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CDIAC Webinar Transcript

New Frontiers in Public Finance: A Return to Direct Lending

Slide 1 – New Frontiers in Public Finance: A Return to Direct Lending (01:33)

Welcome, everyone to the CDIAC webinar, New Frontiers in Public Finance A Return to Direct Lending. This is the first seminar program of the new education year for CDIAC. We've adopted a new format here with Go To webinar. Hopefully this will be a more efficient program structure. We've got a number of programs planned for this year. We want to begin here with a welcome to all the participants. I know we've got a number still to log on, but we will try to stay true to our schedule here. The first thing we will do as we begin the webinar is do a polling question to try to get an idea of who the attendees are affiliated with their organization or agency type to give the speakers an idea who our audience is. Also let you know that there's the opportunity in this format to submit questions throughout the webinar. Speakers will have the ability to view those and to the degree they relate to the presentation will try and integrate them into the discussion. If there are things we can hold off till the end of the presentation we will try to handle them at that time. There is a live captioning capacity within this program. There is a website which we have on the screen now. If you don't have the chance to write that down or record that, the CDIAC website actually references the captioning service and you can access it directly through the CDIAC website. If there are any problems throughout the course of the webinar please give CDIAC a call directly or e-mail us and we will try to address those problems. But hopefully with Go To webinar we will have many, a lot fewer of those technical difficulties than we had with the other programs. For those that are attending that require or would like to get a certificate of attendance, please let us know by e-mail at CDIACeducation@Treasurer.ca.gov. We will get those out as quickly to you as we can. Now we will move on to the polling question.

Polling Question (04:23)

All right if you take a minute to respond to the question and let us know what type of public agency you are affiliated with. Okay so the results indicate we've got 35% other. We've got all right you should be able to see that now. We are still learning the program as we go along. 23% city, 12% County, 8% federal state, 23% of the audience special districts, and 35% other.

Slide 2 – Speaker Introductions (05:13)

So let me begin by just introducing our speakers today. Our facilitator is Alex Wallace, managing Director, head of public finance with US Bank Corp. Has over 20 years of municipal security industry experience. Prior to joining US Bank Corp in August 2009, Mr. Wallace was at Wachovia services where he was the co-head of the municipal securities group; was responsible for the public finance group. He also spent a year as the head of the mid-Atlantic region for Loop capital markets. Prior to joining Wachovia securities Mr. Wallace worked for the state treasurer's office for the state of North Carolina. In addition, is a past chairman of the Carolinas municipal advisory Council. Next we have Glenn Casterline. Glenn is managing director for BLX group in Los Angeles. Joined BL X Founding Organization Works Financial Services group in 1992, and has focused primarily on traditional financial advisory services. He has additional experience in arbitrage rebate compliance and bond proceeds investment strategies. Next we have Brian Forbath. He's a shareholder with Straddling Yocca Carlson & Rauth. He has served as bond counsel, disclosure counsel, underwriter counsel in a variety of financings. He represents many cities in special districts in the state of California. Next we have Jim Manire, managing director with BLX group in Denver. Specializes in municipal bond advisory services and his experiences cover a range of transactional approaches including competitive bond sales, negotiated bond sales, bank purchases and state loans. And with that I will turn it over to our facilitator, Alex, and we will go from there.

Slide 3: A Return to Direct Lending – Overview (07:16)

Thank you Mark and thank you CDIAC for hosting this webinar entitled: New Frontiers in Public Lending - A Return to Direct Lending. Hello, my name is Alex Wallace and I will be serving as the moderator of this very talented panel today. I will begin by introducing the direct purchase product at a high level and lay the groundwork for Glenn and Jim to discuss evaluation and structural considerations and then Brian will discuss legal and regulatory considerations. We will then take a glimpse into the future of direct purchases and finally we will conclude with questions and answers. A reminder that you can e-mail your questions throughout the presentation and our plan is to address them at the very end.

Slide 4: What is direct purchase/private placement financing? (08:13)

If we could start on slide number four. What is a direct purchase/ private placement financing? In its most basic form a direct purchase is a tax-exempt financing either fixed or variable rate that is privately placed to an investor or directly purchased by a bank. This product is also known as a direct placement, a private placement, a funded loan or a direct loan. In terms of tax treatment, prior to the tax reform act of 1986, bank held tax-exempt financing was more common. Subsequently we now have a three-tiered municipal marketplace that includes a bank qualified market, a non-bank qualified market and also a taxable market. Direct lending has occurred with virtually all types of credits from general obligation bonds to appropriation bonds, revenue bonds, lease revenue bonds and also private activity bonds. 501(c)(3) were common users of bank credit and have been a common user of the direct purchase product as well. Next slide please

Slide 5: What is direct purchase/private placement financing? (cont) (09:32)

Direct purchases have been used for a wide range of purposes as well. Equipment purchases, real estate or project development as well as operating or cash flow purposes. Usually in the form of Trans, Tans or Rams. Some general characteristics of the direct purchase product include these transactions are usually purchased by one investor or one bank. They can be facilitated with or without the placement agent. They are executed used either as a loan or a security. Technically private placements are exempt from SEC rule 15c2-12, but may not necessarily be exempt from underwriter obligations under MSRB and gross. These products are highly adaptable, are customized, and pricing can either be fixed rate or variable rate for a defined commitment period. Which usually is shorter than maturity. Next slide please

Slide 6: Why the resurgence over the last few years? (10:45)

Why the resurgence of the past few years? We believe the resurgence is due to a confluence of factors related to the marketplace, to issuers, and to banks. Some of the market factors first. For 2009 and 2010 the American reinvestment and recovery act otherwise known as the stimulus act contained a DE minima’s provision which suspended the cost of carried this allowance for banks thereby (inaudible) the value of tax-exempt holdings, specifically newly originated non-bank qualified tax-exempt holdings. This provision did sunset at the end of 2010. Furthermore, downgrades to bond insurers, to liquidity credit and swap providers, predominantly domestic and foreign banks, forced issuers to seek alternative structures. There's also a high volume of expiring credit and liquidity facilities that created more opportunities for restructurings or alternatives.

There also existed a favorable taxable and tax-exempt ratio which created certain funding advantages for banks and subsequently for issuers. Next slide please.

Slide 7: Why the resurgence over the last few years? (cont) (12:20)

Some issuer factors. Benefits related to restructuring existing variable-rate transactions include the elimination of bank downgrade risk, the elimination of put risk due to either credit or market events, the elimination of trading risk volatility, the opportunity to avoid basis risk creating possible alignment of indices between financing and a swap and finally the ease of execution reduce costs and limited public disclosure requirements next slide please.

Slide 8: Why the resurgence over the last few years? (cont) (13:09)

Bank factors. Lower rated banks are able to participate as a lender or investor. Basal three regulatory changes have encouraged banks to pursue funded loans versus contingent liabilities. There have been reduced opportunities for traditional lending. Banks have also been able to recognize tax-exempt income versus taxable income. There is a positive correlation between bank profits and municipal holdings. Commercial banks it was recently reported that commercial banks have become the third-largest holder of municipal securities behind only households and mutual funds and have jumped ahead of money market funds. Commercial banks hold approximately 327,000,000,000 and municipal securities as of June 30, 2012. That is 23% more than last year. And this number is actually understated as it does not include direct purchases executed as a loan. As loans. This only includes municipal securities that are held on banks' balance sheets. Some have estimated that 75 to 100,000,000,000 of direct purchases have been executed since 2009. There is no industry wide calculation or industry wide database keeping tabs on that number. So, those are clearly estimates. I will now pass it over to Jim to discuss some evaluation and structural considerations. Jim.

Slide 9: Considerations for the borrower when evaluating a direct purchase (15:09)

>> Thank you Alex and thank you CDIAC for Hosting the Webinar on topic that has drawn more and more attention for those of us in the government finance area. What I'd like to do is put a framework around the decision process that is used when a local governmental issuer or state-level authority is making its normal debt management decisions about transactional options and talk about what we see the direct purchase product emerging in that marketplace and what decisions the government finance officers are faced with in terms of selecting this product and comparing it to other products. I'm going to walk through this slide and concentrate primarily on fixed rate transactions and we will have Glenn Casterline address the variable-rate transactions which have a different level of complexity as you would expect. After we get through the fixed rate component, but from a financial advisory perspective what we try to do is get all the options available for a particular transaction under consideration in this realm we now bring direct purchase products into that range of options. And as we evaluate the private placement product, we want to be in a position to compare the economic terms of the alternatives with one another, compare the legal covenants that exist in the current debt, and what changes if any would be necessary to bring direct purchase into the transaction. We want to compare the financial structure that the direct purchase product might offer and create as we typically do some competition by seeking proposals from prospective purchasers so that ultimately the issuer can arrive at an informed choice and be confident that it understands whether there are any additional risks associated with the direct purchase product. So with that framework let me just go into the background of a typical decision-making that that we have made as advisers and issuers over the years.

Slide 10: Direct Purchase vs Public Offering – Fixed rate (18:00)

Traditionally the two options that folks are generally familiar with involve general market or publicly offered transactions and we would consider negotiated or competitive bond sales basically as the primary choices that we would have to make there. Decisions on method of sale are typically made with the input of financial advisors and underwriters but frequently issuers fall into a pattern of either a strong preference for negotiated sales or alternatively strong preference for competitive bidding and the debate about the relative pros and cons of those two approaches has been an active one over the years with different interests being expressed about, in that discussion. But, when you really step back and look at the two alternatives that we typically had between competitive in the negotiated sale because they are both public offerings, there are a lot of similarities. They would in all cases involve disclosure to the market in the form of drafting an official statement. The reading process is a huge issue. Probably greater and more significant than ever in the last few years since the bond insurance option has disappeared for governmental issuers. So, disclosure, ratings. There would in all cases be an underwriter involved to market the securities to an investor, and with the engagement of an underwriter there would be a regulatory is super vision of the SEC and MSRB that would enter into the transaction in some form. Direct purchases are distinctly different in a lot of cases. And they really emerged as an alternative in our market which really deserves comparison with the traditional competitive and negotiated sales that we are more familiar with. It is typical in most cases that there would be no bond rating on a direct purchase. And no disclosure requirement. The issuer, therefore, can focus its energy on different aspects of the transaction and there is a sense of relief I think in some cases that the reading process and the disclosure obligation in fact does not occupy as much time in the flow of the transaction. As Alex indicated there are times when securities dealers involved in the transaction as a placement agent, but that is not always the case and there are a number of direct purchases that are completed without a placement agent. And, again, that changes the nature of the disclosure requirements and creates a scenario in which voluntary disclosure is now being promoted as an important alternative and an important disclosure mechanism to keep the market informed about the transactions. There is no obligation, contractually to continue providing ongoing disclosure and I will remind the audience that the direct purchase transactions are still reportable to CDIAC for the purposes of their record-keeping.

So, what we have observed is that comparing it to traditional general market offerings, it is possible for direct purchase transactions now to perform as well or better than negotiated or competitive sales. We get lots of transparency in terms of the pricing and the general market. And once we are able to get an indication from a direct purchase candidate about the interest rate that would be workable for direct purchase, we are in a position to begin making comparisons of costs, legal covenants and structural features as well. So we encourage our clients to anticipate being involved in this process and be thinking about how they would basically bring a direct purchase into consideration in the same fashion that they have traditionally with the negotiated sales and competitive sales.

To some extent or I should say maybe the objective here is to get control of the transaction early and be proactive more than reactive. As issuers we are finding it more and more common that issuers are being approached directly by direct purchase candidates and again, you are better off to take initiative in the transaction and to seek information through RFP, or some comparative or competitive process to help bring clarity and more transparency to the direct purchase process. It is important, again, as some banks may market directly to local government issuers, and in many markets, the financial advisory community has been contacted and there is a growing list of purchase candidates that can be accessed for this type of product.

Another context that I want to point out that I think many of you will identify with is that the increase in direct purchase transactions over the last few years has taken place in a low interest rate environment that presents lots of refinancing opportunities. There have been many refunding's executed with tremendous savings for issuers of tax-exempt bonds. And so we find ourselves in a situation where the direct purchase product is sort of lining up with the refunding market these days and refunding's are transactions that can be identified in advance and RFPs can be structured that mirror the structural features of the bonds are being refunded, mirror the legal covenants that are part of the bonds to be refunded, and again give the issuer a chance to define the types of proposals they'd like to see from a direct purchase candidate and make an informed selection about getting a purchaser involved. And again, gives you more clarity and certainty that you have made a valid comparison of costs with the general market alternatives that you might have.

Specifically in this refunding environment I will just make a comment that again some of you may have encountered. We are refunding many bonds that were insured back in the early 2000's and eight, 10, 12 years ago. And reserve funds requirements in those transactions were frequently met with a surety product provided by the insurer. We try to refund those transactions now, one of the features that comes up in the analysis is how we treat the debt service reserve requirement and this is one of the areas where direct purchases sometimes give us an advantage because as they typically don't require a rating, frequently they do not require debt service reserves. And that gives us a variation structurally that is helpful to the refunding result. And in the case where you would compare it to a general or public offering, you would still expect in many of those cases a debt service reserve would need to be funded now in the absence of an insurance alternative and we see that tipping the scales in some cases in favor of direct purchase for some of these refunding transactions.

In the fixed rate sphere we do see some appetite among the participants in this market in terms of the term or tenor of the obligation that they would be interested in. We can get fairly reliably competitive quotes on fixed-rate transactions to maturity for 10 or 12 years. As we begin to stretch out into 15 years or 20 years, what tends to happen is we tend to lose some of the banks that might have an appetite for the surety maturities. I will say that we have been able to complete some 20 year fixed-rate transactions as direct purchases but we are cautious about creating expectations of that, and is going to be available on each and every 20 year transaction. More likely you will have a better chance of getting a 20 year fixed rate from a direct purchase if you are an issuer in the double A category with an essential service type transaction that you are trying to execute.

So again we come back to some fundamental good practices about trying to get competitive proposals, seeking quotes from more than one provider and getting a comparison with the general market so that you are aligned on a cost and risk evaluation basis with the alternatives and able to make a good choice and a good recommendation back to your client, the Board of Directors, the city Council, whoever that is. So I'm glad to see a couple other of comments here on slide number 10 again, continuing the commentary on fixed-rate transactions and reinforce the benefits of competitive process and RFP, the ability to control or require certain legal covenants be conformed to in the process. Again, the concept of how period issues are treated comes up, and it really shouldn't be an expectation that your legal covenants are going to differ from those in your parity securities. Particularly if you have parity securities that are rated and are being treated in the market you want to conform and you can generally present the legal covenants that exist in your parity securities as requirements. A transaction that you are considering for direct purchase and make sure that potential purchasers understand the expectations you have for legal covenants as they come in to the process and as they give you a term sheet.

Amortization again, there are banks that are more comfortable with products that reach maturity in six or seven years, there are banks that when you ask for a fixed-rate quote you will still get a variable-rate with a swap in the proposal. But again the thing that has sort of marked this trend toward more direct purchases is that there are growing number of banks who will take traditional terms, traditional structures and are perfectly willing to bid aggressively on that type of a product. So, again, getting input from different banks is helpful so that the conversation covers the whole realm that is available in terms of bidding and structure and preferences. We've hit the point that direct purchases often do not require service reserves. Credit ratings typically are unnecessary and probably another structural point that I need to emphasize before you move into the variable-rate discussion is that direct purchasers frequently aren't as sensitive to prepayment features as the direct or general market purchasers are. Most of you I'm sure are familiar with the technical 10 year called feature the general market purchasers expect. And we are simply, there's not any insistence or the same hard expectation in the direct purchase market that there will be 10 year call flexibility. Frequently we will ask in an RFP process for the purchasing candidates to quote on perhaps a non-callable structure but give us an alternative with a call feature at the five-year mark or at the discretion of the bidder to let us know really what the extent of their there flexibility is. We can explore that flexibility through the RFP process as well and again back to the theme of the refinancing's that is being done in the market. If you're refinancing is now structured so that it has a final maturity in 10 years if you are approaching the market with a product very likely then your refunding bond with a 10 year final maturity is going to be marketed as a non-callable structure. If you're willing to offer a non-callable structure to a direct purchaser you will certainly get a lower interest rate from them than the one they would provide with call flexibility prior to 10 years. So it gives us the opportunity to consider options and reach our own conclusions about the pros and cons of the lower rate versus the call feature and flexibility that we might value going forward with a 10 year maturity.

And then finally the final point here about cost comparisons to some extent direct purchases start out with the advantage of not having be underwriting discounts or rating fee as part of the overhead of the transaction. That has always been the case historically. But it's been the willingness and the aggressiveness of the direct purchase candidates to bring an attractive interest rate into this discussion that has really driven this product and made it one that we consider mainstream in a number of the transactions that we are involved in with our clients. So I'm going to leave it to Glenn to pick up the discussion now on the next slide, slide 11, and get into the more challenging discussion about how things are being priced contract purchase market.

Slide 11: Direct Purchase vs Public Offering – Variable rate (35:05)

>> Thank you Jim and good morning folks. I want to thank you for joining the webinar this morning. In the next couple slides as Jim mentioned, we are going to zero in on a comparison of variable-rate public offerings versus variable-rate purchases. I think it's easier to start with what we are probably most familiar with and that would be variable-rate financing through public offering. And probably the most common type of security or instrument that we typically use our variable-rate demand obligations commonly called the VRBO's or VRBD's, and these are long-term financings that offer long-term amortization. They have, they are supported by a letter of credit where the letter of credit bank serves as both the guarantor and liquidity facility as it is the letter of credit bank that's actually paying the investors directly and receiving a reimbursement from the public agency. Interest rates on these are typically marketed either daily or weekly and the interest rates are determined through the marketing process is actually based on the investor view of the underlying credit of the letter of credit bank which is an important part that we will kind of touch on a little later in the slides but I want to make sure that we all understand that the investors are really looking at the credit strength of the letter of credit bank when having an understanding of when are they going to get their money, are they going to get their money, etc. Typically when we look at the fees relating to VRDO you have the interest rate based on the remarketing, cost of letter credit fees cost for marketing agent fees. And typically the letter of credit, again thought, these VRDO's offer long term amortization, typically these letter of credits only go out the first three, maybe five years, some banks will offer five years terms, but really just go out three years. So the question that arises is well: What's going to happen at the end of that three year period? Will I be able to renew the letter of credit, and if so at what price will the letter of credit fee increase? That creates some uncertainty there with respect to the renewal period. Another common type of security are the floating rate notes, they have been around for a while but have become prevalent over the last few years. In these types of transactions you typically have long-term amortization so this could be a 20 year deal. But the document, or the official statement for these types of securities typically allow for different types of interest rate modes called kind of a multimode document or you could choose different types of interest rate modes throughout the 20 year period. One of these modes are typically include an index bond or index mode where the bonds are then being re-marketed at a

underlying publicly published index. Typically SIFMA or a percent of one month LIBOR. For those of you who are unfamiliar with SIFMA it's the short term tax-exempt index while one month LIBOR is the short term taxable index. So the interest rate on these securities are typically based off one of these indices plus some type of spread. So when you're looking at the all in costs related to these you look at the index plus the spread and we compare that to what typically would get all in kind of a VRDO. Now these particular modes have some type of term to them. In this case are we have seen a lot of the market with a floating rate notes we see them go with initial one-year term and I've seen some go out even as far as seven years. And what that basically means is that the end of the initial term whether it's one year or seven years, the investors put those securities back to the trustee into the point where they will be remarketed into another type of mode. It could be index mode again, or could be some type of VRDO mode whether it is weekly or daily VRDO or could be fixed rate VRDO, but it all really kind of matters is of where is the market at that time. Is there still demand for index notes? If you like the index funds and they work for you at the time, is there demand for today and if there is demand do the spreads that are, I guess being marketed at that time for those types of securities, do they fit within your economic do they fit economically? Can you afford the new spreads. So either like the letter of credit banks of the renewal period we have some uncertainty with respect to the floating rate notes can we market these at attractive rates at the same type of index mode. Looking forward we start drilling down into the private placements and really kind of again, a direct purchase as we touched on earlier a direct purchase really is just a loan directly to a particular investor or a particular bank. What's interesting with the private placements is they work very similar to the floating rate notes in that they offer long-term amortization where you can pay off over 20 years. The interest on the direct purchases going to be basically off of either SIFMA or some percent of LIBOR plus a spread, and they will go out, or the term of the direct purchase with the bank is not necessarily going to be out the whole 20 years. It's probably going to be out 3 to 7 years and the question is what happens at the end of the term. Can I renegotiate with the bank another term similar to 3 to 7 years or is the bank no longer interested in this type of loan and if that's the case well you might have to refinance the direct purchase with another type of floating rate security or maybe even a fixed rate security. We can go ahead and move on to slide 12.

Slide 12: Direct Purchase vs Public Offering – Variable rate (cont) (41:15)

In this particular slide we kind of want to summarize again some of the different comparisons whether it is direct purchase/ floating rate notes vs VRDO's. Again they all offer some form of competitive pricing. When we look at VRDO's we're looking at the underline remarketing rates plus the letter of credit fee plus the remarketing agent fee and you compare that to either on the direct purchase side or the floating rate note side, the index plus the spread and what is most competitive, what provides us with the lower cost at this time. All three securities provides similar terms whether they provide you long-term amortization these are variable-rate instruments and folks don't necessarily like to take on a lot of interest-rate risk so we found many clients actually entering into floating fixed rate interest rate swaps to help manage the interest-rate risks so all three of these vehicles lend to hedging transactions. As we touched on in the last slide each of them have some form of renewal risk with respect to the letter of credits, you know, can we renew that letter of credit after that five year or three year term. As I touched on earlier in one of the earlier slides the basal three requirements are right around the corner actually going into effect in 2015. And they're going to demand higher liquidity ratios for the banks, which kind of I think moving forward we don't quite know what that's going to mean with respect to the letter of credit market if the price of that liquidity that a lot of the banks offer the letter of credits and if they do at what rates are we going to see the letter of credit fees increased dramatically or will we see the supply banks offered letter of credit decreased dramatically. There are still a lot of unknowns with respect to how the basal three requirements will affect particularly the letter of credit market. With respect to floating rate notes again today we can sell floating rate notes with anywhere from 1 to 7 year term attractive spreads to either SIFMA or 1% of LIBOR. But what is the market going to look like at the end of the term whether it is one-year term, five-year term, seven-year term. Can we remark it in the index mode, because we liked it so much, at attractive spreads like we did a year or seven years ago and then we look at the direct purchases again we enter into a direct purchase maybe it lasts 3 to 7 years and what happens at the end of the term? Are the banks still willing to provide this type of direct loan or direct purchase and can we renew for another 3 to 7 years. So again it offers us a fair amount of renewal risk.

The one thing that both direct purchase and quote and maintenance do as compared to VRDO’s, they do eliminate letter of credit counterparty risk which I call financial institutional risk and certainly the market has been very volatile over the years going back to 2008 and it seems like every bank under the sun has been in some type of financial press. And you know we've lived through some very difficult times particularly with Allied Irish Bank and most recently kind of Bank of America. And we actually had a client that did auction rate securities back in 2006. They swapped the auction rate or the variable-rate to into a fixed rate swap and we all know what happened to the auction rate market in 2008. It collapsed. And because at the time interest rates had gone down client was out of the money on your swap and therefore they owe a significant termination payment to the swap counterparty therefore economically it didn't make sense to refinance the auction rate securities with fixed-rate securities. So we had to choose a variable-rate type instrument and obviously that was a VRDO backed by a letter of credit. Which at the time was Allied Irish Bank was chosen. And a couple years later in 2010 Allied Irish Bank is all over the papers, has its issues and by I think it was late fall of 2010 our clients letter of credit or remarking remain Allied Irish Bank back to VRDO went 50 basis points to 500 basis points and we eventually had to refinance the 2010 VRDO’s backed by the ARB letter of credit with a direct purchase offered by a bank that allowed our client to eliminate the letter of credit counterparty risk and have its interests based on some type of published index which in this case was a percent of LIBOR plus a spread. And earlier this year we lived through the Moody’s potential downgrade of Bank of America. There were some concerns that the market was just going to be another Allied Irish Bank occurrence? It caused a lot of stress in the market at the time you know, Moody's came out with their announcements in February. The eventual downgrade did occur back in the summer of this year and we certainly have a lot of clients that were ready to get out of the B of A of a letter of credit. And we did that. And after the downgrade, the effect wasn't too bad and I think that's just because S&P and Fitch have not downgraded B of A so I think the investors looked at majority rules and B of A’s remarketing rates have been relatively stable. But again, we can avoid these potential kind of counterparty risks or the potential spikes in our remarketing rates on the VRDO's to the extent that our letter of credit bank is having some type of financial stress by entering, by issuing floating rate notes or entering into a variable-rate direct purchase where the interest rates are justbased off of some type of published index.

Slide 13: Direct Purchase vs Public Offering – Variable rate (cont) (47:20)

Moving onto slide 13 this is a little table we will go line by line, it gives you comparison between the VRDO direct purchase and the index bonds.

Slide 14: Variable Rate Direct Purchase vs FRNs (47:30)

Slide number 14 actually drills down another comparison between the floating rate notes and the direct purchases because they are so familiar or I should say so similar that we thought it made sense to break up a comparison on them here in this table.

Slide 15: Participating Banks (47:47)

And finally on page 15 we provided a list of participating banks. These are the banks that have been relatively active in the direct purchase markets here in the state of California. Some banks are more aggressive than others as Jim was pointing out many of the banks that are not that aggressive are not that way because primarily allowed them only short-term type durations, something around 5 to 7 year term that would eliminate a few of the banks here on this list, but I will say that a lot of these banks visions and policies change over time. So I wouldn't necessarily want to zero any particular bank that I think offer 5 to 7 terms because you could call them next week and find out they changed the policy now they are doing 10 and 15 year deals. I think in general on the slide we just wanted to show you the different players are who you might want to consider reaching out to and keep these folks in mind. So with that, that kind of ties up my section talking about variable-rate direct purchases and how they compare to variable-rate public offerings and I'm going to turn the rest of the discussion over to Brian Forbath as Brian touches on the legal structure and some of the disclosure issues.

Slide 16: Legal Structure (49:08)

>> Thanks so much, Glenn. I really appreciate it for those of you joining lead I'm Brian Forbath. I’m a shareholder at Stradling Yocca Carlson & Rauth, then bond counsel, disclosure counsel, underwriters counsel, and lots of financing instruments over the years. Historically been involved in all of direct purchases and I think historically those initially began as you know, the scared call from the city attorney or County Counsel saying gosh the finance director is doing an equipment purchase with some bank and I don't know what's going on. Can you take a look at it? Those equipment purchases have more now in the last couple years to lots of different sorts of transactions including new money and refunding for much larger deals. I think from a legal standpoint there's very little difference between direct lending and a public offering. Direct lending has now run the gamut from all the various types of finance that we do in California whether it's general fund lease findings, general obligation bonds, water, sewer, electric revenue bonds, land secured financing, Mello Roos or 501(c)(3) sorts of nonprofits conduit financing. I think it is important to note that just because you are doing a direct placement doesn't mean that it's not, doesn't need to comply with the statutory or constitutional requirement that the issuer has to comply with on a public offering from a bond. You need the same sort of legal authority to do your deal if it is a public sale just the same as if it's a private placement offer or direct lending.

Slide 17: Legal Structure (cont) (50:51)

Flipping over to the slide on page 17. Typically direct purchases use the same form of legal documentation as a public offering although as we've discussed and will discuss further usually there's no requirement for official statement. That means if you are a city county or school district and you are doing a general fund transactions usually some sort of lease structure. If you are a special district with an enterprise fund, then it's usually some sort of installment sale agreement or indenture or resolution etc. The bonds are secured by the same sources of security in the same general ledger lien on revenues or assets as in a public offering. I think sometimes as you will learn, there could be some flexibility with the lender in terms of credit risk. If you have restrictive covenants on the senior lien and revenue deal sometimes you might be able to get a lender to agree to take a subordinate position and so forth but it is something that you obviously need to negotiate. And as Glenn and Jim mentioned earlier typically get the same or similar covenant as in a public offering. There's a few exceptions to that. Going to get into that a little bit later when I talk about my legal considerations. I didn't want to offend my bank council colleagues who might be listening in, but just because you are doing a private placement, it doesn't mean that you still don't have to negotiate and deal with the covenant aspects that you have to deal with having a bank sitting across the table with you and having represented by their own counsel so there are some nuances there, and it's not always as straightforward and easy as you would hope it could be. Sometimes the covenants that you negotiate with the direct lender will be in a separate agreement that would be like a continuing covenant agreement in the form of a standard document we've seen with a lot of direct loans.

Slide 18: Legal Structure (cont) (52:53)

Moving on to the slide on page 18, there's a variety of forms of direct lending in that you could either have the issuance of bonds being sold directly to the purchaser or certificate of participation being sold to the purchaser or the purchaser might choose to be a direct party to a lease or installment purchase agreement or a loan or underneath that structure rather than receiving interest or principal, bond that matures or pays interest, they would just directly receive lease payments or installment payments or loan payments from the issuer. Depending on the structure of the transaction sometimes there's a trustee involved in the trustee makes payments to the direct lender but I think most common would be that the payments are made directly from the issuer to the direct purchaser. And then as Jim, I'm sorry, Glenn mentioned earlier a lot of times on some of the direct loans there will be a swap that create a synthetic fixed-rate transaction and as Jim mentioned you know, you've got to be a little careful there on some of the swap transactions we have seen the swap counterparty will be a different entity with a different credit profile on that party who the actual lender underneath the loan or the lease agreement. So you could have a potential credit risk there. In that you are making direct payments, or making a variable-rate payment underneath the loan and receiving the same variable-rate payment back from a different arm of the bank that may or may not have the same rating thresholds and so forth. So it is just something to think about and talk to your advisors about when you are running that sort of transaction.

Typically direct lending has the same sort of closing documents and certifications and opinion to the public sale. If there’s still will be a requirement for an opinion of your city attorney or your general counsel or your county counsel. You're going to have closing representations and warranties. You're going to have to provide certified copies of your resolution. You will need a final approving opinion of bond counsel etc. It is much similar in terms of documentation and structure, it's very similar to that of a public offering. Going on to the next page on page 19.

Slide 19: Disclosure **(55:35)**

I think the disclosure aspects here are really what sort of sets apart the direct lending from the public offering and that is really that the direct lendings are usually structured to avoid requirements of rule 15c212. And that is really do, because it's done by limiting, you're able to avoid requirements of 15c212 by limiting the number and type of investors who own either the loan or the bonds. And we will get into that when we talk about the investor letter below, but because it's exempt 15c212 there's really no requirement for an official statement or any formal disclosure to be offered into the market. There's also no requirement to provide or file to disclosure filings with EMMA however I would note that most or all direct lending that I’ve been involved when the lender has required continue disclosure filing and sometimes those are more onerous than what you would have to agree to in connection with the 15c212 requirements underneath your disclosure filings and what will happen is sometimes they will want quarterly budget reports. They will want quarterly cash flows, they will want more reports or more information on a more frequent basis than you might otherwise be required. So just something to think about in terms of what you are entering into that, about what the requirements are going to be on that.

I would want to point out that just because you're doing a direct loan and you're not preparing any disclosure it doesn't mean that you as an issuer are not still responsible under federal securities laws. You are still subject to the antifraud provisions of section 17 of the securities act of 1933. Which makes it unlawful to obtain money in interstate commerce by means of an untrue statement of a material fact in the offer or sale of security or by omission of a material fact. You've got to be careful about the information you are providing to your lenders here. They're going to want projections. You're going to want audited financials. They're going to want cash flow statements and so forth and quite often what will happen is the direct purchaser is going to require the same sort of 10 V5 representation, or the representations that you as the issuer normally provide to your underwriter that all the information and the official statement is true and correct and there is no omission of material fact. What will happen is the lender will quite often require you to provide the same sort of representation but not to the offering statement but more to the broader sense of all the information you provided them to enter into the loan is true and correct and there's no omission with material fact. It's a sort of a broader catch on and you want to be careful of that and you’ll want to talk to your lawyers and make sure they protected you accordingly with that.

I would comment that you're going to save yourself time and effort in preparing disclosure documents and so forth but it doesn't mean that the direct lenders are not going to do their due diligence on your credit. They will do the due diligence. They're going to request documents for you. They're going to review stuff. They're going to call and ask your staff questions. They’ll want to sort through your credit and understand aspects of your audit, your budget and so forth. So don't think that that will not happen. It will. The other thing, and I think this is one of the most important aspects of the disclosure process and you should be talking to your lawyers about this when entering into it and that is getting adequate protection in the form as an investor letter from the lender. An investor letter what we call a big boy letter. It is really a way to protect yourself from allegations of security fraud and also to restrict the potential transferability of your securities to the broader market. Usually an investor letter will include a representation that the purchaser or an accredited investor or qualified institutional buyer. Another sort of buzzword underneath the federal securities law is that one, it gets you underneath certain exemptions under 15c212 and it also provides protection under the securities act of 1933 that these investors are smart, they've done their diligence, they've done their homework and you are not selling these securities to mom and pops with, trying to pull the wool over their eyes about what the securities are.

Another presentation of the purchaser purchasing for their own account and not with a view to resell. The purchaser has done its own due diligence, after it received all the information needed to make an informed decision and sometimes you will put transfer restrictions or what is called a traveling letter or traveling big boy letter on that and that requires that if your lender wants to sell your loan or sell the bond or whatever they purchased, they need to get whatever they are selling it to to agree to provide you with a similar representation with their credit investor or qualified institutional buyer that they have done their homework and all that sort of stuff. It is sort of a traveling letter. Those are the things you're going to want to talk to your bond counsel or city or town or counselor general counsel about when you are considering a direct loan.

Slide 20: Common Legal Considerations **(01:01:35)**

Moving onto the next pages some common legal considerations and I could talk for hours on this and we don't have much time so I just thought I would throw out a few things just for folks to think about. Obviously as we talked about one of the important things is just to confirm the legal authority has to do with your direct lending. You still have to comply with all statutory debt limit issues that cities and counties and school districts need to do and what that means is a little more often than not you cannot enter into a loan or a mortgage. You have the structure or a lease or some other aspect to get around to comply with the statutory debt limitations that you have. I think you know, as Jim mentioned, the best practice in terms of covenant negotiation is to send out a set of the documents that you are going to use in order for the lenders to bid on the document sort of on an “as is” basis and that is the best practice and if you can get away with that that's great. I know that's not always the case and it's not always what happens and that substantial time and effort really on the legal side probably more so than on the city staff for town staff for special district staff side goes into the covenant negotiation. Some of the key topics to think about in terms of the covenant negotiations. One that has come up a lot lately as lenders from outside the California market are entering into the California market, some of the lenders over the last couple years didn't really understand how California abatement leases work, and so there were lots of issues and time spent trying to get them up to speed on that. I think they have come a long way, but one of the issues that is still out there and there is a divergence of opinion in the bond counsel community about is earthquake abatement risk or abatement risk in general. Some lenders are requiring that if there is an abatement of that, that there is a legal covenant for the issuer to provide substitute facilities in the event of abatement. And I think some bond counsel, my firm included think that that is not kosher underneath California law in terms of statutory debt limit issues. Other bond firms are okay with it and are willing to opine about it. But that's just an issue for you to consider and think about as you enter into the transaction is a lifeline on a lot of fronts. Another issue just for you to think about is sort of set off and cross default. Some of the lenders that you are considering entering into you have lots of other relationships with. They may be your bank that you keep all of your funds in. They may be a custodian or trustee on other transactions. And you just want to be careful in your covenant negotiation that there's not provisions in there that in the event of a default or covenant defaults on the private loan, they are not willing, that they are not able legally to go after funds that you might have deposited with them underneath a different hat they are wearing as your custodian, your banker and so forth. That is just something to think about.

One other thing I've seen come up in the past, some banks are new to California, sometimes they think of things in sort of a nonprofit mindset in terms of requiring issuers to have liquidity tests and so forth and that is a very standard in a general fund context or in a revenue utility context. So just think about those and be willing to address those. The other one just to talk about is the assignment of transferability. We like to negotiate, your entering into a deal with the bank and ideally you want the bank to be your partner to determine a lease. Obviously the bank wants to keep some flexibility and wants to be able to sell the investments if they have to and so forth and to the extent it's not transferable probably affects the price. But I think the key thing is you really want to make sure that if the bank transfers your loan they transfer in whole and with notice to you. You do not want the bank to be able to break up the loan and a bunch of different pieces and certificate it out to smaller institutions or individual investors. Because you don't know what the bank is going to be telling those investors about you and your credit when they do that. So we always try to negotiate some sort of transfer restriction that at least it’s transferred in whole, you get a notice of where its being transferred to and sometimes we make a requirement that you can transfer it but we are still going to pay you the bank that we entered into the deal with. There are things like default rates and term outs I think Glenn kind of already talked about that. Stuff to think about and consider into consent rights. You want to make sure that you are not allowing the banks to overreach and take consent rights in terms of commitments to other documents that could affect your ability to do parity debt or other obligations. So I know I went over a lot of territory and rather thickly but I just wanted to keep to the timeframe here and I’m going to turn it over to Alex to talk about the future of direct purchases.

Slide 21: Future of Direct Purchases? (01:07:12)

>> Thank you, Brian. So, on slide 21, where do we go from here? Well, the future of the direct purchase market is unclear. We do believe that it will continue to be dependent on and strongly influenced by circumstances related to the market, to you the issuer, and also to banks. Some of the market factors that we see having an influence on the future of direct purchases include regulatory uncertainty, the MSRB and SEC have evolving views on disclosure and, as Brian noted, that has been one of the advantages today. Legislative uncertainty, the status of tax exemption and the tax policy. As we all have read there's been a fair amount of talk about revisiting tax exemption specifically the whole Simpson commission recommending that we eliminate tax exemption. Interest-rate environment. Also perhaps the direction of interest rates could have an impact as well as the taxable tax exempt ratios that we touched on earlier. The emergence of alternative structures, or even the reemergence of traditional structures such as the RDN market. We are seeing more product development in out marketplace today that we have seen in some time and expect that to continue. Issuer considerations include competitive pricing from banks versus market alternatives. Cost of issuance. And ease of execution. Again, two intangible advantages that we see in the marketplace today. Disclosure requirements. Renewal and refinancing risk experience from issuers. We have not gone through a renewal cycle for direct purchases and I think we are entering into that, probably next year, 2009 was the first year that we really started direct purchases. 2010 was probably the first time a lot of banks really got into it. And with traditional three-year structures we are probably going to see some renewal. A renewal cycle next year. Debt policy guidelines. That includes debt mix policy, diversification objectives, counterparty risk. Objectives. If you go to slide 22

Slide 22: **Future of Direct Purchases? (cont)** **(01:10:34)**

Some of the bank considerations, Basal three uncertainty. There is a 2015 implementation date. There have been certain banks that have begun to implement Basal three charges today. Others are waiting until 2015 to be compliant with the expectation that the Basal committee will perhaps change their anticipated requirements. Recovery of bank ratings. If banks ratings recover, does that also mean that the credit enhancement market which has been a driver for direct purchases recovers as well? That remains to be seen. Assessment of tax risk by banks. Tax risk is on two levels. It is specific tax liability of that bank. But it's also more macro in terms of tax policy. The uncertainty of the renewal cycle which I mentioned earlier and finally corporate earnings. And perhaps the return of traditional or new lending opportunities for banks. We believe that that could have an impact on banks appetite and for their capacity for direct purchasing of municipal debt. So this concludes our formal presentation. We now have a few minutes left for the panel to take any questions from the audience.

>> Alex, this is Brian. There was one thing I forgot to mention and I want to make sure I get an invite back to CDIAC at some point. I forgot to mention just because there is no reporting requirements formally for 15c212 direct loans that still doesn't exempt you from any CDIAC reporting requirements that you may have so I just want to remind folks who are entering into direct loans that there are still CDIAC guidelines for that. Thanks Alex.

>> Thank you, Brian. Okay if there aren't any questions, Mark I will turn it back over to you.

>> Well thanks a lot Alex. I appreciate the effort and all the work that the speakers put into this excellent presentation. Jim, Glenn, Brian of course we will have you back you didn't even have to put the plug in there. But we certainly appreciate it. The CDIAC's mandate is to collect data on debt. The statues don't define debt, so we would certainly expect that issuers would continue to notify CDIAC under their statutory obligation. I want to just take a moment to announce some upcoming educational programs. October 17, CDIAC conducts its preconference program at the bond buyer. On the 24th we have another webinar. The economics of pension obligation bond financing for local governments. And two webinars that are not identified on the screen on October, I'm sorry, November 14, focusing on school issuance. We have a webinar school district continuing disclosure practices in today's market. And November 28 webinar again addressing school issues, current practices for structuring school debt obligations. You can continue to track the CDIAC educational programs on the website and sign up for seminar notifications. The slides will be available on our website in the very near future. So if you haven't downloaded those and printed them you will have access to them in the future. With that I think we will close the webinar a minute early. I want to thank you all for your participation and look forward to you participating in future programs. Thanks, speakers and we will talk to you all soon.

>> Thank you everybody

>> Thank you