Massachusetts School Building Authority

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To: Board of Directors, Massachusetts School Building Authority
From: Katherine Craven, Executive Director
Subject: 2011 QSCB Debt Issue
Date: June 8, 2011

As discussed at previous Board meetings, the MSBA is authorized to issue Qualified School Construction Bonds (QSCB). A QSCB is a bond whose interest is taxed federally and also is eligible for a large federal subsidy. At the March 31, 2010 Board meeting, you authorized the issuance of approximately $302 million of QSCBs and further authorized the MSBA to allocate a portion of this amount, approximately $8.7 million, to Commonwealth charter schools. In June 2010, the MSBA exercised a portion of that authorization and issued $151 million of QSCBs, and in December 2010, the MSBA allocated approximately $8.7 million of QSCBs to the Massachusetts Development Finance Agency to issue on behalf of charter schools. Staff would like to issue the approximately $142 million balance of the authorization early in FY 2012.

The use of QSCB proceeds is restricted. Proceeds of a QSCB can only be used for school construction, rehabilitation, and repair projects, and all proceeds must be expended within 3 years of issuance. Also, projects financed with QSCBs must comply with the federal Davis Bacon prevailing wage rates. The MSBA will use the QSCB proceeds primarily for projects included in the Green Repair Program. However, to insure compliance with the federal spend down requirement other projects will be financed with the proceeds.

The structure of a QSCB is also restricted. The final maturity of a QSCB is determined by the U.S. Treasury. The current maximum maturity permitted is 16 years. This means a QSCB will be retired sooner than several past MSBA debt issues. An issuer of a QSCB is allowed to establish and fund a sinking fund for the bond issue. A sinking fund is a custodial account where periodic deposits are made, which are then used to redeem the QSCB at maturity. Funding the sinking fund each year means there will not be a significant increase in MSBA debt service in the year the QSCB debt matures and is retired. The U.S. Treasury also determines the maximum yield on a QSCB sinking fund.[1] The MSBA established a sinking fund for its 2010 QSCBs.

As mentioned above, a QSCB receives a subsidy from the federal government. The QSCB subsidy is the lesser of the actual interest on the debt or the assumed rate[2] as published by the

[1] As of June 1, 2011 the maximum permitted sinking fund yield was 4.54%.
[2] As of June 1, 2011 the assumed interest rate published was 5.02%.

U.S. Treasury. This means that the federal subsidy approaches or equals 100% of the interest cost on the debt. In recent months, the federal subsidy has fluctuated from being sufficient to cover all of the interest to covering almost all of the interest.

Interest earned by a bondholder on a QSCB is included in taxable income by the federal government. The interest by a bondholder on a QSCB is not included in taxable income by the Commonwealth of Massachusetts.

The investor base for a QSCB is different than for traditional tax exempt debt issues. Retail investors are not expected to be significant buyers. Mutual funds and insurance companies are expected to be the primary investors.

As was done in last June's issue, staff intends to issue the QSCBs under a subordinate lien. A subordinate lien would place the QSCB investor second in line to be paid after all the senior bondholders. The principal benefit to the MSBA of issuing subordinate debt is that the subordinate debt service will not be added to senior debt service when calculating the coverage ratio on senior debt. This will result in a higher (better) debt service coverage ratio which makes future senior debt issues more attractive to investors. The principal negative is that subordinate debt may be lower rated by the rating agencies and may require a slightly higher interest rate. All three rating agencies assigned the June 2010 QSCB issue a rating one notch lower than the senior MSBA debt.

The investment banking firms selected as a result of the MSBA's procurement in late 2009 and used for the June 2010 QSCB issue will underwrite this QSCB issue. J.P. Morgan will be the senior book runner for the issue. Two other firms, Morgan Stanley and Citi, will serve as co-senior managers. Other firms to assist in the underwriting are the following: Barclays Capital, Janney Montgomery Scott, Jefferies & Company, Merrill Lynch & Co., Ramirez & Co., Inc., and Raymond James.