MEMORANDUM

To: Board of Directors, Massachusetts School Building Authority
From: James MacDonald, First Deputy Treasurer, Chief Executive Officer
John K. McCarthy, Executive Director, Deputy Chief Executive Officer
Date: January 31, 2018
Subject: Debt Management and Continuing Disclosure Policy

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 January 2016 Board meeting. The SFGB regulations require issuers to file the debt management policies in even-numbered years beginning in 2012.

Staff has reviewed the current policy and policies of other issuers. At this time staff feels the current policy meets the needs of the Authority. The attached version of the MSBA's Debt Management Policy reflects one recommended change to allow the defeasance of currently refundable bonds. There are no other recommendations for changes in policy.

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 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 and Continuing Disclosure 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. 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 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 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 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 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 one cent 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 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 February 15, 2018, the MSBA will have debt totaling $6,025,875,000 outstanding in bonds and $450,000,000 outstanding in Commercial Paper, which will be taken out with the proceeds of the 2018 Series A Bonds and unrestricted funds. The final maturity of existing debt is February 2048. The largest MSBA debt issuance to date was $2,500,000,000, and the smallest issuance was $76,315,000. Interest on $743,380,000 of the outstanding debt is eligible for varying levels of subsidy from the federal government. There are fourteen series of bonds outstanding.

Key Requirements of Trust Agreements

As of February 15, 2018, the MSBA will have issued eighteen series of bonds and has three commercial paper programs outstanding, which will be taken out with the proceeds of the 2018 Series A Bonds and unrestricted funds. The 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 October 2016. Two of the bond series were issued as subordinate lien debt.

The key provisions of the Trust Agreements are:

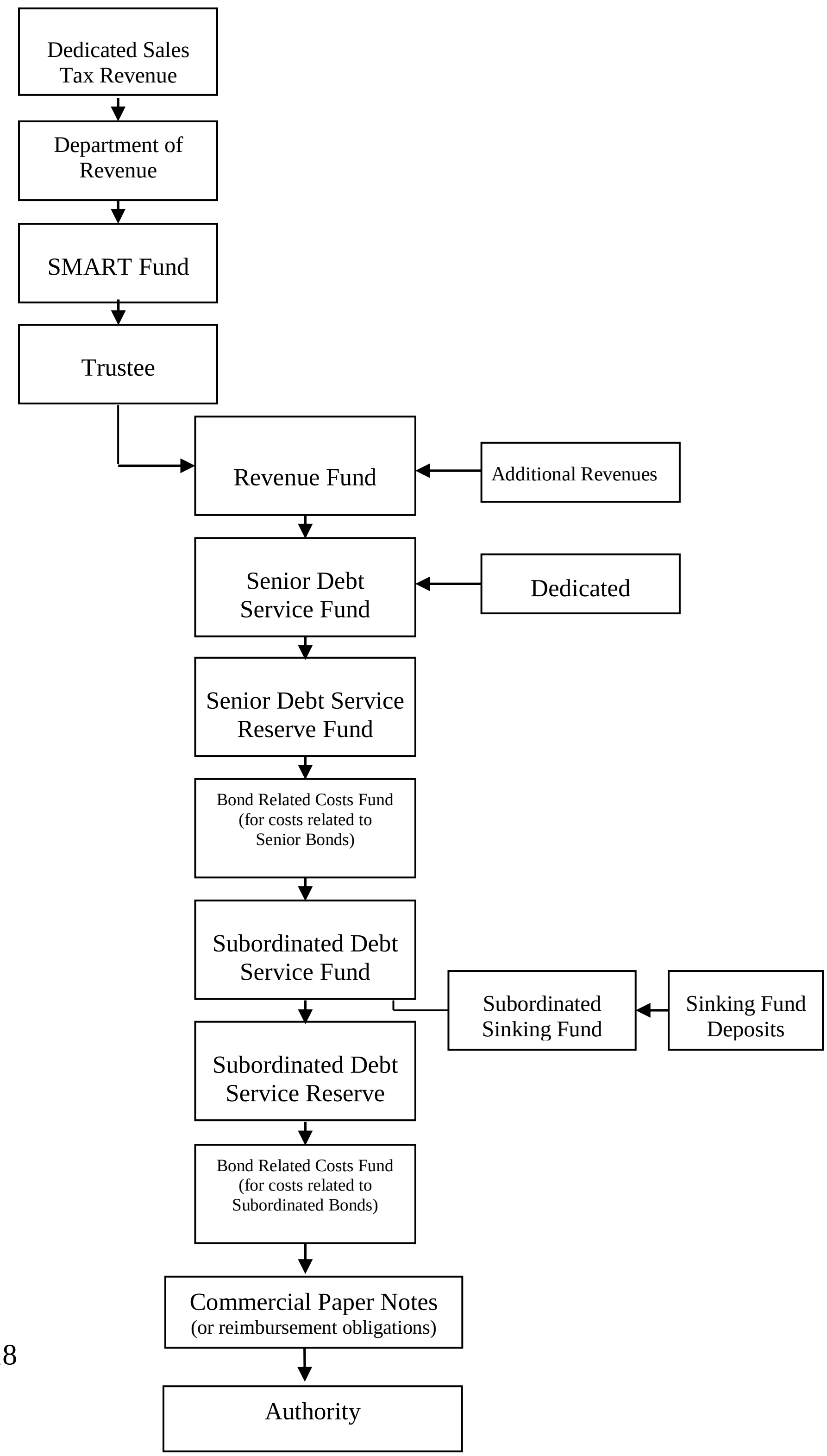
- A gross pledge of sales tax revenues,
- Establishment of a flow of funds, and
- A limitation on the amount of future debt issuance in the form of additional bonds tests.

<u>Gross Pledge of Dedicated Sales Tax Revenue</u>

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, are deposited directly with the Bond Trustee monthly 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

Section 206(b)(v)(A) of the Trust Agreement dated as of August 1, 2005 provides that additional senior lien debt may be issued if recent annual sales tax revenues are 140% or more of the maximum senior net debt service in any future year. Section 206(b)(vi)(A) of the Trust Agreement dated as of June 1, 2010 provides that additional subordinate lien debt may be issued if recent annual sales tax revenues 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), 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.

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.

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 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 have a section with basic information that may be useful to investors. The MSBA will also participate in various investor and public finance conferences. The MSBA may utilize, when deemed appropriate, various forms of media to advertise and promote its bond sales. The media employed will depend upon the type and maturity of debt issued.

Refunding and Defeasance of Debt

The MSBA will monitor its debt portfolio and interest rates to determine the quality of any refunding or defeasance. Defeasance of non-callable or current refundable maturities will be evaluated based on the unrestricted funds available and the impact the defeasance will have on coverage ratios. 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 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
- 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 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.
- The aggregate marked to market value for each counterparty and relative exposure compared to other counterparties.

Review of the Debt Policy

The MSBA shall review the Debt Policy annually and may make recommendations for changes, updates or other revisions as may be deemed necessary.