

May 12, 2016

**MEMORANDUM**

To: Ken Guy, Director, King County Finance and Business Operations Division

From: Rob Shelley, Managing Director, Piper Jaffray & Co.

Re: Conversion of 2015 Multi-modal bonds

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**Overview**

In November 2015, King County issued \$100 million in Junior Lien Sewer Revenue bonds to extinguish its outstanding commercial paper program for the Wastewater Treatment Division (WTD). WTD's financial plan calls for this portion of its debt to remain as part of its variable rate portfolio and, to that end, the new bonds were issued as multi-modal bonds. In November, the ultimate structure for these bonds had not yet been determined so they were issued as one-year notes with a maturity of November 16, 2016. By that date, the County will need to develop and execute a plan to convert or retire the outstanding bonds.

As an initial step in that process, a solicitation of banking institutions was conducted for the provision of one or more of the following products: 1) Irrevocable Direct Pay Letter of Credit (LOC), 2) Standby Bond Purchase Agreement (SBPA), and/or 3) Direct Purchase Bank Loan. One potential variable rate approach that was not considered is the issuance of Floating Rate Notes (FRNs). The reason for this is that in the past 12-18 months the buyer base for this product has shrunk significantly. This has increased pricing for this product to the point that the economics no longer make it a competitive option to achieve the County's goals. Unlike the bank products where pricing is determined as part of the proposal process, the pricing for FRNs is set at market rates at the time of funding. Accordingly, we would only recommend pursuing the FRN approach if it appeared likely that the eventual market rate would be more favorable than the bank product options, and this is currently not the case. This memo summarizes the results of the bank solicitation and provides a recommended approach for the conversion of the 2015 bonds.

**Analysis**

Proposals were received from nine different banking institutions. In total, the County received six proposals to provide LOCs, five proposals to provide SBPAs, and four proposals to provide direct purchase bank loans. Some banks proposed multiple terms for the facilities, but all offered 3-year terms making that the most comparable term. Furthermore, the pricing for either shorter- or longer- terms did not provide sufficient incentive for the County to pursue them.

The most favorable pricing for each product for the three-year term, reflecting estimated market trading differentials and ongoing support costs, is shown in the table on the following page.

## Estimated Annual Cost for Best Proposals Received (3-Year Term)<sup>1</sup>

Facility	Provider	Current Rates	Historic Rates (10-year Avg)
LOC <sup>2</sup>	SMBC	0.870%	1.413%
SBPA <sup>2</sup>	MUFG	0.890%	1.433%
Direct Loan	State Street	0.785%	1.381%

<sup>1</sup> Pricing reflects remarketing fees and estimated market trading differential; does not reflect upfront or ongoing rating costs associated with LOCs and SBPAs. LOC and SBPA pricing is based on the SIFMA index; direct loan pricing is based on 70% of LIBOR.

<sup>2</sup> The Industrial and Commercial Bank of China is a new entry in this market and did provide the most aggressive pricing for both an LOC and a SBPA. They have not yet backed any publicly offered debt so there is no benchmark for where bonds with their backing would trade. Our desk believes that the market premium would be substantial enough that it would not provide the best all-in-cost to the County. Additionally, the County would be exposed to the significant uncertainty associated with the Chinese economy and banking system.

As indicated in the table above, the direct loan proposal from State Street is the most aggressive. Additionally, this proposal is advantageous due to the reduced risks associated with direct purchases generally. In a direct purchase, the bank purchases all of the bonds for its own account for the duration of the agreement. Conversely, LOC- and SBPA-backed weekly floaters are remarketed in the public market each week and, as a result, an issuer is exposed on a weekly basis to any deterioration in the credit-worthiness of the bank supporting the debt. If the market's perception of a bank weakens, that is likely to lead to higher weekly rate resets and a higher borrowing cost for the issuer. This risk is eliminated with the direct purchase mechanism.

Another factor to consider is the October 2016 implementation of money market fund reform. The most significant component of these reforms is that beginning October 14, 2016, tax-exempt institutional money market funds, among others, will have to sell and redeem their shares based on a "floating NAV." While most market participants do not expect this to lead to significant long-term changes in the buyer base for short-term municipal debt, it could create intermittent dislocations leading up to and following the October implementation date. Since, unlike weekly floaters, a direct purchase does not rely on the tax-exempt money market fund buyer base, it will not be directly impacted by these types of dislocations. Although, should these new requirements lead to higher short-term interest rates or increased volatility in the underlying index that determines the rates for a direct purchase, there could be some indirect impact.

One of the considerations we focus on when making a recommendation about a new bank product is how it fits with the County's existing portfolio of bank exposure. That current exposure is summarized in the table on the following page.

## Summary of King County Credit Facilities for Outstanding Bonds

Series	Typed of Bonds	Outstanding as of 1/1/2016	Type of Facility	Provider	Expiration
Junior Lien Variable Rate Demand Sewer Revenue Bonds, Series 2001 A and B	Junior Lien Obligations	\$100,000,000	Letter of Credit	Landesbank Hessen-Thuringen Girozentrale (Helaba)	9/30/2020
Multi-Modal Limited Tax General Obligation Bonds (Payable from Sewer Revenue), Series 2010 A and B	Multi-Modal LTGO/Sewer Revenue Bonds	\$100,000,000	Standby Bond Purchase Agreement	State Street Bank and Trust Company	11/3/2017
Junior Lien Variable Rate Demand Sewer Revenue Bonds, Series 2011	Junior Lien Obligations	\$100,000,000	Bondholder's Agreement	U.S. Bank National Association	05/01/2017
Junior Lien Variable Rate Demand Sewer Revenue Bonds, Series 2012	Junior Lien Obligations	\$100,000,000	Continuing Covenant Agreement	Wells Fargo Municipal Capital Strategies, LLC	12/27/2016
Multi-Modal Limited Tax General Obligation Bonds, Series 2013	LTGO	\$37,340,000	Continuing Covenant Agreement	Bank of America Preferred Funding Corporation	8/6/2016

As illustrated in the table, the County currently has five different bank product providers, with facility expiration dates spread throughout the next four years. Adding a State Street direct purchase to this list would double the exposure to that bank which would put the County at risk should it decide to exit the municipal banking business. Mitigating this is that with a three-year term for the new agreement, there would be significant separation between the expiration dates associated with the two State Street agreements, meaning that the County would not be left in a situation where it would need to replace the full \$200 million at the same time. Additionally, as described above, with a direct purchase the County would not have any exposure to the market's view of State Street's credit worthiness so it would be unlikely for the County to want to terminate the direct purchase loan agreement early for credit-related reasons.

An additional consideration in this process is the amount of associated transaction costs beyond the direct cost of the facility itself. For an LOC or SPBA, in addition to the remarketing fees captured in the pricing comparison above, the County would also be responsible for paying upfront and ongoing rating fees. These fees would add approximately 4-5 basis points per year to the cost of these transactions for the three-year term.

Unlike the authorizing bond ordinances for the County's other variable rate debt which provide for mode changes and remarketings through the final maturity, the authorizing ordinance for the 2015 multi-modal bonds only permits the sale or remarketing of bonds through December 31, 2016, with the Council's stated intent for this limitation being that it wanted to be apprised of what the ultimate structure for the 2015 multi-modal bonds would be. The need for Council action will necessitate a fairly rapid turn of documents in order to meet the November 16, 2016 conversion date and the fact that the County and State Street's counsel have previously been able to successfully reach agreement on document terms gives me some confidence that this timeline is achievable.

**Recommendation**

I recommend that the County accept the proposal from State Street for a direct loan for a term of three years. The pricing of their proposal is the most aggressive of all the direct loan proposals. Additionally, their pricing is very comparable to the most aggressive pricing contained in the proposals received for direct pay LOCs and SBPAs. With a direct loan, though, the County would not incur the upfront and ongoing rating expense associated with LOC/SBPA-backed weekly floaters so the proposal from State Street provides the overall lowest cost to the County once transaction costs are accounted for. In addition to being the most cost-effective, the State Street direct loan eliminates several of the risks associated with weekly floaters so it is strongest from a risk perspective as well. The one downside to accepting the State Street proposal is that the County would then have a total of \$200 million in exposure with one banking institution. While this could prove problematic should State Street ever decide to exit the municipal banking business, the staggered expirations of the two facilities would help minimize that concern.

Please contact me at (206)628-2879 or [robert.e.shelley@pjc.com](mailto:robert.e.shelley@pjc.com) should you have any questions.

Cc: Nigel Lewis, King County Finance and Business Operations Division