FINANCIAL MANAGEMENT FOR GEORGIA LOCAL UNITS OF ADMINISTRATION

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NATURE AND PURPOSE

Often, Local Units of Administration (LUAs) actively participate in the debt market. LUAs use debt to finance cash flow deficiencies or to finance large capital needs such as the construction of a new school building. This chapter provides an overview of the debt that LUAs may issue, including reference to Georgia statutes. In addition, the bond sale process is explained.

CLASSIFICATION OF DEBT

To gain a general overview of debt administration, it is important to review the debt classifications. When LUAs issue debt, it is classified first as either short-term or long-term.

- **Short-term debt usually matures in less than one year from date of issuance.**
- **Long-term debt has a maturity of more than one year after date of issuance.**

Short-term Debt

LUAs may issue short-term debt in various types of instruments as follows:

<u>Tax anticipation notes</u> (TANs) are notes LUAs issue in anticipation of future tax receipts, normally for ad valorem taxes. TANs are due and payable when the LUAs collect the taxes, but must be repaid by December 31 of the year the note(s) are issued. The collateral for the TANs are future property tax receipts. LUAs normally only issue

TANs to solve their cash flow problems.

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<u>Bond anticipation notes</u> (BANs) are notes LUAs issue, usually for capital projects, which they retire from the proceeds of long-term bonded debt (e.g., general obligation bonds). The collateral for the BANs is the authority to sell bonds in the future. Normally LUAs sell BANs when they want to start a construction project after approval of the referendum but before the bonds actually are sold.

<u>Revenue anticipation notes</u> (RANs) are notes LUAs issue in anticipation of receiving revenues at a future date. The revenues are the collateral for the RANs. Georgia LUAs rarely issue RANs.

<u>Notes payable</u> are notes, either secured or unsecured. Often LUAs issue notes to cover short-term cash flow deficits.

Long-term Debt

The most common form of long-term debt that local LUAs incur is bonds. Bonds are defined as:

> **Written promises to pay a specified sum of money, called the face value or principal amount, at a specified date or dates in the future, called maturity dates, together with periodic interest at specified rates.**

The primary difference between bonds and notes is that bonds are issued for a longer period of time and require greater legal formality.

Bonds are classified into different categories according to time of maturity, source of payment and type of issuer.

Time of Maturity

Generally, on the basis of maturity, LUAs classify long-term bonds as either term bonds or serial bonds.

<u>Term bonds</u> come due in a single maturity. However, the LUA usually agrees to make periodic payments into a sinking fund (i.e., a debt service fund) for mandatory redemption of term bonds before maturity or for payment at maturity. Over the years, the issuance of term bonds by LUAs has diminished substantially; however, Federal and corporate bonds still are issued largely as term bonds.

<u>Serial bonds</u> are of an issue in which some bonds mature in each year over a period of years. Usually each year an LUA repays a portion of principal outstanding and makes interest payments. Often LUAs make interest payments semi-annually and principal payments annually.

Source of Repayment

With respect to source of repayment, LUAs also classify bonds as general obligation (GO) or limited liability (i.e., revenue bonds).

> **<u>GO bonds</u> are bonds which are secured by the full faith and credit of the issuer. That is, GO bonds are secured by a pledge of the issuer's ad valorem taxing power or Education Local Options Sales Tax collections (i.e., the collateral). Ad valorem taxes necessary to pay debt service on GO bonds typically are not subject to the 20 mill property tax limit. The advantages of issuing GO debt include:**
>
> 1. **Strongest pledge of the LUA which usually produces lower interest rates than limited liability bonds.**
>
> 2. **The administrative aspects of preparing to borrow are simpler and normally less costly.**
>
> 3. **Because of relative simplicity, these bonds lend themselves more readily to public, rather than private negotiated sales which may reduce the interest cost.**
>
> 4. **The required vote of the LUA's constituents confirms the judgment of the LUA's policymakers to undertake the proposed improvement.**
>
> **The disadvantages of GO debt include:**
>
> 1. **The necessity for voter approval which may delay capital financing.**
>
> 2. **The reduction of overall borrowing capacity because of the legal debt margin (the legal debt margin is discussed later in this chapter).**
>
> **<u>Revenue bonds</u> are bonds in which specific revenues (i.e., most often user charges) of the issuing LUA guarantee the repayment (i.e., the collateral). Enterprise revenue bonds are the most common type of revenue bonds. These bonds finance projects which generate revenue to repay the debt (e.g., a county government will issue water and sewer bonds). Normally LUAs do not sell revenue bonds. Occasionally an LUA might sell revenue bonds to build a football stadium. These bonds are secured by the revenues generated by the athletic events. The LUA's taxing power does not back these bonds.**

Other Bond Features

Bonds have other features which need to be considered.

> **A <u>callable bond</u> is a bond which permits or requires the LUA to redeem the obligation**

before the stated maturity date at a specified price, usually at or above par by giving notice of redemption in a manner specified in the bond contract. Bonds with less than a ten year maturity usually don't have a call provision. A bond contract may include a call option for the following reasons:

- **Voluntary reduction of outstanding debt**

- **Achievement of a reduction of interest costs through refunding (bond refundings are discussed later in this chapter)**

- **Defeasing existing contractual obligations in relation to outstanding debt**

- **Voluntary reorganization of the debt (i.e., changing the maturity schedule)**

A demand bond is a long-term bond which includes a feature whereby the bondholder periodically may return the security back to the LUA at a predetermined price.

A zero coupon bond is a bond in which no interest is paid on a given bond between the date of its issue and the date of its maturity. The bond is issued at a deep discount from par (e.g., a bond with a face value of $100,000 may generate bond proceeds of $65,000), appreciating to its face value at maturity.

REGISTERED BONDS

LUAs register most bonds they issue today. However, prior to 1983, only about three percent of all outstanding municipal bonds were held in registered form (i.e., there were fewer bonds issued). The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) requires that LUAs issue all securities with maturities in excess of one year in fully registered form. Immediately before this registration became mandatory, many LUAs rushed to the bond market to issue bearer bonds. A bearer bond is a bond which is payable to the bearer (i.e., holder of the bond). Today, in order for LUAs to retain their federal tax-exempt status, their bond issues must be issued in registered form rather than bearer form.

LUA borrowers may satisfy this registration requirement either through the issuance of registered certificates in the purchaser's name or through a book-entry system consistent with federal regulations prescribed by the Secretary of the U.S. Treasury. Under the first option, an obligation is in registered form if its ultimate ownership is registered as to both principal and interest and if a transfer between owners is effected by the surrender of the old certificate, updating of the record or registry of owners, and issuance of a new certificate to the new owner by either the issuer or its agent. Under the book-entry approach, the requirement is satisfied if ownership of the obligation is transferable only through entries made on the books maintained by the LUA, its agent, or an entity holding a security in nominee or "street" name for an investor, which provides for the determination of the ultimate beneficial owner. Registration affords protection against payment being made to unauthorized holders of such

bonds, as the owner's name actually is placed on the bond itself.

TEFRA provides only three exemptions to the registration requirement: 1) securities with maturities of one year or less from the issue date; 2) securities that are "not of a type offered to the public;" and 3) securities that fit within a particular category of bonds sold only to foreign investors and payable outside of the United States. Generally, only the first two exemptions are applicable to LUA obligations.

GEORGIA LAW RELATING TO DEBT

Georgia LUAs have the authority to contract or incur indebtedness only as authorized by the Georgia Constitution and other applicable laws. Before borrowing, a LUA should know the limits on its power to issue debt, as well as the types of borrowing not subject to debt limitations.

Short-Term Debt Limitations

Article IX, Section V, Paragraph V of the Georgia Constitution authorizes an LUA to issue short-term debt in the form of short-term tax anticipation notes (TANs) to pay operating costs. The conditions for such temporary loans include the following. In addition, the article sets forth the following procedures and conditions for short-term debt.

- **The amount of debt may not exceed 75% of the total gross income from property taxes the LUA collected in the preceding year.**
- **Such loans are payable on or before December 31 of the calendar year in which they are made.**
- **No such loans may be obtained when there is a loan outstanding which was obtained in any prior year.**
- **The amount of the indebtedness in any one calendar year may not exceed the total anticipated revenue in that calendar year.**

Long-Term Debt Limitations

Article IX, Section V, Paragraph I of the Constitution of the State of Georgia provides:

> **The debt incurred by any Georgia county, municipality, or other political subdivision of this state, including debt incurred on behalf of any special district, shall never exceed 10 percent of the assessed value of all taxable property within such county, municipality, or political subdivision.**
>
> **The exception to this rule is any LUAs which are authorized by law on June 30, 1983, to incur debt in excess of 10 percent of the assessed value of all taxable property therein**

shall continue to be authorized to incur such debt.

This amount of general obligation (GO) debt is classified as an LUA's legal debt margin. As indicated above, generally the amount of debt is limited to 10% of the assessed valuation.

Georgia law requires that counties assess taxable property at 40% of its market value. A sample computation of a legal debt margin follows:

Assessed value of taxable property	**$1,106,625,969**
Debt Limit - 10% of assessed value	**$ 110,662,597**
Less general obligation bonds outstanding	**22,435,000**
Remaining legal debt margin	**$ 88,227,597**

This article also indicates:

> **No such county, municipality, or other political subdivision shall incur any new debt without the assent of a majority of the qualified voters of such county, municipality, or political subdivision voting in an election held for that purpose as provided by law.**

Temporary loans (i.e., short-term debt) are not subject to the legal debt margin. In addition, not included in an LUA's 10% limitation is indebtedness of the county, any cities within the boundaries of the LUA and any public authorities.

The Constitution does not set forth specific projects which an LUA may finance with general obligation bonds, and consequently they may issue these bonds for any projects for which an LUA can expend public funds. Normally, LUAs use this method to construct school buildings.

Article IX, Section V, Paragraph VI of the Constitution provides that before incurring bonded indebtedness the LUA must provide for the assessment and levy of an annual tax sufficient to pay the principal of and interest on the debt within 30 years from incurring the bonded indebtedness. The proceeds of the tax, together with any other monies held for paying the bonds, must be held in a sinking fund (i.e., a debt service fund) to be used exclusively for paying the principal of, and interest on, the bonds.

LUA Leasing

Over the years lease agreements have presented problems for LUAs. While rental agreements or leases themselves generally are not considered to constitute debts which violate the debt limitations placed upon LUAs by the Constitution, the contract can exceed the allowable provisions under which one school board may bind subsequent school boards in legislative matters (pursuant to O.C.G.A. Section 20-2-506). Also, lease purchase agreements, when construed to be nothing more than installment sales contracts, can be interpreted by the courts to impose upon the LUA an unauthorized debt. Therefore, during the 1990 session the General Assembly added a new provision to the law, O.C.G.A. Section 20-2-506, which alleviates some of the problems associated with leases by LUAs. This act authorizes LUAs to enter into multi-year agreements, including lease agreements and lease purchase agreements, for the acquisition of goods, materials, real and personal property, services and supplies, provided that such agreements contain provisions which:

- **require an annual renewal;**
- **may provide for automatic renewal unless positive action is taken by the LUA to terminate such contract;**
- **state the total obligation for each year that the contract is subject to renewal;**
- **provide for the automatic termination of the agreement upon the failure of the school board to appropriate funds for its renewal (i.e., a fiscal funding clause in the contract);**
- **prohibit an LUA from entering a lease purchase agreement for any project that was rejected by the voters within the past four calendar years.**

GSBA Lease Purchase Financing Program. The Georgia School Board Association (GSBA) created a lease program to give LUAs the same advantages businesses enjoy with lease-purchase financing. Through the program, LUAs can acquire essential capital equipment and facilities through renewable lease-purchase agreements. Then GSBA will sell certificates of participation (COPs) to investors through a public offering.

The funds generated from the sale of the COPs are deposited with a trustee bank who is assigned the responsibility of disbursing funds to acquire equipment or construct facilities as defined by lease purchase contracts between the GSBA and participating LUAs. The LUAs then make payments to the trustee. These payments are used to make the principal and interest payments on the COPs.

Title is held by GSBA for the term of the lease, when the equipment or facilities are transferred to LUA ownership. LUAs are cautioned that property acquired by lease cannot be improved until title has passed. Interest to be paid on the COPs is built into the lease payments. The lease(s) are subject to annual appropriation and may be terminated by the

LUA at the end of each calendar year. If the appropriation is not made and the lease is terminated the trustee takes possession of the equipment and/or facility, or the participant has the option to prepay the principal balance due.

There are several cost advantages to a lease purchase financing versus other methods currently available to counties.

- **The fixed rate lease locks in fixed attractive tax exempt interest rates for the useful life of the equipment purchased or facility constructed.**

- **Smaller financings of under $1.0 million which normally cannot support the financing cost of a bond issue, are able to benefit from the economies of scale and take advantage of lower tax-exempt rates available from a publicly offered bond issue.**

- **GSBA, as program sponsor, has obtained a special not-for-profit tax status with the Internal Revenue Service for the benefit of its participating members and thus provides participants with large and small capital needs equal access to an efficient lease purchase financing mechanism.**

DEBT FINANCIAL POLICIES

The LUA school board should adopt financial policies relating to debt. Debt policies allow a school board to view their present approach to debt administration from an overall, long-range vantage point. Debt policies for all school boards need not be the same. Debt policies should address issues such as wealth, conservatism, need, and past practices of the LUA.

As a school board both adopts and applies a debt policy, with its environment and purpose in mind, the following factors should be considered:

- **Legal constraints on capacity and financing alternatives.**

- **The urgency of needs and economic cost of delay.**

- **Willingness and financial ability of the community to pay for such improvements.**

- **Proper balance between internal and external financing.**

- **Determination as to whether current or future residents should pay for specific additions or improvements.**

- **Current interest rates and other market considerations.**

- **The impact on the reliability and integrity of vital systems.**

- **Availabilities of other resources and the alternative uses of those resources.**

- **The financial return on the investment.**

- **The financial condition of the LUA and local control over revenues and expenditures, and their stability.**

- **The nature of the projects to be financed - planned programmatic or non-recurring improvements.**

- **The role and function of LUA served by the expenditure.**

Primary debt policies relate to when to issue debt, the type of debt to be issued and how much debt will be issued.

When to Issue Debt?

When should an LUA borrow money? Obviously the first answer is, "when the LUA needs it." For example, because of the Georgia tax calendar many LUAs do not receive their property taxes until a major portion of their fiscal year has passed. In order to solve short-term cash flow problems, basically there are two alternatives available. Should LUAs borrow by issuing short-term debt (e.g., TANs) or should LUAs accumulate an adequate fund balance to cover their cash flow problems until property taxes are received? The following sample debt policy addresses this issue:

> **"The LUA will limit its short-term borrowing to cover cash flow shortages through the issuance of tax anticipation notes."**

In addition, many LUAs just do not have the available cash necessary to purchase costly equipment or make major building additions or renovations. For these LUAs the only alternatives available are issuing general obligation bonds or entering into capital leases.

Some LUAs view the issuance of long-term debt as a mechanism to equalize the costs of buildings and improvements (i.e., long-lived assets) between present and future constituencies. Long-term debt only might be issued when a significantly large proportion (e.g., 75%) of the LUA's taxpayers, citizens and/or students should benefit from projects financed or when it can be determined that future citizens will receive a benefit from the capital improvement financed with long-term debt. It can be argued that the beneficiaries from capital expenditures should pay for them. Since the beneficiaries are likely to be users who benefit from the services long after the initial investment, deferment of payment by the use of long-term debt can be considered appropriate. In other words, if the asset will last 20 years, the financing might occur over 20 years, resulting in the cost being spread over the projected useful life of the asset.

A sample policy relating to long-term debt follows:

> **"The issuance of long-term debt is limited to capital improvements or projects that cannot be financed from current resources. For purposes of this policy, current resources are defined as that portion of fund balance in excess of the required reserves. Every effort will be made to limit the payback period of the bonds to the estimated useful life of the capital projects or improvements."**

What Type of Debt is Issued?

LUAs have very little flexibility regarding the type of debt that they might issue. As indicated earlier in this chapter, bonds can be classified either as general obligation or as revenue. LUAs generally only issue general obligation bonds because specific revenues are required to support the retirement of revenue bonds.

When an LUA is purchasing equipment and wishes to finance this purchase, the only feasible option is through a capital lease as explained above. Sometimes when a new building is constructed through the sale of general obligation bonds, the required equipment also is included in the bond issue.

Another policy might address the issue of when to use capital leases rather than outright purchases. For example,

> **"Capital leases are used to finance equipment purchases anytime the cost of the equipment purchases exceeds 12% of the general fund budget."**

How Much Debt is Issued?

As indicated earlier in this chapter, the amount of general obligation debt is limited by Georgia Statutes to 10% of the assessed taxable property of the issuing LUA. However, some school boards adopt debt policies which include other types of more restrictive limitations. For example, a school board may chose to limit the debt to a percentage less than the legal limit (e.g., 9%). A policy might limit the amount of an LUA's debt to a certain percentage of assessed value for their debt including any overlapping debt (i.e., debt issued by other LUAs which geographically overlap the issuing LUA). Additional debt policies could be developed relating to the amount of:

- **non-enterprise revenues**
- **debt per capita (e.g., general obligation debt shall not exceed $500 per capita)**
- **debt as a percentage of expenditures (e.g., debt not to exceed 10% of total general LUA expenditures)**

Another policy might require the LUA to make a down payment of at least a certain percentage (e.g., 10%) of the project costs from current revenues.

Other Debt Related Policies

There are various other types of policies that an LUA might consider relating to debt. For example:

- **The LUA will maintain good communications with bond rating agencies and will try to improve or maintain its current level bond rating annually.**

- **The LUA will try to keep the average maturity of general obligation bonds at or below a certain number of years.**

- **An LUA could maintain a debt service fund which is equivalent to the amount of general obligation debt maturing in the subsequent year.**

- **Annual budget appropriations shall include debt service payments and reserve requirements for all debt currently outstanding.**

- **Long-term borrowing should be incorporated into the LUA's capital improvement plan.**

BOND RATINGS

When an LUA is planning to sell a large amount of general obligation bonds, the LUA will request a rating on the creditworthiness of the securities to be issued. Bond ratings are evaluations of credit quality of an issuer with respect to a particular debt obligation (e.g., a bond). The ratings measure the probability of the timely repayment of principal and interest on LUA's bonds. Ultimately, the repayment of debt depends on both the LUA's <u>ability</u> and <u>willingness</u> to make repayment. To judge ability to pay, what really is measured is the degree of control that the LUA can exert to call forth and manage its resources so that its obligations can be met in full when due.

Through the assignment of a letter grade by a bond rating agency, a rating is intended to measure the probability of timely repayment of principal and interest on an LUA bond. The bond rating is not a recommendation to purchase, sell, or hold a particular security, as it does not comment on the array of other factors, such as market price and the personal risk preference of the investor, that go into the investment decision-making process. The rating performs the function of a credit risk evaluation.

The major focus of the rating process is the determination of relative degrees of control or measurement of ability to pay. The other component of credit analysis, the one that is less

easily measured, is willingness to pay. Bond rating agencies look upon tax and expenditure limitation initiatives, voter rejection of millage increases and bond issues, or the unwillingness of LUA officials to make the often difficult decisions to assure budgets balance as symptoms of a possible unwillingness to pay. It is important to note, however, that no one single factor in the bond rating process can be considered as most important.

Bond Rating Agencies

Moody's Investors Services, Standard & Poor's Corporation and Fitch Investors Service are the principal rating agencies for LUA debt. For a fee, each of the agencies provides ratings of the bonds being offered for sale based on information supplied with the issue supplemented by their own research.

Cost of Bond Ratings

The cost of bond ratings varies but the cost has a direct relationship to the size of the bond issue. In 2007, the estimated cost of bond ratings for long term fixed rate bonds based on the Moody's rating agency standard fees follows:

Size of General Bond Issue	Estimated Cost (Moody's)
Less that $1 million	$4,375
$1 million to $9.9 million	$5,300 –$ 8,275
$10 million to $19.9 million	$9,500-$10,600
$20 million to $34.9 million	$12,500-$14,150
$35 million to $54.9 million	$15,750-$17,550
$55 million to $74.9 million	$19,500-$21,250
$75 million to $99.9 million	$24,150-$28,350
Over $100 million	3.25 basis points to a maximum of $85,000

Bond Rating Factors

Generally there are four factors that agencies consider in the rating of bonds:

- **ECONOMIC**
- **DEBT**
- **FINANCIAL**
- **ADMINISTRATIVE**

Economic Factors. The economy is probably the least controllable and often the most difficult factor to predict in LUA credit analysis. Local performance during recent recessionary and inflationary periods has emphasized how little any community can do to offset the effects of national economic trends.

U.S. Census statistics of population and housing characteristics and various measures of employment, unemployment and economic production provide a profile of the community's economy and the well being of its residents. Bond analysts also are interested in what the management of an LUA can do to encourage economic activity (e.g., providing a quality educational program).

Economic downturns also are reflected in higher property tax delinquencies and increasing accounts receivable. Many LUAs have shown particular sensitivity to interest rate movements either because of reduced investment earnings when rates fall or because of reduced private investment when rates rise.

Debt Factors. Control of debt position is particularly critical to any kind of credit analysis. Honoring the promise to repay and the fulfillment of all legal covenants with bondholders are the ultimate tests of an LUA's ability and willingness to pay. Legal security and other bondholders' protection provide the foundation and remain central components of debt analysis.

The economic feasibility and necessity of the project being financed must be determined. When public indebtedness becomes too burdensome, an inability or unwillingness to pay may follow (i.e., the determination of debt burden).

Capital planning for future debt is a positive consideration (see Chapter IV-3 for a discussion of capital improvement programs). Both direct overlapping and underlying debt are considered in the credit rating. Direct debt is that issued by the LUA requesting the rating. Overlapping debt is that issued by a county which overlaps (i.e., the geographic boundaries of the county overlap the geographic boundaries of a second LUA) the rated LUA (e.g., a city). Underlying debt is that issued by a city which is overlapped by a county LUA.

Financial Factors. Annual operating financial performance and resultant year-end position are the ultimate measures of management's control. The balancing of an LUA's budget is a very positive step in improving the LUA's bond rating. If annual revenues exceed annual expenditures and sufficient financial resources have been accumulated to meet unforeseen contingencies and normal liquidity requirements, the financial results are deemed satisfactory.

The level of fund balance related to annual budgets is an important comparison (Chapter IV-2 discusses the amount of fund balance an LUA might maintain). The investment of idle cash is a good measure of prudent management. Bond raters review transfers between funds cautiously.

Administrative/Governmental Factors. To be able to evaluate the ability of an LUA to control

financial conditions, it is particularly important to understand the scope and powers of the LUA's administration. How the LUA is organized and what the relationship is between the school board and the LUA's superintendent are important credit analysis considerations. What service is the LUA responsible for? Answers to each of these questions are addressed by bond raters.

Intergovernmental relationships become important considerations when provisions for services to a common group of taxpayers are shared (e.g., a joint venture between the LUA and a city and a county).

Bond Insurance

Sometimes an LUA's bonds are insured, which allows them to receive AAA ratings from Moody's and Standard & Poor's. The Municipal Bond Investors Assurance Corporation ("MBIA"), Financial Guaranty Insurance Company ("FGIC") and AMBAC Financial Group ("AMBAC") each irrevocably and unconditionally guarantee payment of principal and interest on qualified new issues of municipal bonds.

A municipal bond insurance policy is a non-cancelable guarantee designed to protect the bondholder from nonpayment on the part of the issuer. In the event an LUA fails to meet a scheduled principal or interest payment, the insurer, acting as a third-party guarantor, will make that debt service payment to the holder on time and in full. The insurer has received an "up front" premium from the LUA for the guarantee, the amount of which is determined primarily by the perceived risk associated with the financing. Unfortunately, those LUAs that need the insurance the most can't buy coverage or the premium is prohibitive.

It is important to remember that in each instance the LUA is the first source of payment of principal and interest, and that the underlying credit characteristics of the issuer remain very important in terms of the market's acceptance of the debt which can vary considerably. For this reason, all insured bonds do not provide identical rates of return. Purchasers are willing to accept a lower yield in return for the reduction in risk provided by the insurance. However, there have been many instances where insured bonds have traded at higher or lower yields for similar maturities, which primarily reflect the relative importance of the fundamental credit quality of the issuer.

A much more informal way of securing bond insurance is authorized by O.C.G.A. 20-2-480. School districts may request that the GA DOE withhold sufficient funds from any appropriation entitled to the school district and apply the funds to the principal and interest payments due on the bonds for that fiscal year.

Applying for a Credit Rating

The first step in the rating process is for an LUA to submit an application to a rating agency. The type and level of documentation that is required to be submitted to the rating agency will vary depending on whether the issue is general obligation or revenue supported debt and

whether the issue will require a third-party credit facility. Both Moody's and S&P have specific requirements for each type of obligation. For general obligation securities, the following represents the minimum level of information required:

- current official statement;

- annual financial reports for past three years;

- current year's budget;

- five-year proposed capital improvement program (see Chapter IV-5);

- assessed valuation data for last 5-10 years;

- description of area economy, population, and land area;

- current debt statement including overlapping debt and LUA's share;

- 10 largest employers and taxpayers; and

- a draft of the legal opinion.

The rating process will be facilitated by presenting the most current information well in advance of the actual presentation. Required documentation should be submitted at least one week in advance of a rating meeting and three weeks prior to the scheduled date of sale.

Rating Agency Presentation

The final step is the actual rating agency presentation. The LUA should take care in selecting the person who will participate in the meeting, including the financial advisor. All persons attending should assume an active role in the presentation. The number of participants will be dictated in part by the complexity of the issue, but generally should be no more than six persons. The presentation itself, exclusive of time for questions, should take about one hour. If the meeting goes beyond 75 minutes, it should be because the rating analysts have a number of questions.

Some general guidelines often suggested by financial advisors in preparation for a rating agency presentation include the following:

- **It is important that the formal presentation flow logically from one area to the next. To the extent possible the participants should adhere to the agreed-upon outline, straying only when the rating agency personnel ask questions that lead into other matters.**

- **There should be full disclosure of the LUA's present debt, financial,**

economic, and management conditions. There must be a complete explanation of the bad and the good. In many ways it is advantageous to demonstrate an awareness of difficulties that exist, particularly if something is being done to correct them. In short, stress the positive and emphasize the actions being taken to improve any conditions that are less than desirable.

- **Don't dwell on statutory provisions (i.e., tax and debt limitations) that are well-known to the analysts, who are assigned by region or function and are well-versed in the legal issues. What they are looking for is information on how the various tax and debt limitation measures have impacted the community and what has been done about it.**

- **Avoid "Chamber of Commerce" language. The analyst's charge is to provide an independent appraisal of the credit quality of the municipality, and value judgments and unsubstantial opinions play no role in the evaluation. Try to stay as close as possible to quantifiable data.**

- **Avoid criticisms of elected officials or the "political" process.**

- **Describe any changes in management practices that have resulted in savings or more efficient operation. These are very positive and tend to stick in the analyst's mind.**

- **Avoid comments about other jurisdictions (i.e., federal, state, or local) unless it is to comment on a favorable development. Don't suggest that County X is a better credit than County Y or Z.**

- **Avoid statements of political position (especially about unrelated or controversial topics) and be aware that the most innocent comment can be misinterpreted. For example, avoid passing judgment on any proposed changes to the federal tax code, even if these changes adversely affect the municipal bond market. Discuss these changes in passing and with some statement of concern, but don't question the motives of Congress.**

- **Don't try to provide details to support an answer without being certain of the information. It is much better to simply express an opinion and offer to provide additional detail by mail. In such cases, no answer is better than the wrong answer (one has to assume that the analyst eventually will discover the right answer).**

- **Try to relax as much as possible. Too often a rating presentation is impaired because the LUA officials are nervous and it is evident to the**

rating analysts. With the financial advisor beside him or her, LUA officials can feel more relaxed and the information will sound more credible.

In summary, issuers should use a structured approach to applying for a bond rating and participating in a rating presentation.

OFFICIAL STATEMENTS

LUAs issue official statements to provide potential investors (i.e., the bond buyer) with information about the LUA. In most instances, LUAs provide such information to potential investors through securities dealers and dealer banks that purchase securities for reoffering. There are no specific requirements about the type of data that an LUA might include in its official statement. The overriding consideration is to provide a complete, accurate and objective description of those factors relating to the securities being offered that are necessary to make an informed investment decision.

LUAs may present the data in any order; however, many official statements use the following format for inclusion of information:

- **Cover page**
- **Summary of the official statement**
- **Securities being offered**
- **Description of issuer and enterprise**
- **Debt structure**
- **Financial information**
- **Legal matters**
- **Miscellaneous**

As part of a request for proposal, some LUAs include an official bid form as the last item attached to the official statements.

BOND SALE PROCESS

Sound debt management may encompass the following seven broad steps when issuing debt:

- **Structure Debt**

- **Secure Specialists**
- **Obtain Public Support**
- **Design Bond Issue's Features**
- **Market Bonds**
- **Administer Debt**

Structure Debt

An LUA should conduct a thorough assessment of each proposed debt issue before actually selling bonds. Long-term debt should be incurred only to purchase items with extended life spans. Also, an LUA should make a thorough assessment of the purposes to which the bond or debt proceeds will be applied to be sure that the benefits are worth the cost (i.e., the debt service payments in future years).

A preferred way to issue debt in a controlled atmosphere is to relate the debt to an LUA's capital improvement program (CIP). A CIP is a multi-year planning instrument used by LUAs to coordinate financing and timing improvements in a way that maximizes the return to the public. Normally, a CIP will include the funding plan for each capital project. Chapter IV-3 discusses the CIP process in detail.

LUAs should analyze all the possible ways the approved items can be financed and arrive at the financing scheme which is the most desirable for the LUA. Consider each of the following alternatives to fund the costs:

1. **Current nonrestricted revenues (e.g., property taxes; i.e., pay-as-you-go).**
2. **Dedicated tax revenues (e.g., local option special purpose sales tax).**
3. **Federal and state grants.**
4. **General obligation bonds.**
5. **Capital leases.**

Once a decision is made to sell bonds, determine whether it will be more advantageous for the LUA to sell bonds publicly or to arrange a private sale. Many states require LUAs to advertise publicly the sale of bonds. However Georgia has no such requirement. Bonds may be sold privately through a negotiated or non-public sale. In making this decision, consider several factors.

The size of the issue has a direct bearing on the competitive market. Small issues do not fare

well in the competitive market and cost more per borrowed dollar. If an LUA has a high bond rating and previously sold bonds in the public market, usually it is advantageous to sell the bonds publicly. For comparison purposes, an underwriter can estimate the rate of interest the issuing LUA would have to pay, for both public and private sales.

Secure Specialists

The next step is to engage the services of consulting specialists who normally include an architect and a consulting engineer, financial advisor, bond counsel and registrar/transfer agent. A local attorney, an independent certified public accountant and paying agent can provide other services helpful to the issuance of debt. Each of these consultants can play an important role in the process of issuing and administering debt.

Architect and Consulting Engineer. Both an architect and a consulting engineer is helpful in determining the costs of proposed projects included in an LUA's CIP. Once an LUA decides to proceed with a construction project, these consultants might conduct a feasibility study, complete an engineering design and assist with construction coordination.

Financial Advisor. An important participant in the debt administration process is the financial advisor who can provide a variety of services. A financial advisor should have a thorough knowledge of:

- **Georgia LUA laws and practices.**
- **Investor preferences and prejudices.**
- **How to secure a high bond rating.**
- **Workings of the bond and money markets.**

The services provided by a financial advisor include the following:

- **Survey LUA's debt structure and financial resources to determine borrowing capacity for current and future capital financing requirements.**
- **Gathers all pertinent financial statistics and economic data, such as debt requirement schedule, tax rates, and overlapping debt that would affect or reflect on the issuer's ability and willingness to repay its general obligation bonds.**
- **Advises on the time and method of marketing terms of bond issue (including maturity schedule), interest payment dates, and call features.**
- **Prepares, in cooperation with bond counsel, an official statement, notice of sale, and bid form and distributes them to all prospective underwriters and**

investors.

- **Evaluates the benefits of obtaining one or more credit ratings and contacts the rating services to be sure that they have all the information and data required to evaluate properly the LUA's credit worthiness.**

- **Is present at the sealed bid opening and stands ready to advise on acceptability of bids.**

- **Helps coordinate the printing, signing, and delivery of the bonds.**

- **Reviews bidding procedures for competitive sales and the securing of an appropriate underwriter for negotiated sales.**

LUAs can obtain financial advisory services from three types of firms: investment bankers, commercial banks, and independent consultants. Investment bankers and commercial banks normally provide advisory services as part of their business, often one that is ancillary to the marketing of securities or to making loans. Independent advisors, on the other hand, generally only sell their professional services and do not underwrite municipal bonds.

Bond Counsel. **The bond counsel's principal responsibility is to act as the legal advisor to the investor in the securities by ensuring the legality of the issue. Some of the services provided by bond council include the following:**

- **Determines whether the legal authority for the issuance of the bonds is consistent with constitutional requirements and limitations.**

- **Ensures that the statutory or charter authority for the issuance of the bonds is consistent with constitutional requirements and limitations.**

- **Prepares the legal documents for the issuance of the bonds, including the legal instruments necessary to authorize the issuance of the bonds and to describe the bonds and their security.**

- **Ensures that the bonds are within the applicable debt limitations (i.e., the legal debt margin).**

- **Ensures that any applicable tax limitation as to rate or amount is observed.**

- **Ensures that any required elections (i.e., bond referendums) regarding the bonds are called and held in conformity with the law.**

- **Reviews the official statement to make certain that the legal information is correct and that no material information has been omitted.**

- **Examines the proceedings of the authorizing body (e.g., the city council or county commission) providing for the sale of the bonds to be sure that the bonds will be sold legally.**

- **Ensures a proper advertisement of a competitive sale or that the selection of an underwriter in a negotiated sale is proper.**

- **Determines whether the bid accepted is legally acceptable in a competitive sale.**

- **Answers inquiries from rating services, investors, underwriter's trustee, paying agents and others before the delivery of the bonds.**

- **Prepares an unqualified opinion about the tax-exempt status of bonds.**

If bonds are to be marketed nationally, normally the bond counsel should be "nationally recognized." It is important to consider selecting a nationally recognized firm because its reputation often will affect the purchase price favorably.

Registrar/Transfer Agents. Major banks, local banks and trust companies offer registrar/ transfer agent services. The Securities and Exchange Commission registers some of these banks. Generally, registrar/transfer agents perform the following functions:

- **Prepare the initial set of bonds for delivery to the underwriter, based upon instructions from the underwriter.**

- **Formulate and maintain an accurate list of the registered owners or their nominees.**

- **Carry out transfers and updating the ownership records.**

- **Prevent the issuance of more bonds than are authorized.**

- **Maintain in safekeeping a supply of blank certificates to allow for secondary market trading.**

- **Issue new certificates for those that have been reported as stolen, lost, or destroyed, upon receipt of the appropriate indemnity bond.**

- **Issue new certificates in exchange for, and upon surrender of, mutilated certificates.**

- **Conduct a bond lottery to redeem called bonds.**

- **Administer a program of storage or destruction of canceled certificates.**

Local Legal Counsel. Sometimes an LUA selling bonds will contract with a local attorney to serve as the liaison with the bond council, assuming the bond counsel is from a different geographic region.

Independent Certified Public Accountant. Most LUAs include in their official statements portions of their audited financial statements. It is suggested that an LUA issuing official statements ask its independent auditors to review any included financial information to be sure that it is correct and that it is not taken out of context. If the auditor's report is included, it will have to be changed to reflect the financial data presented.

Paying Agent. After an LUA issues its debt, a bank or trust company is chosen as the paying agent for the government. The registrar/transfer agent usually also serves as the paying agent. Generally the paying agent performs the following functions for registered government securities:

- **Prepare a schedule for standard record dates to identify the registered owners who will receive interest payments on the payable date.**

- **Establish a procedure for receiving notification of the names and addresses of registered owners from the registrar/transfer agent. This step is eliminated if the registrar/transfer agent and the paying agent are the same organization.**

- **Disburse interest payments by check to the registered owners as of the record date upon receipt of sufficient resources from the government. Normally the government is required to submit their payment to the paying agent approximately five days before the due date.**

- **Make payment by check for principal at maturity or call upon the surrendering of the certificate and provision of satisfactory documentation of ownership.**

- **Retain up-to-date records of all interest and principal payments made, including year-to-date totals of both the entire issue and the individual security holders accounts, a list of all registered owners and the extent of their holdings, check numbers amount of check for each holder.**

- **Provide the LUA with periodic reports regarding the amount of principal and interest payments.**

Obtaining Public Support

If general obligation bonds are to be sold, the public support for the bonds must be obtained (i.e., a bond referendum must be held). A campaign to inform voters and develop support for the bond issue is of major concern. An effort must be made to gain voter support for the projects and facilities which the bond issue will support. Also, improving voter understanding

of the financial features and implications of the debt over its lifetime is important. Some of the tasks required to gain public support include the following:

- Survey community to determine voter opinion about the bond issue.
- Enlist support of civic groups to assist with marketing the bond issue to the public.
- Time the bond election carefully to be sure that this is the only bond election on the ballot which reduces confusion for the voter. However, a separate bond election usually is more costly than holding the election at the same time as a previously scheduled election (e.g., a national election).
- Form a bond issue committee which includes a cross section of community interests to assist with the bond campaign.
- Prepare promotion material which highlights the need for the issue and focuses on reservations which voters may have. Note that LUA resources may not be used to finance the preparation of these materials.
- Hold public meetings to take the issue to the community.
- Use the media to explain the need for the bond issue.
- Use door-to-door committees to answer questions about the issue and urge its approval.
- Review election requirements through bond counsel.

Design Bond's Features

An important service that the fiscal advisor provides is helping the LUA design the features of the bond issue. Consideration must be given to:

1. The maturity schedule (i.e., the schedule on which the bonds will be repaid).
2. Bond denominations (i.e., the face amount of the bond certificates).
3. Coupon rates (i.e., the interest rates specified on the interest coupons).
4. The call privilege (i.e., the right of the LUA to redeem the bonds before maturity for principal and accrued interest payable).

Maturity Schedule. Determining the schedule for repayment of principal and interest is a very

important task when selling bonds. With term bonds, the bond principal is not due until maturity. With serial bonds, three types of designs are common for repayment:

1. **<u>Downward Trend in Annual Payments</u> - An LUA makes equal payments of principal annually which results in reduced interest payments as the issue is retired resulting in the total annual payment declining, permitting room (i.e., legal debt margin) for new borrowings.**

2. **<u>Equal Payment Amounts</u> - The annual principal and interest payments are about equal over the life of the issue. The use of this feature occurs when prior debt is outstanding. When the prior debt has matured, there will be an opportunity for issuing new debt.**

3. **<u>Irregular Annual Payments</u> - Annual payments can vary from high payments either at the beginning or end of the issue or any other possible combination.**

LUAs should consider two major factors when deciding about the maturity schedule:

- **The LUA's future borrowing needs as defined in the CIP.**

- **The coordination of the existing maturity schedule with a prior outstanding schedule to provides flexibility to bond when needed.**

Bond Denominations. The denomination is the face amount or par value of a bond which the issuer promises to pay on the bond's maturity date. Now, almost all bonds are sold in $5,000 denominations.

Coupon Rate. Since most bonds now are registered, a bond holder need not clip and submit coupons to redeem their interest payment. However with registered bonds, the coupon rate is the rate payable automatically from the paying agent to the bond holder. Coupon rates can vary for each maturity.

Normally coupon rates are higher for bonds maturing in the long-term since investors perceive that LUAs will face more fiscal uncertainty in the long run than in the short run.

The Call Privilege. A callable bond permits the LUA to pay the obligation before the maturity date by giving notice of redemption as specified in the bond contract. The use of a call option enables the LUA to achieve one or more of the following objectives:

1. **Voluntary reduction of outstanding debt.**

2. **Refunding the debt (we discuss bond refunding in Chapter I-16) resulting in interest savings.**

3. **Reorganizing the debt repayment schedule.**

Generally a "call option" can increase interest costs because of reduced investor demand.

Marketing Bonds

Public marketing of bonds includes the following tasks:

1. **Prepare the documents needed to sell the bond issue.**

2. **Obtain a bond rating from a major bond rating agency.**

3. **Choose the date for selling the bonds.**

4. **Advertise the bonds and accept bids.**

5. **Award the bids, then print and deliver the bonds.**

6. **Close the bonds, including final tabulation of bond amounts and the issuance of debt records.**

Prepare Bond Sale Documents. The first step in planning a bond sale is to prepare a calendar of each step necessary to market the bonds. The dates by which each subsequent task in the marketing process will be accomplished should be stated specifically.

As discussed earlier, an official statement should be prepared which includes the terms by which the bonds will be offered. If the bonds are to be sold publicly, an official bid form must be prepared. The primary item included is the place for the bidder to include the interest rates for each bond maturity. Usually the bid form requests prospective bidders to submit a good faith deposit (i.e., a bid deposit check) in a predetermined amount. Space for the determination of a bond premium or discount also might be included. Finally the bid form requires the bidder to indicate the effective interest rate (i.e., the rate adjusted for premiums or discounts).

Underwriting. Often, bond issues are too large to be bought by a single investor and the LUA cannot effectively handle marketing of the issue to large numbers of individual investors. Thus, bonds typically are sold to an underwriter, a firm which purchases the entire issue. The LUA receives the proceeds of the entire issue quickly, without having to worry about marketing. The underwriter hopes to resell them at a profit to investors.

Administer Debt

The final step after the bonds are sold is to administer the outstanding debt. Special detailed records on the debt must be established and maintained. The accounting records must be established and maintained (e.g., debt service funds). Since most bonds are registered, the LUA's primary responsibility is to submit checks as required to the paying agent for payment

of principal and interest.

REFUNDING DEBT

The refunding of debt is the substitution of one set of credit market instruments for another. In LUAs, the refunding of debt can occur frequently. Technically, a bond refunding can occur only when the bonds are callable bonds (i.e., the LUA can call in the bonds for retirement). However in practice, a new type of refunding became popular during the 1970's known as an advance refunding. In an advance refunding transaction, an LUA issues new debt (i.e., the refunding debt) to provide monies to pay interest on the old outstanding debt (i.e., the refunded debt) as it becomes due, and to pay the principal on the old debt either as it matures or at an earlier call date. The LUA issues the new debt and deposits the debt proceeds with an escrow agent in a trust. The escrow agent for the trust uses these proceeds solely for satisfying scheduled payments of both interest and principal of the refunded debt.

Most advance refundings result in what is called "defeasance of debt." We can classify defeasance of debt into two categories, legal and in-substance, in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 76, <u>Extinguishment of Debt</u>. SFAS No. 76 defines legal defeasance as when:

1. **The LUA pays the creditor and is relieved of all its obligations with respect to the debt (i.e., the refunded debt). This includes the LUA's reacquisition of its outstanding debt securities in the public securities markets, regardless of whether the securities are canceled or held.**

2. **The LUA is released legally from being the primary obligor under the debt either judicially or by the creditor and it is probable that the LUA will not be required to make future payments with respect to that debt under any guarantees.**

An in-substance defeasance occurs if the LUA irrevocably places cash or other assets with an escrow agent in a trust to be used solely for satisfying scheduled payments for <u>both</u> principal and interest of a specific obligation (i.e., the refunded debt). With an in-substance defeasance, the likelihood that the LUA will be required to make future payments also has been determined to be remote.

The LUA should restrict the trust to only monetary assets that are essential risk-free in regard to the following items:

1) **Amount.**

2) **Timing.**

3) **Collection of principal and interest.**

The monetary assets should be denominated in the currency in which the debt is payable (e.g., refunded bonds originally sold in the Japanese market). For debt denominated in U.S. dollars, which is most common, essentially risk-free debt monetary assets are limited to:

1. **Direct obligations to the U.S. Government, including state and local government securities (SLGS).**

2. **Obligations guaranteed by the U.S. Government.**

3. **Securities backed by U.S. obligations.**

The monetary assets also must provide cash flows (i.e., investment maturities and interest earnings) that approximately coincide, as to timing and amount, with the scheduled interest and principal payments of the refunded debt. If the monetary assets are callable, they may not be classified as qualifying assets.

The escrow agent invests the proceeds of the new debt (i.e., the refunding debt) in Federal securities in an amount sufficient to pay the principal and interest on the old debt (i.e., the refunded debt).

Reasons For Advance Refundings

The most common reasons for an advance bond refunding include:

1. **Taking advantage of a lower interest rate for the new debt than of the old debt. For example, in the late 1970's and early 1980's LUAs were issuing debt at interest rates in excess of 10%. However, in the late 1980's, the rates came down and many LUAs refunded their outstanding debt at lower interest rates.**

2. **Restructure amortization schedule. For example, the financial position of some LUAs is such that they cannot repay their debt as required, therefore, they restructure their repayment schedule (i.e., they usually extend their repayment schedule) to better meet their financial needs.**

3. **Remove restrictive bond indenture requirements. For example, as a result of their bond indenture requirements, some governments are limited in the types of investments they may purchase (e.g., they may be limited to savings accounts). Therefore, they will refund their debt to change their bond indenture to allow for more latitude in investing.**

Accounting and financial reporting for bond refundings is presented in Chapter I-16 and the required note disclosures is included in the Audit Report.

TAX REFORM ACT OF 1986

The Tax Reform Act of 1986, which adopted the new Internal Revenue Code of 1986, made a number of substantive changes relating to the issuance of tax-exempt debt by LUAs. The Act:

- **limited projects which qualify for tax-exempt financing,**

- **modified the economics of the marketplace for tax-exempt bonds, reducing their desirability,**

- **established new rules that restrict the flexibility of issuers and make it more complicated for issuers to comply with the law.**

There were, however, a few provisions which give smaller borrowers an advantage in the marketplace.

The Arbitrage Rebate

Arbitrage, as defined by Treasury Regulations, is the ability to obtain tax-exempt funds and invest those funds in higher yielding taxable securities, resulting in a profit to the issuer. An "arbitrage bond" results when any proceeds of an issue are used directly or indirectly to acquire investments which have a materially higher yield than the yield on the bonds, or replace funds which were used directly or indirectly to acquire higher yielding investments.

What Are The Arbitrage Rebate Rules? The arbitrage rebate rules require that all earnings from the investment of gross proceeds of a bond issue that are in excess of the amount that could have been earned had the yield on the investment been equal to the yield on the bonds be remitted to the federal government. In other words, earnings from the investment of bond proceeds exceeding the yield on the bonds must be remitted to the federal government. These rules carry very strict penalties for non-compliance including taxability of interest retroactive to the date of issue.

Generally, arbitrage profit which is made beyond temporary periods specified in the Code must be rebated to the United States Treasury Department. For example, if an LUA invests bond proceeds in higher-yielding, taxable obligations while a project is being constructed, it must rebate those proceeds to the U.S. Treasury.

When Did The Rebate Rules Take Effect? The arbitrage rebate rules are applicable to all tax-exempt governmental bonds issued after August 31, 1986, and private activity bonds (formerly referred to as industrial development bonds) issued after December 31, 1984.

What Funds Are Subject To The Arbitrage Restrictions? As a general rule, arbitrage cannot be earned on the "gross proceeds" of a bond issue.

Exceptions To The Arbitrage Requirements. There are only two exceptions that will preclude an entire issue from compliance of the rebate regulations:

- **If the gross proceeds of the issue are expended for the governmental purposes within six months after the date of issuance of the bonds, the interest earned during that period is not subject to rebate. If all but a minor portion of the proceeds (equal to the lesser of 5% of the proceeds or $100,000) is spent within a six month period, then the exception deadline is extended another six months. Amounts held in a bona fide debt service fund are not considered for the purpose of determining whether the six month test has been met.**

- **Bonds that are issued by small governmental units with general taxing power, which reasonably expect to issue $5 million or less in tax-exempt bonds during each calendar year, are not subject to the rebate requirements if at least 95% of the net proceeds are to be used for local governmental activities of the issuer. In determining whether the $5 million limit is reasonably expected to be exceeded, all governmental bonds issued by the governmental unit <u>and</u> all other governmental units that are subordinate to it must be counted (with the exception of private activity bonds).**

The Revenue Reconciliation Act of 1989 provides an additional exception for issuers that spend the bond proceeds within two years of the issued date. It provides that at least 75 percent of the net proceeds are to be used for construction of property that is owned by a governmental unit or 501(c)(3) organization and that at least 10 percent of the net proceeds are spent within six months, at least 45 percent within one year, at least 75 percent within 18 months, and 100 percent within the two-year period. If such an election is made, the issuer must pay a penalty of 1.5 percent of the amount of the net proceeds that, as of each six-month period, are not spent as required. The issuer may also elect to rebate arbitrage earnings on any reasonably required reserve or replacement fund whereby such amounts would not be considered as net proceeds for determining compliance with the two-year expenditure schedule.

In determining the six month period for tax and revenue anticipation notes, the net proceeds of such an issue (including interest earnings) are considered expended for the governmental purpose of the issue on the first day after the date of issuance that the cumulative cash flow deficit to be financed by the issue exceeds 90% of the aggregate face amount of the issue.

Debt Service Fund Exclusion

In evaluating the amount of investment earnings subject to the rebate calculation for issues not meeting one of the exceptions described above, an exclusion is provided for certain earnings on a bona fide debt service fund. A bona fide debt service fund is a fund used primarily to achieve a proper matching of revenues and debt service within each bond year. A bona fide debt service fund for a single issue must be depleted at least once a year except for a reasonable carryover amount not to exceed the greater of (1) one year's earnings on the fund or (2) one-twelfth of annual debt service. Stated differently, the debt service fund generally must be cleared out within a 13 month period.

Advance Refunding

The restrictions on the advance refunding of governmental bonds prevent LUAs from engaging in more than one advance refunding of a single bond issue even if it could save millions of dollars by doing so, or even if some development in the LUA's fiscal condition requires changes in covenants undertaken in the bond documents.

Defining Arbitrage Rebates. The IRS regulations prescribe a two-step approach for determining the amount of rebate. First, the issuer computes the bond yield, then the rebatable arbitrage. These two steps are as follows:

1. **Calculating bond yields. The yield on the issue is the discount rate that, when used in computing the present value of all of the unconditionally payable payments of principal and interest on the bonds and all payments for qualified guarantees (municipal bond insurance, letters of credit, etc.), produces an amount equal to the bond's issue price. The new regulations give guidance for calculating yields on fixed- and variable-yield issues.**

2. **Calculating rebatable arbitrage. The basic method for computing the rebatable arbitrage involves calculating the future value of nonpurpose investment cash flows using an interest rate equal to the yield on the issue. Using this method, nonpurpose receipts are compounded, or "future-valued," from the date of receipt, or the date deemed to be received, to the computation date. Similarly, payments for nonpurpose investments are future-valued from the date the payments are made to the computation date. The rebatable arbitrage as of any computation date generally is the excess of (1) the future value of all nonpurpose receipts over (2) the future value of all payments for nonpurpose investments. Depending on the size of the issue, a computation date credit of $250 to $1,000 is generally available.**

   The fair market value of any nonpurpose investment held on the computation date is treated as a nonpurpose receipt. In the case of fixed-rate investments, the issuer has the option to value the investments at present value. If the investment is purchased at par, the par amount plus accrued interest can be used.

Rebate Payments. The rules require computations to be performed once every five years, when the rebate payment is due, rather than annually, as had been the case. It may be necessary for issuers to do annual calculations to determine the amount of the contingent liability to be disclosed in financial statements. Further, issuers may choose to perform annual calculations as a planning tool to minimize negative arbitrage earnings and to determine the rebate liability for cash-flow planning.

The new rules also require that at least 90 percent of the rebatable arbitrage be paid once every five years, no later than 60 days after the installment computation date, and 100 percent within 60 days of the final redemption of the issue. Rebate payments are not refundable.

However, it is anticipated that the regulations will allow issuers to recover overpayments if they paid more than the rebatable arbitrage as a result of a mistake--for example, a mathematical error.

For issuers who underpay, a penalty equal to 50 percent of the amount that should have been rebated, plus interest thereon (100 percent for industrial development bonds), could be assessed in lieu of the retroactive loss of the bonds' tax exemption. This remedy will apply only if the failure to pay the full rebate was not due to willful neglect.