# *New Frontiers in Public Finance:*
# ***A Return to Direct Lending***

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# A Return to Direct Lending



## Overview

- What is a direct purchase/private placement financing?
- Why the resurgence over the last few years?

- Considerations for the borrower when evaluating a direct purchase
- Direct Purchase vs Public Offering
- Participating Banks

- Legal Structure
- Disclosure
- Common legal considerations

- Future of direct purchases?
- Questions

# A RETURN TO DIRECT LENDING



## What is direct purchase/private placement financing?

- Definition
  - Tax-exempt financing (fixed or variable) that is privately-placed or directly purchased by an investor or bank
  - Also known as Direct Purchase, Direct Placement, Private Placement, Funded Loan, or Direct loan
- Tax Treatment
  - Common form of tax-exempt financing prior to the Tax Reform Act of 1986
  - Bank Qualified
  - Non-Bank Qualified
  - Taxable
- Types of Credits
  - General Obligation Bonds
  - Appropriation Bonds
  - Revenue Bonds
  - Lease Revenue Bonds
  - Private Activity Bonds

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## What is direct purchase/private placement financing?
*(Cont'd)*

- Use of Proceeds
  - Equipment purchases
  - Real estate or project development

- General Characteristics
  - Principally purchased by one investor or bank
  - With or without a placement agent
  - Executed as a loan or as a security
  - Exempt from SEC 15c2-12, but may not be exempt from underwriter obligations under MSRB rules
  - Highly adaptable structures with the ability to customize to existing industry standards and bond documentation
  - Pricing can be either fixed rate or variable rate (spread over an index) for a defined commitment period

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## Why the resurgence over the last few years?

<u>Market Factors</u>

- For 2009 and 2010, the American Reinvestment and Recovery Act's ("ARRA") "de minimis provision" suspended the cost of carry disallowance for banks, thereby increasing the value of certain tax-exempt holdings
- Downgrades to insurers and liquidity/credit/swap providers (domestic & foreign banks) forced market participants to seek alternative structures.
- High volume of expiring credit/liquidity facilities
- Favorable taxable/tax-exempt ratios (relationship between Libor and SIFMA)

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## Why the resurgence over the last few years? *(cont'd)*

Issuer Factors

- Restructuring/conversion of existing variable rate transactions
- Elimination of bank downgrade risk
- Elimination of "put risk" due to credit or market events
- Elimination of trading risk volatility
- Opportunity to avoid basis risk (alignment of indices between financing and swap)
- Ease of execution (reduced costs and limited public disclosure requirement)

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## Why the resurgence over the last few years? *(cont'd)*

Bank Factors

- Lower-rated banks are able participate as a lender / investor
- Basel III regulatory changes have encouraged Banks to pursue funded loans vs. contingent liabilities
- Reduced opportunities for traditional lending
- Banks are able to recognize tax-exempt income vs taxable income
- Positive correlation between bank profits and municipal holdings
- Commercial banks have become the third largest holder of municipal securities behind only households and mutual funds and ahead of money market funds. Commercial banks hold $327.4 billion in municipal securities as of June 30, 2012.[1]

[1] Source: Bond Buyer and Federal Reserve Flow of Funds, Includes Direct Purchases structured as securities only

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## Considerations for the borrower when evaluating a direct purchase

- Compare economic terms
  - can be fixed rate or variable
  - can be new money, refunding, or a variable rate conversion
  - how do costs and interest rates compare?
- Compare legal covenants
  - make primary covenants non-negotiable
  - request specific terms (prepayment options, no debt service reserve)
  - conform to existing covenants in parity issues
- Compare financial structure
  - maturities beyond 10-12 years not always available
- Seek several proposals
  - bank preferences and appetites vary
  - request alternative quotes for callable, non-callable
- Arrive at an informed choice on performance and any potential risk

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## Direct Purchase vs Public Offering – fixed rate

- Fixed rate financings
  - competitive pricing available from several purchasers (subject to credit and tenor)
  - seek similar terms to refunded or parity issues
    - optional redemption may be more flexible
    - seek amortization based on issuer objectives
  - direct purchases often do not require a debt service reserve fund
  - credit ratings typically unnecessary when entering into a direct purchase
  - direct purchases have a lower costs of issuance
    - no underwriter's discount
    - no rating fees

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## Direct Purchase vs Public Offering – variable rate

- Variable rate financings
  - publicly offered
    - variable rate demand obligations (“VRDOs”)
      - ✓ typically remarketed daily or weekly; paid monthly
      - ✓ remarketing rates (interest) on VRDOs are based on the credit strength of the underlying letter of credit bank
    - floating rate notes (“FRNs”)
      - ✓ reset weekly; paid monthly
      - ✓ interest is based on a published index
        - SIFMA (+ a spread)
        - % of 1M LIBOR (+ a spread)
  - private placement
    - direct purchase
      - ✓ reset weekly; paid monthly
      - ✓ interest is based on a published index
        - SIFMA (+ a spread)
        - % of 1M LIBOR (+ a spread)

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## Direct Purchase vs Public Offering – variable rate *(cont'd)*

- Direct purchase/FRNs vs VRDOs
  - competitive pricing
  - similar terms
    - long-term variable rate financings
    - amortization
    - lends to hedging alternatives
  - renewal risk
    - will the institution (lender) renew the direct purchase or letter of credit?
  - direct purchases and FRNs eliminate LOC bank counterparty risk
    - Allied Irish Bank
    - Bank of America

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## Direct Purchase vs Public Offering – variable rate *(cont'd)*

| | LOC Backed VRDBs | Direct Purchase | LIBOR/ SIFMA Index Bonds (FRNs) |
|---|---|---|---|
| **Commitment Period:** | 1 to 3 years | 1 to 7 years | 1 to 7 years |
| **Failed Remarketing:** | Put to bank; Subject to bank rate/ acceleration | Soft put: Generally subject to penalty rate/ acceleration | Hard put/ Maturity: Default<br>Soft put: Penalty rate |
| **Bank Exposure:** | Ongoing exposure | Limited exposure | None |
| **Issuer's Credit:** | Cost increases in event of downgrade | Cost increases in event of downgrade | No cost impact in event of downgrade |
| **Interest:** | Resets weekly, paid monthly | Resets weekly, paid monthly | Resets weekly, paid monthly |
| **Primary Investors:** | Money market funds | Held by bank | < 13 months: Money market funds<br>> 13 months: Intermediate funds |
| **Call Option:** | At any time; potentially subject to breakage fees | Any time; potentially subject to breakage fees | Generally 3 to 6 months prior to maturity |
| **Considerations:** | • Long-term variable rate financing alternative<br>• Prepayment and amortization flexibility<br>• Structure lends to hedging alternatives<br>• Quick execution. Easiest option to implement | • Long-term variable rate financing alternative<br>• Prepayment and amortization flexibility<br>• Structure lends to hedging alternatives<br>• Bank liquidity facility not required<br>• Eliminates bank counterparty risk (credit and remarketing) and costs | • Long-term variable rate financing alternative<br>• Prepayment and amortization flexibility<br>• Structure lends to hedging alternatives<br>• Diversifies investor base<br>• Bank liquidity facility not required<br>• Eliminates bank counterparty risk (credit and remarketing) and costs |

# A Return to Direct Lending



## Variable Rate Direct Purchase vs FRNs

| Structure: | Floating Rate Notes | Direct Purchase |
|---|---|---|
| **Market** | Public | Private |
| **Investor Base** | Money market funds, short bond funds, SMAs, insurance companies | Commercial and investment banks |
| **Index** | Predominantly SIFMA, but also % of LIBOR | Predominantly % of LIBOR, but also SIFMA<br>Fixed rate |
| **Term** | Up to 7 years | 1-7 year initial maturity |
| **Maturity/Put** | Maturity and hard put less costly | Maturity with soft put |
| **Credit enhancement and Remarketing** | N/A | N/A |
| **Trading Risk Volatility** | None | None |
| **Matching Versus Swap Terms** | Some ability to match terms to swap receipts | Greater ability to structure terms to match swap receipts |

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## Participating Banks

- Banks active in California include….

- ✓ Bank of America
- ✓ Bank of the West
- ✓ BBVA Compass Bank
- ✓ Citibank
- ✓ Comercia Bank
- ✓ First Republic Bank
- ✓ J.P. Morgan Chase
- ✓ Northern Trust
- ✓ RBC
- ✓ Union Bank
- ✓ US Bank
- ✓ Wells Fargo
- ✓ Zions First National Bank

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## Legal Structure

- Common Types of Direct Lending Financings
  - general fund lease revenue financings
  - general obligation
  - water/sewer/electric revenue
  - land secured
  - 501(c)(3)
- Need Legal Authority for the Transaction
  - same constitutional and statutory debt limit restrictions apply

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## Legal Structure *(cont'd)*

- Typically Direct Purchases use the same form of legal documentation as public offering
- Same sources of security and pledge or lien on revenues or assets as in public offering
- Typically same or similar covenants as in public offering
- Sometimes these covenants will be set forth in a Continuing Covenants Agreement

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## Legal Structure *(cont'd)*

- Bonds are either sold directly to the Purchaser or the Purchaser is a party to the Lease, Installment Purchase Agreement, or Loan Agreement and directly receives Lease Payments, Installment Payments, or Loan Payments
- Depending on structure sometimes no Trustee and payments made directly to Purchaser
- Swaps – Sometimes Banks want to spread revenues to different arms of the bank and will propose a floating rate based on an index and a spread and a swap where the Issuer makes a fixed rate payment and receives back a floating rate and spread identical to what they pay on the underlying security
- Typically same closing documents, certifications and opinions as public sale

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## Disclosure

- Usually structured to avoid Rule 15c2-12 requirements
  - no official statement required
  - no requirement to provide/file continuing disclosure with EMMA, however, continuing disclosure is often required to be provided directly to the Purchaser
- Still subject to the Anti-Fraud provisions of Section 17 of the Securities Act of 1933 which make it unlawful to obtain money in interstate commerce by means of an untrue statement of a material fact in the offer or sale of securities, or by omission of material facts
  - direct purchaser's might require 10b5 types of representation as to information provided to them
  - direct purchasers do conduct due diligence and will require budgets, audits, operating data, projections, etc.
- Investor Letter ("Big Boy Letter")
  - representation that purchaser is an "accredited investor" or a "qualified institutional buyer"
  - purchaser is purchasing for its own account and not with a view to resell
  - purchaser has done its own due diligence
  - sometimes transfer restrictions or "traveling" letter

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## Common legal considerations

- Authority to do direct lending
- Covenant Negotiation
  - abatement risk/substitution of asset provisions in lease transactions
  - set off
  - cross default
  - liquidity tests
- Assignment/Transfer
- Default Rates/Terms Outs
- Consent Rights

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## Future of direct purchases?

Market Factors

- Regulatory uncertainty (MSRB & SEC evolving views on disclosure)
- Legislative uncertainty (status of tax exemption and tax policy)
- Interest rate environment and corresponding taxable/tax-exempt ratios
- Emergence of alternative structures or re-emergence of traditional structures

Issuer Considerations

- Competitive pricing vs market alternatives
- Cost of issuance
- Disclosure requirements
- Renewal / restructuring risk at end of term
- Debt Policy guidelines

# A Return to Direct Lending



## Future of direct purchases? *(cont'd)*

Bank Considerations

- Basel III uncertainty (2015 implementation date)
- Recovery of bank ratings
- Assessment of tax risk by banks (micro/macro level)
- Uncertainty of Renewal Cycle
- Corporate earnings (i.e., return of traditional or new lending opportunities) will have some impact on banks appetite and capacity for direct purchases

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Questions