# 2015 Municipal Market Overview

## Texas Bond Review Board
## Public Finance Seminars

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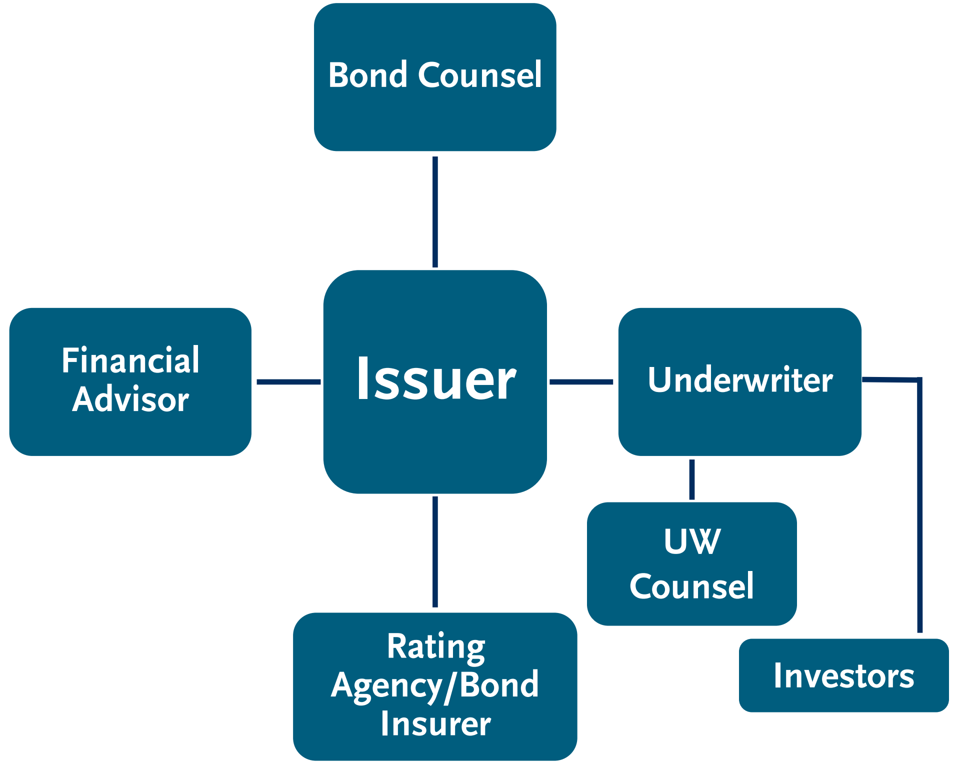
# Kim Edwards, Public Finance, Piper Jaffray & Co.

**Kim Edwards, Sr. VP, Piper Jaffray**
Kim Edwards has worked in the public finance industry for over twenty- five years. She has worked as an Investment Banker for Piper Jaffray since 2012, and prior to that she served as the Executive Director of the Texas Public Finance Authority for 11 years.



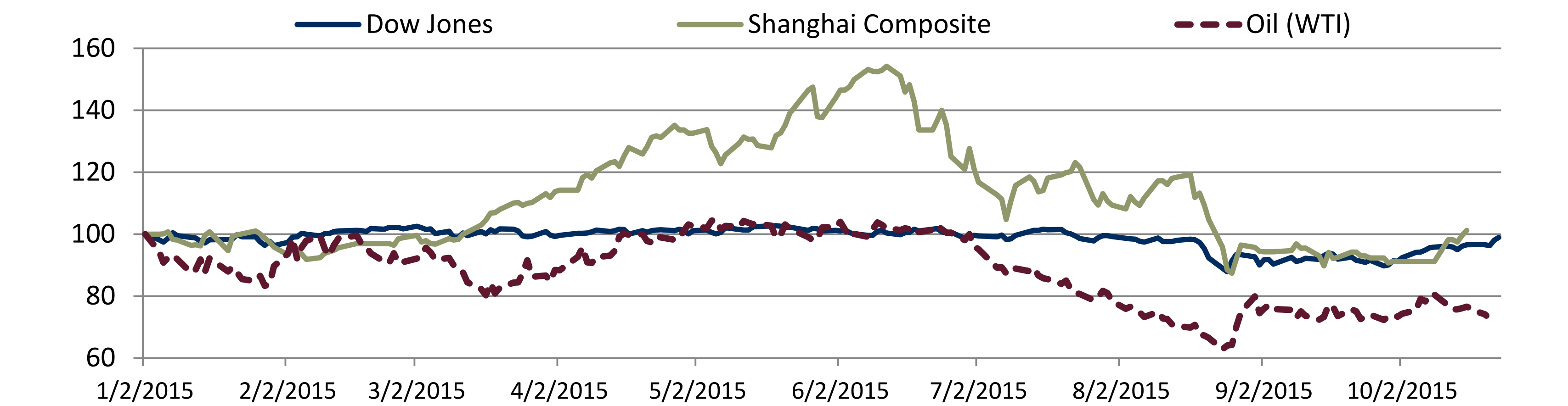

In that capacity she was involved in the issuance and administration of over $5 billion of municipal securities for the State of Texas. She has also served as Assistant Executive Director of the Municipal Advisory Council of Texas, and as a financial advisor to state and local governments, as a Vice President for Government Finance Group in Arlington, VA, and worked for the Government Finance Officers Association and Price Waterhouse in Washington, D.C..

Kim has served on the executive board of the National Association of Treasurer's State Debt Management Network, the Board of Directors of the Municipal Advisory Counsel of Texas and as President of the Texas Chapter of Women in Public Finance. She holds a B.A. from Rice University, an MBA from the University of Texas, and a Masters degree from the LBJ School of Public Affairs at UT Austin. She holds a Series 7, 53 and 63 licenses.

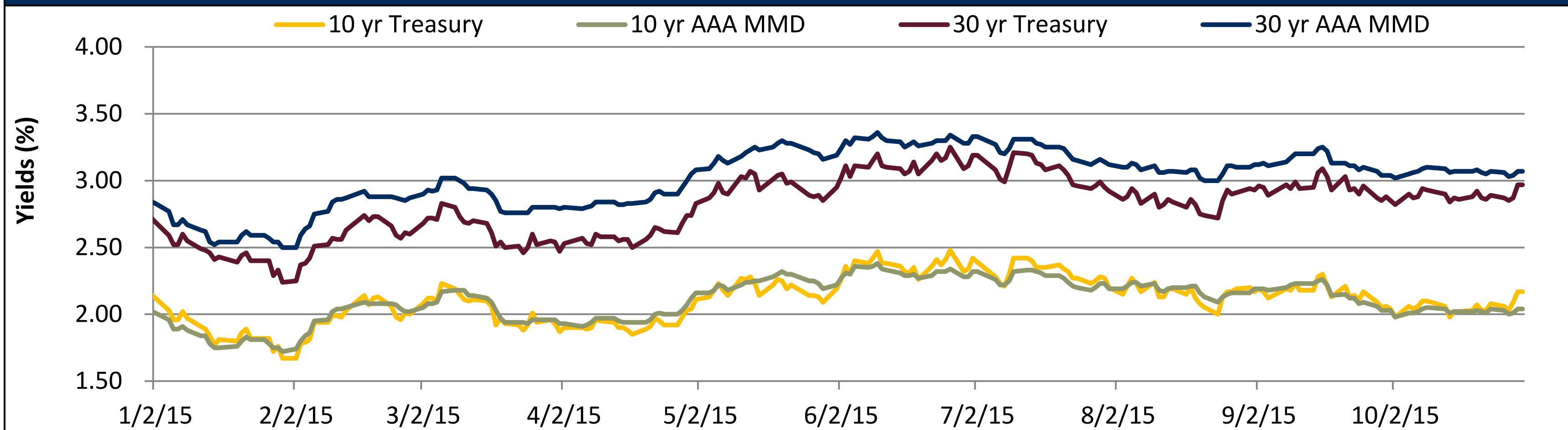
# I. The Municipal Market - National Perspective

# Financial Market Volatility Driven by Global Demand

## Financial Market Indices




## Historical Yield Curve Changes

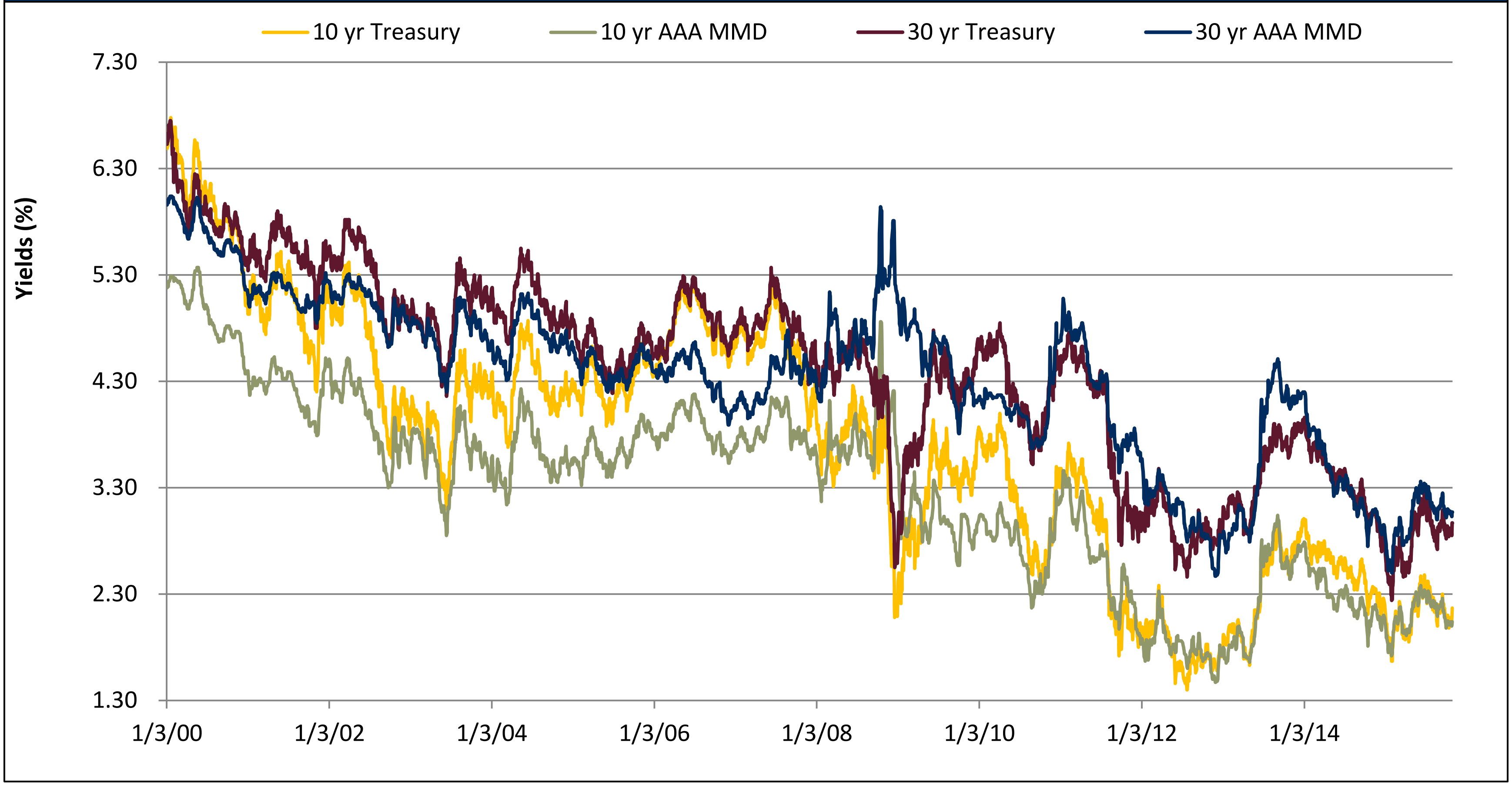



*Source: Yahoo Finance, TM3*

# Historical Interest Rates 2000 – 2015 YTD

- Interest rates are at historical lows, but the relationship between taxable and tax-exempt rates has changed dramatically.

**Historical Yield Curve Changes**

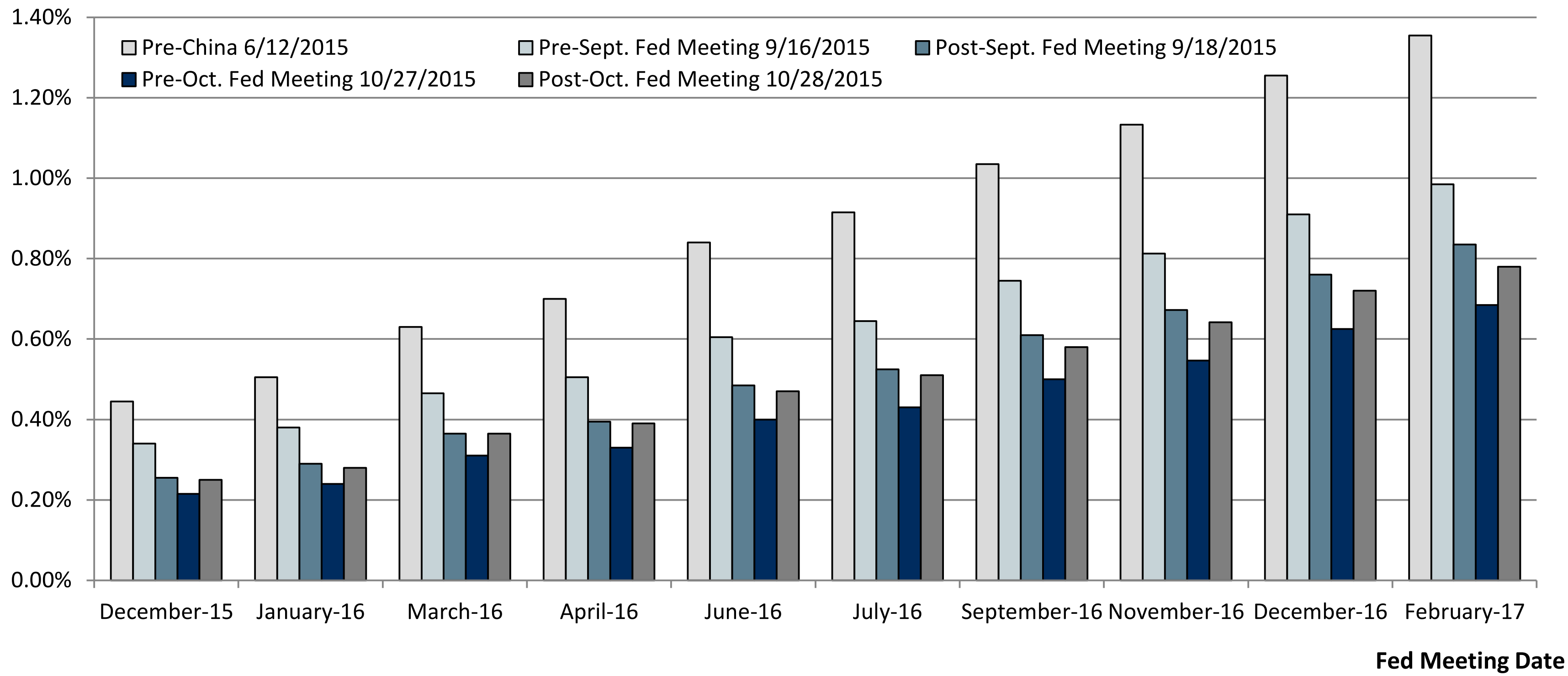



*Source: TM3*

# Volatility Could Dampen Prospects of Future Rate Hikes

| | Nov-15 | Dec-15 | Jan-16 | Feb-16 | Mar-16 | Apr-16 | May-16 | Jun-16 | Jul-16 | Aug-16 | Sep-16 | Oct-16 | Nov-16 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Meeting | | Yes | Yes | | Yes | Yes | | Yes | Yes | | Yes | | Yes |
| Rate Decision | | Yes | Yes | | Yes | Yes | | Yes | Yes | | Yes | | Yes |
| Forecast Release | | Yes | | | Yes | | | Yes | | | Yes | | |

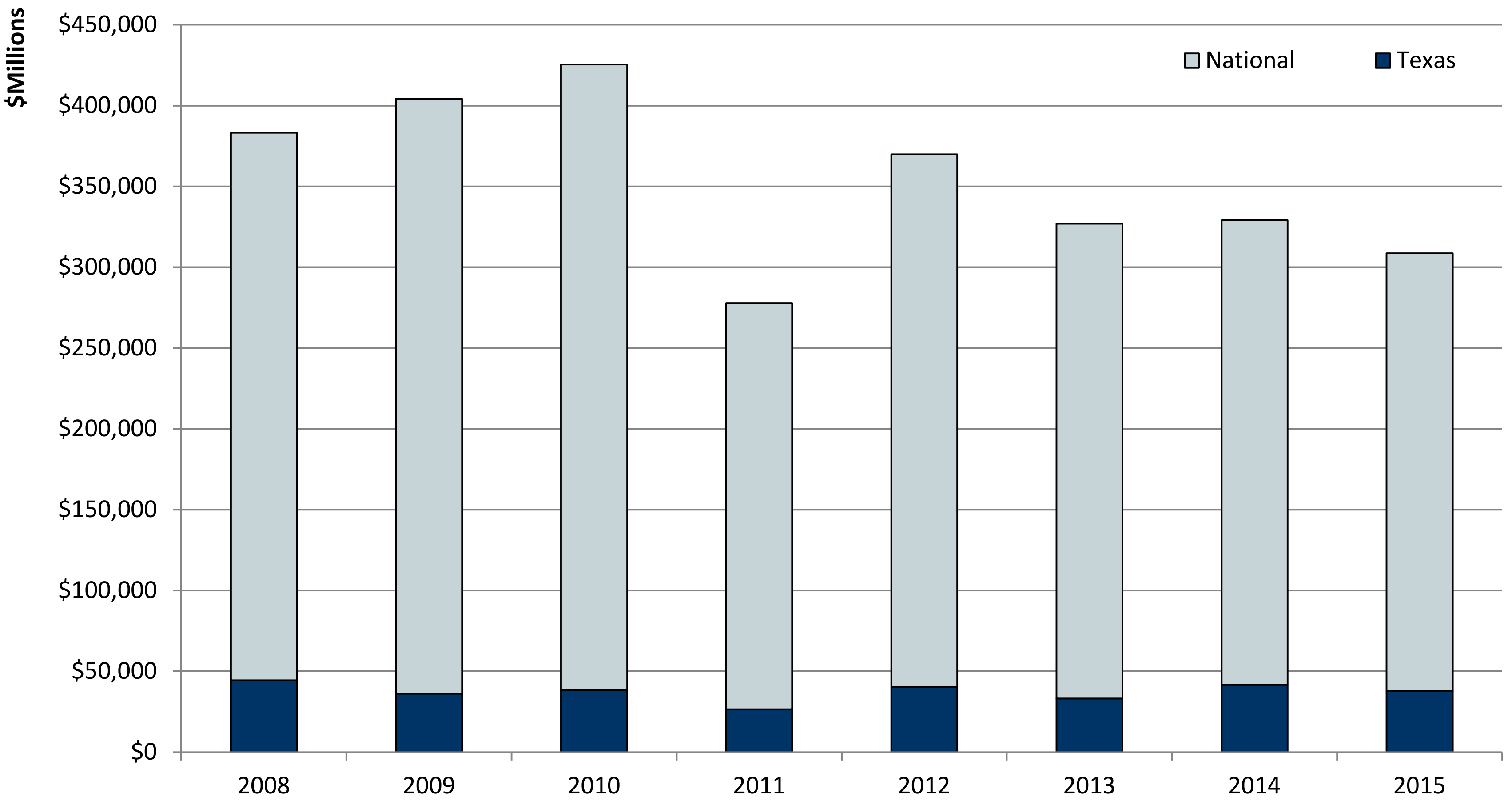
## Market Expectations for Fed Funds Rate




*Source: Bloomberg – 10/28/2015*
*Data based on Fed Futures Contracts*

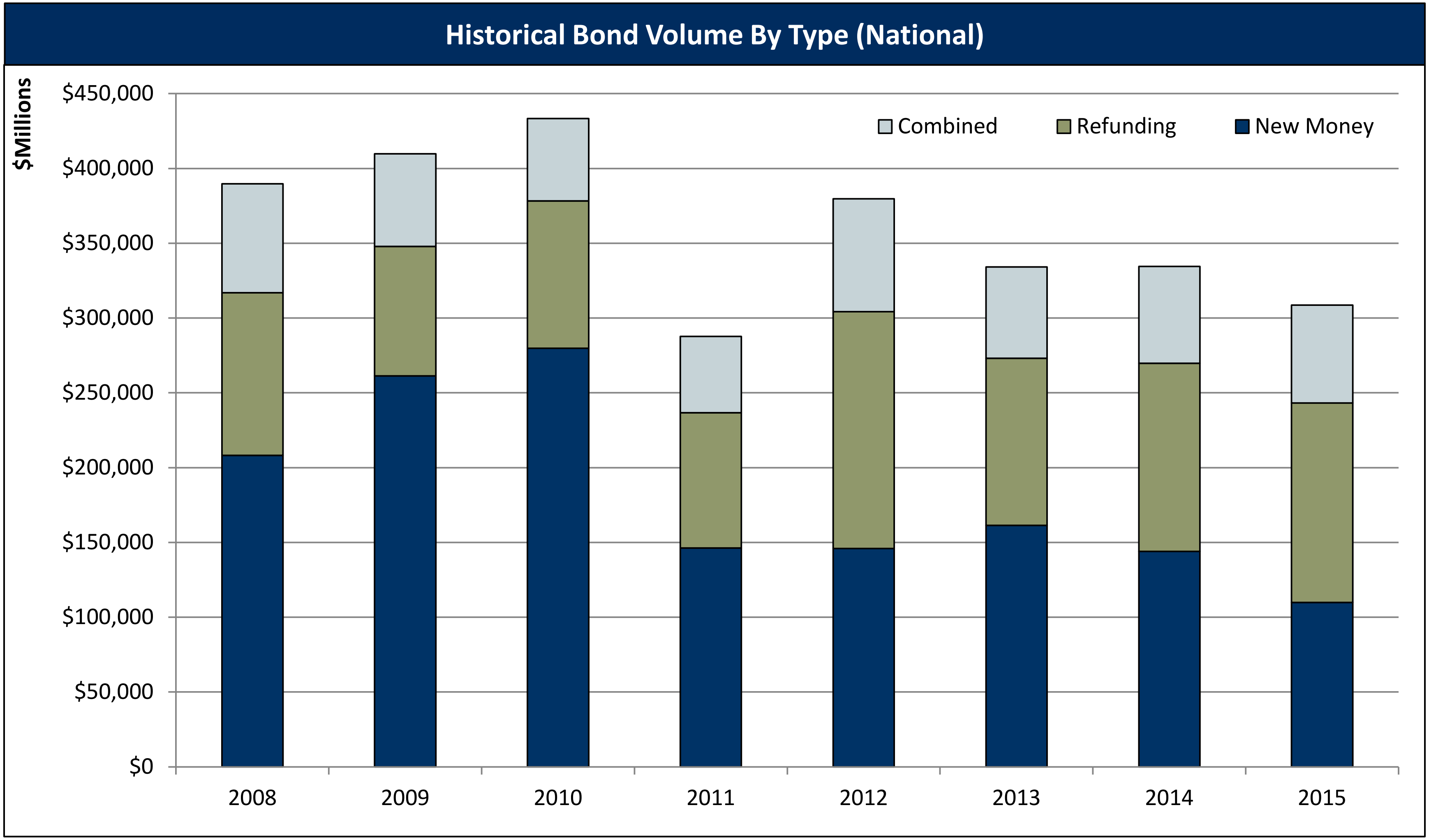
# National Municipal Market Volume 2008 – 2015 YTD

**Historical Bond Volume – Texas vs. Nationally**




*Source: The Bond Buyer and The Texas MAC*
*Excludes Texas TRANs*

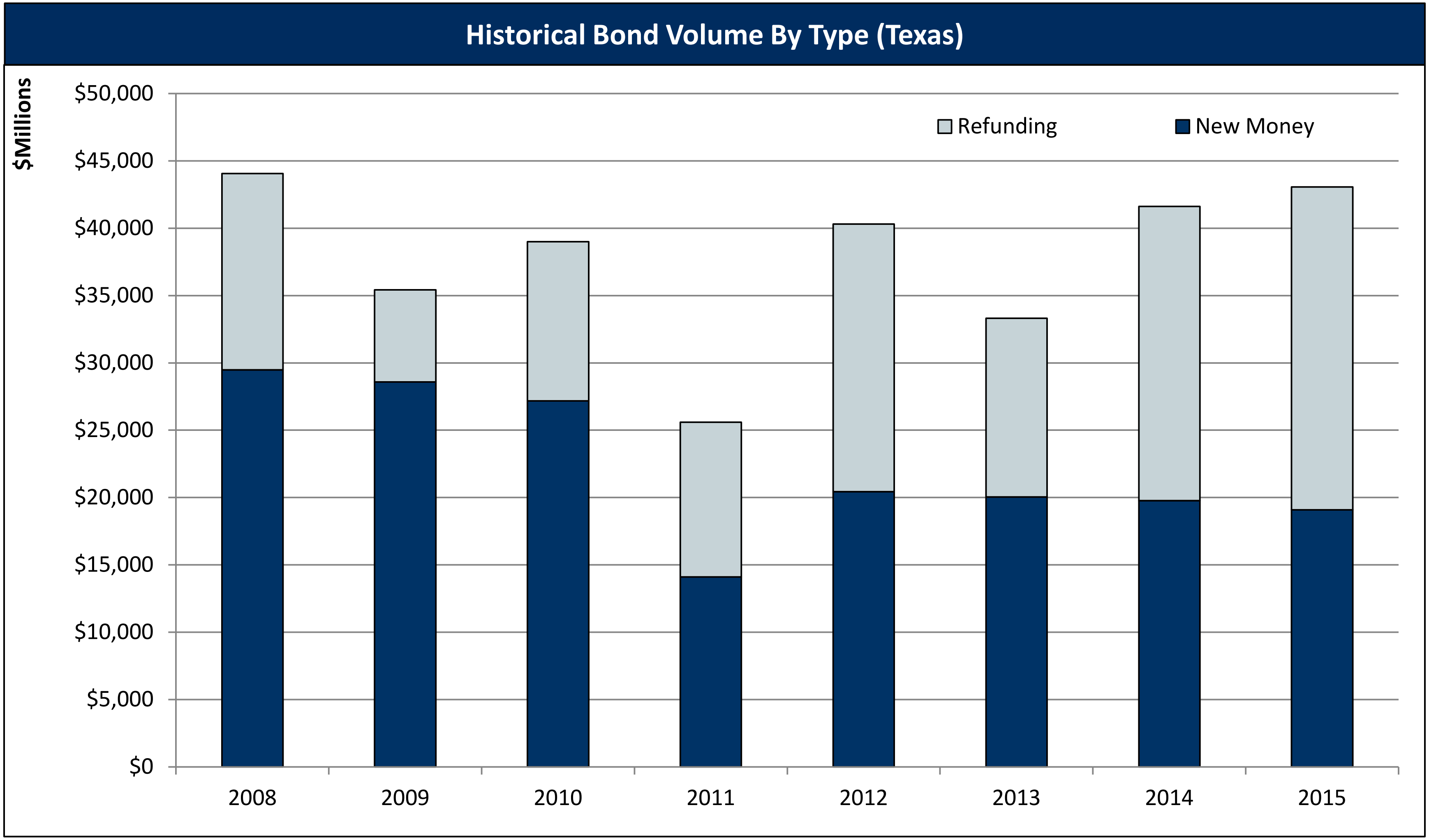
# National Municipal Market Volume 2008 – 2015 YTD




*Source: The Bond Buyer*

# II. The Municipal Market - Texas Perspective

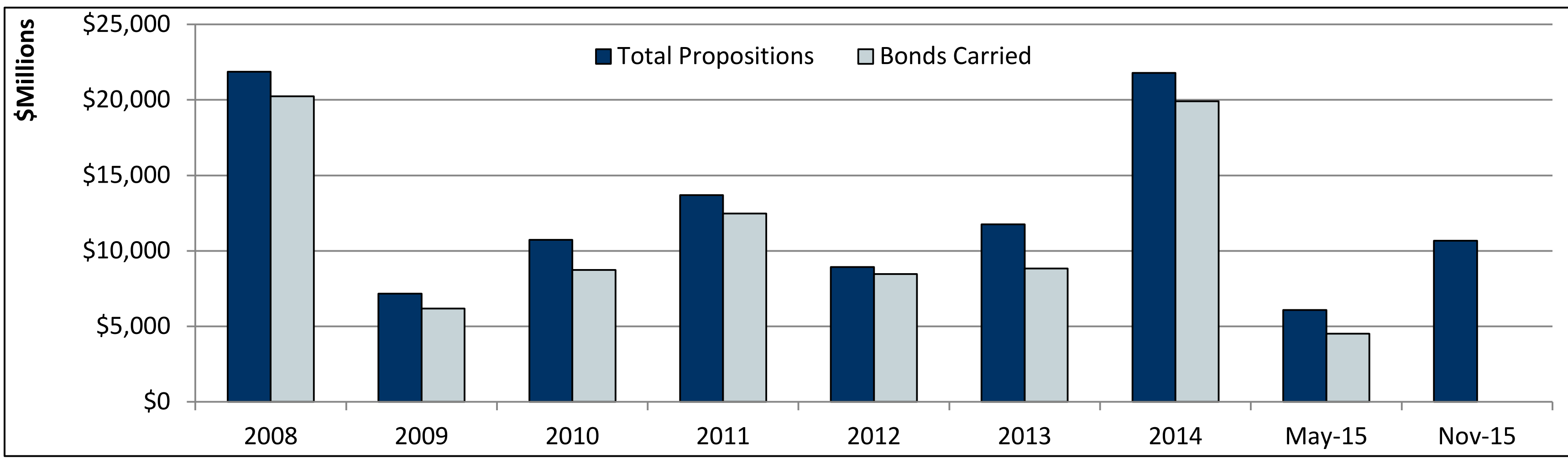
# Texas Municipal Market Volume 2008 – 2015 YTD




*Source: The Texas MAC*
*Excludes Texas TRANs*

# Texas Bond Elections Reflect State's Economic Growth

| | Issuer Type | Elections | Total Propositions | Bonds Carried | Carried % | Issued | Unissued |
|---|---|---|---|---|---|---|---|
| 2015 (Proposed November) | Cities | 16 | 767,095,920 | - | - | - | - |
| | Counties + Road Dist + Tollway Auth | 7 | 1,557,875,000 | - | - | - | - |
| | Community Colleges | 1 | 425,000,000 | - | - | - | - |
| | Schools | 39 | 6,353,570,000 | - | - | - | - |
| | Water and Special Districts | 17 | 1,573,061,009 | - | - | - | - |
| **2015 (November)** | **Total** | **80** | **10,676,601,929** | | | | |
| **2015 (May)** | **Total** | **103** | **5,957,053,005** | **4,381,507,430** | **73.55%** | **1,862,000,511** | **2,519,506,919** |
| **2014** | **Total** | **192** | **21,783,885,023** | **19,913,556,722** | **91.41%** | **5,685,763,387** | **14,227,793,335** |
| **2013** | **Total** | **228** | **11,749,594,190** | **8,836,841,190** | **75.21%** | **5,458,149,082** | **3,378,692,108** |
| **2012** | **Total** | **127** | **8,653,672,935** | **8,205,392,935** | **94.82%** | **4,093,836,326** | **4,111,556,609** |
| **2011** | **Total** | **161** | **13,695,905,035** | **12,483,060,035** | **91.14%** | **3,899,507,965** | **8,583,552,070** |
| **2010** | **Total** | **171** | **10,727,114,000** | **8,734,413,000** | **81.42%** | **5,613,337,000** | **3,121,076,000** |
| **2009** | **Total** | **138** | **7,177,712,267** | **6,188,802,267** | **86.22%** | **2,249,702,384** | **3,939,099,883** |
| **2008** | **Total** | **240** | **21,873,677,101** | **20,232,918,101** | **92.50%** | **11,801,577,274** | **8,431,340,827** |




*Source: The Texas MAC*



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# The Municipal Market - Texas Perspective

- Texas is the second largest issuing state, behind California.

| State | 2015 YTD Volume ($MM) | Rank | 2014 Volume ($MM) | Rank |
|---|---|---|---|---|
| California | 43,059.10 | 1 | 33,616.70 | 1 |
| Texas | 37,779.90 | 2 | 28,292.20 | 2 |
| New York | 30,621.90 | 3 | 24,666.30 | 3 |
| Florida | 16,107.40 | 4 | 9,719.90 | 5 |
| Pennsylvania | 15,253.10 | 5 | 7,439.30 | 6 |
| Washington | 11,026.40 | 6 | 5,936.80 | 11 |
| Michigan | 9,581.80 | 7 | 6,323.20 | 9 |
| Illinois | 9,380.00 | 8 | 10,590.70 | 4 |
| Ohio | 7,219.30 | 9 | 6,233.00 | 10 |
| New Jersey | 6,990.70 | 10 | 7,211.10 | 8 |
| Massachusetts | 6,504.80 | 11 | 7,244.80 | 7 |
| Georgia | 6,176.80 | 12 | 4,148.80 | 17 |
| Virginia | 6,004.90 | 13 | 4,564.20 | 16 |
| Minnesota | 5,994.70 | 14 | 5,211.50 | 13 |
| North Carolina | 5,460.20 | 15 | 2,935.40 | 23 |
| Wisconsin | 5,362.70 | 16 | 4,024.90 | 18 |
| Arizona | 5,312.00 | 17 | 3,555.10 | 19 |
| Maryland | 5,104.10 | 18 | 4,626.00 | 15 |
| Connecticut | 5,092.70 | 19 | 4,899.60 | 14 |
| Oregon | 4,918.90 | 20 | 2,560.20 | 26 |

*Source: The Bond Buyer*

# The Municipal Market - Credit Rating Distribution by State ($MM)

| State | Total Outstanding | Rated | Unrated | AAA | AA | A | BBB | High-Yld |
|---|---|---|---|---|---|---|---|---|
| California | 527,229 | 476,883 | 50,347 | 8,727 | 223,542 | 203,540 | 21,790 | 19,284 |
| New York | 370,342 | 342,393 | 27,950 | 18,349 | 237,125 | 66,530 | 11,630 | 8,760 |
| **Texas** | **310,636** | **283,606** | **27,030** | **117,354** | **96,588** | **50,414** | **17,116** | **2,134** |
| Illinois | 151,666 | 134,296 | 17,369 | 5,985 | 45,473 | 65,652 | 16,410 | 775.80 |
| Florida | 139,622 | 123,662 | 15,960 | 2,730 | 56,373 | 59,629 | 4,215 | 715.60 |
| Virginia | 59,502 | 56,246 | 3,256 | 15,364 | 32,820 | 3,572 | 2,395 | 2,094 |

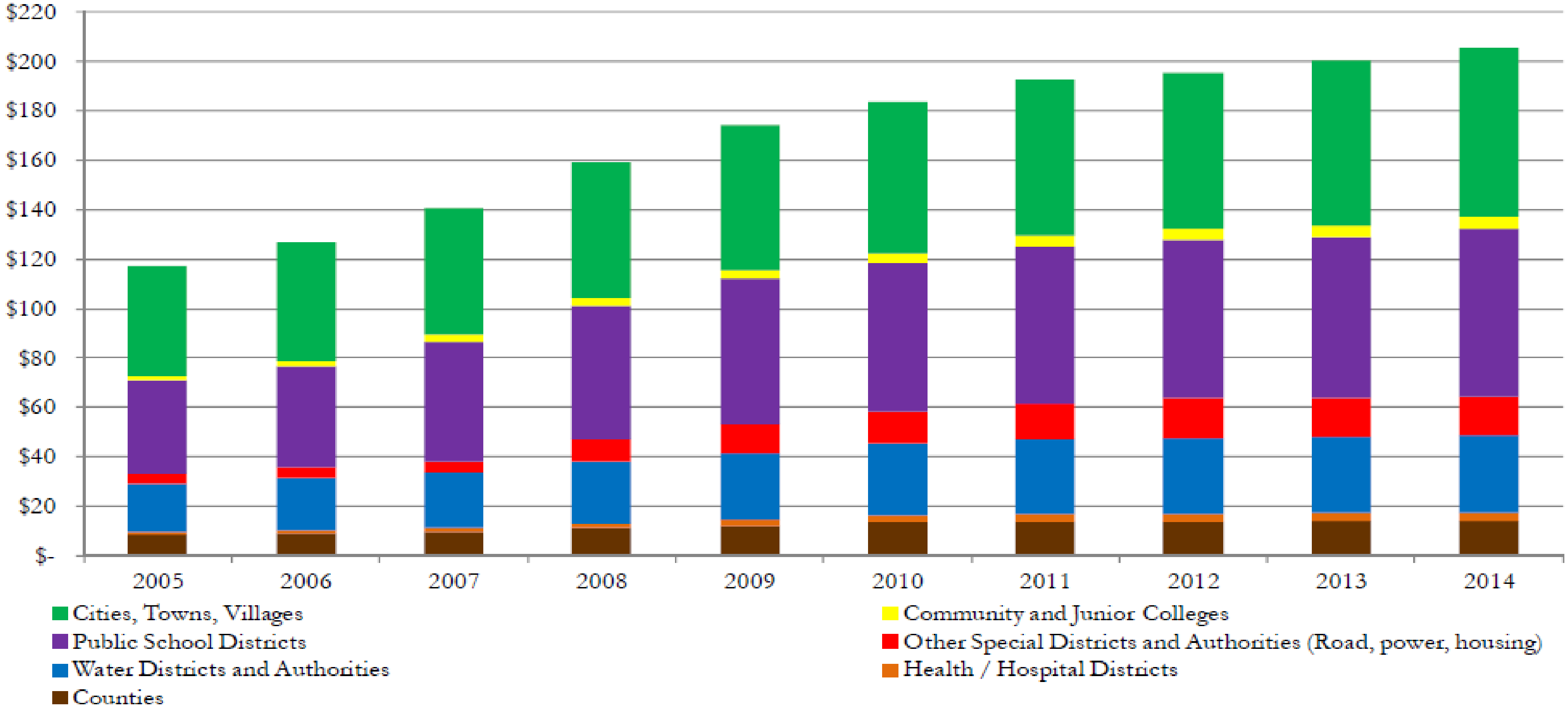
| State | Total Outstanding | Rated | Unrated | AAA | AA | A | BBB | High-Yld |
|---|---|---|---|---|---|---|---|---|
| California | 527,229 | 90.45% | 9.55% | 1.66% | 42.40% | 38.61% | 4.13% | 3.66% |
| New York | 370,342 | 92.45% | 7.55% | 4.95% | 64.03% | 17.96% | 3.14% | 2.37% |
| **Texas** | **310,636** | **91.30%** | **8.70%** | **37.78%** | **31.09%** | **16.23%** | **5.51%** | **0.69%** |
| Illinois | 151,666 | 88.55% | 11.45% | 3.95% | 29.98% | 43.29% | 10.82% | 0.51% |
| Florida | 139,622 | 88.57% | 11.43% | 1.95% | 40.38% | 42.71% | 3.02% | 0.51% |
| Virginia | 59,502 | 94.53% | 5.47% | 25.82% | 55.16% | 6.00% | 4.02% | 3.52% |

*Source: SIFMA Municipal Credit Report, Second Quarter, 2015*

# Texas Local Government Debt Outstanding

- Over 3,500 issuers in Texas; about 1,600 issues in 2014.
- Last year, local issuers were the biggest issuers.

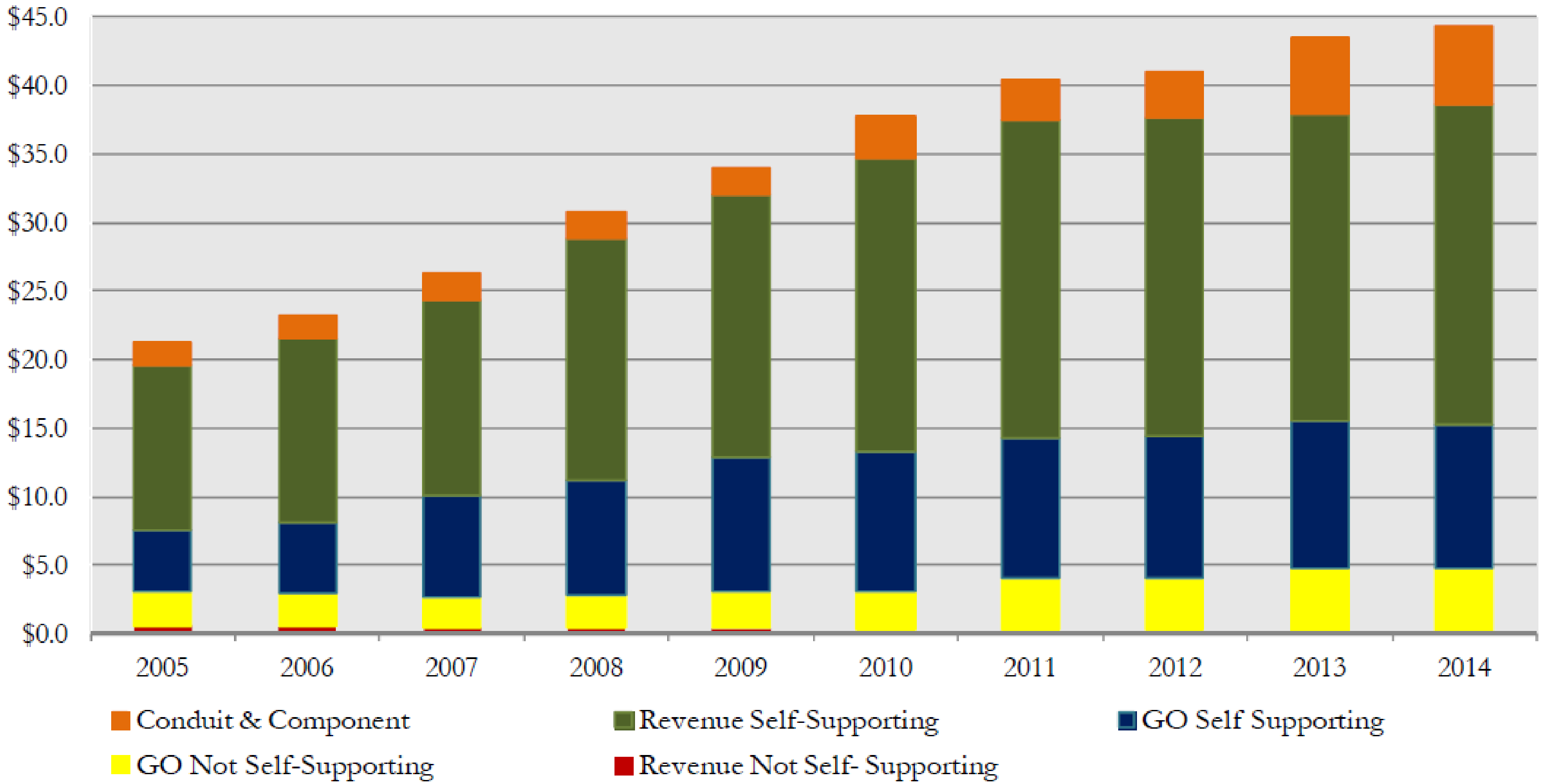
Texas Local Government Debt Outstanding ($ Billions)




*Local debt outstanding for FY 2012 and FY 2013 has been reduced by cash defeasances totaling an estimated $8.20 billion.
Source: Texas Bond Review Board - Bond Finance

# State of Texas Debt Outstanding

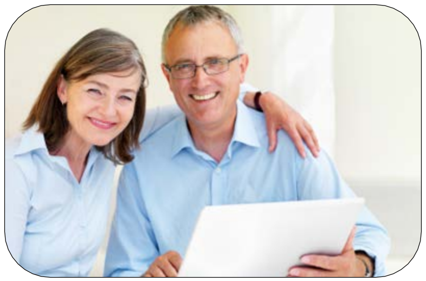
**State of Texas Debt Outstanding ($ Billions)**




Source: Texas Bond Review Board - Bond Finance Office

# III. Who Buys Municipal Bonds?

# Who Buys Municipal Bonds?



## Municipal Issuer

↓

## Underwriter

### Retail Investors

- Individuals buying through a broker

### Middle Markets

- Registered Investment Advisors
- Professional money managers (ex: fee-based advisors)
- Separately Managed Accounts ("SMA" or "Wrap Accounts")
- Trust Companies/ Bank Trust Departments

### Institutional Investors

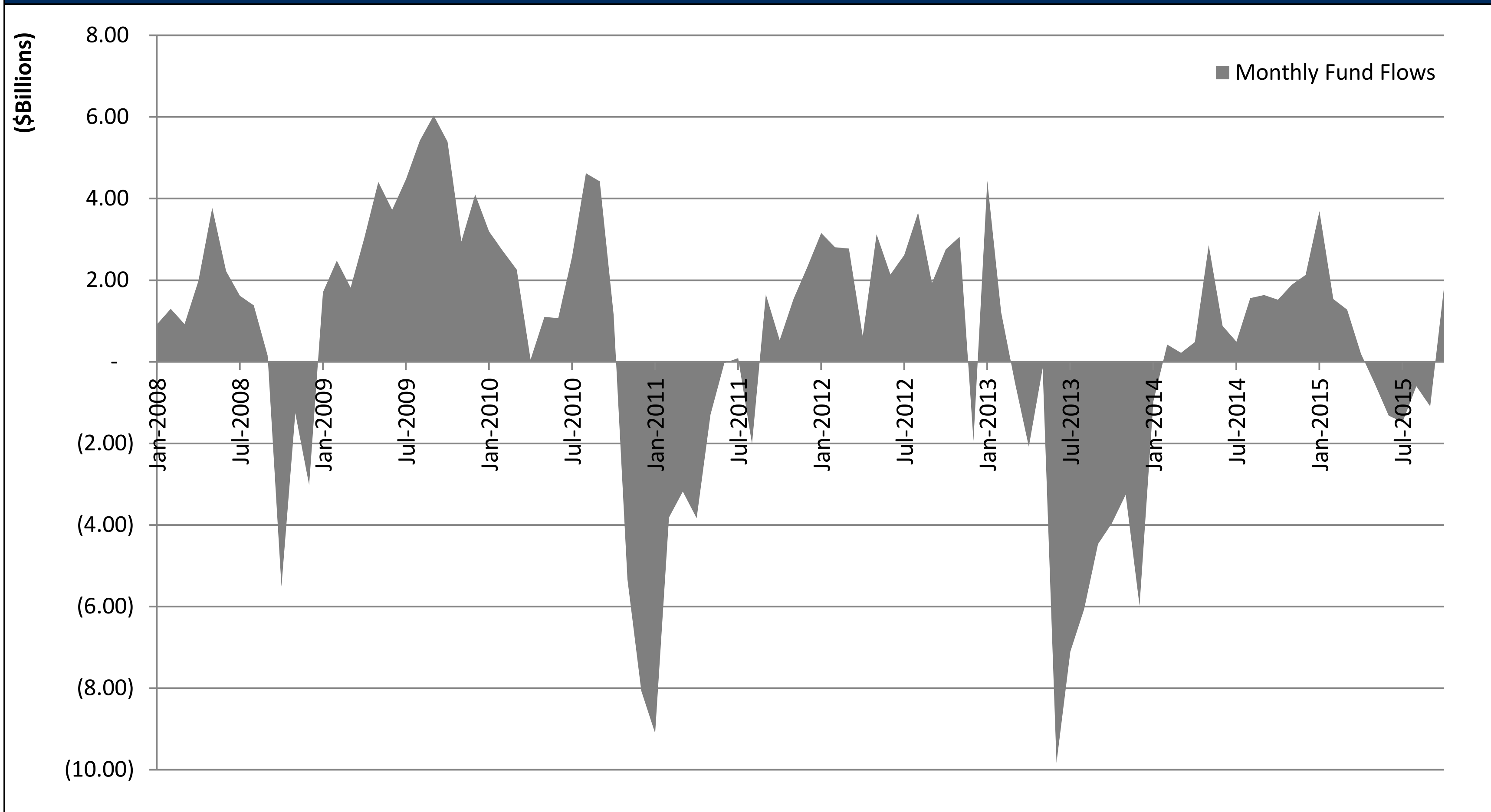
- Mutual Funds (Bond Funds, Money market funds)
- Insurance Companies
- Banks
- Hedge Funds/Arbitrage Accounts
- Pension Funds (taxables)
- Municipalities

### "The Street"

- Broker/Dealers buying inventory or to trade for their own account

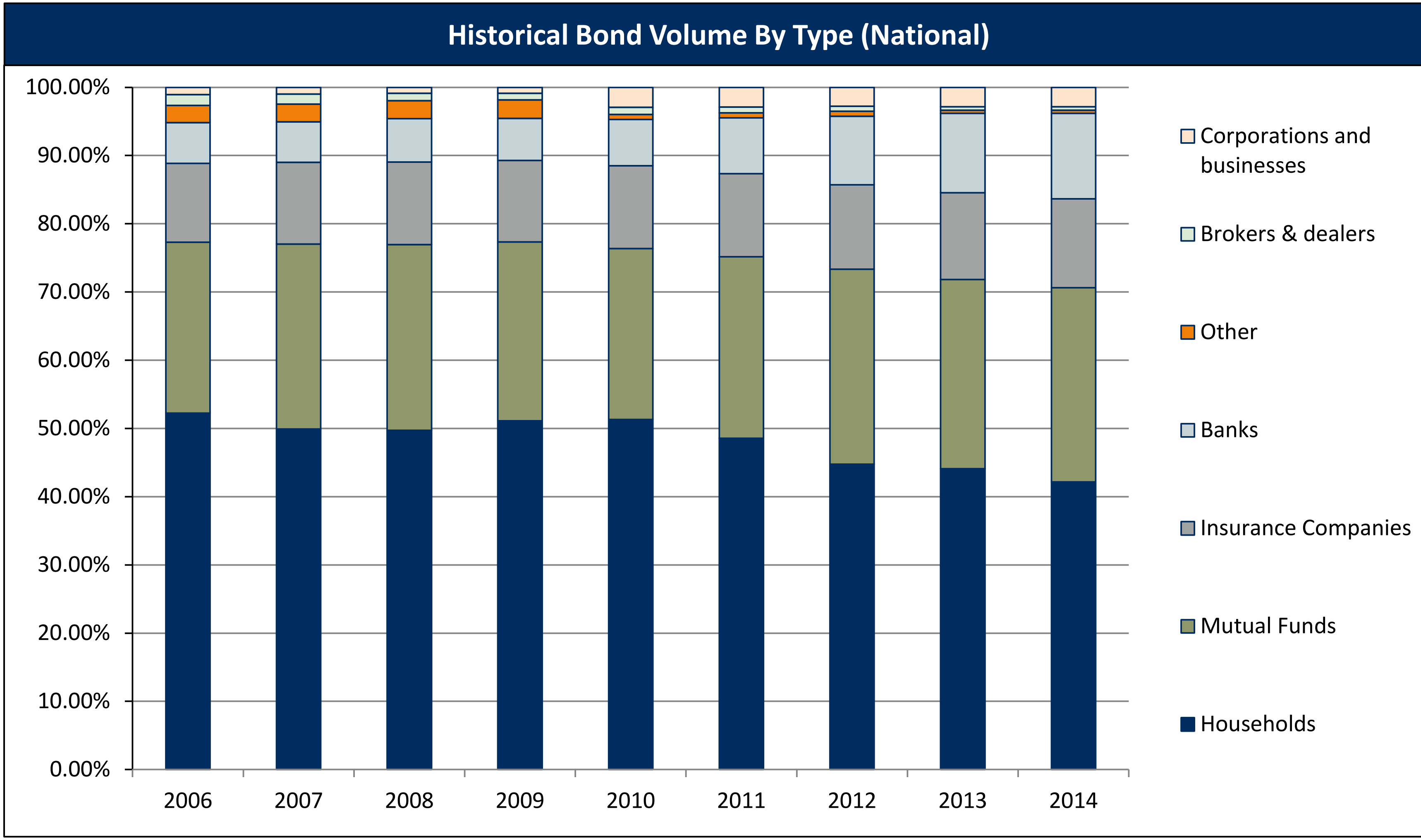
# Municipal Bond Mutual Fund Flows Measure Investor Demand

**Municipal Fund Flows**




*Source: Bloomberg*

# Holders of Municipal Bonds




*Source: Federal Reserve Board*

# Different Maturities May Appeal to Different Buyers

| | |
|---|---|
| **1 year** | ▪ Money Market Mutual Funds (2a-7), Individuals, Corporations |
| **2-5 years** | ▪ Retail: Individuals and Asset managers<br>▪ Corporations<br>▪ Municipalities<br>▪ Short term bond funds |
| **5-10 years** | ▪ Retail: Individuals and Asset managers<br>▪ Intermediate bond funds<br>▪ Banks, Trust Departments |
| **10-20 years** | ▪ Retail: Individuals (depending on yields) and Asset managers<br>▪ Insurance companies<br>▪ Bond Funds<br>▪ Hedge Funds/Proprietary trading desks for arbitrage accounts*<br>**(no longer very active due to lack of leverage)* |
| **30-40 years** | ▪ Bond Funds<br>▪ Insurance Companies<br>▪ Retail: Individuals looking for yield ex: 5% or higher |

# IV. Current Trends in Municipal Finance

# Current Issues in Public Finance - Overview

- Federal Regulatory Environment
- Hot Topics in Texas
- Refundings to lower debt service
- Short Term and Variable Rate products
- Public Improvement Districts
- Bank Qualified Bond Market

# Federal Regulatory Update – Continuing Disclosure

- **SEC Rule 15(c) 2-12 – Continuing Disclosure:** Requires Issuers of Municipal Securities to enter into an "undertaking" to provide continuing disclosure of certain financial and operating data disclosed in the OS (1994).
- **Federal Securities Exchange Act of 1934, Section 10-b-5 – Anti-Fraud provisions**
- **Post 2008/Dodd Frank –** SEC increased enforcement of these provisions, with a number of enforcement actions: Harrisburg PA (misleading statements outside of the offering documents, i.e., statements by an elected official), West Clark Community Schools (false claim of continuing disclosure compliance, inadequate due diligence by underwriter), Greater Wenatchee Regional Events Center (SEC assessed a financial penalty against an issuer)
- **March 2014 SEC launched the MCDC Initiative – Municipalities Continuing Disclosure Cooperation,** "a voluntary self-reporting program targeting material misstatements and omissions in municipal bond offering documents."
- **SEC has fined 58 firms to date** (36 in July, 2015 and 22 in October, 2015)
- **<u>Issuers should develop processes and procedures for POS preparation and filing on-going continuing disclosure.</u>**

*Source: The Texas MAC*

# Federal Update – Misc.

- **Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 975**
- **Municipal Advisor Rule (SEC Rule 15ba1-1, and MSRB Proposed Rule G-42):**

  - Unlawful to provide "advice" to or on behalf of a "municipal entity" or "obligated person" with respect to "municipal financial products" or the issuance of municipal securities unless you are registered with MSRB as a "Municipal Advisor."

  - Imposes a fiduciary duty on the municipal advisor in favor of the municipal entity that they advise

  - Municipal Advisor can not also act as an underwriter (MSRB Rule G-23)

  - Municipal Advisors will be required to pass a Qualification Exam (currently in pilot phase)
- **MSRB Initiatives:**

  - Municipal Advisor Rule

  - Market Structure/Price Transparency: Best Execution Rule, T+2, Retail Price Transparency

  - Bank Loan Disclosure: treat bank loans/private placements as a municipal security
- **Treasury/IRS – Issue Price Rules:** 10% actually sold to public vs. expected to be sold
- **Federal Budget Deal/Debt Ceiling –** SLGS Window to reopen, BABs Sequestration to continue through 2025
- **Highway Funding Bill passed**

*Source: The Texas MAC*

# Hot Topics in Texas – 84th Texas Legislature

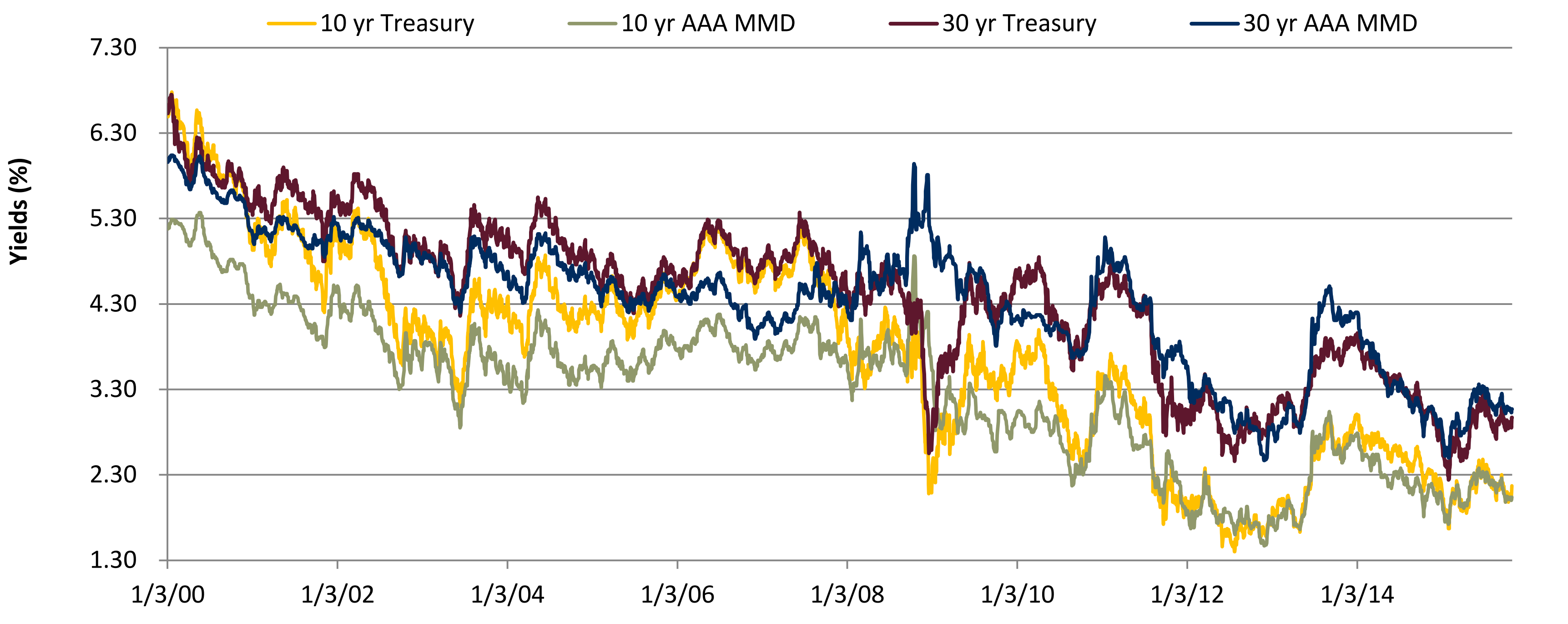
- **House Bill 114: Restricts use of Capital Appreciation Bonds**
- **House Bill 1378: Debt Transparency**
  - (1) requires all cities to file an annual financial report with the state comptroller; and
  - (2) prohibits the issuance of certificates of obligation when there has been a failed bond election on the same issue in the previous three years.
- **HB 3132: Municipal Advisors (Financial Advisor, Investment Advisor)** – requires registration, consistent with federal regulatory requirements imposed by Dodd Frank
- **HB 870/HB 1148 – Public Funds Investment Act Training** – after initial 10 hour training period, reduced to 8 hours every two years, or to zero if investments are limited to CD's or interest bearing accounts
- **HB 2679: Public Facility Corporation "Clean up" bill**
- **School Finance Lawsuits** – Judge reheard arguments reflecting additional funding; Ruling not likely until 2016, some likelihood of a special session.

*Source: The Texas MAC*

# Refunding – Refinancing Debt to Lower Debt Service

- Most bonds are issued with a call option which allows the issuer to call the bonds prior to maturity. Typically, 10 year, par call (Debt Issuance: Chapter 1371 Gov't. Code; Refundings Chapter 1207)
- Refunding – issue new bonds (Refund<u>ing</u>) to pay off old bonds (Refund<u>ed</u>) with an <u>Escrow</u> <u>Account</u>.
- **Refunding economics depend on <u>four</u> variables: coupon of the old bonds, interest rates on the refunding bonds, length of time to the call date, interest rates on the escrow(taxable market).**

**Historical Yield Curve Changes**




*Source: TM3*

# Overview of Refunding Bonds and Bond Issuance Process

- Federal Tax Law allows you to advance refund bonds only <u>one time</u> prior to the call date on a tax-exempt basis.
- **Advance Refunding** – Refunding bonds are issued prior to 90 days before the call date of the refunded bonds. Proceeds of the refunding bonds are placed in an escrow account, invested in Treasury securities, and used to pay debt service on the refunded bonds until the call date.
- **Current Refunding** – Refunding bonds are issued within 90 days of the call date, so the escrow account is only funded for 90 days or less.
- **"Negative Arbitrage"** – In the current interest rate environment, the interest rate on the escrowed investments may be less than the interest rate on the refunding bonds; however, overall, savings can still be positive since the interest rate on the new bonds is so low. The shorter the escrow period, the lower the negative arbitrage.
- **Taxable Advanced Refundings** – It may be possible to issue taxable advance refunding bonds and still obtain debt service savings. Do you "wait it out" until the call date and hope that rates do not go up, or do you do a taxable advance refunding?
- Issuing refunding bonds is like any other bond issue – the Issuer needs to hire Bond Counsel and a Financial Advisor and obtain credit ratings. Combining a refunding with a new money issue may present some economies of scale in terms of issuance costs and administrative effort.

# Refunding Case Study

| Summary of Refunding Results | |
|---|---|
| **General Obligation Bonds** | |
| Par Amt of Refunded Bonds ($): | 18,630,000 |
| Par Amt of Refunding Bonds ($): | 17,095,000 |
| True Interest Cost: | 3.04% |
| NPV Savings (%): | 9.40% |
| NPV Savings ($): | 1,750,814 |
| Savings ($): | 2,172,704 |
| Negative Arbitrage ($): | 579,444 |
| Negative Arb/NPV Savings: | 33.10% |

| Debt Service Savings | | | |
|---|---|---|---|
| **FYE (9/30)** | **Prior Net DS** | **Refunding DS** | **Savings** |
| 2016 | 342,628 | 316,668 | 25,960 |
| 2017 | 920,494 | 850,750 | 69,744 |
| 2018 | 1,212,994 | 1,050,750 | 162,244 |
| 2019 | 1,160,869 | 999,750 | 161,119 |
| 2020 | 1,213,119 | 1,052,000 | 161,119 |
| 2021 | 2,027,019 | 1,866,250 | 160,769 |
| 2022 | 2,100,750 | 1,944,250 | 156,500 |
| 2023 | 2,374,750 | 2,215,750 | 159,000 |
| 2024 | 2,374,375 | 2,215,750 | 158,625 |
| 2025 | 2,375,000 | 2,217,000 | 158,000 |
| 2026 | 2,373,875 | 2,214,250 | 159,625 |
| 2027 | 2,373,375 | 2,212,500 | 160,875 |
| 2028 | 2,373,250 | 2,211,500 | 161,750 |
| 2029 | 2,373,250 | 2,216,000 | 157,250 |
| 2030 | 2,375,625 | 2,215,500 | 160,125 |
| | **27,971,372** | **25,798,668** | **2,172,704** |

# Refunding Case Study

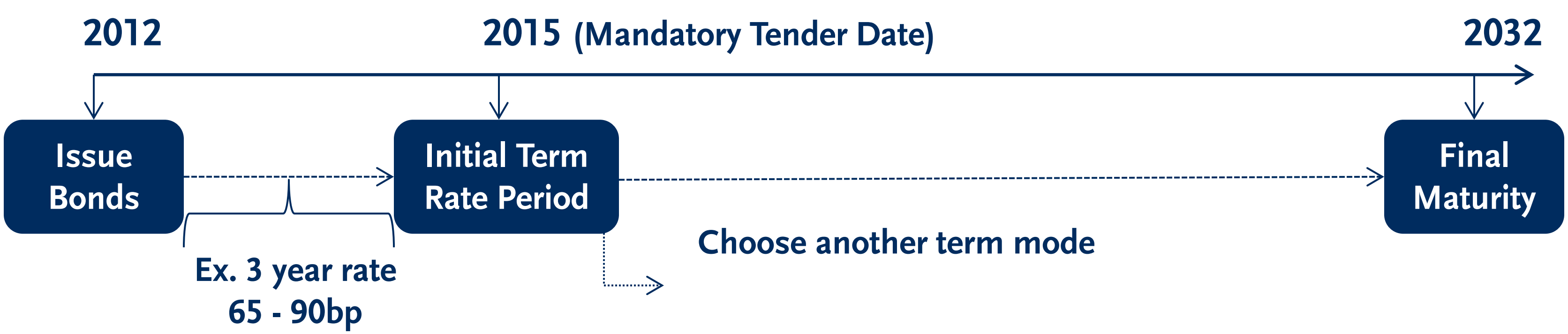
| Maturity by Maturity Savings Analysis | | | | | | |
|---|---|---|---|---|---|---|
| Refunded Maturity | Refunded Coupon | Refunded Par ($) | PV Savings ($) | PV Savings (%) | Negative Arb ($) | Negative Arb/ NPV Savings |
| Series 2008 General Obligation Bonds - Callable 4/1/2017 | | | | | | |
| 4/1/2018 | 5.000% | 292,500 | 6,585 | 2.25% | 1,826 | 27.70% |
| 4/1/2019 | 5.000% | 255,000 | 12,791 | 5.02% | 2,777 | 21.70% |
| 4/1/2020 | 4.250% | 320,000 | 16,168 | 5.05% | 4,749 | 29.40% |
| 4/1/2021 | 4.250% | 1,147,500 | 68,209 | 5.94% | 21,471 | 31.50% |
| 4/1/2022 | 5.000% | 1,270,000 | 123,402 | 9.72% | 28,672 | 23.20% |
| 4/1/2023 | 5.000% | 1,607,500 | 165,228 | 10.28% | 41,828 | 25.30% |
| 4/1/2024 | 5.000% | 1,687,500 | 195,216 | 11.57% | 46,225 | 23.70% |
| 4/1/2025 | 5.000% | 1,772,500 | 222,012 | 12.53% | 51,225 | 23.10% |
| 4/1/2026 | 5.000% | 1,860,000 | 234,913 | 12.63% | 58,078 | 24.70% |
| 4/1/2027 | 5.000% | 1,952,500 | 227,890 | 11.67% | 63,895 | 28.00% |
| 4/1/2028 | 5.000% | 2,050,000 | 221,032 | 10.78% | 69,877 | 31.60% |
| 4/1/2029 | 5.000% | 2,152,500 | 207,978 | 9.66% | 76,880 | 37.00% |
| 4/1/2030 | 5.000% | 2,262,500 | 202,030 | 8.93% | 83,264 | 41.20% |

# Public Improvement Districts

- Texas Public Improvement Districts authorized under Local Government Code Chapter 372.
- Special limited purpose financing vehicle for public improvements
- Funded by a property assessment, which is a lien that remains on the property regardless of subsequent ownership.
- The assessment is established annually at a fixed dollar amount to cover cost of services. It is not an ad valorem tax.
- Can be used to finance core infrastructure and community amenities for new development, through a bond issue
- Can also be established in existing areas, such as a Central Business District, to finance landscape or street scape improvements
- PID is created by the City – it is not a political subdivision of the State or separate legal entity.
- Powerful in that it allows for the tax exempt monetization of assessments and other contracted revenue streams such as TIRZ, 380 agreements and impact fees.

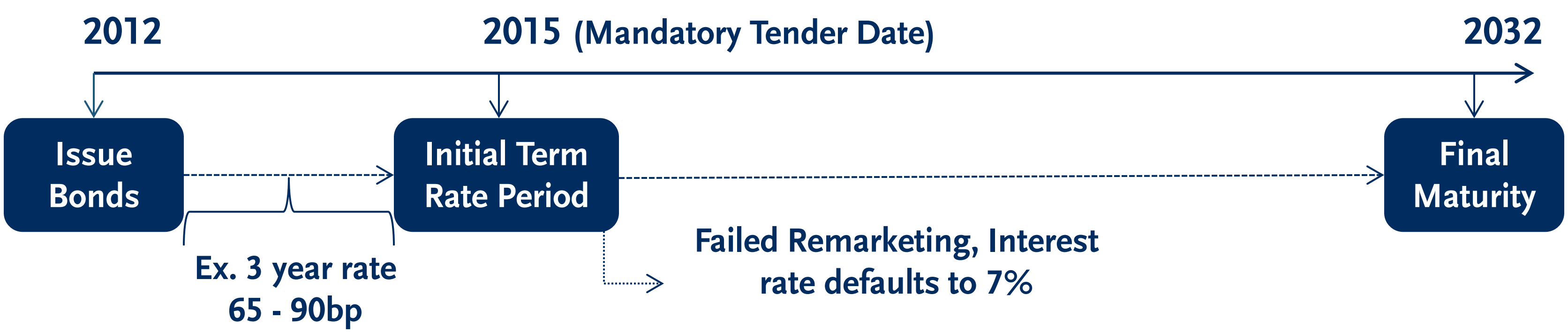
# Variable Rate Alternatives: Term Mode ("Soft Put") Bonds

- Long term bond (20 – 30 years) with provisions to allow the issuer to change the interest rate mode from time to time: fixed mode, weekly mode, or daily mode.
- A Term Mode (i.e. "Soft Put") structure would be priced and bear a fixed interest rate through the initial term rate period. The initial term can range from 1 to 5 years, depending on investor demand and the Issuer's preferences.
- The Issuer will pay a fixed rate during the initial "term" period that reflects the term (one year rate, two year rate, etc), eliminating any interest rate risk during the term. With the short end of the yield curve experiencing very low yields, the overall fixed rates are favorable.
- At the end of the initial term, the Issuer would have the option to convert the bonds to another mode, including fixed rate, or remarket the bonds for another term rate period.



# Variable Rate Alternatives: Term Mode ("Soft Put") Bonds

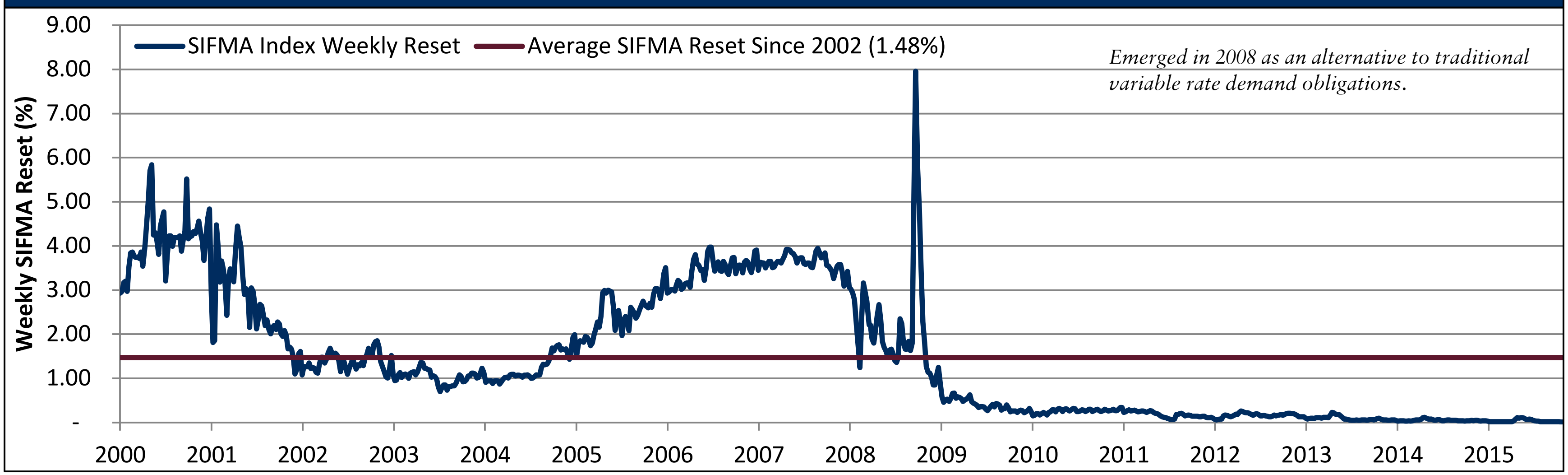
- If for some reason the Bonds are unable to be remarketed at the Mandatory Tender Date, the interest rate on the Bonds would increase to an amount stated in the bond documents.
- **However, a failed remarketing would not constitute an event of default.** The maximum interest rate in Texas is 15%, however typically the Issuer's rate will be between 7% and 10%. This rate can be determined/negotiated based on market acceptance and the Issuer's requirements .
- Unlike a VRDB, the Soft Put structure eliminates counterparty risk and remarketing risk.
- During the entire initial term, the put bonds would not be subject to interest rate changes, market dislocations, or trading differentials due to a credit provider.
- Similar to a VRDB, a Soft Put structure would expose the Issuer to interest rate risk and market access risk at the end of the initial term.



# Variable Rate Alternative: Indexed Floating Rate Bonds

- Variable rate, reset weekly, based on a spread to an index such as SIFMA, or CPI (Securities Industry and Financial Markets Association Municipal Swap Index).
- Interest usually paid monthly.
- Since the interest rate fluctuates, the price of the security stays at par, which limits the risk for a bank to hold it on its balance sheet.
- Bondholder's risk is limited to issuer's credit risk – i.e., the spread to SIFMA widens if credit quality declines.
- Provides bondholder a hedge against rising interest rates.
- Provides issuer access to short-term interest rates with no remarketing or liquidity fees.
- Can be combined with the "Soft Put" term bond structure.

**SIFMA Index Weekly Reset 2000 – Present**

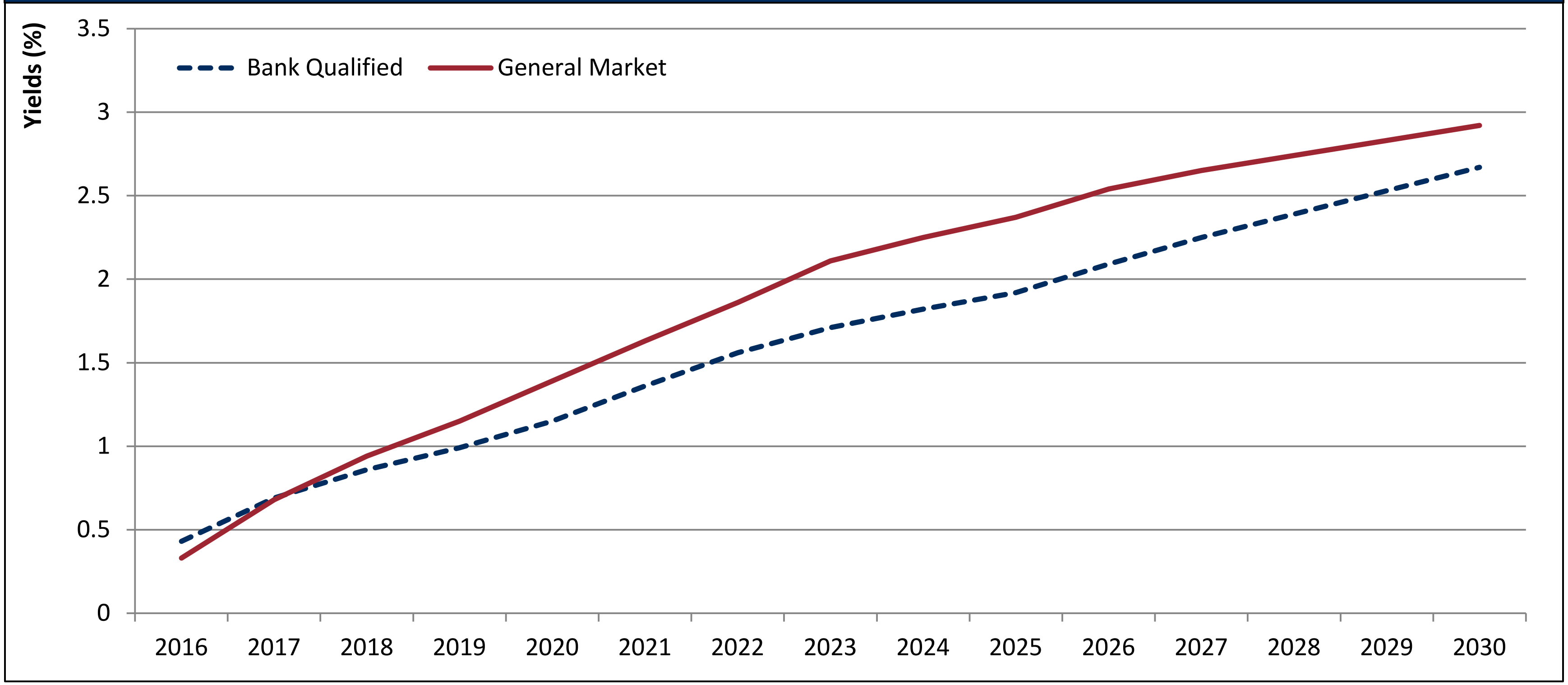



*Source: SIFMA*

# Bank Qualified vs. Tax-Exempt Rates

- "Bank Qualified" – Banks receive a tax-advantage to holding municipal bonds issued by "small issuers" (Less than $10 million per calendar year), so a bank will pay a lower interest rate for "BQ" bonds. When purchased by a commercial bank for its portfolio, the bank may deduct a portion of the interest cost of carry for the position. A bond that is bank qualified is also known as a "qualified tax-exempt obligation." (Section 256(b) Internal Revenue Code).

**Yield Comparison**




*Representative AA GO Clients.*
*Yields as of 10/30/2015.*

# Required Regulatory Disclaimer

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