders. Reduced disclosure requirements are of particular concern to bondholders because local government debt affects creditworthiness, as determined by ratings agencies and investors. Risks

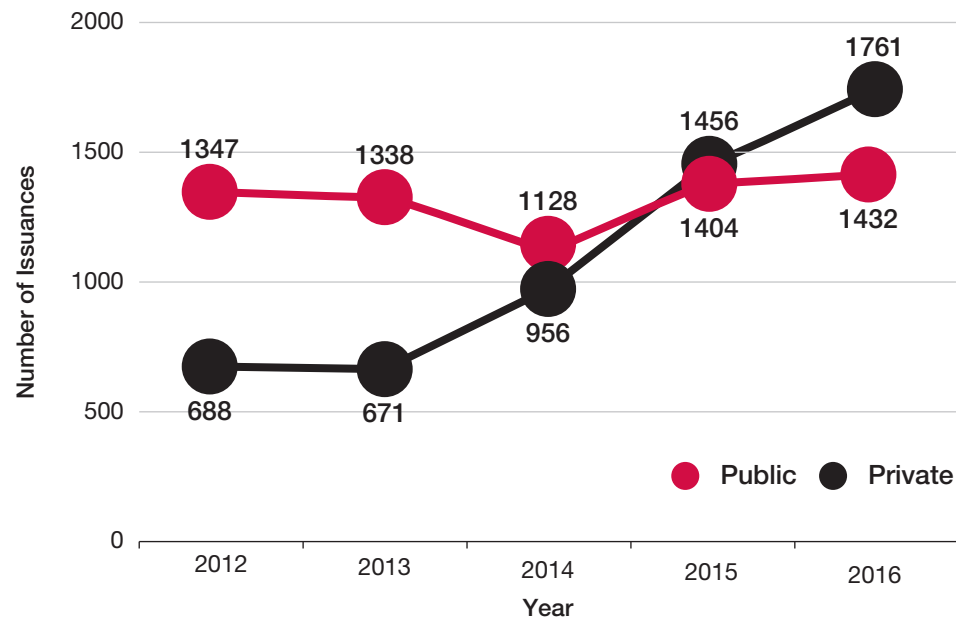
6 Bergstresser, D., & Orr, P. (2014). "Direct Bank Investment in Municipal Debt." *Municipal Finance Journal*, 35, 1.

7 Basel III made Variable Rate Demand Obligations (VRDOs) supported by letters of credit (LOCs) and standby bond purchase agreements (SBPAs) more expensive to banks. From Geoff Buswick et al (2016). *Current Trends in Bank Loans*.

8 American Recovery and Reinvestment Act of 2009 tax provisions increased the value of tax-exempt holdings by permitting banks to invest a greater percent of their total assets without a loss of interest deductions. From Manire, J., Casterline, G. and Forbath, B. (2012). *New Frontiers in Public Finance: A Return to Direct Lending*.

9 Securities Industry and Financial Markets Association (SIFMA). (2013). "White Paper: Considerations Regarding Voluntary Secondary Market Disclosure about Bank Loans," <http://www.sifma.org/issues/item.aspx?id=8589943360>, retrieved April 14, 2017.

Figure 2. California Public Offerings vs. Private Placements 2012-2016



Source: CDIAC

Table 1. Interest Rate and Issuance Cost Average Comparisons, Public Offerings vs. Private Placements

Year	Private Placements, Total Issuance Costs	Public Offerings, Total Issuance Costs	Private Placements, Interest Rate	Public Offerings, Interest Rate
2012	\$116,020	\$369,598	3.50%	2.52%
2013	\$122,250	\$334,973	3.26%	2.97%
2014	\$94,062	\$430,740	3.76%	2.85%
2015	\$85,347	\$392,495	3.48%	3.09%
2016	\$100,178	\$412,871	3.36%	2.74%

Source: CDIAC, <http://www.treasurer.ca.gov/cdiac/debt.asp> (Number of private placements: 2012 - 2016: 688, 671, 956, 1,456, 1,761; number of public offerings: 1,347, 1,338, 1,128, 1,404, 1,432.)

to local governments include the following:

- Reduction in credit quality of public bonds since municipalities

might need to pledge assets or revenue that were previously available to pay off public bondholders as security for bank

loans.¹⁰ Banks' stronger information rights, more restrictive covenants, and greater likelihood to be paid first in the event of a municipal default contribute to the trepidation of bondholders.

- Shorter maturities (3-7 years) than public bonds. Most providers of bank loans are unwilling to provide long-term amortizing debt.¹¹ This can result in uncertain access to refinancing for local governments when loans mature.

Direct Loans Contain Substantial Risks

In addition to our analysis of private placements, we reviewed details of the 41 direct loans reported in the CDIAC database over the 2010 to 2016 period. Of particular concern, our review showed that lenders could accelerate or legally enforce repayment for a number of events (Table 2).

Some items triggering loan defaults, i.e., event of default, appear wholly reasonable, such as in a declaration of bankruptcy. However, events of default contained other provisions that are risky to local governments. For example, a ratings downgrade,

¹⁰ National Federation of Municipal Analysts (NFMA). (2015). "Recommended Best Practices in Disclosure for Direct Purchase Bonds, Bank Loans, and Other Bank-Borrower Agreements." Retrieved November 30, 2016 from http://www.nfma.org/assets/documents/RBP/rbp_bankloans_615.pdf.

¹¹ Ibid.

Table 2. Direct Loan Covenant Analysis

Agreement Term:	Occurrences (of 41 possible)	Percent
Events of Default		
Failure to pay any loan payment and continuation	41	100%
Declaration of bankruptcy or insolvency	41	100%
Cross Default	25	61%
Ratings Downgrade	3	11%
Material Adverse Change	10	24%
Financial Covenants		
Debt Service Coverage Ratio	24	59%
Liquidity Requirement	16	39%
Remedies on Default		
Proceed by court action to enforce performance by the Municipality of applicable covenants and recover the payments of all amounts due	41	100%
Accelerate the immediate repayment of the loan and all unpaid principal and accrued interest	41	100%

Source: CDIAC, <http://www.treasurer.ca.gov/cdiac/>

which occurs if any ratings agency assigns a sufficiently low score to any debt secured by the borrower, is problematic since ratings could be modified with the introduction of a new ratings algorithm or even increased scrutiny on certain types of issuers or specific types of debt. Hypothetically, a ratings downgrade due to the discovery of direct loans could lead local governments to default on those same loans.¹²

¹² Only three of the 41 documents included ratings downgrade provisions, but that may reflect both the size and source of our sample, which contained a disproportionate number of smaller loan amounts.

Our review also found 25 instances in which cross defaults were included as an event of default. In short, if a local government borrower defaults on another liability or obligation unrelated to the bank loan — regardless of the default size or other details — the lender may consider it an event of default. Similarly, 10 loans included material adverse change, i.e., a change in the operations, business, properties, liabilities, or financial prospects of the municipality, as an event of default. This provision is arguably broad and heavily subject to interpretation.

Continued on Back Flap

Policy Landscape

As discussed, the lack of disclosure and risks to local governments are the most serious concerns surrounding bank loans to local governments. In response, California in 2014 enacted legislation to partially address the transparency issue. California now requires the issuer of any debt to state or local governments to submit a report of final sale to CDIAC within 21 days.¹³

However, enforcement provisions appear to be weak. CDIAC estimates that it currently captures 97 percent of public offerings and suspects compliance of private placements to be almost as high; however, it admits that any estimate for direct loans is difficult.¹⁴ Increasing direct loan transparency would be useful to the market on a broad scale and also for local governments, which could more easily evaluate direct loan agreements and argue for more favorable terms. As noted above, other states do not require the reporting of bank loans, but financial markets and local governments would be well served by adopting such standards.

There is currently no federal disclosure requirement beyond issuers providing timely notice to

¹³ California Debt and Investment Advisory Commission, AB 2274, 2013-2014 Reg. Sess. 2014 Cal. Stat. http://leginfo.ca.gov/faces/billNavClient.xhtml?bill_id=201320140AB2274.

¹⁴ Email correspondence with CDIAC, January 27, 2017.

the MSRB about material events, which currently exclude direct loans and private placements. In a positive move, the SEC has proposed amending regulations that would require municipalities to disclose direct loans and private placements. A better solution, mandatory disclosure through the EMMA database, is not currently possible, as the Tower Amendment prohibits “direct or indirect federal regulation of municipal issuers.”¹⁵

The SEC amendments would address the information asymmetry that now exists between banks and other market participants. Currently, banks obtain the best view of the financial situation through strict reporting covenants. Credit analysts have a diminished view, often learning about direct loans and other private placements from year-end audits, but not at the time of the loan.

Federal policy should also require Committee on Uniform Security Identification Procedure (CUSIP) identifiers for direct loans. CUSIPs, nine-digit numbers assigned to all securities approved for trading in

¹⁵ 15 U.S.C. § 78o-4(d)(1) (“Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.”). <http://www.apecp.org.tw/htdocs/doc/USA/Policy/ch2b/78o-4.htm>.

the United States, would ensure that direct loans are correctly identified and incorporated into debt analysis.

The second policy concern, risks to local governments, can be addressed through additional transparency measures and expanded outreach to local governments. For example, CDIAC’s database is accessible only as an exportable spreadsheet. While most useful for research, it is difficult to navigate. The database should be available through an interactive website allowing users to filter by any database category or borrower. In addition, providing machine-readable, keyword-searchable direct loan documents should be standardized to allow users to compare terms of direct loans.

Increased local government borrowing from banks is not yet at a crisis stage, and bank loans often provide additional sources of funding. But poor transparency — and information asymmetries — threaten market stability and increase financial risks to local governments, which are already facing financial pressures from changing demographics to rising pension liabilities. Accordingly, state and federal policymakers should enact the modest changes outlined in this brief. With those policies in place, local governments — and citizens — will be fully informed and better prepared before any crisis takes hold.

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