2018 CIFA Federal Policy Conference

Tax Cuts and Jobs Act – What Now?

March 26, 2018

Bank of America Merrill Lynch

Hawkins Delafield & Wood LLP

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Panelists

Tom Liu, Moderator – Bank of America Merrill Lynch

- Managing Director and Manager, Water and Wastewater/SRF Group
- Over 28 years of experience, specifically with SRF financings
- Served as senior manager on 24 SRF programs throughout the U.S.

Lisa C. Hagan – Hawkins, Delafield & Wood LLP

- Partner, Ann Arbor Michigan Office
- Served as counsel (bond, issuer's, underwriter's) on SRF and other types of financings
- Participated in financings aggregating over $3B during November – December 2017
- Member of the American Bar Association and National Association of Bond Lawyers

Anne Burger Entrekin – Hilltop Securities

- Managing Director and Regional Manager
- Over 31 years of experience including multiple SRF programs across the nation

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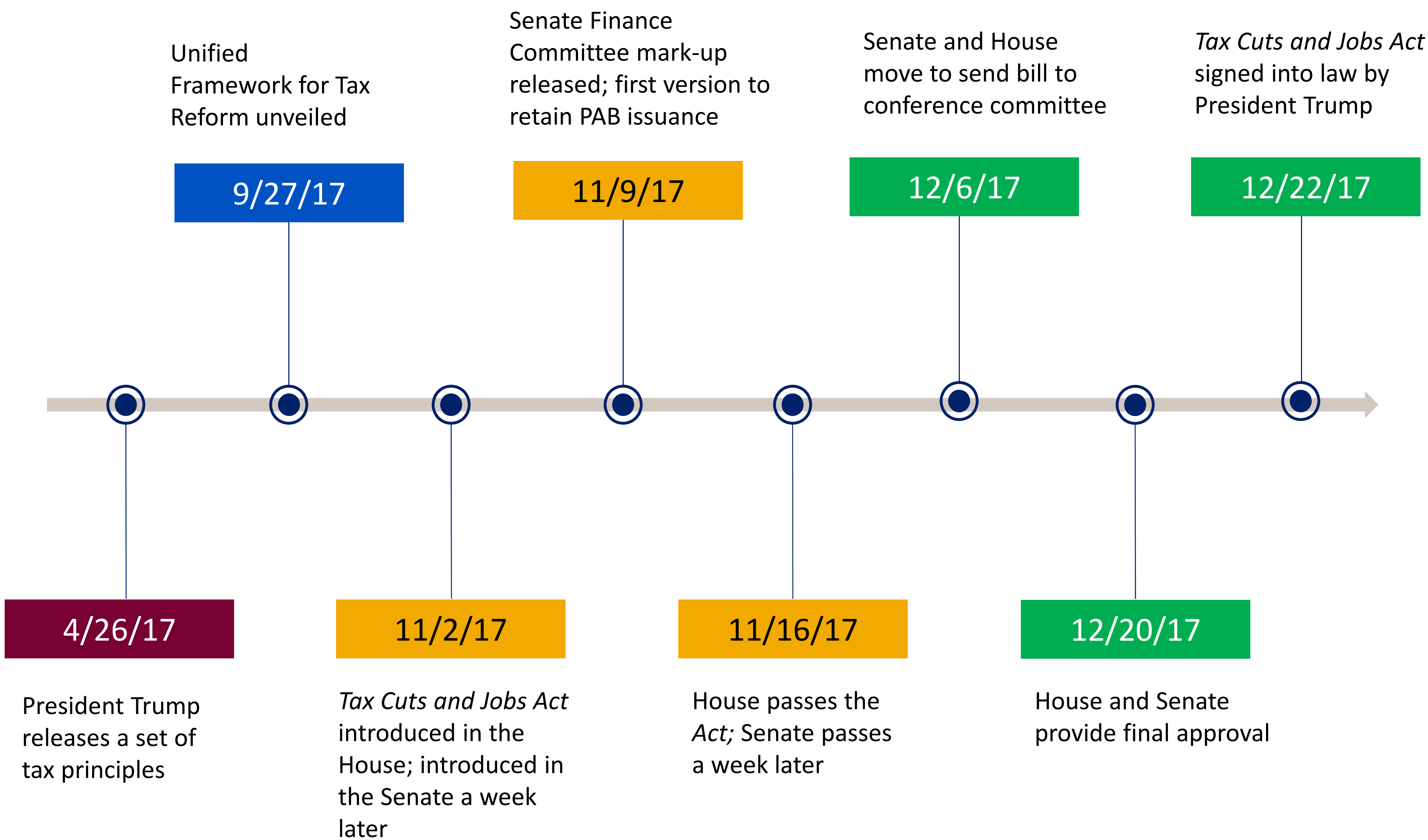
Tax Cuts and Jobs Act Timeline



Sources: Bond Buyer, speaker.gov

Municipal Market Update in Post Tax Reform World

Federal Tax Reform Overview

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The President signed the Tax Cuts and Jobs Act into law on December 22, 2017

Advance Refundings

- The authority to advance refund bonds on a tax-exempt basis expired on December 31, 2017
- There is no transition relief
- Likely implication is reduced new issue supply

Private Activity Bonds

- Private Activity Bonds were not impacted by the tax reform
- There is no change to PAB rules, so the three-year carry-forward rule and other rules governing PABs remain in place

Corporate Tax Rate

- Corporate tax rate revised from 35% down to 21%
- This will likely result in weaker demand for tax-exempt debt from banks and insurance companies
- Impact on pricing/capacity for tax-exempt bank funded vs. unfunded loans

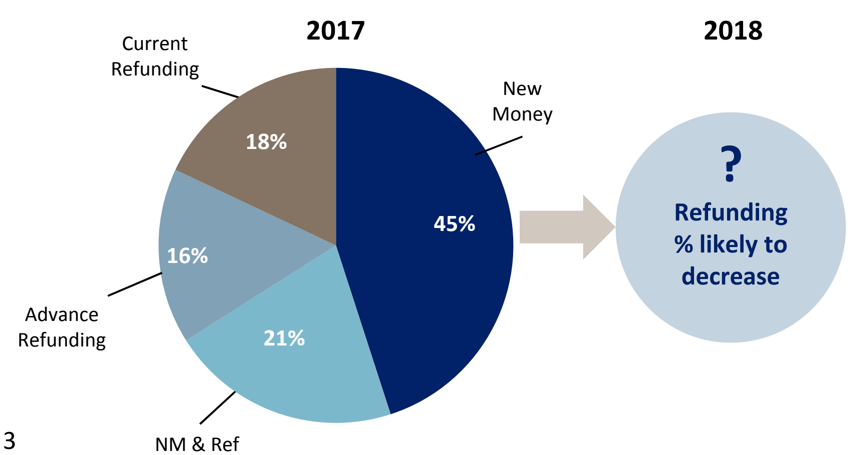
State & Local Tax Deduction

- The law retains the ability for individuals to deduct state and local property and income taxes up to a combined aggregate of $10,000 per year (married filing jointly)

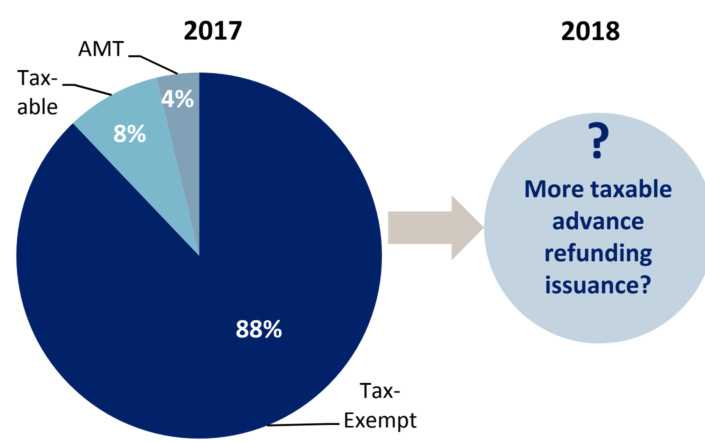
AMT

- The new law retained the individual AMT; the exemption amount will be raised from $84,500 under current law (married filing jointly) to $109,400; the exemption amount phase-out will be increased to $1,000,000
- The corporate AMT was repealed

Issuance by Refunding Type



Issuance by Tax Status



Sources: Thomson Reuters 1/1/2017-12/31/2017

November 2: House releases bill known as H.R. 1, "Tax Cuts and Jobs Act"

- Terminates the ability to issue private activity bonds after December 31, 2017
- Terminates issuance of advance refunding bonds after December 31, 2017
- Terminates issuance of tax credit bonds after December 31, 2017
- Repeals the alternative minimum tax
- Terminates issuance after November 2, 2017 of bonds issued to finance or refinance a professional sports stadium

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November 9: Senate version is released

- Terminates issuance of advance refunding bonds after December 31, 2017
- Terminates issuance of tax credit bonds after December 31, 2017

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December 15: Conference bill is released

- Provisions relating to bonds substantially similar to Senate version
- Eliminates AMT

December 22: Tax Cuts and Jobs Act is signed by the President

- Effective January 1, 2018
- Unlike 1986 tax reform, no transition rules

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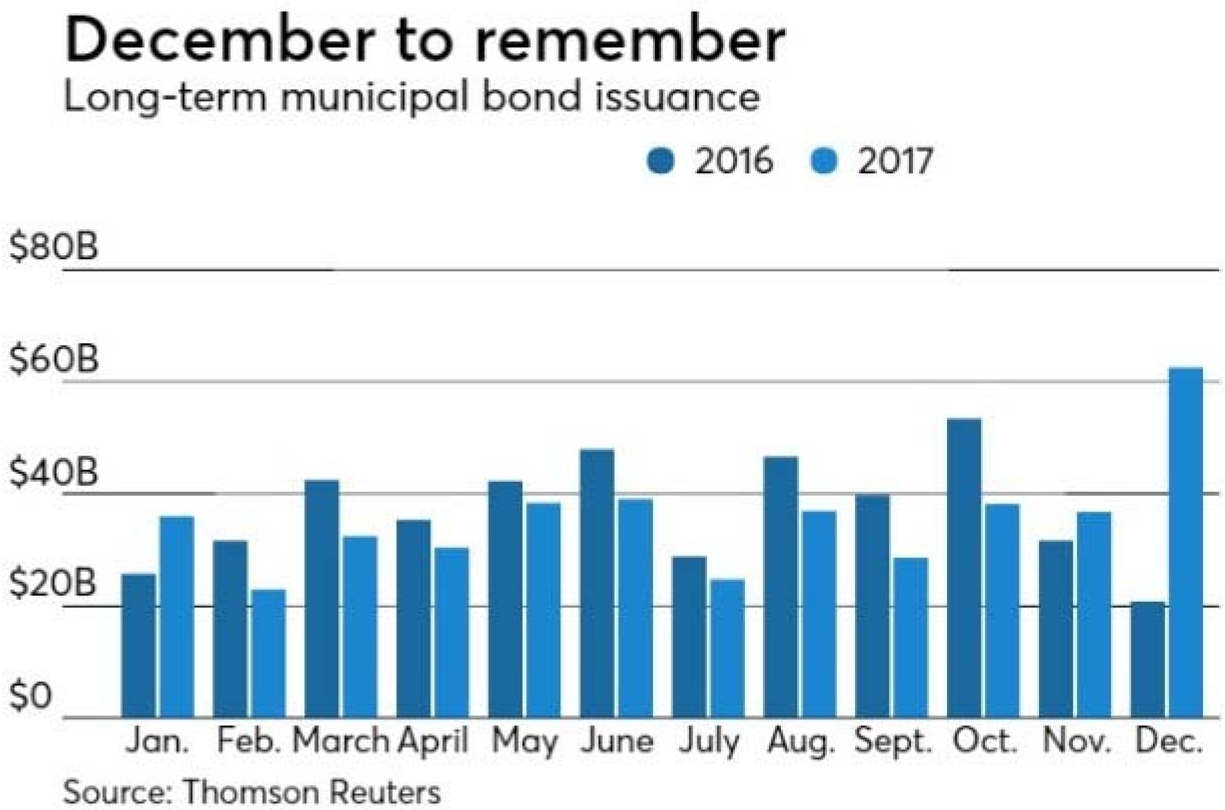
December to remember
Long-term municipal bond issuance
2016
2017
$80B
$60B
$40B
$20B
$0
Jan.
Feb.
March
April
May
June
July
Aug.
Sept.
Oct.
Nov.
Dec.
Source: Thomson Reuters

Why Tax Reform?

- Not a bipartisan effort. Not vetted through typical methods.
- Most believe reform was driven by a surge for revenue, rather than tax policy.
- Advance refunding bonds – "doubling" of federal tax subsidy during escrow period since two sets of tax-exempt bonds. Advance refunding bonds = 20% of bond issues.

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Impact on Tax-Exempt Bonds

- ***Eliminates the ability to issue Advance Refunding Bonds after December 31, 2017***
  - Bonds issued more than 90 days prior to the redemption date of the refunding bonds.
- ***Eliminates ability to issue tax credit bonds after December 31, 2017***
  - These include clean renewable energy bonds, qualified forestry conservation bonds, qualified school construction bonds, qualified energy conservation bonds, and qualified zone academy bonds
- ***Preserves***
  - Private activity bonds
  - Stadium bonds

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Indirect Impact on Tax-Exempt Bonds

- **Potential impact on the creditworthiness of governmental borrowers**
- ***$10,000 limit on deductions of State & local income taxes for those that itemize***
    - Increase the value of a state or local tax-exemption?
    - Will high tax states change their tax structures? (Temporary 2018-2025)
- **Impact on bondholders**
  - ***Reduces tax rates***
    - Corporate tax rate lowered to 21%
    - May trigger rate adjustments in bank placement transactions since many bank placements provide for an interest rate tied to the federal corporate tax rate
    - Temporary (2018-2025) changes in the individual tax rates
- **Impact on bondholders**
  - ***AMT***
    - Permanent repeal of corporate AMT
    - Temporary (2018-2025) increase in the individual AMT threshold

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Indirect Impact on Tax-Exempt Bonds

- **Impact on the creditworthiness of non-profit borrowers**
  - Excise tax on high endowed colleges and universities
  - Permanent change to UBIT rules segregating trade of business activity which may prevent offsetting income in one activity with losses in another activity
  - Tax on institutions with highly compensated individuals
    - 20% tax on compensation over $1M
    - May trigger corporate restructurings

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Tax concerns

- No transition rules
- Corporate margin tax rate adjustment or waiver- reissuance?
- Tax code does not address using tax-exempt bonds to advance refund a taxable bond.

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Alternatives to Advance Refundings…

- issue taxable refunding bonds on an advance refunding basis
- Tender offer
- Forward starting swap or forward delivery contract
- Cinderella bonds
- Shorter par calls
- Make whole calls
- Cash optimization

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It is All About the Math

Recent tax law changes have significantly impacted the municipal bond yield equivalency. Investors are re-evaluating the implications of tax law changes on their returns.

Investor Tax Backet	15%	21%	28%	31%	35%
Tax-Exempt Yields	Taxable Yield Equivalents (%)				
3.50%	4.12%	4.43%	4.86%	5.07%	5.38%
4.00%	4.71%	5.06%	5.56%	5.80%	6.15%
4.50%	5.29%	5.70%	6.25%	6.52%	6.92%
5.00%	5.88%	6.33%	6.94%	7.25%	7.69%

Targeted Cash Optimization

SRF programs have been optimizing cash since inception. The new tax law creates additional considerations relative to cash optimization.

Pre-Tax Reform

Advanced Refunding	
Time Horizon	Any
Overview	Refund bonds prior to the call date
Consideration	Reduces cost of funds by etablishing an irrevocable, verified escrow with eligible securities to fund debt service to the call date

Borrower Funding	
Time Horizon	Any
Overview	Utilize cash (Program Equity/Recycled Dollars) to fund borrower demand
Consideration	Efficient utilization of cash, especially in current yield curve environment, where generally yield on borrower repayments exceeds yield on short-term investments

Post-Tax Reform

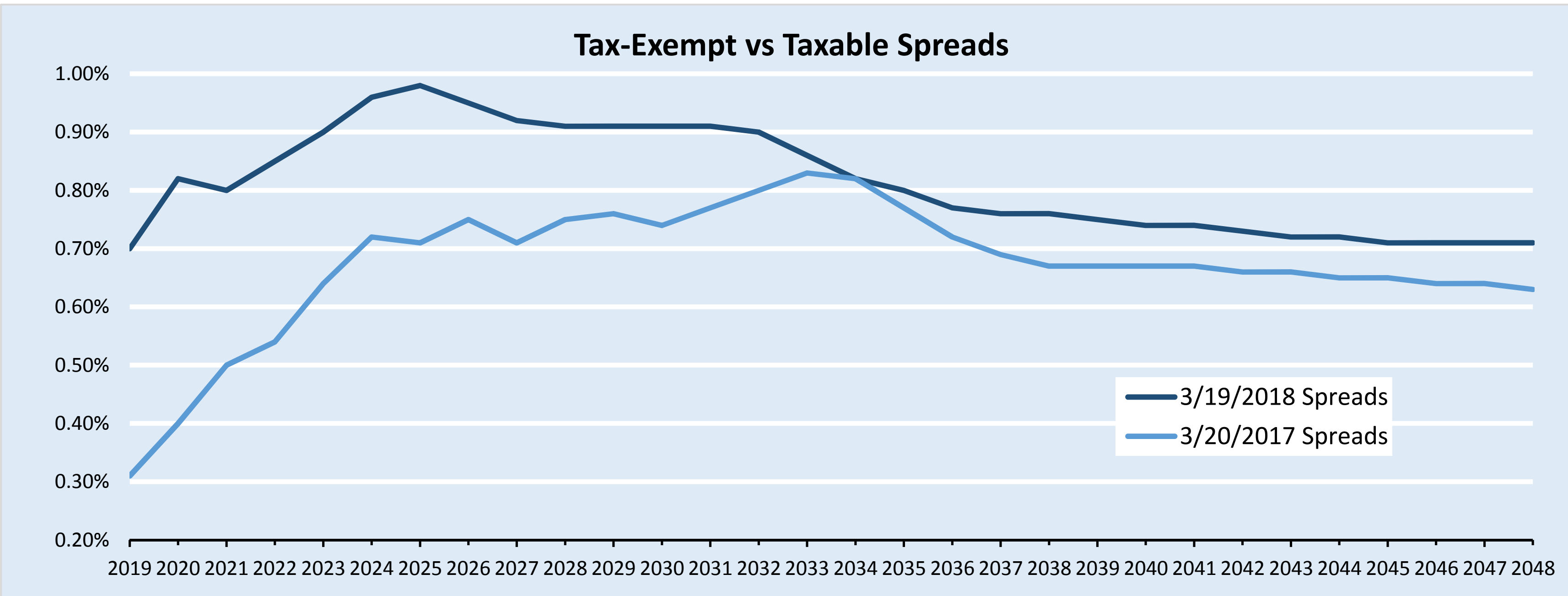
Cash Defeasance	
Time Horizon	Any
Overview	Utilize cash to defease bonds prior to the call date
Consideration	Reduces cost of funds by etablishing an irrevocable, verified escrow with eligible securities to fund debt service to the call date

Borrower Funding	
Time Horizon	Any
Overview	Utilize cash bond proceeds to fund borrower demand
Consideration	While there is a cost of funds, matching debt with borrower repayments creates an appropriate Asset / Liability match

Taxable Advance Refundings

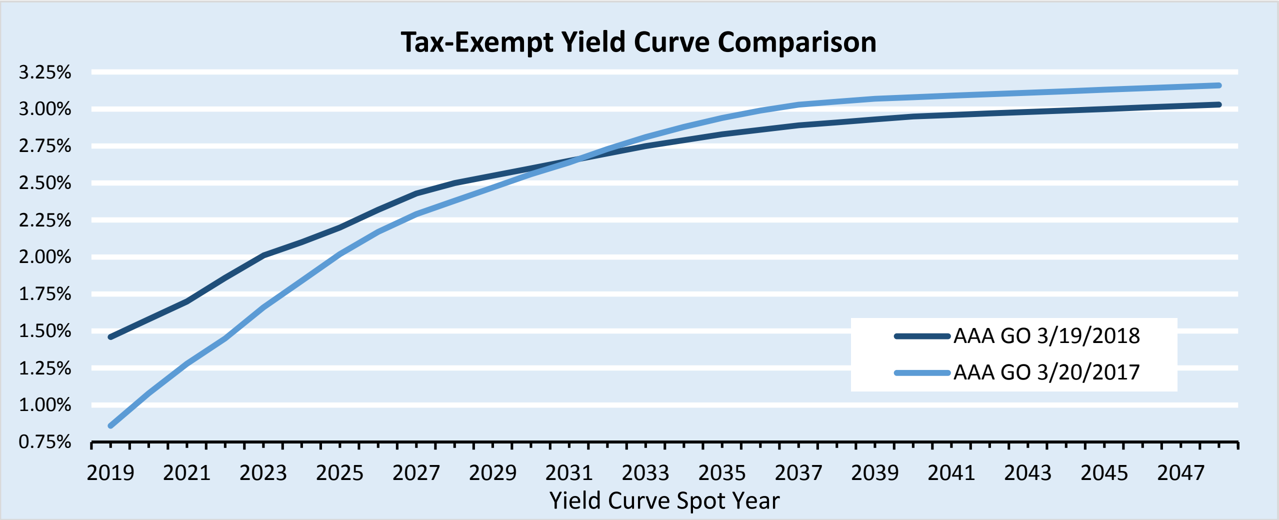
Since Taxable Bonds are not subject to Federal Tax Law requirements, advanced refundings on a taxable basis can still be undertaken post tax law changes.

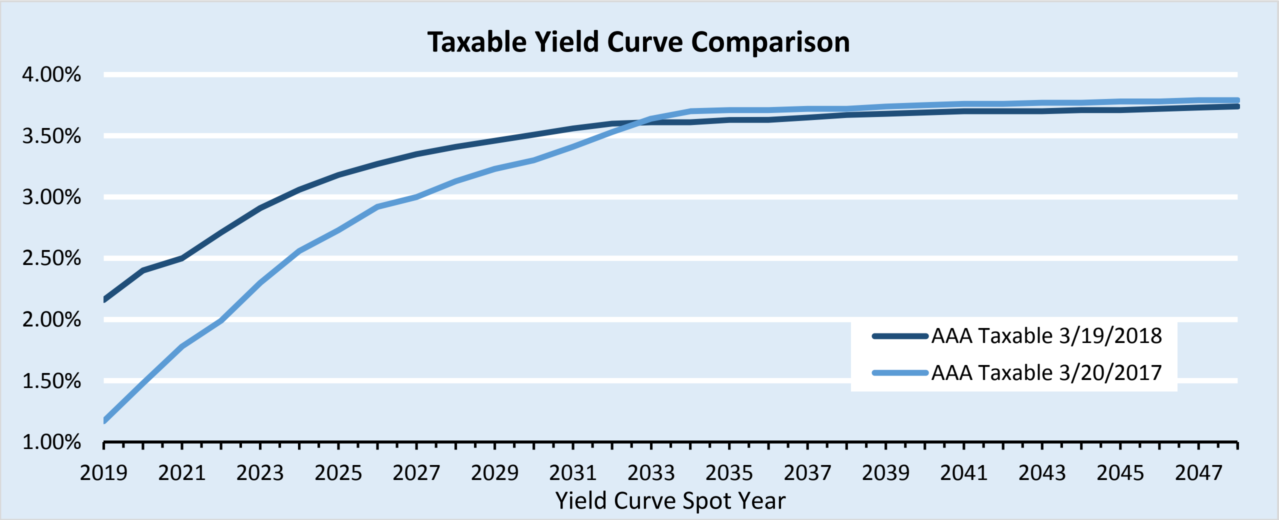
Taxable Advance Refundings	
Time Horizon	Any
Overview	Can lock-in advance refunding savings in advance of refunded bonds call date
Considerations	Potentially higher cost of funds that can be achieved in the current tax-exempt market



Taxable and Tax-Exempt Yield Curves

While the tax law changes have impacted yield curves, changes to the Fed Funds Rate have also influenced current market yields.



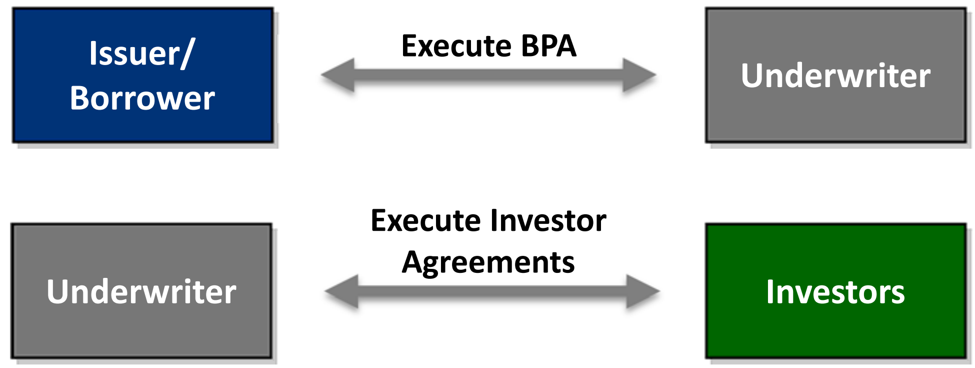


Fed Funds Target Rate Changes
December 14, 2016
0.50% - 0.75%
March 15, 2017
0.75% - 1.00%
June 14, 2017
1.00% - 1.25%
December 13, 2017
1.25% - 1.50%
March 21, 2018
1.50% - 1.75%

Forward Bond Purchase Agreement

In its most simple form, a forward bond purchase agreement ("FBPA") is a public issue sold today and delivers at some decided upon point in the future. All normal disclosures and requirements for a public issue must be met for an FBPA on the sale date.

Forward Bond Purchase Agreement	
Pricing	Price today at current market rates plus forward premium of 6-9 bp/mo. Rate depends on length of delivery period.
Delivery Period	3-12 months
Interest Rate Risk	Low
Non-Delivery Risk	Moderate; underwriter not obligated to purchase bonds if any material change occurs between pricing and delivery (i.e., ratings downgrade, change in tax law). Issuer may owe out-of-pocket costs, primarily legal fees.
Other Considerations	For delivery periods longer than 6-9 months, underwriters may require "investor letter" in which buyers guarantee bond purchases.

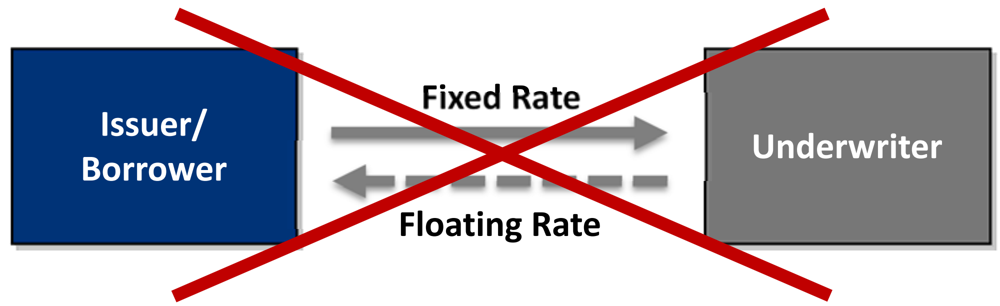


TIMELINE

Forward Starting Cash Settled Swap

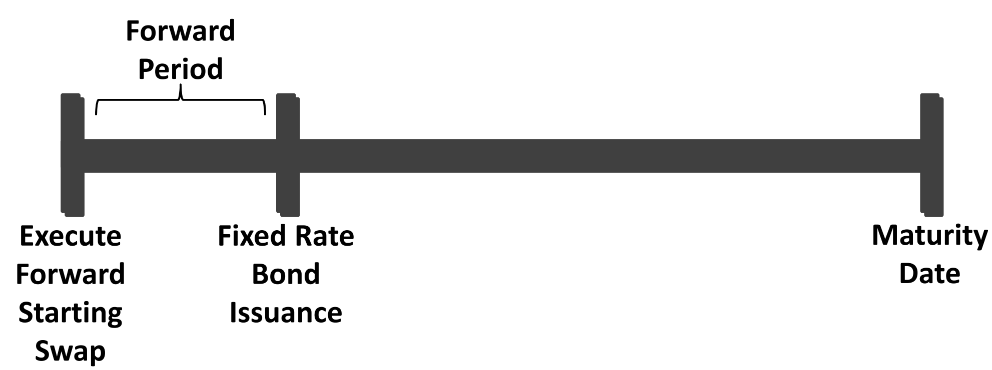
A forward starting cash settled swap uses an interest rate swap to hedge rates for a fixed rate refunding at the first optional call date. This method does not require all normal disclosures and requirements on the execution date.

Forward Starting Cash Settled Swap	
Pricing	Issuer executes a forward starting fixed rate swap with the underwriter for the period leading up to the issuance date.
Forward Period	3-24 months
Interest Rate Risk	Low
Non-Delivery Risk	Fixed rate bonds issued upon termination of forward starting swap, therefore there is no non-delivery risk associated.
Other Considerations	During the forward period, the issuer can terminate the swap. Based on swap market rates, the issuer either receives or makes a payment upon termination. If termination payment is due from the issuer, the money can come from the bond proceeds of the fixed rate bond issuance.



No payments exchanged until issuer decides to cash settle the forward starting swap

TIMELINE



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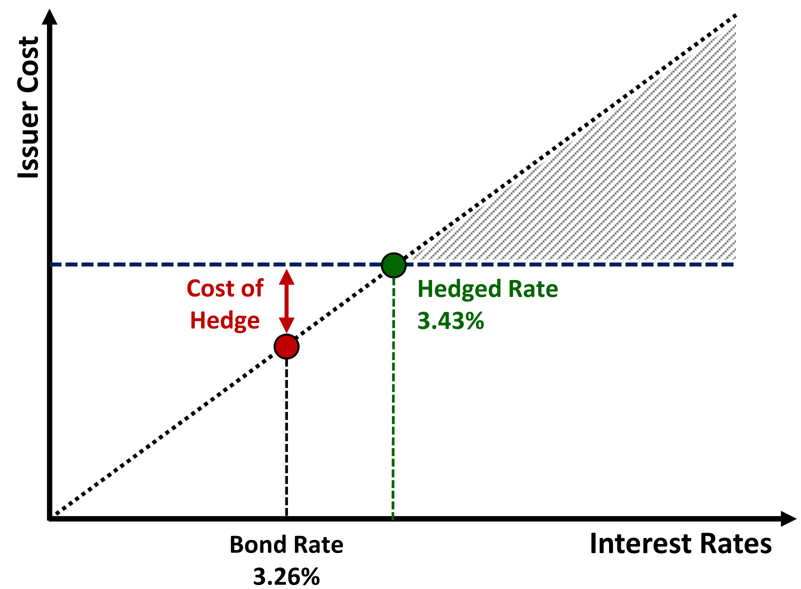
Forward Starting Cash Settled Swap

In a rising rate environment, issuers can utilize a forward starting cash settled swap to protect against the higher cost of issuance associated with a rise in rates. The illustration below is based on a 2 year forward with a 15 year average life.

Forward Starting Cash Settled Swap	
On Bond Pricing Date	The forward starting cash settled swap will be terminated at market value. Based on prevailing market rates, the issuer makes or receives a payment at bond closing. - If swap rates rise more than 17 bps (cost of hedge) and the market value of the swap is in favor of the issuer, the issuer will receive a payment - If swap rates *do not* rise more than 17 bps (cost of hedge) and the market value of the swap is *not* in favor of the issuer, the issuer will make a payment
Result	Issuer achieves today's interest rate plus the hedge cost which is incorporated into the bond deal



- **Bond Rate** – 15 year MMD plus the credit spread for the issuer (2.76% + 0.50% = 3.26%)
- **Hedged Rate** – bond rate plus a combined forward premium and dealer spread (3.26% + 0.17% = 3.43%)
- **Cost of Hedge** – difference between the bond rate and the hedged rate (3.43% - 3.26% = 0.17%)

ADVANCE REFUNDING ALTERNATIVES

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Other Restructuring Alternatives

Strategy	Time Horizon	Overview	Benefits and Considerations
MMD Rate Lock	< 6 months	• Locks in spread to MMD for each maturity	• Reduced basis risk • Issuer credit risk
Forward BPA	< 12 months	• BPA is signed in advance	• BPA may contain "outs" for clean tax opinion, updated OS delivery, etc.
Treasury Lock	< 12 months	• Locks in spread to benchmark UST	• Basis risk for TE issuance • Upfront payment & additional settlement • Issuer credit risk
Forward Starting Swap / Swaption	Any	• Lock-in economics today • Issuer pays fixed, receives float	• High price efficiency • All derivative risks apply • Can include call structure
Cinderella Bonds	Any	• Issuer sells taxable bonds today and converts to tax-exempt bonds in the future	• Product available today • No buy-side interest at this time • Portfolio Managers generally work with one tax status
Tender Offer	Any	• Issuer solicits bonds directly from Investor	• Subject to market premium • May not be able to tender all bonds • Subject to market influences (Hedge Funds)

- *Options –* Issuer sells call rights embedded in outstanding callable bonds; receives and up-front payment equal to the PV savings
- *Modified Make-Whole Call –* Standard make-whole call premiums are based on cash flows to maturity and typically used for only non-economic reasons. However, tax-exempt bonds could be issued with a make-whole call premium that is calculated to the par call date, rather than final maturity, of the bond issue.
- *Variable Rate Debt –* Allows issuers to borrow at relatively low short-term rates and redeem bonds continuously. Synthetic fixed rate structures utilizing a swap may provide lower all-in cost of debt

Positioning for the Future – Shorter Calls

Shorter calls can be very expensive if not exercised. Historical yield curve supports utilization of 10-year call date. Qualitative rationale for shorter calls as important as quantitative rationale.

Rolling Down the Yield Curve :

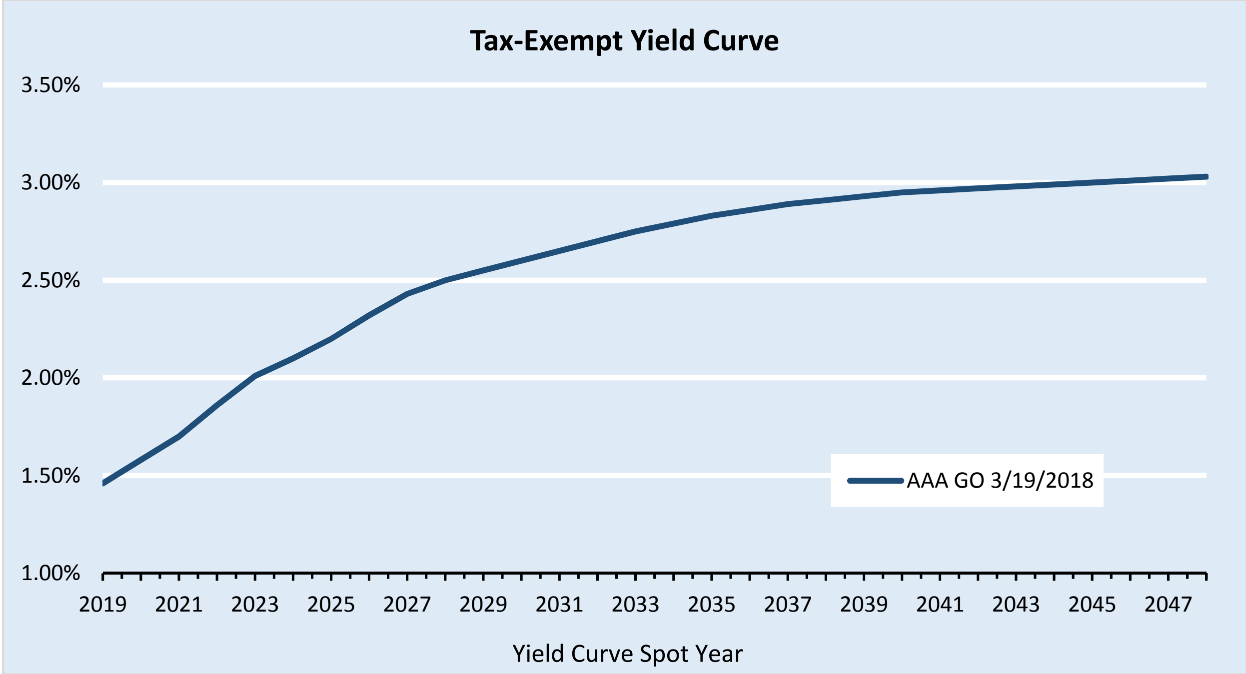
- While lower interest rate environments have historically been conducive to effectuating refunding transactions, simply rolling down the historical yield curve has been a factor as well

Shorter Calls :

- Have significant impact on the TICs for bond issues with shorter call dates
- Yield to Call and Yield to Worst required calculations lead to premiums

Sample 20 Year Bond Issue - Current Yield Curve		
Year Call	Refundable Bond Year	Curve Pick-up (bps)
10	10	41
7	13	26
5	15	16
3	17	8

Sample 20 Year Bond Issue - 5% Coupons		
Year Call	Refundable Bond Year	TIC (bps)
10	10	3.60%
7	13	3.90%
5	15	4.17%
3	17	4.51%



Spreads Impacting Option Prices

Since 1986, treasury regulation 1.148-9 has allowed for one tax-exempt advance refunding per issue. In effect, this has created a continuously callable bond issue.

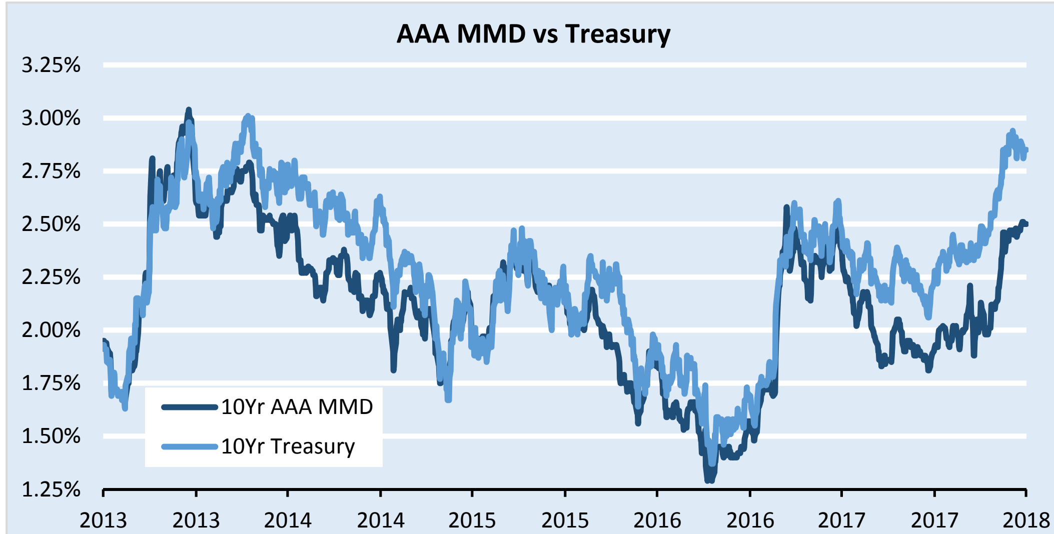
Municipal issues that have not been advance refunded were essentially callable as soon as they were sold.

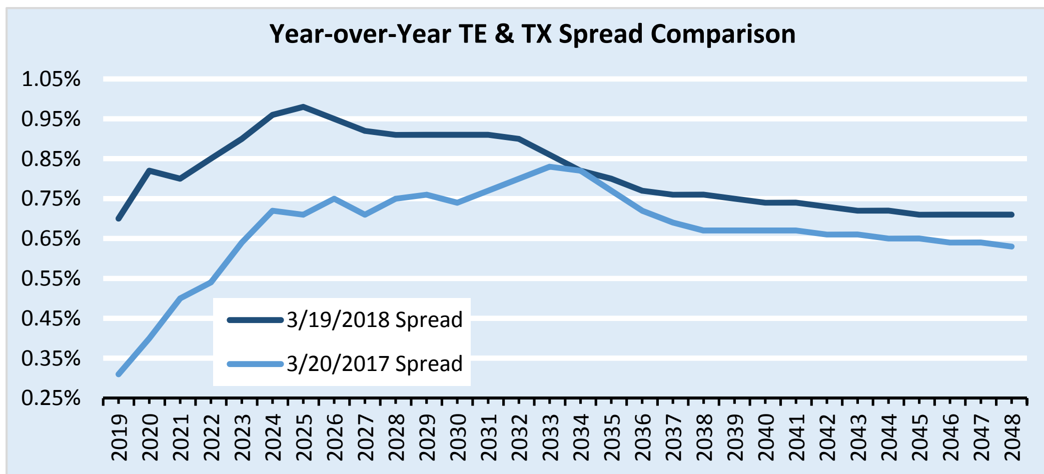
- The optionality associated with reg. 1.148-9 has historically been mispriced by investors
- Due to the Tax Cuts and Job Acts of 2017, it is no longer possible to issue traditional tax-exempt advance refunding bonds

One way for issuers to effect the economics of a tax-exempt advance refunding is through the derivative market.

- Derivative markets price the full value of optionality and are not mispriced as they historically were

We should fully expect the price of call optionality to increase in the near future.





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Bank Qualified Bonds and Bank Direct Placements

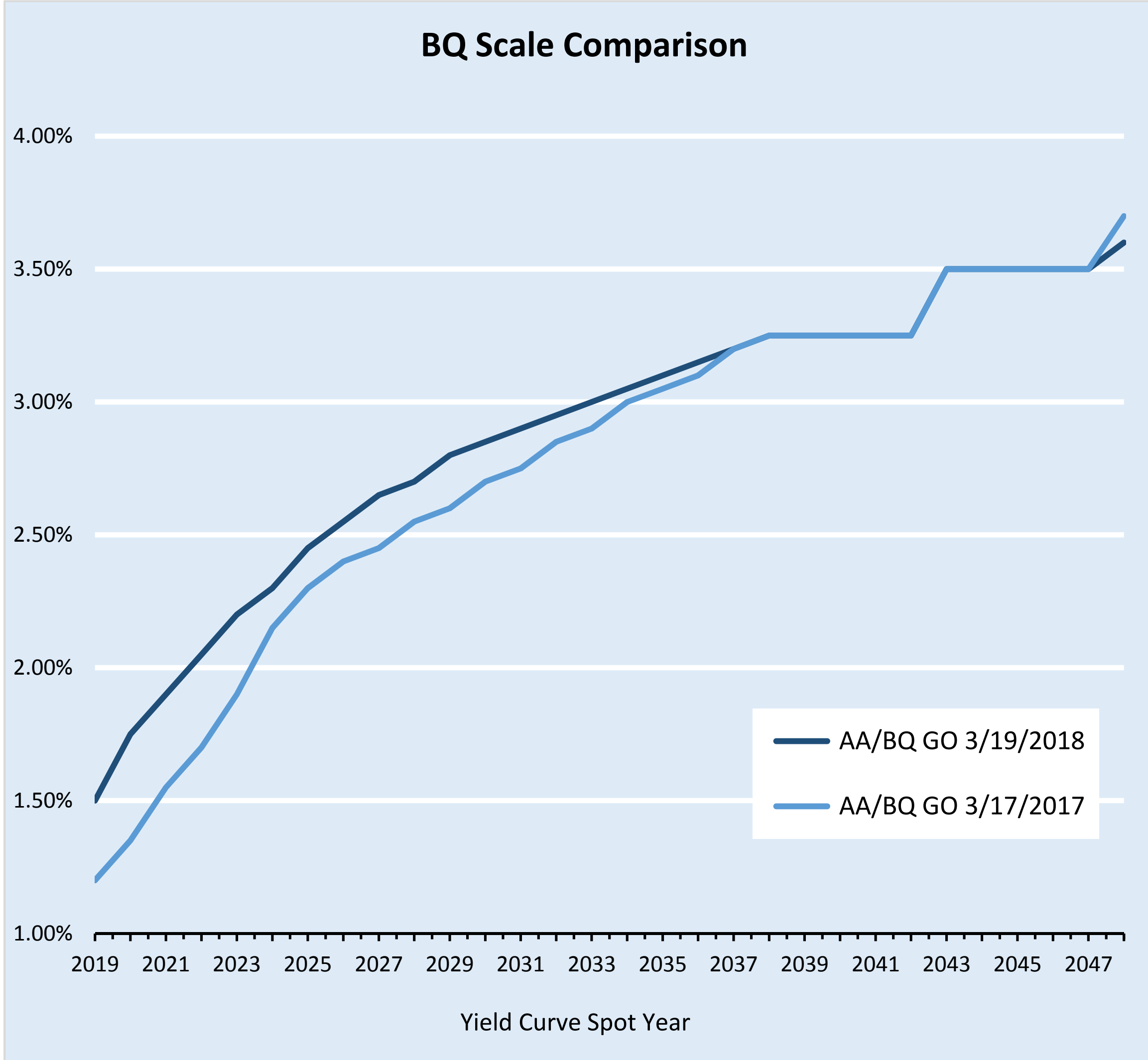
The reduction in the corporate tax rate is expected to impact Bank Qualified interest rates and Banks's interest in Direct placements.

Historically, issuers who qualified for Qualified Tax Exempt Obligations or Bank Qualified issuances, have benefited from lower interest rates than non-Bank Qualified issuers

- However, the reduction in corporate tax rates has reduced the tax advantage, therefore reducing the spread differential

Historically, Banks have been an active participant in the Direct Placement market

- Going forward, due to the reduction in the tax equivalent yield as compared to other Bank investments, it is expected that Bank interest in municipal direct placements will be less than prior years



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