DEBT 101, Volume I – Issuing Bonds

Introduction: Getting Ready to Issue a Bond

Governmental entities have been using debt (most often in the form of "municipal bonds") for over 200 years to fund public infrastructure such as government buildings, water distribution systems, schools, police stations and many other projects that require significant capital investment. When a government issues debt, it receives an infusion of cash to build a project; in return the government repays the bond purchasers over time, plus interest. By using debt, the government can complete a capital project with a repayment schedule that spreads the cost of that project over its useful life, and the bond purchaser receives a reasonably reliable source of investment income.

Before issuing debt, there are many factors that a government official should consider. Appropriate planning and understanding helps to provide the most favorable results to the Issuer and also helps avoid unnecessary risks and negative consequences. Debt issuance requires working with a number of partners, each of whom has a specific role. The debt issuance will result in a financing agreement that is legally binding, and it is critically important that government officials understand the basic terms of the agreement and what the agreement commits them to do.

This document provides a high-level outline of the debt issuing process and important considerations, and is intended to be a resource for the first-time or infrequent bond Issuer. A companion document entitled Debt 101, Volume II discusses Issuer expectations after bond issuance is completed. Both documents refer to more detailed Best Practices, Advisories and other resources. The GFOA strongly advises that Issuers wishing to proceed with a debt financing review these resources as well.

The Financing Team

A successful financing requires assembling a team of capable professionals to assist the Issuer, each with a different specialization and focus on the financing. It is important to understand the different roles of the participants involved.

Bond Counsel

Bond Counsel works directly for the Issuer. Bond Counsel is an attorney (or team of attorneys), typically with specialized experience in municipal financings, that generally issues two legal opinions in the offering:

1. An opinion as to whether the financing is a valid legal, binding obligation of the Issuer, and,
2. An opinion of the nature of the taxability of the interest the investor earns on the financing.

These two opinions are relied upon by investors when considering whether they will purchase the bonds. In order to make these opinions, Bond Counsel must work closely with the Issuer to understand the nature and structure of the issue.

Bond Counsel should also be knowledgeable in local, State and federal laws and regulations related to municipal financings and any special requirements for public agencies.

The Bond Counsel will often also serve as a disclosure counselor for the issue. This attorney assists with the preparation of the official statement and the continuing disclosure agreement, and will help facilitate preparation of the final (closing) documentation.

Municipal Advisor/Financial Advisor

A financial advisor (or "Municipal Advisor" or "MA") is a professional consultant that works directly for the Issuer. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, a Municipal Advisor working for a municipality must be registered with the Securities and Exchange Commission (SEC) and must give fiduciary care in advising the Issuer by putting the Issuer's interests above their own financial interests in a transaction.

The role of the MA varies upon the level of sophistication of the Issuer, but often the MA works as an extension of the Issuer's staff with a specialty focus on the proposed financing. The MA has an independent view of the financing market, and works closely with Bond Counsel and the Issuer to assist in structuring and marketing the financing in the most economical way. The MA will also assist in determining if the method of sale should be through a competitive or negotiated sale. They will further assist by managing the sale and assisting the Issuer through the closing process.

Underwriter/Investment Banker

An Underwriter or Investment Banker is the key conduit between the Issuer and ultimate investor. In a financing, they are ultimately working for the investors. The Underwriter, via the bond sale, agrees to buy the bonds and resell them to investors. Their role varies by the type of sale the Issuer chooses ("competitive" versus "negotiated") as described under "Issuance Process" below.

Other Participants

Paying Agent/Trustee. A paying agent or trustee may be used to take debt service payments from the Issuer and distribute to the investors that actually own the bonds. A paying agent may also be used to hold a reserve or other funds as determined in the issuing documents.

Rating Agency. A rating agency can be obtained in order to help the investor determine the level of repayment risk before purchasing a bond. The higher the rating, in the opinion of the rating agency, the less risk of delinquency, and ultimately the lower the interest rate.

Bond Insurance Provider or Other Credit Enhancer. The financing may also include a credit enhancer to entice the investor to offer a lower rate. The enhancer can be an insurance company, bank or other government authority.

Further information regarding the financing team is available in the following resources:

- GFOA Best Practice: Selecting Bond Counsel
- GFOA Best Practice: Selecting and Managing Municipal Advisors
- GFOA Best Practice: Selecting and Managing Underwriters for Negotiated Bond Sales
- GFOA Best Practice: Using Credit Rating Agencies
- GFOA Best Practice: Debt Issuance Transaction Costs

Legal Considerations

In order to issue debt, Issuers must comply with local, State and federal laws, and enter into a number of legal agreements with various parties. Local and State laws will vary, and it is critical that Issuers consult with specialized legal counsel (Bond Counsel) to determine if they are authorized to issue debt, what actions are required to authorize issuance, and any constraints placed on debt issuance. For example, State law may place legal limits on the amount of debt to be secured by a government's general revenues.

The use of the financed facility will impact the project's eligibility for federal tax exemption, and the associated reduced borrowing cost to the Issuer. Legal counsel should advise the Issuer on tax implications related to private use and tax exempt status affecting the debt obligation. These requirements could have significant impact on interest rates, repayment and continuing disclosure for the debt instrument selected.

Additionally, an Issuer's legal counsel (and/or Municipal Advisor) should consider outstanding debt agreements or other legal agreements that may include financial covenants or restrictions. An Issuer's debt policy may also provide guidance or limits related to legal considerations.

Further information on legal considerations and use of Bond Counsel are available in the following resources:

- GFOA Best Practice: Selecting Bond Counsel
- Debt Issuance Checklist: Considerations When Issuing Bonds

Structuring Considerations

Issuers looking to utilize debt financing should review and update annual capital improvement plans to identify projects that can be funded with annual operating funds, in addition to those that might be candidates for debt financing. Projects should be thoroughly reviewed as to scope, feasibility, cost, useful life of the financed asset, and capacity to repay debt. All of these factors will help determine whether long-term financing is an appropriate tool – and if so, what revenues are appropriate to pledge for repayment and what the term of repayment should be.

Sufficient revenues should be available to meet ongoing debt payments and jurisdiction needs to understand what type of revenues are pledged to support (or "secure") the debt. Potential revenues may include a full or limited taxing power of the jurisdiction, utility revenues, other specific revenue streams, or collateral such as an asset that is being acquired with the debt proceeds.

Various types of debt are typically available to Issuers. Financing tools may include municipal bonds (both taxable and tax-exempt), direct loans from financial institutions, and other less common alternatives. Each option has its own benefits and risks, and the Issuer should utilize a Municipal Advisor to assist with determining which selection best suits a specific circumstance.

Additional information is available in the following resources:

- GFOA Best Practice: Selecting and Managing the Method of Sale of Bonds
- GFOA Best Practice: Issuing Taxable Debt
- GFOA Best Practice: Understanding Bank Loans
- GFOA Best Practice: Debt Management Policy
- Debt Issuance Checklist: Considerations When Issuing Bonds

Issuance Process: How do Bonds Get Sold?

Most local governments do not have the in-house expertise or resources to find investors for their proposed bond offerings, and will require the services of a specialized municipal securities dealer, underwriter or a syndicate of underwriters to sell the bonds for them.

The decision of how to market municipal bonds should be based on the characteristics of the Issuer, the bond issue, and the financial market. Governmental entities usually issue bonds through competitive bid or a negotiated sale. The primary goal of an Issuer undertaking a bond issue should be the proper administration of the bond issue at the least possible issuance cost and interest rate. Both methods are used frequently in bringing municipal bonds to market.

The overriding concern of many Issuers is the minimization of interest rates and issuance costs; however, there currently are varying opinions regarding which type of sale results in the best outcome. Competitive bidding is most appropriate when the Issuer is well known, high demand for the bonds is predicted, and the market is stable. A negotiated sale can more appropriate when the Issuer is less known, the market instrument is complex and less well understood by investors, and/or the market is less stable.

Competitive Bid Process

In a competitive bid sale, the Issuer conducts all of the tasks necessary to offer bonds for sale including structuring the maturity schedule, preparing the official statement, verifying legal documents, obtaining a bond rating, securing credit enhancement, if advantageous, and timing the sale. These tasks are normally done with the assistance of outside consultants, including a financial advisor and bond counsel. Once the issue is structured, the public sale begins with the publication of an official notice of sale that describes the size, maturities, purpose, and structure of the proposed issue, along with instructions for submitting bids. Underwriters submit closed bids to the Issuer on the day and time designated in the official notice of sale. The bonds are awarded to the underwriter that has submitted the best price (i.e., the lowest true interest cost bid). Once the bid is awarded, pricing and major structural aspects of the bonds are locked in regardless of the success or failure of the underwriter to sell the bonds to investors.

Negotiated Sale Process

In a negotiated sale, the bond issue is not structured before an underwriter is chosen. If the Issuer has not retained a Municipal Advisor, the underwriter may assist the Issuer in determining what is to be financed, the method of financing and the financing structure. The underwriter is chosen based on expertise, financial resources, compatibility, and experience. After the underwriter is selected, the Issuer and the underwriter will begin the process of structuring the bond issue and completing the other origination tasks. The underwriter starts the marketing process and develops an interest rate to be negotiated with the Issuer. It is highly recommended that Issuers using a negotiated sale employ a Municipal Advisor not associated with the underwriting firm to represent the Issuer's interests in the process.

Bond Rating

Municipal bond credit ratings measure the Issuer's risk of paying all interest and principal back to investors. A bond rating system helps investors distinguish a company's credit risk. Municipal Issuers rely on specialized rating agencies to determine the overall risk of the issue and assign a "grade" to the bond. The three major rating agencies are Moody's Investor Services, Standard and Poor's, and Fitch Ratings. Ratings have a significant effect on both the ability of the Issuer to raise funds and the price the Issuer will be required to pay.

Credit Rating Agencies

Debt issued by governmental entities is rated to reflect the degree of risk and probability of repayment of all interest and principal to the investor. Investors use the bond ratings to determine the level of repayment risk associated with the specific issue and determine a minimum rate of return for the risk involved. If the bonds have high ratings, they are assumed to have low risk and the investor will therefore require a lower yield. Just the opposite will occur for a lower rated (riskier) bond. There are four major investment grade ratings assigned to bonds by the rating agencies - Highest (AAA/Aaa), High (AA/Aa), Above Average (A), and Medium (BBB/ Baa). All long-term bonds rated below the fourth category are judged to be below investment grade (speculative grade) and are often referred to as "junk" bonds.

Below are five Best Practices related to the sale of bonds. These resources should be read and considered in conjunction with each other because of the interaction of the processes to which they apply.

- GFOA Best Practice: Selecting and Managing the Method of Sale of Bonds
- Selecting and Managing the Municipal Advisors
- GFOA Best Practice: Selecting Bond Counsel
- Selecting Underwriters for Negotiated Bond Sales
- Pricing Bonds in a Negotiated Sale

Issuer Responsibilities During and Following the Bond Sale

The Issuer is more than just a participant in the sale of the bonds. The agency is the owner of the transaction and the obligor of the debt until "maturity" when the debt is fully repaid - perhaps a period of 20 to 30 years. This means staff must take more than a casual interest in the transaction. While the Issuer will hire various finance professionals to assist in the structuring of the transaction and the preparation of various legal documents and financial analysis, staff must also have a firm understanding of the commitments made on behalf of their organization. When the transaction closes, the financing team will move on and the public agency will be left with a number of ongoing commitments. If staff cannot explain the structure and obligations of the transaction to their governing board, the deal most likely should not be done.

The Issuer's typical duties at and after the time of sale include the approval of a pricing scale (if the bonds are to be sold on a negotiated basis). While it may only be a few basis points, the decision to accept or reject a proposed pricing scale could mean the difference of hundreds of thousands of dollars in interest expense over the life of the bonds. Once the sale is completed and bids accepted, the designated staff will sign a bond purchase agreement. Following this, the lawyers will finalize the remaining legal documents which will be signed a day or two before the actual closing of the transaction.

Once the deal closes, staff will need to book the transaction in the general ledger/balance sheet. Depending upon the structure, consulting with external auditors may be advised. In addition, setting up a tickler file with key dates of when bond payments are due and when continuing disclosure information needs to be filed is extremely useful. During the period when there are unspent bond proceeds or reserve funds, staff will want to determine how these funds should be invested. This may be with the help of a third party, the purchase of a guaranteed investment contract, providing specific investment instructions to the Trustee, or in some instances, managing the funds directly in-house. Federal tax laws, in most instances, will require Issuers to rebate any net positive arbitrage earned on the investments of the bond proceeds. As such, staff will need to track interest earnings, offset by the true interest costs, in order do the calculations. Finally, the organization needs to keep detailed records as to how the bond proceeds were spent. First of all, when the original bond documents were signed, staff acknowledged that there was a reasonable expectation that the bond proceeds will be spent within a three year period. If this does not happen, the issuing agency will be required to yield restrict the investments of any remaining unspent bond proceeds. In addition, it is important to be able to report the use of bond proceeds to the governing board and the general public, should the transaction ever be audited by the IRS.

Alternative Financing Products

In addition to traditional municipal bonds, a number of alternatives are available to Issuers. These financing tools carry special considerations, as described briefly below. These financing tools may be more or less appropriate for less frequent Issuers and – as with municipal bonds – a Municipal Advisor and Bond Counsel should be consulted before proceeding.

Commercial Paper is a fixed-income instrument that matures in 270 days or less. This short-term instrument can be a viable alternative for to the more traditional long term debt and may be an appropriate source of funding for the design and construction phase of a project or projects with the long term debt being issued once there is more certainty as to the completion of the project. While perhaps supported by one or more dedicated revenue streams, commercial paper is an unsecured form of a promissory note that pays a fixed rate of interest. The commercial paper may be rolled into a new commercial paper at maturity and is typically backed by a letter of letter issued by a bank. As with any other type of bond or debt instrument, the issuing entity offers the paper assuming that it will be in a position to pay both interest and principal by maturity. One significant aspect of commercial paper is that it is negotiable, which means that it can be freely transferred (traded) from one party to another.

Bank Loans can take on many forms and can typically be structured to provide the Issuer with flexibility regarding duration and repayment. A bank loan may carry a fixed or variable interest rate, in which interest may be repaid in equal payments over a fixed period of time, or there may be interest only with a balloon payment at maturity. In addition, bank loans can be structured as a revolving line of credit. This means the borrower can draw on the funds up to the loan amount, pay some or all of the loan back, and then redraw funds all during the term of the loan. Typically bank loans are for a shorter duration than traditional bond sales and are usually in the five to ten year duration, though some banks may be willing to go as long as 20 years. The legal work involved in preparing loan documents is more straightforward and thus less expensive than a traditional bond deal. While bank loans should be disclosed as part of a debt portfolio, they have no disclosure or continuing disclosure requirements.

Inter-fund Borrowing can be complex, and the ability to do so may be restricted by an Issuer's local Charter, governing board policies, and State laws. The duration of inter-fund borrowing may also be limited in duration. If permitted, this may be a quick, flexible and inexpensive way to do some short-term borrowing for necessary projects or equipment. Typically, the internal borrowing rate would be tied to the investment rate of return pooled portfolio in order to ensure that one fund is not subsidizing another fund.

Ongoing Requirements after the Bond Sale

Continuing Disclosure

Governmental entities issuing bonds generally have an obligation to meet specific continuing disclosure standards set forth in continuing disclosure agreements (CDAs, also called continuing disclosure certificates or undertakings). Issuers enter into CDAs at the time of bond issuance to enable their underwriters to comply with Securities and Exchange Commission (SEC) Rule 15c2-12. This rule, which is under the *Securities Exchange Act* of 1934, sets forth certain obligations of (i) underwriters to receive, review and disseminate official statements prepared by Issuers of most primary offerings of municipal securities, (ii) underwriters to obtain CDAs from Issuers and other obligated persons to provide material event disclosures and annual financial information on a continuing basis, and (iii) broker-dealers to have access to such continuing disclosure in order to make recommendations of municipal securities in the secondary market.

Once bonds have been issued, the Issuer commits (via the CDA) to provide certain annual financial information and material event notices to the public. In accordance with SEC Rule 15c2-12, those filings must be made electronically at the Electronic Municipal Market Access (EMMA) portal (www.emma.msrb.org). It is also important to provide this information to Bond Counsel and financial advisor which insure the annual CDA requirements set forth with in your CDA are being met.

The SEC's Municipalities Continuing Disclosure Cooperation (MCDC) initiatives in 2014, along with other recent regulatory actions, have highlighted the importance of maintaining a reliable system to adequately manage continuing disclosure.

Issuers may choose to provide periodic voluntary financial information to investors in addition to fulfilling the specific SEC Rule 15c2-12 responsibilities undertaken in their CDA. It is important to note that Issuers should disseminate any financial information to the market as a whole and not give any one investor certain information that is not readily available to all investors. Issuers should also be aware that any information determined to be "communicating to the market" can be subject to regulatory scrutiny.

In addition to filing information via EMMA, a government may choose to post its annual financial information and other financial reports and information on the investor section of its web site.

Tax Compliance

To assist the Issuer with Tax Compliance, the National Association of Bond Lawyers (NABL) and the Government Finance Officers Association (GFOA) have jointly developed a checklist to assist Bond Counsel in discussing with Issuers and conduit borrowers, as applicable, post issuance compliance matters.

The checklist is divided into three parts: tax, securities and State law matters. The checklist can serve as a framework for discussion at an appropriate time during the transaction or as a written document prepared by Bond Counsel and furnished to the Issuer or conduit borrower after completion of the financing.

Bond Counsel may need to explain various items on the checklist to provide the Issuer with a more complete understanding of the noted concept. The checklist can be amended or supplemented as needed to address the particular financing issue. Issuers and conduit borrowers are encouraged to contact Bond Counsel at any time they may have questions or concerns pertaining to tax, securities or State law issues.

It is important to remember the goal of establishing and following written procedures is to identify and resolve noncompliance, on a timely basis, to preserve the preferential status of tax-advantaged bonds.

For additional information on post-issuance compliance you can refer to the following references:

- GFOA Best Practice: Debt Management Policy
- Post Issuance Compliance Checklist
- Debt Issuance Checklist: Considerations When Issuing Bonds
- Debt 101, Volume II

Glossary / Other References

http://www.msrb.org/msrb1/pdfs/MSRB-Glossary-of-Municipal-Securities-Terms-Third%20Edition-August-2013.pdf

http://www.investinginbonds.com/story.asp?id=52