Step 3: Debt Policy Considerations

While there are no national standards for debt policies, many state and local governments have adopted written policies in order to enhance their position in debt-related matters. Formal debt policies are often used as a means of establishing credibility with bond rating agencies. The Government Finance Officers Association (GFOA) encourages municipalities to establish a formal, comprehensive debt policy. This policy establishes debt limits and parameters while providing sufficient flexibility to respond to changing circumstances. The debt policy also furnishes instructive guidance for debt management decision-makers and be formally adopted by the local elective or appointed government body.

Many local governments and special districts have incorporated informal debt policies into a variety of documents. These documents frequently include official budgets, capital improvement plans, general or comprehensive plans, charters, grant applications, council resolutions, and/or administrative practices. However, when these policies are scattered, unwritten, or developed on a case-by-case basis, it is unlikely that decisions will be made with consideration of other current, past, or future policy alternatives. Having a formal set of policies assists debt managers in the decision-making process and helps identify conflicts, inconsistencies, and gaps in a municipality's approach to financial policy and debt management. Potential benefits of formal policies include:

- Consistency in financial decisions.
- Prescription of improvements that are desired.
- Identification of strengths and weaknesses in the overall financial system.
- Establishment of standard operating procedures to guide daily financial activities.
- Measures of performance.
- Improvement in bond rating translating into money saved.
- Linking of long-term financial planning with day-to-day operations.
- Attention to the total financial picture versus single issue.
- Significant ability to insulate from fiscal crisis.

Formal debt policies describe local government policies and procedures currently in use. Policies also integrate short and long-term capital infrastructure objectives with reasonably conservative estimates of available financial resources. Formal debt policies may also include:

- Purposes for which debt can be issued
- Integration of capital spending and debt financing
- Debt limitations
- Types and criteria for which debt can be issued
- Debt structure
- Use of taxable debt
- Credit policy
- Method of sale
- Selection of the finance team
- Refunding policy
- Disclosure requirements
- State and Federal tax compliance
- Investment of bond proceeds

The sample debt management policy and statements are offered for general use when developing a formal debt policy. The items listed in the guide are not exhaustive nor are they appropriate for all situations and municipalities. They are presented as examples of policies and/or ideas which may be evaluated, altered, and used as appropriate.

CONSIDERATIONS

The process of issuing municipal bonds begins well before the issuer holds a bond election, prepares an Official Statement, or sells the bonds. The framework for responsible debt management is established in advance by the development of a long-term plan for capital improvements and expenditures. The first step to creating a long-term plan is preliminary analysis involving three broad considerations:

1. Project feasibility (a cost-benefit assessment).

2. Various financing options (e.g. bank loan, local option levy, bonds, etc.).

3. The advantages of a public offering (negotiated sale or competitive bid) as opposed to private placement, where private placement is legally allowed. *As a*

general rule, the debt redemption schedule should not extend beyond the useful life of the project being financed.

Issuers should review proposed debt offerings against statutory debt ceiling limitations as early in the debt issuance process as possible - when capital needs and tentative amounts are considered. See the statutory general obligation debt limits for most Oregon districts and municipalities. The Debt Management Division also provides issuers with overlapping debt reports for comparison of total debt outstanding to each applicable debt ceiling.

Capital Improvement Plan

A well-thought-out long-term capital planning program is composed of all the levels of needs and desires for community facilities, balanced by the realism of government's limited resources to serve its population. The equation must include a cost-benefit analysis that produces an objective measure of the best choice, given the variables.

Once a formal capital improvement plan is developed, it is submitted to the municipality's elected officials for approval. If properly prepared, a capital improvement plan will demonstrate a community's commitment to infrastructure improvements and long-term economic well being. It will also show a realistic and thoughtful self-evaluation of community financial liabilities and funding resources. This can be a strong positive credit quality indicator to investors and credit rating agencies. Typically, a good plan identifies the following:

- Those community needs that are appropriate for debt financing and do not exceed the statutorily permitted debt levels.
- A ranking of each proposed capital improvement project and expenditure item.
- A timeline of when the improvements will commence and the number of years to complete construction.
- The amount budgeted for each year.
- The financing method proposed and a systematic review of all funding alternatives such as tax revenues, user fees, rents, intergovernmental grants and loans, and public-private financing partnerships.

Capital Improvement Budget

The capital improvement budget is adopted based on the capital improvement plan which is typically approved by the governing body. It should include enacting statutes for appropriations and the necessary bond issues. The capital budget may differ from the long-term capital improvement plan because of financial constraints and changing circumstances. After adoption of the capital budget, the capital plan should be updated to include any changes necessary in future years as a result of current budget revisions. Future operating costs must be determined once a capital project has been selected. These costs include debt service and the maintenance and operational expense of any physical facility. Operating expenditures should be estimated and adjusted for anticipated inflation.

Capital Improvement Projects

Local governments should evaluate their past economic growth and financial performance, current conditions, and the implications of these trends for the future. Governments experiencing significant community growth usually require capital expenditures on a variety of projects. Capital project construction and improvements are expected to have a useful life of more than one year and are defined in ORS 310.140. Capital improvements generally do not include items such as normal operating budgets, routine maintenance and repairs, consumables, and personnel salaries. The following are some examples of capital projects:

- Land acquisition.
- Major recreational and cultural facilities.
- New construction and improvement or replacement of older facilities to meet the rising expectations and standards of the community.
- General community services and infrastructure needs such as schools, sewer and water facilities, police and fire protection equipment.
- Other projects which may be specific or unique to a particular local government jurisdiction (i.e. sometimes projects may arise in response to the needs of certain groups).

Tax Anticipation Notes

Local governments sometimes find that the timing of expenditures and the timing of tax receipts do not always align well. To bridge the gap between expenditures and tax receipts, a government may issue tax anticipation notes. Since these notes are a form of cash flow borrowing, rather than a capital project borrowing, some additional policy considerations are appropriate. The local jurisdiction should create additional policies for the following:

- Arbitrage considerations
- Maximum sizing of notes
- Reinvestment risks and repayment timing

Public Employee Retirement System (PERS) – Pension Obligation Bonds

Employers must assess certain risks prior to making a lump sum payment as this affects the anticipated value of the payment or the rate relief that the employer is anticipating. These risk variables include, but are not necessarily limited to:

- *Unfunded Actuarial Liabilities (UAL) and Lump-sum Payment Treatment*
  UAL is the difference between the present value of "accrued liabilities" and the value of assets (either smoothed or fair market value) as of a specific date. Lump-sum payments will not change accrued liabilities, as these actuarial liabilities represent future benefits to be paid to members or their beneficiaries. Instead, lump-sum payments will be treated as prepaid contributions, which will increase the actuarial value of assets attributed to the employer making the payment. By increasing the value of assets to offset the actuarial liabilities, the UAL will be reduced, therefore reducing the employer's rate.

  A lump-sum payment does not affect the accrued liabilities attributed to the employer making the payment. The lump-sum payment will be used to increase the assets attributed to the employer, which will be used to offset the employer's liabilities, thus reducing the employer's overall UAL.

  The reduction in the individual employer's contribution rate will be equivalent to an amortization of the lump-sum payment over the expected payroll of the employer, increasing with wage inflation over the course of the remaining amortization period, and discounted at the assumed earnings rate. The rate relief, as a percentage of employer's payroll, may change over time depending on the actual future payroll of the employer and assumptions and methods adopted by the Board for financing the system's obligations.

- *Basis for Lump-sum Payments*
  The most recent actuarial valuation will become the basis for calculating UALs. Lump-sum payments made after completion of the valuation will be based on those results.

  An employer may have an outstanding UAL that was calculated on an individual employer basis, or as a participant in an actuarial funding pool. A lump-sum payment may be made to offset all, or a portion of, the outstanding UAL regardless of its source.

- *Changing Nature of UALs*
  Each time a valuation is conducted, it provides a new assessment of the system's financial position. Employer UALs are an important product of each valuation. Valuations represent a financial "snap-shot" of employer pension obligations as of a particular point in time. As subsequent valuations are conducted, they provide a fresh look at the system's pension obligations. These obligations can experience significant changes from valuation period to valuation period. This, in turn, can cause the UAL of the system and of individual employers to also change.

- *Assumed Rate of Return on Investments*
  The PERS actuarially assumed rate of return on investments is currently 8.00%. More information can be found on the PERS website. This estimate is what the PERS Fund expects to earn, on average, over a 30-year period and is the basis for amortizing employer liabilities and surpluses. This would also be the basis for amortizing employer lump-sum payments. Because this assumption is subject to review during each valuation, it could change if necessitated by a change in long-term market projections.

  A decrease in the assumed rate from the current 8% would cause a reduction in the anticipated value of the unamortized portion of the lump-sum payment, thus reducing the amount of rate relief associated with the lump-sum payment as a percentage of payroll. In turn, an increase in the assumed earnings rate will result in an increase in the anticipated value of the unamortized portion of the lump-sum payment, thus increasing the amount of rate relief as a percentage of payroll. Given current market conditions, if a change were made, it would likely result in a reduction in the assumed rate.

- *Side Fund*
  If a supplemental lump-sum contribution is made by an employer participating in either the State and Local Government Revenue Pool (SLGRP) or the School Districts Pool, it will be held, with interest, in a Side Fund according to provisions of the PERS administrative rule (OAR 459-009-0084). This is necessary so that

the employer making the supplemental contribution receives the benefit of that contribution, rather than being included with the entire pool. The value of the side fund is treated as an employer asset to offset the UAL. The Net UAL is the UAL less the value of the Side Fund.

- *Earnings Crediting Policy*

  Earnings credited to the employer via lump-sum payments will be actual regular account earnings, or losses, adjusted for administrative costs and charges used to fund the contingency reserve. This can directly impact the value of the unamortized portion of a lump-sum payment in future crediting periods.

  Because lump-sum payments will be amortized based on the assumed earnings rate (currently 8% per year), any crediting of earnings to the lump-sum payment that is below the 8% assumed earnings rate would result in a reduction in the anticipated value of the lump-sum payment and the employer would receive less of an offset to the employer's UAL costs than originally anticipated. Likewise, earnings credited in excess of the assumed rate would result in an increase in the anticipated value of the lump-sum payment, which would provide a greater offset to the cost of an employer's pension liabilities.

- *Projected Payroll of Employer*

  The reduction in an employer's contribution rate attributable to a lump-sum payment is based on a projection of the last known payroll of the employer. If the payroll of the employer increases, either faster or slower than assumed, the employer contribution (as a percentage of payroll) will decrease or increase, but the dollar amount of annual rate relief will remain unchanged.

  Just as a change in the assumed earnings rate or the amortization period may affect the rate relief, a change in the assumed growth in payroll will also impact the rate relief as a percentage of payroll.

- *Effect of Legal Contingencies*

  Unsolved questions of law, including, but not limited to, those raised by litigation, may change the calculation of liabilities or assets.

Derivatives

With the onset of the financial crisis in 2008, the risks related to derivative products such as swaps, hedges and rate locks are now more widely understood. Derivative products can be used as part of a total portfolio but carry with them many risks normally not born by the investors of fixed rate debt. It is important that clear policies be developed long before entering into transactions which involve derivatives. MDAC has a sample swap policy from the City of Portland and the Port of Portland. Any derivative policy should address the following areas:

- Responsible Parties
- Process for approval
- Purpose
- Form of agreement
- Method of procurement
- Risk Analysis
- Risk Mitigation
- Counter party credit ratings
- Collateralization and downgrade provisions
- Monitoring & Mark to Market
- Termination