PMA SECURITIES

ILLINOIS MUNICIPAL TREASURERS ASSOCIATION

IMTA Institute 2023

Debt Policy

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Debt Management Policies

<u>Purpose of a Debt Management Policy</u>

- Create tools to reconcile capital needs with available resources
- Establishes some basic parameters and principles
- Educate stakeholders
- Board-approved policies provide protection against political expediency

<u>Key Components of a Debt Management Policy</u>

Through the Issuance Process

I. Scope and Purpose
II. Uses of Debt
III. Types of Debt Permitted
IV. Debt and Debt Repayment Structure
V. Debt Issuance Practices

Post-Issuance

VII. Ongoing Post-Issuance Administrative Activities

Scope and Purpose

Debt management policies typically start with a statement of purpose to explain the overall objective of adoption and debt management policy.

Example

"The purpose of this policy is to establish a framework for debt management to work in conjunction with the Capital Improvement Program Development. These guidelines will enhance the quality of decisions, rationalize the decision making process, identify objectives for staff, and demonstrate a commitment to long-term planning.

This Policy will be a positive factor in the municipal market's assessment of the City's credit quality. The City's financial condition and credit ratings should always be the primary considerations when considering the issuance of debt. It should be recognized that these guidelines are not immutable; changing circumstances require flexibility and revision. Anticipation of every future contingency is unrealistic. When adjustments are necessary, the reasons for such policy changes need to be well documented if the City wishes to demonstrate to the credit markets and its citizens that its commitment to sound debt management principles is unchanged."

Uses of Debt

The Debt policy should consider when it is appropriate to use debt and when it is not appropriate; however, this policy does not exist in isolation. Other Policies intrinsic to Debt Management include:

- Capital Improvement Planning
- Economic Development
- Fund Balance Policy
- Long-term Financial Planning, etc.

<u>Capital and Equipment</u>

- When is it appropriate to use debt for capital projects?
- When is it appropriate to use debt for equipment?
- When is it appropriate to use other funding sources?
  - Operating Levy (PAY GO)
  - General Fund balance
  - Equipment Replacement fund balances

<u>Economic Development Initiatives</u>

- When is it appropriate to use debt for economic development initiatives?
  - Capital Projects vs. Developer Incentive “Gap” Payments
- When should interfund loans be used to provide temporary financing?

Types of Debt Permitted (IL)

General Obligation (GO)

- Unlimited GO Bonds
- Limited GO Bonds

Direct Revenue Bonds

- Typically utilities (Water, Sewer, Electric, Stormwater), but could include other revenues (TIF Revenues)

Alternate Revenue Bonds

- Typically utilities (Water, Sewer, Electric, Stormwater), but could include other revenues (TIF Revenues)
- In addition to one of these revenue streams, the municipality pledges its GO taxing ability

Special Assessment Bonds

- Secured by a special assessment against the property

Other Financing Options

- Anticipation Notes
- Tax Securitization Bonds

Debt Limitations

Debt limitations exist for both:

- Amount of Debt
- Debt Service Requirements

Sources of these limits include:

- **Limits imposed by Law (for non-Home Rule units of government)**
  - Statutory Debt Limit: 8.625% of municipality's EAV
  - Non-referendum Debt Limit: 0.5% of municipality's EAV
- **Limits imposed by Contract**
  - Revenue Debt – Additional Bonds Test for new debt to be issued "on a parity"with existing debt
  - Revenue Debt – Debt Service Coverage requirements
- **Limits imposed by Rating Agency reaction**
  - Increases to Debt or Debt Service can affect financial ratios that are correlated with a given rating
- **Limits imposed by Policymakers**
  - Stricter limits intended to promote fiscal discipline
  - Can be modified as circumstances change

Example Debt and Debt Service Limits

Below are example **debt and debt service limitation** policies from medium-sized Illinois municipalities.

Example No. 1

Direct Debt to Equalized Value

- Guideline: 1.0% to 3.0% limit
- 75% of Guideline: 2.5%

Direct Debt per Capita

- Guideline: $500 to $1,000 per capita
- 75% of Guideline: $875 per capita

Debt Service Expenditures as a % of General Fund Expenditures

- Guideline: 5% to 10%
- 75% of Guideline: 8.75%

Impact on Credit Rating

- The Village will seek to maintain or improve its current bond rating and will specifically discuss with the Board any proposal which might cause that rating to be lowered

Example No. 2

✓ **The City should not exceed credit industry benchmarks where applicable. Therefore, the following factors should be considered in developing debt issuance plans:**

Ratio of Net Bond Debt to Estimated Full Value

- The formula for this is Net Bonded Debt, which is the total outstanding debt divided by the current Estimated Full Value as determined by the most recent EAV

Net Bonded Debt per Capita

- The formula for this is Net Bonded Debt divided by the current population as determined by most recent census information available

Ratio of Annual Debt Service to General Governmental Expenditures

- The formula for this is annual debt service expenditures divided by General Government expenditures

Debt Issuance Practices

Per the GFOA, a Debt Management Policy should include guidance on the issuance process including:

- Selection and use of professional service providers, including an independent financial advisor, to assist with determining the method of sale and the selection of other financing team members.
  - Disclosure Counsel for assistance with preparing and documenting the Official Statement?
- Criteria for determining the sale method (competitive, negotiated, private placement) and investment of proceeds.
- Use of comparative bond pricing services or market indices as a benchmark in negotiated transactions, as well as to evaluate final bond pricing results.
- Criteria for issuance of advance refunding and current refunding bonds. (no more Tax-Exempt Advance Refundings post Tax Cut and Jobs Act of 2017, effective 12/31/17)
- Use of credit ratings, minimum bond ratings, determination of the number of ratings, and selection of rating services.

Example Debt Issuance Practices

Below are example **debt issuance practice** policies from medium-sized Illinois municipalities.

Example No. 1

Professional Team

To provide assistance in debt issuance, the Village will select a financial advisor and/or investment banker and bond counsel on a competitive basis; these advisors will be retained for several years to provide continuity and allow them to develop an understanding of the Village's needs.

Method of Sale

The Village will generally conduct financing on a competitive basis; however, a negotiated financing may be used where market volatility or the use of an unusual or complex financing or security structure causes a concern with regard to marketability.

Example No. 2

Structure of Debt Issuances

The duration of a debt issue shall not exceed the economic or useful life of the improvement or asset that the issue is financing. The City shall design the financing schedule and repayment of debt so as to take best advantage of market conditions and, as practical, to recapture or maximize its credit capacity for future use, and moderate the impact to the taxpayer.

Method of Sale

Indebtedness to be issued by the City will be offered through the competitive bidding process except as expressly approved by the Mayor and City Council. If it is proposed that debt not be issued through competitive bidding, such request will state the compelling reasons why the competitive bidding process is not deemed suitable for the particular issuance of debt.

Competitive Sale - Underwriter is not known ahead of time.

- Financial Advisor conducts an open bid and the Bonds are awarded to the Underwriter with the lowest average rate

Negotiated Sale - Underwriter is selected ahead of time by the issuer.

- A formal selection process can be facilitated by a Financial Advisor or the issuer can proceed by itself

Post Issuance Compliance

After the Debt is issued there are required **ongoing administrative activities**.

Investment of Bond Proceeds

- IRS: Arbitrage Rebate and Yield Restriction

MSRB Disclosure Requirements

- SEC Rule 15c2-12
- Annual Report preparation and posting on EMMA website (usually within 180 to 210 days of FYE)
- Material Events Disclosure (within 10 business days)

Record Retention

- IRS: Life of the Bonds (or life of the refunding bonds) + 3 years

Private Business Use Monitoring

- IRS: If the financed facility has any management contracts, leases or sub-leases

Consider adopting a separate Post-Issuance Compliance Policy to formally designate team members and their ongoing post-issuance responsibilities.

Post Issuance: Investments

Investment of Bond Proceeds

Arbitrage Rebate and Yield Restriction compliance are two restrictions after issuance.

- **Arbitrage Rebate**
  - Issuers must rebate certain excess earnings on proceeds of tax-exempt bonds to the federal government.
  - There are two notable exceptions that allow issuers to keep any positive arbitrage.
    1. Small Issuer Exception
       - $5 million or less of Tax-Exempt debt issued in a calendar year for municipalities.
    2. Spending Test
       - 6-month, 18-month, or 24-month spending exceptions.
  - Perform calculations no later than 5-year anniversary, and if needed make payment within 60 days.
- **Yield Restriction**
  - Prohibits investments that earn a rate higher than the arbitrage yield (i.e., borrowing rate).
  - For a new project, Yield Restriction would typically apply to any unspent bond proceeds remaining after the standard three-year Temporary Period expires.

Post Issuance: Disclosure

MSRB Disclosure Requirements – Material Events

The Continuing Disclosure Undertakings for municipal securities issued on or after February 27, 2019, and subject to Securities and Exchange Commission Rule 15c2-12 (the "Rule"), must include two additional reportable events:

1. **The incurrence of a financial obligation of the obligated person**, if material, or agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the obligated person, any of which affect security holders, if material

2. A default, event of acceleration, termination event, modification of terms, or other similar events under the terms of a financial obligation of the obligated person, **any of which reflect financial difficulties**

The above two reportable events are in addition to the 14 enumerated reportable events under the Rule.

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Capital Improvement Plans

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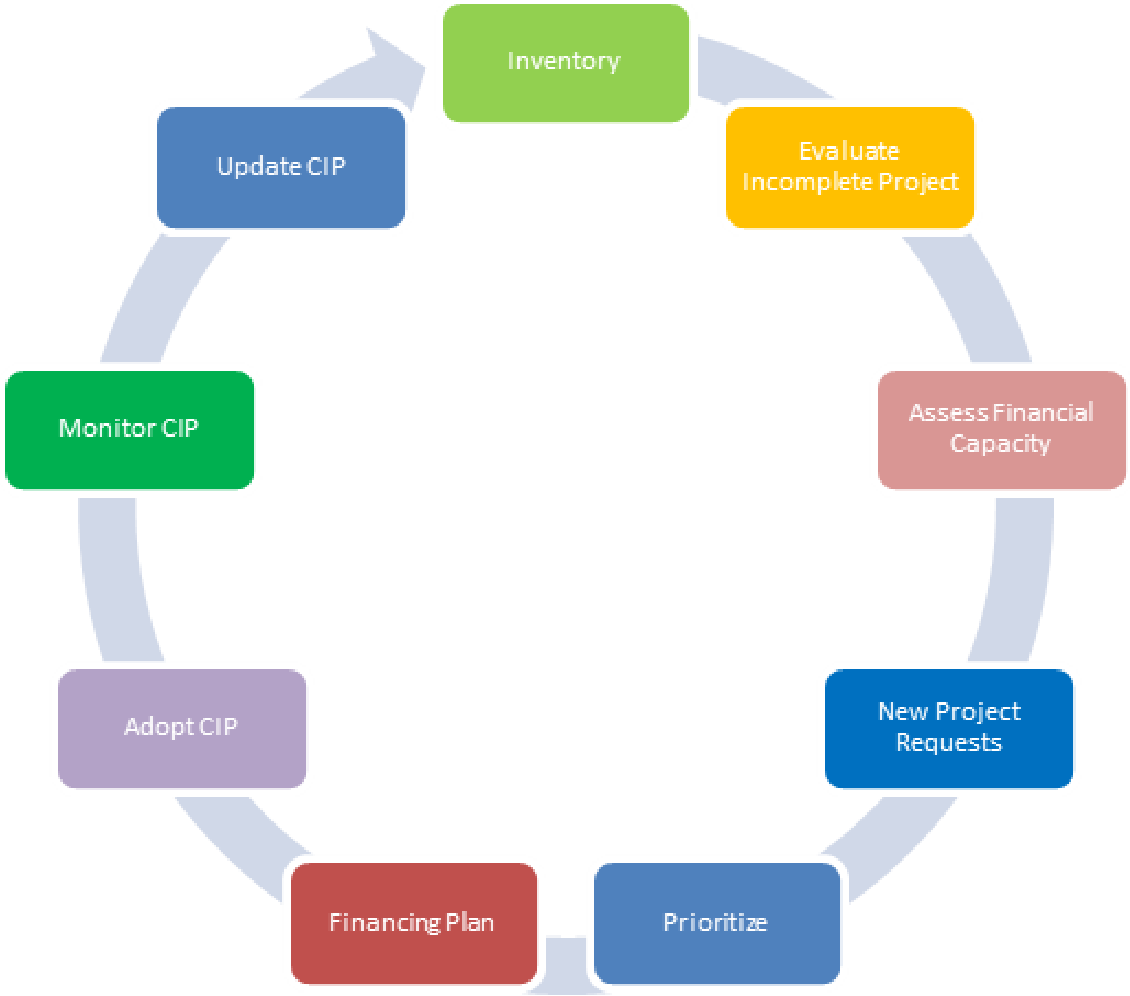
Capital Improvement Plan

- Definition - A Capital Improvement Plan ("CIP") is a short range plan that identifies capital projects and major equipment purchases. The CIP provides a schedule of when these projects or purchases will occur. It also should identify options for the financing of the project or purchase.
  - Short Range – usually between 3 and 10 years but varies by community
  - The CIP not only lists the projects and purchases but ranks them in order of importance

CIP – Steps to Formulating



CIP - Benefits

1. Allows for a systematic evaluation of all potential projects at the same time
2. Assures the most important projects receive funding
3. Provides the ability to stabilize debt and consolidate projects to reduce borrowing costs
4. Serves as a public relations and economic development tool
5. Focus on preserving infrastructure while ensuring the efficient use of public funds
6. Integrates budgeting for the project as well as the operational needs once the project has been completed
7. An opportunity to foster cooperation among departments and an ability to inform other units of government of the priorities of the municipality
8. Improves project planning and timing sequence
9. Assures the most appropriate method of funding is selected

* Source: GFOA Website: https://www.gfoa.org/capital-improvement-planning-budgeting-resource-center

CIP – Important Elements

Projects

Budgets

Funding Sources

Assigned Resources

Project Coordination

Project Timelines

Financial Impact- Project

Financial Impact - Operational

CIP - Challenges

1. Can be time-intensive for all parties involved
2. Fiscal Restraints
   - Revenue Sources
   - Funding Options
   - Return on Investment
   - Up front costs even if long-term savings
3. Project justification
4. Project prioritization

CRITERIA	%	Score (1 – 10)	Points
Quality of Life	20%	7	1.40
Infrastructure	15%	8	1.20
Economic Development	15%	7	1.05
Health & Public Safety	15%	6	0.90
Impact on Operational Budget	10%	5	0.50
Regulatory Compliance	10%	6	0.60
Timing & Location	10%	7	0.70
Special Considerations	5%	5	0.25
		TOTAL PROJECT SCORE	6.60

DOCUMENTATION

1. What went well?
2. What went poorly?
3. What can be done better?
4. What did we learn?
5. Are there any actions for follow up?

CIP – Quiz Question #1

TRUE OR FALSE????

- CIP Stands for Capital Improvement PLAN
  - FALSE (and TRUE)
    - It should be looked at as a Capital Improvement PROGRAM
      - A plan is just a schedule of projects
      - A program can encompass many essential components
        - Funding sources
        - Overall project schedule
        - Resource availability

CIP – Quiz Question #2

TRUE OR FALSE????

- The CIP should include **ALL** construction projects to have any real value
  - FALSE
    - To maintain manageability it is ideal to differentiate maintenance-related projects from new construction
    - Usually funds set aside for O&M vs. new projects
    - Some maintenance can be performed with in-house staff which impacts operating and not capital funds

CIP – Quiz Question #3

TRUE OR FALSE????

- The CIP is just a WISH LIST without any expectation that the projects will be completed
  - FALSE
    - Internal staff must be able to plan and coordinate their efforts around a solid program they can count on
    - CIP should be viewed as a road map providing surety and predictability for all involved
    - Though the map may be redrawn each year as it gets updated it should never lose its integrity

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Method of Sale

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Participants in a Bond Transaction

Sale Types

PUBLIC OFFERING	DIRECT PLACEMENT
• The Issuer and financial advisor prepare an official statement • Underwriter that will resell the bonds to investors selected via a competitive or negotiated sale • Issuer obtains a bond rating • Requires disclosure counsel to review the official statement • Will likely have a lower interest rate, but will have higher costs of issuance	• No official statement, rating, underwriter or disclosure counsel is required • A term sheet is sent out to banks and other local units of government that will provide a proposal to purchase the bonds directly • The interest rate is typically higher than a public offering but may result in a lower overall financing cost since some costs of issuance are avoided • This process has typically proven to be effective for relatively smaller bond issues paid off with a shorter amortization

Types of Public Offerings

COMPETITIVE SALE

- The Issuer engages a municipal advisor to manage the bond issuance process
- Underwriter selected via a competitive sale in which multiple bids are received to purchase the bonds
- The winning bidder sells the bonds to investors
- The bidder with the lowest true interest cost is selected
- The underwriter's fee is included in the bid and taken into account in the calculation of the true interest cost

NEGOTIATED SALE

- The Issuer preselects a broker-dealer as underwriter
- The underwriter's fee is negotiated by the Issuer in consultation with the Financial Advisor during the pre-selection process
- This firm sells the bonds to investors

Choosing the Method of Sale

A **competitive** sale is appropriate when:

- Issuer has a strong underlying credit rating at least in the "A" category
- General obligation bonds or full faith obligations (e.g. alternate revenue bonds or debt certificates)
- Structure does not include special features that would require extensive explanation to the market
- Issuer is frequently in the market and/or issue size is conducive to attracting investors

A **negotiated** sale is appropriate when:

- Issuer has a credit rating lower than "A"
- Debt structure is complicated
- Issuer wants input in how bonds are allocated among underwriting firms and/or the types of investors to be reached
- Other factors exist that the issuer, in consultation with its municipal advisor, believes favor the use of a negotiated sale process

Source: Selecting and Managing the Method of Sale of Bonds (February 2014), Government Finance Officers Association (Best Practice).
See the following webpage: http://www.gfoa.org/selecting-and-managing-method-sale-bonds

Method of Sale – Competitive vs. Negotiated

Competitive vs. Negotiated Sale

- One of the biggest financing decisions that an issuer will navigate is whether to bring an issue to the market as a competitive or negotiated sale.
- The best approach for the sale must be chosen to meet financing goals and specific needs.
- If the issuer has in-house expertise, defined as dedicated debt management staff whose responsibilities include daily management of a debt portfolio, this analysis and selection could be made by the issuer's staff.
- However, in the more common situation where an issuer does not have sufficient in-house expertise, this analysis and selection should be undertaken with the advice of a municipal advisor.*

*Source: GFOA Best Practices Website: https://www.gfoa.org/selecting-and-managing-method-sale-bonds

Competitive Sale – MuniAuction Platform

11/5/2019 MuniAuction: AON Auction Results: Mt.Prospect.Vlg.IL.GO.19B

Observation MuniAuction®

Auction Date	Type	Start	End	Time Now	Status
Tue., Nov 5, 2019	AON	11:15:00 am	11:30:00 am	11:34:32 am EST	Over

Connected to server

NOTICE: The minimum coupon is 3.0% for years 2027 and later.

Reoffering Information is now available on the Best Bid Page

Refresh

$7,705,000*
Village of Mount Prospect, Cook County, Illinois
General Obligation Bonds, Series 2019B

	Bidder	Firm	TIC	Time	Gross Interest	+ Discount/ (Premium)	Total Interest	Bid No.	Cumulative Improvement
1st	HUTC-LJ	Hutchinson	2.856040%	11:27:56 am	$3,430,742.50	(325,799.05)	$3,104,943.45	1	-
2nd	MESI-MO	Mesirow	2.867002%	11:29:52 am	$3,498,460.83	(375,048.00)	$3,123,412.83	1	-
3rd	RWBA-DK	Robert Baird	2.913646%	11:28:53 am	$3,313,320.83	(172,671.30)	$3,140,649.53	3	0.111296%
4th	NORT-DS	Northland	2.914305%	11:29:50 am	$3,430,742.50	(274,870.65)	$3,155,871.85	6	0.327529%
5th	FTNF-VP	FTN Financial	3.335070%	11:28:50 am	$3,675,058.96	(115,107.50)	$3,559,951.46	2	0.045864%
							Total Bids:	**13**	

*Preliminary, subject to change

Competitive Sale – Parity Platform

The following table represents the results of the bidding on a $11.45M Parity sale for the Village of Orland Park, which is rated “AA+” by S&P. The Village received bids from five different bidders.

Orland Pk Vlg
$11,455,000 General Obligation Bonds, Series 2023

The following bids were submitted using *PARITY*® and displayed ranked by lowest TIC.
Click on the name of each bidder to see the respective bids.

Bid Award*	Bidder Name	TIC
☐	HilltopSecurities	4.607160
☐	J.P. Morgan Securities LLC	4.674906
☐	Robert W. Baird & Co., Inc.	4.761633
☐	StoneX Financial Inc.	4.792515
☐	KeyBanc Capital Markets	4.882351

*Awarding the Bonds to a specific bidder will provide you with the Reoffering Prices and Yields.

Negotiated Sale

Unlike a competitive sale, bond pricing in a negotiated sale requires a much greater degree of issuer and municipal advisor involvement.

GFOA's Best Practices recommend the following*:

1. Communication of specific goals and expectations to the underwriter
2. Management of underwriting fees
3. Formulate proper pre-marketing effort
4. Analyze market for timing purposes
5. Evaluate structural features such as optional redemption (call features) and how they may impact the overall interest impact of an issue
6. Evaluation of recent comparable issues as related to the pre-pricing scale
7. Constant contact during the sales process to evaluate the potential for a pricing adjustment based on market demand
8. Post issuance summary with results

*Source: GFOA Best Practices Website: https://www.gfoa.org/pricing-bonds-negotiated-sale

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