Issues Impacting Financings in the Current Market

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Introductions

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Overview

- Bond Market Conditions
- Refunding Basics
- Valuing Potential Refundings and Alternatives
- Recent SEC News in the Municipal Market
- Recent Rule 15c2-12 Amendments

BOND MARKET CONDITIONS

The MMD “AAA” Index

- The Municipal Market Data (MMD) Index is a daily index of AAA-rated municipal bond rates
- Issuers’ bond yields are priced relative to the MMD
  - The relative difference is called the “spread” to the MMD
  - The spread varies due to the following:
    - Credit rating
    - Bank qualification
    - Length of maturity
    - Coupon or interest rates

Variables that Impact the Municipal Bond Market

FED Reserve Policy
Quantitative Easing
Fed Funds Rate

Budget and Credit of the US Government

Inflation Expectations

Health of national, state and local economies

State of Illinois Fiscal Challenges – Budget Impasse/Pension Situation

Bank Qualification

THE MUNICIPAL BOND MARKET

Municipal Bond Supply and Demand

Europe

Municipal Bankruptcies (*e.g.*, Detroit)

Chicago’s Fisc
Challenges

Credit ratings of state and local governments

Level of federal and state income taxes

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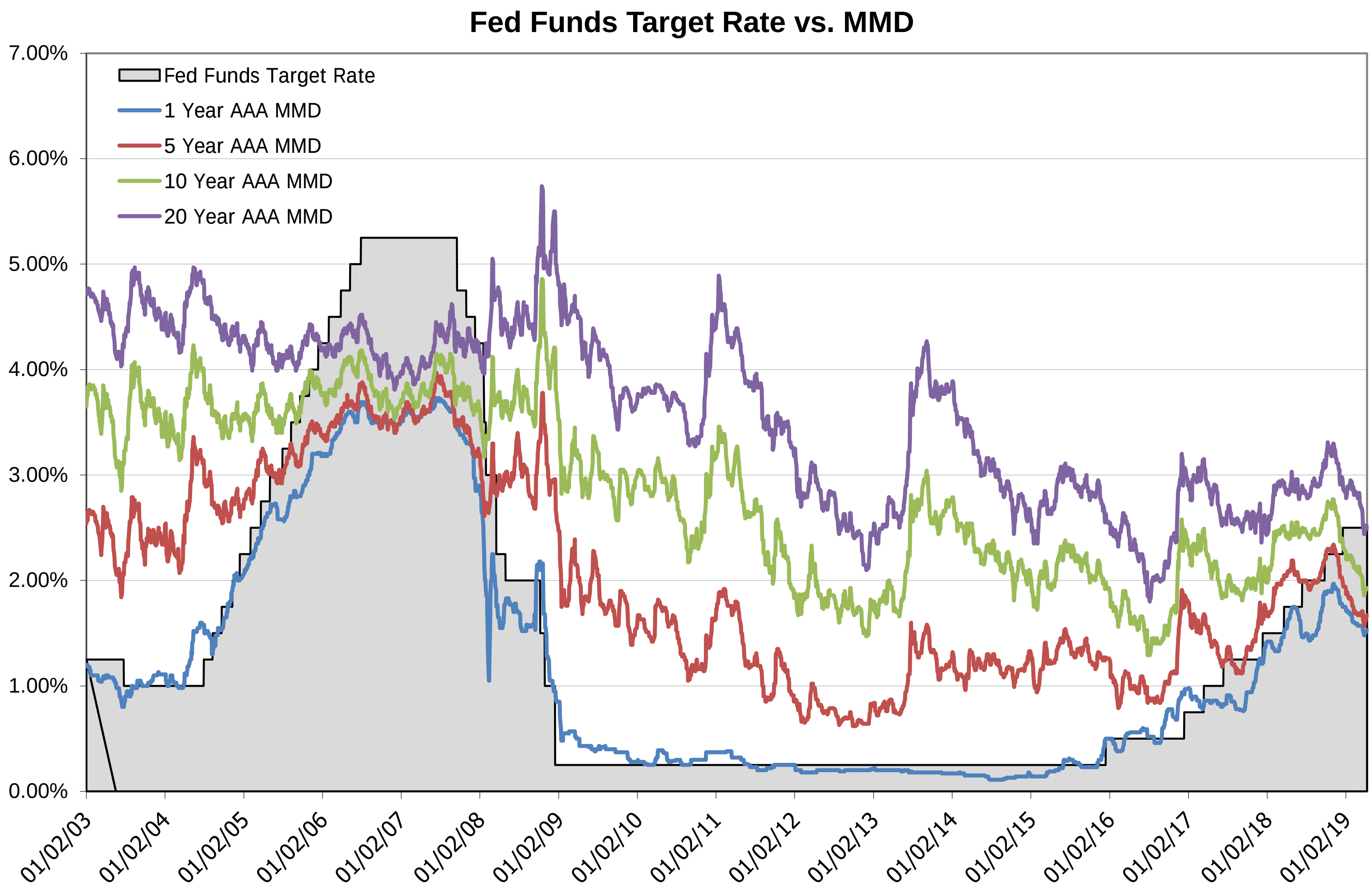
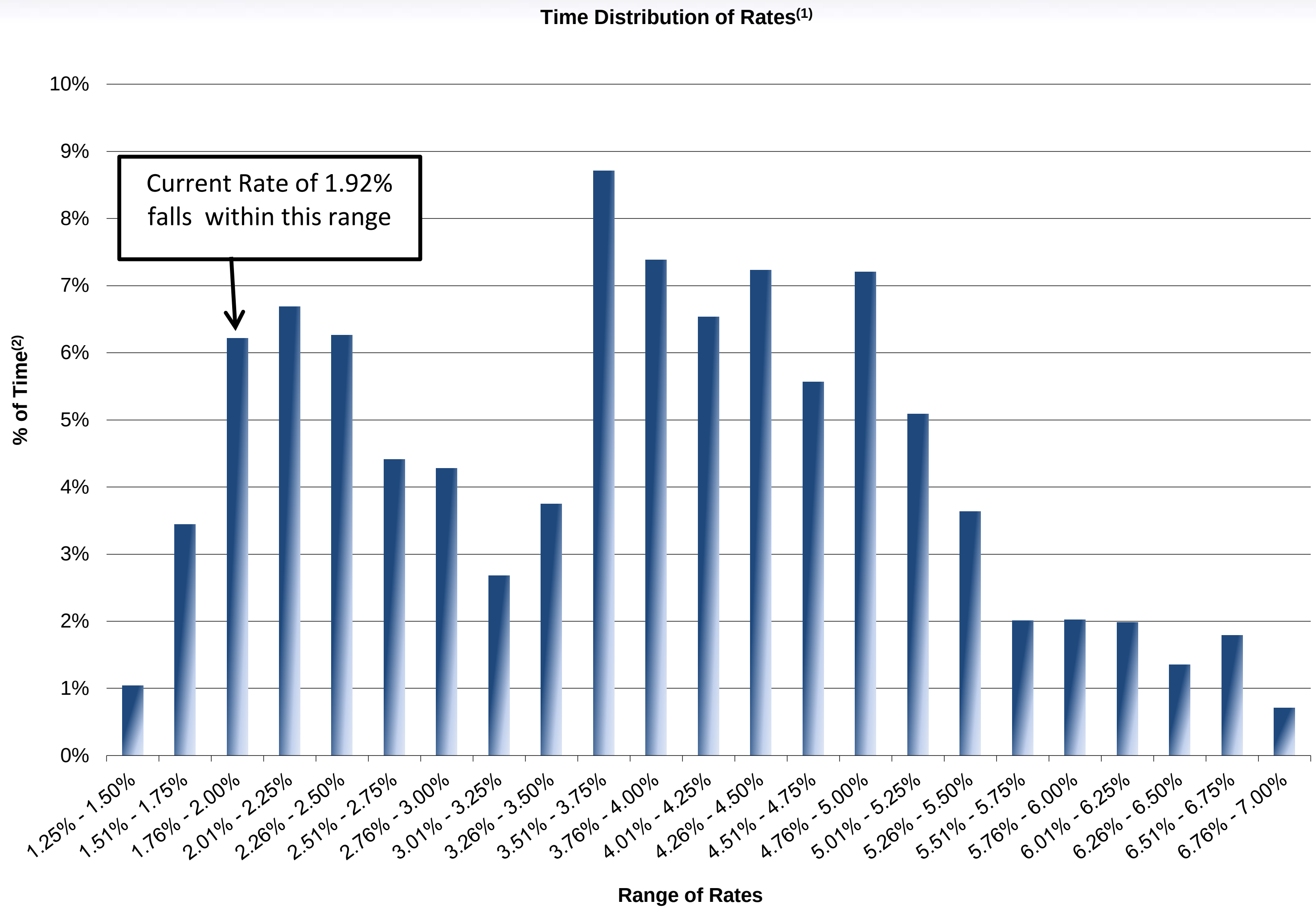
Schaumburg, IL May 2-3, 2019

Historical MMD January 2003 to the Present



Municipal Market Data as of April 11, 2019

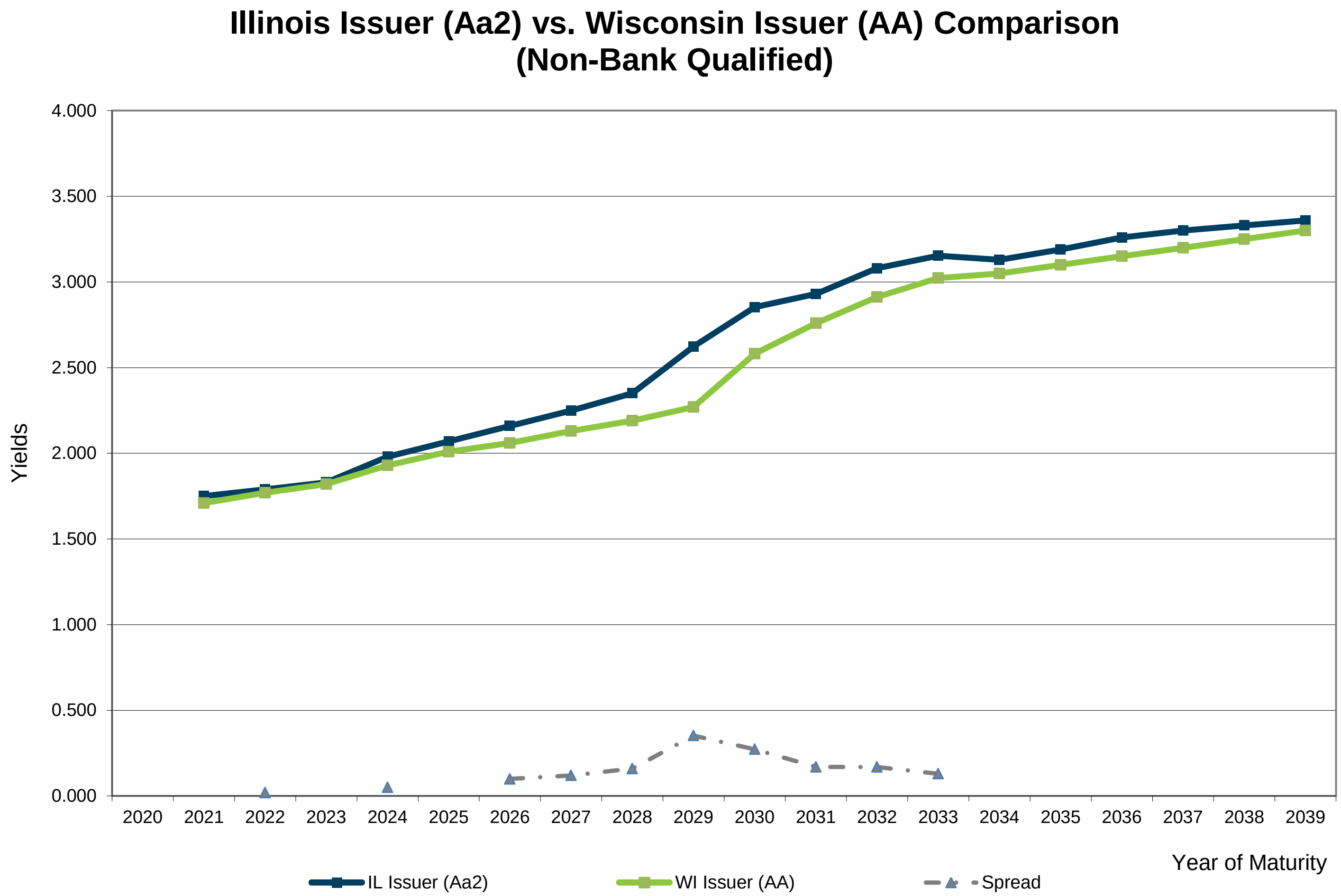
Current 10-Year MMD



(1) Current Rate is the MMD 10-year rate as of 04/10/19
(2) Data encompasses MMD 10-year rates between 01/02/90 and 04/10/19. Past performance does not guarantee future results.
Source: The Municipal Market Data "MMD" is a AAA municipal bond market index produced by TM3.

The "Illinois Penalty"

- The Illinois penalty will vary depending on term and credit rating. In this example, the Illinois penalty is as wide as 0.35% at the 10-year term



Source: Bloomberg

REFUNDING BASICS

State Law Authorization

- Refunding Bonds are authorized under Section 19-15 of the School Code
- Refunding Bonds may be issued to pay outstanding bonds in order to:
  - Realize interest savings
  - Restructure debt burden
    - State law: max term of refunding bonds is 20 years
    - Tax law: if refunding bonds are tax-exempt, average life of refunding bonds cannot exceed 120% of useful life of asset financed (or refinanced) with refunded bonds
- Tax levies for Refunded Bonds must be abated
- No BINA Hearing required
- No 30-day Petition Period required

Basic Types of Refundings

- The call date is the date at which the issuer can payoff its bond issue

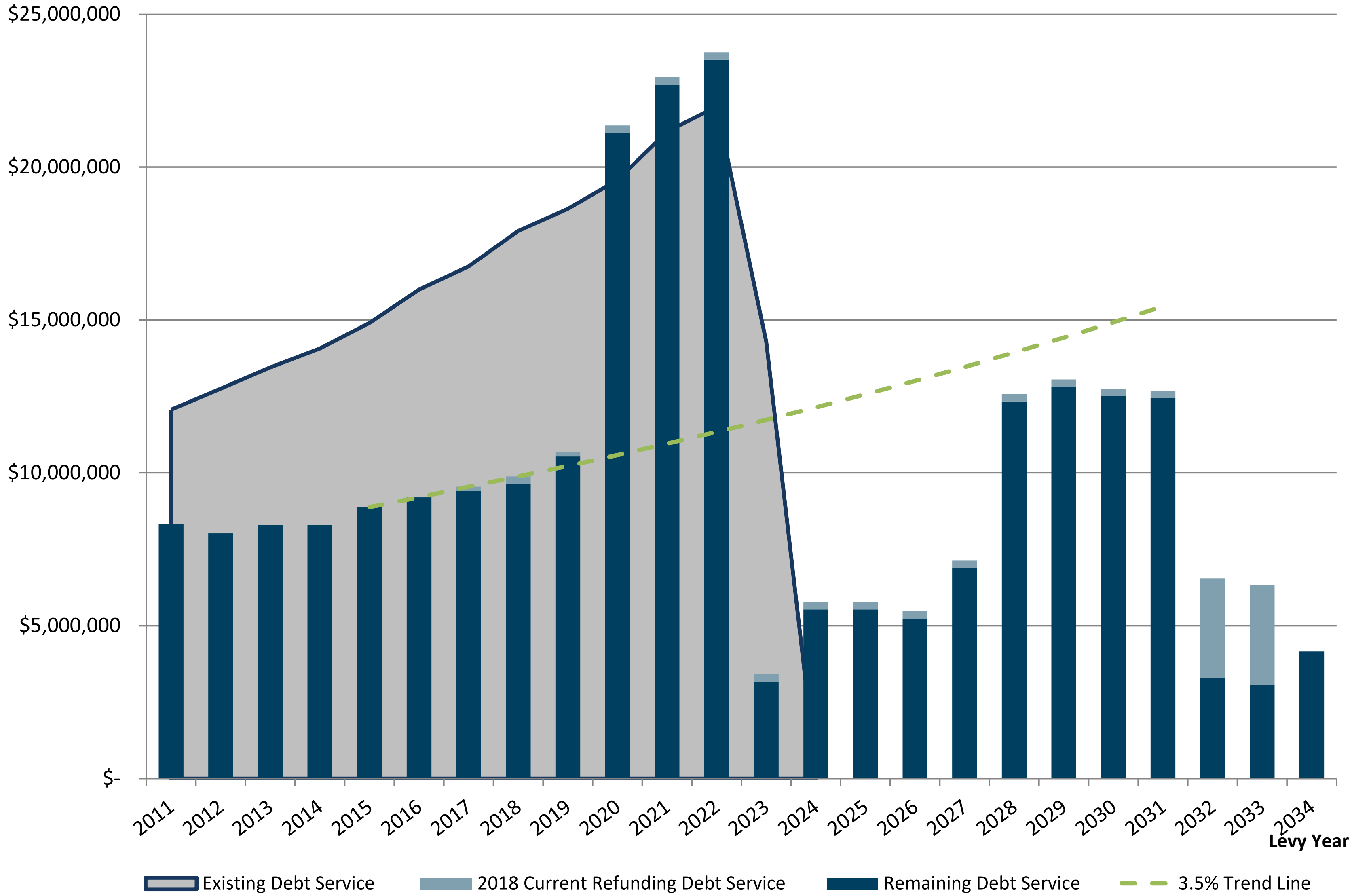
- Advance refunding
  - Refunding bond issue that closes 91 or more days in advance of the call date
  - Refunding proceeds invested in an escrow until the call date
  - **THE U.S. TAX CODE NO LONGER ALLOWS FOR ONE TAX-EXEMPT ADVANCE REFUNDING IN THE "LIFE" OF A BOND ISSUE**

- Current refunding
  - Current refunding bonds need to close within 90 days of the call date
  - At this time, U.S. tax code allows for multiple current refundings

How Refunding Bonds Might Help A School District

- B&I levies (for each bond) are set at the time the bond is sold and are filed with the county clerk(s) prior to closing
- Refundings allow the issuer to change B&I levies:
  - Lower interest rates may allow savings from a refinancing (new, lower B&I levies replace existing B&I levies)
  - Restructure existing debt service levies based on lower EAV projections for a targeted tax rate over time (lower B&I levies in the short term)
  - Restructure to accommodate a new money financing to meet an actual constraint (e.g. DSEB) or self-imposed (B&I levy objective)
  - A combination that captures savings and restructures debt service with a targeted tax levy

EXAMPLE 1:
Restructure existing debt service levies based on lower EAV



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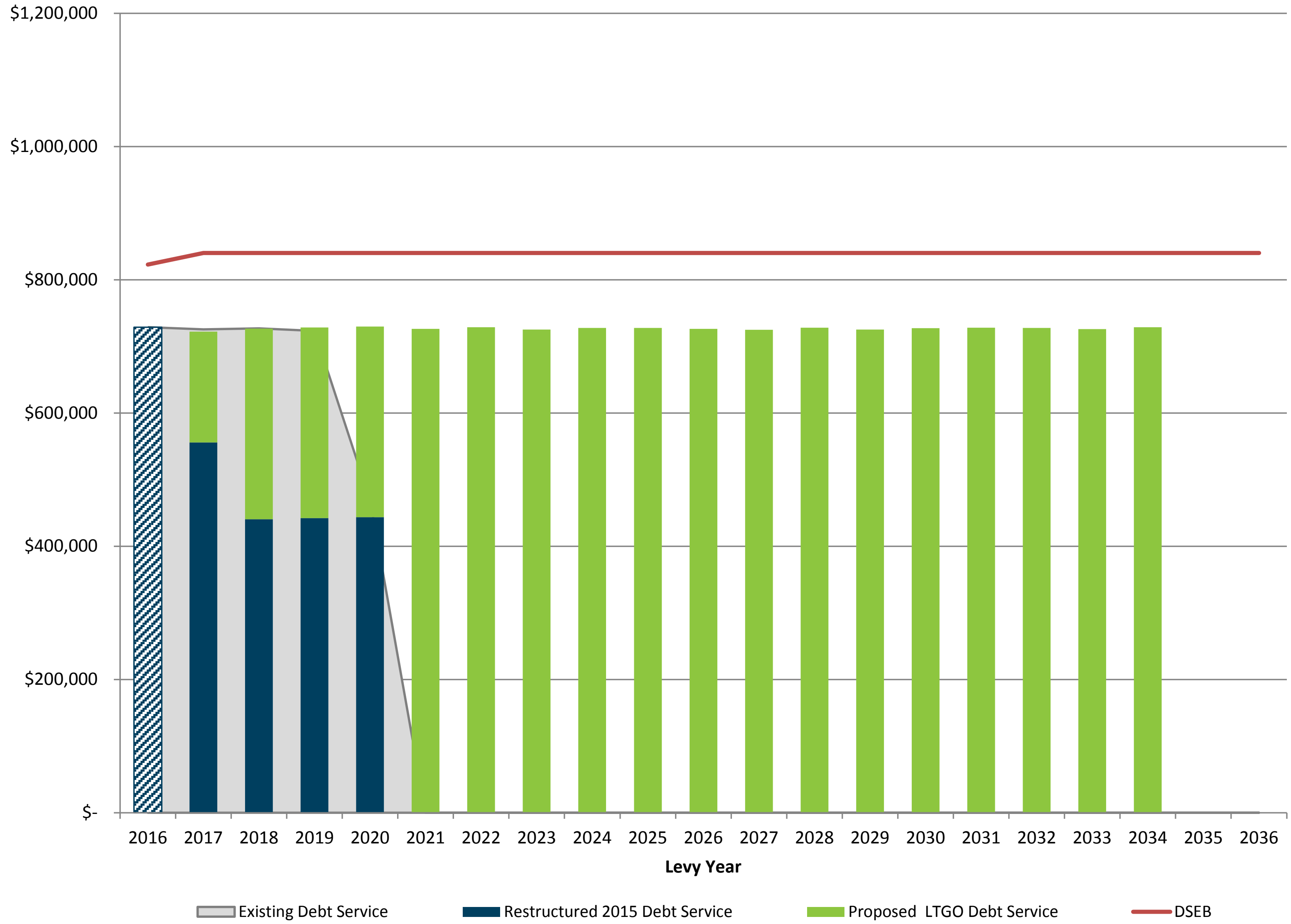
EXAMPLE 2:
Restructure to accommodate a financing to meet a constraint



VALUING POTENTIAL REFUNDINGS & ALTERNATIVES

Valuing Potential Refundings

- Traditionally, the value is measured by the minimum PV savings as a percent of the refunded bonds par amount
- Effectiveness of minimum PV savings % as a measuring tool depends upon other factors
  - Time to the call date (is it already a current refunding?)
  - Current interest rates relative to historical interest rates and interest rate expectations
  - Shape of the yield curve which impacts the cost of the escrow
  - Impact of new tax law
- Some practitioners recommend that PV savings should at least exceed the inefficiency of the escrow
- Complex call option valuation model to compute a refunding efficiency percentage is not as useful due to the tax law change

Valuing Potential Refundings
(cont'd.)

- It is not necessary to refund all the callable bonds
  - Bonds closer to the call sometimes save little or not at all
  - Identify the relative value versus the current yield curve (i.e. where does bank qualification provide the most value)
- Lastly, a refunding should consider future borrowing plans
  - If the district has potential new money plans in the next few years, it may want to consider a restructuring of outstanding bonds to minimize the impact of the new money issue
  - If the bonds are refunded today for cash flow savings, the cost of the restructuring may increase eliminating the savings
    - Due to lengthening of the issue
    - Eligibility for tax-exempt refunding not available
- If your finance team recommends a taxable refunding make sure they explain why it is taxable and how does that benefit the district

Transactions to Replace Advance Refundings

1. **Wait for Current Refunding**
2. Forward Settlement Current Refunding
3. Taxable Advance Refunding
4. Secondary Market Purchase Refunding
5. Cinderella Bonds (Taxable Convertible Bonds)
6. Derivative Products (forward starting swaps and swaptions)

Waiting for Current Refunding

- Bond maturity shortens for better yield
- Negative escrow arbitrage eliminated
- Risk of interest rate increase exists
- Delayed savings until bond issuance

BUILD AMERICA BONDS (BABs)

- Special taxable bonds which typically were issued to pay the issuer a federal subsidy (Direct Pay BABs)
- The federal subsidy for Direct Pay BABs is equal to 35% of the interest
- Issued in 2009 and 2010 to finance capital projects
- Optional call dates are approaching for many BABs
- In some states, to manage market risk, issuers are advance refunding BABs on a tax-exempt basis and foregoing receipt of the subsidy
- This approach is likely unavailable to IL schools since IL schools can not “legally defease” general obligation bonds

RECENT SEC NEWS IN THE MUNICIPAL MARKET

Primary Market Disclosure

- The official statement is a document prepared by, or on behalf of, the school district in connection with a primary offering of its bonds.

- The official statement discloses all material information on the offering for potential investors.

Secondary Market Disclosure

- Continuing Disclosure Undertaking
  - SEC Rule 15c2-12
    - Requires an underwriter to enter into an agreement with issuers to provide audited financial information, other financial information (possibly) and event disclosures to the market
    - SEC believes this information is important for market transparency and to promote a fair and efficient market
- Filings must be made electronically at the EMMA (Electronic Municipal Market Access) portal [www.emma.msrb.org]

Recent SEC Municipal Enforcement Actions
Town of Ramapo, New York – Primary Market Disclosure

- In April 2016, the SEC charged the Town and certain Town officials, including Christopher St. Lawrence, the former Director of Finance and Town Supervisor, and others, with fraud for allegedly improperly disclosing a deteriorating financial situation in official statements.
- The SEC alleged that Town officials resorted to fraud to hide the strain in the Town's finances caused by the financing of a controversial minor league baseball stadium and by the Town's declining sales and property tax revenues.
- In a parallel action, the DOJ brought criminal charges against St. Lawrence.
- The jury rejected St. Lawrence's arguments that (i) no investors were harmed as all of the bonds were at all times fully and timely paid and (ii) St. Lawrence received no personal financial gain in connection with the alleged fraudulent activity.
- St. Lawrence was found guilty of 20 counts of conspiracy, securities fraud and wire fraud.
- St. Lawrence was sentenced in December of 2017 to 30 months in prison and fined $75,000.
- In October of 2018, the SEC civil action concluded with final judgment against St. Lawrence, enjoining him from violating federal securities laws and ordering him to pay an additional $327,000 fine.

Recent SEC Municipal Enforcement Actions (cont'd.)

Keith Borge (College of New Rochelle) – Secondary Market Disclosure

- On March 28, 2019, the SEC charged Keith Borge, the former controller of the College of New Rochelle, a New York-based not-for-profit college, with violating, and aiding and abetting violations of, the antifraud provisions of the federal securities laws.
- On the same day, in a parallel action, the United States Attorney's Office for the Southern District of New York announced criminal charges against Borge.
- In 1999, the College entered into a CDU in connection with certain bonds issued by a related development corporation.
- According to the SEC, by 2013, the College was under considerable financial stress as student enrollment declined and tuition revenues decreased. To address the College's operational cash flow needs, Borge allegedly withdrew funds from the College's endowment fund and created false entries in the College's audited financial statements for fiscal year 2015 to hide the misappropriation.
- Borge filed the audited financial statements for fiscal year 2015 on EMMA, as required by the 1999 CDU.
- As a result, according to the SEC, secondary market purchases and sales of the 1999 bonds were made based on false and misleading financial information.
- Borge agreed to a partial settlement with the SEC and pleaded guilty to securities fraud, with potential monetary sanctions and prison sentence to be determined at a later date.
- Geoffrey S. Berman, the United States Attorney for the Southern District of New York, stated that Borge "committed federal crimes for which he will now pay the price."

General Principles Re: Disclosure

- All participants in the disclosure process should be encouraged to raise additional potential disclosure items at all times in the process

- Disclosure questions should be discussed with appropriate management team members

- The process of revising and updating disclosure should not be viewed as a mechanical insertion of more current numbers. While it is not anticipated that there necessarily will be major changes in the form and content of the disclosure at the time of each update, everyone involved in the process should consider the need for revisions in the form and content of the sections for which they are responsible at the time of each update.

RECENT RULE 15C2-12 AMENDMENTS

CDU Reportable Events Disclosure

- Must be filed within 10 business days after the occurrence of the event
- Most common reportable events:
  - Rating changes
  - Bond calls
  - Payment delinquencies

Two New, Additional Reportable Events

- August 20, 2018: the SEC adopted Amendments to Rule 15c2-12, which added two new events to the list of 14 reportable events.
- On and after February 27, 2019, the additional events must be added to new CDUs.
  - **Existing CDUs are unaffected.**
- Why the change?
  - Increasing use of direct purchases for bonds as an alternative to public offerings.
  - Perceived lack of investor access to information related to direct purchases.

New Reportable Event #15–Financial Obligation – Incurrence or Agreement

- **Reportable Event #15:**
  - (a) the incurrence of a **financial obligation,** if material, or
  - (b) any **agreement** to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation which affect bond holders, if material.

“Financial Obligation”

- “Financial obligation” means: (a) a **debt obligation,** (b) a derivative instrument entered into in connection with, or pledged as security or a source of payment for, an existing or planned debt obligation and (c) a guarantee of a debt obligation or a derivative
  - **Does not include a municipal security that is issued under an official statement that has been posted on EMMA**
  - Leases that “operate as vehicles to borrow money” (*i.e.,* financing leases) are debt obligations, but **operating leases are not**
  - A “derivative instrument” includes a swap, a security-based swap, a futures contract, a forward contract, an option or similar instrument (or combination)

“If Material. . .”

- The materiality of a financial obligation or its terms is determined under general securities law standards (*i.e.*, **would the information be important to a reasonable investor in making an investment decision?**)

New Reportable Event #16—Defaults and Other Events Reflecting Financial Difficulty

- **Reportable Event #16:**
  - a **modification of terms,** acceleration, termination, **default** or other similar event under a new or pre-existing financial obligation which reflect financial difficulties

Consequences for Failure to Comply

- Bondholders may sue for specific performance
- May affect secondary market liquidity
- Rule 15c2-12 requires issuers to disclose CDU non-compliance in official statements **(five-year look back)**
- May affect access to market or result in increased interest rates on new issuances
- Issuers that fail to make CDU filings may also face SEC action

TAKEAWAYS

- Know what questions to ask when presented with a refunding opportunity
- Consider refunding opportunities for existing bonds, including BABs
- Be aware of recent SEC enforcement actions and the new reportable events

Questions and Answers

We thank you for your time!

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