

Client Alert

Current Issues Relevant to Our Clients

November 4, 2013

GFOA Releases Best Practices for Bank Loans

The Government Finance Officers Association (GFOA) recently published a statement of best practices for the use of bank loans (broadly defined as fixed-rate loans with defined maturities and variable rate loans or lines of credit with flexible payment provisions) by state and local governments. The paper recommends that governments adopt written policies and procedures for bank loans, engage outside financial and legal counsel to help them structure, solicit and execute those loans, and, where appropriate, undertake voluntary disclosure of bank loans to apprise investors and other interested parties of their financing activities.

Given the GFOA's wide following among government finance professionals, lenders providing loans to governmental entities should be familiar with these recommendations. Careful attention to the issues governments face when undertaking bank loans will help lenders provide thoughtful solutions to their customers.

Why Did the GFOA Release This Paper Now?

Governmental issuers have significantly increased their use of direct bank loans since the financial crisis of 2008/2009. Attractive terms for bank loans coupled with undesirable conditions for variable rate issuances in the public bond market have led governmental borrowers to the bank loan market. Although direct bank lending to governments is nothing new from an historical perspective, the increased volume and often highly structured nature of today's bank loans have resulted in considerable attention from market participants, rating agencies and regulators. Many governments that rarely or never used bank loans in the past are now being advised to consider them as an important financing tool.

What Should Lenders Know About the Paper?

First, it recommends that governments that use or may use bank loans develop specific policies and procedures for undertaking them. These policies will necessarily be informed by a variety of considerations, including an issuer's debt structure, legal authority and accounting characterization, that govern an issuer's financing options. In addition to learning the legal framework to which a borrower's financing activities are subject, lenders should inquire about any formal policies and/or procedures adopted by their customers. That information will help banks provide proposals that most closely align with the needs of their customers.

Second, the paper recommends that a government consult with its financial advisor and legal counsel prior to and throughout the negotiation of a bank loan. Engaging legal counsel in connection with proposing bank loans is sound advice for lenders as well. We frequently see lengthy and detailed term sheet negotiations relating to bank loans (owing in significant part to the dynamic nature of the product — it can be structured in many different ways to meet the requirements of the borrower and the lender alike), and lenders should expect that to continue. Although it can be disappointing for a lender to invest resources in negotiating a transaction that may not materialize, the certainty that results from a precise term sheet benefits both parties and leads to a smooth transaction. Lenders should also consider including appropriate disclosures and disclaimers in term sheets to address issues arising under the SEC's recent municipal advisor rulemaking.

Finally, the paper recommends that governments voluntarily disclose information about their bank loans, if the loans are material to bondholders. Although governmental borrowers and their lenders generally welcome transparency in that regard, such disclosure presents issues for both parties. As the paper points out, governments are not currently required to disclose bank loans, but any voluntary disclosure could be subject to materiality and timeliness standards imposed on disclosures under federal securities law, including SEC Rule 15c2-12, and raise other legal and practical considerations.

The GFOA paper mentions two ways in which bank loans may be disclosed by a government: (i) through disclosure of the financing documents in their entirety, and (ii) in summary form. The former approach may create concerns for borrowers and lenders in that it allows other parties full access to the pricing and terms to which the borrower and lender agreed. The latter approach may raise concerns over whether the summary discloses enough details to provide complete and accurate information about the bank loan to rating agencies, bondholders and other interested parties, and may add to the cost of such disclosure as well.

To address these concerns, governments and lenders may wish to disclose redacted versions of the financing documents in their entirety, omitting commercially sensitive information that is not considered material. This approach may disclose more of the structure and terms of a bank loan than the issuer and lender might otherwise prefer, but it would still protect the most sensitive provisions (pricing) while providing a high level of transparency to interested parties.

In any event, lenders should have a policy regarding disclosure of their loans by governments and detail the same in their term sheets. Agreeing on a course of action in advance will avoid the need to resolve any differences between the lender's policy and the issuer's policy at or after closing. Lenders would also be well served to understand the reasons their customers may want or need to disclose the terms of bank loans, and the issues they face in making such disclosure. We encourage lenders to discuss the topic of disclosure with their customers in connection with structuring a bank loan transaction.

For More Information

To discuss any topic covered in this alert, please contact a member of our Credit Enhancement Group or visit us online at Chapman.com.

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