



## GFOA RECOMMENDED PRACTICE APPLICABLE IN CANADA

### Debt Management Policy (2003) (DEBT)\*

**Background.** Debt management policies are written guidelines and restrictions that affect the amount and type of debt issued by a government, the issuance process, and the management of a debt portfolio. A debt management policy improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning, including a multi-year capital plan. Adherence to a debt management policy signals to rating agencies and the capital markets that a government is well managed and should meet its obligations in a timely manner.

Debt levels and their related annual costs are important long-term obligations that must be managed within available resources. An effective debt management policy provides guidelines for a government to manage its debt program in line with those resources.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that all governments adopt comprehensive written debt management policies, and that governments review them at least annually and revise them as necessary. A Debt Management Policy should address:

- *Direct Debt* - debt payable from general revenues, including capital leases,
- *Revenue Debt* - debt payable from a specific pledged revenue source,
- *Revolving Loan Funds and Pools*
- *Other Types of Hybrid Debt* – debt payable from special revenues or containing other unique security pledges, and
- *Interfund Borrowing* – loans for short-term cash flow needs.

1. **Debt Limits.** The Policy should define specific limits or acceptable ranges for each type of debt. Limits are generally set for legal, public policy, and financial reasons.

a) *Legal limits* may be determined by legislation, including local charter, bylaws, resolution or ordinance, or covenant.

b) *Public Policy limits* can include:

- Purposes for which debt proceeds may be used or prohibited,
- Types of debt that may be issued or prohibited,
- Relationship to and integration with the Capital Improvement Program, and • Policy goals related to economic development, capital improvement financings, tax increment financing, and public-private partnerships.

c) *Financial limits* generally reflect public policy or other financial resource constraints, such as reduced use of a particular type of debt due to changing financial conditions. Appropriate debt limits can positively impact bond ratings, if the government demonstrates adherence to such policies over time. Financial limits are often expressed as ratios customarily used by credit analysts. Different financial limits are used for different types of debt. Examples include:

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- *Direct Debt* can be measured or limited by the following ratios:
    - ✓ Debt per capita,
    - ✓ Debt to personal income,
    - ✓ Debt to taxable property value, and
    - ✓ Debt service payments as a percentage of general fund revenues or expenditures
  - *Revenue Debt* levels are often limited by debt service coverage ratios (e.g., annual net pledged revenues to annual debt service) or credit rating impacts (e.g., additional bonds should not lower ratings) contained in bond covenants.
  - *Short-Term Debt Issuance* should describe the specific purposes and circumstances under which it can be used, as well as limitations in term or size of borrowing.
2. ***Use of Derivatives.*** The Policy should:
- Specify how derivatives fit within the overall debt management program.
  - State the conditions under which derivatives can be utilized.
  - Identify the types of derivatives that may be employed or are prohibited.
  - Identify approach(es) for measuring, evaluating, and managing derivative risk, including basis risk, tax risk, counter-party risk, termination risk, liquidity renewal risk, remarketing risk, and credit risk.
  - State the methods for procuring and selecting derivative products.
3. ***Debt Structuring Practices.*** The Policy should include specific policies regarding the debt structuring practices for each type of bond, including:
- Maximum term (often stated in absolute terms or based on the useful life of the asset(s)),
  - Average maturity,
  - Debt service pattern such as equal payments or equal principal amortization,
  - Use of optional redemption features that reflect market conditions and/or needs of the government,
  - Use of variable or fixed-rate debt, foreign currency debt, credit enhancements, derivatives, and short-term debt, and limitations as to when each can be used, and
  - Other structuring practices should be considered such as capitalized interest, deferral of principal and/or other internal credit support, including general obligation pledges.
4. ***Debt Issuance Practices.*** The Policy should provide guidance regarding the issuance process, which may differ for each type of debt. These practices include:
- Criteria for determining the sale method (competitive, negotiated, placement) and investment of proceeds,
  - Criteria for issuance of advance refinancing and current refinancing of bonds,
  - Selection and use of professional service providers,
  - Use of comparative bond pricing services or market indices as a benchmark in negotiated transactions, as well as to evaluate final bond pricing results, and
  - Use of credit ratings, minimum bond ratings, determination of the number of ratings, and selection of rating services.
5. ***Debt Management Practices.*** The Policy should provide guidance for ongoing administrative activities including:

- Investment of bond proceeds,
- Primary and secondary market disclosure practices, including annual certifications as required,
- Federal and provincial legislation compliance practices, and
- Market and investor relations efforts.

### **References.**

- GFOA Recommended Practice:
  - *Debt Management Policy* (1995 and 2003), Approved by the GFOA's Executive Board, February 28, 2003.
- *A Guide for Preparing a Debt Policy*, Patricia Tigue, GFOA, 1998.
- *Benchmarking and Measuring Debt Capacity*, Rowan Miranda and Ron Picur,
- GFOA, 2000.

\* This RP replaces the GFOA's RPs – Development of a Debt Policy and Analyzing Debt Capacity and Establishing Debt Limits.

Approved by the GFOA Committee on Canadian Issues, May, 2003.