Government Finance Officers Association

Types of Debt Instruments and Understanding Refundings

Julia H. Cooper and Dianne McNabb

Agenda

I. Introduction of Speakers
  A. Julia Cooper, Director of Finance, City of San Jose, CA
  B. Dianne McNabb, PFM
II. Types of Debt Instruments
  A. Tax-Exempt Bonds
  B. Taxable Bonds
  C. Tax Credit Bonds
  D. Direct Subsidy Bonds
  E. Fixed vs. Variable Rate
  F. Tax Increment Financings
  G. Capital Leases
  H. Bank “Loans”

Agenda Continued

- III. Understanding Refundings
  - A. Call Features
  - B. Refunding Candidates
  - C. Current Refundings
  - D. Advance Refundings
  - E. Financial and Policy Objectives
    - i. Formal policy guidelines
  - F. Financial Savings / Results
    - i. Evaluation factors
    - ii. Appropriateness
  - G. Bond Structure and Escrow Efficiency
    - i. Features that affect flexibility
  - H. Savings Optimization

Agenda Continued

IV. Debt Administration/Management

- A. Compliance
- B. Disbursement of Bond Proceeds
- C. Disclosure
- D Record Retention
- E. Arbitrage Rebate Compliance
- F. IRS Audits

V. Using Professionals and Market Data

- A. Municipal Advisors
- B. Using EMMA
  - i. Disclosure document repository
  - ii. Pricing Results
  - iii. Review Secondary Market Trading

VI. Summary

TYPES OF DEBT INSTRUMENTS

Julia Cooper

Decision to Finance Capital Project

- **<u>Cash or Debt</u>** -- Is the project more suitable for capital financing or operating/cash financing?
  - » Capital expenditures are outlays that produce benefits beyond the current accounting period.
  - » Using working capital (excess cash) to pay upfront for capital needs can be a viable option, if it's plentiful…
  - » Intergenerational Equity – spread the cost of the capital improvement over useful life of the project and to taxpayers/rate payers enjoying the benefits of the asset

Decision to Finance Capital Project

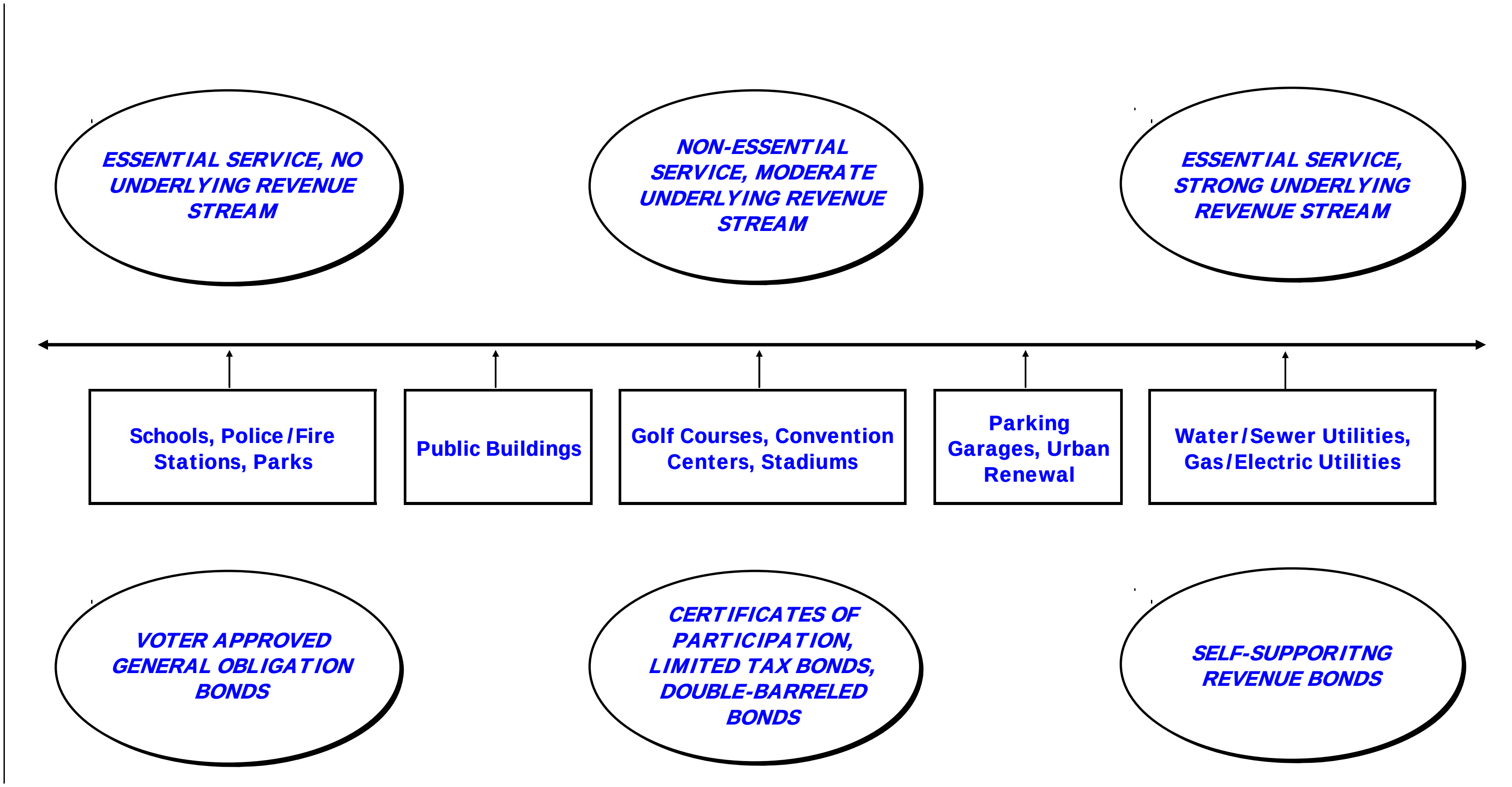
Bonds or Leases?

- Bonds are a form of debt repaid, usually with interest, over an extended period.
- Capital leases, according to GASB exhibit at least one of the following:
  - Government becomes the owner of the asset at the end of the lease;
  - Government can purchase the asset at a significant discount;
  - Term of the lease covers ¾ or more of the remaining useful life of the asset; or
  - Value of the lease is close to the value of the asset if purchased.
- Leases not meeting criteria of capital leases are considered operating leases

What Makes Municipal Bonds Unique?

- If municipal bonds are issued for a governmental or public purpose, interest earnings are generally exempt from federal taxation.
- There are about 70,000 state and local governments authorized to issue tax-exempt debt.
- In addition, some state and local governments extend state and local income tax exemptions for state taxpayers owning in-state bonds.

What Type of Debt to Issue?



Considerations in Type of Debt and Structuring Decisions

- Tax-exempt versus Taxable bonds
- Type of Security Pledge
- Long-term versus short-term debt
- Fixed rate versus variable rate bonds
- Interim financing vehicles – commercial paper
- Tax Credit Bonds
- Public Market
- Private Placements

Tax-Exempt Bonds

- Government purpose obligations
  - Interest is exempt from federal income tax for individuals and some corporations.
  - Proceeds must be used for state and local governmental purposes. Federal government treated the same as private parties.
  - Subject to arbitrage rebate.
  - Subject to advance refunding restrictions.
  - Issuance must be authorized by governing body.

Taxable Bonds

- Carry higher interest rates.
- Flexibility for private use or payment.
- No arbitrage rebate compliance – can invest proceeds at a profit.
- Can advance refund more than once

Tax-Exempt v. Taxable Bonds

Tax-Exempt Bonds

- Interest is exempt from Federal & (usually) state income tax.
- Proceeds must be used for governmental purposes.
- Subject to arbitrage rebate.
- Limited to one (1) advance refunding.

Taxable Bonds

- Carry higher interest rates.
- Flexibility for private use or payment.
- No arbitrage rebate
- Can invest bond proceeds at a profit.
- Can advance refund more than once.

Why Issue Taxable Bonds

- Because you have to – private activity bonds
- Because you want to – for flexibility
- Because it might be cheaper to – direct interest subsidy bonds
- Because the Federal government takes away tax-exempt financing

Taxable Debt – Private Activity Bonds

- Use of bond proceeds may prevent issuance of tax-exempt bonds.
- Generally, if more than 10% of the bond proceeds are used in a trade or business, **AND** if more than 10% of the bonds are secured directly or indirectly by a trade or business, then the bonds are **private activity bonds** and not eligible for tax-exempt financing.
- Some exceptions for particular uses are available.
- Federal government is treated like a trade or business

Taxable Debt – Creates Greater Flexibility

- Issuing taxable debt for projects that are eligible for tax-exempt financing might be beneficial, even though interest costs are higher
- Incentive-based third-party management contracts.
- Operational flexibility

Taxable Debt – Build America Bonds (BABs) & Direct Subsidy Payment Bonds

- Recent Build America Bonds (BABs) provided direct interest payment subsidy to issuers that resulted in lower borrowing costs for many issuers.
- While BABs are no longer available, popularity of direct interest payment subsidy bonds may encourage future programs to be made available.
- Not to be confused with tax credit bonds

Tax Credit Bonds

- Allow holder of tax credit bond ("TCB") the ability to claim a federal tax credit equal to a percentage of the bond's par value (face value) for a limited number of years.
- This tax credit percentage is set at the current yield on taxable corporate bonds.
- TCBs generally deliver a larger federal subsidy to the issuer than do municipal bonds.
  - The subsidy to the issuer is the full 5.70% instead of the difference between the taxable rate and the lower tax-exempt rate of 4.75%.3
  - With tax credit bonds, the issuer does not pay any interest.

Do I Need Short-Term or Long-Term Debt?

- Long term
  - Length: to 50 years
  - Names: Bonds, Debentures, Leases
- Short term
  - Length: to 5 years
  - Examples: Bond, grant, tax or revenue anticipation
  - Names: BANs, TANs, RANs, Commercial Paper

Notes

- **Notes Secured by:**
  - Pledge of anticipated property taxes or other revenues;
  - Proceeds from bonds previously authorized but not yet issued.

- **Purposes for Note Issuance:**
  - Capital costs
  - Acquire loans or assets
  - Cash flow borrowing to manage imbalances (not deficits) between tax receipts and expenditures

Short-Term Debt

- **Tax anticipation notes (TANs)**
  - Generally a "cash flow" borrowing
  - Serviced by future tax collections, within a 13 month (or less) period
- **Bond anticipation notes (BANs)**
  - Secured by anticipated proceeds from a forthcoming bond sale
- **RANs, GANs, or TRANs**
  - Anticipation of revenues, grants, etc.
  - A cash flow borrowing

Variable Rate Demand Bonds (Notes)

- Is a long-term bond with a short-term (floating) rate
- Interest rate resets periodically during life of debt
- Interest rates are based on length of reset period & market conditions at time of reset
- VRDN is most common form of variable rate bond
- Remarketing agent sets rate periodically (daily, weekly, monthly, other)
- Holder can generally put bond on 7 day notice
- Callable at reset at par
- Letter of Credit/Liquidity facility needed for credit risk and in event of put – becoming harder to secure LOCs
- Remarketing agent needed

Advantages of Variable Rate Debt (VRDN & CP)

For Debt Issuers

- Lower interest costs
- Matches interest payment interest earnings
- Option to redeem or purchase
- Bonds (refinance) at any time at par
- May hedge short-term investments

For Bondholders

- Short-term commitment of funds
- VRDBs are money market eligible

Disadvantages of Variable Rate Debt (VRDN & CP)

For Debt Issuers

- Interest Rate Risk
- Additional Financing Costs
- Rating change for liquidity/credit provider
- Liquidity providers more difficult (and expensive) to obtain & maintain
- Requires constant staff monitoring
- Increased rating agency scrutiny

For Bondholders

- Lower Interest Income
- Uncertain Interest Income

Types of Bonds – General Obligation

- Require bond election for authorization (usually).
- Issued for any public purpose:
  - Real property;
  - Land acquisition, etc.
- Secured by issuer's taxing power
- Viewed as lowest credit risk to investors
- Attracts lowest interest rates.

Types of Bonds -- Revenue Bonds

- Require no voter approval (usually)
- Secured solely by designated revenues
  - Enterprise revenues: water, sewer, sanitation, airport, parking
  - Sales taxes;
  - Assessments;
  - Limited property tax (some states)
- Sell at higher interest rates
- May require a reserve fund
- Features:
  - Must meet promises set forth in bond ordinance:
  - Promise to maintain revenues or asset at level sufficient to pay bonds and maintain operations (rate covenant)
  - Limit on additional bonds

Types of Bonds – Tax Increment Financing

- Financing tool to attract economic development projects, create jobs, foster infrastructure investment and redevelop blighted areas.
- Technique for financing a qualifying capital project, or its related infrastructure, from a stream of revenue generated within the geographic area defined as a TIF district.
- TIF districts generally rely upon incremental property taxes generated in a specific area, but can also apply to other taxes, including sales taxes.
- Most states have established laws and eligibility requirements to designate an area as a TIF district – refer to specific state laws

Certificates of Participation/Lease Revenue

- May require voter approval, depending on state laws.
- Secured with tax pledge and specific revenue pledge.
- Intent is to pay debt service from revenues, but credit may not be investment grade without tax pledge.
- Issued for revenue producing projects where stability of revenue stream is uncertain:
  - Golf courses;
  - Parking systems;
  - Convention centers/stadiums, etc.
- Generally sell at interest rates comparable to GOs.

Capital Leases

- *Capital Leases*
  - Lease: payment is subject to annual appropriation
  - Certificates of participation (COP) in a lease
- *Parties in Lease Transaction*:
  - **Lessor** – leases the asset to the lessee (usually a municipal or not-for-profit financing shell)
  - **Lessee** – leases the asset from the lessor (municipality using the asset)
  - **Lender/funding source** – owns the benefits of the lease (bank, leasing company)
- More expensive than Direct Debt
- Used when state laws limit the use of Direct Debt
- Readily marketable, if asset is essential to government
- Can be used for financing real property, equipment

Capital Lease - Lessor Rights

- Lease payment subject to annual appropriation (avoids “debt” definition in most states)- Leads to rating below the municipality’s GO Bond rating.
- Asset can only be used for general governmental purpose (incentive to continue to make lease payments)
- Lessee payment default:
  - “locked” out of the use of the asset
  - Lessor may be able to sell or release the asset

Bank “Loans” – Direct Bank Borrowings

- **Lines of Credit**
  - Allows interim financing and aggregation of small projects funded over time into larger long-term bond issue.
  - Provides interim project funding in anticipation of reimbursement from other entity such as Federal grants.
  - Can provide flexible, short-term variable rate index financing with amortizing principal repayment
- **Direct Bank Borrowings**

  Direct lending from bank to government agency

  - Can provide more flexible terms, repayment obligations

Financing Capital Improvements - Summary

- Careful consideration of many factors critical in determination to issue debt
- Useful Life of Facility (cash v. debt)
- Source of Revenue to repay obligation (type of debt)
- Use of Facility (tax-exempt v. taxable)
- Ability to access public markets (public offering v. private placement)
- Cost of borrowing (variable v. fixed rate)

Post Issuance Compliance Activities

- Trustee Oversight and Management
- Budget and Accounting
- Tracking Compliance
- Record Retention
- Bond Project Monitoring
- IRS Arbitrage Requirements

Understanding Refundings

Dianne McNabb

Call Features

Call = Terms for prepayment in advance of scheduled maturity

Call Features may include:

- Optional Redemption
- Mandatory Redemption (term bonds)
- Extraordinary Redemption (tied to specific events)
  - Optional – event triggers issuer option
  - Mandatory – event triggers without option

Should be discussed at time of bond issuance, as there is typically a trade-off in interest rates

Optional Redemption

Most municipal bonds have an *optional call* feature which allows issuers to prepay bonds at a specified price on certain dates in the future

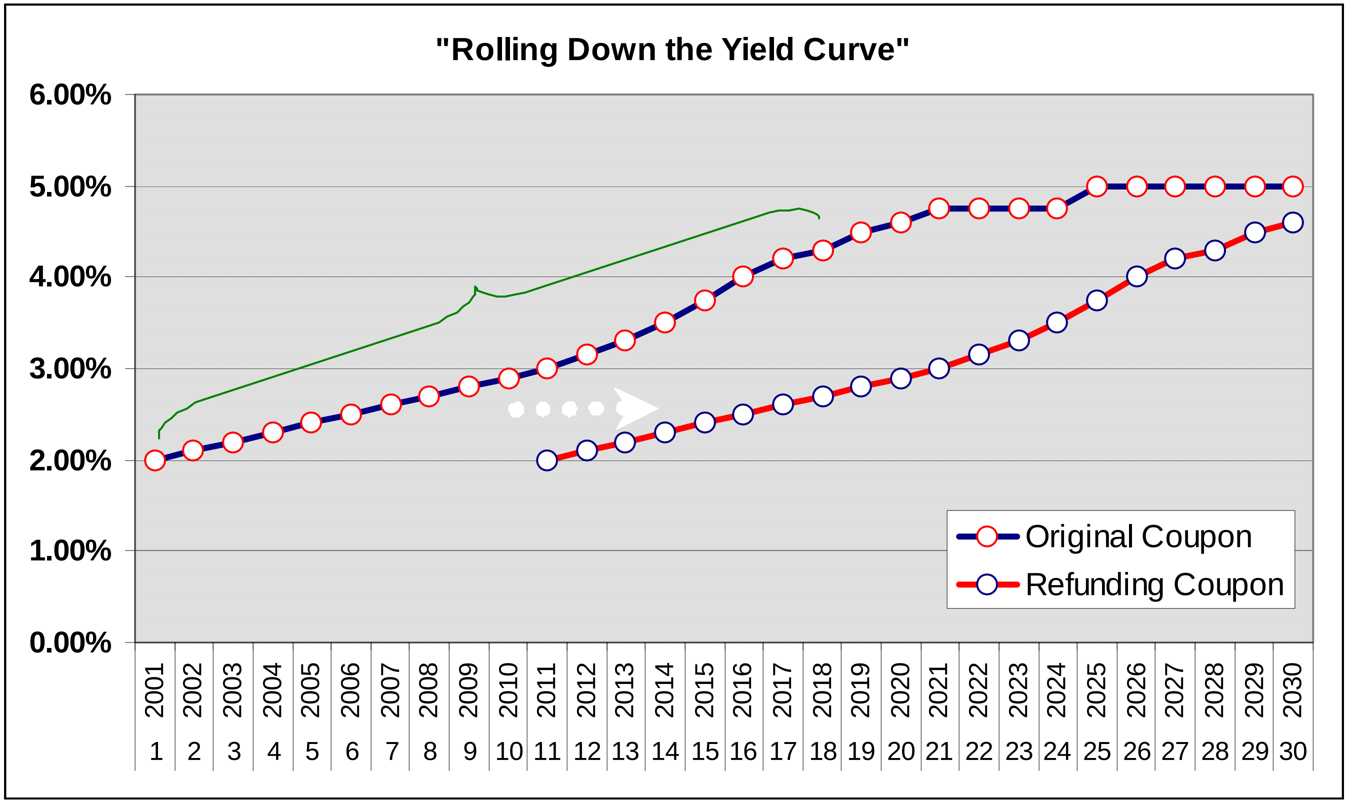
- » Call date is usually 8-10 years
- » Call notice: typically 30 to 60 days prior to call date
- » There may be a schedule of call prices/dates

December 1, 2016 to November 30, 2017	102
December 1, 2017 to November 30, 2018	101
December 1, 2018 and thereafter	100

Refunding Candidates

- You only save interest on callable bonds
- In the current market, the closer to the call date, the more efficient the refunding and greater the savings
- Best candidates in current market:
  - 2001-2003 issues, typically with call dates in 2011, 2012 and 2013
  - Issues with longer period between call date and final maturity
- Some bond refundings offering “good” savings include significant negative arbitrage, so issuers may consider waiting, despite the attractive savings level

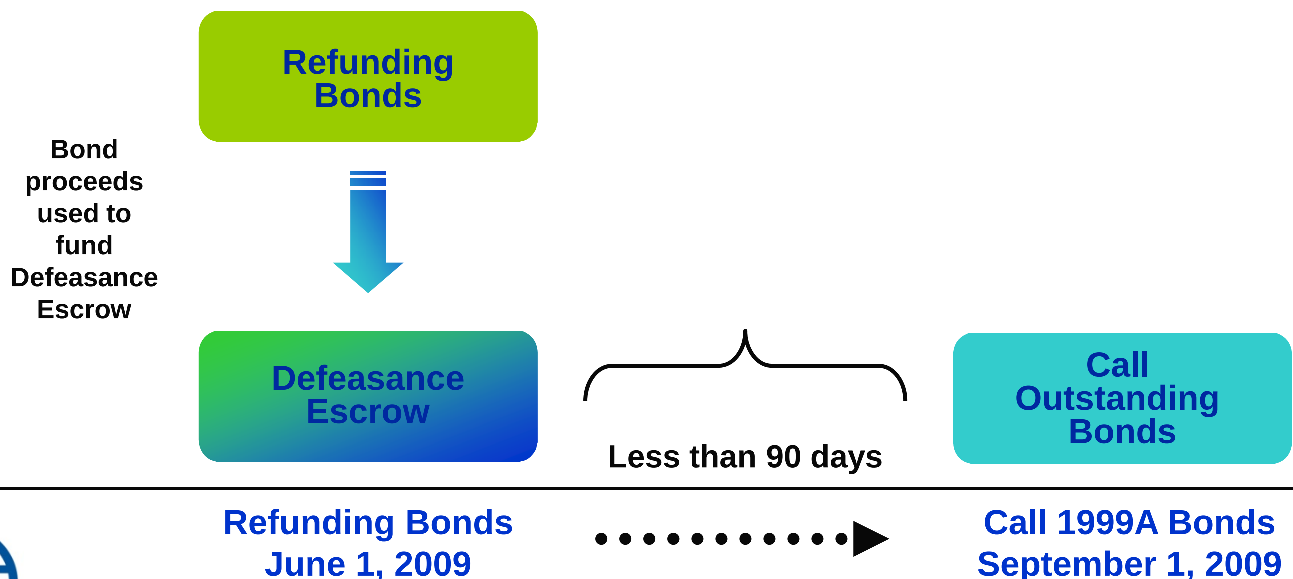
Rolling Down the Yield Curve



Current Refunding Bonds

Refunding bonds sold <u>within 90 days</u> of the first call date of refunded bonds

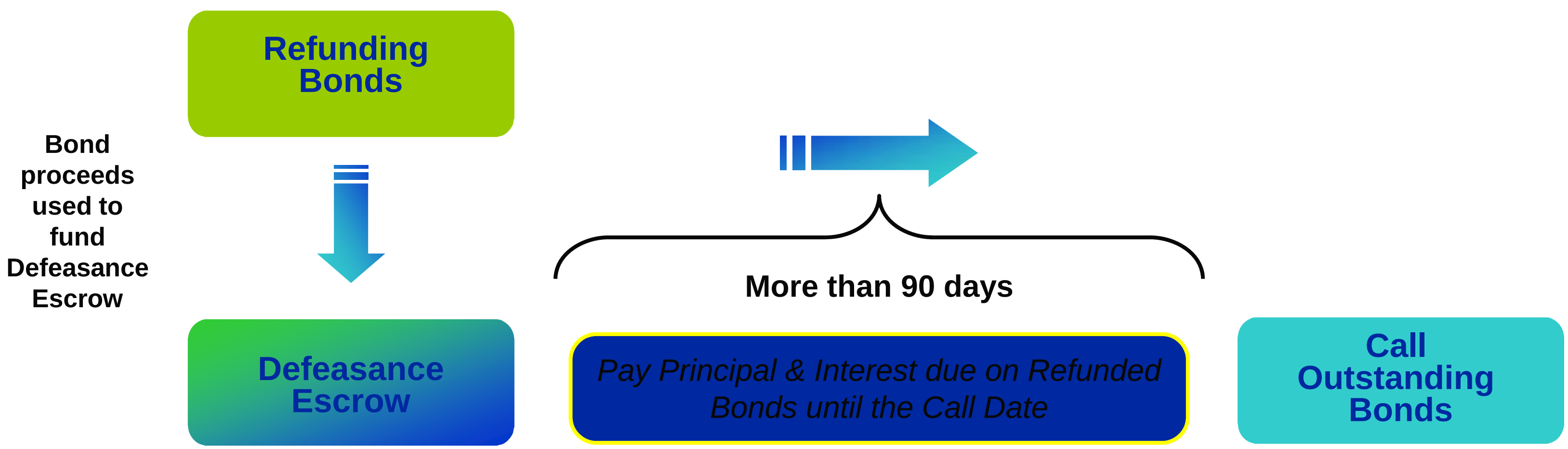
- Proceeds may be invested in escrow without yield restriction
- No IRS Regulations limiting to the number of current refundings



Advance Refunding Bonds

Refunding bonds sold <u>more than 90 days</u> to the first call date of the refunded bonds

- Escrow yield restricted to arbitrage yield of refunding bonds
- IRS Regulations limits issuers to ***one*** advance refunding per issue



Refunding Bonds
June 1, 2009

Call 2001A Bonds
August 1, 2011

Economics of Refunding

- Reduction in interest rates on prior "refunded" bonds versus new "refunding" bonds
- Remaining term and amount of refunded bonds
- Length of the escrow (i.e. years between refunding and call date)
- Efficiency of the escrow
  - Ability to earn the escrow yield limit
  - Investment dates vs. refunded bond payment dates

Additional Considerations

» Negative arbitrage (earnings) in escrow
  – Consider financial risk and trade-off of waiting
  – Each month you wait, escrow loss decreases
  – Calculate "break-even rate" to evaluate interest rate risk

» Extension of call date
  – Potential benefit of retaining ability to call bonds
  – Potential for change in use of facility (i.e., private lease or sale)

» Impact of Debt Service Reserve Fund for revenue bonds
  – If you have high yielding investments, will you lose the ability to retain all earnings?
  – If you have a reserve surety, will you need to fund-up reserve with cash or bonds – in this case, you need to consider the "negative earnings"

Financial and Policy Objectives

Issuer Objectives

- Achieve savings through debt service reduction
- Restructuring or deferral of debt service
- Consolidation of debt
- Removal or amendment of Bond Covenants

Or Combination of Above Objectives

Debt Policy Considerations

- A Debt Policy is highly recommended for all municipalities
- A Debt Policy should address refunding savings thresholds
- Policy may differentiate between Current and Advance refundings
  - Expected results will be impacted by length of time between call date and final maturity
  - As callable bonds mature, savings opportunities are foregone

Savings Thresholds or Targets

- Net present value savings as % of par value of bonds

  NPV Savings = annual savings present-valued to the issue date, net of related costs of issuance

  Threshold can be % of *refunding* par or *refunded* par – or both

- Are thresholds minimums, or triggers?
- Absolute savings

  Is there a dollar level at which staff time/effort is not worth savings?

- Amount of savings compared to COI (costs of issuance)

Financial Savings and Evaluation

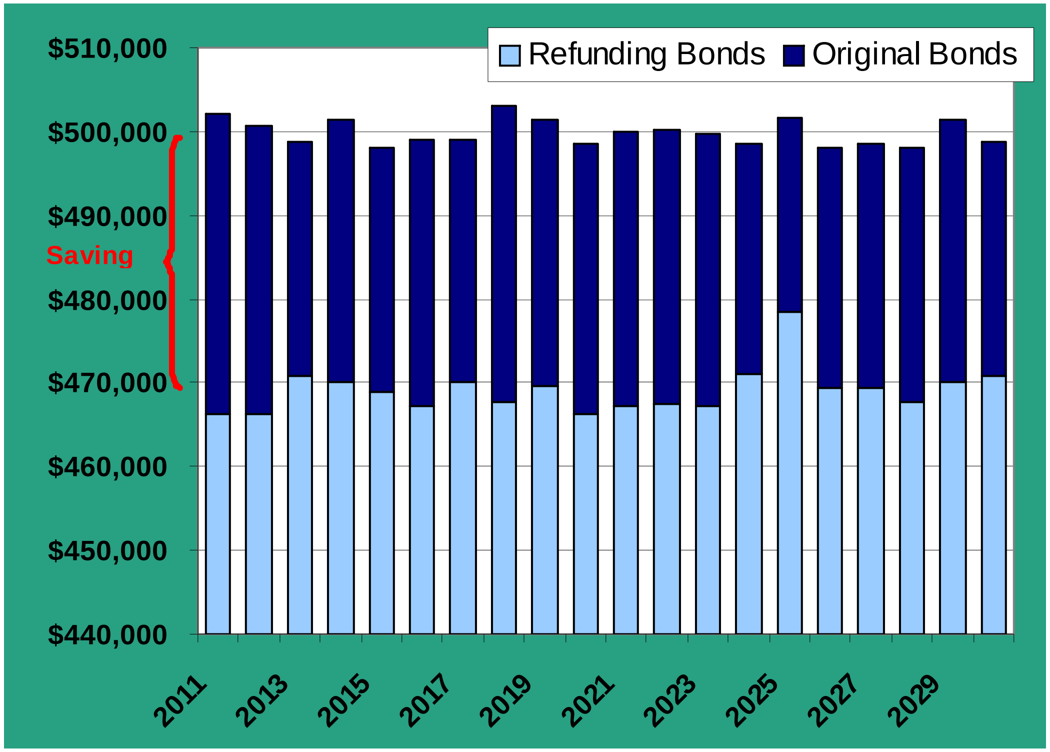
How to Evaluate a Refunding

Key Factors in Evaluating a Refunding

- NPV Savings - $$ and as % of par
- Current vs. historical interest rate levels
- Shape of yield curve
- Term to maturity (years remaining after the call date)
- Absolute level of savings: minimum $ threshold (e.g. $1 million)
- Consider "opportunities lost" as currently callable bonds are retired

Measuring Savings

	Year	Original Bonds	Refunding Bonds	Cash Flow Savings
1	**2010**	**502,095**	**466,203**	35,893
2	**2011**	**500,645**	**466,203**	34,443
3	**2012**	**498,715**	**470,848**	27,868
4	**2013**	**501,290**	**470,018**	31,273
5	**2014**	**498,065**	**468,808**	29,258
6	**2015**	**499,065**	**467,208**	31,858
7	**2016**	**499,065**	**470,208**	28,858
8	**2017**	**503,145**	**467,668**	35,478
9	**2018**	**501,320**	**469,703**	31,618
10	**2019**	**498,495**	**466,163**	32,333
11	**2020**	**499,925**	**467,173**	32,753
12	**2021**	**500,200**	**467,573**	32,628
13	**2022**	**499,763**	**467,178**	32,585
14	**2023**	**498,613**	**470,958**	27,655
15	**2024**	**501,750**	**478,533**	23,218
16	**2025**	**498,000**	**469,470**	28,530
17	**2026**	**498,500**	**469,270**	29,230
18	**2027**	**498,000**	**467,680**	30,320
19	**2028**	**501,500**	**470,050**	31,450
20	**2029**	**498,750**	**470,700**	28,050
		$ 9,996,900	**$ 9,381,608**	**$ 615,293**
			NPV Savings	**$ 440,023**
	Savings as % Refunded Bonds			**7.15%**
	Savings as % Refunding Bonds			**6.69%**



- ~$30,000 Annual Cash Flow Savings
- $440,293 NPV Savings
- 7.1% of Refunded Bonds
- 6.7% of Refunding Bonds

Debt Service Reserve Fund Impacts

Gross-to-Gross Refunding

- Comparison solely of gross debt service
- Does not take into account reinvestment of bond proceeds (DSRF)

Net-to-Net Refunding

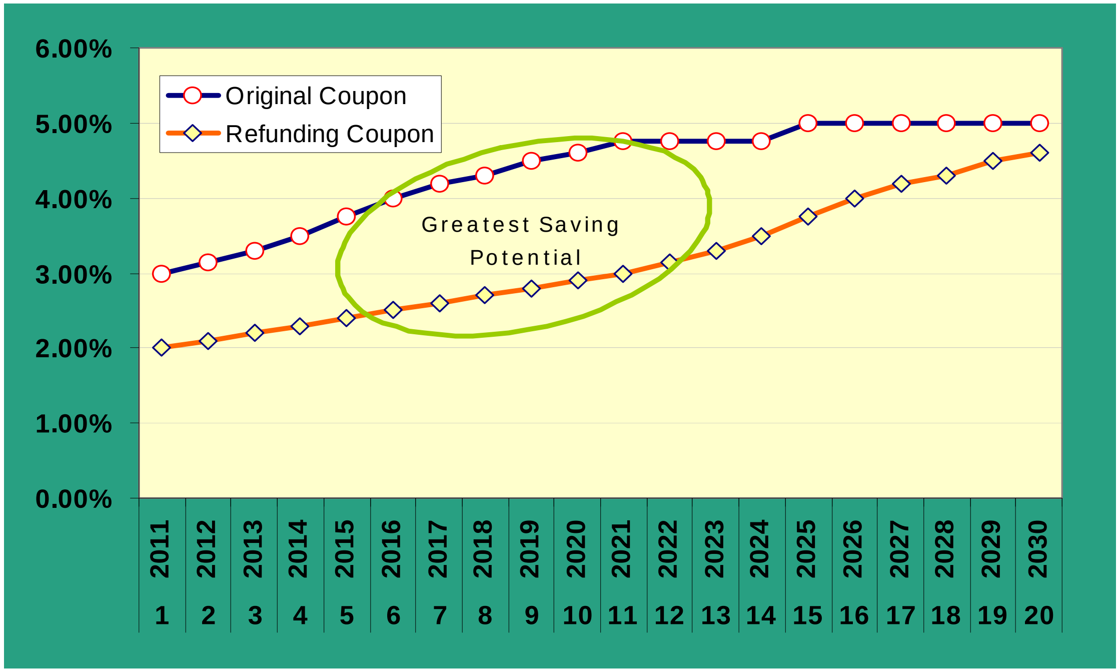
- Compares Net Debt Service
- Takes into account reinvestment of bond proceeds (DSRF)

Net-to-Net Refunding

		Original Bonds	DSR Earnings	Net Debt Service	Refunding Bonds	DSR Earnings	Net Debt Service	Gross Savings	NPV Savings	DSR Earnings	Net NPV Savings
1	**2011**	502,095	25,157	**476,938**	466,203	17,421	**448,781**	35,893	35,243	(7,464)	**27,779**
2	**2012**	500,645	25,157	**475,488**	466,203	17,421	**448,781**	34,443	32,633	(7,202)	**25,431**
3	**2013**	498,715	25,157	**473,558**	470,848	17,421	**453,426**	27,868	25,563	(6,949)	**18,614**
4	**2014**	501,290	25,157	**476,133**	470,018	17,421	**452,596**	31,273	27,592	(6,705)	**20,887**
5	**2015**	498,065	25,157	**472,908**	468,808	17,421	**451,386**	29,258	24,917	(6,470)	**18,447**
6	**2016**	499,065	25,157	**473,908**	467,208	17,421	**449,786**	31,858	26,110	(6,242)	**19,868**
7	**2017**	499,065	25,157	**473,908**	470,208	17,421	**452,786**	28,858	22,833	(6,023)	**16,810**
8	**2018**	503,145	25,157	**477,988**	467,668	17,421	**450,246**	35,478	26,961	(5,811)	**21,150**
9	**2019**	501,320	25,157	**476,163**	469,703	17,421	**452,281**	31,618	23,191	(5,607)	**17,584**
10	**2020**	498,495	25,157	**473,338**	466,163	17,421	**448,741**	32,333	22,840	(5,410)	**17,430**
11	**2021**	499,925	25,157	**474,768**	467,173	17,421	**449,751**		22,285	(5,220)	**17,065**
12	**2022**	500,200	25,157	**475,043**	467,573	17,421	**450,151**	32,628	21,384	(5,037)	**16,347**
13	**2023**	499,763	25,157	**474,605**	467,178	17,421	**449,756**	32,585	20,571	(4,860)	**15,711**
14	**2024**	498,613	25,157	**473,455**	470,958	17,421	**453,536**	27,655	16,840	(4,689)	**12,151**
15	**2025**	501,750	25,157	**476,593**	478,533	17,421	**461,111**	23,218	13,637	(4,525)	**9,113**
16	**2026**	498,000	25,157	**472,843**	469,470	17,421	**452,049**	28,530	16,113	(4,366)	**11,747**
17	**2027**	498,500	25,157	**473,343**	469,270	17,421	**451,849**	29,230	15,900	(4,212)	**11,687**
18	**2028**	498,000	25,157	**472,843**	467,680	17,421	**450,259**	30,320	15,887	(4,064)	**11,823**
19	**2029**	501,500	25,157	**476,343**	470,050	17,421	**452,629**	31,450	15,876	(3,922)	**11,954**
20	**2030**	498,750	528,302	**(29,552)**	470,700	495,954	**(25,254)**	28,050	13,646	(15,822)	**(2,176)**
		$9,996,900	**$1,006,290**	**$ 8,990,610**	**$9,381,608**	**$ 826,955**	**$ 8,554,652**	**$582,540**	**$ 440,023**	**$(120,602)**	**$ 319,421**
	DSR	**$ 503,145**	**5.00%**		**$ 478,533**	**3.64%**					
							Savings as % of Refunding Par		6.69%		4.85%
							Savings as % of Refunded Par		7.15%		5.19%

- Net-to-Net Refunding reflects true savings
- May reduce savings level (e.g. **7.1%** vs. **5.2%**)

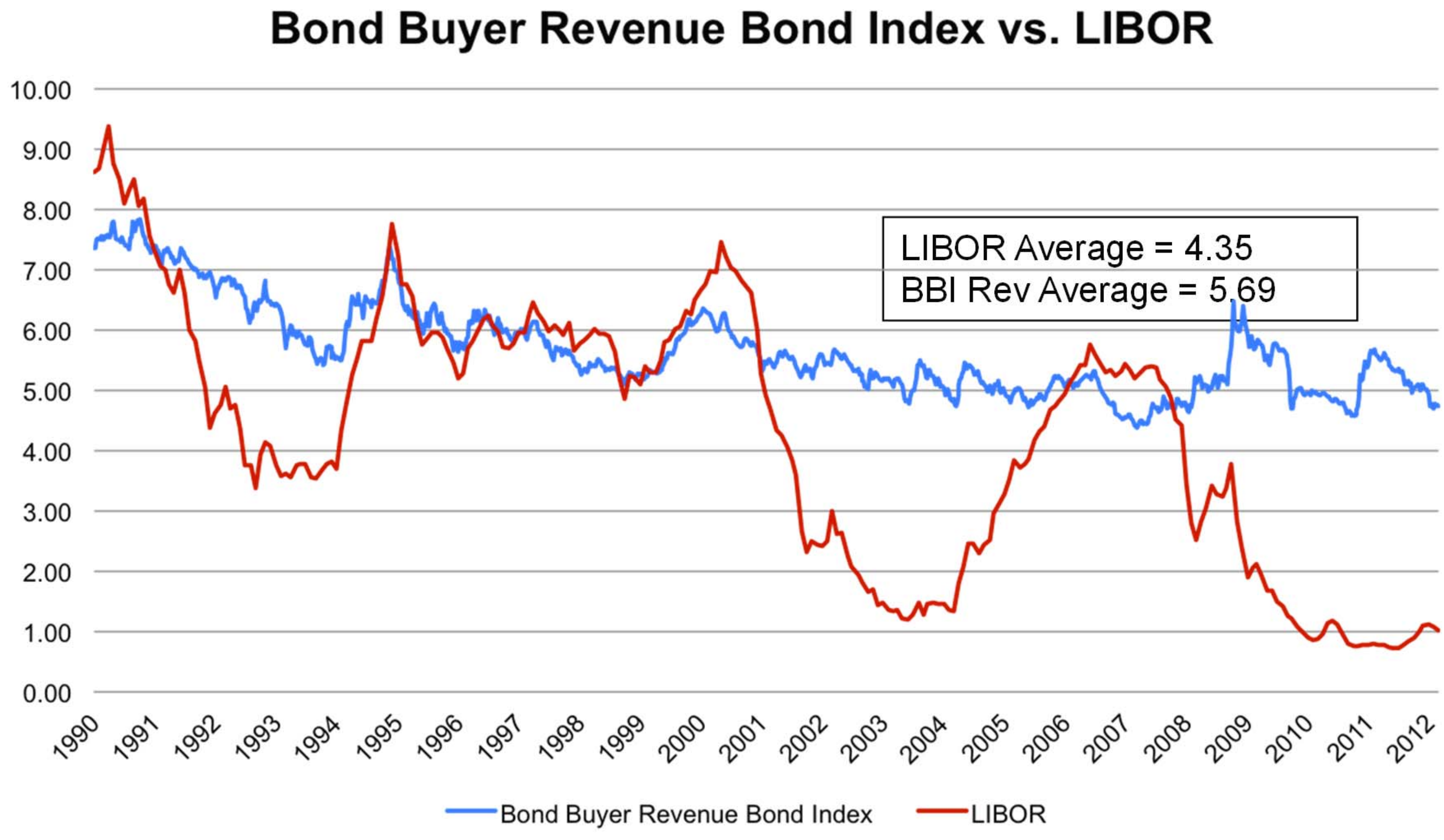
Shape of the Yield Curve



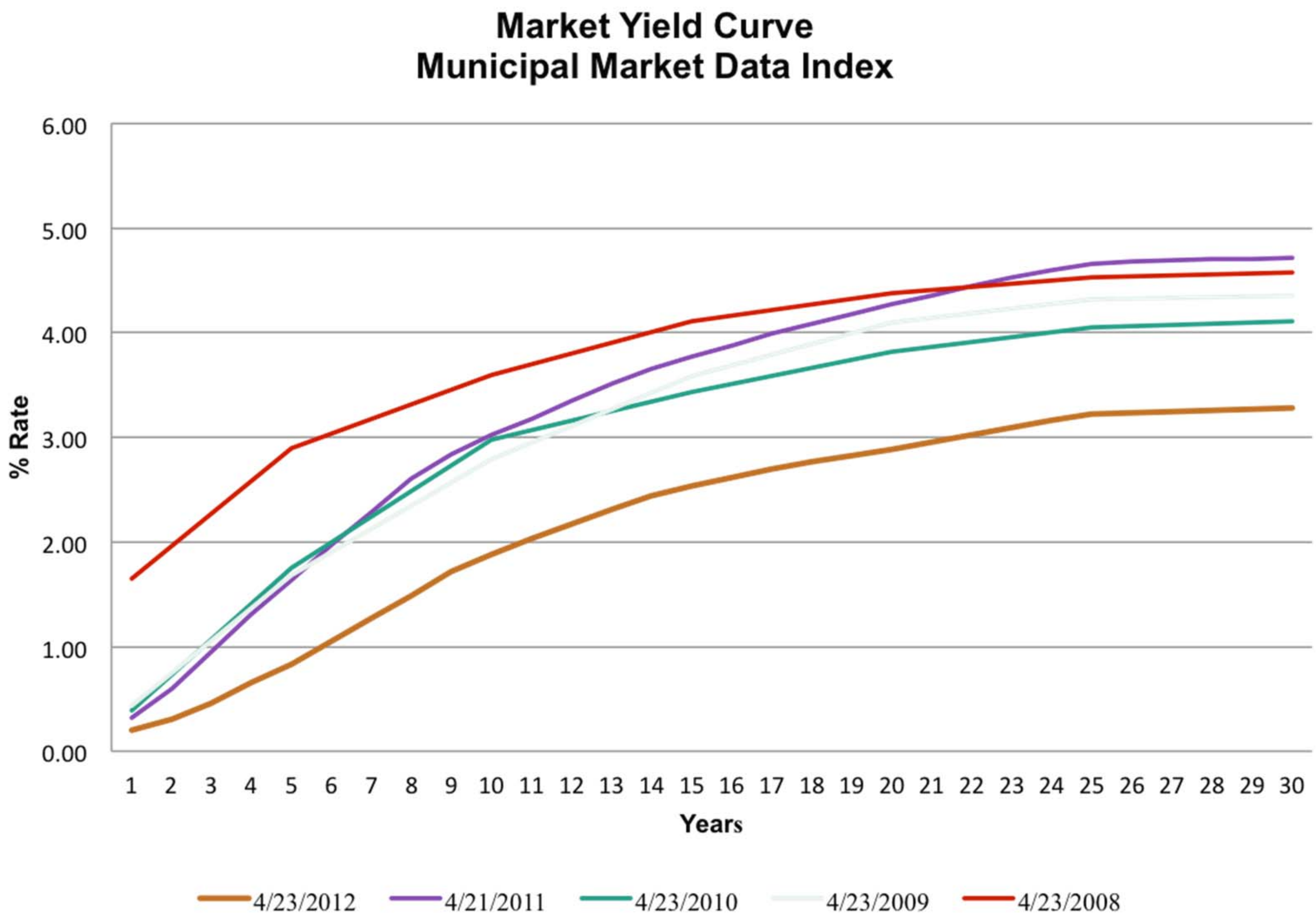
Shape of the Yield Curve + Time to Final Maturity

- » 3.0% to 10.0% in par value required to issue refunding bonds
- » % spread of 100 bps more significant later years:
  - –3 year = 300 bps / 9 years = 900 bps

Historical Rate Comparison



Historical Rate Comparison



Refunding Bond Structure

Escrow Sizing/Efficiency

Defeasance

Legal Defeasance

- Escrow securities backed by full faith & credit of U.S. government (e.g., U.S. Treasuries / SLGS)
- Requires bond counsel opinion
- Debt removed from books

Economic Defeasance

- Escrow securities <u>not</u> backed by full faith & credit of U.S. government (e.g., Corporates & Agencies)
- Higher yield / Greater savings
- Debt remains on the books
- Or, otherwise not meet conditions (i.e. verification)

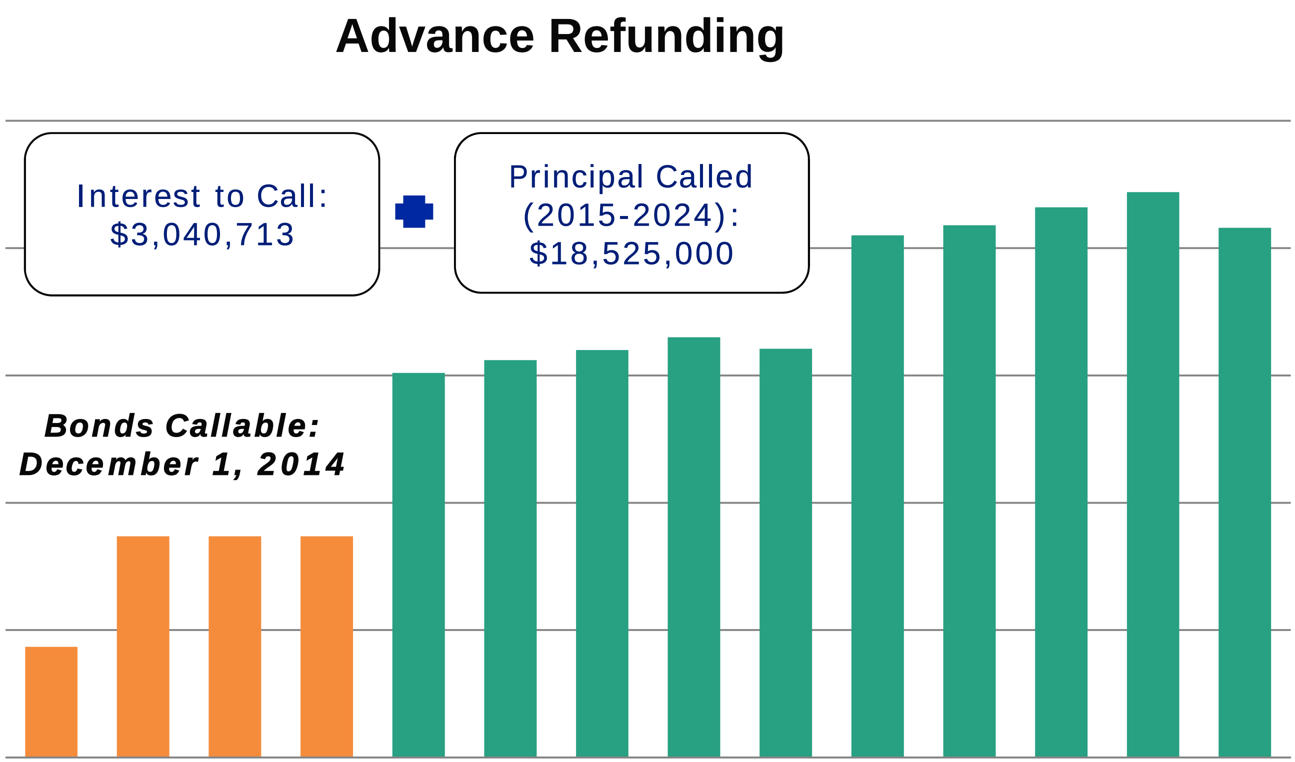
Defeasance Escrow

Refunding Escrow is used to Defease Refunded Bonds until they can be called

- Portfolio of "eligible securities", as defined in the Indenture (U.S. Treasuries / SLGS)
- Escrow cash flows must be sufficient to pay:
  - Principal
  - Interest
  - Call Premium

  to the call date, without reinvestment
- If escrow earnings rate is lower than the interest rate being defeased, you need to deposit more proceeds in the escrow (i.e. higher escrow cost)

Escrow Requirements



Escrow Requirements

Debt Service of Callable Bonds				
Date	Principal	Coupon	Interest	Debt Service
12/1/2011	-	-	434,388	434,388
6/1/2012	-	-	434,388	434,388
12/1/2012	-	-	434,388	434,388
6/1/2013	-	-	434,388	434,388
12/1/2013	-	-	434,388	434,388
6/1/2014	-	-	434,388	434,388
12/1/2014	-	-	434,388	434,388
6/1/2015	-	-	434,388	434,388
12/1/2015	1,510,000	4.00%	434,388	1,944,388
6/1/2016	-	-	404,188	404,188
12/1/2016	1,560,000	4.00%	404,188	1,964,188
6/1/2017	-	-	372,988	372,988
12/1/2017	1,600,000	4.10%	372,988	1,972,988
6/1/2018	-	-	340,188	340,188
12/1/2018	1,650,000	4.25%	340,188	1,990,188
6/1/2019	-	-	305,125	305,125
12/1/2019	1,605,000	5.00%	305,125	1,910,125
6/1/2020	-	-	265,000	265,000
12/1/2020	2,050,000	5.00%	265,000	2,315,000
6/1/2021	-	-	213,750	213,750
12/1/2021	2,090,000	5.00%	213,750	2,303,750
6/1/2022	-	-	161,500	161,500
12/1/2022	2,160,000	5.00%	161,500	2,321,500
6/1/2023	-	-	107,500	107,500
12/1/2023	2,220,000	5.00%	107,500	2,327,500
6/1/2024	-	-	52,000	52,000
12/1/2024	2,080,000	5.00%	52,000	2,132,000
Total	$ 18,525,000		$ 8,353,963	$ 26,878,963

Date	Refunded Bonds	Interest to Call	Escrow Requirement
12/1/2011	-	$ 434,388	$ 434,388
6/1/2012	-	434,388	434,388
12/1/2012	-	434,388	434,388
6/1/2013	-	434,388	434,388
12/1/2013	-	434,388	434,388
6/1/2014	-	434,388	434,388
12/1/2014	18,525,000	434,388	18,959,388
	$ 18,525,000	$ 3,040,713	$ 21,565,713

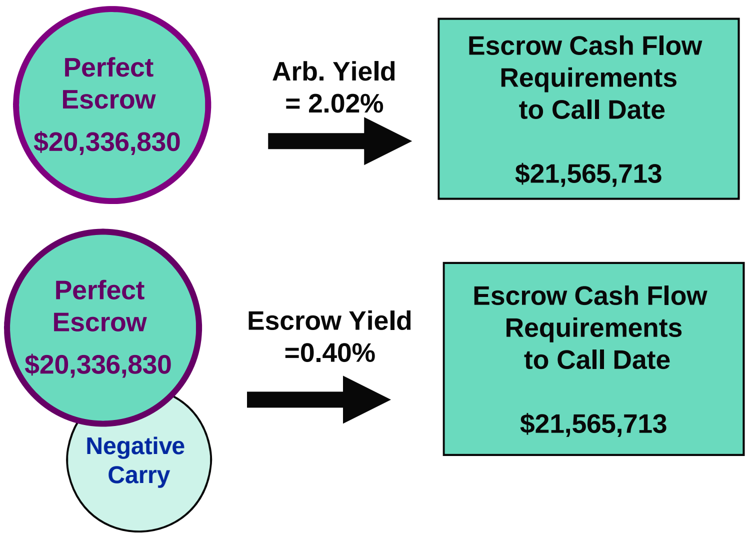
$ 3,040,713	**Interest to Call December 1, 2011**
$ 18,525,000	**Bonds to Call December 1, 2011**
$ 21,565,713	**TOTAL ESCROW REQUIREMENT**

Escrow Structuring

DATE	Escrow Requirement	U.S. Treasuries	0.030% 12/1/2011	0.020% 6/1/2012	0.090% 12/1/2012	0.160% 6/1/2013	0.220% 12/1/2013	0.300% 6/1/2014	0.410% 12/1/2014	TOTAL SLG Earnings
10/13/2011		$ 0								
12/1/2011	$ 434,388	423,579	17	-	47	84	116	159	10,386	10,809
6/1/2012	434,388	394,031	-	50	177	315	434	593	38,787	40,356
12/1/2012	434,388	394,081	-	-	177	315	434	593	38,787	40,307
6/1/2013	434,388	394,259	-	-	-	315	434	593	38,787	40,129
12/1/2013	434,388	394,573	-	-	-	-	434	593	38,787	39,814
6/1/2014	434,388	395,008	-	-	-	-	-	593	38,787	39,380
12/1/2014	18,959,388	18,920,600	-	-	-	-	-	-	38,787	38,787
Total	$ 21,565,713	$21,316,131	$ 17	$ 50	$ 402	$ 1,031	$ 1,852	$ 3,121	$ 243,109	$ 249,582

- Escrow cash flow requirement = $21,565,713
- IRS Regulations allow escrow to be invested at the arbitrage yield on the refunding bonds (e.g., 2.02%)
- Perfect escrow (e.g., 2.02%) would cost = $20,336,830
- Market escrow cost @ 0.40% yield = $21,316,131
- Negative arbitrage is $979,301 – these are foregone savings

Negative Carry



$	21,565,713	Escrow Requirement
$	20,336,830	Perfect Escrow Cost
$	1,228,883	Investment Earnings

$	21,565,713	Escrow Requirement
$	21,316,131	Escrow Cost
$	249,582	Investment Earnings
$	(979,301)	Negative Carry

- Proceeds invested @ bond rate pays for itself
- Proceeds invested lower than bond yield (0.40%) creates inefficient escrow due to yield loss (negative arbitrage) of $979,301
- Inefficient Escrow results in increase in par value of refunding bonds by 1.62%

Bond Sizing Requirements

Bonds Outstanding $6.15 Million

Principal & Interest $1.6 Million

+

Additional Par
3.0% to 8.0%

Assumes DSR transfers from prior bonds

1. **Cost of Issuance:** .50% to 1.0%
2. **Underwriter's Discount:** .50% to 1.0%
3. **Redemption Premium:** 1.0% to 3.0%
4. **Negative Carry *:** 1.0% to 3.0%

* Advance Refunding

Advance Refunding Bonds: $8,000,000

Optimizing Savings

- Obtaining highest yielding securities
- Obtaining most efficient timing of escrow investments
- Take into account negative arbitrage
- Consider impacts of DSR funding
- Comparison should be net-to-net basis, taking into account DSRF investment earnings
- Consider break-even rate if you wait, and other options
- Look at the broader picture of interest rates and yield curves

DEBT ADMINISTRATION AND MANAGEMENT

Julia Cooper

Debt Administration and Management Activities

- Preclosing Activities – It Starts Here!
- Post Issuance Compliance – Best Practices
  - Record Retention
  - Investment and Reinvestment Activities
  - Rebate Monitoring
- IRS Compliance
  - IRS is now asking issues if they have WRITTEN post issuance compliance policies and procedures in place.
  - GFOA along with NABL working on new post issuance compliance guidance.
  - Issuers may want to discuss this with counsel, as it is being emphasized in IRS audits.

Managing Compliance from the Start

- Understanding Business Terms
- Understanding Regulatory Obligations
- Preparing for Investment and Re-investment of bond funds

Understanding the Business Terms – Tax Certificate and Form 8038

- ***Don't view as closing certificate***
- Review early in process, ensure consistency
- Lack of project specificity can be a **red flag** during an IRS audit
- Understand the document; ask questions
- What is your bond year and why do you care?
- Do you have annual rebate calculation requirements?
- What representations are being made regarding:
  - Project
  - Use of funds
  - Spend-down of proceeds
  - Yield Restriction

Trustee Oversight and Management

- Use technology to your advantage – Get online access from day of closing
- Online reporting reduces paper
  - Ease of creating electronic records
  - Easier to get documents to rebate consultant
- Methodology for monitoring activity
  - Transfer of funds
  - Interest earnings appropriate credits

Budget & Accounting –
Impact on Tax Compliance

- Annual budget actions necessary to appropriate debt service and related payments
- Budget documents must provide documentation of annual budget and appropriation of debt service
- How are reserve fund earnings treated?
- How are you going to annually "clean out" your debt service payment funds

Post-Issuance Compliance Checklist Highlights

- Tax Law Requirements
  - General Matters
  - Use of Proceeds
  - Private Activity Bonds
  - Arbitrage
  - Pool Bonds
  - Record Retention
- Disclosure Requirements
- Miscellaneous Requirements

Copy of checklist can be found on GFOA website at:

http://www.gfoa.org/downloads/PostIssuanceCompliance.pdf

Disbursement of Bond Proceeds

- Establish Procedures for Disbursement of Bond Proceeds and Train Staff
  - Project staff
  - Finance staff
- Understand eligible expenditures
  - Working capital limits
  - Private Activity limits/restrictions
  - Use of proceeds
  - Develop procedures for allocation expenditures of bond proceeds to Projects

Record Retention

- Establish Record Retention Requirements and Procedures
- IRS record retention requirements
  - Term of bonds + 6 years
  - Types of records

- IRS Website
  - www.irs.gov/taxexemptbond/index.html

Arbitrage Rebate Compliance Activities

- Internal monitoring of rebate compliance
- Recommend annual calculations during construction period
  - Set aside annual rebate liability in Rebate Fund
  - Get it out of the Construction Fund
- Paying rebate is not bad, just need to monitor and pay as required
- Pay attention to requirements in Tax/Arbitrage Certificate **<u>BEFORE</u>** you sign

Bond Project Monitoring – Facility Use

- Maintain records of facility use
  - See Record Retention Requirements
- Review all agreements for facility use
  - Potential impact on tax-exemption
- Everything must be reviewed by bond and tax counsel
  - Putting solar panels on roof top or placing cellular phone receiver on roof top could negatively impact tax-exemption
  - Operator Agreements for facilities can also impact tax-exemption

Preparing for IRS Audit

- Odds of any one bond issue being audited are relatively low
- Good recordkeeping is essential
  - Issuers/conduit borrowers should maintain complete and detailed records of investments and expenditures of bond proceeds
  - Thorough and complete records of the use of facilities financed with bond proceeds should be maintained, including management contracts/other use agreements
- Ensuring proper allocation of bond proceeds
- Federal tax regulations require allocations of proceeds of bonds to specific expenditures be made not later than 18 months after the date the expenditure is paid or the date the project is placed in service, but in any event, these allocations must be made within 60 days of the 5th anniversary of the date of issue of the bonds

What to Do When Faced with IRS Audit?

- First, don't panic
  - In case of a questionnaire -- IRS is only asking questions, it is not asserting that there is anything wrong with your bonds
  - In the case of the audit, the IRS may also be simply checking to see if the bonds are in compliance with tax rules
- Second, **don't ignore** the questionnaire or the audit notice

What to Do When Faced with IRS Audit?

- Timelines for Response -- Questionnaire or audit notice will have a time limit for a response
  - Questionnaires --
    - IRS indicated will liberally grant extensions of time to respond
    - Need to request extension before the IRS response deadline has passed
  - Audit –
    - IRS will usually grant an extension of time for a response
    - Request must be made in a timely manner

Tracking Compliance Activities – Securities Laws

- Annual Reporting
- Material Event Reporting
- "Just Because" Reporting
  - Market Participant inquiries
  - Event or occurrence drawing attention to organization
- Continuing Disclosure Filings
  - Make sure that your ongoing annual filings include ALL information that is included in your Continuing Disclosure Agreement (CDA).
    - Underwriters have to ensure that you are complying.
    - SEC being very aggressive – even with issuers – about maintaining appropriate and expected disclosure standards.
- All information sent to EMMA – www.emma.msrb.org

San Jose: Internal Procedures – Reports/Data Required

Continuing Disclosure Enclosures (FY 6/30/10 Annual Report)

Schedule 2

Last Revised: November 1, 2010

Issuer/ Issue	Received	Posted	Enclosure	Source	Notes/Comments
2009A	JS	JS	City of San José CAFR	Finance Dept website	
	JS	JS	The San José System, Historical Operations	Corsina Trevias, ESD	Received
	JS	JS	The San José System, Net System Revenue Coverage	Corsina Trevias, ESD	Received
City of San José Financing Authority					
1997B	JS	JS	City of San José CAFR	Finance Dept website	
	JS	JS	City of San José Adopted Operating Budget - Total City Source and Use of Funds	CMO Budget website	
	JS	JS	Sales Tax Rates Table	BOE website	
	JS	JS	Pooled Investment Fund, General Pool Investments Table	Maria Oberg, Investment	
	JS	JS	Bonded and Certificated General Fund Lease Obligations Table	Debt Management	
2001A	JS	JS	City of San José CAFR	Finance Dept website	
	JS	JS	City of San José Parking System Hourly and Monthly Rates and Charges by Facility	Frank Hernandez, DOT	Received
	JS	JS	City of San José Parking System Historical Parking Revenues	Frank Hernandez, DOT	Received
	JS	JS	City of San José Parking System Historical Breakdown of Garage Revenues	Frank Hernandez, DOT	Received
	JS	JS	City of San José Parking Fund Historical Revenues, Expenditures and Fund Balances	Frank Hernandez, DOT	Received
	JS	JS	Redevelopment Agency CAFR	Alex Guiang, RDA or RDA website	Received
	JS	JS	Merged Area Redevelopment Project Acreage and Estimated Tax Increment Revenues	Alex Guiang, RDA	Received
2001F	JS	JS	City of San José CAFR	Finance Dept website	
2002B	JS	JS	City of San José CAFR	Finance Dept website	
	JS	JS	City of San José Adopted Operating Budget (selected sections)[4]	CMO Budget website	
	JS	JS	Appropriation Ordinance Section No 32.02, page 1[5]	ordinance on 'zeus' (Z:)	
2003A	JS	JS	City of San José CAFR	Finance Dept website	

GOVERNMENT FINANCE OFFICERS ASSOCIATION

San Jose: Internal Procedures – Status Reporting

Continuing Disclosure Status Report (FY 6/30/10 Annual Report)

Schedule 1

Last Revised: November 1, 2010

Issuer / Issue	Financial Analyst	Due Date	Prepared by Analyst	Reviewed by FA	Reviewed by Debt Admin	Reviewed by Div. Mgr.	Signed	Posted
City of San José								
Community Facilities District No. 1 Special Tax Bonds, Series 1997	JPD	12/31/10	JS	JPD	CS	N/A	JHC	JS
Community Facilities District No. 6 Special Tax Bonds, Series 2001	JPD	12/31/10	JS	JPD	CS	N/A	JHC	JS
Community Facilities District No. 9 Special Tax Bonds, Series 2003	JPD	12/31/10	JS	JPD	CS	N/A	JHC	JS
Community Facilities District No. 10 Special Tax Bonds, Series 2003	JPD	12/31/10	JS	JPD	CS	N/A	JHC	JS
Improvement District No. 99-218SJ Limited Obligation Improvement Bonds, Series 24Q	JPD	12/31/10	JS	JPD	CS	N/A	JHC	JS
Reassessment District No. 02-219SJ Limited Obligation Refunding Bonds, Series 24R	JPD	01/01/11	JS	JPD	CS	N/A	JHC	JS
Airport Revenue Refunding Bonds, Series 1998A	TT	12/31/10	JS	TT	CS	N/A	JHC	JS
Airport Revenue Bonds, Series 2001A	TT	12/31/10	JS	TT	CS	N/A	JHC	JS
Airport Revenue Refunding Bonds, Series 2002AB	TT	12/31/10	JS	TT	CS	N/A	JHC	JS
Airport Revenue Bonds, Series 2004C (AMT)	TT	12/31/10	JS	TT	CS	N/A	JHC	JS
Airport Revenue Bonds, Series 2004D	TT	12/31/10	JS	TT	CS	N/A	JHC	JS
Airport Revenue Bonds, Series 2007A (AMT)	TT	12/31/10	JS	TT	CS	N/A	JHC	JS
Airport Revenue Bonds, Series 2007B	TT	12/31/10	JS	TT	CS	N/A	JHC	JS
General Obligation Bonds, Series 2001	DZ	03/31/11	JS	DZ	CS	N/A	JHC	JS
General Obligation Bonds, Series 2002	DZ	03/31/11	JS	DZ	CS	N/A	JHC	JS

Benefits of EMMA
(Electronic Municipal Market Access)

- No reliance on third parties to post/disseminate information on a timely basis
- Ability to uniformly "speak to the market"
- Ability to provide investors with alternative ways to obtain additional information about your entity
  - URL postings
- Easy verification of available information
- Ability for **<u>ALL</u>** investors to access the same information (for free)
- www.emma.msrb.org
  - Many tools and background information available to issuers

Best Practice Tips for Issuers

- Create an e-mail address for notification purposes – not an individual
  - debt.management@sanjoseca.gov
- Create electronic ticker system for entire debt management team – Track Everything!
- Monitor for compliance on regular basis (daily, weekly, monthly)
- Establish Policies and Procedures and review periodically
- Maintain Records

SEC Regulations: Municipal Advisors

- The Dodd-Frank Bill contained financial reforms that will be noticed in many ways and will impact your relationship with:
  - rating agencies
  - financial advisors
  - swap advisors
  - investment brokers
  - underwriters
- The most noticeable change will be the SEC's and MSRB's regulation of "Municipal Advisors"

Definition of Municipal Advisors

- SEC finalized definition which goes into effect July 1.
- **Appointed members of state and local governing boards and state and local government employees are NOT included in the definition.**
- Only those with a fiduciary duty to the issuer may provide them with advice unless an exemption is met (e.g., issuer has a municipal advisor, issuer has RFP out for underwriter services).
- If an issuer has a MA and wishes to receive advice from another party (e.g. underwriter) it must put in writing that it has a MA and will rely on them for advice related to the ultimate transaction.
- More info: http://gfoa.org/downloads/GFOAmarulebriefjan2014.pdf

Municipal Advisors

- MAs must now be registered with the SEC and MSRB
- MSRB developing further regulations
- Definition of Fiduciary Duty
  - Suitability standard – MA may not recommend a product that is not suitable for that specific entity.(pending MSRB reg)
- Separate rules for swap advisors and swap transactions.
  - Government wishing to engage in these transactions MUST hire a swap advisor that is independent from the swap dealer
- MAs will have to meet new professional requirements and standards
- Rules similar to Broker/Dealers (e.g., pay to play, etc), will be put into place

Role of Underwriters

- MSRB Rules related to Underwriters
  - Effective November 27, 2011, **underwriters** of municipal securities will also be required to provide certain written disclosures to issuers if they wish to be considered to be "acting as an underwriter"
  - Investment banker may provide input and assistance, but they cannot be a "municipal advisor" and an "underwriter" in the same transaction.
  - As underwriter, firms do not have a fiduciary responsibility to the issuer, but are a buyer of the bonds.
  - Disclaimers are beginning to reflect new language that analysis and input is for "marketing" purposes, in order to support engagement as underwriter, and is not to be considered advice.

These rules are not new, but are becoming more visible and familiar to issuers

Written Disclosure from Municipal Advisor

- Municipal advisory relationships are to be evidenced by a writing, to include:
  - the basis of compensation
  - disclosure of affiliations,
  - disclosures of conflicts, and
  - whether the municipal advisor is registered with the Commission and the Board (as is required by law)

  These practices are recommended by the GFOA and will likely be part of mandated MSRB rulemaking in the near future.

- The writing is to be amended or supplemented during the term of the municipal advisory engagement as necessary to reflect changes in the disclosures
- The only party with a fiduciary responsibility to the issuer is a Municipal Advisor, and not an underwriter

Questions?

Please use the Webinar Question Feature on the task bar.

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