EHLERS
LEADERS IN PUBLIC FINANCE

Debt Management Policies

Wisconsin Government Finance Officers – Spring 2017 Conference

April 20, 2017

Discussion Topics

- Introduction – What Is It
- Purpose for Developing a Debt Management Policy
- Components to Include in a Debt Management Policy:
  - Conditions For the Issuance of Debt
  - Restrictions on Debt Issues
  - Financial Limitations
  - Structuring Considerations & Practices
  - Debt Issuance Process
  - Debt Management Process

What is a Debt Policy?

- A formal debt policy is an essential financial management tool for any governmental entity authorized to issue debt.

- Debt policies are written guidelines affecting the amount, issuance, process, and type of governmental debt.

Reasons To Establish a Debt Policy

- A formal debt policy is a written guideline affecting the amount, issuance, process, and type of debt.
  - First the policy establishes criteria for the issuance of debt obligations so that acceptable levels of indebtedness are maintained;
  - Second, the debt policies transmit the message to investors and rating agencies that the municipality is committed to sound financial management; and
  - Third, debt policies can provide consistency and continuity to public policy development for staff and elected officials.

Purpose of Policy

- A debt policy typically begins with a statement of purpose outlining the policy's objective.
- The purpose is generally to ensure that debt is used wisely and that future financial flexibility remains relatively unconstrained.
- The purpose statement might describe the policy scope.
- The purpose statement also covers oversight and delegation of duties.

Components of a Debt Policy

- Debt issuance and management is successful ***<u>only</u>*** when you, the Issuer:
  - Understand your conditions or purposes for which to issue debt
  - Receive clear information on implications of decisions including:
    - When is it appropriate to issue debt (Conditions for debt issuance).
    - Type of Debt Issue (taxable/tax-exempt, GO, Revenue, Competitive/Negotiated
    - Debt Structuring
    - Financial Limitations (debt capacity, financial impact, debt per capita, etc.)
    - Bond Rating Considerations
    - Levy Limit Restrictions
    - When to Refund Debt and Savings Requirement (may be different current vs advance refundings)
    - Use of Fund Balance
    - Post Issuance Requirements
- Developing debt management policies will assist you in each of the areas identified above.

Prior to issuing debt what should you consider?

Conditions for Debt Issuance

- Debt policies should specify the conditions or purposes for which debt can be issued
  - Acceptable purposes and standards and conditions for use of debt

- Two approaches to project financing:
  - Pay-as-You-Go – using cash
  - Borrowing using bonds or other forms of municipal

- Favorable market conditions
  - When interest rates are low debt rather than use cash

Conditions for Issuing Debt – cont.

- Help distribute costs and benefit appropriately
  - Payers use the asset over it's life
- Resources are adequate to cover debt service
  - May allow for better management of tax rates and fees
  - Cash flow and fund balance considerations
  - Levy limits restrict ability to save and use cash; debt generally exempt from levy limits
- Permissible debt instruments
  - Recognize any state imposed limits

Restrictions on Debt Issuance

- G.O. borrowing capacity limited to 5% of a municipality's equalized value

- Self imposed limitations
  - Moody's using the following ratings in their rating methodology
    - Aaa up to 15%
    - Aa 16%- 35%
    - A 36% - 80%
    - Baa 81% +

- Other options that do not count against G.O. limit:
  - Utility revenue bonds
  - Community Development Authority (CDA) lease revenue bonds
  - Use of cash (be careful if you use cash!)

Restrictions on Debt Issuance – cont.

- Maximum term of debt
  - General Obligation: 20 years
  - Revenue: 40 years

- Use of proceeds
  - Notes (term of 10 years or less): any public purpose
  - Bonds (term longer than 10 years): restricted purposes

- General Obligation debt limit
  - Outstanding G.O. debt cannot exceed 5% of a municipality's equalized value

Financial Limitations

- How much to borrow (Within Established Limitations)
  - Include all construction and soft costs in the financing
  - May be other items to capitalize
- Source of revenues
  - Tax levy, utility revenues, TIF revenues
  - May dictate the structure and type of debt
- Term of repayment
  - Market or rules may dictate longest available term
  - Should match the useful life of the asset financed
- Existing and future debt considerations
  - Impact on levy or other revenue stream
  - Affordability based on the need for future financing(s)

Financial Limitations – cont.

- Bank qualification
  - Can issue up to $10 million in calendar year and maintain BQ status
  - BQ debt enjoys lower interest rates
- Reimbursement
  - May reimburse for expenses incurred generally within last 18 months
  - Must declare intent to do so within 60 days of incurring expense for hard construction costs

Financial Limitations – cont.

- Policy Considerations
  - Debt Per Capita
  - Direct Debt per Value
  - Overall Debt Per Capita
  - Annual Debt Service as a % of total expenditures or revenues
  - Percentage of Debt Paid Within 10-Years
  - Many Other Considerations

Structuring Considerations

- Debt must be secured by something
- Two main types of security pledges:
  - General Obligation (G.O.): irrevocable pledge to levy an ad valorem property tax for payment of debt service
  - Revenue: secured by specified revenue source
    - Utility system, lease payments, Tax Increment, etc.
- G.O. pledge considered the strongest = lowest interest rates

Structuring Considerations – cont.

- Variety of borrowing options – Policy to require that all financings options be considered – including:
  - Bonds sold in commercial market
  - Local bank
  - State programs: State Trust Fund Loan, Clean Water Fund Loan (sewer), Safe Drinking Water Fund Loan (water)
  - USDA Rural Development Loan Program

- Each option has pros and cons

Structuring Considerations – cont.

- Essential to managing the risk associated with debt issuance
  - Maturity guidelines
  - Debt Service Schedules
  - Use of credit enhancements
  - Use of redemption features
  - Use of capitalized interest

Structuring Considerations – cont.

- Term – number of years for repayment
  - Call feature
- Match payments with revenue availability
  - Typically semi-annual payments
- Existing debt
  - Demand for available revenues
  - Fund balance and tax impacts
  - Bond Covenants – often contain conditions that must be met before additional debt can be issued
- Be aware of statutory or regulatory constraints

Structuring Considerations – cont.

- Include all project costs (design, legal, land, construction, underwriter discount)
  - Can you offset costs with cash on hand or grants?

- Do you want to borrow to cover costs of issuance (municipal advisor, bond counsel, rating agency, other third party professionals)?

- Do you need to capitalize interest?
  - Borrowing for funds to pay interest until other revenue available
  - Potential buffer to fiscal impacts
  - Common approach for TIDs when revenue may be several years away

Debt Issuance Process

- Selection and use of professional service providers
- Determining method of sale & Timing
- Levy Impact
- Credit ratings

Debt Issuance Process – cont.

- Issuing debt may involve many entities:
  - Municipal Advisor
  - Bond Counsel
  - Disclosure Counsel
  - Purchaser
  - Rating Agency
  - Third Party Service Providers
    - Bond Registrar or paying agent
    - Trustee
- Policy should name and define the role of each participant.
- The Policy should elaborate on the selection process for consultants.

Debt Issuance Process – cont.

- Independent Municipal Advisor will assist in determining the method of sale

- Two primary options available for bringing a debt issue to market:

  – ***Competitive offering:*** terms and conditions of debt are pre-determined and the issue is marketed for potential purchase through submission of bids

  – ***Negotiated offering:*** Issuer selects a firm to underwrite and market the transaction in advance of the sale

Debt Issuance Process – cont.

Competitive Sale:

- Preferred method for “off-the-shelf” debt offerings
  - Market clearly understands the security and structure (i.e. G.O.)
  - Frequent issuer or highly-rated (“A” or above)

- Open and transparent process – underwriters (purchasers) compete on the basis of the lowest cost proposal

- Should be the default option unless circumstances dictate otherwise

Debt Issuance Process – cont.

Negotiated Sale:

- Debt may carry unusual features, structure, or other provisions
- Will finance a system or facility with no historical revenues
- Type of debt will only draw interest from select class of investor
- “Story” Bond – requires active marketing efforts of underwriting firm to draw investor interest

Debt Issuance Process – cont.

Debt Planning – Levy Impact:

- Borrowing for future capital projects may impact tax levy unless debt service offset by other source (i.e. utilities, TID, assessment, etc.)
- Recommended to undertake 5-10 year capital project planning that takes into consideration:
  - Estimated cost
  - Priority
  - Timing
  - Potential financing source
- ***Not meant to be a rigid plan, but rather a tool to complete a capital project plan with a predictable impact***

Debt Issuance Process – cont.

- May target mill rate rather than specific dollar amount of levy
- Large expansion of tax base can present opportunity to borrow while minimizing mill rate impact:
  - Closure of a tax increment district
  - Large development outside of a tax increment district
- Debt levy in dollar terms may go up, but impact for individual tax payer could be zero or even a reduction in taxes

Debt Issuance Process – cont.

Rating Process:

- Three main agencies assess relative risk of holding a municipality's debt:
  - Standard & Poor's
  - Moody's
  - Fitch (not commonly used in Wisconsin)
- Higher rating = more secure investment = lower interest rates
- ***Not all Issuers benefit from receiving a rating. Your municipal advisor can assist in making this determination and in the rating process if deemed beneficial.***

Debt Management Process

- Managing and investing bond proceeds
- Refunding bonds
- Post-issuance compliance
  - Arbitrage and yield restrictions
  - Continuing disclosure
- Market and investor relations
- Credit rating goals

Debt Management Process – cont.

Record Keeping:

- All issuers should maintain a complete debt inventory that includes (provided in Post-Sale Report and Closing Memo):
  - Original face amount
  - Amount outstanding
  - Interest rate(s)
  - Maturity dates/payment dates
  - Lender/bondholder(s)
  - Purpose and source of payment (levy, TIF, utilities, etc.)
  - Amount subject to pre-payment
  - Pre-payment terms
- Necessary for debt management and required by auditors to accurately present long-term obligations

Debt Management Process – cont.

Debt Refinancing:

- Refundings are undertaken for:
  - Debt service savings: reduce interest expense or shorten term
  - Restructuring purposes: better match resources to expenses
  - Re-cast bond covenants
  - Change of security; G.O. to revenue, or vice versa
  - Balloon extensions / Interim take-outs

Debt Management Process – cont.

- Current refundings
  - Issuer can execute as many current refundings per original issue as desired – no limit
  - Typically do not count against bank qualification limitations
  - Do not require funding of defeasance escrow

- Advance refundings
  - Issuers can execute only one tax-exempt advance refunding per original issue
  - Will typically count towards BQ limit, even if original issue was BQ
  - Requires funding defeasance escrow with third party bank or trust company (and CPA verification of sufficiency)

Debt Management Process – cont.

- Most common measurement is net present value (NPV) savings as percent of the refunded amount
  - Takes into consideration all costs and/or cash contributions
  - Discounts stream of savings to “today’s” dollars

- GFOA recommends 3.00-5.00% minimum

- Can also evaluate future value, or actual cash flow savings, for materiality

Debt Management Process – cont.

Post-Issuance Compliance:

- Two main areas of post-issuance compliance:
  - Arbitrage: relates to interest earned on bond proceeds
  - Continuing disclosure: relates to dissemination of certain financial information to the market
- Both can require action by issuer for years (entire life of the issue for continuing disclosure)

Debt Management Process – cont.

- Arbitrage Rules – Background:
  - Prohibit abuse associated with investing gross proceeds of a tax-exempt issue in higher yielding taxable securities (i.e. “arbitrage”)
  - Failure to comply can jeopardize tax-exemption of the bonds
  - Two Categories
    - Yield Restriction Requirements – Govern when an issuer can <u>earn</u> an investment return in excess of the bond yield
    - Rebate Requirements - Govern whether the issuer can <u>keep</u> those profits as opposed to rebating them back to the IRS

EHLERS
LEADERS IN PUBLIC FINANCE

Debt Management Process – cont.

- Continuing Disclosure – Annual Report
  - State and local governmental bond issuers may also (likely) be subject to a “Continuing Disclosure” requirement
  - In most cases, the Issuer must provide an “Annual Report” each year to the bond market (through a website, EMMA)
  - The “Annual Report” generally consists of (i) the latest audited financial statements, plus (ii) certain “operating data”

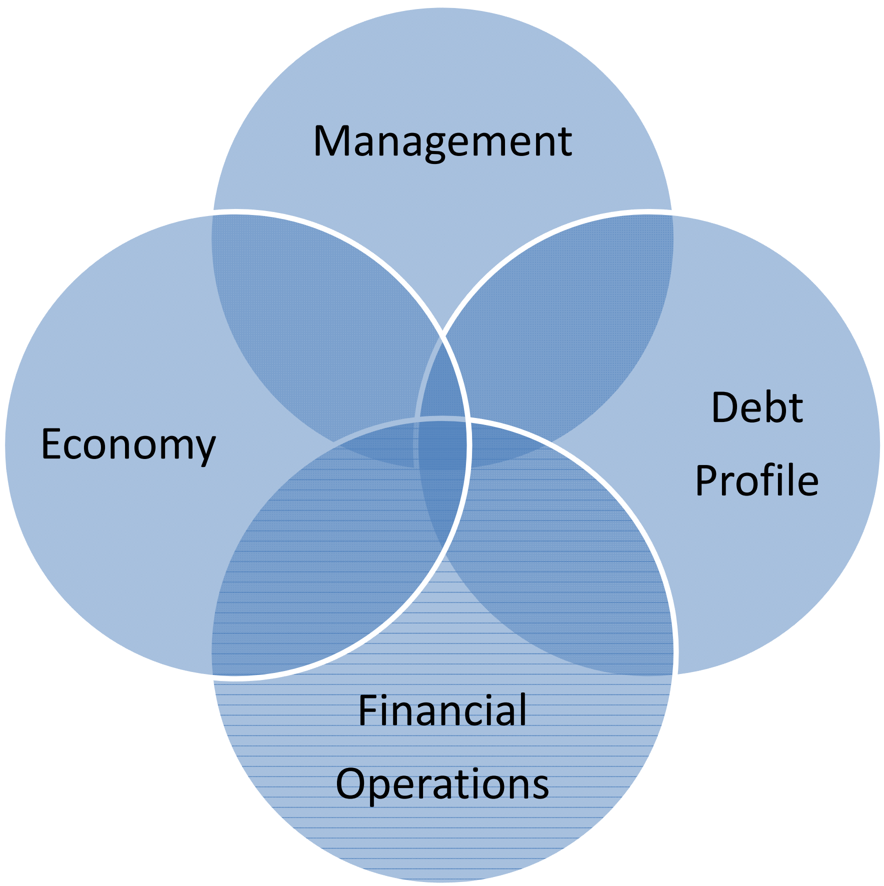
Debt Management Process – cont.

- Continuing Disclosure: Reportable Events
  - Issuers must also report certain events:
    - e.g., a redemption
    - e.g., a rating change

- Issuers must monitor for the occurrence of these events and must report them on EMMA within 10 days – call your financial professionals!

  - All the events are listed in the Continuing Disclosure Agreement

Debt Management Process - Rating Factors



EHLERS

LEADERS IN PUBLIC FINANCE

Phil Cosson

Senior Municipal Advisor

(262) 796-6161

pcosson@ehlers-inc.com

Dawn Gunderson

Senior Municipal Advisor

(262) 796-6166

dgunderson@ehlers-inc.com