Private Activity Bond (Conduit) Financing

There are many parties involved in a Private Activity Bond (PAB) or conduit financing transaction. A list of the main players involved on the financial side of a bond issue is listed below along with a description of their roles.

Borrower
In conduit revenue bond financings, the Issuer issues the bonds not for its own use but to re-lend the bond proceeds to a private party, which actually uses the proceeds, to finance an affordable housing project or a manufacturing project. The borrower can be a for-profit or a non-profit entity. In affordable housing rental project financings, the borrower is often a limited partnership or limited liability company organized solely and only to own and operate the project. Most bond and mortgage guarantors (like FHA) require the project owner to be a "single asset" entity, meaning that the owner owns no projects other than the one being financed and conducts no business other than owning and operating the project being financed. This is generally desirable because it minimizes extraneous bankruptcy risks. In affordable housing projects, typically the developer is the general partner and 1% owner with the remaining 99% equity interest sold to the limited partners. This is particularly true in tax credit financings because the limited partners can utilize the tax credits only if they are legally a part owner of the facility.

Issuer
In a conduit transaction, the governmental issuer is both a borrower and a lender. The governmental issuer borrows money from investors by issuing bonds. (For a transaction to be tax-exempt, the entity borrowing the money must be a state or political subdivision or a legal entity acting as an "instrumentality" or "on behalf of" a state or a political subdivision.) But in a conduit financing, the governmental issuer is also a lender – it uses the money it borrows from bondholders to lend to other borrowers, and then uses the loan repayments received from those borrowers to repay the bondholders. Depending on the type of loan involved, the governmental issuer enters into various financing documents with the borrower, which may include a loan agreement, a promissory note, a mortgage, insurance guarantees or other security.

Financial Advisor
Financial Advisors are more frequently used in competitively sold issues, where investment banking firms compete and bid for the right to sell the bonds, rather than negotiate the purchase with the issuer. But they are sometimes used in negotiated issues, as well. The benefit of independent financial advisors is that they act solely on behalf of the issuer. Although there is and needs to be a relationship of trust between the issuer and the underwriter, they are by the nature of their roles at opposite sides of the table as seller and purchaser, and an F.A. can provide an independent financial analysis of what the underwriter is telling the issuer.

Bond Counsel
Bond counsel is a law firm with “nationally recognized” expertise in municipal bond transactions. Investors will not buy municipal bonds unless there is an opinion of a recognized law firm to the effect that the bonds are validly issued and (in most cases) the interest on the bonds is tax-exempt. Bond counsel also should be experienced with all aspects of structuring a financing and advises the issuer and the underwriter on the legal aspects of the bond issue.

Underwriter or Placement Agent
The underwriter or placement agent is an investment banking firm that helps structure the bond issue and purchases and resells the bond. If a bank or other investor purchases the bonds directly from the issuer, the transaction is called a private placement rather than an underwriting, and there is no public offering of the bonds. If an investment banking firm helps the issuer place the bonds with the purchaser, it is referred to as a private placement agent.

Credit Enhancement Provider
A Credit Enhancement: 1) qualifies the issue as investment-grade by substituting the higher credit rating of the enhancer for the lower credit rating of the project; 2) improves its’ marketability; 3) raises more debt in the bond marketplace; 4) reduces the cost of borrowing; 5) improves the project’s debt term; and 6) mitigates the risk to investors from a project that under performs or fails to pay principal and interest when due.

Credit enhancement may be provided by large national or regional banks with investment-grade credit ratings, government service entities such as Fannie Mae and Freddie Mac or Federal and State entities and in any of the following options: 1) bank direct-pay letter of credit; 2) bank standby letter of credit; 3) Fannie Mae or Freddie Mac credit agreement; 4) bond insurance; 5) Mortgage insurance from HUD/FHA; or 6) Mortgage insurance from a State or local government entity.

Trustee

The trustee's role is to represent and protect the interest of the bondholders and this usually includes holding all funds and other security for the bonds. A Trustee is almost always a commercial bank. The primary agreement signed by the Trustee is the Trust Indenture, but the Trustee may also be a party to other agreements, depending on the nature of the transaction.