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LOCAL GOVERNMENT SERVICES

Debt Management Handbook

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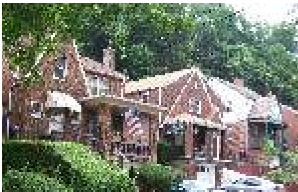

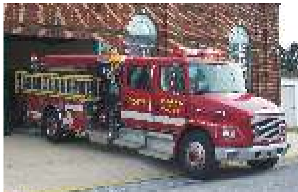

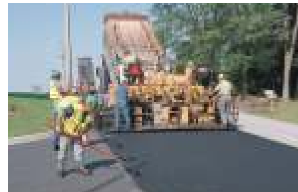

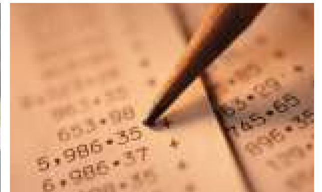

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Debt Management Handbook

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Foreward

This handbook introduces local government officials to the general concepts underlying the process of incurring new debt and managing existing debt. It is not a substitute for sound legal advice. For the most current information, municipal legal and financial advisors should be consulted. For specific advice and guidance on matters relating to borrowing, a municipal solicitor should be the priority contact.

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I. Role of Debt Management

Debt management is an important part of municipal financial management. It involves planning, budgeting, accounting and public relations. Proper debt management can mean the difference between controlling debt and being controlled by it.

Debt Management - Why Do I Need It?

Debt management is important to the overall financial administration of a municipality. If a municipality incurs debt, it should do so only with proper planning and awareness of the impact the debt will have on its overall finances. Debt commits future revenues to its repayment, requiring elected officials to make provisions for it far into the future. Without proper perspective and preparation, the municipality's debt, as any household budget, could get out of hand and create financial difficulties. It is also possible to back unconsciously into a difficult financial position by accumulating year-end deficits, much like a household that overextends its use of credit. Proper management of debt helps to avoid these problems.

The procedures to follow when issuing debt may seem complex and intimidating at the outset. There are laws which regulate how much and when to borrow and for what purposes. They spell out the procedure to issue debt, and define responsibilities until the debt is paid off. The information contained in this handbook, and that supplied by financial advisors and solicitor, will help to explain the law, the municipality's responsibilities and the proper way to incur debt.

What is Debt Management?

Debt management consists of the policy planning and procedures that are to be followed in incurring debt and in planning for the funding to meet debt service requirements. It should be keyed into the municipality's capital budget process, as well as with the annual operating budget preparation.

A primary goal of debt management is to maintain access to the debt market, which can be accomplished by avoiding unnecessary or unreasonable amounts of debt. Difficulty in meeting debt payments or, in the extreme, default, have very serious consequences. The market for the municipality's debt could disappear or become very costly, making it impossible to borrow funds in future years. Just like a personal credit rating, the credit rating of the municipality should be guarded with care. Proper debt management helps to safeguard that rating.

Debt management is an important aspect of financial administration and should be conducted in conjunction with every aspect of the budget. Plan borrowing needs with the aid of a capital budget. Justified capital projects can be planned in advance to keep borrowing costs low.

Proper debt management helps to recognize that the effects of incurring debt for a capital facility, such as a new municipal building, go beyond the annual costs of debt service and should be reflected in the operating budget. Each year, make provisions in the budget not only for debt service throughout the term of the borrowing, but also for funds to operate and maintain the new facility, calculating increased costs for utilities, insurance, janitorial services and others as appropriate. Before borrowing, make certain that the municipal revenues to meet all of these obligations will be available and budgeted.

Debt management also involves sound, overall administration. Good debt management requires establishing a process and policy for deciding the need, timing and purpose for incurring debt. Borrowing is only one way to obtain needed financing; other alternatives should be considered to determine the proper course. Develop a written policy, and follow it in determining when to borrow.

Make arrangements in advance to have the services of a financial specialist, such as bond counsel, accountant or an investment banker, available. When considering a debt offering, bring these specialists into the process early; don’t wait until it is close to the time to enter the bond market. Involving them early in the process saves time and headaches later. An ongoing relationship with these specialists, their early involvement in the planning for debt, may provide easier access to the bond market.

Finally, proper debt management requires the municipality to take steps to protect its credit rating. This means sound day-to-day management; keeping debt within manageable bounds; making sure that proper financial accounting exists; and maintaining contact with financial advisors.

II. When Is Borrowing Appropriate?

There is no hard and fast rule for determining when to borrow. Local officials must make that decision given the circumstances, the community's preferences and financial ability, and other available options. However, there are some general guidelines to follow in making that decision.

Aspects to Consider

First, consider how the borrowed money will be used. Will the borrowed funds be used for a long-range public purpose? Local governments may only spend money for public purposes. Furthermore, with only a few exceptions, state law permits local government units to borrow only for capital projects. The exceptions are borrowing to fund the unit's unfunded actuarial accrued pension fund liability, self-insurance pools and to pay for a countywide reassessment of real estate.[1] With court approval, a unit may also issue unfunded debt to pay off unpaid prior years' obligations or legal judgments.

Second, only incur debt to finance a project that returns benefits to the community throughout the term of the debt. In other words, the public should reap the benefits from the project, at least as long as it takes to pay for it. State law limits the life of a debt issue to 40 years or the stated useful life of the project, whichever is shorter. As part of a capital budget process, bonds with a term of 30 years can be issued to fund the current portion of a capital budget even if all the items included in the budget do not have useful lives of 30 years (for example, fire trucks and police cars).[2]

Third, carefully weigh the alternatives to borrowing. Does the municipality qualify for a capital grant from either the federal or state government? Some examples of these are the community development block grants from the federal government, and the community facilities or housing/community development financial grant programs of the state government. Such grants might finance a portion or all of the project. If a decision is made to pursue one of these grants, be aware that there may be matching provisions as well as other regulations and requirements. Can the municipality comply with those requirements? Would the costs of complying outweigh the benefits?

If a particular project is not needed for a few years, a good option is to create a capital reserve fund; a special fund into which monies are regularly deposited in anticipation of capital projects. This fund could be used to reduce or eliminate the need to borrow, thereby saving interest costs over the long term.

Fourth, consider financing the project from current revenues (pay-as-you-go). Perhaps the costs could be met by levying a one-time tax or fee.

A series of factors should be considered when deciding whether to borrow. These include:[3]

Factors Favoring Pay-As-You-Go

1. Municipalities must immediately face up to the fiscal realities rather than borrow to defer costs. Pay-as-you-go encourages municipalities to take a harder look at the need for projects and the costs involved before undertaking them.
2. Avoiding debt affords municipalities greater flexibility in times of economic downturns because future resources are not committed to repay debt. Municipalities will not be saddled with debt service payments during the times they are least able to pay. During recessions, capital costs can be cut by postponing projects and reducing outlays without harming current operations.

3. Interest costs are avoided. The total interest on every $1,000 bond issued at 8 percent amounts to approximately $1,600 over 20 years. The pay-as-you-go approach avoids this cost.
4. Borrowing capacity is saved for those times the municipality actually needs it.
5. Debt is not passed on to future generations.

Factors Favoring Pay-As-You-Use (Borrowing)

1. As revenues increase over time, the fixed costs of the debt repayments will represent a smaller portion of total revenues. Paying debt should become easier over time.
2. Projects that are currently needed should not be delayed unnecessarily because of low current revenues. This is especially applicable to new or growing communities. Postponement of projects might delay the municipality's development and retard growth in its tax base.
3. Borrowing ensures that new residents and future generations using the facilities help to pay for them, as future taxes or user fees go to debt service.
4. During times of inflation, the dollars used to repay the debt are worth less than the dollars borrowed.

I've Decided to Borrow - What Next?

There are a number of things you must know and consider once you make the decision to borrow. The issuance of debt is a highly regulated, structured process. Laws, and the market for debt itself, impose many obligations and responsibilities.

This handbook will help to explain the legal limits, official responsibilities and the general procedures to follow for issuing debt. There is a proper, legal way to borrow.

References

1. 53 Pa C.S.A. Local Government Unit Debt Act, Section 8002 (c).
2. 53 Pa. C.S.A.; Local Government Unit Debt Act, Section 8142.
3. Moak, Lennox L. *Municipal Bonds: Planning, Sale and Administration*. Chicago: Government Finance Officers Association, 1982, p. 103.

III. Legal Framework Governing Debt

Local governments in Pennsylvania are creatures of the state; their existence, form and powers are derived from the Constitution of the Commonwealth and the acts of the General Assembly. One of those powers is the power to borrow funds and pledge future revenues. Municipal debt has been controlled by the Commonwealth since 1874. State law controls the ability of local governments to incur debt, particularly the amount of debt to be incurred.

Pennsylvania Constitutional Provisions

The Pennsylvania Constitution does not contain absolute debt limits (except for the City of Philadelphia). Rather, it grants to the General Assembly the authority to set debt limits for all general-purpose units of local government.

The Constitution in Article IX, Section 10 gives the Legislature discretionary power to establish debt limits with certain exceptions: the debt limits so established are to be determined in relation to the total revenues of local governments; and total revenues are to be measured for a time period (determined by the legislature) immediately preceding the year of borrowing. Also, these debt limits set by the Legislature do not apply to the City of Philadelphia. The Constitution, in Article IX, Section 12 limits Philadelphia's ability to incur debt to a total of 13.5 percent of the value of its assessed taxable realty, based on an average of the immediately preceding 10 years.

The Constitution in Article IX, Section 10 specifies that certain types of debt are excluded from the statutory debt limits. It excludes from the limit all debt that (1) is self-liquidating or self-sustaining, or (2) has been approved by a vote of the electorate. Local governments, therefore, may incur any amount of these two types of debt without reference to constitutional or statutory limits, although there are practical and perhaps more stringent limits - those imposed by the bond market itself.

The Constitution, within the same Section, attaches a duty to the right to borrow. It requires any local government incurring debt to adopt a binding covenant to repay the debt and interest, at specified times, from a sinking fund or other revenues. This guarantees that the debt issues of Pennsylvania local governments are negotiable instruments and, therefore, more attractive to investors.

Local Government Unit Debt Act

The General Assembly fulfilled its constitutionally-imposed responsibility to establish debt limits with passage of the Local Government Unit Debt Act in 1972. This Act, reenacted in 1978 and since amended, contains the absolute debt limits determined by the Legislature. It prescribes the exclusive method of borrowing by local governments, and it applies to all units of local government, except Philadelphia city and county.

General Debt Limits. The statutory debt limits are expressed as percentages of a "borrowing base." As prescribed by the Constitution, the Act defines the borrowing base for any local government unit as the average of total revenues for the three fiscal years immediately preceding the year of borrowing.[1] The period of three years was selected by the Legislature to be long enough to avoid extreme fluctuations of revenues in any one year and short enough to reflect current fiscal reality. In general, total revenues include all money received by a local government unit from any source which is unrestricted as to its use. Excluded are subsidies received for a particular project financed by debt; interest earned on sinking funds, reserves or other restricted funds; revenues, user fees and other receipts pledged for self-liquidating debt or lease rental debt; and money from

sale of capital assets and other nonrecurring income. Local government officials have the responsibility to calculate and certify the borrowing base to the Department of Community and Economic Development. The services of the municipal auditor or an independent accountant can be helpful in the preparation of the certification to the Department, although their participation is not required.

The debt limits are as follows:[2]

1. 100 percent of its borrowing base for a school district of the first class (Philadelphia School District).
2. 300 percent of its borrowing base for any county.
3. 225 percent for a school district of the first class A through fourth class.
4. 250 percent of its borrowing base for any other unit of local government.

It is important to note that the debt limits presented above apply only to nonelectoral debt. As constitutionally mandated, the debt limits exclude voter-approved and self-liquidating debt, debt qualifying as "subsidized debt" under the Act and debt incurred to fund an unfunded accrued actuarial pension fund liability to the extent used to actually fund the liability. Subsidized debt is defined as debt for which a local government receives payments from the Commonwealth, federal government, another local government unit or an authority. The best example of such payments are state subsidies to school districts on behalf of school construction projects.

Self-liquidating debt and subsidized debt are not automatically excluded from the debt limits. Local government officials must prove to the Department of Community and Economic Development what constitutes self-liquidating and subsidized debt excluded from the debt limits. The Local Government Unit Debt Act, Sections 8024, 8025 and 8026, details the procedure to certify to DCED the amount of debt qualified for exclusion from the debt limits.[3]

The Local Government Unit Debt Act also sets limits for a broader measure of debt: one that includes obligations for lease rental debt payments to an authority or other units of government. In general, lease rental debt is debt incurred by some other entity, such as an authority or another local government, which you are obligated to pay from municipal revenues because of a lease, subsidy contract or other type of guarantee. In essence, your municipality will be paying or guaranteeing the debt service payments of another entity through lease rental payments or under other contractual arrangements or in case of default. The Act restricts the combined amounts of nonelectoral and lease rental debt to the following limits:[4]

1. 200 percent of its borrowing base for a school district of the first class (Philadelphia School District).
2. 400 percent of its borrowing base for counties.
3. 225 percent for a school district of the first class A through fourth class.
4. 350 percent of its borrowing base for all other units of local government.

Special Debt Limits. The debt limits as set forth in the Act afford some flexibility. First, because the borrowing base is calculated on local government total revenues, the debt limit will grow to reflect municipal growth (and presumably needs) as measured by increasing revenues. Second, the Legislature has foreseen that special circumstances could increase the need to borrow. For that reason, the Legislature has built into the Act a mechanism to increase the limits in the presence of special needs.

For any county assuming countywide responsibility for specified programs, the law allows additional debt in the amount of 100 percent of its borrowing base. The additional debt limit could also be claimed by a local government assuming responsibility for any of the same specified programs in adjacent areas if the county has not already done so.[5] The programs specified in the law include the following:

- hospitals and other public health services
- air and water pollution control
- flood control
- environmental protection
- water distribution and supply systems
- sewage and refuse collection and disposal systems
- education at any level
- highways
- public transportation or port operations

The additional debt may only be incurred to finance capital facilities for use in any of the above programs.

Court-Approved Borrowing. If a local government has incurred debt up to its statutory limit, and needs to borrow more money as a result of a certain event (such as a lawsuit) or to protect the public health and safety, the Act allows petition to the Court of Common Pleas for additional authority to borrow.[6] Additional borrowing must be shown to be necessary for any of the following reasons:

1. to replace assets lost as a result of fire, flood, storm, war, riot, civil commotion or other catastrophe.
2. to replace or improve facilities to protect the public health or safety.
3. to pay a tort liability settlement not covered by insurance.
4. to meet costs of complying with federal or state mandates, such as those for health, safety, pollution control or environmental protection facilities.

Reclassification of Existing Debt. The Local Government Unit Debt Act contains a procedure for the voters to approve debt retroactively.[7] The question must be put before the voters in a referendum. If a majority of the voters approve, the remaining unpaid debt previously classified as nonelectoral may be reclassified as electoral and removed from calculation of the remaining borrowing capacity. The Department of Community and Economic Development must give its approval before the debt may "officially" be reclassified. This requires the local government to submit to DCED a certified copy of the resolution calling for the election, proof of advertisement of the election and a certified return of the election.

Municipality Authorities Act

Primarily during the 1930s, municipal authorities became a popular vehicle in Pennsylvania for issuing debt as the state and local governments sought legal ways to finance needed projects restrained by the rigid and often insufficient debt limits contained in the 1874 Constitution. The debt limits at that time were based on the assessed value of real estate. In the deflationary environment of the Depression, debt limits reflected neither needs nor the ability to repay debt, and did not allow for special borrowing needs. Creation of debt by authorities offered a way around the restrictive limits because it was not considered to be debt of the municipalities which created them. The General State Authority (GSA) became the state government's vehicle around the restrictive constitutional debt limits. Once the courts ruled the state's arrangement with GSA legal, local governments followed suit by creating their own authorities. The Pennsylvania State Public School Building Authority was created to issue bonds for school construction.

Today, the statutory debt limits have eliminated the need to use municipal authorities as a vehicle to skirt the debt limits. The limits are set at levels high enough to meet the borrowing needs of most municipalities, grow along with a municipality's economy, and allow for additional borrowing in the presence of special needs.

Municipal authorities, however, continue to have a role in local government. They are particularly useful as a means for financing and apportioning costs of projects used by more than one municipality. The fees derived from users or payments from municipalities under leaseback arrangements finance both the operations of the authority and the repayment of its debt.

The revised law governing authorities, known as Act 22 of 2001 repeals Act 208 of 1947, known as the "Parking Authority Law", and Act 164 of 1945, the "Municipalities Authorities Act of 1945." Both statutes are continued, with amendment, as Chapters in Title 53 (Municipalities Generally) of the Pennsylvania Consolidated Statutes entitled, "Parking Authorities" and "Municipalities Authorities Act", respectively. This Act allows flexibility in the ways authorities can structure debt and how they recover costs from users. Sometimes, there are compelling administrative or political reasons to finance a project through an authority rather than directly by the municipal government.

Additional state laws authorize creation of special purpose authorities, such as parking authorities, housing authorities and redevelopment authorities. These special kinds of authorities are widely used and offer specific benefits.

It is wise to consider the financing option afforded by municipal authorities. Depending upon the type of project and particular circumstances, it might be more advantageous to finance a project through an authority rather than directly by the municipality. For more information, request a copy of *Municipal Authorities in Pennsylvania* from the Governor's Center for Local Government Services, Department of Community and Economic Development, or consult with your solicitor for more detailed advice on a particular proposal.

Federal Tax Law

The tax treatment of debt securities profoundly affects the cost of borrowing for local governments. Tax-exempt bonds can carry lower interest rates than taxable issues. At one time, virtually all municipal bonds were exempt from federal taxation. This is no longer the case. Today, local governments must carefully design bond issues and the projects they finance to preserve their tax-exempt status.

The Internal Revenue Code generally exempts interest earned on state and local government bonds from federal taxation. This federal tax exemption is important because it effectively lowers the cost of borrowing for state and local governments. Here's how it works.

Interest received by holders of state and local government bonds is not included in their gross income for tax purposes and, therefore, is not taxed. Interest income from other similar investments, such as corporate bonds, are taxable thus reducing the after-tax yield to investors. As a result, tax-exempt bonds can offer a lower stated interest rate than taxable bonds and still attract investors, particularly those in the upper-income tax brackets. The lower interest rates on municipal tax-exempt bonds results in significant savings to municipalities over the life of the bonds.

Tax Reform Act of 1986. The federal Tax Reform Act of 1986 made significant changes to the tax treatment of state and municipal bonds with far-reaching effects for both holders and issuers of such bonds. Fewer types of bonds are tax exempt. The Act establishes new classifications for bonds and expands taxability.

For tax purposes, the Act distinguishes between what are termed governmental bonds and private activity bonds. In general, the Tax Reform Act imposes tax on the interest paid by municipally-issued private activity bonds while it retains the exemption for governmental bonds. The Act also establishes an overall cap, based on population on the total amount of private activity bonds that can be issued in each state. States have the authority to allocate the overall cap among all bonds issued by state and local agencies.

Municipal officials need to be aware that interest on some bonds issued after 1986 may be taxable by the federal government under recent changes in law. If so, the costs of borrowing will be greater than for

nontaxable bonds for the reasons presented earlier. The types of projects financed through debt issues and the way they are structured is critical in determining the tax status of the bonds. The careful management of debt in this area can avoid significant interest costs over the long term.

Private Activity Bonds. The term private activity bonds replaces the previous category of industrial development bonds. The category is broader than the one it replaces, and further restricts tax-exempt debt issues. All interest paid by governments to holders of private activity bonds is taxable, except that paid by "qualified" private activity bonds, as explained below. In addition, the interest on private activity bonds constitutes a tax preference item when calculating the federal alternative minimum income tax for both individuals and corporations; diminishing the attraction of these bonds to investors, driving up interest rates and borrowing costs of local governments.

A municipal bond which meets either of the following tests is considered a private activity bond and is taxable:

1. The funds have a private business use and private security interest.
2. The funds will be used for a private loan.

A private business use and private security interest exist if any of the following conditions are met:[8]

1. More than 10 percent of the bond proceeds are used for any private business use, that is, a use either directly or indirectly in a trade or business of a person other than a government unit.
2. More than 10 percent of the payment of the bond's principal or interest is directly or indirectly:
   a. secured by any interest in property used in a trade or business or by payments in respect of such property.
   b. to be derived from payments (whether or not to the issuer) in respect of property, or borrowed money, used in a trade or business.

A special rule applies to bonds issued to finance gas or electric power projects. The rule caps at $15 million the aggregate amount that businesses and individuals may use.

A bond will meet the private loan test if more than five percent or $5 million, whichever is less, of the proceeds are loaned to nongovernmental persons.

The tests for private activity bonds are presented here in general terms only. The purpose is to provide general guidance, not definitive criteria. There are many exceptions to the general rules and allowances for special circumstances. For example, government owned and operated sewer and water facilities might not be subject to the 10 percent use test for private business use. The Act is subject to interpretation by the IRS and the tax courts as rulings are applied to specific instances. You should rely on the municipal solicitor or bond counsel for guidance and current rulings.

Qualified Private Activity Bonds. Certain bonds are termed qualified private activity bonds based on the kinds of projects financed. Like governmental bonds, qualified private activity bonds are tax-exempt. While their proceeds finance private activity-type projects, the projects themselves serve the general public's interest to a degree that warrants their tax exemption.

Examples of qualified private activity bonds include the following:

- exempt facilities bonds (multi-family residential rental projects; airports; docks and wharves; mass commuting facilities; sewage disposal facilities; solid waste disposal facilities; electric energy or gas facilities; water facilities; local district heating or cooling facilities; and hazardous waste facilities)
- qualified mortgage bonds (both multi-family housing and single-family housing)
- qualified veterans' mortgage bonds (loans to veterans for the purchase of homes)

- qualified student loan bonds
- qualified redevelopment bonds and
- qualified 501(c)(3) bonds (for tax-exempt entities or governmental units)

The federal and volume limits are complex, subject to change and beyond the scope of this handbook. For specific information, consult your municipal solicitor.

Arbitrage. Arbitrage refers to the ability of a local government to issue tax-exempt bonds and reinvest the proceeds in higher-yielding taxable bonds. The spread between the interest paid on the tax-exempt municipal bonds and the interest received from the taxable bonds produces investment earnings for the local government. Although the investment bonds may be taxable, municipalities do not pay taxes.

Current federal law attempts to minimize the opportunity for abuse of arbitrage by imposing penalties on municipalities that engage in this practice. In addition to fines, the penalties may also include the loss of tax-exempt status (retroactively) for the bonds issued by the municipality.

The rules and regulations governing arbitrage are complex and new interpretations continuously occur. Not all investment earnings are subject to arbitrage restrictions. Because of the complexity of this matter, you are urged to consult your advisors for the best current advice.

Pennsylvania Tax Law

State law exempts from state and local income taxes interest paid on bonds and notes issued by the Commonwealth and its political subdivisions. It also prevents the direct taxation of the bonds under the county intangible personal property tax or taxation of their transfers. No distinctions are made between government bonds and private activity bonds under state law. Regardless, Pennsylvania residents must pay state income taxes on interest earned from bonds issued by other states and their subdivisions.

The tax exemption in state law is important to local governments because it decreases their borrowing costs. As discussed earlier, tax exemption allows municipal bonds to carry a lower rate of interest than taxable bonds, as investors are willing to settle for less interest in return for the tax exemption privilege.

Securities Laws

Federal and state laws concurrently regulate the issuing and trading of debt securities. The federal securities laws and Pennsylvania Securities Act impose requirements and responsibilities on borrowing municipalities.

Federal Securities Laws. Federal securities law requires the registration of most securities offered to investors and submission of prospectuses for review. However, nontaxable municipal bonds are exempt from the stringent registration and regulatory requirements of the Federal Securities Act of 1933 and the Securities Exchange Act of 1934. Tax-free municipal securities and accompanying prospectuses need not be filed with and reviewed by the Securities Exchange Commission as required for offerings of corporate and taxable securities. Likewise, the extensive disclosure requirements do not apply to tax-free municipal bonds. However, the antifraud provisions do apply to municipal borrowers.

State Securities Law. At the state level, the applicable law is the Pennsylvania Securities Act of 1972, as amended.[9] Like its counterpart federal laws, the Pennsylvania Act requires registration of certain securities offerings and sets standards for the type and amount of information that must be disclosed. The state law, however, exempts all municipal bonds, whether taxable or not, from filing and registration with the Pennsylvania Securities Commission. Guarantees of debt securities (such as those evidencing lease-rental debt) are considered separate securities and may also be exempt from registration under certain conditions. Like federal law, the antifraud provisions in the state law, however, still apply to municipal debt issues.

Fraud. Fraud within the meaning of both federal and state securities law applies not only to misrepresentation of facts, but also extends to information that should have been disclosed to investors but was not. The stringent antifraud provisions of both federal and state securities law apply to municipal bonds, whether or not the bonds are exempted from registration. This means that municipal officials could be held liable for any misrepresentation or omission of material facts related to the debt offering. For that reason, municipal borrowers need to ensure that their offerings are accompanied by a full, accurate and adequate disclosure of all relevant information. The penalties for not complying with the antifraud provisions, plus possible lawsuits, underscore the importance of communications with investors.

Disclosure. To interest investors in a particular bond sale and to comply with the antifraud provisions in securities laws, municipal borrowers must disclose basic information about the bond issue and the issuing municipality. The major problem for municipal borrowers, especially those with little experience with the debt market, is knowing what the market expects in terms of disclosure. What should be included? How should it be presented? What constitutes full and adequate disclosure?

Fortunately, the Government Finance Officers Association (GFOA) has addressed the needs of local officials by compiling a manual entitled *Disclosure Guidelines for State and Local Government Securities.*[10] The guidelines describe in detail both the content and format of the official statements which accompany offerings of municipal securities. Compliance with the guidelines is not mandatory, but it is recommended. The market favors their use, and they offer protection from antifraud laws.

Official Statement. The official statement is the equivalent of a prospectus for a corporate security; it is the primary tool used to market municipal securities. It should contain all the necessary information an investor needs, including a summary of all the important documents and agreements that support the bond offering, a full disclosure of security provisions, the opinion of the bond counsel as to legality and taxability of the issue, the covenant and financial statements. The financial statements may or may not be audited; however, they should state whether or not they comply with generally accepted accounting principles.

Official statements are not subject to SEC review. Rather, they are filed with the Municipal Securities Rulemaking Board and copies are provided to investors. However, the SEC has the authority to investigate cases of alleged fraud based on the contents of the official statement.

Advertising. The Pennsylvania Securities Commission has issued regulations governing the advertising of a debt offering that apply to governmental units (although registration of their securities is not required).[11] The regulations basically cover “tombstone” advertisements, and require the disclosure of basic information about the issuer and security, such as name and address of issuer; title of security; price, yield, date of issue; name of underwriter; tax status; and a disclaimer that the advertisement is not an offer to buy or sell.

References

1. 53 Pa C.S.A. 8002 (c); Local Government Unit Debt Act, Section 8002 (c).
2. 53 Pa C.S.A. 8022 (a) & (f); Local Government Unit Debt Act, Section 8022(a) & (f).
3. 53 Pa C.S.A. 8024, 8025, 8026; Local Government Unit Debt Act, Section 8024, 8025, 8026.
4. 53 Pa C.S.A. 8022 (b) & (f); Local Government Unit Debt Act, Section 8022(b) & (f).
5. 53 Pa C.S.A. 8022 (d); Local Government Unit Debt Act, Section 8022(d).
6. 53 Pa C.S.A. 8022 (e); Local Government Unit Debt Act, Section 8022(e).
7. 53 Pa C.S.A 8023; Local Government Unit Debt Act V, Section 8023.
8. Hawkins, Delafield and Wood. *Analysis of Provisions of the Tax Reform Act of 1986 Affecting Tax-Exempt Obligations. 1986*
9. 70 P.S. 1-101 et seq.; Pennsylvania Securities Act of 1972.
10. Copies may be obtained from the Government Finance Officers Association,180 N. Michigan Avenue, Suite 800, Chicago, IL 60601, (312) 977-9700.
11. 64 Pa.Code 606.031(e).

IV. Types of Borrowing

There are several different types of classification for debt. The classification of debt is important because it determines which laws, regulations and limits apply.

Electoral and Nonelectoral & Lease Rental Debt

The primary classifications of debt are electoral, nonelectoral and lease rental. Electoral debt is debt that has been incurred with the approval of a majority of the voters in a referendum. It also includes debt which is approved by the voters subsequent to its incurrence. The Pennsylvania Constitution exempts electoral debt from the statutory debt limits contained in the Local Government Unit Debt Act. The only limits to this type of borrowing are the willingness of the voters to borrow and the willingness of the debt market to buy the debt.

Nonelectoral debt are the bonds or notes the municipality issues directly, without voter approval. Lease rental debt is the backing by the municipality of debt of an Authority or another local government unit through leases, subsidy agreements, guarantees or other agreements.

Nonelectoral debt and lease rental debt, on the other hand, are limited by law. The Local Government Unit Debt Act establishes the limits for nonelectoral debt by type of local unit. However, if a majority of the voters approve in a referendum, nonelectoral debt and lease rental debt can be reclassified as electoral debt and is no longer chargeable against the debt limit.

General Obligation and Revenue Debt

General obligation debt is created when a municipality backs its borrowings with the municipality's full faith, credit and taxing powers. No specific revenues are pledged; instead, the debt is repaid from general revenues. When issuing general obligation debt, the Local Government Unit Debt Act and the Pennsylvania Constitution require municipalities to establish a covenant to repay the debt at specified dates and in stated amounts over the life of the debt. General obligation debt is usually considered by investors to be the most secure type of debt because it is backed by the municipality's full faith, credit and taxing power.

Revenue debt, on the other hand, is secured by pledges of specific revenues, usually those generated by the facility purchased or constructed by the debt. The debt is repaid from user fees and charges, and not from general tax revenues. However, portions or all of revenue debt may be guaranteed by a municipality's full faith, credit and taxing power. This means that if pledged revenues from the facility are insufficient to pay the debt service, the remainder must be paid from the municipality's general revenues. This type of debt is termed guaranteed revenue debt.

Authorities primarily issue revenue debt, although municipalities may also issue revenue debt. Authorities cannot issue general obligation debt. Municipalities, however, may use their full faith and credit to guarantee the revenue bonds issued by authorities, making them, in effect, general obligation bonds. From the standpoint of the municipality, this guarantee creates lease rental debt, chargeable against the municipality's debt limits. This guarantee can be used to lower the costs of borrowing for projects with uncertain revenues. In many cases a guaranteed revenue stream is necessary to make the bonds salable. Revenue debt may be excluded from the statutory debt limits if municipal officials certify to the Department of Community and Economic Development that such debt is self-liquidating.

The Local Government Unit Debt Act requires that all bonds and notes be labeled to indicate whether they are general obligation, revenue, guaranteed revenue or limited guaranteed revenue bonds or notes.[1] The following are special kinds of general obligation debt.

Bond Anticipation Notes

Bond Anticipation Notes (BANS) are issued in anticipation of issuing long-term debt. They are short-term, issued for one year or less, but can be "rolled over" or continued, if needed. BANS are usually issued to finance start-up costs of a project that a municipality intends to finance with long-term debt in cases where the long-term debt cannot be issued immediately for certain reasons; for example, if the municipality is unable to estimate total construction costs at the outset of construction.

BANS may be issued in amounts up to the total amount expected to be financed through long-term debt. The notes must be paid by exchange with the long-term bonds or from the proceeds of the sale of the long-term bonds. In practice, BANS are infrequently issued. Instead, most municipalities issue short-term debt, which then may be refinanced as part of the major bond issue.

Small Borrowing for Capital Purposes

The Local Government Unit Debt Act permits municipalities to issue small amounts of nonelectoral debt, up to a certain threshold, without meeting all the statutorily-prescribed procedures for issuing debt.[2] Specifically, municipalities may authorize small amounts of debt by resolution rather than ordinance and without the need to receive the approval of the Department of Community and Economic Development.

The total amount of debt issued in this fashion is limited, in the aggregate, to the lesser amount of $125,000 or 30 percent of the municipality's nonelectoral debt limit. This means that the amount of small borrowing in any year, when combined with the outstanding portion of any small borrowing from prior years, may not exceed these limits. In addition, the life of such debt may not exceed five years, and it may not cause the total debt outstanding to exceed the statutory debt limits. This particular borrowing technique may be used only for capital projects; it can not be used for refunding or funding unfunded debt, or for lease rental debt.

Funding Unfunded Debt

Municipalities may borrow money to fund "unfunded debt."[3] However, a number of restrictions and requirements discourage its use except for when it is absolutely needed.

The Local Government Unit Debit Act defines unfunded debt as current obligations for expenses incurred in the same or prior years, or for court judgments against municipalities, whose local revenues are insufficient to pay without drastically curtailing services. In addition, the municipality must be unable to raise sufficient tax revenue to pay these obligations because of tax limits, timing in the fiscal year, or because it would not be in the public interest to do so. Unfunded debt does not include any amounts for payments of debt incurred under the Local Government Unit Debt Act.

Municipalities must obtain court approval before financing unfunded debt through borrowing. Officials must petition the court of common pleas, requesting approval to issue bonds or notes. After a hearing, the court will grant approval upon all of the following determinations:

1. The unfunded debt is a legal obligation of the municipality;
2. There has been an unforeseeable decline in revenues, or taxes levied have not produced the revenues anticipated, or it was not reasonable to foresee such obligation;

3. Paying the debt by curtailing services would be dangerous to the public health, safety or education; and
4. It is not feasible or in the public interest to levy additional taxes in the current fiscal year.

All these requirements must be met before the situation qualifies as unfunded debt.[4]

If the court approves the local government paying the unfunded debt through borrowing, it will determine a debt repayment schedule that does not jeopardize the municipality's ability to provide services or require the levy of excessive taxes. The life of the debt may not exceed 10 years. The court has the authority to rule that a portion of the debt is not subject to the statutory debt limits. Following court approval, the municipality must issue the debt in compliance with all the usual requirements.

Tax Exempt Municipal Leasing

The various municipal codes enable municipalities to acquire capital equipment through leasing arrangements with vendors rather than borrowing funds to make these purchases.

The primary benefit to municipalities of acquiring capital equipment through leases rather than borrowing is avoiding the debt limits. If the term of the lease is less than the useful life of the asset, and the lease is carefully worded to terminate in any year that the municipality fails to appropriate funds to meet the lease payments, and there is no pledge of the municipality's full faith credit and taxing power, obligations for payment under the lease are not considered debt under the statutory debt limits. Acquiring capital equipment through leasing might be less expensive than borrowing because the interest rate might be less and there would be no administrative costs to issue and service debt.

A leasing arrangement may also be attractive to a vendor. First, the vendor makes a sale, with payments extended over time. Second, if the transaction is treated as a true sale rather than a rental agreement, the vendor could receive the municipal interest payments tax free. This lowers the cost to the vendor of offering a lease.

Compare the costs of leasing versus borrowing before deciding which one to pursue. Be sure the vendor (lessor) discloses to you both the full purchase price and the true interest cost. You may even find that executing leases is easier and faster than borrowing. In some circumstances, your municipality can derive benefits from leasing. However, there are areas for caution. Consult your municipal code for dollar limits above which municipalities are required to award leases based on competitive bids. There may be other restrictions or requirements to follow. Consult the solicitor for details.

Lease Rental Debt and Guaranteed Debt

Lease rental debt is used most often in conjunction with an authority. Under this type of arrangement, an authority (or other government entity) acquires or constructs a facility for the purpose of leasing it to a local government unit, such as a school district or municipality. The authority arranges the financing and issues debt. It may arrange for the construction or acquisition of the facility, or it may pass this task to the leasing municipality. The facility is designed to meet the needs and specifications of the lessee, which ordinarily will operate and maintain it. The authority may undertake similar arrangements with a number of governmental entities.

Although the debt so incurred is owned by the authority, the debt service is paid by the governmental entity through lease payments as it uses the facility. This arrangement is called a leaseback. The lease payments secure the debt issued by the authority. By signing the lease, the leasing municipality pledges its general revenues to pay the debt incurred by the authority for the leased facility. This guarantee makes the debt of authorities more attractive to the debt market and lowers borrowing costs.

Municipalities may also incur lease rental debt by guaranteeing or agreeing to subsidize the debt issued by an authority or another local government unit in the event of insufficient revenues. A leaseback arrangement need not exist for a municipality to guarantee the debt of another entity.

For purposes of the statutory debt limits, lease rental debt is considered to belong to the municipality that leases the financed facility or guarantees the debt of the authority or other local government unit. The Local Government Unit Debt Act imposes limits on this broad measure of debt — all direct debt (nonelectoral debt) plus lease rental debt — at amounts higher than for direct, nonelectoral debt alone. Therefore, if your municipality has lease rental debt, it is added to your direct, nonelectoral debt and applied against the statutory debt limits to restrict the additional nonelectoral debt you may incur.

There is a distinction between lease rental debt incurred in conjunction with an authority or another local government unit, and leases for capital equipment with vendors as discussed earlier. Capital equipment leases can be written to avoid classification as "debt" and application to the debt limit; however, lease rental debt is charged against the debt limits. Leases for capital equipment are never "lease rental debt." If the lease agreement does constitute debt, it would be nonelectoral debt.

Self-Liquidating and Subsidized Debt

The Local Government Unit Debt Act defines self-liquidating debt as any debt which is payable solely from rents, rates or charges on users of facilities financed by such debt.[5] The Act further includes within its definition any debt payable solely from special levies or assessments of benefits earmarked exclusively for the purpose of repaying the debt. The Act also defines subsidized debt as debt payable from the Commonwealth, Federal Government or subsidy contract with another local government or authority.[6] Portions of all of the major types of debt — general obligation, guaranteed revenue, revenue and lease rental — may be classified as self-liquidating or subsidized debt.

It is important to distinguish self-liquidating and subsidized from other types of debt because self-liquidating and subsidized debt do not count against the statutory debt limits. By categorizing and excluding self-liquidating or subsidized debt from all other types of debt, you can increase your municipality's remaining capacity to borrow.

Municipalities must certify to the Department of Community and Economic Development the amount of debt that can be properly classified as self-liquidating or subsidized.[7] The Act sets forth the procedures to follow to establish that the revenues generated by the facility will be sufficient to pay both the operating expenses of the facility and the debt service as it comes due, or that the subsidies to be received will be sufficient to cover the debt service payments. If a prospective debt issue would push debt beyond the municipality's debt limit, it must be excluded before any new debt can be issued.

Calling, Defeasing and Refunding

There may be times when, subsequent to selling bonds or notes, interest rates fall to levels significantly below the rates paid on these obligations. There may also be times when restrictive covenants contained in a bond indenture (most likely for revenue bonds) become difficult to live with. If you could terminate or replace those bonds with new debt carrying lower rates or without the difficult restrictions, you could save on interest costs and avoid headaches.

There are several techniques available to defease, or terminate, a debt issue before its scheduled maturity. One method is to call the debt issue and repay the holders. This requires including a call feature in the original bond issue. A call feature gives the issuer the right to call and repurchase all or part of a bond issue at a specified date or dates during its life. The bondholders receive early payment of the principal and any unpaid interest

earned to date (and in most cases a premium for early redemption). The early payments could be made possible by an accumulation of cash or, more likely, from the proceeds obtained by a new issue of debt in a refunding.

Another technique which can be used to defease a debt issue is through a refunding. Refunding is the issuance and sale of new debt to obtain funds to pay or redeem outstanding debt at or before maturity. In a refunding, the cash is not used to repay the holders in advance of maturity. Rather, the funds go into an escrow account. Money from the escrow account is then used to meet the interest and principal payments on the refunded obligations according to the original schedule. In essence, the refunded debt is more secure following a refunding because sufficient money has already been set aside to repay the obligations. Refunded debt, whether redeemed or provided for by an escrow account, is then defeased, that is, no longer considered a debt of the municipality. The covenants on the defeased debt restricting the use of revenues also cease to exist. In most cases, a call provision is needed to use a refunding to repay outstanding bonds; a call provision is not necessary if an escrow fund is used to defease the bonds.

Bonds are frequently called to produce savings. The savings may accrue from avoided interest costs, by either redeeming the bonds with cash or replacing them with lower-yielding bonds. When estimating savings, the additional costs must also be considered: any premium paid to bondholders to exercise a call feature and the administrative costs of any refunding. Most municipalities will need to consult a financial advisor to perform the necessary, complicated calculations, as well as to design and arrange for a refunding.

In most cases, there is a front-end cost for including a call feature in a bond offering. Bondholders, depending upon circumstances and expectations for changes in interest rates, may not view a call feature favorably. Consequently, investors may demand a higher return for callable bonds. Inclusion of a call feature in a bond issue does not obligate the issuer to exercise it. The call provision *allows* the bond to be redeemed early; it does not *require* it. Any refunding should be approached with caution. Your solicitor should check all recent changes in federal tax law.

Tax and Revenue Anticipation Notes

The Local Government Unit Debt Act permits municipalities to incur short-term obligations in the current fiscal year prior to receipt of tax collections or other revenues.[8] Both the Act and federal tax laws limit the amount that may be borrowed. The primary purpose of such borrowing is to alleviate cash flow problems.

Short-term anticipation notes authorized by the Debt Act may anticipate taxes or revenues, or both. They may not exceed the lesser of 12 months or the end of the fiscal year. They are not considered to be “debt” of the municipality, and therefore do not count against the debt limits. The Local Government Unit Debt Act specifies the issuing procedures and restrictions. Be aware of federal tax code regulations which will also have a bearing on the amount of debt you may issue. The requirements for issuing tax and revenue anticipation notes are discussed in Chapter 5.

References

1. 53 Pa. C.S.A. 8141; Local Government Unit Debt Act, Section 8141.
2. 53 Pa. C.S.A. 8109; Local Government Unit Debt Act, Section 8109.
3. 53 Pa. C.S.A. 8129; Local Government Unit Debt Act, Section 8129.
4. *In re Council of Borough of Aliquippa,* 427 A.2d 693, 58 Pa.Cmwlth. 214, 1981.
5. 53 Pa. C.S.A. 8002 (b); Local Government Unit Debt Act, Section 8002(b).
6. 53 Pa. C.S.A. 8024; Local Government Unit Debt Act, Section 8024.
7. 53 Pa. C.S.A. 8025, 8026; Local Government Unit Debt Act, Sections 8025 and 8026.
8. 53 Pa. C.S.A. 8121; Local Government Unit Debt Act, Section 8121.

V. Procedures and Techniques to Issue Debt

Money, like corn and oats, is a commodity. It is for sale, generally to the highest bidder. Municipal borrowers compete for funds in the capital market. Investors buy and sell municipal bonds based on risks and returns, the same as other investments. This section describes the market in which original issues of debt are sold.

The Marketplace

Local banks can be a source of funds for local governments. Depending upon the amount needed, a municipality may be able to borrow directly from or sell its bonds to a local bank. If bonds are involved, the bank often will hold the bonds until maturity. Borrowing from a bank resembles a loan made by a bank to an individual. It can be relatively simple and the least expensive method for small borrowings.

Most new debt issues are sold in the open market. The bonds are sold to bond dealers, or groups of bond dealers operating as a syndicate, in a process known as underwriting. Municipalities may sell their bonds to dealers known as underwriters by public bids or by privately negotiated sale. The method selected is governed by the circumstances of the offering and an informed judgment about which method will yield the better, meaning cheaper, results.

Underwriters may be investment bankers, securities dealers or local banks. They buy the bonds directly from the municipality and resell them to investors. Underwriters are compensated by the markup they charge when they resell the bonds. They act as agents between the issuing (borrowing) municipality and investors. They assume any risk that investors may not want the bonds they buy or the possibility investors will buy them only at a price lower than the underwriters paid for them.

The market for municipal securities is diverse. Individual investors, insurance companies, banks, institutions and mutual funds all buy municipal bonds from underwriters. Despite the diversity of investors, their common interest is in the tax-free nature of municipal bonds.

Another source of funds is bond pool authorities. Such pools provide funds for capital improvement projects to municipalities and school districts.It can be comparatively less expensive to borrow from such entities, especially for small borrowers, because you can take advantage of the economies of scale normally resulting from large debt issues.

Credit Ratings

Credit ratings provide important information to investors. They constitute an independent judgment regarding the ability of a borrower to meet scheduled debt service payments as promised. The possibility of missed payments constitutes one of the risks of buying bonds that investors (lenders) must weigh.

While always important, credit ratings assume greater importance as the size of a bond issue grows. As more investors are needed to purchase large issues, it is less likely every investor will possess sufficient firsthand knowledge of an issuer to evaluate the investment adequately. Therefore, they must rely more heavily upon independent evaluations of credit-worthiness.

Credit ratings affect the cost of borrowing. The lower the rating, the greater the risk, and the greater return (that is, higher interest rate) investors will demand. Conversely, a favorable rating could result in lower interest costs and produce significant savings to the issuing government unit over the life of a bond issue.

Among the major rating agencies that express opinions on government bonds are Moody's Investors Service, Standard and Poor's, and Fitch's. For a fee, plus sufficient information, these agencies will rate the credit quality of a bond issue or the issuer itself.

What information forms the basis for the ratings? Generally, the rating agencies analyze four categories of information: debt burden; budgetary operations and fiscal discipline; source and amounts of revenue; and socio-economic (population trends, economic growth and diversity and personal income trends). Analysts also consider the quality of the issuer's financial records, including whether they are prepared according to generally accepted accounting principles. Each rating agency assigns relative weights to the collected information to produce a rating. As the weightings vary from one agency to another, so can ratings.

Many municipalities, especially those participating frequently in the debt market, recognize the importance of favorable credit ratings. As a result, they have a strategy for dealing with the rating agencies. The strategy usually involves compiling requested data and presenting it in person to the agencies and maintaining good communications both before and after the bonds are issued. Some local governments employ financial advisors for this purpose. They have found it to their benefit to cooperate fully with the rating agencies, even to the extent of providing them with timely, accurate and complete information periodically throughout the life of the bonds.

Credit Enhancement

From the perspective of a borrower, the purpose of credit enhancement is to save on interest costs over the life of a bond issue. Various techniques of credit enhancement may produce these savings by allowing a municipality to issue bonds at lower interest rates than its credit rating ordinarily would allow.

There are two main types of credit enhancements: municipal bond insurance and a bank letter of credit. Each reduces investor credit risk —the risk of missed payments for interest and/or principal — by transferring the risk to a third party (the insurance company or bank). In effect, the municipality trades its credit rating for that of a third party.

Of course, there is a cost to credit enhancement. Fees vary according to type, credit rating, amount and length of coverage. Issuers must carefully compare these costs with the possible improvement in the bond's credit rating and the potential savings in interest accruing over the life of the bond issue. The use of a credit enhancement only makes sense if the interest savings outweigh the cost.

Insurance. Some major insurance carriers, such as the Municipal Bond Insurance Association and the American Municipal Bond Assurance Corporation, offer municipal bond insurance. If an issuer of an insured bond issue is unable to make any of the debt service payments as scheduled, the insurance will make the missed payments. The insurance does not relieve the municipality of the need to meet its obligations; the insurance transfers the rights of the bond holders to the insurance company (a process known as subrogation).

Not all credit rating agencies recognize the credit protection afforded by insurance. Standard and Poor's is one which does recognize the increased protection by granting its highest rating to insured bond issues.

The cost of bond insurance consists of a one-time premium, paid when the bond issue is originally offered. The insurance then provides protection for the life of the bonds. The cost of the premium generally ranges from 0.1 to 2 percent of the total debt service (principal plus interest) of the issue. It may be paid by either the issuing municipality or the underwriter.

Letter of Credit. A letter of credit is a promise by a bank to meet the debt service payments on a bond in specified amounts if the issuing municipality is unable to make the payments. In effect, a letter of credit provides the municipality with a back-up source of funds. When a municipality arranges for a bank letter of credit, it substitutes the bank's credit rating for that of the municipality. For a letter of credit to benefit a

municipality, the credit rating of the bank must be higher than that of the municipality. Banks charge an annual fee for a letter of credit. The fee is based on the amount of authorized available funds.

Funds borrowed through the exercise of a letter of credit are debt obligations under the Local Government Unit Debt Act; all requirements of the Act must be met before the debt is drawn down. The interest rates charged by banks for exercising letters of credit are usually determined in reference to the prime rate (the rate banks charge their best commercial borrowers). These rates may exceed the stated rates paid by municipalities on their bonds. These costs are in addition to the annual fees charged by banks for arranging this support.

Requirements for Borrowing

Once a municipality makes a decision to incur debt for a capital project, it must comply with a number of requirements imposed upon it by the Local Government Unit Debt Act. The major requirements are summarized in this section. Consult both the Act and legal and financial advisors for the details that may apply.

Ordinances. Before a municipality can borrow funds, the governing body must enact an ordinance or a resolution in the case of small borrowings. For electoral debt, the municipality must adopt a resolution signifying its determination to incur electoral debt and calling for an election. Once authorized by the electorate, the issuance of bonds, notes or lease rental debt as electoral debt requires the enactment of an ordinance.

The ordinance is both an information tool for the municipality's citizens and a means to officially begin the process of incurring debt. Notice of the ordinance must be published both before and after its enactment. The law requires that the ordinance contain certain items, which include the following: [1]

- an indication of the type of debt to be incurred (electoral, nonelectoral, or lease rental debt).
- an indication of the form of debt (general obligation, revenue or guaranteed revenue).
- a repayment schedule and interest rates.
- a covenant.
- a notice whether the bonds will be sold at public or private sale.
- authorization for an officer of the municipality to prepare a debt statement (which must be submitted to DCED), to execute and deliver the bonds or notes, and to take other official action as may be needed.
- an identification of the project/purpose for which the debt is being issued and its useful life.

Filings and Calculations

Prior to issuing most types of debt, the Local Government Unit Debt Act requires municipalities to make filings with the Department of Community and Economic Development.[2] With the exception of tax anticipation notes, all debt proceedings must be filed in the Office of Chief Counsel in Harrisburg. The DCED reviews the filings to ensure the municipality does not exceed its borrowing base and that it has complied with all the procedures stipulated by the Act. A fee must accompany filings with the DCED. The fee is currently set at $50 plus 1/32 mill of the principal amount of the debt.[3] There is no fee for tax anticipation notes or small borrowings for capital purposes under Section §109 of the LGUDA.

The Act allows the DCED 20 days from receipt of filing to conduct its review and to notify the municipality of its approval or disapproval. The DCED will issue either a certificate of approval or a certificate of disapproval to the municipality. If the DCED cannot approve the application, it must notify the municipality of its reasons. The Department may extend the review period by a maximum of 20 days.

During the DCED review period, the borrowing action may be challenged. If your application is challenged, the municipality may be delayed, or even prevented from issuing debt. The application you file with DCED must, by law, contain certain items. These include certified copies of the following (whichever are applicable to your particular borrowing):

- the ordinance or resolution with proofs of publication.
- the return of the election (if electoral debt).
- the accepted proposal for the purchase of the bonds or notes.
- the ordinance or resolution awarding the bonds or notes with proofs of advertisement.
- the debt statement and certificate of borrowing base.
- certification and proof of any amount that could be excluded from the debt limits as self-liquidating or subsidized debt.

In case of lease rental debt, the filing with the DCED should include certified copies of the following:

- the ordinance or resolution authorizing the lease rental debt with proofs of publication.
- the debt statement and borrowing base certificate.

Some of the information needed for the filings can be found in the Annual Audit and Financial Report; however, parts may need to be updated with the most current data available. For the borrowing base calculation and debt statement, the Office of Chief Counsel of the DCED has forms you can request and use for the filings. The calculations are described below.

Borrowing Base. Whenever a local government unit requests permission to incur debt, it must file a certificate of its borrowing base. This calculation establishes the base against which the statutory debt limits are applied. The borrowing base, as stipulated in the Local Government Unit Debt Act, is calculated as the average of total revenues (with certain adjustments) for the immediately prior three fiscal years. For each year, the beginning number is total revenues received from all sources. This figure can be obtained from Schedule C-2 of the Annual Audit and Financial Report. From this amount, the following components are subtracted:

- state and federal subsidies and reimbursement related to a particular project financed by debt.
- revenues, receipts, assessments and the like pledged for self-liquidating debt.
- interest earned on money in sinking funds pledged for debt.
- grants and private contributions measured by construction or acquisition of specific projects.
- nonrecurring receipts.

The remainder for each year is added together and the sum is divided by three. The necessary calculations may be performed by local government officials or an independent accountant. The certificate must be signed by authorized local officials or by an independent accountant.

Debt Statement. All filings to request authority to incur new debt must include a debt statement.[4] The debt statement establishes the amount of municipal debt outstanding and its remaining borrowing capacity under the debt limits. It contains a calculation of the borrowing base, the gross amount of outstanding debt, the amount of debt being issued, the debt which can be excluded from the debt limit, and the applicable limit for the combination of nonelectoral debt and lease rental debt. Any debt previously excluded from the limit as either self-liquidating or subsidized must be recertified as an unchanged amount except for decreases resulting from payments, or revised and certified. A debt statement need not accompany the informational filings requested for tax and revenue anticipation notes.

Five major items must be shown on the debt statement:

1. gross incurred debt, by type (electoral, nonelectoral, and lease rental).
2. all credits and exclusions (by item) from gross debt.
3. the aggregate principal amount of new bonds, notes or lease rental debt being issued.

4. the borrowing base (shown on an accompanying borrowing base certificate).
5. the nonelectoral debt limit and the nonelectoral plus lease rental debt limit.

In a filing for a refunding, the debt statement should also contain the principal amount of bonds or notes being refunded (which will no longer be deemed outstanding).

A debt statement form can be obtained from the Office of Chief Counsel of the DCED. It must be signed by municipal officials, verified under oath or affirmation, and dated not more than 60 days before filing with the DCED. A debt statement must also be prepared for a small borrowing for capital purposes, although it need not be filed with the DCED.

Small Borrowings

You may authorize small borrowings for capital purposes by resolution rather than by an ordinance and avoid the advertising requirements.[5] However, a home rule charter may specify that an ordinance is required. It is not necessary to file with and obtain the prior approval of the DCED, pay a filing fee or create a sinking fund.

Small borrowings are notes which, when all such small borrowings are considered in total, do not exceed the lesser of either of the following:

- $125,000.
- 30 percent of the nonelectoral debt limit.

You should note that these limits apply to the *aggregate* amount of all small borrowings *in addition* to the amount you are currently borrowing.

There are additional restrictions on small borrowings that do not apply to other borrowings. They are:

- the principal of each small debt issue may not remain outstanding for more than five years.
- the incurrence of the small borrowing cannot cause your net outstanding debt to exceed your statutory debt limits.

Tax and Revenue Anticipation Notes

Short-term tax or revenue anticipation notes may only be issued to alleviate a cash flow problem arising because budgeted taxes or revenues have not yet been received, but will be by the end of the fiscal year. Traditionally, such notes were not viewed as additional sources of revenue, but simply as a means to correct an imbalance in the timing between expenditures and the receipt of funds.

The Local Government Unit Debt Act treats tax and revenue anticipation notes differently from other types of borrowing. The notes are not “debt” obligations and do not count against the statutory debt limits. The law does specify certain restrictions and procedures that must be followed when issuing these notes. The restrictions and procedures are the same for both tax and revenue anticipation notes.

There is a maximum amount which you can borrow in tax or revenue anticipation notes. The limit under the Local Government Unit Debt Act is 85 percent of the estimated taxes (revenues) which remain to be collected in the current fiscal year or during the period in which the note will be outstanding, whichever is less.[6] The actual amount you are permitted to borrow under current federal tax code regulations is limited to the cumulative cash flow deficit, which may be somewhat less than 85 percent. The estimate must be based on past history of collections and current economic conditions. Local government officials must certify the amount of anticipated revenues.

To issue anticipation notes, the governing body must pass a resolution authorizing the debt. Home rule charters may require an ordinance and public notice. The authorizing resolution should specify the anticipated taxes or revenue (or both) that will be received during the current fiscal year and are pledged as security for the notes. It may also establish one or more sinking funds into which the anticipated taxes or revenues are deposited as received.

Notes may be sold at public, private or invited sale. They may not be sold for less than their face value. The notes may be in registered form or contain coupons. The repayment schedule may be designed to meet your needs, but the life of the notes may not extend beyond the end of the fiscal year in which they are issued. The notes are general obligations of the local government unit.

Before the tax or revenue anticipation notes become legal and valid, they must be filed with the DCED. This filing must contain the following items:

- a written certification of the estimate of expected taxes (revenues), signed by municipal officials, and dated no more than 30 days prior to the date the notes are authorized.
- certified copies of the authorizing and awarding resolution.
- a true copy of the accepted proposal for the purchase of the notes.

The filing with the DCED is for information purposes only; the DCED's approval is not necessary. However the DCED will issue a receipt which is required for closing.

The holder of your tax/revenue anticipation notes (most likely a bank) requires you to complete a certificate of cumulative cash flow. The certificate, a federal requirement under arbitrage restrictions, determines the tax status (taxable or tax-exempt) of the notes.

Professional Advisors

Professional advisors can provide the highly specialized services you will need at some point either in planning for or managing debt, or in bringing a debt issue to market. These specialists can help you develop a sound debt policy and save you time and money in the long run. All municipal borrowers, no matter how familiar with the debt market, need the services of experts at some point in the process. There is no question of doing it on your own. Therefore, it is important to know who some of these experts are and what they do.

Some of the major types of professional advisors are bond counsel (attorneys), certified public accountants (CPAs), financial advisors and investment bankers and underwriters. It is worthwhile to maintain access to these specialists during all phases of planning for and marketing debt.

Bond Counsel. Bond counsel are attorneys who prepare the legal opinions to accompany the official statements. Their main purpose is to assure potential investors of the legality of the issue. Bond counsel review the legal status of the bond offering, including the legal basis for the municipality to issue the bonds, and determine if the bonds legally bind the issuer. They may also draft the required bond ordinance or resolution. Bond counsel may perform their duties for either the municipality or underwriter, or both. Ultimately, they protect the rights of the investors, thereby improving the salability of the bonds.

Certified Public Accountants. Certified public accountants are professional accountants who can provide a range of financial services to local governments, from calculating the borrowing base to preparing the financial data for the official statement. They may be useful for any of the required filings with the DCED.

Financial Advisors. Financial advisors have the training and experience to advise you on the design of a financing plan for projects, help you develop a debt policy, design a schedule for your debt payments, forecast costs and help design and market your bond issue. In a private bond sale, they can represent the municipality in

the negotiations and provide the expertise needed to make a private sale work. Local commercial bankers, underwriters and independent consultants can act as financial advisors.

Investment Bankers and Underwriters. Investment bankers and underwriters link you to the private capital market. They purchase your bonds, assume certain risks and resell your bonds to investors. They can be either security dealers or commercial banks.

In addition to providing specialized functions, professional advisors have the expert knowledge to assist you in various matters pertaining to debt management and the sale of bonds. They can help you schedule your debt to match your needs with your resources, and time your entry into the market to obtain the most favorable results. They may be able to assist in obtaining the essential credit ratings for your bonds. They also can help to keep debt load within manageable limits.

Selecting a Professional Advisor

The selection of professional advisors is important. Select responsible professionals whose knowledge, expertise and experience meets the municipality's needs. Some professional advisors, such as lawyers and CPAs, are certified in their profession; other types are not. None are certified in their ability to work with local governments.

The selection process, then, can be difficult. How should a municipality find the best possible expertise?

1. Define needs. What expertise is available on staff?
2. For those specialists in professions where certification is required, check out their certification. Do they currently possess the credentials they claim? Are they professionals in good standing?
3. Check with other municipalities. With whom have they worked? Whom would they recommend?
4. Request and check references. What types of services did they provide and how well did they perform them?
5. Check for experience in providing the type of service you need. Has the attorney ever written an opinion for a municipal bond offering?
6. Consult other professionals: Whom would they hire?

If the bonds are to be marketed nationally, the bond counsel should have national recognition. The reputation of the bond counsel is crucial to securing the confidence of investors, and can affect the purchase price.

Once you engage professional advisors, recognize your responsibility to provide supervision. It is important to work *with* them; don't simply hire them and turn them loose. Good communications are essential. Define expectations, especially about reporting.

Because of the diversity of services provided by financial advisors, it is important to have a formal written contract before the municipality engages their services. The contract must specify the services and the amount of compensation.

A good source of information on selecting financial advisors is a publication by the Government Finance Officers Association entitled *The Price of Advice: Choosing and Using Financial Advisors.*[7] This publication provides invaluable guidance on how to choose and use financial advisors.

Method of Selling Bonds

Two major methods are used to sell original issue bonds: competitive public sale and negotiated private placement. Competitive public sale is a familiar technique to procure equipment and supplies. Advertise the specifications and request bids, then award the contract on the basis of the most favorable bid. Selling bonds works in a similar fashion. Advertise the bond issue well in advance of the sale to attract as many bidders as possible, specifying the amount of the bonds, maturity dates and other material features. At the appointed time and place, open the bids and, if successful, award the bonds to the lowest cost bidder.

A negotiated private sale occurs when a municipality, either directly or indirectly through an underwriter, negotiates a price for its bond issue with a buyer (usually an underwriter). The underwriter who negotiates for the bonds might also help design the bond issue and prepare the official statement.

While many states require public sales, Pennsylvania is an exception in that it permits negotiated sales either by negotiation or by invitation. The Local Government Unit Debt Act allows municipalities to use either method as circumstances warrant.[8] However, prior to selling bonds or notes through a private sale, the law requires the governing body to pass a resolution stating that a private sale by negotiation is in the best financial interest of the local government unit. This resolution could be incorporated into the ordinance authorizing the bond sale. Despite this additional requirement, the vast majority of bond sales in the Commonwealth are negotiated sales.

Unusual or complicated bond issues favor the use of negotiated sales. However, successfully negotiated sales usually require experience and a high level of expertise on the part of the issuer. Professional financial advisors can provide the necessary know-how. Negotiated sales can be more prone to public criticism than competitive sales because the issuer selects the underwriter and negotiates the price. Questions may be raised: i.e. Are the terms and prices favorable? Would another underwriter have been better? These characteristics of private sales increase the importance of qualified, professional assistance during every stage of the process.

Full Disclosure and Investor Needs

The importance of full and adequate disclosure was discussed in an earlier chapter. While there are general guidelines on what should be disclosed in any debt offering, the particular circumstances of each offering often determine both the nature and the amount of information that should be disclosed.

It is in the best interest of the issuer to make a full and adequate disclosure. First of all, as pointed out in Chapter 3, proper disclosure offers protection from potential lawsuits. Second, full information allows underwriters to offer a fair price based on the merits of the issue. Uncertainties will increase the risk factor, thus the price to the municipality. Indeed, high interest costs are often the penalty inflicted upon issuers who are inexperienced or less diligent in their duties.

Advertising and Public Relations

Once a municipality has decided to incur debt to finance a capital project, it should recognize the importance of selling the idea to its citizens. A good information and public relations campaign can deter possible public opposition, saving time, trouble and money in the long run. Sell the idea to taxpayers. Explain why the project is needed and why the manner of financing was selected as the best alternative. Anticipate arguments against the plan and meet them directly. The importance of these communications is heightened if the municipality wishes to incur electoral debt and will place the question before the voters in a referendum. Dispel the mysteries quickly; tell voters the purpose of the debt and explain the tax impacts. Be up front. Taking the initiative, and publicizing the details of the borrowing plan early, can help to avoid or to minimize the effect of the opposition using the same information.

Discontented citizens can mount opposition to the application to the DCED for permission to incur debt. This could require the DCED to delay the application and hold hearings. This problem can send a bad signal to the debt market.

References

1. 53 Pa. C.S.A. 8103; Local Government Unit Debt Act, Section 8103.
2. 53 Pa. C.S.A. 8201; Local Government Unit Debt Act, Section 8201.
3. 71 P.S. 240.5A; Administrative Code, Section 605-A.
4. 53 Pa. C.S.A. 8110; Local Government Unit Debt Act, Section 8110.
5. 53 Pa. C.S.A. 8109; Local Government Unit Debt Act, Section 8109.
6. 53 Pa. C.S.A. 8122; Local Government Unit Debt Act, Section 8122.
7. Copies may be obtained from the Government Finance Officers Association, 180 N. Michigan Avenue, Suite 800, Chicago, IL 60601, (312) 977-9700.
8. 53 Pa. C.S.A. 8161; Local Government Unit Debt Act, Section 8161.

VI. Managing Outstanding Debt

Whenever a local government unit incurs debt, it assumes additional duties and responsibilities. Some duties are the result of federal and state law, while others are imposed by the debt securities market. The ability of a local government to fulfill those duties is directly related to how well it manages its debt. Debt management must begin well in advance of borrowing funds. Otherwise, the opportunity to control debt may be lost. The ability to control one's debt means the difference between a planned, orderly assumption and repayment of debt, or financial strain and crisis. Investors are more willing to purchase debt issued by those who exercise control.

Debt management helps to control debt by enabling a local government to assess its needs for borrowed funds and to evaluate its ability to repay its debts. A written debt policy in conjunction with a well-developed capital budgeting program will help to guide borrowing decisions. Debt management can also provide a customized, sound plan to help a local government meet its obligations in a responsible, timely fashion. Debt management is an important aspect of sound, overall management. It should be integrated with the budget process so that both the capital and operating budgets reflect the uses and effects of borrowing.

Municipal debt concerns do not end once the debt is issued. Rather, duties and responsibilities to bondholders continue as long as the obligations are outstanding. These duties include paying debt service when due and conducting affairs responsibly for the protection of creditors. Municipalities must inform lenders of current financial conditions to comply with requirements and agreements regarding sinking funds.

Keeping Lenders Informed

Proper and adequate disclosure is an ongoing and dynamic process; it does not culminate with the preparation and release of the official statement to accompany an initial offering. Additional disclosures to reflect current conditions must be made annually and as needed throughout the life of a debt issue. Such reporting is one of the most important aspects of debt management. There are many users of current information. Among them are bondholders, rating agencies and bond buyers in the secondary market. This information is crucial to make buy and sell decisions in a constantly changing market.

Current information may be provided in any of three forms: official statements by those local governments that regularly offer and sell bonds; annual financial reports; and statements compiled expressly for users of current information. Whichever form is used, the information must be timely, sufficient to meet the needs of users and available to them on a continuing basis.

What constitutes adequate disclosure for current data? As is true for the information that must accompany initial offerings, there are no set requirements for what should be disclosed on a continuing basis. Whatever material information that could reasonably affect the investment decisions of the average prudent investor must be disclosed. The adequacy of disclosure must be judged in light of circumstances surrounding particular debt issues.

The Governmental Finance Officers Association (GFOA) has developed a series of guidelines to assist in the development of current disclosures. While the guidelines are not legally binding on borrowers, they reflect the type of information that the market has come to expect from current disclosures. Copies of the guidelines are contained in the GFOA publication *Disclosure Guidelines for State and Local Government Securities* discussed earlier. GFOA revises the guidelines from time to time to reflect changing market needs. The latest guidelines for annual disclosure comprise five sections.

1. Cover page and introductory information.
    a. name of local government, type of issue, and source for more information about each.
2. Description of the issuer and enterprise, debt structure and finances.
3. Legal matters.
    a. pending legal proceedings.
    b. any changes in the legal opinion issued for an initial offering.
4. Changes in indebtedness.
    a. any additional authorized borrowing since the last disclosure.
    b. any changes with respect to outstanding issues.
5. Miscellaneous.
    a. ratings.
    b. interest of certain persons named in the information statement.

In addition to annual disclosures, municipal borrowers are obligated to release information when events having a significant effect upon their financial resources occur. Major developments concerning a debt issue or the local government itself may necessitate immediate disclosure. Such developments could include a default, a change in credit rating, a natural disaster, a severe loss in the tax base or similar problems. The prime concerns in such releases are timeliness and reliability.

Be sure to present information accurately, clearly, timely and to all those who need it. The GFOA recommends using both local and regional newspapers and specialized news wires to communicate with the market. It also recommends submitting documents to a central repository (such as "Munifiche" maintained by *The Bond Buyer,* and that maintained by Securities Data Company, Inc.) so that the documents remain available to users. Keep in mind that the purpose of disclosure is to provide investors with current information necessary to make decisions.

Debt Service Funds

The Local Government Unit Debt Act requires a local government to establish and maintain a sinking fund anytime it issues bonds or notes.[1] The sinking fund must exist until the bonds or notes are repaid. Sinking funds are not required for tax anticipation notes or small borrowings for capital purposes or for lease rental debt. The purpose of a sinking fund is to provide a pool of money which can be used to pay debt service as scheduled (to "sink" bonds that have been "floated"). Therefore, the money in a sinking fund should, at minimum, be sufficient to make any required payment when scheduled. The agreement with the holders of the bonds and notes might specify the amounts and times of sinking fund deposits. The Local Government Unit Debt Act requires that money sufficient for debt service payments be deposited prior to the time they become due and payable. The Act specifies the treasurer of each local government as the official who is responsible for making deposits in the sinking funds.

Sinking funds may be maintained with any bank or bank and trust company located in and authorized to do business in Pennsylvania. The depository of the sinking fund may also serve as the paying agent.

The governing body of each local government is vested with responsibility to manage and control the sinking funds. Sinking funds, therefore, are part of the assets of a local government and should be reflected in the Annual Audit and Financial Report of each local government. The local government unit is responsible for the audit of sinking funds. The DCED, under a grant of authority by the Local Government Unit Debt Act, may conduct an audit of any sinking funds not audited by an independent public accountant and reported annually.[2]

The DCED may impose penalties, including criminal prosecution, on local officials found in violation of requirements to establish and to make adequate deposits into sinking funds.

References

1. 53 Pa.C.S.A.8106; Local Government Unit Debt Act, Section 8106.
2. 53 Pa.C.S.A.8226; Local Government Unit Debt Act, Section 8226.

Additional Information

Listed below are materials available from the Office of Chief Counsel, Pennsylvania Department of Community and Economic Development, 4th Floor, Commonwealth Keystone Building, Harrisburg, PA 17120-0225 (717) 783-8452. These materials include sample proceedings for various types of debt filings and the text of the Local Government Unit Debt Act.

- Sample Proceedings for Five-Year General Obligation Debt
- Sample Proceedings for Tax And Revenue Anticipation Notes
- Information Sheet for Lease Rental Debt
- Sample Proceedings for Small Borrowings for Capital Purposes
- Model Forms for Petition Court of Common Pleas for Authority to Fund Unfunded Debt
- Local Government Unit Debt Act

Copies of sample forms are also available on the web at www.newPA.com, select Communities in PA or search on "Local Government Unit Debt Act."

A number of publications governing various aspects of municipal debt are available from the Government Finance Officers Association, 180 North Michigan Avenue, Suite 800, Chicago, IL 60601 (312) 977-9700. Please contact GFOA directly for prices and ordering information.

- Competitive v. Negotiated: How to Choose the Method of Sale for Tax-Exempt Bonds
- Debt Issuance and Management: A Guide for Smaller Governments
- Disclosure Guidelines for State and Local Government Securities, 1977
- A Guide to Municipal Leasing, 1983
- A Guide to Registered Municipal Securities, 1983
- Information Flows in the Municipal Bond Market, 1989
- Municipal Bonds: Planning, Sale and Administration, 1982
- Pricing Bonds in a Negotiated Sale: How to Manage the Process
- Purchasing Credit Enhancement: How to Decide if Bond Insurance Makes Sense
- Tax-Exempt Financing: A Primer

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