MEMORANDUM

TO: Board of Directors, Massachusetts School Building Authority

FROM: John K. McCarthy

DATE: March 19, 2014

RE: MSBA Debt Management Policy Update

The State Finance Governance Board ("SFGB") regulations 976 CMR 2.01-2.08 require certain Massachusetts entities issuing debt to periodically approve and file a debt management policy with the SFGB. The regulations require that the governing board of the issuer formally adopt the policy every two years. The MSBA's Board of Directors ("Board") voted to adopt the Authority's current debt management policy at the June 6, 2012 Board meeting. The SFGB regulations require issuers to file the debt management policies in even-numbered years beginning in 2012.

The attached version of the MSBA's Debt Management Policy reflects proposed edits that would update the current policy voted on by the Board in June 2012. The attached version is marked up in order to highlight the proposed edits to the current policy. There are not any proposed edits that make any change to the current debt management practices of the MSBA. The proposed edits include language that attempt to clarify the language of the existing policy to best reflect current practices, which are based on the policy adopted in June 2012. The proposed edits include:

- Updated mission statement language to match the MSBA's mission statement precisely;
- Updated references to the State Finance and Governance Board (formerly Finance Advisory Board);
- Updated MSBA debt outstanding data as of March 26, 2014, including outstanding debt, final maturity date, average life, average annual debt service, number of series of debt issued on senior and subordinate lien;
- Language clarifying key elements of the Trust Agreement, including monthly transfer of dedicated revenue and the additional bonds test;
- Updated language regarding consideration of the structuring of debt;
- Updated language regarding compliance and investor relations to more accurately reflect MSBA's Post Issuance Compliance and investor relations practices;
- Language clarifying that although the MSBA has not entered into any derivative transactions, prior to doing so in the future the MSBA would ensure compliance with SFGB regulations; and
- Language clarifying the timing of updates to the policy and filing with the SFGB.

Staff will continue to review the MSBA's Debt Management Policy on an annual basis to ensure that the policy continues to include key aspects of effective debt management.

Staff recommends the Board formally vote to adopt the attached Debt Management Policy. Staff will file the updated policy with the SGFB, prior to March 31, following an affirmative vote of the Board.

Massachusetts School Building Authority

Debt Management Policy

Purpose

The purpose of this policy is to describe and provide a framework for the issuance of debt by the Massachusetts School Building Authority (MSBA or Authority) in support of its mission. The primary mission of the MSBA is to provide grants to public K-12 school districts for school construction and renovation projects in order to partner with Massachusetts communities to support the design and construction of educationally-appropriate, flexible, sustainable, and cost-effective public school facilities. ~~maintain affordable, educationally sound, sustainable and efficient schools in local communities~~. Debt issued by the MSBA will be used to provide grants to cities, towns and regional public school districts throughout the Commonwealth.

The MSBA recognizes that one of the keys to sound financial management is a written debt management policy. The development of a debt policy is a recommended practice by the Government Finance Officers Association and bond rating agencies. The advantages of this debt management policy are that it enhances the quality of decisions made by the MSBA in relation to management of its debt, identifies clear objectives for MSBA staff, and demonstrates a commitment to long-term financial planning.

This debt management policy establishes the parameters for issuing and managing the MSBA's debt. It provides guidelines regarding the timing and purposes for which debt may be issued, presents the types of permissible debt, selection of finance professionals, modeling, market surveillance, relations with credit rating agencies and the methods of sale that may be used. Adherence to this debt management policy helps to ensure that the MSBA maintains a sound financial position and that the MSBA's credit quality and credit ratings are protected.

Provisions of the MSBA's Enabling Act

The MSBA was created by chapter 208 of the Acts of 2004, Chapter 70B of the Massachusetts General Laws, Section 35BB of Chapter 10 of the Massachusetts General Laws and Chapter 210 of the Acts of 2004, each as amended from time to time (the "Act"). Pursuant to the Act, the Commonwealth has dedicated a one percent ~~of the Commonwealth's~~ state-wide sales tax to the MSBA.

Section 3B of chapter 70B of the Massachusetts General Laws specifically authorizes the MSBA to issue debt. The aggregate principal amount of all bonds issued by the MSBA cannot exceed $10,000,000,000 outstanding at any time. The Act permits the MSBA to enter into a trust agreement with a bond trustee to pledge revenues and provide protections to bondholders of its debt. Debt issued by the MSBA is authorized by a resolution of the MSBA's Board of Directors. Prior to the issuance of debt, the MSBA must advise the State Finance and Governance~~Finance~~ ~~Advisory~~ Board of the timing and terms of the debt issue. Debt of the MSBA is not considered debt of the Commonwealth or any of its political subdivisions.

The Executive Director shall be responsible for retaining appropriately qualified staff to implement the provisions of this policy.

Current Debt Outstanding

As of March 26, 2014, ~~May 16, 2012~~ the MSBA will have debt totaling $5,646,470,000 ~~5,443,265,000~~ outstanding. The final maturity of existing debt is May 2043 ~~October 2041~~. The largest MSBA debt issuance to date was $2,500,000,000, and the smallest issuance was $142,380,000. The average life of the debt outstanding is ~~16.5~~15.6 years. The average annual debt service is $348,520,926~~326,890,268~~. Interest on $743,380,000 of the outstanding debt is eligible for varying levels of subsidy from the federal government.

Key requirements of Trust Agreements

As of March 26, 2014~~May 16, 2012~~, the MSBA has ten ~~seven~~ series of debt outstanding. The ten ~~seven~~ bond issues have been issued pursuant to a Trust Agreement and series-specific supplemental agreements. The original Trust Agreement was adopted in August 2005. The most recent Supplemental Trust Agreement was adopted in July 2013 ~~November 2011~~. Eight ~~Five~~ series have been issued as senior lien debt, and two series have been issued as subordinate lien debt.

The key provisions of the Trust Agreements are:

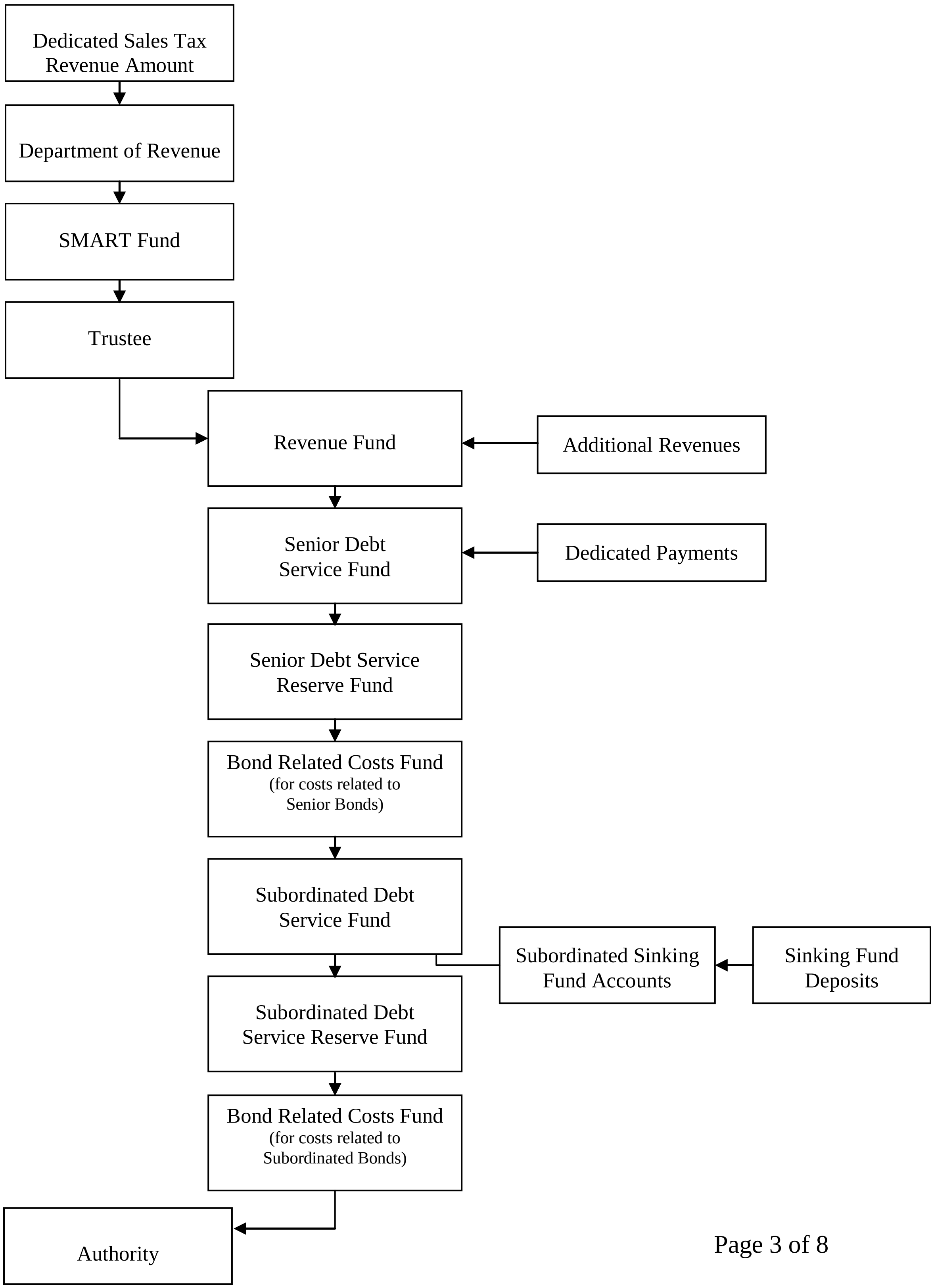
- A gross pledge of sales tax revenues,
- Establishment of a flow of funds, and
- A limitation on the amount of future debt issuance in the form of additional bonds tests.

Gross Pledge of Dedicated Sales Tax Revenue

Under the Trust Agreements, the MSBA has covenanted a true unconditional gross pledge of the Dedicated Sales Tax Revenue. All dedicated sales tax receipts, once collected by the Massachusetts Department of Revenue, ~~is~~are transferred monthly ~~are deposited~~ directly to~~with~~ the Bond Trustee ~~monthly~~ to provide for required debt service fund set asides for payment of principal and interest on the MSBA's outstanding debt. After the Bond Trustee has fully funded any required Debt Service Fund(s) deposit(s), the remaining revenues are forwarded to the MSBA.

Flow of Funds

The Trust Agreement established a flow of funds which sets the priority of funding various accounts. By order of priority, the senior bondholder debt service and reserve accounts are funded first, the subordinate bond debt service and reserves are funded next, and lastly, any remaining funds are made available to the MSBA. The following chart shows the flow of funds as prescribed pursuant to the MSBA's Trust Agreement.



Additional Bonds Test

The Trust Agreements provide that no additional senior lien debt will be issued unless ~~recent annual~~ sales tax revenues, as calculated per Section 206(b)(v) of the Trust Agreement dated as of August 1, 2005, are 140% or more of the maximum senior net debt service in any future year. The Trust Agreements further provide that no additional subordinate lien debt will be issued unless ~~recent annual~~ sales tax revenues, as calculated per Section 206(b)(vi) of the Trust Agreement dated as of June 1, 2010, are 130% or more of the maximum net debt service (both senior and subordinate lien) in any future year. These provisions are intended to make MSBA debt highly rated and attractive to many investors.

Professional Services Selection Process

To assist in its debt program, the MSBA may engage the professional services of a bond counsel, disclosure counsel, bond trustee, underwriters, financial advisor(s), municipal advisor(s), auditor(s), rebate consultant(s), verification agent(s), reinvestment agent(s), bidding agent(s), and other professional services as may be required.

Prior to engaging the services of any professional, the MSBA shall undertake a selection process as permitted by the MSBA's Procurement Policy, which includes issuing~~–~~ a Request for Services (RFS). Each RFS shall contain appropriate criteria to be used in selecting a firm(s). These criteria may include, but not be limited to:

- individual or team members,
- experience of individuals or team,
- capacity of the firm,
- prior service to MSBA,
- understanding of the MSBA's business processes and practices, specific needs, and debt structure, and
- fees.

In selecting a firm(s) the Authority should strongly consider any fees to be paid; however, it shall not be required to select the lowest bidder. Rather, the MSBA should select the most responsible, responsive and qualified bidder offering the best value. The responses to a RFS should be reviewed by a selection committee. The committee's recommendation is subject to approval by the MSBA Board or Executive Director. Upon receipt of the necessary approval, a firm(s) may be engaged to provide professional services.

Modeling, Debt Affordability and Stress Tests

The MSBA will prepare or update a finance model prior to each debt issuance. The purpose of the financial model is to provide the MSBA with an understanding of its capacity to fund school renovation or construction grants over a long term horizon. The model should be run using conservative assumptions. Generally, sales tax growth should be assumed to be modest, and future interest rates should be assumed to be higher than the current rates. The model will provide data to assist in the determination of the appropriate debt structure for upcoming debt issues. The model will also be used to run various scenarios or stress tests to allow the MSBA to gauge sensitivities and risks with model assumptions.

Ongoing Debt Market Surveillance

The MSBA shall monitor debt markets on an ongoing basis. The monitoring shall have three points of focus: secondary trading of MSBA debt, slope of the yield curve and spreads between taxable and tax-exempt municipal debt. Such monitoring will assist in the sizing, timing and structure of future new money and refunding issues.

Special emphasis on market surveillance should occur immediately following each bond sale. Trades of new MSBA bonds should be monitored to determine the consistency of the initial pricing to secondary market transactions. In the event that new MSBA bonds trade at prices significantly different from original issuance, the MSBA shall review available market information to try to determine the reason for such difference.

Debt Structuring

The structure of each new MSBA debt issue must be viewed in conjunction with past debt issuances and expected future capital needs. The structure of each debt offering should consider the following factors: current debt structure, expected capital needs over the next several years, slope of the yield curve, spread between senior and subordinate lien debt, spread between taxable and tax-exempt municipal debt, percentage of debt that is fixed rate, and costs of credit enhancement. Maturity should be consistent with expected useful life of projects receiving grants that are funded by the issuance of debt by the MSBA.

The primary factor in structuring a debt issue is the impact on the MSBA's Additional Bonds Test. The MSBA should avoid structures that significantly increase the maximum adjusted bond debt service calculation. The year with the highest net debt service will limit the amount of debt the MSBA is permitted to issue ~~debt~~ under the Trust Agreement in future years, and the structure of each issuance should carefully consider the impact on annual debt service as a result of the issuance, as well as the impact on estimated future borrowing that is anticipated in order to support projects receiving grants through MSBA's capital programs.

The debt structure of the MSBA may include both fixed and variable rate debt. The fixed rate portion of the debt portfolio shall be 90% or greater as of the delivery of any new issuance of variable rate debt.

Method of Debt Issuance

The MSBA will issue debt either through a competitive bid process or by negotiation with underwriters. The method of debt issuance should be dictated by the goal of achieving lower cost source of funding. Factors to consider in determining which method of issuance to use are the following: size, type of bond, target investor base, complexity, market volatility, type and length of final maturity.

Approach to Credit Ratings

The MSBA will pursue policies that both achieve a high credit rating and do not prevent the Authority from performing its mission. The Authority will avoid overly restrictive covenants that may achieve a higher rating but severely limit the capacity to provide grant funding.

The MSBA will maintain an ongoing dialogue with the rating agencies. This dialogue will require the MSBA to notify the rating agencies of both favorable and unfavorable developments that may potentially affect the credit of the MSBA.

Legality

The MSBA will receive an opinion acceptable to the market, from a nationally recognized law firm that specializes in Bond Counsel services, that each financing transaction complies with applicable law and all agreements in connection with any financing are legal, valid and binding obligations of the MSBA.

Continuing Disclosure, Post Issuance Compliance, and Investor Relations

The MSBA will provide continuing disclosure at or above industry standards. Every debt issue will contain a provision committing the Authority to provide ongoing disclosure. The MSBA will maintain Post Issuance Compliance procedures that facilitate compliance with applicable laws, rules, regulations, covenants, or any other monitoring and reporting, requirements associated with outstanding debt. The MSBA will collaborate with the Bond Trustee to ensure that required disclosures are submitted timely through the Electronic Municipal Market Access ("EMMA") website operated by the Municipal Securities Rulemaking Board ("MSRB"). The MSBA will track and respond as necessary to non-disclosure requirements associated with debt issuance, such as the calculation and payment of arbitrage rebate. ~~–~~The MSBA website ~~may~~ will have a section with basic information that may be useful to investors that may include, but not be limited to, debt and investment management policies and audited financial statements of the MSBA. The MSBA will also participate in various investor and public finance conferences in order to communicate with MSBA investors and other participants in the municipal securities markets. The MSBA may utilize, when deemed appropriate, various forms of media to advertise and promote its bond sales. The type of media employed will depend upon the type and maturity of debt issued.

Refunding of Debt

The MSBA will monitor its debt portfolio and interest rates to determine the quality of any refunding. A refunding must be considered in the context of the overall debt structure of the MSBA. Prior to refunding any debt, the MSBA shall conduct an analysis of the efficiency of the potential refunding. Savings from a refunding of a bond series will be spread over numerous years to achieve the goal of lowering the maximum adjusted bond debt service to facilitate future debt issuance.

Derivatives

To date, the MSBA has not entered into any derivative transactions.

Prior to entering into a new financial transaction that involves a derivative financial product, the MSBA will ensure compliance with regulations established by the State Finance and Governance Board in CMR 976 2.06. In addition to approvals and the submittal of information required pursuant to CMR 976 2.06, p~~P~~rior to engaging in a derivative transaction, the MSBA shall prepare a detailed report on the proposed transaction, which shall include, but not be limited to, the following:

- A clear statement of the reason for entering into the derivative transaction;~~,~~
- The process for executing the derivative transaction;~~,~~
- A statement explaining the intended benefit;~~,~~
- A review of the long-term implications associated with entering into the derivative transaction, including costs of borrowing, historical interest rate trends, variable rate capacity, credit enhancement capacity, opportunities to refund related debt obligations and other similar considerations;~~,~~ and
- The risks inherent in the proposed derivative transaction, including but not limited to, counterparty risk, termination risk, liquidity risk, rollover risk, basis risk, tax event risk and/or amortization risk.

Derivative transactions shall not:

- be used for speculative purposes;
- create extraordinary leverage or risk;
- lack adequate liquidity to terminate without incurring significant costs; or
- provide insufficient price transparency to allow reasonable valuation.

If the MSBA has entered into any derivative transactions, then the MSBA shall issue a report on derivative transactions at least once per year, or more frequently as requested by the MSBA Board of Directors. Such report shall include the following:

- A summary of key terms of the agreements, including notional amounts, interest rates, maturity and method of procurement;~~.~~
- The marked to market value of each derivative agreement;~~.~~
- The full name, description and credit ratings of each counterparty or the applicable guarantor;~~.~~
- The amounts that were required to be paid and received, and any amounts that were actually paid and received;~~.~~

- Listing of any credit enhancement, liquidity facility or reserves and accounting of all costs and expenses associated with the credit enhancement, liquidity facility or reserves;~~.~~ and
- The aggregate marked to market value for each counterparty and relative exposure compared to other counterparties.

Review of the Debt Management Policy

The MSBA shall review the Debt Policy annually and may make recommendations for changes, updates or other revisions as may be deemed necessary. Pursuant to regulations established by the State Finance and Governance Board, the MSBA will provide the State Finance and Governance Board with a copy of the adopted Debt Management Policy, or with evidence that there has been no material change to the most recently filed policy, prior to March 31 of each even-numbered year.