

Banking & Finance

“SLGing” it out with the US Government

By Keith T. Zimmet, Esq.

Imagine you are in the process of refinancing a large real estate loan, or possibly borrowing new funds to acquire real estate, and at the last minute you are told the cost of your transaction just increased. Not because of the property, your credit, or anything you did. Not because of general increases in interest rates. No, the increase in your cost of refinancing is brought to you by the U.S. Government.

What does the U.S. Government have to do with local real estate developments? A great deal more than you may think.

In California, state and local governmental agencies and joint powers authorities can issue tax-exempt development or revenue bonds. The proceeds from the bonds are then loaned to private entities to assist such private entities in acquiring land and/or constructing new facilities for the benefit of the local community. Because the bonds are tax-exempt, these private entities benefit from lower interest rates.

Over time, however, the projects are sold or are in need of refinancing. With the substantial drop in interest rates in recent years, what may have seemed like a low interest rate when first obtained is today an above-market rate. As a result, those private entities with sufficient equity in their projects (admittedly, a much smaller class than in previous times), may find it necessary or desirable to refinance their debt.

Alternatively, if the owner of the property desires to sell the project, prospective buyers often cannot assume the obligations arising under tax-exempt bonds financing, and therefore a buyer will need to obtain its own financing to pay-off the existing bonds and remove the existing liens on the real property.

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Attempts to refinance or prepay tax-exempt bonds are often complicated by restrictions which include substantial prepayment fees or even periods during which prepayment is prohibited. To facilitate such a sale or refinancing of real property, lenders have created the defeasance process.

Defeasance is the substitution of government securities as collateral for the existing loan.

Under federal legislation, issuers of tax-exempt bonds are restricted from earning arbitrage profits by investing bond proceeds. That is, they cannot earn more on the loan proceeds from the bonds that they are paying in interest on the bonds. To facilitate the need for these special low-yield securities, since 1972 the United States Treasury has been issuing State and Local Government securities (commonly known as “SLGS”). These SLGS are a useful tool in finance because the terms of the securities can be modified exactly to meet the needs of the defeasance escrow. SLGS may only be purchased by states, municipalities, and other local government bodies (though often funded by private borrowers), and are commonly used for deposit in an escrow account in connection with the defeasance of tax-exempt bonds.

The use of SLGS in the defeasance process provides a stable means by which tax-exempt bonds can be refinanced or

paid-off prior to maturity without triggering prepayment fees or violating prepayment prohibitions. But that stability is dependent upon the U.S. Treasury regularly issuing SLGS.

When the U.S. Government approaches its debt limit, the United States Treasury may suspend the issuance of additional debt to delay reaching the limit. The sale of SLGS is often the first to be suspended. From May 6, 2011 through August 2, 2011, the United States Treasury suspended the sale of SLGS because the U.S. Government was very close to reaching its debt limit. In fact, the U.S. Treasury has closed the SLGS window six times since 1996.

During periods when the SLGS window is closed, state and local governments have to bid in the open market for securities to deposit into defeasance escrow accounts. This often results in increased costs for state and local governments, as well as private real estate acquisitions and financings dependent upon the issuance or refunding of tax-exempt bonds.

With state and local governments currently cash strapped and the real estate market operating at anemic levels, the last thing the bond market needs is uncertainty from Washington, D.C.

As we begin 2012, let us hope that the U.S. Government once again is seen as a

stabilizing force in the financial marketplace and not the cause of uncertainty.



Keith T. Zimmet, Esq., Managing Shareholder of Lewitt Hackman, Chairs the Firm's Commercial Finance Practice Group, and is a member

of the Firm's Corporate Practice Group and Real Estate Practice Group.