ICCCFO SPRING CONFERENCE
The New Federal Tax Law –
Its Impact and Debt Strategies
Going Forward

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THE MUNICIPAL BOND MARKET

VARIABLES THAT IMPACT THE MUNICIPAL BOND MARKET

- FED Reserve Policy Fed Funds Rate
- Global Political Events Centered around Washington, D.C.
- Inflation Expectations
- Health of National, State and Local Economies
- State of Illinois Political Challenges
- Bank Qualification
- Municipal Bond Supply and Demand
- Europe
- Chicago’s Fiscal Challenges – Pension Issues
- Municipal Bankruptcies (e.g. Detroit, Puerto Rico)
- Credit Ratings of State and Local Governments
- Level of Federal and State Income Taxes

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• Signed into law by the President on December 22, 2017

• The new law enacts the following:
  – Preserves most tax-exempt private activity bonds (including qualified 501(c)(3) bonds and mortgage revenue bonds)
  – Repeals the use of tax exempt advance refundings, effective Dec. 31, 2017; no transition period provided
  – Repeals tax-credit bonds (including qualified zone academy bonds and clean renewable energy bonds), effective Dec. 31, 2017
  – Preserves the sale of tax-exempt debt for financing professional sports stadiums
Additionally, the law:

- Repeals the Alternative Minimum Tax ("AMT") for corporations, but it remains for individuals
- Reduces the Corporate Income Tax from 35% to 21% (effective 2018)
- Creates 7 individual tax brackets- ranging from 10% to 37%
- Aggregate of $10,000 limit will apply to the deduction for state and local income, property and sales taxes
- Interest deductible on mortgage loans of $750,000 or lower
The Municipal Market Data “MMD” is a AAA municipal bond market index produced by TM3. As of April 10, 2018.

Fed Funds Target Rate from U.S. Department of Treasury.

*Periods characterized by “flat” yield curve.*
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• An advance refunding is a bond issue that closes more than 90 days before the redemption date on the refunded bonds.
To Refund **Outstanding Bonds:**

- Wait (until 90 days before call date)
- Advance Refund **Taxably**
- Forward Settlement Tax-Exempt Current Refundings (within 90 days of call date), also known as a “rate lock”
- Taxable Convertible “Cinderella” Bonds
- Derivative Products (i.e., Swaps, Swaptions)

To Preserve Future Refunding Flexibility on **Newly-Issued Bonds:**

- Short Par Calls (under 9-10 years)
- Make Whole Calls
  - Call at any time based upon calculation
- Combine “Par Call” with “Make Whole”
Potential Effects of Tax Reform on the Muni Market
• National municipal bond issuance has markedly decreased since tax reform was implemented

*Source: Bloomberg*
• Corporate tax rates being reduced to 21% from 35% will make municipal bonds less attractive to insurance companies and banks
  – These buyers will be at higher relative yields, but still buyers
  – Their reduced participation, specifically in the belly of the curve, may likely result in some yield curve steepening

• Other municipal investors:
  – Individual Retail: Increased demand for tax-free munis due to the loss of various deductions
  – Professional Retail: Buy on behalf of individual investors
  – Arbitrage accounts: Ratio driven/opportunistic buyers who will be mindful of, but not beholden to, the new benchmark entry points of insurance companies and banks as that evolves from past norms

• Will the expectation of a reduction in municipal supply offset the loss of participation by significant institutional investors?
Bank private placements have traditionally been cost effective for several reasons:

- Lower costs of issuance avoiding bond rating and preparation of formal offering document
- Bank appetite for tax-exempt income
- Bank qualification, which allows banks an extra tax benefit for purchasing the bonds of small issuers

The lower tax rate on corporations (including banks) reduces demand for municipal bonds; in fact, many banks have stated that the returns they will demand are between .35% and .50% higher

Depending on the size and length of maturity of the bond issue and the rating of the issuer, a public offering (competitive or negotiated sale) may result in more favorable results
• Most municipal issuers will likely see increased cost in managing their debt capital structure.

• Tools to potentially, somewhat mitigate tax reform impact on advance refundings:
  – Forward Delivery Bonds – Cost is driven by the shape of the yield curve, but only has limited applications.
  – Shorter Calls – Not a demand issue as investors will buy at certain levels however, this optionality may be costly.
  – Taxable Bonds – Can be used to advance refund tax-exempt bonds, although more costly.

• Community colleges will need to work with their financial advisor to customize solutions which meet their financial goals, risk tolerances, etc.
**Predictions**

- **Lower Municipal Bond Supply**
  - Both tax-exempt and taxable
  - Strong investor demand could moderate upward interest rate pressure
- **Credit Spreads Continue to Decrease**
  - Investors see value in Municipals vs. Corporate/Treasuries
- **Flattening Yield Curve Means Reduced Cost to Extend Debt**
  - Promotes cost effective financing of long-term capital
  - Reduces cost of debt structuring for tax levy management
- **Constructive Tension on Tax-Exempt Interest Rates**
  - Will Lower Supply Decrease Rates or Lower Marginal Tax Rates Increase Rates?
2018 Challenges Look Similar to Those of 2017

- Market focus is on higher rates, increasing inflation, debt ceiling issues, and Fed activity
- The effects of the new tax law may not be fully known until well into 2018
- *Will markets really look different or is it just a different version of the same thing?*

Current Market Themes

- As they have historically done, Treasury & Muni markets will likely continue to react to geopolitical events
- It is unknown whether the anticipated diminished demand by bank and insurance companies for munis will be offset by the elimination of advance refunding supply
- Regarding the Fed and its new Chair, news reports anticipate at least two more rate hikes during 2018, which will likely result in a flattening yield curve
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