

Bank Opportunities With Revenue Bonds

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Practice Area: Banking and Commercial Finance

Banks have the opportunity to assist their commercial loan customers through the purchase of tax-exempt revenue bonds or by providing credit enhancement to support tax-exempt revenue bonds. Because the investor who purchases the taxexempt bond is generally not required to pay federal income tax on the interest received on the bond, the investor will accept a lower rate of interest. This lower interest rate is passed on to the benefit to the borrower, often with a fixed rate for a long term. This *Bulletin* provides an overview of the structure of a typical revenue bond and the opportunities presented to commercial lenders. This *Bulletin* does not attempt to summarize all the requirements for tax-exemption, but highlights key considerations that will help a banker evaluate these opportunities. Some large banks act as corporate trustees on bond issues and are also involved in the public or private placement of revenue bonds, however this *Bulletin* will focus only on the loan or "credit" opportunities for banks.

Revenue Bond Overview

Conduit Structure. There are several parties to the revenue bond transaction and the agreements can be complex, with their own specialized language. As a starting point, it helps to remember that only a government entity can issue taxexempt debt. For example, a government entity may borrow for its own capital needs by issuing a taxexempt school bond or a highway bond. These are sometimes referred to as "general obligation" bonds, because they are payable from the funds of the government, and backed by some taxing authority. With the revenue bond, the bond proceeds are passed on to a private borrower for its capital needs. Therefore, with a revenue bond the government entity first borrows from the bond investor, then turns around and lends the proceeds to a qualified borrower. The government issuer only acts as a "conduit" for payments, it has no obligation to pay the revenue bonds other than from payments ("revenues") received from the borrower. Because the government issuer is not obligated on the revenue bonds, Banks have the opportunity to evaluate the borrower's credit risk and either purchase and hold the bonds in their own portfolio or provide credit enhancement for publicly traded bonds, as described in this *Bulletin*.

In Wisconsin, revenue bond issuers include the Wisconsin Health and Educational Facilities Authority ("WHEFA"), Wisconsin Housing and Economic Development Authority ("WHEDA"), municipalities, local redevelopment authorities and housing authorities. Each of these issuers is authorized by state statute to provide financing to specific types of borrowers and projects. The issuer is typically paid a fee at closing and then an annual fee thereafter. Certain issuers can issue bonds which are exempt from both state and federal income taxation, potentially resulting in an even lower interest rate to the borrower. Although the complex structure and documentation of the conduit transaction can lead to significant initial closing costs to the borrower, those costs are almost always recovered after a few years of reduced interest rates.

Industrial Revenue Bonds. One common type of conduit financing is the “industrial development revenue bond” or “IRB.” Under the current Tax Code these are also known as “Qualified Small Issue Bonds.” The maximum amount of an individual IRB issue is \$10 million. The proceeds of an IRB must be used to construct and equip manufacturing facilities. There are statutory limits on the size of an IRB borrower as well as an annual aggregate state limit, known as the “volume cap.” In Wisconsin, the volume cap is allocated by the Department of Commerce, based upon several factors, including projected job creation/retention.

Section 501(c)(3) Bonds. Another common type of conduit financing is with 501(c)(3) Bonds, which may be issued for the benefit of non-profit organizations such as colleges, hospitals and senior living facilities. The borrower must have received formal designation from the IRS as a section 501(c)(3) corporation, exempt from federal income taxation. Even though the 501(c)(3) corporation is exempt from income taxation and is likely exempt from property taxation, it can only issue tax-exempt debt through the conduit structure described above. The IRS places fewer restrictions on 501(c)(3) Bonds than on IRBs. In particular, there is no size limit on the borrower and the state volume cap is not applicable. One key restriction on 501(c)(3) Bonds is that the proceeds must be spent on improvements to be owned and occupied by the 501(c)(3) entity. For example, a hospital cannot finance the construction of medical offices to be used by private physicians. Section 501(c)(3) Bonds have not traditionally been available to churches or church schools through 12th grade, even though they are 501(c)(3) organizations, due to issues concerning government support of religion. However, in some states charter schools and certain church-sponsored schools have recently borrowed using tax-exempt bonds. Ultimately, bond counsel who is giving the tax-exemption opinion will have to be satisfied that a school affiliated with a church can qualify as a borrower.

Indian Tribal Bonds. The Tax Code authorizes recognized Indian Tribes to issue federally tax-exempt bonds. Because a recognized Indian Tribe is a sovereign government, a Tribe does not need to use a conduit issuer, it can issue tax-exempt bonds for its own use. Technically, Tribal bonds are not conduit bonds, but the market for Tribal bonds and the opportunities for Banks are currently similar to those for revenue or conduit bonds. A key limitation on Indian Tribal bonds is that the bond proceeds can only be used for an “essential governmental function” of the Tribe. An “essential governmental function” is one customarily performed by state and local governments, such as providing roads, schools, community centers and public health clinics. Other projects such as hotels and golf courses may be problematic. A casino could not be financed with tax-exempt bond proceeds. It is important to note that the revenue stream from a casino or hotel can be used to secure bonds issued to finance a permitted project such as a community center. Given the significant gaming revenues earned by Tribes in Wisconsin and throughout the country, Indian Tribal bonds are receiving increased attention from banks and investors.

Bank Opportunities

Bank Purchase of Bonds. A Bank may purchase revenue bonds issued for the benefit of its customer. This is essentially the same as a term loan to the customer, but using the conduit structure described above. In that case, the Bank can negotiate the interest rate, collateral and covenants imposed on the Borrower, just as in a commercial loan. Although the term of the bonds may be long, typically 20-30 years, the Bank can set the interest rate for an initial term of say five years, with a reset formula thereafter. The Bank can also offer a swap or rate cap to provide interest rate protection to the Borrower. The Bank can place limits on prepayment, as with any commercial loan. If the borrower defaults, the Bank can either negotiate a waiver/forbearance or accelerate the Bonds and exercise remedies against the borrower. One cautionary note here, if the parties amend the payment terms during the life of the Bonds, as in a forbearance, for example, Bond Counsel should be consulted to make sure the changes do not trigger the loss of tax-exemption. The Bank purchase of bonds can be fairly simple, without any need for a corporate trustee or an underwriter to sell the bonds. The Tax Code offers one additional advantage that makes small Section 501(c)(3) bond issues attractive to Banks. Under Section 265 of the Tax Code, if the aggregate amount of bonds issued by the issuer (governmental unit) is less than \$10,000,000 in a year, then the Bank can take a deduction for the cost of purchasing and carrying the Section 501(c)(3) bonds. The \$10,000,000 limit includes all bonds issued for the benefit of the governmental unit (i.e. roads, public improvements, etc.) during the year and has not been increased since 1986. Therefore only the smallest bond issues will qualify for the Section 265 treatment.

Letter of Credit. As an alternative to a Bank's purchase of bonds, the Bank may issue its direct pay letter of credit to support the Bonds. Letters of credit are often used to support variable rate demand bonds or "VRDBs." A VRDB bears interest at a floating rate, usually reset on a weekly basis, and is sometimes referred to as a "low floater." The VRDB is payable on demand or "put" by the bondholder. At the time of issuance, the Borrower enters into a Remarketing Agreement with an underwriter, who will set the interest rate from time to time at a rate just high enough to make sure the VRDBs remain outstanding and are not put for payment. Because of the variable rate and demand feature, VRDBs are typically used by sophisticated borrowers, often in a mix with fixed-rate term debt.

VRDB's are usually backed by a bank letter of credit to ensure that the bond is always payable when put by the bond investor. With the direct pay letter of credit, each scheduled outstanding principal and interest payment is paid by the bond trustee's draw upon the letter of credit, even if there is no event of default. The letter of credit must be in an amount sufficient to cover the principal amount of the VRDB, plus a specified number of days of interest (typically one scheduled interest payment plus a few additional days of coverage). Even if the VRDBs have a 30 year life, the term of the letter of credit can be shorter, for example, three to five years. If, at the expiration date a replacement letter of credit is not in place, there will be a drawing on the Bank's letter of credit to purchase the VRDB.

VRDBs have become a relatively standard product, purchased and held by money market funds. The VRDBs are sold on the strength of the letter of credit provider, therefore only Banks with a long term debt rating of "A" or better will be able to issue letters of credit to support VRDBs. A smaller bank could theoretically take the credit risk with the borrower and then have its letter of credit wrapped by a correspondent bank with a sufficient rating. The combined costs of the two letters of credit would have to be competitive with those of a single provider, however.

As with any letter of credit transaction, the Bank can impose collateral requirements and covenants on the borrower. In addition, on VRDBs the Bank can set forth the amortization requirements, since the Bank bears the credit risk. One advantage of VRDBs for borrowers is that the borrower may be able to negotiate covenant waivers with the letter of credit bank if needed. The bondholders should not care about the covenants so long as the letter of credit remains in place. By contrast, with fixed rate, publicly held bonds, the borrower would need consent from at least a majority of bondholders. It is not usually practical to obtain consent from the required number of bondholders. If the Bank does not agree to waive an event of default, it has the option to trigger an acceleration of the Bonds and a drawing on its letter of credit and can exercise its legal remedies such as foreclosure.

Liquidity Facility. As an alternative to the Bank letter of credit, the Bank may be asked to provide a "liquidity facility" in connection with VRDBs. The liquidity facility is a commitment by the Bank to purchase VRDBs which are tendered by investors, prior to a payment default by the borrower. The liquidity facility protects the investor as well as the borrower in the event that when the VRDBs cannot be remarketed based upon the current rate or market environment. The investor knows that the bonds are truly payable on demand and the borrower will not have to come up with the cash upon demand by the investor. In this case, the primary credit risk is not covered by the Bank. A liquidity facility is used when the primary credit risk is covered by bond insurance or the borrower has a very strong long term credit rating from a nationally recognized rating agency. To the extent the Bank purchases VDRBs under the liquidity facility, the Bank receives the benefit of collateral securing the VDRBs. In addition, the Bank may dictate the rate at which VDRBs bear interest while held by the Bank.

Conclusion

Although the structure of a revenue bond can appear complex, there are a number of benefits to the borrower, including a relatively low interest rate, a fixed interest rate, if desired, and a long amortization period. Commercial lenders who are generally familiar with revenue bonds can add value to the transaction by purchasing the bonds for the Bank's own account or by providing a letter of credit or liquidity facility to support the bonds.

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