Resolution No.: 16-1173
Introduced: October 20, 2009
Adopted: October 27, 2009

COUNTY COUNCIL
FOR MONTGOMERY COUNTY, MARYLAND

By: County Council at Request of County Executive

SUBJECT: Approval of Local Government Debt Policy

Background

1. State of Maryland Chapter 693 of the Laws of 2009 requires that each local government adopt a debt policy and submit it to the State Treasurer.

2. On October 8, 2009 the Chief Administrative Officer transmitted a recommended a Local Government Debt Policy to the Council.

Action

The County Council for Montgomery County, Maryland approves the following resolution:

The attached Local Government Debt Policy is approved.

This is a correct copy of Council action.

Linda M. Lauer

Linda M. Lauer, Clerk of the Council

Montgomery County, Maryland

Debt Policy

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Debt Policy

I. Introduction

Montgomery County recognizes that one of the attributes of sound financial management is a comprehensive debt policy. Adherence to a debt policy signals to residents, rating agencies and the capital markets that a government is well managed and should meet its obligations in a timely manner. The development of a debt policy is a recommended best practice by the Government Finance Officers Association. A debt policy establishes the parameters for issuing and managing debt. It improves the quality of decisions, provides justification for the structure of debt issuance, identifies policy goals, and demonstrates a commitment to long-term financial planning, including a multi-year capital plan.

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

This debt policy is to be used in conjunction with the operating and capital budgets, the capital improvement program (CIP), and other financial policies.

II. Legal Framework

The Annotated Code of Maryland, Article 25A, Section 5(P), authorizes borrowing of funds and issuance of bonds up to a maximum of the sum of six percent of the assessed valuation of all real property and 15 percent of the assessed valuation of all personal property within the County. Article 25A, Section 5(P) provides that obligations having a maturity not in excess of twelve months shall not be subject to, or be included in, computing the County's legal debt limitation. However, the County includes its BANs/Commercial Paper in the calculation because it intends to repay the notes with the proceeds of long-term debt to be issued in the near future.

The Montgomery County Charter, Section 312 provides for the issuance of public debt for other than annual operating expenditures and imposes general requirements for fiscal policy: The capital improvements program must provide an estimate of costs, anticipated revenue sources, and an estimate of the impact of the program on County revenues and the operating budget. Bond issues may not be for longer than 30 years.

In November 1990, County voters approved an amendment to the Montgomery County Charter, Section 305, to require that the County Council annually adopt spending affordability guidelines for the capital and operating budgets. Spending affordability guidelines for the CIP have been interpreted in subsequent County law to be limits on the amount of County general obligation debt, which may be approved for the first and second years of the CIP and for the entire six-year period of the CIP. Similar provisions apply to debt of the Maryland-National Capital Park and Planning Commission

(M-NCPPC). These limits may be overridden by an affirmative vote of seven Councilmembers.

Chapter 20 of the Montgomery County Code sets various financial guidelines in law such as the deposit of funds, the borrowing of money generally, the activities of the Department of Finance, revenue bonds, and spending affordability.

Internal Revenue Service rules under the Tax Reform Act of 1986, as amended, provide limits on the tax-exempt issuance of public debt, and limit the amount of interest the County can earn from investment of the bond proceeds. County shares of costs for some major projects, such as those relating to mass transit and highway interchanges, are dependent upon Federal appropriations and allocations.

Federal Office of Management and Budget circular A-87 prescribes the nature of expenditures that may be charged to Federal grants. Federal legislation will influence the planning and expenditures of specific projects, such as requirements for environmental impact statements for Federally assisted road projects, and the Davis-Bacon Act, which requires local prevailing wage scales in contracts for Federally assisted construction projects.

The American Recovery and Reinvestment Act (ARRA) created a number of additional tax-advantaged forms of governmental debt. These forms of debt are expected to result in lower costs and therefore savings to taxpayers. The County will utilize beneficial provisions of the act and issue these new forms of debt where appropriate and advantageous to the County.

III. County Debt Policies

Policy on Funding the Capital Improvements Program (CIP) with Debt
Much of the CIP should be funded with debt. Capital projects usually have a long useful life and will serve future taxpayers as well as current taxpayers. It would be inequitable and an unreasonable fiscal burden to make current taxpayers pay for many projects out of current tax revenues. Bond issues, retired over approximately 20 years, are both necessary and equitable.

Projects deemed to be debt eligible should:

- Have a useful life at least approximately as long as the debt issue with which they are funded.
- Not be able to be funded entirely from other potential revenue sources, such as intergovernmental aid or private contributions.
- Special Note: With a trend towards more public/private partnerships, especially regarding projects aimed at the revitalization or redevelopment of the County's central business districts, there are more instances when public monies leverage private funds. These instances, however, generally bring with them the "private activity" or private benefit (to the County's partners) that generally make it necessary for the County to use current revenue as its funding source. It is County fiscal policy that financing in partnership situations ensure that tax-exempt debt is issued only for those

improvements that truly meet the IRS requirements for this lowest cost form of financing.

Policy on General Obligation Debt Limits
General obligation debt usually takes the form of bond issues, and pledges general tax revenue for repayment. Paying principal and interest on general obligation debt is the first claim on County revenues. By virtue of prudent financial management and the long-term strength of the local economy, Montgomery County has maintained the highest quality rating of its general obligation bonds, AAA. This top rating by Wall Street rating agencies, enjoyed by very few local governments in the country, assures Montgomery County of a ready market for its bonds and the lowest available interest rates on its debt.

Debt Capacity

To maintain the AAA rating, the County adheres to the following guidelines in deciding how much additional County general obligation debt may be issued in the six-year CIP period:

<u>Overall Debt as a Percentage of Assessed Valuation</u> - This ratio measures debt levels against the property tax base, which generates the tax revenues that are the main source of debt repayment. Total debt, both existing and proposed, should be kept at about 1.5 percent of full market value (substantially the same as assessed value) of taxable real property in the County.

<u>Debt Service as a percentage of the General Fund</u> - This ratio reflects the County's budgetary flexibility to adapt spending levels and respond to economic condition changes. Required annual debt service expenditures should be kept at about ten percent of the County's total General Fund. The General Fund excludes other special revenue tax supported funds. If those special funds supported by all County taxpayers were to be included, the ratio would be below ten percent.

<u>Overall Debt per Capita</u> - This ratio measures the burden of debt placed on the population supporting the debt and is widely used as a measure of an issuers' ability to repay debt. Total debt outstanding and annual amounts issued, when adjusted for inflation, should not cause real debt per capita (i.e., after eliminating the effects of inflation) to rise significantly.

<u>Ten year Payout Ratio</u> - This ratio reflects the amortization of the County's outstanding debt. A faster payout is considered a positive credit attribute. The rate of repayment of bond principal should be kept at existing high levels and in the 60-75 percent range during any ten-year period.

<u>Per Capita Debt to Per Capita Income</u> – This ratio reflects a community's economic strength as an indicator of income levels relative to debt. Total debt outstanding and annual amounts proposed should not cause the ratio of per capita debt to per capita income to rise significantly above about 3.5 percent.

These ratios will be calculated and reported each year in conjunction with the capital budget process, the annual financial audit and as needed for fiscal analysis.

Policy on Terms for General Obligation Bond Issues
Bonds are normally issued in a 20-year series, with 5 percent of the series retired each year. This practice produces equal annual payments of principal over the life of the bond issue, which means declining annual payments of interest on the outstanding bonds, positively affecting the pay-out ratio (see Debt Limits, below). Thus annual debt service on each bond issue is higher at the beginning and lower at the end. When bond market conditions warrant, or when a specific project would have a shorter useful life, then different repayment terms may be used.

Policy on Other Forms of General Obligation Debt
The County may issue other forms of debt as appropriate and authorized by law. From time to time, the County has issued Commercial Paper/Bond Anticipation Notes (BANs) for interim financing to take advantage of favorable interest rates within rules established by the Internal Revenue Service.

Policy on Use of Revenue Bonds
Revenue bonds are secured by the pledge of particular revenues to their repayment in contrast to general obligation debt, which pledges general tax revenues. The revenues pledged may be those of a Special Revenue fund, or they may be derived from the funds or revenues received from or in connection with a project. Amounts of revenue debt to be issued should be limited to ensure that debt service coverage ratios shall be sufficient to ensure ratings at least equal to or higher than ratings on outstanding parity debt. Such coverage ratios shall be maintained during the life of any bonds secured by that revenue stream.

Policy on Use of Appropriation-backed Debt
Various forms of appropriation backed debt may be used to fund capital improvements, facilities, or equipment issued directly by the County or using the Montgomery County Revenue Authority or another entity as a conduit issuer. Under such an arrangement, the County enters into a long-term lease with the conduit issuer and the County lease payments fund the debt service on the bonds. Appropriation-backed debt is useful in situations where a separate revenue stream is available to partially offset the lease payments, thereby differentiating the project from those typically funded with general obligation debt. Because these long-term leases constitute an obligation of the County similar to general debt, the value of the leases is included in debt capacity calculations.

Policy on Issuance of Taxable Debt
Issuance of taxable debt may be useful in situations where private activity or other considerations make tax-exempt debt disadvantageous or ineligible due to tax code requirements or other considerations. The cost of taxable debt will generally be higher because investors are not able to deduct interest earnings from taxable income. Taxable debt may be issued in instances where the additional cost of taxable debt, including legal, marketing, and other up-front costs and the interest cost over the life of the bonds, is outweighed by the advantages in relation to the financing objectives to be achieved.

Policy on Use of Interim Financing
Interim Financing may be useful in situations where project expenditures are eligible for long term debt, but permanent financing is delayed for specific reasons, other than

affordability. Interim Financing should have an identified ultimate funding source, and should be repaid within the short term. An example for interim financing would be in a situation where offsetting revenue will be available in the future to pay off a portion of the amounts borrowed, but the exact amounts and timing of the repayment are uncertain.

Policy on Use of Short Term Financing
Short term financing (terms of seven years of less) may be appropriate for certain types of equipment or system financings, where the term of the financing correlates to the useful life of the asset acquired, or in other cases where the expected useful life is long, but due to the nature of the system, upgrades are frequent and long term financing is not appropriate. Short term financings in the CIP are also of a larger size or magnitude than smaller purchases typically financed with short term Master Lease financing in the Operating Budget.

Policy on Use of Current Revenues
Use of current revenues to fund capital projects is desirable as it constitutes "pay-as-you-go" financing and, when applied to debt-eligible projects, reduces the debt burden of the County. Decisions to use current revenue funding within the CIP have immediate impacts on resources available to annual operating budgets, and require recognition that certain costs of public facilities should be supported on a current basis rather than paid for over time.

Current revenues from the General Fund are used for designated projects which have broad public use and which fall outside any of the specialized funds. Current revenues from the Special and Enterprise Funds are used if the project is associated with the particular function for which these funds have been established.

The County has the following policies on the use of current revenues in the CIP:

- Current revenues must be used for any CIP projects not eligible for debt financing by virtue of limited useful life.
- Current revenues should be used for CIP projects consisting of limited renovations of facilities, for renovations of facilities which are not owned by the County, and for planning and feasibility studies.
- Current revenues may be used when the requirements for capital expenditures press the limits of bonding capacity.
- Except for excess revenues which must go to the Revenue Stabilization Fund, the County will, whenever possible, give highest priority for the use of one-time revenues from any source to the funding of capital assets or other nonrecurring expenditures so as not to incur ongoing expenditure obligations for which revenues may not be adequate in future years.

Policy on Use of Federal and State Grants and Other Contributions
Grants and other contributions should be sought and used to fund capital projects whenever they are available on terms that are to the County's long-term fiscal advantage. Such revenues should be used as current revenues for debt avoidance and not for debt service.

Policy on Minimum Allocation of PAYGO

PAYGO is current revenue set aside in the operating budget, but not appropriated, and is used to replace bonds for debt eligible expenditures. To reduce the impact of capital programs on future years, the County will fund a portion of its CIP on a pay-as-you-go basis. Pay-as-you-go funding will save money by eliminating interest expense on the funded projects. Pay-as-you-go capital appropriations improve financial flexibility in the event of sudden revenue shortfalls or emergency spending. It is the County's policy to allocate to the CIP each fiscal year as PAYGO at least ten percent of the amount of general obligation bonds planned for issue that year.

Policy on Operating Budget Impacts

In the development of capital projects, the County evaluates the impact of a project on the operating budget and displays such impacts on the project description form. The County shall not incur debt or otherwise construct or acquire a public facility if it is unable to adequately provide for the subsequent annual operation and maintenance costs of the facility.

IV. Debt Issuance and Structuring Policies

Credit Ratings

The County's ability to borrow cost-effectively depends upon its credit standing as assessed by the three major credit rating agencies: Moody's, Standard and Poor's, and Fitch. The Director of Finance shall be responsible for maintaining relationships with the rating agencies that currently assign ratings to the County's various debt obligations. This effort shall include providing periodic updates of the County's general financial condition along with coordinating meetings and presentations in conjunction with a new debt issue. The Director shall be responsible for determining whether or not a rating shall be requested on a particular financing, and which of the major rating agencies shall be asked to provide such rating.

Fixed or Variable Rate Mode

The County will use variable debt to balance interest rate cost risk across its debt portfolio. The use of variable rate debt allows the County to take advantage of short term interest rates, which are typically lower, as well as to provide interim financing for the general obligation bond funded portion of the capital program and to provide interim financing in instances where prepayment or restructuring is a high probability and redemption in the short term is likely. Variable rate debt secured by the County's general obligation pledge includes Variable Rate Demand Notes (VRDOs) and Bond Anticipation Notes (BANs).

Method of Sale - Competitive vs. Negotiated Sales

The County as a matter of policy shall issue its debt obligations through a competitive sale unless the Director of Finance determines that such a sale method will not produce the best results for the County. Generally, a negotiated sale process may be used when the County is attempting to market more complex bond transactions such as a new credit structure, or at times when a competitive sale does not produce bids or produces bids that are unsatisfactory to the County.

When appropriate and approved by the Finance Director, the County may elect to sell its debt obligations through a private placement or limited public offering. Selection of an institution to underwrite the debt shall be made pursuant to the selection procedures developed by the Department of Finance and consistent with other competitive procurements.

Selection of Service Providers

The Director of Finance is responsible for establishing a solicitation and selection process for securing professional services that are required to develop and implement the County's debt program. Goals of the solicitation and selection process shall include encouraging participation from qualified service providers, both local and national, and securing services at competitive prices. The solicitation and selection of process for services will comply generally with the County's Procurement requirements for such services, if appropriate.

Bond Counsel – Pursuant to Section 213 of the County Charter, the County Attorney may, with the approval of the County Council, employ special legal counsel to advise on bond and debt issuance matters. Upon advice and consultation with the Director of Finance, the County Attorney shall make recommendations to the County Council regarding the selection of bond counsel to be employed, and the duration of the employment for individual or a series of financings.

Underwriters, Remarketing Agents, Paying Agents, and Liquidity Providers – The Director of Finance shall solicit proposals from the service providers noted above for all debt issues when applicable. The principal criteria for selection will be the relative cost of the service, the experience of the provider, and the willingness of the provider to comply with the County's terms and conditions. The solicitation process shall include formation of a review committee to evaluate written proposals and, if deemed necessary, conduct oral interviews. The period for employment may relate to an individual transaction, a series of financings, or a specified period of time.

Other Services – The Director of Finance shall periodically solicit for providers of other services necessary to carry out the debt issuance activities of the County, such as printers, periodicals, appraisers, escrow agents, verification agents, and trustees. The Director may request that another party in the transaction hire these providers or the County can hire them directly. In either case, the selection of such additional service providers shall take into account an evaluation of the cost and perceived quality of service of the proposed service provider.

V. Debt Management Policies

Arbitrage Rebate Reporting - The County will comply with all arbitrage rebate requirements as established by the Internal Revenue Service and all disclosure requirements established by the Securities and Exchange Commission. This effort includes tracking investment earnings on bond proceeds, calculating rebate payments in compliance with the tax law and rebating positive arbitrage earnings to the federal government in a timely manner in order to preserve the tax exempt status of the County's outstanding debt issues.

Disbursements and Management of Accounts – The Director of Finance or a designee will be the County's Representative controlling disbursements from bond accounts held by trustees. Bond accounts include, among others, debt service reserve funds, construction/project accounts, rebate accounts, and costs of issuance accounts. At the appropriate time, upon completion of a project, the Department of Finance will proactively close the trust accounts related to a particular bond issue. This practice will ameliorate the possibility of unauthorized use of the bond proceeds and will further comply with IRS regulations relative to spend-down requirements and arbitrage rebate calculations.

Investment of Bond Proceeds – Any investment of bond proceeds shall be in accordance with the Investment Guidelines and/or Policies listed in the Trust Indenture. Selection of securities and/or providers shall be accomplished through a competitive process and bond counsel must monitor that process. If it is anticipated that the bond proceeds will be disbursed in approximately 12 months, for those shorter-lived projects where liquidity is required, funds can be managed by the trustee in a money market account.

Internal Controls and Compliance - The County will ensure that adequate systems of internal control exist to provide reasonable assurance as to compliance with applicable laws, regulations, and covenants associated with outstanding debt.

Investor Relations and Continuing Disclosure – The County will maintain compliance with disclosure standards promulgated by state and national regulatory agencies and provide on-going disclosure information to investors on its dedicated debt management and disclosure web site found at: http://bonds.montgomerycountymd.gov/. Information to be made available to the public and updated on an annual basis include the County's Annual Information Statement, to be updated and published by January 15 of each year. Also available are the County's Comprehensive Annual Financial Report (CAFR) and operating and capital improvements budgets. Information to be posted will also include reportable events pursuant to SEC Rule 15(c) 2-12, and information required in any applicable Continuing Disclosure Agreements associated with past bond issues.

Refundings - The County will monitor its outstanding debt in relation to existing conditions in the debt market and will refund any outstanding debt when sufficient cost savings can be realized. Generally, a refunding is economic at a point where the County can save, on a net present value basis, at least three percent of the amount of bonds being refunded. In cases of advance refunding, the County will purchase State and Local Government Securities (SLGs) to fund the escrow. If SLGs at not available, upon permission from the Finance Director and with guidance from bond counsel, the County may fund the escrow with competitively bid US Treasury securities.

VI. Administration and Implementation

The Director of Finance is responsible for the administration and issuance of debt including the completion of specific tasks and responsibilities included in this policy. The County will evaluate the debt policy at least every five years.