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Debt Administration 101

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FGFOA – Palm Beach Chapter

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Section 1: Debt Management Policy

What is a Debt Management Policy?

- Written guidelines, allowances, and restrictions that guide the debt issuance practices of state and local governments, including the issuance process, management of a debt portfolio, and adherence to various laws and regulations

- A debt management policy should improve the quality of decisions, articulate policy goals, provide guidelines for the structure of debt issuance, and demonstrate a commitment to long-term capital and financial planning

- Adherence to a debt management policy (along with other policies such as a fund balance policy) signals to rating agencies and the capital markets that a government is well managed and therefore is likely to meet its debt obligations in a timely manner

- Debt management policies should be approved by an issuer's governing body to provide credibility, transparency and to ensure that there is a common understanding among elected officials and staff regarding the issuer's approach to debt financing

What Should Debt Management Policy Address?

- **Debt Limits**
  - Policy should consider setting specific limits or acceptable ranges for each type of debt
  - Limits are generally set for legal, public policy, and financial reasons
  - Legal restrictions may be determined by state law, local charters, resolution/ordinance, bylaws, covenants, or bond referenda approved by voters
  - Public policy considerations include purpose for which debt proceeds may be used, types of debt used, and relationship to and integration with issuer's CIP
  - Financial restrictions may include things like debt per capita and debt to taxable property value for G.O. debt and debt service coverage/ABT for revenue backed debt
- **Debt Structuring Practices**
  - Policy should include specific guidelines regarding the debt structuring practices for each type of bond
  - Includes maximum term, average maturity, debt service pattern, use of optimal redemption features, use of variable or fixed-rate debt, credit enhancements, derivatives, short-term debt and limitations as to when, and to what extent, each can be used

What Should Debt Management Policy Address?

- **Debt Issuance Practices**
  - Policy should provide guidelines for the issuance process, which may differ for each type of debt
  - Includes selection and use of professional service providers, criteria for determining method of sale, criteria for issuing current refunding and advance refunding bonds, and use of credit ratings
  - May include language outlining who is in charge of providing due diligence and signing off on the offering document
- **Debt Management Practices**
  - Policy should provide guidance for ongoing administrative activities
  - Includes investment of bond proceeds, primary and secondary market continuing disclosure practices, arbitrage rebate monitoring, federal and state law compliance practices, and ongoing market and investor relations efforts
- **Use of Derivatives**
  - Policy should clearly state whether or not the entity can use derivatives
  - If allowed, a separate and comprehensive Derivatives Policy should be developed

Section 2: Types of Municipal Debt

Why do Municipalities Issue Debt?

- State and local governments, and various governmental agencies, have been using debt in one form or another for over 200 years
- Debt issued by states, cities, counties, and other governmental entities is used to fund public infrastructure such as government buildings, water distribution systems, schools, police stations and many other projects that require significant capital investment
- When a government issues debt, it receives an infusion of cash to build a project; in return, the government repays its investors over time, plus interest
- By using debt, the government can complete a capital project with a repayment schedule that spreads the cost of the project over its useful life
- At the same time, the investor receives a reasonably reliable source of investment income

Types of Municipal Debt

- **Tax-Exempt Municipal Bonds**
  - Debt issued for a public purpose such as constructing schools, hospitals and highways
  - Exempt from federal taxes; can also be exempt from state income taxes (not applicable in Florida)
  - The Tax Cuts and Jobs Act of 2017 eliminated the ability to do a tax-exempt advance refunding of tax-exempt bonds – can still advance refund in other ways
  - Priced based off a tax-exempt yield curve such as Municipal Market Data (MMD)
- **Taxable Municipal Bonds**
  - Debt issued to finance a project or activity that does not provide any obvious public benefit
  - Not exempt from federal taxes; can still be exempt from state taxes
  - Typically sold at higher yields than tax-exempt bonds and priced based off the U.S. Treasury yield curve
  - Examples include Build America Bonds (BABs), pension bonds, sports facility bonds, and some advance refunding bonds

Types of Municipal Debt

- **Private Activity Bonds (PABs)**
  - A municipal security of which the proceeds are used by one or more private entities
  - A municipal security is considered a PAB if it meets two conditions:
    - More than 10% of the proceeds of the issue are used for any private business use (the "private business use test")
    - The payment of the principal of or interest on more than 10% of the proceeds of such issue is secured by or payable from property used for a private business use (the "private security or payment test")
  - Interest on PABs is NOT tax-exempt unless the bonds fall within certain defined categories which make them "qualified bonds" or "qualified PABs"
  - Qualified PABs are usually subject to the alternative minimum tax (AMT)
  - Some examples of qualified PABs include airport bonds, seaport bonds, solid waste bonds, multi-family housing revenue bonds, 501(c)(3) bonds, etc.

Types of Municipal Debt

- **Bank Loan**
  - Direct loan issued by a financial institution (most commonly a commercial bank)
  - Similar to bonds, can be issued as both tax-exempt and taxable
  - Historically considered easier to issue than bonds due to lack of disclosure and timing
  - Limitations with bank loans exist including final maturity (usually within 20 years), size, security structure, amortization schedule, etc.

- **Commercial Paper**
  - Unsecured, short-term debt (maturities rarely range longer than 270 days) usually backed by a line of credit with a bank
  - Essentially a promissory note secured by the borrower’s financial health
  - Maturing principal of outstanding commercial paper is usually paid with newly issued commercial paper (“roll over”) thereby commercial paper is a way to borrow funds on a short-term basis for an extended period of time
  - Does not need to be registered with SEC

Types of Municipal Debt

- **Certificates of Participation**
  - An instrument evidencing a pro rata share in a specific revenue stream, usually lease payments by the issuer that are typically subject to annual appropriation
  - Certificate generally entitles the holder to receive a share, or participation, in the payments from a particular project
  - The payments are passed through the lessor to the certificate holder
  - Often used by Florida school districts in place of voter approved G.O. debt
- **State Revolving Fund (SRF) Loan**
  - SRF is a fund administered by a state for the purpose of providing low-interest loans for investments in water and sewer infrastructure
  - SRF receives its initial capital from federal grants and state contributions
  - SRF's "revolve" through the repayment of previous loans and interest earned
  - Florida's SRF is made up of three programs: Clean Water SRF, Drinking Water SRF and SRF Management

Types of Municipal Debt

- **Letter of Credit / Line of Credit**
  - Letter of credit is used to guaranty a payment; often used as an enhancement to variable rate debt
  - Line of credit is a loan from a financial institution that allows drawing of funds up to a specified limit and for a specified time
- **Other Types of Municipal Debt**
  - Bond Anticipation Notes (BANs)
  - Grant Anticipation Notes (GANs)
  - Revenue Anticipation Notes (RANs)
  - Tax Anticipation Notes (TANs)
  - Tax and Revenue Anticipation Notes (TRANs)

Section 3: Security Structures

Security Structures

- **General Obligation Bonds**
  - Bonds are backed by full faith and general credit of the issuer
  - Often payable from the issuer's ad valorem taxes
  - In Florida, voter approval is required to issue G.O. bonds – voters approve amount, final maturity, and anticipated use of funds
  - Not as many G.O. bonds issued in Florida as in other states where voter approval may not be required or may be easier to obtain
  - Although we have seen more and more Florida G.O. referendums pass as of late as voters seem to understand the need for local governments to fund capital projects and the relatively limited amount of security sources available
  - Typically seen as the safest type of municipal bonds and therefore are traditionally the highest rated bonds that an issuer has and are sold at the lowest interest rates of any municipal bond related debt

Security Structures

- **Revenue Bonds**
  - Specific revenue pledge used to pay debt service
  - Common revenue bonds in Florida include, but are not limited to, sales tax bonds, water and sewer bonds, stormwater bonds, airport/seaport bonds, toll road bonds, PST-backed bonds, and TDT-backed bonds
  - Voter approval usually not required
  - Approval is provided by a local government's elected officials or an entity's appointed Board of Directors
  - Revenue bonds typically include a debt service coverage requirement, an additional bonds test and may include a debt service reserve fund
  - Typically sell at higher interest rates than G.O. bonds
- **Double-Barreled Bonds**
  - Bonds whose principal and interest are payable from both revenue from a defined project and an issuer's taxing power (G.O.)

Security Structures

- **Covenant to Budget and Appropriate (CB&A) Bonds**
  - Bonds are secured by an issuer's pledge to annually appropriate from legally available non-ad valorem revenues
  - Ad valorem property taxes are not included in security
  - Expenses for essential services (police, fire) have priority under State statute over debt service payments
  - Very common bonding method used in Florida

- **Special Assessment Bonds**
  - Bonds that are secured by an at-large or select group of property owners who are benefitting from the proceeds of the bond issue and usually payable from property taxes
  - Traditionally a higher concern from investors for potential defaults which result in higher interest rates but can be mitigated by utilizing the Uniform Method of Collection on annual property tax bills
  - Common type of special assessment bonds issued in Florida include CDDs, stormwater, sewer (septic tank removal), undergrounding utilities

Section 4: Structuring Alternatives

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Tax Status

- **Tax-Exempt Bonds**
  - Restriction on uses; must be issued for a public purpose
  - Arbitrage rebate considerations; cannot be advance refunded with tax-exempt debt
  - Lower interest rate
- **Taxable Bonds**
  - No restrictions on uses
  - No arbitrage rebate considerations; no advance refunding issues if using taxable refunding
  - Higher interest rate
- **Alternative Minimum Tax (AMT) Bonds**
  - Issued to fund qualified private activity projects
  - Take on many of the same structuring qualities as tax-exempt bonds
  - Interest rate is equal to a tax-exempt rate plus an AMT spread

Interest Rate Mode

- **Fixed Rate Bonds**
  - Interest rates (coupons/yields) are set at the time of sale
  - Eliminates interest rate risk to both issuer and investor
  - Simplifies budgeting process for issuer
- **Variable Rate Bonds**
  - Interest rates fluctuate during the life of the bonds
  - Include variable rate demand bonds (VRDBs), auction rate securities (ARS), commercial paper, floating rate notes (FRNs), etc.
  - May need additional credit enhancement such as letter of credit
  - Can make budgeting more difficult as debt service is unknown at time of pricing
  - Can be used as an asset-liability management tool
- **Capital Appreciation (Zero Coupon) Bonds**
  - Bonds pay no interest but rather are issued at an extremely discounted price

Serial vs. Term Bonds

- **Serial Bonds**
  - Bonds do not mature or come due on a single date; instead, have maturity dates which are staggered over several years
- **Term Bonds**
  - Bonds which mature or come due on a single date
  - Often include mandatory redemption (sinking fund) provisions

Maturity (December 1)	Amount	Interest Rate	Yield*	CUSIP No.
2025	$ 1,530,000	5.00%	2.34%	696543QK6
2026	1,965,000	5.00	2.51	696543QL4
2027	2,065,000	5.00	2.66	696543QM2
2028	2,170,000	5.00	2.76	696543QN0
2029	2,275,000	5.00	2.86	696543QP5
2030	2,390,000	5.00	2.95	696543QQ3
2031	2,510,000	5.00	3.02	696543QR1
2032	2,635,000	5.00	3.07	696543QS9
2033	2,765,000	5.00	3.12	696543QT7
2034	2,905,000	5.00	3.17	696543QU4
2035	3,050,000	5.00	3.22	696543QV2

$17,775,000 5.00% Term Bonds Due December 1, 2040 Priced @ 113.532% to Yield 3.39%* CUSIP No. 696543QW0
$12,610,000 5.00% Term Bonds Due December 1, 2045 Priced @ 112.899% to Yield 3.46%* CUSIP No. 696543QX8

Credit Ratings

- Rating agencies access the creditworthiness of issuers and their ability to pay debt and assign a rating based on that creditworthiness

- Rating assigned can significantly affect interest rate that issuers pay on debt

- **Rating agencies evaluate:**
  - Financial performance
  - Debt burden
  - Local economic conditions
  - Management

- **Three major credit rating agencies:**
  - Moody’s
  - Standard and Poor’s (S&P)
  - Fitch

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<tr><th colspan="2">Moody's</th><th colspan="2">S&P</th><th colspan="2">Fitch</th><th></th></tr>
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Source: Moody’s Investors Service, Inc.; Standard and Poor’s Financial Services LLC; Fitch Ratings, Inc.

Credit Enhancement

- **Bond Insurance**
  - Guarantees the repayment of the principal and all associated interest payments to bondholders in the event of default
  - Issuers typically pay for bond insurance upfront out of bond proceeds, the cost of which is offset by a reduction in interest rates at the time of pricing
  - Two primary and active insurers left in the municipal market: Assured Guaranty (A2/AA) and Build America Mutual (AA)
- **Debt Service Reserve Fund (DSRF)**
  - Cash, typically coming from bond proceeds or issuer's cash reserves, that is set aside by the issuer to pay for debt service if revenues fall short
  - Used often with revenue-back transactions, especially non-essential service revenues
  - Calculation for DSRF traditionally based on MADS or three-prong test
  - Surety bond can be purchased from bond insurer in lieu of cash
- **Letter of Credit**

Other Structuring Considerations

- **Bond Covenants**
  - Debt service coverage, additional bonds test, anti-dilution test
- **Optional Redemption Provisions**
  - Non-callable, 10-year par call, make-whole call
- **Principal Repayment**
  - Level principal, level debt service, wraparound structure
- **Length to Maturity**
  - Most “new money” bonds are structured with a 30-year final maturity to match the useful life of the projects
  - Refunding bonds are usually structured with the same final maturity as refunded bonds
- **Capitalized Interest**
  - Used primarily for projects that generate revenue once in operation

Section 5: Documents Needed / Players Involved

Documents Needed

- **Bond Resolution / Ordinance**
  - Authorizes the debt and establishes the framework to issue debt
  - Approved by governing body
- **Preliminary Official Statement (POS) / Official Statement (OS)**
  - Contains all relevant information about the financing including purpose and security pledge and a description of the issuer
  - Typically includes sources and uses of funds and a preliminary/final debt service schedule
  - Appendices often include bond resolution/ordinance, issuer's financial statements, a form of the bond counsel opinions, and any engineer's or consultant's report
  - Includes continuing disclosure agreement that binds issuer into providing certain financial and other relevant information to investors on an annual or timely basis
- **Bond Purchase Agreement (BPA)**
  - Agreement between issuer and underwriter establishing all terms of the sale

Players Involved

- **Issuer**
  - Main emphasis is on getting resolution/ordinance approved, producing disclosure document (POS/OS), presenting to rating agencies, and providing due diligence
  - Typically led by CFO/Finance Director/Debt Manager
  - Others involved may include budget/accounting departments, issuer counsel, clerk's office, and department managers (water, wastewater, solid waste, stormwater, airport, etc.)
- **Financial Advisor (or Municipal Advisor)**
  - Must be registered with SEC and must give fiduciary care in advising issuer by putting the issuer's interests above their own financial interests during a transaction
  - Works as an extension of the issuer's staff, assisting in structuring of transaction, organizing and coordinating financing process, selecting financing team, and helping issuer determine most appropriate sales method (negotiated vs. competitive)
  - Represents issuer during the sale of bonds
  - Typically paid through bond proceeds and can be retained via flat retainer or hourly fee

Players Involved

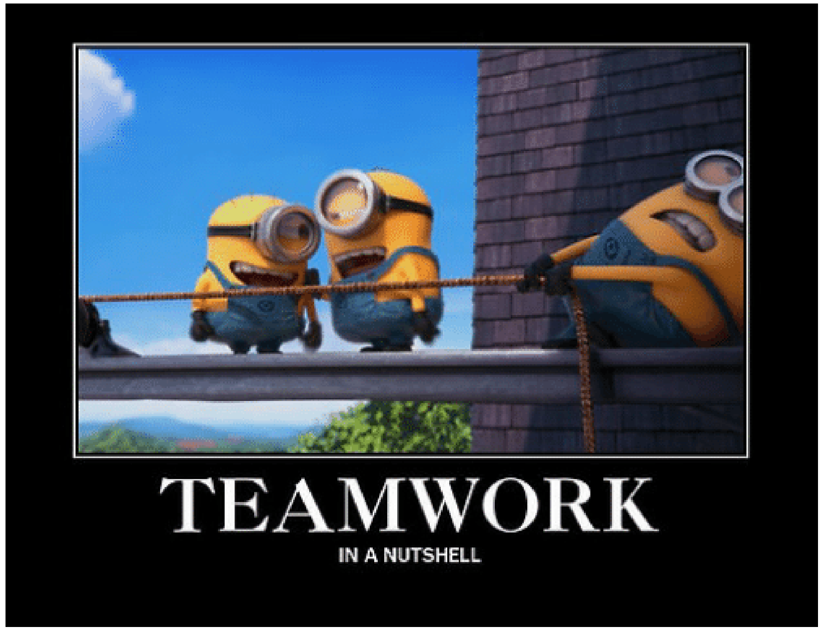
- **Bond Counsel**
  - Provides opinion as to whether the financing is a valid legal, binding obligation of the issuer
  - Provides opinion as to the nature of the taxability of the interest that investor earns
  - Interprets federal, state and local laws, regulations, constitutions, statutes, charters and resolutions/ordinances
  - Responsible for drafting resolution/ordinance and for coordinating the execution of all documents needed to close transaction
  - Typically paid through bond proceeds
- **Disclosure Counsel**
  - Provides advice on issuer's disclosure obligation and prepares the POS/OS and continuing disclosure agreement
  - Many issuers have the same bond counsel and disclosure counsel
  - Typically paid through bond proceeds as a percentage of bond counsel fee

Players Involved

- **Underwriter**
  - Investment bank or commercial bank that serves as key conduit between issuer and investors (institutional, retail, professional retail)
  - Through bond sale process, underwriter agrees to buy the bonds from the issuer and resell them to the investor
  - In negotiated sale, underwriter will assist with structuring of transaction, lead marketing/sales effort and helps with most other aspects of the financing process
  - In competitive sale, underwriter submits a bid to buy the bonds with little-to-no input on financing structure
  - Typically paid through bond proceeds via gross (or underwriter's) spread:
    - Gross spread: difference between the price paid by the underwriter to the issuer and the price at which the bonds are initially offered to the investors
    - Underwriter's fees: takedown (sales commission), management fee (fee for managing sales process), expenses (includes underwriter's counsel, IPREO, CUSIP, DTC, Dayloan, etc.) and underwriter's risk (market risk taken when underwriting bonds)
    - Fees vary depending on credit, size, and complexity of financing

Players Involved

- **Underwriter's Counsel**
  - Retained by underwriter's to assist with the reviewing of documents and to assist with due diligence
  - In charge of preparing bond purchase agreement
  - Typically paid through underwriter's spread
- **Others**
  - Paying Agent / Registrar / Trustee
  - Escrow Agent / Verification Agent
  - Rate Consultants / Consulting Engineers
  - Rating Agencies
  - Bond Insurer / Credit Enhancer
  - Dissemination Agent
  - Printer



Estimated Financing Schedule

- **Negotiated/Competitive Bond Issuance**

(Weeks 1-4)	(Weeks 5-6)	(Weeks 7-8)	(Week 9)	(Week 10)	(Weeks 11-12)
PREPARE DRAFT DOCUMENTS (Authorizing Resolution/Trust Indenture/Preliminary Official Statement/Notice of Sale/Opinions/Etc.)	CREDIT RATING/ ENHACEMENT SUBMIT AGENDA FOR APPROVAL	APPROVAL DUE DILIGENCE CALL PRINT PRELIMINARY OFFICIAL STATEMENT	MARKET THE BONDS TO INVESTORS	PRICE THE BONDS SET INTEREST RATES	PREPARE AND EXECUTE FINAL DOCUMENTS CLOSE BOND ISSUE (WIRE FUNDS)

- **Bank Loan**

(Week 1)	(Week 2)	(Weeks 3-5)	(Weeks 6-7)	(Weeks 8-9)	(Week 10)
PREPARE BANK LOAN RFP	CIRCULATE BANK LOAN RFP TO POTENTIAL BIDDERS	PREPARE DRAFT DOCUMENTS (Authorizing Resolution, Opinion, etc.) RESPOND TO RFP QUESTIONS	RECEIVE, EVALUATE AND AWARD BIDDER DISTRIBUTE BANK LOAN DOCUMENTS FOR APPROVAL	APPROVE ALL AUTHORIZING AND FINAL BANK LOAN DOCUMENTS	PREPARE AND EXECUTE DOCS AND WIRE FUNDS

**Assumes Issuer has bond and/or disclosure counsel, financial advisor, and underwriting team (negotiated sale) in place*

Section 6: Refundings

Refundings

- Bond refundings are most commonly used by state and local governments to achieve savings on interest costs
- Less frequently used to remove or revise burdensome bond covenants or to restructure debt service payments
- Debt management policies should address preservation of future refunding flexibility when issuing any debt, formal refunding objectives, and monitoring of refunding opportunities on outstanding debt
- When evaluating a potential refunding, issuers should analyze their refunding objectives, the efficiency of any related escrow, and the unique aspects of executing the refunding transaction and how it could affect additional outstanding debt
- Two main types of refundings:
  - **Current refunding:** refunded bonds are redeemed within 90 days from the date the refunding bonds are issued
  - **Advance refunding:** Refunded bonds remain outstanding for a period of more than 90 days from the date the refunding bonds are issued

Refundings

- Keys to analyzing refunding opportunities:
  - **Things to look for:** when looking for potential refunding candidates, pay specific attention to the outstanding debt's tax status, optional redemption (prepayment) provisions, coupons (bonds), yield (bank loan), final maturity, and remaining par amount
  - **Monitor refunding opportunities:** establish, with the help of your financial advisor, a process to identify and monitor potential refunding opportunities in your outstanding debt portfolio as interest rates change
  - **Establish guidelines on refunding objectives:** guidelines may include net present value savings (minimum 3%-5%), negative arbitrage efficiency, rate efficiency/sensitivity analysis, and/or refunding efficiency (call option value)
  - **Establish guidelines on savings structure:** the most common savings structure is uniform savings, but others like upfront, accelerated or deferred savings are used as well
  - **Analyze refunding escrow:** what escrow investments make the most sense taking into account investment guidelines provided in the financing documents
  - **Purpose of refunding:** some refundings are not completed for interest savings purposes and these refundings should be evaluated differently than those that are

Refundings

- Prior to the 2018, issuers were allowed one advance refunding of tax-exempt bonds using tax-exempt refunding bonds over the life of the original financing
- As a result of the Tax Cuts and Jobs Act of 2017, only one tax-exempt (or tax-advantaged) bond can be outstanding at a time for a single issuance
- Although traditional tax-exempt advance refundings are no longer permitted, issuers still have the ability to "lock-in" interest savings from a refunding of outstanding tax-exempt bonds utilizing multiple strategies, including:
  - Taxable advance refunding bonds
  - Tax-exempt forward delivery bonds
  - Convertible "Cinderella" bonds
  - Forward starting swaps
- Some issuers are now issuing their new tax-exempt bonds with shorter optional redemption dates (5-8 years) than traditionally used (10 years) in order to mitigate the fact that tax-exempt advance refundings are no longer allowed – but this approach can be costly if interest rates rise and refunding does not occur

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Source: www.MSRB.org