Municipal Lease Financing

An Investment Option for Community Bankers

By Lance L. Dominique

What does a municipality do when it needs equipment, but doesn't want to purchase it for cash, rent it, or issue bonds? The municipality utilizes what is called municipal lease/purchase financing.

Municipal lease financing is a form of tax-exempt financing often used by municipalities or other governmental entities that want to finance essential equipment over time. By making installment payments over usually a two- to five-year period, the municipality is able to purchase needed equipment. The types of equipment financed range from garbage trucks to computer systems.

A Municipality's Option

The are several reasons why a municipality utilizes municipal lease financing. Often the cost of the equipment being financed is not large enough to justify the expense of a municipal bond issue. In many cases the useful life of the equipment is not long enough for a 10- or 20-year bond issue. Municipal lease terms take into consideration the useful life of the equipment. This type of financing also allows a municipality to acquire equipment when it is needed. Municipal lease financing can be completed in a fraction of the time a bond issue takes. The municipality is also able to avoid creating debt since municipal lease financings are a line item expense.

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Since municipal lease financing is an expense to the municipality, funds must be appropriated for each year for the financing to continue. If funds are not re-appropriated for the financing, the municipality can terminate the lease. This is a legitimate way in which the municipality can get out of the lease. From an economic standpoint, it doesn't make much sense for the municipality to non-appropriate since the municipality is building equity in the equipment with each payment. Each payment consists of principal and interest. By the end of the term, the municipality owns the equipment outright, the last payment usually being for one dollar.

There is an example of a municipality that had its bond rating lowered one-half grade due to a non-appropriation on theater equipment. This case reinforced the need to structure municipal lease financing when only

Municipal Lease/Purchase Obligations

What kinds of state and local governments use this type of financing?

Lease/purchase financing has been used by almost all types of taxing bodies, including state governments, counties, cities, schools, park forest preserves and other municipal districts throughout the country.

Who are the investors in the financings?

These securities have been sold to bank investment and loan portfolios, trust departments, insurance companies and individual investors.

What kinds of equipment are usually financed?

Equipment most often financed includes computers, fire trucks, photocopiers and telephone interconnect systems. Occasional financings can be arranged for anything from water towers to water meters. In addition, many real estate financings have been handled in this manner.

How are the payment schedules determined?

The municipality and the leasing company select a mutually satisfactory repayment schedule. The municipality has the option of paying monthly, quarterly, semi-annually or annually. The repayment period can be from two to seven years. In most cases, the frequency of payment is monthly and the total life of the obligation is two to five years. Some real estate financings have had 10- to 20-year maturities, but these are rare.

What dollar amount is involved in each purchase?

Lease purchase agreements are written in all sizes from $5,000 into the millions of dollars. The typical transaction is between $10,000 and $250,000. Individual offerings or packages of offerings can be tailored

truly essential equipment is involved. As nice as the arts may be, municipalities do not have to provide a public theater; however, they do need to provide garbage pickup, extinguish fires and process data.

Tax Exempt

As with most types of financings, a tax-exempt investment product is created as a result of municipal lease purchase financing. That investment is the tax-exempt municipal lease purchase obligation, or more accurately, the municipal installment purchase agreement. The latter of the two is more accurate since this is not a true lease but an installment loan.

The municipal lease structure usually carries a high tax-exempt yield and short maturity. This unique investment is purchased by an individual or institutional investors. As mentioned earlier, two to five years is most common. Today, municipal lease purchase obligations are yielding 5.5 to 6.75 percent net tax exempt. Municipal leases are often originated in bank-eligible form. Therefore, they are treated favorably under "TEFRA."

The municipal lease industry volume has grown substantially in popularity with both municipality and investor alike.

Since the municipality is paying back a fixed amount of principal and interest, the investor receives principal and interest during the term. In essence the investor is lending the municipality the money to acquire the equipment and, in return, receives a tax-exempt stream of payments. This money goes to the manufacturer or vendor who has sold the equipment to the municipality, with a portion going to the leasing company who originated or underwrote the financing.

The municipal lease industry volume has grown substantially in popularity with both municipality and investor alike. Annual volume has grown steadily to approximately $7 billion from $1 billion in 1980. Constant demand for services by taxpayers and the static budgets of municipalities and fewer federal government dollars are the main reasons why municipal lease financing will continue to remain a sound form of financing and productive tax-exempt investment for investors. □

to fit the needs of the investor.

How do yields on municipal lease/purchase obligations compare with those available on municipal bonds?

Yield relationships vary over time but the rate of return on municipal leases has tended to average 100 basis points over the 20-year "bond buyer."

Why wouldn't the state or local government issue bonds?

Most equipment purchased does not cost enough or does not have long useful life to justify the expense of issuing municipal bonds. Lease/purchase obligations are written to match the useful life of the equipment. Additionally, the generation of a lease/purchase obligation is much less time consuming than the creation of a bond issue.

What risk does the investor assume?

Nearly always, the terms of a lease/purchase agreement specify that the government unit acquiring the equipment has entered into a multi-year contract. By law, the funds must be appropriated annually since these are expenses, not true debt, like a municipal bond. The investor assumes the risk that the municipal taxing body will be unable or unwilling to raise enough money from all sources at its disposal to appropriate the necessary funds.

What is the annual volume nationally?

Estimates of current volume range around $6 to $7 billion per year. During the 1990s, the combination of rising equipment costs, static municipal budgets and continued citizen demand for services should lead to an increase in the volume of equipment financed in this manner.

How long has this business been in existence?

Banks have been financing equipment for their local communities through installment purchase contracts for more than 100 years. Transactions independently originated did not become significant until about 1969. The growth of the municipal lease/purchase business since 1969 has been very rapid and consistent.

Are these investments liquid?

Really, no. Municipal lease/purchase obligations can be sold to another party by the initial investor, but they are not liquid in the same way municipal bonds or listed stocks are liquid. A best-efforts basis is used to find another investor for a lease/purchase obligation.

If these are not really leases, why are they called lease/purchase obligations?

The early lease/purchase documents were titled "Lease with Option to Renew." These contracts had to be renewed each year and for this reason were called "leases." As previously discussed, current documentation stays in place for the life of the agreement and only the funding is appropriated annually.