# Debt Management for Counties

*By Jim Culotta, Research Assistant, National Association of Counties (NACo)*

The act of borrowing, obtaining funds today in exchange for a promise to pay them back tomorrow, is one of the most potent and profound activities undertaken in government finance. In recent years, counties have increasingly turned toward the issuance of debt to help finance basic infrastructure projects, such as schools, roads, and hospitals. A poorly designed or poorly managed bond issue can burden taxpayers with excess interest costs over the life of the issue. For this reason, it is more critical than ever that counties effectively manage their debt.

## Debt Policy: An Important Financial Management Tool

A formal debt policy is an essential part of effective financial management and should be incorporated into a county's capital improvement program. There are several reasons to establish a debt policy. First, it establishes the parameters for the issuance of debt, which help prevent exceeding acceptable levels of indebtedness. Second, debt policies give investors and rating agencies evidence of the county's commitment to sound financial management. Third, debt policies provide consistency and continuity for public policy development and help guide county decision makers.

The Government Finance Officers Association (GFOA) recommends that all state and local governments intending to issue debt develop a comprehensive debt policy. A debt policy should include the following elements:

- Purposes for which debt may be issued.
- Legal debt limitations, or limitations established by policy.
- Use of moral obligation pledges.
- Types of debt permitted to be issued and criteria for issuance.
- Structural features that may be considered.
- Credit objectives.
- Method of sale.
- Selection of external financial professionals.
- Refunding of debt.
- Disclosure (primary and secondary market).
- Compliance with federal tax law provisions, including arbitrage requirements.
- Integration of capital planning and debt financing activities.
- Investment of bond proceeds where otherwise not covered by explicit written law or written investment policy.

In order to be an effective management tool, debt policy provisions must be compatible with the jurisdiction's goals pertaining to the capital program and budget, the financial plan, and the operating budget. It is important to find the appropriate balance between establishing limits on the debt program and providing sufficient flexibility to respond to unforeseen circumstances and opportunities. The debt policy should be formally adopted by the county board and continuously monitored to ensure compliance.

## Analyzing Debt Capacity and Establishing Debt Limits

When a county issues bonds, it enters into a long-term commitment that requires it to make timely principal and interest payments over the life of the bonds. Therefore, the county needs to ensure that future debt service payments to bondholders can be made on time, without jeopardizing essential county services. A comprehensive and routine analysis of debt capacity provides assurance that the amount of debt issues by the county is affordable and cost-effective. An analysis of debt capacity should cover the following range of factors:

- Statutory or constitutional limitations affecting the amount that can be issued.
- Other legal limitations, such as coverage requirements or additional bonds tests imposed by bond covenants.
- Measures of the tax and revenue base.
- Evaluation of trends relating to the county's financial performance.
- Debt service obligations.
- Measures of debt burden on the community.
- Tax-exempt market factors affecting interest costs.

## Bond Ratings

When a county borrows money by selling bonds, the most important variable that determines the interest cost of the bonds is their bond rating. Bond ratings are an assessment of credit quality or, conversely, the risk that the borrower will not make scheduled payments of principal and interest. Rating agencies base their ratings on a number of key economic, debt, financial and governmental factors.

## Economic Factors

Rating agencies focus on major employers and taxpayers, regional economic factors, the impact of national and international economic developments on the local economy, and demographic data regarding the county's population (such as per capita income, average age, educational attainment, etc.).

## Debt Factors

Rating agencies evaluate debt per capital, debt as a percentage of the assessed value of property, debt service as a percentage of annual revenues, payout rate, use of short term or variable rate debt, authorized but unissued debt and the legal structure of the issue's security.

## Financial Factors

Rating agencies analyze the county's comprehensive annual financial reports, annual budgets, revenue and expenditure composition and growth rates, accounting methods, contingent obligations (such as pension liabilities), intergovernmental transfers, and cash liquidity levels.

## Administrative Factors

Rating agencies assess the county's management professionalism, ability to respond to economic adversity, willingness of elected officials to make unpopular financial decisions, the county's state objectives related to debt management, economic development activities, tax policies, capital improvement planning, employee relationships (e.g. unions), and the county's willingness to adhere to long-range financial plans.

# Major Forms of Debt Securities

**General Obligation (GO) Bonds** are the most common form of debt issuance by state and local governments. These securities are commonly referred to as "full-faith-and credit" bonds because they are based on the pledge of a government unit to levy the necessary taxes to pay the interest and retire the principal. Unlimited-tax GO bonds legally obligate the county to levy taxes on all assessed property within its jurisdiction at whatever level necessary to meet the debt service payments. Limited-tax GO bonds are backed only by special taxes such as a sales tax; others are backed only by specific revenue sources. Historically, voter approval has been required to authorize the issuance of GO bonds. However, a growing number of jurisdictions have been given authority to issue limited amounts of GO bonds without referendum.

**Revenue Bonds** are limited-liability obligations. The security for revenue bond issues is provided by a pledge of a specific revenue stream - usually derived from the project being funded or the enterprise system of which the project is a part. This ensures equitable distribution of the debt burden. These bonds are not backed by the taxing power, and as a result, they are not included in the usual debt limits. Unlike GO bonds, revenue bonds typically do not require voter approval.

**Certificates of Participation (COP)** are a form of lease obligation in which the county enters into an agreement to pay a fixed amount annually to a third party, usually a nonprofit agency or a private leasing company. Otherwise, they do what municipal bonds do: They raise money to acquire equipment or construct a facility. According to municipal finance experts, almost anything can be engineered for lease. COPs do not need voter approval, and they do not generally count toward a jurisdiction's debt volume limitations. Payments are subject to annual appropriations. However, COPs are not permissible in all states, and they are generally more expensive to issue than bonds due to the involvement of a third party. More importantly, COPs are considered riskier investments because government can, in any given year, negate a lease contract without being considered in default. As a result, investors often require higher interest rates.

## Investment Grade Rating Designations of Major Rating Agencies

| Investment Grade Category | Fitch | Moody's | Standard & Poor's |
|---|---|---|---|
| Highest Quality | AAA | Aaa | AAA |
| Very high quality | AA | Aa | AA |
| High or strong quality | A | A | A |
| Adequate or satisfactory quality | BBB | Baa | BBB |

Note: Fitch and Standard & Poor's use "+" and "-" to indicate relative quality with a major category. Moody's indicates better quality within a category by the symbols Aa1, A1 and Baa1.

## How To Win A Bond Referendum

Most capital finance experts agree that bond referendums are risky business. This helps explain why a growing number of local officials are turning to COPs and other bond alternatives that do not require voter approval. However, bonds remain the basic means of raising money for capital improvements. When the voters say no to a bond referendum, more than a worthwhile infrastructure project my be at stake. A county's bond rating may be downgraded if county officials can't deliver the votes most of the time. The following are a few tips for a successful bond referendum campaign:

- Start off with a clearly defined statement of purpose - why the project that will be bond-financed is necessary.
- Get your voters attention and educate them on the issue.
- Meet with the news media early and often to gain their support and free publicity.
- Develop a good track record by promising only what you can deliver.
- Finance the bond campaign adequately by tapping funds from private industries and county government agencies affected by the bond, if allowable by law.

**Internet Resources**

Fitch Investors Service, L.P. (http://www.fitchinv.com)
Moody's Investors Service (http://www.moodys.com)
Standard & Poor's Rating Services (http://www.standardpoor.com)
Government Finance Officers Association (http://www.gfoa.org)
U.S. Securities and Exchange Commission (http://www.sec.gov)
Municipal Securities Rulemaking Board (http://ww1.msrb.org)
The Bond Buyer (http://www.bondbuyer.com)

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Association *of* Minnesota Counties
125 Charles Avenue, St. Paul, MN 55103-2108
Main Line: 651-224-6540, Fax: 651-6540
www.mncounties.org