

California Debt and Investments Advisory Commission
The Mechanics of a Bond Sale

Developing a Debt Management Policy

David Persselin, City of San José
Jo Mortensen, Public Resources Advisory Group

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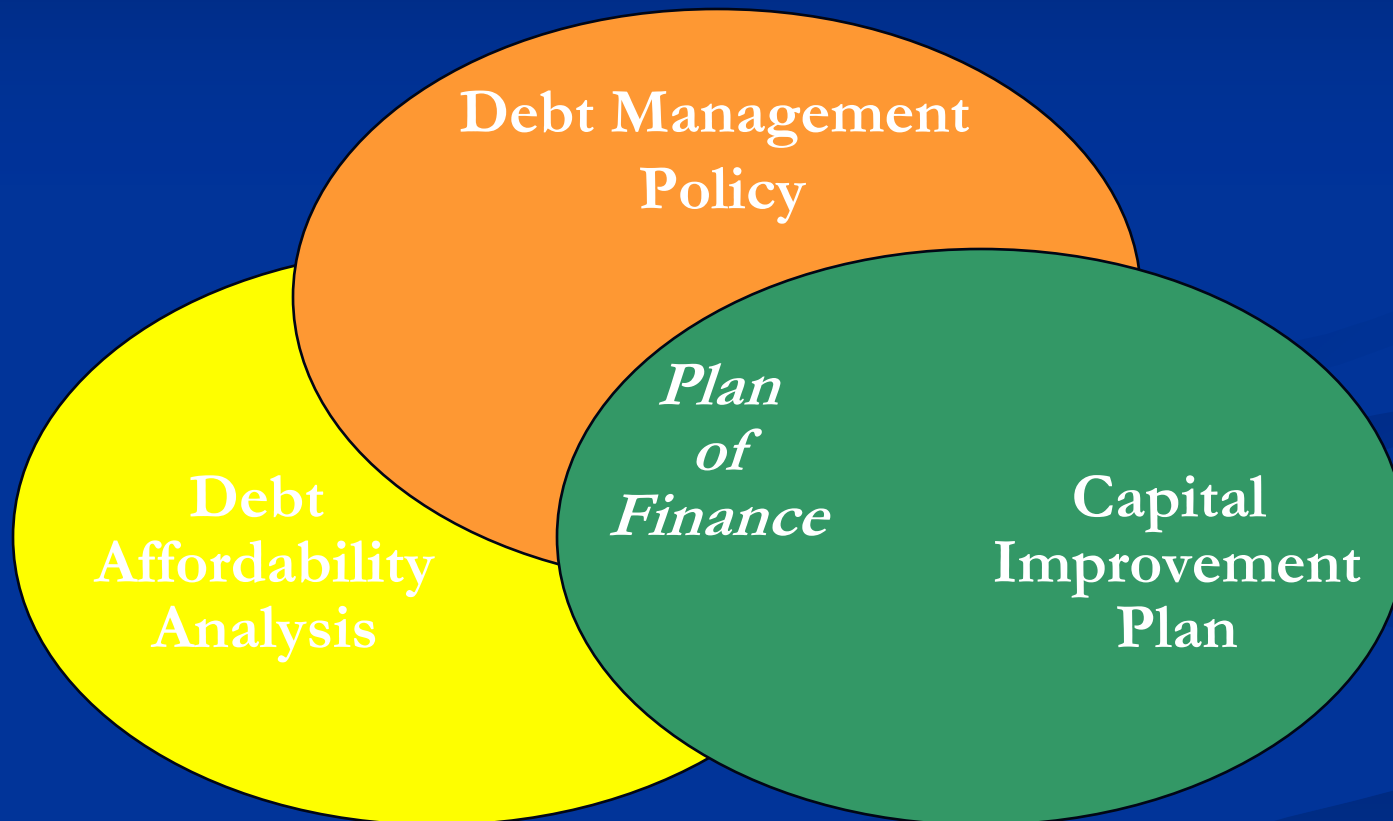
Plans vs Policies

“In preparing for battle, I have found that plans are useless, but planning is indispensable.”

Dwight D. Eisenhower

- Plans change over time in response to real world circumstances
- But policies:
 - Are the guiding principles of plans
 - Establish core values independent of circumstantial stressors
 - Frame the decision-making process, even (or *especially*) when the plan deviates from previously stated policies

Effective Plans are Informed by Policy



Characteristics of Effective Fiscal Policies

- Explicit
- Current
- Literal
- Available
- Comprehensive
- Relevant

Fitch Ratings on Management Practices

■ Very Significant

- Fund balance policy
- Debt affordability policy

■ Significant

- Pay-as-you-go capital financing
- Multi-year forecasting
- Quarterly reporting
- Quick debt retirement

■ Influential

- Contingency plans
- Non-recurring revenue policy
- Depreciation of fixed assets (GASB 34 implementation)
- 5 Year CIP integrating operating cost impacts
- GFOA financial reporting award
- GFOA budgeting award

Standard & Poor's Top Ten Practices

- Established budget reserve
- Regular economic and revenue reviews
- Prioritized spending plans and established contingency plans
- Formal capital improvement plan
- Long-term planning
- Debt affordability model
- Pay-as-you-go financing
- Multi-year financial plan
- Effective management and information systems
- Well-defined and coordinated economic development plan

Debt Management Policies - GFOA Recommended Practices

- Purposes for which debt may be issued
- Legal debt limitations
- Types of debt permitted
- Structural features preferred
- Credit objectives
- Methods of sale
- Methods for selecting outside professionals

Common Elements in Debt Policy Statements

- | | | | |
|----|---------------------------|----|-----------------------------------|
| 1 | Purposes and uses of debt | 19 | Sale process |
| 2 | Types of debt | 20 | Assessed value |
| 3 | Capital expenditures | 21 | Analysis requirements |
| 4 | Refunding bonds | 22 | Reserve capacity |
| 5 | Disclosure | 23 | Per capita limitations |
| 6 | Statutory limitations | 24 | Size of issuance |
| 7 | Project life | 25 | Intergovernmental coordination |
| 8 | Rating agency relations | 26 | When not to issue debt |
| 9 | Operating budget | 27 | Operating revenue |
| 10 | Revenue and TIF bonds | 28 | Lease debt |
| 11 | Bond rating goals | 29 | Capitalized interest guidelines |
| 12 | Misc. limitations | 30 | Market value limitations |
| 13 | Repayment provisions | 31 | Credit enhancement |
| 14 | Maturity guidelines | 32 | Limited tax GO bonds ¹ |
| 15 | General fund revenue | 33 | Inter-fund borrowing |
| 16 | Expenditure limitations | 34 | Variable rate debt |
| 17 | Professional services | 35 | Debt service funds |
| 18 | Short-term debt | 36 | Derivatives |

¹In California, effectively a lease obligation

Basic Questions to be Addressed in a Debt Policy

- What is the purpose of the financing?
- What is the legal authority for issuance of the debt?
- How will the debt be repaid?
- Will bonds be sold with an investment grade rating and who will be the ultimate purchasers?
- What are the qualifications of the professional advisors and underwriters assisting in the financing, and how will they be selected?
- What is the proposed method of selling the debt?

What is the purpose of the financing?

- Is the project to be financed well defined and has it received necessary approvals?
 - Have construction bids been received?
- Should the project be financed with bonds or on a “pay as you go” basis?
 - By borrowing, the people who benefit from the project will be paying for it (“intergenerational equity”)
 - Important to maintain healthy cash reserves
 - Never finance operations or maintenance costs

What is the legal authority for the issuance of debt?

- Financing plan should identify the legal statute that permits the issuance of the debt
 - Issuer's Bond Counsel will provide it in its Bond Opinion

How will the debt be repaid?

- Will the project being financed generate its own revenues?
 - Will bonds be supported by the revenues alone?
 - How will on-going maintenance be paid for?
- Will a pledge of the general fund be required?
 - What is the impact on future budget flexibility?
- How will issuing debt affect debt ratios for issuer?
 - Debt as % of general fund revenues
 - Debt per capita
 - Debt to personal income
 - Debt as % of Assessed Value

What is the rating requirement for the bonds being issued?

- Will bonds only be sold if they achieve minimum investment grade rating (BBB-)?
- Will bond insurance be considered?
- Will non-rated bonds be considered?
 - Land Secured
- To whom will the bonds be marketed?
 - Suitability

How will professionals involved in the bond sale be selected?

- Will the issuer create a pool of professionals to use on all its financings?
 - Bond Counsel, Disclosure Counsel, Financial Advisor, Special Tax Consultant, Appraiser
 - Benefit from working with core team of consultants but periodic review is important
- Underwriter selection process for negotiated transactions
 - On a RFP basis for each financing?
 - Create a pool of Underwriters and select from this pool for each financing?
 - At a minimum, each firm should demonstrate its credentials for each type of financing

What is the proposed method of sale?

■ Negotiated Sale

- Issuer and underwriter negotiate the interest rates on the bonds and the underwriter's discount
- Useful for large sales, new or "story" credits, or uncertain market conditions
- Typically require independent consultant to verify "on the market" pricing

■ Competitive Sale

- On an advertised date, issuer receives bids from all the banks who wish to buy the bonds
- By definition, is on the market pricing
- Typically used with established credits with high market acceptance

Example of Debt Policy: Land-Based Financings

- Clear public purpose
- Active role of issuer
- Applicant credit quality
- Reserve fund
- Capitalized interest
- Value-to-lien ratio
 - Minimum 3:1
- Annual maximum special tax burden
 - No more than 2% of value of home
- Maximum tax burden
- Benefit apportionment
- Special tax district administration
- Foreclosure covenants
- Disclosure to bond holders
- Disclosure to prospective purchasers

Example of Debt Policy: Interest Rate Swaps

- Not to be used for speculative purposes
 - Always used in combination with underlying bonds
- Define maximum level of swaps in a portfolio
- Level of tax risk that is acceptable
 - LIBOR swaps versus SIFMA Swaps
- Counterparty exposure
 - Minimum of AA-
 - Diversification of counterparties
- Evaluating termination payment exposure
- Should be considered in conjunction with a variable rate debt policy

Example of Debt Policy: Refundings

- Conventional rule of thumb is to achieve present value savings of 3% to 5% of refunded bond
 - Tax law limits you to one advance refunding, so make it count
 - Higher savings appropriate if period to call is long
 - Lower savings appropriate if time between call date and maturity is short
 - Higher threshold for refundings with swaps
 - Restructuring opportunity in the future?
- Alternative methodology: refunding efficiency (% of call option value)
- Flexibility

Debt Affordability Analysis: Effective Debt Capacity Policies

- Legal limits
- Public policy limits
- Financial limits

Debt Capacity: A Precious Commodity

- Debt capacity is limited; make it count
- Funds borrowed for project today cannot be used for other projects tomorrow
- Funds committed for debt repayment today are not available to fund services tomorrow
- Long-term capital planning key to managing debt capacity

Debt Capacity Analysis

- How much debt is too much debt?
- Why is a policy needed?
- What makes a debt policy effective?
- How do I construct my own debt policy?

Debt Capacity Ratios

- Determining “capacity” is an art, not a science
- Capacity in policies often based on standard ratios
 - Debt as % of assessed valuation
 - Debt per capita
 - Debt as % of personal income
 - Debt service as % of revenues or expenditures
 - Determine how to treat self-supporting debt

Developing Debt Capacity Analyses

- Identify peer groups
- Collect financial data
 - CAFRs
 - Phone calls
- Construct indicators
 - For peer group
 - For self / compare
- Construct scenarios

Rating Agencies Have Provided Guidance on Debt Capacity

■ Moody's

- General Rule: Debt burdens (measured as a % of full valuation) from 0-3% is low; 3-4% is average; 5-7% is high, and above 7% is a red flag.

■ Standard & Poor's

- February 4, 2000 Research Publication: *"Top 10 Ways to Improve or Maintain A Municipal Credit Rating"*
- June 27, 2006 Research Publication: *"Public Finance Criteria: Financial Management Assessment"*

■ Fitch Ratings

- June 10, 2004 Research Publication: *"Local Government General Obligation Rating Guidelines"*
- June 27, 2006: *"The Bottom Line: Local Government Reserves and Policies that Shape Them"*

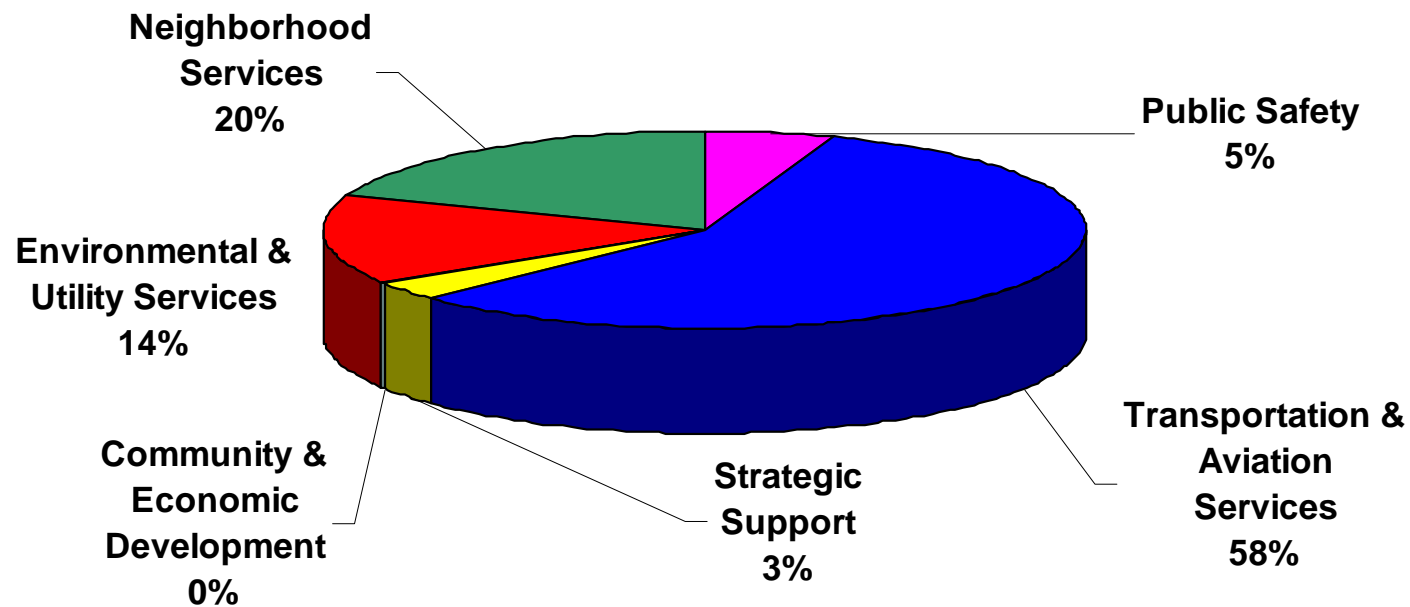
City of San José – Connecting the Dots: Planning to Execution

- Budget and financial planning function performed in City Manager's Budget Office
 - Responsible for budget development and monitoring
 - Responsible for revenue forecasting
- Debt Management is separate division within the Finance Department
 - Indirect involvement in budget and financial planning process through coordinated effort with City Manager's Office



City of San José - 2007-2011 Capital Improvement Program

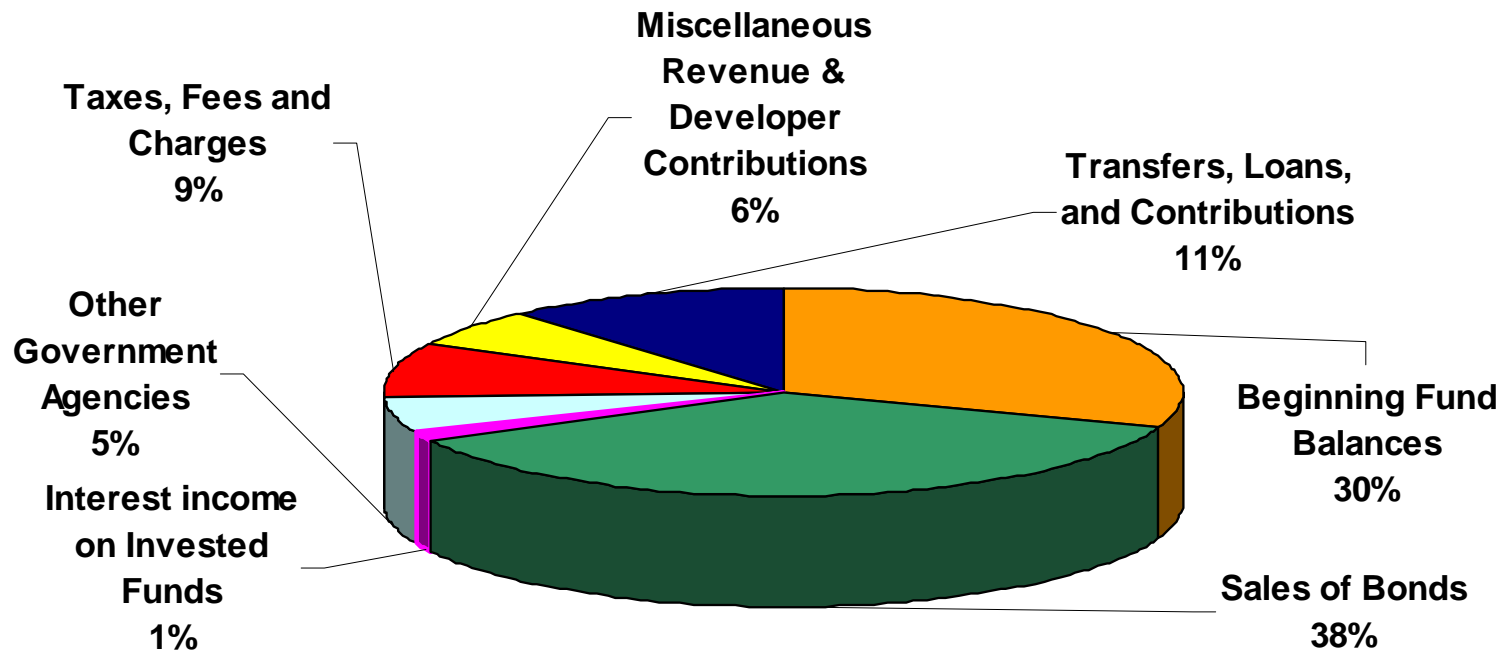
2007 -- 2011 Summary
Capital Improvement Program Use of Funds



5 Year CIP Total - \$2,887,972,120

City of San José - 2007-2011 Capital Improvement Program

2007 -- 2011 Summary Capital Improvement Program Source of Funds



5 Year CIP Total - \$2,887,972,120

Funding Approaches

- Pay-as-you-go
- Grant funding
- Capital contributions
- Low interest loans
- Joint ventures – privatization
- Municipal bonds



Summary

- Policies Are Powerful
 - Fundamental foundation for long-term fiscal health: underlying basis for case-by-case decision-making
 - Provides context for what you would “but for”
 - Essential component of any contingency plan
 - Articulates your values before they are under stress

Questions?

