The Baker Group

**Scott Fletcher**
*Director of Public Finance*
The Baker Group LP
sfletcher@GoBaker.com

# Communities Need Financing Assistance from Their Community Banks

Community banks have long served as financial service leaders for their local communities. The need for new and improved infrastructure in the United States continues to rise, resulting in a growing need to finance these projects.

There are multiple paths for municipalities to access capital or refinance existing financial obligations, and they are looking to their community banks for assistance. In general, municipalities can enter into a financing agreement by using one or more of the following:

- Issuing municipal bonds through a public sale, either as a competitive or negotiated underwriting
- Accessing state or federal aid such as grants
- Utilizing a state-revolving fund or conduit issuer
- Obtaining bids from financial institutions for a direct loan, a.k.a. a private placement

Over the past ten years, there has been a significant rise in the issuance of private placements. On the surface, it makes sense for a municipality to consider it as "the path of least resistance." It's true that, all things equal, obtaining financing through a private placement involves fewer parties in the transaction and lower fees. However, there is a growing trend of unintended consequences for both issuers and community banks for private placement transactions that needs to be considered.

Private placements can be tricky for community banks. On one hand, community bankers want to support their local communities; however, bidding on them is challenging. There are risks for community banks investing in private placements that need to be factored in that include, but are not limited to:

- Illiquidity Profile
  - There is not an active secondary market
- Credit Profile
  - They are typically non-rated and non-insured
- Lack of Call Protection
  - Most come with any-time call options
- Lending Limit Constraints
  - The size of private placements is steadily growing, limiting a bank's ability to purchase the entire deal
- No Continuing Disclosure Requirements
  - Creates difficulty for post-purchase credit monitoring

Community bankers are experts in pricing loans but they don't commonly price securities in the bond market. Loans have far greater credit risks than the public finance sector so it wouldn't be appropriate to use a loan pricing model when bidding on a private placement. According to bank call report data through the second quarter of 2021, the median yield on loans for banks with $500 million or less in assets was 5.26%. Offer anywhere close to that when bidding on a private placement and you might get run out of town! The question is, how much lower should the yield be compared to your average loan portfolio and how much higher should it be compared to a municipal bond of a similar structure?

In an efficient market, yields on a private placement should be higher than those seen in municipal bonds of a similar structure. The illiquidity profile, credit profile, optionality, and lack of disclosure requirements should be key factors in driving the yield higher than their municipal bond counterparts. Finding that balance can be tricky, especially when bidding against your peers. Public finance is also incredibly nuanced, making the bidding process for a private placement even more challenging.

One of the unintended consequences for both issuers and investors of private placements is the lack of continuing disclosure

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requirements. As mentioned, one benefit to the municipality is there is no burden to produce financials or file material event disclosures in the future. However, this can be mistaken by municipal officials to mean that they no longer need to file disclosures when they have outstanding bonds.

In 2019, the SEC amended Rule 15c2-12 to require municipal bond issuers to file disclosures pertaining to the incurrence of a financial obligation. Meaning, if a municipality chooses to issue a private placement, it must file a material event disclosure to the MSRB if it has outstanding bonds. A recent study by the Federal Reserve titled "Limits of Disclosure Regulation in the Municipal Bond Market," revealed that only about 20%-46% of private debt was disclosed to the MSRB. This suggests that municipal officials are largely in the dark on what disclosures are needed, putting them at risk of running afoul of the SEC's regulations.

For investors, the lack of continuing disclosures for private placements negatively impacts transparency in the municipal bond market. This takes a huge step back from the improved transparency following the MSRB's creation of the Electronic Municipal Market Access ("EMMA") system in March of 2008. Some municipalities in certain parts of the country have outright abandoned issuing traditional municipal bonds and have only used private placements for their financing needs. As a result, they no longer report any financial transparency to the market and could be missing out on better yield execution for their capital needs.

More than ever before, municipal officials need the support of their local community banks for their financial needs. This relationship can be mutually beneficial to banks looking to enhance their public funds depository relationships as well as expand into areas for more lending opportunities. Far too many municipalities are being underserved by not being shown a cost/benefit analysis of their financing options. In certain cases, it makes sense to obtain financing through a private placement but there are risks that must be discussed. In other cases, it would be more beneficial to go in the direction of a traditional municipal bond, obtain funds through state and/or federal aid, or seek out state revolving fund options. The Baker Group can help community banks and their local municipal officials navigate through these decisions as a trusted financial resource to their community.

For more information on how you can help your local community, please contact:

**Scott Fletcher**
**Director of Public Finance**
**The Baker Group LP**
**866.214.1153**

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