Debt Administration

Local Government Finance Officer Certification Program Level I

- Introductory Governmental Accounting I
- Introductory Governmental Accounting II
- Debt Administration
- Purchasing
- Treasury Management
- Capital Investment Management

Road Map
Course Objectives

Define type of debt instruments

Recall Georgia statutes relating to debt issuance

Recognize bond-rating process and the players in the process

Identify the components of official statements used in debt offerings

Why Governments Borrow Money

Chapter 1
Chapter Objectives

- Identify why governments borrow money
- Recall the differences between short-term and long-term debt
- Identify how a CIP is valuable to the debt process
- Define debt policy
- Recognize why a CIP should be integrated into a debt policy

Why Borrow Money?

To finance infrastructure projects
- School buildings
- Streets and roads
- Government office buildings
- Higher education buildings
- Hospitals
Why Borrow Money?

To finance infrastructure projects

- Electric power-generating and transmission facilities
- Water treatment facilities and water and sewer infrastructure
- Low income housing

MUNICIPAL BOND CREDIT REPORT

LONG-TERM MUNICIPAL ISSUANCE BY GENERAL USE OF PROCEEDS

Short-term debt
• Will be repaid within one year
• Typically used for operating purposes
• Issued to cover operating short-falls, in anticipation of receipt of specific type of revenue
• Generally referred to as anticipation notes (discussed in Chapter 3)

Long-term debt
• Will not be repaid within one year
• Generally limited to financing capital projects
• Limited by State law –
  • How much debt can be issued?
  • For how long can debt be issued?
Long-Term v. Short-Term Debt

Long-term debt

- Promotes intergenerational equity
  - principle that users of a particular facility should be the same people who pay for facility
  - Example: Water & Sewer System

Capital Improvement Program

Capital Improvement Program (CIP) = Plan for capital expenditures to be incurred each year over a fixed period of several years (usually five to seven) to meet capital needs
Capital Improvement Program

CIPs generally

- Describe each project to be undertaken
- Identify the expected beginning and ending date of each project
- Set out the amount to be expended in each year
- Describe the method of paying for the expenditures

Capital Improvement Program

Why have a CIP?

- Provides an organized and practical method of planning and financing a government’s capital needs
Examples of Capital Assets

- Land
- Buildings
- Machinery & Equipment
- Furniture

Major Steps in Capital Decision Making Process

- Key dates
- Responsible parties
- Criteria for evaluating projects
- Projects
  - Contracted
  - Managed In-House
- Funding sources

Calendar
Prioritization
Management
Funding
Debt Policy

- A written set of principles and practices that guides and informs the debt issuance process
- Valuable management tool
- If debt policy is integrated with the CIP could lower interest costs by raising credit ratings

Debt Policy Components

Debt Limits*

- Legal Limits
  - State Constitution or law
  - Local charter, by-laws, resolution, or ordinance
- *GFOA recommended practice “Debt Management Policy”
Debt Policy Components

Debt Limits

Public Policy Limitations

- Purposes for which debt proceeds are used
- Types of debt issued or prohibited
- Relationship to CIP
- Goals, such as economic development v. governmental capital improvement financings

Financial Limits

- Reflect public policy considerations
- Represent financial resource constraints
- Generally expressed as ratios customarily used by credit rating agencies
  - Debt per capita
  - Debt to personal income
  - Debt to taxable property value
  - Debt service as a percentage of general fund revenues or expenditures
Debt Policy Components

Debt Structuring Practices

• Maximum term
• Average maturity
• Debt service patterns
• Use of redemption features
• Use of variable or fixed-rate debt, credit enhancements, derivatives, short-term debt, and limitations

Debt Policy Components

Debt Issuance Practices

• Criteria for determining the sale method (competitive, negotiated, private placement)
• Criteria for issuance of advance refunding and current refunding bonds
• Selection and use of professional service providers
Debt Policy Components

Debt Issuance Practices

• Use of comparative bond pricing services or market indices as a benchmark in negotiated transactions, as well as to evaluate final bond pricing results
• Use of credit ratings, minimum bond ratings, determination of the number of ratings, and selection of rating agencies

Debt Management Practices

• Investment of bond proceeds
• Compliance with primary and secondary market disclosure requirements
• Arbitrage and rebate monitoring and filing
• Federal and State law compliance practices
• Market and investor relations efforts
• Example: State of Georgia Debt
• Management Plan
Chapter 1 Summary

- Governments rely upon the issuance of debt to help finance basic infrastructure projects
  - roads, jails, administration buildings, schools, and hospitals
- Long-term debt issuance should be limited to financing capital projects

Chapter 1 Summary

Capital Improvement Plan (CIP) identifies projects to be financed
- CIP is a plan for capital expenditures to be incurred each year over a fixed period of several years (usually five to seven) to meet capital needs
Chapter 1 Summary

- Short-term debt (usually anticipation notes that will be repaid within one year)
  - Usually issued to cover current operating shortfalls, in anticipation of the receipt of some type of current revenues
- A debt policy
  - A set of principles and practices, which guides and informs the debt issuance process

Chapter 1 Summary

- Every government should have a formal debt policy.
  - The formal debt policy has the ability to reduce interest costs by improving credit ratings, especially when strongly tied to the CIP.
- CIP is valuable to debt process
  - Provides an organized and practical method of planning for and financing capital needs.
CHAPTER EXERCISES

Typical Methods of Financing Capital Projects

Chapter 2
Chapter Objectives

Identify the different sources available for capital projects funding

Recall the advantages and disadvantages of each source

Typical Funding Sources

- Grants
- Capital Contributions
- Low-Interest Loans
- Joint Ventures/Privatization
- Pay-As-You-Go Financing
- Debt Financing
- Sales Tax
Grants

- Advantage
  - Funds provided by federal or state government

- Disadvantages
  - Limited
  - Recordkeeping can be burdensome

Grants

Sources of grant information

- Regional Commissions
- ACCG
- GMA
- DCA
- GEFA
- GDOT
- Federal Government
Capital Contributions

Impact Fees
- Charge on new development to pay for the construction or expansion of capital improvements that will benefit the new development
- Georgia Law
- Georgia Department of Community Affairs


Low-Interest Loans

Examples:
- State Bond Banks (not currently in use in Georgia)
- State Revolving loan Programs
  - GEFA
Privatization/Joint Ventures

Privatization

- Complete transfer of service provision to a private company
- Most governmental services do not generate enough revenue for privatization

Joint Ventures

- Legal entity or other organization that results from contractual arrangement
- Owned, operated, or governed by two or more participants
- Separate and specific activity subject to joint control
- Participants retain ongoing financial interest and responsibility
Pay-As-You-Go-Financing

• Paying for capital projects with cash on hand
• Advantages:
  • Cost Savings of interest, fees and expenses of issuing debt
  • Financial Flexibility Preserved
    • Governments can decide revenues to obligate each year to fund capital projects

Pay-As-You-Go-Financing

Advantages
• Borrowing Capacity Protected
• Perception Credit Quality Enhanced
  • Possible favorable view by credit rating agencies because not overburdened with debt
Pay-As-You-Go-Financing

Disadvantages

- Insufficient funding for capital needs
- Discourages intergenerational equity
- “Lumpy” capital expenditures
- Sudden tax increases

Debt Financing

- Issuance of long-term debt (bonds)

  Advantages

  - Current revenues used each year for repayment of debt service rather than entire capital needs
  - Permits capital improvements to be implemented as needed, rather than when adequate cash is available
**Debt Financing**

**Advantages**

- Debt is repaid in reduced-value dollars since inflation reduces the value of money over time
  - Promotes intergenerational equity

**Disadvantages**

- Reduces financial flexibility – debt service requirements must be met
  - Limits future borrowing capacity
  - Perception of credit quality reduced
SPLOST Financing

Special Purpose Local Option Sales Tax

- Optional one percent county sales tax used to fund general governmental capital outlay projects
- May not be used for operating or maintenance expenses
- Primary intent is to pay for specifically enumerated projects

SPLOST Financing

- Tax is imposed when county board of commissioners call for a local referendum and referendum passes
- SPLOST is imposed on the sale of food and beverages
- May be levied for up to five years, or up to six years if intergovernmental agreement is signed between county and municipalities within county
SPLOST Financing

• Law is specific as to steps required to approve and implement a SPLOST
• Failure to adhere to procedures could result in SPLOST levy being susceptible to legal challenge

TSPLOST

• Transportation Local Option Sales Tax
• Created by Transportation Investment Act
• 12 districts
• Voter approval required
• Funds transportation projects
TSPLOST

• Voter referendum fails—local government must provide 30% match to received Local Maintenance Improvement Grants
• Voter referendum passes—local government must provide 10% match to received Local Maintenance Improvement Grants

TSPLOST

Effective July 2017 – any County not within a Transportation Investment Act region may impose a single county TSPLOST for transportation purposes
• Effective July 2016 for metro Atlanta Counties
• Counties must have regular SPLOST or MARTA tax in effect to impose a TSPLOST for transportation purposes
Chapter 2 Summary

Typical sources of funding capital projects include:

- Grants
- Capital contributions
- Low-interest loans
- Joint ventures/privatization
- Pay-as-you-go financing
- Debt financing
- Sales Tax

### Typical Sources of Funding Capital Projects

<table>
<thead>
<tr>
<th>Source</th>
<th>Advantage</th>
<th>Disadvantage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grants</td>
<td>Funds provided by Federal or State Government</td>
<td>Record keeping and reporting requirements</td>
</tr>
<tr>
<td>Capital Contributions</td>
<td>Capital asset contributed by developer</td>
<td>Does not cover full costs</td>
</tr>
<tr>
<td>Low Interest Loans</td>
<td>Low interest cost</td>
<td>Only available for certain projects</td>
</tr>
<tr>
<td>Joint Ventures</td>
<td>Allows pooling of resources to share risks</td>
<td>Not an option for all services</td>
</tr>
<tr>
<td>Pay-as-you-go financing</td>
<td>Save interest costs</td>
<td>May be insufficient funding</td>
</tr>
<tr>
<td>Debt Issuance</td>
<td>Allows capital projects to be completed in a</td>
<td>Reduced financial flexibility, Future borrowing capacity limited, Perception</td>
</tr>
<tr>
<td></td>
<td>timely manner, Frees current revenues for</td>
<td>of credit quality reduced</td>
</tr>
<tr>
<td></td>
<td>operating costs, Promotes intergenerational</td>
<td></td>
</tr>
<tr>
<td></td>
<td>equity, Repayment in reduced value dollars</td>
<td></td>
</tr>
<tr>
<td>SPLOST</td>
<td>Provides resources for pay-as-you-go financing.</td>
<td>Requires voter approval, Revenue available for approved projects only</td>
</tr>
<tr>
<td>TSPL OT</td>
<td>Provides resources for pay-as-you-go financing.</td>
<td>Requires voter approval, Revenue available for approved projects only</td>
</tr>
</tbody>
</table>
CHAPTER EXERCISES

Common Types of Debt Issued

Chapter 3
Chapter Objectives

Long-Term Debt
- Different types
- Advantages/Disadvantages

Short-Term Financing
- Options
- Advantages/Disadvantages

Common Types of Debt

Municipal Bonds
- General Obligation (GO) Bonds
- Revenue Bonds
- Notes or Short-Term Borrowings
- Special Assessment Bonds
- Capital Leases
- Certificates of Participation
General Obligation (GO) Bonds

- Debt instruments issued by state and local governments to raise money for capital improvements
- Backed by full faith and credit of issuing government
- Can be issued with SPLOST

General Obligation (GO) Bonds

- Tool to raise funds for projects that will not provide direct sources of revenue
  - Roads and bridges, parks, equipment, administration building
- Typically used to fund projects that will serve the entire populace
  - Not a particular entity of specific population group
General Obligation (GO) Bonds

- Advantages
  - Lower interest rate than other types of bonds
  - Low risk to investors since backed by taxing power of issuing government
  - Necessity of receiving approval through referendum
    - Confirms popular support
    - See Resources for reference to Georgia laws

General Obligation (GO) Bonds

Disadvantages

- Need for referendum could delay project
- Constrained by legal debt limitations
  - See Resources for reference to Georgia laws
- When paid from general tax revenues, taxpayers paying for project are not necessarily ones benefiting from project
Revenue Bonds

• Method of financing projects that have specific revenue stream
  • Water and sewer projects, sanitation projects
• Mature not longer than 40 years (compared with 30 years for GO Bonds)
• Make up majority of municipal bonds issued

Revenue Bonds

Characteristics:
• Revenue generated by projects pays principal and interest on bonds
• Projects generally serve only those who receive and pay for the specific service
• Legally secured by pledge of revenues, not full faith and credit of issuer
Revenue Bonds

Characteristics:
- Not subject to voter approval
- Not included in debt limitation calculations
- Interest rates generally higher than GO Bonds

Revenue Bonds

Other requirements
- Debt service reserve fund requirements
  - Amount required by bond documents to be maintained in debt service reserve fund
  - Money set aside if revenues not sufficient
- Feasibility studies
Revenue Bonds

Other requirements

- Coverage requirements
  - Issuer’s commitment to maintain rates/charges
  - Net revenues divided by annual debt service
  - Higher coverage requirements may be required for systems/projects with less dependable revenue streams

Revenue Bonds

Other requirements

- Additional bond tests
  - Imposed before more bonds can be issued if secured by same revenues
  - Revenues must be sufficient for current bonds plus new bonds
Debt Administration

Additional Parity Bonds. Except as provided below, the Authority covenants and agrees that it will not borrow upon any other certificates, bonds, or obligations of any kind or nature payable from the reserve fund the net earnings from any other source or sources, nor pledge the reserve fund for payment of any bonds of any kind or nature.

The Authority reserves the right from time to time, in its sole discretion, to issue Additional Parity Bonds ranking pari passu with the lien thereon of Series 2010 Bonds in an unlimited amount.

(a) The payments required to be made into the Reserve Fund, as the same may have been enlarged and extended in any proceeding authorizing the issuance of any Additional Parity Bonds, must be currently being made in the full amount as required and such funds must be at their proper balances immediately prior to the issuance of such Additional Parity Bonds.

(b) The Authority reserves the right, from time to time, to issue Additional Parity Bonds ranking pari passu on such moneys in an unlimited amount, provided that all of the following conditions are met:

(i) The Authority shall authorize the issuance of such Additional Parity Bonds and shall provide in such proceedings, among other things, the date and the rate or rates of interest such Additional Parity Bonds shall bear, and the payment dates, maturity dates and redemption provisions with respect to such Additional Parity Bonds and any other matters applicable thereto as the Authority may deem advisable.

(ii) Such Additional Parity Bonds and all proceedings relative thereto, and the security therefor, shall be validated as prescribed by law.

(iii) The Chairman or Vice Chairman of the Authority shall execute simultaneously with the issuance of such Additional Parity Bonds a certificate certifying either (i) that the Authority’s Historical Pro Forma Debt Service Coverage Ratio for each of the Authority’s two most recent fiscal years preceding the date of issuance of such Additional Parity Bonds is at least 1.10:1, or (ii) that the Authority’s Projected Debt Service Coverage Ratio for each of the Authority’s two succeeding fiscal years will be at least 1.10:1.

(iv) The Authority shall deposit and maintain in the Reserve Account an amount equal to the Maximum Annual Principal and Interest Requirement coming due in any succeeding Sinking Fund Year on the outstanding Bonds and the Additional Parity Bonds in accordance with Section 502; provided, the Authority may at any time fulfill any portion of its obligation to fund the Reserve Account by depositing in the Reserve Account a Reserve Account Surety Bond as provided in Section 502.

Example: Additional Bonds Test

Revenue Bonds

Advantages

• Financing is not delayed by need for voter referendum
• Self-supporting revenue bonds are not counted toward debt limits
• Responsibility for repaying bonds is distributed only among the users of the project
Revenue Bonds

Disadvantages

- Higher costs when compared to GO Bonds
- Generally, if issuer defaults on bonds, government is not legally responsible
- Require more preparation and administration than GO Bonds
- Citizens do not have opportunity to approve/disapprove since no referendum

Special Assessment Bonds

Issued to finance capital improvements that benefit taxpayers in a particular, carefully defined area of the community

- Examples
  - CIDs—Community Improvement Districts
  - TADs—Tax Allocation Districts
- Can be risky if too few property owners
Capital Leases

- Widely used to acquire equipment and facilities
- Advantages
  - Do not require voter approval
  - Easy, effective method of obtaining funding
  - Non-appropriation clause

Example:

- Non-Appropriations Clause

Contractor acknowledges that County is a governmental entity, and the contract validity is based upon the availability of public funding under the authority of its statutory mandate. In the event that public funds are unavailable and not appropriated for the performance of County’s obligations under this contract, then this contract shall automatically expire without penalty to County thirty (30) days after written notice to Contractor of the unavailability and non-appropriation of public funds. It is expressly agreed that County shall not activate this non-appropriation provision for its convenience or to circumvent the requirements of this contract, but only as an emergency fiscal measure during a substantial fiscal crisis, which affects generally its governmental operations.
Capital Leases

Disadvantage

• High interest rates

Certificate of Participation (COPs)

• Specialized form of lease-purchase agreement
• Individual investors buy a share of the lease revenues, rather than interest in project or bonds
• Each certificate represents a proportional interest in the payments that are due under the lease
Anticipation Notes

• Short-term obligations
• Issuer repays a specified principal amount on certain date, together with interest at a stated rate
• Usually payable from defined source of anticipated revenues
• Georgia law—See Resources page

Anticipation Notes

• Examples
  • BANs—bond anticipation notes
  • GANs – grant anticipation notes
  • RANs—revenue anticipation notes
  • TANs—tax anticipation notes
  • TRANs – tax and revenue anticipation notes
• Advantages
  • Marketed quickly and easily
  • Low costs
Anticipation Notes

- Disadvantage
  - Overdependence by governments

- Avoiding overdependence
  - Proper budgeting of revenues and increasing taxes (if necessary) each year
  - Maintain recommended general fund unrestricted fund balance
    - GFOA now recommends minimum of 2 months
      - General Fund operating revenues
      - General Fund operating expenditures

Chapter 3 Summary

- Two types of municipal bonds
  - General Obligation (GO) Bonds
  - Revenue Bonds

- GO Bonds backed by full faith and credit of issuing government
  - Any revenues available for principal and interest payment

- Revenue Bonds have specific revenue stream to repay principal and interest
Chapter 3 Summary

- A special assessment
  - An improvement to a property, usually at property owner’s request, for which bonds are issued to pay for cost of improvement
  - Lease-purchase financing is utilized by many governments to acquire equipment and facilities

- A Certificate of Participation (COP)
  - A specialized lease-purchase arrangement in which an individual buys a share of the lease revenues rather than the bond being secured by those revenues

- Short term note
  - Short-term obligation of an issuer to repay to specified principal amount on a certain date, together with interest at a stated rate, usually payable from a defined source of anticipated revenues
## Chapter 3 Summary

<table>
<thead>
<tr>
<th>Debt</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue Bonds</td>
<td>No delays in financing, Not counted towards debt limit, Repayment of debt is spread among users</td>
<td>Higher interest than GO bonds, Does not require public approval</td>
</tr>
<tr>
<td>General Obligation Bonds</td>
<td>Low interest, Approval of voters</td>
<td>Delays financing, Legal debt limits</td>
</tr>
<tr>
<td>Special Assessment Bonds</td>
<td>Owners pay for improvements to land</td>
<td>Higher likelihood of default</td>
</tr>
<tr>
<td>Capital Lease</td>
<td>Does not require voter approval, Easy method of financing capital purchases</td>
<td>Higher interest rates</td>
</tr>
<tr>
<td>Certificate of Participation</td>
<td>Provides tax-free investment option</td>
<td>Lessor retains a security interest in the asset</td>
</tr>
<tr>
<td>Short Term Notes</td>
<td>Marketed quickly at a low cost</td>
<td>Overdependence by governments</td>
</tr>
</tbody>
</table>

### CHAPTER 3 EXERCISE
The Rating Process

Chapter 4

Chapter Objectives

Recall the definition of a bond rating

Define the various bond rating designations

Recall how ratings are obtained

Identify the available credit enhancements
Bond Ratings

- An opinion of the ability and willingness of the issuer of the bonds to make timely payments over the life of the bonds
- Three largest rating agencies
  - S&P
  - Fitch
  - Moody’s
Bond Ratings

- Include descriptions and characteristics of the bond issuer
  - Financial
  - Administrative
  - Economic
  - Demographic

- Designed to be a simple and standardized method of communicating risk

<table>
<thead>
<tr>
<th>Bond Ratings</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Moody's</strong></td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td><strong>Best Quality</strong></td>
</tr>
<tr>
<td><strong>High Quality</strong></td>
</tr>
<tr>
<td>AA2</td>
</tr>
<tr>
<td>AA3</td>
</tr>
<tr>
<td><strong>Upper Medium Grade</strong></td>
</tr>
<tr>
<td>A2</td>
</tr>
<tr>
<td>A3</td>
</tr>
<tr>
<td><strong>Medium Grade</strong></td>
</tr>
<tr>
<td>Ba2</td>
</tr>
<tr>
<td>Ba3</td>
</tr>
</tbody>
</table>
How Are Ratings Obtained?

Conversations between investment banker and bond rating agency analysts
  • Investment banker describes transaction
  • Analysts provide feedback on likelihood of favorable rating and the factors that would weigh positively or negatively in the final determination

Steps in the Process
  1. Rating application
  2. Analytical team assigned
  3. Collection of information
  4. Interaction with issuer
  5. Analysis
  6. Rating committee
  7. Rating notification
  8. Rating dissemination
  9. Surveillance
Information Needed for Ratings

- Local or regional economic conditions
- Issuer’s general debt structure and current debt information
  - CIP
  - All outstanding bonds
- Financial condition of the issuer
  - Three years of audited financial statements (at least)
  - Current budget information

Information Needed for Ratings

- Local or regional demographic factors
- Management practices of governing body and administration, including description of administrative structure
- Specific transaction structure and documentation
Credit and Rating Enhancements

Credit enhancement

- Process of reducing credit risk (and potentially increasing credit ratings) by providing collateral, insurance, or other agreements
  - Provides investors with additional assurance that they will be compensated in the event the government is unable to pay the bonds
- Two primary types
  - Bond insurance
  - Letters of credit

Bond Insurance

- Purchased through an upfront one-time payment of an insurance premium at the time of the bond closing
- Bond ratings are based on the credit of the bond insurance company, rather than on the underlying credit of the issuer
- Guarantees principal and interest will be paid as scheduled
Bond Insurance

- Cost-effectiveness depends
  - Interest cost savings exceed premium
  - For smaller governments, may be cheaper and simpler than applying for credit rating
- Premiums are not cheap
  - .1% to 2% of combined principal and interest payable over life of bonds

Bond Insurance

- Advantages
  - Improved credit rating on the issue
  - Results in lower interest costs
- Disadvantages
  - Must pay upfront insurance premium
  - Premium can be expensive
  - Sometimes not cost effective
Letters of Credit

- Unconditional pledge of a bank’s credit to make principal and interest payments of specified amount for specified period of time
- Two types
  - Direct pay
  - Standby

Example: Letter of Credit
Letters of Credit

- Direct Pay Letters of Credit
  - All debt service payments made by draws on letter of credit
  - Issuer reimburses bank for such payments
- Standby Letters of Credit
  - Issuer has primary responsibility for making debt service payments
  - Letter of credit drawn on if issuer defaults

Letters of Credit

Banks charge two fees for letters of credit

- Commitment fee
  - One-time payment made when bonds are issued
  - Usually ranges from .25% to 1% of debt amount
- Draw-down (Drawing) fee
  - Specified amount due for each draw payable at time of draw
  - Interest charge due for time between draw and reimbursement
Letters of Credit

Advantages

• Improves the bond’s credit rating
  • Bonds take rate of the bank
• Simplifies an otherwise complicated security arrangement

Letters of Credit

Disadvantages

• Fee can be substantial
• Must be renewed every 3-5 years
• May not be able to find a bank willing or able to issue letter of credit
• Acceleration of payment in event of failure to reimburse bank for draws
Chapter 4 Summary

Bond rating
- an opinion of the ability and willingness of an issuer of bonds to make timely payments over the life of the bonds
- Given at the request of the issuer

Rating designation
- Communicates a rating agency’s opinion about the risk of the bonds

Chapter 4 Summary

Information needed for ratings includes
- local or regional economic condition
- general debt structure and levels
- financial condition of the issuer
- local or regional demographic factors
- management practices and governmental administration
- specific transaction structure and documentation
Chapter 4 Summary

• Credit enhancement
  • process of reducing credit risk by requiring collateral, insurance, or other agreements to provide bond investors with assurance that they will be repaid

• Two types of credit enhancement
  • bond insurance and letters of credit

Chapter 4 Summary

• Bond insurance
  • Guarantees the payment of principal and interest on a bond issuer if the issuer defaults

• Letters of credit
  • Financial instruments used by a government to substitute the credit risk of the provider of the letter of credit (usually a bank) for a weaker issuer
The Players

Chapter 5
Chapter Objectives

Recall the roles and responsibilities of
- Municipal advisors
- Bond counsel
- Underwriters
- Underwriters counsel
- Paying agents, registrars, trustees
- Securities depositories

Who Are the Players?

- Municipal Advisors
- Bond counsel
- Underwriter
- Underwriter’s counsel
- Trustee, paying agent and bond registrar
- Securities depository
Municipal Advisor

- Indispensable part of the financing team
- Prior to the 2010 Dodd-Frank Act, activities were largely unregulated
- SEC adopted new rules effective July 1, 2014
  - Seek to protect interests of municipal entities
  - Imparts that municipal advisors have explicit fiduciary duty to government clients
  - Municipal advisor prohibited from serving as underwriter on issuance

Municipal Advisor

- Serves as the government’s “bond market” expert
- Should generally be first professional retained
- Come from
  - Investment banking firms
  - Commercial banks
  - Independent financial advisory firms
Municipal Advisor

- Independent from financial interest in transaction
- No involvement with underwriting, trading and sales of bonds
- Hiring process
  - Selected by issuing government
  - Often through RFP process

Municipal Advisor

Role of Municipal Advisor
- Serves as independent financial consultant to issuing government
- Protects issuer’s financial interest during entire bond issuance process
- Assists with major decisions
  - What type of debt to issue
  - How to structure the debt
  - Whether to use competitive bid or negotiated sale
Municipal Advisor

Common methods of compensation

- Flat-dollar amount per bond issued
  - Municipal Advisor benefits if transaction is large
  - Lack of perceived independence from transaction
  - Not the preferred method
- Hourly Basis/Fixed Fee
  - Paid hourly rate with a “not-to-exceed” amount
  - Preferred method of paying Municipal Advisor

Bond Counsel

"You knew I was a lawyer when you hired me."
**Bond Counsel**

- Hired and compensated by the bond issuer
- Key player and selected early in the process
- Issues one or more opinions on the bond offering
- Typically a specialized law firm hired by the issuer to prepare the legal opinions

**Role of Bond Counsel**

- Prepares and oversees bond proceedings
- Obtains required government approvals
- Ensures the issuer properly authorizes the issuance of the bonds and meets all legal requirements relating to bond issue
- Interprets relevant regulations and laws
- Assists in structuring bond issue
- Drafts key financing documents
Bond Counsel

- Common Methods of Compensation
  - Percentage of bonds sold
  - Hourly basis
  - Fixed fee
- How Selected
  - RFP is preferred method
  - GFOA recommended practice—Selecting Bond Counsel at www.gfoa.org

Underwriters

- Securities dealer helps the issuer bring bonds to market
- Key role is to buy bonds from issuer and resell to investors
- Usually investment firm or securities subsidiary of commercial bank
Underwriters

Selection of Underwriters

- Depends on type of sale
- Competitive Bid
  - Submit sealed bid
  - Identify not known until bids are opened
- Negotiated Sale
  - Selected by issuer prior to sale date

Underwriters

Compensation of Underwriters

- Depends on type of sale
- Competitive Bid
  - Part of bid price
- Negotiated Sale
  - Paid underwriting spread
  - Underwriting spread has four components
    - Management fee
    - Underwriting fee
    - Takedown
    - Expenses
**Underwriters’ Counsel**

- Represents underwriters in negotiated sale
- Prepares the bond purchase agreement
  - Contract for selling bonds to underwriter and how underwriter will resell bonds

**Other Players**

- Paying Agent
- Bond Registrar
- Trustee
- Securities Depository
- Printer
Chapter 5 Summary

• Municipal Advisor
  • Helps issuer make most crucial decisions
    • What type of debt to issue
    • How to structure debt
    • Whether to use a negotiated sale or competitive bid process

• Bond Counsel
  • Hired and compensated by issuer
  • Issues an opinion on bond offering

Chapter 5 Summary

• Underwriter
  • Key role is to buy the bonds from the issuer and resell to investors

• Paying agent
  • Responsible for transmitting payments from issuer to security holders

• Registrar
  • Responsible for maintaining records to identify owners of registered bonds
Chapter 5 Summary

• Trustee
  • Financial institution serving as custodian of funds for benefit of bondholders

• Securities depository
  • Clearing agency registered with SEC provides
    • Immobilization
    • Safekeeping
    • Book-entry services
    • Used as an alternative to paying agent/registrar

CHAPTER 5 EXERCISE
Chapter Objectives

Recall methods, including advantages and disadvantages of:

- Competitive bid
- Negotiated sale
- Private placement
**Competitive Bid**

- Issuer prepared bond issue structure
- Publishes a notice of sale requesting bids from underwriters
- Underwriters submit closed bids to issuer
- Bond awarded to best bidder
  - Lowest true interest cost
  - Winning underwriter resells bonds

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**Competitive Bid**

When to use competitive bid

- Market is familiar with issuer, issuer is stable and regular borrower
- Active secondary market in which to resell bonds
- Issuer has unenhanced credit rating of A or above or can obtain credit enhancement
**Competitive Bid**

When to use competitive bid

- Debt structure is backed by issuer’s full faith and credit or historically strong and performing revenue stream
- Issue is not too large or too small
- Issue not complex
- Interest rates are stable, market demand is strong

**Competitive Bid**

Advantages

- Promotes appearance of open and fair process
- Bonds are sold at the lowest interest cost given market conditions at time of sale
Competitive Bid

Disadvantages

- Inflexible to restructuring maturity schedules and interest rates after bonds are awarded
- Does not encourage underwriters to participate in substantial pre-marketing efforts
- Issuer has less control in determining underwriting firm and how bonds are resold to investors

Negotiated Sale

- Issuer works with single underwriter
- Selected underwriter assists issuer with
  - Structuring bond issue
  - Preparing official statement
  - Obtaining bond rating
- Underwriter engages in presale marketing and negotiates interest rates with issuer
Negotiated Sale

When to use Negotiated Sale
- Issuer has poor credit
- Unusually large or small bond issue
- New entity
- Unusual financing terms
- Innovative structure or security

Advantages
- Underwriter is able to engage in presale marketing efforts prior to bond sale
- Allows more flexibility in underwriter selection
- Increases flexibility for issuer with sale date and bond structure
Negotiated Sale

Disadvantages

- May appear biased
- Issuers often do not have adequate information to negotiate effectively with underwriters

Private Placement

- Government markets bonds directly to investors
  - Commercial banks
  - Insurance companies
- Used when a public bond sale is
  - Too expensive
  - Likely to be ineffective
Private Placement

- Higher interest costs
- Lower disclosure requirements
- Faster sales process

Chapter 6 Summary

- Competitive bid process involves the issuer, usually assisted by municipal advisor, with structuring bond issue and publishing notice of sale
- Negotiated sale
  - Issuer works with single underwriter
- Private placement
  - Government markets bonds directly
### Chapter 6 Summary

<table>
<thead>
<tr>
<th>Method of Sale</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitive Bid</td>
<td>Fair process, Low interest cost</td>
<td>Does not allow for restructuring maturity dates and interest rates after bonds are awarded, No premarketing, No choice of underwriter selected</td>
</tr>
<tr>
<td>Negotiated Sale</td>
<td>Pre-marketing, Allows some choice in underwriter selected, More flexibility with bond structure</td>
<td>May appear biased, Issuers may not have enough information to effectively negotiate</td>
</tr>
<tr>
<td>Private Placement</td>
<td>Faster sale process, Disclosure may not be as stringent</td>
<td>Higher interest rates, more restrictive debt covenants</td>
</tr>
</tbody>
</table>

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**CHAPTER 6 EXERCISE**
Bond Structuring Interest and Maturities

Chapter 7

Chapter Objectives

Define terms describing elements of bond structuring

Recognize different types of maturity schedules
Debt Structure

Refers to duration and timing of principal and interest payments

- Maturity dates
- Serial bonds or term bonds
- Provisions for calling the bonds

Maturity

- The date bond must be repaid
- Maturity matching principle
  - Debt maturity should approximately coincide with useful life of project being financed
Fixed-Rate Bonds

- Each maturity in bond issue has a set interest rate that does not fluctuate throughout life of bonds.
- Two types of fixed-rate bonds:
  - Serial
  - Term

Serial Bonds

- Series of bonds that mature in regular pattern, usually over entire life of bond issue.
- Interest paid at regular intervals, usually semi-annually.

See Exhibit 7-2
Fixed-Rate Bonds

Term Bonds

• Single final maturity date when the entire principal is repaid
• Usually requires use of sinking fund redemptions

See Exhibit 7-2

Debt Service Structure

• Schedule of table listing periodic payments
  • Principal/interest requirements over life of bonds
• Types of debt service structures
  • Level debt service
  • Level principal
  • Graduated principal
  • Principal deferral
**Level Debt Service**

- Principal and interest relatively constant over life of bonds
- Easier to budget or project amount of tax revenues needed

See Exhibit 7-3

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**Level Principal**

- Principal is constant
- Interest due declines

See Exhibit 7-3
Graduated Principal

- Little or no principal payments in early years
- Principal payments increase in later years
- Use when have service financed with revenue bonds and will take few years to reach revenue collections sufficient to pay debt service
- Higher interest costs due to more principal outstanding for longer period of time

Deferred Principal

- Deferral of principal for a given period of time, such as construction period
- Higher interest costs
Variable Rate Bonds

- Called “floaters”
- Act like short-term notes
- Interest rate is adjusted on prearranged dates
  - Can tender bonds for repayment on interest rate adjustment date
  - If hold bonds, new interest rate applies
- Typically secured by letter of credit
- Risks include interest rate risk and lack of market risk

Chapter 7 Summary

- Maturity
  - The date on which the principal of the bond must be repaid
- Fixed-rate bonds
  - Have a set interest rate that does not fluctuate throughout the life of the bond
- Serial bond issue
  - Series of bonds that mature in a regular pattern, usually annually over the entire life of the issue
Chapter 7 Summary

- Term bond issue
  - Single final maturity date when the entire principal will be repaid for all the bonds in the issue

- Debt service structure
  - Schedule or table listing the periodic payments necessary to meet principal and interest requirements over the period of time bonds are to be outstanding

Chapter 7 Summary

- Level debt service structure
  - Combined annual amount of principal and interest payments remains relatively constant over the life of the bonds

- Deferred principal
  - All principal payments deferred for a given period

- Variable rate bonds
  - Act like short-term notes because they have short-term interest rates
CHAPTER 7 EXERCISE

Bond Documents

Chapter 8
Chapter 7 Summary

Recall various elements of following bond documents:

- Bond resolution
- Notice of sale
- Bond purchase agreement
- Continuing disclosure agreement
- Tax certificate
- Official statement

Bond Resolution

- Document adopted by the issuer’s governing body authorizing the issuance and sale of the bonds
- Includes
  - Form of the bonds
  - Dollar value of the bonds
  - Security supporting the repayment of the bonds
  - Approval of the offering documents
  - Approval of the terms of the sale
- Bond Resolution.pdf
Notice of Sale

• Publication by the issuer describing the terms of a competitive bid of an issue of bonds
  • Notice of Sale.pdf

Notice of Sale

• Includes
  • Date and time of sale
  • Description of bonds, including redemption provisions
  • Form and payment of bonds
  • Good faith deposit
  • Basis of the award
  • CUSIP numbers
  • Approving opinion
  • Official statement
  • Timing and method of the delivery of the bonds
  • Credit enhancements, if any
  • Bond counsel and municipal advisor
**Bond Purchase Agreement**

- Used in a negotiated sale
- Contract between the underwriter and the issuer describing the final terms, prices, and conditions upon which the underwriter will purchase and resell the bonds
  - [Bond Purchase Agreement.pdf](#)

**Continuing Disclosure Agreement**

- Underwriters cannot purchase bonds unless the issuer has agreed, in writing, to provide ongoing disclosure
- Underwriter must make a reasonable determination at the time of issuance of the bonds that there will be continuing disclosure
  - [Continuing Disclosure Certificate.pdf](#)
Official Statement

• Disclosure document
  • Prepared by or for the issuer
  • Describes the bond issue, the economic, financial, and social characteristics of the issuer, and the security for the bonds

• Disclosure
  • Principle that accurate and complete information that investors may need to make an informed investment must be made available to potential investors

• Official Statement.pdf

Official Statement

• Underwriters use a “preliminary” official statement (POS) in negotiated sales to market bonds to potential investors

• POS differs from the final Official Statement in that it can omit certain information that will not be known until the time of sale of the bonds
Tax Certificate

• Provides information about the bond issue that supports bond counsel’s opinion relating to the tax status of the bonds
  • Taxable v. Tax-Exempt
  • Tax Certificate.pdf

Chapter 8 Summary

• Bond Resolution
  • Governing body’s authorization for the issuance and sale of bonds

• Notice of Sale
  • Publication by the issuer describing the terms of a competitive sale (bid)

• Bond Purchase Agreement
  • contract between the underwriter and issuer in a negotiated sale
Chapter 8 Summary

• Disclosure
  • Principle that accurate and complete information must be available to purchasers or prospective purchasers

• Tax Certificate
  • Contains facts and certifications of issuer that are relied upon by bond counsel to deliver opinion

• Official Statement
  • Final disclosure document prepared by issuer

CHAPTER 8 EXERCISE
So, Am I Done Yet?

Chapter 9

Chapter 8 Summary

Recall the bond proceed investment provisions

Define arbitrage and how it relates to bonded debt

Recognize continuing disclosure requirements
**Introduction**

- An issuer's responsibilities do not end with the delivery of the bonds on the closing date
- Each bond issue has disclosure requirements until the final maturity
- Events and requirements occurring after the sale should be considered important components of the debt administration program

**Investment of Bond Proceeds**

- On the closing date, the issuer will receive “net proceeds” from the sale of the bonds
- First post-sale responsibility = invest the proceeds
  - Investment should follow the investment policy of the government
  - Identify personnel responsible for investments
    - Conform to all legal, statutory, and regulatory requirements
  - Investment schedule should reflect the anticipated need to access funds for the capital project
Arbitrage Restrictions

- Arbitrage restrictions = determining whether yield on investments acquired with bond proceeds must be restricted
  - Arbitrage = spread between the tax-exempt interest rate on the bonds and the rate on investments
  - Question to ask – can you earn it?
  - Generally, the yield on the investment of proceeds must be limited to the yield on the bonds

Rebate Requirements

Rebate requirements = determining whether interest earned on investments must be rebated (or paid) to IRS

- If you earn it, do you have to pay it to the IRS?
- YES! Paid to IRS every five years and within six months after the final maturity of the bonds
- Penalties for noncompliance
Continuing Disclosure

Secondary Market Disclosure – U.S. Securities and Exchange Commission Rule 15c2-12 bars underwriters from buying municipal securities unless the issuer agrees in writing to provide continuing disclosure of certain material information (“continuing disclosure undertaking”)

Annual financial information – at time municipal securities offered for sale, continuing disclosure undertaking must describe:

• Type of information to be provided
• Accounting principles used to prepare financial statements and timing of statements
• Date in each year by which annual financial information will be provided
• Who will be providing the information
• Listed Events – specified in the Rule
Continuing Disclosure

- Underwriters are obligated to “reasonably determine” that issuer or obligated person has undertaken, in written agreement or contract, for benefit of bondholders, to provide continuing disclosure
- Issuers provide information to the (MSRB)
  - via the MSRB’s Electronic Municipal Market Access System (EMMA)
Maintaining Relations

- Bondholders and ratings agencies have an on-going interest in the issuer’s debt management practices
- GFOA has a recommended practice – Maintaining an Investor Relations Program
- Rating agencies monitor bond issues on a regular basis and can revise bond ratings based on these reviews

Chapter 9 Summary

- Issuer receives net proceeds of bond issue
  - These proceeds have to be invested
- Arbitrage earnings—spread between tax-exempt interest rate and investment interest rate
  - Unless certain exceptions are met, must be rebated to IRS
Chapter 9 Summary

SEC Rule 15c2-12 bars underwriters from buying municipal securities unless issuer has agreed, in writing, to provide continuing disclosure of certain material information
The What, Why, and When of Refunding Bonds

Chapter 10

Chapter Objectives

Define refunding

List the reasons for refunding

Identify types of refunding
Refunding Defined

A bond financing procedure in which the issuer refines all or certain maturities of an outstanding bond by issuing new bonds

- Proceeds of the new bonds can be used to immediately retire the old debt
- Alternatively, proceeds of the new bonds can be used to purchase securities with cash flows that are used to pay off the old bonds as they mature

Georgia Law and Refunding's

- Maturity of the refunding bonds
  - Cannot extend past the final maturity of the original bonds
- Refunding bonds
  - Cannot be issued at an interest rate higher than the original debt
Georgia Law and Refunding's

Principal amount of the refunding bonds

- Cannot exceed the principal amount of the original bonds except to reduce the total principal and interest payments over the remaining term of the original bonds

Reasons for Refunding

- To take advantage of more favorable interest rates
- To change the structure of debt service payments
- To escape from unfavorable bond covenants
Reasons for Refunding

To take advantage of more favorable interest rates
• Drop of 2 to 2.5%, explore refunding
• Include issuance costs in analysis

Reasons for Refunding

To change the structure of debt service payments
• Can indicate credit weakness
• Consider alternatives
  • Tax increases
  • User fees
  • Interfund loans
  • One-time transfer of operating reserves
Reasons for Refunding

To escape from unfavorable bond covenants

- A covenant is a clause in a bond document that either requires or forbids an act
- Common covenants is the debt service coverage ratio
  - Coverage ratios are the promises an issuer makes regarding the maintenance of fees or charges at levels necessary to pay debt service

Types of Refunding

- Current Refunding
- Advance Refunding
Types of Refunding

Current Refunding
- Proceeds of new debt immediately redeem old debt
- Federal tax law definition
  - Refunding in which prior bonds are called or mature within 90 days after issuance of refunding bonds

Types of Refunding

Advance Refunding
- Refunding that is not a current refunding
- Most common type
- Original bonds refinanced prior to call or maturity date
- Proceeds are escrowed and used to pay old bond
Chapter 10 Summary

- Refinancing of bonds is called refunding
- Three primary reasons to refund debt:
  - More favorable interest rates
  - Change structure of debt service payments
  - Escape from unfavorable bond covenants

Chapter 10 Summary

- Two types of refunding
  - Current
  - Advance
- Current
  - Old bonds are paid off immediately with funds from new bonds
- Advance
  - Funds are escrowed and payments are made on old debt from escrowed funds
CHAPTER 10 EXERCISE

QUESTIONS?
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Thank You!

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