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CONDUIT FINANCING FOR COMMERCIAL DEVELOPMENT: THE ELEMENT OF RISK

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On January 22, 2002, Kmart Corp., a national retailer that used discount prices and celebrity-branded products to reach millions of American consumers, filed for bankruptcy protection. The court filings, which listed $16.3 billion in assets and $10.3 billion in liabilities, indicated that restructuring the company would result in the closure of hundreds of stores and the loss of an untold number of jobs. Less than three months later Kmart confirmed that it did indeed intend to close underperforming stores - as many as 284 of them.

In addition to the impact such closures will have on local economies, a number of local governments face the prospect of defaults on locally-issued conduit financings. *The Bond Buyer* recently reported that since 1986 governmental issuers throughout the U.S. have sold approximately 96 tax-exempt bond issues on behalf of Kmart. All of these financings were used for the construction of retail shopping stores. As Kmart filed for bankruptcy protection most of these bonds entered technical default. Clearly, Kmart is responsible for repayment of the bonds without recourse to the public entities that issued the bonds on Kmart's behalf. Nonetheless, these local governments may bear some negative consequences from a default, including a tarnished name in the marketplace and the cost of resolving bondholder claims.

Whether financing the commercial development of one of Kmart's 164 California-based stores or a commercial project for another private-sector firm, conduit debt issued for commercial development is dependent upon public-private partnerships. These unions offer substantial rewards for Californians; but, they also pose a type of risk with which many governmental issuers are unfamiliar. This article considers the use of conduit financing for commercial development in California and presents a few strategies for reducing a public entity's associated risk from these financings.

Conduit Financing

Conduit revenue bonds are issued by a governmental entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a non-governmental borrower who builds and operates the project. The use by a private firm of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit.

A conduit revenue bond is payable solely from the loan payments received from the non-governmental party. The governmental issuer typically has no liability for debt service on the bonds except for the administration of the bond. In some cases, the payments may be assigned to a trustee who holds the funds in trust for the bondholders. Although the issuer has no liability, their reputation and standing with respect to future debt financing may be negatively affected. More importantly, should the bond default, the governmental entity will likely be drawn into the settlement process.

Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Since the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

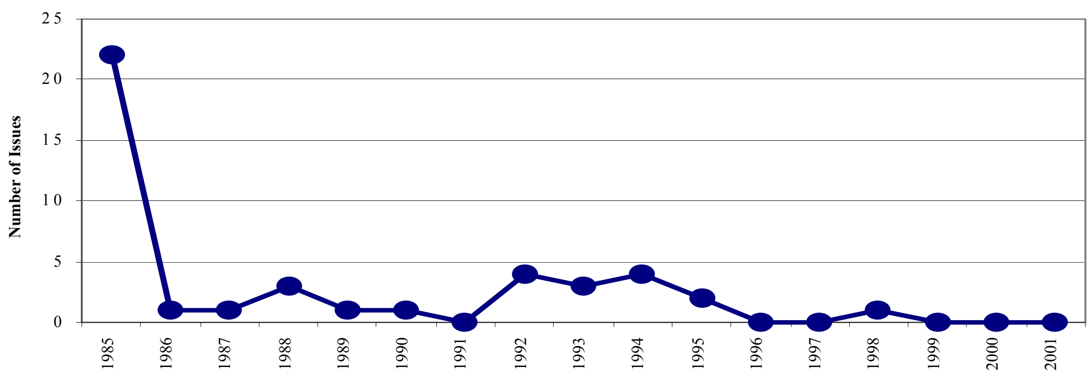
Conduit Financing for Commercial Development in California

Using its database of debt issuance, CDIAC has identified 2,718 conduit revenue bonds issued between 1985 and the present. These bonds, totaling $36.6 billion, were issued for a variety of purposes, including commercial and industrial development, single- and multi-family housing, and educational and health facilities. Of the 2,718 issues, only 43 bonds were issued by public entities for commercial development purposes. The total amount of bonds issued for this purpose between 1985 and the present was $319 million or less than 1 percent of the total . The low ratio of commercial development projects among the population of conduit transactions reflects changes made in the Internal Revenue Code in 1986 that made it more difficult for private firms to be eligible for tax-exempt financings.

As Figure 1 indicates, debt issuance for commercial development purposes after 1986 corresponds roughly to periods of economic recession. Peaks appear in the trend line in the early 1980s and 1990s, possibly reflecting the renewed interest among local governments in this financing structure as a way to revitalize sagging local economies. The state of the State's economy may elevate interest in this financing mechanism, making it a good time to examine the potential lessons from past experiences in this arena.

Figure 1

Conduit Bonds Issued for Commercial Development
Number of Bonds Issued
1985 to present

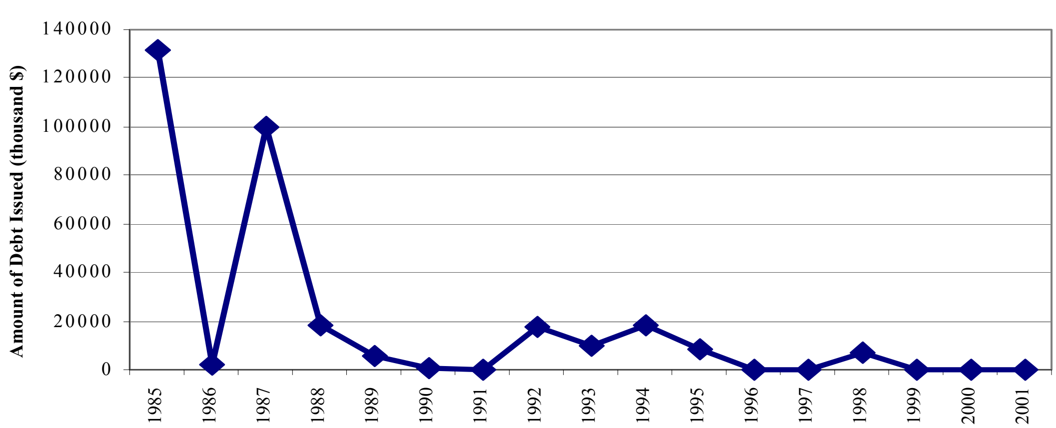


The volume of conduit bond issuance displays a similar pattern as the number of bonds issued. The average amount of debt issued for each bond sold varied between $4 million and $100 million.

Since CDIAC's database reports only the debt issued by public entities, but does not track amortization, some of the debt reported in Figure 2 may have been repaid. This fact is important when considering the exposure public entities in the state face as a consequence of issuing conduit bonds for commercial development purposes. In general, however, the low volume of debt issued seems to suggest that California governmental issuers face a low level of risk as a consequence of these transactions.

Figure 2

Conduit Bonds Issued for Commercial Development
Dollars Issued (thousand $)
1985 to present



Risk Management Strategies for Conduit Issuers -- Because conduit revenue bonds are not founded on the credit of the governmental issuer and because the projects are not owned or operated by them, issuers need to consider the credit quality of the project and its public purpose or benefit before using their conduit authority.

Many issuers require that the project or the non-governmental party obtain a minimum investment grade credit rating. That rating may be enhanced by bond insurance or a letter of credit. Projects that have a particularly important public benefit or that provide additional collateral, such as a deed of trust or secured interest in the project, may place less emphasis on the credit standing of the private entity.

An alternative approach for otherwise worthy projects that cannot meet the minimum rating standards is to require that the bonds be privately placed. Private placement can ensure that only a small number of "sophisticated" investors will own the bonds. To some extent the governmental issuer is insulated against problems that may arise concerning initial disclosure or adverse publicity that might befall the project in the future by selling to these investors. Inherent in private placement, is the understanding that sophisticated investors incorporate credit and project risk into their pricing of the bonds.

Finally, issuers should use their conduit authority to finance essential projects that meet the goals of the issuer and not just the non-governmental party. Projects financed with these goals in mind will minimize future problems.

This Offprint was previously published in DEBT LINE, a monthly publication of the California Debt and Investment Advisory Commission (CDIAC). CDIAC was created in 1981 to provide information, education, and technical assistance on public debt and investment to state and local public officials and public finance officers. DEBT LINE serves as a vehicle to reach CDIAC's constituents, providing news and information pertaining to the California municipal finance market. In addition to topical articles, DEBT LINE contains a listing of the proposed and final sales of public debt provided to CDIAC pursuant to Section 8855(g) of the California Government Code. Questions concerning the Commission should be directed to CDIAC at (916) 653-3269 or, by e-mail, at cdiac@treasurer.ca.gov. For a full listing of CDIAC publications, please visit our website at http://www.treasurer.ca.gov/cdiac.