ILLINOIS ASBO
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Washington's Impact on the Municipal Bond Market

Presented by:

Tammie Beckwith Schallmo
Senior Vice President, Managing Director
PMA Securities LLC

Anjali Vij
Partner, Chapman and Cutler LLP

Introductions

Anjali Vij (Speaker)
- *Partner, Chapman and Cutler LLP*

Tammie Beckwith Schallmo (Speaker)
- *Senior Vice President, Managing Director, PMA Securities, LLC*

Maureen Jones (Moderator)
- *Assistant Superintendent for Finance & Operations/CSBO, Community Consolidated School District 89*

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Who is Part of Washington?

- The President
- Congress
- The Federal Reserve
- The Securities & Exchange Commission (SEC)

2021 Federal Legislative Proposals

- Several bills were introduced in Congress last year to help spur investment in infrastructure and growth in the economy
  - Reinstatement of Tax-Exempt Advance Refundings
  - Increase in Bank Qualification Limits
  - Increase in Federal Income Tax Rates
    - Makes municipal bonds more attractive to investors
  - New federally-subsidized bond programs

Reinstatement of Tax-Exempt Advance Refundings

- A Federal tax law change is necessary to allow for a tax-exempt advance refunding of bonds originally issued for new money
  - An advance refunding is a refunding that closes more than 90 days before the call date
  - The call date is the date on which the prior bonds can be paid off

- School districts lost this ability at the end of 2017 under the Tax Cuts & Jobs Act
  - Purpose of 2017 restriction was to reduce the amount of tax-exempt bonds outstanding, which was perceived as one of several loopholes in the tax code that was eliminated to offset lower tax rates

Bank Qualification

- Tax-exempt municipal bonds are designated as Bank Qualified ("BQ") if a school district does not expect to issue more than $10 million of tax-exempt securities in a single calendar year

- Allows a financial institution to deduct 80% of its interest expense allocable to the purchase of tax-exempt securities, essentially providing banks a double tax benefit

- Some of the savings are passed along to the district as a lower interest rate versus a traditional tax-exempt bond or non-bank qualified ("NBQ")

Bank Qualification, continued

- Last year’s legislation would have increased the cap on the annual Bank Qualified limit from $10 million to $30 million
- Occurred in 2009 as part of the American Recovery and Reinvestment Act (temporarily raised to $30 million)

New Federally-Subsidized Bond Program

- Similar to Build America Bonds under the American Recovery and Reinvestment Act
  - Available to school districts in 2009 and 2010
  - Taxable bonds with a 35% subsidy rate

- Congress introduced a variation of Build America Bonds in 2021
  - Higher subsidy rate of 42%, with a step down over time

What Happened? Where Do We Go From Here?

- None of these bills were enacted!

Tools to Manage Market Risk for Refundings

- Taxable Advance Refunding
  - An advance refunding is a refunding that closes more than 90 days before the call date
- Tax-Exempt Current Refunding
  - Within 90 days of the call date
  - Variation is a repurchase current refunding
- Forward Settlement Tax-Exempt Current Refunding
- Secondary Market Repurchase Refunding

Valuing Potential Refundings

- Traditionally, the value is measured by the minimum present value (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
- Some practitioners recommend that PV savings should at least exceed the inefficiency of the escrow

Break-Even Market Movement

- The breakeven market movement (BEMM) is the amount that interest rates would have to increase between two different dates for an issuer to be indifferent between the two choices

- For example, if the BEMM is 0.75%, and tax-exempt rates increase by more than 0.75% between February 2022 and September 2022, the District would be better off selling refunding bonds on a taxable basis sooner

Taxable Advance Refunding

Concept

Bonds are issued such that investors are unable to deduct interest received on the bonds

Potential Advantages

- Simple bond issue
- No IRS oversight for the Bonds
- Allows issuer to take advantage of current market rates

Potential Disadvantages

- Investors require higher rate of interest
- Advance refundings cost more (also due to the need to escrow bond proceeds)

Waiting for a Current Refunding

<u>Potential Advantages</u>

- Bond maturity shortens for better yield
- Negative escrow arbitrage reduced or eliminated

<u>Potential Disadvantages</u>

- Risk of interest rate increase exists
  - Consider the BEMM
- Delayed savings until bond issuance

What is a Forward Settlement Current Refunding?

- In a “Forward,” the interest rate is set in the present, but the bonds close in the future

- This strategy allows the District to lock in a rate above the current market mitigating market risk
  - Allows refunding bonds to be issued tax-exempt
  - The escrow is more efficient
  - Reduces the Break-Even Market Movement

- Large commercial banks propose different terms that are not in a typical public offering
  - For example, a “default rate” and a “taxable rate”

What is a Forward Settlement Current Refunding?

- A bank and the District would sign a Continuing Covenants Agreement (the CCA) that contains warranties and covenants, most of which pertain to the District's continued ability to pay the Bonds
  - Most of the events of default are unlikely to occur, but the most common one is a payment default.
  - The occurrence of an event of default will trigger the automatic increase in the interest rate on the bonds to the "default rate" and the rate can be reduced upon the cure for the default.
  - Other common events of default are cessation of operations and insolvency.

What is a Forward Settlement Current Refunding?

- A bank typically requires the District to sign a Rate Lock Agreement which commits both parties to the transaction at the quoted interest rate.

  - It also contains a market based “breakage” or “termination” fee that the District would have to pay to a bank if the District decides not to deliver the Bonds, for any reason.

Secondary Market Purchase Refunding

Concept

The District purchases bonds they wish to refund directly from bondholders and cancels them with the proceeds of new bonds

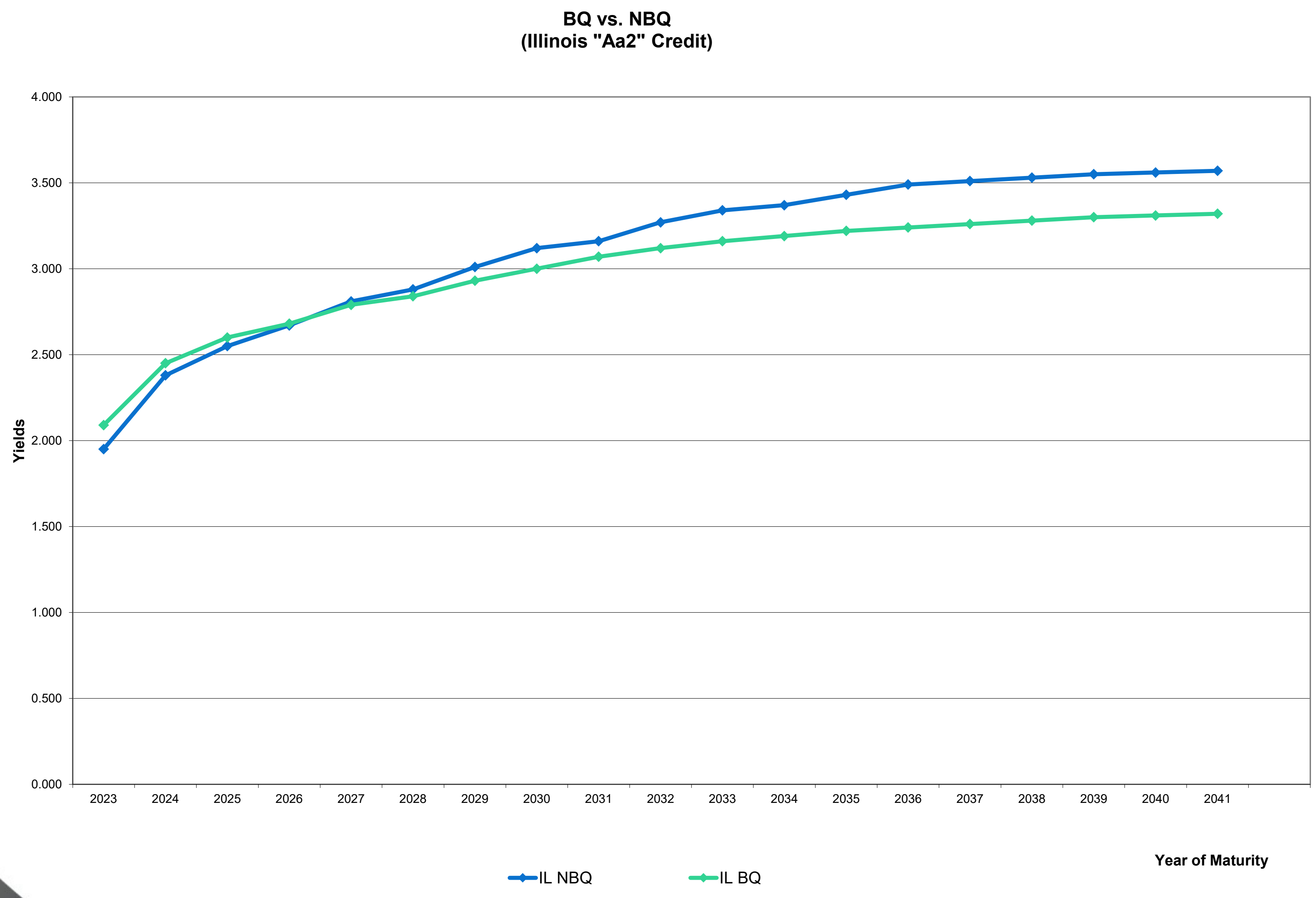
Potential Pros

- May allow the District to currently refund non-callable bonds or currently refund callable bonds more than 90 days from the call date
- Allows issuer to take advantage of current market rates

Potential Cons

- Can be expensive as investors require a premium
- Requires a willing seller
- Federal securities laws must be considered

Estimated Current BQ Benefit*



- Depending on the spot on the yield curve, the estimated current BQ benefit is as much as 0.25%

*Based on actual bond sales for Village of Round Lake Beach (Aa2 BQ) and Village of Fox Lake (Aa2 BQ) in April 2022.

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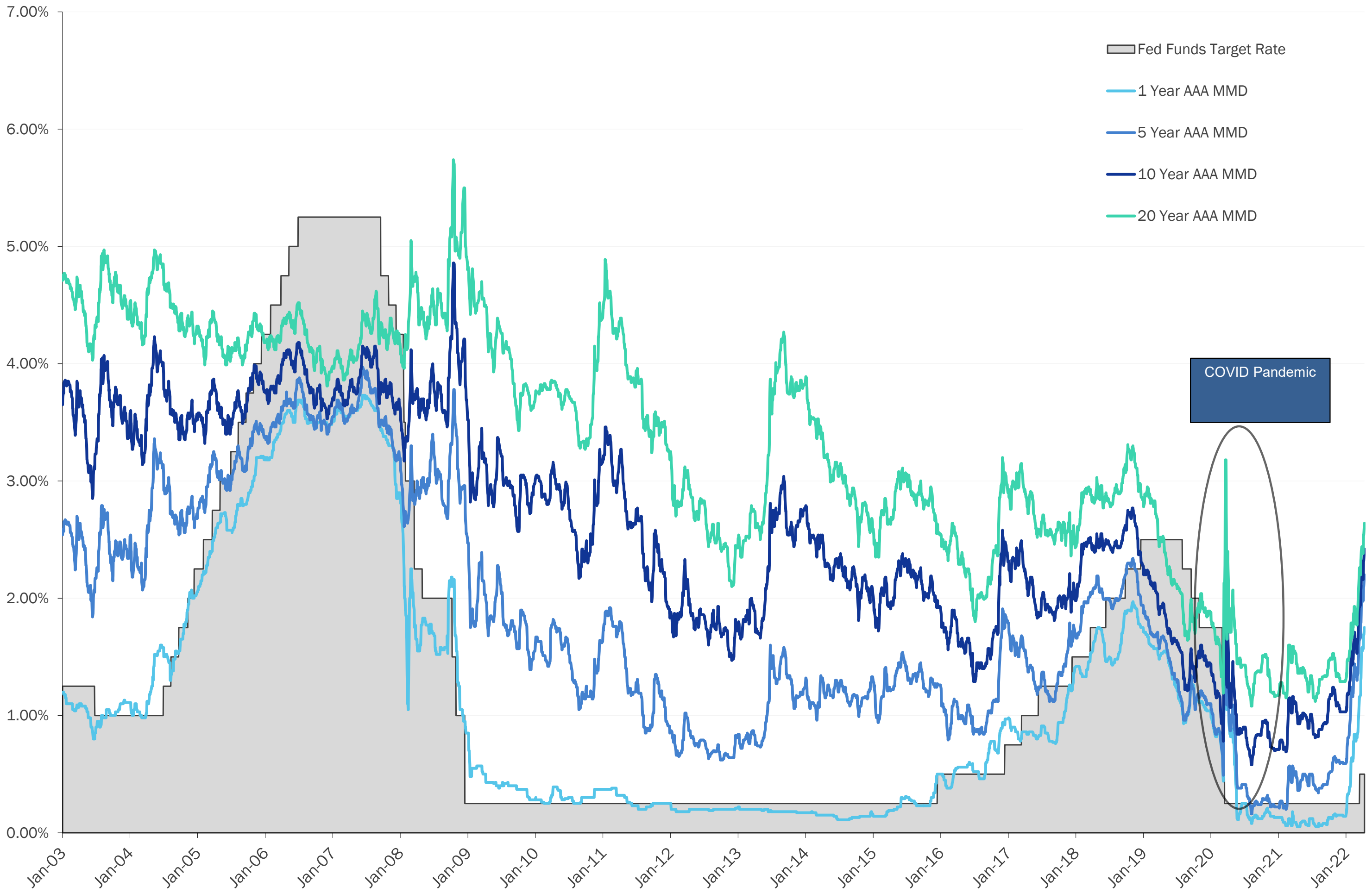
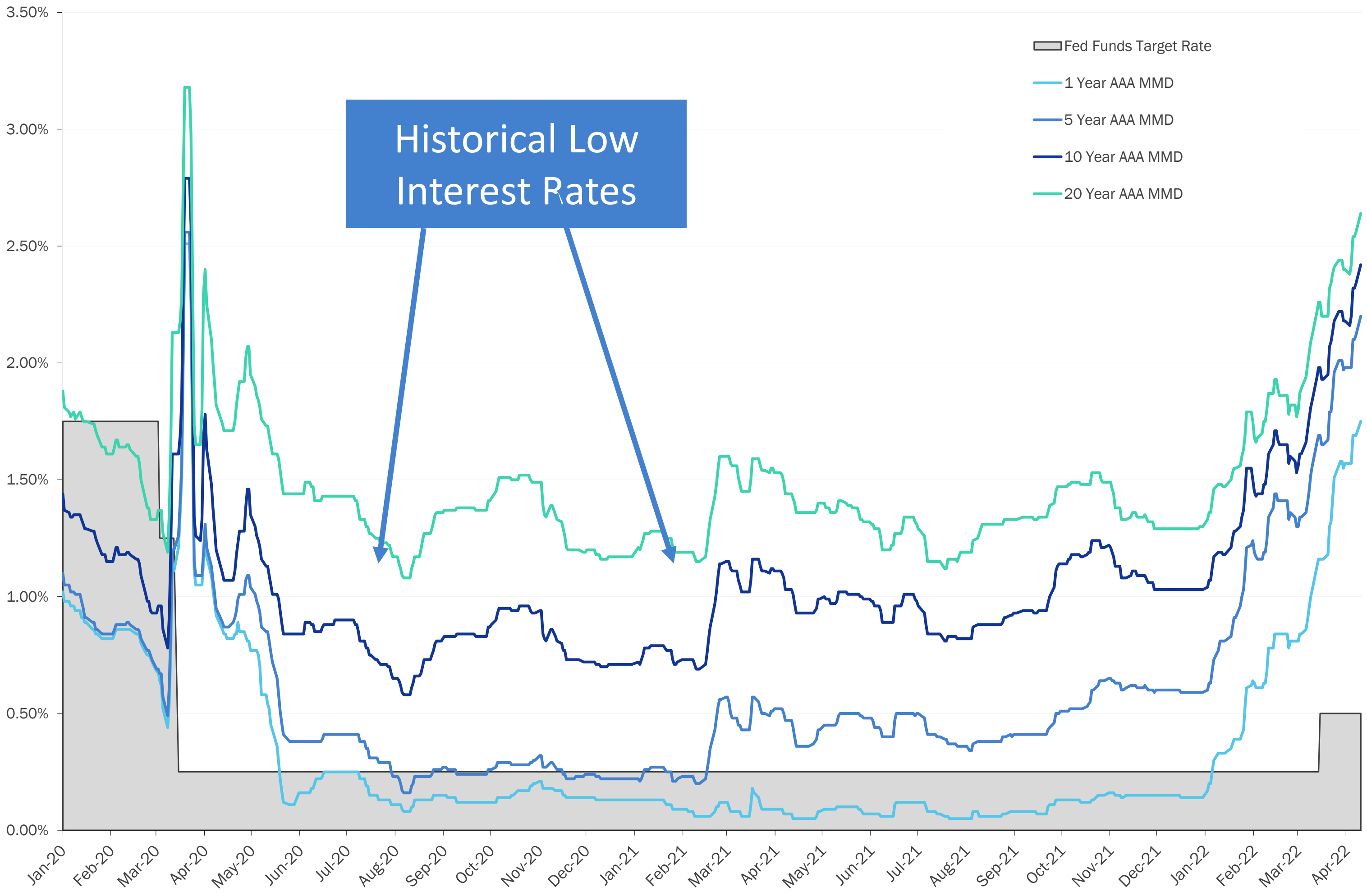
Historical Interest Rates*



*The Municipal Market Data "MMD" is a AAA municipal bond market index produced by TM3. As of April 11, 2022.

- The chart to the left is a "AAA" rated index known as the "MMD"
- An issuer's bonds sell at a "spread" to the index due to its own credit rating and the "Illinois Premium"

Historical Interest Rates*



- Since January 3, 2022 rates in the MMD have increased as follows:
  - 5-year: 1.61%
  - 10-year: 1.39%
  - 20-year: 1.34%

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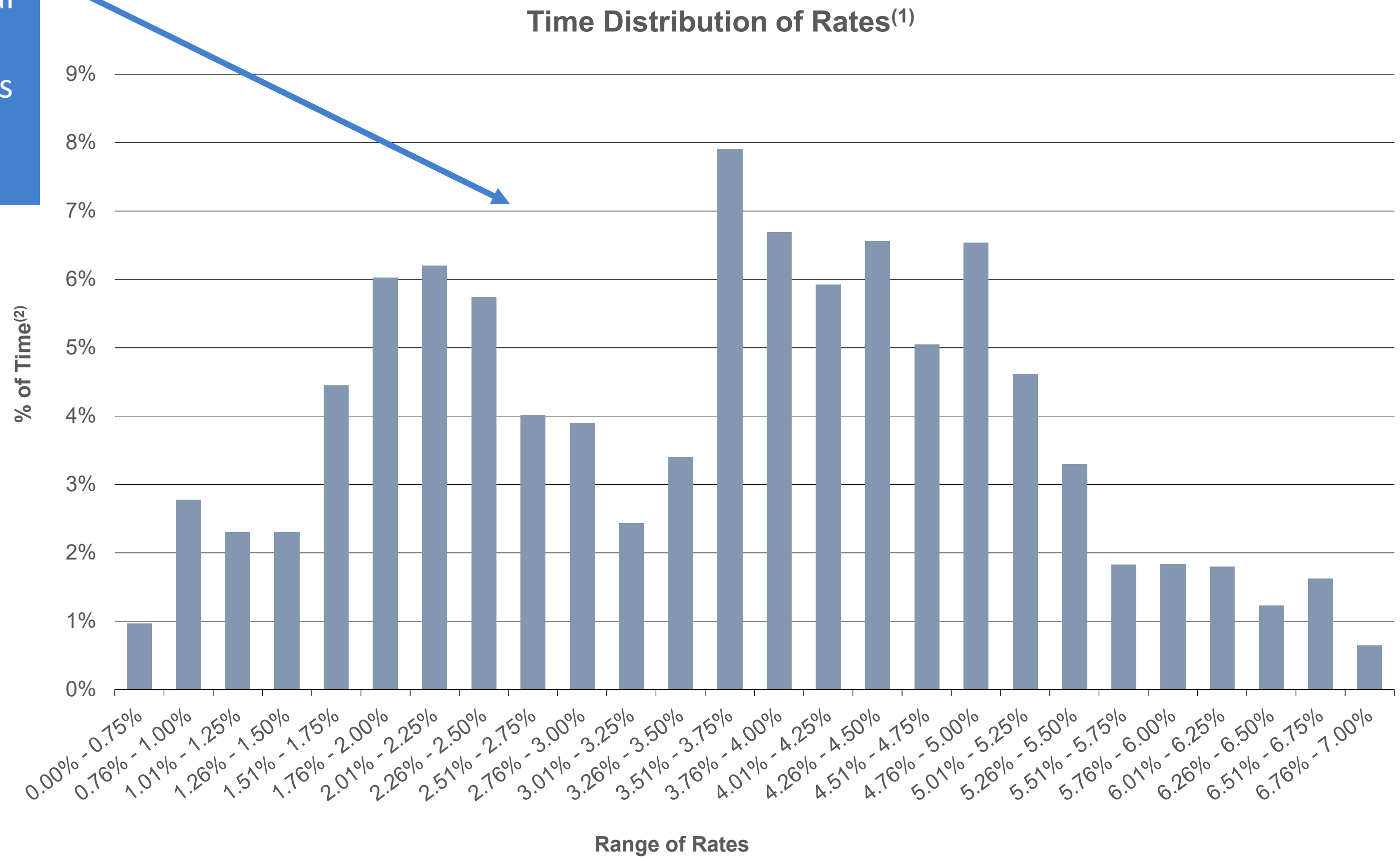
Dispersion of Historical Interest Rates by Range*

Current 10-year rate of 2.42% falls within this range



- Since January 1, 1990, the 10-year MMD has been lower than it is today **25%** of the time
- Two months ago, the 10-year MMD had been lower **6%** of the time

(1)Current Rate is the MMD 10-year rate as of 04/11/22.

(2)Data encompasses MMD 10-year rates between 01/02/90 and 04/11/22. Past performance does not guarantee future results.

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Federal Reserve Policy Tool Kit

Policy Tool (Tightening Monetary Policy)	Risks
Raise Fed Funds Rate	Economic Slowdown
	Higher Unemployment
	Recession
Slow Asset Purchases (or Sell Bonds)	Rising Rates
	Slower Housing
	Fiscal Pressure
	Corporate Earnings Pressure
	Reduced Market Liquidity
Reduce Forward Guidance	Less Certainty

What Will Continue to Impact the Municipal Bond Market?

- The Russia/Ukraine conflict
- Inflation does not decline as expected
- The Federal Reserve raises interest rates too quickly, undermining global economic expansion
- COVID cases increase and/or new variants emerge
- Supply and demand of municipal bonds
- Possible Washington power shift after midterm elections
- The SEC

Questions and Answers

We thank you for your time!

Presenters:

MODERATOR INFO:

Maureen Jones, Assistant Superintendent for Finance & Operations/CSBO
Community Consolidated School District 89
(630) 469-8900, ext. 3506; mjones@ccsd89.org

PANELISTS INFO:

Tammie Beckwith Schallmo, Senior Vice President, Managing Director; PMA Securities, LLC
(630) 657-6446; tschallmo@pmanetwork.com

Anjali Vij, Partner; Chapman and Cutler LLP
(312) 845-3472; anjvij@chapman.com

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