CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

The Use of Debt Policies to Manage Risk | Part 1

Module 4 discusses the various interlocking financial, legal, and political implications and risks of debt financing. Other topics include considerations of how debt will affect the organization and its ability to fulfill its functions and how a well-developed debt policy is instrumental in assessing and managing risks on the path to a successful debt issuance.

Editor's Note: This transcript has been prepared by the California Debt and Investment Advisory Commission (CDIAC) and it believes it to be a fair and accurate reproduction of the comments of the speakers. Any errors are those of CDIAC and not the speakers.

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Narrator: Using debt presents your agency with opportunities to advance strategic capital projects in a manner that allocates costs over the life of assets, preserves cash reserves, and accounts for the equity interests of your constituency. But, as you have learned in this series, debt also presents a wide range of risks—to you, your agency, and your constituents. An elected official's challenge is to make decisions that limit or mitigate the risks of debt financing, so that your agency will maximize the opportunities it presents.

But, how does an elected official assess and manage risks associated with a debt financing decision? This module addresses how the risks of debt can be managed through the use of a comprehensive debt management policy. First, we will examine the categories of risk that should be foremost in the minds of elected officials making debt issuance decisions. Then, we will examine the elements of a debt management policy, the characteristics that make them most effective, and how they will help you meet the risk management challenge.

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Narrator: It is not realistic or advantageous to eliminate all risks of debt issuance, but a debt management policy that is well-developed, and communicated and utilized across all levels of your agency, substantially improves the probability of a successful and sustainable project financing. Elected officials are more likely to protect the interests of the agency and their constituents if they adopt a risk management mindset and carefully consider the risks that come with debt issuance. Obviously, there are financial risks, since debt issuance is a financial transaction. But, the decision to issue debt also presents political, regulatory, market, and credit risks—in many ways equally disruptive.

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Narrator: Financial risks require an assessment of long-term affordability and solvency. Projects that are not sensibly scaled or have not accounted for lifecycle costs and effective asset management may create future financial and operational risks that threaten the contractual promises made to lenders, including timely debt service payments. In recessionary periods, important agency expenditures may need to be set aside or drastically cut if they share the same revenue source as that used to pay principal and interest. This solvency risk—curtailment of the agency's ability to meet its expenditures during the budget year and over the life of the

debt—will be significantly shaped by the debt's structural features, like interest rate mode, debt service schedule, and underlying revenue projections.

Ultimately, the financial risks of debt must be evaluated for their potential impact on service-level solvency: the agency's ability to provide services at the level required and expected by the community. This evaluation requires an understanding and accounting for the debt's financial demands in the context of the agency's long-term financial sustainability.

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Narrator: The long-term, inflexible demands created by debt pose a risk to the service-level expectations of constituents. Dissatisfied constituents present heightened political risks to elected leadership and to strategic planning and policy objectives. Debt maturities and repayment schedules that create questions of taxpayer and intergenerational equity will likely add to citizen discontent, especially if the authority to issue the debt and raise the repayment source was not obtained through a highly transparent or voter-approved method. Many less noticeable aspects of a debt transaction present heightened risks of political fallout, including unresolved conflicts of interests presented by the selection of external financial professionals or sale method, overly-complex or exotic financing techniques, or the inappropriate use or administration of proceeds.

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Narrator: Municipal debt is serious business to regulatory agencies charged with protecting the interests of investors and the federal treasury, and ensuring fair and orderly markets. The legal obligations created by debt raise substantial regulatory risks. Issuers of tax-exempt debt commit to lenders that they will protect the debt's tax-exempt status by adhering to post-issuance IRS requirements for the investment and use of debt proceeds for the life of the debt. Not doing so could result in the tax exemption being revoked retroactively, exposing your agency to potentially monumental liabilities.

Legal and contractual obligations to disclose material information about the agency's ability to borrow and repay lenders and investors must be fulfilled in accordance with federal anti-fraud and continuing disclosure laws and regulations. Complete, accurate, and timely disclosure of material information is required at the time of issuance and throughout the life of the debt. These regulations also apply to well-intentioned public communication by elected officials. Public statements that are overly optimistic or pessimistic, or that present only one side of a two-sided issue, can mislead investors. Providing material information to some market participants and not others (selective disclosure) can create unfair and exploitable advantages in the market. Failure to meet these obligations and manage regulatory risks can lead to serious sanctions and enforcement actions, not only against the agency but against you, the elected official.

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Narrator: Market risks are those that affect the overall economy and securities market. Certain structural features of debt can expose the agency to risks when interest rates or investor demand is volatile. There are features designed to mitigate this volatility, but they can increase the costs of financing or limit the agency's ability to pursue alternatives, like refinancing. Other market risks have less to do with the structural features and more to do with the agency's willingness and ability to appropriate funds to pay debt service. Inevitable recessions that shrink revenues or tax receipts present risks to the agency's security pledge and repayment

capacity. Market risks that can weaken an agency's repayment ability can be local or regional including unexpected demographic shifts, business closures, or changes in the supply and demand fundamentals of municipal enterprises.

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Narrator: Agencies typically secure a credit rating for their debt prior to issuance. The rating reflects the general financial capacity of the issuer, the reliability of the repayment source, and the strength of agency management practices, all in the context of the economic and demographic factors. The better the rating, the lower the interest cost on your agency's debt. Every new issue of debt presents credit risk to the agency. Debt that is structured in a way that increases fiscal stress on the agency over time and creates questions of financial sustainability will damage the agency's credit rating, leading to less market access and higher interest costs on future borrowings.

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Narrator: By issuing debt, you and your agency will be confronted by numerous risks influenced by your agency's unique set of financial, political, and administrative circumstances. A successful financing requires a thorough risk assessment and administrative preparation that instills a risk management approach throughout the agency, including the governing body.

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DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

The Use of Debt Policies to Manage Risk | Part 2

Module 4 discusses the various interlocking financial, legal, and political implications and risks of debt financing. Other topics include considerations of how debt will affect the organization and its ability to fulfill its functions and how a well-developed debt policy is instrumental in assessing and managing risks on the path to a successful debt issuance.

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Narrator: Establishing a strong agency-wide foundation of strategic, capital, and financial planning is a critical prerequisite to the use of debt. The most important tool to manage risk and reap the benefits of debt for your community is a comprehensive debt management policy. A debt management policy consists of written guidelines, allowances, and restrictions that guide an agency's debt management from proposal, to issuance, and through to repayment. It communicates policy goals, guides debt structuring, improves the quality and consistency of decisions, and, ultimately, manages risks.

The Government Finance Officers Association has developed a structural framework for debt management policies. Once adapted to the agency's unique strategic and organizational circumstances, you will have a comprehensive policy that mitigates the risks of debt issuance and meets the legal criteria in California statute.

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Narrator: When debt issuance is proposed by a local public agency, California law requires the agency to certify that the proposed debt is consistent with its adopted debt policies and that the policies include a handful of essential elements: purposes for which debt may be used; types of debt that may be issued; relationship to the budget or capital improvement program; policy goals related to planning goals and objectives; and internal controls to ensure that debt proceeds will be used as intended.

Good debt management policies are not cookie-cutter, but the recommended elements will help you understand how the policy acts as a risk management tool. A debt management policy is generally organized into four main sections: limitations, structuring, issuance, and management.

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Narrator: The limitations section consists of general legal, financial, and policy limitations, and specifies how they apply to the types of debt the agency is able to issue. This section should articulate the constitutional, statutory, or charter limitations on debt issuance. It should also establish acceptable circumstances for the use of debt

versus pay-as-you-go financing, requirements to align the term of the debt to the asset life, and formal integration with the capital improvement plan.

Limitations and acceptable conditions for the use of specific long- and short-term debt instruments, fixed versus variable interest rates, and special purpose financing like inter-fund borrowing, lines of credit, and capital leases are also important elements. Under this section, the agency will establish policy goals and limits addressing the financial risk of long-term affordability and solvency. It will set policy on the capacity for specific debt types and repayment sources. This is done through incorporating benchmark financial ratios and metrics that will allow for periodic assessment and projection of financial impacts as new debt or refinancing is considered. Current and prospective credit risk can be better analyzed and credit agency ratings improved through these assessments.

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Narrator: The structuring section includes the guidelines and restrictions on the structural features that apply generally to the issuance of all debt types, but also specific features if they are unique to a type of debt or financing circumstance. This section will address the agency's policy regarding limits on term or maturity, and it will establish objectives regarding the schedule of debt service for the project and across the agency's debt portfolio.

Policies regarding early redemption or call features are also an important structuring element. These features give the issuer the option to repay the bond prior to its maturity date, creating the opportunity to refinance, or remove or replace contractual restrictions. These options may increase the interest rate but provide flexibility. This section should include circumstances under which credit enhancement is considered and the method for evaluating its cost-effectiveness. Credit enhancement is a form of insurance purchased from a third-party that boosts the repayment security of the debt. It normally involves an up-front cost in exchange for a lower interest rate.

Other structuring considerations are policies on capitalizing interest, that is, including the interest payments scheduled during construction and before the asset is ready for use in the borrowing. And the use of derivatives such as interest rate swaps, caps, or locks. Derivatives are complicated structures often used with variable rate debt and are meant to mitigate interest rate risk. If used, a supplementary, in-depth derivatives policy is highly recommended.

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Narrator: The issuance section provides policy guidance regarding the issuance process which may differ for each type of debt. Typical elements include the requirements for bond ratings and how relationships with the credit ratings agencies are managed and by whom. The mechanics and timing of the issuance process will also have an effect on contending with market risk. This section will address policies regarding the preferred method of sale—competitive bid or negotiated sale—and criteria for determining the best approach. It will also discuss the conditions under which selling debt directly to investors in a private placement or borrowing directly from a bank are viable options.

One of the most important elements in the Issuance section for the management of political risk concerns the selection of external professionals as members of the finance team. It should establish the solicitation process

for each professional role, agency staff responsible for the process, criteria for evaluation, and limitations aimed at managing real or perceived conflicts of interest.

Refinancing debt can produce interest costs savings, structural advantages across the debt portfolio, and relief of contractual limitations. The issuance section will establish the conditions under which refinancing, or refunding, will be considered and the method for evaluating the wisdom of a refunding decision.

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Narrator: Finally, the management section of the policy provides guidance for ongoing administrative activities. This is the section of the policy that provides strong regulatory and political risk mitigation—where the agency clearly commits to timely and complete disclosure and transparency. The section will discuss the agency's specific disclosure responsibilities under federal securities laws, what information will be provided to the market, and who will be responsible for preparing it initially, at issuance, and over the life of the debt.

The management section includes policies and limitations regarding information that is likely to reach investors including any information regarding the agency's financial condition posted to the agency website or communicated in press releases, at agency proceedings, and during public events. These elements will include administrative steps for vetting information for material misstatements or omissions before it is made public, and for making timely, complete, and accurate information available to the entire market. It will also include requirements for periodic training for professional staff and elected officials that may speak to the market.

The management section will also cover elements regarding the use and investment of tax-exempt debt proceeds. Policies will be established for compliance with the specific federal regulations for the private use of financed assets, expenditure tracking, investment returns, and arbitrage. This section also provides the internal controls and financial risk mitigation to ensure proceeds are spent for the intended purposes and directs the investment of debt proceeds prior to expenditure. It is common to integrate this policy with the agency's adopted investment policy.

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Narrator: There are several characteristics that are consistent among the most effective debt management policies. Highly effective policies are regularly reviewed and updated. This is particularly important when economic or fiscal conditions change; strategic, capital improvement and financial plans are modified; administrative structures are altered; and laws and regulations have been added or amended. Elected officials need to be personally engaged in the development, review, and maintenance of the debt management policy, and the governing body should provide formal approval after a transparent process.

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Narrator: The formal use of a debt advisory committee helps align debt issuance with the agency's policy elements and can further inform the decisions of the governing body by providing a multi-disciplinary, first-level review of proposed debt. Committees may include officials such as the treasurer, finance director, public works director, or executive officer, as well as members of the governing body. Appointed members of the public are also frequently included. Some responsibilities assigned to the committee may include reviewing debt structures and policy exceptions, selecting professionals, reviewing documents, validating due diligence, and evaluating post-issuance compliance.

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Narrator: The agency's administrative structure must be fully integrated with the debt management policy. Frequently, this administrative structure is developed and maintained by a working group composed of legal, executive, or dedicated debt management staff; accounting, budget and program leadership; public works executives; the agency's bond counsel; and independent municipal advisor. Initial development requires identification of all requirements and obligations imposed on the agency for the use and administration of debt by-laws and regulations as well as contracts and agreements. Then, the process and internal controls for meeting the obligations are built into existing administrative guidelines, policies, and procedures. Integration with existing documents will increase the likelihood of consistent policy application across the agency. Working groups can also play a valuable role in the development and validation of any continuing disclosure or other information released to the market.

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Narrator: The process of developing and maintaining a debt management policy allows for discussion and consensus building around every characteristic, feature, and objective of debt issuance, well in advance of the actual need to issue debt. The process eliminates unsuitable or impulsive choices and provides mitigation across all risk classes. A debt management policy will balance limitations on the use of debt while providing sufficient flexibility to respond to unforeseen circumstances and opportunities.

Risk management involves assessing and mitigating risk on day one but also having the capacity to manage the components of risk as they inevitably change. The policy will enable the agency to manage financial and regulatory risks by integrating standard operating and administrative procedures that will guide and control daily financial activities and effectively manage federal disclosure and tax compliance obligations. It also builds consistency of administration through staff transitions.

The agency will have a tool to manage financial and market risks because the policy will focus the agency on the function of debt in the overall financial plan, rather than on the individual debt issuance or transaction. The predetermined portfolio performance measures and benchmarks will give the agency the vision it needs to chart a prudent financial course. The policy will validate your agency's commitment to financial sustainability and risk management, convey competence to the market, mitigate credit risks, and afford your agency the lowest possible cost of funds.

A well-constructed debt management policy that is clearly communicated protects the interests of the community and of public servants who act in good faith to meet community goals and constituent needs. For elected officials, the debt policy safeguards against politically motivated claims of favoritism or bias. A policy will yield the most robust mitigation of risks when it is developed transparently, employed diligently, and consistently integrated with long-term financial and capital improvement planning.

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Narrator: The risks of debt financing are abundant and dynamic, and often quite complicated. But imprudent debt financing decisions that are the product of insufficient risk assessment and management can have damaging effects on your agency, your community, and on you, personally, as a fiduciary.

A comprehensive debt management policy will allow you and your agency to be prepared for risk management challenges and secure the rewards of high-quality decision-making that will stand the tests of time.