

# Debt Management Policy

## Purpose

To establish a policy for the issuance of debt and financing instruments for the City.

## Policy

The attached document, Debt Management Guidelines, establishes the scope and purpose for the issuance of debt instruments consistent with the limitations of the North Carolina Local Government Bond Act. The policy specifies Uses of Debt Financings, Responsibility, Service Providers and Oversight, Refundings, Arbitrage Compliance, Credit Ratings, Reporting and Disclosure, Capital Acquisition, Interest Rate Exchange Agreements, and any Exceptions to the Policy.

## Policy Review

The Department of Finance and Budget and Management Services Department are responsible for revision and changes to the policy as needed.

### 1. Purpose:

The purpose of the City of Durham, North Carolina (City) debt management policy is to provide guidance for the issuance of City debt obligations and the maintenance of the City's ability to incur debt and other long-term obligations at favorable interest rates for capital improvements, facilities, and equipment beneficial to the City and necessary for essential services. The City of Durham issues and manages debt in accordance with the Local Government Bond Act, North Carolina General Statutes (N.C.G.S.) Chapter 159 Article 4 which prescribes a uniform system of limitations upon and procedures for the exercise by all units of local government in North Carolina of the power to borrow money secured by a pledge of the taxing power; and the limitations on local debt as noted in N.C.G.S. 159 -55. Other applicable provisions to certain debt and debt refunding actions are contained within N.C.G.S. Chapter 159, Local Government Finance. Long term planning to meet the current and future capital needs of Durham require a sound debt position and guidelines that protect the credit quality of the City.

### 2. Scope:

These debt guidelines apply to all debt issued by the City in the various funds; noting that there are specific requirements imposed by the type of debt issue which may be inconsistent with or not applicable to, some portion of these guidelines. Among these limitations are Council and/or voter approval, length of time to issue debt for approved uses and capital requirements such as length of asset lives and dollar value of assets financed. Further restrictions are related to the nature of the debt and whether it is general obligation debt (backed by the taxing authority of the City) or debt backed by specified pledged revenue and/or collateral.

### 3. Definitions:

- a. Debt Service: The periodic repayment to creditors/holders of debt principal and interest on debt obligations.
- b. Bonds: A debt obligation, or a written promise to pay back an amount (face value of the bond), plus interest, by way of periodic payments within a specified period of time.
- c. Bond Rating: An evaluation of the credit risk associated with a particular bond issue by internationally recognized independent rating agencies (Fitch, Moody's or Standard & Poor's). The City of Durham currently enjoys a general obligation AAA/Aaa rating which indicates the City is viewed as having an extremely strong ability to repay debt obligations.
- d. General Obligation Bonds: The City may borrow money from lenders, pledging the full faith and credit of the City to pay the loan through tax revenue. The method requires both the approval of voters through the referendum process and the approval of the Local Government Commission. The City sells general obligation bonds (G.O. bonds) to pay for expenses associated with capital projects or any public improvement as described in NC Statute 159-48. Bond sales are held as needed based on the cash flow needs of the projects being financed. The City manages its G.O. bond cash-flow either through the use of bond anticipation notes or by self-funding through the City's pooled cash. The City may also issue general obligation debt under the 2/3 rule,

wherein the City may issue up to 2/3 the value of general obligation debt retired in the prior year so long as no new general obligation debt was issued in the same year.

e. Certificates of Participation (COPs): Alternative financing method requiring no voter approval. The City may enter into Certificates of Participation (Installment Sales) contracts for buildings or equipment using the building or equipment to secure the financing. COPs should only be used when the property being financed has sufficient value to secure the debt and will survive the term of the financing. Issuance of COPs will be made in accordance with the provisions of N.C.G.S. 159-153 and with the approval of the Local Government Commission.

f. Capital Projects: Generally, major City projects with a cost of at least \$100,000 and a useful life of at least 10 years. Capital projects can include the cost of land acquisition, construction, renovation and/or the acquisition of major equipment.

g. Revenue Bonds: Bonds issued by the City which are backed with specified revenue sources from an enterprise fund for which the bonds were issued. The City's enterprise funds include fee for service business activities such as the Water and Sewer Fund and the Storm Water Fund. The City may borrow money from lenders, pledging the revenues from charges and fees of the enterprise fund activities to repay the debt. Revenue bonds do not require voter approval. The City can sell revenue bonds once a year to pay for expenses associated with capital projects. Issuance of revenue bonds will be made in accordance with the provisions of G.S 159 - 5 and with the approval of the Local Government Commission.

h. Finance Officer: The City officer performing the duties of finance officer of a unit of local government pursuant to N.C.G.S. 159-24 of the Local Government Budget and Fiscal Control Act. The City of Durham's Finance Officer is the Director of Finance.

i. Advance Refunding: In general, advance refundings of outstanding bonds for economic savings will be undertaken when a net present value savings of at least five percent (5%) of the refunded debt can be achieved. Recommendations of refundings, which produce a net present value savings of less than five percent, will be considered on a case-by-case basis. A refunding with negative savings will not be considered unless it fulfills a compelling public policy objective. LGC guidelines suggest that generally refundings contemplate a net present value savings exceeding three percent (3%) and that the term of the original debt not be extended when bonds are refunded.

j. Debt Restructuring: The City is authorized to refund outstanding indebtedness when existing bond covenants or other financial structures impinge on prudent and sound financial management. Savings requirements for current or advance refundings undertaken to restructure debt may be waived by the Director of Finance upon a finding that such a restructuring is in the City's overall best financial interests.

k. Two-Thirds Bonds: The City is authorized to issue general obligation debt under the 2/3 rule, established by state statute, wherein the City may issue new G.O. bonds up to 2/3 the value of the general obligation debt retired in the prior year so long as no other new general obligation debt was issued in the same year.

l. Local Government Commission: The Local Government Commission (LGC) is composed of nine members: the State Treasurer, the Secretary of State, the State Auditor, the Secretary of Revenue, and five others by appointment. The State Treasurer serves as Chairman and selects the Secretary of the Commission, who heads the administrative staff serving the Commission. A major function of the Commission is the approval, sale, and delivery of substantially all North Carolina local government bonds and notes. A second key function is monitoring certain fiscal and accounting standards prescribed for units of local government by the Local Government Budget and Fiscal Control Act.

m. Swaption: An option granting its owner the right but not the obligation to enter into an underlying swap. While options can be traded on a variety of swaps, the term swaption typically refers to interest rate swaps. An interest rate swap is a written contract entered into in connection with the issuance of debt obligations for the City or in connection with City debt already outstanding with a counterparty to provide for an exchange of payments based upon fixed and/or variable interest rates.

n. Counterparty: Literally, a party to a contract. The City and the City's counterparty to a financial contract each share risk in the performance of the contract by the other.

o. Collateralize: To pledge security (marketable securities, real property, etc.) which unconditionally guarantees payment on financial contractual obligations.

p. Lease/Purchase Agreements: Lease/purchase financings may be undertaken when the project or equipment will contribute to the efficient operation of the City or to the efficient provision of an existing service. Lease/Purchase agreements will be made in accordance with the provisions of G.S. 159-153 and with the approval of the Local Government Commission.

q. Private Placements: Debt may be privately placed with a lending institution when private placement will enhance the attractiveness of the offering consistent with the receipt of the lowest true interest cost possible. The Local Government Commission must approve the use of all private placements, in accordance with NC Statute 159-153.

r. Defeasance: To set aside sufficient money to retire outstanding debt. A full defeasance results in release from covenants and contractual obligations contained in the bond documents.

s. Arbitrage: With respect to the issuance of municipal securities, arbitrage refers to the difference between the interest paid on tax-exempt bonds and the interest earned by investing the proceeds of the bonds in higher-yielding securities. Federal income tax laws generally restrict the ability to earn arbitrage in connection with tax-exempt bonds. An arbitrage rebate payment made by an issuer to the federal government in connection with an issue of tax-exempt bonds. The payment represents the amount, if any, of arbitrage earnings on bond proceeds and certain other related funds, except for earnings that are not required to be rebated under limited exemptions provided under the Internal Revenue Code. An issuer generally is required to calculate, once every five years during the life of its bonds, whether or not an arbitrage rebate payment must be made.

t. Lessor: One who lets property under a lease. The party leasing the property is known as the lessee.

u. Enterprise Fund: A separate fund used to account for operations in which the cost of providing services is recovered primarily through user charges or fees. Municipalities establish enterprise funds for many fee for services activities that mirror business-like enterprises.

v. Debt or Bond Covenant: Legal obligations contained in a bond issue document such as a covenant for a specified debt service coverage ratio.

w. Debt Coverage Ratio: A bond covenant or obligation, the ratio is a stipulated formula measurement of the amount of net revenues available from specified revenues to cover required annual debt service payments. The ratio amount and formula for calculation are included in the bond document.

x. Backloading: The practice of scheduled debt repayment that delays principal and/or interest costs toward the end of the life of the obligation rather than making payments that are substantially equal annually over the life of the debt. Similarly, frontloading is a debt repayment schedule where annual costs are large in the first years and reduce during the life of the obligation.

y. Parity Debt: With regard to the City's use of revenue bonds to finance enterprise fund capital acquisition, such as water and sewer capital projects; parity debt is the debt associated with the issue of revenue bonds, which are secured by the charges and fees of the City's enterprise fund, such as the water and sewer utility. Subordinate or other debt may exist (such as general obligation bonds issued specifically for water and sewer capital projects and repaid by charges and fees of the utility) without being specifically secured by current utility charges or fees. Parity debt generally requires a higher debt coverage ratio than all debt (parity debt plus subordinate or other debt) in that it is not secured by the full faith and credit of the City.

z. Underwriter: Investment banking entity or groups of such entities that purchase, for resale to the public, bonds or other debt obligations issued by the City and/or the LGC on behalf of the City.

aa. True Interest Cost (TIC) and Net Interest Cost (NIC): Methods used to select the lowest effective interest cost bid in competitive bid sales. Net Interest Cost (NIC) is an average interest cost rate for a bond issue, calculated on the basis of simple interest (not compound interest). The NIC calculation does not take into consideration the time value of money. The winning NIC bid may not provide the lowest effective interest cost in present value terms. True Interest Cost (TIC) is the internal rate of return that will be paid by the issuer to investors. It is the

interest rate that discounts the debt service payable for a bond issue to its present value, or net proceeds. Because TIC takes into account the time value of money, it generally more accurately measures the issuer's true cost of borrowing than does the NIC.

bb. Credit Enhancement: Credit enhancement encompasses a variety of provisions that may be used to reduce the credit risk of an obligation. Credit enhancements are often incorporated into debt instruments. Techniques of credit enhancement include: Collateralization where one or more parties may agree to post collateral and collateral levels may be fixed or vary over time; third party loan guarantees; letters of credit issued by a financial institution; bond insurance where an insurance policy may provide for compensation in the event that a party defaults and surety bonds where a surety (third party) ensures that the principal party (the City) obligations to the obligee (bond holders) will be performed.

cc. Government Finance Officers Association (GFOA): The purpose of the Government Finance Officers Association is to enhance and promote the professional management of governments for the public benefit by identifying and developing financial policies and practices and promoting them through education, training and leadership. The GFOA produces *Governmental Accounting, Auditing, and Financial Reporting* or GAAFR which serves as the definitive source of practical guidance on all aspects of accounting, auditing, and financial reporting for state and local governments.

dd. Notional Amount: In the context of an interest rate swap, the notional principal amount is the specified amount on which the exchanged interest payments are based. Each period's rates are multiplied by the notional principal amount to determine the value of each counter-party's payment.

#### **4. Debt Issuance:**

a. Debt Instruments: Consistent with the limitations of the Local Government Bond Act the City provides for long term financing needs through the use of, but not limited to, general obligation bonds, certificates of participation, revenue bonds, installment sales/lease obligations and private placements. Debt obligations are generally approved locally and by the Local Government Commission as required by state statute. Referenda, notices and public hearings, again as required by state statutes, are conducted prior to final debt approval and issuance.

b. Competitive Sale: With the exception of GO bond sales that are conducted by the LGC, the City will seek to issue its debt obligations using a competitive process unless it is determined by the Director of Finance that an alternative sale method will produce better results for the City.

c. Negotiated Sale: When determined to be appropriate by the Director of Finance, the City may elect to sell its debt obligations through a negotiated sale. Such determination may be made on an issue-by-issue basis, for a series of issues, or for part or all of a specific financing program. Selection of the underwriter or underwriting syndicate shall be made pursuant to selection procedures set forth in these debt guidelines.

d. Voter Authorization: The City will seek voter authorization to issue general obligation bonds as directed by the City Council, and in accordance with North Carolina General Statute (NCGS) 159-49. Such authority will be sought only after it is determined that the project costs are eligible and appropriate for multi-year financing.

e. Debt Limits: The City will not issue general obligation bonds if such issuance would cause the City to default on or breach the covenants of any prior bonds. In addition, the aggregate limit should be the lower of the limit set forth in NC Statute 159-55 (eight percent (8%) of the total assessed value of all real and personal property revenues within the City's limits) or a set target debt limit or ratios established by the City Council. Currently, the statutory limitation imposed by North Carolina is not a meaningful limitation to the City's ability to add debt. The City Council has not established a finite target ratio limit but is advised by the Director of Finance that a flexible budgetary tool would suggest comparing current and planned debt to a twelve percent (12%) of total revenues test. While the City Council is not held to this debt capacity standard, the Council is advised that exceeding such a budget target would likely require limitations on the short-term growth of debt service, or, alternatively, an increase in revenues. The LGC guidelines declare a heavy debt burden may be evidenced by a debt service to total expenditures ratio exceeding fifteen percent (15%), or per capita and/or debt to appraised property value ratios exceeding those of similar municipalities. Maintenance of the City's general obligation AAA and Aaa (triple A) credit ratings is an overriding standard guiding debt management. Recommendation of any debt actions that would knowingly unfavorably impact the triple A credit ratings of the City will not be made without the express request of the City Council. Any debt action recommendation that would have a negative impact on the

maintenance of a minimum unrestricted fund balance of the general fund of twelve percent (12%) of adjusted appropriations will not be made without the express request of the City Council.

f. Length of Debt: Debt will be structured for the shortest period consistent with a fair allocation of costs to the useful life of the asset. Debt issues that include multiple projects with different useful lives can be split into segments with different term lengths. Alternatively, a blended useful life for the projects to be financed can be used to determine the term of the debt.

g. Cost and Fees: Where practical, all costs and fees related to issuance of bonds will be paid out of the proceeds of the bond issue.

h. Variable-Rate Securities: In response to market conditions including an analysis of interest rate risk, the City may choose to issue securities that pay a rate of interest that varies according to a pre-determined formula or results from a periodic remarketing of the securities, consistent with state law and covenants of pre-existing bonds. The City will have no more than twenty percent (20%) of its outstanding general obligation bonds in variable rate form.

i. Backloading Repayment Costs: The City will seek to structure debt with level principal and interest costs over the life of the debt. Backloading of costs will be considered only when natural disasters or extraordinary or unanticipated external factors make the short-term cost of the debt prohibitive, when the benefits derived from the debt issuance can clearly be demonstrated to be greater in the future than in the present, when such structuring is beneficial to the City's overall amortization schedule, or when such structuring will allow debt service to more closely match project revenues during the early years of the project's operation.

## **5. Use of Debt Financing:**

Subject to the purposes for bond issue noted in N.C.G.S. 159-48, the City generally issues bond financing for the acquisition of, or construction of, major capital projects. Other debt financing, such as COPs, are generally used to provide for significant fleet and mechanical equipment but are also available for use on other capital projects as deemed in the best interest of the City. Similarly, revenue bonds may be utilized for enterprise fund debt financing such as major capital projects for the Water and Sewer Fund. Debt service is generally budgeted annually and adopted by City Council. Debt service will not be recommended for operational expenses without the express request of the City Council.

## **6. Responsibility:**

The Finance Officer (Director of Finance) has the primary responsibility for developing, recommending and monitoring debt financing and debt refunding/restructuring strategies and instruments. The selection and sourcing of financial consultants and service providers is also within the scope of duties of the Director of Finance. The Treasury Manager, under the direction of the Director of Finance, is tasked with daily operational debt responsibility.

## **7. Service Providers and Oversight:**

a. Bond Counsel: The City will retain external bond counsel (who must be an attorney) for all debt issues. All debt issued by the City will include a written opinion by bond counsel affirming that the City is authorized to issue the debt, stating that the City has met all state constitutional and statutory requirements necessary for issuance, and determining the debt's federal income tax status. Bond counsel will be selected through a competitive process administered jointly by the City's Department of Finance and the City Attorney's Office.

b. Underwriters: The City shall use a competitive bidding process in the sale of debt unless the nature of the issue warrants a negotiated sale. The City shall attempt to award the bonds based on a true interest cost (TIC) basis. However, the City may award bonds based on a net interest cost (NIC) basis as long as the financial advisor agrees that the NIC basis can satisfactorily determine the lowest and best bid.

c. Financial Advisor: The City will retain an external financial advisor, to be selected for through a competitive process administered by the City's Department of Finance. The utilization of the financial advisor for certain bond sales will be at the discretion of the Department of Finance on a case-by-case basis and pursuant to the financial advisory services contract. The selection criteria for financial advisors will include comprehensive municipal debt

experience, experience with diverse financial structuring requirements and pricing of municipal securities. For each City bond sale the financial advisor will provide the City with information on pricing and underwriting fees for comparable sales by other issuers.

d. Other Services: The Director of Finance shall periodically solicit, on a competitive basis, other service providers (escrow agents, verification agents, trustees, etc.) as needed to facilitate the sale of bonds or the post-sale management of bond issues. The City's financial advisor will, on occasion, facilitate the competitive selection process on behalf of the City as provided for in the City Financial Advisory Agreement.

e. Local Government Commission: All bonds issued under the authority of the Local Government Bond Act are approved by the Local Government Commission. Approval of an application as noted in N.C.G.S. 159-51 for a bond issue to the LGC is contingent on criteria established in N.C.G.S. 159-52. Such criteria require resolution of issues such as low tax collection rate (below ninety percent (90%)), receipt of a qualified audit opinion, or violations of the Local Government Budget and Fiscal Control Act.

## **8. Debt Refunding:**

a. Open Market Purchase of City Securities: The City may choose to defease its outstanding indebtedness through purchases of its securities on the open market when market conditions make such an option financially feasible. The Director of Finance shall be responsible for developing procedures for executing open market purchases and the savings objectives to be achieved by undertaking such action.

b. Repayment: Debt will be structured to achieve the lowest possible net cost to the City given market conditions. Moreover, to the extent possible, the City will design the repayment of its overall debt so as to recapture rapidly its credit capacity for future use. Also, with respect to annual debt service paid by the General Fund (GF), a target ceiling of the percentage of GF revenues budgeted per year that are budgeted to pay interest and principal payments will be established on an annual basis.

## **9. Arbitrage Compliance:**

Arbitrage is the profit that results from investing low-yield tax-exempt bond proceeds in higher-yield securities. Federal law requires that investment earnings in excess of the bond yield (arbitrage earnings) must be rebated to the Federal Government. However if a jurisdiction meets certain IRS spend-down exceptions for bond proceeds, it is allowed to keep any positive arbitrage interest earnings. Arbitrage regulations apply to all of the City's tax-exempt financings. The Department of Finance will invest bond proceeds at the highest yield possible, consistent with the City's investment guidelines and any restrictions imposed by the governing documents of each series of bonds. The Department of Finance is responsible for monitoring investments and cash flows of the City's bond funds, and contracting for third party arbitrage compliance calculations on an annual basis. The Department of Finance will pay arbitrage rebates due and report rebate payments to City Council in the Quarterly Financial Report.

## **10. Credit Ratings:**

a. Rating Agency Relationships: The Director of Finance shall be responsible for maintaining relationships with the rating agencies that assign ratings to the City's various debt obligations. This effort shall include providing periodic updates on the City's general financial condition along with coordinating meetings and presentations in conjunction with a new debt issuance. The ratings provide investors with a simple way to compare the relative investment quality of different bonds. Bond ratings express the opinions of the rating agencies as to the issuer's ability and willingness to pay debt service when it is due. Ratings are generally determined by the following four factors:

1. Fiscal factors: Financial results have the most significant impact on the rating process. This review involves an examination of results of operations, including a review of the actual fiscal performance versus planned budget performance, with deviations from the plan to be explained. The general fund financial statement is examined with emphasis on current financial position and fund balances, as well as three to five year trends in planning and budgeting procedures. Pension liabilities are also important in the analysis process. The early production of the City's CAFR is a positive step in providing meaningful, valuable and timely information to the rating agencies.

2. Economic factors: The overall economic strength of the City is heavily weighted in the evaluation of the City's creditworthiness by diversity of both the economic base and tax base. The diversity of the City's industries reflects its abilities to weather industry-specific downturns as well as general economic recession. In either scenario, stronger surviving industries carry the ailing industries through the period of downturn. In a truly diverse economy, it is rare that all industries will deteriorate to the same level at the same time. The strength of the City's tax base is equally crucial. The City relies on taxes on its residents and businesses for the majority of its revenues. The ability of the City to continue to receive those revenues is directly related to the ability of its taxpayers to pay their taxes. Property values, employment, unemployment, income levels, costs of living, and other factors impacting the wealth of the taxpayers provide an indication of the strength of the City's tax base.

3. Debt Factors: The City's overall debt burden is considered in the credit analysis process. In addition to government regulated debt ceilings, the City's ability to maintain manageable debt levels and debt service coverage is evaluated. Positive indicators are proper management of existing debt, proactive efforts in identifying and executing financially prudent refunding opportunities, and closely matching capital financing structures to the funding needs of the project.

4. Administrative/Management factors: These factors include the examination of the form of government and assessment of the City's ability to implement plans as well as to fulfill legal requirements. The focus is on the capabilities of the management staff within the City, which is seen as a vital ingredient in assessing its credit quality. Managerial and legislative willingness to make difficult decisions, development of financial policies, and the reliability and continuity of regularly-updated accounting financial information are key. Management that keeps in regular contact with the rating agencies is well-regarded. Continual monitoring of factors impacting credit ratings is provided by the Director of Finance. These factors include the avoidance of operating deficits and the maintenance of high collection rates for all revenues.

b. Use of Rating Agencies: The Director of Finance shall be responsible for determining if a rating shall be requested on a particular financing, and which of the major rating agencies shall be asked to provide such a rating.

c. Credit Enhancement: The City shall seek to use credit enhancement (letters of credit, bond insurance, surety bonds, etc.) when such credit enhancement proves cost-effective. Selection of credit enhancement providers should be conducted using a competitive process when practical. Credit enhancement may be used to improve or establish a credit rating on a City debt obligation even if such credit enhancement is not cost effective if, in the opinion of the Director of Finance, the use of such credit enhancement meets the City's debt financing goals and objectives.

d. Minimum Long-Term Rating Requirements: The City's minimum rating requirement for its direct, long-term, debt obligations is a rating of "A" or higher. If such a debt obligation cannot meet this requirement based on its underlying credit strength, then credit enhancement shall be sought to ensure that the minimum rating is achieved. If credit enhancement is unavailable or is determined by the Director of Finance to be uneconomic, then the obligations may be issued without a rating.

e. Debt Coverage: In order to enhance future credit ratings, (and thereby reduce insurance and/or interest costs) the City will maintain a minimum of one hundred-five percent (105%) operating coverage. Coverage ratios for revenue bonds will be maintained at the levels required in the respective debt covenants. Coverage ratios will be monitored and reported as part of the City's annual debt affordability analysis. The City's water and sewer utility system revenue bonds generally contain rate covenants that require the annual current operating receipts exclusive of transfers (i.e. rate and fee charges for services – not fund balance transfers), and net of annual current expenses, be sufficient to pay for the annual current water and sewer debt service. This amount generally is required to be not less than one hundred-twenty percent (120%) of the parity debt service and one hundred percent (100%) of all debt service in the fund. The City is generally obligated to adjust rates and fees to sufficiently provide for the maintenance of debt coverage ratios.

## **11. Reporting and Disclosure:**

a. Reporting: Required annual reporting on debt is contained in the *Comprehensive Annual Financial Report* (CAFR) as well as the *City of Durham, North Carolina Final Budget*. These publications are also available on the City's web site. Quarterly financial reports to the City Council produced by Budget and Management Services and the Department of Finance detail currently planned debt issues. The reports are also available on the City's

web site. Additionally, the City Council holds annual budget and fiscal retreats where the Director of Finance presents the City's annual debt affordability analysis. The City's current and future debt positions, debt capacity, and debt planning are outlined and ratios and trends are discussed.

b. Debt Benchmarking: The Director of Finance at least annually presents debt benchmarking data to the City Council which includes but is not limited to per capita debt, debt to assessed valuation, and outstanding and authorized G.O. debt. Benchmarking will also include historical and comparative data for selected North Carolina municipalities.

c. Disclosure: The City will provide full, accurate disclosure of all material information to investors, lenders, lessors and other financing participants necessary for such parties to make an informed judgment about the City's debt and financial condition. At a minimum, this information shall be provided to such parties from issuance of the debt to its retirement. The City will follow established market practices and contract for necessary services to provide such disclosure. To fulfill the need for both initial (at the time of issuance) and continuing disclosure, the City will follow the guidance of the Government Finance Officers Association (GFOA), including its Disclosure Guidelines publication. The City will also disclose all bond sales, annually file certain financial information and operating data related to the bonds with the national and state repositories, and prepare announcements of significant events to meet the Securities and Exchange Commission to meet their requirements of Rule 15c-12.

## **12. Capital Acquisition:**

a. Overview: The *Capital Improvement Program* (CIP) is a statement of the City of Durham's policy regarding long-range physical development of public assets and infrastructure. The CIP is developed for a period of not less than six years and is updated and revised annually. To be included in the CIP, a project requires a total expenditure of at least \$100,000 and a useful life of at least 10 years. The CIP provides a schedule of project execution, cost estimates (including associated operating costs), and the location of the improvements.

b. Council Authorization: No City debt issued for the purpose of funding capital projects shall be authorized by the City Council unless it has been included in the approved Capital Improvement Plan or until the Council has modified the Plan to include the project(s) to be funded by debt. Such modification shall occur only after the Council has received a report of the impact of the contemplated borrowing on the existing capital improvement plan and recommendations as to the financing from the Department of Finance.

c. Debt Impacts of Capital Acquisition: The Director of Finance, during the annual capital acquisition process, will prepare and present an analysis of all existing and proposed debt for capital improvement projects and the impact of that debt on the debt ratios, debt limits, and credit ratings of the City. This analysis can be presented in conjunction with the overall City debt position review or as supplemental materials.

d. Funding Process: Funding of capital projects is based on the *Capital Improvement Program* budget which is adopted annually by City Council. Procedures for recommending project development, prioritization and funding are authorized by City Council and the City Manager. The use of formal advisory, scoring, and citizen panels, aids the City the evaluation of requests from City Council, City departments and citizen interest groups. Overriding criteria include financial, effectiveness, equity, and timing factors. Those process steps are developed and maintained as part of the annual CIP process. Those procedures dealing with developing funding recommendations are outside the scope of this debt policy.

## **13. Guideline Exceptions:**

Any deviation from the above guidelines must be confirmed in advance and in writing by the Finance Officer. The Finance Officer is not authorized to override any policy, procedure or provision that is legally mandated or the result of City Council action.

## **14. Interest Rate Exchange Agreements:**

See Attachment I



## **Attachment I Interest Rate Exchange Agreements**

### **Introduction**

The City of Durham, North Carolina ("City") has determined to compile in a single written instrument the policies and practices to be used in connection with the City procurement of and entering into interest rate swap agreements (also known as interest rate exchange agreements) and related transactions. For such purpose, the City staff has reviewed the relevant policy adopted for the State of North Carolina and has consulted the Local Government Commission and the City's financial advisor and bond counsel. Specific legislative authorization for these agreements and transactions exists in G.S. Chapter 159, Article 13, §§ 159-193 to 200, inclusive, as enacted by Chapter 388, Session Laws of 2003 ("State Statute").

This policy will govern the use by the City of interest rate exchange agreements. An "Interest Rate Swap Agreement" or "Interest Rate Exchange Agreement" is a written contract entered into in connection with the issuance of debt obligations for the City or in connection with City debt already outstanding with a counterparty to provide for an exchange of payments based upon fixed and/or variable interest rates. The failure by the City to comply with any provision or condition of this policy will not invalidate or impair any Interest Rate Exchange Agreement. Prior to entering into any interest rate swap agreement, the City council will pass a resolution authorizing the same.

The City maintains the right to modify this policy and make exceptions to certain guidelines at any time to the extent that the execution of an Interest Rate Swap Agreement achieves one or many of the goals outlined below.

### **I. Conditions Under Which Interest Rate Swap Agreements May Be Entered Into**

#### **A. Purposes**

Interest Rate Swap Agreements may be used for the following purposes:

1. To achieve significant savings as compared to a product available in the bond market. Savings gained by executing an interest rate swap agreement shall be calculated after adjusting for a) applicable fees, including takedown, remarketing fees and credit enhancement fees and b) call options that may be available on the bonds. Examples may include synthetic fixed rate debt and synthetic variable rate debt. Alternatively, significant savings are deemed to occur if the use of derivatives helps to achieve fixed or variable rate diversification of a particular bond offering.
2. To enhance investment returns within prudent risk guidelines.
3. To prudently hedge risk in the context of a particular financing or the overall asset/liability management of the City. Examples may include buying interest rate caps and entering into delayed start swaps.
4. To incur variable rate exposure within prudent guidelines.
5. To achieve enhanced flexibility in meeting overall financial objectives than available in conventional markets. An example may include the sale to a counterparty of an option to require the City to issue or incur particular obligations to retire other obligations (swaption) with an upfront payment to the City.
6. To optimize capital structure, including schedule of debt service payments and/or fixed vs. variable rate allocations.

#### **B. Permitted Instruments**

The City may expressly utilize the following financial products on a current or forward basis, after identifying the objective(s) to be realized and assessing the attendant risks:

1. Interest rate swaps, including fixed, floating and/or basis swaps.
2. Interest rate caps/floors/collars.
3. Options, including swaptions, caps, floors, collars and/or cancellation or index based features.

The permitted instruments outlined above are not intended to relate to various interest rate hedging products. They are not intended to encompass other derivative products that the City may consider.

#### **C. Legality**

The City will abide in all respects with the provisions of G.S. Chapter 159, Article 13 as may be amended from time to time. In addition, the City must receive an opinion acceptable to the market from a nationally

recognized bond counsel law firm that the interest rate swap agreement is a legal, valid and binding obligation of the City and entering into the transaction complies with applicable law.

**D. Speculation**

Interest rate swap agreements will not be used for speculative purposes. Associated risks will be prudent risks that are appropriate for the City to take.

**E. Independent Financial Advisor**

The City will retain an experienced, independent financial advisor prior to entering into an Interest Rate Swap Agreement. Duties of the financial advisor will include advice with respect to the structure, terms and provisions of any proposed interest rate exchange transaction and provision of an opinion to the City that any interest rate swap agreement approved by the City provides fair market value to the City as of the date of its execution. In appropriate circumstances, the Local Government Commission may serve as financial advisor for these purposes.

**II. Contract Solicitation and Procurement Methods**

The City will procure interest rate swap agreements by either competitive bidding or through negotiations with one or more counterparties. The City, with the advice of the Local Government Commission if necessary, will determine which parties are qualified and may participate in a competitive or negotiated transaction. When the City wishes to achieve diversification of counterparty exposure in a competitively bid transaction, the City may allow a firm or firms not submitting the bid that produces the lowest cost to match the lowest bid and be awarded up to a specified percentage of the notional amount of the interest rate swap agreement. In addition, to encourage competition, the City may allow bidders to match the winning bid up to a specified amount of the notional amount as long as their bid is no greater than a specified spread from the winning bidder. The parameters for the bid will be disclosed in writing to all potential bidders.

Notwithstanding the competitive parameters outlined above, the City may procure interest rate swap agreements by negotiated methods in the following situations:

1. The City makes a determination that, due to the size or complexity of a particular swap, a negotiated transaction would result in the most favorable pricing and terms. The City will use an independent financial advisory firm and/or the Local Government Commission to assist in the price negotiations in the development of terms and in risk assessment.
2. The City makes a determination, in light of the facts and circumstances, that doing so will promote its interests by encouraging and rewarding innovation.
3. If procured through negotiation, the City shall obtain an independent opinion from its financial advisor that the terms and conditions of the interest rate swap agreement reflect a fair market value of such agreement as of the date of its execution.

**III. Counterparty Selection Criteria**

The City will structure swap agreements to protect itself from credit deterioration, including the use of a credit support annex or other forms of credit enhancement to secure counterparty performance. Such protection shall include any terms and conditions which at the City's sole discretion are necessary or in the City's best interest.

The City shall attempt to do business with highly rated counterparties (or an entity which unconditionally guarantees the payment obligations of a counterparty) in which the long-term ratings at the date of execution are at least "Aa3" or "AA-" by one or more Nationally Recognized Statistical Ratings Organizations ("NRSRO") and no less than "A2" or "A" by one or more NRSRO. For counterparties that do not meet this minimum ratings threshold, the Agency should seek credit enhancement in the form of:

1. Credit guarantee through insurance or contingent swap counterparty providing support;
2. Collateral; and
3. Ratings downgrade triggers.

In addition, the counterparty must have minimum capitalization of at least the initial notional amount of the swap and must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market. The City shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties.

If after entering into an agreement the ratings of the counterparty are downgraded by any one of the rating agencies below the ratings required by this policy, then the agreement shall be subject to termination unless a) the counterparty provides either a substitute guarantor or assigns the agreement, in either case, to a party that is acceptable to the City that meets the rating criteria or b) the counterparty (or guarantor) collateralizes the interest rate swap agreement in accordance with the criteria set forth in this policy and the interest rate swap agreement.

#### **IV. Form and Content of Interest Rate Swap Agreements**

To the extent possible, the interest rate swap agreements entered into by the City will contain the terms and conditions set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement, including any schedules and confirmation. The schedule will be modified to reflect specific legal requirements and business terms desired by the City.

##### **A. Terms and Notional Amount of Swap Agreement**

The City shall determine the appropriate term for an interest rate swap agreement on a case-by-case basis. In connection with the issuance or carrying of bonds, the term of the swap agreement between the City and a qualified swap provider shall not extend beyond the final maturity date of existing debt of the City of a specific project, or in the case of a refunding transaction, beyond the final maturity of the refunding bonds. At no time shall the total net notional amount of all swaps exceed the total amount of the outstanding bonds. For purposes of calculating net exposure, credit shall be given to any fixed versus variable rate swaps that offset for a specific project or bond transaction. For variable rate transactions, credit may also be given for any assets that are used to hedge a transaction as long as in the City's judgment such assets are reasonably expected to remain in place on a conterminous basis with the swap.

Terms and conditions of any swap shall be negotiated by the City in the best interests of the City subject to the provisions of the State Statute and the guidelines set forth. The swaps between the City and each counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions and provisions as the City, in consultation with its legal counsel and financial advisor deems necessary or desirable.

Subject to the provisions contained herein, the City's swap documentation and terms should include the following:

1. Downgrade provisions triggering termination shall in no event be worse than those affecting the counterparty.
2. Governing law for swaps will be New York, but should reflect North Carolina authorization provisions.
3. Collateral thresholds should be set on a sliding scale reflective of credit ratings (See *Provisions for Collateralization*).
4. Eligible thresholds should be limited to Treasuries, Federal Agencies and any other securities which in the City's sole discretion shall be deemed reasonable and creditworthy.
5. Termination value should be set by "market quotation" methodology, when the City deems appropriate.
6. The City shall only agree to an Additional Termination Event for the City to the extent that the City's underlying ratings falls below "Baa", "BBB" and "BBB" from Moody's, Standard & Poor's and Fitch, respectively and no form of credit support rating of "A3" from Moody's or "A-" from Standard & Poor's and Fitch or greater is in place.

##### **B. Termination Provisions**

All swap transaction shall contain provisions granting the City the right to optionally terminate the agreement at its market value at any time. The City will also consider embedding optionality including provisions that permit the City to assign its rights and obligations under the interest rate swap agreement. In general, except in the event of the counterparty's ratings being downgraded below the ratings required by this policy (See *Counterparty Selection Criteria*) the counterparty will not have the right to assign or optionally terminate an agreement.

##### **C. Events of Default**

Events of default of a counterparty will include the following:

1. Failure to make payments when due,
2. Material breach of representations and warranties,
3. Illegality,
4. Failure to comply with downgrade provisions, and
5. Failure to comply with any other provisions of the agreement after a specified notice period.

The City will incorporate into any swap contract the right to terminate the agreement upon an event of default by the counterparty. Such right may be conditioned on the consent of a third party such as the Local Government Commission and any person providing credit enhancement or liquidity in any related transaction. Upon such termination, the counterparty will be the “defaulting party” for purposes of calculating the termination payment owed.

## **V. Swap Analysis and Risk Exposure Associated with Interest Rate Swap Agreements**

### **A. Evaluation of Interest Rate Swap Agreements**

Before entering into an interest rate swap agreement, the City will evaluate all the benefits and risks inherent in the transaction. Such an evaluation will include the following:

1. The identification of the proposed benefit and potential risks, which shall include, but not necessarily limited to, those risks outlined herein.
2. Independent analysis of potential savings from proposed transaction.
3. Fixed versus variable rate and swap exposure on a project and per counterparty basis before and after the proposed transaction.

In addition, in evaluating a particular transaction involving the use of interest rate swap agreements, the City will review and discuss with the Local Government Commission the long-term implications associated with entering into interest rate swap agreements, including costs of borrowing, historical interest rate trends, variable rate capacity, credit enhancement capacity, opportunities to refund related debt obligations and other similar considerations.

### **B. Evaluation of Swap Risks**

Risks to be evaluated would include:

1. Counterparty Risk – The risk of a payment default on a swap by an issuer’s counterparty.
2. Termination Risk – The risk that a swap has a negative value and the issuer owes a “breakage” fee if the contract has to be liquidated.
3. Rollover Risk – The risk that an issuer cannot secure a cost-effective renewal of a letter or line of credit or; the risk of a failed remarketing or auction with respect to any variable rate bonds associated with a swap.
4. Basis Risk – A mismatch between the rate on an issuer’s underlying bonds and the swap (e.g., a tax-exempt VRDO issue which trades at 70% of LIBOR while the issuer only receives 67% of LIBOR under the swap).
5. Tax Event Risk – The risk that the spread between taxable and tax-exempt rates will change as a result of changes in income tax laws or other conditions.
6. Amortization Risk – The risk that the amortization with the swap will not be fully integrated with the amortization of the underlying bonds.

### **C. Provisions for Collateralization**

The City will endeavor to diversify its exposure to counterparties. To that end, before entering into a transaction, the City will determine its exposure to the relevant counterparty or counterparties and determine how the proposed transaction would affect the exposure.

Should the rating of the counterparty, or if secured, the entity unconditionally guaranteeing its payment obligations not satisfy the requirements of the *Counterparty Selection Criteria*, then the obligations of the counterparty will be fully and continuously collateralized by direct obligations of, or obligations the principal and interest on which are guaranteed by, the United States of America and such collateral will be deposited with the City or an agent thereof. In the case of an interest rate swap agreement, such collateral posted by the counterparty will have a net market value of at least 102% of the net market value of the agreement to the City. Other provisions are as follows:

1. Threshold amounts for collateralization shall be determined by the City on a case-by-case basis. The City will determine the reasonable threshold limits for the initial deposit and for increments of collateral posting thereafter.
2. Collateral shall be deposited with a third party trustee, or counterparty (in a segregated account), mutually agreed upon between the City and the counterparty.
3. A list of acceptable securities that may be posted as collateral and the valuation of such collateral will be determined and mutually agreed upon during negotiation of swap agreement with each swap counterparty.
4. The market value of the collateral shall be determined on at least a monthly basis, or more frequently if the City determines it is in the City's best interest given the specific collateral security.
5. The City shall determine on a case-by-case basis whether other forms of credit enhancement are more beneficial to the City.

#### VI. Limitations on Termination Exposure

In order to diversify the City's counterparty risk, and to limit the City's credit exposure to one counterparty, limits will be established for each counterparty based upon both credit rating of the counterparty as well as the relative level of risk associated with each existing and projected swap transaction. The following guidelines provide general termination exposure guidelines with respect to whether the City should enter into an additional transaction with an existing counterparty. The City may make exceptions to these guidelines at any time to the extent that the execution of a swap achieves one or many of the financial goals of the City.

Such guidelines set forth will also not mandate or otherwise force automatic termination by the City or the counterparty. Such provisions will only act as guidelines in making a determination as to whether or not a transaction should be executed given certain levels of existing and projected net termination exposure to a specific counterparty. The calculation of net termination exposure per counterparty will take into consideration multiple transactions, some of which may offset the overall exposure to the City.

Under this approach, the City will set limits on individual counterparty exposure based on existing as well as new or proposed transactions. The sum of the **current market value** and the **projected exposure** shall constitute the maximum net termination exposure. For outstanding transactions, current exposure will be based on the market value as of a recently completed swap valuation report provided by the City's swap advisor. Projected exposure shall be calculated based on the swap's potential termination value taking into account possible adverse changes in interest rates as implied by historical or projected measures of potential rate changes applied over the remaining term of the swap. For purposes of this calculation, the City shall include all existing and projected transactions of an individual counterparty and all transactions will be analyzed in aggregate such that the maximum exposure will be additive.

The exposure thresholds, which will be reviewed periodically to ensure that they remain appropriate, will also be tied to credit ratings of the counterparties and whether or not collateral has been posted. If a counterparty has more than one rating, the lowest rating will govern for purposes of calculating the level of exposure. If contingent swap counterparty or swap insurance is used to provide financial support for the primary counterparty, the rating of the support entity shall be used. A summary table is provided below:

<b>Credit Ratings</b>	<b>Maximum Collateralized Exposure</b>	<b>Maximum Uncollateralized Exposure</b>	<b>Maximum Total Termination Exposure</b>
AAA	Not applicable	[\$150 million]	[\$150 million]
AA Category	[\$75 million]	[\$75 million]	[\$150 million]
Below AA	[\$75 million]	–	[\$75 million]

If the exposure limit is exceeded by a counterparty, the City shall conduct a review of the exposure limit per counterparty. The City, in consultation with its Financial Advisor, shall evaluate appropriate strategies to mitigate this exposure.

**VII. Standards for Procurement of Credit Facilities**

The selection of the provider of the credit enhancement or liquidity facility in connection with an Interest Rate Swap Agreement will be based on the following criteria:

1. Credit rating
2. Capacity of the provider
3. Ability of provider to make required payments
4. Duration of the agreement relative to the duration of the Interest Rate Swap Agreement
5. Terms of the agreement, including termination events
6. Trading value of the provider's facility
7. Prior experience with provider
8. Cost, relative to other proposals and potential savings versus unenhanced obligations
9. Overall exposure of the City to the provider
10. Overall exposure of market to provider
11. Ability to accept terms and condition proposed

The procurement of any liquidity and credit enhancement facilities will be in compliance with applicable State law.

**VIII. Ongoing Management**

The City will seek to maximize the benefits and minimize the risks it carries by actively managing its swap program. This will entail continuous monitoring of market conditions, in conjunction with the swap counterparty, for emergent opportunities and risks. Active management may require modifications of existing positions including:

1. Early termination
2. Shortening or lengthening the term
3. Sale or purchase of options
4. Application of basis swaps

Proposed modifications must be consistent with the policies outlined herein, as well as further the goals of the swap program.

**IX. Monitoring**

The City will monitor its use of interest rate swap agreements as follows:

5. 1. After each interest rate swap agreement has been completed, staff will prepare a description of the contract, including a summary of its terms and conditions, the notional amount, rates, maturity and other provisions thereof.
6. 2. On each payment date, staff will determine any amounts which were required to be paid and received, and that the amounts were paid and received.
7. Staff will annually determine that each counterparty is in compliance with its rating requirements, or more frequently when information is available that could negatively affect the counterparty's ratings.
8. If a counterparty is no longer in compliance with its rating requirements, staff will determine that it is in compliance with the downgrade provisions (See Counterparty Selection Criteria).
9. Staff will annually determine all material changes in connection with existing swap agreements or new swap agreements entered into by the City since the last annual examination.
10. Staff will track, at least annually, the market value of each of the City's interest rate swap agreements.
11. For swap transactions entered into to generate debt service savings, the City will calculate on an annual basis the actual debt service requirements versus the projected debt service on the swap transaction at the original time of execution. Such a calculation shall include the determination of the cumulative actual savings versus the projected savings at the time a swap is executed.
12. Staff will determine, at least semiannually, that all posted collateral, if required, has a net market value of at least 102% of the net market value of the agreement to the City (See Provisions for Collateralization).
13. During the first half of the term of the Interest Rate Swap Agreement, 50% of any realized cash flow savings generated from the transaction will be placed in a reserve account to be used to off-set any

potential cash flow losses over the life of the transaction. During the second half of the term of the swap agreement, the appropriate level of the reserve will be determined on an annual basis.

**X. Reporting**

The City will reflect the use of interest rate swap agreements on its financial statements in accordance with generally accepted accounting principles.