



Massachusetts School Building Authority

Timothy P. Cahill
Chairman, State Treasurer

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Executive Director

MEMORANDUM

To: Board of Directors, Massachusetts School Building Authority
From: Katherine Craven, Executive Director
Date: March 31, 2010
Subject: 2010 QSCB Bond Authorization

As discussed at previous Board meetings, the American Recovery and Reinvestment Act of 2009 (ARRA) authorized two new types of debt for issuers such as the MSBA: Build America Bonds (BABs) and Qualified School Construction Bonds (QSCBs).

The BABs provide a subsidy from the federal government to the issuer equal to 35% of the interest on the bond. BABs have been well received by both investors and issuers, with over \$86.9 billion issued in less than a year. In December 2009, the MSBA successfully issued \$450 million in BABs.

The original QSCBs provided a federal tax credit to the buyer of the QSCB equal to the assumed interest rate on the QSCB. The intent of the original legislation was to make QSCBs a source of 0% interest rate debt for the issuer of QSCBs for construction of school projects. The QSCBs were not well received by investors, with only \$2.6 billion issued over the past year. Recently, QSCBs were issued with a supplemental coupon averaging 1.5% thereby defeating the goal of 0% interest financing for school construction.

To increase the attractiveness of QSCBs, Congress passed and the President recently signed legislation that amended how the QSCBs could be issued. The recent legislation allows QSCBs to be issued in a fashion similar to BABs. Issuers of QSCBs will receive a federal government subsidy for the interest on the bonds. The recent legislation should achieve the original intent of an effective 0% interest rate debt for school projects and makes QSCBs an attractive way for the MSBA to borrow funds.

Even though the recent federal legislation makes QSCBs similar to BABs, there are several notable differences from BABs.

- The QSCB federal interest subsidy is much higher than the federal interest subsidy on BABs. The QSCB subsidy is the lesser of the actual interest on the debt or the assumed rate¹ as published by the U.S. Treasury. This means that the federal subsidy approaches 100% of the interest cost on the debt.
- The final maturity of QSCBs is determined by the U.S. Treasury. The current maximum maturity permitted is 16 years. This means QSCBs will be retired sooner than several past MSBA debt issues.
- An issuer of QSCBs is allowed A debt to establish and fund a sinking fund. A sinking fund is a custodial account where periodic deposits are made, which are then used to redeem

¹ As of March 22, 2010 the assumed rate was 5.67%.



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QSCBs at maturity. This means there will not be a significant increase in MSBA debt service in the year the QSCB debt matures and is retired.

- The use of QSCB proceeds is more restrictive than for a BAB issue. Proceeds can only be used for school construction, rehabilitation, and repair projects. Proceeds can only be used for obligations incurred after April 3, 2009.² Projects financed must comply with the federal Davis Bacon prevailing wage rates. Proceeds must also all be expended within 2 years of issuance.

The authorization being requested is for approximately \$305 million. This is the amount of the QSCB volume cap allocated to the MSBA for 2009 and 2010. A portion of the QSCBs may be reallocated by the MSBA to charter schools. The investor base for QSCBs is expected to be similar to BAB investors. These include insurance companies, bond mutual funds and possibly pension funds. Retail investors are not expected to be significant buyers.

Staff intends to discuss with the rating agencies issuing the debt on 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.

The firms selected as a result of the procurement done in late 2009 and used for the December 2009 MSBA BABs issue will underwrite the QSCBs. The ten firms are Barclays Capital; Citi; Goldman, Sachs & Co.; Janney Montgomery Scott; Jefferies & Company; J.P. Morgan; Merrill Lynch & Co.; Morgan Stanley; Ramirez & Co., Inc.; and, Raymond James. The debt may be issued in multiple series with rotating lead managers.

² The QSCB 2009 allocations were issued on that date.