

Recommended Best Practices

Listed below are recommended best practices that the District should consider incorporating into its policies and procedures. Most of these best practices are based on the Government Finance Officers Association (GFOA) prescribed recommendations and can be found at the GFOA website at <http://www.gfoa.org/>. The GFOA recommended best practices are updated periodically. We have attached the most current GFOA best practices related to debt issuance.

Focus on Transparency and Integrity Going Forward

Based on concerns raised by the community regarding past debt issuances, it is recommended that there be a continued commitment by the District as follows:

- Form a Citizens' Bond Oversight Committee for future voter approved bonds, even if not required by State statute. At the time of committee appointment, there should be a written plan for the committee's mission and process.
- Establish an Audit Committee based on consultation with the District's external auditor.
- Create a Staff Debt Review Committee consisting of the District Cabinet and the Director of Maintenance, Operations, Facilities, and Transportation. The purpose of this committee is to 1) review proposed financings and 2) annually review the administration of the District's outstanding debt.

Ethics Training

To further supplement the District's continued focus on ethics, it is recommended that District leadership receive formal ethics training. While a law currently exists (often referred to by the authorizing bill, Assembly Bill 1234) which requires certain local agency officials receive two hours of training in general ethics principles and ethics laws every two years, this law does not apply to school districts, but nevertheless provides a framework. It is recommended that the District establish a policy for the frequency and participation in such training.

There are a number of training options available and a few examples are:

- The California Fair Political Practices Commission has a free online training program that focuses on
 - Conflicts of Interest
 - Misuse of Public Funds
 - Transparency Laws
 - Laws relating to Fair Processes

The website for this training is: <http://www.fppc.ca.gov/index.php?id=477>

- The United States Office of Government Ethics provides a number of training modules that focus on different elements of ethics in government. The link is http://www.usoge.gov/training/training_modules.aspx
- Our firm offers a training course titled, *Creating and Sustaining a Culture of Ethical Consideration*.

Best Practices related to Debt Issuances

Listed below are the recommended best practices identified by the *Government Finance Officers Association (GFOA)* related to issuing debt. The attached document provides detail on each of these sections.

- **Debt Management Policy**

Establish written guidelines that address debt structuring practices, debt issuance practices and debt management practices. Incorporating such a policy will improve the quality of decisions made and provide justification for the debt structure utilized. Furthermore, adhering to a debt management policy is a strong indication to rating agencies and the capital markets that the District is well managed.

- **Selecting and Managing the Method of Sale of State and Local Government Bonds**

The District should adopt specific guidelines and practices for selecting a method of sale that is most likely to achieve the lowest borrowing costs while taking into account both short and long-term implications to local taxpayers. The guidelines should be based on a thorough analysis of the structure of the proposed debt issuance including a review of the credit rating, security and any other factors that contribute to the proposed issuance.

- **Selecting Financial Advisors**

It is highly recommended that the District utilize an independent financial advisor for all debt issuances. Furthermore, it is recommended that the District undertake a Request for Proposal (RFP) process to compare qualifications and costs and select the most appropriate firm. Additionally, the District should periodically initiate an RFP for financial advisors to obtain current market costs and services. As an RFP has not been conducted recently, now would be an opportune time to initiate this process.

- **Selecting Bond Counsel**

Similar to selecting a financial advisor, it is also highly recommended that the District initiate a competitive process utilizing an RFP process to compare and select the most qualified and cost effective firm based on the District's criteria.

- **Selecting Underwriters for Negotiated Bond Sales**

If a negotiated sale is decided upon (with the input of a financial advisor), in order to promote fairness, objectivity and transparency, the District should use an RFP process to evaluate underwriters.

- **Pricing Bonds in a Negotiated Sale**

As the GFOA best practice states, "one of the most important outcomes of the sale of bonds, the cost of borrowing, is established through the pricing process. Unlike a competitive sale, bond pricing in a negotiated sale requires a much greater degree of issuer involvement. The issuer negotiates both the yield on the bonds and the underwriters' compensation (also called underwriter discount), which includes the sales commission, management fee, underwriting risk, and expenses. An issuer's success in negotiating the price of its bonds depends on its ability and willingness to devote sufficient time to understanding the market and the historical performance of its bonds." Therefore, undertaking a pricing negotiation requires significant preparation on the part of the District. Such preparation should begin with the previously recommended Staff Debt Review Committee, a thorough review of the current GFOA best practices, and identification of the resources needed (including independent research and advice) to represent the District in the negotiation.

- **Using Variable Rate Debt Instruments**

The GFOA advises issuers who plan to issue variable rate debt to exercise caution and carefully evaluate their objectives and consider how the debt and its risks associated will be managed over the long term. Issuance of variable rate debt should be guided by the issuer's overall financial and debt management objectives and financial condition.

- **Analyzing and Issuing Refunding Bonds**

The GFOA recommends that issuers develop formal policy guidelines in their debt management policies to provide a financial framework for decision makers regarding the evaluation of refunding.

As mentioned above, specific detail for each GFOA best practice is in the attached document. Furthermore, the GFOA website provides additional resources as well as up to date information for these best practices.

Attachment

Government Finance Officers Association

Best Practices Related to Debt Issuances

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BEST PRACTICE

Debt Management Policy (1995 and 2003) (DEBT)

Background. Debt management policies are written guidelines and restrictions that affect the amount and type of debt issued by a state or local government, the issuance process, and the management of a debt portfolio. A debt management policy improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning, including a multi-year capital plan. Adherence to a debt management policy signals to rating agencies and the capital markets that a government is well managed and should meet its obligations in a timely manner.

Debt levels and their related annual costs are important long-term obligations that must be managed within available resources. An effective debt management policy provides guidelines for a government to manage its debt program in line with those resources.

Recommendation. The Government Finance Officers Association (GFOA) recommends that all state and local governments adopt comprehensive written debt management policies, and that governments review them at least annually and revise them as necessary. A Debt Management Policy should address:

- *Direct Debt* - debt payable from general revenues, including capital leases,
- *Revenue Debt* - debt payable from a specific pledged revenue source,
- *Conduit Debt* - debt payable by third parties for which the government does not provide credit or security,
- *State Revolving Loan Funds and Pools*
- *Other Types of Hybrid Debt* – debt payable from special revenues or containing other unique security pledges, and
- *Interfund Borrowing* – loans for short-term cash flow needs.

1. ***Debt Limits.*** The Policy should define specific limits or acceptable ranges for each type of debt. Limits are generally set for legal, public policy, and financial reasons.

a. *Legal limits* may be determined by:

- State constitution or law,
- Local charter, by-laws, resolution or ordinance, or covenant.

b. *Public Policy limits* can include:

- Purposes for which debt proceeds may be used or prohibited,
- Types of debt that may be issued or prohibited,
- Relationship to and integration with the Capital Improvement Program, and
- Policy goals related to economic development, capital improvement financings, tax increment financing, and public-private partnerships.

c. *Financial limits* generally reflect public policy or other financial resource constraints, such as reduced use of a particular type of debt due to changing financial conditions. Appropriate debt limits can positively impact bond ratings, if the government demonstrates adherence to such policies over time. Financial

limits are often expressed as ratios customarily used by credit analysts. Different financial limits are used for different types of debt. Examples include:

- *Direct Debt* can be measured or limited by the following ratios:
 - Debt per capita,
 - Debt to personal income,
 - Debt to taxable property value, and
 - Debt service payments as a percentage of general fund revenues or expenditures.
- *Revenue Debt* levels are often limited by debt service coverage ratios (e.g., annual net pledged revenues to annual debt service) or credit rating impacts (e.g., additional bonds should not lower ratings) contained in bond covenants.
- *Conduit Debt* limitations may reflect the right of the issuing government to approve the borrower's creditworthiness, the purpose of the borrowing issue, or a minimum credit rating. Such limitations reflect sound public policy, particularly if there is a contingent impact on the general revenues of the government or marketability of the government's direct debt.
- *Short-Term Debt Issuance* should describe the specific purposes and circumstances under which it can be used, as well as limitations in term or size of borrowing.

2. *Use of Derivatives.* The Policy should:

- Specify how derivatives fit within the overall debt management program.
- State the conditions under which derivatives can be utilized.
- Identify the types of derivatives that may be employed or are prohibited.
- Identify approach(es) for measuring, evaluating, and managing derivative risk, including basis risk, tax risk, counter-party risk, termination risk, liquidity renewal risk, remarketing risk, and credit risk.
- State the methods for procuring and selecting derivative products.

3. *Debt Structuring Practices.* The Policy should include specific policies regarding the debt structuring practices for each type of bond, including:

- Maximum term (often stated in absolute terms or based on the useful life of the asset(s)),
- Average maturity,
- Debt service pattern such as equal payments or equal principal amortization,
- Use of optional redemption features that reflect market conditions and/or needs of the government,
- Use of variable or fixed-rate debt, credit enhancements, derivatives, and short-term debt, and limitations as to when each can be used, and
- Other structuring practices should be considered such as capitalized interest, deferral of principal and/or other internal credit support, including general obligation pledges.

4. *Debt Issuance Practices.* The Policy should provide guidance regarding the issuance process, which may differ for each type of debt. These practices include:

- Criteria for determining the sale method (competitive, negotiated, placement) and investment of proceeds,
- Criteria for issuance of advance refunding and current refunding bonds,
- Selection and use of professional service providers,
- Use of comparative bond pricing services or market indices as a benchmark in negotiated transactions, as well as to evaluate final bond pricing results, and
- Use of credit ratings, minimum bond ratings, determination of the number of ratings, and selection of rating services.

5. *Debt Management Practices*. The Policy should provide guidance for ongoing administrative activities including:

- Investment of bond proceeds,
- Primary and secondary market disclosure practices, including annual certifications as required,
- Arbitrage rebate monitoring and filing,
- Federal and state law compliance practices, and
- Market and investor relations efforts.

References

- *A Guide for Preparing a Debt Policy*, Patricia Tigue, GFOA, 1998.
- *Benchmarking and Measuring Debt Capacity*, Rowan Miranda and Ron Picur, GFOA, 2000.

Approved by the GFOA's Executive Board, February 28, 2003.



GFOA Recommended Practice

Selecting and Managing the Method of Sale of State and Local Government Bonds (1994 and 2007) (DEBT)

Background. State and local government bond issuers should sell their debt using the method of sale that is most likely to achieve the lowest cost of borrowing while taking into account both short-range and long-range implications for taxpayers and ratepayers. Differing views exist among issuers and other bond market participants with respect to the relative merits of the competitive and negotiated methods of sale. Moreover, research into the subject has not led to universally accepted findings as to which method of sale is preferable when taking into account differences in bond structure, security, size, and credit ratings for the wide array of bonds issued by state and local governments.

Concerns have been raised about the lack of a competitive Request for Proposals (RFP) process in the selection of underwriters in a negotiated sale and the possibility of higher borrowing costs when underwriters are appointed based on factors other than merit. As a result, issuers have been forced to defend their selection of underwriters for negotiated sales in the absence of a documented, open selection process.

There is also a lack of understanding among many debt issuers about the appropriate roles of underwriters and financial advisors and the fiduciary relationship that each has or does not have with respect to state and local government issuers. The relationship between issuer and financial advisor is one of “trust and confidence” which is in the “nature of a fiduciary relationship”. This is in contrast to the relationship between the issuer and underwriter where the relationship is one of some common purposes but also some competing objectives, especially at the time of bond pricing.

Recommendation. When state and local laws do not prescribe the method of sale of municipal bonds, the Government Finance Officers Association (GFOA) recommends that issuers select a method of sale based on a thorough analysis of the relevant rating, security, structure and other factors pertaining to the proposed bond issue. If the government agency has in-house expertise, defined as dedicated debt management staff whose responsibilities include daily management of a debt portfolio, this analysis and selection could be made by the government’s staff. However, in the more common situation where a government agency does not have sufficient in-house expertise, this analysis and selection should be undertaken in partnership with a financial advisor. Due to the inherent conflict of interest, issuers should not use a broker/dealer or potential underwriter to assist in the method of sale selection unless that firm has agreed not to underwrite that transaction.

The GFOA believes that the presence of the following factors may favor the use of a competitive sale:

- The rating of the bonds, either credit-enhanced or unenhanced, is at least in the single-A category.
- The bonds are general obligation bonds or full faith and credit obligations of the issuer or are secured by a strong, known and long-standing revenue stream.
- The structure of the bonds does not include innovative or new financing features that require extensive explanation to the bond market.

Similarly, GFOA believes that the presence of the following factors may favor the use of a negotiated sale:

- The rating of the bonds, either credit-enhanced or unenhanced, is lower than single-A category.
- Bond insurance or other credit enhancement is unavailable or not cost-effective.
- The structure of the bonds has features such as a pooled bond program, variable rate debt, deferred interest bonds, or other bonds that may be better suited to negotiation.
- The issuer desires to target underwriting participation to include disadvantaged business enterprises (DBEs) or local firms.
- Other factors that the issuer, in consultation with its financial advisor, believes favor the use of a negotiated sale process.

If an issuer, in consultation with its financial advisor, determines that a negotiated sale is more likely to result in the lowest cost of borrowing, the issuer should undertake the following steps and policies to increase the likelihood of a successful and fully documented negotiated sale process:

- Select the underwriter(s) through a formal request for proposals process. The issuer should document and make publicly available the criteria and process for underwriter selection so that the decision can be explained, if necessary.
- Enter into a written contractual relationship with a financial advisor (a firm unrelated to the underwriter(s)), to advise the issuer on all aspects of the sale, including selection of the underwriter, structuring, disclosure preparation and bond pricing.
- Due to inherent conflicts of interest, the firm acting as a financial advisor for an issuer should not to be allowed to resign and serve as underwriter for the transaction being considered.
- Due to potential conflicts of interest, the issuer should also enact a policy regarding whether and under what circumstances it will permit the use of a single firm to serve as an underwriter on one transaction and a financial advisor on another transaction.
- Issuers with sufficient in-house expertise and access to market information may act as their own financial advisor. Such issuers should have at least the following skills and information: (i) access to real-time market information (e.g. Bloomberg) to assess market conditions and proposed bond prices; (ii) experience in the pricing and sale of bonds, including historical pricing data for their own bonds and/or a set of comparable bonds of other issuers in order to assist in determining a fair price for their bonds; and (iii) dedicated full-time staff to manage the bond issuance process, with the training, expertise and access to debt management tools necessary to successfully negotiate the pricing of their bonds.
- Remain actively involved in each step of the negotiation and sale processes in accordance with the GFOA's *Recommended Practice, Pricing Bonds in a Negotiated Sale*.
- Require that financial professionals disclose the name(s) of any person or firm compensated to promote the selection of the underwriter; any existing or planned arrangements between outside professionals to share tasks, responsibilities and fees; the name(s) of any person or firm with whom the sharing is proposed; and the method used to calculate the fees to be earned.
- Review the "Agreement Among Underwriters" and ensure that it governs all transactions during the underwriting period.

- Openly disclose public-policy issues such as the desire for DBEs and regional firm participation in the syndicate and the allocation of bonds to such firms as reason for negotiated sale; measure and record results at the conclusion of the sale.
- Prepare a post-sale summary and analysis that documents the pricing of the bonds relative to other similar transactions priced at or near the time of the issuer's bond sale, and record the true interest cost of the sale and the date and hour of the verbal award.

References

- *Who are the Parties in My Deal? What are Their Roles? How Do I Sell My Bonds?*, Julia H. Cooper and David Persselin, Government Finance Review, April 2006.
- *An Elected Official's Guide to Debt Issuance*, J.B. Kurish and Patricia Tigue, GFOA, 2005.
- *Debt Management Policy*, GFOA Recommended Practice, 2003.
- *Pricing Bonds in a Negotiated Sale*, GFOA Recommended Practice, 2000.
- *Preparing RFPs to Select Financial Advisors and Underwriters*, GFOA Recommended Practice, 1997.
- *Debt Issuance and Management: A Guide for Smaller Governments*, James C. Joseph, GFOA, 1994.
- *Competitive v. Negotiated: How to Choose the Method of Sale for Tax-Exempt Bonds*, GFOA, 1994.
- *Competitive v. Negotiated Sale Debt*, Issue Brief No. 1, California Debt Advisory Commission, September 1992.

Approved by the GFOA's Executive Board, October 19, 2007.



BEST PRACTICE

Selecting Financial Advisors (2008) (DEBT)*

Note: This Best Practice (BP) is one of a group of five relating to the sale of bonds. These five BPs should be read and considered in conjunction with each other because of the interaction of the processes to which they apply. The five BPs are:

Selecting and Managing the Method of Sale of State and Local Government Bonds

Selecting Financial Advisors

Selecting Bond Counsel

Selecting Underwriters for Negotiated Bond Sales

Pricing Bonds in a Negotiated Sale

Background. State and local governments employ financial advisors to assist in the structuring and issuance of bonds whether through a competitive or a negotiated sale process. Unless the issuer has sufficient in-house expertise and access to market information, it should hire an outside financial advisor prior to undertaking a debt financing. A financial advisor represents the issuer, and only the issuer, in the sale of bonds. Issuers should assure themselves that the selected financial advisor has the necessary expertise to assist the issuer in selecting other finance professionals, planning the bond sale, and successfully selling and closing the bonds. In considering the roles of the financial advisor and underwriter, it is the intent of this Recommended Practice to set a higher standard than is required under MSRB Rule G-23, because disclosure and consent are not sufficient to cure the inherent conflict of interest.

Recommendation. The Government Finance Officers Association (GFOA) recommends that issuers select financial advisors on the basis of merit using a competitive process and that issuers review those relationships periodically. A competitive process using a request for proposals or request for qualifications (RFP) process allows the issuer to compare the qualifications of proposers and to select the most qualified firm based on the scope of services and evaluation criteria outlined in the RFP.

Before starting the RFP process, issuers should decide whether the financial advisor will assist the issuer for a single bond sale, for a multi-year engagement or whether the issuer seeks to establish a qualified pool of financial advisors to choose from for future bond sales. The RFP then can be carefully written in order to result in the form of relationship desired by the issuer. Additionally, issuers should write the RFP to comply with applicable procurement requirements.

If an issuer is contemplating the possibility of selling bonds through a negotiated sale, the financial advisor should be retained prior to selecting the underwriter(s). This allows the issuer to have professional services available to advise on the appropriate method of sale, and if a negotiated sale is selected, to prepare the underwriter RFP and assist in the evaluation of the underwriter responses.

No firm should be given an unfair advantage in the RFP process. Procedures should be established for communicating with potential proposers, determining how and over what time period questions will be addressed, and determining when contacts with proposers will be restricted.

Due to potential conflicts of interest, the issuer also should enact a policy regarding whether, and under what circumstances, it would permit a firm to serve as an underwriter on one transaction and a financial advisor on another transaction. Additionally, it is recommended that when an issuer has a financial advisor contract with a firm that also is a broker-dealer, there should be a lockout period from the time that the financial advisor contract ends to the time when the broker-dealer can serve as a negotiated underwriter for the issuer.

Request for Proposal Content. The RFP should include at least the following components:

1. A statement from the issuer stating that due to inherent conflicts of interest, the firm selected as financial advisor will not be allowed to resign in order to serve as underwriter for the proposed transaction (See GFOA Recommended Practice, *Selecting and Managing the Method of Sale of State and Local Government Bonds*).
2. A clear and concise description of the scope of work, specifying the length of the contract and indicating whether joint proposals with other firms are acceptable.
3. Clarity on whether the issuer reserves the right to select more than one financial advisor or to form financial advisory teams.
4. A description of the objective evaluation and selection criteria and explanation of how proposals will be evaluated.
5. A requirement that all fee structures be presented in a standard format. Issuers also should ask all proposers to identify which fees are to be proposed on a “not-to-exceed” basis, describe any condition attached to their fee proposal, and explicitly state which costs are included in the fee proposal and which costs are to be reimbursed.
6. A requirement that the proposer provide at least three references from other public-sector clients, preferably from ones that the firm provided similar services to those proposed to be undertaken as the result of the RFP.

Requested Proposer Responses. RFPs should request relevant information related to the areas listed below in order to distinguish each firm’s qualifications and experience, including:

1. Relevant experience of the individuals to be assigned to the issuer, identification of the individual in charge of day-to-day management, and the percentage of time committed for each individual on the account.
2. Relevant experience of the firm with financings of the issuer or comparable issuers and financings of similar size, types and structures, including financings in same state.
3. Discussion of the firm’s financial advisory experience necessary to assist issuers with either competitive or negotiated sales.
4. Demonstration of the firm’s understanding of the issuer’s financial situation, including ideas on how the issuer should approach financing issues such as bond structures, credit rating strategies and investor marketing strategies.
5. Demonstration of the firm’s knowledge of local political, economic, legal or other issues that may affect the proposed financing.
6. Discussion of the firm’s familiarity with GFOA’s Recommended Practices relating to the selling of bonds and the selection of finance professionals.

7. Disclosure of the firm's affiliation or relationship with any broker-dealer.
8. Analytic capability of the firm and assigned individuals and the availability of ongoing training and educational services that could be provided to the issuer.
9. Description of the firm's access to sources of current market information to assist in pricing of negotiated sales and information to assist in the issuer in planning and executing competitive sales.
10. Amounts and types of insurance carried, including the deductible amount, to cover errors and omissions, improper judgments, or negligence.
11. Disclosure of any finder's fees, fee splitting, payments to consultants, or other contractual arrangements of the firm that could present a real or perceived conflict of interest.
12. Disclosure of any pending investigation of the firm or enforcement or disciplinary actions taken within the past three years by the SEC or other regulatory bodies.

Additional Considerations. Issuers should also consider the following in conducting the financial advisor selection process:

1. Take steps to maximize the number of respondents by using mailing lists, media advertising, resources of the GFOA and applicable professional directories.
2. Allow adequate time for firms to develop their responses to the RFP. Two weeks should be appropriate for all but the most complicated RFPs.
3. Establish evaluation procedures and a systematic rating process, conduct interviews with proposers, and undertake reference checks. Where practical, one individual should check all references using a standard set of questions to promote consistency. To remove any appearance of a conflict of interest resulting from political contributions or other activities, elected officials should not be part of the selection team.
4. Document and retain the description of how the selection of the financial advisor was made and the rankings of each firm.
5. Consider whether to require disclosure of gifts, political contributions, or other financial arrangements in compliance with state and local government laws or other applicable policies.

Basis of Compensation. Fees paid to financial advisors should be on an hourly or retainer basis, reflecting the nature of the services to the issuer. Generally, financial advisory fees should not be paid on a contingent basis to remove the potential incentive for the financial advisor to provide advice that might unnecessarily lead to the issuance of bonds. GFOA recognizes, however, that this may be difficult given the financial constraints of many issuers. In the case of contingent compensation arrangements, issuers should undertake ongoing due diligence to ensure that the financing plan remains appropriate for the issuer's needs. Issuers should include a provision in the RFP prohibiting any firm from engaging in activities on behalf of the issuer that produce a direct or indirect financial gain for the financial advisor, other than the agreed-upon compensation, without the issuer's informed consent.

Form of Contract. As part of the RFP package, the issuer may also include a "Form of Contract" which incorporates elements and provisions conforming to prevailing law and procurement processes and requires RFP respondents to comment on the acceptability of the Form of Contract. The comments on the acceptability of the Form of Contract should be part of the evaluation process. The contract development process should allow for reasonable negotiation over the final terms of the contract. A final negotiated contract should make clear those services that will be included within the basic financial advisor fee and any services or reimbursable expenses that might be billed separately.

References

- *Preparing Requests for Proposals*, Issue Brief No. 3, California Debt Advisory Commission, October, 1994.
- *Debt Issuance and Management: A Guide for Smaller Governments*, James C. Joseph, GFOA, 1994.
- *A Guide for Selecting Financial Advisors and Underwriters: Writing RFPs and Evaluating Proposals*, Patricia Tighe, GFOA, 1997.
- GFOA Best Practice, “Pricing Bonds in a Negotiated Sale,” 2008.
- GFOA Best Practice, “Selecting Bond Counsel,” 2008.
- GFOA Best Practice, “Selecting Underwriters for Negotiated Bond Sales,” 2008.
- GFOA Best Practice, “Selecting and Managing the Method of Sale of State and Local Government Bonds,” 2007.
- Municipal Securities Rulemaking Board Rule G-23, *Activities of Financial Advisors*, <http://www.msrb.org/msrb1/rules/ruleg23.htm>.

* This Recommended Practice, along with the Recommended Practice on Selecting Financial Advisors, replaces the 1997 RP, Preparing RFPs to Select Financial Advisors and Underwriters.

Approved by the GFOA’s Executive Board, October 17, 2008.



Recommended Practice

Selecting Bond Counsel (1998 and 2008) (DEBT)

Background. An essential member of a governmental issuer's bond financing team is bond counsel. Bond counsel renders an opinion on the validity of the bond offering, the security for the offering, and whether and to what extent interest on the bonds is exempt from income and other taxation. The opinion of bond counsel provides assurance both to issuers and to investors who purchase the bonds that all legal and tax requirements relevant to the matters covered by the opinion are met. An issuer should assure itself that its bond counsel has the necessary expertise to provide an opinion that can be relied on and will be able to assist the issuer in completing the transaction in a timely manner.

Recommendation. The Government Finance Officers Association (GFOA) recommends that issuers select bond counsel on the basis of merit using a competitive process and review those relationships periodically. A competitive process using a request for proposals (RFP) or request for qualifications (RFQ) permits issuers to compare qualifications of firms and select a firm or firms that best meets the needs of their community and the type of financing being undertaken. The RFP or RFQ should clearly describe the scope of services desired, the length of the engagement, evaluation criteria, and the selection process. Issuers should have a clear understanding of their service needs (single transaction, multiple transaction, or establishment of a qualified pool of firms) and develop the RFP/RFQ to meet these needs. Additionally, issuers should carefully develop an RFP that complies with state and local procurement requirements.

A RFP or RFQ should require firms proposing to serve as bond counsel to submit information that permits the issuer to evaluate the following factors, at a minimum:

1. Experience of the firm with financings of the issuer or comparable issuers, and financings of similar size, types and structures, including financings in the same state.
2. In preparing the RFP the issuer should determine whether specialized tax advice beyond normal bond counsel services is required. In those instances, the firm's experience in tax matters and the attorneys who practice full time in the area of public finance tax law should be identified in detail. If the firm has no attorneys who specialize in public finance tax law, the response should indicate how the firm intends to provide competent tax advice.
3. Experience of the firm with and its approach to applicable federal securities laws and regulations. In preparing the RFP the issuer should determine whether specialized securities law services beyond normal bond counsel services is required. In those instances, the firm's experience in municipal securities law matters and the attorneys who practice full time in the area of municipal securities law should be identified in detail. If the firm has no attorneys who specialize in municipal securities tax law, the response should indicate how the firm intends to provide competent municipal securities law advice.
4. Knowledge and experience of the attorneys that would be assigned to the transaction, particularly the individual with day-to-day responsibility for the issuer's account.
5. Ability of the firm and assigned personnel to evaluate legal issues, prepare documents, and complete other tasks of a bond transaction in a timely manner.
6. Relationships or activities that might present a conflict of interest for the issuer.

7. Level of malpractice insurance carried, including the deductible amount, to cover errors and omissions, improper judgments, or negligence.

Individuals in the organization with experience in public finance and/or responsible for debt management activities should be involved in the RFP or RFQ development and response review. This may include representatives from the finance department and internal counsel. To remove any appearance of a conflict of interest resulting from political contributions or other activities, elected officials should not be part of the evaluation and/or selection team. In reviewing and evaluating the RFP or RFQ responses, evaluation procedures and a systematic rating process should be established which consider the following:

1. The use of oral interviews of proposers, in which the attorney who would have day-to-day responsibility for the issuer's account should be asked to assume the lead role in presenting the qualifications of the firm.
2. The selection should not be driven solely by proposed fees. The experience of the firm with the type of transactions and the ability to deliver the required legal services in a timely manner are the most important factors in the selection of bond counsel.
3. For issuers that have ongoing needs of a similar nature, continuity should be considered an important factor in the evaluation process.
4. Different fee arrangements are possible depending on the type and nature of the engagement. Fee arrangements include both fixed fee and hourly which may or may not include a cap on the total compensation. Additionally, fees may also be paid contingent on the sale of bonds. Generally bond counsel fees should not be paid on a contingent basis to remove the potential incentive for bond counsel to render legal or tax opinions that would result in the inappropriate issuance of bonds. However, this may be difficult given the financial constraints of many issuers; in the case of contingent fee arrangements (as well as other fee arrangements), issuers should undertake ongoing due diligence to ensure the bond issue and structure remains appropriate for their organization. Fees and method of compensation (fixed fee, hourly, or retainer) should appropriately reflect the complexity and scope of the services to be provided.
5. Before making a final selection, the issuer should check the references furnished by the prospective bond counsel and determine the outcome of examinations by the IRS or other regulatory agencies of transactions in which the prospective bond counsel was involved. Where practical, one individual should check all references using a standard set of questions to promote consistency.

The issuer may also choose to include a "Form of Contract" in the RFP or RFQ package, which incorporates elements and provisions conforming to prevailing law and procurement processes. The RFP or RFQ should require respondents to comment on the acceptability of the Form of Contract. The comments on the acceptability of the Form of Contract should be part of the evaluation process. The contract development process should allow for reasonable negotiation over the final terms of the contract and/or engagement letter. A final negotiated contract or the engagement letter should make clear those services that will be included within the basic bond counsel fee and any services or reimbursable expenses that might be considered separately billable.

If co-bond counsels are being engaged, the issuer should:

1. delineate in the RFP or RFQ or engagement letter the roles and responsibilities of each firm;
2. assign discrete tasks to each firm in order to minimize cost duplication; and
3. exercise appropriate oversight to ensure coordination of tasks undertaken by the firms.

If co-bond counsels are engaged or if bond counsel firms are rotated, the issuer should:

1. evaluate whether higher costs for legal services will result because of the need for two or more firms to familiarize themselves with the issuer; and

2. consider the possible need to resolve differing viewpoints of each bond counsel.

Throughout the term of the engagement, the performance of bond counsel should be evaluated in relation to the stated scope of services and any areas where service needs to be improved should be communicated to the lead attorney. Ongoing contracts should be reviewed regularly and resubjected to competitive selection periodically.

References

- GFOA Recommended Practice; *Preparing RFPs to Select Financial Advisors and Underwriters*, 1997.
- Patricia Tigue, *A Guide to Selecting Financial Advisors and Underwriters: Writing RFPs and Evaluating Proposals*; GFOA, 1997.
- "Model Engagement Letters," National Association of Bond Lawyers, 1998.
- "The Selection and Evaluation of Bond Counsel," National Association of Bond Lawyers, 1998.

Approved by the GFOA's Executive Board, February 22, 2008.



BEST PRACTICE

Selecting Underwriters for Negotiated Bond Sales (2008) (DEBT)*

Note: This Best Practice (BP) is one of a group of five relating to the sale of bonds. These five BPs should be read and considered in conjunction with each other because of the interaction of the processes to which they apply. The five BPs are:

Selecting and Managing the Method of Sale of State and Local Government Bonds

Selecting Financial Advisors

Selecting Bond Counsel

Selecting Underwriters for Negotiated Bond Sales

Pricing Bonds in a Negotiated Sale

Background. State and local governments select underwriters for the purpose of selling bonds through a negotiated sale. The primary role of the underwriter in a negotiated sale is to market the issuer's bonds to investors. Assuming that the issuer and underwriter reach agreement on the pricing of the bonds at the time of sale, the underwriter purchases the entire bond issue from the issuer and resells the bonds to investors. In addition, negotiated sale underwriters are likely to provide ideas and suggestions with respect to structure, timing and marketing of the bonds being sold.

Issuers must keep in mind that the roles of the underwriter and the financial advisor are separate, adversarial roles and cannot be provided by the same party. Underwriters do not have a fiduciary responsibility to the issuer. A financial advisor represents only the issuer and has a fiduciary responsibility to the issuer. In considering the roles of underwriter and financial advisor, it is the intent of this Recommended Practice to set a higher standard than is required under MSRB Rule G-23, because disclosure and consent are not sufficient to cure the inherent conflict of interest.

The issuer's goal in a negotiated bond sale is to obtain the highest possible price (lowest interest cost) for the bonds. To maximize the potential of this occurring, the issuer's goal in the underwriter selection process is to select the underwriter(s) that has the best potential for providing that price. Those underwriters are typically the ones that have demonstrated both experience underwriting the type of bonds being proposed and the best marketing/distribution capabilities.

Recommendation. The Government Finance Officers Association (GFOA) recommends that unless the issuer has sufficient in-house expertise and access to market information, it should hire an outside financial advisor prior to undertaking a negotiated debt financing. The financial advisor can lend objective knowledge and expertise in the selection of underwriters for negotiated sales. GFOA recommends that a firm hired as a financial advisor should not be allowed to resign in order to underwrite the proposed negotiated sale of bonds.

GFOA further recommends the use of a Request for Proposal (RFP) process when selecting underwriters in order to promote fairness, objectivity and transparency. The RFP process allows the issuer to compare respondents and helps the issuer select the most qualified firm(s) based on the evaluation criteria outlined in the RFP. An issuer and its financial advisors should have a clear understanding of the issuer's underwriting needs and should carefully develop an RFP that complies with state and local bidding requirements (including the use of regional, local or disadvantaged firms if deemed appropriate by the issuer).

A negotiated bond sale does not entail the purchase of any goods or services by an issuer from an underwriter. Therefore, an RFP process for underwriters should not be treated as a procurement process for goods or services, notwithstanding the obligation of the issuer to comply with state and/or local procurement requirements. The only legal relationship between the issuer and an underwriter is created by a Bond Purchase Agreement signed at the time of the pricing of the bonds, wherein the issuer agrees to sell the bonds to the underwriter at an agreed upon price.

An RFP process can result in selection of one or more underwriters for a single transaction or result in identification of a pool of underwriters from which firms will be selected over a specific period of time for a number of different transactions. Each issuer should weigh the advantages and disadvantages of each type of arrangement with the assistance of their financial advisor.

No firm should be given an unfair advantage in the RFP process. Procedures should be established for communicating with potential proposers, determining how and over what time period questions will be addressed, and determining when contacts with proposers will be restricted.

Request for Proposal Content. The RFP should include at least the following components:

1. A clear and concise description of the contemplated bond sale transaction.
2. A statement noting whether firms may submit joint proposals. In addition, the RFP should state whether the issuer reserves the right to select more than one underwriter for a single transaction.
3. A description of the objective evaluation and selection criteria and explanation of how proposals will be evaluated.
4. A requirement that all underwriter compensation structures be presented in a standard format. Proposers should identify which fees are proposed on a “not-to-exceed” basis, describe any condition attached to their fee proposal, and explicitly state which costs are included in the fee proposal and which costs are to be reimbursed.
5. A requirement that the proposer provide at least three references from other public-sector clients, preferably clients where the firm provided underwriting services similar to those proposed to be undertaken as the result of the RFP.

Requested Proposer Responses. RFPs should include questions related to the areas listed below to distinguish firms’ qualifications and experience, including but not limited to:

1. Relevant experience of the firm and the individuals assigned to the issuer, and the identification and experience of the individual in charge of day-to-day management of the bond sale, including both the investment banker(s) and the underwriter(s).
2. A description of the firm’s bond distribution capabilities including the experience of the individual primarily responsible for underwriting the proposed bonds. The firm’s ability to access both retail and institutional investors should be described.
3. Demonstration of the firm’s understanding of the issuer’s financial situation, including ideas on how the issuer should approach financing issues such as bond structures, credit rating strategies and investor marketing strategies.
4. Demonstration of the firm’s knowledge of local political, economic, legal or other issues that may affect the proposed financing.
5. Documentation of the underwriter’s participation in the issuer’s recent competitive sales or the competitive sales of other issuers in the same state.
6. Analytic capability of the firm and assigned investment banker(s).
7. Access to sources of current market information to provide bond pricing data before, during and after the sale.
8. The amount of uncommitted capital available and the ability and willingness of the firm to purchase the entire offering of the issuer, if necessary, in the case of a firm underwriting.

9. Any finder's fees, fee splitting, or other contractual arrangements of the firm that could present a real or perceived conflict of interest, as well as any pending investigation of the firm or enforcement or disciplinary actions taken within the past three years by the SEC or other regulatory bodies.

Additional Considerations. Issuers should also consider the following in conducting the underwriter selection process:

1. Take steps to maximize the number of respondents by using mailing lists, media advertising, resources of the GFOA, resources of the financial advisor and applicable professional directories.
2. Give adequate time for firms to develop their responses to the RFP. Two weeks should be appropriate for all but the most complicated RFPs.
3. Establish evaluation procedures and a systematic rating process, conduct interviews with proposers, and undertake reference checks. Where practical, one individual should check all references using a standard set of questions to promote consistency. To remove any appearance of a conflict of interest resulting from political contributions or other activities, elected officials should not be part of the selection team.
4. Document and retain the description of how the selection was made and the rankings of each firm.

Underwriter's Compensation. The underwriter in a negotiated sale is compensated in the form of an underwriter's discount or "spread", which consists of the negotiated difference between the amount the underwriter pays the issuer for the bonds and the amount the underwriter expects to receive selling the bonds to investors. The underwriter's discount includes up to four components: the management fee, takedown, expenses and underwriting fee. The only component of spread that can be fixed in a proposal is the management fee. The management fee compensates the investment bankers for the time and expertise brought to the negotiated sale by the investment bankers. It is appropriate to ask the proposer for a firm management fee quote, although its weighting in the evaluation criteria should be low. In addition, issuers may want to leave room to negotiate this fee lower or higher, depending on the actual complexities of the transaction.

The remaining components of spread, as noted below, should be determined through the negotiation process.

1. Expenses – includes various fees and overhead expenses and also should not be part of the RFP evaluation criteria. However it is important to note that all underwriter expenses be clearly identified and defined at the appropriate time during the bond negotiation.
2. Takedown – is the "sales commission" of the deal. Current market levels of takedown can be determined by the issuer or its financial advisor just prior to the time of negotiation. The takedown is the principal component of the potential profit to an underwriter in a bond sale. The issuer must weigh the impact of takedown on the resulting true interest cost to the bond issuer. An inadequate takedown may result in less aggressive marketing of the bonds and a higher interest cost to the issuer. A fair balance must be struck between a "market rate" takedown and the cost to the issuer in future interest costs.
3. Underwriting Fee – is almost never part of the final underwriter's discount and should not be part of the discussion at the RFP stage. Discussion of the payment of an underwriting fee may occur during pricing negotiation, but only to the extent the underwriter agrees to underwrite a substantial amount of unsold bonds.

Issuers should include a provision in the RFP prohibiting any firm from engaging in activities on behalf of the issuer that produce a direct or indirect financial gain for the firm, other than the agreed-upon compensation, without the issuer's informed consent. Procedures should be established for communicating with potential proposers, determining how and over what time period questions will be addressed, and determining when contacts with proposers will be restricted.

References

- *Preparing Requests for Proposals*, Issue Brief No. 3, California Debt Advisory Commission, October 1994.
- *Debt Issuance and Management: A Guide for Smaller Governments*, James C. Joseph, GFOA, 1994.
- *A Guide for Selecting Financial Advisors and Underwriters: Writing RFPs and Evaluating Proposals*, Patricia Tigue, GFOA, 1997.
- GFOA Best Practice, "Selecting Bond Counsel," 2008.
- GFOA Best Practice, "Selecting Financial Advisors," 2008.
- GFOA Best Practice, "Selecting and Managing the Method of Sale of State and Local Government Bonds," 2007.
- Municipal Securities Rulemaking Board Rule G-23, *Activities of Financial Advisors*, <http://www.msrb.org/msrb1/rules/ruleg23.htm>.

* This Recommended Practice, along with the Recommended Practice on Selecting Financial Advisors, replaces the 1997 RP, Preparing RFPs to Select Financial Advisors and Underwriters.

Approved by the GFOA's Executive Board, October 17, 2008.



BEST PRACTICE

Pricing Bonds in a Negotiated Sale (1996, 2000, and 2010)

Note: This Best Practice (BP) is one of a group of five relating to the sale of bonds. These five BPs should be read and considered in conjunction with each other because of the interaction of the processes to which they apply. The five BPs are:

Selecting and Managing the Method of Sale of State and Local Government Bonds

Selecting Financial Advisors

Selecting Bond Counsel

Selecting Underwriters for Negotiated Bond Sales

Pricing Bonds in a Negotiated Sale

Background. One of the most important outcomes of the sale of bonds, the cost of borrowing, is established through the pricing process. Unlike a competitive sale, bond pricing in a negotiated sale requires a much greater degree of issuer involvement. The issuer negotiates both the yield on the bonds and the underwriters' compensation (also called underwriter discount or gross spread), which includes the takedown (or sales commission), management fee, underwriting risk, and expenses. An issuer's success in negotiating the price of its bonds depends on its ability and willingness to devote sufficient time to understanding the market and the historical performance of its bonds.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local government issuers strive for the best balance between the yield for each maturity and the takedown to achieve the lowest overall cost of financing. The following actions by issuers are recommended to improve the pricing process:

1. Communicate to the underwriter specific goals to be achieved in the pricing of bonds and expectations regarding the roles of each member of the financing team, including the issuer and an independent financial advisor employed to assist in the pricing process. Identify the issuer representative who has authority to make key decisions and be available throughout the pricing process.
2. Take steps during the underwriter selection process and prior to final pricing to manage the compensation to underwriters by
 - including a provision in the request for proposal that requires respondents to indicate the range of costs for each component of compensation and specify an expected maximum for each,
 - setting a cap on fees and expenses, and
 - obtaining and reviewing information on each component of underwriters' compensation for other recent similar sales.
3. Develop an understanding of prevailing market conditions, evaluate key economic and financial indicators, and assess how these indicators likely will affect the timing and outcome of the pricing. Obtain a pricing book from the underwriter and/or the financial advisor which would include the following information:
 - the supply and expected demand for municipal bonds;
 - the release of key economic indicators, actual or anticipated actions by regulatory or political bodies, and other factors that might affect the capital markets;
 - the interest rates and current market yields of recently priced and outstanding bonds with similar characteristics;

- the interest rates and interest rate indices for bonds with similar characteristics provided by independent services that track pricing performance; and
 - the historic benchmark index data for the bond issue being sold and for other bond issues being sold.
4. Issuers should be aware they have an important role in determining how bonds will be allocated among syndicate members and ultimate investors. Issuers should consider order priority and the designation policies in reviewing the preliminary pricing wire and the Agreement Among Underwriters prior to the sale. To a large extent the designation policy controls the distribution of underwriter compensation among the syndicate members.
 5. Work with the underwriter to develop an appropriate premarketing effort to gauge and build investor interest. In consultation with outside professionals (e.g., financial advisor, underwriter, pricing consultant), consider providing for retail orders either through a separate retail order period or by identifying certain maturities as retail priorities. If doing a retail order period, issuers should take measures to establish the legitimacy of the retail orders such as limiting order size and disclosure of zip code designation.
 6. Request that the senior managing underwriter propose a consensus pricing scale on the day prior to the pricing that represents the individual views of the members of the underwriting syndicate and obtain a number of interest rate scales from other syndicate members.
 7. Evaluate carefully whether structural features, such as call features and original issue discount, that impact the true interest cost (TIC) of a bond offering, but limit future flexibility in managing the debt portfolio, will result in greater overall borrowing costs.
 8. During the marketing of the bonds, the issuer should have sufficient current market information and be in close contact with the lead underwriter. Consider repricing at lower interest rates at the end of the order period, giving consideration to order flow and order volumes.
 9. The issuer should review the proposed allotments of the bonds to ensure achievement of the issuer's objectives.
 10. Evaluate the bond sale after its completion to assess the level of up-front costs of issuance, including whether the underwriters' compensation was fair given the level of effort and market conditions; and the pricing of the bonds, both in terms of the overall TIC and on a maturity-by-maturity basis.
 11. Develop a database with information on each issue sold with regard to pricing performance, including the types of bonds sold (general obligation or revenue bonds), credit rating, maturities, yield and takedown by maturity, and the TIC.

References

- *Pricing Bonds in a Negotiated Sale: How to Manage the Process*, J.B. Kurish, GFOA, 1994.
- GFOA Best Practice, "Selecting and Managing the Method of Sale of State and Local Government Bonds," 2008.
- GFOA Best Practice, "Selecting Financial Advisors," 2008.
- GFOA Best Practice, "Selecting Underwriters for Negotiated Bond Sales," 2008.
- GFOA Best Practice, "Selecting Bond Counsel," 2008.

Approved by the GFOA's Executive Board, October 15, 2010.



ADVISORY

A GFOA ***advisory*** identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Using Variable Rate Debt Instruments (1997 and 2010) (DEBT)

Background. Issuing variable rate debt is a sophisticated strategy. In optimal conditions, a government might experience lower borrowing costs or reduce the impact of volatile investment earnings by issuing variable rate securities; however, their use exposes governments to many additional forms of risk. Users of variable rate debt need to be informed about these risks and their implications and possess or retain substantial expertise to mitigate them.

Short-term interest rates are generally lower than long-term interest rates. Governments with debt that resets to prevailing interest rates can save money in their long-term financing if rates stay constant or fall over the life of the debt. If rates rise, governments are better off issuing fixed-rate debt from the outset. This interest rate risk is only one form of risk associated with variable rate debt. Additional risk is introduced by liquidity and remarketing provisions. Variable rate debt programs typically involve regular re-marketing or rollover events, and these provisions determine what happens when there are problems in that process. Those problems can impose sudden principal repayments or large increases in interest rates.

In addition to these forms of risk, governments need staff to actively monitor and manage variable rate debt throughout the time that it is outstanding. Governments without the capacity to manage such a program or who cannot secure the expertise to do so should consider issuing fixed rate debt.

Variable rate debt can be used as a tool for interim financing. Since the expectations of variable-rate investors are, by their nature, short-term, variable rate debt can be redeemed on short notice without any penalty. This feature makes variable rate debt a preferred tool for financing projects for which a prepayment or restructuring is a high probability. Certain variable rate products, most notably commercial paper, can be issued incrementally as funds are needed to finance current construction and reduce the long-term cost of construction financing, and then refunded with a long-term financing when the project is completed. Although variable rate debt is a valuable instrument, issuers should consult with their independent financial advisors and rating agencies to determine the appropriate level of variable rate exposure for their individual circumstances.

Advisory. The Government Finance Officers Association (GFOA) advises governments who plan to issue variable rate debt to exercise caution and carefully evaluate their objectives and consider how this debt and the various risks associated with it will be managed over the long term. Issuance of variable rate debt should be guided by the government's overall financial and debt management objectives and its financial condition. In particular, an issuer should:

1. Review statutes or ordinances governing the issuance of debt, both at the local and state levels, to ensure that the issuance of variable rate debt (including particular instruments) is permitted and to understand any conditions, such as amounts, interest rate ceilings, or requirements governing debt-related funds.

2. Ensure that the government's debt policy specifically addresses the use of variable rate debt, including goals to be achieved, permitted instruments, amounts that may be issued, steps to minimize risk, and monitoring requirements.
3. Evaluate the impact on debt service requirements assuming different interest rate scenarios and develop appropriate contingency plans for a rising interest rate environment, including setting aside reserves consistent with applicable arbitrage regulations or purchasing hedging instruments. An issuer also should consider the impact of changing interest rates on rate covenants and its financial position. Governments using variable rate debt should have adequate financial capacity to accommodate rapid and potential large changes in borrowing costs.
4. Evaluate the total cost of issuing variable rate debt, including fees to tender agents, remarketing agents, and liquidity providers under expected and adverse scenarios (e.g., if tendered bonds cannot be immediately remarketed). If the issuer is considering an interest rate cap, the cost of purchasing the instrument also should be assessed in relation to interest rate risk exposure. The issuer should include the cost of financial advisors or other expertise needed to monitor the variable rate instrument.
5. Evaluate the need for an externally provided liquidity facility. If needed, an issuer should undertake an evaluation of possible providers, including their credit ratings, the consequences of a change in this rating, the posting of collateral, the maximum interest rate if bonds are tendered, and the timing of renewal provisions.
6. Ensure the diversification of remarketing agents, liquidity facility providers and counterparties in their selection. This would assist the issuer in diversifying its exposure in market uncertainties and create competition among the various remarketing agents.
7. Develop a full understanding of the unique risks that arise when variable rate payments are realized through an interest rate swap, including counterparty risk, basis risk, rollover risk, and termination risk.

To evaluate the appropriate amount of variable rate debt to be issued for risk mitigation purposes, the following criteria should be evaluated:

1. Balance sheet risk mitigation. The following factors should be analyzed on the basis of the fund that will be repaying the debt:
 - a) The historic average of cash balances over the course of several prior fiscal years;
 - b) Projected cash balances based on known demands on a given fund and on the issuer's fund balance policies; and
 - c) Any basis risk, such as the difference in the performance or duration of the issuer's investment vehicle compared to the variable rate debt instrument to be used by the government.
2. Interest Rate Risk. In determining the amount of interest rate risk, the issuer should consider the specific fund exposed to the risk and the budgetary flexibility that fund has in accommodating rapid increases in interest rates.
3. Remarketing Risk. Issuers should have specific backup contingencies in the event that they cannot remarket their bonds. These should include sources of funds to cover redemptions and provisions for substitution remarketing.
4. Liquidity/Renewal Risk. Issuers should have a plan that specifies their actions and backup provisions should one or more guarantors to the transaction fail to perform. This also applies to a government's ability to renew its liquidity agreements during a difficult market.
5. Rollover Risk. Issuers should have the flexibility to act quickly if bonds rollover and cannot be sold, in which case remarketing agents effectively "put" their bonds. Documents should clearly indicate how the issuer should handle these bonds.

References.

- GFOA Advisory, *Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy*, 2010.
- GFOA Best Practice, *Debt Management Policy*, 2003.

Approved by the GFOA's Executive Board, March 5, 2010.



BEST PRACTICE

Analyzing and Issuing Refunding Bonds (1995 and 2010) (DEBT)

Background. Bond refinancing (“refunding”) is an important debt management tool for state and local government issuers. Refundings are commonly executed to achieve interest cost savings, remove or change burdensome bond covenants, or restructure the stream of debt service payments to avoid a default, or in extreme circumstances, an unacceptable tax or rate increase.

We have defined the following key terms and definitions in order to effectively evaluate a refunding candidate:

- Optional Call Provision / Optional Call Date
- Current vs. Advance Refunding
- Escrow Defeasance Portfolio
- Legal vs. Economic Defeasance

Optional Call Date - Most municipal bond issues are structured with an Optional Call Provision, which allows the issuer to refund/refinance the existing bonds by purchasing the outstanding bonds at a pre-determined price (e.g. 101%), and replacing them with new refunding bonds. The Optional Call Date is typically 10 years from the date of issuance of the bonds.

Current vs. Advance Refunding - There are two types of refundings, as defined by Federal Tax laws; a current refunding in which a refunding takes place (i.e., refunding bonds are sold) within 90 days of the optional call date, and an advance refunding in which refunding bonds are sold more than 90 days prior to the first call date.

Escrow Defeasance Portfolio - The mechanics of a refunding are the same in both cases: issue refunding bonds in an amount sufficient to generate proceeds to fund an Escrow Defeasance Portfolio. The Escrow Defeasance Portfolio or refunding escrow consists of a combination of cash and securities that are sufficient to pay the escrow requirement: the debt service, call premium, and outstanding principal of refunded bonds due on the optional call date.

Legal vs. Economic Defeasance - A legal defeasance typically occurs when an Escrow Defeasance Portfolio is funded with either State and Local Government Series securities (“SLGS”) or securities that are direct obligations of the U.S. Government. An economic defeasance occurs when the refunding escrow is funded with permitted investments that do not meet the defined criteria of a legal defeasance, such as Federal Agency securities (“Agencies”) or other typically higher-yielding securities. In a legal defeasance, the refunded bonds are legally removed from the issuer’s balance sheet, while under an economic defeasance the refunding bonds may remain on the balance sheet.

Recommendation. At the outset of evaluating each refunding, the Government Finance Officers Association (GFOA) encourages issuers to solicit the advice of their bond counsel and financial advisor in order to outline key legal and financial issues.

There are three key concepts that must be taken into consideration when evaluating a refunding candidate:

1. Financial and Policy Objectives
2. Financial Savings / Results
3. Bond Structure and Escrow Efficiency

Financial and Policy Objectives - Refundings may be undertaken for a number of financial and policy objectives, including to achieve debt service savings, eliminate restrictive bond/legal covenants, restructure the stream of debt service payments, or achieve other policy objectives.

Although in most circumstances issuers may undertake a refunding to obtain economic savings, issuers may refund an issue to restructure their debt portfolio in order to obtain budgetary/cash flow relief or to address exposure to other Government Finance costs/liabilities.

Financial Savings / Results - The GFOA recommends that issuers develop formal policy guidelines in their debt management policies to provide a financial framework for decision makers regarding the evaluation of refunding candidates

Formal policy guidelines:

- offer a systematic approach for determining if a refunding is cost-effective,
- promote consistency with other financial goals and objectives,
- provide the justification for decisions on when to undertake a refunding,
- ensure that staff time is not consumed unnecessarily in evaluating refunding proposals,
- ensure that some minimum level of cost savings is achieved, and
- reduce the possibility that further savings could have been achieved by deferring the sale of refunding bonds to a later date.

If a refunding is undertaken to achieve cost savings, the issuer should evaluate:

- issuance costs that will be incurred and the interest rate at which the refunding bonds can be issued,
- the maturity date of the refunded bonds,
- call date of the refunded bonds,
- call premium on the refunded bonds,
- structure and yield of the refunding escrow, and
- any transferred proceeds penalty.

One test often used by issuers to assess the appropriateness of a refunding is the requirement specifying the achievement of a minimum net present value (NPV) savings. A common threshold is that the savings (net of all issuance costs and any cash contribution to the refunding), as a percentage of the refunding bonds, should be at least 3-5 percent. This test can be applied to the entire issue or on a maturity-by-maturity basis. In addition, issuers may establish a minimum dollar threshold (e.g. \$100,000 or \$1 million NPV savings).

It is important to note that federal tax law typically permits an issuer to conduct one advance refunding over the life of a bond issue. As such, an issuer must take greater care (i.e., require a higher savings threshold) when evaluating an advance refunding candidate.

In certain circumstances, lower savings thresholds may be justified. For example, when an advance refunding is being conducted primarily for policy reasons (other than economic savings), interest rates are at historically low levels or the time remaining to maturity is limited, and as such, future opportunities to achieve greater savings are not likely to occur.

Savings also can be evaluated by additional metrics, such as compared to the optional call value and to historical interest rate trends. Financial analysis of refunding candidates must take into account a number of financial variables. GFOA recommends that issuers utilize an independent financial advisor to assist in performing such analyses.

Bond Structure and Escrow Efficiency - Debt management practices should anticipate the potential for refundings in the future. When bonds are issued, careful attention should be paid to the bond structure to address features that may affect flexibility in the future.

Some examples of such sales practices are:

- optional redemption provisions,
- bond coupon characteristics
- giving up call rights for certain maturities in exchange for a lower interest rate on the bonds,
- call provisions that permit the redemption of bonds in any order of maturity or on any date,
- call provisions that permit the issuer to call bonds at the earliest date without incurring a significant interest-rate penalty, and
- coupons on callable bonds priced as close to par as possible at the time of original issue.

Finally, it is important to create a refunding escrow that is efficient and will optimize savings. An escrow is efficient if escrow securities mature or pay interest when debt service payments of the refunded escrow are due – the lower the cost of the escrow (assuming all legal and permitted investment guidelines are met) the more efficient the escrow.

Issuers may purchase escrow securities in the open market or State and Local Government Securities (SLGS), a special series of U.S. Treasury securities, as well as other permitted investments, and/or use a hybrid structure. In addition, issuers may consider implementing an economic defeasance, as opposed to the standard legal defeasance.

Each option must be evaluated, considering the yield of the escrow securities and the effect of any inefficiency.

Among the issues that should be considered with regard to each type of instrument are the following:

- SLGS can be structured to comply with the federal tax law limits on investment return on escrow securities and eliminate any inefficiency in the escrow.
- Open market securities may have a higher return but may not mature or pay interest on the date when debt payments are due.
- Other permitted investments may provide even higher yields, resulting in greater savings, but often do not allow issuers to meet the requirements for a legal defeasance.

Finally, issuers may be required to increase the issue size or blend higher- and lower-yielding securities to comply with yield-restriction requirements and generate sufficient revenues. Such inefficiency may be eliminated by future escrow substitutions. Additionally, forward supply agreements, guaranteed investment contracts, or float contracts also may be considered to minimize escrow inefficiencies. However, issuers need to be concerned with potential counterparty risk, with these investment instruments.

References.

- GFOA Best Practice, Investment of Bond Proceeds, 2007.
- GFOA Best Practice, Debt Management Policy, 2003
- *Debt Issuance and Management: A Guide for Smaller Governments*, James C. Joseph, GFOA, 1994.
- “Understanding Current and Advance Refundings,” *Government Finance Review*, April 1992.

Approved by the GFOA’s Executive Board, February, 2011.