VMBB

VERMONT MUNICIPAL BOND BANK

Serving the needs of Vermont's Municipalities since 1970

MEMORANDUM

To: Senate Committee on Government Operations

From: Robert W. Giroux, Executive Director

Date: February 21, 2014

Re: S.55 and S.204

I would like to thank the Senate Committee on Government Operations for providing me with the opportunity to comment on S.55 – An act relating to increasing efficiency in state government finance and lending operations and S.204 - An act relating to the establishment of the 10 Percent for Vermont Program. I am Robert Giroux, a resident of Georgia, VT and the Executive Director of the Vermont Municipal Bond Bank ("Bond Bank").

Overview

As you know, the Vermont Municipal Bond Bank is a body corporate and politic and is constituted as an instrumentality exercising public and essential governmental functions of the State of Vermont. The Bond Bank was created by the Legislature in 1969, became operational in 1970, and was the very first bond bank in the nation. The Bond Bank provides a means of lower-cost financing for Vermont's cities, towns, school districts and other public bodies that may issue debt (these entities are referred to as 'Governmental Units"). Rather than issue their debt directly to the public markets or to a bank or other purchaser, the Governmental Units issue the debt to the Bond Bank in return for a loan. Almost all of Vermont's Governmental Units have issued general obligation bonds to the Bond Bank. The Bond Bank is also authorized to make loans to certain public utilities that issue revenue bonds.The Bond Bank pools its loans to secure bonds issued by the Bank to the capital markets. Bonds are secured by the payments made by each of the Governmental Units for its respective loan.

Bond Bank bonds are also secured by a debt service reserve funded from the proceeds of Bond Bank bonds. The reserve is backed by the so-called "moral obligation" of the State of Vermont. This means that if the reserve fund is drawn upon to pay debt service on Bond Bank bonds in the event that an individual Governmental Unit fails to make a payment on its loan, the Legislature is obligated but not required to appropriate funds necessary to replenish the reserve fund. While this obligation of the State is not a "full faith and credit" obligation that would cause it to be debt of the State, the moral obligation backing of the reserve fund is a strong source of security and commitment of the State's

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resources. The State carefully monitors the use of the moral obligation, as it can impact the State's credit rating and cost of its own borrowing.

The loans from the Governmental Units also benefit from an intercept provision in Vermont law. If a Governmental Unit fails to make a loan payment to the Bond Bank; the Governmental Unit's state aid is intercepted by the State Treasurer to satisfy the loan payment.

Given these very strong security provisions, as well as the strength and diversity of the pool of Governmental Unit borrowers, the Bond Bank maintains very high credit ratings from Stand & Poor's (AA+) and Moody's (Aa2). Such ratings help the Bond Bank issue debt at lower cost, thus benefitting all of the Governmental Units. In general, the higher debt is rated, the lower the interest rate on such debt. S&P's and Moody's ratings reflect credit risk to the holder of the debt. If there is more risk, the investor will price in a premium (higher interest rates) for taking such risk. If there is less risk, therefore, there is less of a premium, so the cost of the debt will be lower.

The Bond Bank is empowered to issue its bonds to make funds available at reduced rates and on more favorable terms for borrowing by such Governmental Units through the purchase by the Bond Bank of their bonds. Since its enactment, the Bond Bank has issued over $2.0 billion in tax-exempt and taxable bonds to finance or refinance 1,079 projects for more than 375 different Governmental Units. Almost all of such loans were for general obligation bonds issued by Governmental Units. The Bond Bank's current loan portfolio includes almost 300 municipalities, just under 600 loans and over $570 million in loans outstanding. Eight loans in the current loan portfolio are for revenue bonds, representing 1.42% of loans outstanding. Loans are provided to Governmental Units for capital projects such as school buildings, town offices, public safety buildings, fire trucks, electrical generation facilities and other capital and infrastructure projects.

In order to fulfill the State's policy and the Bond Bank's mandate to provide such reduced rates and more favorable terms, the Bond Bank has made it a priority to maintain its very high credit ratings. As stated previously, the Bond Bank is currently rated Aa2 by Moody's and AA+ by Standard & Poor's. Because annually there is a lack of new Vermont tax-exempt bonds for sale, the Bond Bank trades closer to a AAA than a AA rated issuer, resulting in even lower interest costs for Governmental Units. Approximately 80% of new Bond Bank bonds issued are sold to individual Vermont investors and not to Wall Street banks or other national/international institutions. This very strong demand by Vermonters for Bond Bank bonds was very beneficial during the recent Great Recession, as well as, preceding recessions. While nationally many municipal issuers experience difficulties issuing tax-exempt bonds during recessions, the Bond Bank has successfully sold its bond series at very attractive interest rates even during difficult economic times because of the strong Vermont "retail" demand.

By statute, the Bond Bank is not permitted to compete with local banks. The Bond Bank does not provide any cash flow borrowing such as tax anticipation notes, revenue anticipation notes or bond anticipation notes. The Bond Bank only provides longer term bond financing to Vermont's Governmental Units.

Creation of a State Bank

The Bond Bank has an excellent track record of providing financing to Vermont Governmental Units' capital, infrastructure and education projects at a low cost and with a "user friendly" process. While the emphasis for Bond Bank financings is not economic development, with the annual financing of +$40 million in municipal construction and asset purchases, economic development is an indirect result.

The North Dakota State Bank ("NDSB") is often used as an example of a successful public bank that would improve financing opportunities for Vermonters and Vermont's Governmental Units. In the case of municipal bond financing in North Dakota, the NDSB does not have a role to play in municipal bond financing. The State of North Dakota has designated the North Dakota Public Financing Authority ("Authority") as the instrumentality responsible for meeting the long-term financing needs of North Dakota's Governmental Units. A review of the Authority's 2013 Series A Official Statement shows that it operates very similarly to the Bond Bank. Like the Bond Bank, Authority bonds are issued using a pool of borrowers, with loans being made to municipal borrowers using bond proceeds. Pooling bonds creates an economy of scale that makes the cost of issuing bonds cheaper for all. Unlike the Authority, the Bond Bank does not charge borrowers a loan origination fee, nor does it charge an annual borrower assessment. By issuing pooled bonds, the Bond Bank is able to spread out the fixed cost of issuance to multiple borrowers, creating substantial economies of scale. Internal Revenue Service regulations allow up to 2.0% of a tax-exempt bond issue to cover the cost of issuing bonds. The Bond Bank is typically in the 0.65% to 0.80% range. As a comparison, the North Dakota Public Finance Authority charged 1.25% for the cost of issuance on its last bond issue.

It has been implied that a Vermont State Bank could be a source of revenues to the State of Vermont. If that is the case for Vermont municipal bonds, then the revenues would have to come from an interest rate surcharge or new fees charged to municipal borrowers that would generate the excess funds to be delivered to the State. The Bond Bank only chargers its borrowers interest rates sufficient to repay the bonds issued in support of the loans, and not a penny more.

According to the Gund Institute's study, the capitalization of a state bank could be made from unrestricted assets. There are no unrestricted assets held by the Bond Bank that would be available to capitalize a state bank. The Bond Bank has never received an appropriation or other form of financial assistance from the State. The reserves the VMBB does have were generated by its borrowers. The VMBB uses those reserves to cover operations, contingencies and new programs, and to support potential loan defaults. The credit rating agencies take the Bond Bank's general reserves into account when assigning the Bond Bank its rating. The loss of those reserves would in all likelihood trigger a ratings downgrade for the Bond Bank.

The downgrading of the State's credit rating would also have disastrous consequences for Vermont's Governmental Units. Because Moody's rates the Bond Bank off of the State of Vermont's Moral Obligation pledge, a downgrade to Vermont's Moody's rating would drop the VMBB's rating as well.

A decline in Bond Bank ratings would translate into a significant increase in municipal borrowing costs. For a $45 million loan pool, a ratings downgrade from an AA to an A would mean Bond Bank borrowers would see interest expense on their bonds increase by approximately $2.2 million over the life of that one bond series. The Bond Bank typically has twenty bond series outstanding at any point in time. As new bond series are issued subsequent to a ratings downgrade, Vermont's municipal borrowers would ultimately be paying approximately $44 million more in interest over the life of the bonds because of a ratings downgrade.

Summary

The Bond Bank has an excellent record supporting Vermont's Governmental Units with obtaining long-term financing for important capital projects. In addition to issuing low cost bonds, the Bond Bank also assists municipalities with strategizing financing options, project design and approval, and with post issuance compliance. The Bond Bank is very sensitive to the difficult nature of issuing municipal bonds. Most Vermont Governmental Units only issue bonds once a generation, so the institutional memory from the last bond issue is no longer present for that borrower. The Bond Bank provides Governmental Units with a full spectrum of support necessary to get them from a successful bond vote all the way to project completion and post issuance compliance on their bonds. I encourage you to visit the Bond Bank's website at www.vmbb.org for more information.

Thank you for the opportunity to provide the Committee with information on the Vermont Municipal Bond Bank and the opportunity to comment on S.55 and S.204.

I welcome your questions.