CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: PUBLIC SAFETY FINANCE AND STRATEGIC SUPPORT COMMITTEE

FROM: Julia H. Cooper

SUBJECT: **DEBT POLICY AMENDMENT**

DATE: November 5, 2012

Approved Alex Gurza

Date 11-8-12

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

It is recommended that the Public Safety, Finance and Strategic Support Committee accept and approve the proposed revisions to the City of San José's Debt Management Policy and direct staff to return to the City Council with the appropriate resolution and amended policy.

OUTCOME

City Council's approval of the proposed revisions to the City's Debt Management Policy will guide the City's issuance of short-term and variable rate debt consistent with the best practices recommended by the Government Finance Officers Association of the United States and Canada.

BACKGROUND

The City of San José Debt Management Policy ("Policy") was approved by the City Council on May 21, 2002. It requires an annual review of the Policy by Finance Department staff and submittal of any proposed changes to the Public Safety, Finance and Strategic Support Committee ("Committee") for their review and subsequent consideration and approval by the entire City Council. This is the first amendment recommended to the Policy since adoption in 2002. This highlights that the City has been well served by the Policy over the last decade even through the financial market disruption beginning in 2008.

ANALYSIS

In response to the referral from the June 19, 2012 City Council meeting, the Finance Department has reviewed the short-term and variable rate borrowing provisions included in the Policy. Finance Department staff conducted a survey review of the Government Finance Officers Association

("GFOA") and the debt policies of San Francisco, Los Angeles, and San Diego. The recommendations below are based on recent amendments to GFOA best practices and City experience. The City's short-term and variable rate policies are generally consistent with our peer cities.

Short-Term Debt

General Provisions Section III.B of the Policy currently provides guidance on the use of short-term borrowing as follows:

> Short-term borrowing, such as commercial paper and lines of credit, will be considered as an interim source of funding in anticipation of long-term borrowing. Short-term debt may be issued for any purpose for which long-term debt may be issued, including capitalized interest and other financing-related costs. Additionally, short-term borrowing may be considered if available cash is insufficient to meet short-term operating needs.

The Policy currently provides broad flexibility in the use of short-term borrowing in terms of the facilities or operating costs to be financed, the source of revenue for repayment, and the amortization period for repayment. The Finance Department recommends amending the Policy to limit the amortization period of short-term debt to the economic or useful life of the project and, unless the City Council determines that extraordinary circumstances exist, must not exceed seven (7) years. The recommendation further requires that a reliable revenue source must be identified for the repayment of the debt at the time of issuance.

Variable-Rate Debt

Debt Issuance Section III.B of the Policy currently provides guidance on the use of variable rate borrowing as follows:

> 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. Such issuance must be consistent with applicable law and covenants of pre-existing bonds, and in an aggregate amount consistent with the City's creditworthiness objectives.

Finance Department staff recommend amending the Policy to reflect GFOA best practices to consider the following:

- The useful life of the project or facility being financed or the term of the project requiring the funding.
- Market conditions:
    - Renewal risk - if the credit provider decides not to renew the credit support and no replacement is identified, the outstanding obligation will need to be repaid in full.
    - Interest rate risk – interest rates may increase significantly depending on the overall financial market conditions.

  - Downgrade risk – the credit ratings of the credit provider supporting the debt may be downgraded in the future. To the extent a downgrade occurs, the obligation may become unmarketable.
  - Marketability risk – if there is a lack of market demand, the obligation may be tendered and another investor may not be found.
- Overall debt portfolio structure when issuing variable rate debt for any purpose, including but not limited to:
  - Maintaining a reasonable level of variable rate debt as a percentage of the entire portfolio.
  - Business reasons for maintaining variable rate debt.

Guiding Principles

Finance Department staff will continue to provide administrative guidance regarding the appropriateness of issuing short-term and variable rate debt.

Attached is a redline copy of the changes to the Policy for your review and consideration.

EVALUATION AND FOLLOW-UP

The City of San José Debt Management Policy requires an annual review of the Policy by Finance Department staff and submittal of any proposed changes to the Committee for their review and subsequent consideration and approval by the entire City Council. Finance Department staff will continue to evaluate review the Policy on an annual basis and return with any proposed amendments.

PUBLIC OUTREACH/INTEREST

This item will be posted on the City's website for the Committee meeting on November 15, 2012.

☐ **Criterion 1**: Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**

☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

COORDINATION

This memorandum was coordinated with the City Attorney's Office.

CEQA

Not a Project, File No.PP10-068 (b), General Procedure & Policy Making.

Julia H Cooper
JULIA H. COOPER
Acting Director of Finance

For questions, please contact Peter Detlefs, Acting Debt Administrator, at (408) 535-7015.

Attachment

CITY OF SAN JOSE, CALIFORNIA

CITY COUNCIL POLICY

TITLE **DEBT MANAGEMENT POLICY**	PAGE **1 OF 5**	POLICY NUMBER **1-15**
	EFFECTIVE DATE **5/21/02**	REVISED DATE

APPROVED BY COUNCIL ACTION

May 21, 2002, Item 3.3, Resolution No. 70977

POLICY

This Debt Management Policy sets forth certain debt management objectives for the City, and establishes overall parameters for issuing and administering the City's debt. Recognizing that cost-effective access to the capital markets depends on prudent management of the City's debt program, the City Council has adopted this Debt Management Policy by resolution.

DEBT MANAGEMENT OBJECTIVES

The purpose of this Debt Management Policy is to assist the City in pursuit of the following equally-important objectives:

- Minimize debt service and issuance costs;
- Maintain access to cost-effective borrowing;
- Achieve the highest practical credit rating;
- Full and timely repayment of debt;
- Maintain full and complete financial disclosure and reporting;
- Ensure compliance with applicable State and Federal laws.

GENERAL PROVISIONS

I. SCOPE OF APPLICATION

These policies establish the parameters within which debt may be issued by the City of San José, the City of San José Financing Authority, and the City of San José Parking Authority. Additionally, these policies apply to debt issued by the City on behalf of assessment, community facilities, or other special districts, and conduit-type financing by the City for multifamily housing or industrial development projects.

The City Council, as a member of Joint Powers Authorities such as the San José-Santa Clara Clean Water Financing Authority, shall take these policies into account when considering the issuance of Joint Powers Authority debt.

Supplemental policies, tailored to the specifics of certain types of financings, may be adopted by the City Council in the future. These supplemental policies may address, but are not limited to, the City's general obligation, lease revenue, enterprise, multifamily housing, and land-secured financings.

II. RESPONSIBILITY FOR DEBT MANAGEMENT ACTIVITIES

The Finance Department shall be responsible for managing and coordinating all activities related to the issuance and administration of debt. The Director of Finance is appointed by the City Manager and is subject to his or her direction and supervision. In accordance with the City Charter, Article VIII, Section 806, the Director of Finance is charged with responsibility for the conduct of all Finance Department functions.

Departments implementing debt-financed capital programs will work in partnership with the Finance Department to provide information and otherwise facilitate the issuance and administration of debt.

A. Debt Management Policy Review and Approval

This policy shall be adopted by City Council resolution, and reviewed annually by the Finance Department to insure its consistency with respect to the City's debt management objectives. Any modifications to this policy shall be reviewed and approved by the Finance and Infrastructure Committee and forwarded to the City Council for approval by resolution.

B. Annual Debt Report

The Finance Department shall prepare an annual debt report for review and approval by the Finance and Infrastructure Committee and the City Council, containing a summary of the City's credit ratings, outstanding and newly-issued debt, a discussion of current and anticipated debt projects, refunding opportunities, a review of legislative, regulatory, and market issues, and an outline of any new or proposed changes to this Debt Management Policy.

C. Debt Administration Activities

The Finance Department is responsible for the City's debt administration activities, particularly investment of bond proceeds, compliance with bond covenants, continuing disclosure, and arbitrage compliance, which shall be centralized within the Department.

III. PURPOSES FOR WHICH DEBT MAY BE ISSUED

A. Long-term Borrowing

Long-term borrowing may be used to finance the acquisition or improvement of land, facilities, or equipment for which it is appropriate to spread these costs over more than one budget year. Long-term borrowing may also be used to fund capitalized interest, costs of issuance, required reserves, and any other financing-related costs which may be legally capitalized. Long-term borrowing shall not be used to fund City operating costs.

B. Short-term Borrowing

Short-term borrowing, such as commercial paper and lines of credit, will be considered as an interim source of funding in anticipation of long-term borrowing. Short-term debt may be issued for any purpose for which long-term debt may be issued, including capitalized interest and other financing-related costs. Prior to issuance of the short-term debt, a reliable revenue source shall be identified to secure repayment of the debt. The final maturity of the debt issued to finance the project shall be consistent with the economic or useful life of the project and, unless the City Council determines that extraordinary circumstances exist, must not exceed seven (7) years. Additionally, short-term borrowing may be considered if available cash is insufficient to meet short-term operating needs.

C. Refunding

Periodic reviews of outstanding debt will be undertaken to identify refunding opportunities. Refunding will be considered (within federal tax law constraints) if and when there is a net economic benefit of the refunding. Refundings which are non-economic may be undertaken to achieve City objectives relating to changes in covenants, call provisions, operational flexibility, tax status, issuer, or the debt service profile.

In general, refundings which produce a net present value savings of at least three percent (3%) of the refunded debt will be considered economically viable. Refundings which produce a net present value savings of less than three percent (3%) will be considered on a case-by-case basis. Refundings with negative savings will not be considered unless there is a compelling public policy objective that is accomplished by retiring the debt.

DEBT ISSUANCE

I. DEBT CAPACITY

The City will keep outstanding debt within the limits of the City's Charter and any other applicable law, and at levels consistent with its creditworthiness objectives.

The City shall assess the impact of new debt issuance on the long-term affordability of all outstanding and planned debt issuance. Such analysis recognizes that the City has limited capacity for debt service in its budget, and that each newly issued financing will obligate the City to a series of payments until the bonds are repaid.

II. CREDIT QUALITY

The City seeks to obtain and maintain the highest possible credit ratings for all categories of short- and long-term debt. The City will not issue bonds directly or on behalf of others that do not carry investment grade ratings. However, the City will consider the issuance of non-rated special assessment, community facilities, multifamily housing, and special facility bonds.[1]

III. STRUCTURAL FEATURES

A. Debt Repayment

Debt will be structured for a period consistent with a fair allocation of costs to current and future beneficiaries of the financed capital project. The City shall structure its debt issues so that the maturity of the debt issue is consistent with the economic or useful life of the capital project to be financed.

B. Variable-rate Debt

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. Such issuance must be consistent with applicable law and covenants of pre-existing bonds, and in an aggregate amount consistent with the City's creditworthiness objectives. When making the determination to issue bonds in a variable rate mode, consideration will be given in regards to the useful life of the project or facility being financed or the term of the project requiring the funding, market conditions, and the overall debt portfolio structure when issuing variable rate debt for any purpose.

C. Derivatives

Derivative products[2] may have application to certain City borrowing programs. In certain circumstances these products can reduce borrowing cost and assist in managing interest rate risk. However, these products carry with them certain risks not faced in standard debt instruments. The Director of Finance shall evaluate the use of derivative products on a case-by-case basis to determine whether the potential benefits are sufficient to offset any potential costs.

IV. PROFESSIONAL ASSISTANCE

The City shall utilize the services of independent financial advisors and bond counsel on all debt financings. The Director of Finance shall have the authority to periodically select service providers as necessary to meet legal requirements and minimize net City debt costs. Such services, depending on the type of financing, may include financial advisory, underwriting, trustee, verification agent, escrow agent, arbitrage consulting, and special tax consulting. The City Attorney's Office shall be responsible for selection of bond counsel and, in those circumstances where the City Attorney's Office determines it to be necessary or desirable,

---

[1] In most cases, a bond which cannot achieve an investment-grade rating will not be rated at all, because there is little value from a bond-marketing perspective in a below investment-grade rating.

[2] A derivative product is a financial instrument which "derives" its own value from the value of another instrument, usually an underlying asset such as a stock, bond, or an underlying reference such as an interest rate index.

disclosure counsel. The goal in selecting service providers, whether through a competitive process or sole-source selection, is to achieve an appropriate balance between service and cost.

V. METHOD OF SALE

Except to the extent a competitive process is required by law, the Director of Finance shall be responsible for determining the appropriate manner in which to offer any securities to investors. The City's preferred method of sale is competitive bid. However, other methods such as negotiated sale and private placement may be considered on a case-by-case basis.

DEBT ADMINISTRATION

I. INVESTMENT OF BOND PROCEEDS

Investments of bond proceeds shall be consistent with federal tax requirements, the City's Investment Policy as modified from time to time, and with requirements contained in the governing bond documents.

II. DISCLOSURE PRACTICES AND ARBITRAGE COMPLIANCE

A. Financial Disclosure

The City is committed to full and complete primary and secondary market financial disclosure in accordance with disclosure requirements established by the Securities and Exchange Commission and Municipal Securities Rulemaking Board, as may be amended from time to time. The City is also committed to cooperating fully with rating agencies, institutional and individual investors, other levels of government, and the general public to share clear, timely, and accurate financial information.

B. Arbitrage Compliance

The Department of Finance shall maintain a system of record keeping and reporting to meet the arbitrage compliance requirements of federal tax law.