MEMORANDUM

TO: Board of Directors, Massachusetts School Building Authority

FROM: John K. McCarthy

DATE: September 17, 2014

RE: Arbitrage Rebate Update

The Internal Revenue Service Code ("Code") requires tax-exempt debt issuers to rebate "excess earnings" on certain investments funded with tax-exempt bond proceeds back to the federal government. Excess earnings occur when the yield on a bond funded investment is greater than the interest cost of the tax-exempt bond issue associated with the investment. Simply put, if the bonds of a tax-exempt series of debt are issued with an interest cost of 4.0%, and the bond proceeds are invested at 5.0%, the additional 1% of interest earnings must be rebated to the federal government.

The Code requires issuers of tax-exempt debt to report the earnings on their bond proceeds every five years, through final maturity, to determine if there are any "excess earnings". If there are any such excess earnings identified at the five year computation date, the issuer must make a rebate payment equal to 90% of the total excess earnings amount to the federal government. Following the final maturity of a bond issue, one final calculation is performed and the final rebate liability determined at that time requires a payment equal to 100% of the "excess earnings" to the federal government.

Earnings on unexpended balances in project funds, bond refunding and defeasance escrows, and debt service reserve funds are subject to arbitrage rebate calculations. Due to the longer duration of investments for debt service reserve funds, it is common during some interest rate environments for the debt service reserve to have excess earnings, and therefore a rebate liability. The shorter duration of investments of project funds and escrows tend to have lower yields than the associated bond issue interest cost, and accordingly often reduce the rebate liability.

The MSBA engages an independent arbitrage rebate consultant annually to perform arbitrage calculations on each of the MSBA's outstanding series of debt. The MSBA uses this information in order to ensure that the MSBA is appropriately setting aside funds, as a result of earnings from investments which may be yielding more more than the authority is permitted to keep, and will be rebated to the federal government at the required five year computation date. Currently, the MSBA has three debt service reserve accounts which are earning more than the interest cost on the related bond issue. [1] Each year, the interest earnings which are subject to rebate are transferred by the MSBA into a separate restricted account which will eventually be used to make the rebate payment to

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[1] The three debt service reserve accounts are for the 2005 A, 2007 A, and 2009 A bond issues.

the federal government. This advanced planning ensures that adequate funds are available in the year that a rebate payment is payable to the federal government.

It is important to note that the MSBA has a portion of its investments of bond proceeds invested in highly rated, tax-exempt, bonds of Massachusetts issuers, and these securities are not subject to rebate. The regulations exclude the earnings on tax-exempt bonds from rebate calculations, thus these investments will not increase the MSBA's rebate liability.

Based on the most recent arbitrage rebate calculations on all of MSBA's outstanding series of debt as of June 30, 2013, performed by American Municipal Tax-Exempt Compliance Corporation ("AMTEC"), the MSBA has a total estimated rebate liability of $11,064,419 based on an analysis of all of MSBA's outstanding debt. Of this amount, there is rebate payment due to the federal government in October 2014 for earnings related to the 2009 Series A bonds, and that required rebate payment of $1,226,558, which represents 90% of the total estimated rebate liability on that series of debt, was paid by the MSBA on September 4, 2014 in order to ensure compliance. The MSBA was able to make this payment from funds previously set aside in a separate account that was established for the purpose of designating funds for rebate payments, as described previously.

Staff will provide the next annual update on the MSBA's arbitrage rebate liability following the close of the first quarter of fiscal year 2016, which will reflect any changes to the liability as a result of the updates to the next arbitrage rebate reports that will be completed following the close of fiscal year 2015.