Florida Government Finance Officers Association

Fall 2016 CGFO Exam Review Course - Debt Administration

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Speaker Information

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Recommended Reading

- Florida Statutes: http://www.leg.state.fl.us/Statutes/index.cfm?Mode=View%20Statutes&Submenu=1&Tab=statutes&CFID=61337195&CFTOKEN=805006b04f078c4b-38D48B13-B101-C85F-E43E2B8C3935F901
  - Florida Statutes 163.335 Findings and Declarations of Necessity
  - Florida Statutes 200.065 Method of fixing millage
  - Florida Statutes 218.25 Limitation of shared funds

Recommended Reading (Cont.)

- IRS Publication 4079, Tax-Exempt Governmental Bonds – IRS: http://www.irs.gov/pub/irs-pdf/p4079.pdf
- FAQs regarding Record Retention Requirements, Government Entities – IRS: https://www.irs.gov/Tax-Exempt-Bonds/Tax-Exempt-Bond-FAQs-Regarding-Record-Retention-Requirements

Recommended Reading (Cont.)

- Recommended Practice Statements, Debt Management – GFOA: http://gfoa.org/best-practices?field_committee_value=All&field_type_value%5B%5D=best_practice&field_type_value%5B%5D=advisory&term_node_tid_depth%5B%5D=3&term_node_tid_depth%5B%5D=98&term_node_tid_depth%5B%5D=94&term_node_tid_depth%5B%5D=97&term_node_tid_depth%5B%5D=96&term_node_tid_depth%5B%5D=95

Recommended Reading (Cont.)

- GFOA Publications:
  - Debt Issuance and Management: A Guide for Smaller Governments
  - Guide to Preparing a Debt Policy
  - An Elected Official's Guide to Rating Agency Presentations
  - An Elected Official's Guide to Debt Issuance
  - Tax Exempt Financing: A Primer
  - Investing Public Funds

Capital Improvement Program

- Financial planning, budgeting, and management tool
- Balances project needs with current and future financing
- Can be accomplished through borrowing, grants, etc.

Capital Improvement Program (con't)

- Pay as you go – Pay for capital improvements from current revenues and/or fund balances
  - When project is expected to be short lived
  - When project is small
  - When debt cannot be issued

Debt Issuance Considerations

- Matching type of financing with revenue stream
- Matching term of financing with useful life of asset
- Evaluation of potential risks and benefits
- Coordination of proposed financing with existing debt
- Overlapping debt

Debt Policy

- Amount of GO debt allowed - % total income, % property value, % past revenue
- Amount of variable rate debt allowed
- **Restriction of debt service term to useful life of asset being financed**
- Should not be too restrictive
- Method for selecting underwriter

Question 1

Florida Statutes Require Adoption by Local Governments of Comprehensive Debt Policies

A) True

B) False

Municipal Market

- Consists of the individuals, institutions and processes that result in the sizing, structuring, and sale of obligations by state and local gov't agencies
- Most state & local securities exempt from SEC registration requirements
- Once all conditions for Notice of Sale met, almost any entity can bid on issue

Tax-Exempt Obligations

- Municipal obligations can be tax exempt or taxable
- Tax exempt refers to exemption of interest earnings from federal income tax to bond holders
- Can also be exempt from state income tax through reciprocal immunity (McCulloch vs. Maryland, 1819)

Taxable Gov't Issues

- Could be used for private activity, avoids arbitrage issues
- Could be way to get around debt cap
- Although taxable, state and federal regulations still exist
- Taxable bond issues can be used to pension obligations
- Bank Qualified Bond: Purchased by bank; allows bank to receive interest rate deduction

Federal Limitations
Tax Reform Act of 1986

- Volume of small-issue industrial development bonds (IDBs)
- Restricts purposes for debt primarily to public purposes
- Earnings on bond proceeds limited to same % rate as bond yield; excess subject to rebate action
- One advance refunding per issue
- Fully Registered (if maturity over 1 year)

Question 2

One of the advantages of taxable bonds is that there are no regulations, either state or Federal

A) True

B) False

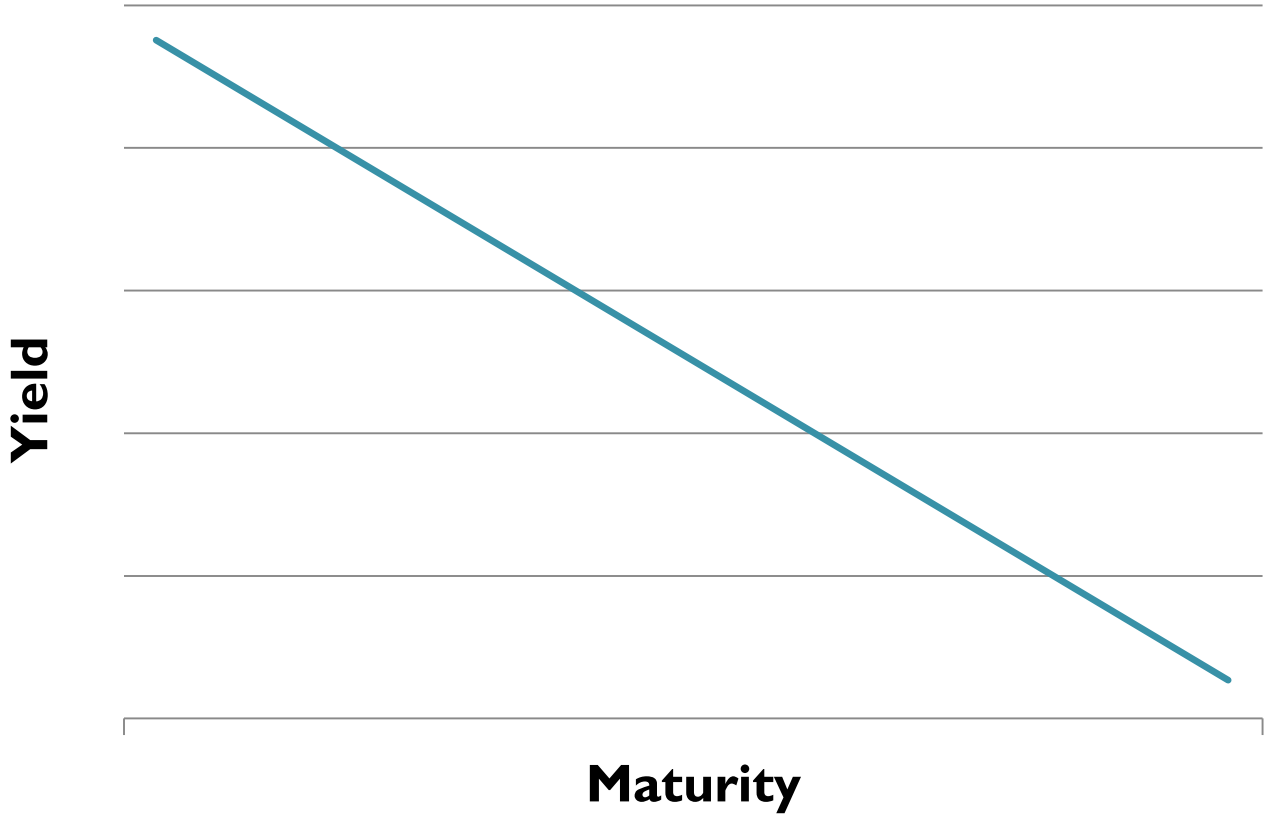
Government Purpose Test

- Financed asset available for general public use as opposed for private benefit
- Payment of the obligation is not obtained from a private firm that will benefit from the project
- Purpose must be < 10% for use by private person / business (= Public Purpose)
- Payment of principal or interest of > 10% of bond by private source (= Private Purpose)
- Simply passing Private Purpose test does not exempt issue from regulation

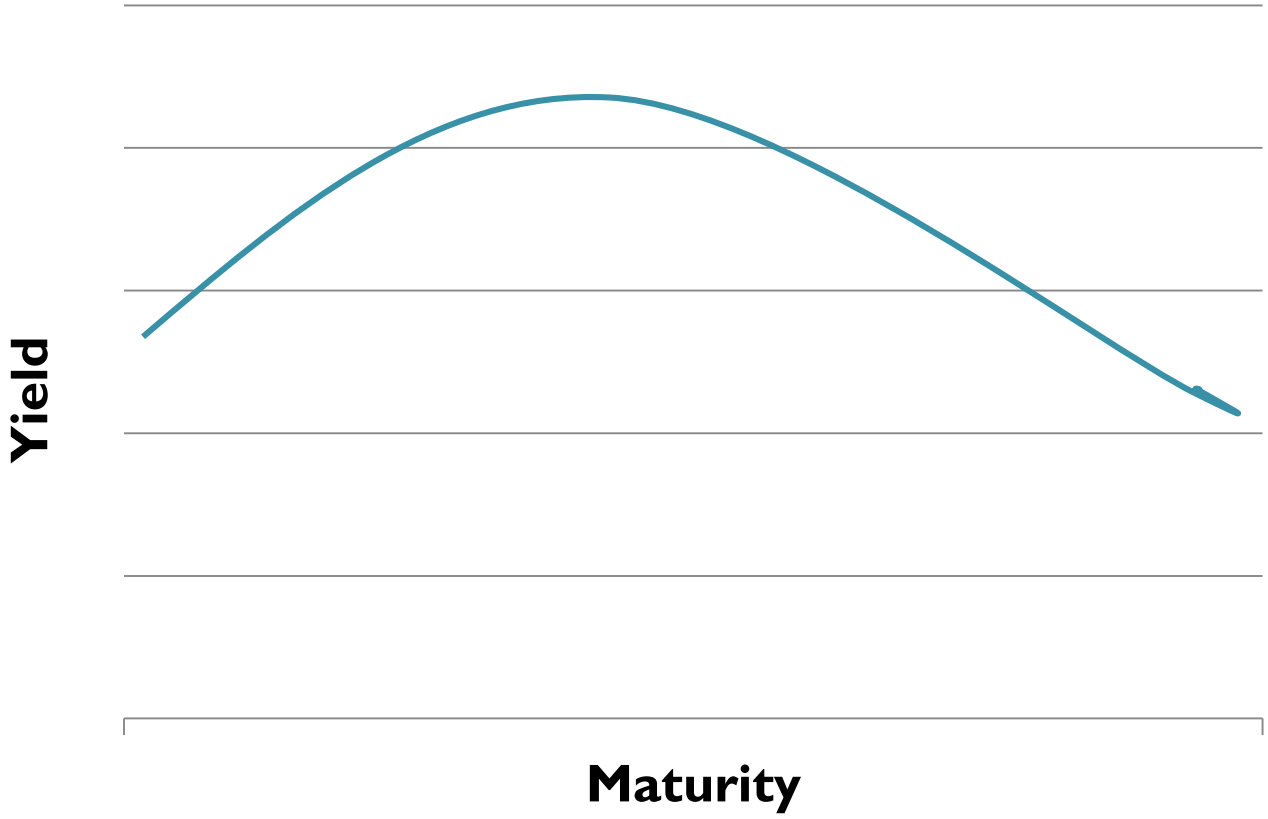
Bond Basics

- Yield Curve: Relationship between the bond interest rate and the bond maturity
- "Inverted" yield curve: unstable market conditions, longer maturities have lower rates of return
- "Humped" yield curve: Intermediate maturities high
- "Normal" yield curve: Longer maturities have higher rates of return
- If interest rates fall significantly,
  - Issuers may exercise call provisions
  - Existing bonds would sell at premium

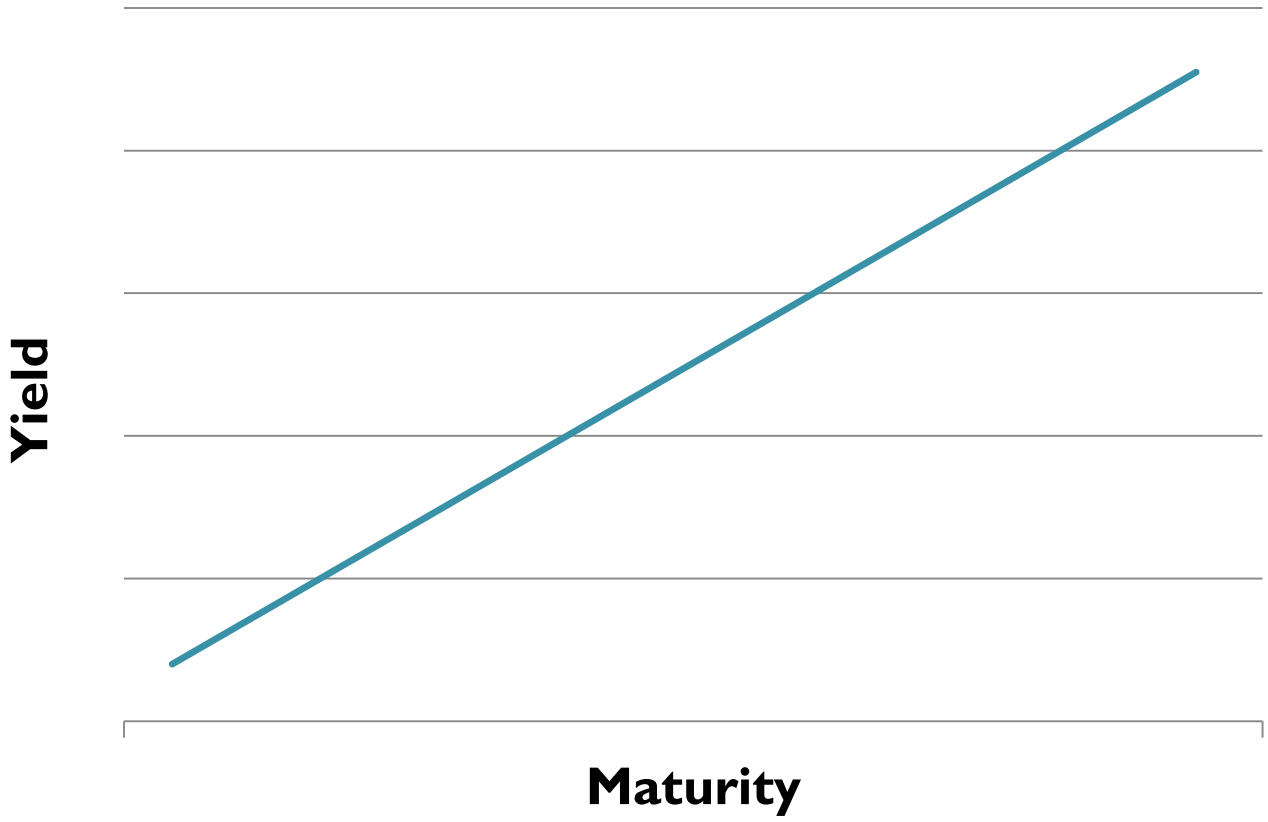
Example of "Inverted Yield Curve"



Example of "Humped Yield Curve"



Example of "Normal Yield Curve"



Question 3

The private activity/use test provides that bonds will be tax exempt if less than 15% of proceeds are used for private purposes

A) True

B) False

Difference Between Notes and Bonds

- Bonds
  - Issued in $5,000 denominations
  - Series with staggered due dates (maturities)
- Notes
  - Typically marketed in denominations of $100,000
  - Usually have a maturity of 1 year

Municipal Notes

- Two (2) general types
  - Issued in anticipation of receipt of specified revenue (Tax ANs, Revenue ANs)
  - Issued in anticipation of permanent financing (Bond ANs)
- Basis Point = 1/100th of 1% interest
- Interest and sinking fund payments exempt from tax calc for rollback

Question 4

Municipal Bonds are normally issued in $10,000 denominations

A) True

B) False

General Obligation Bonds

- Frequently sold via competitive method
- Favorable interest rates
- Voter approval usually required for amount & anticipated use
- Pledge of full faith and general credit required; is most secure bond
- FL local debt millage limit: Based on gov't debt policy

Revenue Bonds

- Specific revenue pledged to service debt
- Voter approval usually not required
- Debt service reserve may be required
- Coverage covenants usually included
- Trustee required
- Higher interest rates than GOs
- "Double-barreled" bonds = blend of GO and revenue bonds (separate bond resolution)

Special Assessment Bonds

- Voter approval usually not required
- Debt is secured by beneficiaries, limited group of property owners
- Complexity greater than GOs
- Market concerns about defaults
- Limited revenues to secure debt
- Higher interest costs due to higher risk

Certificates of Participation

- Voter approval usually not required
- Complexity greater than GOs
- Subject to annual appropriation
- Less secure than GO bond
- Created as part of lease / purchase; lender receives portion of lease payments

Question 5

Lease-purchase agreements require a vote by citizens when the lease is subject to an annual appropriation by the governing body

A) True
B) False

Financing Team

- Financial advisor
- Bond counsel
- Underwriter
- Paying agent / registrar
- Trustee
- Other

Financial Advisor

- Usually hired first, works in the interest of the issuer
- Assists in developing financing requirements and methods
- Assists in selecting the rest of the financing team
- Helps organize and coordinate all steps in process
- Basis of Compensation:
  - hourly
  - flat fee
  - sliding scale

Bond Counsel

- Certifies legal authority to issue the debt
- Provides an opinion that debt is tax exempt
- Interprets federal, state & local laws, regulations, constitutions and statutes, charters and ordinances
- May draft ordinance or trust indenture
- Basis of compensation: hourly rate with cap or flat fee
- Strong reputation key in selection

Underwriter

- Purchases and remarkets the securities
- Usually an investment or commercial bank
- Bids on Competitive Sales
- Participates in structuring negotiated sales
- Basis of Compensation: Underwriter spread
- Should be: competent, reasonably priced and have no conflicts of interest

Underwriter Spread

- Take-down – Compensation for selling bonds; sales commission
- Management fee – Managing the activities of the bond preparation
- Expenses – Incurred in the sale process
- Underwriting fee or "risk" – Risk associated with buying and reselling the issue

Others on the Team

- Paying Agent/Registrar
  - Securities Depository
- Bond Printer
- POS / OS Printer
- Trustee – Acts as fiduciary to protect interests of investors
- Escrow Agent -

Question 6

The financial advisor represents the public interest in a bond issue and sale

A) True
B) False

Competitive Sales

- Efficient method to sell GO bonds
- Bidding open to underwriters, commercial and investment banks, as well as corporations and individuals
- Notice of Sale
- Bid Form
- POS
- Basis of award
- Good Faith Deposit

Basis of Award

- Net interest cost (NIC) = total interest payments + discount (or less premium) divided by bond-year dollars
- Bond-year dollars = sum of the product of each year's maturity value and the number of years to its maturity
- True interest cost (TIC) is based on the time value of money (greater weight on early interest payments than on future ones) – **preferred method**

Bond Computation Exercise

Pond County issues $25,000,000 issue with the following maturities.

Years to Maturity	Par Amount	Interest
1	$4,000,000	1.50%
2	$5,000,000	2.00%
3	$5,000,000	2.25%
4	$5,000,000	2.50%
5	$6,000,000	2.75%

Bond Year Dollars = _____

Average Maturity = _____

Negotiated Sales

- Typically used for more complex issues and issuers unknown in the marketplace
- Underwriter assists with structuring and origination services
- When prices and maturities agreed upon, underwriter signs bond purchase agreement
- Gross spread = difference between price paid by the underwriter and price sold by underwriter
- Usually NOT used for GO bonds

Private Placement

- Marketing securities directly to investors (no underwriting firm), lower issue costs
- For complex transactions; limited disclosures; faster sale
- For small taxable issues; not rated
- Higher interest rates
- Minimal marketing effort; faster sale
- Very small portion of bond market

Structuring the Issue

- Determined by Finance Officer and Financial Advisor
- Three essential considerations
  - Match the structure to life of project
  - Closely coordinate pledged revenue with debt service requirements
  - Ensure compliance with debt management guidelines & policies

Question 7

Competitive Sales are typically used for more complex issues and issuers unknown in the marketplace

A) True
B) False

Debt Service Structure

- Level principal maturity schedule
- Level debt service schedule
- Graduated principal redemption
- Deferred principal
- Capitalized interest: payment of project interest from proceeds of issue until revenue starts
- Variable Rate Issue: Interest rate, renewal and rollover risk

Redemption Provisions

- Call options
  - Earlier the call option date, lower price issuer could get for bond
  - Lower interest rate does not mean more call protection
- Put options: Right of holder to cash out principal & interest; exercised if interest rates rise significantly
- Mandatory Redemption: Issuer required to call outstanding bonds – Sinking funds
- Optional Redemption: Issuer right to call bonds at their discretion

Notice of Sale

- Date, time & place of sale
- Description of the bonds
  - Amount of offering
  - Security
  - Dated date: when the securities begin to accrue interest
  - Maturity date & schedule
  - Form & payment of the bonds

Notice of Sale
Good Faith Deposit

- Paid by underwriter
- Typically 1 to 2 percent of the par value of the issue

Notice of Sale
CUSIP Numbers

- Committee on Uniform Securities Identification Procedures (CUSIP)
- Uniform method of identifying municipal, US Government, and corporate securities

Notice of Sale
Additional Contents

- Approving opinion
- How to obtain Official Statement
- Delivery of the Bonds
- Credit Enhancement
- Bond Counsel and Financial Advisor
- Additional Bond Covenants: Set criteria for issuing additional bonds under same pledged revenues.

Question 8

The MSRB bond number identifies the bond in the marketplace

A) True

B) False

Disclosure

- All materials prepared by an issuer that describe its proposed issue
- 1975, Municipal Securities Rulemaking Board (MSRB) oversees municipal broker / dealers / market
- 1990, SEC Rule 15c2-12 placed disclosure requirements on brokers / dealers
- SEC has no direct authority over municipal issuers

Preliminary Official Statement (POS)

- Summarizes proposed issue
- Used by Underwriter to market issues
- Often only disclosure investors will see
- May contain other source documents

Official Statement (OS)

- Issued after the sale of bonds
- Coupon interest rates
- Same info as POS with updates
- Contains information on security pledged and financial condition of issuer

Rule 15c2-12

- Underwriters must comply with:
  - Due diligence review of the POS
  - Distribution of the POS
  - Timely Receipt of Final OS
  - Distribution of the Final OS

Continuing Disclosure

- Issuer must provide timely information on its current credit-worthiness for entire period bond is outstanding
- ALL issuers required to file informational return with IRS regardless of size
- ALL tax exempt issues with maturity > 1 year must be fully registered
- Other required Info: Pledged revenues, debt service coverage, audited FS

Question 9

The SEC's Rule 15c2-12 regulates the issuing governments' continuing disclosure requirements

A) True

B) False

Credit Ratings Process

- Issuer provides info about financial and economic conditions
- Should meet in person for complex issues and if significant changes since last rating
- Team usually meets with credit agency; includes Finance Officer, Financial Advisor, and Bond Counsel
- Analyst makes recommendation to rating committee
- Underlying ratings are only published on request

Credit Rating Agencies

- Rating committees do the actual work of developing the agency credit rating
- Rating Report: A document published by the rating agency for the investing public
- Governments need to inform rating agencies of financial issues they might foresee for the coming period(s) and how they plan to address
- Personal meetings best when significant changes; CFO, Financial Advisor & Bond Counsel should attend

Credit Ratings

- High credit ratings usually = lower interest costs
- Underlying rating = what rating would be without credit enhancements, published on request
- Issuer must provide updates to rating agency while issue is outstanding
  - Debt management ability
  - Administrative issues
  - Financial performance and trends
  - Economic basics and outlook

Credit Ratings

	Moody's	S&P	Fitch	Meaning
Investment Grade	Aaa	AAA	AAA	Prime
	Aa1	AA+	AA+	High Grade
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Upper Medium Grade
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Lower Medium Grade
	Baa2	BBB	BBB	
	Baa3	BBB-	BBB-	
Junk	Ba1	BB+	BB+	Non Investment Grade Speculative
	Ba2	BB	BB	
	Ba3	BB-	BB-	
	B1	B+	B+	Highly Speculative
	B2	B	B	
	B3	B-	B-	
	Caa1	CCC+	CCC+	Substantial Risks
	Caa2	CCC	CCC	Extremely Speculative
	Caa3	CCC-	CCC-	In Default w/ Little Prospect for Recovery
	Ca	CC	CC+	
		C	CC	In Default
			CC-	
	D	D	DDD	

Question 10

An underlying rating is the credit rating without credit enhancements, such as bond insurance, and is published only on request

A) True

B) False

Credit Enhancements
Bond Insurance

- One time up front fee
- Bond insurer guarantees the timely payment of principal and interest on a bond issue, like letter of credit
- Requested in much the same way as a credit rating
- Premium based on credit worthiness
- Bond insurance only cost effective when comparing present value of issue with and without the insurance

Credit Enhancements
Surety Policies

- Used in place of a debt service reserve
- Debt Service Reserve (DSR) is a set-aside for covering payments to service the debt
- MOB (Municipal-Over-Bond) – Spread between municipal bond index and US Treasury index

Refunding and Restructuring

- To achieve debt service savings
- To remove or revise restrictive covenants
- To reduce existing debt service burden
- Refunding and restructuring will probably attract the same group of investors

Current Refundings

- Occur within 90 days of date bonds can be redeemed
- Normally exempt from arbitrage restrictions
- Yield Burning: Refunding escrow using above market securities
- Coverage Ratio: Historic earnings meet required future debt service coverage

Advance Refunding

- Refunded bonds not retired within 90 days of issuance of refunding bonds
- Proceeds placed in irrevocable escrow account until needed
- Yield on escrow is restricted
- Once the escrow has been funded the refunded bonds are legally defeased
- Bond Swapping

Question 11

The minimum net present value of debt service savings for a refunding is 7%

A) True

B) False

Investment of Issue Proceeds

- Should reflect anticipated need
- OS usually includes a list of permitted investments
- Net Present Value for refunding should be evaluated individually for each project

Arbitrage Compliance

- Invested earnings restricted to about the amount of yield on the borrowing
- Excess earnings must be rebated to IRS
- If too much rebated, request refund
- Must keep records 3 years after last bond matures
- If can't produce records, can't prove compliance to IRS; issue may be taxable, penalties
- If refunded, do not have to maintain records past call date if no new money issued

Exemptions to Limitations on Arbitrage Earnings

- Gross proceeds of an issue are expended within 6 months from the date of issuance
- Issuers of less than $5 million per year
- Spend-down tests: 24 months and 18 months
- Purchase of other tax-exempt municipal bonds

Electronic Municipal Market Access (EMMA)

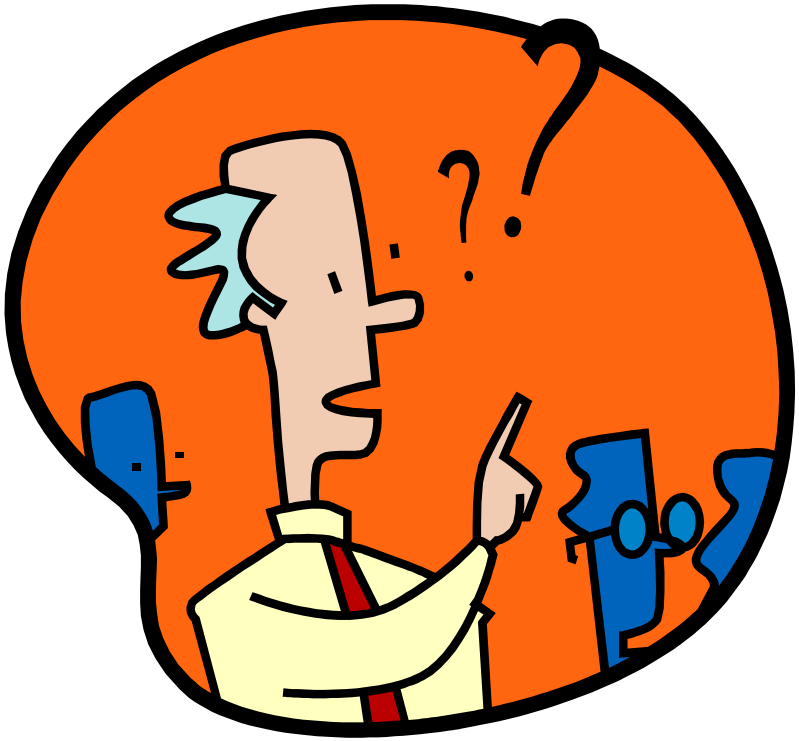
- Comprehensive, centralized online source (web site) established by SEC
- Provides free access to municipal disclosures, market data, educational materials
- Government must file "material event notice" with EMMA within 10 days of becoming aware of the situation

Question 12

IRS Regulations require that records be maintained until 3 years after the last bond matures

A) True
B) False

Derivatives

- Financial instruments whose value is based upon (derived) from the value of another asset or interest rate level
- Interest rate swaps are common derivative products
- Derivative Risks:
  - Basis Risk –
  - Counterparty Risk -
  - Term Mismatch Risk –
  - Termination Risk –
  - Rollover Risk –
  - Tax Event Risk -

Questions & Answers