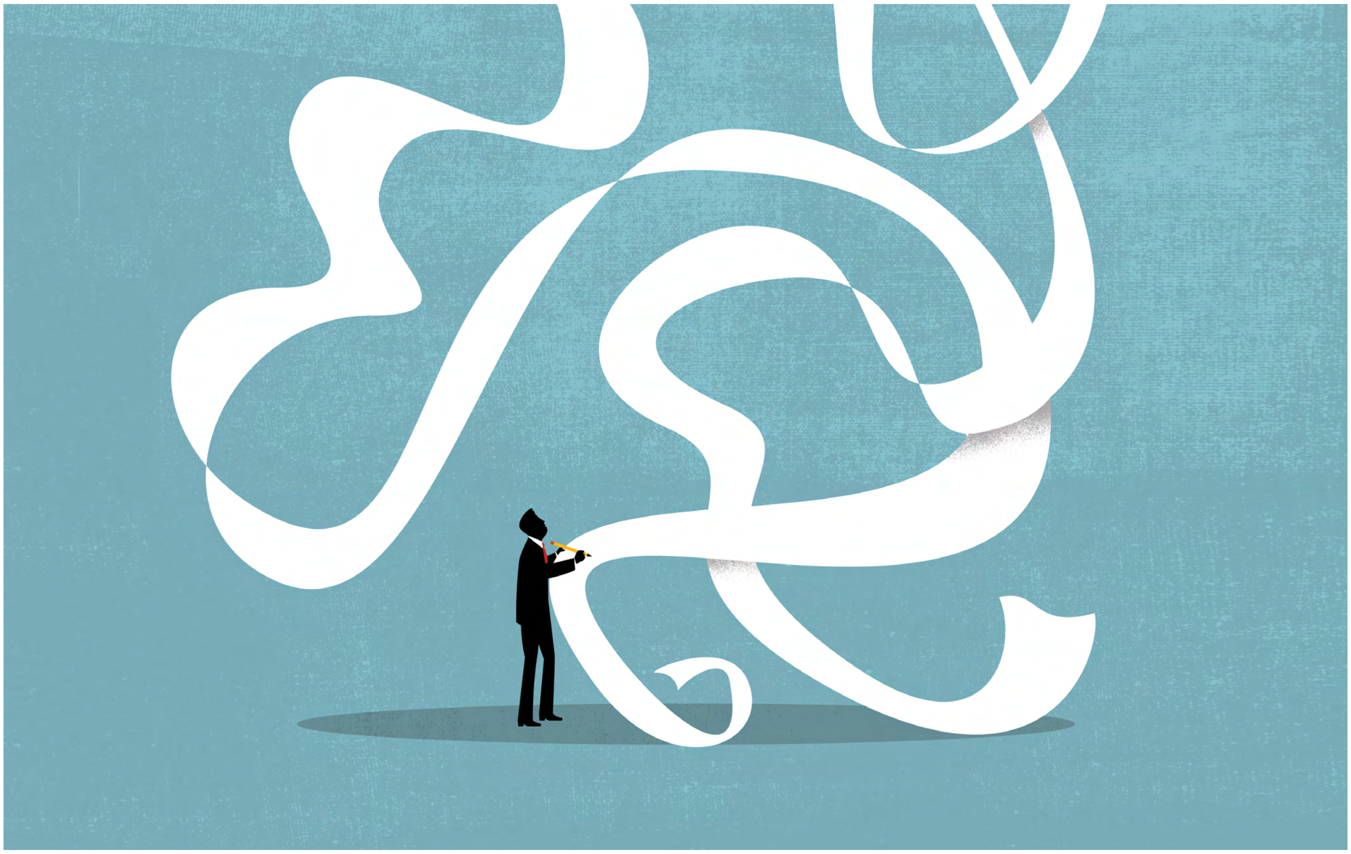

PERSPECTIVE

Obliging the Issuers

BY JUSTIN MARLOWE

At a glance, U.S. Steel Corporation, Penn Hills Charter School of Entrepreneurship, and the Little Sisters of the Poor don't have much in common. One is the second-largest steel company in the United States. One is a charter school with a curriculum that brings business and economics to life for K-8 students. The other is a group of nuns who run nursing homes. Their missions don't seem to overlap. And yet, all three have upgraded their buildings and equipment with low-cost financing made available through the Allegheny County, Pennsylvania, Industrial Development Authority (IDA). In other words, taxpayers in greater Pittsburgh have supported all three, directly or indirectly.

IDA acts as a "conduit." It borrows money and then lends that money to for-profit companies, healthcare organizations, cultural institutions, and other entities that contribute to the region's economic development. The benefiting entity then repays the IDA, who then repays the bonds. A properly executed conduit transaction is a win-win. An economic development project with tangible public benefits that might not otherwise pencil out is made possible through access to affordable, often tax-exempt financing.

That's why it's concerning, but not entirely surprising, that conduit financings have once again drawn the attention of regulators and the ratings agencies. This fresh round of scrutiny is both a challenge and an opportunity for state and local finance professionals.

Conduit bonds are part of a broader economic development toolkit made possible by the municipal bond market. That toolkit includes lease revenue bonds, "63-20" bonds, private activity bonds, and certain types of municipal securitizations, among many others. These tools all follow from the same basic strategy where a state or local government borrows money on behalf of a third party "obligor." Core to this approach is that the borrowing government is not a "real party in interest." In other words, investors who buy the conduit bonds are repaid only if the obligor makes its payments. This ensures that the financing doesn't directly affect the borrowing government's balance sheet.

Conduit financings have a long and colorful history. Throughout the early 1980s small municipalities flooded the municipal market with hundreds of millions of dollars of industrial revenue bonds (IRB)—a conduit financing on behalf of a for-profit entity. Congress's desire to curb such abuse of IRBs helped set in motion a much broader set of municipal market reforms eventually codified in the Tax Reform Act of 1986. Conduit financings more generally have been closely watched since.

Which brings us to the most recent wave of scrutiny. In February 2023, S&P Global Ratings made the startling announcement that it had slashed the general obligation credit rating for the Village of Bolingbrook, Illinois, from AA to BBB-. That massive downgrade followed Bolingbrook's failure to make a series of payments on sales tax-backed conduit bonds. Those bonds were issued in 2005 to support a retail development now anchored by a Bass Pro Shop. Like many retail centers around the country, this development's sales tax collections remain well below their pre-Covid levels. In turn, Bolingbrook has not made regular debt service payments. S&P called that delinquency a failure of Bolingbrook's management. Bolingbrook believes, consistent with the conduit agreement, that it is obligated to pay only if the sales tax revenues are available. At the moment, S&P is alone in its view that conduit bonds are a "moral obligation" of the issuing government. Nonetheless, some conduit bond-issuing states and localities around the country have called the Bolingbrook downgrade a proverbial shot-across-the-bow.

A few weeks later the Securities and Exchange Commission (SEC) shined its own spotlight, perhaps inadvertently, on conduit financings. For the past several years, the SEC has been developing new regulations designed to curtail nefarious behavior in the asset-backed securities (ABS) market. ABS are securities backed by the revenues generated by a pool of assets like mortgages, car loans, or credit cards. In the post-mortem of the 2008 financial crisis, we learned that in the run-up to that crisis, investment banks would design an ABS for corporations and other clients, but then simultaneously bet against them with short sales and credit default swaps. The SEC has been intent on preventing similar conflicts of interest in the future.

That effort culminated in late February 2023 with the SEC's proposed Rule 192. It would require bankers, traders, and other parties to ABS transactions to, in effect, document that they have not bet against those same transactions.

State and local governments have little reason to care about Rule 192. They don't issue the types of ABS in question, and they most certainly don't bet against them. However, Rule 192 adopts a broad definition of ABS that includes, oddly enough, most municipal conduit financings. Conduit financings require that the obligor's payments go directly from the issuing government to the bond holders. In other words, they are "securitized" in a way that counts as an ABS. According to the SEC's own analysis, this definition of ABS includes about $100 billion of active municipal conduit bonds.

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Rule 192's effect could be negligible. Underwriters and municipal advisors who participate in conduit financings might set up some additional compliance procedures and carry on. The SEC might also decide to carve out municipal conduit financings altogether. But one can also imagine a more drastic scenario where Rule 192 compliance costs cause some conduit-backed economic development projects to no longer pencil out. The potential challenges are clear.

But so are the opportunities. Now is the time for states and localities to revisit their objectives, policies, and procedures on conduit financings. Does your jurisdiction have a clear statement on which types of projects or obligors are good candidates for conduit financings? Are elected officials and board members aware of the potential "moral obligation" and attendant credit risk that accompanies conduit financings? If your jurisdiction has participated in conduit financings, do you routinely monitor the financial strength of your private and nonprofit obligors? Careful consideration of these questions will help to ensure that conduit bonds are best used to their full effect.

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