Bank Loans & Private Placements (Presentation to the St. Louis Chapter of the Government Finance Officers Association) May 2019

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For the decade prior to 2018 there was a huge growth in Bank Loans and Private Placements. The Tax Cuts and Jobs Act of 2017 ("2017 Tax Act") made bank loans less attractive compared to traditional public offerings. The appeal of bank loans and private placements may be further diminished by new Securities and Exchange Commission disclosure rules that became effective on February 27, 2019.

To clarify today's discussion, I'm going to begin with a definition of terms.

- Public offering – A public offering is the sale of securities to a wide range of investors which includes institutions and individuals.

- Private placement – A private placement occurs when an issuer sells the securities directly to a bank or to a limited number of investors (such as a small group of banks or insurance companies).

- Bank loans – A bank loan is a financing in which a bank enters into a loan agreement or other type of financing agreement with the issuer. A bank loan is simply one type of a private placement. Accordingly, today I may use the term bank loan and private placement interchangeably.

Historically bank loans and private placements were used by municipalities primarily for small or short-term financings such as for vehicles and equipment. For the decade prior to 2018, there was a growing trend by municipalities to use bank loans for a wider variety of financings including capital projects traditionally financed with publicly sold bonds or lease obligations. The trend was due to a number of benefits associated with bank loans including the following:

1) Bank financing is often easier to access than publicly sold obligations. There is no voter requirement, no official statement and generally no bond rating.

2) The absence of a rating requirement is a transaction positive for some issuers who dislike the work involved in the rating process.

3) Bank loans typically have fewer parties involved and therefore lower up-front fees and costs. In addition to no ratings, there is no underwriter which is one of

the higher cost components of publicly sold bonds. Many private placements don't include a bond counsel or a financial advisor. (Note that although the absence of a bond counsel or a financial advisor reduces the costs of issuance the exclusion of these parties is often not in the best interest of municipalities).

4) Many bank loans allow the debt to be called at any time which provides opportunities for refunding.

5) Finally, prior to February 27, 2019 there were no SEC or Municipal Securities Ruling Board requirements relating to continuing disclosure for private placements and bank loans. Effective in February were changes to SEC rule 15c2-12 requiring disclosure of private placements and bank loans in certain circumstances. (see http://www.msrb.org/~/media/Files/Resources/10-Things-to-Know-New-SEC-Rule-15c2-12.ashx?).

While Bank financing **does in fact** eliminate certain costs of issuance like underwriting fees and rating fees it's often not the best method of financing.

1. There are often higher interest rates than the rates you would obtain from a public offering.

2. Banks often require short-term financing (generally 10 years or shorter).

3. Banks often impose unfavorable covenants.

4. Bank covenants can be so unfavorable that they can negatively impact your credit and bond rating.

5. Finally, although you all trust your local bank, keep in mind that banks are profit motivated and unlike municipal advisors, banks have no fiduciary duty to protect your interests. Banks often boast that they can provide issuers easy financing with lower costs of issuance but they have no obligation to present other options that may be more favorable. In fact, the bank's terms may be very unfavorable when compared to a public offering.

Let's take a look at some of these factors in greater depth beginning with interest rates.

Average Rate Comparison in California

Year	Private Placements	Public Offerings
2012	3.50%	2.52%
2013	3.26%	2.97%
2014	3.76%	2.85%
2015	3.48%	3.09%
2016	3.36%	2.74%

Unfortunately, I was unable to find a national comparison of rates on private placements compared to public offerings. I did, however, find this comparison of rates in California over the five-year period from 2012 to 2016. Note that in some years private placement rates were almost 1% higher than the rates for public offerings.

Based on my own experience and analysis of the market, I believe these interest rate differentials are indicative of the national variation suggesting that, in general, private placement rates are much higher than the rates on public offerings.

While there are always exceptions, as I previously mentioned, banks generally don't want to make municipal loans that extend beyond 10 years. Some banks have much shorter lending limits.

As I noted, banks often impose unfavorable covenants including the following:

1. Bank loans often include unreasonable events of default that can result in a mandatory redemption of the loan. One example I found was that if the issuer's rating is adversely changed it will constitute an event of default.

2. Another example I read was that an adverse change in financial condition would allow the bank to redeem the loan. In this case the loan documents didn't quantify what constitutes an adverse change in financial condition. It's fully at the discretion of the bank to make this determination.

3. Many loans have provisions known as "gross-up provisions" that allow the bank to change the rate on the loan if the corporate tax rate is changed. Last year I read that billions of loans had rate resets after the 2017 Tax Act was enacted.

4. There are often other provisions relating to rate resets that are related to the length of the loan. For example, you may have a 10-year loan in which the rate is only fixed for 5 years and then changed based on some predefined future condition such as the bank's prime rate.

These covenants can be so unfavorable that they can negatively impact your bond rating. Consequently, S&P has adopted a policy whereby issuers must submit their bank loan documents to S&P in order to retain their rating.

The following are a few examples of how bank loans impact credit and are therefore are a matter of concern for both rating agencies and bondholders:

- Keep in mind that debt is debt. Whether you borrow with bonds or obtain a bank loan, a borrowing increases the municipality's debt obligations. If this amount is significant it can affect the municipality's rating.

- As I mentioned bank loans often have negative covenants and these covenants can include provisions that hurt a municipality's credit. Many loans include numerous events that can be treated as a default and often the only remedy is a loan redemption. This, of course, could force a municipality to have a significant draw on reserves for loan repayment and consequently could lower the municipality's credit and bond rating.

- Many bank loans include balloon structures. As an example, a loan may be based on a 15-year level debt amortization but the loan matures in 10 years. This means that in 10 years the municipality will either have a draw on reserves to pay the loan or will need to implement a refinancing and the rates and terms of that refinancing are presently unknown.

In spite of these drawbacks, bank loans remained an attractive option for many financings; however, the financial benefits of bank loans changed with the passage of the 2017 Tax Act which reduced the corporate tax rate from 35% to 21%.

In August 2018, Bloomberg wrote an article titled "Biggest U.S. Banks Slash Muni-Bond Holdings After Tax Cut." According to this article, for the second quarter of 2018 institutions decreased their municipal debt holdings by nearly $6 billion dollars.

As a result of the 2017 Tax Act, banks are no longer obtaining a significant benefit from the tax exemption of municipal securities and are often no longer offering rates that are competitive with publicly sold debt.

Stated differently, in general you can expect much higher rates on bank loans than you received prior to 2018. Of course rates are affected by general market conditions so when I say much higher rates I'm referring to the rates in proportion to publicly sold issues.

Bank loans may continue to be beneficial in certain circumstances. For small financings such as a vehicle acquisition, a bank loan probably remains a favorable approach.
As I previously mentioned, a benefit of bank loans is that they are often callable at any time. As you know under the 2017 Tax Act, advance refundings were eliminated.

Accordingly, a bank loan that permits a redemption at any time may be a very favorable feature.

For large capital expenditures, Bank loans may be an expensive alternative to publicly sold bonds or lease obligations. But this is not necessarily true in all cases.
Rather than ruling out the possibility that bank loans or private placements may be feasible for a particular transaction, the best approach is to engage a municipal advisor who can advise on likely outcomes. When the outcome is unclear the municipal advisor can prepare a request for proposals that permits firms to submit proposals for either a private placement or public offering.

- This approach will enable you to determine whether a bank loan or public offering is the best method of sale.

- If you determine that a bank loan is the best approach, then a competitive proposal will also help you determine which bank offers the best rates and terms.

- Finally, if you determine to proceed with a bank loan, then a municipal advisor can also assist you in developing favorable financing terms that won't negatively affect your bond rating.

Looking forward is another deterrent to borrowing with bank loans and private placements. New Securities and Exchange Commission Rules became effective in February 27, 2019 relating to continuing disclosure for bank loans and private placements. All municipalities should consult with a municipal advisor and bond counsel prior to incurring any new obligations that may be impacted by these rules.

In conclusion, consider that although the process of obtaining a bank loan is easier than a public sale, always remember that the role of a finance director is not to obtain the easiest available financing but rather to obtain the most favorable financing available based on terms and cost.