Trends in the Muni Market

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Major Impacts on the Muni Market

- Refunding Bonds
- Bank Loans
- MCDC
- Puerto Rico
Big Picture Dynamics – Market Observations and Market Structure

May 24, 2016
Chris Mier
Loop Capital Markets

Government Finance Officers Association of the United States and Canada
The New Volume Decline

New issue volume was down for 8th consecutive month year-over-year in April by an average of 16% per month.

The decline was caused by drop in refunding volume, even though, on average:

(1) 10-Yr MMD was lower by about 23 bps 2016 YTD compared to the same period in 2015.

(2) Muni-Treasury ratios were about the same.

(3) The Treasury curve was flatter this year by 7 bps. Higher rates on the front end of the curve improve escrow yields and alleviate negative arbitrage.

Sources: The Bond Buyer, Thomson/Reuters
Current Activity and 2016 Outlook

We estimated $385 billion in new municipal bond volume for the 2016 calendar year, with new money issuance increasing and advance refundings declining.

However, the increase in new money volume has not made up for a steeper drop in refundings than anticipated so far.


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<td>22.5%</td>
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If YTD trend continued through December, 2016 volume would be:
(1) $350 billion, if issuance followed the same pattern as in 2015
(2) $416 billion, if it followed the average pattern 2007-2015

Sources: The Bond Buyer, Loop Capital Markets
As yields have fallen, muni bond funds have experienced 31 consecutive weekly inflows from Oct-15 through May-16, totaling $19.5 billion. YTD net inflow is $12.7 billion.

Source: Lipper
The 10-Yr Muni/Treasury ratio is currently around 88%, with munis moderately rich by historical standards.

The range over the 2015 calendar year for the 10-yr ratio was 24 points.
The muni curve is the flattest it has been since January 2008, partially due to initiation of Fed tightening and the expectation of a continued reduction in accommodation.

Strong mutual fund inflows, lower supply and absence of low risk alternatives with desirable attributes are contributing factors to demand, pressing down on longer dated yields.

Source: Thomson/Reuters

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Credit Spread

Muni credit spreads are close to the tightest levels since the credit crises.

Yet, the perception of credit risk is quite high due to headlines about Puerto Rico, City of Detroit, Chicago Public Schools, City of Chicago, State of Illinois, oil-producing states, etc.

Source: Thomson/Reuters
Type of Muni Issuance

Competitive issuance has been steadily increasing, on a relative basis, compared to negotiated.

Private placements peaked in 2014 at 7.1%, but represented only 2.8% of total issuance from January through April 2016.

Source: The Bond Buyer
Education issuance is strongest, on a relative basis, in at least 10 years. In their 2016 State of the State addresses, governors emphasized education more than any other issue, including jobs.

Transportation issuance is trailing partially due to cutbacks in federal funding, including matching funds.

Source: The Bond Buyer
Green Bonds

A green bond is a bond whose proceeds are used to fund environment-friendly projects.

The Green Bond Principles (Jan-2014) was created to increase transparency and disclosure regarding the sale of green bonds.

The Climate Bonds Initiative has also joined the movement toward increasing awareness of opportunities to fund green projects.

The first U.S. entity to use this term was the Commonwealth of Massachusetts, which in June 2013 sold $100 million of 20-year notes it referred to as “green bonds.”

The issuance proved popular among both individuals and institutions that are compelled, by charter, to dedicate a portion of their cash in green investments.

Municipalities sold $3.8 billion in green bonds in 2015, compared with $2.4 billion in 2014.
Types of Financings Used Today/Tomorrow

Not One Size Fits All

i. Long Term Debt
ii. Short Term Debt
iii. Variable Rate Debt
iv. Direct Bank Loans
v. Commercial Paper Programs
vi. Refundings
Long Term Debt

Low tax-exempt fixed rates provide less impetus for issuers to consider floating-rate products.

By issuing long term debt, issuers can lock in low cost of borrowing and eliminate interest rate remarketing and bank risk associated with variable rate debt.

Issuance can be structured to match future cash flows from the project, target certain maturities, create desired debt service schedule, etc.

Today’s 30-Yr MMD is lower than 99.5% of its closing rates over the last 10 years.
Floating rate notes ("FRNs")
- Variable rate pegged to SIFMA and LIBOR

The size of the fixed spread is determined by the issuer’s credit spread, the swap arbitrage relationship and supply-demand conditions at the time of issuance. Over time, both the credit and relative value versus swaps of an issue may change.

Source: The Bond Buyer

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Variable Rate Debt

The multi-year decline in municipal variable rate demand bond (VRDBs) issuance* could reverse if long-term muni rates rise.

Reset rates in the VRDB market have remained historically low for several years, and issuers continue to have ample access to credit and liquidity support.

Growth in VRDB balances will depend on whether banks provide increased direct loans to issuers as an alternative to liquidity support facilities.

Advantages:
- Lower interest costs, increased financial flexibility

Disadvantages:
- Interest rate risk, credit facility cost, bank downgrade risk, greater complexity

* VRDB issuance fell more than 52% from 2010-15

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Case Study—Swap Termination & Variable Rate Debt Conversion

Credit downgrades and other contract termination events are written into the swap contracts and letter of credit agreements.

To mitigate these risks, the issuer used the line of credit to make swap termination payments and then repaid the amounts owed on the line with proceeds from new fixed-rate bond issue while maintaining tax-exempt status.

The issuer also executed an interest rate mode conversion for variable rate bonds that were tied to the swap contracts. After the swaps are terminated, outstanding bonds were tendered and reoffered as fixed rate bonds.

The elimination of variable rate debt and interest rate swaps greatly simplified issuer’s debt structure, a positive credit development. It also eliminated the expense of maintaining liquidity facilities, which had become more expensive to maintain.

The strategy enabled the issuer to exit the swap contracts in a way that did not exhaust system liquidity or impair debt service.
Direct Bank Loans

When short-term interest rates are very low, direct bank loans provide low-cost financing and allow issuers to avoid bank fees associated with VRDBs, while banks benefit from tax-exempt interest on loan assets.

However, such on-balance sheet financing becomes more expensive for issuers and less appealing to banks in a higher interest rate environment as banks' cost of funds increases.

Advantages
- Ability to do a lower-cost transaction because there is less need for professionals and associated fees (ratings, for example)
- Faster to execute from when need is first identified to when funds are needed. Can forego lengthy vetting of investment banks and syndicate formation.
Commercial Paper Programs

Municipal commercial paper (CP) programs are short-term financial instruments (1-270 days), sometimes backed up by lines of credit to achieve low interest rates.

Advantages:
- Issuance of CP can be accomplished relatively quickly
- Provides the issuer with the maximum flexibility to defer long-term bond issuances for smaller projects, or as bridge financing.
- Loans can be paid off with short-term notice without penalty
- Low cost financing (short end of the curve)
- Amounts drawn can be closely matched to the capital cash flow requirements
- Minimal disclosure, simple documentation

Disadvantages:
- Administration and monitoring of rollovers and payments
- Same as for VRDB transactions, if applicable
Refundings are down

In Jan-Apr 2016, refundings are down 36%, while new money volume is 19.5% higher than during the same period in 2015.

Steep drop in refundings occurred despite interest rates that are close to historic lows and relative flat yield curve that favors advance refundings.

We expect refundings to pick up through the rest of this year as higher Treasury rates on the front end of the curve improve escrow yields.
Trends in the Muni Market

May 24, 2016
Matt Posner, Principal
The Court Street Group LLC

Government Finance Officers Association of the United States and Canada
Court Street Group LLC (CSG)

- CSG is a research, data provider and consulting firm with focuses on public finance and international debt markets
- Independent policy analysis for market participants, issuers, and legislative and regulatory bodies
- Supporting financial technology solutions for municipal bond origination, secondary transactions and enhanced disclosure
- Aiding Latin American public infrastructure investment opportunities
Preserving Tax-Exempt Interest Will Be Difficult

• There will be comprehensive tax-reform debate under the next Administration, regardless of the political party

• Tax-Reform nearly always includes a conversation about exemptions

• Drum beat grows louder with bad actors and growing understanding of the depth of public pension issues

• Municipal bonds are a low-hanging fruit because not universally understood and have competing interests

• Corporate tax-reform could also remove incentives for bank-qualified and insurance companies
Important Proposals To Follow: HQLA

• A 2014 proposal by bank regulators exclude municipal bonds as high-quality liquid assets when large banks take into account liquidity-coverage ratios

• Final rules released earlier this year (effective July 1, 2016) by the Federal Reserve improve for IG GO bonds and insured bonds, but only slightly

• The House of Representatives passed a bill that would treat IG municipals in a higher bracket

• The Senate has yet to take up the bill
Important Rule Proposals To Follow: HQLA

Consistent Growth in Bank Municipal Holdings

Source: Federal Reserve
Important Rule Proposals To Follow: Mutual Fund Liquidity

• Last Fall the SEC proposed a set of rules to enhance liquidity provisions for all mutual funds that will change the way these investors approach municipal bonds

• Proposed rules appear to specifically target municipal bond funds

• Result will be a more conservative investment strategy penalizing lower-rated issuers and those that issue longer-dated bonds

• Next step: SEC to offer revised rules after reviewing industry letters
Important Rule Proposals To Follow: Mutual Fund Liquidity

(Generally) Consistent Growth in Mutual Fund Holdings

Source: Federal Reserve
Important Rule Proposals To Follow: Mutual Fund Liquidity

Headline Impact on Mutual Funds 2010-2011 (Source: ICI)
The Legacy of MCDC

- MCDC is in its last stages, under current form.

- This is the year in which the SEC is going to take action against issuers – have not done any yet.

- Some issuers have been contacted but still unclear of scope

- The question remains about its overall impact on market participant’s behavior going forward.

- At this point in time: minimal changes to market participants’ behavior is what data suggests.
The Legacy of MCDC

EMMA Filings #s 2013-2016 Q1

Source: MSRB
The Legacy of MCDC

Audited Financials/CAFRs Submitted by Month 2012-2015

Source: MSRB

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Puerto Rico Biggest Congressional Issue Facing Market

- Likely the most mismanaged government in U.S. history over a long period of time
- What Congress and the President decide to do sets perception of precedents in the market and that is why all finance officers should care
- Implications for pension priority
- Implications for GO sanctity
- Implications for headline risk and fund outflows/litigation with fund complexes
Mainstream Media Misperception

Puerto Rican Investor Breakdown

- **30%** Puerto Rican Investors and Banks
- **28%** Mainland Retail and Mutual Funds
- **21%** Hedge Funds
- **21%** Bond Insurance

Source: CSG
Puerto Rico Biggest Congressional Issue Facing Market


Yield (%)

Fund Flows ($B)

Source: ICI, Bloomberg
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Located in New York & Washington, D.C.
How All of This Affects Life on the Ground

May 24, 2016
Kenton Tsoodle, City of Oklahoma City
OKC Overview (as of 6/30/2016):
• $1.5 Billion debt portfolio
• General Obligation Bonds
• Revenue Bonds
• Private Placements
• Bank Loans
• Commercial Paper
• Various Entities and Ratings
Responding to Market Changes
Market changes experienced:

- Low rates for a long time
- Change in bank appetite for loans
- Bye-bye bond insurance
- Increased use of Moral Obligations
- Refundings
- Increased taxable issuance
- Challenges with retail investor participation
OKC GO Spreads vs. MMD

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Role of Credit Enhancements:

- Last used bond insurance in 2007
- AAA/Aaa GO Credit
- Selective use of Moral Obligation
- Rating usually 1-2 notch below
- Exposure limited by debt policy
- 2015 was able to procure a surety policy in lieu of a reserve fund
Bank Loans/Private Placements:

• Appetite has been somewhat lower/more stringent
• Usually want shorter term (<7 year WAM, <10 year maturity) and more coverage
• Typically want limited exposure i.e. smaller size loans, or find a partner(s) for larger loans
Bank Loans/Private Placements:

- OKC uses for short term needs and “unusual” projects
- Have done several fixed rate notes or private placement bonds
- Variable rate lines of credit based on 30 day LIBOR plus spread
Responding to Regulatory Changes
Regulatory changes experienced:

- Post issuance compliance procedures (8038 checkbox)
- G-17 Letters
- MA Rule
- MCDC review/responses
- Increased scrutiny/due diligence by underwriters
Regulatory changes continued:

- Increased scrutiny of Official Statements/CDAs (everyone)
- Changes in rating methodologies and increased scrutiny by rating agencies
- Increasing enforcement activity by various regulators
Municipal Advisor Rule:

- Underwriter’s all wanted exception letters signed
- Investment side of the house got the same letters
- Posting of exception language on website
- MA staffing issues – 2 year rule
- Back to business as usual
Response to regulatory activity:
• MCDC self review
• Responded to underwriter’s questions from their review
• Added a dedicated position for post issuance compliance
• Comprehensive review of CDAs
• Updated CDAs for new issues
Response to regulatory activity:

- Inventory of compliance requirements
- Enhanced internal oversight of the annual filing process on EMMA
- Centralized records for bond related items including documentation of filings
Response to regulatory activity:

- **Enhanced use of EMMA**
  - Custom home page
  - Notifications
  - Set up organization account
  - CUSIP 6 groups

- **Enhanced verification process after filing**
Conclusions?
What keeps me up at night?!!!

• Most issuers have limited staff
• Changes never stop
• Am I aware of all of my requirements?
• Do I know what everyone in my organization is doing? (Decentralization)
• Is anyone going to buy my bonds?
Market Monitoring by You and Your Outside Professionals is Key!

- Interest rates
- Types of financing products available
- Refunding opportunities
- Investors
Regulatory Monitoring is a Must!

- Stay plugged in and educated!
- Use GFOA, bond counsel, municipal advisor, and other sources for information
- Develop good policies and procedures and continually update them
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