Addressing Governmental Cash-Flow Difficulties Due to COVID-19 Through Short-Term Tax-Exempt TRANs

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Agenda

- Overview: Existing Challenges for Governments
- Review: TRANs what they are and applicable rules
  - Definition
  - Regulations and Governance
  - Applicability and Examples
- Review: Additional TRAN Liquidity through the Municipal Liquidity Facility
  - Definition
  - Eligibility and Applicability
  - Purchase Amounts and Examples

Introduction

- **Problem** - State and local governments ("Issuers") facing delays and reductions in taxes and other revenue, and increased costs, may be experiencing cash-flow difficulties
- **Possible Solution** - Code permits Issuers to finance temporary cash flow shortfalls on tax-exempt basis
  - Tax and Revenue Anticipation Notes (TRANS)
  - Tax anticipation notes – TANs
  - Revenue anticipation notes – RANS
- **Additional Liquidity for TRANs** - Federal Reserve through the use of the Municipal Liquidity Facility is acquiring certain TRANS

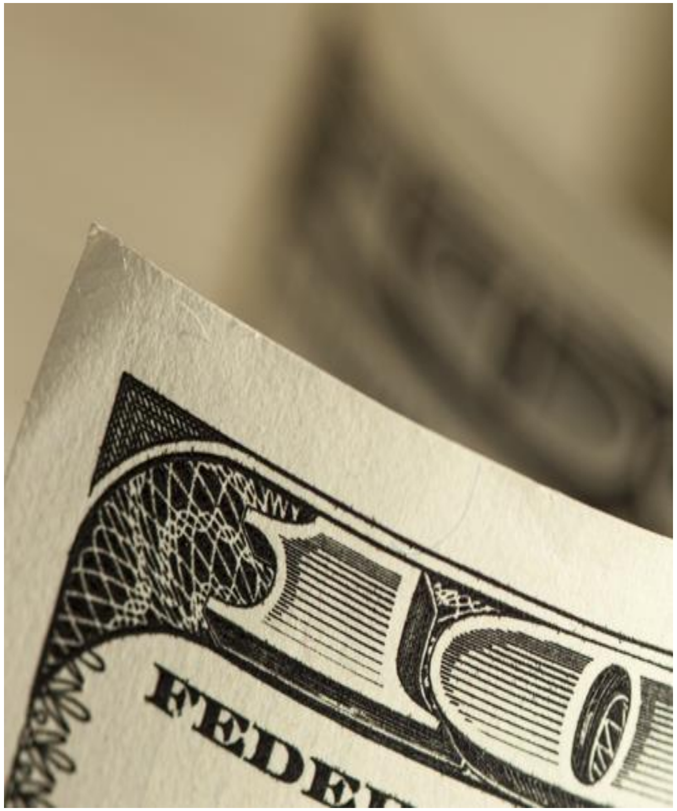
Understanding the Potential of TRANs

TRANs: Purpose

- In any given year, an Issuers' taxes and other revenues may not be received in time to match Issuer expenses
- TRANs address this mismatch by allowing the Issuer to borrow at a tax-free rate to pay expenses until tax and/or other revenues are received
- Some issuers use TRANs annually

TRANs: Purpose

- TRANs have a more important role to play amid COVID-19
  - Assist with increased or new cash-flow difficulties
  - Philadelphia reported a drop of 47% in tax revenue in April, partially due to delayed tax payments
- May see easier issuance now with the Municipal Liquidity Facility
  - Provides federal funds to acquire certain TRANs and similar short-term obligations



TRANs: Applicable Rules

- IRS Code imposes restrictions on tax-exempt obligations
- For TRANs
  - Issuers may use TRANs to finance working capital needs
  - Issuance must be appropriately sized for working capital needs-discussion points
    - Proceeds-Spent-Last Rule
    - Overissuance
    - Investment and Expenditure Restrictions

TRANs: Applicable Rules

- **Proceeds-Spent-Last/Cumulative Cash Flow Deficit Rule**
  - This rule instructs Issuers on how to apply other rules- the arbitrage and overissuance rules
  - It is an ordering rule for obligations issued to finance working capital expenditures
    - Generally, proceeds of tax-exempt obligation are treated as "spent" after all other available sources for working capital purposes have been spent
    - Understanding this rule is essential to properly sizing a TRANs issue and for applying the investment and expenditure rules

TRANs: Applicable Rules

- **Proceeds-Spent-Last/Cumulative Cash Flow Deficit Rule** (cont'd)
  - Rule is applied by looking at current fiscal year's:
    - Expected revenues to be used for working capital
    - Expected working capital expenses
    - Carryover revenues from the prior fiscal year
    - Reasonable working capital reserve-generally 5% of prior fiscal year's actual expenses
  - Cumulative surplus/deficit is computed at various points in fiscal year to determine largest deficit expected for fiscal year and the timing of that deficit

TRANs: Applicable Rules

- **Proceeds-Spent-Last/Cumulative Cash Flow Deficit Rule (cont'd)**
  - Prior year carryover-Cumulative cash flow surplus from prior year
  - Expected revenues-Identify all expected revenues to be used for working capital purposes and when those revenues are expected to be received
    - Proceeds from TRANs are disregarded
  - Expected expenses-Identify all expected expenses for the fiscal year and when those expenditures are expected to be paid
    - Sinking fund deposits to pay TRANs are disregarded
  - Carryover the surplus/deficit from each computation period to the next computation period to determine the cumulative for the year

TRANs: Applicable Rules

- **Proceeds-Spent-Last/Cumulative Cash Flow Deficit Rule (cont'd)**
  - Reasonable working capital reserve
    - Generally, 5% of prior fiscal year's actual expenditures
    - Hold the thought-Working capital reserve is not permitted to be excluded when applying the TRANs rebate safe harbor

TRANs: Applicable Rules

- **Overissuance Rule**
  - Purpose – Ensure obligations are not issued sooner, are not issued in an amount larger, and do not stay outstanding longer, than needed for the governmental purpose
  - If this rule is violated the obligations may be taxable obligations
  - Facts and circumstances test but generally, TRANs that are treated as spent within the permitted yield restriction temporary period will not violate overissuance rules
    - Again, Proceeds-Spent-Last Rule applies for determining whether the temporary period is met

TRANs: Applicable Rules

- **Arbitrage-Investment and Expenditure of Proceeds**
  - Two independent arbitrage rules that place investment restrictions on TRAN proceeds and certain other amounts (“Gross Proceeds”)
    - The Yield Restriction Rule prohibits investment earnings on unspent Gross Proceeds of tax-exempt obligations outside of a temporary period or another exception applying
    - The Rebate Rule generally requires that investment earnings on investments acquired with Gross Proceeds of tax-exempt obligations be paid or rebated to the United States unless a temporary period or another exception applies

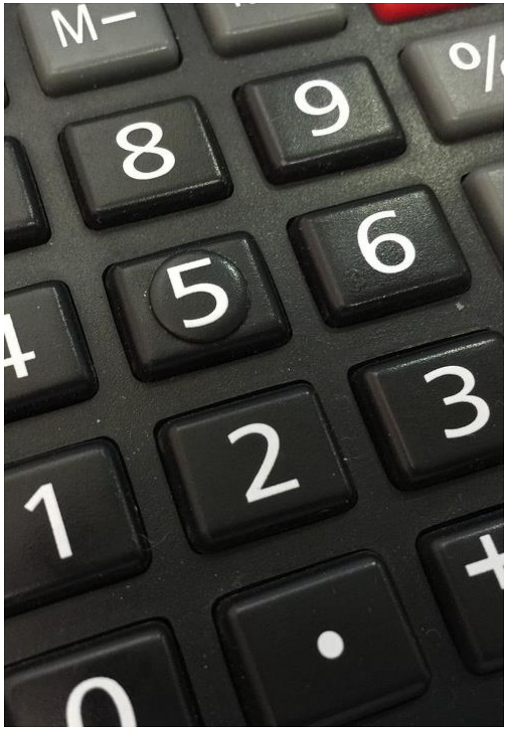
TRANs: Applicable Rules

- **Yield-Restriction Rule**
  - Generally prohibits investment of proceeds in higher yielding investments
  - 13-month temporary period during which proceeds do not have to be yield-restricted
  - For TANs, the temporary period may be extended to two years if
    - TAN is reasonably expected to be paid from tax revenues from one fiscal year
    - TAN matures by the earlier of two years or 60 days after the last date for timely payment of taxes
  - Even if an obligation qualifies for a temporary period to the Yield Restriction Rule, the Issuer may be required to rebate those earnings under the Rebate Rule

TRANs: Applicable Rules

- **Rebate Rule**
  - Investment earnings on certain investments must be paid to the United States or the bonds become arbitrage bonds
  - Six-month spending exception. Gross Proceeds spent within 6 months of the issue date of an issue
  - Special "Six Month Safe Harbor" for TRANs
    - The **actual** cumulative cash flow deficit exceeds 90% of the proceeds of the TRANs within six months after issuance of the TRANs
    - The actual deficit is measured looking at all available amounts including a reasonable working capital reserve
  - Another exception-Issuer on the date of issuance does not expect to issue more than $5 million or does not in fact issue more than $5 million in the calendar year

TRANs: Formula Scenario



- Example:
  - Projected revenues received on first day of the month
  - Projected expenses, paid on the first of the month
  - Carryover cumulative surplus from prior year is $2 million
  - Reasonable working capital reserve is $1,650,000 (5% of prior year's actual working capital expenditures)

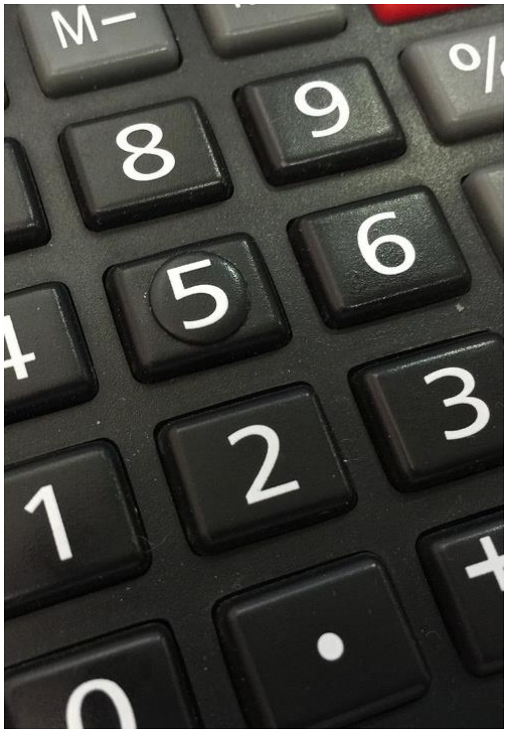
TRANs: Formula Scenario (cont'd)

Month	Projected Revenues	Projected Expenses	Projected Cumulative Cash Flow	Actual Cash Flow
Opening Balance	$2,000,000, less $1,650,000 working capital reserve	N//A	N/A	$2,000,000
Month 1	$700,000	$1,300,000	($250,000)	$1,400,000
Month 2	$700,000	$12,000,000	($11,550,000)	($9,400,000)
Month 3	$1,000,000	$17,000,000	($27,550,000)	($25,250,000)
Month 4	$1,200,000	$2,000,000	($28,350,000)	($26,050,000)
Month 5	$15,000,000	$4,000,000	($17,350,000)	($15,650,000)
Month 6	$20,000,000	$3,000,000	($350,000)	($332,000)

TRANs: Formula Scenario (cont'd)

Month	Projected Revenues	Projected Expenses	Projected Cumulative Cash Flow	Actual Cash Flow
Month 7	$5,000,000	$3,000,000	$1,650,000	$1,418,000
Month 8	$1,500,000	$800,000	$2,350,000	$2,168,000
Month 9	$700,000	$1,200,000	$1,850,000	$1,568,000
Month 10	$850,000	$1,000,000	$1,700,000	$1,893,000
Month 11	$700,000	$1,000,000	$1,400,000	$1,458,000
Month 12	$1,000,000	$1,000,000	$1,400,000	$1,433,000
Month 13	$750,000	$700,000	$1,450,000	$1,358,000
Totals	$49,100,000 plus $350,000 from available revenues at start $49,450,000	$48,000,000	N/A	N/A

TRANs: Formula Scenario (cont'd)



- Further dissection
  - Note that under the Proceeds-Spent-Last Rule, the largest expected cumulative deficit and largest actual cumulative deficit occurs in Month 4
  - Applying the expectations test, the highest cumulative deficit is $28,350,000, which is the largest permitted size of the TRANs issue
  - For yield restriction, the temporary period is met and there should be no overissuance
  - For rebate, the actual amount spent is only $26,050,000, which could, absent the safe harbor, cause a rebate obligation
  - The TRANs safe harbor for rebate however would be met under the actual expenditures (excluding the reasonable working capital reserve, as required)

Increased Liquidity for TRANs with the Municipal Liquidity Facility

Municipal Liquidity Facility: Overview

- **Purpose** - Enhance liquidity of short-term municipal securities market
- **Method Used**
  - Federal Reserve created special purpose vehicle (SPV) to purchase Eligible Notes from Eligible Issuers
  - Department of Treasury initial equity investment in the SPV of $35 billion
  - SPV may purchase up to $500 billion in Eligible Notes

Municipal Liquidity Facility: Overview (cont'd)

- Authority to purchase Eligible Notes ends Dec. 31, 2020 unless Treasury and Federal Reserve Board extend
- There is a 10BP origination fee at the time of issuance; can be paid from proceeds
- BLX is the administrative agent coordinating review and purchase application

Municipal Liquidity Facility: Eligible Issuers

- States
- Cities with populations of more than 250,000
- Counties with populations of more than 500,000
- Multi-State Entities
  - Created by compact between at least two states and approved by Congress
  - Acting under Compact Clause of Constitution
- Only one issuer per state, city, county, multi-state entities, unless Federal Reserve approves additional to facilitate assistance to political subdivisions and other governmental entities
- On behalf of entities – if approved by Federal Reserve – for purposes of managing cash flow of the on-behalf-of state, city, county, or multi-state entity

Municipal Liquidity Facility: Eligible Issuers (cont'd)

- Must be solvent
- Unable to obtain adequate credit accommodations from other banking institutions
  - Must provide evidence
  - Does not mean can't get a loan; considers terms on which such loan is available
- Required credit ratings by two or more nationally recognized statistical rating organizations (NSRO) :
  - Tests on two dates, April 8, 2020, and at time of purchase (if drop in rating)
  - Required rating when two or more ratings
    - For Multi-State Entities:
      At least A-/A3 on 4/8 and BBB-/Baa3 on date of purchase
    - For Other Issuers:
      At least BBB-/Baa3 on April 8 and BB-/Ba3 on the date of purchase
  - If only one NSRO rating on April 8, may still be an Eligible Issuer if met the required minimum rating on April 8 as determined by that NSRO, and at the time of purchase, met the required rating, as determined by at least two NSROs

Municipal Liquidity Facility: Eligible Notes

- TRANS, TANs, and BANs and other similar short-term notes
- Maturity no later than 36 months from issuance
- For tax-exempt notes, interest will be a fixed interest rate based on comparable maturity overnight index swap rate plus applicable spread based on average of credit rating
- For taxable notes, the rate is determined by taking the tax-exempt rate, as determined above, and dividing by .65
- New issuance only – no refinancings after Dec. 31, 2020

Municipal Liquidity Facility: Eligible Notes (cont'd)

- Proceeds must be used for
  - Working capital problems arising from income deferral from extension of tax deadlines, reduction or deferrals of tax or other revenues, or increases in expenses related to and resulting from COVID-19; and debt service payments on obligations of the Eligible Issuer, its political subdivisions or other governmental entities
  - Purchase notes of a political subdivision or another governmental entity of the relevant Eligible Issuer that will use the proceeds for similar needs
  - Pay costs of issuance and origination fee
- Notes may be prepaid with approval of Federal Reserve
- Relevant legal opinions and disclosures are required

Municipal Liquidity Facility: Eligible Notes (cont'd)

- Obligations must be secured by strongest security of Eligible Issuers for publicly offered securities
  - Depends on applicable constitutional and statutory provisions
  - For other than Multi-State Issuers, typically must be general obligations or backed by tax or other specified governmental revenues
  - For authorities, agencies, or other entity of a state, city, or county, the Eligible Issuer must commit credit, pledge revenues, or guarantee the Eligible Notes
  - For Multi-State Issuers, parity with existing debt secured by senior lien on such entities gross or net revenues

Municipal Liquidity Facility: Amount That May Be Purchased

- Aggregate amount up to 20% of
  - For states, cities, and counties, the general revenue from such entities own sources of general and utility revenue, determined as of fiscal year 2017
  - For Multi-State Entities the gross revenue as reported in the audited financial statement for fiscal year 2019
- States may request that more be purchased to assist political subdivisions (broadly defined) and other governmental entities that are not eligible for the Facility

Municipal Liquidity Facility

- May 19, Federal Reserve Issued Municipal Liquidity Application Materials
  - Not first come, first serve program
  - Eligible Issuer submits a Notice of Interest with required information
    - Submit a Notice of Interest for each issuance of Eligible Notes
  - MLF will notify Eligible Issuer when to submit an application

Thank You!

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