



Best Practice

## **Understanding Bank Loans (2013) (DEBT)**

**Background.** Bank loans are an important tool in a government’s financing toolkit. For purposes of this Best Practice, the term “bank loans” includes fixed-rate loans with defined maturities and loans or lines of credit that have variable interest rates and flexible payment provisions.

One potential advantage of bank loans is that the process for execution of bank loans generally is simpler than a bond issue that is marketed to the public market, with fewer issuance costs and ongoing compliance requirements. Additionally, bank loans can often be structured in a manner that more closely conforms to specific project or repayment considerations than is the case with bond issues. However, because bank loans are typically not executed in an environment that is as transparent as the bond market, an issuer may have limited ability to assess whether the proposed interest rate(s), fees and terms are consistent with reasonable market comparables.

Governments should develop specific policies and procedures that address the proper legal and financial aspects of using bank loans for their jurisdiction. Governments also should become familiar with the various types of terms used in these financial products. Governments need to know how bank loans are characterized for legal and accounting purposes, including how they are treated in your financial statements, and what types of disclosures should be made about these loans. State and local laws should be reviewed to ensure these financings are within legal limits and the financing is characterized appropriately.

Public disclosure of bank loans currently is not required beyond the reporting requirements in the government’s financial statements. However, many market participants have suggested that providing information about outstanding bank loans is necessary to assess an issuer’s outstanding debt obligations and general credit quality.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that governments considering the possibility of entering into bank loans should develop policies and procedures related to these debt obligations. When developing these policies and procedures, and when evaluating the various debt alternatives available to it, governments should consult with their financial advisor and legal counsel. These professionals should be engaged by the government prior to and throughout the negotiations for a bank loan. Outside professionals including financial advisors and pricing agents can assist with making an assessment of proposed structures, terms and pricing. Furthermore, governments should disclose information about the bank loan, if material to bond holders, as discussed below.

Some of the questions that should be addressed before a government pursues a bank loan include -

1. Has the government retained outside professionals to help determine the legality and fiscal prudence of a bank loan?
2. Does the government have the legal authority by state and local statute to enter into the contemplated financings?
3. For transactions less than \$10 million, has the government considered or discussed with its professional team the option of issuing bank qualified debt?
4. From a statutory standpoint, is the bank loan considered to be debt, and if so, does it apply against the government’s debt capacity or other considerations?
5. Does a bank loan offer a better solution to the issuer’s needs than a financing offered in the public bond markets? What are the terms that best fit these specific borrowing needs (including fixed vs. variable interest rates)?

6. How will the bank loan provider be solicited, evaluated and selected?
7. Is the government using competitive means to obtain a bank loan? How can the government best negotiate the final terms with the selected financing provider?
8. Has the government thoroughly reviewed and discussed the term sheet of the loan prior to its execution, and does the term sheet have comprehensive information about the loan?
9. What is the interest rate on the bank loan? Is it fixed for the term of the loan or does it reset prior to the maturity of the loan? Is the interest rate a variable rate with predetermined interest reset dates or an index upon which it is based? Can the government manage the risk of an increase in the interest rate, and to what extent?
10. Is the loan a fully amortizing loan, or does it incorporate a non-amortizing bullet maturity? How is the debt service schedule structured – level or ascending? Can additional debt be incurred by the government, if necessary? If so, what is the formula for determining how much additional debt can be incurred? Is there a coverage ratio requirement in the loan? Are there penalties for prepaying the loan prior to maturity?
11. What are the covenants included in the bank loan, and who within the government is responsible for ongoing compliance?

### *Disclosure Considerations*

In order to enhance communication to its citizens and other parties interested in reviewing a government's credit profile, governments should *voluntarily* disclose information about bank loans. While disclosure of bank loans currently is not required under Securities and Exchange Commission's Rule 15c2-12, any voluntary disclosure may be held to same standards of materiality and timeliness as information disclosed under Rule 15c2-12.

A bank loan that does not have a security-based or other financial connection to any outstanding public-market debt may not be relevant to investors, rating agencies, the public, or other entities. Therefore, if a government chooses to disclose information regarding a bank loan, GFOA recommends that those governments disclose information regarding those bank loans that may be relevant to current or prospective bondholders. Disclosure of bank loans would be important to bond holders if the bank loan(s) is (are) secured by any or all of the same revenues as the outstanding bonds, and is/are large enough to be material to the creditworthiness of the government. Additionally, if a government executes numerous bank loans, the combination of those loans may be material. If the government has outstanding bonds, it is important for the issuer to discuss with its counsel any possible material issues related to a bank loan, especially if it could interfere with debt service payments, or is a large financial transaction.

Voluntary disclosure of bank loans may be accomplished in a variety of ways – either by posting the entire financing agreement documentation, through the normal disclosure mechanisms used by the government, (which would include placing this information in the government's financial statements) or by preparing a summary of material terms. The government along with its professional team should determine both the extent of information it provides and the manner in which it is disseminated. Some information that should be considered for summarization and disclosure include:

1. Loan amount and date incurred
2. Final maturity date of the loan
3. Debt service schedule, if including principal amortization, interest rate(s), interest calculations
4. Interest rate method of calculation, if variable
5. Use of loan proceeds
6. Legal security and/ source of payment
7. Covenants, events of defaults and remedies
8. Term-out provisions, or information about payment acceleration or other non-standard payment considerations
9. Any other information that an issuer believes to be important

Governments also should consult with legal counsel to ensure that any voluntary disclosures contain an appropriate disclaimer identifying the one-time nature of the information as of the posting date, issuer limits on responsibility and other relevant information as advisable. A government may wish to update the information particularly if the loan is repaid before its maturity, or if the loan terms are extended or otherwise modified – items that may be material as determined by the government, legal counsel and other members of the financing team.

When utilizing the MSRB's Electronic Municipal Market Access (EMMA) system to disclose bank loan information, governments need to be aware that the bank loan will not have a CUSIP number associated with it. Therefore the information will need to be uploaded as "other information" connected with a bond issue already established in EMMA. As with all disclosure decisions, issuers should consult with counsel and others on the financing team about how best to disseminate this information. Bank loan disclosures would normally be handled in the same way the issuer provides other disclosure information (e.g., EMMA, issuer web site).

### References

MSRB Notice on Bank Loans - MSRB Notice 2011-52 - <http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-52.aspx>

Municipal Bond Industry Paper on Disclosure of Bank Loans - <http://www.nfma.org/assets/documents/position.stmt/wp.direct.bank.loan.5.13.pdf>

Recommended for the Executive Board's approval by the Committee on Governmental Debt Management, September 2013.