MEMORANDUM

TO: Board of Directors, Massachusetts School Building Authority
FROM: James A. MacDonald, First Deputy Treasurer, Chief Executive Officer
John K. McCarthy, Executive Director, Deputy Chief Executive Officer
DATE: April 15, 2022
RE: Authorization for Defeasance and Plan of Finance

Background

In recent months there have been several factors underlying a steady rise in interest rates that are also impacting the municipal bond market. These include fears of inflation going back to before the end of 2021, anticipated hikes in the interest rate by the Federal Reserve and the significant and ongoing effects of the Russian invasion of Ukraine.

The annual inflation rate in the US accelerated to 8.5% in March, which is the highest it has been since December of 1981; slightly above market forecasts and driven largely by the higher costs associated with energy and food. In addition to what has been referred to as runaway inflation, the job market has also exhibited signs of an extremely tight labor force, in turn supporting expectations of sharper interest-rate hikes to damper an overheating economy.

The combination of these economic factors has impacted treasury rates upwards all along the yield curve, but most dramatically in short term rates. For a point of reference, as of April 13, 2022, the 2-year treasury rate was 2.37%, which is up 164 basis points year-to-date, the 5-year treasury rate was 2.66%, up 140 basis points year-to-date, the 10-year rate was 2.70%, up 118 basis points to date, and the 30-year rate was 2.81%, up 91 basis points to date.

Request for Authorization to Defease Outstanding MSBA Debt

The rise in interest rates is anticipated to continue. This creates an enhanced economic opportunity for the Authority to utilize a cash defeasance strategy of retiring its outstanding high coupon bonds with available cash. Increasing rates, particularly short-term rates, provide the Authority with the ability to realize higher rates of return in the related defeasance escrow account, which reduces the amount of cash needed upfront to pay off what is typically higher coupon debt on its future call date.

The Authority's strategy and plan of finance for cash defeasance of outstanding debt is two-fold, and the amount of the request for authorization of $400 million supports a minimum of two transactions.

The first anticipated transaction relates to the use of existing debt service reserve funds associated with the Series 2012A, 2012B, 2020A and 2020B bonds. In 2020 the Authority invested $200 million of related debt service reserve funds in a Guaranteed Investment Contract (GIC) with Mass Mutual. The GIC was structured to mature on July 25, 2022 so as to be available to pay off the 2012A and 2012B bonds on their August 15, 2022 call date. The Authority's proposed use of the GIC funds will continue to support the management of strong coverage levels, as well as to create more level repayment of debt service obligations.

Finally, given the expectation of a rising rate environment, the Authority plans to utilize the remaining authorization to execute a second strategic defeasance of its outstanding high-coupon debt. This high coupon debt is primarily on the longer-end of the Authority's debt service curve. This transaction would be in keeping with the continued objectives of reducing and flattening the Authority's overall fixed rate costs and maximizing the amount of savings obtained.