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How to manage long-term debt

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ME A

The municipal bond market is "big business." Municipal debt is being issued both to provide capital assets and to counteract the impact of inflation. It is being issued at a rate of over \$60 billion and 8,000 issues per year. As of 1976, there was \$240.1 billion of municipal debt in the marketplace.

Yet, very little attention is being given to proper debt management—even after recent fiscal crises brought about by the inappropriate use of debt. What needs to be recognized is that debt management is a sophisticated process that can save a community many dollars in tax money (e.g., lower interest rates, better acceptance in the financial marketplace). Conversely, poor debt management costs money. Given the size of this market, the increased use of debt, and the implications of a Proposition 13 "tax revolt," it surely follows that debt must be issued at the lowest possible cost.

What then, is effective debt management? This article will examine:

- Long range capital planning.* Which capital projects should a governmental unit undertake?
- Capital budgeting and appropriations.* How much money should be available for capital projects in a year, and from what fund sources?
- Debt authorization.* How much debt can a government unit issue?

- Debt use guidelines.* What is the proper use of debt, and what is the debt capacity of a government unit?
- The rating agencies.* What is the key role that "ratings" play in the cost of debt, and how can governments influence their ratings?
- Identification of debt.* What comprises long-term debt?
- Bond issuance.* How should bonds be issued to assure the lowest overall cost of debt?
- Disclosure.* What information is required by the rating agencies and potential investors?
- Payment of debt.* What is "refunding," and what are its objectives?
- Monitoring, control, and management of debt.* How do the administration and the legislative body of an issuing government control debt use?

Municipal debt can be classified in two ways: the maturity of the debt (short-term versus long-term) and the security for the debt (general obligation versus revenue debt). Short-term debt, which is issued and repaid within a year or less, forms a major portion of the municipal bond market. Long-term debt, which is issued to finance construction or purchase of capital (long-lived) assets, is the focus of this article.

It will perhaps be helpful to define further terms that will be used. Debt

may be classified as "general obligation" or "revenue" debt. General obligation means that the bondholder is assured that payment of principal and interest has priority over any other expenditure from the local government's tax base, and that, if required, taxes will be increased to meet such payment. Revenue debt is repaid from the revenues derived from a particular project, such as a health care institution (where revenues are patient fees) or a tollway (where the revenues are tolls paid by users). Less secure than general obligation bonds, revenue bonds bear a higher interest rate.

A new form of debt security is the so-called "moral obligation" debt. Such bonds are revenue debt unless there is a danger of default. In that case, the issuing body may be morally obligated to pay the debt.

In recent years, there have been two major, well reported cases of misuse of municipal debt, the Urban Development Corporation (e.g., misuse of moral obligation debt) and New York City (e.g., misuse, by continued "rollovers," of short term debt). There has been some misuse of debt on a smaller scale, but given the large amount of municipal debt issued and outstanding, the cases of misuse (accidental or deliberate) have been miniscule. The impact on the municipal bond market, how-

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ever, of the Urban Development Corporation and New York City has been significant.

How is such misuse to be avoided? Here are 10 guideposts.

Long-Range Capital Planning

Which capital projects should a government unit undertake? Capital assets are by their very nature permanent and expensive. They usually require more than one fiscal year for need evaluation, design, and acquisition. It is important that capital assets fulfill a need, that facilities are available when required, and that funds are available when needed.

Effective capital planning cannot be performed for a single fiscal year at budget time or on a "crash" basis. A capital plan, enabling decision makers to prioritize capital needs, must look ahead for three to five years. It should identify such factors as the particular population being served, the total acquisition cost of the assets, the construction period, operating and maintenance costs, alternative facilities to fulfill the program's need, and alternative forms of financing, such as federal grants or leasing of comparable property.

Capital Budgeting, Appropriations

How much money should be available for capital projects in a year, and from what fund sources? The annual capital appropriations by the legislative body will determine how much capital is acquired in any year and the source of the funding (e.g., bonds or operating funds).

Such appropriations, therefore, can control capital costs, debt issuance, and the financial condition of a jurisdiction. Too much capital spending can be as detrimental as too little.

Effective legislative decisions on

capital budgets require information and the time to evaluate the information.

□ The information should include needs, objectives, capital and operating costs, benefits, alternatives, and so on for capital project.

□ The overall size of the capital budget and the overall sources of funding must be clear, including the impact that any bond monies to be used will have on the jurisdiction's overall debt structure and capacity.

Capital budgets may be enacted in a number of different ways. The spending authority may be granted for an individual project or it may be given to an agency to spend as the agency sees best. The capital budget, once appropriated, may remain valid until the projects have been completed; in other cases, the legislature must act each year on a capital budget.

Debt Authorization

How much debt can a government unit issue? A governmental jurisdiction (e.g., city, county, state) must have legal authorization to issue debt. Debt authorization thus becomes a major control over financial condition and debt use. State and local debt, generally, can be authorized in one of three ways: citizen approval (a referendum), legislative approval or formula approval (based on total revenue or debt per capita, for instance), or a combination of these. Because a citizen referendum may be required for general obligation bonds, whereas revenue debt often does not require voter approval, public officials often turn to revenue bonds. But while this may avoid public wrath at the polling place, it may also result in higher interest rates and, ultimately, in higher costs to the taxpayers.

The legislative body can authorize debt in one of several ways:

- Automatically authorize when funds for the capital project are appropriated.
- Authorize up to a specified amount, for a specified number of years, for either specific or general purposes.
- Authorize to cover all debt requirements for a year or other time period.
- Authorize as a function of operating or other revenues.
- A combination of the above.

No matter how debt is authorized, steps should be taken to assure a periodic review of debt authority by the legislative body (e.g., "sunset" legislation).

The legislative body should also be concerned with the types of projects to be built, the extent of the jurisdiction's responsibility, the impact of the new debt on the jurisdiction's debt burden as well as on the market for the debt, and both the total cost of the debt and the control of the debt.

Debt Use Guidelines

What is the proper use of debt, and what is the debt capacity of a government unit? The answers to these questions depend on the guidelines that are established on how such debt is going to be used.

□ *Debt Capacity.* Perhaps the most widely asked question about long-term municipal debt is: "How much is enough?" or "How much can I afford to issue?" Too much debt mortgages the future, of course, and may increase the cost of long-term debt. But there is no magic answer as to how much debt is "enough." It will vary with each community, depending upon what a government wants to pay for debt,

the type of capital project (such as revenue producing or job creating), the bond rating, and the percentage of budget used for debt service.

There are a number of ways to establish limits on debt authorization, and thus debt use. With the increasing cost of debt, quantitative approaches are becoming popular. Such approaches consider future debt service (e.g., how much will future generations be taxed), future capital needs, the cost of debt, and debt related ratios. One state government is considering basing its debt capacity on the same factors that rating agencies use for bonds.

□ *Debt versus Cash.* How much should debt be used to finance capital construction? Of course, a government can use 100 percent debt financing for capital construction. However, excessive use of debt will increase the cost of such financing, will overburden future generations, will limit the debt which can be issued, and will under-tax current generations. For many revenue bond issues, the jurisdiction is expected to show its faith in the project by contributing some of its own "equity." But there are no fixed rules concerning the proper balance between debt and equity. One government has decided that two-thirds of any new construction will be financed through debt, and one-third through operating funding.

□ *Bondability.* While only capital items (long-lived assets) should be purchased with bond money, there are many possibilities within this guideline. For instance, should bond funds be limited to buildings, roads, and other long-lived assets, or can they be used for books, desks, and other furnishings? Actually, what is to be purchased is apt to determine the structure of the bond issue. The

average life of the bond issue should not exceed the average life of the assets it purchases, or future generations will be paying for assets they no longer benefit from (e.g., such short-lived assets as automobiles and computers).

Rating Agencies

What is the key role that ratings play in the cost of debt, and how can governments influence these ratings? The volume and diversity of state, local, and public authority bond offerings have prompted the development of municipal bond rating agencies. These examine an issuer's credit and offer opinions to the bond buying public. The higher the rating, the lower the interest that is paid for borrowing money.

The two most widely accepted rating agencies are Moody's Investor Services, Inc., and Standard & Poors Inc. (S&P). While there are no set formulae for reviewing bonds, most analysts agree that the important factors in credit rating are the ability to meet principal payments, debt outstanding, the economic and fiscal condition of the jurisdiction, and such judgmental factors as the competence of the jurisdiction's management.

A recent study of state credit ratings indicated that, from 1972 to 1976, seven states received rating revisions from double-A to triple-A. These improved bond ratings followed favorable long-range developments that impressed the rating agencies—such as conservative debt policies and sound debt management, government reorganization and tax reforms, capital projects that would improve long-range economic prospects for the state, and light debt burdens over the long term or increasing debt burdens more than

compensated for by expanding state resources.

On the other hand, during this same five-year period, seven states had their triple-A general obligation bond rating lowered. The causes were large increasing debt burdens, repeated borrowing to cover general fund deficits, apparent reluctance to increase taxes as much as required to cover operating deficits, uncertain economic prospects, and borrowing to cover defaulted authority loan payments guaranteed by the state.

Identification of Debt

What comprises long-term debt? Long-term debt is not limited to formal bond obligations. Certain actions by the legislative body could unintentionally—and substantially—take a jurisdiction over its debt capacity.

Perhaps the major source of "hidden" long term debt is pension obligations. When these exceed formal debt obligations, they cause enormous fiscal strain on a jurisdiction. Indeed, sophisticated investors and rating agencies are beginning to consider such obligations as part of a government's outstanding debt. And as total debt increases, the cost of new bonds could also increase.

Bond Issuance

How should bonds be issued to assure the lowest overall cost of debt? A number of factors must be considered.

□ *The length or maturity of the bond.* This will be determined, in part, by the nature of the underlying asset. The maturity schedule may be "even" (in a 20-year schedule, 1/20 will mature each year), or the principal payments may be made in varying amounts, according to the cash available from the jurisdiction.

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□ *The size and frequency of the offering.* For jurisdictions which come to market often, too large or too frequent an offering may affect the salability of the bonds. Thus, size and frequency must be balanced.

□ *The method of sale*—competitive or negotiated. Most general obligation bonds are sold at competitive auction. Generally, competitive offerings result in a lower interest cost to the jurisdiction. This might not be true, however, when a revenue bond is used to finance a non-familiar asset, such as a hospital.

□ *The source of financial advice.* Jurisdictions which do not enter the bond market often will not likely have the expertise to determine the structure of issues, market timing, and how to bring issues to market. At times, those familiar with the market will also need advice. If this advice is provided by an outside financial advisor, it is important that the advisor be independent. He himself should not underwrite the bonds or deal with the bonds in the secondary market. An alternate source of advice is an advisory board consisting of individuals in the jurisdiction who understand the capital market.

□ *Cash requirements forecasting.* Such forecasting is necessary to determine when bonds should be issued.

Disclosure

What information is required by the rating agencies and potential investor? Prior to each bond sale, the jurisdiction issues an official statement to underwriters, the investment community, and rating agencies. This official statement offers information about the jurisdiction (its organization, size, history, demographics), the bond issue (structure,

size, term, maturity, legality), and finances (financial statements, other indebtedness, cash flow forecast, pension information).

Prior to the 1975 fiscal problems of the Urban Development Corporation and New York City, the official statement was not widely used. Since that time, there have been increased demands to disclose all relevant information for investment decisions. Furthermore, misrepresentation or omission of significant information could be construed as fraud and subject the issuer to federal, regulatory, or judicial action.

There has not, however, been complete agreement about what should be disclosed. In December, 1976, the Municipal Finance Officers Association did prepare *Disclosure Guidelines for Offerings of Securities by State and Local Governments*, and many states and local governments have been preparing official statements within these guidelines. Federal legislation is also pending which would require "distribution statements" on any new bond offering and annual reports for jurisdictions which have outstanding debt. It would also give the Securities and Exchange Commission the authority to revise information requirements as they saw appropriate. No action is anticipated on this legislation in the near future.

Payment of Debt

What is "refunding" and what are its objectives? The goal of any government is to repay the principal and interest on outstanding debt in an orderly fashion. This is usually achieved by periodic principal and interest payments. In recent years, however, many bonds have been "refunded" by the issuance of new bonds to replace the existing bonds.

This enables a government to reduce its overall interest cost or to revise what might have been unfavorable structural elements in the existing bonds.

Bond refunding is quite complex and may be subject to the arbitrage rules of the Internal Revenue Service. In addition, the ability to refund is defined by the structure of the outstanding bonds.

Control and Management of Debt

How do the administration and the legislative body of an issuing government control debt use? There are a number of control points built into the overall debt management process. It is particularly important that debt is "in control" when jurisdictions issue large amounts of debt and go to the market frequently. Thoughtful development of guidelines by the legislative body, careful authorization, and well thought out appropriations offer perhaps the best assurance that debt is not being used indiscriminately. Some jurisdictions are establishing legislative committees to monitor debt management.

Conclusion

To provide needed services and to rebuild our cities and states has required significant new capital construction. Managing such debt begins with effective long-range capital planning and concludes with the repayment of the debt. It is a complex process that calls for overall monitoring, control, and coordination by the issuing jurisdiction. Effective debt management can minimize the cost of debt financing to a government organization. Ineffective debt management not only increases cost, it can also negatively impact the jurisdiction's overall fiscal structure. ▲