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BURR FORMAN LLP

results matter

GFOASC – Investment Products and Opportunities

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Interesting Couple of Months…

Source: The Greeneville Sun

Current Market Overview

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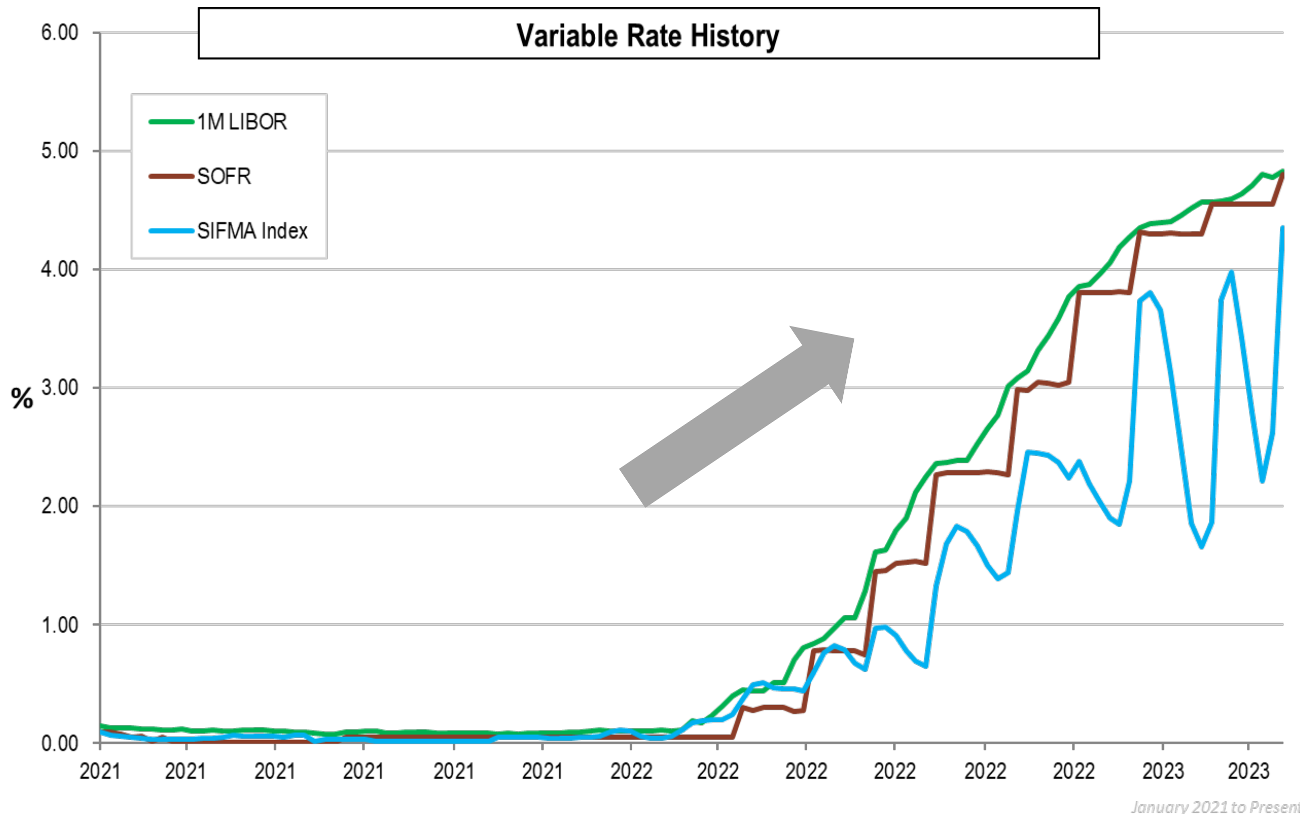
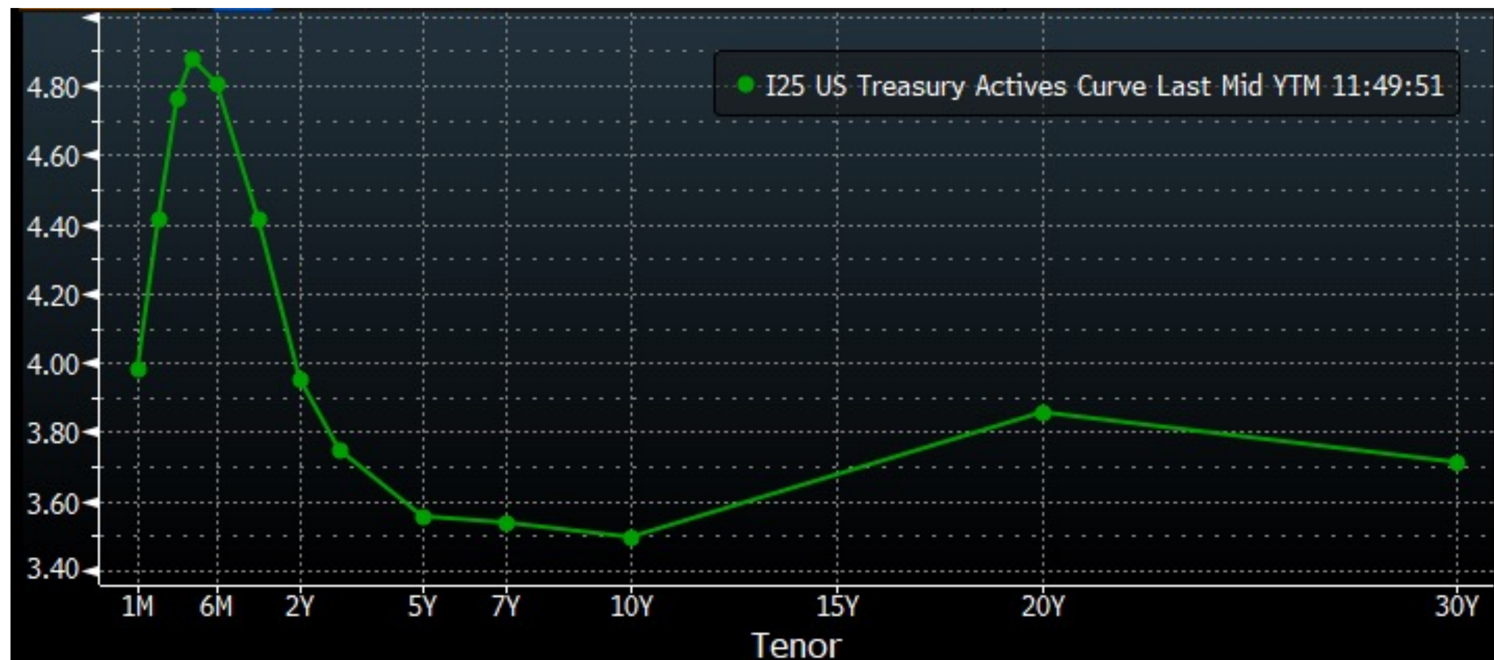
- Short-term interest rates had been near zero for nearly two years through March 2022.
- Beginning in March 2022, the Fed has raised its target Fed Funds rate at nine straight meetings from 0% - 0.25%, up to 4.75 – 5.00%.
- The chart below highlights the 1M LIBOR, SOFR, and SIFMA rates since January 2021.



Source: Bloomberg

- As a result of the expectation of future short-term rate increases and an elevated probability of a recession, the fixed income yield curve has been, and continues to be, significantly inverted.

- Given the shape of the yield curve, clients are now considering short-term investments for their **debt service funds, fund balances, or institutional cash** in addition to bond proceeds. Additionally, the inverted yield curve is an opportunity for clients to reinvest bond proceeds **close to or even above the arbitrage yield.**



Source: Bloomberg, 3/27/23

Opportunities for South Carolina Local Governments

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- In February 2023, the average monthly rate for the South Carolina Local Government Investment Pool ("LGIP") was 4.75%, while 6 month U.S. Treasury bills averaged 4.95% over the same period (peaking at 5.12%).

Month	LGIP Average Monthly Rate	6M Treasury Average Monthly Rate
July	1.72	2.77
August	2.32	3.09
September	2.62	3.68
October	3.24	4.25
November	3.94	4.59
December	4.32	4.67
January	4.57	4.79
February	4.75	4.95
Average Delta	**0.66%**	

- Investing in LGIP allows issuers to capture current market conditions and affords maximum flexibility, but subjects issuers to market fluctuations.

- Based on where Fed Funds Futures are trading, the market currently anticipates Fed rate cuts in July or September of 2023 as a potential recession looms. With the rise in short-term rates that has occurred, a portfolio with fixed rates would lock in today's rates, but would provide less flexibility for issuers.

Source: Bloomberg, Office of the State Treasurer, South Carolina

Opportunities for South Carolina Local Governments *(continued)*

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- South Carolina law provides limits on the investment of funds for the State of South Carolina and South Carolina municipalities, counties, school districts, public service districts, and political subdivisions. The restrictions may apply to certain funds including project funds, acquisition funds, capitalized interest accounts, debt service reserve funds, debt service funds, institutional cash, and fund balances.

- The authorized investments include, but are not limited to:

  – US Treasury Bonds and Notes

  – Agency Securities (some required to be rated)

  – Municipal Bonds (some required to be rated)

  – Certificates of Deposit

  – Money Market Funds, including the LGIP

  – Collateralized Repurchase Agreements ("Repos")

  – State can also invest in corporate debt obligations and guaranteed investment contracts, if rated

- When making investment decisions, issuers should consider the value of certain portfolio characteristics including risk, liquidity, and budget certainty.

Source: Bloomberg

Description of Select Permitted Investments

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Investment Type	Description
US Treasury Bonds	▪ Government bonds and notes issued by the US Treasury ▪ Considered virtually "risk-free" and are backed by the full faith and credit of the US Government
Agency Securities	▪ Government bonds issued by federal government agencies (e.g. FHLB, FNMA, GNMA, TVA); some required to be rated A3/A3 or higher ▪ Not all are explicitly backed by the full faith and credit of the US government, but may carry an implicit backing, making them a low-risk investment
Municipal Bonds	▪ Bonds issued by state and local governments, as well as non-profits ▪ Typically, permitted investment are limited to highly rated municipal bonds (e.g. A-/A3 or higher)
Money Market Funds	▪ A type of mutual fund that invests in highly liquid, short-term investments, that are typically very highly rated and carry minimal credit risk ▪ Due to the short-term nature of the investments, these funds have low liquidity risk
Repurchase Agreements ("Repos")	▪ An investment agreement collateralized with US Treasury/US Agency securities ▪ Bidders for repurchase agreements are typically limited to providers rated at least investment grade ▪ Include the ability to negotiate fixed draw schedules or anytime draws at par

Spotlight

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Repurchase and Forward Delivery Agreements

U.S. Treasuries

Treasury Portfolio: Overview

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Credit Quality: Moody's – Aaa Standard & Poor's – AA+ Fitch – AAA	▪ Treasury securities (bills, notes and bonds) are considered to be of the highest credit quality of any U.S. dollar-denominated debt obligations. ▪ The " full faith and credit" of the United States is pledged to meet debt service payments on these securities.
Interest Rate / Market Risk: Risk exists, but can be mitigated employing an asset / liability matching framework for portfolio construction.	▪ Treasury securities like any other debt instrument are subject to valuation changes due in part to changes in market rates. ▪ If interest rates decrease, the value of bonds generally increases, and as interest rates decrease the value of bonds decreases. ▪ However, if the bonds are held to maturity, the market value is generally unimportant as the par value (principal value) will be repaid in full at maturity regardless of a change in market value. ▪ Shorter term bonds have less change in price for a given change in interest rates than longer term bonds.
Portfolio Construction: Highly customizable to the specific situation and flexible. If the project schedule changes the portfolio can be adjusted given the new circumstances.	▪ To mitigate the potential for security valuation volatility to impact distributions issuers may construct their portfolios such that bond maturities are closely aligned with anticipated outflows. ▪ For example, if you anticipate needing to draw funds in 6 months, you might choose to buy a bond that matures in 6 months rather than one that matures in a year. ▪ Having bonds mature rather than selling into the market for liquidity, eliminates market/interest rate risk for funds being distributed.

Repurchase Agreements

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- A Repurchase Agreement ("Repo") is an investment agreement with a guaranteed interest rate on invested proceeds that is collateralized with US Treasury and US Agency securities from the onset.
    - The provider sells to securities to the issuer and then buys them back at a pre-determined rate.
    - Collateral is held by a 3rd party custodian.
    - The provider chooses the custodian and pays all associated fees.
    - Functions like a collateralized money market account; issuer looks first to provider to purchase securities.
    - The provider must over-collateralize the agreement by posting Treasury and/or US Agency securities valued at a pre-determined level outlined in the bid specifications.
- Bidders for repurchase agreements are typically limited to providers rated at least BBB- by Standard & Poor's, Baa3 by Moody's or BBB- by Fitch (or higher if required by the permitted investments, statute or authorizing bond documents).
- ***Credit Ratings Trigger:*** If the provider's long-term credit rating no longer meets the minimum ratings requirement (downgrade or withdrawal), the provider must cure the downgrade by either posting additional collateral, obtaining a guaranty from a higher-rated counterparty, or transferring the agreement to a higher-rated counterparty. ***If the provider fails to cure the downgrade as contemplated above, the Borrower has the right to withdraw the funds at par plus accrued interest.***
- Repos offer the ability to withdraw funds at par for pre-determined reasons (project expenses, debt service deficiency, scheduled payment of debt service). As a result, ***repos can be a suitable option for clients prioritizing draw flexibility in their construction, debt service reserve, capitalized interest, and debt service funds.***
- For this reason, most auditors allow repurchase agreements (unlike other fixed rate securities such as US Treasury or US Agency securities) to be valued at par, regardless of the change in interest rates or the value of the posted collateral. ***Withdrawals may not be made for reinvestment.***
- A Repo combines liquidity along with the ability to earn a fixed rate of return. The fixed rate of a repurchase agreement is based on the cost of collateral and the anticipation of future rates.

Repurchase Agreements *(continued)*

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- Providers post collateral (US Treasury and/or US Agency securities) with a third party custodian.
    - If the provider defaults, the repurchase agreement and ancillary documents provide that the custodian sells the collateral in order to cover the Borrower's principal and accrued interest.
    - Collateral is valued at least weekly and in an amount to over-collateralize the principal by the required haircut.
- Once the Borrower enters into the agreement, ***funds cannot be withdrawn for reasons other than those stated previously*** and the agreement cannot be terminated (unless the termination is due to a provider default or downgrade) ***without the Borrower paying a termination payment to the provider.*** This includes any type of restructuring, refunding, or advance refunding.
    - Independent of any rate movements under these circumstances, the Borrower would owe a termination payment to the provider. However, generally as interest rates rise, the termination payment owed by the Borrower would increase.
- If the Borrower withdraws funds prior to the maturity date due to a provider default or downgrade, the Borrower would be exposed to then-current market investment rates.

Forward Delivery Agreements

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- A Forward Delivery Agreement ("Forward") is another type of investment agreement with a guaranteed interest rate on invested proceeds.
  - The provider agrees to provide or deliver securities to the issuer on a pre-determined date at a pre-determined price (interest rate).
- Like Repos:
  - Assets are typically held by a 3rd party custodian (or by trustee if DSRF).
  - Bidders for Forwards are typically limited to providers rated at least BBB- by Standard & Poor's, Baa3 by Moody's or BBB- by Fitch (or higher if required by the permitted investments, statute or authorizing bond documents).
  - Forwards have substitution or other cure provisions following changes in credit ratings.
  - Early termination (even for refundings) likely involves a penalty or "breakage" fee
- Unlike Repos:
  - Forwards used primarily for known or established revenue stream (like DSRF or debt service funds).
  - Not very flexible.
  - Not really collateralized but issuer always owns assets (either cash or securities that mature).

Graphic Representation of Select Permitted Investments

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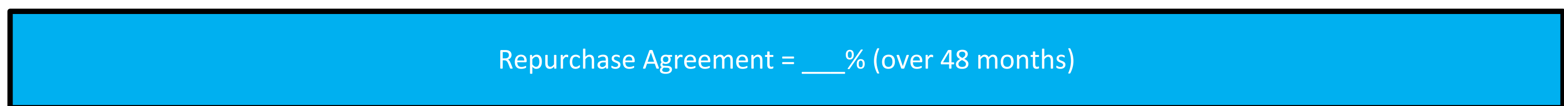

Repurchase Agreement

T = __% | T = __% | T = __% | T = __% | T = __% | T = __% | T = __% | T = __%

Laddered US Treasury/Agency Portfolio

Investment Product	Fixed Rate of Return?	Flexibility?[(1)]	Credit Risk?[(2)]	Reinvestment Risk?	Price/ Valuation Risk?[(3)]	Downgrade Trigger?[(4)]
Repurchase Agreement	Yes	Yes	Yes	No	No	Yes
Laddered US Treasury/ Agency Portfolio	Yes	No	No	Yes	Yes	No

(1) Flexibility refers to the ability to withdraw money at par for stated purposes (project expenses/debt service deficiency/scheduled payment of debt serivce).

(2) Credit Risk refers to the risk of loss of principal due to default by the obligor on the investment obligation. Treasuries assume no credit risk since they have the backing of the full faith and credit of the U.S. government. Each of the investments described above is either with a very highly rated borrower or is backed by such collateral.

(3) Assumes repurchase agreement allows for draws for debt service deficiency or project expenses at par, should confirm with auditors.

(4) Downgrade Trigger refers to a mechanism by which the client can get additional security for its investment or, depending on the downgrade trigger, withdraw its money at par if there is a downgrade of the obligor.

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Additional Legal Considerations

Approval of Investments/Documentation

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- Investment policy/limits
- Delegation of authority
- Ordinance/resolution
- Authorized representatives
- Form of direction (e-mails count!)
- Standalone Agreement vs. Master/Supplement
- Standardized form and separate letter agreement
- Closing deliverables

- Risk of loss/opportunity cost
- Termination penalties
- Counterparty risk (rating downgrade or bankruptcy)
- Federal tax considerations (e.g., arbitrage/rebate)

Yield Restriction vs. Rebate Considerations

- ***Yield Restriction*** - Investment earnings restrictions placed on certain classes of funds following the temporary period. General restrictions are as follows:
  - One-eighth of 1 percentage point (0.125%) for investments typically held in a project fund.
  - One-thousandth of 1 percentage point (0.001%) for investments in a refunding escrow or allocable to replacement proceeds (i.e. Debt Service Fund).
- ***Temporary Period*** - Period when proceeds may be lawfully invested at a "materially higher" yield than the bond yield and are subject to rebate. Different classes of funds have different temporary periods. General temporary periods are as follows:
  - Construction proceeds three years if substantial binding obligation to commence projects or expend at least 5% of net sale bond proceeds within 6 months.
  - Current refunding proceeds 90 days.
  - Replacement proceeds - "bona fide debt service funds" and "reasonably required reserve funds"
  - "Minor portion" exempt from temporary period

Spending Exceptions to Rebate Rules:

- ***Small Issuer Exception*** - Bond proceeds are not subject to Rebate during the Temporary Period if the aggregate face amount of all tax-exempt bonds issued by a governmental unit during a calendar year does not exceed $5 million or $15 million (school construction). Following the Temporary Period, unspent proceeds are subject to **Yield Restriction**.
- ***Six-month Exception*** - Issuer must spend 95% of proceeds, including interest earned, within 6 Months.

  31. The School District expects to qualify for the six-month spending exception to the arbitrage rebate requirements contained in Section 148(f)(5)(B) of the Code and Section 1.148-7(c) of the Regulations with respect to the Original Proceeds allocable to refunding the Bonds to be Refunded.
- ***Two-year Exception*** - Issuer must spend 100% of proceeds, including interest earned, and meet each of the following interim spending requirements:

6 Months: 10%	**12 Months: 45%**
18 Months: 75%	**24 Months: 100%**

- ***Other Exceptions***:
  - Bona fide debt service fund
  - Reasonably required reserve fund
  - Minor portion

- Securities, certificates of deposits and GICs/Repos
- Doesn't apply to SLGs
- Value is respected by IRS/"Phantom Earnings"
- Application – Escrow Fund, project and other bond-related funds
- Bidding Process/Bidding Agent

- IRS safe harbor to determine Fair Market Value:
- Valued according to established securities market
- Must conduct “bona fide solicitation”
  - Bid specifications in writing/timely distributed
  - Include material terms of bid and certain disclaimers
  - Commercially reasonable
  - Reasonably expected deposit and draw-down schedule
- Typically engage a bidding agent

Bona Fide Solicitation

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- Three or more bids *preferred* from providers (no material financial interest or MFI)
- MFI – lead underwriter in recent deal, financial advisor or related parties
- Winning bid is highest yield/lowest cost ("best" bid)
- **No last look!**
- Lowest cost can't be higher than cost of SLGs
- Investment bidding costs and record retention
- Certificate of bidding agent

MSRB Disclosure

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