



PICKING UP THE PACE WITH FANNIE AND FREDDIE

BY DAN WILES, PRINCIPAL



One of the latest “hot trends” in public finance is the Property Assessed Clean Energy bonds.

In California, we refer to them by their authorization as “AB 811 deals.” PACE transactions are planned as contractual assessments against property, either residential or commercial, to support the repayment of financing issued to provide energy and/

“PACE transactions are planned as contractual assessments... to provide energy and/or water conservation improvements.”

or water conservation improvements. These improvements can include, but also extend far beyond, photo voltaic solar panels. Improvements as fundamental as insulation, weather-stripping, on demand water heaters and the like, can fall within the definition of eligible improvements. As of this writing, no California jurisdiction has actually issued bonds to the public based solely on AB 811 contractual assessments.

The key to these financings is the status of the contractual assessment. Similar to all real property assessments and real property taxes, the lien securing PACE financings has a priority ahead of (senior to) mortgages secured by the property. If the taxes and assessments are not paid, the lien could be foreclosed with the property is sold to satisfy any unpaid amounts. With a higher priority, the amounts due on the PACE transaction are paid first, before any amounts on the mortgage. If the proceeds of the sale are less than the amount

needed to pay both the tax and assessment lien and the mortgage, the mortgage is not fully paid.

That priority provides a solid credit foundation for a PACE financing, making the bonds acceptable to investors. On the flip side, the priority of the tax and assessment lien impairs the security of the mortgage. As purchasers of the majority of residential mortgages in the United States, both the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) have a keen interest in the development of PACE financings.

AB 811 provides no specific limit on the possible size of a contractual assessment lien for energy improvements. Absent other specific requirements, the lien could completely eliminate the property owner’s equity and significantly impair the security of the mortgage. Some agencies planning PACE programs have included limitations on the size of the assessment lien relative to the value of the property and the total amount of outstanding debt. The general goal has been to limit the financing to less than the property owner’s existing equity.

On May 5, 2010, both Fannie Mae and Freddie Mac issued guidance letters to sellers and servicers of mortgages, containing substantially similar messages. The Fannie Mae letter states: “The terms of the Fannie Mae/ Freddie Mac Uniform Security Instruments prohibit loans that have senior lien status to a mortgage.” The Freddie Mac letter states:

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ABCs OF CROSS YEAR TRANS FOR SCHOOL DISTRICTS

BY ADAM BAUER, PRINCIPAL

In recent years, California school districts have experienced decreased state funding and property tax revenues. The decrease in revenues is due to the cyclical financial weaknesses of the California economy. These weaknesses cause cash flow problems which, due to voter-approved propositions, are difficult to resolve. School districts are included in local government agencies with limitations. Not only is it very difficult for school districts to raise revenue, but it is also very challenging to make expenditure reductions given the legal and political consequences associated with such reductions. Personnel is the greatest expenditure for a school district but it is also one of the most inflexible components of the expenditures. Prior to eliminating a teaching position, a school district must provide a lay-off notice in advance of the State budget approval and the upcoming fiscal year. The standard practice for school districts has been to notify more teachers than necessary that they might be laid off. The challenges of the layoff process detailed above combined with mid-year adjustments to timing of funding make it very difficult for

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RECENT CREDIT RATING UPGRADES AND DISCLOSURE OBLIGATIONS

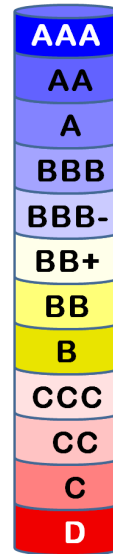
BY JOSHUA LENTZ, ASSISTANT VICE PRESIDENT

To better reflect the position of municipal credits compared to corporate credits, earlier this year Moody's implemented its global rating system. This action caused upgrades of many municipal issuer's underlying credit ratings, in some cases without the issuer's knowledge or participation. Fitch also recalibrated its rating system which also caused upgrades on many municipal issuer's underlying credit ratings. To date, Moody's has recalibrated over 3,000 California municipal credits and state ratings as part of their global scale recalibration.

There are several reasons for the rating upgrades, ranging from quantitative to political in origin. These reasons could be the topic of a separate discussion but the rating upgrades do lead to several questions. One of the questions created is: Do these unrequested surprise rating upgrades on already outstanding issues require a material

event notice? Many bond counsels believe the answer is yes. Rule 15c2-12 that governs disclosure provides that issuers must give notice, as a material event, of rating changes. This includes rating upgrades. Therefore, notice is required. In order to determine whether an issuer received an upgrade, issuers should have received a notification from a rating agency or should contact the applicable rating agency to find out if they have received an upgrade.

The Municipal Securities Rulemaking Board ("MSRB") has recently filed a request to the SEC to allow it to post these credit rating upgrades directly to the MSRB's Electronic Municipal Market Access site ("EMMA"). This would eliminate the need for issuers to provide individual material event notices on such rating upgrades. In order to allow for



SUMMARY OF CREDIT RATINGS*

AAA	Extremely strong capacity to meet financial commitments. Highest rating.
AA	Very strong capacity to meet financial commitments.
A	Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.
BBB	Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.
BBB-	Considered lowest investment grade by market participants.
BB+	Considered highest speculative grade by market participants.
BB	Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.
B	Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.
CCC	Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments.
CC	Currently highly vulnerable.
C	Currently highly vulnerable obligations and other defined circumstances.
D	Payment default on financial commitments.

*based on Standard and Poor's rating criteria

the direct posting of credit rating changes to EMMA, the MSRB needs to reach agreement with each major rating agency. However, until the SEC makes a ruling, issuers should prepare and file material event notices with EMMA based on these upgrades. ♦

NOVEMBER BALLOT MEASURE EXPECTED ON VITAL SERVICES

BY JIM FABIAN, PRINCIPAL



The "Local Taxpayer, Public Safety and Transportation Protection Act" ballot measure has gathered approximately 1.13 million

signatures well in excess of the required amount and has been certified for the November 10, 2010 state-wide ballot.

The primary purposes of the "Local Taxpayer, Public Safety and Transportation Protection Act" are to do the following:

- ♦ Close loopholes to prevent the taking of local taxpayer funds currently dedicated to cities, counties, special districts

and redevelopment agencies. It would also revoke the State's authority to borrow local government property funds.

- ♦ Prevent State borrowing, taking or redirecting of the State sales tax on gasoline (Proposition 42 funds) and Highway User Tax on gasoline (HUTA) funds that are dedicated to transportation maintenance and improvements. It would also prevent the State from redirecting public transit funds.

- ♦ Reduce pressure for local tax and fee increases that become necessary when the State redirects local funds.

Information about the initiative can be found at the website www.savelocalservices.com. ♦

CASTOFF NOW ONLINE

The Committee on Assessments, Special Taxes and Other Financing Facilities, known as CASTOFF, has launched its website www.CASTOFFonline.com, dedicated to providing its members and other interested parties with the latest happenings



in the world of land-secured finance.

The membership consists of private sector industry professionals specializing in the fields of law, public financial advising, real estate, investment banking, tax policy and consulting, engineering and special tax consulting, real estate appraising and other related professional disciplines. ♦

ABC'S OF CROSS YEAR TRANS (CONTINUED FROM FRONT PAGE)

school districts to manage their cash flows.

There are very few options available to school districts to assist with the mismatch of revenues and expenditures. A few counties allow temporary loans from the County Treasurer's Investment Pool but that action requires approvals by both the County Board of Supervisors and the County Treasurer. Traditionally, many school districts have issued Tax and Revenue Anticipation Notes ("TRANS") to help with that mismatch of revenues and expenditures. In the "XYZs of California School Debt Financing, Third Edition," Orrick, Herrington & Sutcliffe defines TRANS as "short term debt instruments used to finance cash flow deficits in anticipation of receiving taxes and other revenues." If structured correctly, TRANS are particularly useful to school districts because they are one of the few financing instruments that can be used to pay operating expenses of school districts.

Typically, TRANS are issued at the beginning of the Fiscal Year for a 12 or 13-month term

and repaid from revenues from the same fiscal year. However, given the decrease of revenues to school districts, many need more time to repay their TRANS. While some school districts may be able to wait until November (historically a month in which school expenditures exceed revenues) to issue their TRANS, others who need TRANS earlier may need to issue two TRANS in one fiscal.

Many school districts have avoided the issuance of TRANS that cross fiscal years ("Cross Year TRANS") over the last few years by being very disciplined with their cash management and using non general fund cash balances to bridge the mismatches in revenues and expenditures. However, several years of prudently maintaining this balance has weakened school districts' cash balance position and many will not be able to continue paying their obligations without a significant improvement in the economy or Cross Year TRANS.

While the California economy appears to be slowly improving, school districts are not likely to have their finances improve for some time due to large State budget cuts and the lag time local government budgets encounter. More school districts are turning to Cross Year TRANS in order to meet their cash flow needs. With the lack of bond insurance providers and the limited amount of investor interest

in purchasing Cross Year TRANS, school districts need to pay special attention to the structure of their TRANS. Detailed below are the common indices used to benchmark short term financings as well as a summary of the school district

TRANS sold since September 2009. As you can see in the graph below there are significant differences in how school district TRANS have priced recently. Some of the key factors that affect the pricing of a TRANS are timing, structure, term, type of sale, and rating.

To achieve the lowest interest rate possible, school districts need to structure their TRANS to be viewed favorably by both rating agencies and investors. Most TRANS are structured such that when the pledged revenues are received, a portion is set aside in a trust account

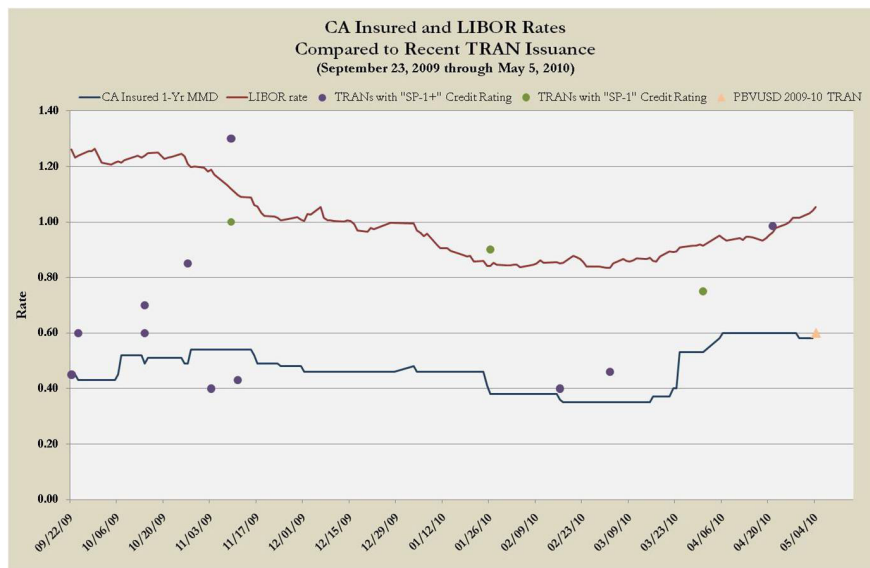


to repay the TRANS.

This gives investors some certainty that when received, pledged revenues will be used to repay the TRANS. While this protects investors once the pledged revenues are received, it does not address the possibility that a school district may not receive the pledged revenues. In Moody's Investor Services recent publication, "Application of Moody's Short-Term Note Methodology to California TRANS Issues,"

Moody's states that "the primary risk associated with a TRANS is the predictability and sufficiency of the deferred revenues as a source of repayment is weak at best."

In order to help mitigate the concern of a school district not receiving the pledged revenues on time or as projected, cash balances outside the general fund are often identified as possible repayment sources. Often times these funds include non debt capital funds, internal services funds, workers compensation and self insurance funds, and deferred maintenance funds. These sources of funds are often referred to as "alternative liquidity." Identifying a school district's alternative liquidity is a difficult balance because it is necessary to show that liquidity as available as a repayment source; however, if it is viewed as too easily available, Tax Counsel may require a reduction in the size of the TRANS. Working with a



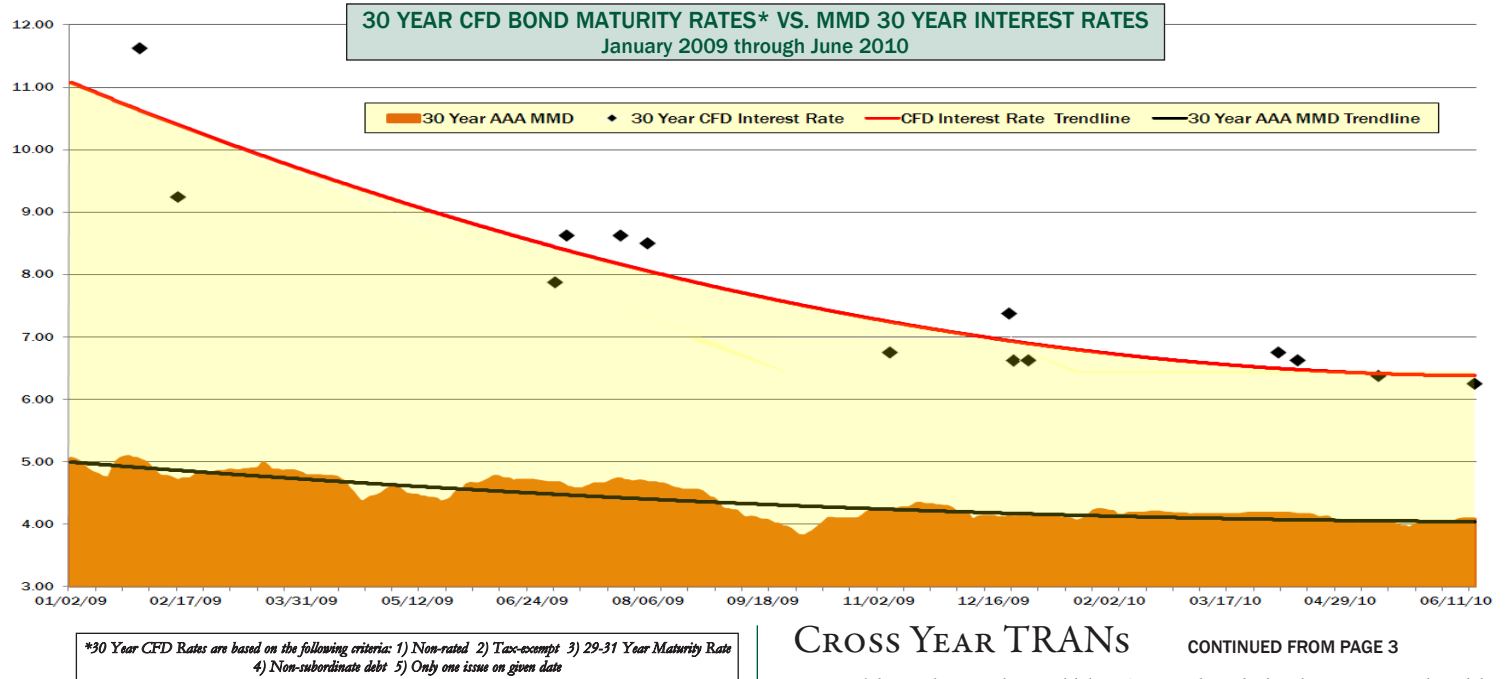
TRENDS IN CFD ISSUANCE

BY THOMAS G. JOHNSEN, PRINCIPAL

CFD bond issuance has continued to be significantly lower than in prior years. In 2009 twenty-four stand alone CFD bonds sold and closed. To May 15 CDIAC lists eight CFD bonds as being sold in calendar year 2010.

of development, rather than focusing on value-to-lien as a primary credit indicator. Bonds sold have reduced net proceeds compared to historic precedent. The median size of CFDs sold in 2010 is approximately \$10 million, with about one-half of the issues having less than \$5 million in net proceeds. ♦

Interest rates on CFD bonds have declined significantly from the



peak of early 2009. Low supply of non-rated bonds and increasing investor confidence in bonds primarily secured by developed property special tax revenues have lead to recent 30 year interest rates of 6.25%-6.50%. The graph above indicates nominal rates and spread of the MMD for CFDs over the last 18 months.

In the near future, CFD bonds will be sold by districts previously formed with moderate to high development and current special tax revenue based on units sold, occupied or under construction. CFD bond buyers are more focused on project momentum, current special tax revenue derived from developed units and the level and timing

CROSS YEAR TRANS

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reputable and experienced Tax Counsel early in the process should help avoid later complications.

While alternative liquidity is essential to creating a solid credit, investors also expect that it will not actually be needed. A school district also needs to demonstrate its ability to budget and prepare for midyear budget adjustments. This is especially important for school districts because their ability to increase revenues or reduce expenditures midyear is very limited and their fund balances are considered low when compared to other local government agencies. Preparing detailed actual cash flows from the immediate year prior, estimated current year cash flows and projections of future cash flows for the upcoming fiscal year are critical for rating agency review and for building investor confidence.

After determining the primary credit features, it is time to make additional adjustments in order to make either a cross year TRAN or a traditional TRAN a more attractive credit while also meeting the cash flow needs of a school district. A school district needs to also consider the best approach for entering the market. Some alternatives may be to review the local pooled TRAN programs, if available, along with standalone options. If you would like additional information concerning school district TRANs or any school finance matter, please contact Adam Bauer at 949-660-7303. ♦

FANNIE & FREDDIE

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“The purpose of this Industry Letter is to remind Seller/Serviceers that an energy-related lien may not be senior to any Mortgage delivered to Freddie Mac.”

Both Fannie Mae and Freddie Mac emphasized their support for energy efficiency initiatives and expressed interest in working with federal and state agencies on program development. For now, the ultimate resolution of this issue as these programs move beyond the experimental stage is unclear. ♦

