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CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

13TH Annual Pre-Conference at *The Bond Buyer's* 24TH Annual California Public Finance Conference

ALTERNATIVE FINANCING IN THE MUNICIPAL MARKET:

FINANCIAL AND POLICY CONSIDERATIONS

OCTOBER 8, 2014 SAN DIEGO, CA

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SESSION THREE:

FINANCIAL MANAGEMENT – RISK ANALYSIS AND ALLOCATION

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The Best Portfolio Mix

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- There isn't one
- Economic, political, demographic, regulatory, etc. factors matter
- Risk-centric approach to debt policy might help reduce cost and limit risks
  - Traditional fixed rate debt and risk aversion
    - Certain benefits
    - Opportunity cost – the foregone lower costs of other alternatives – focus on hidden costs of decisions
    - Exchange of one set of risks for another
    - Commitment risk – lack of flexibility to respond to future risks

Portfolio Restructuring

Long-Term Risks

- Economic
- Competitive
- Political
- Regulatory
- Demographic
- Catastrophic
- Environmental

Asset-Liability Matching

- A balance sheet risk management approach that links the interest rate sensitivity of liabilities and assets
- Rule of thumb: variable rate debt = 100-150% of cash
  - More if revenues are economically sensitive
- If revenues and expenses are economically sensitive, then even issuers without significant cash balances might find fixed rate debt quite risky

Debt Policy

- Flexible, risk-centric approach might be beneficial for certain issuers
- Cost/Benefit Analysis of alternative debt products
  - Ask the “right” questions
  - Fully understand proposed structures, what assets are pledged and decisions being made
  - Be mindful of potential impacts and interdependency
  - Think about budget and operational performance
- Holistic analysis of the commitments being undertaken both financially, legally and politically

Risk Analysis of Alternative Structures

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- How does this product differ from TFRD?
- What are the key benefits and risks?
- How does this product fit into/impact my current debt portfolio and/or asset liability management?
- What is the current market for this product? Size? Investors? What types of issuers have used it?
- Has it been tested in an adverse situation? What was the outcome and impact on the issuer?
- What transaction features are most attractive to investors? Do they come with a certain cost for the issuer?

Risk Analysis of Alternative Structures (Cont'd)

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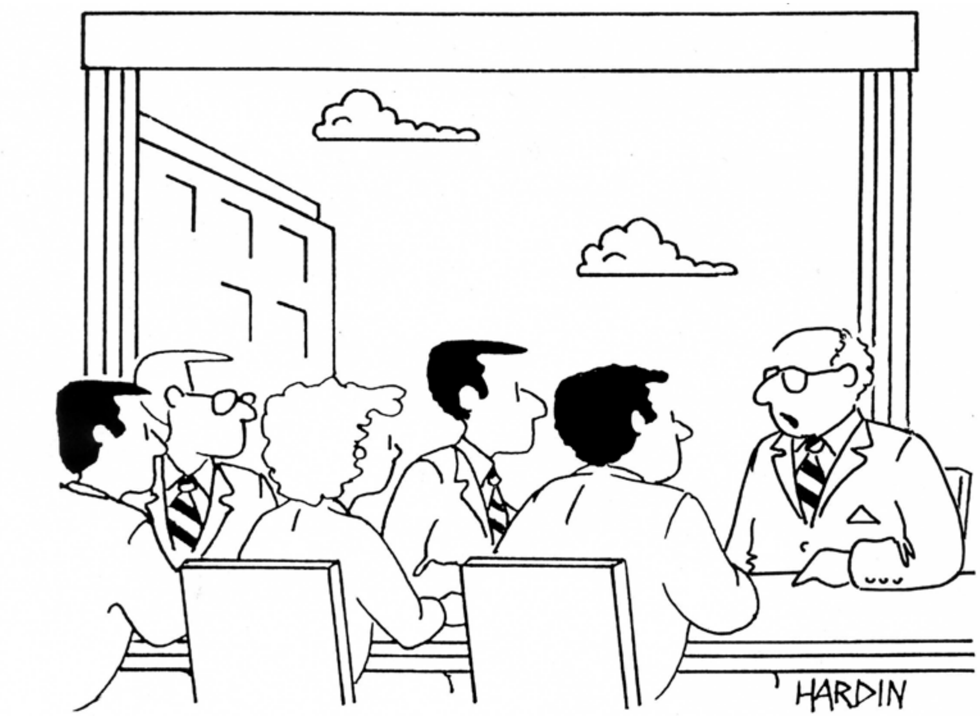
- What structural features are investors most concerned about?
- What are the accounting and disclosure requirements? What is required and what do investors expect in terms of disclosure?
- What is the rating agencies' view on the product and impact on credit quality?
- Does the product require expert knowledge of finance products or monitoring of markets, counterparties, etc.?
- Is there a risk that the issuer could be responsible to cover a payment of another party such as the U.S. government that is relied upon for repayment of the debt
- What is the worst theoretical outcome for an issuer that uses this product?

Keep Focused

- Think about your own mission, not what capital market creditors want from you



"We've considered every potential risk except the risks of avoiding all risks."

Risk Analysis: Recent Periods in the Municipal Markets

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2008 – 2010 "Stimulus Period"

Themes

- Auction rate market collapses
- Federal stimulus programs aids issuance (ARRA)
- Bank and bond insurer downgrades
- Taxable/crossover buyer participation
- Short-term market alternatives emerge

Issuer Behavior

- ARS and VRDNs restructured to fixed rate
- Taxable and private placement markets readily accessed
- Focus on counterparty risk/exposure (Credit enhancement substitutions Swap terminations)
- New money projects accelerated before ARRA sunset

2011 – 2012 "Stabilization Period"

Themes

- Banks emerge as 3rd largest Muni bond holders
- Short and long-term rates dip to historical lows
- Credit spreads stabilize
- FRN and DP markets continue to grow
- Tax-exempt/ taxable ratios above 100%

Issuer Behavior

- Refundings
- Fixed rate bias (95% of issuance volume)
- Taxable and private placement markets continued to be viable alternatives
- Other alternative markets tested Counterparty fatigue (credit and swap)

2013 - 2014 "Recovery and Growth Period?"

Themes

- Inconsistent views on recovery leads to volatility on the long-end
- Credit events (e.g. Detroit)
- Volume decline
- Convergence continuing between FRN and DP markets
- Clients exploring all markets (direct purchases, tax-exempt, taxable and swap market)

Regulation & Legislative Impacts

- Dodd-Frank
- Muni Advisor Rule
- Volcker Rule
- Basel III
- Tax Reform

Examples of Alternative Structures

Public Market	Private Market
Floating Rate Notes - SIFMA based or Libor based - Hard / Soft Put **Callable Commercial Paper** **Century Bonds**	**Direct Purchases** - Fixed rate and floating rate **Drawdown Facilities**
P3's **Synthetic Structures**	

Macro Risks to Alternative Structures

Regulatory

- Dodd-Frank
- Basel III (HQLA)
- Muni Advisor Rule
- Volcker Rule
- Tax Reform

Political risk

- Recent credit events (Detroit, P.R., pensions)

Disclosure

- Possibility of two-tiered disclosure system

Liquidity

- Market depth and flexibility

Micro Risks to Alternative Structures

Counterparty risk	• Bank products (credit enhancement, direct purchases, swaps) and Dealer/Remarketing Agent risk
Tax risk (SIFMA vs. LIBOR)	• Change in corporate tax rate can change deal economics
Renewal risk	• Bank appetite for exposure to certain credits can change just as market liquidity
Structural risk	• Acceleration, transfer risk, etc.

Rating Agency Perspective

- Alternative products might provide benefits
- Less standardized and uniform terms and conditions/lack of transparency create potential for considerable risk exposure
- S&P analyzes an obligor's comprehensive debt position, so even if there is no legal requirement, exposure to alternative products should be disclosed
- Covenants which could lead to acceleration, create demands on liquidity, or cross-default other debt, could have credit implications

Rating Agency Perspective (Cont'd)

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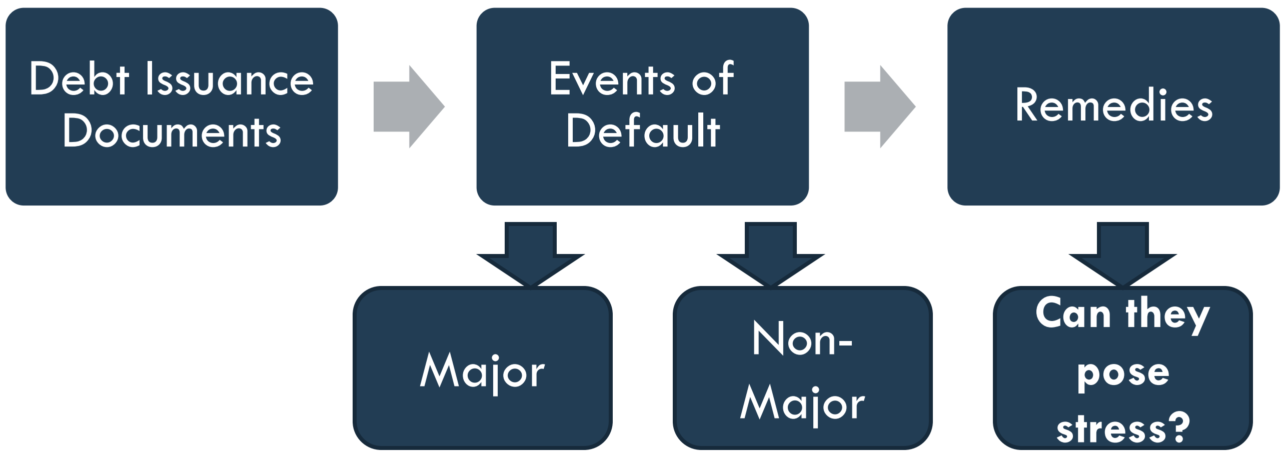
- The credit impact on an obligor's portfolio is considered holistically: all introduced risks are analyzed regardless of the financing vehicle
- Additional risk from alternate structures stems from:
  - Potential Acceleration of P&I payments
    - Events of Default
    - Covenants and remedies
  - Cross-default provisions between alternative financing debt and capital market debt
  - Breached covenants and default events could lead to a liquidity crisis for the obligor

Rating Agency Perspective (Cont'd)

- Incorporation of alternative financings into the analysis of an obligor's debt profile is critical



- The combination of the magnitude of potential accelerated debt relative to an obligor's liquidity, and the immediacy of such liquidity calls will be key

Rating Agency Perspective (Cont'd)

- Acceleration provisions that favor private lenders:
  - Subordinate the claims of the issuer's capital market lenders
- Even if the events of default do not include acceleration as a remedy, they could still cause the acceleration of other parity debt through:
  - Cross-default provisions or
  - Most favored nation clauses
- Most favored nation clauses pose a particular risk to credit quality because the events of default may change in unknown ways

Rating Agency Perspective (Cont'd)

- Repayment Risk tied to VRDBs, alternative financing products, and other debt instruments:
  - Predictable
  - Event-driven
- Where event-driven risk exists, evaluation of:
  - Likelihood of triggering acceleration, termination payment, or collateral posting requirements
  - Assessment of management's capacity to respond to these liquidity demands through available balance sheet liquidity, capital market access, or lines of credit
- Debt Management and Investment Policies Critical

The Risk of Distress

- The strength of the municipal market is based on mutual trust
- Detroit, San Bernardino, Stockton, Puerto Rico – no sizable municipal distresses as expected
- Distressed focused hedge funds
- Predatory participants introduce a far more adversarial perspective
- Political leaders facing fiscal pressure are vulnerable to the "easy" options

The Risk of Distress (Cont'd)

- Uncertainty in how things will be restructured
- Uncertainty in how the various parties will be treated
- Conflicting short-term and long-term interests
- There are some opportunities in distressed markets
  - Yield-hungry lenders

Case Study

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Summary of Proposed Creditor Treatment

Stockton Plan of Adjustment

($ in Millions)

Class	Name	Impaired / Unimpaired I / U	Claim $	Recovery (%)
1A, 1B	2003 Police/Fire/Library Certificates (Ambac)	I	$12.6	106.4%
2	2006 SEB Bonds (NPFG)	U	12.1	100.0%
3	2004 Arena Bonds (NPFG)	I	45.1	96.7%
4	2004 Parking Structure Bonds (NPFG)	I	31.6	83.9%
5	2007 Office Building Bonds (Assured)	I	40.4	53.9%
6	Pension Obligation Bonds (Assured)	I	124.3	51.9%
8	SCC 16 Claims	U	0.5	100.0%
10	Restricted Revenue Bond and Notes Payable	U	n/a	100.0%
11	Special Assessment and Special Tax Obligations	U	n/a	100.0%
12	General Unsecured Claims (incl. Franklin and OPEB)	I	579.8	0.9%
13	Convenience Class Claims (<$100)	U	n/a	100.0%
14	General Liability Tort Claimants	I	n/a	0.9%
15	CalPERS Claim for Pension Obligations	U	289.2	100.0%
17	Workers Compensation Claims	U	51.1	100.0%
18	Stockton Police Offiers' Claims	I	8.5	13.0%
19	Price Claims	I	1.4	n/a
20	Golf Course Secured Claim	I	4.1	100.0%
Pro-Forma Treatment of Retirees (Pension and Retiree Health)				
12, 15	City Retirees (combining retiree health and pension treatment)	I	$551.0	53.4%

Detroit Plan of Adjustment

($ in Millions)

Class	Name	Impaired / Unimpaired I / U	Claim $	Recovery (%)
1A, 1B,	Water and Sewer District Bond Claims	I	$5,779.9	100.0%
2A-F	Secured General Obligation Claims	U	485.0	100.0%
3	Other Secured Claims	U	8,855.5	100.0%
4	HUD Installment Note Claims	U	90.1	100.0%
5	COP Swap Claims	I	85.0	30.0%
6	Parking Bond Claims	U	8.1	100.0%
7	Limited Tax GO Claims	I	163.5	11.5%
8	Unlimited Tax GO Claims	I	388.0	74.0%
9	COP Claims	I	1,473.0	10.0%
10	Police and Fire Retirement System	I	1,250.0	59.0%
11	General Retirement System	I	1,879.0	60.0%
12	OPEB Claims *(includes both Safety and General)*	I	4,303.0	11.5%
13	Downtown Development Authority	I	33.6	11.5%
14	Other Unsecured Claims	I	150.0	11.5%
15	Convenience Claims (<$25,000)	I	n/a	25.0%
16	Subordinated Claims	I	n/a	0.0%
Pro-Forma Treatment of Retirees (Pension and Retiree Health)				
10, 11, 12	City Retirees (combining retiree health and pension treatment)	Impaired	$7,432.0	31.8%

Source: Respective Plans of Adjustment, Amended Plans of Adjustment, Disclosure Statements and Amended Disclosure Statements for Stockton and Detroit

Questions & Answers

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