

MUNICIPAL DEBT ESSENTIALS
Day 2: : PLANNING A BOND SALE
Debt Policy and Plan of Finance

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What We Will Cover

- Debt policies
- Debt capacity
- The plan of finance
- Practice (after the break)

Debt Policies



Purpose of Debt Policy

- Creates tools to reconcile capital needs with available resources
 - When to use “pay as you go” versus issuing debt
 - Takes a longer view of resource allocation
- Establishes some basic parameters and principals
 - When, why and how debt can be issued
 - Amount, type, issuance process, management of the debt portfolio
 - Promotes objectivity in the decision-making process
- Educates stakeholders
 - Explains the what, why and how of the process to non-finance staff, elected officials and the public
 - Provides an opportunity to discuss policy elements
 - Increases transparency to stakeholders

Why Policies Can be Powerful

- Guiding principles are a place to start
 - Policies help make difficult decisions easier by establishing values and priorities before they are placed under stress by adverse circumstances
 - All modern cultures maintain a written scripture of inherited wisdom
 - Policies provide a place to record lessons for future generations
 - Not every life lesson needs to be learned from experience
- Board approved policies provide protection against political expediency
- Regulators, rating agencies and other second-guessers love written policies
 - “Demonstrates” sound financial management to rating agencies and investors

“Good judgement is the result of experience and experience the result of bad judgement”

--Mark Twain

What Should be Included in Debt Policy?

- Debt objectives
- Debt instruments
- Debt capacity
- Debt structure
- Debt issuance process
- Debt Management
 - Refunding
 - Tax covenants
 - Disclosure covenants
 - Other covenants
- Resources
 - <http://www.gfoa.org/debt-management-policy>
 - <http://www.treasurer.ca.gov/cdiac/publications/policy.pdf>

Debt Objectives

- How will the agency determine whether to issue debt?
 - Integration of capital planning and debt financing activities
 - Funding options, including debt, evaluated on case-by-case basis
- Type of debt authorized and the authorization process
- Striking the balance
 - Current resources (pay-as-you-go) vs. future resources (debt)
 - Current users vs. future users (generational equity)
 - Investment vs. deferral
- Limits on indebtedness
 - Imposed by State and/or federal law
 - Affordability constraints
 - Limits imposed by parity debt covenants

What Type of Debt Should be Covered by Policy?

- Direct debt
 - General Obligation Bonds
 - Appropriation debt (e.g., lease revenue obligations)
- Revenue Debt
- Variations on the theme
 - Long-term and short-term
 - Fixed-rate and variable-rate
 - Publicly offered and privately placed
- Other debt to consider
 - Conduit Debt
 - State and Federal subsidized borrowing programs
 - Interfund Borrowing

Debt Structure

- Term
 - Should not exceed useful life of asset
 - More rapid amortization creates future capacity
- Repayment pattern
 - Level debt service
 - Escalating debt service
 - Wrapping around existing debt
- Deferral of principal
 - Capitalized interest until completion of project
 - Capital appreciation bonds
- Redemption features
- Coupon structures
- Variable vs. fixed interest rates

Debt Issuance Process

- Criteria for determining the method of sale
 - Credit rating or “story bonds”
 - Volatility of market
 - Frequency of issuances
 - Social policies (small businesses)
 - Public v. private offering
- Selection of professional team
- Credit ratings
 - When is a rating necessary?
 - Which rating agencies?
- Credit enhancement –
 - Municipal bond insurance
 - Letters of credit
 - Collateral pledges (reserves)
- Disclosure – preparing an OS

Debt Management

- Who is responsible for ongoing responsibilities related to debt?
- Monitoring refunding opportunities
- Tax compliance
 - Private use
 - Arbitrage rebate
 - Timely expenditure of proceeds
 - Other risks
- Disclosure compliance
 - Annual disclosure
 - Material events
 - Maintaining communications with credit agencies and investors
- Covenant compliance
 - Insurance
 - Filings
 - Keeping records
- Investment of Bond Proceeds

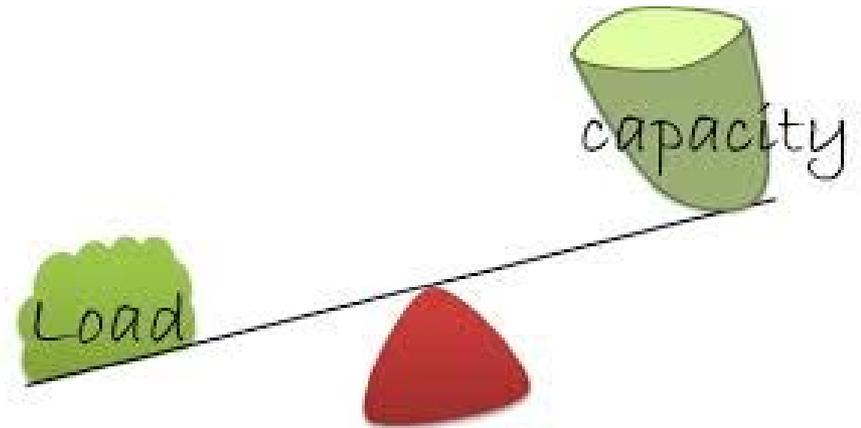
Refunding

- A refunding “uses up” a valuable asset, your call option
- Refundings usually undertaken for savings, but can also be used to restructure debt or change legal covenants
- Issuers typically use a Present Value Savings minimum of between 3% and 5% of refunded par
 - Measured on a maturity-by-maturity or aggregate basis
 - But much higher savings are often obtained, especially if the issuer exercises patience
- Advance refundings merit higher thresholds
 - A bond issue can be “advance” refunded only once
 - Low interest earnings on the escrow creates “negative arbitrage,” requiring that more bonds are sold to fund escrow
 - New “rule of thumb” is that net savings should exceed negative arbitrage

SB 1029 adds Section 8855 of the Government Code

- Amends current law that requires “the issuer of any proposed debt issue of state or local government shall, no later than 30 days prior to the sale of any debt issue, submit a report....” to include:
 - “a certification by the issuer that it has adopted local debt policies concerning the use of debt and that the contemplated debt issuance is consistent with those local debt policies.”
- A local debt policy shall include all of the following:
 - (A) The purposes for which the debt proceeds may be used.
 - (B) The types of debt that may be issued.
 - (C) The relationship of the debt to, and integration with, the issuer’s capital improvement program or budget, if applicable.
 - (D) Policy goals related to the issuer’s planning goals and objectives.
 - (E) The internal control procedures that the issuer has implemented, or will implement, to ensure that the proceeds of the proposed debt issuance will be directed to the intended use.

Debt Capacity



Sources of Restrictions

- Restrictions imposed by law
- Restrictions imposed by contract
- Restrictions influenced by rating agency and investor reaction
- Restrictions imposed by affordability and fiscal discipline

Restrictions Imposed by Law

- The State Constitution limits “indebtedness”
 - “Indebtedness” (paid out of property taxes requires 2/3 vote (schools can issue with 55% approval)
 - Statutory restrictions on the amount of debt as a per cent of assessed valuation
 - Proposition 39 school debt (with 55% approval) also has restrictions on expected tax rates
- Various court decisions have carved out key exceptions for leases, revenue bonds paid out of “special funds,” and obligations imposed by law
 - Restrictions are reflect local policy and market discipline
- More significant than the restrictions on debt are the restrictions on the revenues that can be raised to repay debt
 - Proposition 13 (1978) limited property taxes and instituted the need for voters to approve special taxes
 - Proposition 218 (1996) closed judicially-defined exceptions to Prop 13, requiring votes for all taxes, and restricted fees and assessments
 - Proposition 26 (2010) further tightened the rules requiring voter approval

Restrictions Imposed by Contract

- Many indentures impose limits on additional “parity” debt: the Additional Bonds Test (ABT)
 - Typically, limited restrictions on subordinate lien obligations
- Established based on feedback from rating agencies, bond insurers, investors
 - Can effect rating and insurance premium
 - 1.25 coverage of debt service by “net revenues” (after payment of operating and maintenance expenses) is common for revenue bonds

Rating Agency Data

- Rating agencies (Moody's, Standard & Poor's, Fitch and Kroll) publish information
 - How they evaluate debt factors into their ratings
 - What are the medians for various ratios at different rating levels
- Can be helpful in understanding the landscape, but should not be overvalued
 - Their job is to assign ratings, not prescribe best practice
 - Credit is only one factor in making a public policy decision
 - Arguably, the key stakeholders are local, not third-party investors

Key Credit Ratings Medians

- Have the advantage of appearing objective
- Rating agencies tend to focus on “classic” debt factors
 - Direct debt per capita and as a % of assessed valuation
 - Overlapping debt
 - Coverage of revenue debt

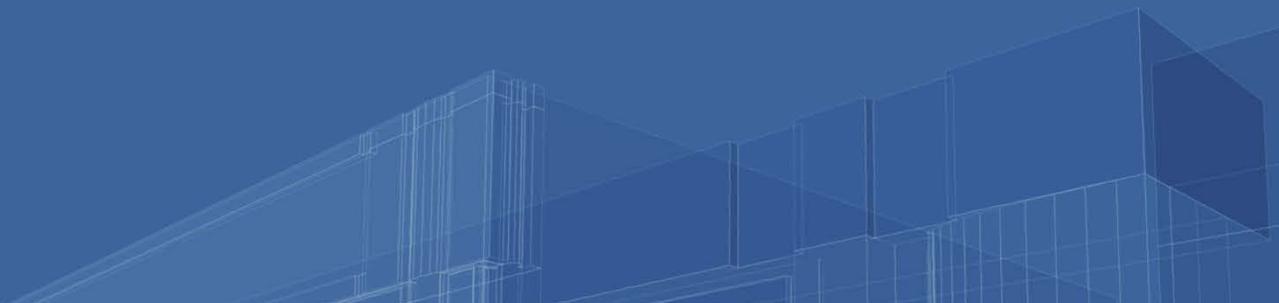
Municipal Financial Ratio Analysis - US Cities				
	US Local Government Medians			
Selected Indicators	Aaa	Aa	A	Baa
General Fund Balance as % of Revenues	32.90%	30.71%	28.73%	8.79%
Unassigned General Fund Balance as % of Revenues	21.36%	20.42%	20.82%	3.20%
Direct Net Debt as % of Full Value	0.70%	1.02%	1.51%	1.83%
Overall Debt Burden (Overall Net Debt as % Full Value)	2.22%	2.91%	4.36%	4.33%
Full Value Per Capita	\$137,429	\$79,934	\$48,008	\$36,394

Source: Moody's Median Report 2011 US Local Government Medians

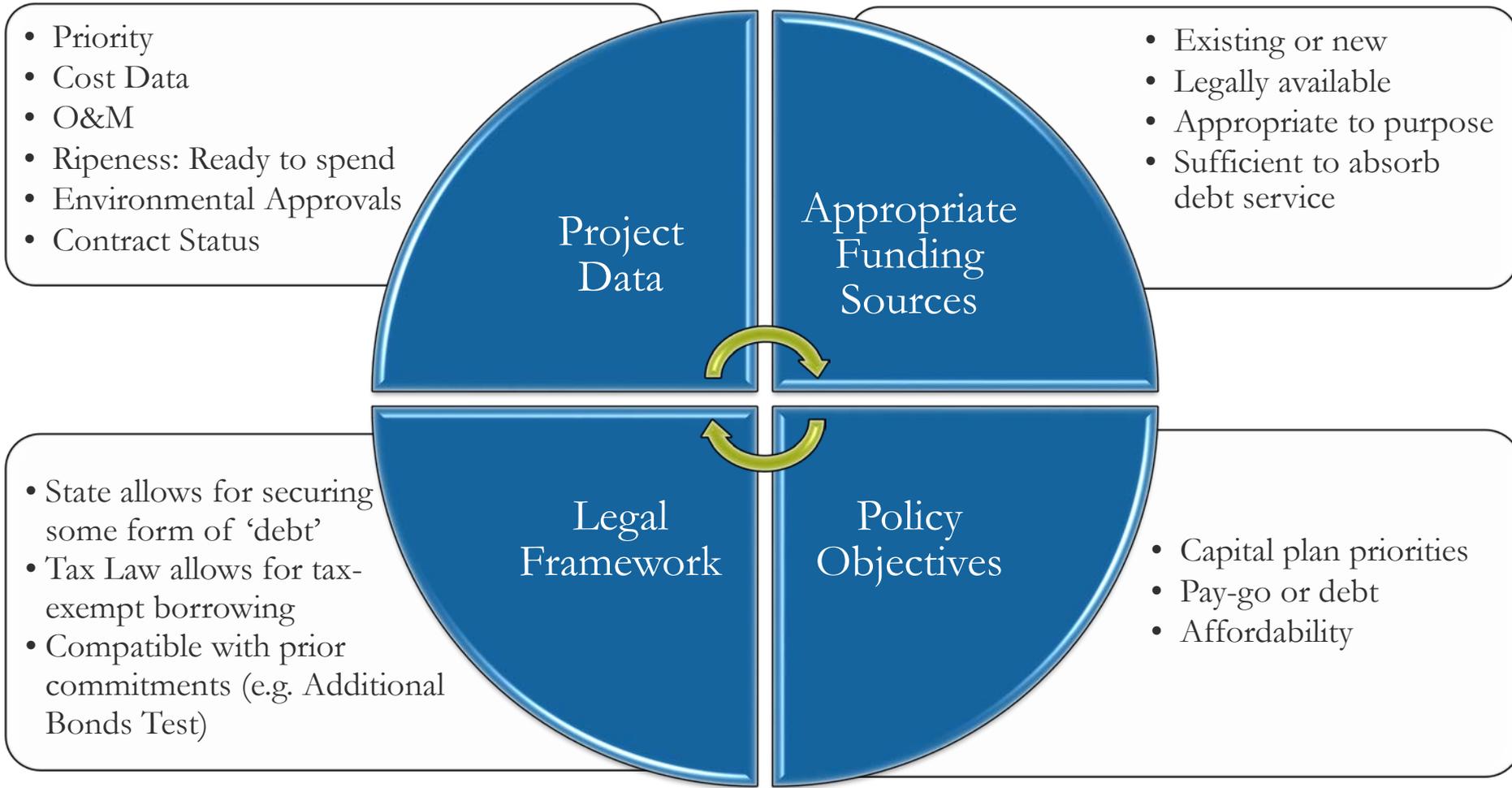
Restrictions imposed by affordability and fiscal discipline

- This is the hard stuff
 - Very little external guidance
 - But it is really the measure of capacity that matters
- Appropriation debt (lease revenue certificates of participation and bonds) is probably the most important
 - Varies widely by agencies
 - 6% of the General Fund might be a rule of thumb
 - But a custom-designed target is best
- Voter approved debt (usually GO bonds)
 - Measured by rating agencies as % of AV
 - Local agencies usually more focused on tax levy
- Total debt
 - Some agencies combine voter-approved and appropriation debt
 - Overlapping debt of other agencies is virtually impossible to control, but it may be a factor in ratings

Plan of Finance

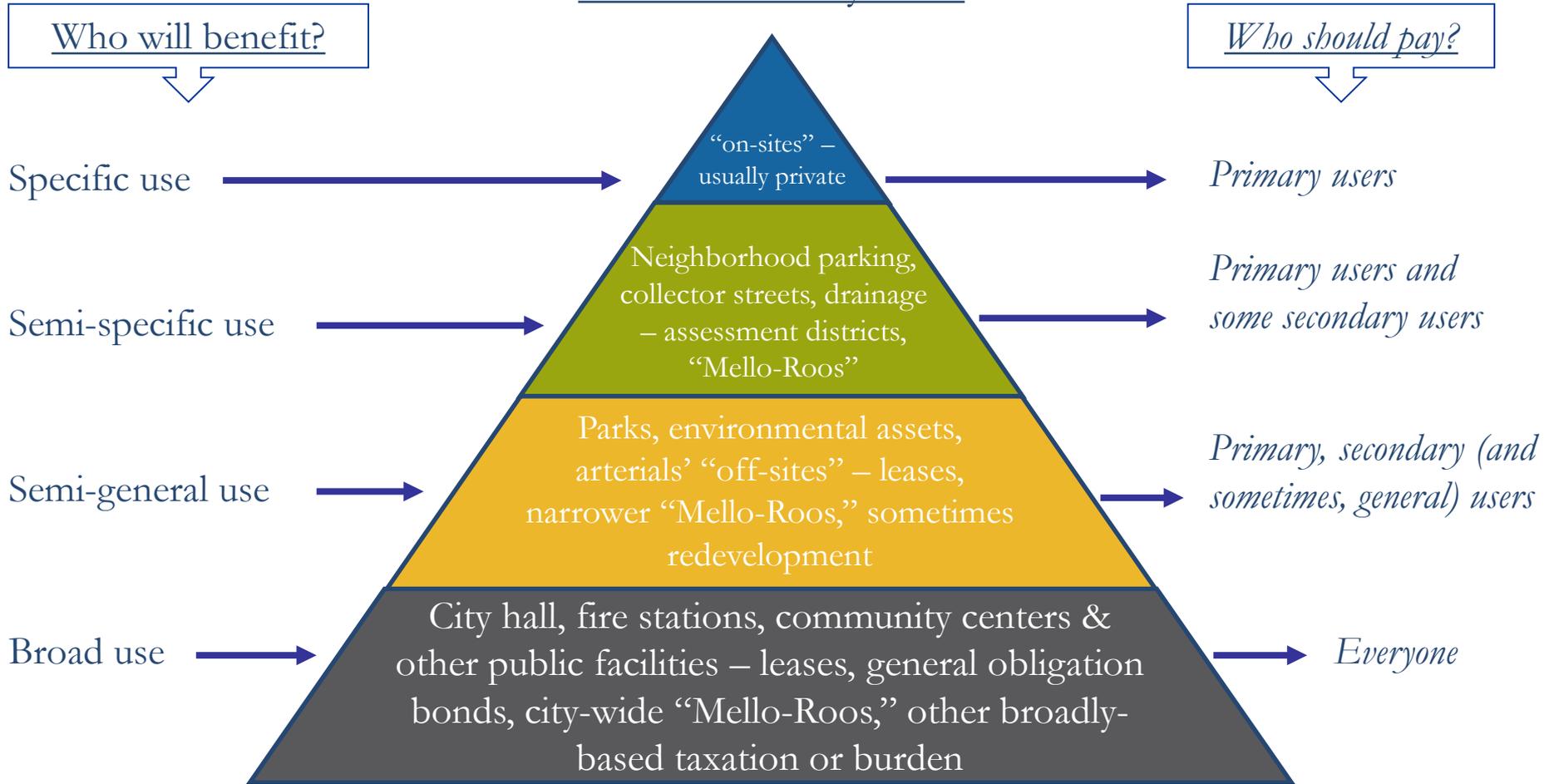


Components of a Financing Plan



Aligning Benefits with Repayment Burdens

The “Merits” Pyramid

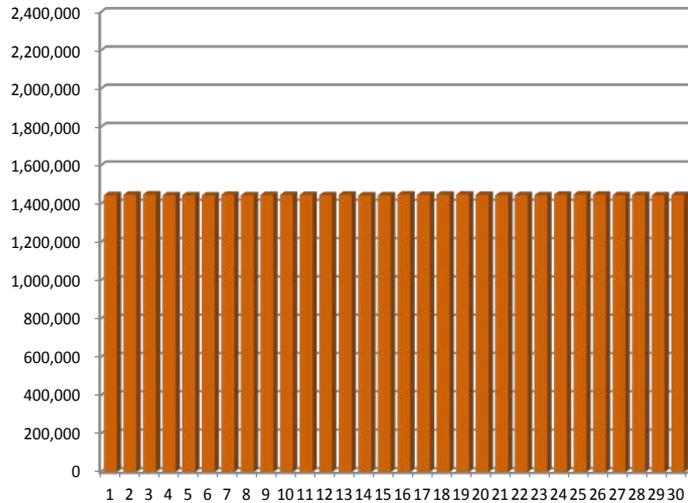


Revenue Sources Determine Type of Bond

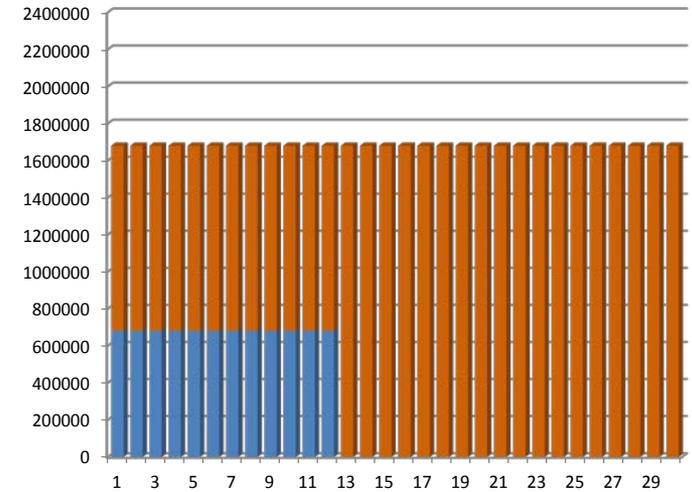
< Higher Grade		Types of Bonds			> Lower Grade	
	General Obligation	Enterprise Revenue	Lease Revenue (Certificates of Participation)	Special Tax	Special Assessment	
Revenue Pledge	“Full faith and credit” of issuer. Secured by property taxes	Net revenue of a specified enterprise, such as water, sewer, solid waste, or parking	Lease payments for use of government asset; paid from general fund	Lien on property; bonds paid from tax levied in addition to normal 1% ad valorem tax	Lien on property; bonds paid from annual assessment on property that benefits	
Vote?	2/3rds vote threshold; Schools may be 55%	No public vote required	No public vote required	2/3rds vote of property owners by acreage or by vote of registered voters	50% + 1 vote of assesses, weighted by amount of assessment	

Repayment Terms: Level, Escalating or Wrapped

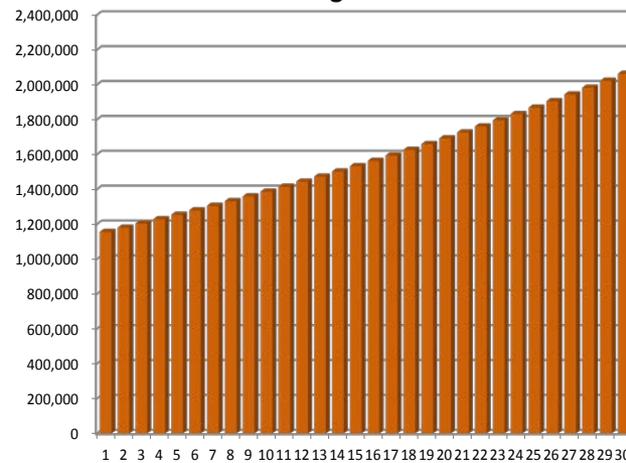
Level Debt Service



Wrapped Debt Service



Escalating Debt Service



MSRB Rule G-42 Disclosures

MSRB Rule G-42: Disclosure of Conflicts of Interest and Legal or Disciplinary Events

Pursuant to Municipal Securities Rulemaking Board (“MSRB”) Rule G-42, on Duties of Non-Solicitor Municipal Advisors, Municipal Advisors are required to make certain written disclosures to clients which include, amongst other things, Conflicts of Interest and any Legal or Disciplinary events of KNN Public Finance, LLC (“KNN Public Finance”) and its associated persons.

Conflicts of Interest

KNN Public Finance represents that in connection with the issuance of municipal securities, KNN Public Finance may receive compensation from an Issuer or Obligated Person for services rendered, which compensation is contingent upon the successful closing of a transaction and/or is based on the size of a transaction. Consistent with the requirements of MSRB Rule G-42, KNN Public Finance hereby discloses that such contingent and/or transactional compensation may present a potential conflict of interest regarding KNN Public Finance’s ability to provide unbiased advice to enter into such transaction. This conflict of interest will not impair KNN Public Finance’s ability to render unbiased and competent advice or to fulfill its fiduciary duty to the Issuer.

If KNN Public Finance becomes aware of any additional potential or actual conflict of interest after this disclosure, KNN Public Finance will disclose the detailed information in writing to the Issuer in a timely manner.

Legal or Disciplinary Events

KNN Public Finance, LLC, has never been subject to any legal, disciplinary or regulatory actions nor was it ever subject to any legal, disciplinary or regulatory actions previously, when it was a division of Zions First National Bank or Zions Public Finance, Inc.

A regulatory action disclosure has been made on Form MA-I for one of KNN Public Finance municipal advisory personnel relating to a 1998 U.S. Securities and Exchange Commission (“SEC”) order that was filed while the municipal advisor was employed with a prior firm, (not KNN Public Finance). The details of which are available in Item 9; C(1), C(2), C(4), C(5) and the corresponding regulatory action DRP section on Form MA and Item 6C; (1), (2), (4), (5) and the corresponding regulatory action DRP section on Form MA-I. Issuers may electronically access KNN Public Finance’s most recent Form MA and each most recent Form MA-I filed with the Commission at the following website: www.sec.gov/edgar/searchedgar/companysearch.html.

The SEC permits certain items of information required on Form MA and Form MA-I to be provided by reference to such required information already filed on a regulatory system (e.g., FINRA CRD). The above noted regulatory action has been referenced on both Form MA and MA-I due to the information already filed on FINRA’s CRD system and is publicly accessible through BrokerCheck at <http://brokercheck.finra.org>. For purposes of accessing such BrokerCheck information, the Municipal Advisor’s CRD number is 4457537.