

Capital Markets Update

2011 – The More Things Change, the More They Stay the Same



38th Ohio APT Annual Conference

Friday, October 7, 2011

Michael G. Sudsina
(216) 215-7753
mike@sudsina.com



**SUDSINA &
ASSOCIATES, LLC**
REGISTERED
MUNICIPAL
ADVISERS
www.sudsina.com
fax (216) 803-2280

Stephen Szanto
(440) 773-5090
ssapfa@en.com



Taking Up Where We Left Off...

Last year we talked with you about:

- Interest Rates
- Bond Insurance
- Rating Agencies
- Build America Bonds, and
- Financial Market Reforms

This year we will pick up where we left off with Financial Market Reforms since developments on that front have had an impact on all the other areas.



Financial Market Reforms Initiated in 2010

Dodd – Frank Act

- Requires registration and regulation of previously unregulated swap and other municipal advisors.
- Addresses the composition and authority of the Municipal Securities Rulemaking Board (the "MSRB") and funding of the Governmental Accounting Standards Board ("GASB").
- Directs a number of studies regarding the municipal securities market, including a study to address "the advisability of the repeal or retention of" the Tower Amendment.
- The new regulations/ laws dealing with banks and derivatives were postponed until after the 2012 elections – wonder why???



Dodd-Frank: MSRB

- MSRB Board reorganized to have a majority of “public” members.
- Old Board had 15 members consisting primarily of bankers with a couple of public representatives.
- New Board has 21 members with a “majority” of public members

Public Members

- Former housing agency CEO
- Large county deputy administrator
- Large city COO
- Non-profit CFO
- 501 (c) 3 foundation
- Bond attorney
- University CFO
- College professor
- Electric industry attorney, and
- 2 investment advisors

Security Firm Members

- De La Rosa & Co.
- Stone & Youngberg, LLC
- Dougherty & Co

Bank Members

- First Southwest
- Citi Bank
- Goldman Sachs
- RBC

Advisor Members

- 2 New Jersey firms
- 1 Chicago firm



Dodd-Frank: Tower Amendment

- The Tower Amendment to the Securities Exchange Act of 1934 was adopted in 1975 and **restricts the SEC as well as the MSRB from directly or indirectly requiring muni issuers to file documents with them before their securities are sold.**
- Proposals being considered to repeal the Tower Amendment – intended to be a move towards more transparency in the municipal market.
- **Will place greater demands on municipalities to stay current with reporting requirements and disclosure information.**
- MSRB's Electronic Municipal Market Access (EMMA) system is designed to assist with requirements (www.emma.msrb.org). Official statements and other disclosure documents are available at the EMMA site and continuing disclosure can be made through the site.



2011 – Much A Do About Nothing?

- Yet there has been a great deal of activity in Washington to further the reform and regulation of the municipal market
- The Municipal Securities Rulemaking Board (the "MSRB") has been very busy writing new regulations for Municipal Advisors which have had an impact on other service providers including underwriters and bond counsel
- Yet it pulled all five of its proposed municipal advisor rules submitted to the SEC since the SEC has yet to define the term "Municipal Advisor"



Five Major MSRB Rules – Proposed, then Pulled

- **G-17 – Fair Dealing**
 - In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.
- **G-20 – Gifts & Gratuities**
 - *General Limitation on Value of Gifts and Gratuities.* No broker, dealer or municipal securities dealer shall, directly or indirectly, give or permit to be given any thing or service of value, including gratuities, in excess of \$100 per year to a person other than an employee or partner of such broker, dealer or municipal securities dealer, if such payments or services are in relation to the municipal securities activities of the employer of the recipient of the payment or service. For purposes of this rule the term "employer" shall include a principal for whom the recipient of a payment or service is acting as agent or representative.



Five Major MSRB Rules – Proposed, then Pulled

- **G-36 – Fiduciary Duty**

Proposed Rule G-36 is very simple and states: “In the conduct of its municipal advisory activities on behalf of municipal entity clients, a municipal advisor shall be subject to a fiduciary duty, which shall include a duty of loyalty and a duty of care.”

- **G-42 – Political Contributions**

The proposed Rule G-42, which is modeled after Rule G-37 for dealers but contains some key distinctions, would not take effect until six months after the SEC approves final registration rules that define the term “municipal advisor.” The commission also would have to publish the proposed rule for public comments and approve it before it took effect. Muni advisor contributions made before the effective date of the rule would not result in a ban on business for compensation. Once G-42 is approved, dealer-financial advisors would be subject to it rather than Rule G-37. But G-37 would continue to apply to dealers involved in underwriting, remarketing, and private placements of munis. Both rules are designed to prevent pay-to-play practices, but while G-37 would temporarily bar dealers from engaging in negotiated business for making certain political contributions, G-42 would temporarily bar advisors from receiving compensation.

- **New A-11 – Municipal Advisor Assessments**



Proposed Rule G-36 Effect on Municipal Issuers

- Underwriters

Claim NO fiduciary duty to issuer (only investor) and requiring issuer acknowledgement in bond purchase agreements

- Bond Counsel

Also claiming no fiduciary duty to issuer regarding financial matters relating to the issue (structure, rating, etc.)

As a result, issuers have no one to turn to for expert advice as bond issue is being prepared and marketed



Proposed Rule G-36 Effect on Municipal Issuers

Case 1 – School Treasurer Can't Sleep at Night

- \$14,000,000 Voted Bond Issue
- Financing team consisted of underwriter, bond counsel & treasurer
- Voted millage very tight versus market conditions
- No discussion prior to pricing day regarding millage impact of proposed debt service structure
- On pricing day structure designed meet investor preferences
- Final structure will cause debt service to exceed ballot millage within 3-5 years
- Bonds sold with 10 year call feature



Proposed Rule G-36 Effect on Municipal Issuers

Case 2 – School Certificates of Participation Sold with Bond Insurance

- \$14,000,000 Unvoted COPs Issue
- Financing team consisted of underwriter, bond counsel & treasurer
- District rated Aa2 underlying and Aa3 stable outlook for COPs
- Underwriter proposed using insurance to make deal easier to sell
- Only one insurance company doing business – at the time rated AA+ by S&P, Aa3 negative outlook by Moody's
- Investors look to lowest rating to make pricing decision (Aa3 negative outlook)
- Cost-benefit analysis of insurance by underwriter flawed by using arbitrary present value discounting rate rather than comparing insured TIC vs. uninsured TIC.
- Insurance cost District over \$150,000
- Bond Counsel incurred \$30,000 additional fee time due to insurance requirements
- By agreeing to have the deal insured the District also agreed in insurance company requirements, including constraining what the District can do with the building being financed



Proposed Rule G-36 Effect on Municipal Issuers

Case 3 – City Refunding Bonds Leave Money on the Table

- \$17,000,000 Refunding Bond Issue
- Financing team consisted of underwriter, bond counsel, finance director & out of state FA that hadn't been involved with an Ohio general obligation issue since 2001
- Bonds being refunded had an 8 year call which made the refunding feasible in the first place
- Refunding bonds sold as non-bank qualified issue with 10 year call feature
- Had issue been split into 2 bank-qualified issues City would have garnered an additional \$150,000 to \$200,000 present value savings



Proposed Rule G-36 Effect on Municipal Issuers

Case 4 – Happy School Treasurer & Superintendent

- \$31,000,000 Voted Bond Issue
- Financing team consisted of 2 underwriters, bond counsel, financial advisor & treasurer
- Voted millage very tight versus market conditions
- Much discussion before pricing with all parties as to structure and millage impact
- Trader initially suggested mostly term bonds in structure; banker and FA agreed to serial bond structure prior to pricing
- Healthy discussion during pricing day regarding millage impact of proposed debt service structure resulting in shortening the issue by 4 years saving taxpayer over \$3,000,000 in debt service
- Final structure will cause debt service to NEVER exceed ballot millage
- Bonds sold with 7 1/2 year call feature



News and Muni's

- **Municipal Bankruptcies loomed on the Horizon or in the Major Headlines.**
- **More issuers were downgraded than upgraded.**
- **These events, and actions reminded me of the book Henny Penny – The Sky is Falling. Letters of credit, lines of credit were like hens teeth – from Henny Penney!**
- **And then Congress became embroiled in the Debt Ceiling versus Deficit Issue which resulted in the U.S.A. being downgraded!!!! The very next week, Hudson Ohio was upgraded to a AAA by the very firm that downgraded the U.S.A. The City is also rated Aaa by Moodys'. Hudson does not have weapons of mass destruction like the U.S.A., either.**
- **After this all Summer long debate on the Debt Ceiling and its final resolution; rates have dropped!**
- **Almost every week a major institution has agreed to pay the SEC major fine.**
- **We are only noting the ones over \$10,000,000 – but no one has accepted any blame or guilt. Apparently people used their Blackberrys to rig bids???**



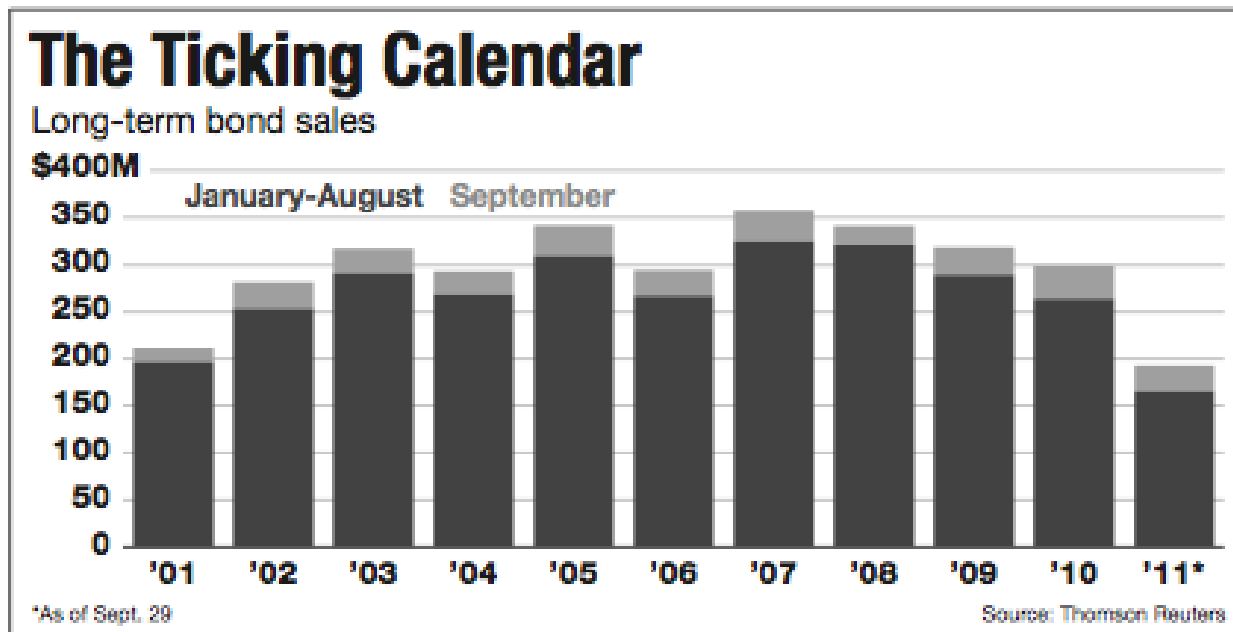
Structuring Issues

- **Competitive issues sell much differently today than prior 2003.**
- **Documents are transmitted by the internet and email all day long.**
- **If something happens on the day of sale, like a disaster, then you postpone the sale and everything is just transmitted again.**
- **Issues have multiple personalities. There is the short part of the loan, the middle and the long end. Not every firm is the same. Issuance size is an important variable. Bank qualified versus non-bank qualified is also very important this year. Call options vary. Ratings have a bigger impact on debt today than ever before. Increments within the rating have a bigger impact than ever before.**



2011 – Much A Do About Nothing – Market Volume

- For the first 6 months of 2011 issuance of municipal debt was down nearly 50% - so, significantly less activity—so the demand is very high which helps keep rates low, especially in Ohio.





Interest Rates!!!

Good News

Rates are still great in this doomsday world

- Good time to borrow!
- Some refundings work.

Mentor 19 year Bonds TIC 2.88%
Hudson 20 year Bonds TIC 3.05%
Bay Village 20 year Bonds TIC 3.15%
Defiance 20 year Bonds TIC 3.32%
Oregon 1-year Notes NIC 0.69%
Sandusky 1-year Notes NIC 0.65%

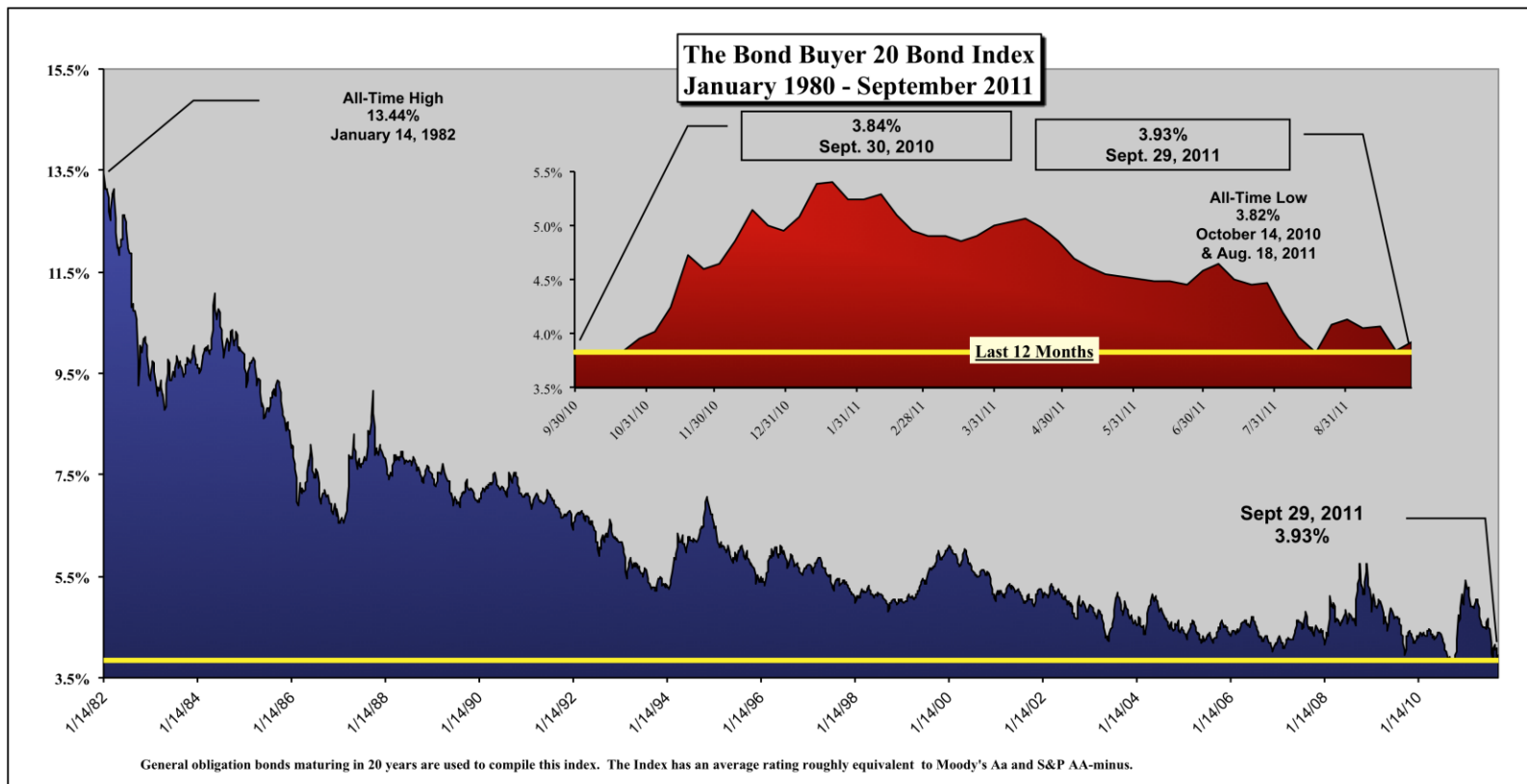
Bad News

- I can't earn any interest!
 - STAROhio @ 0.04%
 - 1 year treasury @ 0.10%
 - 2 year @ 0.25%
 - 5 year @ .96%
 - 10 year @ 1.92%
 - 30 year treasury @ 2.87%
- Why doesn't my refunding work?



Interest Rates – Long-term Tax-exempt Muni's

- Long-term rates have plummeted as of late to record lows.

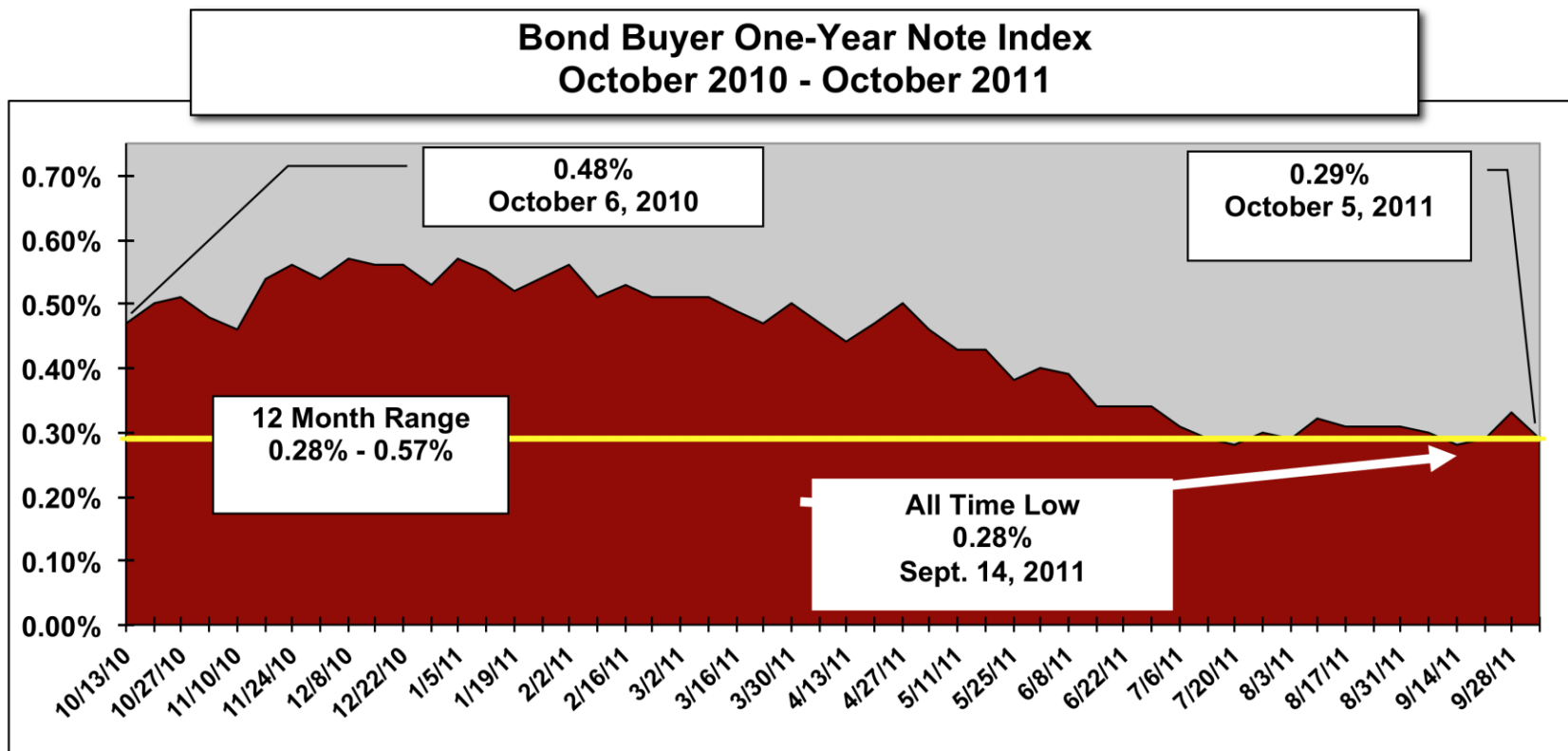


Average since January 1980	6.49%	Highest since January 1980 (1/14/82)	13.44%
10-year average	4.62%	Lowest since January 1980 (9/23/10 & 8/18/11)	3.82%
5-year average	4.54%		



Interest Rates – Short-term Tax-exempt Muni' s

- Short term rates are also at record lows.
- Note ratings are still very important; and concentrated marketing is still very important.





Bond Insurance



Radian Insurance looking to team up with National League of Cities to create first ever “mutual” bond insurance company



Dodd-Frank Impact on Rating Agencies



MSRB Rule 17g-7 Becomes Effective September 26th (00:05:08 min)

In accordance with the Dodd-Frank Act, Rule 17g-7 requires Nationally Recognized Statistical Ratings Organizations (NRSROs) to include in any rating report a description of the representations, warranties, and enforcement mechanisms available to investors, and to also compare how these mechanisms differ from those in issuances of similar securities.



Rating Agencies



- Without reasonably available bond insurance, underlying credit ratings are more important than ever.
- With added regulatory scrutiny, however, agencies are:
 1. Asking for more information,
 2. Asking many more questions on how you are running your business,
 3. Placing more emphasis on cash balances,
 4. Looking for the ways you have tried to balance the budgets, including whether you have been able to make the tough decisions like laying people off,
 5. Placing importance on your ability to access the capital markets, and
 6. Annual surveillance interviews are more prevalent.

As a result, rating presentations and conference calls are longer than in the past



Rating Agencies

- **The Rating discussions/presentations are done by conference call.**
- **The discussions have become more involved.**
- **There are follow-up calls by the rating agencies.**
- **Rating criteria are constantly changing.**



Rating Agencies

Financial Management Best Practices

Discipline	Policies and Practices
<ul style="list-style-type: none">Revenue and expenditure assumptions	The district budgets conservatively each year using assumptions that underestimate revenues and overestimate expenditures.
<ul style="list-style-type: none">Budget amendments and updates	The district amends the adopted annual budget on a quarterly basis.
<ul style="list-style-type: none">Long-term financial planning	The district adheres to the State's 5-year forecast requirement. Accordingly the forecast is updated every 6 months.
<ul style="list-style-type: none">Long-term capital planning	The district maintains a long-term capital plan in order to plan and prepare for major capital improvements and expenditures.
<ul style="list-style-type: none">Investment management policies	The district has formally adopted investment policies.
<ul style="list-style-type: none">Debt management policies	The district has formally adopted debt issuance and debt management policies.
<ul style="list-style-type: none">Reserve and liquidity policies	The district's formal policy is to maintain General Fund cash reserves at no less than 15% of annual budgeted revenues.



Bank Qualified Bonds / Build America Bonds

- The \$30,000,000 Bank Qualified ceiling was dropped back down to \$10,000,000. Bank qualified paper is anywhere from 25 to 50 basis points lower in yield than non-bank qualified paper.
- Build America Bonds are Gone! This was a very popular program. It may even come back in 2012.
- Most Tax Credit Bonds are gone. This concept may also come back with the intent of replacing some categories of tax-exempt bonds.



Summary

- **Congressional financial market reform is going to create new demands on issuers to ensure disclosure requirements are met – become familiar with MSRB’s EMMA (Electronic Municipal Market Access System)**
- **Fiduciary requirements are leaving issuers in a lurch unless they engage advisors to sit on their side of the table (see GFOA best practices)**
- **Interest rates are at record lows**
- **Without bond insurance, underlying credit ratings are more important to bond buyers than ever.**
- **Both competitive and negotiated deals take more work.**
- **Current audited financial statements are more important than ever.**
- **Credit ratings, both long-term and short-term ratings, have and will continue to have a material impact on interest rates.**
- **The municipal market is becoming much more regulated.**
- **Need to take an active role in marketing your bonds – use your website**
- **Markets continue to be healthy, thriving and constantly changing.**