TAX-EXEMPT LENDING FOR COMMUNITY BANKS

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Government entities and nonprofit 501(c)(3) organizations are among the most active borrowers in the tax-exempt bond markets.

Historically, banks and other financial institutions have been involved in lending to tax-exempt entities in several ways. One of which is by providing a letter of credit to support variable rate demand obligations, or "VRDOs," issued by or for the benefit of nonprofit borrowers and governmental entities, such as counties, cities, school districts, townships or boroughs, and sold in the capital markets by underwriters who initially purchase the obligations. In the case of nonprofit organizations that do not have the legal ability to directly issue tax-exempt debt, the obligations must be issued through a conduit authority having the power under Pennsylvania law to issue tax exempt bonds or notes for the benefit of the intended ultimate user of the VRDO proceeds, i.e. the "borrower." Such issuers may include general municipal authorities, "special purpose" municipal authorities such as a hospital or water and sewer authority, industrial development authorities, redevelopment authorities, or one of the various state level issuers, such as the Pennsylvania Economic Development Authority or the Pennsylvania Higher Educational Facilities Authority.

VRDOs represent a type of variable rate bond that is structured to provide the benefit of allowing governmental or nonprofit organizations to borrow money on a long term basis, but at short-term interest rates. Such obligations typically have the following features: (i) the interest rate is reset by an independent "remarketing agent" on a periodic basis, usually daily, weekly or monthly; (ii) the holders of the obligations have the right to "put" or require the issuer/obligor to repurchase the bonds at the holder's option ("optional tender"), thus allowing the holders to readily cash-out of their investment; (iii) the obligations are subject to a required purchase and sale ("mandatory tender") upon the happening of certain specified events, such as the replacement of a supporting letter of credit, the expiration of the letter of credit without provision of an alternate letter of credit or at the direction of the letter of credit bank following a default by the obligor under the governing letter of credit documents; and (iv) upon an optional tender or mandatory tender, the remarketing agent attempts to remarket and find new buyers of the bonds.

To make all of this work, a bank or other financial institution issues a letter of credit in favor of the trustee or paying agent for the VRDOs. The letter of credit provides that the trustee or paying agent may draw upon the letter to make payments of principal and interest on the bonds when due and to provide a source of payment of the purchase price of VRDOs that are subject to optional or mandatory tender and which the remarketing agent has been unable to remarket and sell for any reason. All draws under the letter of credit must be repaid by the borrower to the issuing bank, with interest at a bank-designated interest rate. These arrangements have the effect of providing credit enhancement for the VRDOs by substituting the credit and credit rating of the letter of credit bank for the credit and credit rating of the governmental or nonprofit conduit borrower. This structure also provides bankruptcy preference protection to payments of the purchase price of tendered bonds to the extent that such purchase price payments are drawn on the letter of credit and not the borrower's own funds. A bank or other financial institution issuing a supporting letter of credit is effectively extending a credit facility to the borrower, which would by documented between the letter of credit bank and the borrower by a reimbursement or letter of credit agreement and secured by mortgages, personalty or other collateral in the same manner as any other loan.

For a community bank to provide such credit enhancement, however, the bank needs to have debt that is rated in the capital markets by one of the nationally recognized rating agencies like Standard & Poor's Ratings Services, Moody's Investors Service or Fitch Ratings. Otherwise the function of substituting credit ratings for the VRDOs does not work. In the past, in order to work around this problem, smaller banks could accommodate their customers by structuring a transaction whereby (i) a financial institution with the requisite rating would issue a fronting letter of credit to the VRDO trustee or paying agent and (ii) the community bank would issue a backing letter of credit to, or otherwise enter into a reimbursement agreement with, the fronting letter of credit bank providing for the payment by the "backing" bank of all draws on the fronting letter of credit. The "credit" extended by the backing bank to its governmental or nonprofit customer would be documented and collateralized as a loan transaction.

Such arrangements worked fairly well while letter of credit commitment fee rates were relatively low and until the credit market turmoil that occurred in 2007, 2008 and into 2009. During this period, the availability of letters of credit essentially disappeared as many letter of credit banks experienced significant draws on their credit facilities as investors exited the VRDO market *en masse*. This resulted in letter of credit banks holding a substantial exposure to "bank bonds" which they now owned as a result of letter of credit draws to fund the purchase price of optional tenders and for which there existed no demand for a remarketing and sale. This liquidity issue no longer exists for the most part, but the fallout from the turmoil is that the bank pricing for letters of credit has significantly increased to the point where it is difficult for a VRDO transaction to economically justify the dual level of fees involved in the use of two letters of credit. This is particularly true given the current historically low fixed interest rates, and the fact that many issuers or conduit borrowers are choosing to utilize fixed rate tax-exempt debt in order to take advantage of the low rates and to avoid the uncertainties and pitfalls of letter of credit backed VRDOs.

Another potential method of participating in tax-exempt lending by community banks is through the provision by the bank of a "liquidity facility" for VRDOs in the form of a standby bond purchase agreement delivered to the bond trustee or paying agent for the benefit of the VRDO issuer or conduit borrower. This is an agreement whereby the delivering bank agrees that it will purchase VRDOs that are the subject of an optional tender by bondholders or a mandatory tender under the bond documents in the event the tendered bonds cannot be sold by the remarketing agent. The bank becomes the owner of the tendered bonds, which then typically bear interest at a much higher "bank rate" and are subject to accelerated amortization and repayment if the bonds remains "Bank Bonds" for a specified period of time. Unlike a letter of credit, a standby bond purchase agreement is limited solely to the purchase of bonds, and does not support scheduled payments of principal and interest. However, similar to the letter of credit structure, the delivering bank must have an adequate recognized credit rating in order for the standby bond purchase agreement to meaningfully support and add credit enhancement to the VRDO issue.

The good news is that even if a bank or other financial institution does not have a formal or adequate credit rating by S&P, Moody's or Fitch, it can still take advantage of tax-exempt lending opportunities by making direct tax-exempt loans to government entities or 501(c)(3) nonprofit organizations. These kinds of loans are sometimes referred to as "bank-qualified" or "BQ" loans. Unfortunately, but perhaps not surprisingly, the tax law and IRS rules and regulations governing bank-qualified loans are complex and can be difficult to understand for financial institutions that do not regularly engage in such lending.

There are two levels of analysis involved in looking at a potential bank-qualified loan. The first is whether the loan can qualify for tax-exempt treatment at all. Not every loan to a government body or a nonprofit organization is or can be tax exempt. The use of bond/loan proceeds and the project to be financed must all fit within one of the qualifying categories and set of rules for tax-exempt debt under the Internal Revenue Code and accompanying IRS regulations. The second level of analysis is whether the loan, even if tax-exempt, can be bank-qualified.

What does it mean for tax-exempt obligations to be bank qualified? Under the Internal Revenue Code, financial institutions that acquire tax-exempt bonds or notes are subject to loss of a corresponding deduction for its interest carry expense unless the subject bonds or notes are designated as “qualified tax-exempt obligations” under Section 265(b)(2)(B) of the Code. If so designated and qualified, a financial institution is subject to only a 20% loss of its allocated interest deduction, the so-called “TEFRA penalty.” An issuer can only designate a bond or note as a “qualified tax-exempt obligation” if (i) the bond or note is not a “private activity bond” other than a qualified 501(c)(3) bond (for example, a small issue manufacturing bond), (ii) the issuer reasonably anticipates that it will not issue more than $10 million in tax-exempt bonds (other than non 501(c)(3) private activity bonds) in the calendar year in which the bond or note was issued and (iii) the issuer did not designate more than $10 million of bonds or notes as qualified tax-exempt obligations in that calendar year. Certain special rules apply for purposes of aggregating related issuers, dealing with composite issues (i.e. issues for more than one purpose, such as a partial refunding and partial new money issue) and allowing a “deemed designation” of certain qualifying bonds used to refund other outstanding bank-qualified debt.

Those financial institutions who are active in bank-qualified lending will remember that the American Recovery and Reinvestment Act of 2009 (ARRA) had significantly expanded these bank-qualified limitations for obligations issued in calendar year 2009 and 2010 by (i) increasing the ceiling on the $10 million limits described above to $30 million and (ii) allowing the conduit 501(c)(3) borrower or governmental entity (if different from the actual issuer) to be treated as the “issuer” for purposes of the bank-qualified rules so that the expanded $30 million limits could be measured “by borrower” and not “by issuer.” ARRA also created a safe harbor basket of tax-exempt bonds or notes that could held by financial institutions in an amount up to 2% of their assets having the same tax effect as designated bank-qualified bonds. These changes greatly increased the capacity of a single issuer to issue, and ability of financial institutions to acquire and fund, bank-qualified tax-exempt obligations. Regrettably, Congress failed to include in the year-end tax bill that was signed by President Obama on December 17, 2010 an extension of these special bank-qualified rules, including the 2% safe harbor, beyond December 31, 2010. Consequently, tax-exempt obligations that are issued after that date are once again subject to pre-ARRA rules and limitations.

Community banks that desire to engage in tax-exempt lending to government entities and nonprofit organizations can explore the alternatives described above. While this is a highly technical area, the demand and credit quality that many of these kinds of borrowers present are often very attractive. This is particularly true of government borrowers whose obligations are backed by its full faith, credit and taxing power pursuant to a borrowing under the Pennsylvania Local Government Unit Debt Act.