

## **Model Finance Transaction Policies for Public Entities: Debt Management Policy**

The State Funding Board is developing finance transaction policies to guide public entities in preparing their own policies. Adopting financial policies can help entities:

- make better financial decisions;
- provide clear objectives for staff;
- demonstrate strong financial management practices to credit rating agencies; and
- distinguish policy decisions from transaction decisions.

Adopting financial policies does not prevent unforeseen or negative events from occurring, nor does it prevent bad decisions. When public entities, including the State, all state agencies, local governments, and any other board, authority, district, or body created by any of these, are guided by sound financial policy in the financial decision-making process, the effects of negative events and bad decisions can be minimized.

All public entities incurring or issuing debt should have adopted a debt management policy by January 1, 2012. The minimum requirements for the policy are described below and required language is provided in Attachment A. The policy adopted by a public entity should address financing needs and the role debt will play in the overall financial management strategy. The policy need only address the particular types of debt that the entity plans to use. An entity may need only a simple policy, particularly if it borrows only through a federal or state agency loan program or from a community financial institution. A conduit entity, such as an industrial development board, lending only to private entities may need only a simple policy.

Before adopting a policy, the members of the public entity should have a basic understanding of public finance. This will allow the members to participate more fully in policy discussions and to gain more value from outside professional assistance. The entity bears sole responsibility for the development, adoption, and implementation of the policy, even when using professional assistance.

### **The scope of the debt management policy**

The following four principles should be included in a debt management policy, whether simple or detailed, to guide every debt transaction:

- understand the transaction;
- explain to citizens what is being considered;
- avoid conflicts of interest; and
- disclose costs and risks.

The policy should address the following items in reasonable detail and should include methods by which the public and all stakeholders are informed about them:

- any decision to finance debt, how debt instruments will be structured and sold, and all proposed and actual costs involved in issuing debt;
- any extra costs related to issuing debt—for example, the costs of work performed by professionals;
- the selection process for professionals who provide services related to debt;
- any conflicts of interest;
- all ongoing debt and related costs;
- all initial and ongoing federal compliance issues; and
- the plan for regularly reviewing and amending the policy.

### **Minimum requirements of the policy**

The debt policy must include provisions that cover transparency, professionals, and conflicts of interest written substantially to conform with the language in Attachment A.

For all public entities other than conduit entities lending to non-public entities, the policy must require clear disclosure of the terms and life of each debt issue, including principal and interest payments. This disclosure must include a debt service schedule outlining the rate of retirement for the principal amount. If the policy permits deferral of payment on principal or backloading, the policy must require specific justification for each deferral—it may not, however, permit blanket approval. In no event may payment of either principal or interest exceed the useful life of any asset financed.

It is recommended that the policy address the maximum total level of debt that the public entity is willing to assume. This may be based on locally adopted economic indicators, such as per capita debt, a comparison of debt to property values, or debt service as a percentage of revenues or expenditures. The policy should either require or recommend that this limitation be evaluated before additional debt is assumed and be monitored and reported to the governing body periodically.

Variable rate debt can be a valuable borrowing tool. It can provide flexibility and reduce the overall cost of debt. Variable rate debt does expose the public entity to additional risk. It is recommended that the policy address the level and type of variable rate debt the entity is willing to assume at any time.

A list of resources and a glossary are provided to assist with developing debt management policies. (See Attachments B and C.)

## Attachment A: Minimum Language

### 1. Transparency

- The Entity shall comply with legal requirements for notice and for public meetings related to debt issuance. In the interest of transparency, all costs (including interest, issuance, continuing, and one-time) shall be disclosed to the citizens/members, governing body, and other stakeholders in a timely manner. *(The method for disclosure of costs and other information, including documentation of compliance with the policy, shall be developed and outlined in the policy.)*

### 2. Professionals

- The Entity shall require all professionals engaged in the process of issuing debt to clearly disclose all compensation and consideration received related to services provided in the debt issuance process by both the Entity and the lender or conduit issuer, if any. This includes “soft” costs or compensations in lieu of direct payments.
- Counsel<sup>i</sup>: The Entity shall enter into an engagement letter agreement with each lawyer or law firm representing the Entity in a debt transaction. *(No engagement letter is required for any lawyer who is an employee of the Entity or lawyer or law firm which is under a general appointment or contract to serve as counsel to the Entity. The Entity does not need an engagement letter with counsel not representing the Entity, such as underwriters’ counsel.)*
- Financial Advisor<sup>ii</sup>: If the Entity chooses to hire financial advisors, the Entity shall enter into a written agreement with each person or firm serving as financial advisor for debt management and transactions.  
Whether in a competitive or negotiated sale, the financial advisor shall not be permitted to bid on, privately place or underwrite an issue for which they are or have been providing advisory services for the issuance.
- Underwriter: If there is an underwriter, the Entity shall require the Underwriter to clearly identify itself in writing (*e.g.*, in a response to a request for proposals or in promotional materials provided to an issuer) as an underwriter and not as a financial advisor from the earliest stages of its relationship with the Entity with respect to that issue. The Underwriter must clarify its primary role as a purchaser of securities in an arm’s-length commercial transaction and that it has financial and other interests that differ from those of the Entity. The Underwriter in a publicly offered, negotiated sale shall be required to

provide pricing information both as to interest rates and to takedown per maturity to the governing body (*or its designated official*) in advance of the pricing of the debt.

### 3. Conflicts

- Professionals involved in a debt transaction hired or compensated by the Entity shall be required to disclose to the Entity existing client and business relationships between and among the professionals to a transaction (including but not limited to financial advisor, swap advisor, bond counsel, swap counsel, trustee, paying agent, underwriter, counterparty, and remarketing agent), as well as conduit issuers, sponsoring organizations and program administrators. This disclosure shall include that information reasonably sufficient to allow the Entity to appreciate the significance of the relationships.

Professionals who become involved in the debt transaction as a result of a bid submitted in a widely and publicly advertised competitive sale conducted using an industry standard, electronic bidding platform are not subject to this disclosure. No disclosure is required that would violate any rule or regulation of professional conduct.

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<sup>i</sup> The requirement for an engagement letter does not apply to any lawyer who is an employee of the Entity or any lawyer or law firm under a general appointment as counsel to the Entity and not serving as bond counsel for the transaction.

If bond counsel for a debt transaction does not represent the Entity in that transaction, the Entity will enter into a fee payment letter agreement with such lawyer or law firm specifying:

- a. the party represented in the debt transaction; and
- b. the Entity's obligation with respect to the payment of such lawyer or law firm's fees and expenses.

<sup>ii</sup> For new issues of debt which constitutes a "security" for which the Time of Formal Award (as defined in Rule G-34(a)(ii)(C)(1)(a)) occurs after November 27, 2011, the Municipal Securities Rulemaking Board has prohibited broker, dealer or municipal securities dealer serving as a financial advisor to an issuer for a particular issue from switching roles and underwriting the same issue. Policies must be adjusted to comply with amended Rule G-23 as it applies to securities, including exceptions to the prohibition.

## Attachment B: Resources

1. Comptroller of the Treasury
  - Guide For The Issuance Of Notes By The Counties, Consolidated Governments, And Municipalities Of Tennessee ([www.tn.gov/comptroller/lf/pdf/guide2003.pdf](http://www.tn.gov/comptroller/lf/pdf/guide2003.pdf))
2. Government Finance Officers Association (GFOA) ([www.gfoa.org](http://www.gfoa.org))

### Best Practices Governmental Debt Management

- [Analyzing an Advance Refunding](#) (1995)
- [Business Preparedness and Continuity Guidelines](#) (2005 and 2008)
- [Debt Management Policy](#) (1995 and 2003)
  - [Post Issuance Compliance Checklist](#)
- [Debt Service Payment Settlement Procedures](#) (2003 and 2007)
- [Investment of Bond Proceeds](#) (1996 and 2007)
- [Issuer's Role in Selection of Underwriter's Counsel](#) (1998 and 2009)
- [Issuing Taxable Debt by U.S. State and Local Governments](#) (1998)
- [Maintaining an Investor Relations Program](#) (1996, 2003 and 2010)
- [Payment of the Expense Component of Underwriters' Discount](#) (1996 and 2010)
- [Pricing Bonds in a Negotiated Sale](#) (1996, 2000, and 2010)
- [Public-Private Partnerships for Economic Development](#) (2008)
- [Role of the Finance Officer in Privatization](#) (2009)
- [Selecting and Managing the Method of Sale of State and Local Government Bonds](#) (1994 and 2007)
- [Selecting Bond Counsel](#) (1998 and 2008)
- [Selecting Financial Advisors](#) (2008)
- [Selecting Underwriters for Negotiated Bond Sales](#) (2008)
- [Tax Increment Financing as a Fiscal Tool](#) (2006)
- [Understanding Your Continuing Disclosure Responsibilities](#) (2010)
- [Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy ADV](#) (1995, 2003, 2005 and 2010)
  - [Derivatives Checklist](#)
- [Using a Web Site for Disclosure](#) (2002 and 2010)
- [Web Site Presentation of Official Financial Documents](#) (2009)

### Best Practices Budgeting and Fiscal Policy

- [Adoption of Financial Policies](#) (2001)
- [Incorporating Capital Project Budget in the Budget Process](#) (2007)

### Advisories Governmental Debt Management

- [Auditor Association with Financial Statements Included in Offering Statements or Posted on Web Sites](#) (2005 and 2006)
- [Evaluating the Sale and Securitization of Property Tax Liens](#) (1997)
- [Evaluating the Use of Pension Obligation Bonds](#) (1997 and 2005)
- [Issuing Build America and other Direct Subsidy bonds](#) (2010)
- [Need for Considerable Caution in Regard to OPEB Bonds](#) (2007)

- [Understanding the Issuer's Role in Secondary Market Securitization of Tax-Exempt Obligations](#) (1993, 1996, and 2005)
- [Underwriter Disclaimers in Official Statements](#) (2000)
- [Using Variable Rate Debt Instruments ADV](#) (1997 and 2010)

[Publications: Capital Finance and Debt Administration](#) (11 titles)

- *Benchmarking and Measuring Debt Capacity*
- *Debt Issuance and Management: A Guide for Smaller Governments*
- *An Elected Official's Guide to Debt Issuance*
- *An Elected Official's Guide to Tax Increment Financing*
- *An Elected Official's Guide to Rating Agency Presentations*
- *A Guide for Preparing a Debt Policy*
- *A Guide for Selecting Financial Advisors and Underwriters: Writing RFPs and Evaluating Proposals*
- *Making Good Disclosure: The Role and Responsibilities of State and Local Officials Under the Federal Securities Laws*
- *Purchasing Credit Enhancement: How to Decide if Bond Insurance Makes Sense*
- *Structuring and Sizing the Bond Issue*
- *Tax Exempt Financing: A Primer*

[Publications: Financial Management and Budgeting](#) (26 titles)

- *Financing the Future: Long-Term Financial Planning for Local Governments*

3. International City/County Management Association (<http://icma.org/en/icma/home>)
  - Management Policies in Local Government Finance, 5<sup>th</sup> edition ([http://bookstore.icma.org/product1.cfm?product\\_ID=1190&DID=7](http://bookstore.icma.org/product1.cfm?product_ID=1190&DID=7))
4. Municipal Technical Advisory Service (<http://www.mtas.tennessee.edu/>)
5. County Technical Assistance Service (<http://www.ctas.utk.edu/>)
6. Rating Agencies:
  - a. Fitch Ratings ([www.fitchratings.com](http://www.fitchratings.com))
  - b. Moodys ([www.moodys.com](http://www.moodys.com))
  - c. Standard & Poors ([www.standardandpoors.com](http://www.standardandpoors.com))
7. Municipal Securities Rulemaking Board ([www.msrb.org](http://www.msrb.org))
  - Electronic Municipal Market Access ([www.emma.msrb.org](http://www.emma.msrb.org))
8. Securities Industry and Financial Markets Association ([www.sifma.org](http://www.sifma.org))
  - Investing in Bonds (<http://investinginbonds.com/>)
9. California Debt and Investment Advisory Commission ([www.treasurer.ca.gov/cdiac/](http://www.treasurer.ca.gov/cdiac/))

## Attachment C: Glossary

**Conflicts of Interest** occur in situations where parties in a transaction have multiple interests or relationships that could possibly corrupt the motivation to act. The presence of a conflict of interest indicates the potential for divided loyalty and does not automatically indicate wrong doing.

**Costs** means fees and expenses of professionals and service providers and other similar fees and expenses, whether or not payable at the time the debt is incurred. “Costs” also means recurring and nonrecurring fees and expenses during the life of the debt.

**Debt** means indebtedness lawfully issued, executed or assumed by a public entity. Debt is created when a public entity agrees to pay over time to someone else, in exchange for receiving an upfront payment or loan or for acquiring an asset. “Security” refers both to debt that can be transferred or delivered to another party, as well to property or assets pledged as collateral for a debt. Common instruments or evidence of debt are:

**Bonds** are debt instruments issued for a period of one year or longer, usually for permanent financing.

**Notes** are debt instruments issued for a short period of time, often for interim financing. Notes may be rolled to bonds. Examples are Capital Outlay Notes, Tax and Revenue Anticipation Notes, Bond Anticipation Notes, and Grant Anticipation Notes.

**Capital leases or a lease purchase are** written agreements allowing the use of property in exchange for payment of funds.

**Loans** are debt agreements usually with a financial institution such as a local bank or an organized loan program such as the Tennessee Municipal Bond Fund or the State Revolving Loan Program. Loans are also internal loans between funds within the entity or **seller financed loans**.

**Debt service** means a series of payments including **interest** (the amount or fee earned or paid for use of money or credit, calculated on the amount of principal) and **principal** (the amount of money borrowed or credit provided) required on a debt over time. The rate of interest can be **variable** or **fixed**.

**Schedule** means the plan listing the amount and when debt service will be paid.

**Backloading** refers to delaying repayment of principal until the end of the financing term. A standard or default structure for debt service is level debt service payments, similar to a standard home mortgage. Backloading should be considered only when

beneficial to the overall amortization of debt, upon the occurrence of natural disasters, or when project revenues are not available during the early years of a project.

**Maximum total level of debt** means the maximum principal amount of debt a public entity will have outstanding at any time, usually for each type of debt issued.

**Federal compliance issues** means the ongoing responsibilities of a public entity after issuing debt. If the debt is sold as being “federally tax-exempt,” then the entity will have to comply with federal tax law. If the debt is a “security” for federal securities laws, then the public entity is subject to anti-fraud provisions and possibly is subject to continuing disclosure obligations.

**Finance transaction** means both debt obligations and derivatives. A derivative is a financial product deriving value from a separate security. This term refers to many different products. “Derivative” includes an Interest Rate Agreement as defined in Tennessee Code Annotated Section 9-22-103 and other transactions as identified by the State Funding Board.

**Guidelines** means the document adopted by the Tennessee State Funding Board providing statutorily required guidance on Interest Rate and Forward Purchase Agreements. The current version became effective November 1, 2009. The Guidelines are available on the internet at <http://tn.gov/comptroller/lf/pdf/SFB%20Guidelines%2010-9%20Final.pdf>

**Professionals** means individuals or firms advising or offering to provide professional services to a public entity with respect to a finance transaction. Examples of professionals are:

**Advisor** means an individual or firm with a deep knowledge in a specific area, engaged in the business of advising others. It can include a Financial, Swap, or Program Administrator.

**Counsel** means a legal advisor or attorney, whether an individual or a firm, representing a client. It can include Bond, Disclosure, Issuer, Swap, Tax, or Underwriters Counsel.

**Counterparty** means the other party or participant in an agreement or contract; usually it refers to the other party in an Interest Rate (or swap) Agreement.

**Lender** means an individual or firm who loans a borrower money.

**Paying Agent** means an individual or firm that transfers the periodic interest and principal payments from the public entity to the investors.

**Registrar** means the individual or firm responsible for maintaining a record or list of owners or investors in debt (sometimes referred to as holders of the debt).

**Remarketing Agent** means the firm responsible for reselling to new investors debt instruments that have been “tendered” for purchase by their holders. The remarketing



agent is also usually responsible for resetting the interest rate for variable rate debt instruments.

**Underwriter** means the firm that buys new debt for reselling to the public for a profit. The underwriter may acquire the debt either through negotiation or by award on the basis of competitive bidding.

**Verification Agent** usually means a certified public accountant or other independent third party that determines that the cash flow from investments purchased with proceeds of a refunding debt issue, along with other money, will be sufficient to pay the refunded bonds.

**Public Entity** is a governmental organization or unit that has a legal existence and is authorized to borrow money or enter into debt. It includes the State, state agencies, local governments, local government instrumentalities, and any other authority, board, district, instrumentality, or entity created by the State, a state agency, local government, a local government instrumentality, or any combination of the above. It does not include legal entities without debt authority, such as a county school board; however, a special school district with debt authority is included.

**Governing Body** means the group of individuals with the authority to make decisions for a public entity, often referred to as the “legislative body.” Governing bodies are subject to the Tennessee Open Meetings Law (requiring public notice and recording of minutes). **Members** are the individuals serving on the governing body.

**Conduit Entity** means a governmental entity or agency that borrows money to lend to another entity, and not to finance a project for itself. Examples of conduit issuers are health and education boards, economic development boards, and public building authorities.

**Risk** refers to the uncertainty (downside) involved in a debt transaction, including investment, business, credit, market, liquidity, operations, tax, and basis risks.

**State Agency Loan Program** refers to programs offered by the state or state agencies, such as the State Revolving Loan Program offered by the Tennessee Local Development Authority or the Qualified School Construction Bond program offered by the Tennessee State School Bond Authority.

**State Funding Board** means the state entity whose members are the Governor, the Commissioner of Finance and Administration, the Comptroller, the State Treasurer, and the Secretary of State. The State Funding Board is created by Tennessee Code Annotated Section 9-9-101.