

The Promise and the Pitfalls of Complex Financing Vehicles

A recent editorial cartoon stated: “The solution was simpler than the one delivered by the politicians.” We find this statement appropriate beyond the political world. News stories of complex financing methods perennially return to public attention, frequently disguised as fashionable and attractive vehicles. Subprime mortgages, sale leasebacks, swap agreements, and variable or floating rate debt appear attractive at first glance. Each of these financing instruments truly do have “a time and purpose under heaven.” There are many examples of the questionable use of legitimate financial instruments. In the following few examples, a simpler approach likely would have been a better choice.

One of the many innovations in public finance has been variable rate debt. This financing option enables borrowers to finance long-term assets by borrowing funds priced at the short end of the yield curve. The use of direct pay letters of credit from highly rated commercial banks simplified the credit risk analysis for investors, which increased the attractiveness of this investment vehicle. At first glance, the use of variable rate debt appears to offer a win-win situation for all parties involved.

The capital markets found a way to manage the interest rate movement risk inherent with variable rate transactions by locating parties who had entered into variable rate agreements and were now willing to swap their payments with another party who had fixed payments, and vice versa. Swap agreements enable willing parties to exchange their existing payment schedules for one they find more attractive. A swap is a mutual agreement between a risk taker and someone who is risk averse. Usually a cash payment is made to the risk taker to equalize the transaction. The perception of market conditions by the participants to the transaction determines which party is seen as the risk taker and which is risk averse.

For years, the credit rating agencies recommended that municipal borrowers have no more than 25% of their debt in variable rate instruments, the theory being that exposure beyond this level made it too difficult to manage the interest rate risk associated with variable rate debt. Governments could not raise taxes fast enough if interest rates rose on all their outstanding debt. This was sage advice! Most Catholic institutions with variable rate debt greatly exceeded these recommended limits, often having 100% of their outstanding interest payments subject to market forces. Catholic parishes and schools have far fewer alternatives to raise additional cash, particularly in the short-term, and carry far less reserves compared to the average unit of government.

Some Catholic institutions that entered into variable rate debt agreements attempted to manage the risk of variable interest payments by entering into a swap agreement. Large governmental entities often employ full-time staff exclusively committed to monitoring the many risks inherent in swap agreements. Across America, units of government without such oversight have lost hundreds of millions of dollars because of swap agreements that have gone bad. Even large governmental organizations that were considered to be sophisticated investors have lost tens of millions of dollars on these instruments.

Like their unfortunate governmental counterparts, some of our parishes and schools are discovering the very real and unexpected risks involved with these transactions. Recently, we met with a school that was forced to collapse its swap transaction because the credit rating of the letter of credit provider had been downgraded and a replacement letter of credit could not be obtained. The swap provider’s fee to unwind the swap agreement was about 10% of the face value of the original loan. A high school we have met with is holding its breath because its letter of credit provider might be downgraded. The action may trigger an unanticipated fee in excess of \$1 million to

The Promise and the Pitfalls of Complex Financing Vehicles (Continued from Page 1)

unwind the swap agreement. The salient point in each case is that the schools were making their debt payments in a timely fashion, yet incurred or are in danger of incurring significant, unexpected costs related to the complex financing vehicles they chose.

Does that make variable rate debt or swap agreements bad? No, it merely suggests that the use of complex financing instruments is probably best left to borrowers who have the resources both to closely monitor the many risks and to cover unanticipated losses.

The use of a floating rate debt instrument, in particular, suggests the need for a more in-depth analysis of the proposed financing structure. A floating rate financing should only be considered when the financing model supports a fixed solution at the then-current interest rates. All too often, this instrument is used because the project does not cash flow at a fixed rate. Furthermore, unlike a fixed rate financing, the issuance of floating rate debt necessitates active management on the part of the borrower. The marketing agent's periodic repricing of the debt needs to be monitored to ensure market rate pricing. Someone needs to monitor the credit rating of the letter of credit provider to ensure that minimum standards are being met or a replacement provider can be found. Most Catholic entities are unable to provide this level of management even initially, let alone for the life of the transaction.

A recent proposal appearing within Catholic circles is the concept of selling church assets and then leasing them back from the purchaser. This strategy is presented as a means to release equity in owned assets, the proceeds of which can then be used for repairs and renovations. This is an idea that periodically surfaces in the public finance sector as well, and in most cases is routinely and summarily dismissed. It is an idea that can be appropriate and applicable to the private sector, when business owners essentially elect pay a second time for an asset they already own. Income tax considerations often play a key part in this decision. This might well be a much more difficult "sell" when trying to convince parishioners or school parents to pay a second time for an asset they have already purchased. If the beneficiaries are reluctant to pay for maintenance of assets they already own, they are even less likely to pay for the asset a second time.

At CFC our philosophy is: keep it simple. If a pastor, principal or bishop cannot explain the proposed financing vehicle and describe how it works in a sound bite, it is probably too complex for their situation. This may limit the variety of financing instruments we present to current and prospective clients; however, both they and we will sleep more soundly at night.

Check Out Our New Website!

www.catholicfinance.org

CFC's new website has additional content and more user-friendly navigation for your convenience! We hope this will be the first place you come to when you're looking for help. The detailed case studies featuring both local and national clients will provide insight into what your fellow parishes have gone through. Also, you just may see a picture of your parish featured!

We welcome your feedback and are interested in hearing what content you would like to see added to the website. Email us at info@catholicfinance.org.

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