STEP 4: TYPES OF DEBT INSTRUMENTS

A decision on the type of debt to use can be made once capital project funding is approved. The following list briefly summarizes the types of debt and financial instruments that are currently authorized for Oregon local governments. For further definitions and information on varying types of bonds, see the MSRB Glossary.

General Obligation Bonds

General Obligation (GO) bonds typically benefit a community as a whole and are secured by the full-faith-and-credit and taxing power of the issuing municipality. The municipality pledges unconditionally to pay the interest and principal on the debt as it matures. For Oregon local governments, a GO pledge means that all unrestricted resources of the issuer may be used to meet debt service, including an *unlimited property tax* on all taxable property within the district. Local government GO bonds may only be issued if authorized by a ballot election of the issuing jurisdiction. Voter Authorized General Obligation bonds are supported by an unlimited tax levy outside of the limits imposed by Article XI, Section 11 and 11b of the Oregon Constitution.

Under ORS 287A.050-287A.145 general obligation debt can be incurred for capital construction and improvements having an expected useful life of more than one year. This does not include maintenance and repair (the need for which could be reasonably anticipated), supplies, and equipment that are not intrinsic to a structure. General obligation debt has been the traditional form of financing for capital projects such as land acquisition, schools, water facilities, sewerage facilities, and roads that are owned and operated by governments. GO bonds can also be issued to replace outstanding general obligation bonds, and are commonly referred to as Refunding Bonds.

There are several types of GO bonds which place varying emphasis on the full-faith-and-credit security and the issuer's taxing ability. These types of Unlimited Tax GO (ULTGO) bonds are categorized by source of repayment, as follows below.

Non Self-Supporting GO Bonds

Non-self-supporting GO bonds or tax-supported bonds are those which are paid for by property taxes or other tax sources. School district bonds in Oregon are traditionally supported by property taxes and are historically GO Non-self-supporting bonds. Non Self-Supporting and partially self-supporting GO bonds determine a district's Net Bonded debt. Net Bonded debt is a measure of the debt burden on property of the district.

Self-Supporting GO Bonds

Self-Supporting GO bonds are debt issues paid from a project's revenue. The proceeds of Self-Supporting bonds are used to construct a revenue-generating enterprise or facility or there is an independent source of funds for bond repayment. These may be fully Self-Supporting or only partially Self-Supporting. If fully self-supporting, the bonds are not included in the Net Bonded debt of the district, but are included in its Gross Bonded debt. If only partially Self-Supporting, they are included in the Net Bonded debt and Gross Bonded debt calculations. (See "Computing Net Direct Debt"). Another name for these types of bonds is Double-Barreled bonds.

Appropriation Bonds

Certificates of Participation (COPs), sometimes referred to as "Lease Purchase Agreements", may be an alternative to issuing bonds and are often used to finance real property or equipment, construction of public facilities, and facility maintenance and renovation. COPs are authorized under ORS 271.390. COP's principal and interest (debt service) payments are not secured by a particular revenue source nor does the government have the authority to levy extra taxes beyond constitutional limits to pay debt service. COPs are secured by an obligation of the government to make regular payments to meet debt service and, most commonly, a security pledge of the real property or equipment. In the typical COP, if the issuer defaults, the structure or asset is "repossessed." The security of the instrument, in the eyes of the investors, lies in the expectation that the government will choose not to forgo use of the structure or asset which may be a facility critical to the government's function. COPs differ from Full Faith and Credit Obligations in that COPs are subject to annual appropriation and therefore are not bonds. Since they are subject to annual appropriation, collateral (if used) is generally viewed as one means to incent the issuer to keep appropriating or lose access to an essential public asset. Since the real credit is the annual appropriations of the issuer, highly rated issuers sometimes issue COPs with little or even no collateral. In these cases, future access to the capital markets would be eliminated should they fail to appropriate for the payment of the COP.

Some attributes of Certificates of Participations include:

- No voter approval is required, nor is adherence to the restrictions of the Uniform Revenue Bond Act (ORS 287A.150).
- General fund revenues, at the option of the governing body, can be used to pay the debt service.
- Interest rates are generally higher because the payments are subject to annual appropriation and lack a pledge of specific taxes.
- COPs are more complex than GO bonds. This may result in higher issuance costs and fees.
- COPs are typically rated at least one notch below the district's GO rating.

Full Faith and Credit Obligations

Full Faith & Credit Obligations (FF&C) may be secured by a variety of pledges except as restricted by the Oregon Constitution or Statutes or by local charter. FF&C bonds are authorized under ORS 271.390. In such a case, the municipality is still required to use all legally available resources to meet its obligations. FF&C bonds are backed by the general revenue and taxing power of the issuer within the limits of Sections 11 and 11b of Article XI of the Oregon Constitution. FF&C obligations are not subject to an annual appropriation process and are therefore often seen as a better credit than COPs.

FF&C (Self-Supporting) bonds are generally perceived by investors to have a higher risk than the unlimited-tax general obligation bond, but are still perceived to be less risky than COPs. The difference in interest rates will depend on numerous factors, including the financial condition and reputation of the issuer, the revenue source used to repay the debt, the security pledge, and the nature of the asset being financed.

Rating agencies will typically rate FF&C obligations one step below the full unlimited-tax general obligation rating of the district.

There are two types of FF&C bonds which place a varying emphasis on credit security and the issuer's taxing ability. These types of obligations are categorized below.

Full Faith & Credit (Non Self-Supporting)

FF&C Non Self-Supporting obligations are paid by property taxes or other tax sources up to the limit imposed by Oregon's Constitution, Article XI, Section 11(b).

Full Faith & Credit (Self-Supporting)

FF&C Self-Supporting obligations are paid from a project's revenue stream. The proceeds are used to construct revenue generating enterprises or facilities, or there is an independent source of funds for repayment. The taxing authority behind the security pledge on the obligation is limited by Sections 11 and 11b of Article XI of the Oregon Constitution.

Revenue Obligations and Bonds

Revenue Bonds are usually payable from revenues generated by the project or enterprise. They may be issued under the authority of the Oregon "Uniform Revenue Bond Act" (ORS 287A.150) and must adhere to applicable state and federal statutes and regulations. Alternatively, Revenue Obligations may be issued under ORS 271.390. Both bonds and obligations have the same security structure and considerations with the note that revenue bonds are more widely recognized by investors outside of Oregon markets. No ad valorem property taxes are levied or pledged. Revenue bondholders do not have recourse against the full-faith and unlimited or limited taxing power of the government and these bonds are expected to be fully self-supporting. The bonds are generally repaid from user charges, grants, excise taxes or from enterprise earnings and do not rely on the ad valorem taxing powers of the government for their security. The following are advantages to issuing Revenue Bonds:

- Governments have the ability to finance traditional projects without pledging the power to tax, reserving this power for other services. Special districts have been created to promote projects as an alternative to general government action. Although they don't have the power to tax, they may have the power to float bonds and serve as conduits for financing non-governmental activities in the tax-exempt market.
- Those responsible for the payment are those who benefit reflecting a "user pays" philosophy.
- Revenue bonds are usually not restricted by various debt limitation statutes.
- Voter approval is usually not required. However, bonds issued pursuant to the "Uniform Revenue Bond Act" may be subject to voter approval if sufficient petition signatures are gathered during the 60-day period following publication of the bond notice.

Revenue Bonds often have other associated requirements and several distinctive disadvantages such as:

- Repayment revenue depends on the continuity of the revenue source. This may result in significantly higher interest rates and issuance costs than ULTGO bonds because of their limited security.
- Higher coverage requirements (i.e. revenues compared to debt service).
- Requirement to maintain a debt service reserve.
- Generally require more complex financial arrangements.
- Bonds (not Obligations) require adherence to Oregon's Uniform Revenue Bond Act, which has a 60-day notice period during which the bond cannot be sold and is subject to voter referral.

Revenue Bonds are often categorized by source of revenue. Some examples of different types of Revenue Bonds follow.

Enterprise Revenue Bonds

Enterprise Revenue Bonds finance projects that are expected to generate revenues to repay the debt. The bonds are issued under the provisions of the Uniform Revenue Bond Act (ORS 287A.150) or under other specific statutes.

Special Revenue Bonds

Special Revenue Bonds are secured by special revenues such as an assessment or gasoline tax. These funds are directed to a special fund established for the purpose of bond repayment. The contents of the fund form the bond's security and repayment source.

Double-Barreled Revenue Bonds

Some revenue bonds are dually secured with a dedicated revenue source and a jurisdiction's qualified or unqualified tax pledge. This enhancement generally results in a higher credit rating for the security which can result in lower interest rates for the bonds.

Industrial Development Revenue Bonds

Industrial Development Revenue Bonds (IDBs or IDRBs) are revenue bonds authorized to be issued in Oregon through the Oregon Business Development Department, port districts, and cities of over 300,000 in population. These bonds finance construction of facilities for eligible private enterprises to increase employment and to promote economic development and diversity. IDBs are private activity bonds and require an allocation of the State's private activity bond volume cap to qualify as tax exempt.

Urban Renewal Bonds

Tax Increment (Urban Renewal) Bonds, are authorized for cities, designated agencies of cities, and counties as authorized by Article IX, Section 1c of the Oregon Constitution and ORS Chapter 457 (Urban Renewal of Blighted Areas—Tax Increment Financing of Urban Renewal Financing). Urban Renewal Bonds are similar to GO bonds in that they are repaid by property taxes. Also, they may be used for similar infrastructure improvements such as streets, sewers, property acquisition and housing development. A difference is that they must be issued for the purpose of remedying “blighted’ conditions within a specific community. These bonds are repaid through taxes on any increase in assessed value above the frozen level, rather than the entire assessed value of the property as in GO bonds. This is referred to as “Divide the Taxes Revenues”. To use these bonds, an urban renewal area must be designated and property assessments for this designated area are then “frozen” at prevailing rates.

Taxes Revenues are calculated by multiplying the Incremental Assessed Value of an urban renewal area by the consolidated billing tax rate. The consolidated billing tax rate is the sum of the tax rates of taxing districts that overlap the area. The incremental assessed value is the difference between the assessed value of all taxable property in the Area from the date the area was formed adjusted for certain later changes to the area and the current assessed value of all taxable property in the area.

The security for the borrowing is the expected growth in property tax revenues resulting from the urban renewal improvements. These bonds may be considered riskier than General Obligation or Revenue Bonds because there is no guarantee that resultant property values and tax revenues will increase. Consequently, this usually results in higher interest rates paid on the bonds.

Local Improvement District Financing

Local Improvement District Bonds, known as Assessment Bonds are authorized in ORS Chapter 223. These bonds are secured by charges or assessments to property owners who benefit from the improvements. To collect the charges or assessments, municipalities may form Local Improvement Districts (LID) within which the improvements are to be made.

Special districts, such as county road districts, may use special assessment procedures and authority to issue bonds to finance various local improvements such as sewer, water and streets. Special assessment bonds are issued for the amount of the unpaid assessments and an amount necessary to establish a debt service fund and pay issuance costs. Properties that benefit from the improvements are proportionately assessed the actual cost of the improvement. The method of distributing the cost of the improvements among the benefitted properties may be determined in a number of different ways and is determined by the governing body. The assessment payments are used to meet debt service obligations. Since assessment payments are notoriously unpredictable, the timing of payments is uncertain, and the credit quality of the bond is diminished. Some assessment financings are issued as Full Faith and Credit Obligations (ORS 271.390) with the assessments as the basis for the bond payments but offering the issuer’s full faith and credit as security for the obligations.

If the issuer uses its full faith and credit to secure the obligations, it is important that the issuer develop internal guidelines sufficient to protect the issuer from having to pay the bonds without getting offsetting assessment payments. These guidelines, or policies, should include a maximum loan to assessment ratio which considers all liens on the property, the maximum size of the assessments, concentration of assessed property ownership and financial capacity of the property owner to make payments. Some issuers require additional collateral from property owners that own large portions of the LID, whose assessed value versus assessment ratio does not meet the guideline or may not meet the financial standards of the issuer.

Historically, Oregon had a special kind of assessment bond known as a Bancroft bond. These bonds were additionally secured by an unlimited general obligation of the issuer and did not require voter approval. Oregon's Constitution was amended to prohibit this type of bond issuance.

Private Activity Bonds

Private Activity Bonds (PAB) are government debt instruments issued for the direct benefit of private businesses. These bonds bear numerous restrictions imposed by federal and state regulations. Specifically, they are subject to the limitations and provisions of the Federal Tax Reform Act of 1986 of the Internal Revenue Code, and ORS 286A.605 to 286A.625.

A frequent advantage of PABs is the private-use of a municipality's tax-exempt name as a conduit to tax-exempt interest rates. Another advantage is that the government issuer incurs no legal responsibility to repay private activity conduit bonds; rather, the private business' credit quality provides the security for the debt financing and ultimately all repayment responsibilities.

The paramount consideration for the issuance of PABs in the State of Oregon is to maximize economic benefits to the citizens of the State by the promotion of appropriate economic development and other public purposes. PABs are issued to increase the number of family wage jobs, promote economic recovery and development and support the development of Oregon's small businesses, including businesses owned by women or minority groups and assist lower income families to obtain housing.

Private Activity Bonds authorized for a variety of uses including: single family mortgage, small issue industrial development, student loans, water/sewer/solid waste, hazardous waste facilities, district heating and cooling, local gas and electric, and tax-increment financing bonds.

Private Activity Bonds are subject to a statewide bond volume cap limit. The amounts allocated for PABs, as provided in ORS 286A.615, are determined on a per capita basis using U.S. Federal government census data for Oregon's population. The Oregon Legislature determines PAB allocations each calendar year for the various state agencies such as the Oregon Economic Development Commission, Business Development Department, Housing and Community Services Department, Office of Energy, and the PAB Committee. The current volume cap and allocations are located at:

http://www.oregon.gov/treasury/Divisions/DebtManagement/Pages/Private-Activity-Bond-Committee.aspx

The Oregon State PAB Committee is responsible for the allocation and reallocation of PABs among local governments, districts, and other public issuers. Oregon Administrative Rule 170-71-0005, "Allocation of Private Activity Bond Limit," provides PAB allocation guidance and procedures for Oregon local governments and municipalities. For additional information, contact the State Treasurer's Debt Management Division.

Short Term Debt

By convention, short-term debt is defined as debt with a stated final maturity at the time of sale of 13 months or less. General Obligation and Revenue Bonds are classified as long-term debt, whereas short-term debt instruments are usually referred to as notes or warrants. Local governments, districts and agencies may, pursuant to ORS 287A.180, pledge anticipated taxes, grants, anticipated bond proceeds, or other revenues when entering into contracts with lending institutions for short-term financing. The Office of the State Treasurer, Debt Management Division does not track municipal debt of less than 13 months. Several types of short-term instruments are described below.

Tax Anticipation Notes and Warrants

Tax Anticipation Notes (TANs) and warrants are both issued to provide interim financing for operations to which taxes are committed but not yet collected. In general, these instruments are used to alleviate a cash flow situation in which collections do not coincide with expenditure needs. Usually TANs are retired from tax collections, and only from proceeds of the tax levy whose collections they anticipate. Under ORS 287A.180, short-term debt, such as TANs, may not be issued prior to the beginning of the fiscal year in which the taxes or other revenues are expected to be received. Additionally, TANs must be repaid no later than the end of the fiscal year in which the borrowing occurs. Obligations issued in anticipation of taxes or other revenues may not be issued in an amount greater than 80 percent of the amount budgeted to be received in the fiscal year in which the obligations are issued.

Bond Anticipation Notes

Bond Anticipation Notes (BANs) are issued to provide immediate funds to begin a project prior to issuing approved bonds. Bond anticipation notes, under authority of ORS 287A.180, may be repaid according to the schedule determined by the governing body. Obligations issued to provide interim financing for capital assets must mature not later than one year after the estimated completion date or acquisition of the capital assets. In periods of market instability and volatile interest rates, bond anticipation notes may be used to delay the sale of a long-term debt issue until the market climate becomes more favorable to the issuer. BANs may be sold in a fashion similar to bonds or more commonly they are sold as direct bank placements or as lines of credit. Other considerations related to the issuance of BANs include:

- Difference between long term rates or cost of capitalizing interest versus short term rates.
- Timing of ratings on long term debt.
- Coverage requirements related to revenue bonds.
- Actual cost of the project.

It is important to note, however, that deferring long term debt involves the risk that interest rates may rise from the time of the planning phase of the project to the actual issuance of the permanent financing. Care must be taken in financial projections to allow sufficient room in projections to allow for some upward movement in interest rates.

Revenue Anticipation Notes

Revenue Anticipation Notes (RANs) are used as interim financing prior to collection of revenues that will be generated once a project is completed. RANs may also be used for operating purposes prior to collection of specific revenues.

Grant Anticipation Notes

Grant Anticipation Notes (GANs) may be used to finance a project for which a state or federal grant has been committed.

Refunding Bonds

Refunding bonds are issued to replace or refinance previously issued debt with new debt. Refunding is typically used to restructure debt, to save borrowing costs through lower interest rates and revise legal restrictions or covenants. There are two principal types of refunding bonds as noted below.

Current Refunding

Current refunding usually involves selling new bonds to refinance outstanding bonds prior to their maturity date but slightly before or after their "call date". The current refunding may take place no earlier than three months before the "call" and any time after the call. Under federal law, the payment of bonds must occur within 90 days of selling the new bonds, otherwise the refunding will be considered an "advanced refunding." Under Oregon Law, the redemption of the bonds must occur within one year to be considered a current refunding and not fall under the State's advance refunding rules. The refunding is normally done to create interest cost savings or remove a covenant the municipality considers onerous. The new bond is sold for the remaining principal of the old bond plus any interest accrued until the date the bonds are called. Current Refundings are authorized by ORS 287A.360.

Advance Refunding

Advance refunding occurs when outstanding bonds are refinanced 90 days prior to or "in advance of" their maturities and prior to the call dates for Federal Law purposes and one year for Oregon purposes. Bond proceeds are placed and invested in an irrevocable escrow structured so that they produce interest and maturing principal to pay off the previous debt as it matures or is called. Accordingly, the refunded bonds do not count as part of the municipality's debt limitations. To insure the escrowed proceeds are available and do produce the expected payments, normally non-callable, full faith and credit obligations of the US Government are used.

The federal government restricts yield on the investment of the proceeds of an advance-refunding bond. State regulations also limit the size of the refunding bond and the manner in which the proceeds can be invested. State regulations require that advance-refunding bonds be sold only to achieve a net dollar benefit to the issuer or for debt reorganization purposes. An advanced refunding must comply with OAR 170-062-00.

Advanced refunding proceeds are most often invested in special State and Local Government Series (SLGS) Securities. SLGS are securities offered by the U.S. Treasury to state and local government entities as an investment alternative which assists issuers of tax-exempt securities in complying with yield restrictions and arbitrage rebate provisions of the Internal Revenue Code. SLGS securities are issued in book-entry form and are non-marketable. The SLGS demand deposit security is a one-day certificate of indebtedness. The principal and daily-accrued interest is automatically rolled over each day until redemption is requested. The interest rate on SLGS demand deposit securities is based on an adjustment of the average yield in the most recent auction of the 13-week U.S. Treasury bills.

SLGS securities are purchased through the U.S. Treasury and additional information can be obtained at http://www.treasurydirect.gov.

Issuers of advance refunding bonds that are issued more than one year prior to a call must comply with ORS 287A.360-287A.380 and the State Treasurer's Administrative Rule detailing the "Procedure for Submission, Review and Approval of an Advance Refunding Plan", OAR 170-62-000).

Zero Coupon, Capital Appreciation, and Deferred Interest Bonds

Typical fixed rate bonds pay interest every six months until they mature. These are also referred to as “Current Interest” bonds. Zero Coupon, Capital Appreciation (CABs), and Deferred Interest Bonds (DIBs) do not pay current interest, but rather delay payment to the investor until maturity. This may provide a payment option that better meets the issuer’s ability to pay the debt service. It is important to note that these types of bonds appeal to a different segment of the bond market and therefore may pay different yields than current interest bonds.

Variable Rate Bonds

Variable rate bonds do not have a fixed interest rate, rather the interest rate is allowed to fluctuate in response to a particular market rates. The rate is periodically “reset” based on a period that is generally set by a remarketing agent, who is hired by the issuer and remarkets the bonds each period at the lowest rate that the remarketing agent believes is necessary to remarket all of the outstanding bonds. This period can range from every day to several years. Alternatively, an auction process has been employed for the re-pricing of bonds. These products are called auction rate securities. The bonds that are remarketed are called Variable Rate Demand bonds. Since it is possible that a remarketing may fail, variable rate demand bonds require a bank to provide liquidity to buy any un-remarketed bonds. This market is very large and trades occur quickly. It is also a market for only the highest rated securities so if an issuer is not at least AA rated, the bonds will probably need credit enhancement, most commonly provided by the same banks that provide the liquidity. These transactions bear significant risks related to interest rates, bank credits, and enhancement/liquidity renewals. Additionally, these transactions may be complicated and have higher issuance costs, and therefore may not be suitable for all issues. Since the interest rates vary on variable rate bonds, the issuer must be prepared to pay high interest rates at any point in time. However, the long term average interest rate for this type of transaction is well below the long term average rate on fixed rate debt.