Types of Debt Instruments and Understanding Refundings

Julia H. Cooper and Dianne McNabb
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   B. Dianne McNabb, PFM

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TYPES OF DEBT INSTRUMENTS

Julia Cooper
Decision to Finance Capital Project

- **Cash or Debt** -- Is the project more suitable for capital financing or operating/cash financing?
  - Capital expenditures are outlays that produce benefits beyond the current accounting period.
  - Using working capital (excess cash) to pay upfront for capital needs can be a viable option, if it’s plentiful…
  - Intergenerational Equity – spread the cost of the capital improvement over useful life of the project and to taxpayers/rate payers enjoying the benefits of the asset
Decision to Finance Capital Project

**Bonds or Leases?**

- **Bonds** are a form of debt repaid, usually with interest, over an extended period.

- **Capital leases**, according to GASB exhibit at least one of the following:
  - Government becomes the owner of the asset at the end of the lease;
  - Government can purchase the asset at a significant discount;
  - Term of the lease covers \( \frac{3}{4} \) or more of the remaining useful life of the asset; or
  - Value of the lease is close to the value of the asset if purchased.

- **Leases** not meeting criteria of capital leases are considered operating leases.
What Makes Municipal Bonds Unique?

- If municipal bonds are issued for a governmental or public purpose, interest earnings are generally exempt from federal taxation.
- There are about 70,000 state and local governments authorized to issue tax-exempt debt.
- In addition, some state and local governments extend state and local income tax exemptions for state taxpayers owning in-state bonds.
What Type of Debt to Issue?

- **Essential Service, No Underlying Revenue Stream**
  - Schools, Police/Fire Stations, Parks

- **Non-Essential Service, Moderate Underlying Revenue Stream**
  - Golf Courses, Convention Centers, Stadiums

- **Essential Service, Strong Underlying Revenue Stream**
  - Parking Garages, Urban Renewal
  - Water/Sewer Utilities, Gas/Electric Utilities

**Voter Approved General Obligation Bonds**

**Certificates of Participation, Limited Tax Bonds, Double-Barreled Bonds**

**Self-Supporting Revenue Bonds**
Considerations in Type of Debt and Structuring Decisions

- Tax-exempt versus Taxable bonds
- Type of Security Pledge
- Long-term versus short-term debt
- Fixed rate versus variable rate bonds
- Interim financing vehicles – commercial paper
- Tax Credit Bonds
- Public Market
- Private Placements
Tax-Exempt Bonds

• Government purpose obligations
  – Interest is exempt from federal income tax for individuals and some corporations.
  – Proceeds must be used for state and local governmental purposes. Federal government treated the same as private parties.
  – Subject to arbitrage rebate.
  – Subject to advance refunding restrictions.
  – Issuance must be authorized by governing body.
Taxable Bonds

- Carry higher interest rates.
- Flexibility for private use or payment.
- No arbitrage rebate compliance – can invest proceeds at a profit.
- Can advance refund more than once
**Tax-Exempt v. Taxable Bonds**

**Tax-Exempt Bonds**
- Interest is exempt from Federal & (usually) state income tax.
- Proceeds must be used for governmental purposes.
- Subject to arbitrage rebate.
- Limited to one (1) advance refunding.

**Taxable Bonds**
- Carry higher interest rates.
- Flexibility for private use or payment.
- No arbitrage rebate
- Can invest bond proceeds at a profit.
- Can advance refund more than once.
Why Issue Taxable Bonds

• Because you have to – private activity bonds
• Because you want to – for flexibility
• Because it might be cheaper to – direct interest subsidy bonds
• Because the Federal government takes away tax-exempt financing
Taxable Debt – Private Activity Bonds

• Use of bond proceeds may prevent issuance of tax-exempt bonds.
• Generally, if more than 10% of the bond proceeds are used in a trade or business, **AND** if more than 10% of the bonds are secured directly or indirectly by a trade or business, then the bonds are **private activity bonds** and not eligible for tax-exempt financing.
• Some exceptions for particular uses are available.
• Federal government is treated like a trade or business
Taxable Debt – Creates Greater Flexibility

- Issuing taxable debt for projects that are eligible for tax-exempt financing might be beneficial, even though interest costs are higher.
- Incentive-based third-party management contracts.
- Operational flexibility.
Taxable Debt – Build America Bonds (BABs) & Direct Subsidy Payment Bonds

- Recent Build America Bonds (BABs) provided direct interest payment subsidy to issuers that resulted in lower borrowing costs for many issuers.
- While BABs are no longer available, popularity of direct interest payment subsidy bonds may encourage future programs to be made available.
- Not to be confused with tax credit bonds
**Tax Credit Bonds**

- Allow holder of tax credit bond (“TCB”) the ability to claim a federal tax credit equal to a percentage of the bond’s par value (face value) for a limited number of years.
- This tax credit percentage is set at the current yield on taxable corporate bonds.
- TCBs generally deliver a larger federal subsidy to the issuer than do municipal bonds.
  - The subsidy to the issuer is the full 5.70% instead of the difference between the taxable rate and the lower tax-exempt rate of 4.75%.3
  - With tax credit bonds, the issuer does not pay any interest.
Do I Need Short-Term or Long-Term Debt?

- **Long term**
  - Length: to 50 years
  - Names: Bonds, Debentures, Leases

- **Short term**
  - Length: to 5 years
  - Examples: Bond, grant, tax or revenue anticipation
  - Names: BANs, TANs, RANs, Commercial Paper
Notes

• **Notes Secured by:**
  – Pledge of anticipated property taxes or other revenues;
  – Proceeds from bonds previously authorized but not yet issued.

• **Purposes for Note Issuance:**
  – Capital costs
  – Acquire loans or assets
  – Cash flow borrowing to manage imbalances (not deficits) between tax receipts and expenditures
Short-Term Debt

- **Tax anticipation notes (TANs)**
  - Generally a “cash flow” borrowing
  - Serviced by future tax collections, within a 13 month (or less) period

- **Bond anticipation notes (BANs)**
  - Secured by anticipated proceeds from a forthcoming bond sale

- **RANs, GANs, or TRANs**
  - Anticipation of revenues, grants, etc.
  - A cash flow borrowing
Variable Rate Demand Bonds (Notes)

- Is a long-term bond with a short-term (floating) rate
- Interest rate resets periodically during life of debt
- Interest rates are based on length of reset period & market conditions at time of reset
- VRDN is most common form of variable rate bond
- Remarketing agent sets rate periodically (daily, weekly, monthly, other)
- Holder can generally put bond on 7 day notice
- Callable at reset at par
- Letter of Credit/Liquidity facility needed for credit risk and in event of put – becoming harder to secure LOCs
- Remarketing agent needed
Advantages of Variable Rate Debt (VRDN & CP)

For Debt Issuers
- Lower interest costs
- Matches interest payment interest earnings
- Option to redeem or purchase
- Bonds (refinance) at any time at par
- May hedge short-term investments

For Bondholders
- Short-term commitment of funds
- VRDBs are money market eligible
## Disadvantages of Variable Rate Debt (VRDN & CP)

<table>
<thead>
<tr>
<th>For Debt Issuers</th>
<th>For Bondholders</th>
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<tbody>
<tr>
<td>• Interest Rate Risk</td>
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<td>• Additional Financing Costs</td>
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<td>• Rating change for liquidity/credit provider</td>
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<td>• Liquidity providers more difficult (and expensive) to obtain &amp; maintain</td>
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<tr>
<td>• Requires constant staff monitoring</td>
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<tr>
<td>• Increased rating agency scrutiny</td>
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<tr>
<td>• Lower Interest Income</td>
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<tr>
<td>• Uncertain Interest Income</td>
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</table>
Types of Bonds – General Obligation

• Require bond election for authorization (usually).
• Issued for any public purpose:
  • Real property;
  • Land acquisition, etc.
• Secured by issuer’s taxing power
• Viewed as lowest credit risk to investors
• Attracts lowest interest rates.
Types of Bonds -- Revenue Bonds

- Require no voter approval (usually)
- Secured solely by designated revenues
  - Enterprise revenues: water, sewer, sanitation, airport, parking
  - Sales taxes;
  - Assessments;
  - Limited property tax (some states)
- Sell at higher interest rates
- May require a reserve fund
- Features:
  - Must meet promises set forth in bond ordinance:
  - Promise to maintain revenues or asset at level sufficient to pay bonds and maintain operations (rate covenant)
  - Limit on additional bonds
Types of Bonds – Tax Increment Financing

- Financing tool to attract economic development projects, create jobs, foster infrastructure investment and redevelop blighted areas.
- Technique for financing a qualifying capital project, or its related infrastructure, from a stream of revenue generated within the geographic area defined as a TIF district.
- TIF districts generally rely upon incremental property taxes generated in a specific area, but can also apply to other taxes, including sales taxes.
- Most states have established laws and eligibility requirements to designate an area as a TIF district – refer to specific state laws.
Certificates of Participation/Lease Revenue

• May require voter approval, depending on state laws.
• Secured with tax pledge and specific revenue pledge.
• Intent is to pay debt service from revenues, but credit may not be investment grade without tax pledge.
• Issued for revenue producing projects where stability of revenue stream is uncertain:
  – Golf courses;
  – Parking systems;
  – Convention centers/stadiums, etc.
• Generally sell at interest rates comparable to GOs.
Capital Leases

- *Capital Leases*
  - Lease: payment is subject to annual appropriation
  - Certificates of participation (COP) in a lease

- *Parties in Lease Transaction:*
  - **Lessor** – leases the asset to the lessee (usually a municipal or not-for-profit financing shell)
  - **Lessee** – leases the asset from the lessor (municipality using the asset)
  - **Lender/funding source** – owns the benefits of the lease (bank, leasing company)

- More expensive than Direct Debt
- Used when state laws limit the use of Direct Debt
- Readily marketable, if asset is essential to government
- Can be used for financing real property, equipment
Capital Lease - Lessor Rights

- Lease payment subject to annual appropriation (avoids “debt” definition in most states)- Leads to rating below the municipality’s GO Bond rating.

- Asset can only be used for general governmental purpose (incentive to continue to make lease payments)

- Lessee payment default:
  - “locked” out of the use of the asset
  - Lessor may be able to sell or release the asset
Bank “Loans” – Direct Bank Borrowings

• **Lines of Credit**
  - Allows interim financing and aggregation of small projects funded over time into larger long-term bond issue.
  - Provides interim project funding in anticipation of reimbursement from other entity such as Federal grants.
  - Can provide flexible, short-term variable rate index financing with amortizing principal repayment

• **Direct Bank Borrowings**
  
  Direct lending from bank to government agency
  - Can provide more flexible terms, repayment obligations
Financing Capital Improvements - Summary

• Careful consideration of many factors critical in determination to issue debt
• Useful Life of Facility (cash v. debt)
• Source of Revenue to repay obligation (type of debt)
• Use of Facility (tax-exempt v. taxable)
• Ability to access public markets (public offering v. private placement)
• Cost of borrowing (variable v. fixed rate)
Post Issuance Compliance Activities

- Trustee Oversight and Management
- Budget and Accounting
- Tracking Compliance
- Record Retention
- Bond Project Monitoring
- IRS Arbitrage Requirements
Understanding Refundings

Dianne McNabb
Call Features

Call = Terms for prepayment in advance of scheduled maturity

Call Features may include:

- Optional Redemption
- Mandatory Redemption (term bonds)
- Extraordinary Redemption (tied to specific events)
  - Optional – event triggers issuer option
  - Mandatory – event triggers without option

Should be discussed at time of bond issuance, as there is typically a trade-off in interest rates
Optional Redemption

Most municipal bonds have an *optional call* feature which allows issuers to prepay bonds at a specified price on certain dates in the future

» Call date is usually 8-10 years
» Call notice: typically 30 to 60 days prior to call date
» There may be a schedule of call prices/dates

- December 1, 2016 to November 30, 2017: 102
- December 1, 2017 to November 30, 2018: 101
- December 1, 2018 and thereafter: 100
Refunding Candidates

- You only save interest on callable bonds
- In the current market, the closer to the call date, the more efficient the refunding and greater the savings
- Best candidates in current market:
  - Issues with longer period between call date and final maturity
- Some bond refundings offering “good” savings include significant negative arbitrage, so issuers may consider waiting, despite the attractive savings level
Rolling Down the Yield Curve

"Rolling Down the Yield Curve"

- Original Coupon
- Refunding Coupon
Current Refunding Bonds

Refunding bonds sold within 90 days of the first call date of refunded bonds

- Proceeds may be invested in escrow without yield restriction
- No IRS Regulations limiting to the number of current refundings

Refunding Bonds

Bond proceeds used to fund Defeasance Escrow

Defeasance Escrow

Less than 90 days

Call Outstanding Bonds

Refunding Bonds
   June 1, 2009

Call 1999A Bonds
   September 1, 2009

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Advance Refunding Bonds

Refunding bonds sold more than 90 days to the first call date of the refunded bonds

- Escrow yield restricted to arbitrage yield of refunding bonds
- IRS Regulations limits issuers to one advance refunding per issue

Refunding Bonds

More than 90 days

Call Outstanding Bonds

Pay Principal & Interest due on Refunded Bonds until the Call Date

Defeasance Escrow

Bond proceeds used to fund Defeasance Escrow

Refunding Bonds

June 1, 2009

Call 2001A Bonds

August 1, 2011
Economics of Refunding

- Reduction in interest rates on prior “refunded” bonds versus new “refunding” bonds
- Remaining term and amount of refunded bonds
- Length of the escrow (i.e. years between refunding and call date)
- Efficiency of the escrow
  - Ability to earn the escrow yield limit
  - Investment dates vs. refunded bond payment dates
Additional Considerations

» Negative arbitrage (earnings) in escrow
  – Consider financial risk and trade-off of waiting
  – Each month you wait, escrow loss decreases
  – Calculate “break-even rate” to evaluate interest rate risk

» Extension of call date
  – Potential benefit of retaining ability to call bonds
  – Potential for change in use of facility (i.e., private lease or sale)

» Impact of Debt Service Reserve Fund for revenue bonds
  – If you have high yielding investments, will you lose the ability to retain all earnings?
  – If you have a reserve surety, will you need to fund-up reserve with cash or bonds – in this case, you need to consider the “negative earnings”
Financial and Policy Objectives
Issuer Objectives

- Achieve savings through debt service reduction
- Restructuring or deferral of debt service
- Consolidation of debt
- Removal or amendment of Bond Covenants

*Or Combination of Above Objectives*
Debt Policy Considerations

- A Debt Policy is highly recommended for all municipalities
- A Debt Policy should address refunding savings thresholds
- Policy may differentiate between Current and Advance refundings
  - Expected results will be impacted by length of time between call date and final maturity
  - As callable bonds mature, savings opportunities are foregone
Savings Thresholds or Targets

- Net present value savings as % of par value of bonds
  
  NPV Savings = annual savings present-valued to the issue date, net of related costs of issuance

  Threshold can be % of refunding par or refunded par – or both

- Are thresholds minimums, or triggers?

- Absolute savings

  Is there a dollar level at which staff time/effort is not worth savings?

- Amount of savings compared to COI (costs of issuance)
Financial Savings and Evaluation
How to Evaluate a Refunding

Key Factors in Evaluating a Refunding

- NPV Savings - $$ and as % of par
- Current vs. historical interest rate levels
- Shape of yield curve
- Term to maturity (years remaining after the call date)
- Absolute level of savings: minimum $ threshold (e.g. $1 million)
- Consider “opportunities lost” as currently callable bonds are retired
## Measuring Savings

<table>
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<tr>
<th>Year</th>
<th>Original Bonds</th>
<th>Refunding Bonds</th>
<th>Cash Flow Savings</th>
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<tr>
<td>2010</td>
<td>502,095</td>
<td>466,203</td>
<td>35,893</td>
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<tr>
<td>2011</td>
<td>500,645</td>
<td>466,203</td>
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<td>2012</td>
<td>498,715</td>
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<td>2013</td>
<td>501,290</td>
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<td>2014</td>
<td>498,065</td>
<td>468,808</td>
<td>29,258</td>
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<td>2015</td>
<td>499,065</td>
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<td>2016</td>
<td>499,065</td>
<td>470,208</td>
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<td>2017</td>
<td>503,145</td>
<td>467,668</td>
<td>35,478</td>
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<td>2018</td>
<td>501,320</td>
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<td>2019</td>
<td>498,495</td>
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<td>2020</td>
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<td>2021</td>
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<td>2029</td>
<td>498,750</td>
<td>470,700</td>
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- **NPV Savings**: $440,023
- **Savings as % Refunded Bonds**: 7.15%
- **Savings as % Refunding Bonds**: 6.79%
- **Annual Cash Flow Savings**: ~$30,000
- **NPV Savings**: $440,293
- **7.1% of Refunded Bonds**
- **6.7% of Refunding Bonds**
Debt Service Reserve Fund Impacts

Gross-to-Gross Refunding

» Comparison solely of gross debt service
» Does not take into account reinvestment of bond proceeds (DSRF)

Net-to-Net Refunding

» Compares Net Debt Service
» Takes into account reinvestment of bond proceeds (DSRF)
## Net-to-Net Refunding

<table>
<thead>
<tr>
<th>Year</th>
<th>Original Bonds</th>
<th>Original Earnings</th>
<th>Refunding Bonds</th>
<th>Refunding Earnings</th>
<th>Net Debt Service</th>
<th>Gross Savings</th>
<th>NPV Savings</th>
<th>DSR Savings</th>
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<td>472,843</td>
<td>17,421</td>
<td>452,049</td>
<td>29,230</td>
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<td>473,343</td>
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<td>(25,254)</td>
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<td>(3,64%)</td>
<td>(4.68%)</td>
<td>(4.85%)</td>
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Total: $9,996,900 $1,006,290 $8,990,610

DSR: $503,145 5.00%

Savings as % of Refunding Par: 6.69% 4.85%
Savings as % of Refunded Par: 7.15% 5.19%

- Net-to-Net Refunding reflects true savings
- May reduce savings level (e.g. 7.1% vs. 5.2%)
Shape of the Yield Curve + Time to Final Maturity

» 3.0% to 10.0% in par value required to issue refunding bonds

» % spread of 100 bps more significant later years:
  – 3 year = 300 bps / 9 years = 900 bps
Historical Rate Comparison

**LIBOR Average = 4.35**
**BBI Rev Average = 5.69**
Historical Rate Comparison

Market Yield Curve
Municipal Market Data Index

% Rate

Years

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30

Refunding Bond Structure
Escrow Sizing/Efficiency
Defeasance

Legal Defeasance
» Escrow securities backed by full faith & credit of U.S. government (e.g., U.S. Treasuries / SLGS)
» Requires bond counsel opinion
» Debt removed from books

Economic Defeasance
» Escrow securities not backed by full faith & credit of U.S. government (e.g., Corporates & Agencies)
» Higher yield / Greater savings
» Debt remains on the books
» Or, otherwise not meet conditions (i.e. verification)
Defeasance Escrow

Refunding Escrow is used to Defease Refunded Bonds until they can be called

- Portfolio of “eligible securities”, as defined in the Indenture (U.S. Treasuries / SLGS)

- Escrow cash flows must be sufficient to pay:
  - Principal
  - Interest
  - Call Premium
to the call date, without reinvestment

- If escrow earnings rate is lower than the interest rate being defeased, you need to deposit more proceeds in the escrow (i.e. higher escrow cost)
Escrow Requirements

Advance Refunding

- **Interest to Call:** $3,040,713
- **Principal Called (2015-2024):** $18,525,000

*Bonds Callable: December 1, 2014*
## Escrow Requirements

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<tr>
<th>Date</th>
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<th>Interest to Call</th>
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<td>434,388</td>
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<td>$18,525,000</td>
<td>$8,353,963</td>
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**$3,040,713** Interest to Call December 1, 2011

**$18,525,000** Bonds to Call December 1, 2011

**$21,565,713** TOTAL ESCROW REQUIREMENT
Escrow Structuring

- Escrow cash flow requirement = $21,565,713
- IRS Regulations allow escrow to be invested at the arbitrage yield on the refunding bonds (e.g., 2.02%)
- Perfect escrow (e.g., 2.02%) would cost = $20,336,830
- Market escrow cost @ 0.40% yield = $21,316,131
- Negative arbitrage is $979,301 – these are foregone savings

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<th>DATE</th>
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<th>0.030% 12/1/2011</th>
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<th>0.160% 6/1/2013</th>
<th>0.220% 12/1/2013</th>
<th>0.300% 6/1/2014</th>
<th>0.410% 12/1/2014</th>
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<td>434</td>
<td>593</td>
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<td>40,129</td>
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<td>394,573</td>
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<td>593</td>
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<td>-</td>
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<td>Total</td>
<td>$ 21,565,713</td>
<td>$ 21,316,131</td>
<td>$ 402</td>
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<td>$ 249,582</td>
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</table>
Negative Carry

- Proceeds invested @ bond rate pays for itself
- Proceeds invested lower than bond yield (0.40%) creates inefficient escrow due to yield loss (negative arbitrage) of $979,301
- Inefficient Escrow results in increase in par value of refunding bonds by 1.62%
Bond Sizing Requirements

1. Cost of Issuance: 0.50% to 1.0%
2. Underwriter’s Discount: 0.50% to 1.0%
3. Redemption Premium: 1.0% to 3.0%
4. Negative Carry *: 1.0% to 3.0%

* Advance Refunding Bonds: $8,000,000

Assumes DSR transfers from prior bonds

Bonds Outstanding $6.15 Million
Principal & Interest $1.6 Million

Additional Par 3.0% to 8.0%

Advance Refunding Bonds: $8,000,000

GOVERNMENT FINANCE OFFICERS ASSOCIATION
Optimizing Savings

Obtaining highest yielding securities
Obtaining most efficient timing of escrow investments
Take into account negative arbitrage
Consider impacts of DSR funding
Comparison should be net-to-net basis, taking into account DSRF investment earnings
Consider break-even rate if you wait, and other options
Look at the broader picture of interest rates and yield curves
DEBT ADMINISTRATION AND MANAGEMENT

Julia Cooper
Debt Administration and Management Activities

- Preclosing Activities – It Starts Here!
- Post Issuance Compliance – Best Practices
  - Record Retention
  - Investment and Reinvestment Activities
  - Rebate Monitoring
- IRS Compliance
  - IRS is now asking issues if they have WRITTEN post issuance compliance policies and procedures in place.
  - GFOA along with NABL working on new post issuance compliance guidance.
  - Issuers may want to discuss this with counsel, as it is being emphasized in IRS audits.
Managing Compliance from the Start

- Understanding Business Terms
- Understanding Regulatory Obligations
- Preparing for Investment and Re-investment of bond funds
Understanding the Business Terms – Tax Certificate and Form 8038

• *Don’t view as closing certificate*
• Review early in process, ensure consistency
• Lack of project specificity can be a **red flag** during an IRS audit
• Understand the document; ask questions
• What is your bond year and why do you care?
• Do you have annual rebate calculation requirements?
• What representations are being made regarding:
  • Project
  • Use of funds
  • Spend-down of proceeds
  • Yield Restriction
Trustee Oversight and Management

- Use technology to your advantage – Get online access from day of closing
- Online reporting reduces paper
  - Ease of creating electronic records
  - Easier to get documents to rebate consultant
- Methodology for monitoring activity
  - Transfer of funds
  - Interest earnings appropriate credits
Budget & Accounting – Impact on Tax Compliance

- Annual budget actions necessary to appropriate debt service and related payments
- Budget documents must provide documentation of annual budget and appropriation of debt service
- How are reserve fund earnings treated?
- How are you going to annually “clean out” your debt service payment funds
Post-Issuance Compliance Checklist Highlights

- Tax Law Requirements
  - General Matters
  - Use of Proceeds
  - Private Activity Bonds
  - Arbitrage
  - Pool Bonds
  - Record Retention
- Disclosure Requirements
- Miscellaneous Requirements

Copy of checklist can be found on GFOA website at:
Disbursement of Bond Proceeds

- Establish Procedures for Disbursement of Bond Proceeds and Train Staff
  - Project staff
  - Finance staff
- Understand eligible expenditures
  - Working capital limits
  - Private Activity limits/restrictions
  - Use of proceeds
  - Develop procedures for allocation expenditures of bond proceeds to Projects
Record Retention

- Establish Record Retention Requirements and Procedures
- IRS record retention requirements
  - Term of bonds + 6 years
  - Types of records
- IRS Website
Arbitrage Rebate Compliance Activities

- Internal monitoring of rebate compliance
- Recommend annual calculations during construction period
  - Set aside annual rebate liability in Rebate Fund
  - Get it out of the Construction Fund
- Paying rebate is not bad, just need to monitor and pay as required
- Pay attention to requirements in Tax/Arbitrage Certificate **BEFORE** you sign
Bond Project Monitoring – Facility Use

• Maintain records of facility use
  • See Record Retention Requirements

• Review all agreements for facility use
  • Potential impact on tax-exemption

• Everything must be reviewed by bond and tax counsel
  • Putting solar panels on roof top or placing cellular phone receiver on roof top could negatively impact tax-exemption
  • Operator Agreements for facilities can also impact tax-exemption
Preparing for IRS Audit

• Odds of any one bond issue being audited are relatively low

• Good recordkeeping is essential
  • Issuers/conduit borrowers should maintain complete and detailed records of investments and expenditures of bond proceeds
  • Thorough and complete records of the use of facilities financed with bond proceeds should be maintained, including management contracts/other use agreements

• Ensuring proper allocation of bond proceeds

• Federal tax regulations require allocations of proceeds of bonds to specific expenditures be made not later than 18 months after the date the expenditure is paid or the date the project is placed in service, but in any event, these allocations must be made within 60 days of the 5th anniversary of the date of issue of the bonds
What to Do When Faced with IRS Audit?

• First, don’t panic
  • In case of a questionnaire -- IRS is only asking questions, it is not asserting that there is anything wrong with your bonds
  • In the case of the audit, the IRS may also be simply checking to see if the bonds are in compliance with tax rules

• Second, don’t ignore the questionnaire or the audit notice
What to Do When Faced with IRS Audit?

- Timelines for Response -- Questionnaire or audit notice will have a time limit for a response
  - Questionnaires --
    - IRS indicated will liberally grant extensions of time to respond
    - Need to request extension before the IRS response deadline has passed
  - Audit –
    - IRS will usually grant an extension of time for a response
    - Request must be made in a timely manner
Tracking Compliance Activities – Securities Laws

- Annual Reporting
- Material Event Reporting
- “Just Because” Reporting
  - Market Participant inquiries
  - Event or occurrence drawing attention to organization
- Continuing Disclosure Filings
  - Make sure that your ongoing annual filings include ALL information that is included in your Continuing Disclosure Agreement (CDA).
  - Underwriters have to ensure that you are complying.
  - SEC being very aggressive – even with issuers – about maintaining appropriate and expected disclosure standards.
- All information sent to EMMA – www.emma.msrb.org
### San Jose: Internal Procedures – Reports/Data Required

**Continuing Disclosure Enclosures (FY 6/30/10 Annual Report)**

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<th>Item</th>
<th>Received</th>
<th>Posted</th>
<th>Enclosure</th>
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<td>Excess Operating Budget</td>
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### San Jose: Internal Procedures – Status Reporting

**Continuing Disclosure Status Report (FY 6/30/10 Annual Report)**

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<th>Reviewed by Debt Admin</th>
<th>Reviewed by Div. Mgr.</th>
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Benefits of EMMA (Electronic Municipal Market Access)

• No reliance on third parties to post/disseminate information on a timely basis

• Ability to uniformly “speak to the market”

• Ability to provide investors with alternative ways to obtain additional information about your entity
  • URL postings

• Easy verification of available information

• Ability for **ALL** investors to access the same information (for free)
  • [www.emma.msrb.org](http://www.emma.msrb.org)

• Many tools and background information available to issuers
Best Practice Tips for Issuers

• Create an e-mail address for notification purposes – not an individual
  • debt.management@sanjoseca.gov

• Create electronic ticker system for entire debt management team – Track Everything!

• Monitor for compliance on regular basis (daily, weekly, monthly)

• Establish Policies and Procedures and review periodically

• Maintain Records
SEC Regulations: Municipal Advisors

- The Dodd-Frank Bill contained financial reforms that will be noticed in many ways and will impact your relationship with:
  - rating agencies
  - financial advisors
  - swap advisors
  - investment brokers
  - underwriters

- The most noticeable change will be the SEC’s and MSRB’s regulation of “Municipal Advisors”
Definition of Municipal Advisors

• SEC finalized definition which goes into effect July 1.

• Appointed members of state and local governing boards and state and local government employees are NOT included in the definition.

• Only those with a fiduciary duty to the issuer may provide them with advice unless an exemption is met (e.g., issuer has a municipal advisor, issuer has RFP out for underwriter services).

• If an issuer has a MA and wishes to receive advice from another party (e.g. underwriter) it must put in writing that it has a MA and will rely on them for advice related to the ultimate transaction.

Municipal Advisors

• MAs must now be registered with the SEC and MSRB
• MSRB developing further regulations
• Definition of Fiduciary Duty
  • Suitability standard – MA may not recommend a product that is not suitable for that specific entity. (pending MSRB reg)
• Separate rules for swap advisors and swap transactions.
  • Government wishing to engage in these transactions MUST hire a swap advisor that is independent from the swap dealer
• MAs will have to meet new professional requirements and standards
• Rules similar to Broker/Dealers (e.g., pay to play, etc), will be put into place
Role of Underwriters

- MSRB Rules related to Underwriters
  - Effective November 27, 2011, underwriters of municipal securities will also be required to provide certain written disclosures to issuers if they wish to be considered to be “acting as an underwriter”
  - Investment banker may provide input and assistance, but they cannot be a “municipal advisor” and an “underwriter” in the same transaction.
  - As underwriter, firms do not have a fiduciary responsibility to the issuer, but are a buyer of the bonds.
  - Disclaimers are beginning to reflect new language that analysis and input is for “marketing” purposes, in order to support engagement as underwriter, and is not to be considered advice.

These rules are not new, but are becoming more visible and familiar to issuers
Written Disclosure from Municipal Advisor

- Municipal advisory relationships are to be evidenced by a writing, to include:
  - the basis of compensation
  - disclosure of affiliations,
  - disclosures of conflicts, and
  - whether the municipal advisor is registered with the Commission and the Board (as is required by law)

*These practices are recommended by the GFOA and will likely be part of mandated MSRB rulemaking in the near future.*

- The writing is to be amended or supplemented during the term of the municipal advisory engagement as necessary to reflect changes in the disclosures
- The only party with a fiduciary responsibility to the issuer is a Municipal Advisor, and not an underwriter
Questions?

Please use the Webinar Question Feature on the task bar.

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