The Municipal Financing Puzzle

FGFOA Nature Coast Chapter Meeting

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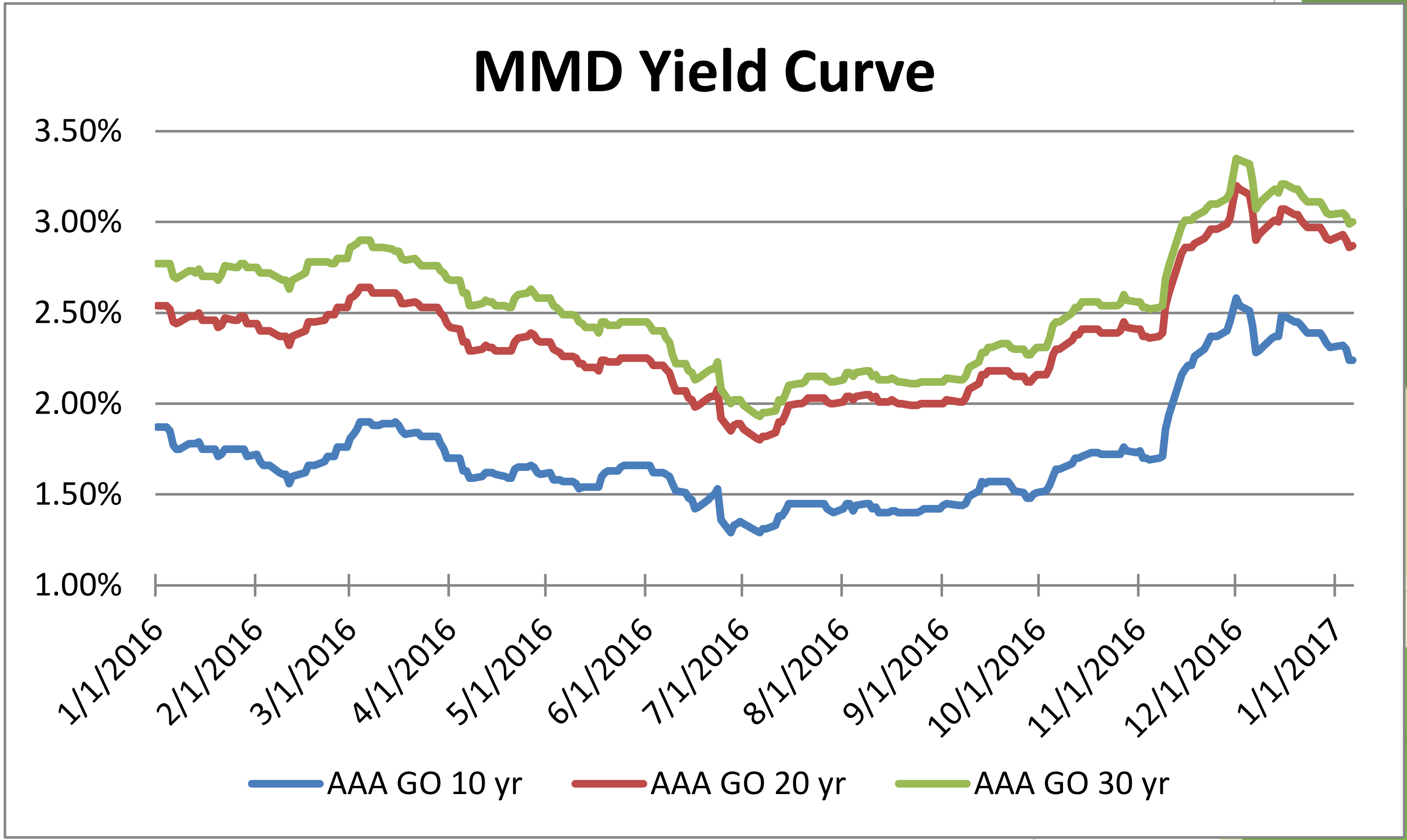
Outline for Today

- Current Municipal Market
- Issuance Process
- Ratings and Other Credit Considerations
- Post Issuance & Arbitrage Rebate Compliance
- Municipal Advisory Regulations

I. Current Municipal Market

Market Rate Movement over the Last Year

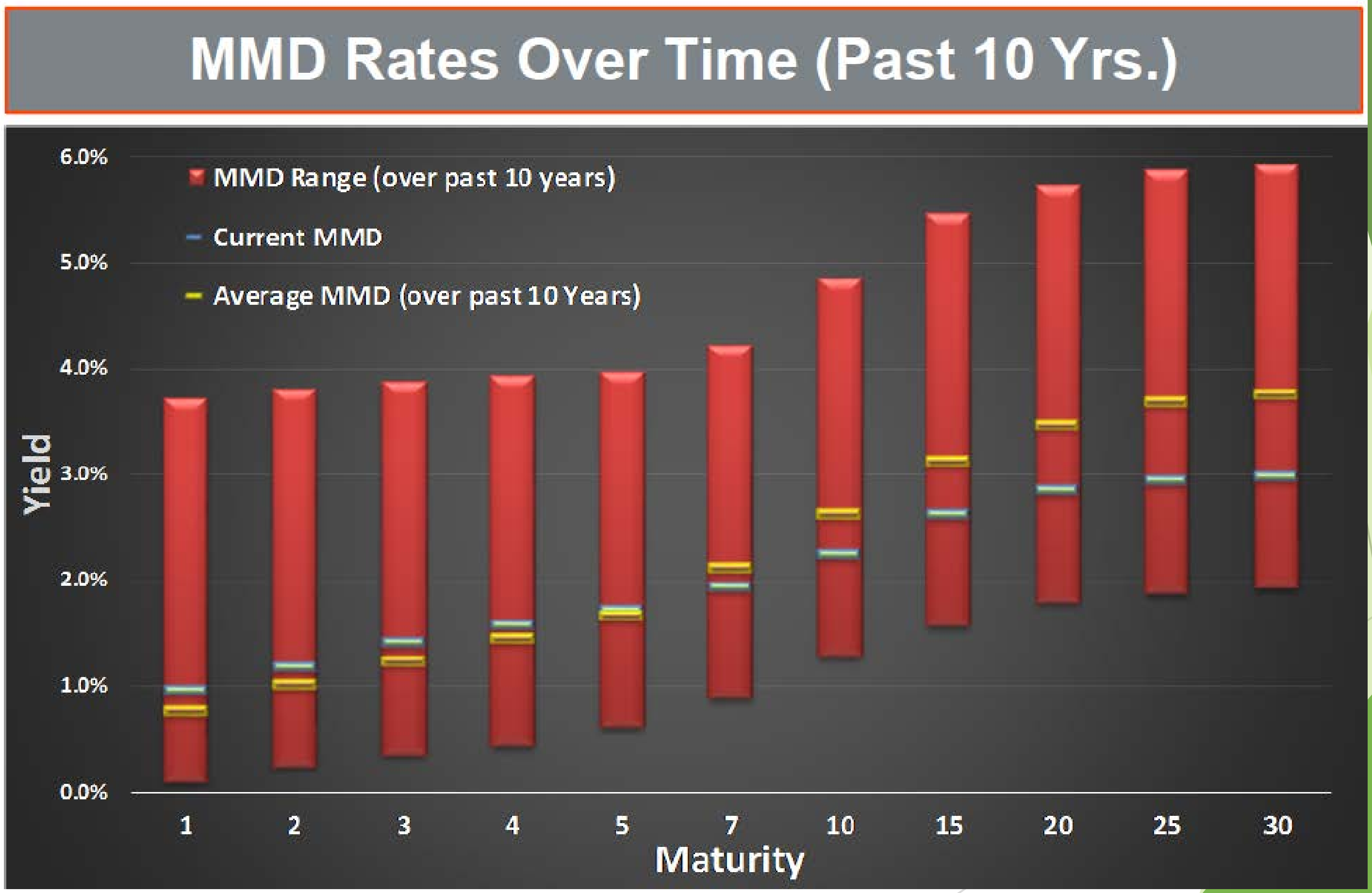
- Interest Rates hit historic lows in mid-2016, but ended the year with a sharp increase after the election



Source: TM3 as of 1/6/2017

Current Municipal Market Rates in Perspective

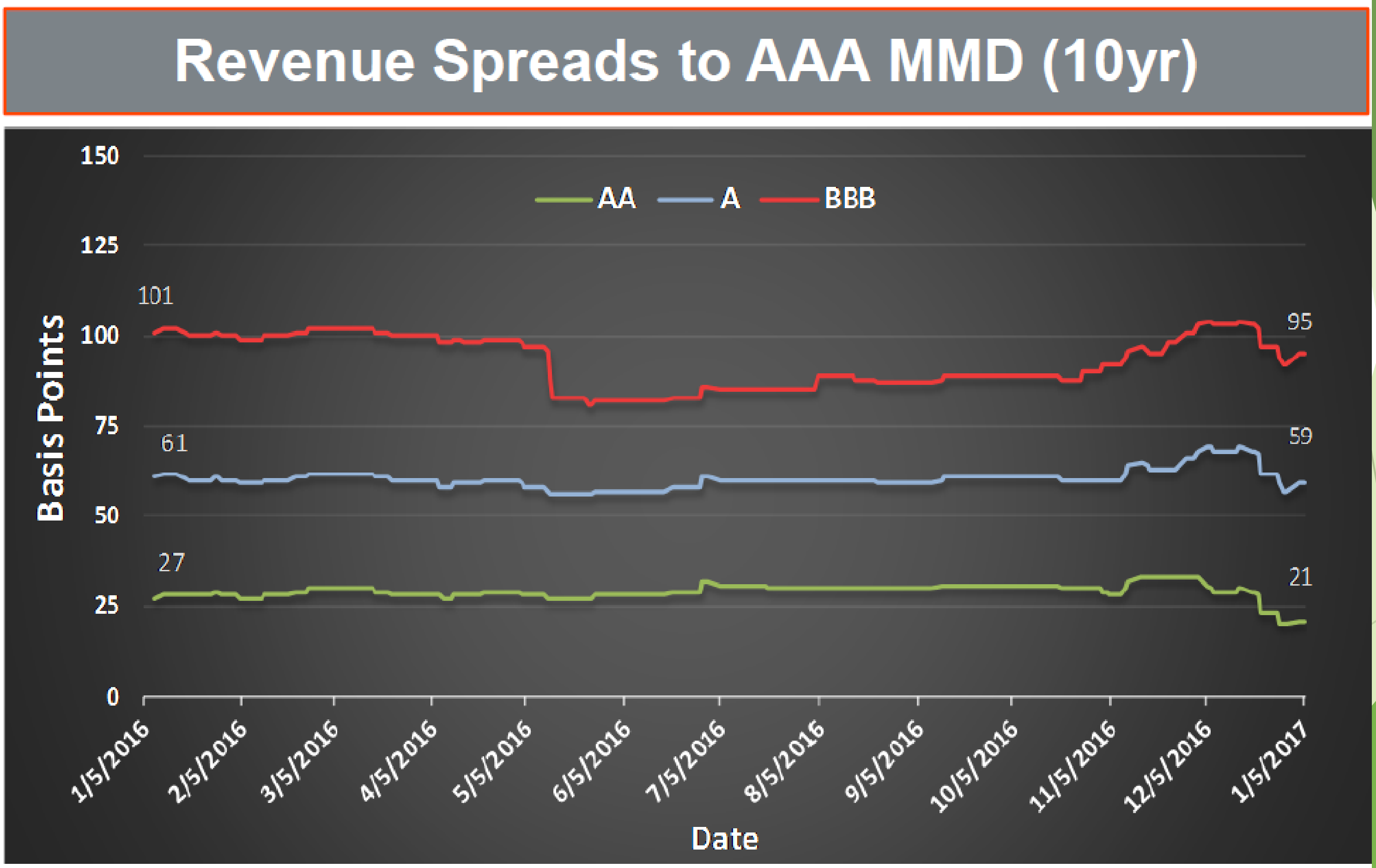
- Short-term rates are slightly above historical average, while long-term rates are still well below average



Source: Thomson Reuters as of 1/6/2017

Credit Spreads

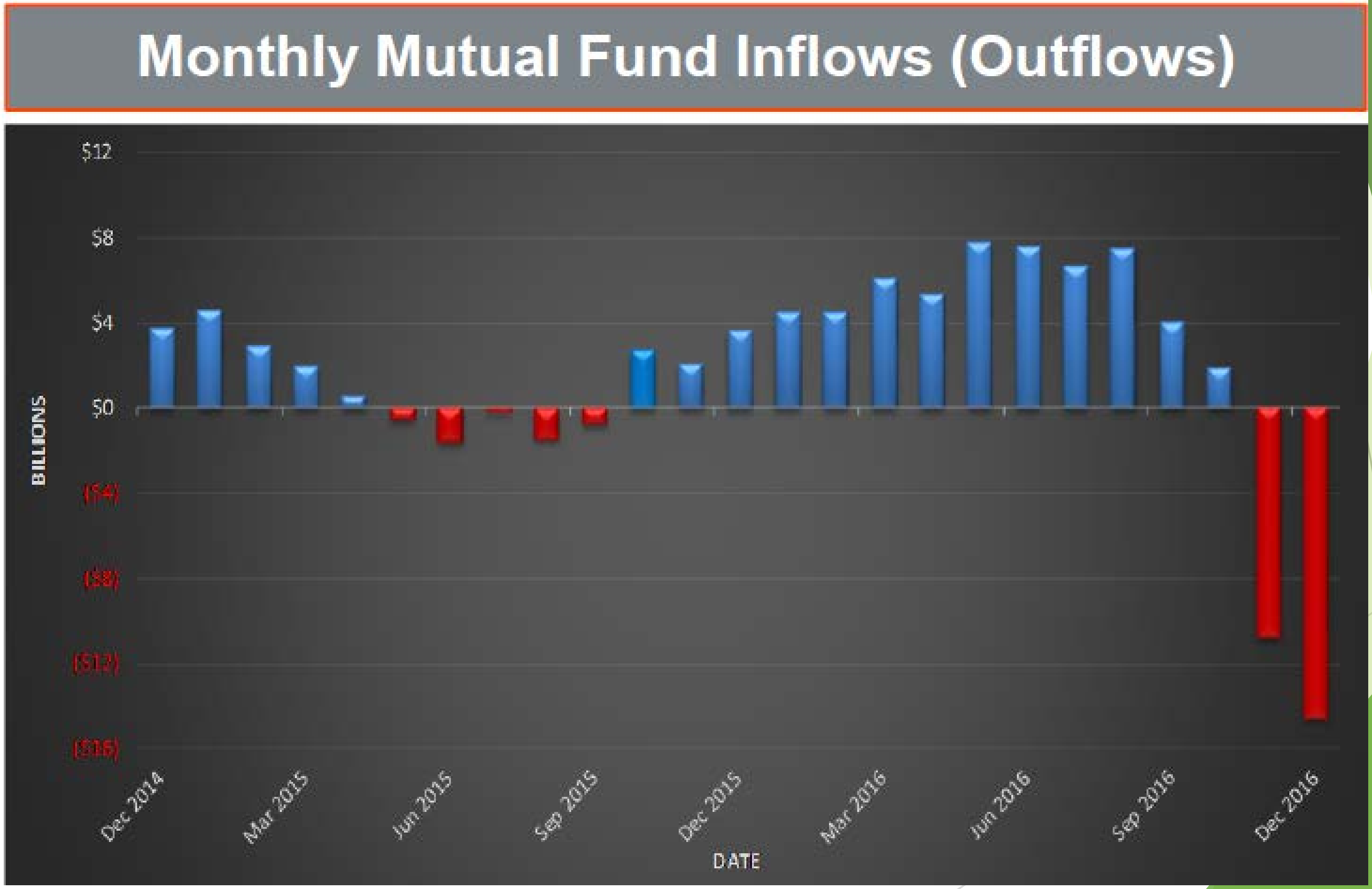
- Credit spreads have slightly narrowed over the past year



Source: Thomson Reuters as of 1/6/17

Municipal Bond Flows over last 2-Years

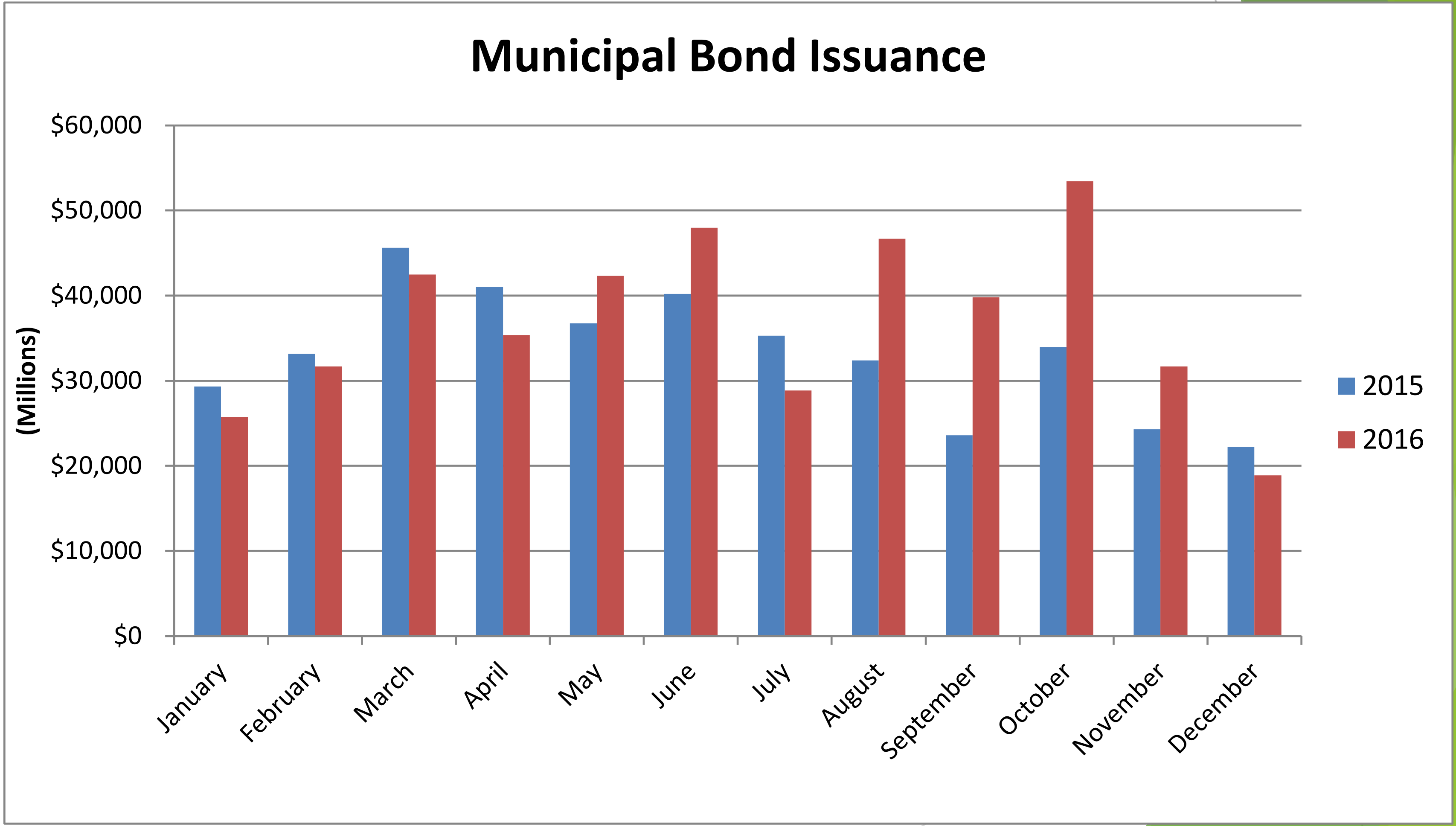
- Strong demand from investors throughout 2016 helped push interest rates to historic lows



Source: Investment Company Institute (ICI)

Municipal Bond Monthly Issuance

- Municipal Bond Issuance increased in 2016



Source: Bond Buyer

Commercial Banks Continue to Play in 2017

- **Role of banks in municipal finance**
  - Traditional role
    - Bank qualified (less than $10 million) and short term financings
  - Current role
    - Larger and Longer term financings
      - Most banks able to go out at least 10 years, 15 to 20 years for few banks
      - Par amounts over $100 million for some institutions
  - Factors to consider
    - All bank proposals are NOT created equal
    - Call provisions vary by Bank
      - Non-callable
      - "Make whole" language is rarely "make whole"
      - Callable anytime (with or without penalty)
    - Terms and conditions
      - Rating downgrade triggers
      - Interest rate adjustment language (Corporate Tax Law or Taxability)
      - Acceleration in the event of a default

Financing Transaction

Debt Issuance Process:

- Project identification
- Assemble the team
- Develop a financing plan
  - Security and debt structure
- Create a timeline
- Obtain board approval
- Issue debt

Project Identification

- Determine what is being financed
  - New Money
  - Refunding
- Evaluate use and purpose
- Useful life of asset

Assemble the Team

Develop a Financing Plan

- Revenue available for debt payments
- Tax Status
- Loan amortization term
- Determine public or private issuance
- Funding deadline(s)

Tax Status

- Tax-Exempt
  - Proceeds used for government purpose
  - Subject to arbitrage rebate compliance
  - Restricted to one advance refunding
- Taxable
  - Proceeds used for private use or function
  - No rebate or refunding restrictions

Term of Transaction

- Project type
- Useful life
- Revenue type
- Policy objectives

Issuance Type

- Public Bonds
  - Long amortization term
  - Unique credit/project circumstances
  - Transfer future tax law changes
- Private Bank Loans
  - Short amortization term
  - Simple structure
  - Known credit
- Other (CP, SRF, etc.)

Summary of Options

Type of Financing	Pros	Cons
Publicly Offered Bond	• Able to reach a broad market of investors • Can issue bonds out to 30-years • Flexible schedule	• Need ratings or credit enhancement • Higher costs of issuance • Greater administrative requirements
Privately Placed Bank Loan	• Does not require ratings or credit enhancement • Lowest rates available if structured to enable banks to receive tax advantage (Bank Qualified rates) • Minimal cost of issuance • Fewer administrative requirements (continuing disclosure)	• Typically longest allowable term is 15-20 years • Interest rate subject to increase if tax laws change
Commercial Paper	• Generally low interest rates (short term) • Flexible repayment schedule • Early prepayment allowed	• Interest rate is variable • Requires letter of credit, which can be costly (credit risk)
State Revolving Fund Loan Program	• Interest rates are usually lower than what is available in public market • The SRF takes care of sale process and arbitrage compliance • Potential for principal forgiveness through legislative appropriation • Typically subordinate pledge of revenues	• Stringent application process • Specific coverage requirements • Term limited to 20 years with level debt service • Loans are disbursed on a cost incurred basis, not upfront (reimbursement) • Limited amount of capacity available

Funding Deadline

- Targeted call date
- Proceeds needed for project
- Current market dynamics
- Interim funding considerations

II. Ratings and Other Credit Considerations

Bond Ratings

- What is a Bond Rating?
  - Measure of risk to bondholders
  - Reflects issuer's ability & willingness to repay debt on time and in full
  - The Rating factors in expected loss and recovery
  - Denotes credit quality by rating level:
    - AAA, AA, A, BBB, etc.
  - Independent opinion (subjective process)
  - Forward looking projection
  - 3 Main Agencies
    - Moody's
    - Standard and Poor's
    - Fitch

Bond Ratings

- A Bond Rating is NOT
  - Audit
  - Recommendation to buy, sell or hold a security
  - Static or permanent
    - Regular Surveillance updates are now common
  - Opinion of community's quality of life or quality of service delivery
  - Performance evaluation of current political leadership

Rating Scale

Highest Rating

Below Investment Grade

S&P	Fitch	Moody’s
AAA	AAA	Aaa
AA+	AA+	Aa1
AA	AA	Aa2
AA-	AA-	Aa3
A+	A+	A1
A	A	A2
A-	A-	A3
BBB+	BBB+	Baa1
BBB	BBB	Baa2
BBB-	BBB-	Baa3
BB	*BB*	*Ba*
B	*B*	*B*
C	*C*	*C*

Changes in Rating Criteria – The Scorecard

- **Changes in Moody's Rating Methodology for Local Government General Obligation Debt**

Factor 1 Economy/Tax Base	Factor 2 Finances	Factor 3 Management	Factor 4 Debt/Pensions
30%	30%	20%	20%
Was 40%	Unchanged	Unchanged	Was 10%

- Rationale for change in weightings:
  - Factor 1 weighting lowered to reduce the influence of tax base size
  - Factor 4 weighting increased to include a specific quantitative measure for pensions

Factors & Sub-Factors	Weights
Factor 1: Economy/Tax Base	**30%**
Full Value (market value of taxable property)	10%
Full Value per Capita	10%
Median Family Income	10%
Factor 2: Finances	**30%**
Fund Balance as % of Operating Revenue	10%
5-Year Dollar Change in Fund Balance as % of Revenues	5%
Cash Balance as % of Revenues	10%
5-Year Dollar Change in Cash Balance as % of Revenues	5%
Factor 3: Management	**20%**
Institutional Framework	10%
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	10%
Factor 4: Debt/Pensions	**20%**
Net Direct Debt / Full Value	5%
Net Direct Debt / Operating Revenue	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues	5%

Source: Moody's Investor Services

Changes in Rating Criteria – The Scorecard

- The local government scorecard is a tool providing a composite score of a local government's credit profile based on the weighted factors Moody's considers most important, universal and measurable, as well as possible notching factors dependent on individual credit strengths and weaknesses

- Designed to enhance transparency by identifying critical factors as a starting point for the rating analysis

- The scorecard is not a calculator and it is not to determine the final rating

- Outside of the indicated factors, Moody's may adjust the grid score for a variety of "below the line" adjustments, which are more characteristic factors that are likely to not apply to all issuers, but can impact credit strength

- The final rating is determined by a committee, which considers, but is not bound by the scorecard

- The scorecard-indicated rating will not match the actual rating in every case

Moody's Rating Scorecard

- The following is a sample scorecard for a Florida County

Sample County - Moody's Rating Scorecard

		Score	Aaa	Aa	A	Baa	Ba	B and Below	Weight	Implied Rating
Debt and Pensions	Net Direct Debt / Full Value	0.69%	< 0.75%	0.75% ≤ n < 1.75%	1.75% ≤ n < 4.00%	4.00% ≤ n < 10.00%	10.00% ≤ n < 15.00%	≥ 15.00%	5%	Aaa
	Net Direct Debt / Operating Revenues	0.55x	< 0.33x	0.33x ≤ n < 0.67x	0.67x ≤ n < 3.00x	3.00x ≤ n < 5.00x	5.00x ≤ n < 7.00x	≥ 7.00x	5%	Aa
	3-Year Average of Moody's Adjusted Net Pension Liability / Full Value	0.12%	< 0.90%	0.90% ≤ n < 2.10%	2.10% ≤ n < 4.80%	4.80% ≤ n < 12.00%	12.00% ≤ n < 18.00%	≥ 18.00%	5%	Aaa
	3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues	0.10x	< 0.40x	0.40x ≤ n < 0.80x	0.80x ≤ n < 3.60x	3.60x ≤ n < 6.00x	6.00x ≤ n < 8.40x	≥ 8.40x	5%	Aaa
Managament	Institutional Framework	A	Very Strong	Strong	Moderate	Limited	Poor	Very Poor	10%	A
	Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	1.00x	> 1.05x	1.05x ≥ n > 1.02x	1.02x ≥ n > 0.98x	0.98x ≥ n > 0.95x	0.95x ≥ n > 0.92x	≤ 0.92x	10%	A
Finances	Fund Balance as % of Revenues	20.78%	> 30.0%	30.0% ≥ n > 15.0%	15.0% ≥ n > 5.0%	5.0% ≥ n > 0.0%	0.0% ≥ n > -2.5%	≤ -2.5%	10%	Aa
	5-Year Dollar Change in Fund Balance as % of Revenues	-9.96%	> 25.0%	25.0% ≥ n > 10.0%	10.0% ≥ n > 0.0%	0.0% ≥ n > -10.0%	-10.0% ≥ n > -18.0%	≤ -18.0%	5%	Baa
	Cash Balance as % of Revenues	71.64%	> 25.0%	25.0% ≥ n > 10.0%	10.0% ≥ n > 5.0%	5.0% ≥ n > 0.0%	0.0% ≥ n > -2.5%	≤ -2.5%	10%	Aaa
	5-Year Dollar Change in Cash Balance as % of Revenues	44.91%	> 25.0%	25.0% ≥ n > 10.0%	10.0% ≥ n > 0.0%	0.0% ≥ n > -10.0%	-10.0% ≥ n > -18.0%	≤ -18.0%	5%	Aaa
Economy/Tax Base	Tax Base Size: Full Value ($ million)	8,160,777	> $12B	$12B ≥ n > $1.4B	$1.4B ≥ n > $240M	$240M ≥ n > $120M	$120M ≥ n > $60M	≤ $60M	10%	Aa
	Tax Base Per Capita	58,020	> $150,000	$150,000 ≥ n > $65,000	$65,000 ≥ n > $35,000	$35,000 ≥ n > $20,000	$20,000 ≥ n > $10,000	≤ $10,000	10%	A
	Median Family Income as % of US Median	53%	> 150% of US median	150% to 90% of US median	90% to 75% of US median	75% to 50% of US median	50% to 40% of US median	≤ 40% of US median	10%	Baa

Bond Insurance

- An insurance policy purchased by the issuer at pricing that guarantees the timely payment of principal and interest on the bonds. The issuer benefits from its bonds pricing at lower interest rates that reflect the credit enhancement provider's credit ratings – but, of course, the issuer must pay a fee for this benefit

- Prior to 2007/2008, there were seven "Aaa/AAA/AAA" rated insurance providers -- today there are none

- Assured Guaranty Municipal Corp. (AGM) and Build America Mutual (BAM) are the two most prevalent bond insurers in today's market

  - Assured Guaranty Municipal Corp. (AGM) is currently rated "AA" (stable) by Standard & Poor's and ***"A2" (stable) by Moody's***

  - Build America Mutual (BAM) is currently rated "AA" (stable) by Standard & Poor's

ASSURED GUARANTY MUNICIPAL

BAM BUILD AMERICA MUTUAL

Debt Service Reserve Fund

- The DSRF is an amount often required to be set aside to cover one year of principal and interest payment
  - Standard DSRF Test, Lesser of:
    - Maximum Annual Debt Service
    - 125% Average Annual Debt Service
    - 10% of Par Amount

- DSRFs are often used with revenue bonds although we have seen many essential service issuers (water and sewer, electric, etc.) and certain other credits being done without DSRFs recently

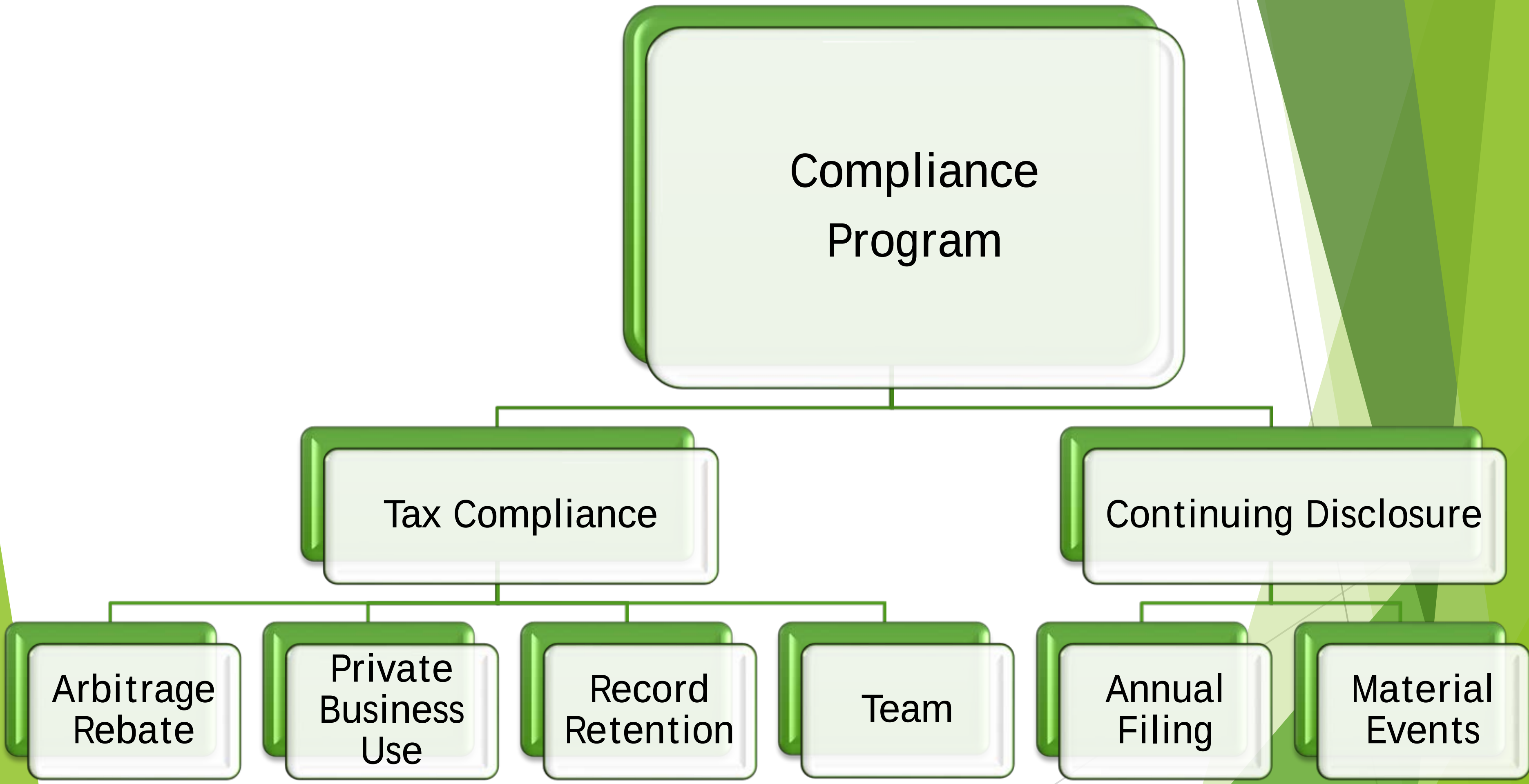
- Questions to ask when considering a DSRF:
  - Do the outstanding bonds have an existing DSRF?
  - How is this DSRF funded? Is it funded with cash, surety or letter of credit?
  - If issuing refunding bonds, are they required by the authorizing documents and/or the market to have a DSRF?
    - If required to have a DSRF, can existing cash funded DSRF be transferred into refunding deal (usually it can) or can existing surety be transferred over (usually they can't)?
    - If new bonds are not required to fund a DSRF, can existing cash DSRF be released?

III. Post Issuance & Arbitrage Rebate Compliance

Thoughts & Considerations

- The IRS is focused on post-issuance compliance
  - Attempting to influence issuers to adopt and implement written post-issuance compliance procedures
    - IRS is conducting Audits, "soft-contact" surveys
    - Implemented changes to 8038 series forms
- Arbitrage rebate and yield restriction compliance is an integral part of post-issuance compliance
  - Keeping good records, making timely allocations, and proactively monitoring arbitrage rebate and yield restriction liabilities will mitigate audit risk
- Issuers must develop process for identifying and quantifying private use when planning for issuance and post issuance

Components of a Compliance Program

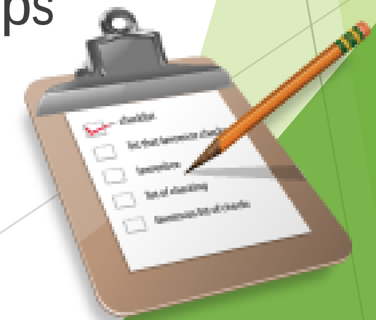


A Change In IRS Focus

- Prior focus was on pre-issuance type compliance problems
  - Is the project financeable with tax-exempt bond proceeds?
  - Less focused on post-issuance compliance, such as arbitrage rebate
- Beginning in 2007, shift in focus to post-issuance compliance
  - "Soft contact" surveys sent to 501(c)(3) organizations and governmental entities to assess post-issuance compliance
  - Significant increase in number of IRS audits
  - Emphasis on <u>written</u> policies and procedures to manage post-issuance compliance
  - Change in IRS Forms to include acknowledgement from issuers of written compliance procedures
- **Arbitrage rebate** is a significant part of post-issuance compliance
  - Also includes private business use compliance and related requirements

IRS – Best Practices – Written Procedures

- Issuer’s must conduct their own due diligence;
- Review their written procedures at regular intervals;
- Identifying the official or employee responsible for review;
- Provide training for the responsible official/employee;
- Retain adequate records to verify compliance;
- Procedures implemented must be reasonably expected to timely identify noncompliance; and
- Procedures must ensure the issuer will take steps to timely correct noncompliance.



Golden Rule: Best practice is to have processes, procedures and internal controls that prevent failures

The New IRS Form 8038

Form **8038-G**
(Rev. September 2011)
Department of the Treasury
Internal Revenue Service

Information Return for Tax-Exempt Governmental Obligations
▶ **Under Internal Revenue Code section 149(e)**
▶ **See separate instructions.**
Caution: *If the issue price is under $100,000, use Form 8038-GC.*

OMB No. 1545-0720

42 If the issuer has superintegrated the hedge, check box . . . . ▶ ☐
43 If the issuer has established written procedures to ensure that all nonqualified bonds of this issue are remediated according to the requirements under the Code and Regulations (see instructions), check box . . . . ▶ ☐
44 If the issuer has established written procedures to monitor the requirements of section 148, check box . . . . . ▶ ☐

- IRS revised Form 8038-G in September 2011 to include lines #43 and #44
- Issuers that are unable to check the boxes on the Form 8038-G may receive greater scrutiny

Arbitrage Rebate & Yield Restriction Compliance

- Determine the yield for arbitrage purposes
- Compile and maintain a list of bonds in need of rebate and yield restriction calculations
- Identify temporary periods
- Monitor compliance with yield restriction requirements
- Perform calculations no later than 5-year anniversary dates and final maturity dates (may be earlier than 5-years)
- Make payments no later than 60 days after computation date
- Initiate corrective steps if payments are not made timely, or if other violations are identified

Funds Subject to Rebate

Proceeds Category	**Funds**
Sale Proceeds / Investment Proceeds ("Proceeds")	Project / Construction Funds Capitalized Interest Funds Debt Service Reserve Funds Escrow Funds Costs of Issuance Funds
Transferred Proceeds ("Proceeds")	Any of the above
Cash / Revenue Funded ("Replacement Proceeds")	Debt Service Funds Debt Service Reserve Funds

Arbitrage Rebate – Follow the Money!

- Must conduct calculation, even if there may not be any anticipated liability
- You must complete and keep arbitrage calculation, even if the liability is $0
- The arbitrage rebate computation is the financial roadmap that the IRS uses to trace the expenditure of proceeds and by extension, the facilities financed.
- IRS Consistency Requirement for Sections 141-150 of the Code

IV. Municipal Advisory Regulations

"The new regulations arrived earlier today."

Definition of Municipal Advisor

- Dodd-Frank defines "municipal advisor" as a **PERSON**

(Not a municipal entity or an employee of a municipal entity)

THAT

PROVIDES MUNICIPAL FINANCIAL ADVICE

Includes "Advice" Regarding the Structure, Timing, Terms, or Other Similar Matters

OR

SOLICITS BUSINESS FOR MUNICIPAL FINANCIAL PRODUCTS ON BEHALF OF UNAFFILIATED 3rd PARTIES

Source: Page 777 of the Full Rule (http://www.sec.gov/rules/final/2013/34-70462.pdf). Please note this is for informative purposes only and should not be considered legal advice.

Municipal Advisor Regulations

- What is Advice?
  - Definition is construed broadly
  - Is an objective determination, based on all relevant factors
  - Factors include:
    - Whether person makes a "Particularized Recommendation"
    - Whether the content, context and manner of presentation would reasonably cause someone to take action OR refrain from taking action
    - How individually tailored the information is to a specific OR targeted group of muni entities or obligated persons
  - Definition excludes: General information

- Became Effective on July 1, 2014

Source: Page 777 of the Full Rule (http://www.sec.gov/rules/final/2013/34-70462.pdf). Please note this is for informative purposes only and should not be considered legal advice.

Providing Municipal Financial Advice

- What is advice under Rule 15Ba1-1(d)(1)(ii)

Recommendations of municipal financial products

Recommendations for the issuance of municipal securities

Recommendations based on the structure, timing, and terms of municipal products or issuance of municipal securities

Recommendations particularized to the specific needs, objectives, and/ or circumstances of municipal entity or obligated person

Source: Page 777 of the Full Rule (http://www.sec.gov/rules/final/2013/34-70462.pdf). Please note this is for informative purposes only and should not be considered legal advice.

General Information Not Considered to be Advice

- What is NOT advice under Rule 15Ba1-1(d)(1)(ii)

Publicly held information (outside of municipal entities or obligated person)

Unspecific Information (not specific to a particular municipal entity or type of municipal entity)

Factual information (no assumptions/opinions/viewpoints)

Educational material (instructional or explanatory info)

Source: Page 777 of the Full Rule (http://www.sec.gov/rules/final/2013/34-70462.pdf). Please note this is for informative purposes only and should not be considered legal advice.

Rule of Thumb

- If the advice can be reasonably viewed as a specific suggestion to the municipal entity to either act or refrain from acting with regard to municipal financial products or the issuance of municipal securities, then it is Advice under the Rule

Source: Page 777 of the Full Rule (http://www.sec.gov/rules/final/2013/34-70462.pdf). Please note this is for informative purposes only and should not be considered legal advice.

Incentives for Using MAs

- Fiduciary duty
- Reduced borrowing and issuance costs
- Better financing terms
- Positive impact on taxpayers/ratepayers

Source: Page 777 of the Full Rule (http://www.sec.gov/rules/final/2013/34-70462.pdf). Please note this is for informative purposes only and should not be considered legal advice.

Underwriter Exemptions

- Underwriters can only provide “advice” in certain defined situations
- Exemptions
  - “Underwriter exemption”
    - Underwriter has been engaged to underwrite a specific issue (does not include being part of an underwriting pool if the firm is not actively working on a specific transaction)
    - Can provide advice regarding structure, timing, terms and other similar advice regarding specific issues, if they are engaged for that particular issue
  - “RFP exemption”
    - Responses to RFPs for a particular issue
  - “Independent Registered Municipal Advisor (IRMA) exemption”
    - Issuer has hired an independent Municipal Advisor (PFM) that is not the proposed underwriter
      - Independent MA is engaged to evaluate proposals from underwriters
      - Independent MA cannot be associated with proposed underwriter within the past two years

Source: Page 777 of the Full Rule (http://www.sec.gov/rules/final/2013/34-70462.pdf). Please note this is for informative purposes only and should not be considered legal advice.

Discussion

What Does Your Final Puzzle Look Like?