

Auditor of State  
Local Government Officials' Conference

2017



SQUIRE  
PATTON BOGGS

# Fundamentals of Debt

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## Topics To Be Discussed

- Debt
- General Obligations
- Revenue (Special) Obligations
- Lease Purchase Financing
- Other Types of Financing Options
- Components of a Bond
- State Law Issues
- Federal Securities Law Issues
- Federal Tax Law Issues

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## Debt

### What Is Debt?



*Webster's Dictionary: "something owed ... obligation"*

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## Debt

- A duty or obligation to pay money, deliver goods or render service under an express or implied agreement
- Example: obligation to make annual payments, plus interest for the cost associated with the reconstruction of a City street
- Repayment terms evidenced by a Note

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## Debt

- How does a political subdivision in Ohio borrow money?
- Can I go to the local bank and get a loan?



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## Debt

### **The Ohio Constitution says:**

“No bonded indebtedness of the state, or any political subdivisions thereof, shall be incurred or renewed unless, in the legislation under which such indebtedness is incurred or renewed, provision is made for levying and collecting annually by taxation an amount sufficient to pay the interest on said bonds, and to provide a sinking fund for their final redemption at maturity.”

– Article XII - Section 11

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## Debt

- Rules for most issuers dictated by State law
  - Limits amount of debt that can be issued
  - Places fiscal responsibility on its officials
  - Protects taxpayers from unlimited debt burden
- Legislation to authorize borrowing required
- Legislation authorizes security, source of repayment and other terms

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## State Law – Purpose

Subdivisions may issue bonds to finance projects of all types. Many projects such as airports, roads, sewers, and schools are secured by payments from tax collections or project revenues.



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## Eligible Projects

- Water and sanitary sewer improvements
- Park land, greenspace, land for road construction
- Administration buildings, maintenance buildings
- Fire and police stations
- Community, recreation and convention centers
- Road and street improvements, extensions
- Fire equipment, fire trucks, road equipment, trucks
- Landscaping, furniture, office equipment
- Energy conservation, 911 systems

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## Types of Debt

- Notes and Bonds
  - General Obligation
  - Revenue
- Lease obligations
  - Capital lease obligations
  - Operating lease obligations
  - Lease purchase (appropriation) agreements
- Loans

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## What Are General Obligations?

- Ohio Revised Code Chapter 133
- Permanent Improvements
- Security and Sources of Payment
  - Ad Valorem Property Taxes
- Debt Limitations
  - Voted
  - Unvoted

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## Security & Sources of Payment

- General Obligations are secured by property taxes (and all other resources of issuer)
- Source of repayment may come from other sources such as
  - Municipal Income Tax
  - Special Assessments for the Project Financed
  - Other Nontax Revenues (Enterprise Funds)
- Limited obligations provide for a specific pledge
  - Taxes Limited to Particular Purpose
  - Pledged Utility Revenues
  - Special assessments for specific projects

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## Debt Limitations

- Direct Debt Limitations, based on Assessed Valuation
  - Exemptions include “self supporting” debt
  - Direct Debt Limitations for Different Subdivisions
- Indirect Debt Limitation (10-Mill Limitation)
  - Applies to Unvoted General Obligation debt
  - Constitution and Revised Code
  - Calculates debt over all Overlapping Subdivisions

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## Revenue (Special) Obligations

- Revenue obligations pledge a specific revenue
  - Utilities
  - Income Tax
  - Sales Tax
- Projects and Systems Have Identifiable Users
- Sold Without Voter Approval
- Debt Service Reserve Fund (DSRF)

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## Revenue (Special) Obligations

- Coverage Covenants
- Additional Bonds Test
- Debt Limitations
- Market limitations

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### Leases

- Capital Lease
  - Capital asset financing where Lessee owns asset at the end of the lease term
- Operating Lease
  - Lessee makes lease payments for term of lease
  - Fair market purchase option at end of lease; if not exercised, Lessee returns asset to Lessor
- Lease Appropriation Financing
  - Annually Renewable Lease
  - Subject to Annual Appropriation (less secure than GO/revenue pledge)
  - Not "Debt" for state law purpose - can help with debt limits
  - Used for essential assets of issuer

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### Other Types of Financings - Loans

- Ohio Public Works Commission (OPWC)
- Ohio Water Development Authority (OWDA)
- State Infrastructure Bank (SIB)
- Private Placement aka "Bank Loan"
- Loans can be secured in a number of ways
- Repayment terms negotiated between parties

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### Types of Securities

**Bond Anticipation Notes**

- Issued in anticipation of specified revenues or permanent financing.
- Usually mature within 13 months.
- Can be marketed quickly and inexpensively.
- Low interest rates.
- Deferment of permanent financing.

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## Types of Securities

Bonds

- Permanent financing
- Usually mature over longer period (20 years)
- Marketing that takes longer and more expensive
- Higher interest rates

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## Components of a Bond

- Principal/Par Amount
- Maturity Date
- Interest Rate
- Call provisions
  - Par Call
  - Premium Call
  - Make Whole Call

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## Interest Rates & Yield Curves

AAA GO MMD vs. AA GO MMD

As of 3/17/2017  
SOURCE: Thomson Reuters

Years	AAA GO	AA GO
1	0.8	0.82
2	0.96	1
3	1.12	1.18
4	1.29	1.37
5	1.5	1.6
6	1.7	1.83
7	1.91	2.06
8	2.07	2.25
9	2.19	2.39
10	2.29	2.5
11	2.38	2.61
12	2.46	2.7
13	2.54	2.79
14	2.62	2.87
15	2.7	2.95
16	2.77	3.02
17	2.83	3.08
18	2.88	3.13
19	2.92	3.17
20	2.95	3.2
21	2.98	3.21
22	2.97	3.22
23	2.96	3.23
24	2.99	3.24
25	3	3.25
26	3.01	3.26
27	3.02	3.27
28	3.03	3.28
29	3.04	3.29
30	3.05	3.3

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## Debt Service Schedule

- Details how much principal and interest will be paid each year and at maturity.
- At the time of issuance, the public funds manager or finance director can decide how many bonds to pay off each year.

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## What Is A Rating?

- Provide an analysis (and rating) of the issuer's credit quality.
- There are three primary rating agencies:
  - Standard & Poor's (S&P)
  - Moody's
  - Fitch



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## Credit Rating

	MOODY'S INVESTORS SERVICE	S&P Global	FitchRatings	Description
Investment Grade	Aaa	AAA	AAA	Highest Quality
	Aa1	AA+	AA+	High Quality
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Good Quality
	A2	A	A	
A3	A-	A-		
Below Average	Baa1	BBB+	BBB+	Below Average
	Baa2	BBB	BBB	
	Baa3	BBB-	BBB-	
Below Investment Grade	Ba1, Ba2, Ba3	BB+, BB, BB-	BB+, BB, BB-	Speculative
	B, Caa	B, CCC, CC	B, CCC, CC, C	Very Speculative
	Ca, C	D	DD, DD, D	Default

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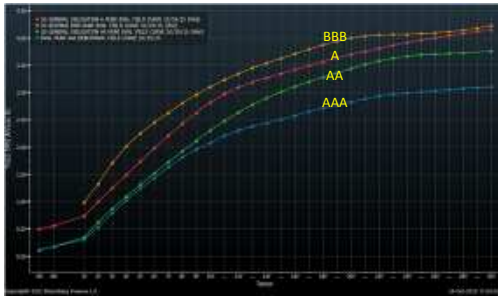
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## Ratings & Interest Rates



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## Credit Ratings

- Rating agencies review overall health of issuer
  - Economy
  - Finances
  - Management
  - Debt burden



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## Marketing the Bonds

- How does an issuer sell its bonds?
- Who assists me with this process?
- A **Preliminary Official Statement** (POS) is sent to prospective investors (via hardcopy and/or electronic distribution).
- Retail Investors
- Institutional Investors

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## Competitive Sale

- In a competitive sale, the issuer solicits bids from underwriting firms to purchase its bonds.
- Issuer determines the size and other essential characteristics of the issue prior to soliciting bids.
- A Notice of Sale containing bid parameters and terms of the issue is distributed to underwriters.
- Each bid takes into account both the interest rate paid to investors and the amount of compensation paid to the underwriting firm for selling the bonds.
- Bonds are awarded to the firm or syndicate offering the lowest interest rate (highest price) bid.
- Final terms and underwriter who will purchase the bonds are outlined in the Certificate of Award.

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## Negotiated Sale

- Underwriting firm is selected well in advance of the proposed sale date.
- Underwriter also proposes an amount of compensation known as underwriter's discount.
- The underwriting firm takes the lead in marketing the bonds to investors.
- Underwriter proposes interest rates at which various maturities will be offered to investors.
- Upon approval by the issuer, underwriter will approach investors to determine whether bonds can be sold at the proposed rates.
- Adjustments are made to the interest rate scale until final terms are reached reflecting the supply and demand of the bonds.
- Once terms for the sale have been reached a bond purchase agreement is signed by the issuer and underwriter (purchaser) agreeing to the terms.

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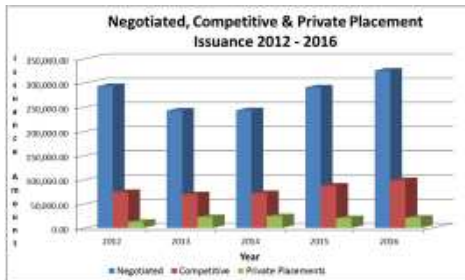
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## Negotiated vs. Competitive Sale



Source: Bound Buyer

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### New Money vs. Refunding

- New Money bonds issued in order to obtain the initial funding necessary for a particular project.
- Refunding involves issuing new bonds to retire existing bonds.
- Refundings are done to reduce interest expense (savings threshold), eliminate restrictive covenants or restructure existing debt

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### Legal Considerations: Bond Issuance

- Federal Tax Law – “Tax-Exempt”
  - Use of Tax-Exempt Financed Facility – Private Use
  - Payment of Debt Service – Private Payment
  - Bank Qualification – QTEO
  - Arbitrage /Rebate
- Federal Securities Law
  - No Omission or Misstatement of Material Facts
  - Primary and Secondary Disclosure



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### SEC Disclosure: Bond Issuance

- Some issuers send periodic credit updates to bondholders.
- Others send an annual report to bondholders.
- Continuing disclosure materials MUST be sent to rating agencies and MSRB’s EMMA system.

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## Working Group

- Issuer
  - Financial Advisor
  - Bond Counsel
  - Underwriter(s)
  - Underwriters' Counsel
  - Rating Agencies
  - Bond Insurer
  - Trustee, Registrar, Paying Agent
- Verification Agent
  - Escrow Agent
  - Bond Printer
  - Bondholders

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## Questions?



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