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Line of Credit Borrowing

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The Department of Finance soon will submit to the Council a proposal for the County to procure lines of credit to potentially access funds during the upcoming decline in revenues resulting from the Covid-19 health crisis. The County has never previously procured lines of credit. This memo provides information about line of credit. The Department of Finance will provide Council with details about the County's line of credit proposal in a separate submission expected in the next week or two.

1. What is a line of credit?

A line of credit is a type of bank loan[1] that allows incremental borrowing up to a set dollar amount extended over a specified period of time. At the outset, the bank and the borrower agree on the maximum loan amount that will be available under the line of credit. In the case of a public sector borrower, the government provides a note to the bank that is backed by the full faith and credit of the jurisdiction.

The borrower may draw funds from the line of credit up to the maximum loan amount. Lines of credit typically have a specified duration (term), such as one, two, or five years. The borrower pays a service fee to the bank to secure access to the specified funds throughout the term of the line of credit loan. During the term of the loan, the borrower may repay some or all of the borrowed funds and then redraw funds again up to the maximum amount. A line of credit bank loan may carry a fixed or variable interest rate. The borrower pays interest on the loan balance (that is, the amount actually borrowed) during the term of the loan and must repay the entire outstanding balance at the end of the term.

A government may use line of credit funds for operating or capital expenditures. The County's Finance Department intends to use the lines of credit to maintain cash flow as necessary to meet operating expense obligations in the wake of the COVID-19 revenue downturn. Finance has characterized the line of credit as "insurance" against a severe and long-term recession.

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[1] Bank loans taken by a public sector entity are also referred to as "direct placements."

2. How does a line of credit compare to other forms of County borrowing?

Public sector entities, including Montgomery County, borrow funds in a variety of ways. Generally, County borrowing is intended to help finance capital projects or equipment acquisition. Common forms of County borrowing include:

General Obligation (GO) Bonds: GO bonds are secured by the full faith and credit and taxing power of the County. Bonds are issued in serial maturities of one to 20 years, normally with five percent of the principal retired each year.

Revenue Bonds: Revenue bonds finance revenue producing projects such as parking garages and solid waste facilities. Bonds are repaid from revenues generated from these projects.

Bond Anticipation Notes (BAN)/Commercial Paper: BAN/commercial paper are a type of short-term borrowing with the expectation that the principal will be repaid with the proceeds of long-term general obligation bonds.

The County also employs other forms of borrowing including capital leases for construction or acquisition of certain facilities as well as certificates of participation, master leases, and short-term leases for equipment acquisition.

Lines of credit differ from more traditional forms of County borrowing in several respects.

a. Use of funds: The County has taken on debt almost exclusively to finance capital projects or to acquire durable equipment. A line of credit would provide cash to meet operating expenses or to pay debt service on past borrowing.

b. Term: County GO and revenue bonds typically have a term of 20 or more years. Equipment leases often have terms that extend seven years. Lines of credit may have much shorter terms. A recent Brookings Institution study found that state and local government lines of credit most commonly extend for two to three years.[2] (See next question for information a possible legal constraint regarding County line of credit borrowing.)

c. Payback Schedule: For most forms of borrowing, the County receives funds at the outset and then subsequently repays the debt in fixed installments over a specified term. In contrast, with a line of credit, the County would pay interest on the loan balance while the line is open and also could repay borrowed funds any time during the loan term.

d. Borrowing Cost: Short-term bank loans (including lines of credit) and long-term bond issuances are distinct debt markets with differing borrowing cost considerations. As noted by the Government Finance Officers Association (GFOA), "because bank loans are typically not executed in an environment that is as transparent as the bond market, an issuer may have limited ability to assess whether the proposed interest rate(s), fees and

[2] Ivanov, Ivan T, and Zimmermann, Tom, *The "Privitization" of Municipal Debt*, Brookings Institution Hutchins Center on Fiscal and Monetary Policy, September 2018, https://www.brookings.edu/wp-content/uploads/2018/08/WP45.pdf

terms are competitive with a publicly offered bond issue and typically are of shorter duration." [3]

3. Are there any legal restrictions on the County's use of lines of credit?

The County Charter authorizes the County to incur debt. However, the Charter limits the use of debt to fund operating expenses:

> *No indebtedness for a term of more than one year shall be incurred by the County to meet current operating expenses.*[4]

According to a 1991 County Attorney opinion, operating expenses mentioned in the Charter are "generally understood to mean the normal cost of maintaining and operating County programs. Operating expenses usually involve the costs associated with physical maintenance, administration, salaries, claims, insurance, and rentals."[5] As such, if the County were to use a line of credit to fund operating expenses, then any dollars borrowed from the line of credit would have to be repaid within 12 months.

4. Is borrowing through lines of credit an advisable practice for local governments?

While taking on debt to pay government operating expenses is not sound fiscal policy during normal swings in the economic cycle, this practice is more justified when used to provide a fiscal buffer in times of severe and unanticipated revenue drop and cash flow challenges.

The Brookings Institute found that state and local governments are more likely to borrow from banks during periods of "transitory shock," that is, an episode of falling revenues and sudden, unanticipated costs. The Brookings study did not envision a pandemic, but instead discussed the effects of prolonged, severe winter weather.

> *To the extent that businesses in the municipality lose revenues because of unexpected adverse winter weather, the municipality will collect less in tax revenues, leading to reductions in total income. Similarly, unexpected adverse winter weather could increase the operating costs of municipal entities through lost employee productivity, further reducing municipal income. We find that counties use credit lines to buffer adverse transitory income shocks. Consistent with the transitory nature of these shocks, outstanding credit line drawn amounts increase following these transitory shocks. Overall, our evidence on both permanent and transitory income shocks suggests that in a scenario of economic*

[3] Government Finance Officers Association, *Bank Loans and Direct Placements,* https://www.gfoa.org/bank-loans-and-direct-placements.
[4] Montgomery County Charter, Section 312.
[5] Memorandum for Marc P. Hansen, Senior Assistant County Attorney to Charles L. Short, Director of Department of Family Resources, October 23, 1991, http://www.amlegal.com/pdffiles/MCMD/10-23-1991.pdf.

stress municipal entities are likely to shift debt structure towards private debt and therefore accelerate the trend higher reliance of public entities on bank loans. [6]

Bank lines of credit are an established form of government borrowing, particularly during times of cash flow challenges spurred by sudden revenue loss and unanticipated demand for emergency services. In fact, lines of credit are one the most common forms of bank lending to states and local governments.[7] The Government Finance Officers Association (GFOA) characterizes bank loans, including lines of credit, as "an important tool in a government's financing toolkit" that may be simpler to execute and incur lower issuance costs than a bond issuance.[8]

The GFOA considers use of lines of credit a "best practice" when a government develops specific policies and procedures to address the legal and financial aspects of using bank loans. GFOA recommends that governments establish these policies after taking into account multiple considerations including legal limitations, accounting and disclosure requirements, government debt capacity, the competitiveness of interest rates, and repayment terms. [9]

5. What are the disclosure requirements for line of credit borrowing?

Public disclosure of bank loans (including lines of credit) is required in government financial statements. State and local governments must report their bank loan capacity, including unused portions of lines of credit, to inform investors about the resources available to meet debt service obligations. A statement by the Government Account Standards Board (GASB) concluded that "financial statement users need information about unused lines of credit …. Disclosure of information related to unused lines of credit … provides users with information about potential sources for principal and interest repayments that could be accessed if cash resources of the indebted government are insufficient."[10] The GASB requirements do not limit disclosures of lines of credit to those used to repay debt, but include all lines of credit that could provide a potential source of liquidity.[11]

In February 2019, amendments to Security Exchange Commission (SEC) Rule 15c2-12 took effect regarding government bond issuances. In many cases, these SEC rule amendments will require state and local governments to disclosure of bank loans. The SEC rule clarifies that, for reporting purposes, government financial obligations include "direct placements, loans, lines of

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[6] Op. cit., Ivanov and Zimmermann.
[7] Ibid.
[8] Op. cit., Government Finance Officers Association, *Bank Loans and Direct Placements.*
[9] Ibid.
[10] Governmental Accounting Standards Board, *Statement No. 88: Certain Disclosures Related to Debt, including Direct Borrowings and Direct Placements*, March 2018, https://www.gasb.org/jsp/GASB/Document_C/DocumentPage?cid=1176170308047&acceptedDisclaimer=truehttps://www.gasb.org/jsp/GASB/Document_C/DocumentPage?cid=1176170308047&acceptedDisclaimer=true
[11] Governmental Accounting Standards Board, *GFOA Member Alert: Implementing GASB 88*, https://www.gfoa.org/gfoa-member-alert-implementing-gasb-88

credit or other credit arrangements with private lenders or commercial banks."[12] In addition, GFOA advises that "many market participants have suggested that providing information about outstanding bank loans is necessary to assess an issuer's outstanding debt obligations and general credit quality." [13]

6. How do bond rating agencies view line of credit borrowing?

As mentioned above, state and local governments must disclose most bank loans in their financial statements. As such, rating agencies will be fully aware of these loans when evaluating the credit worthiness of a jurisdiction. According to the GFOA, "rating agencies treat bank loans akin to a bond issue or other long-term debt." [14] In some cases, rating agencies have cited a jurisdiction's increased reliance on lines of credit as a cause for an increasing debt position which, in turn, was a contributing factor for a ratings downgrade.

On the other hand, the availability of a line of credit could bolster a government's credit worthiness by offering a government an additional source of liquidity. According to a Standard and Poor's public sector ratings guide, the measurement of "liquidity and reserves" includes "all lawfully available cash reserves and external working capital or liquidity sources, including bank lines in force within the life of any short-term obligations."[15] Indeed, in a report on the effect of the Covid-19 crisis on state and local government credit conditions, Standard and Poor's identifies the absence of lines of credit and other sources of liquidity to address short-term cash needs as a risk factor for a ratings downgrade.[16]

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[12] Government Finance Officers Association, *Understanding Your Continuing Disclosure Responsibilities*, https://www.gfoa.org/understanding-your-continuing-disclosure-responsibilities-0.

[13] Op. cit., Government Finance Officers Association, *Bank Loans and Direct Placements.*

[14] Ibid.

[15] S&P Global Ratings, *U.S. Public Finance Ratings Criteria – Tax-Secured and Utilities*, July 2016, page 222, https://www.spratings.com/documents/20184/1282625/USPF+Criteria+Book+-+Oct16+-+Tax/22725e62-301b-4d1f-98e6-11a1436702d0

[16] Padilla, Oscar, and Little, Timothy W., S&P Global Rating, *The COVID-19 Outbreak Weakens U.S. State and Local Government Credit Conditions*, April 2, 2020, https://www.spglobal.com/ratings/en/research/articles/200402-the-covid-19-outbreak-weakens-u-s-state-and-local-government-credit-conditions-11411641