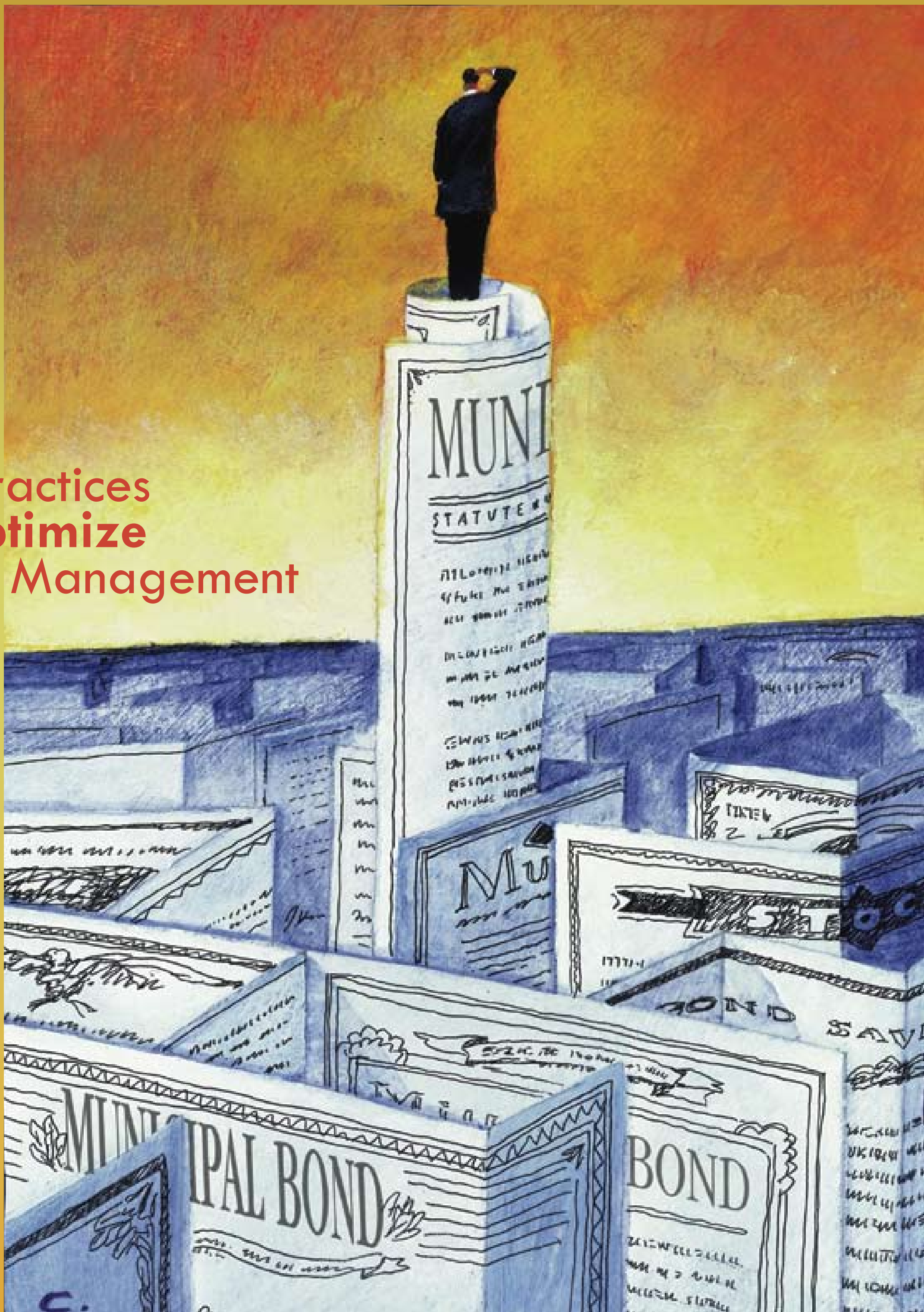


Best Practices **Optimize** Debt Management

BY JONAS BIERY AND ERIC JOHANSEN

For many finance officers, issuing bonds and managing outstanding debt is just one of many tasks, and local governments sometimes go years between bond issues, in which case the market is likely to have evolved since the last time they entered it. Keeping up with market changes and industry best practices is, therefore, an ongoing challenge. The Government Finance Officers Association's 22 best practices on nearly all aspects of debt management provide a resource to help finance officers explain, document, and defend their debt-related decisions and recommendations to elected officials, staff, and the taxpayers and ratepayers they serve. This article highlights the GFOA's key recommendations.

PLANNING AND PREPARING TO ACCESS THE CAPITAL MARKETS

The Debt Management Policy. A debt management policy is a group of written guidelines and restrictions that describe debt capacity and limitations, and provide direction regarding debt portfolio management and implementation. A well-written debt management policy identifies goals and objectives, guides the debt issuance process, improves the quality of decisions, and ultimately demonstrates commitment to good management and long-term planning. A debt management policy functions best when it includes all debt-related factors and interacts efficiently with broader governmental policies and priorities.

Keeping up with market changes and industry best practices is an ongoing challenge.

Before creating or revising a debt management policy, an issuer should consider the primary objectives and desired outcomes, and fine-tune the document to the specific nuances of the organization. All debt management policies are aimed at supporting the lowest possible cost of borrowing, but a small entity might achieve that goal through a different set of conditions than a larger one.

Review, input, and support are needed, not just from financial managers and elected officials, but also from individuals across the organization — especially capital project managers and staff members who are responsible for budget preparation. Furthermore, policies should be reviewed at least annually and revised as necessary. Given the pace of regulatory and market change in recent years, maintaining a policy that accommodates the current environment is more important than ever.

Using a Website for Disclosure. Providing timely access to quality financial information demonstrates accountability and transparency and can enhance communication to investors, credit analysts, citizens, and other public stakeholders. Publishing information on an issuer website does not meet continuing disclosure responsibilities as set forth in Securities Exchange Commission Rule 15c2-12.

Things that may be made available via a website include relevant policy documents (including the debt management policy and other financial policies), audited financial statements, official bond offering disclosure, continuing disclosure documents, and other interim financial or management reports. Any documents posted online should be identical to those made available via hard copy. Many governments already post information about their actions online, but not with their financial or debt information.

Online information must be protected from misuse or misinterpretation. Access points to financial information should include a legal disclaimer stating that documents are accurate only as of the date on the page or form, and are not intended to reflect the entirety of the issuer's financial condition. Bond counsel can help identify appropriate precautionary language. Issuers also need to develop and test security provisions and software compatibility, including instructions for downloading software needed to view a document.

Websites that are used for disclosure also require ongoing monitoring and maintenance. Documents that are no longer current should be moved to an archive section that is labeled as historical information provided for information only. If the organization has advanced IT capabilities, it can also be useful to monitor exactly which information is accessed most frequently and adjust its presentation to make that information more prominent and easily accessible.

Maintaining an Investor Relations Program. Capital financing would not be possible without a substantial pool of informed investors. Developing an investor relations program can provide another enhancement, leading to reducing borrowing costs. An issuer should identify the individuals responsible for speaking on its behalf and managing communication to investors; issuers often use a website to communicate information about their investor relations programs. Your bond counsel and financial advisor will provide advice on appropriate conditions for program development.

A debt management policy functions best when it includes all debt-related factors and interacts efficiently with broader governmental policies and priorities.

THE BOND SALE

Who Should I Hire First? Every bond sale requires the participation of several outside parties that the issuers retain to carry out the financing. The primary parties include bond counsel, the financial advisor, underwriters, the underwriters' counsel, and the trustee/paying agent. The specific order in which these outside parties should be selected is driven by the recommendations contained in several GFOA best practices. Issuers should retain a financial advisor and bond counsel in the earliest stages of a financing because issuers and their financial advisor will determine early on whether the bonds will be sold through competitive bidding or through a negotiated sale with a pre-selected underwriter or syndicate of underwriters. If a competitive sale is determined to be in the best interests of the issuer, then there is no need to conduct a request for proposals process for pre-selecting an underwriter, since the underwriter is determined at the time the bonds are sold, based on the lowest true interest cost that is bid for the bonds.

Bond counsel should be hired early on to provide consistent legal advice throughout the bond sale process. The role of the bond counsel does not depend greatly on the method of sale chosen, so there's no reason to defer the selection. Some issuers prefer to hire bond counsel without the assistance of a financial advisor, but may wish to involve the financial advisor if the issuer is not experienced in evaluating the skills and experience of legal counsel.

The underwriter's counsel is typically not a party in a competitive sale. If the issuer and its financial advisor select a negotiated sale, underwriter's counsel is typically determined soon after the underwriter is selected. The trustee/paying agent can be hired at any time after the financial advisor and bond counsel; however, the scope of the trustee/paying agent's role may not be determined until later in the bond sale process.

Selecting the Financial Advisor. The financial advisor represents the issuer on matters related to the bond sale. Unlike the underwriter, the financial advisor has an absolute fiduciary obligation to represent the best interests of the issuer in the financing. Municipal Securities Rulemaking Board Rule G-23 now prohibits a firm that is initially hired as financial advisor from switching roles in the middle of the financing to become the underwriter in a negotiated sale. Previously, broker-dealers that also provide financial advisory services could be hired as financial advisor, recommend a negotiated sale, and subsequently resign as financial advisor in order to underwrite the bonds. This practice demonstrates a clear conflict of interest and was finally prohibited by the MSRB in November 2011.

The GFOA recommends that the issuer hire financial advisors through a competitive RFP process. The RFP is intended to identify the firm that best matches the needs of the issuer. Most importantly, the issuer should assess whether the individuals identified in the proposal have the skills and expertise that best match the types of bonds expected by the issuer (revenue, general obligation, tax increment). The proposing firm should also demonstrate an understanding of the issuer's debt profile and financial condition.

Financial advisors should also be asked to describe their access to timely bond market information. This is especially critical if the issuer expects to issue bonds through negotiation with an underwriter. A financial advisor who doesn't have sufficient market information is less able to effectively negotiate the pricing of the bonds on behalf of the issuer.

Issuers should request fee proposals in the RFP, but should be mindful that the lowest fee should not necessarily be the deciding factor. Fees should be presented in a standard format so they can be compared accurately, and any conditions attached to the fee proposal should be clearly identified. Fees charged by the hour, with a "not-to-exceed" cap, may be in the issuer's best interest since fees based on transaction size can lead to a perception that the financial advisor is recommending a larger transaction than necessary.

A financial advisor should be familiar with debt management best practices and express a commitment to following them. Finally, it should go without saying that a financial advisor should never be selected based solely on the recommendation of an underwriter seeking to underwrite the issuer's bonds.

Selecting the Method of Sale. Having selected the financial advisor, the next task is to determine how the proposed bonds should be sold. The two primary ways are through competitive bidding or a negotiated sale with pre-selected underwriters. The question of competitive versus negotiated sales generates more heated discussion and debate than almost any other topics in public finance. While the majority of studies and academic research have found that competitive sales result in lower borrowing costs for issuers, the findings of these studies have not been universally accepted in the industry, especially among those firms and individuals whose business relies on negotiated sales. The GFOA's Method of Sale best practice recommends that the method of sale decision should be based on an analysis of the specific characteristics of the proposed bonds and should not be influenced by outside parties with a vested interest in the outcome of the decision.

The GFOA believes that the presence of the following characteristics may favor the selection of a competitive sale:

- The rating bonds of the bonds is A or better.
- The bonds are general obligation bonds or full faith and credit obligations, or are secured by a strong, known, and long-standing revenue stream.
- The structure of the bonds does not include unusual features that require extensive explanation to the market.

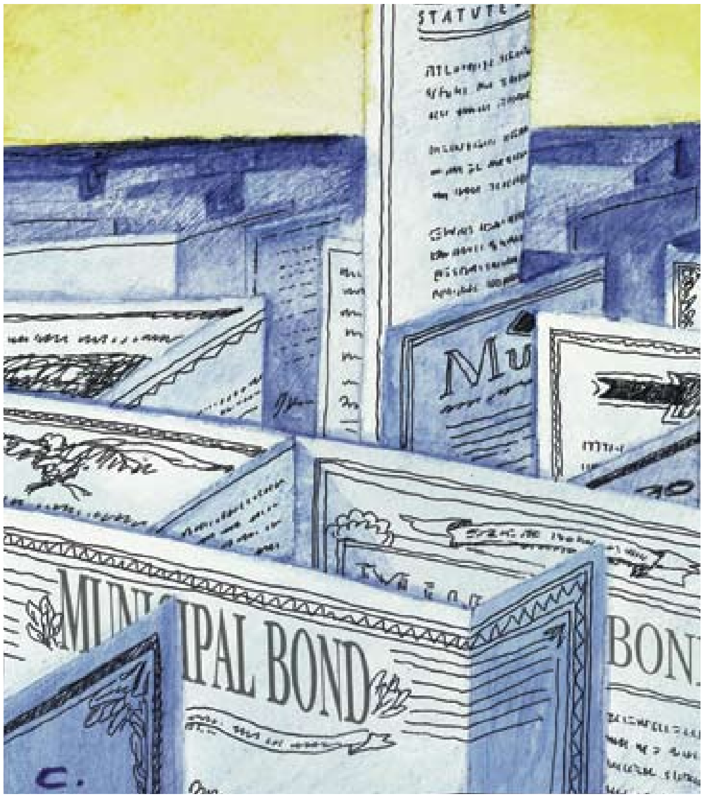
Conversely, the presence of the following characteristics may favor the use of a negotiated sale:

- The rating of the bonds is less than A and credit enhancement is unavailable or not cost-effective.
- The structure of the bonds has features such as a pooled bond program, variable rate debt, or deferred interest.
- The issuer's desire to target underwriting participation specifically to include disadvantaged business enterprises or local firms.

In recent years, approximately 80 percent of the bonds sold in the municipal market have been sold through negotiation. This suggests that many issuers decide their method of sale based on factors other than those outlined in the GFOA best practice. Determining what optimal percentage of bonds "should" be sold competitively, based on the criteria above, is a not a perfect science and is beyond the scope of this article. However, the universe of bonds that lend themselves to competitive sale would seem much larger than the approximately 20 percent of bonds that are actually sold through competitive bidding.

Many issuers approach new bond issues with the presumption that the bonds will be sold through competitive bidding. However, if the issuer and its financial advisor determine that the bonds may be better suited for negotiation, then the method of sale can be switched. For example, if the ratings of the bonds are lower than anticipated, or if the structure of the bond issue becomes especially complex, then the bonds may become better suited for negotiation. In any event, the method of sale should be determined by rational analysis.

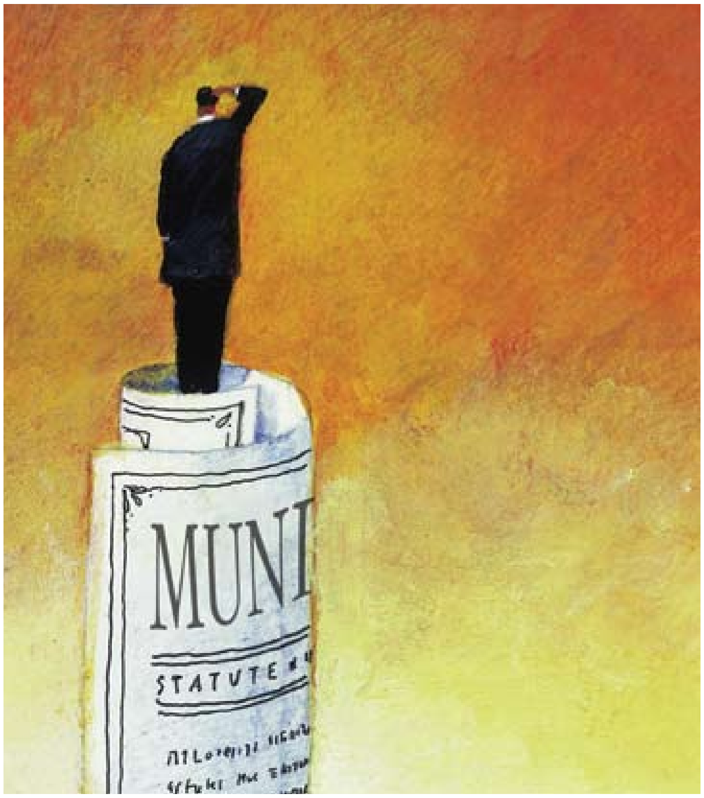
Selecting Underwriters for Negotiated Bond Sales. If a negotiated sale is determined to be the best option, given the characteristics of the proposed bonds, the next step in the bond sale process is to select the underwriter or team of



underwriters that will offer to purchase the bonds from the issuer at the time of the bond sale. The primary role of the underwriter is to market the bonds to investors.

The GFOA's best practice on this subject, Selecting Underwriters for Negotiated Bond Sales, recommends most issuers not to consider a negotiated sale unless it is represented by a financial advisor. When the issuer isn't represented by a financial advisor, the underwriter may be free to dictate compensation and bond pricing without minimal meaningful negotiation by the issuer. Few issuers have access to reliable real-time bond market data or sufficient experience in negotiating the pricing of their bonds.

The GFOA further recommends that underwriters in a negotiated sale be selected through a competitive RFP process to promote fairness, objectivity, and transparency. The RFP process allows issuers and their financial advisors to select the most qualified firm or firms, based on relevant selection criteria stated in the RFP. A key criterion in selecting the underwriter is its experience with the type of bonds proposed by the issuer. Relevant experience is also important for the investment bankers who will work most closely with the issuer and the underwriting desk of the firm that will be responsible for selling and distributing the issuer's bonds. Proposals should also demonstrate an understanding of the issuer's financial condition, including ideas on how the issuer might approach the structure of the bonds, credit rating strategies, and investor marketing strategies.



Underwriters are compensated in the form of an underwriting "spread," or discount from the face amount of the bonds. Underwriters are typically compensated only if the bonds are successfully sold and closed. The RFP should request that proposers provide their best estimate of the underwriting spread, broken down into the four typical spread components:

- Management fee, or the compensation paid to the underwriter for transaction management and banking-related services.
- Takedown, the sales commission.
- Expenses, or reimbursement for fees and direct overhead expenses.
- Underwriting, a fee paid only in the event that the underwriter agrees to underwrite a substantial amount of unsold bonds.

While the spread estimate provided in the proposals should not be viewed as a firm bid, it does provide a basis for the issuer and financial advisor to negotiate the final spread at the time the bonds are sold. If the spread proposed at the time of sale is significantly higher than what the underwriter originally proposed, the issuer and its financial advisor should require an explanation. The GFOA's best practice on Pricing Bonds in a Negotiated Sale provides additional guidance on negotiating the underwriting spread.

Pricing Bonds in a Negotiated Sale. Pricing bonds in a negotiated sale refers to the process of determining the bond yields, coupons, underwriting spread, optional redemption provisions, serial versus term bonds, and other structuring and pricing details. From the finance officer's perspective, the process can be simple or difficult. Issuers that choose not to be represented by a financial advisor are likely to simply accept the interest rates, yields, and underwriting spread offered by the underwriter with little informed negotiation. This approach is simple, but it isn't likely to result in a defensible best outcome. On the other hand, issuers represented by an experienced financial advisor that is armed with current data on comparable transactions and prepared to reject the proposed pricing, if necessary, can be confident they will receive fair pricing of their bonds. Negotiation can be challenging and time consuming, but it is also the only way to ensure that the pricing of a negotiated sale reflects actual market conditions. Issuers that aren't willing to obtain the resources necessary to negotiate the best price on their bonds should probably not use a negotiated sale. The GFOA's best practice, Pricing Bonds in a Negotiated Sale, provides a roadmap for leveling the playing field in a negotiated sale.

> Providing timely access to quality financial information demonstrates accountability and transparency and can enhance communication to investors, credit analysts, citizens, and other public stakeholders.

Perhaps the most critical task in preparing to negotiate the pricing of bonds is assembling data on similar bond issues near the time of the issuer's pricing (often referred to as "comparables" or "comps"). The finance officer should require both the underwriter and financial advisor to provide independently prepared information about comparable transactions and be prepared to recommend a scale of bond yields and coupons based on other transactions in the market. This data should be accompanied with information about general bond market conditions, expected economic and financial releases that might affect the bond market, and other information that helps to provide an understanding of the "tone of the market" at the time the issuer plans to price its bonds. This information should be provided several days before the proposed pricing date and updated until the point of final pricing, as market conditions change.

The pricing bonds best practice also lists other important steps to help the issuer realize the best possible results from its negotiated sale. These include preparing a marketing plan for the bonds, considering retail order periods, evaluating alternative structuring features such as premium or discount bonds and optional redemption provisions, negotiating priority and designation policies, monitoring order flow during the order period, and analyzing the pricing after the sale.

POST-ISSUANCE REQUIREMENTS

A finance officer's debt management responsibilities do not end once the bonds are closed and the proceeds are received. Post-issuance requirements require ongoing attention throughout the life of the bonds (and beyond). Post-issuance activities include:

- Investing and reinvesting the bond proceeds.
- Tracking the arbitrage rebate of tax-exempt bonds.
- Monitoring the use of facilities financed with tax-exempt debt to make sure the bonds remain tax-exempt over their life.
- Filing annual continuing disclosures and material event notifications.

Understanding Your Continuing Disclosure Responsibilities. Debt issuers are obligated, under the continuing disclosure agreements entered into at the time of closing, to provide the market with annual updates of certain financial and operating data pertaining to their outstanding bonds. Certain "material events" described in the CDA must also be disclosed when they occur. The GFOA best practice on continuing disclosure recommends that finance officers thoroughly familiarize themselves with their ongoing obligations prior to executing the CDA. In particular, the finance officer should be familiar with the type of information that must be filed annually with Electronic Municipal Market Access, the Municipal Securities Rulemaking Board's electronic repository of continuing disclosure filings, and the required annual filing dates. Governments' debt policies should acknowledge continuing disclosure obligations.

Issuers can also voluntarily disclose budgets, interim financial reports, investment information, and revenue forecasts through EMMA. Issuers should discuss this decision with their bond counsel and financial advisors. As with all disclosure filings, the voluntary information must be accurate and complete.

SPECIAL SITUATIONS

A debt policy should also address several situations that don't arise often. Appropriate policy considerations can help limit overexposure to unique risks that can be associated with special situations such as refundings, taxable debt, tax increment financing, and public-private partnerships.

Analyzing and Issuing Refunding Bonds. Refundings can be a useful tool for reducing ongoing interest costs, removing burdensome bond covenants, or accommodating short-term cash flow challenges. If not managed appropriately, however, refundings can lead to unnecessary costs and reduced savings potential due to premature action or poor structuring. The GFOA strongly recommends that issuers solicit the advice of their financial advisor and bond counsel when evaluating a refunding opportunity.

> Capital financing would not be possible without a substantial pool of informed investors. Developing an investor relations program can help.

A debt management policy should define the level of savings required in order to execute a refunding. For example, a common requirement is that a refunding produce a minimum of 3-5 percent present value savings. For smaller issues, it might be appropriate to set a hard target such as a minimum of $100,000 present value savings (net of issuance costs). Under current federal tax code, issuers typically get only one opportunity to perform a refunding in advance of the bond call date. Issuers might therefore choose to have more stringent policies for pursuing advance refundings– for example, setting a higher savings threshold, or adding a provision requiring additional analysis of the opportunity cost of an advance refunding versus waiting for a later date.

Issuing Taxable Debt. While tax-exempt debt offers a comparatively lower borrowing cost, there are circumstances where governments might want to consider taxable debt — to provide operating flexibility for a financed project, in conjunction with projects that have private-use elements (such as stadium/concert venues, economic development, and mixed-use projects), or for financing pension obligations. From a policy perspective, however, a government should prevent overexposure to the increased costs associated with taxable debt.

Tax Increment Financing. Policies related to tax increment financing should include descriptions of when it is appropriate to use tax increment financing and how it can be used to support broader economic development efforts. TIF is typically rated lower than general obligation debt or essential service revenue bonds, so governments need to define minimum credit rating thresholds and limit the amount of total TIF

Swaps in the Aftermath of the Banking Debacle

The Importance of Reviewing the GFOA's Advisory and Checklist on Derivatives

By Peter Shapiro

The importance of developing appropriate policies and procedures for your jurisdiction — and understanding the new regulations — has never been greater.

From 2000 to 2007, many cities, counties, states, school districts, and public authorities rushed into the swap market, seeking promised savings and, sometimes, underestimating risks.* We now look back at this period as one of excessive optimism — across all markets, from derivatives to equities to mortgages of every stripe. Like other market participants, governmental entities took on greater risk in the swap market for often meager benefit. In some cases, governments entered into 30-year swaps for a benefit of only 0.25 percent per year, which, even in those complacent times, was not a great risk-reward trade-off. In reaction to this and other markets within the financial system, Congress acted to impose tough new regulation of the derivatives market, including special protections for municipal swap users.

New Regulations, Protections

Under the Dodd-Frank Act, the Commodity Futures Trading Commission and the Securities and Exchange Commission have begun developing rules for a multi-trillion-dollar market that developed in a largely unregulated environment. These new rules could directly affect your organization's activities both today and in the future. The key provisions include:

- A narrowing of who can use swaps without going through a clearinghouse. (Swaps are an exchange of two securities, interest rates, or currencies for the mutual benefit of both parties.)

- Reporting requirements to enhance accountability and visibility.

- Registration requirements for all parties using swaps.

- Business conduct standards for banks to help prevent abuses.

The act creates a new set of protections for state and local governments, which are classified as "special entities." Banks will no longer be able to act as both advisors and swap counterparties, so governments will need to obtain the services of a qualified swap advisor or other "qualified independent representative." An independent advisor will be charged with evaluating any recommendations made by banks and will be required to take on a fiduciary duty to the governmental entity — something that banks have always been loath to do.

Taking Another Look at Swaps and the Importance of Developing a Derivatives Policy

The changing regulatory landscape hasn't hampered the recovering market, as some governments have saved money using swaps. But before determining if these transactions are right for your jurisdiction, carefully review the GFOA's Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy advisory and the accompanying derivatives checklist, and have extensive discussions with financial and swap advisors about the appropriateness of any potential transaction.

As state and local governments again consider using swaps, they need to look at how the financial crisis revealed fundamental issues that had not been well-recognized before. Most important were two shaky assumptions: first, that the market for floating rate bonds (notes with variable interest rates) would always function well; and second, that a swap could always be terminated at a reasonable cost. The crisis showed just how shaky these assumptions were.

Floating rate debt had been a reliable mainstay of the municipal market since the 1970s; then the unheard-of happened. First, an entire part of the market, whose smooth functioning was taken for granted, collapsed. The Auction Rate Securities market's demise put more than $300 billion of floating rate debt into limbo, at a cost to muni borrowers that few anticipated. Then, the longest-standing segment of the floating rate market, variable rate demand bonds (securities with interest rate resets that are reset periodically, often referred to as daily or weekly floaters) was severely weakened by the banking debacle. Variable rate demand bonds require a backstop from a creditworthy bank to gain market

acceptance, and the biggest single casualty of the crisis was the creditworthiness of banks. With fewer healthy banks standing, bank backstops became much more costly and harder to come by. Because most swaps are used in conjunction with floating rate bonds, the unsustainability of the floating rate market made swap structures crater or become much more costly. Financings that were expected to save 0.25 percent per annum, compared with conventional fixed rate bonds, were instead costing 1.75 percent or more.

Next, when governments wanted to exit their swaps, they found that the costs had turned much uglier than anyone had forecast. The cause was straightforward: When interest rates drop, the cost of terminating swaps (when the government is a fixed-rate payer) increases. Pre-crisis, governments had evaluated this risk, looking at interest rate scenarios in which 10-year Treasury rates dropped to the lows of the prior generation, less than 4 percent. But in the aftermath of the crisis, rates fell below 2 percent, and remain there today. Swap termination costs rose astronomically, and government finance officers throughout the nation rued the day they ever heard the word "swap".

Once burned, twice shy. But now governments may wish to give swaps a second look. First, there could be an opportunity to finance long term at rates in the 1.5 to 2 percent range — less than half the cost of conventional fixed-rate bonds. Second, the problems in the floating rate market have led to a new set of products that allow governments diverse new ways to gain market access: direct purchase programs, index notes, extendible securities, and other products that don't rely on the continued shaky health of banks. Third, governments have the opportunity to design better swap programs. A key error of earlier swap programs — which is abundantly clear with the benefit of hindsight — was the failure to include par calls (the earliest date a bond can be called — when the issuer gives notice that the amount of the bond will be paid — at face value) in swaps. Ten-year par calls are standard features of most fixed-rate bonds, and they should have been included in swaps. In fact, swaps can include even greater flexibility, with par calls beginning as soon as three years. With a par call, a swap can be terminated at no cost, regardless of where rates have moved, virtually eliminating the risk of a crippling termination expense. Including a call typically costs between 0.15 and 0.35 percent, but could be a cost worth spending upfront for more long-term savings.

Conclusions

As the markets return to some semblance of normality, and the lessons of the crisis are absorbed, governments may wish to cautiously wade into swaps. Important regulations could help prevent governments that shouldn't be in the market from entering it, and provide important safeguards from bankers and advisors who now have a regulatory framework from which to work. One area in particular that might be worth reviewing is restructuring old swaps to replace weakened banks with stronger ones. Others are harvesting gains where they are available and hedging in the commodities market. The commodities market is different from the securities market but could yield savings for governments by, for instance, locking in the low cost of natural gas for future transit or heating use.

The swap market must be approached with mindfulness of risks both real and remote. The importance of developing appropriate policies and procedures for your jurisdiction — and understanding the new regulations — has never been greater. But for investors with the sophistication and appropriate policies in place to use it, a review of available opportunities may be worthwhile.

*My firm, Swap Financial Group, is in the business of helping public agencies better understand and mitigate risks, and ensure fair pricing, when they are up against banks in the swap market.

PETER SHAPIRO is managing director of Swap Financial Group.

relative to another benchmark (such as general obligation debt capacity).

Because tax increment revenues can be unpredictable, it might also be important to define minimum revenues that must be generated before tax increment debt can be accommodated. In addition to describing a conservative methodology for projecting future tax increment revenues, this may include a requirement that feasibility studies or other financial analysis be performed. If TIF financing is to be supported by other legally available revenues, a policy might describe limits or conditions under which those supporting revenues can be applied. In general, a debt management policy should encourage management to perform appropriate due diligence and conservative planning targets to protect against potential tax increment revenue shortfalls.

Public-Private Partnerships, Conduit Debt, and Privatization. While projects developed with non-governmental partners can encourage significant economic development, public-private partnerships and quasi-governmental debt frequently entail relatively higher risk to a government issuer. A debt management policy needs to ensure that appropriate due diligence is performed so the jurisdiction does not take on excessive risk that could damage its broader credit quality and negatively affect borrowing capacity for more essential projects. Risks associated with these projects can also be mitigated by setting a minimum rating threshold (such as A3/A-, or "above investment grade") and limiting sale of bonds to accredited investors.

CONCLUSIONS

The GFOA's best practices provide valuable guidance on nearly all aspects of debt management. Adhering to these best practices can help to ensure successful outcomes on an issuer's financings and can help staff, elected officials, and the public understand the policy basis for a finance officer's decisions. Including best practice recommendations within an issuer's adopted debt and financial policies can help to further strengthen the credibility of those policies. All 22 best practices relating to debt management are available on the GFOA's website at www.gfoa.org.

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